A TAX TREATY THAT DOESN'T TAX? THE UNIQUE HISTORY OF THE UNITED STATES-BERMUDA TAX TREATY AND THE SUBSEQUENT PROBLEMS FACING THE UNITED STATES INSURANCE INDUSTRY

Yelena Tsvaygenbaum[*]

ABSTRACT

This casenote addresses the history and potential problems of the 1986 US-Bermuda Tax Treaty, which narrowly focuses on the taxation of insurance premiums. Since Bermuda itself has no income tax, this unequal treaty gives the island state an advantage over the USA. The original reasons for entering into such a treaty have been eliminated, and the lack of tax information and possibility of tax evasion from non-Bermuda residents present problems for the future of US-Bermuda relations. Renegotiation of the treaty may be a prudent idea, in order to remedy these problems and increase taxable incomes. Since Bermuda's flexible environment for reinsurance and insurance is attractive globally, its market is a benefit to the United States, although US reinsurers are bound by higher taxes. However, domestic concern about Bermuda's insurance industry include concerns about tax loopholes in acquisition and corporate inversion, attack by the IRS under §845(b), and overcharging. Various federal bills have been proposed to "level the playing field," appealing for changes in state legislation on reinsurance may be the best idea to increase economic activity domestically.

In 1986, Bermuda and the United States signed the United States-Bermuda Tax Treaty. This treaty is unique because unlike all other tax treaties it does not alleviate double taxation. One of the major goals of tax

---

[*] J.D. Candidate, University of Connecticut School of Law, 2009; B.S., Bentley University, 2006. I am grateful to Professors Ruth Mason and Thomas E. Baker for their invaluable assistance. Thank you also to the staff of the Connecticut Insurance Law Journal for their editorial assistance and to my family for their love and support.

treaties is to alleviate double taxation for companies and individuals that pay taxes in multiple countries. Bermuda, however, does not tax income, thus no double taxation is possible. Furthermore, unlike most treaties, the tax treaty is very narrow in scope - it covers only the taxation of insurance premiums. Why should the United States have a narrow treaty with Bermuda? The first part of the article will try to answer that question by providing an overview of the treaty and reviewing its legislative history. The second part of the article will discuss the insurance industry in Bermuda after treaty ratification, specifically the current problems the U.S. insurance industry faces as a result of the tax environment in Bermuda.

PART I. LEGISLATIVE HISTORY OF UNITED STATES-BERMUDA TAX TREATY

A. OVERVIEW OF THE UNITED STATES-BERMUDA TAX TREATY[1]

Under certain circumstances, the United States-Bermuda Tax Treaty provides for relief from taxation of insurance business profits. The business profits of a Bermudian insurance company will not be taxed in the United States unless a company has a permanent establishment[2] in the

---

[1] Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland (On Behalf of the Government of Bermuda) Relating to the Taxation of Insurance Enterprises and Mutual Assistance in Tax Matters, U.S.-Berm., Jul. 11, 1986, T.I.A.S. No. 11,676 [hereinafter U.S.-Bermuda Tax Treaty]; *Treasury Department Technical Explanation of Bermuda Tax Treaty*, TAX NOTES TODAY, Sept. 29, 1986, *available at* LEXIS, 86 TNT 195-12.

[2] A permanent establishment is defined as:

> [A] regular place of business through which the business of an enterprise of insurance is wholly or partly carried on. The term "permanent establishment" . . . include[s] especially a place of management, a branch, an office, and premises used as a sales outlet. The term "permanent establishment" . . . also include[s] the furnishing of services, including consultancy, management, technical and supervisory services, within a Covered Jurisdiction by an enterprise of insurance through employees or other persons but only if:(a) activities of that nature continue within the Jurisdiction for a period or periods aggregating more than 90 days in a twelve-month period, provided that a permanent establishment shall not exist in any taxable year in which such services are rendered in that Jurisdiction for a period or periods

United States. The tax treaty also provides relief from Bermudian taxation to American insurance companies unless the companies have a permanent establishment in Bermuda.[3] In practice, no relief from taxation is needed because Bermuda does not tax income.

Even if an American insurance company has a permanent establishment in Bermuda, it will not incur an income tax in Bermuda. Thus, the relief from taxation is a concession by the United States, not Bermuda. Furthermore, by agreeing to only tax a permanent establishment of a Bermudian insurance company, the United States provides a greater benefit to Bermuda-based companies than enjoyed by U.S.-based companies. Under the regular U.S. Code, the business profits of a domestic insurance company are taxed when the insurer has a trade or business carried on in the United States and the business profits are effectively connected with the trade or business.[4] In contrast, under the treaty, the business profits of a Bermudian insurance company are taxed by the United States when the insurer has a fixed place of business in the United States and the insurer's income is attributable to that fixed place of business.[5] Thus, a Bermudian insurance company, unlike a U.S.-based company, has to be more than engaged in a trade or business in the United States before the United States can tax its business profits. The difference in taxation between a U.S.-based company and a Bermuda-based company is due to the fact that foreign companies in the United States are taxed only on their source income (income earned in the United States), while domestic companies are taxed on a world-wide basis.

The relief from taxation granted to Bermuda-based companies includes two exceptions. Relief is only granted if more than 50% of a resident company's stock is owned by a U.S. citizen, a U.S. resident, or a Bermuda resident. The purpose of the qualifying provision is to prevent treaty

---

> aggregating less than 30 days in the taxable year; or (b) the services are performed within the Jurisdiction for an associated enterprise.

U.S.-Bermuda Tax Treaty, *supra* note 1, at art. 3. *See also Treasury Department Technical Explanation of Bermuda Tax Treaty*, TAX NOTES TODAY , Sept. 29, 1986, *available at* LEXIS, 86 TNT 195-12.

[3] U.S.-Bermuda Tax Treaty, *supra* note 1, at art. 4; *Treasury Department Technical Explanation of Bermuda Tax Treaty*, TAX NOTES TODAY , Sept. 29, 1986, *available at* LEXIS, 86 TNT 195-12.

[4] S. FOREIGN RELATIONS COMM., TAX CONVENTION WITH THE UNITED KINGDOM (ON BEHALF OF BERMUDA), S. REP. NO. 100-23, at 14-15 (1988).

[5] *Id.* at 15-16.

shopping.[6] However, it is much lower than the qualifying provision under the 1981 United States Model Tax Treaty, which requires 75% of a company's stock to be held by individuals in the country of residence.[7] The second exception which is also meant to prevent treaty shopping provides for no tax relief on resident's income when a resident uses the income in substantial part to make distributions to people who are not U.S. citizens, U.S. residents or Bermuda residents.[8] There is an exception to the exception – if there is substantial and regular trading on a public stock exchange, tax relief is allowed for companies where U.S. citizens, U.S. residents, or Bermuda residents own less than 50% of the stock.[9] Thus, publicly traded companies satisfy the requirements for tax relief. The treaty also contains a waiver of the U.S. excise tax.[10] An excise tax is a tax imposed on insurance premiums paid to foreign insurers.

The treaty also includes a savings clause and a nondiscrimination clause. The savings clause allows the United States to reserve their right to tax their own residents and citizens as if the treaty was not in force.[11] The savings clause is traditionally placed into tax treaties to ensure that the U.S. tax burden for U.S. residents and U.S. citizens is not unintentionally reduced.[12] The nondiscrimination clause provides that neither country may

---

[6] Treaty shopping is a tax avoidance strategy where a company that resides in a country without a treaty with the United States routes income through a jurisdiction with a favorable tax treaty with the United States. Thus, the company receives tax benefits under the tax treaty to which it was not directly entitled. AM. LAW INST., INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION II: PROPOSALS ON UNITED STATES INCOME TAX TREATIES 150-151 (1992).

[7] U.S. Model Income Tax Convention, art. 16, ¶ 210.16, Jun. 16, 1981, 1 TAX TREATIES (CCH). When the United States-Bermuda Tax Treaty was ratified, the 1981 Model Tax Treaty was the most recent model tax treaty. Subsequent model tax treaties have lowered the 75% threshold to 50% making them comparable to the U.S.-Bermuda Tax Treaty. *See* U.S. Model Income Tax Convention, art. 22, ¶ 210.22Sep. 20, 1996, 1 TAX TREATIES (CCH); U.S. Model Income Tax Convention, art. 16, ¶ 209.16, Nov. 15, 2006, 1 TAX TREATIES (CCH).

[8] U.S. Model Income Tax Convention, art. 16, ¶ 211.16, Jun. 16, 1981, 1 TAX TREATIES (CCH).

[9] *Id.*

[10] The treaty is reciprocal. Any benefit provided to Bermuda is also provided to United States. *Id.* at ¶ 211.02. Thus, in theory, there is also a waiver of Bermuda excise taxes on U.S. insurance premiums. However, Bermuda does not have an excise tax.

[11] U.S.-Bermuda Tax Treaty, *supra* note 1, art. 4(1); *Treasury Department Technical Explanation of Bermuda Tax Treaty*, TAX NOTES TODAY, Sept. 29, 1986, *available at* LEXIS, 86 TNT 195-12.

[12] Ernest R. Larkins, *U.S. Income Tax Treaties in Research and Planning: A Primer*, 18 VA. TAX REV. 133, 186-187 (1998).

tax a permanent establishment that is a resident of the other country less favorably than it taxes its own resident insurance entities that carry on the same activities.[13] Therefore a Bermudian permanent establishment cannot be taxed more severely in the United States than a similar U.S. insurance company.

The treaty also provides for mutual assistance on tax matters. The purpose of a mutual assistance provision is to prevent or decrease tax avoidance.[14] Bermuda agrees to aid United States and vice versa in tax information gathering. In the past, Bermuda's bank secrecy laws have proved to be an obstacle to enforcement efforts in cases involving U.S. persons with business dealings in Bermuda. The agreement provides a comprehensive set of exchange of information rules. The mutual assistance provision, however, is narrower in scope than the 1981 United States Model Tax Treaty. For example, under the tax treaty, the exchange-of-information rules are not effective for taxable years prior to 1977 for matters other than tax fraud or tax evasion.[15] "Matters other than tax fraud and evasion" are defined as civil tax matters with the exception of civil fraud.[16] Another limitation under the treaty is that Bermuda can refuse to provide documents that were created after the treaty went into force, if providing such documents causes a breach of confidentiality.[17] Confidential information is defined as information protected by Bermuda statutory and common law.[18] The post-entry-into-force limitation does not apply when a document is created before the treaty went into force, but is still relevant after the treaty was ratified.[19]

Congress ratified the treaty with two reservations. First, the waiver of the insurance excise tax was set to sunset on January 1, 1990.[20] Second, the treaty permits the U.S. government to impose insurance excise taxes

---

13 U.S.-Bermuda Tax Treaty, *supra* note 1, art. 4(7); *See also* S. FOREIGN RELATIONS COMM., TAX CONVENTION WITH THE UNITED KINGDOM (ON BEHALF OF BERMUDA), *supra* note 4, at 20.

14 Larkins, *supra* note 12, at 205.

15 *Testimony of Alan L. Fischl on Bermuda Tax Treaty Before Joint Tax Committee,* TAX NOTES TODAY, Sept. 29, 1986, *available at* LEXIS, 86 TNT 195-7.

16 *Id.*

17 *Id.*

18 *Id.*

19 *Id.*

20 *Metzenbaum Amendment Kills Provisions in Barbados and Bermuda Tax Treaties to Waive Some Excise Taxes on Insurance Premiums*, TAX NOTES TODAY, Oct. 14, 1988, *available at* LEXIS, 88 TNT 209-42.

unless future agreements explicitly override this provision.[21] The purpose of the treaty amendments was to ensure that the waiver of the excise tax was temporary and would not be granted in the future without explicit intent to do so.[22]

B. WHY MAKE THE TREATY?

Tax treaties remove impediments to international investment and to the free flow of capital generally.[23] There are two purposes of a tax treaty: to prevent tax avoidance and evasion and to reduce international double taxation.[24] Neither purpose was the primary reasons behind the United States-Bermuda Tax Treaty.

The Bermuda government sought a tax treaty with the United States because the United States signed a tax treaty with Barbados. Bermuda wanted similar benefits that Barbados received from the United States under the United States-Barbados tax treaty. The United States-Barbados Tax Treaty eliminated U.S. excise tax imposed on insurance premiums paid to Barbadian insurers by including the U.S. excise tax in the "Taxes Covered" section of the tax treaty.[25] The inclusion of the U.S. excise tax in the "Tax Covered" treaty section is not unusual as it is included in the 1981 Model Tax Treaty, (the most recent model tax treaty at the time of the United States-Barbados Tax Treaty ratification) and subsequent model tax treaties.[26]

An insurance excise tax is imposed on premiums which are not subject to net-basis taxation, but are attributable to U.S.-based risks.[27] In other words, United States imposes an excise tax when a company that does not

---

[21] *Id.*

[22] *See infra* Part I.B, for information on excise taxes.

[23] *Testimony of Alan L. Fischl on Bermuda Tax Treaty Before Joint Tax Committee, supra* note 15.

[24] *Id.*

[25] Convention Between Barbados and the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.-Barb., art. 2.1.a, Dec. 31, 1984, T.I.A.S. No. 11,090.

[26] *See* U.S. Model Income Tax Convention, art. 2, ¶ 211.02, Jun. 16, 1981, 1 TAX TREATIES (CCH); U.S. Model Income Tax Convention, art. 2, ¶ 210.02, Sep. 20, 1996, 1 TAX TREATIES (CCH) ; U.S. Model Income Tax Convention, art. 2, ¶ 209.02, Nov. 15, 2006, 1 TAX TREATIES (CCH).

[27] U.S. DEP'T. OF TREASURY, REPORT TO CONGRESS ON THE EFFECT OF U.S. REINSURANCE CORPORATIONS OF THE WAVIER BY TREATY OF THE EXCISE TAX ON CERTAIN REINSURANCE PREMIUMS 7 (1990) [hereinafter Treasury Excise Tax Study].

have a trade or business in the U.S. either insures or reinsures risks located in the United States.[28] The purpose of the excise tax is to ensure that all premiums tied to risks located in the United States are taxed (in this way, while foreign insurers that insure U.S.-based risks have a U.S. trade or business are taxed on a net basis, foreign insurers that insure U.S.-based risks and *do not* have a U.S. trade or business are taxed via the excise tax).[29]

Although, a waiver of the insurance excise tax has been included in treaties with countries such as the United Kingdom, France, and Italy,[30] Barbados was the first country to receive the waiver that did not itself have an excise tax on insurance premiums. Thus, the waiver of tax was not needed to alleviate double taxation in Barbados. The Treasury Department acknowledged that the waiver of the excise tax was an unintended effect of the Barbados treaty.[31] Bermuda, a competitor of Barbados in the insurance industry, asked the United States to confer a similar benefit on it. Alan Fischl, a Legislation Attorney, testified before the Joint Committee on Taxation during a hearing on the proposed United States-Bermuda Tax Treaty, that because Barbados and Bermuda were competing centers for insuring non-domestic risks, fairness would indicate that insurance-related treaty benefits granted to one country should be extended to the other.[32]

The United States also believed that having a tax treaty with Bermuda would be beneficial for the United States-Bermuda diplomatic relations. During the Senate Foreign Relations Committee Bermuda Tax Treaty Hearing, Navy representatives spoke in a closed session on the security benefit of the treaty.[33] Non-confidential security reasons for ratifying the United States-Bermuda Tax Treaty were discussed by James Medas, the Deputy Assistant Secretary for the European and Canadian Affairs in the Department of State. He testified that there were strong security reasons

---

[28] This is most apparent in reinsurance contracts, where a foreign reinsurer contracts to indemnify a portion of the insurer's claims based in the U.S. For reinsurance premiums, the rate of the excise tax is 1%. I.R.C. § 4371 (2002).

[29] Treasury Excise Tax Study, *supra* note 27, at 7.

[30] *Testimony of Mindy Pollack on Bermuda Tax Treaty Before Senate Foreign Relations Committee*, TAX NOTES TODAY, Sept. 29, 1986, *available at* LEXIS, 86 TNT 195-11.

[31] *Testimony of Alan L. Fischl on Bermuda Tax Treaty Before Joint Tax Committee, supra* note 15.

[32] *Id.*

[33] *Senate Foreign Relations Committee Agenda for Bermuda Tax Treaty Hearing*, TAX NOTES TODAY, Sept. 29, 1986, *available at* LEXIS, 86 TNT 195-8.

for the United States-Bermuda Tax Treaty. [34] The military bases which occupy about 10% of the entire island provide an "an excellent vantage point to observe extremely vital areas of the Atlantic and in conjunction with bases in Iceland and the Azores make an indispensable contribution to our security."[35] J. Roger Mentz, the Assistant Secretary of the Tax Policy Department of the Treasury, agreed with the Department of State, stating that the important national security interest was a *primary* motivating factor leading to the negotiation of the United States-Bermuda Tax Treaty.[36] He added that the uniqueness of the treaty is directly attributable to concerns over national security.[37] Furthermore, Mentz stated before the Senate Foreign Relations Committee that the treaty would be a major step towards establishing a network for exchange of tax information between the United States and the Caribbean.[38]

Due to these reasons, in 1986 the Senate ratified the tax treaty. The "indispensable contribution" Bermuda made to U.S. security in the mid-1980s may be doubtful, however. Less than a decade after the Senate Foreign Relations Committee heard testimony from Medas and Mentz, a government report described the U.S. military bases in Bermuda as rest and relaxation oases for senior naval officials and their families.[39] In 1995, President Clinton announced that the U.S. bases in Bermuda would close.[40] He cited the end of the Cold War, budget deficits, and *the bases' reputation of being a vacation location for naval officers* as reasons for closing the bases in Bermuda.[41] Thus, the claim that Bermuda represented a strong security interest in the mid-1980s is probably overstated.

Even before the announcement that the U.S. naval bases in Bermuda would close, the tax treaty was not without controversy. There were three

---

[34] *Testimony of James Medas on Bermuda Tax Treaty Before Senate Foreign Relations Committee*, TAX NOTES TODAY, Sept. 29, 1986, *available at* LEXIS, 86 TNT 195-9.

[35] *Id*.

[36] *Mentz's September 25, 1986 Statement to the Senate Foreign Relations Committee Concerning Bermuda Tax Treaty*, TAX NOTES TODAY, Sept. 29, 1986, *available at* LEXIS, 86 TNT 195-10.

[37] *Id.*

[38] *Id.*

[39] Frank J. Parker, *Closing Bermuda's U.S. Naval Bases*, 22 REAL EST. ISSUES 28, 30 (Aug. 1997).

[40] *Id.* at 29.

[41] *Id.* at 30 (emphasis added).

main criticisms of the treaty[42] - (1) there was no need to enter into a treaty because there was no double taxation;[43] (2) the exchange of information clause was not as comprehensive as that in other treaties;[44] and (3) the Treasury Department should study whether the U.S. reinsurance companies are at a competitive disadvantage to foreign companies due to the waiver of excise taxes on insurance premiums before the United States ratifies the United States-Bermuda Tax Treaty.

The last criticism was especially a concern for the Reinsurance Association of America (RAA). The Assistant General Counsel of RAA, Mindy Pollack, commented on the impact the Bermuda treaty would have on the domestic reinsurance market.[45] During her testimony before the Senate Foreign Relations Committee, Pollack urged Congress to wait until the Treasury Department studied the impact of excise tax waivers on the domestic reinsurance market before ratifying the treaty.[46] Subsequently, Congress passed a tax bill that required the Treasury Department to study the competitive effect of U.S. treaties on the U.S. reinsurance corporations' in comparison to foreign reinsurance corporations when the treaties include a waiver of the excise tax on insurance premiums [hereinafter the Treasury Excise Tax Study].[47] The Treasury planned to renegotiate the Bermuda treaty if the Treasury Excise Tax Study indicated that waivers of insurance excise taxes cause a disadvantage to U.S. companies.[48]

Senator Dodd of Connecticut argued that instead of granting a benefit to other countries, the inadvertent mistake provided in the tax treaty with Barbados – the waiver of the insurance excise tax - should be deleted from

---

[42] *Rostenkowski Letter to Treasury Secretary Baker Regarding United States-Bermuda Tax Treaty,* TAX NOTES TODAY, July 22, 1986, *available at* LEXIS, 86 TNT 144-5.

[43] In fact, the U.S. had never negotiated a treaty with a country that did not have income taxes. *Testimony of Alan L. Fischl on Bermuda Tax Treaty Before Joint Tax Committee, supra* note 15.

[44] Bermuda can refuse to provide documents that were created after the treaty went into force if providing such documents causes a breach of confidentiality. For discussion on the Exchange of Information Clause, see *supra* Part I.A. at 5-6.

[45] *Testimony of Mindy Pollack on Bermuda Tax Treaty Before Senate Foreign Relations Committee*, *supra* note 30.

[46] *Id*.

[47] Tax Reform Act 1986, Pub. L. No. 99-514, § 1244, 100 Stat. 2085, 2581 (1986). For the Excise Tax Study, see *infra* text accompanying notes 57-61.

[48] *Comments of Treasury Secretary Mentz on U.S.-Bermuda Tax Treaty*, TAX NOTES TODAY, Oct. 6, 1986, *available at* LEXIS, 86 TNT 200-3.

the United States-Barbados Tax Treaty.[49] Renegotiating the treaty would remove the competitive disadvantage currently facing the Bermudian insurance industry.[50] The Treasury Department believed that renegotiating the treaty with Barbados less than a year after the ratification of the United States-Barbados Tax Treaty would impair American credibility as a treaty partner.[51] The Barbados Ambassador to the United States, Peter Laurie, urged Congress to await the results of the Treasury Excise Tax Study to see whether a waiver of the excise tax on the insurance premiums places the United States at a disadvantage.[52] The Barbados ambassador believed that agreements such as the United States-Barbados Tax Treaty provide successful examples of cooperation between the United States and countries in the Caribbean.[53] He feared that renegotiating the tax treaty only a few months after it was ratified would be viewed as a lack of cooperation between the parties upsetting the relationship between the United States and countries in the Caribbean.[54] On the other hand, Senator Dodd believed that placing Barbados and Bermuda on equal competitive positions by extending the excise tax waiver to Bermuda would only compound the problem because a waiver would only reduce U.S. tax revenue.[55] Congress agreed with the Senator. While ratifying the United States-Bermuda Tax Treaty in 1988, Congress passed legislation that sunset the waiver of the excise tax with respect to premiums paid or credited on or after January 1, 1990 in both Barbados and Bermuda.[56]

The Treasury released the Treasury Excise Tax Study on the impact of the waiver of excise taxes on the domestic insurance market in March 1990, after the excise tax on insurance premiums was reinstated in Bermuda and Barbados.[57] The Treasury Excise Tax Study revealed that the

---

[49] *Sens. Byrd, Dodd, & Pell Urge Treasury to Renegotiate Barbados Treaty Rather than Altering Bermuda Treaty*, TAX NOTES TODAY, Oct. 22, 1986, *available at* LEXIS, 86 TNT 211-6.

[50] *Id*.

[51] *Comments of Treasury Secretary Mentz on U.S.-Bermuda Tax Treaty*, *supra* note 48.

[52] *Barbados Tells Senators that Renegotiating the U.S.-Barbados Tax Treaty Could Upset the U.S.-Caribbean Policy*, TAX NOTES TODAY, Nov. 13, 1986, *available at* LEXIS, 86 TNT 226-3.

[53] *Id.*

[54] *Id.*

[55] *Sens. Byrd, Dodd, & Pell Urge Treasury to Renegotiate Barbados Treaty Rather than Altering Bermuda Treaty*, *supra* note 49.

[56] *Metzenbaum Amendment Kills Provisions in Barbados and Bermuda Tax Treaties to Waive Some Excise Taxes on Insurance Premiums*, *supra* note 20.

[57] Treasury Excise Tax Study, *supra* note 27, at 1.

United States is at a slight disadvantage when it offers a waiver of insurance excise taxes to foreign jurisdictions which charge low or no tax on insurance premiums.[58] The Treasury Excise Tax Study also pointed out that depending on the reinsurance market, the cost of the excise tax is passed down to U.S. consumers that pay the premiums.[59] Thus, a waiver of the excise tax, although it might disadvantage domestic reinsurers, may actually provide a savings to U.S. consumers.[60] The Treasury Excise Tax Study cautioned, however, that it did not factor in the various regulatory requirements and non-tax aspects affecting firms in foreign countries.[61]

C. WHAT TO DO WITH THE TREATY?

The primary reasons motivating the United States and Bermuda to enter into a tax treaty no longer hold. Bermuda wanted the waiver of the excise taxes on insurance premiums. The waiver sunset two years after the treaty ratification. The United States entered into the treaty due to a concern over security interests in Bermuda. After the end of the Cold War and the closing of the naval bases in Bermuda, the strong security reasons no longer exist. The only pertinent aspect of the treaty is the mutual assistance provision. However as discussed in Part I.A, the provision is limited because it allows Bermuda to refuse to provide documents that were created after the treaty went into force, if providing such documents causes a breach of confidentiality.

As Bermuda has a favorable tax environment, third parties may try to engage in tax evasion or tax avoidance in their resident country by transferring income to Bermuda. The United States may try to renegotiate the treaty to receive better tax information. Renegotiation, however, will not change the fact that Bermuda does not tax income. The United States could terminate the treaty completely, sending the policy message that the United States will not make treaties with countries that do not tax.[62]

Another possibility is to renegotiate the treaty so that Bermudian companies that are managed and controlled in the United States will be taxed (under the treaty only Bermudian companies that have a permanent

---

[58] *Id.* at 3.

[59] *Id.* at 2.

[60] *Id.*

[61] *Id.*

[62] STAFF OF JOINT COMM. ON TAXATION, 110TH CONG., PRESENT LAW AND ANALYSIS RELATING TO SELECTED INTERNATIONAL TAX ISSUES 65 (Comm. Print 2007), http://www.house.gov/jct/x-85-07.pdf.

establishment in the United States are taxed).[63] The "managed and controlled" test would greatly impact the taxation of captive insurance companies, which are domiciled in Bermuda due to Bermuda's historic expertise and regulatory system, but are managed domestically.[64] However, it is politically infeasible to implement the "managed and controlled" test because the Internal Revenue Code uses the place of incorporation test to define residence. Thus, implementing the "managed and controlled" test would require a change in legislation. Furthermore, it would go against U.S. policy and past precedent.[65]

Even if the United States-Bermuda Tax Treaty is terminated or renegotiated, companies could still circumvent tax laws. Tax planners could aid companies to set up insurance entities in such a way that the companies do not have a permanent establishment or carry on trade or business in the United States, thus avoiding net income taxation.[66]

According to the Joint Committee on Taxation, terminating the treaty would have little practical effect on the industry because reinsurance companies can organize in such a manner that they do not engage in a trade or business in the United States.[67] Thus, the United States should try to renegotiate the treaty. United States should seek a stronger mutual assistance provision and a change of how business profits of Bermudian entities are taxed in the United States. A stronger mutual assistance provision that allows the United States access to confidential information from Bermuda would aid United States to track down and prosecute those companies and individuals that avoid or evade taxes.

The treaty could also allow the United States to tax income of Bermudian insurance entities that have a trade or business in the United States. U.S. taxation of foreign entities whose resident country does not

---

[63] STAFF OF JOINT COMM. ON TAXATION, 109TH CONG., OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES 180 (Comm. Print 2005), http://www.house.gov/jct/s-2-05.pdf; John Kelly, Note, *Haven or Hell: Securities Exchange Listing Standards and Other Proposed Reforms as a Disincentive for Corporate Inversion Transactions*, 14 MINN. J. GLOBAL TRADE 199, 201 (2004).

[64] A captive insurance company is a closely held insurance company that is controlled by its insureds. TOWERS PERRIN, TILLINGHAST, CAPTIVE INSURANCE COMPANY GLOSSARY 3, (2004) http://www.towersperrin.com/tp/getwebcachedoc?webc=TILL/USA/2004/200409/Captive_Insurance_Company_Glossary.pdf.

[65] Reuven S. Avi-Yonah, *For Haven's Sake: Reflections on Inversion Transactions*, 27 TAX NOTES INT'L 225, 229 (2002).

[66] STAFF OF JOINT COMM. ON TAXATION, *supra* note 62, at 13.

[67] *Id.*

have a tax treaty with the United States is based on a U.S. trade or business threshold. This threshold provides a greater tax base than provided under the current tax treaty. Under the United States-Bermuda Tax Treaty, the United States can only tax profits attributable to permanent establishments of Bermudian insurance companies. A permanent establishment requires a company to have a fixed place of business in the United States, which is a higher threshold than requiring a company to have a trade or business in the United States.[68] Although there is a concern that tax planners could even circumvent the "trade or business" requirement due to the nature of the insurance industry,[69] it would still capture more taxable income than under the current permanent establishment standard. Another way the United States could increase taxable income would be to tax profits earned from insuring U.S. risks by Bermudian companies. The treaty could define taxable income from a permanent establishment as any income earned that is attributable to insuring US-based risks. Thus, both domestic and Bermudian insurance companies would be taxed at the same rate for insuring US-based risks. Bermuda may not agree to such a provision because it would greatly increase the tax burden of Bermudian companies.

PART II. POST-BERMUDA TAX TREATY RATIFICATION: THE REINSURANCE INDUSTRY

A. BERMUDA'S INSURANCE INDUSTRY: AN OVERVIEW

Bermuda's insurance industry is divided into insurance, making up 35% of the industry, and reinsurance, making up 65% of the industry.[70] Half of all risks insured are of American origin and one third of all risks are of European origin.[71] More than half (about 60%) of the policies sold in Bermuda are for property insurance and reinsurance.[72] Most importantly, Bermuda is a major global center for reinsurance.[73]

---

[68] *See supra* Part I.A; U.S.-Bermuda Tax Treaty, *supra* note 1, art. 3.

[69] Especially in reinsurance, a substantial transaction can be carried out without having a business location in the U.S. *Reinsurance Association Supports Increase in Excise Tax on Reinsurance Ceded to Foreign Reinsurers*, TAX NOTES TODAY, Feb. 22, 1990, *available at* LEXIS, 90 TNT 41-47.

[70] Donald Kremer, *Reinsurance Company CEO Testifies on Impact of Increased Taxes*, TAX NOTES TODAY, Sept 27, 2007, *available at* LEXIS, 2007 TNT 188-35 [hereinafter *Reinsurance Company CEO Testifies*].

[71] *Id.*

[72] *Id*.

[73] The other global reinsurance centers are New York, London, and Zurich. *Id.*

Reinsurance is a type of insurance arrangement that transfers risk from an insurer to a reinsurer.[74] The relationship between the reinsurer and the original insurer, known as the cedent, is contractual.[75]

Policyholders pay premiums to their primary insurer, and that insurer, as the reinsured, in turn pays to the reinsurer a certain percentage of those premiums as consideration. Since the reinsurer does not incur the normal cost of writing primary insurance, such as administrative expenses and commissions paid to agents, the reinsurer can profitably reinsure the risks for only a percentage of the premiums paid to the primary insurer.[76]

Furthermore, the reinsurer pays the original insurer, known as the cedent, a commission.[77] The commission compensates the ceding company for its acquisition and operating costs.[78] It also reflects the anticipated profitability of the business.[79] Through reinsurance, insurance companies can insure a greater amount of risk, including risk that is less desirable, providing insurance to a greater number of customers. The transfer of risk also helps make the coverage more affordable.[80] Numerous U.S. insurers cede more than half of their business to reinsurers. Most of these reinsurers are domiciled abroad.[81]

The Bermuda regulatory system allows companies, to form, license and start underwriting insurance in a matter of a few months.[82] In the United States however, it is very hard to start up an insurance company because insurance is regulated by states, and each state has its own licensing requirements.[83] Rules between states are often contradictory, and it is

---

[74] BARRY R. OSTRAGER & MARY KAY VYSKOCIL, MODERN REINSURANCE LAW AND PRACTICE 1-4 (2d ed. 2000).

[75] *Id.*

[76] Bluewater Ins. Ltd. v. Balzano, 823 P.2d 1365, 1367 (Colo. 1992), *quoted in* BARRY R. OSTRAGER, *supra* note 74 at 1-1, 1-5.

[77] *Reinsurance Company CEO Testifies*, *supra* note 70.

[78] *Id*.

[79] *Id*.

[80] *Id*.

[81] For certain lines of insurance the proportion between foreign-based reinsurers and domestic reinsurers is even greater. For example, two-thirds of all hurricane and earthquake reinsurance purchased by U.S. insurers is from foreign reinsurance companies. *Id*.

[82] *Id*.; Forming a company in Bermuda imposes very little limitations. There is limited case law that interprets the meaning and application of the major aspects of Bermuda corporate law. As of 2002, Bermuda had 12,000 companies, most of which had no assets, personnel, operations, or substantial economic ties with Bermuda. Orsolya Kun, *Corporate Inversions: The Interplay of Tax, Corporate, and Economic Implications*, 29 DEL. J. CORP. L. 313, 346 (2004).

[83] *Reinsurance Company CEO Testifies*, *supra* note 70.

almost impossible to be licensed in all 50 states.[84] Bermuda and Bermudian reinsurers, on the other hand, have a special expertise in providing reinsurance.[85] Bermuda, unlike the United States, is not subject to regulatory price controls or coverage mandates.[86] Capital is not trapped in "red tape" that limits the insurer's ability to enter or exit various markets.[87] Thus, Bermuda is a popular choice to purchase reinsurance from or form reinsurance companies.

Bermuda also provides an utmost favorable environment for responding to insurance crises, where timeliness is essential.[88] For example, in the mid-1980s, U.S. businesses faced a shortfall in liability insurance coverage. At the time, it was the biggest insurance industry crisis of the 20th century.[89] In reaction to the crisis, investors tried to form a new U.S. liability company called the American Slip.[90] After three years of trying to start up a new insurance company, the effort was abandoned because the company failed to secure enough state licenses to conduct business on a national level.[91] Meanwhile, Bermuda's flexible regulatory environment allowed insurance companies ACE and XL to form in a matter of few months to provide specially crafted, excess liability insurance products to fulfill the need for liability insurance.[92] Since the mid-1980s liability insurance market crisis, there have been three more crises which provided a wave of insurance company formations – Hurricane Andrew and the property insurance crises of 1992-1994; the 9/11 tragedy and the ensuing financial market turmoil in 2001-2002; and the insurance market crunch following Hurricanes Katrina, Rita, and Wilma in 2005.[93]

Bermuda's insurance industry is beneficial to the U.S. insurance industry because it provides a favorable and readily available marketplace from which to purchase insurance and reinsurance policies. Over the years however, the domestic insurance industry has shown concern over the favorable tax environment Bermuda provides. U.S. reinsurers are subject to much higher taxes than Bermuda-based reinsurers. U.S. reinsurers pay income taxes on their premium investment income, while Bermudian

---

84 *Id.*
85 *Id.*
86 *Id.*
87 *Id.*
88 *Id.*
89 *Reinsurance Company CEO Testifies, supra* note 70.
90 *Id.*
91 *Id.*
92 *Id.*
93 *Id.*

reinsurers are only subject to U.S. income taxes when they have a permanent establishment in the United States. Only the income attributable to the permanent establishment is subject to the U.S. income tax. Unless there is a permanent establishment in the United States, Bermuda-based reinsurers are only subject to the 1% excise tax on reinsurance premiums of U.S.-based risks. Another concern is the tax avoidance transactions between a Bermuda-based reinsurer and its U.S.-based cedent when the two parties are related entities. Domestic insurers believe that there is an industry-wide problem of non-arm's length premium pricing and tax avoidance transactions between related entities.[94] U.S. companies complain that the favorable tax treatment for Bermudian companies and potential for tax avoidance makes it hard to compete with Bermudian reinsurers.[95]

B. DOMESTIC CONCERN OVER THE REINSURANCE INDUSTRY IN BERMUDA: UNITED STATES TAX BASE EROSION

The U.S. insurance companies, such as The Hartford, have shown concern over the tax practices in the reinsurance industry in Bermuda.[96] The first concern is reinsurers overcharging when providing reinsurance to a related entity. A related insurer agrees to pay above market price for reinsurance because it routes income from a high-tax jurisdiction, the United States, to a no-tax jurisdiction, Bermuda. Because the insurer and reinsurer are related entities, the income remains under control in the same economic family, while decreasing the amount of income subject to U.S. taxation. Another concern is that a Bermudian reinsurer and its U.S. affiliate-cedent can scheme together in a tax avoidance plan where the transaction shifts income from the United States, a high-tax jurisdiction, to Bermuda, a no-tax jurisdiction, with minimal risk transfer. Both of these practices would provide greater tax savings for Bermuda reinsurers that could provide a competitive advantage over the U.S.-based reinsurers.[97] The Bermuda reinsurance industry asserts that such concerns are

---

[94] Jon Almeras and Ryan J. Donmoyer, *Insurers Approach U.S. Congress to Fix Bermuda*, 20 TAX NOTES INT'L 1388, 1390 (2000).

[95] *See id.*

[96] *Id.* at 1388.

[97] Ben Seessel, Comment, *The Bermuda Reinsurance "Loophole" A Case Study of Tax Shelter and Tax Havens in the Globalizing Economy,* 32 U. MIAMI INTER-AM. L. REV. 541, 559-61 (2001).

unfounded due to the requirement under I.R.C. § 482 and I.R.C. § 845(b) that premiums be charged at arm's length prices.[98]

I.R.C. § 482 allows the Secretary of the Treasury to reallocate funds including gross income, deductions, credits, or allowances between companies that are owned and controlled by the same parent.[99] The purpose of § 482 is to ensure that integrated businesses properly reflect income attributable to controlled transactions and to prevent tax avoidance regarding such transactions.[100] The principal behind § 482 is the arm's length standard – "[i]n determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing arm's length with an uncontrolled taxpayer."[101] Some analysts of the Bermuda reinsurance industry believe that § 482 is not applicable to the reinsurance industry because insurance regulators require reinsurance premiums to reflect an arm's length price.[102] Thus, even if the reinsurer and the insurer are both owned by the same parent, the insurer would pay a reinsurance premium at a market price, as if it was a transaction between unrelated entities. Since the insurance regulators require that reinsurance premiums be set at market prices, the taxable income of related insurers and reinsurers escapes § 482 scrutiny.[103] U.S. insurers and their supporters, however, assert that despite the arm's length requirement, reinsurance is still sold at non-market rates to related entities.[104] Furthermore, they claim that § 482 does not provide adequate audit techniques to effectively police an industry-wide problem of undercharging premiums to related entities.[105]

Section 845 (b) provides the Treasury Department authority to "reallocate items and make adjustments in reinsurance transactions to

---

[98] *Reinsurance Company CEO Testifies*, *supra* note 70.

[99] I.R.C. § 482 (2002).

[100] I.R.C. § 482 (2002); *Bermuda Triangle: Tax Havens, Treaties and U.S. P&C Insurance Competitiveness*, TAX NOTES TODAY, January 8, 2002*, available at* LEXIS, 2002 TNT 5-24 (2002).

[101] *Bermuda Triangle: Tax Havens, Treaties and U.S. P&C Insurance Competitiveness*, *supra* note 100 (internal quotations omitted).

[102] Seessel, *supra* note 97, at 559.

[103] U.S. Steel Corp. v. Comm'r, 617 F.2d 942, 947 (2d Cir. 1980) (holding that if a taxpayer can show that the price he was charged would have been the same in an independent transaction with an unrelated party, then the taxpayer is free from § 482 allocation despite evidence that suggests that the transaction has shifted tax liability among related entities); Lee A. Sheppard, *Would Imputed Income Prevent Escape to Bermuda*, 86 TAX NOTES 1663, 1664 (2000) ("Reinsurers charge the same as an unrelated comparable price, which is a winning argument under section 482").

[104] Almeras, *supra* note 94, at 1389-90.

[105] *Id*.

prevent tax avoidance or evasion."[106] Reallocation can occur as a result of transaction of either related or unrelated parties. Tax avoidance may occur when the tax benefits received from a transaction is disproportionate to the risk transferred between parties.[107] For example, a Bermuda company in comparison to its domestic affiliate enjoys greater tax benefits because it pays no income taxes.[108] Tax avoidance may occur when a transaction between a domestic insurer and its related Bermudian reinsurer transfers minimal risk but large amounts of income, in the form of a reinsurance premium.[109] The overpayment of premium is a scheme to shift income from a high-tax jurisdiction to a no-tax jurisdiction.[110] "Long-tail" reserves – insurance policies that incur claims long after the premium is paid – can also support a finding of tax avoidance because there is a potential for the reinsurer to earn significantly higher income from the long-term premium investment while incurring a small amount of risk.[111]

The Tax Court, however, limited Section 845(b) in *Trans City Life Insurance Company v. Commissioner*.[112] In *Trans City Life Insurance Co.*, Trans City Life entered into a reinsurance agreement with Guardian Life, an unrelated entity, which ceded some of its insurance policies to Trans City Life. As a result of this reinsurance agreement, Trans City Life qualified for a "small life insurance company deduction" under I.R.C. §806.[113] The IRS, however, denied Trans City Life the deduction, concluding that the tax benefit was disproportionate to the risk transferred under the reinsurance agreement, causing a tax avoidance effect.[114] In its analysis, the IRS compared the small risk fees incurred by Trans City Life under the reinsurance agreement to the tax savings claimed under the small life insurance company deduction.[115] The Tax Court disagreed with IRS's analysis. The Tax Court claimed that the appropriate comparison is between the exposure of loss, which Trans City Life acquired under the reinsurance agreement with Guardian Life and the tax savings claimed under the

---

[106] I.R.C. § 845(b) (2002); STAFF OF JOINT COMM. ON TAXATION, *supra* note 62, at 21.

[107] Seessel, *supra* note 97, at 554.

[108] *Id.* at 555; Insurance companies make their profit on investing premiums that are received many years prior to a claim payment.

[109] *Id.* at 555.

[110] *Id.* at 544-46.

[111] *Id*. at 544.

[112] Tran City Life Ins. Co. v. Comm'r, 106 T.C. 274 (1996).

[113] *Id.* at 278.

[114] *Id.* at 276.

[115] *Id.*

deduction.[116] The exposure of loss was measured by the difference between the face value of the reinsurance agreement and the loss reserves (the investment income) backing the reinsurance agreement. Under that comparison, the Tax Court claimed that the risk incurred was not disproportionate to the tax savings.[117]

Due to the Tax Court's decision in *Trans City Life Insurance Co.*, market-priced reinsurance agreements generally will not be subject to §845(b) attack.[118] However, the IRS has officially refused to follow the Tax Court's decision in *Trans City Life Insurance Co.* [119] Its non-acquiescence is due to its disagreement with the Tax Court on the definition of risk.[120] The Tax Court concluded that risk transfers exist when there is a possibility of loss.[121] In contrast, the IRS concluded that no real risk transfer for tax purposes occurred between parties in a reinsurance agreement when the possibility of loss is remote to the reinsurer.[122] Due to the IRS' non-acquiescence, reinsurers may still be subject to attack by the IRS under §845(b).

The third concern domestic insurers have over the Bermuda insurance industry is that companies are domiciled in Bermuda in order to avoid paying U.S. taxes all together. Specifically, they argue that the U.S. tax code contains a "loophole" that allows for U.S. tax base erosion. The "loophole" refers to a transaction that restructures U.S.-based insurance companies into Bermuda-based entities in order to avoid U.S. taxation. The "loophole," also referred to as a corporate expatriation, has existed in the tax code for a long time, but was never used until 1999.[123] The U.S. insurers have appealed to Congress to fix the "loophole" because it allows companies to move to Bermuda to avoid paying U.S. taxes.[124] Reinsurers, however argue that they are not in Bermuda to avoid taxes, pointing out that they are subject to the U.S. excise tax on gross premiums regardless of

---

[116] *Id.* at 308-310.

[117] *Id.* at 309.

[118] Seessel, *supra* note 97, at 557.

[119] Action on Decision CC-1997-011.

[120] Non-acquiescence is "an agency's policy of declining to be bound by lower-court precedent that is contrary to the agency's interpretation of its organic statute, but only until the Supreme Court has ruled on the issue." BLACK'S LAW DICTIONARY 1076 (8th ed. 2004).

[121] *Tran City Life Ins. Co.,* 106 T.C. at 308-10.

[122] *Id. at 310-11*

[123] *Bermuda Triangle: Tax Havens, Treaties and U.S. P&C Insurance Competitiveness*, *supra* note 100 (internal quotations omitted).

[124] Almeras, *supra* note 94, at 1388.

whether they incur a net profit or a loss.[125] Even while paying the excise tax, a Bermuda-based reinsurer is at a greater advantage than the U.S.-based reinsurer because a Bermuda-based company can avoid paying U.S. taxes on the investment income.

The "loophole," which facilitates the tax advantage, covers two types of transactions – expatriation/inversion and acquisition. The inversion occurs when a U.S.-based insurer reorganizes itself as a U.S. subsidiary of a Bermuda-based holding company. Shareholders of the former U.S. parent company (now the U.S. affiliate) receive shares in the Bermudian corporation in exchange for their old shares of stock.[126] Companies such as PXRE, Folks America Re, and Everest Re, have restructured to become a subsidiary of a Bermuda-domiciled holding company.[127] SEC filings of companies that re-domesticate in Bermuda make it clear that the tax advantage was a major benefit.[128]

There are three forms of inversions – stock inversions, asset inversions, and drop down inversions.[129] Stock inversion transactions occur when a newly-formed foreign holding company purchases stock of the U.S.-based parent company and the U.S. parent becomes the subsidiary of the new foreign parent.[130] The shareholders exchange their U.S. parent stock for new foreign parent stock.[131] Asset inversion transaction occurs when a U.S. parent transfers its assets to a new foreign parent before being

---

125 *Reinsurance Company CEO Testifies*, *supra* note 70.

126 Hale E. Sheppard, *Fight or Flight of U.S.-Based Multinational Businesses: Analyzing the Causes for, Effects of, and Solutions to the Corporate Inversion Trend*, 23 NW. J. INT'L L. & BUS. 551, 553 (2003).

127 Bermuda-domiciled holding companies have been compared to "banks" with subsidiaries, where each subsidiary borrows from its "bank." *Reinsurance Company CEO Testifies*, *supra* note 70. Under a bank-subsidiary scenario, there is a potential for earning stripping. Earning stripping is the practice of moving income from a high tax jurisdiction to a low or no-tax jurisdiction to avoid paying high taxes. It is achieved when a U.S. company makes a deductible interest payment to a foreign company. The net tax benefit will be the difference between the foreign tax imposed on the interest income and the U.S. tax saved by obtaining the deduction for interest expense. Kun, *supra* note 82, 338-9. Unlike earning stripping, reinsurance requires a true transfer of risk and an arm's length premium price. *Reinsurance Company CEO Testifies*, *supra* note 70. Therefore, under a reinsurance agreement, a Bermuda-based holding reinsurance company does not engage in earning stripping.

128 *Bermuda Triangle: Tax Havens, Treaties and U.S. P&C Insurance Competitiveness*, *supra* note 100 (internal quotations omitted).

129 Kelly, *supra* note 63, at 201.

130 *Id*.

131 *Id*.

liquidated.[132] Shareholders exchange their stock of the U.S. parent for stock of the new foreign parent.[133] The drop down transaction is a combination of stock inversion and asset inversion transactions.[134]

An inversion is not a tax-free transaction. Under I.R.C. §357, the offshore move is treated as a sale or exchange.[135] Thus companies that are restructuring via a corporate inversion must recognize an unrealized gain on their assets. The offshore move can be very costly, but that depends on the fair market value of the assets and the company's adjusted basis in the assets.[136] The inversion is most beneficial for smaller or new U.S. companies which want to reorganize under Bermuda law.[137] U.S.-based long standing insurance companies cannot invert to Bermuda because they would be liable for billions of dollars in capital gains taxes.[138]

The second aspect of the loophole is acquisition. Acquisition works when a Bermuda based company buys a U.S. insurer.[139] For example, ACE, a Bermuda-based company acquired Capital Re, a U.S. company. If a U.S. company becomes a domestic subsidiary of a foreign company, by either inversion or acquisition, it is no longer subject to direct U.S. taxation on a residence basis. Instead, direct investment income in the U.S. is subject to a 30% tax at the source, insurance premiums are subject to a 4% tax, and reinsurance premiums are subject to a 1% tax.[140] Tax avoidance occurs when a domestic affiliate reinsures a premium sold in this country to their off-shore parent.[141] A foreign parent, unlike a U.S. parent, will not pay taxes on its investment income. The Hartford, and other U.S.-based insurers are concerned about the unlevel playing field.[142]

---

132 *Id*.

133 *Id*.

134 *Id*. at 201-202.

135 I.R.C. §357 (2002).

136 Almeras, *supra* note 94, at 1388.

137 Seessel, *supra* note 97, at 544.

138 David Cay Johnston & Joseph B. Treaster, *Insurers Want U.S. to Curb Competitors' Fund Transfers to Bermuda*, N.Y. TIMES (East Coast Late Edition), Sep 26, 2007, at C4.

139 Almeras, *supra* note 94, at 1388.

140 *Id.* at 1389.

141 *Id*.

142 *Id*. at 1388.

ILLUSTRATIONS OF CORPORATE INVERSIONS AND ACQUISITIONS

INVERSION

Country	Scenario 1	Scenario 2a	Scenario 2b
United States	U.S. Insurance Parent Company, "ABC Co"	U.S. Insurance Parent Company, "ABC Co"	ABC RE Subsidiary, "ABC Co"
Bermuda	Unrelated Reinsurance Company, "Bermuda RE"	ABC Co Subsidiary, "ABC RE"	Bermuda Parent Company, "ABC RE"

In Scenario 1, a U.S.-based insurance company contracts with an unrelated reinsurance company domiciled in Bermuda. ABC Co pays Bermuda RE insurance premiums in exchange for Bermuda RE insuring part of ABC Co risks. Because Bermuda RE is insuring risks located in the United States but does not have a trade or business in the United States, it does not pay the U.S. taxes on the investment income earned from the insurance premiums on a net basis. Instead, it pays a 1% excise tax on the reinsurance premium received.

In Scenario 2a, a U.S.-based insurance company sets up a reinsurance subsidiary in Bermuda. ABC Co pays its own subsidiary ABC RE insurance premiums in exchange for reinsuring part of its risks. ABC Co forms a subsidiary in Bermuda for the sole purpose of facilitated the corporate inversion transaction. Then ABC Co inverts itself (Scenario 2b) – ABC RE becomes the parent company and ABC Co becomes its subsidiary. The corporate structure turns upside down - the foreign subsidiary becomes the parent and the parent becomes the subsidiary. This results in the reinsurer being subject to only a 1% tax on the reinsurance premiums via the excise tax.

ACQUISITION

Country	Scenario 1	Scenario 2
United States	U.S. Reinsurance Parent Company, "ABC RE"	"Bermuda Insurance-ABC RE" (now with a Bermuda parent)
Bermuda	Unrelated Insurance Company, "Bermuda Insurance"	Parent Insurance Company, "Bermuda Insurance"

In an acquisition, a Bermuda insurance company which insures U.S.-based risks contracts with a U.S. company to reinsurer part of its risk (scenario 1). The U.S. reinsurance company pays a 30% direct tax on reinsurance premiums received for risks located in the United States. In the

second scenario, the unrelated insurance company, purchases the U.S. reinsurance company. The newly acquired U.S. reinsurance company is structured so that it is not a permanent establishment and thus completely escapes U.S. direct taxation.[143] Similar to the inversion example above, the Bermuda-based company is only subject to the 1% excise tax on reinsurance premiums.

Corporate inversions have been criticized as being "unpatriotic."[144] In response to criticism of corporate expatriations, as part of the Homeland Security Act of 2002, Congress forbade the Department of Homeland Security to contract with companies that have expatriated through a corporate inversion.[145] The contract ban, however, generally does not extend to domestic subsidies of newly inverted entities.[146] Thus, the Department of Homeland Security can still contract with an expatriated company as long as it contracts with the company's domestic subsidiary. Furthermore, the statute is limited by three exceptions. The statute allows a waiver of the contract ban if the waiver is required for the interest of security, if the waiver prevents the loss of jobs, or if the waiver prevents the Government from incurring additional costs.[147] After much criticism that the exceptions made the statute ineffective, Congress amended the statute by eliminating the "loss of jobs" and "additional costs" exceptions.[148] The "interest in homeland security" exception remains in the statute.[149] Even with the amendment, the legislation has been criticized as primarily symbolic – a way for Congress to appear doing something without actually changing anything.[150] The Homeland Security Act has little, if any effect on an expatriated corporation's ability to enter into government contracts because the Department of Homeland Security can

---

[143] *See* discussion *supra*, Part I.A - business profits of a Bermudian company are exempted from U.S. taxation unless the Bermuda company has a Permanent Establishment in the U.S. If there is a U.S.-based permanent establishment, the Bermuda Company will be taxed only on the business profits attributable to the permanent establishment (source-basis taxation). U.S.-Bermuda Tax Treaty, *supra* note 1, arts. 3-4.

[144] Michael S. Kirsch, *The Congressional Response to Corporate Expatriations: The Tension Between Symbols and Substance in the Taxation of Multinational Corporations*, 24 VA. TAX REV. 475, 482 (2005).

[145] Homeland Security Act of 2002, Pub. L. No. 107-296, 835, 116 Stat. 2135, 2227 (2002) (codified as amended at 6 U.S.C. 395 (2003)), amended by Homeland Security Act Amendments of 2003, Pub. L. No. 108-7, 101(2), 117 Stat. 526, 628 (2003).

[146] Kirsch, *supra* note 144, at 512-13.

[147] *Id.* at 498.

[148] *Id.*

[149] *Id.*

[150] *Id.* at 511-12.

still contract with an expatriated company by either hiring a domestic subsidiary of the company or ruling the contract is in the best interest of homeland security.[151]

Corporate inversions may also alter the brand image of a company.[152] For example a Connecticut based toolmaker, Stanley Works, rejected reincorporating in Bermuda because of public disapproval.[153] Brand image concerns are unlikely, however, in the reinsurance industry because reinsurers do not directly deal with the end consumer, the policy holder. Most policy holders will never know if and by whom their policy has been reinsured.

C. "LEVELING THE PLAYING FIELD" BETWEEN UNITED STATES AND BERMUDA INSURERS OR COMBATING THE UNITED STATES TAX BASE EROSION

According to U.S. insurers, the favorable tax treatment in Bermuda makes it difficult for U.S.-based insurers to compete with Bermuda companies. The Tax Reform Act of 1986 increased significantly the U.S. tax burden of domestic property and casualty reinsurers by requiring insurance companies to discount their loss reserve deductions.[154] The legislation had no effect on foreign reinsurers, who continued to be subject to a 1% excise tax on premiums paid to reinsure U.S. risks.[155] The problem was temporarily compounded by the United States-Bermuda treaty which for a short period of time waived the excise tax.[156]

A more significant change since the Tax Reform Act of 1986 is the increase in corporate inversions – U.S. insurance companies becoming Bermuda-based companies and the formation of new Bermuda-based insurance companies which directly compete with U.S.-based insurers. Thus, the difference in tax treatment provides a great disadvantage for U.S. insurers, especially U.S.-based property and casualty insurers. Furthermore, U.S.-based companies are concerned about "sham"

---

[151] *Id*.

[152] Victor Fleischer, *Brand New Deal: The Branding Effect of Corporate Deal Structures*, 104 MICH. L. REV. 1581, 1582 (2006).

[153] *Id.* at 1582.

[154] *Reinsurance Association of America's Testimony at Ways and Means Hearing on Foreign Income Tax Bill*, TAX NOTES TODAY, Jul. 23, 1992, *available at* LEXIS, 92 TNT 150-102.

[155] *Id.*

[156] *See supra* Part I.

reinsurance companies, where transactions occur on a non-arm's length price.

Congress has debated how to level the playing field between domestic and foreign insurance companies. The three major proposals are (1) to increase the excise tax, which is the only tax imposed on foreign reinsurers, (2) to subject reinsurance transactions between related entities to a greater tax, or (3) to tax the newly expatriated company as if it were still a domestic company.

Proposed bill, H.R. 5270, which is supported by the domestic reinsurers and the RAA increases the excise tax of reinsurance premiums.[157] Foreign companies which (re)insure risk located in the United States, but do not have a trade or business in the United States are subject to a 4% excise tax on insurance premiums and a 1% excise tax on reinsurance premiums. The proposed bill would increase the reinsurance excise tax to 4% from 1%, to bring it up to par to the insurance premium excise tax.[158] The RAA argues that the Tax Reform Act of 1986 substantially increased taxes on domestic reinsurers, effectively creating a tax preference for non-resident foreign companies selling reinsurance to the U.S. market.[159] Thus, the RAA concludes, an increase in the excise tax would neither disadvantage foreign competitors nor interfere with the international flow of reinsurance corporations.[160] The Treasury Excise Tax Study,[161] however, found that raising the excise tax from 1% to 4% would give U.S. companies a significant advantage over foreign companies that were located in high-tax jurisdictions, such as the United Kingdom and Germany.[162] However increasing the excise tax to 4% would not offset the competitive advantage enjoyed by tax-haven-based reinsurers for long-tail lines of business.[163]

---

[157] H.R. 5270, 102d Cong. (1992); *Reinsurance Association of America's Testimony at Ways and Means Hearing on Foreign Income Tax Bill*, *supra* note 154.

[158] *Reinsurance Association of America's Testimony at Ways and Means Hearing on Foreign Income Tax Bill*, *supra* note 154.

[159] *Reinsurance Association Supports Increase in Excise Tax on Reinsurance Ceded to Foreign Reinsurers*, *supra* note 69.

[160] *Id*.

[161] For background discussion on the Treasury Excise Tax Study *see supra* Part I, at 19-21.

[162] Treasury Excise Tax Study, *supra* note 27, at 3; *Bermuda Triangle: Tax Havens, Treaties and U.S. P&C Insurance Competitiveness*, *supra* note 100 (internal quotations omitted).

[163] Treasury Excise Tax Study, *supra* note 27, at 13-14; *Bermuda Triangle: Tax Havens, Treaties and U.S. P&C Insurance Competitiveness*, *supra* note 100, 80-81 (internal

Unsurprisingly, foreign reinsurers oppose H.R. 5270. An increase in the excise tax raises concerns over the diminishing economic stability in the Caribbean insurance industry.[164] The Government of Barbados testified before the Ways and Means Committee during the hearing on H.R. 5270 that a provision that increases the excise tax would hinder the U.S. domestic insurance market because the tax would make increase the cost of insurance in the United States and in turn make it more costly for U.S. firms to enter into alternative reinsurance markets.[165] Barbados further argued that the excise tax provision is barred by the United States-Barbados treaty (and tax treaties with most other foreign countries) because it discriminates against premiums paid to persons in a foreign country as opposed to those paid to persons based in the United States.[166] Not all differences in tax treatment between foreign and domestic entities, however, amount to improper discrimination.[167] Discrimination only occurs when similarly situated entities are taxed differently.[168] If two entities are not similarly situated, a difference in taxation does not result in discrimination.[169] In this case, foreign reinsurers and domestic reinsurers are not similarly situated because domestic reinsurers are taxed on a world-wide basis, while foreign reinsurers are not.[170] Foreign reinsurers that have a U.S. trade or business are taxed on a source-basis, while foreign reinsurers that do not have a U.S. trade or business are taxed via the excise tax.[171] As the tax base between domestic reinsurers and foreign reinsurers is different, a difference in taxation does not result in discrimination.

Other proposed bills include H.R. 4192 and H.R. 1755. These bills modify the tax code so that transactions between related entities are taxed higher than transactions between unrelated entities. The 106th Congress

---

quotations omitted). A long-tail line of business refers to insurance coverage for a risk that is not realized until a significant time has passed. An example of long-tail line of business is liability coverage for a company, which used asbestos in its product in the 1970s, but didn't receive any claims until 1990s. Another example is life insurance, where policy holders purchase insurance years prior to their death.

[164] *Government of Barbados' Testimony at Ways and Means Hearing on Foreign Income Tax Bill*, TAX NOTES TODAY, Jul. 23, 1992, *available at* LEXIS, 92 TNT 150-103.

[165] *Id.*

[166] *Id.*

[167] *Bermuda Triangle: Tax Havens, Treaties and U.S. P&C Insurance Competitiveness*, *supra* note 100 (internal quotations omitted).

[168] Shaffer v. Carter, 252 U.S. 37, 56 (1920).

[169] *Id.* at 56, 57.

[170] Treasury Excise Tax Study, *supra* note 27, at 7.

[171] *Id.*

proposed H.R. 4192, that provided for an amendment to §845.[172] The bill proposed altering the treatment of a related-party reinsurer. Thus, if a domestic person directly or indirectly reinsures a U.S. risk with a related foreign reinsurer (as opposed to an unrelated entity), then the investment income of the domestic insurer shall be increased and the domestic company will be subject to a greater tax.[173] The proposed plan would not affect reinsurance arrangements between unrelated parties.[174] This will impede an affiliated transaction whose purpose is to effectively move money from one entity to another within the same economic family. The 107th Congress proposed the Reinsurance Tax Equity Act of 2001 (H.R. 1755).[175] The proposed bill was an amendment to §832(b)(4). The U.S. tax code allows a property and casualty insurance company to deduct reinsurance premiums paid from gross premiums written on insurance contracts during the taxable year.[176] The amendment provides under certain circumstances a denial for the deduction of reinsurance premiums paid for direct or indirect reinsurance of U.S. risks with "related insurers."[177] Thus if an insurer pays a reinsurer which is also its subsidiary, the reinsurance premium, the insurer cannot deduct the amount when calculating its gross premium amount for tax purposes.

The latest proposed bill is H.R. 3884, which amends §7701 in its treatment of foreign holding companies.[178] If a domestic company through a corporate inversion becomes a foreign holding company, it will still be treated as a domestic company for tax purposes provided that after an inversion more than 80% of the company is still owned by former shareholders.[179]

Although Congress has tried to level the playing field between U.S.-based and Bermuda-based reinsurers, none of the proposed bills have become statute. U.S. reinsurers should continue to lobby Congress for a legislative fix of tax avoidance in the reinsurance industry. However, the

---

[172] H.R. 4192, 106th Cong. (2000); STAFF OF JOINT COMM. ON TAXATION, *supra* note 62, at 56.

[173] H.R. 4192, 106th Cong. (2000); STAFF OF JOINT COMM. ON TAXATION, *supra* note 62, at 56.

[174] Almeras, *supra* note 94, at 1390.

[175] STAFF OF JOINT COMM. ON TAXATION, *supra* note 62, at 56.

[176] H.R. 1755, 107th Cong. (2001); STAFF OF JOINT COMM. ON TAXATION, *supra* note 62 at 56.

[177] STAFF OF JOINT COMM. ON TAXATION, *supra* note 62, at 56.

[178] H.R. 3884, 107th Cong. (2002); *Preventing Corporate Inversions*, TAX NOTES TODAY, Apr. 2, 2002, *available at* LEXIS, 2002 TNT 63-2.

[179] *Preventing Corporate Inversions*, *supra* note 178.

fix may be worse than the problem of tax avoidance because tax legislation may provide unintended tax disadvantages to legitimate reinsurance transactions. Furthermore, legislation that impedes tax benefits enjoyed in other countries may send a negative message that more powerful countries such as the U.S. can dictate the tax policy of smaller and less powerful foreign jurisdictions.

Another approach is for the U.S. reinsurance industry to pressure insurance regulators to ensure that reinsurance transactions are made under an arm's length standard. Furthermore, stricter insurance regulation practices may decrease the potential for "shell corporations" that try to operate as reinsurers. An additional approach to limit "shell corporations" is for the Treasury Department to renegotiate the United States-Bermuda Tax Treaty to increase greater exchange of information (specifically access to confidential information from Bermuda).

Lastly, U.S. reinsurers should try to form a favorable regulatory system domestically for reinsurance companies. As insurance is regulated individually by each state, U.S. reinsurers may appeal to individual states to pass legislation favorable to reinsurance companies in exchange for an increase in economic activity in that state. This is the best approach because states are always looking to bring in more business. Moreover it would decrease the domestic insurers' reliance on the reinsurance market in Bermuda.