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District Court Rules § 4371 Excise Tax Inapplicable to Foreign-to-Foreign Retrocessions

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On February 5, 2014, the United States District Court for the District of Columbia (the "Court") granted summary judgment for the plaintiff in Validus Reinsurance Ltd. v. United States of America, Civil Action No. 13-0109 (ABJ), and held as a matter of law that the Federal Excise Tax (FET) on insurance transactions does not apply to retrocessions.

In this case, Validus Reinsurance Ltd. ("Validus Re"), a Bermuda reinsurer, had reinsured U.S. risks and then retroceded a portion of those risks to foreign persons not eligible for an FET exemption under a Tax Treaty. The Internal Revenue Service (IRS), pursuant to its position as stated in Rev. Rul. 2008-15, assessed an excise tax of 1 percent on Validus Re for the retrocession. Validus Re paid the tax and appealed.

Under IRC § 4371, there is an excise tax of 4 percent that is imposed on each dollar of premium paid on (1) casualty insurance and indemnity bonds, and an excise tax of 1 percent on (2) life insurance, sickness and accident policies and annuity contracts. There is also a 1 percent excise tax on reinsurance covering any contracts listed in (1) or (2).

In looking to the plain language of the statute, the Court found that the excise tax statute did not apply to retrocession transactions. The Court noted that the tax imposed on reinsurance transactions only applied to the reinsurance of contracts as defined under IRC §4371(1) and (2) and would not apply to retrocessions because reinsurance is not listed in (1) or (2). The Court rejected the IRS's argument that retrocessions should be included under the excise tax statute to effect Congress's intent of placing U.S. and foreign reinsurers on equal ground (because foreign reinsurers are not subject to income tax). The Court noted that because the language of the statute was clear, the IRS's interpretation was precluded.

The Court's ruling in this case calls into question the interpretation of IRC § 4371 put forth by the IRS in Revenue Ruling 2008-15, 2008-12 I.R.B. 633 (2008). Specifically, Rev. Rul. 2008-15, Situation 2 contemplates a U.S. insurer that reinsures U.S. risks with Foreign Reinsurer A, which then reinsurers those risks with Foreign Reinsurer B. Neither Foreign Reinsurer A nor Foreign Reinsurer B is eligible for an FET treaty exemption. The revenue ruling concludes that there would be an FET due on both reinsurance transactions. Given the Court's decision regarding retrocessions, the IRS's interpretation in this scenario may be in question, with the second of the two transactions being a retrocession not subject to the excise tax.

As part of its motion for summary judgment, Validus Re also raised the issue of whether the FET could constitutionally apply to an extraterritorial transaction between foreign persons, even if U.S. risks were ultimately insured. Because the Court's decision was based on the plain language of the statute, it did not address this specific issue.

The decision leaves a few additional unanswered questions. For example, in Rev. Rul. 2008-15, Situation 1, a U.S. corporation insures U.S. risks with Foreign Insurer, which then reinsures those risks with Foreign Reinsurer. Neither Foreign Insurer nor Foreign Reinsurer is eligible for an FET treaty exemption. The ruling concludes that the FET applies to both the direct insurance transaction between U.S. corporation and Foreign Insurer, and the reinsurance transaction between Foreign Insurer and Foreign Reinsurer. Although the Validus Re decision addresses foreign-to-foreign retrocessions, the treatment of foreign-to-foreign reinsurance transactions similar to that discussed above remains unclear. Also unclear is the application of the excise tax to retrocessions from a U.S. reinsurer to a foreign person. The Validus Re ruling would appear to say that such a retrocession would not be subject to tax.

The IRS has not yet indicated whether it will acquiesce to the Court's decision. We will keep abreast of developments in this area and will be sending out additional alerts as these questions are clarified.