
Court Holds Excise Tax Does Not Apply to Foreign Retrocessional Reinsurance

By Robert Tomilson / Feb 27, 2014

In *Validus Reinsurance, Ltd. v. United States*, No. 13-0109 (ABJ), 2014 WI 462886 (D.D.C. 2014), the U.S. District Court for the District of Columbia found that although foreign reinsurance contracts covering certain U.S. risks are subject to excise tax under Internal Revenue Code Section 4371, the statute's plain language does not encompass retrocessional reinsurance.

In February 2012, the Internal Revenue Service (the IRS) requested that Validus Reinsurance Ltd., a Bermuda-based reinsurer, "consent to the assessment of [an] Excise Tax" in the amount of \$326,340 for the year 2006. While the IRS considered the excise taxes over six years delinquent, it agreed to waive any penalties (but not interest) because the reinsurer had "reasonable cause" to believe it was not subject to the tax. Validus paid the tax (and interest) and then filed a claim for a full refund. The IRS failed to act on the refund claim and Validus filed an action with the court.

Section 4371 imposes a variety of excise taxes on insurance transactions involving policies issued by foreign insurers or reinsurers. In particular, Section 4371(3) imposes an excise tax at the rate of one cent for each dollar of premium paid on a "policy of reinsurance" issued by a foreign reinsurer covering contracts taxable under paragraph (1) or (2) of Section 4371. The statute defines a policy of reinsurance subject to the tax as "any policy or other instrument by whatever name called whereby a contract of reinsurance is made, continued, or renewed against, or with respect to, any of the hazards, risks, losses, or liabilities covered by contracts taxable under paragraph (1) or (2) of section 4371." Section 4371(1) taxes premiums paid on a policy of casualty insurance or indemnity bond at a rate of four cents on each dollar of premium paid; Section 4371(2) taxes premiums paid on a policy of life, sickness or accident insurance or annuity contract at a rate of one cent on each dollar of premium paid.

Validus argued that the plain language of Section 4371 does not impose an excise tax beyond the first cession of reinsurance, as retrocessional coverage is not the reinsurance of casualty, life, accident, sickness or annuity contracts. The IRS argued that Congress intended to impose a tax on "any and all" successive levels of insurance or reinsurance obtained from a foreign reinsurer covering U.S. risks. The party paying premium, the cedent or retrocedent, generally has the duty to remit premium taxes, although certain reinsurance agreements shift the cost if not the duty to pay such tax. Therefore, both Validus and the IRS raised issues related to Congress' authority to impose excise taxes extra-territorially (on a Bermuda reinsurer) and whether such authority comports with international law.

Finding the language of the statute unequivocal, the court said it was unnecessary to address the collateral issues of extra-territoriality. Section 4371, the court found, contains a "clear internal limitation" on its application to reinsurance policies i.e., the excise tax applies to "premium paid on the policy of reinsurance covering any of the contracts taxable under paragraphs (1) or (2)." The contracts taxable under paragraph (1) are contracts for casualty insurance and indemnity bonds and under paragraph (2) are contracts for life, sickness, accident and annuity contracts. Retrocessional coverage does not reinsure casualty, life, sickness or annuity contracts or indemnity bonds. Rather, it reinsures the risk assumed by reinsurers. Accordingly, the court held that reinsurance of reinsurance, or retrocessional coverage, is outside Section 4371's scope. In reaching its decision, the court noted that the IRS's Revenue Ruling 2008-15, addressing issues not presented in this case, assumed that retrocessional reinsurance is taxable under Section 4371. The court indicated that it would not defer to a ruling that contrasts with clear statutory language.

The court's opinion is not binding on courts in other jurisdictions, but it is certainly influential. Foreign reinsurers that have been paying U.S. excise tax on retrocessional coverage should consider filing for refund. While it is anticipated that the IRS will appeal the decision, the clarity of the court's reasoning and the unambiguous language of the statute make a successful IRS appeal challenging.

If you have any questions about this issue, please contact Robert Tomilson at rtomilson@clarkhill.com or 215.640.8550.