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Chairman Neal, Ranking Member Tiberi and members of the Subcommittee, thank you very much for inviting me to appear before you today to discuss important legislation to close a loophole in current law allowing foreign insurance groups to avoid paying U.S. tax on business written in the United States. This ability to avoid tax increases their return on equity and provides them a significant advantage over domestic competitors in raising capital. This unfair tax advantage began to be exploited around 20 years ago. It has already caused a significant migration of insurance capital abroad. If left unchecked, much more of the U.S. insurance capital base will eventually migrate abroad.

One of my foreign competitors recently put it more boldly, chastising U.S. companies for not relocating to tax havens: "If you're not in one of these [offshore] domiciles, shame on you. All things being equal, the tax advantage will win over time."[1]

This is clearly one of the most important issues faced by my company since I founded it over 40 years ago. I am the Chairman and Chief Executive Officer of W. R. Berkley Corporation, the Country's 9th largest commercial lines insurer with revenues close to $5 billion. We operate in five major business segments: regional property casualty; specialty lines; reinsurance; alternative markets; and international. Our companies are located in 27 states and write business in all 50 states and the District of Columbia.

[1] John Berger, President and CEO at Harbor Point (now Alterra Capital), quoted in The Insurance Insider (February 24, 2010).

The views I am expressing today are shared by a coalition of twelve other major domestic commercial lines and financial guarantee insurers with 150,000 employees located across the United States, including: AMBAC Financial Group, Inc.; American Financial Group, Inc.; Berkshire Hathaway Inc.; The Chubb Corporation; EMC Insurance Companies; The Hartford Financial Services Group, Inc.; Liberty Mutual; Markel Corporation; MBIA Insurance Corporation; Scottsdale Insurance Company, a Nationwide subsidiary; The Travelers Companies, Inc.; and Zenith Insurance Company.

Introduction and Summary: The unfair tax advantage for foreign-owned insurance groups

Current law allows foreign-domiciled insurers with U.S. affiliates to use related-party reinsurance transactions to strip their profits from both underwriting and investment activities out of the U.S. tax base (where the income was generated) to a more favorable tax jurisdiction. This transaction can be done instantly and generally requires only a book-keeping entry.[2] By contrast, U.S.-based insurers must pay current U.S. tax on all of their income from these policies. Thus, even though the U.S. income-generating activities are the same, these foreign-domiciled insurers can avoid tax on much if not all of their underwriting and investment income and generate significantly greater after-tax returns than comparable U.S. competitors.

Chairman Neal, I want to thank you for your leadership in addressing this loophole and would like to make three important points with respect to the proposed legislation.

- First, use of related party reinsurance provides a significant competitive tax advantage for foreign-based insurers in raising capital. H.R. 3424 is an appropriate, effective remedy to close this loophole and level the competitive playing field.

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[2] In such cases, the foreign-domiciled insurance group is required to pay only an one-percent excise tax on the reinsurance premiums paid from the U.S. member to its offshore affiliate. The one-percent excise tax is often waived by treaty, including in our treaties with England, Ireland, Germany and Switzerland. Once those resources are located in the low-tax or no-tax country, any income earned is taxed only at the local rate. In the case of Bermuda, there is no corporate income tax on that income.

- Second, contrary to the opponents' claims, the bill will have little or no impact on the availability or cost of catastrophic coverage in coastal areas or other U.S. markets, because the bill does not impact third party reinsurance which provides needed capacity for catastrophic coverage.

- Third, fixing the loophole is not protectionist and does not violate tax treaties or trade agreements, as the opponents have argued. The bill does not favor domestic companies over foreign competitors, but rather ensures that U.S. insurers and their foreign-based competitors are taxed similarly in writing U.S. business.

Foreign Insurers' Competitive Advantage in Raising Capital

The loophole under current law allows foreign-controlled insurance groups to avoid U.S. income tax on their U.S. written business that is ceded to an affiliate overseas. The only tax imposed (which is often waived by treaty) is a one-percent excise tax on the reinsurance premiums paid from the U.S. member to its offshore affiliate. By contrast, a U.S.-controlled insurer must pay income tax on its underwriting and investment income.

This difference in treatment gives foreign-based insurers a competitive advantage in raising capital from investors over domestic-based insurers because it provides higher after-tax returns on equity (ROE) for foreign-based groups. For example, over the past several years, Bermuda-based companies have enjoyed a significantly higher average ROE and generally lower effective tax rates than U.S.-based companies.

Opponents have argued that the reinsurance excise tax is sufficient to eliminate any competitive income tax advantage. In testimony before the Senate Finance Committee and in the press, Donald Kramer, the CEO of Ariel Reinsurance Company, has argued that there is no significant tax advantage for foreign-based companies because they are subject to the 1% reinsurance excise tax and get no tax benefit for their losses.[3] However, Mr. Kramer himself previously explained his reasons for

[3] Testimony before the Senate Finance Committee (September 26, 2007).

establishing a reinsurance company in Bermuda to serve the U.S. market:

> I couldn't set up in the U.S. It's not as economically efficient. In good years you get taxed to death, and when you have losses the only benefit is to carry them forward. You have to wait too many years to recover your investment.[4]

Obviously, he didn't believe the potential imposition of the reinsurance excise tax and the inability to take losses outweighed the tax advantage of being in Bermuda.

Dowling and Partners, a leading expert on the insurance industry, has concluded that, absent legislative help from Washington, "The percentage of U.S. (re)insurance premium written by entities enjoying an offshore tax advantage will continue to grow. It's simple economics that the movement offshore will continue."[5]

The economics are indeed "simple." An excise tax of 1% on $100 of premium is equivalent to a 35% income tax on only $2.85 of profit. Therefore, if a foreign-owned insurer believes it will earn more than merely $2.85 of profit from underwriting and investment, it will elect to bear the excise tax and reinsure with an affiliate in a tax haven overseas.

As a further illustration, assume that a foreign-controlled U.S. insurer reinsures $100 of premium with an affiliate in a no-tax jurisdiction. After upfront expenses of $20, the affiliate earns 6% per year on its investment of the remaining $80. Assume further that the remaining $80 is paid out ratably in claims over five years (i.e., a five-year "tail"). The foreign affiliate would earn nearly $17 of investment income over the five years. Compared to a U.S. taxpayer, the U.S. tax savings would be $5 (approximately $6 of avoided U.S. income tax less the $1 excise tax). And this example assumed no underwriting profit and did not take into account the discounting of loss reserves applicable to U.S. taxpayers![6] The benefit is even larger for longer-tailed lines of business.

[4] "It's not just the climate," Forbes, p. 42 (November 7, 1994).

[5] Dowling & Partners, IBNR Weekly #15, Vol. XIV, p. 5 (April 13, 2007).

[6] U.S. insurance companies are required to discount their loss reserves effectively prepaying tax on their investment income in the first year. By shifting their reserves overseas through the device of affiliate

Moreover, the excise tax is often waived by treaty. In fact, several companies have recently re-domesticated to Switzerland or another treaty jurisdiction to avoid imposition of the excise tax. These foreign groups can now avoid the excise tax on their related party reinsurance pursuant to the treaty.

The bill will not adversely affect capacity or pricing in coastal states or other U.S. markets.

Predictably, offshore insurers are arguing vigorously to maintain their unfair advantage. They have resorted to scare tactics, attempting to confuse the real issues by claiming the legislation will adversely affect pricing and capacity for catastrophe reinsurance in the coastal states and the rest of the U.S. insurance market. But the facts are undeniable and the opponent's claims are simply false. The bill will have little or no impact on the availability or cost of catastrophic coverage in coastal areas or elsewhere.

First, foreign insurers actually supply only a very small amount of the total direct catastrophic coverage in the coastal states and other states. For example, a recent examination by the LECG group of the Neal Bill on Homeowners Multiple Peril in Florida (the line of business most relevant to consumers) found "no potential impact of the proposed legislation on reinsurance capacity or insurance rates." [7] According to the findings in the LECG report:

> [T]he principal writers of Florida Homeowners Multiple Peril in aggregate cede only .3% of their direct business premium to offshore affiliates, although they cede net reinsurance of 12.2% of direct premiums to unaffiliated insurers, both domestic and offshore…Thus, while it is true that unaffiliated reinsurance is a significant element in the Homeowners Multiple Peril market, offshore affiliate

reinsurance (or similarly through a loss portfolio transfer), foreign companies largely avoid this requirement.

[7] "The Neal Bill and the Florida Homeowners Multiple Peril Market," LECG, LLC (July 13, 2010).

> reinsurance [the target of the Neal bill] appears to have no impact on the Florida market.[8]

Thus, given their minimal share of the market, it is difficult to understand how the legislation could adversely affect pricing or capacity for catastrophe coverage in Florida or other coastal states.

Second, the proposed legislation targets only reinsurance between affiliates. It merely prevents excessive use of affiliate transactions to shift underwriting and investment profits to tax havens overseas. These transactions add no additional capacity to the market – the risk remains in the same corporate group. Third party reinsurance, which adds needed capacity for catastrophic coverage, remains unaffected by the legislation. Thus, statistics cited by the opposition regarding the amount of claims paid by third party foreign reinsurers after Katrina, while laudable, are irrelevant to the issue at hand.

Third, excessive affiliate reinsurance – the loophole targeted by the legislation – is typically used to shift reserves and the attendant investment income overseas to avoid U.S. tax. There is little benefit from this technique with respect to catastrophe-exposed property coverage because claims are paid out quickly before much investment income can accrue. Use of this ploy is far more advantageous and hence more prevalent in other lines of business, where claims are paid out more slowly. The legislation will thus have far greater impact on these non-catastrophic, "long-tailed" lines of business.

Finally, the U.S. is far and away the largest market for catastrophic insurance in the world. It's disingenuous for foreign insurers to imply they will abandon this market if reasonable limits are imposed restricting their tax advantage. Somehow, we and other U.S.-based competitors have managed to remain profitable while paying U.S. taxes on our U.S. business. The proposed legislation does not prevent them from using affiliate reinsurance (which is the premise of the Brattle Group's findings). It merely levels the playing field and ensures they can't avoid paying U.S. income tax on their U.S. business. At a time of

[8] See id.

record federal deficits, this will capture billions in tax revenue from foreign-based groups currently operating and profiting in the U.S.

<u>The proposed legislation levels the playing field and is consistent with tax treaty and trade obligations</u>

The legislation is consistent with our tax treaty obligations because it does not "materially disadvantage" foreign groups relative to domestic insurers in writing coverage of U.S.-based risks and it directly relates to a "tax relevant difference" between foreign and U.S.-based insurance groups.

Foreign groups affected by the proposal may elect to be treated similar to U.S. taxpayers with respect to such income. According to David Rosenbloom, former International Tax Counsel at Treasury and director of NYU law school's international tax program, "that should be sufficient by itself to ensure that the Neal bill is nondiscriminatory."[9] Mr. Rosenbloom also notes that differing treatment of persons in differing circumstances is acceptable:

> In the words of the Treasury Technical Explanation of the U.S. Model Income Tax Convention, if a difference in treatment ''is directly related to a tax relevant difference in the situations of the domestic and foreign persons being compared, that difference is not to be treated as discriminatory.'' One difference between a foreign company not engaged in business in the United States and a U.S. company is that the former is not subject to U.S. income tax. That seems like a pretty big difference in circumstances. This is the main reason why the Staff of the Joint Committee on Taxation has concluded that the Neal bill is not discriminatory. The Staff has correctly observed that ''payments leaving U.S. taxing jurisdiction may, in appropriate circumstances, consistent with U.S. tax treaties, be subjected by the United States to tax that would not be imposed on a payment to a U.S. person.[10]

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[9] H. David Rosenbloom, "Practitioner Responds to Criticism of the Neal Bill," Tax Notes pp.703-4 (May 10, 2010), attached hereto as Appendix 2.
[10] See id.

For similar reasons, the bill does not violate U.S. trade obligations under the General Agreement on Trade in Services (GATS), as the opponents have argued. Trade experts Stu Eizenstat, John Veroneau, and Jay Smith have concluded that H.R. 3424 "seeks to close a tax loophole, based on objective criteria, in a manner anticipated by Uruguay Round negotiators and fully consistent with GATS."[11]

In reaching their conclusion, they found that: (i) H.R. 3424 does not violate the U.S. commitment to provide national treatment to foreign reinsurers because the bill "does not draw distinctions based on national origin, levels the playing field between similarly situated reinsurers, and is based on objective criteria regarding the deductibility of payments that erode the U.S. tax base," and (ii) the bill "clearly falls within the scope of GATS Article XIV (d) as a measure aimed at ensuring the equitable or effective imposition or collection of direct taxes."[12]

Conclusion

In closing, we believe that legislation addressing this problem is important to a continued robust domestic insurance industry. To level the playing field and to preserve the U.S. capital and associated tax base, H.R. 3424 or similar legislation needs to be enacted quickly to prevent foreign-based insurers from continuing to strip their income derived from U.S. business outside the U.S. Only legislation can correct the unfair competitive advantage available to foreign-based groups.

The reinsurance industry has already been lost overseas to tax havens as a result of the tax advantage. We should not sit idly by and let the same migration occur with our primary domestic insurance industry. The P&C industry plays a key role in the financial infrastructure that we all have been so focused on over the past eighteen months. It is a critical part of the financial framework that allows American business to

[11] Memorandum from Covington & Burling, LLP (July 8, 2010), attached hereto as Appendix 3. Ambassador Eizenstat was Under Secretary of Commerce for International Trade, Under Secretary of State for Economic, Business and Agricultural Affairs, and Deputy Secretary of the Treasury. Ambassador Veroneau was Deputy U.S. Trade Representative and General Counsel of USTR. Jay Smith was previously a professor of International Affairs at George Washington University.

[12] See id.

prosper. It is important that we continue to have a vibrant domestic insurance industry.

I want to thank Chairman Neal, Ranking Member Tiberi and the other Members of the Subcommittee for inviting me to express my views today. I am happy to answer any questions that you may have.