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**Before the Subcommittee on Select Revenue Measures**
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Chairman Neal, Ranking Member Tiberi and members of the Subcommittee, I am very pleased to appear before you today to discuss our strong support for H.R. 3424 (introduced by Chairman Neal) to close the affiliate reinsurance loophole. I believe this legislation will recapture billions in lost tax revenue and is essential to a vibrant domestic insurance industry.

I am the Vice-Chairman and Chief Administrative Officer of The Chubb Corporation, a U.S. property-casualty insurance company that has provided business and personal insurance for over 120 years. We are the 11th largest property and casualty insurer in the United States and have a worldwide network of some 120 offices in 27 countries staffed by 10,400 employees.

I am testifying today on behalf of a coalition of many of the largest domestic commercial lines and financial guarantee insurers. Collectively, we have over 150,000 employees, and approximately $1 trillion in assets with offices and employees located throughout the United States.

## Overview of the Issue

Mr. Chairman, I want to focus on just a relatively few points today:

- The unintended affiliate reinsurance loophole that your bill seeks to close costs the Treasury and U.S. taxpayers billions in revenues;

- Allowing foreign-owned insurance companies to enjoy a de-facto tax holiday on much of their U.S. business places U.S.-owned companies at a severe disadvantage in raising capital;

- These basic tax inequities are eroding the insurance industry base in the United States;

- The Congress, the Bush Administration, and the Obama Administration all have previously expressed the need to close the loophole to restore competitive balance;

- The loophole inhibits funding for state and local infrastructure needs because it shrinks the market for tax-exempt financing. Quite simply, foreign-owned insurers that pay no U.S. taxes do not buy tax-exempt municipal bonds;

- There is no basis in fact to support the claims that the current tax situation must be maintained to encourage risk spreading, or increase capacity. There is also no evidence to support that the notion that the savings these foreign insurers derive by not having to pay U.S. taxes is passed along to the consumer in the form of lower premium costs;

- This tax advantage clearly was never intended – it is untenable for foreign-based companies to be favored over U.S. companies in serving the domestic market;

- H.R. 3424 is a much-needed and balanced solution to staunch the flow of capital and our tax base overseas, and restore competitive equity to our tax code.

**<u>The Affiliate Reinsurance Loophole</u>**

We are concerned about a loophole in our current tax system that allows foreign-owned property and casualty insurance companies operating in the U.S. to avoid billions of dollars in U.S. tax annually.

This loophole enables them to strip much of their underwriting and investment income from writing U.S. business overseas into tax havens, merely by reinsuring that business with a foreign affiliate. This provides foreign groups a significant and unfair tax advantage over domestic groups in attracting capital for writing P&C insurance to cover U.S.-based risks.

In the late 1990s, this loophole was described as the foreign-controlled insurance companies' "own Bermuda Triangle… Instead of ships and planes vanishing without a trace, these companies have figured out how to make their federal tax burden disappear."[1]

In the decade since, it has caused a significant migration of insurance capital abroad, resulting in erosion of U.S. tax revenues. First, several U.S. insurance groups "inverted" into tax havens, moving their capital and tax base offshore, including Arch Capital Group, White Mountains Group, Everest Re Group, and others. In addition, several new holding companies have been formed (and several U.K.-based companies have redomesticated) in tax havens. In either case, these foreign-based companies have sought, and will continue to seek, to use this competitive advantage to attract capital and to acquire U.S. companies or U.S. lines of business. Since Katrina, Bermuda companies and other offshore enterprises have received the vast majority of new capital raised in the industry.

As a result of this continued migration, premiums ceded to related-party foreign reinsurers have more than doubled over the last seven years. In 2008 alone, as shown in Table 2 of the Joint Tax Committee pamphlet prepared for this hearing, over $33 billion of U.S. P&C insurance premiums moved offshore to related foreign affiliates, stripping billions in associated tax revenues. The bulk of this offshore activity is centered in low-tax or no-tax jurisdictions and such activity has more than doubled since 2001.[2] Bermuda, which is a no-tax jurisdiction, accounts for nearly two-thirds of the total related party reinsurance of U.S.-based insurance in 2008. This data indicates that

[1] Editorial, The Baltimore Sun, May 15, 2000.
[2] Two countries, Bermuda and the Cayman Islands, have no corporate tax while Ireland, with a 12.5 percent corporate tax rate, can be considered a low-tax jurisdiction. Switzerland generally has a higher statutory tax rate than Ireland; however, possible special relief may apply that could make the effective tax rate of a company located in Switzerland significantly lower than the statutory rate.

the principal incentive for this increased related-party reinsurance activity has been the avoidance of U.S. income tax.

If effective legislation is not adopted, a leading industry analyst recently predicted that much more of the U.S. insurance capital base will migrate abroad, stating that "redomestication offshore will be a competitive necessity for many U.S. primary 'specialty' insurers."[3]

The Bush Administration, the Obama Administration and the Congress have all previously expressed the need to close this loophole and eliminate this inequitable tax advantage. In oral testimony before the House Ways and Means Committee and a written response to a question in 2002, then Treasury Assistant Secretary Pam Olson stated:

> The Treasury Department is concerned about the use of related party reinsurance to avoid U.S. tax on U.S. source income. In particular, the use of related party insurance may permit the shifting of income from U.S. members of a corporate group to a foreign affiliate. Existing mechanisms for dealing with insurance transactions are not sufficient to address this situation.[4]

More recently, the Obama Administration reached a similar conclusion:

> Reinsurance transactions with affiliates that are not subject to U.S. Federal income tax on insurance income can result in substantial U.S. tax advantages… These tax advantages create incentives for foreign-owned domestic insurance companies to reinsure direct insurance of U.S. risks with foreign affiliates to an extent that would not occur between unrelated parties acting at arm's length. It is inappropriate to allow a deduction for reinsurance

[3] IBNR Weekly #7, Vol. XVII, Dowling & Partners, p. 1 (Feb. 26, 2010).
[4] Hearing of the House Committee on Ways and Means on Corporate Inversions, June 6, 2002, Serial 107-73, pages 9-10 and 26, https://waysandmeans.house.gov/legacy.asp?file=legacy/fullcomm/107cong/6-6-02/107*73final.htm.

premiums paid under such circumstances.[5]

Congress actually tried to fix the problem in 2004 by strengthening the transfer pricing rules in section 845 in 2004, because it was "concerned that foreign related party reinsurance arrangements may be a technique for eroding the U.S. tax base."[6]

Unfortunately, this change failed to stem the tide (as evidenced by the Joint Tax Committee table 2), because the core problem is not effectively addressed by transfer pricing rules. Rather, the unfair advantage caused by the structure of the tax law creates a strong incentive for foreign-controlled insurers to cede more and more profitable business to foreign affiliates than they would ever consider ceding to a related party.

It is difficult for the IRS to use transfer pricing rules to police such transactions, because such rules -- as the name suggests -- are limited to arm's length pricing and do not address behavior.[7] Moreover, establishing a true arm's length price is exceptionally difficult in these circumstances because each transaction is unique and can be dramatically changed not just by price and risk but also by the terms and conditions. Finally, the mere ceding of reserves offshore dramatically lowers tax payments even without a shift in underwriting profits.

If the transfer pricing rules worked, we would expect that the bulk of the profits would remain in the U.S. and the competitive tax advantage would disappear. However, by contrast to U.S. companies, most Bermuda insurers have exceptionally low effective tax rates, demonstrating their success in transferring the bulk of their underwriting and investment income offshore to avoid tax under existing mechanisms. Also, as shown in the table in Appendix 1, the differential between pre-tax return-on-equity (ROE) and after-tax ROE

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[5] See General Explanation of the Administration's Fiscal Year 2011 Revenue Proposals, department of the Treasury (Feb. 2010), p. 45.
[6] See, e.g., H.R. Rept. 108-548, American Jobs Creation Act of 2004, Committee on Ways and Means, 108th Cong., 2d Sess, p. 250.
[7] See Joint Committee on Taxation, *"Present Law and Analysis Relating to Selected International Tax Issues"* (JCX-85-07) at 66, (Sept. 24, 2007).

for the Bermuda Inc. group is a negligible average of 1.4 percentage points. By contrast, the differential between the pre-tax ROE and the after-tax ROE for the U.S. P&C Industry averages 4 percentage points. As a result, U.S. companies have to significantly outperform their foreign competitors on a pre-tax basis merely to deliver the same return to investors.

When Congress became aware of a similar problem with respect to debt, it addressed the problem by curtailing the amount of tax-favored borrowing by U.S. firms from related foreign parties. Congress did not address the problem through the transfer pricing rules, because it recognized that those rules were not capable of dealing with the problem. Chairman Neal's bill reflects this model.

The rapid growth in related party reinsurance not only means a loss of tax revenue in the United States, but also has other adverse consequences as well. For example, there will be significantly less demand for municipal bonds, reducing funding for investment in critical projects, such as schools, transportation, water and sewer projects, and other basic infrastructure. Domestic property and casualty insurers are major investors in tax-exempt bonds, providing financing for vital state and local needs. According to the Built by Bonds coalition, "P&Cs are the single largest corporate investors in municipal bonds, holding 12% of bonds outstanding." This is nearly half of all corporate investment.

Not surprisingly, foreign-controlled groups that take advantage of the affiliate reinsurance loophole are not large investors in state and local bonds. After all, there is little need for tax-exempt interest when a company is able to strip investment income overseas to a low-tax or no-tax jurisdiction and avoid paying U.S. tax. Thus, unless the loophole is closed to prevent investment income from being stripped offshore, the market for tax-exempt bonds is likely to diminish as the use of affiliate reinsurance grows.

## H.R. 3424

We believe that H.R. 3424[8] provides an appropriate and effective remedy to the problems caused by offshore related party reinsurance. To preserve the tax base and begin leveling the playing field, the legislation would deny a deduction to U.S. insurers for excessive reinsurance ceded to foreign or otherwise non-taxable affiliates. Similar to the earnings stripping rules under section 163(j), the bill strikes a proper balance and only denies deductions for "excessive" related party reinsurance transactions that are being used to strip income out of the U.S. tax base and avoid U.S. tax.

The bill is not protectionist because it does not favor domestic companies over foreign competitors. For similar reasons, it does not violate tax treaties and is consistent with our trade obligations.[9] The fix merely would level the playing field in taxing U.S. insurers and their foreign-based competitors similarly in writing U.S. business. We do not believe we should receive special treatment in accessing foreign markets relative to our foreign competitors, nor should our foreign-based competitors be advantaged in the U.S. market relative to us under the tax code.

Finally, opponents have argued that the legislation will adversely affect capacity or pricing in the U.S. market. However, these are just scare tactics meant to obfuscate the real issues. The legislation only affects reinsurance ceded to foreign affiliates. These transactions add no additional capacity to the market because the risk remains within the same overall enterprise. The proposed legislation expressly does not affect third-party reinsurance – arm's length arrangements that shift a portion of an insurer's risks to unrelated parties and add overall capacity to the market by spreading and diversifying risk among different parties.

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[8] The staff of the Senate Finance Committee has released a discussion draft that is very similar to H.R. 3424.

[9] See H. David Rosenbloom, "Practitioner Responds to Criticism of the Neal Bill," Tax Notes pp.703-4 (May 10, 2010); Memorandum from Covington & Burling, LLP (BNA TaxCore July 8, 2010).

Nor will the bill cause U.S. residents' insurance premiums to increase. Bermuda insurance industry trade group executive Brad Kading himself admitted that Bermuda company profits derived from the tax advantage are “going back to shareholders,”[10] not consumers. In a competitive market, if costs rise for only some of the market participants the end-price to the consumer does not change, but rather the affected group will have to rationalize their cost structure to remain competitive. Furthermore, contrary to rhetoric by offshore interests, affiliate reinsurance plays little, if any, role in providing catastrophe coverage in coastal markets and thus the rates for and availability of such insurance will remain unaffected by the legislation. And given that the U.S. market is the largest in the world and highly profitable, it is difficult to imagine that foreign groups will stop providing coverage in the U.S. market if they are required to compete on a level playing field with domestic competitors.

Finally, even if the opponents’ claims were credible, any purported effect on capacity or pricing would arise from closing a tax loophole providing an unfair competitive advantage for foreign-based companies at the expense of their U.S. competitors and other U.S. taxpayers. It is unfathomable that Congress ever intended to favor foreign-based companies over U.S. companies in writing insurance covering U.S. risks.

Chairman Neal, we want to commend you and your staff for your leadership in efforts to close this loophole and eliminate the unfair competitive advantage for foreign-controlled insurers. Passage of this bill will help protect the U.S. tax base and restore competitive balance to the marketplace, stemming the migration of the domestic P&C insurance industry. We are hopeful that legislation to close this loophole will be adopted this year.

Thanks, once again, to all of the members of the Subcommittee for inviting me to express my views regarding this important and complex issue. I would welcome the opportunity to answer any questions that you may have.

[10] “Don’t Blame Bermuda for the Soft Market,” National Underwriter Property & Casualty, p. 8 (November 26, 2007).