COMMITTEE ON FINANCE
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Max Baucus, Chairman
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Contact: Carol Guthrie
202-224-4515

Hearing Statement of Senator Max Baucus (D-Mont.)
Regarding Offshore Tax Issues: Reinsurance and Hedge Funds

Benjamin Franklin said: "In this world, nothing can be said to be certain, except death and taxes."

Today, we will examine how some folks are going far afield in this world to make their taxes far less certain.

We will look at how people go offshore to avoid taxation in three settings: Insurance, hedge funds, and personal compensation.

The first setting that we will examine today is insurance.

Insurance companies make a living by doing two things: They set premiums based on their prediction of the likelihood of events against which they insure. That's called "underwriting."

And they also make money by investing the premiums that they collect until they have to pay out claims. If they are good at these two jobs, they make a profit.

Customers buy insurance from insurance companies to guard against the risk of a fire, disaster, or some other calamity. In exchange for paying premiums, the customers shift some of their risk to the insurance companies.

Insurance companies also buy insurance. Property and casualty insurance companies pay premiums to "reinsurance" companies in exchange for shifting some of their risk to the reinsurance company.

Sometimes the reinsurance company is also the parent company of the property and casualty insurance company. In that case, the property and casualty insurance company shifts risk to the parent reinsurance company at something less than an arm's length transaction.

Here's were the tax avoidance comes in. Some parent insurance companies set up their headquarters in low tax jurisdictions, like Bermuda. Subsidiary property and casualty insurance companies shift risk to the Bermuda parent. Because of Bermuda's low tax burden, the Bermuda parent can get a greater after-tax return on their investment activities.

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As a result, the subsidiary property and casualty insurance companies can charge lower premiums for their insurance. They get a competitive advantage over insurance companies doing business in jurisdictions that tax investments.

The second setting that we will examine today involves hedge funds.

Foundations and other nonprofits are some of the largest investors in hedge funds. The law requires nonprofit investors that invest directly in hedge fund partnerships to pay the unrealized business income tax, known as "UBIT." The policy behind the law is that tax-exempt entities should not be able to have an unfair advantage over tax-paying entities doing the same thing.

To avoid UBIT, nonprofit investors sometimes invest in hedge funds through offshore entities incorporated in low or no tax jurisdictions, such as the Cayman Islands or Bermuda. These offshore entities are called "blockers."

The third setting that we will examine today is the compensation of hedge fund managers.

Hedge fund managers receive fees from offshore blocker corporations used by nonprofits and foreign investors. Some hedge fund managers elect to defer their income. Deferring income means that you pay taxes later, which is the same as a significant tax savings.

In each of these three settings, people can argue that there are legitimate business reasons for the offshore transaction. And in each of these three settings, people can legitimately question whether someone is avoiding paying their taxes.

Today, we will see whether Ben Franklin was right about the certainty of taxes in this world. We will see whether there are parts of this world where people get away without paying taxes. And we'll examine whether this is something — unlike death — that we can do something about.

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