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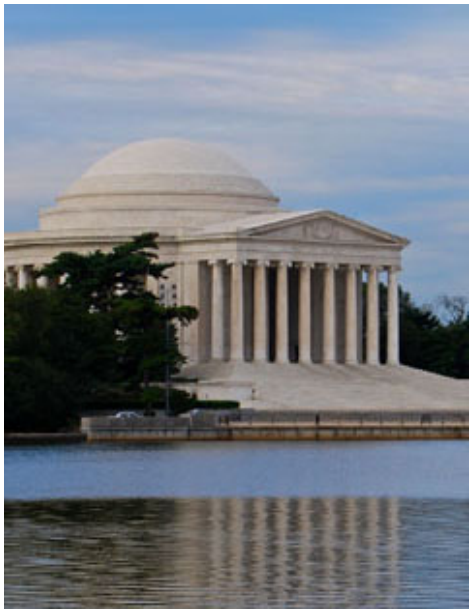

IRS Reversal of "Cascading" Foreign Insurance Excise Tax Ruling May Present Refund Opportunities

The IRS no longer imposes multiple levels of excise tax on certain foreign-to-foreign reinsurance transactions involving U.S. insureds. This article explains why companies should work with their tax advisors to reevaluate tax positions with respect to the foreign insurance excise tax—it may be appropriate to stop paying the excise tax and consider filing claims for refund in certain circumstances.

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After a government loss in the D.C. Circuit Court of Appeals, the IRS conceded its "cascading" federal excise tax ("FET") position by issuing Revenue Ruling 2016-3.[1] This ruling revokes the position previously taken by the IRS in Revenue Ruling 2008-15,[2] which had imposed multiple levels of FET on solely foreign-to-foreign reinsurance transactions when the direct insurance contracts involved U.S. insureds. Based on the IRS's formal revocation of its prior position, companies should evaluate their FET positions in situations in which premiums are paid on foreign-to-foreign reinsurance transactions. The practical application of Revenue Ruling 2016-3 may be for companies to (1) stop paying FET on certain foreign-to-foreign reinsurance transactions, even if some of the direct insurance risk that is the subject of the reinsurance contract covers U.S. insureds; and (2) evaluate whether an opportunity exists for a refund of previously paid "cascading" FET.

Background

Section 4371 imposes a federal excise tax on insurance and reinsurance premiums paid to foreign insurers and reinsurers with regard to certain coverages involving a U.S. insured. The excise tax rate is four percent of premiums for certain direct premiums, and one percent of premiums

1 2016-3 I.R.B. 282.

2 2008-12 I.R.B. 633.

for other types of direct premiums and for reinsurance premiums. The purpose of the statute is to level the playing field between domestic and foreign insurance and reinsurance businesses.

FET liability is reported on IRS Form 720, *Quarterly Federal Excise Tax Return*. Liability for this excise tax is joint and several as between the insured, the broker who sold the policy, and the insurer; IRS may collect the tax from any of these parties. In practice, the insured or reinsured party under the policy for which a premium subject to FET is being paid typically bears the economic burden of the FET.

In Revenue Ruling 2008-15, the IRS addressed four FET scenarios. The IRS's position was that a "cascading" FET can be imposed on certain foreign-to-foreign reinsurance transactions including foreign-to-foreign retrocessions (i.e., reinsurance purchased by a reinsurer to cover all or part of the reinsurer's risk). In other words, multiple premiums with respect to the same risk could be subject to FET.

Validus Reinsurance, a Bermuda reinsurance corporation, challenged the IRS position on foreign-to-foreign retrocession taken in Revenue Ruling 2008-15. Validus paid (ceded) premiums for nine retrocessions, all purchased from foreign reinsurers (called retrocessionaires). These reinsurance policies were negotiated, executed, and performed outside the United States. The IRS determined Validus owed FET on these wholly foreign retrocessions. Validus paid the assessed tax and timely filed claims for refund on the grounds that the tax did not apply under the statute, and alternatively, that the tax was unconstitutional. When the IRS did not act on the refund claims within six months, Validus filed suit in the United States District Court for the District of Columbia. In *Validus Reinsurance, Ltd v. United States*,[3] the district court granted summary judgment to Validus, ruling that the FET reached "first-leg" U.S. to foreign reinsurance transactions but not the subsequent foreign-to-foreign retrocessions. The court found that the statute was unambiguous.[4]

Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

[3] 19 F. Supp. 3d 225 (D.D.C. 2014).

[4] *Id.* at 230-231.

On the government's appeal, the U.S. Court of Appeals for the District of Columbia Circuit affirmed the district court's judgment.[5] Unlike the district court, however, the court of appeals concluded that the statute was ambiguous. Nevertheless, the court resolved the case by invoking the presumption against extraterritoriality, which generally provides that federal statutes are meant to apply only within the territorial jurisdiction of the United States, unless a contrary intent appears. Neither the text nor the legislative history of section 4371 shows that Congress intended to reach wholly foreign retrocessions, reasoned the appellate court.

While the *Validus* case was in litigation, some taxpayers filed "protective" FET refund claims with respect to this issue.

Revenue Ruling 2016-3

On January 4, 2016, IRS issued Revenue Ruling 2016-3. The ruling states that the IRS reconsidered Revenue Ruling 2008-15 in light of the appellate court's *Validus* decision holding that section 4371 does not impose FET on foreign-to-foreign retrocession transactions, and that "the IRS will no longer apply the one percent cascading FET imposed by section 4371(3) to premiums paid on a policy of reinsurance issued by one foreign reinsurer to another foreign insurer or reinsurer under the situations described in Revenue Ruling 2008-15."[6]

In revoking Revenue Ruling 2008-15, the 2016 ruling states:

> No inference should be drawn that the revocation of Rev. Rul. 2008-15 affects the liability for excise tax under section 4371 on any other policies of insurance or reinsurance. For example, absent a foreign reinsurer qualifying for a treaty wavier or an exemption from tax under section 4373(1), the IRS will apply a one-percent excise tax under section 4371(3) to reinsurance premiums paid on a policy of reinsurance…issued by that foreign insurer to either:
>
> > (i) a foreign insurer that has elected to be treated as a domestic corporation under section 953(d); or

[5] 786 F.3d 1039 (D.C. Cir. 2015).

[6] 2016-3 I.R.B. 282.

(ii) a foreign insurer or reinsurer that is exempt from excise tax on the premiums it receives under section 4373(1) because the premiums are effectively connected to the conduct of a U.S. trade or business and taxable under section 882(a).[7]

Revenue Ruling 2016-3 also provides that the IRS will continue to enforce the provisions of treaties that place limits on the availability of a treaty waiver of FET for premiums paid to a foreign insurer or reinsurer.

Observations

- The IRS's revocation of Revenue Ruling 2008-15 applies more broadly than just to the retrocession situation addressed in *Validus*. The revocation of the IRS's previous position also applies to the other foreign-to-foreign reinsurance transactions described in Revenue Ruling 2008-15.
- Taxpayers who have been paying FET on wholly foreign reinsurance transactions like those described in Revenue Ruling 2008-15 should work with their tax advisors to evaluate their tax positions with respect to the FET. It may be appropriate to stop paying the one-percent FET on foreign to foreign reinsurance transactions, depending on the particular facts of the transactions.
- Taxpayers who have paid FET for prior periods on transactions described in now-revoked Revenue Ruling 2008-15 should evaluate whether the opportunity for a refund of FET exists if they have not already done so. In most cases, *the statute of limitations for FET paid in the first quarter of 2013 expires April 30, 2016.*
- With respect to protective claims that were filed with the IRS, we note that the IRS has not indicated when it will process these pending refund claims for cascading FET. In light of this uncertainty and the potential for delay, taxpayers may wish to affirmatively perfect such claims with the IRS.

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[7] *Id.*

The "no inference" language in Revenue Ruling 2016-3 implies that the IRS will continue to assert that the FET imposed by section 4731(3) applies in certain reinsurance situations. Each taxpayer's specific situation should be carefully examined to determine whether there would be a liability on a going-forward basis.

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