

Excise Taxes and Reinsurance: Wholly Foreign Retrocessions Are Not Taxable.

Under Section 4371 of the Internal Revenue Code, foreign insurers are subject to an excise tax on casualty insurance and indemnity bonds, provided that they are issued to an “insured.” I.R.C. § 4371(1). Related reinsurance policies are also subject to this tax. I.R.C. § 4371(3). An “insured” is either “a 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 “a foreign corporation, foreign partnership, or nonresident individual, engaged in a trade or business within the United States, against, or with respect to hazards, risks, or liabilities within the United States.” I.R.C. § 4372(d)(1), (2).

Foreign insurers are also subject to an excise tax on life, sickness, and accident insurance and annuity contracts, but only to the extent that the policy or contract relates to a U.S. citizen or resident. I.R.C. §§4371(2) (imposing tax), 4372(e) (limiting scope to U.S. lives). Again, the tax reaches related reinsurance policies. I.R.C. § 4371(3).

Foreign insurers who are subject to U.S. income taxes as non-resident aliens under Section 882(a) of the Code are exempt from the excise tax. I.R.C. § 4373(1).

Last week, the District of Columbia Circuit addressed an interesting issue: when a foreign reinsurer that issues policies subject to tax under Section 4731(3) purchases reinsurance from another foreign reinsurer to protect itself from the risks under the taxable policies, are the reinsurance policies it has purchased subject to the excise tax as well? In the Court’s view, they are not. *Validus Reinsurance, Ltd. v. United States*, 2015 U.S. App. LEXIS 8602, slip op. at *2 (D.C. Cir. May 26, 2015).

The taxpayer, Validus, is based in Bermuda and is in the reinsurance business; it does not do business here. *Validus*, 2015 U.S. App. LEXIS 8602, slip op. at *3. It does sell reinsurance policies to insurance companies that are incorporated in the United States or do business here, and the reinsurance policies it sells cover U.S. risks. *Id.* To protect itself, Validus purchases reinsurance for a portion of the risks covered by the reinsurance policies it issues; these policies are known as retrocessions. The case revolved around nine retrocession transactions that Validus entered into with foreign reinsurers that were negotiated, executed and performed outside of the United States. *Id.*, slip op. at *4.

If these retrocession policies were taxable, Validus would be liable for the tax under Section 4374 of the Code, which makes both the insurer and the insured liable for the excise tax. Accordingly, Validus paid the tax and pursued a refund claim. *Id.*, slip op. at *4. After the IRS failed to act on its refund claim, Validus filed a refund action in district court and was granted summary judgment. *Id.*, slip op. at *5.

On appeal, the D.C. Circuit affirmed. In the Court’s view the relevant statutory language was ambiguous. Focusing on the statutory definition of a “policy of reinsurance” in Section 4372(f) of the Code, the Court concluded that both parties had offered plausible constructions of the language; the taxpayer’s view was that wholly foreign retrocessions were not taxable, while the government asserted that they were. *Id.*, slip op. at *9-*12. After wrangling with the parties’ contentions and the surrounding statutory context, the Court concluded that the text of Section 4371 was “ambiguous with regard to its application to wholly foreign retrocessions.” *Id.*, slip op. at *15.

To resolve the ambiguity, the Court turned its focus to the presumption against extraterritoriality, which led the Court to conclude that wholly foreign retrocessions were not taxable because there was not a sufficiently clear expression of Congressional intent for the excise tax to reach them. Because the presumption against extraterritoriality is a statutory construction principle that does not arise frequently, I will cover the D.C. Circuit's reasoning in some detail in a separate post.

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