

Financial Services

Captive Insurance Update

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IRS Issues Guidance on Application of Federal Excise Tax to Foreign Insurers and Reinsurers (Cascading Theory)

March 24, 2008

Alert Number: 08-03

The Internal Revenue Service recently issued Revenue Ruling 2008-15 and Announcement 2008-18 which provide guidance with respect to the applicability of the US Federal Excise Tax under section 4371 on insurance premiums paid to a foreign insurer on transactions between foreign insurers and reinsurers.

The Revenue Ruling describes the insurance excise tax consequences under section 4371 of insurance premiums paid by one foreign insurer (foreign insurer) to another (foreign reinsurer). In particular, the ruling addresses the excise tax consequences of such payments where the foreign insurer is eligible for a waiver of the excise tax by income tax treaty but the foreign reinsurer is not. The ruling addresses both types of insurance excise tax waivers that may be provided by treaty. Revenue Ruling 2008-15 clarifies and amplifies Revenue Ruling 58-612.

Revenue Ruling 2008-15 describes the following situations:

Situation 1

Foreign Insurer, a foreign corporation incorporated in Country X, issues policies of casualty insurance to U.S. Corporation, a domestic corporation, with respect to hazards, risks, losses, or liabilities wholly or partly within the United States. Foreign Insurer is not engaged in a trade or business in the United States. Country X does not have an income tax treaty with the United States.

Foreign Insurer enters into a reinsurance agreement with Foreign Reinsurer, a foreign corporation incorporated in Country Y, whereby Foreign Reinsurer agrees to indemnify Foreign Insurer against all or part of the loss that Foreign Insurer may sustain under the policies it has issued to U.S. Corporation. Foreign Reinsurer is not engaged in a trade or business in the United States. Country Y has an income tax treaty with the United States that does not exempt insurance premiums from the excise taxes imposed by section 4371.

Situation 2

Foreign Reinsurer A, a foreign corporation incorporated in Country W, issues policies of reinsurance to Domestic Insurer, a U.S. corporation, that cover casualty insurance contracts issued to or for, or in the name of, an insured as defined in section 4372(d). Foreign Reinsurer A enters into a reinsurance agreement with Foreign Reinsurer B, incorporated in Country Y, whereby Foreign Reinsurer B agrees to indemnify Foreign Reinsurer A against all or part of the loss that Foreign Reinsurer A may sustain under the policies it has issued to Domestic Insurer. Country W and Country Y have income tax treaties with the United States that do not exempt insurance premiums from the excise taxes imposed by section 4371.

Situation 3

The facts are the same as in Situation 1, except that there is an income tax treaty in force between the United States and Country X (the "U.S.-X Treaty") that has a limited excise tax exemption. Foreign Insurer is a resident of Country X for purposes of the U.S.-X Treaty and satisfies the requirements of the limitation on benefits article in that treaty.

Financial Services

Captive Insurance Update

Bermuda

PRICEWATERHOUSECOOPERS 

Situation 4

The facts are the same as in Situation 1, except that Foreign Insurer is a resident of Country Z and there is an income tax treaty in force between the United States and Country Z (the “U.S.-Z Treaty”) that contains a comprehensive limitation on benefits article. Foreign Insurer satisfies the requirements of the limitation on benefits article in that treaty. In Situation 4, the treaty is an anti-conduit treaty where the excise tax will not be imposed on residents unless there is an anti-conduit arrangement.

The IRS assumes for purposes of this revenue ruling that Foreign Insurer has not entered into such policies with U.S. Corporation as part of a conduit arrangement.

Conclusions:

Situation 1

In Situation 1, the premiums paid by U.S. Corporation on the policies of casualty insurance issued by Foreign Insurer are subject to the four-percent excise tax imposed by section 4371(1), because the policies were issued by Foreign Insurer, a foreign corporation, to U.S. Corporation, an “insured” for purposes of section 4372(d). In addition, premiums paid by Foreign Insurer on the policies of reinsurance issued by Foreign Reinsurer with respect to the foregoing insurance policies are subject to the one-percent excise tax imposed by section 4371(3) because section 4371(3) imposes an excise tax on reinsurance policies issued by a foreign reinsurer with respect to risks covered by contracts described in section 4371(1).

Situation 2

In Situation 2, the reinsurance premiums paid by Domestic Insurer to Foreign Reinsurer a covering casualty insurance contracts issued by Domestic Insurer are subject to the one-percent excise tax imposed by section 4371(3), because the policies of reinsurance cover contracts described in section 4371(1). The premiums paid by Foreign Reinsurer A to Foreign Reinsurer B are also subject to the one-percent excise tax imposed by section 4371(3) based on the same analysis.

Situation 3

In Situation 3, the premiums paid by U.S. Corporation on the policies of casualty insurance issued by Foreign Insurer would generally be exempt from the section 4371(1) excise tax under the U.S.-X Treaty. However, the U.S.-X Treaty also provides that such premiums are not exempt to the extent that the risks covered by such premiums are reinsured with a foreign reinsurer not entitled to the benefits of a treaty that provides an exemption from insurance excise taxes. Therefore, because the risks are reinsured with Foreign Reinsurer, who is not entitled to the benefits of a treaty that provides an exemption from insurance excise taxes, the insurance premiums received by Foreign Insurer from U.S. Corporation are subject to the four-percent excise tax as of the date the reinsurance premiums are paid by Foreign Insurer to Foreign Reinsurer. In addition, premiums paid by Foreign Insurer to Foreign Reinsurer on the policies of reinsurance covering contracts described in section 4371(1) are subject to the one-percent excise tax imposed by section 4371(3), because Foreign Reinsurer is a resident of Country Y, which has an income tax treaty with the United States that does not exempt insurance premiums from the excise taxes imposed by section 4371.

Situation 4

In Situation 4, the insurance premiums paid by U.S. Corporation on the policies of casualty insurance issued by Foreign Insurer are exempt from the section 4371(1) excise tax after application of the U.S.-Z Treaty because Foreign Insurer satisfies the requirements of the limitation on benefits provision of the U.S.-Z Treaty and the policies were not entered into as part of a conduit arrangement. However, the premiums paid by Foreign Insurer to Foreign Reinsurer on the policies of reinsurance issued by Foreign Reinsurer are subject to the one-percent excise tax imposed by section 4371(3), because Foreign Reinsurer is a resident of

Financial Services

Captive Insurance Update

Bermuda

PRICEWATERHOUSECOOPERS 

Country Y, which has an income tax treaty with the United States that does not exempt insurance premiums from the excise taxes imposed by section 4371. The fact that the original insurance premiums paid by U.S. Corporation to Foreign Insurer are exempt from tax after application of the U.S.-Z Treaty does not preclude imposition of the excise tax under section 4371(3) on premiums paid by Foreign Insurer to Foreign Reinsurer. Such reinsurance premiums are paid on policies of reinsurance covering contracts described in and capable of being taxed under section 4371(1).

The Service has based its conclusions on a literal reading of the statute and the application of differing "limitation of benefits" provision found in US Income Tax Treaties. The reinsurance excise tax imposed by section 4371(3) on policies of reinsurance covering contracts described in paragraph (1), (2) or (3) of section 4371 applies to reinsurance premiums paid by one foreign insurer or reinsurer to another foreign reinsurer, unless the second foreign reinsurer issuing the policies is itself entitled to an exemption from the excise tax under an income tax treaty with the United States.

The Ruling also relies on *United States v. Northumberland Insurance Co., Ltd.*, 521 F. Supp. 70 (D. N.J. 1981), where the court held that the premiums ceded for a reinsurance policy issued by a foreign reinsurer are taxable if the underlying policy is issued to an "insured" as defined in section 4372(d), and there is no requirement that the reinsured qualify as an "insured" to be subject to the excise tax.

PwC Observes:

As indicated above Section 4371 generally imposes an excise tax on each policy of insurance or reinsurance covering US risks issued by any foreign insurer or reinsurer. The Service reads this section as; imposing the tax not only on the first such policy of insurance or reinsurance, but on each such subsequent reinsurance policy as well. (See for example TAM 9621001). This application of the excise tax is commonly referred to as the "cascading" theory.

The issue of whether there is a cascading excise tax has been debated for a number of years. In Revenue Ruling 2008-15, the Service has now clearly announced its position that the excise tax is imposed on every insurance or reinsurance transaction involving US risk even those involving two foreign parties. It is unclear how the IRS will enforce these rules; however, it is possible that they would attempt to obtain information from the US insured, US broker or US insurance company as the case may be. Conceivably in some cases they may also attempt to impose a tax obligation on the US party as a withholding agent.

Announcement 2008-18

In conjunction with the issuance of Revenue Ruling 2008-15, the Service also issued Announcement 2008-18. The Announcement introduces a voluntary compliance initiative intended to encourage certain taxpayers that may have failed to pay or withhold excise taxes due under section 4371, or failed to disclose that it has claimed a waiver from the taxes pursuant to an income tax treaty, to become compliant with its obligations. In general, if a taxpayer participates in this initiative in accordance with the terms specified in Ann. 2008-18, the IRS states that it will not conduct examinations covering insurance excise tax liabilities arising under the four situations set forth in Rev. Rul. 2008-15, or any similar fact pattern, to the extent that premiums are paid or received by the participating taxpayer during any quarterly tax period prior to October 1, 2008.

In the case of a nonparticipating taxpayer, the IRS may conduct examinations of the taxpayer covering any and all excise taxes due under section 4371 for any open tax periods, including tax periods beginning prior to October 1, 2008, and determine and assess the correct excise taxes due under section 4371, including interest, additions to tax, and, if applicable, penalties under section 6712 for failure to disclose a treaty-based return position under section 6114 and the regulations thereunder, and penalties under section 7270 for failure to comply with section 4374.

Financial Services

Captive Insurance Update

Bermuda

PRICEWATERHOUSECOOPERS 

Any foreign insurer or reinsurer, as defined in section 4372(a), or any other foreign person liable for the tax imposed by section 4371 of the Code ("eligible foreign person"), is eligible to participate if such person has failed to file timely one or more Form 720 returns (Quarterly Federal Excise Tax Return) and pay or remit any foreign insurance excise taxes due with respect to premiums paid or received during any quarterly tax period ending prior to October 1, 2008. An eligible foreign person also includes any foreign insurer or reinsurer that has failed to satisfy the treaty-based return disclosure requirements of Treas. Reg. § 301.6114-1(c)(viii), if applicable, with respect to claiming an exemption from foreign insurance excise tax under a U.S. income tax treaty during any such period. Notwithstanding that a foreign insurer or reinsurer is an eligible foreign person, certain failures by that person to file a Form 720 return and pay excise tax will not fall within the scope of the initiative. Accordingly, such failures to file and pay occurring during any quarterly tax period ending prior to October 1, 2008, will not be protected.

A participating taxpayer under this voluntary compliance initiative must file its Form 720 return with the Cincinnati Service Center. In addition to filing its Form 720 return with the Cincinnati Service Center, a participating taxpayer must also notify the IRS of its election to participate by including the following notation in red print at the top of the Form 720 return the following statement: "Election to participate in FET Voluntary Compliance Initiative pursuant to Announcement 2008-18."

PwC Observes:

Affected taxpayers should review their compliance in light of Revenue Ruling 2008-15 and consult with their tax professionals to determine their eligibility to participate in the voluntary compliance initiative. This initiative only provides protection in certain cases, and does not apply to failures to pay excise taxes with respect to a situation where the foreign insurer or reinsurer entered into an excise tax closing agreement with the Service and failed to pay excise taxes on premiums which do not qualify for the exemption because the foreign person has retroceded, in whole or in part, the premiums on US risk to a non treaty country or to a party not entitled to the exemption under the treaty.

Based on this Ruling and Announcement, it should be assumed that the Service intends to focus on this particular area and put an emphasis on examining foreign insurance or reinsurance companies writing U.S. risks and potentially other U.S. participants directly or indirectly involved.

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