The Bermuda Reinsurance 'Loophole': A Case Study of Tax Shelters and Tax Havens in the Globalizing Economy

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THE BERMUDA REINSURANCE ‘LOOPHOLE’: A CASE STUDY OF TAX SHELTERS AND TAX HAVENS IN THE GLOBALIZING ECONOMY

“In this era of interdependence, the actions of each nation can and will affect other nations as never before.”

-Robert Rubin, Former Clinton Treasury Secretary*

“The power to tax involves the power to destroy.”

-McCulloch v. Maryland, 17 U.S. 316, 431 (1819).

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Imagine a world in which you could choose the rate at which you pay taxes. In today's globalizing economy, that fantasy is becoming a reality.¹ This paper examines the process whereby

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¹ "Globalization is the process that fitfully brings the elements of world society together." THE GLOBALIZATION READER 1 (Frank J. Lechner and John Boli eds., 2000); "The term 'globalization' refers to those processes which tend to create and consolidate a unified world economy." JAMES TWINING, GLOBALIZATION & LEGAL THEORY 4 (2000); "A truly global economy is claimed to have emerged or to be in the process of emerging, in which distinct national economies and, therefore, domestic strategies of national economic management are increasingly irrelevant." PAUL HIRST & GRAHAME THOMPSON, GLOBALIZATION IN QUESTION; THE INTERNATIONAL ECONOMY AND THE POSSIBILITIES OF GOVERNANCE 1 (1996). There are two schools of thought in globalization theory concerning the role of the nation state. One holds the state to be undermined and/or made obsolete by the process, the other is that the state is necessary to and reinforced by globalization.

One school says governments are going to wither away. I'm not in that school. I am in the school that says the state is still important for two reasons: one, it's the vessel for our olive trees; for our identity, for our sense of community, place, history. At the same time, the size of your state is going to have to go down, but the quality of your state is going to have to rise, because the state is still the filter, the vehicle,
one can shelter income from taxation through the process of shifting one's capital and domicile out of the country to a low or no tax jurisdiction termed a tax haven. To illustrate, this article focuses on a case study. The case study concerns the process whereby Bermuda property and casualty insurance companies avoid U.S. taxation by shifting the capital reserves retained on insurance policies sold domestically to a Bermuda parent corporation, which in turn earns tax free income by investing that capital.

II. THE WORKINGS OF THE TAX ‘LOOPHOLE’

A. How the Tax Avoidance is Effectuated

Bermuda property and casualty insurers that are avoiding taxes by taking advantage of a ‘loophole’ in the current tax code can be divided into two categories. The first set is comprised of

with which you will kind of interact with this globalization system. You still need the rule of law, the oversight, the quality institutions...Governance still matters.

Interview by David Gergen with Thomas Friedman, Author: The Lexus and the Olive Tree: Understanding Globalization, as reported in NEWS HOUR WITH JIM LEHRER (May 26, 1999), available in LEXIS.

Globalization has had positive effects on the development of tax systems and has encouraged countries to engage in base broadening and reducing tax reforms. However it has also created an environment in which tax havens thrive and which governments may be induced to adopt harmful preferential tax regimes to attract mobile activities.

ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT COMMITTEE ON FISCAL AFFAIRS, HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE, OECD’s Committee on Fiscal Affairs (1998).

2. The term “tax haven” refers to a tax jurisdiction with a) no or only nominal effective tax rates; b) lack of effective exchange of information; c) lack of transparency; and d) absence of a requirement of substantial activities. OECD Tax: Harmful Tax Practices (Feb. 20, 2001), at http://webnet1.oecd.org/pdf/M00004000/M00004517.pdf; Steven Sieker, Offshore Financial Centers and ‘Harmful Tax Competition: The Developments, TAX ANALYSTS, WORLDWIDE TAX DAILY, (Jan. 29, 2001), available in LEXIS 2001 WTD 19-22. A tax shelter is defined in several sections of the Internal Revenue Code. One general definition is a “plan or arrangement if a significant purpose of such partnership, entity, plan or arrangement is the avoidance or evasion of Federal income tax.” I.R.C. § 6662(d)(2)(C)(iii)(III).

3. ‘Loophole’ is defined in the context of taxation as: “A provision in the tax code by which a taxpayer may legally avoid or reduce his income taxes.” BLACK’S LAW DICTIONARY 652 (Abridged 6th ed. 1991). This article analyzes the legality and the legitimacy of such tax avoidance in a specific instance described in the case study.
established Bermuda-based companies that have recently purchased or formed United States property and casualty affiliates. 4 The second class of insurers are smaller United States companies that have reorganized under Bermuda law but maintained a property and casualty affiliate in this country. 5 In both cases, tax avoidance is effectuated when the domestic affiliate reinsurance a premium sold in this country to their offshore parent. 6

Property and casualty insurers make most of their income from investing reserves rather than from the sale of premiums. 7


5. Several U.S. companies have relocated to Bermuda recently including PXRE, Folksam Reinsurance, and Everest Reinsurance. In announcing their moves to Bermuda, the companies cite reduction in corporate taxes as an advantage of reorganizing there. Almeras & Donmoyer, supra note 4 at 1660. An affiliated company is a company “effectively controlled by another company... related as parent and subsidiary, characterized by identity of ownership of capital stock.” BLACK’S LAW DICTIONARY, supra note 3, at 37.

6. “Reinsurance is not double insurance nor co-insurance. Reinsurance is a contract whereby the reinsurer agrees to indemnify a reinsured for all or part of a loss which the reinsured may sustain under a policy or policies of insurance.” JOHN S. DIACONIS, REINSURANCE LAW & PRACTICE: NEW LEGAL AND BUSINESS DEVELOPMENTS IN A CHANGING GLOBAL ENVIRONMENT 3,5 (1999). The company originally writing the insurance is called the “primary insurer” or “ceding insurer”, or “the reinsured.” The act of transferring the risk is called “ceding.” Sometimes a reinsurer may cede the risk to a further reinsurer, this transaction is called “retrocession” and the second reinsurer is called a “retrocessionaire.” ROBERT H. JERRY, UNDERSTANDING INSURANCE LAW 898 (2nd ed. 1996).

Reinsurance, to an insurance lawyer, means only one thing- the ceding by one insurance company to another of all or a portion of its risks for a stipulated portion of the premium, in which the liability of the reinsurer is solely to the reinsured, which is the ceding company, and in which contract the ceding company retains all contact with the original insured and handles all matters prior to an subsequent to loss.

JOHN ALAN APPLEMAN & JEAN APPLEMAN, INSURANCE LAW AND PRACTICE WITH FORMS 480 (1976). A premium is “the sum paid or agreed to be paid by an insured to the underwriter (insurer) as the consideration for the insurance.” BLACK’S LAW DICTIONARY, supra note 4, at 819.

7. Johnston & Treaster, supra note 4, at A1. Reserves are the assets retained by an insurer to pay out the potential claims made by their insureds. JERRY, supra note 6, at 900.
Bermuda has no corporate income tax.\(^8\) Thus, the Bermuda parent earns tax-free income in Bermuda on the investment of its capital reserves "ceded" to it by their U.S. affiliate. In contrast, property and casualty insurers domiciled in the U.S. pay income taxes on earnings from invested reserves at the federal corporate rate.\(^9\) Further, when a domestic insurer reinsures premiums sold in this country with an offshore subsidiary, the investment income earned offshore is subject to United States taxation.\(^10\)

The United States affiliate of a Bermuda company is taxed on the "ceding commission" it receives from its parent/reinsurer as payment for acquiring the premium.\(^11\) Additionally, a one-

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Sums of money an insurer is required to set aside as a fund for the liquidation of future unaccrued and contingent claims, and claims accrued, but contingent and indefinite as to amount. Reserves of an insurance company are the amount treated as liability on the balance sheet which the company estimates will be sufficient to meet its policy obligations.

BLACK'S LAW DICTIONARY, supra note 3, at 906.

8. There are no taxes in Bermuda on income or profits, dividends, or on any capital asset, gain or appreciation for either individuals or entities. PRICE WATERHOUSE COOPERS, DOING BUSINESS IN BERMUDA: INFORMATION GUIDE (Sept. 1, 1991).


Since Bermuda does not tax corporate income, this arrangement allows these companies to transfer reserves into this tax haven in order to elude payment of United States income tax and to gain as much as ten percent profit advantage over United States insurers. Meanwhile American companies are subject to and continue to pay a 35 percent corporate income tax rate.

Id.


11. The parent in these transactions, as reinsurer, pays a "ceding commission" to its affiliate to cover costs including the marketing and sales of the premium. These ceding commissions are taxed as income to the affiliate at the applicable U.S. corporate rate. The parent and the affiliate are always careful to perform these transactions at arm's length to avoid negative tax treatment. (Signifying that the affiliate is paid a market price). Jon Harkavy, Bermuda "loophole" Should Remain; Tax Code Changes Outlined in H.R. 4192 Illogical, Damaging to Insurance Industry, Business Insurance, May 29, 2000
percent excise tax is assessed to the domestic affiliate on policies that are reinsured offshore. The Bermuda-based company, (parent and affiliate combined) pays no further taxes on premiums marketed and sold in the United States and invested offshore. For the reasons given above, domestic property and casualty insurers fear that Bermuda-based insurers have incurred a significant competitive advantage through their ability to avoid taxation.

B. The Purpose of Reinsurance

The traditional purpose of reinsurance is to spread risk and balance an insurer’s portfolio to reduce the danger of catastrophic loss to an insurer. Legislators who want to close the ‘loophole’

available in LEXIS. Acquisition costs are costs initially born by the primary insurer, but are usually transferred to the reinsurer upon cession of the premium. “Acquisition costs include the commissions paid to agents, brokerage fees, marketing, underwriting, contracting, accounting and collection of premiums.” DIACONIS, supra note 6, at 16.

12. I.R.C. §4371 (2001). If the parent company wishes to avoid paying the excise tax, the parent can elect to be taxed as a U.S. corporation under I.R.C. §953(d) (in which case it would have to pay U.S. taxes on income earned from investing its reserves). I.R.C. 953(d) (2000). For the U.S. affiliate who chooses to pay the §4371 one-percent tax, however, a premium that is reinsured offshore is completely deductible from income. Almeras & Donmoyer, supra note 4.

13. The result is that the Bermuda parent shelters “the considerable investment income earned by those reserves from U.S. tax, while the U.S. affiliate reports little or no taxable income.” Lee Sheppard, Would Imputed Income Prevent Escape to Bermuda? Tax Analysts, Tax Notes, Mar. 20, 2000, at 1664.

14. Domestic insurers who are concerned include Chubb, the Hartford, Kemper and Liberty Mutual. Reorganization to a foreign domicile is treated as a sale or exchange under section 367; thus, an inverting company would have to recognize unrealized gain on their assets, a “§367 toll charge.” The insurers who have inverted to Bermuda have little gain to tax. The larger insurers have gains to tax from numerous investments. See I.R.C. §367(a) (2000); Sheppard, supra note 13, at 1663-4. Section 367 is more difficult for large companies to navigate than it is for smaller ones. Further, convincing the shareholders of an older domestic company to vote for relocation can be problematic. Robert J. Staffaroni, Size Matters: Section 367(a) and Acquisitions of U.S. Corporations by Foreign Corporations, 52 Tax Law 523 (1999).

15. Reinsurance: 1) permits an insurer to transfer excessively large or dangerous risks; 2) increases an insurer’s capacity to write policies because through reinsurance an insurer reduces its potential losses and therefore liberates reserves that it is legally required to maintain to cover claims made by insureds; 3) allows a ceding company to rid itself of a particular class of risk; 4) stabilizes profits and losses by allowing the ceding company to obtain certainty of its ability to cover risks it has insured. JERRY II, supra note 6, at 900. Reinsurance is treated as an asset on an insurer’s balance sheet, which enables an insurer to reduce its legally required reserve requirement, giving the insurer more capital to invest or to insure other risks. DIACONIS, supra note 6, at 7.
argue that there is no risk being shifted from the domestic affiliate to the Bermuda-based parent in these reinsurance transactions. They argue that the Bermuda-based companies are merely shifting risk and capital from one pocket to another. The following section explores the question of whether sufficient risk is shifted between the members of these affiliated corporations to constitute valid transactions for federal income tax purposes.

III. TAX SHELTERS

A. Introduction and the Economic Substance Doctrine

The Internal Revenue Service (IRS) has the authority to disregard transactions that are created solely for the purpose of creating tax benefits. For a transaction to be disregarded for federal tax purposes it must lack "economic substance and legitimate business purpose." Learned Hand addressed the issue of a party seeking to avoid taxation by purely procedural action in the seminal case of Gregory v. Helvering. In Gregory, a

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17. The risk that is shifted is the duty of the reinsurer to indemnify the reinsured for losses that original insureds suffer and claim. See generally DIACONIS, supra note 6, at 3; JERRY, supra note 6, at 901.


The Treasury has recently proposed codification of the economic substance doctrine. See Lawrence Summers, Summers Speech on Corporate Tax Shelters, 2000 Tax Notes Today 40-34, (Feb. 28, 2000), available in LEXIS 2000 TNT 40-34.

Where there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effected by the parties.


corporate reorganization complying with all formal statutory requirements of the Internal Revenue Code was disregarded by the court for Federal income tax purposes because no valid economic purpose had existed for the creation and immediate liquidation of the transferee corporation. The transaction was ruled an attempt to convert ordinary dividend income into capital gains, (taxed at a lower rate than ordinary income) for tax purposes alone, absent any business purpose. The following subsections analyze the economic substance and business purpose that exists in the reinsurance transactions that are the focus of this case study.

B. The UPS Case

In a controversial decision, United Parcel Service of America Inc., et al. v. Commissioner, the Tax Court utilized section 61 to declare a reinsurance arrangement a sham. For many years, the United Parcel Service (UPS) issued excess value insurance to its customers. UPS divested itself of this business and “spun-off” a Bermuda company, Overseas Partners Ltd. (OPL), by selling most of OPL’s shares to UPS shareholders while UPS retained a 2.67% interest. UPS then selected a primary insurer, National Union Fire Insurance Co. (NUF), to insure the excess

20. Id.

21. Id. In a frequently quoted passage Learned Hand wrote that a taxpayer “may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one’s taxes.” Helvering v. Gregory 69 F.2d 809, 810 (1934) (citations omitted). However, the Supreme Court in affirming Hand’s opinion stated that an operation “having no business or corporate purpose” should not be afforded recognition for federal tax purposes. Helvering v. Gregory 293 U.S. 465, 469 (1935).

22. United Parcel Service of America Inc., et al. v. Comm’r, 78 T.C.M. 262 (1999). One reason the case was controversial was because income was reallocated under section 61 of the Internal Revenue Code and not another provision. See David Lupi-Sher, As Briefs are Filed, Practitioners Question Decision in UPS Case, 2000 TAX NOTES TODAY 196-4 (Oct. 9, 2000), available in LEXIS 2000 TNT 196-4. See also Brief for Appellant, United Parcel Service of Amer. Inc. v. Comm’r, 1999 TAX NOTES TODAY 153-1, available in LEXIS 1999 TNT 153-1.

23. In 1983, the year before OPL was formed, UPS earned approximately $48 million profit before taxes on the excess value insurance it sold to customers and paid approximately $21 million dollars in taxes on this income. Net profit equaled $26 million. United Parcel Service, 78 T.C.M. at 269.

24. UPS, in 1983 was owned by approximately 14,000 shareholders comprised of mostly employees, ex-employees and their families. Id. at 274.
value charges. UPS stated that the primary business reason for establishing this arrangement was concern over potential regulatory conflicts caused by the company continuing to issue excess value insurance to its customers. The Tax Court found that the threat of state regulatory conflict was vague, and UPS's documentation and testimony poorly supported UPS's fear of sanction. Further, the court found that:

... the amount of premiums and predictability of losses made it highly unlikely that either NUF or OPL would suffer a business loss; ... the risk level shifted from UPS to NUF to OPL was insignificant; UPS continued to administer the insurance program on NUF's behalf; and the business that UPS had divested itself from had been a profitable one.

25. In trial testimony, the broker who helped to arrange the transaction for UPS stated that NUF was a "front." Id. at 266. "A front has been generally described as an arrangement whereby an insurance company allows another company to use its name for a fee." Id. at 279 n.27 (citing Old Sec. Life Ins. v. Cont'l Ill. Bank & Trust, 740 F.2d 1384, 1397 n.2 (7th Cir. 1984); Northwestern Nat'l Ins. Co. v. Marsh & McLennan, Inc., 817 F. Supp. 1424, 1426 (E.D. Wis. 1993)).

26. Id. at 273.

27. In 1984, OPL, UPS's insurance subsidiary earned approximately $42 million in profit. OPL, because it was a Bermuda corporation, paid no income taxes. Net profit was $42 million, an increase of $16 million from 1983 when the reinsurance scheme was not in place. OPL was exclusively owned by UPS and UPS shareholders. A ceding commission of 2.25% percent was allocated to NUF. This percentage included funds to pay for the one percent excise tax upon reinsuring the premium offshore. Id. at 267.

28. UPS alleged that they were concerned that the excess value activity that they were engaged in was possibly illegal under various State insurance laws. Id. at 288.

29. The executive in charge of UPS's insurance department admitted in court that nobody at UPS had ever discussed the possible illegality of its excess value insurance business with any state regulators nor did anyone request a legal opinion from UPS's counsel on possible illegality. The court found that UPS's willingness to divest itself from a multi-million dollar per year business on vague and unsubstantiated concerns of legal ramifications was not realistic. Id.

30. Lupi-Sher, supra note 22, at 201. The way the transaction was organized, UPS representatives continued to sell the excess value insurance policies to customers and to pay all the claims of loss. The possibility that NUF would pay a claim was extremely unlikely under the contract because NUF's liability was only for individual claims over $100,000. OPL was thus equally unlikely to be called upon to indemnify NUF as reinsurer. The premiums NUF received from UPS well exceeded the market value of the
The court declared the transaction lacked business purpose and economic substance, deemed it a sham, and allocated almost $100 million of taxable income back to UPS for the year 1984.\(^{31}\)

The UPS case is currently on appeal before the Court of Appeals for the Eleventh Circuit.\(^{32}\) The Tax Court's decision "on its face might be read to require a business purpose for shifting economic activity, and its associated income, from one affiliated company to another."\(^{33}\) What the Eleventh Circuit court decides could have wide-ranging implications.\(^{34}\) The outcome may affect some of the Bermuda companies who are reinsuring property and casualty premiums in Bermuda. However, the reinsurance transactions that UPS performed differed from the transactions that are the subject of this case study. First, UPS was careless in the manner it performed its transactions. "The parties weren't even willing to follow the form of an insurance contract consistently[.]"\(^{35}\) Bermuda-based companies can also cite a genuine business purpose for reinsuring in Bermuda.\(^{36}\) "While

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\(^{31}\) Lupi-Sher, \textit{supra} note 22, at 201, 202.

\(^{32}\) Lupi-Sher, \textit{supra} note 22, at 200.

\(^{33}\) Luchsinger as quoted in Lupi-Sher, \textit{supra} note 22, at 207.

\(^{34}\) The UPS case was reversed by the Eleventh Circuit in June of 2001. The court held that "UPS's restructuring of its excess-value business had both real economic effects and a business purpose, and it therefore under our precedent had sufficient economic substance to merit respect in taxation." United Parcel Serv. Of Am. v. Comm'r, 254 F.3d 1014, 1020 (11th Cir. 2001). The Eleventh Circuit remanded the case to the tax court to consider the IRS's alternative arguments in support of its finding of a deficiency pursuant to sections 482 and 845(a) of the Internal Revenue Code. \textit{Id.}

\(^{35}\) Martin J. McMahon, the Clarence J. Tesell Prof. of Law, Univ. Fl. quoted in Lupi-Sher, \textit{supra} note 22 at 206.

\(^{36}\) The advantages of making Bermuda a domicile include "[1] a long-established history as a highly reputable offshore business center[,] ... [2] excellent professional and other business services[,] ... [3] a regulatory system that is essentially self-monitoring by the industry, with minimum government involvement for those companies that meet certain solvency and liquidity requirements." \textit{PRICE WATERHOUSE COOPERS, DOING BUSINESS IN BERMUDA; INFORMATION GUIDE}, 38 (Sept. 1, 1991). Bermuda law allows companies to issue products the United States will not, and grants faster approval for new products. Patricia Brown, Dep't Treas. Int'l Tax Counsel (Treaty Affairs), \textit{quoted in Molly Moses, Tax Shelters: Treasury Studying Whether Section 482 Can Stop Insurance Firms Abusive Income Shifts}, 202 \textit{DAILY TAX REPORT G-4} (Oct. 18 2000).
the court in UPS faulted the company's lack of contemporaneous documentation to support its move of the insurance business . . . companies are finding plenty of reasons other than tax to relocate there [to Bermuda]. Further, the Bermuda parents pay realistic ceding commissions to their domestic affiliates, which is evidence that the reinsurance transactions that are the focus of this case study are economically substantial.

**C. I.R.C. § 845 “Certain Reinsurance Agreements.”**

In the early 1980’s Congress became concerned that business entities could manipulate their level of taxable income through the use of reinsurance. In 1984, as part of a broad revision of insurance tax law, Congress enacted code section 845. Section 845 grants the Secretary of the Treasury [hereinafter “Secretary”] power to reallocate income, assets, and deductions to more properly reflect income between related parties to a reinsurance transaction when a reinsurance transaction has a significant tax avoidance effect. The “operative standards” for meaningless labels attached, the Government should honor the allocation of rights and duties effected by the parties.


38. Bermuda reinsurers are careful to conform their reinsurance transactions to market norms. They pay proper ceding commissions equivalent to what other unrelated reinsurers pay. Sheppard, supra note 13, at 1665.

39. “Because reinsurance generally involves transferring risks on large blocks of business, it also can significantly affect federal tax liabilities by shifting premiums, reserves, and other income and deduction items from the reinsured company to the reinsurer.” Michel F. Kelleher and Edward R. Horkan, Trans-City Spells Relief for 'Tax-Avoidance' Attacks on Reinsurance, 85 J. TAX’N 154 (1996).

40. Id.

41. I.R.C. § 845(a) provides that in the case of a reinsurance agreement between two or more related persons (within the meaning of I. R.C. § 482), the Secretary may allocate among such persons income, deductions, assets, reserves, credits, or other items related to such an agreement, or can characterize any such items, or make any other adjustment to reflect the proper source and character of the taxable income (or any item used in determining taxable income) of each person. I.R.C. § 845(b) provides that if the Secretary determines that any reinsurance contract has a significant tax avoidance effect on any party to such contract, the Secretary may make proper adjustments with respect to the party to eliminate the tax avoidance effect, including treating the contract as terminated on December 31 of each year and reinstated on January 1 of the next year. I.R.C § 845 (2001); Priv. Ltr. Rul. 93-46-004, available in LEXIS 1993 PRL LEXIS 1869. “A tax avoidance effect is significant if the transaction is designed so that the tax benefits enjoyed by one or both parties to the contract are disproportionate to the risk transferred between the parties.” Conference Agreement 1984-3 C.B. (Vol 2) 315 [hereinafter Conference Agreement].
the exercise of the Secretary's authority under the related party rules of subpart (a) and the unrelated party rules of subpart (b) respectively are the following objective test of: 1) whether adjustments are necessary to more properly reflect income; or 2) whether the reinsurance transaction has a significant tax avoidance effect. 42

Section 845 "would appear to be the ideal tool for attacking reinsurance contracts that basically shift income to a Bermuda parent." 43 However, as explored below, section 845 has not been used to terminate the current tax avoidance effectuated by Bermuda reinsurers and their domestic affiliates.

1. Section 845(a)

The Bermuda reinsurers and their domestic affiliates are related parties according to section 482 because they are owned and controlled by the same interests. 44 Under section 845(a) the Secretary has the authority to reallocate income or deductions to reflect the proper source and character of that income. 45 Upon a simple reading, it appears the Secretary could reallocate income earned by the Bermuda parent to the domestic affiliate under section 845(a).

A problem inheres, however, because the Secretary does not have tax jurisdiction over the Bermuda parent. 46 "Even though income from insurance from U.S. risks is U.S. source income, according to section 861(a)(7), it cannot be considered effectively

42. Conference Agreement, at 315.
43. Sheppard, supra note 13, at 1664.
44. Sheppard supra note 13, at 1663.

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. I.R.C. § 482 (2001). In the case of these Bermuda reinsurance transactions, the companies involved are commonly owned parent and subsidiary. Id.
46. "The United States does not have tax jurisdiction over the Bermuda parents." Sheppard, supra note 13, at 1667.
connected unless the Bermuda parent has a U.S. trade or business." Income that Bermuda property and casualty insurers earn from premiums sold domestically and reinsured offshore is not treated as "effectively connected" to a U.S. trade or business under the Code.

According to the plain language of section 845, the Secretary can deny the domestic affiliate a deduction when the affiliate reinsures the premium to its offshore parent. The income earned from the premium reinsured offshore would then be "imputed" to the domestic affiliate. This approach is similar to a recently proposed amendment to section 845 that was not passed into law and has not been reintroduced. The proposed amendment was controversial and raised several problems. These include allegations of U.S. protectionism, invidious discrimination against Bermuda, and disapproval from Europe for using imputed income to determine a foreign entity's taxable income.

47. Sheppard, supra note 13, at 1667.

The following items of gross income shall be treated as income from sources within the United States: Amounts received as underwriting income derived from the issuing of any insurance or annuity contract in connection with property in, liability arising out of an activity in, or in connection with the lives or health of residents of, the United States. I.R.C. §861(a)(7)(A).

48. I.R.C. §864(c)(4)(C); Sheppard, supra note 13, at 1667.

49. "[T]he Secretary may . . . make any adjustment . . . to reflect the proper source and character of the taxable income of each person." I.R.C. 845(a) (2001).

50. Imputed means: attributed vicariously; that is, an act, fact, or quality is said to be "imputed" to a person when it is ascribed or charged to him, not because he is personally cognizant of it or responsible for it, but because another person is, over whom he has control or for whose acts or knowledge he is responsible. BLACK'S LAW DICTIONARY, supra note 3, at 520.


52. In the year 2000, Congressional representatives proposed a bill that would "impute" the income earned on the reserves ceded and invested offshore to the domestic affiliate by multiplying the ceded reserves held in Bermuda (as required to be retained and recorded by the National Association of Insurance Commissioners) and a Federal midterm rate calculated by the formula found in section 1274(d) of the Internal Revenue Code. 106 H.R. 4192 (2000). The proposed amendment to section 845 was very controversial for several reasons. First, H.R. 4192 was viewed as a protectionist measure, protecting domestic insurance property and casualty insurers from international competition. Further, the proposed law was perceived as an attempt to penalize Bermuda for having low tax rates, while other, perhaps more influential countries such were effectively exempted from the amendment. (Switzerland and Ireland reinsure risks sold
To utilize his or her allocation authority under section 845(b), the Secretary must first determine that a transaction has a significant tax avoidance effect. As described in the legislative history, "a tax avoidance effect is significant if the transaction is designed so that the tax benefits enjoyed by one or both parties to the contract are disproportionate to the risk transferred between the parties." According to the legislative history, in order to determine the risk transferred in proportion to the tax benefits derived from a reinsurance transaction, the Secretary should take certain factors into account. Two of the listed factors most applicable to this case study are "the character of the business reinsured" and the "relative tax positions of the parties involved."

The "character of the business reinsured" refers to the duration of the reserves transferred. Duration of the reserves transferred is important in an analysis of tax savings because a premium that can be invested over a period of many years before a claim is paid. Long-term investments have the potential to earn significantly more taxable income than premium shorter-term investments. Reserves that are being reinsured to Bermuda today are considered long term or "long-tail" reserves.


53. Conference Agreement, at 316. The Conference Report also states that any transaction within the scope of the unrelated party rule is within the scope of the related party rule. See Priv. Ltr. Rul., supra note 41.


55. These factors include; 1) the duration or age of the business reinsured; 2) the character of the business reinsured; 3) the structure for determining the potential profits of each of the parties; 4) the duration of the reinsurance agreement between the parties; 5) the parties' rights to terminate the reinsurance agreement and the consequences of a termination; 6) the relative tax positions or tax brackets of the parties; and 7) the general financial situations of the parties. Id. at 317-18.

56. Id.

57. Id.

58. In 1942, when the excise tax (I.R.C. §4371 one-percent excise tax placed upon premiums reserved offshore) was added to the code, reserves that could be invested for
The existence of "long-tail" reserves supports a finding by the Secretary of a tax avoidance effect according to the legislative history.59

A second characteristic that can signal a significant tax avoidance effect, according to the legislative history, is the disparate "relative tax positions of the parties involved." Bermuda reinsurers pay no taxes on the income they derive from the premiums they reinsure. Thus the Bermuda parent's tax position relative to their domestic affiliate is extremely beneficial.60 This supports the finding by the Secretary of a significant tax avoidance effect under 845(b) as well. However, a recent Tax Court decision has limited the applicability of section

longer than three years (long-tail business) were almost non-existent. "Thirty years ago there wasn't enough long-tail business for this ('loophole') to work." Robert Marzocchi, Chief Tax Executive at Chubb, as quoted in Almeras & Donmoyer, supra note 4. "The estimated advantage of reinsuring to Bermuda is 9 percent for break-even business with a 5-year tail and an arm's length ceding commission", argues Nancy Johnson, a sponsor of the bill proposed last year to close the 'loophole'. Rep. Nancy Johnson, R- Conn., Johnson Release on Bermuda "Loophole", 2000 TAX NOTES TODAY 54-100 (March 20, 2000), available in LEXIS 2000 TNT 54-100. The domestic and Bermuda insurers disagree on what the ability to avoid taxation on investment premiums means in net dollars to the insurance companies. Those who are fighting to have the 'loophole' closed, claim that reinsuring business in Bermuda tax-free "would boost a United States insurer's after-tax earnings by $11.37 on a $100 premium." Marzocchi et al., at 1388. The Bermuda-based insurers are, not surprisingly, much more conservative in their estimates of tax savings. Bermuda companies admit to an advantage, but claim that the domestic insurers are basing their estimates on faulty assumptions. Bermuda insurers claim the actual advantage is $.05 net saved on the same $100 premium. Tax Analysis prepared by the law firm of Vinson & Elkins, Washington as cited in Douglas McLeod, U.S. Treasury May Study Tax Claims; Bermuda Companies Say Advantages Are Exaggerated by Rivals, BUS. INS., (Nov. 13, 2000), available in LEXIS. A Standard and Poor's commentator suggested that the advantage of tax-free investment income is diminished when the reinsurance market is poor as it is today.

In a lagging market environment, the one-percent excise tax becomes more significant: "If you are underwriting at a loss, you are going to pay a heck of a lot more (being taxed at a flat rate) on a premium basis than you would on an income basis . . . (efforts to close the 'loophole') are clearly competition trying to limit competition." Donald S. Watson of Standard and Poor's Ins. Rating Serv. as quoted in Dan Lonkevich, Bermuda Tax 'Loophole' Battle Lines Drawn, National Underwriter Property and Casualty Risk & Benefits Management. At (April 10, 2000) available in LEXIS.

59. "Coinsurance of yearly renewable life insurance will generally not have significant tax avoidance effect for the parties to the transaction because it does not involve the transfer of long-term reserves as under the coinsurance of ordinary life insurance." Conference Agreement, at 317.

60. Id. at 318. "The essential tax benefit or avoidance effect from a reinsurance transaction arises because income and deductions will have differing economic value depending on the tax bracket of the insurance company." Conference Agreement at 1064.

61. "In the United States these earnings are subject to the 35 percent corporate income tax and about 5 percent in state taxes." Johnston & Treaster, supra note 4, at A1.
845(b) to prevent tax evasion.

3. Section 845 is limited by the Tax Court

In Trans City Life Insurance Company v. Commissioner, the taxpayer assumed liability on insurance policies through a retrocession agreement with an unrelated party, Guardian Life. By virtue of this reinsurance agreement, Trans City qualified itself for tax benefits under section 806 "Small life insurance company deduction." The IRS determined that the transaction between Guardian Life and Trans City Life had a significant tax avoidance effect within the meaning of section 845(b), because the risks transferred to Trans City Life were not commensurate with the tax benefits derived by Trans City Life. The IRS denied Trans City Life the deduction it had claimed pursuant to section 806, and assessed a deficiency that was subsequently reversed by The Tax Court.

Relying on the legislative history to section 845 as well as the National Association of Insurance Commission's (NAIC) Model Regulation of 1985, the Tax Court reversed the IRS's determination because the court found that legitimate risks were in fact transferred between the parties to the agreement. The 1985 NAIC Model Regulation states that a ceding company cannot receive credit, liberating legally required reserves, if genuine risk is not transferred from the ceding company. The

**References**

62. Trans City Life Ins. Co. v. Comm'r, 106 T.C. No. 15 (1996). The transaction of reinsurance to a further reinsurer, is called "retrocession" and the second reinsurer is called a "retrocessionaire." JERRY, supra note 6, at 898.

63. Trans City Life Ins. Co. 106 T.C. No. at 278.

64. Id. at 276.

65. The Tax Court was disturbed that despite Congressional suggestion that the Treasury issue regulations pursuant to I.R.C. § 845, the Treasury had not done so at the time of the decision. CITE (Regulations are yet to be issued.) In light of this fact, and probably due to an argument by the taxpayer that section 845 absent regulations was an unconstitutionally vague statute, the Tax Court limited section 845's application. The Tax Court reversed the IRS's determination despite acknowledging the deferential "arbitrary and capricious" standard of review, which allows a court to overturn the Commissioner's determination under section 845 only if the determination is found to be "arbitrary, capricious or without sound basis in fact." Id. at 303-4. Scholars have argued that against Congressional intent, the courts have not consistently applied a deferential standard that should be afforded to the Commissioner's determinations in preventing tax evasion. See Francis M. Allegra, Section 482: Mapping the Contours of the Abuse of Discretion Standard of Judicial Review, 13 Va. Tax Rev. 423 (1994).


67. Id. at 309.
court used the NAIC's approval of Trans City's transaction as evidence that genuine risk was transferred. "The NAIC was concerned that affording reinsurance treatment for regulatory purposes absent a meaningful transfer of risk did not fairly represent the financial condition of the parties to the reinsurance agreement." Bermudas companies can assert that real risk is transferred, as supported by the credit to the legally required reserves granted by the NAIC to the domestic affiliate upon the reinsurance of a premium to Bermuda.

The court reached its determination by applying the seven factors (cited above, note 54) outlined in the legislative history as well as an eighth, over-arching factor that the court itself derived from the legislative history. The factor the Tax Court derived and subsequently based its decision on was the "risk transferred versus the tax benefits derived by the taxpayer." In respondent's (IRS's) view, petitioner assumed minimal risk, as reflected in the size of the risk fees, while enjoying disproportionate tax benefits. We reject respondent's position of the proper measure of risk. A more appropriate standard is to compare the tax benefits (in this case, petitioner's tax savings from the small life insurance company deduction) to petitioner's exposure to loss under the Agreements, measuring the latter based on the difference between the face amount of the reinsured policies and the amount of reserves backing those policies. By that reckoning, the insurance risk incurred by petitioner was not disproportionate to the tax benefits.

The decision stands as precedent that a market-priced reinsurance agreement, like the Bermuda agreements that are the subject of this case study, will not be particularly vulnerable to attack under section 845.

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68. Id. at 310.
69. See generally Harkavy, supra note 11. Through reinsurance to the Bermuda parent, the domestic affiliate frees up reserves legally required to be maintained by the NAIC. Sheppard, supra note 13, at 1664.
70. Trans City Life Ins. Co. 106 T.C. No. at 308-10.
71. Id. at 309.
72. Sheppard, supra note 13, at 1665.
The IRS refused to acquiesce to the Tax Court’s decision.\textsuperscript{73} The Service claimed that the appropriate standard to determine the risk transferred between parties to a reinsurance agreement is the practicable probability that a reinsurer will have to pay a claim and not the mere possibility that the reinsurer will have to pay a claim.\textsuperscript{74} However, with \textit{Trans City} as precedent the IRS will have difficulty in enforcing its determinations under section 845 against a taxpayer’s challenge.

\textit{D. Section 482}

Section 482 affords the Secretary the power:

To distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, (owned and controlled directly or indirectly by the same interests) if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.\textsuperscript{75}

Two factors must exist to sustain an allocation under section 482: 1) commonly controlled companies; and 2) the earning of income

\textsuperscript{73} “Non-acquiescence: An administrative agency’s policy of declining to be bound by judicial precedent which is contrary to the agency’s interpretation of its organic statute, until the Supreme Court has ruled on the issue,” \textit{BLACK’S LAW DICTIONARY}, \textit{supra} note 3, at 729. The IRS reasoned that if the possibility of loss is remote to the reinsurer, no real risk has been transferred. The court ruled that if there was a possibility of loss, and the NAIC concurred that risk was transferred, then risk should be considered transferred for tax purposes. “The Service disagrees with the court’s definition of ‘risk,’ in the overriding economic substance test of section 845(b), in terms of the amount of risk, or the possibility of loss, rather than the amount at risk, or the probability of loss.” Action on Decision CC-1997-011 at 2.

\textsuperscript{74} \textit{BLACK’S LAW DICTIONARY}, \textit{supra} note 3, at 729.

\textsuperscript{75} In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. I.R.C. § 482 (2001).
by one or more of these companies which, without the Commissioner's reallocation, would not be adequately reflected in income that would otherwise be taxable under the Internal Revenue Code.\textsuperscript{76}

Reinsurance of premiums to Bermuda involves a transaction between commonly controlled companies which allows a domestic affiliated company to transfer capital reserves to its parent company resulting in tax-free income. Despite the apparent applicability, the Treasury has not taken a position on whether section 482 is an adequate solution to the problem presented in this case study.\textsuperscript{77}

Many analysts believe that section 482 is not applicable to the tax evasion effectuated by these Bermuda reinsurance transactions.\textsuperscript{78} This is because a showing by the related companies that they have dealt "at arm's length" affords a "presumption of correctness" in the taxpayer's calculation of taxable income.\textsuperscript{79} The Bermuda parents generally deal "at arm's length" by charging market rates to their domestic affiliates for reinsurance policies.\textsuperscript{80} Further, a showing that the Bermuda companies had a legitimate business purpose in reinsuring premiums to Bermuda may nullify the Commissioner's

\begin{itemize}
\item \textsuperscript{76} Local Fin. Corp. v. Comm'r, 407 F2d 629 (1969); see also B. Forman Co. v. Comm'r 453 F2d 1144 (1972).
\item \textsuperscript{77} Deputy Treasury International Tax Counsel Patricia Brown stated "...more study is needed to determine whether legislation is needed and whether section 482 is an adequate solution for the problem." quoted in Moses, supra note 36.
\item \textsuperscript{78} See e.g. Robert Marzocchi, Chubb Spokesman, Attorney Follows Up on Insurance Taxation Meeting 2000 Tax Analysts 189-35, June 28, 2000 available in LEXIS; Shepherd, supra note 13.
\item \textsuperscript{79} Lufkin Foundry & Machine Co. v. Comm'r 468 F.2d 805 (1972).
\item \textsuperscript{80} Sheppard, supra note 13, at 1664.
\end{itemize}
determination of a deficiency in tax paid.\textsuperscript{81} As discussed above, insurance companies enjoy significant regulatory advantages by issuing reinsurance in Bermuda.\textsuperscript{82}

The Commissioner, using a Section 482 remedy termed "transfer pricing," often addresses tax avoidance using offshore-related entities.\textsuperscript{83} A common example of transfer pricing is a U.S. controlled company that shifts income derived from a valuable intangible (such as a patent) offshore to a foreign-based subsidiary, charging below market rates for the sale of the intangible to the offshore affiliate.\textsuperscript{84} As a result, the company shelters income from taxation when the offshore affiliate subsequently earns tax-free or minimally taxed income flowing from the intangible asset. Analytically, this scenario is similar to the subject of this case study because a source of income is being transferred offshore to a related company in a zero tax jurisdiction. However, this example is different from transferring insurance reserves to Bermuda through related party reinsurance because the domestic affiliates of Bermuda companies charge market rates. Further, insurance is not like a patent because: 1) there is a contractual obligation to indemnify the reinsured in case of loss (a bargained-for possibility that the asset transferred offshore will be disbursed); and 2) profits are made on these reserves through investing capital not through licenses to an intangible asset.\textsuperscript{85}

\begin{itemize}
\item \textsuperscript{81} "Reallocation was unwarranted where, although facts justified government's critical analysis of transactions of family controlled corporations, there were sound business reasons for transactions and to hold otherwise would have been to substitute government's business judgment for that of the corporation." Braun Co. v. Comm'r, 396 F.2d 264, 268 (1968).
\item \textsuperscript{82} See also Sheppard, supra note 13, at 1664. "One of the big advantages of Bermuda regulation is that it takes no time to get the regulators to approve new products." Id.
\item \textsuperscript{83} See generally Allegra, supra note 65.
\item \textsuperscript{84} See generally Allegra, supra note 65.
\item \textsuperscript{85} Section 482 requires a U.S. insurer to deal with a related foreign reinsurer at arm's length. We have suggested that this mandate has been read to refer to price, not to require related parties to behave in all respects as if they were unrelated. This would mean that the U.S. company either would pay a lower price for reinsurance form the affiliate or would be deemed to receive some kind of payment in return for services, intangibles, or other value that it conveyed to the affiliate. Yet there do not seem to be any identifiable intangibles here and we are mindful of the fact that in United States Steel, the Second Circuit cautioned against grafting a "crippling degree of economic
Section 482 could be applied to these reinsurance transactions if the Bermuda company is shown to be a "shell corporation." \(^{86}\) "As a transfer pricing matter, (the Treasury) sees no reason to respect a transaction in which a U.S. company reorganized to Bermuda, if the company still functioned the way it did before the inversion, carrying out most functions in the United States." \(^{87}\) However, Treasury studies show that some existing Bermuda insurance companies have only a handful of employees in Bermuda while others have most of their employees there. \(^{88}\)

**E. Temporary Regulations**

Former Secretary of the Treasury Lawrence Summers believes that the rapid growth of corporate tax shelters is "the most serious compliance issue threatening the American tax system." \(^{89}\) Summers estimates that corporate tax shelters cost the Treasury at least $10 billion dollars a year. \(^{90}\) In order to ameliorate the growing proliferation of corporate tax shelters, the Treasury has issued temporary regulations that require more extensive disclosure by investors and promoters of certain types of tax shelters. \(^{91}\)

\[^{86}\] "One hundred per cent of net income of five foreign sales corporations was properly allocated to domestic parent corporation where foreign corporations did not engage in substantial business activities, did not deduct wages or salaries, and virtually did nothing at all to earn income reported." Phillip Bros. Chemicals, Inc. v. Comm'r 435 F.2d 53, 70 (1970).

\[^{87}\] Patricia Brown, Dep't Treas. Int'l Tax Counsel (Treaty Affairs), quoted in Moses, supra note 36.

\[^{88}\] Patricia Brown, Dep't Treas. Int'l Tax Counsel (Treaty Affairs), quoted in Moses, supra note 36. "[I]t does not require a lot of people to write reinsurance; rather, it takes a handful of very sophisticated people... One reinsurer is reputed to have a mere seven people, but that is all it takes to do the work." Sheppard, supra note 13, at 1665.

\[^{89}\] Christopher Bergin, Corporate Shelters are Serious Threat to System, Summers Says 2000 TAX NOTES TODAY 40-1 (Feb. 29, 2000) available in LEXIS 2000 TNT 40-1.

\[^{90}\] Id.

\[^{91}\] The Internal Revenue Code already required registration of any potentially abusive tax shelter. See I.R.C. § 6111 (2001). The regulations strengthen and broaden the scope of the existing law. The first set of regulations require tax shelter promoters to
The temporary regulations intend to provide the IRS with early notification of "large corporate transactions with characteristics that may be indicative of tax shelter activity." The temporary regulations define two categories of transactions that have to be reported with an investor and promoter's income tax return.

The first category of "reportable transaction" includes arrangements described in a concurrently published list of tax shelters. Two transactions on this list that include offshore components are: 1) transactions in which the reasonably expected economic profit is insubstantial in comparison to the value of the expected foreign tax credits; and 2) transactions in which contingent installment sales of securities accelerate and allocate income to a tax-indifferent partner, and allocate later losses to another partner.

The reinsurance transactions that are the focus of this article are not subject to a foreign withholding tax in Bermuda. Although tax credits are not an issue, these reinsurance transactions are designed to "exploit inconsistencies between U.S. and foreign tax laws" which may qualify them as a "reportable" transaction under the temporary regulations.

register with the IRS transactions: 1) that have been structured for a significant purpose of tax avoidance or evasion; 2) that are offered to corporate participants under conditions of confidentiality; and 3) for which the tax shelter promoters may receive fees in excess of $100,000. (A promoter is "one who promotes, urges on, encourages, incites, advances, etc. One promoting a plan by which it is hoped to insure the success of a business, entertainment, etc. venture." BLACK'S LAW DICTIONARY, supra note 3, at 844.) The second set of regulations, issued pursuant to section 6112 of the code, requires promoters of corporate tax shelters to keep lists of investors and deliver these materials for inspection by the IRS upon request. The third set requires corporate taxpayers to disclose their participation in certain "reportable transactions" by attaching a short statement to their income tax returns. The temporary regulations also established the Office of Tax Shelter Analysis to examines transactions that are reported to the IRS under the new regulations. IRS Announces Disclosure Requirements for Corporate Tax Shelters, 2000 Tax Notes Today 40-13, (Feb. 29 2000) available in LEXIS 2000 TNT 40-13; 65 Fed. Reg. 11205 (Mar. 2, 2000).

93. Id.
94. Id. The first category is limited to transactions where Federal income taxes are reduced through use of a shelter by more than $1 million in any single taxable year or by a total of more than $2 million for any combination of years. The list is published at 2000-1 C.B. 826.
95. Notice 98-5, 1998-1 C.B. 334
96. Transactions involving foreign tax credits: generally are structured to yield little or no economic profit relative to the expected U.S. tax benefits, and typically involve either 1) the
These reinsurance transactions do not involve installment sales contracts.

The second category of "reportable transaction" also requires registration with the Treasury where the taxpayer's sheltering arrangements comport with two or more characteristics on a given list. The two listed characteristics most applicable to the Bermuda reinsurance plan are items (E) and (F) on the list.

(E) The transaction involves participation of a person that the taxpayer knows or has reason to know is in a Federal income tax position that differs from that of the taxpayer (such as a tax exempt entity or foreign person), and the taxpayer knows or has reason to know that such a difference in tax position has permitted the transaction to be structured on terms that are intended to provide the taxpayer with more favorable income tax treatment than it could have obtained without the participation of such person.

(F) The expected characterization of any significant aspect of the transaction for Federal income tax purposes differs from the expected characterization of such aspect of the transaction for purposes of taxation of any party to the transaction in another country.

Both (E) and (F) seem to apply. This suggests that the domestic affiliate should register with the IRS the Bermuda reinsurance scheme. (E) probably applies to the domestic affiliate, because the domestic affiliate knows that the Bermuda parent is in a more advantageous Federal income tax position and that the reinsurance transaction will provide the company, as a whole, more favorable tax treatment. (F) probably applies because the income tax consequences are significantly different on earnings derived from premiums that would be invested domestically.
compared with the no income taxes that are assessed on the investment income in Bermuda.

However, a transaction that has at least two of the foregoing characteristics is not a reportable transaction if any of the following conditions is satisfied (A) the taxpayer has participated in the transaction in the ordinary course of its business in a form consistent with the customary commercial practice, and the taxpayer reasonably determines that it would have participated in the same transaction on substantially the same terms irrespective of the expected Federal income tax benefits; (B) the taxpayer has participated in the transaction in the ordinary course of business in a form consistent with customary commercial practice, and the taxpayer reasonably determines that there is a long-standing and generally accepted understanding that the expected Federal income tax benefits from the transaction are allowable under the Code for substantially similar transactions.99

Exception (A) may apply because, as discussed previously, the Bermuda reinsurers generally perform their reinsurance transactions in conformity with customary commercial practice and for a business purpose other than tax avoidance. Exception (B), a reinsurer may argue, applies because none of these reinsurance transactions, (that conform to market norms, thus excluding UPS) have been successfully attacked by the IRS. However, exception (B) requires that the taxpayer "reasonably determine a long-standing and generally accepted understanding that the expected tax benefits are allowable." This standard will be more difficult to prove for the Bermuda reinsurer. This is because it may be difficult to prove that it is "generally accepted" that the tax avoidance effectuated by reinsurance to Bermuda is allowable when there is much controversy over the legitimacy of these transactions.100

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99. Id.
100. The temporary regulations addressing corporate tax shelter disclosure, registration, and investor listing may be revised to address taxpayer concerns before being finalized this year. IRS acting chief counsel Richard W. Skillman noted that some of the most vehement criticism has come over the standard used by exception (B). He
IV. TAX HAVENS

The year 2000 witnessed unprecedented criticism of tax havens leveled by multinational organizations and high-tax jurisdictions. The criticism centered on three topics: 1) a steep rise in funds being transferred to tax havens and the corresponding loss of revenue to high tax jurisdictions; 2) banking secrecy that obscures evidence of tax evasion and money laundering; and 3) concern that the massive amount of capital being deposited offshore will lead to an increase in instability in the world’s financial system. This article focuses on the first listed concern, the transfer of growing amounts of capital from high tax to low tax jurisdictions and the corresponding loss of revenue to the transferee jurisdictions.

In June 2000, the OECD issued its report on harmful tax competition and practices. The report has four main parts.

101. The term “tax haven” refers to a tax jurisdiction with a) no or only nominal effective tax rates; b) lack of effective exchange of information; c) lack of transparency; and d) absence of a requirement of substantial activities. OECD Tax: Harmful Tax Practices, supra note 2; Steven Sieker, Offshore Financial Centers and ‘Harmful Tax Competition’: The Developments, 22 Tax Notes INT’L 557 (Jan. 29, 2001), available in LEXIS 2001 WTD 19-22.

The OECD is an organization of 30 countries that “share the principals of the market economy, pluralist democracy and respect for human rights.” The original 20 members are Western European countries, the United States and Canada. Today Japan, countries in Eastern Europe, Australia, and New Zealand are members. See OECD Online: Membership, at http://webnet1.oecd.org/oecd/pages/home/displaygeneral/0,3380,EN-countryslist-0-nodirectorate-no-no-159-0,00.html (last visited October 4, 2001). “So called tax havens accounted for 1.2 percent of the world population and 3 percent of the world GDP, but 28 percent of the assets and 31 percent of the net profits of American multinationals, though only 4.3 percent of their workers.” James Hines & Eric Rice, Fiscal Paradise: Foreign Tax Havens and American Business, Economist, Jan. 29, 2000 at 13.

102. A U.S. District Court Judge for the Southern District of Florida has recently issued an order granting the IRS permission to serve American Express and MasterCard with summonses that seek information about credit and debit card accounts held by customers with offshore accounts. See John Hembera, U.S., IRS Targets AMEX, Mastercard in Offshore Fishing Expedition, 2000 WTD 210-10 (Oct. 30, 2000), available in LEXIS 2000 WTD 210-10.

103. Steven Sieker, supra note 101, at 557.

104. The report was in preparation for many years. Sieker, supra note 101, at 567. Globalization has had positive effects on the development of tax systems and has encouraged countries to engage in base
The first part identifies harmful tax practices among OECD member countries and sets a deadline by which these member countries must change certain practices to avoid sanction. The second part identifies and lists harmful tax haven jurisdictions. The third part is an attempt to include non-OECD members in the effort to combat tax havens and the fourth part encourages OECD members to adopt certain practices with respect to uncooperative tax havens.

The OECD's list of harmful tax havens was intended to be a warning to the identified countries. A new list is to be drafted in July of 2001 for the purposes of sanctions termed by the OECD as "coordinated defensive measures." Bermuda and five other jurisdictions escaped "blacklisting" by signing advanced letters of commitment whereby they pledged to remove the tax practices deemed to be harmful in their respective jurisdictions.

The OECD report on harmful tax practices has met with widespread criticism, including from within the OECD itself. The OECD's Business Investment and Advisory Committee (BIAC) asserts that tax competition between nations is positive because it encourages governments to be efficient. Further, the BIAC states that if adopted, OECD sanctions "would create a cartel-like atmosphere that would be in clear conflict with the broadening and reducing tax reforms. However it has also created an environment in which tax havens thrive and which governments may be induced to adopt harmful preferential tax regimes to attract mobile activities."

Organization for Economic Co-operation and Development Committee on Fiscal Affairs, HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE, OECD's Committee on Fiscal Affairs (1998).

105. Sieker, supra note 101 at, 563.
106. Id.
107. Id. The OECD's list of tax havens contains roughly 30 countries and territories, including a number of Bermuda's Caribbean neighbors. Measures that OECD members were encouraged to adopt with regard to uncooperative tax havens include; the disallowance of deductions, exemptions, and credits related to transactions with uncooperative tax havens; the enhancement of audit and enforcement activities with respect to uncooperative tax havens; and the imposition of transactional charges on certain transactions involving uncooperative tax havens. Id at 563-64.
108. Sieker, supra note 101, at 563.
110. Sieker, supra note 101 at, 569.
concept of free trade and investment across national frontiers.”

Independent analysts are similarly critical of the OECD’s proposed action to block any sanctions issued in connection with the OECD report. The BIAC noted that OECD members Switzerland and Luxembourg abstained from participating in the report because of similar practices affording bank secrecy and tax shelters to foreign investors. Furthermore, critics note that the United States and the United Kingdom, both members of the OECD, serve as significant “tax havens” for foreign investors.

Finally, criticism of the OECD report has come from Republicans in the United States Congress and from the George W. Bush administration. Conservatives feel that high taxation is an impediment to financial growth and an evil to be avoided.

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112. The OECD is essentially a cartel consisting of the world’s richest countries, most of which are high-tax jurisdictions ... most OECD member states are guilty of egregious unfair tax competition that is much more serious and harmful than that of which the OECD is complaining. These activities have been conveniently ignored in the OECD’s self assessment of harmful activities by its own members.” Id. The Caribbean Community (CARICOM) is considering taking legal action through the World Trade Organization. Sieker, supra note 101 at 568.

113. See e.g. Langer, supra note 111 at 2835.

114. It does not surprise anyone when I tell them that the most important tax haven in the world is an island. They are surprised, however, when I tell them that the name of that island is Manhattan. Moreover, the second most important tax haven in the world is located on an island. It is a city called London in the United Kingdom.... Hundreds of billions of dollars of tax-free, interest-bearing bank deposits are held in U.S. banks by nonresident aliens and foreign corporations. Except for residents of Canada, the amount of interest paid is not even supposed to be reported to the IRS. Langer, supra note 111, at 2835.

115. See Letter from Dick Armey, Maj. Leader, U.S. House of Representatives to Treasury Secretary Larry Summers (Sept. 7, 2000) reported in Sieker, supra note 100. Armey argues that the OECD’s sanctions are draconian, and impinge on the Sovereignty of the subject nations; “I believe it is contrary to American economic interests to restrict tax competition.” Sen. Don Nickles, as quoted in George Fields, Offshore Offensive In Doubt: Republicans Raise Policy Questions, MIAMI HERALD, Feb. 23, 2001, at C3. “I guess I would take a pass at the moment on whether or not we as an independent entity want to be strictly allied with what the OECD has said.” Id. (quoting Treasury Secretary Paul O’Neill).

116. Sieker, supra note 101 at 570.
Further, they hold the view that taxes are a cost of doing business, and like most other costs, one that should be reduced whenever possible.\textsuperscript{117}

The OECD defends its list by arguing that being a low tax jurisdiction alone will not invite sanction. "In order for low or only nominal taxes to be harmful, the low or nominal tax rate must be accompanied by one of the criteria of no effective exchange of information, lack of transparency or no substantial activities."\textsuperscript{118} The OECD claims that their aim is preventing noncompliance with tax laws, or "to put it in the vernacular, it is directed against 'tax cheats'."\textsuperscript{9}

V. CONCLUSION

The Bermuda loophole will probably remain in place because the reinsurance transactions have elements of economic substance, and legitimate business purpose, and probably "the cure is worse than the problem."\textsuperscript{119} Moreover, even if the Treasury or Congress closes the loophole with respect to Bermuda, the reinsurance business would shift to other tax efficient jurisdictions such as Switzerland and Ireland.\textsuperscript{120}

Essentially, the debate surrounding harmful tax havens and international tax competition "centers on the perceptions of the proper role of government."\textsuperscript{121} "The very notion of 'harmful' tax competition is predicated, to some extent, on the supposition that the government is entitled to impose high taxes and that it is inappropriate, immoral, or illegal for taxpayers to avoid those

\textsuperscript{117} Id.
\textsuperscript{119} OECD's response to House Ways and Means Member Sam Johnston, R-Texas, as quoted in; Summaries of Today's Important Tax Items, 2001 TAX NOTES TODAY 42-H, (March 2, 2001), available in LEXIS 2001 TNT 42-H.
\textsuperscript{120} "The only way to solve the problem is to restrict trade to a point that government can't tolerate." Donald Watson of Standard and Poor's Insurance Rating Service as quoted in Dan Lonkevich, supra note 58.
\textsuperscript{121} Id.
\textsuperscript{122} Sieker, supra note 101, at 570. "It is no coincidence perhaps that these international developments achieved critical momentum when countries such as the United States, Canada, England, and others in Europe were led by left-leaning governments" when the OECD issued its report concerning harmful tax competition. Id. See also George Guttman, Is the United States Picking on Bermuda? 86 TAX NOTES 1669, 1671 (Mar. 20, 2000). "The Clinton administration has proposed blacklisting tax havens that don't come into line." Id.
Members of the Bush Treasury have vowed to pursue the Clinton administration’s efforts to police tax evasion through continued enforcement of the temporary regulations. However, the Bush Treasury has determined to “wait to see how the regulations work for a year” before finalizing them.

If widespread use of tax shelters is permitted to continue, more and more companies will be forced to participate in tax sheltering activities or suffer a competitive disadvantage in the marketplace. Moreover, the position that the Bush administration takes on tax shelters could have profound effects on the economies of several offshore jurisdictions, including Bermuda. The global economy will continue to be shaped by the debate over whether it is proper to allow tax shelters in “tax haven” jurisdictions to sap the tax base of the world’s more powerful nations. Conversely, questions persist concerning whether it is just and legal for more powerful nations to dictate the tax law and policy of other sovereign jurisdictions.

Ben Seessel

123. Sieker, supra note 101 at, 570. See, e.g., Ulrich Beck, What is Globalization 4-5 (Patrick Camiller trans., 2000). Beck argues that the economic elite can decide for themselves where they want to invest, live, domicile their businesses, and pay taxes. He terms these fortunate people “virtual taxpayers.” Beck believes that the ability to decide one’s tax jurisdiction is eroding the modern nation in favor of the transnational corporation. Moreover, Beck argues that multi-national corporations benefit extensively from the infrastructure that the nation states provide, yet refuse to support them with their tax dollars. He claims that “virtual taxpayers” undermine the “democratic public good of which they take advantage” through their “legal yet illegitimate” avoidance of taxation.

124. See, e.g., “Senate Confirms Weinberger by Voice Vote.” Summaries of Today’s Important Tax Items, supra note 100 (case changed). Mark Weinberger was appointed by Bush as assistant Secretary of the Treasury for tax policy. Weinberger assured the Senate in confirmation hearings that he “would follow through on Clinton administration efforts to combat abusive corporate tax shelters.”

125. “One Year Later, Corporate Shelter Regs Still Controversial.” Summaries of Today’s Important Tax Items, supra note 100.

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