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APPEALS COURT AFFIRMS DISTRICT COURT RULING IN VALIDUS CASE—§ 4371 EXCISE TAX INAPPLICABLE ON FOREIGN-TO-FOREIGN TRANSACTIONS

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On May 26, 2015, the United States Court of Appeals for the District of Columbia Circuit (the Court) affirmed the District Court's grant of summary judgment in favor of the plaintiff in *Validus Reinsurance Ltd. v. United States of America*.[1] The Court held, as a matter of law, that the Federal Excise Tax (FET) on insurance transactions does not apply to foreign-to-foreign reinsurance transactions, including retrocessions.

As we described in a previous *Taxing Times* Tidbit,[2] Validus Reinsurance Ltd. ("Validus"), 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,[3] assessed an FET of 1 percent on Validus for the retrocession. Validus paid the tax, and appealed.

Under Internal Revenue Code (IRC) § 4371, there is an excise tax of 4 percent that is imposed on each dollar of premium paid covering U.S. risks 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 (3) a 1 percent excise tax on reinsurance covering any contracts listed in (1) or (2).

The District Court's ruling on Feb. 5, 2014 held, in looking to the plain language of the statute, that the excise tax statute did not apply to retrocession transactions. The District 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 District Court noted that the language of the statute was clear and, therefore, did not look beyond it.

The District Court's ruling called into question two situations. First, in cases where a U.S. reinsurer retrocedes risks with a foreign retrocessionaire not eligible for treaty benefits, under the District Court's reading of the statute, no FET would be due on such U.S.-to-foreign retrocessions. This outcome ran counter to long-standing industry understanding and practice where, for FET purposes, retrocessions were treated as a type of reinsurance transaction.

Second, Example 1 in Rev. Rul. 2008-15 states that in cases where a foreign direct writer has insured U.S. risks, then reinsured such risks with a foreign reinsurer not eligible for a treaty exemption, the foreign-to-foreign reinsurance transaction is subject to the FET. The District Court's ruling did not address such situations, as it limited itself to a discussion of retrocessions, leaving an open question as to whether these transactions are taxable.

On April 3, 2014, the United States gave notice of its intent to appeal. Oral arguments were heard on Feb. 20, 2015, with the Government maintaining that retrocessions were a type of reinsurance and that the plain reading of the statute, on which the District Court based its opinion, should result in retrocessions being subject to the FET. Validus countered that the District Court was correct in treating reinsurance transactions as distinct from retrocessions, and further argued that clear Congressional intent to apply the FET in an extraterritorial manner was lacking.

First, the Circuit Court addressed the application of the FET to retrocessions, noting that paragraph (3) of IRC § 4371 imposed a tax on reinsurance policies covering those described in paragraphs (1) and (2). Focusing on the statute's use of the word "covering," the Government argued for an expansive interpretation that would result in all reinsurance and retrocessions with underlying U.S. risks being potentially subject to tax. Validus argued for a more restrictive interpretation that would make the FET applicable only to reinsurance transactions. The Court found that both the Government and Validus presented plausible interpretations, and thus focused its analysis on the purpose of the statute. The Court noted that the statute seeks to level the playing field between domestic and foreign insurance and reinsurance businesses by imposing an excise tax on persons insuring or reinsuring U.S. risks where such persons are not subject to U.S. income tax on the income derived from such U.S. risks. It further stated that because a retrocession is "merely another type of reinsurance," Validus' interpretation of the statute would create a distinction between retrocessions and reinsurance issued by foreign persons to domestic insureds that would be at odds with the clear purpose of the FET. The Court thus concluded that retrocessions would be subject to the FET in the same manner as reinsurance transactions.

Next, the Court turned to the application of the FET in the foreign-to-foreign context. Citing *Morrison*,[4] the Court noted that a statute has no extraterritorial application unless such application is clearly expressed in the statute itself, in the statute's context or purpose, or in its legislative history. The Government offered, and the Court found, no indication that the FET was meant to apply in an extraterritorial manner. While acknowledging the Government's argument that the FET is always technically extraterritorial inasmuch as it applies to foreign persons not subject to U.S. income tax, the Court differentiated between U.S.-to-foreign transactions where one party to the contract is in the United States, which clearly were within the purview of the statute, and foreign-to-foreign transactions whose treatment was less clear. The Court further noted that, according to the Government's argument,

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the extraterritorial reach of the FET could extend indefinitely as U.S. risks are retroceded again and again, finding such situation clearly different from that authorized under IRC § 4371. Because IRC § 4371 was ambiguous with respect to wholly foreign retrocessions, the Court relied on the presumption against extraterritorial application and found for Validus.

While the Court's decision was a clear victory for Validus and other offshore reinsurers, it also cleared up two ambiguities that arose from the District Court's decision. First, by stating that retrocessions were a type of reinsurance, the taxability of U.S.-to-foreign retrocessions is confirmed. Second, by limiting the FET's extraterritorial scope, it is now clear that a foreign-to-foreign reinsurance transaction is not subject to the FET.

The IRS' renewed focus on the cascading excise tax, which began with the publication of Rev. Rul. 2008-15, caused many offshore insurers to have an unexpected U.S. tax bill during these past seven years. Some offshore reinsurers were not prepared or able to track specific risks on all underlying contracts and had to estimate the magnitude of their premiums relating to U.S. risks based on such factors as the domicile of the ceding company. This methodology could never provide a fully accurate picture, especially in instances where an underlying contract covers worldwide risks. Notwithstanding the IRS' assurances that it would not look past the first foreign-to-foreign transaction to assess the FET, as U.S. risks moved further down the chain of reinsurance and retrocessions, the FET exposure remained, but the ability of companies to accurately track the taxable premium became more and more imprecise and difficult. With the Validus decision, this uncertainty is no more.

During the course of the Validus litigation, many foreign insurers that paid the cascading FET submitted protective refund claims, and for those insurers that have not yet acted, it is likely that there will be additional refund claims in the coming months. The deadline for the IRS to file a notice of appeal was August 24, 2015, which passed without any action on their part. We now await word on how the IRS will approach the refund claims. ■

Note: The views expressed are those of the author and do not necessarily reflect the views of Ernst & Young LLP.

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END NOTES

[1] *Validus Reinsurance Ltd. v. United States of America*, 19 F. Supp. 3d 225 (D.D.C. 2014), aff'd, 786 F.3d 1039 (D.C. Cir. 2015).

[2] Edward C. Clabault, "District Court Rules § 4371 Excise Tax Inapplicable on Foreign-to-Foreign Retrocessions," *Taxing Times* Vol. 10, Issue 2 (May 2014), at 30.

[3] 2008-12 I.R.B. 633.

[4] *Morrison v. Nat'l Austl. Bank Ltd*., 561 U.S. 247, 255 (2010).