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'IRS Overreach Rejected in Validus Decision' by Mark R. Goodman, Freeborn & Peters LLP

[Editor's note: Mark R. Goodman is a Partner in Freeborn & Peters LLP's Corporate Practice Group. He has three decades of experience advising the insurance industry on corporate, regulatory and transactional matters. Copyright 2014, Mark R. Goodman]

A recent court decision rejected the IRS's novel "cascading" excise tax theory with respect to reinsurance transactions between two non-U.S. companies. *Validus Reinsurance Ltd. v. United States of America*, No. 13-0109 (D. D.C.). The implications of this decision are relevant to U.S. ceding companies and to their reinsurers, both domestic and foreign. If the decision stands, it could even have an effect on the pricing of reinsurance and, therefore, an indirect effect of the pricing of direct policies in the U.S.

The U.S. Federal Excise Tax

The Internal Revenue Code (26 U.S.C. 4371) imposes a federal excise tax (FET) on insurance and reinsurance bought from non-U.S. companies (4% on direct P&C policies; 1% on direct life and A&H policies and annuities; and 1% on reinsurance). The IRS has for some time taken the position that the excise tax applies not only to the reinsurance bought by a U.S. ceding company from a non-U.S. reinsurer, but also would apply to that reinsurer's retrocession of those same risks to another non-U.S. company (and to any further such retrocession, in a "cascading" fashion).

The IRS laid out its position in 2008 (Rev. Ruling 2008-15). Many commentators at that time thought that this position made little sense, both because there was no logical end to the IRS's attempted reach (a retrocession of a retrocession of a retrocession, etc., *ad infinitum*) if it were applied as presented in the Revenue Ruling, and because the IRS was attempting to expand its taxing power to transactions between two non-U.S. taxpayers that were entered into entirely outside of the U.S.

The *Validus* Decision

Validus is a Bermuda-based reinsurer and is not a U.S. taxpayer. The decision does not contain a complete recitation of all of the facts, but it appears that Validus reinsured a U.S.-based insurer with respect to policies issued in the U.S. by that ceding company. Any FET imposed on that first reinsurance transaction, which would have been paid by the ceding company, was not at issue in this case. Validus retroceded to another non-U.S. insurer a portion of the risks that Validus had assumed from the U.S.-based ceding company. Because the party paying the premium is the party required to pay the FET, the IRS in early 2012 asserted that Validus owed FET on that retrocession. Validus paid the FET and then filed suit in 2012 to challenge the IRS's position. Both parties moved for summary judgment, having agreed upon a stipulated statement of facts.

District Court Judge Amy Berman Jackson ruled in favor of Validus. She held as a matter of law that the plain language of the FET statute imposing a tax on reinsurance agreements only applies to reinsurance of direct policies. The relevant portion of the statute (26 U.S.C. 4371(3)) imposes a 1% FET on "the premium paid on the policy of reinsurance covering any of the [casualty, life or accident and health] contracts taxable under paragraph (1) or (2)." Because this language refers only to

reinsurance of the kinds of direct policies that might be subject to FET tax, the judge held that the language providing for a tax on reinsurance agreements did not include reinsurance of reinsurance, *i.e.*, retrocessions.

In deciding that the FET does not apply to retrocessions from one non-U.S. company to another non-U.S. company, the court rejected the IRS's "cascading" tax theory under a fact pattern essentially identical to the Situation 2 laid out in the IRS's 2008 Revenue Ruling. Because the court's decision rests entirely on its interpretation of the FET provisions of the Internal Revenue Code, it never reached the broader arguments about whether the U.S. has the power to tax non-U.S. transactions between non-U.S. taxpayers.

The judge rejected the IRS's arguments about Congressional intent, holding that under rules of statutory construction, the court is bound to follow the plain language of the statute, and that where statute is clear on its face, then no examination of Congressional intent is necessary. The IRS also argued that Congress would have created an express exemption for retrocessions if it had intended that the FET would only apply to the first level of reinsurance, but the judge rejected that argument, holding that there was no need for such an exemption since the taxation of retrocessions was simply not within the scope of the language of the FET statute.

Unresolved Questions

It remains to be seen if the IRS appeals this decision. In the meantime, insurers and reinsurers will want to examine whether they are able to file claims similar to those in Validus' suit for a return of FET taxes paid (to the extent that such claims are not time-barred). At a minimum, insurers and reinsurers will want to examine how this decision will affect their response if the IRS asserts that the company owes FET on retrocessions. In addition, companies that have entered into Closing Agreements with the IRS that govern payment of FET on retrocessions will want to review and, to the extent possible, reconsider those agreements.

In the meantime, this decision leaves at least two unanswered questions:

(1) Does the FET apply to a retrocession by a U.S. company to a non-U.S. company?

(2) Where a non-U.S. company issues a direct policy that is subject to the FET (e.g. the 4% FET for P&C policies), does the 1% FET on reinsurance transactions apply to reinsurance ceded by that non-U.S. company to another non-U.S. company?

(3) How does this decision affect the other scenarios addressed in the IRS's 2008 Revenue Ruling, particularly with respect to insurance policies and reinsurance agreements issued by a non-U.S. company that is domiciled in a country with which the U.S. has a tax treaty?

On the face of the court's decision, and based on Judge Jackson's reading of the FET statute, it appears that the answer to the first question would be no. The decision on its face states that the FET does not apply to retrocessions at all. A retrocession by a U.S. reinsurer would not be "reinsurance covering any of the [direct] contracts taxable under paragraph (1) or (2)" of 26 U.S.C. 4371. Such a result would not be consistent with how the FET has been applied historically, even before the 2008 Revenue Ruling, but would be consistent with the ruling in the Validus decision. This result would leave the IRS in a worse position than it was before issuance of its 2008 Revenue Ruling. This is an example of what can happen when a regulatory body likes the IRS overreaches by being overly aggressive in interpreting its powers.

The second question is whether the FET applies to the reinsurance of a non-U.S. insurer that issues a direct policy that itself is subject to the FET (essentially Situation 1 as laid out in the IRS's 2008 Revenue Ruling). The *Validus* decision does not address that issue at all, and in particular does not reach the issue of whether the IRS has the power to tax a transaction between two non-U.S. companies that occurs outside of the U.S., *i.e.* whether there is sufficient nexus to the US to allow the IRS to include this kind of transaction within its jurisdiction. The answer to this question of extraterritorial jurisdiction will have to await another day.

The other scenarios addressed in the IRS's 2008 Revenue Ruling address the effect of tax treaties on imposition of the FET tax. The *Validus* decision does not address the effect of such tax treaties - and does not address the other situations addressed in that Revenue Ruling. However, under the reasoning of the *Validus* court's ruling, if the original reinsurance ceded by a US company to a non-U.S. reinsurer were exempt from FET because of the effect of a tax treaty, then no FET would end up being assessed on any reinsurance or retrocession.

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