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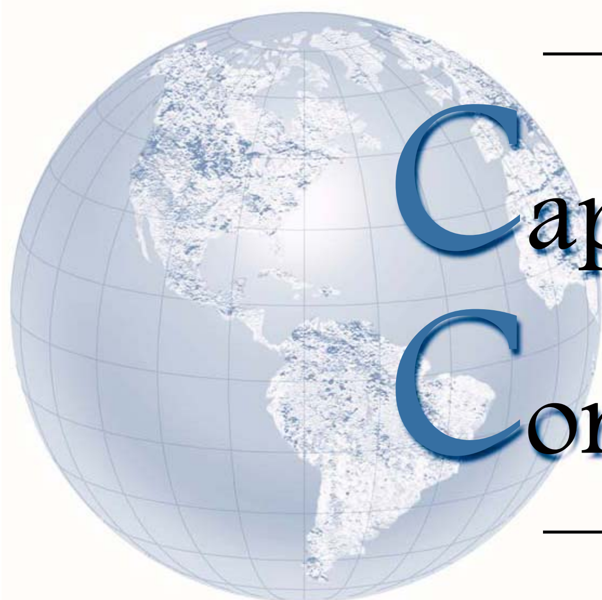

Captive Insurance Company Reports

IRS Guidance: FET Applies on a Cascading Basis

Editor's Note: The following was written by **P. Bruce Wright**, Esq. and **M. Kristan Rizzolo**, Esq., partners in the international law firm of Dewey & LeBoeuf LLP practicing respectively in the New York and Washington, DC, offices.

On March 7, 2008, the U.S. Internal Revenue Service (IRS) issued Revenue Ruling 2008–15 in advance of its planned publication on March 24, 2008. This ruling formally states the IRS's long held, and much questioned, position regarding the federal excise tax (FET) on insurance and reinsurance premiums imposed by Section 4371 *et seq.* of the U.S. Internal Revenue Code of 1986, as amended (the "Code"). *The Ruling said that this FET is to be applied on a "cascading" basis; that is, in general, that the FET is imposed on sequential cessions of the same risks, as long as the underlying policy covers U.S. risks.*

The IRS also released an advance copy of Announcement 2008–18, which will be published along with the Revenue Ruling. *The Announcement describes a "voluntary compliance initiative" that sets forth the means by which taxpayers may comply with the imposition of the FET on a cascading basis prospectively, beginning with the fourth quarter 2008, without incurring exposure for prior periods.*

Section 4371

In general, the FET is imposed on insurance and reinsurance policies issued by non-U.S. insurers and reinsurers, unless otherwise exempt by treaty. Under § 4371 of the Code, the FET is imposed at a rate of 4 percent on each policy of casualty insurance or indemnity bond issued to an "insured." It is imposed at a rate of 1 percent on each life insurance, sickness and accident policy, or annuity contract issued with respect to a U.S. resident or citi-

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zen and on each policy of reinsurance covering any of the policies or contracts taxable under § 4371 of the Code.

Section 4372(d) of the Code defines the term "insured" as (1) a U.S. domestic corporation or partnership, or an individual resident of the United States against, or with respect to, hazards, risks, losses, or liabilities wholly or partly within the United States; or (2) a non-U.S. corporation, non-U.S. partnership, or nonresident individual engaged in a trade or business within the United States against, or with respect to, hazards, risks, losses, or liabilities within the United States.

There are two general exceptions to the application of the FET. First, it does not apply to a policy if the premiums for that policy are effectively connected with the conduct of a trade or business within the United States and, thus, subject to U.S. federal income tax. Second, many U.S. income tax treaties waive the FET on policies issued by companies entitled to treaty benefits; however, virtually all of the waivers are conditional. (Two older treaties still contain an "unqualified" FET waiver whereby subsequent reinsurance with an "unprotected" company does not affect the original exemption.)

Most of the treaties waive the FET only as long as the U.S. risks covered by the policy issued by the company entitled to treaty protection are not subsequently reinsured with a reinsurer that is not entitled to the benefits of a U.S. income tax treaty with an FET waiver. The U.S.-U.K. treaty is unique in that the FET is waived, provided an insurance or reinsurance policy issued by a U.K. insurer or reinsurer covering U.S. risks is not entered into as part of a "conduit arrangement" (the previous U.S.-U.K. treaty contained an "unqualified" FET waiver). For this purpose, a policy is considered to be entered into as part of a conduit arrangement if (1) all or substantially all of the income from such policy is paid, directly or indirectly, to a person not entitled to treaty benefits as good as or better than those in the U.S.-U.K. treaty; and (2) the main purpose or one of the main purposes of the transaction was to obtain increased treaty benefits for the recipient of the income.

Section 4374 of the Code places the liability for the payment of the FET on:

> any person who makes, signs, issues, or sells any of the documents and instruments subject to the [FET], or for whose

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use or benefit the same are made, signed, issued, or sold.

If a non-U.S. insurer or reinsurer obtains an FET closing agreement (in general, an agreement entered into with the IRS) establishing its eligibility for an FET waiver pursuant to a U.S. income tax treaty, a U.S. payer of premium, whether it be a U.S. broker, policyholder, or insurer, is relieved of any liability to pay the FET with respect to premiums paid to that non-U.S. insurer or reinsurer in the event that the premiums are ceded to a reinsurer that is not entitled to the benefits of a U.S. income tax treaty with an FET waiver.

In the closing agreement, the non-U.S. insurer or reinsurer agrees, in general, to:

- ✔ Be liable as a U.S. taxpayer for and pay the FET due under Code § 4371 *et seq.* of the Code, subject to any applicable exemption under a U.S. income tax treaty
- ✔ Retain records and make such records available for IRS inspection
- ✔ File FET returns with the IRS on Form 720
- ✔ Provide a letter of credit in favor of the IRS

It should be noted, however, that an FET closing agreement is not a prerequisite to treaty benefits.

> "This 'cascading' tax assessment is actually simple to understand. Premiums leaving the United States to a treaty country, like the United Kingdom, are free of FET by virtue of the U.S./U.K. tax treaty. However, the ongoing cession by the U.K. insurer or reinsurer to a non-treaty country reinsurer is, in theory, subject to U.S. FET. Easy to theorize, but impossible to police. This provision has always been on the books, and paid no heed by one and all."
>
> ~*CICR* Editor Emeritus Hugh Rosenbaum

Revenue Ruling 2008–15

The Revenue Ruling addresses four factual situations. First, a non-U.S. insurance company (the "Foreign Insurer"), incorporated in a country that has no income tax treaty with the United States, issues direct insurance policies to a U.S. corporation with respect to risks located wholly or partly within the United States. The Foreign Insurer then purchases reinsurance, covering all or part of the loss that the Foreign Insurer may sustain with respect to those policies, from a non-U.S. reinsurer (the "Foreign Reinsurer") that is incorporated in a country that has a U.S. income tax treaty which does *not* contain an FET waiver. Neither the Foreign Insurer nor the Foreign Reinsurer is engaged in a U.S. trade or business.

Under this scenario, the Revenue Ruling held that the FET is imposed (1) with respect to the premium paid by the U.S. corporation to the non-U.S. insurer at a 4 percent rate *and* (2) with respect to the premium paid by the non-U.S. insurer to the non-U.S. reinsurer at a 1 percent rate.

A second scenario contemplated by the Revenue Ruling is where a non-U.S. reinsurance company ("Foreign Reinsurer A"), incorporated in a country that has a U.S. income tax treaty which does *not* contain an FET waiver, issues reinsurance policies to a U.S. insurer (the "Domestic Insurer") with respect to policies that cover U.S. risks. The Foreign Reinsurer A then cedes some or all of those risks to another non-U.S. reinsurance company ("Foreign Reinsurer B"), incorporated in a different country that has a U.S. income tax treaty which does *not* contain an FET waiver. The Revenue Ruling does not specify whether either Foreign Reinsurer A or Foreign Reinsurer B is engaged in a U.S. trade or business.

Here, the FET is imposed (1) with respect to the premium paid by the Domestic Insurer to the Foreign Reinsurer A at a

> **1 percent rate *and* (2) with respect to the premium paid by Foreign Reinsurer A to the Foreign Reinsurer B at a 1 percent rate.**

The third factual situation involves a non-U.S. insurance company (the "Foreign Insurer"), entitled to the benefits of a U.S. income tax treaty containing a qualified FET waiver, issues direct insurance policies to a U.S. corporation with respect to risks located wholly or partly within the United States. The Foreign Insurer then purchases reinsurance, covering all or part of the loss that the Foreign Insurer may sustain with respect to those policies, from a non-U.S. reinsurer (the "Foreign Reinsurer") that is incorporated in a country that has a U.S. income tax treaty which does *not* contain an FET waiver. Neither the Foreign Insurer nor the Foreign Reinsurer is engaged in a U.S. trade or business.

> **In this instance, the FET is imposed (1) with respect to the premium paid by the U.S. corporation to the Foreign Insurer at a 4 percent rate *and* (2) with respect to the premium paid by the Foreign Insurer to the Foreign Reinsurer at a 1 percent rate.**

Fourth, a non-U.S. insurance company (the "Foreign Insurer"), entitled to the benefits of a U.S. income tax treaty containing an FET waiver subject to a conduit arrangement limitation, issues direct insurance policies to a U.S. corporation with respect to risks located wholly or partly within the United States. The Foreign Insurer then purchases reinsurance covering all or part of the loss that the Foreign Insurer may sustain with respect to those policies, from a non-U.S. reinsurer (the "Foreign Reinsurer") that is incorporated in a country that has a U.S. income tax treaty which does *not* contain an FET waiver. Neither the Foreign Insurer nor the Foreign Reinsurer is engaged in a U.S. trade or business.

> **In this case, the Revenue Ruling held that the FET (1) is not imposed with respect to the premium paid by the U.S. corporation to the Foreign Insurer, *but* (2) is imposed with respect to the premium paid by the Foreign Insurer to the Foreign Reinsurer at a 1 percent rate.**

None of the situations in the Revenue Ruling involve a cession to a third non-U.S. company; however, the analysis in the Revenue Ruling seems to suggest that the FET would be imposed with respect to each subsequent retrocession involving underlying U.S. risks.

Announcement 2008–18

The Announcement describes a "voluntary compliance initiative" that the IRS has designed to encourage non-U.S. insurers and reinsurers to pay the FET in accordance with the holdings in the Revenue Ruling. The IRS has granted a 6-month window for non-U.S. insurers and reinsurers to become compliant by either filing returns and paying the FET or making the required disclosers with respect to treaty-based exceptions for prospective transactions. The Announcement does not provide amnesty, but *it does state that the IRS will not examine the "cascading" FET liability, for periods prior to October 1, 2008, of any non-U.S. insurer or reinsurer that is compliant for the fourth quarter of 2008 and thereafter.*

The Announcement applies only to the FET with respect to transactions between two non-U.S. companies. FET liabilities with respect to policies between U.S. insureds or ceding companies and non-U.S. insurers or reinsurers will continue to be subject to examination.

In order to comply, a participating insurer or reinsurer must timely file a Form 720, *Quarterly Federal Excise Tax Return,* and pay any FET due with respect to premiums paid or received on or after October 1, 2008, or timely disclose, as required by Code § 6114, that it is taking a treaty-based return position, claiming an FET exemption with respect to such premiums if not otherwise required to file a Form 720. In addition, participating insurers and reinsurers must keep certain records with

respect to premiums paid or received on or after October 1, 2008, in accordance with Treasury Regulation § 46.4371–4.

Dewey & LeBoeuf Commentary

The IRS's position that the FET is imposed on a cascading basis raises significant substantive and administrative questions that all involved will have to address. The most fundamental questions are whether the United States has the right to impose a tax with respect to transactions that have no U.S. nexus, and even if it does, whether Congress intended § 4371 of the Code to extend that far. In addition, there are questions surrounding the interpretation of the various treaty provisions related to FET waivers. It is unclear whether any U.S. treaty partners will agree that the excise tax provision in the treaty allows the application of the FET on a cascading basis.

In this regard, it is interesting to note an example regarding the application of the FET that was cited in the *Report of the Senate Foreign Relations Committee on the Income Tax Protocol between Germany and the United States Signed June 1, 2006* (Explanation of Article 2). This example concerns how the FET is applied in a circumstance where a portion of the risk under a policy issued by a German insurer to a U.S. insured is ceded to a non-U.S. reinsurer that is not entitled to the benefits of a U.S. treaty which grants an FET waiver. In that case, the example notes that the U.S. insured is liable for FET at a rate of 4 percent on the premium with respect to the risk that was reinsured. There is no mention of an additional FET due by either the U.S. insured or the German insurer on the premium ceded to the non-U.S. reinsurer.

The administrative issues also will be substantial for both the IRS and the non-U.S. insurers and reinsurers trying to determine which premiums are subject to the FET. The complexity of some commercial reinsurance transactions makes the determination of premium subject to the FET. Further, it is unclear how the IRS intends to collect the FET in many cases. As noted above, closing agreements with the IRS require the posting of letters of credit and, as such, this issue may be addressed by these agreements. However, the IRS may attempt to levy against a non-U.S. insurer's or reinsurer's U.S. assets. Indeed, the IRS indicated in a 1996 Technical Advice Memorandum that the cascading FET would be enforced against any property located in the United States.

How non-U.S. insurers and reinsurers will respond to the Revenue Ruling and the Announcement remains to be seen, but it seems clear that the criticism of the IRS's position, which has been voiced for more than 3 decades, likely will continue.

CICR comment: Non-American domiciles are already reeling from stagnant growth and even shrinkage, including a migration of captives back to the United States. This is just one more hurdle for them to overcome—unless they have favorable tax treaties with the United States. ■

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