

# ACCOUNTING FOR THE MISSING MILLIONS: THE CASE OF TAX HAVENS

(with special reference to Bermuda)

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The problem of identification and classification of off-shore financial flows and extra-territorial funds is discussed with special reference to the case of the "captive" insurance market in Bermuda. The problem is examined in the context of the UN SNA definitions relating to the evaluation of insurance activities and the difficulty of gaining access to relevant and complete data. The conclusion is reached that the conduct of off-shore financial operations by local institutions and the resulting surpluses generated remain essentially extranational and thus contribute very little to the domestic value added of the tax haven concerned. Furthermore, by its very nature, information relating to the transactors involved, as well as the value of their transactions, is difficult to obtain. This raises a much wider issue, however, as to whether such surpluses are ever identified in any country's national income estimates.

## 1. INTRODUCTION

To set the context of the specific problem considered in this paper there is presented first a brief description of the Bermuda economy. This is followed by a more detailed survey of the country's "international" sector, particularly as it relates to insurance management activities. The contribution of the insurance sector to the economy is examined, firstly, in the light of the UN SNA standard definitions with respect to the computation of the value added produced by the insurance industry and, secondly, in relation to what is seen to be the actual economic impact of the sector in practice. The final section of the paper suggests possible alternative national accounts treatments of the substantial magnitudes involved, and indicates to which area these sums should probably be attributed. What seems quite clear, however, is that it is inappropriate to allocate the net income concerned to the domestic product of the country of local residence of the corporate entity from which such "off-shore" activities are managed.

### 1.1 *The Economy of Bermuda*

Bermuda is a British Colony comprising a string of small islands no more than 15 miles long and 21 square miles in area. It is situated in the Northern Atlantic about 750 miles south of New York and 850 miles due east of the coast of South Carolina. It has a population of about 55,000 people of mixed racial groups who are split (roughly speaking) half and half between black and white. On this basis, the estimated GDP at factor cost of some \$350 million<sup>1</sup> in 1975<sup>2</sup>

<sup>1</sup> 1 Bermuda dollar—1 U.S. dollar.

<sup>2</sup> Author's estimate. Ministry of Finance Report; "The Structure of the Bermuda Economy", April 1977.

yields a fairly high annual *per capita* income of over \$6,500. This income level, although by no means evenly distributed, is sufficient (when combined with a comparatively high level of employment) to ensure a very reasonable standard of living for the vast majority of the country's inhabitants. The economy is mainly dependent on tourism which directly contributes a gross value of \$166 million in the form of hotel, food, tourist goods, transportation, etc., receipts. Although there is a very high import leakage element, tourist income comprises about 25 percent of the GDP. Tourism is also estimated to generate roughly an additional \$1 induced value added in the economy for each and every direct \$1 spent by visitors.<sup>3</sup>

## 1.2 *Estimate of GDP*

In the calculation of this estimate of GDP, apart from the domestic labour compensation payments and other direct local cost items, the value of the financial operations of Bermuda based international management insurance firms and other "exempt" foreign companies has been excluded. Conceivably, these activities could have been included in GDP, requiring that the respective GNP estimates should be appropriately adjusted for an imputed "capital factor income" payment, but it was felt that this procedure would have been more misleading than the one actually adopted.

## 2. CORPORATE STRUCTURE IN BERMUDA

### 2.1 *International Companies*

The term "International Companies" is very loosely applied in Bermuda to describe a population of legal entities with a foreign business focus. These companies constitute a significant sector of the island's economic structure (mainly in terms of their number and influence) but they do not necessarily make any important direct contribution to the economy itself. Such international companies fall into two broad categories: (1) exempted companies; and (2) non-resident corporate bodies. The two basic essential common characteristics which distinguish them from other types of business are, firstly, that they mainly carry on operations outside Bermuda; and, secondly, that their primary motivation is to take advantage of Bermuda's favourable tax conditions. Companies falling into the "exempt" category are constituted from within the island; while the other non-residents, being already constituted abroad, gain special entry into the island only by permit.<sup>4</sup>

### 2.2 *Exempted Companies*

An exempt company is incorporated in Bermuda but under its Memorandum of Association of Incorporation it is declared to be "exempted" from the requirements of:

<sup>3</sup>B. Archer and S. Wanhill, "The Impact of the Tourist Dollar in Bermuda", Report for the Department of Tourism, 1976.

<sup>4</sup>Economic Census of Bermuda, 1970.

- (i) registering the nationality or occupation of any of its shareholders;
- (ii) registering the transferees of any shares of the company;
- (iii) declaring the amount paid for any such shares.

Such companies may obtain, by application to the Minister of Finance, exemption from any possible future income tax, profit or capital gains tax for the period up to 1996.

The corporate entity may not own or take mortgages on land in Bermuda and it can do business in Bermuda only in furtherance of extra-territorial business affairs, i.e. the firms are effectively domestic transactors in foreign business who are engaged primarily in "off-shore" economic transactions unrelated to the state of the Bermuda economy.

The important point about exempted companies is that they are incorporated under Bermuda law to operate *outside* Bermuda from a principal place of business *within* Bermuda.

### 2.3. *Non-Resident Corporate Bodies*

These are companies incorporated abroad which acquire restricted residential status in Bermuda under the Immigration and Protection Act, 1966. They cannot engage in nor carry on any trade or business in the island except under the specific authority of a permit granted by the Minister of Immigration and Labour. The permit may be limited in duration to a specified time and it may be subject to certain conditions and limitations.

The significant feature of non-resident corporate bodies is that they are incorporated *outside* Bermuda but they actually operate *within* Bermuda under special permit whilst transacting the bulk of their business outside the country. They must have a principal place of business in Bermuda and they are required to have a resident manager and an identifiable physical location of operation. These enterprises which include the international airlines, shipping companies, certain international hotels, etc. are effectively branches of international companies and they may be treated as such in the national accounts.

There is also a special group of companies known as "non-resident insurance undertakings", which are covered by the term international companies. Unlike "non-resident corporate bodies" they can conduct insurance business from a place in Bermuda as principals to local insurance companies.

Other non-resident proprietorships or partnerships, such as the external branches of standard insurance businesses selling insurance to the Bermuda public, may also operate through agents or brokers in Bermuda.

### 2.4. *Local Companies*

In principle, local companies are defined as those where 60 percent of the shareholding is held by residents of Bermuda. But some companies possess a special licence, issued by the Ministry of Finance, which allows them to operate in Bermuda as local companies even though they do not meet the local shareholding percentage requirements. Such companies are effectively foreign owned as well as controlled enterprises. For the purposes of the national accounts, these

“licensed” establishments should be treated as subsidiaries of foreign companies.

In Bermuda the term “international business” is normally used to refer only to exempted business undertakings and “permit” companies (i.e. non-resident corporate bodies) including trusts.

### *2.5. Number of International Companies*

In his latest Annual Budget Speech the Minister of Finance reported that, at the beginning of 1977, there were some 3,630 officially registered companies classified as “exempt” in Bermuda. Only a month earlier, however, the number was alleged to be 3,136 indicating that there is either a rapid growth in this class of business or that “registration” (or, specifically, the payment of a registration fee) is not an accurate or appropriate guide in this context. It means, however, that a large number of Bermuda based companies are free to deal in transactions throughout the world other than in Bermuda. They are not allowed to compete with the local community.

### *2.6. Type of Business and ownership*

Of those 3,300 or so companies referred to above, nearly 40 percent (1,258 companies) are in the related areas of mutual funds, finance investment holdings funds and unit trusts, with most being in investment holding funds. Another 593 companies (or nearly 20 percent) are involved in shipping operations. Insurance and insurance management account for another 487 companies (or nearly 15 percent); commercial trading represents 401 companies and companies involved in the exploitation of natural resources make up a not insignificant proportion. Nearly 97 percent of the total number of exempted companies present in Bermuda are declared to be active. It is interesting to note that according to recently released statistics, the nationality of ownership of these companies is divided 35 percent U.S., 25 percent U.K. and Europe, 10 percent Canada, 10 percent Middle and Far East, with the remaining 10 percent being joint ventures between two or more nationalities.

## 3. INSURANCE BUSINESS

Slightly under 600 exempt companies have powers to act as insurance institutions. But some corporations do not exercise these powers, and informed sources have estimated that (as indicated earlier) there are only about 490 *active* exempted insurance companies based in Bermuda. Of these, however, probably less than 100 (i.e. around 3 percent of all “exempted” companies) actually participate in the commercial market as regular professional insurers in the normally accepted sense.

### *3.1. “Captive” Insurance*

Bermuda has become best known as an insurance centre in recent years as a result of the establishment of a number of rather specific insurance and re-

insurance companies in the Islands. The so-called insurance “captive” has contributed significantly to this development. The “captive” is an operating insurance subsidiary or management insurance unit specifically designed to insure or manage the insurance of risks of parent and affiliated companies. It provides a method of minimizing insurance costs through more effective risk management and the control of losses and also by direct access to the reinsurance market. In addition, the “captive” has the advantage of being able to invest premium reserves without restriction for maximum returns consistent with good insurance (and investment) management.

### *3.2. The Official Regulation of Insurance Activities*

The internal regulation of insurance business in Bermuda is alleged to be fairly strict. Before a company can be formed, bank references and financial statements must be supplied and an assurance given that a quorum of the proposed company’s Board will reside in Bermuda. It is frequently asserted that the lawyers, bankers, auditors and management companies associated with the setting up of an insurance business will refuse to support it if they find anything that they regard as improper about its operation. It is thus generally argued by Bermuda insurance companies that this self-policing is normally very successful. Although there was one notable failure in Bermuda some years ago connected with medical insurance and mal-practice liability, the industry is generally regarded as “safe”. On the other hand, the government feels that additional regulations are now in order and it is currently engaged in preparing a new Insurance Act. Nevertheless, it is officially declared that the public interest may still best be served by utilizing the existing self-policing procedures to the maximum. So as to ensure greater security for policyholders, it is expected that the new Act will adopt the liquidity requirements imposed by the United Kingdom. But, although the drafters of the bill originally required a full accounting by the “captive” insurance companies, it was decided to drop this proposal in favour of a simple solvency certificate. The certificate, a brief signed by two of the captive’s directors and certified by the company’s auditors, is simply designed to be a guarantee to the policy-holders that the company is solvent. Thus it will be sufficient for the captives merely to show that they can cover a run of claims and the details of their operations will remain undisclosed.

The act is really only concerned with establishing certain safeguards to protect policy holders who range from local residents holding small life policies (who constitute only a very small element of the insurance business) to giant multinationals like Exxon. It appears to have very little to do with the regulation of the industry itself or the control of the type of activities engaged in.

### *3.3. Casualty, etc. Insurance*

Bermuda also undertakes a certain amount of protection and indemnity (P and I) insurance and it is estimated that at least one-third of the world’s merchant shipping entered in the United Kingdom “P. and I. Club” is insured in

Bermuda.<sup>5</sup> In addition, new types of marine insurance on a mutual basis against shipowners' liability with respect to strike risk, war, and cargo is now written in Bermuda. The particular reason for choosing Bermuda is thought to lie in the fact that shipowners operating their vessels and fleets from many countries and flying the flags of several nations (and not always their own) are able to base their insurance business on "neutral" ground. This is said to provide them with the necessary freedom to work with the various currencies of the world when handling the requirements of their members in different ports and places around the globe. In addition, of course, in basing such operations in Bermuda, they are free to make appropriate investment decisions to minimise tax liability and expense.

Another interesting form of insurance undertaken in Bermuda is that owned by 35 oil companies from various countries. It is reported that the representative insurance company was formed because there was no longer available to petroleum companies—on terms consistent with sound business practice—commercial insurance covering substantial potential risks that include catastrophe coverage, offshore and onshore property pollution and the bringing under control of wild oil or gas wells, including the extinguishing of oil or gas well fires. In view of the magnitude of these risks in the petroleum industry, this company was established as a mutual type insurance company to provide reasonable and effective insurance and re-insurance coverage. The company, based in Bermuda, writes insurance around the world with a limit per occurrence of up to U.S. \$100 million with deductibles of U.S. \$1, U.S. \$5 or U.S. \$10 million. The assets of the member companies exceed U.S. \$10,000 billion and the insurance rates are based on the respective values of the parent companies' assets.<sup>6</sup>

Many of the world's leading risk management consultants have established offices with personnel in Bermuda specifically to assist with the management of insurance companies. For companies located within the sterling area similar facilities are available by incorporation of insurance companies in Guernsey that are managed from Bermuda.

Not surprisingly, certain of the practices involved in exempt company captive insurance management business—with its potential for overseas tax evasion—have been challenged by the U.S. Internal Revenue Service (IRS). Currently two suits have been filed by the Ford Motor Company and the Carnation Company against the U.S. Government in respect of objections to demands for the payment of additional taxes. The Internal Revenue Service contends that premiums paid from a Ford operation in England to its Bermuda "captive" constituted, in essence, a constructive dividend to Ford in the U.S. In the Carnation Company case, the action concerns the payment of premiums on U.S. risks to Carnation's "captive" subsidiary, where the latter had been used as the major reinsurance agent. The two actions are primarily concerned with the

<sup>5</sup>J. H. Blades, "The Bermuda Insurance market" (paper prepared for the Marine Discussion Group of the Insurance Institute of London), February 8th, 1977.

<sup>6</sup>Blades, *op. cit.*

levying of tax on what the U.S. Government considers to be undeclared company profits. To outside observers, there seems little doubt that if the U.S. Government wins these actions the growth and continued existence of the "captive" insurance market in Bermuda will be adversely affected (the market is already highly sensitive to local political rumours). Certain insurers already based in Bermuda believe, however, that not only will the IRS lose their case but that this type of operation will continue to prosper because of the particularly attractive business conditions existing in Bermuda.

The main reason for establishing a "captive" affiliated unit is that it helps to ensure what is euphemistically referred to as "the chronological stabilization of income" of the companies involved. But this activity is regarded more specifically by extra-territorial state governments as "the maximization of non-taxable profit gain" by parent companies resident in their respective headquarter countries. The activity of a "captive" is mainly concerned with, on the one hand, controlling the payment of premiums while managing the reinsurance of these premiums and any claims submitted by its parent company; and, on the other, managing or controlling the overall corporate investment and dividend programme. This usually refers to the reinvestment of premium surpluses in the Euro-bond or Euro-currency market in London, Zurich, etc.

Secondly, and almost equally important, the "captive" generates surplus insurance funds which can be regarded as a new source of cash. These premium surpluses provide much needed liquidity and additional cash flow for the parent company at times when alternative sources of funds are difficult or expensive to obtain.

Thirdly, there is a genuine concern in the insurance sector about the lack of capacity in the existing insurance market for the coverage of major potential risks such as those that can be suffered by oil or airline companies. Furthermore, it is felt there is a need to establish this type of coverage and protection on a world-wide basis.

Fourthly, in the U.K. and U.S. in particular, the emphasis on improved safety and health standards has required companies to establish new environmental protection programmes and introduce special machinery and techniques to improve health and security. Much recently introduced legislation in America and Europe involves both cost and risk and this type of business enables companies to build an expense factor into their insurance rates. In addition, they have the possibility of turning this particular cost factor into a profit point.

Finally, through the very big advantage of the favourable tax treatment in the U.S. and other countries which enables large corporations to transfer funds and to utilize them between various companies, "captive" insurance firms can adjust third party claims without damaging the parent company's name or its sales.

In the overall analysis, therefore, "captive" insurance companies appear to have their primary focus of interest in protecting stockholders' earnings rather than in specifically minimising the cost of actual corporate insurance risks of the conventional kind.

#### 4. THE SNA TREATMENT OF INSURANCE ACTIVITIES

The premiums for insurance against risks, like accident, fire and other casualties, and for life insurance and pension funds, consist of a charge for the service of insuring, a payment for the risk of insuring, and, in the case of life insurance and pension funds, a substantial element of saving. In ascertaining the gross value of the services rendered, it is necessary to separate out the service cost charge for insurance from the other components of the premium.<sup>7</sup>

##### 4.1. *Casualty Insurance*

In the case of casualty insurance, the payment for the risk of carrying the insurance during a given period is taken to be equal to the claims paid during the period. The service charge is consequently assumed to be equivalent (in the long run) to the difference between the premiums received and the claims paid. The amount of the service charge thus calculated for a given year may be more or less than the service charge the casualty insurance company actually takes into account in setting premiums because the claims may be less or more than the expected, i.e. "normal", run of claims. These "normal" risks are reflected—over time—in the premiums set by the casualty insurance company. In addition, however, claims in respect of the period of account may be outstanding and the premiums paid may include pre-payments of premiums in respect of future periods of account. The computed service charge may therefore contain elements of capital gain or loss and also reflect financial claims of policy-holders on the casualty insurance company.

##### 4.2. *Life Insurance*

In the case of life insurance, the service charge is considered to be equivalent to the excess of premiums received over the combined sum of the claims paid and the net additions to the actuarial reserves, excluding the interest on these reserves, which accrues to policy-holders. The actuarial reserves cover the equity of policy-holders on the reserves of life insurance companies and include the reserves set aside to cover the risk of insuring during the year in question, pre-payments for risks and other elements of saving involved in life insurance policies. Life funds are reserves which are earmarked for policy-holders and which include contingency reserves in addition to actuarial reserves.

Service charges in respect of casualty insurance are included in intermediate consumption in the case of producers. The service charge is usually allocated among the various classes of policy-holders in proportion to the amount of premiums which they pay. Apportioning the service charge in this fashion is assumed to approximate the relative value of the services rendered, even though premium rates vary to reflect the element of risk and its variability. (In the long run, however, if actual claims reflect different computed risk rates, this allocation procedure is probably appropriate).

In the Income and Outlay account of non-financial enterprises and all other sectors except financial institutions where double contra claims and premiums

<sup>7</sup>United Nations "System of National Accounts", 1968.

entries are identified, outlays on net casualty insurance premiums (i.e. in this case net of the service charge)<sup>8</sup> on the disbursements side are balanced by casualty insurance claims on the receipts side, i.e. overall the account uses a “net net” concept for casualty insurance.

## 5. SNA TREATMENT OF “CAPTIVE” INSURANCE ACTIVITIES

Whilst the standard treatment of insurance business in the national accounts clearly applies to “normal” casualty and life insurance operations in Bermuda, the application of the same procedure to “captive” insurance business would evidently lead to exceptionally large “service charges”, the main element of which would be the operating surpluses of the exempt affiliated insurance management enterprises. For the most part these firms reinvest their surpluses in Europe on behalf of parent companies and probably set aside only a comparatively small amount for reinsurance. The captive is not so much concerned with insurance as with overall corporate profit maximization (or the minimization or tax liability) and the investment management of surplus funds. The operating surplus does not accrue from its own activities but from a particular legislative situation which conveniently allows overseas companies to shunt funds round the world for their own benefit. (Local Bermuda banks and accounting firms strongly deny that international business is attracted to Bermuda because “it is running from some other tax haven” and that “captives” are anything other than true insurance units, but at the same time they recognise that the desire to establish a base in Bermuda arises mainly from the wish to enjoy the tax free benefits available.)<sup>9</sup>

These surpluses, nominally accruing to the captive (casualty) insurance firms, are neither true operating surpluses comprising part of value added nor surpluses accruing to Bermuda. But the question remains: what are these surpluses? And, how should they be treated in a system of national economic accounts?

Ignoring the conventional procedure on the grounds that it is inappropriate, two alternative treatments suggest themselves:

(1) To classify “captive” operations not as casualty insurance business but as a form of life insurance (or company “life” protection) and evaluate the service charge appropriately, i.e. less any net additions to actuarial reserves (assuming they can be identified) held either by the captive or (more likely) by its parent company. But given that the actuarial reserves of the parent will be affected by many other transactions in different parts of the world, the result would probably be meaningless. More often than not it would probably reflect a negative value added for the Bermuda-based operation. Furthermore, not only would it be very difficult to quantify such net additions to total actuarial reserves but also it would be particularly difficult to identify those elements of the additions to reserves which reflected the net premium surpluses specifically

<sup>8</sup>The SNA uses the phrase “net premiums” ambiguously in different sections of the report both to refer to “premiums less claims” and “premiums net of insurance service charge”.

<sup>9</sup>For example: Address to shareholders of the Chief General Manager of the Bank of Bermuda Ltd., April 15, 1977.

“accruing” to (or generated by) the local “captive” companies. For a variety of reasons, in addition, such funds tend to flow fairly freely between different financial activities and centres.

(2) To ignore such surpluses entirely (except for the local service charge element) and consider them as undistributed profits of overseas parent companies in exactly the same way as they are clearly regarded by the respective official Inland Revenue agencies. In this case the insurance premium payments of the parent paid to its affiliate should not be regarded as an intermediate cost (as it is probably at present) but as part of the value added accruing to the company and held, effectively, as undistributed profits on which interest is also earned. The estimated surplus would then need to be allocated to the country in which the head office of the corporation concerned is based and not to the GDP of the country where its local tax haven affiliate is situated. Under this treatment only the actual local operating costs of the insurance management office would be regarded as the service charge and, effectively, the operating surplus of the enterprise would be zero. In practice, this treatment would appear to reflect most closely what is actually taking place in the tax haven concerned.

An added difficulty arises, however (whichever course of action is chosen), because one insurance management company may be acting for a hundred or more other non-insurance operating companies.

## 6. CONCLUDING REMARKS

The special case of insurance operations in (direct) tax free areas has been considered here but similar problems arise with respect to re-depositing, re-lending and other financial activities and trust operations pursued by “off-shore” banking units and investment enterprises based in other tax havens such as the Bahamas, Cayman Islands, Philippines, etc. What are apparent intermediate costs are often essentially dividends or undistributed surpluses—belonging for the most part to foreign multi-national corporations. Because of the highly mobile nature of such funds, however, it is either difficult or impossible to identify the magnitude and precise origin of these “missing millions”, but their proper evaluation would provide a much better insight into the way in which the international economy operates and perhaps help to account to some extent for often inexplicable foreign exchange rate fluctuations. Such monitoring may not be feasible at the present moment—requiring as it does the co-operation of many different countries and the free exchange of “confidential” information between them—but it is perhaps a goal that should be sought after so that agreement can be reached at the international level.