

Captive insurance update



Federal excise tax: DC District Court rules ‘Cascading’ insurance excise tax does not apply to retrocessions

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In brief

In *Validus Reinsurance, Ltd. v. United States of America*, the United States District Court for the District of Columbia held that the insurance federal excise tax (FET) does not apply to secondary reinsurance transactions covering US risks between two foreign reinsurance companies.

In detail

In Revenue Ruling 2008-15 the IRS stated that premiums covering US risks paid by a foreign insurer or reinsurer to another foreign reinsurer are subject to a one percent FET. In essence, the FET is imposed on a cascading basis, as the payment of premiums to the foreign insurer or reinsurer is also subject to FET.

Validus Reinsurance, Ltd. (Validus), a Bermuda reinsurance company, purchased reinsurance policies from foreign reinsurers. In accordance with Rev. Rul. 2008-15, the IRS applied the cascading FET rule to these reinsurance arrangements which are referred to in the industry as “retrocessions.” Retrocessions are reinsurance transactions between two reinsurance companies. Validus paid the FET in full, and then initiated a cause of action seeking a refund of the FET.

The District Court ruled in favor of Validus. It noted that Validus’ transactions are retrocessions and reasoned that the plain language of the statute does not impose an excise tax on retrocessions. Interestingly, the court did not limit the exemption from FET for retrocessions to the cascading FET, thus this exemption can be read broadly. The court also did not address whether premiums covering US risks paid by a foreign insurer to another foreign reinsurer are subject to FET.

The takeaway

The District Court’s ruling is a very favorable development for offshore reinsurers which retrocede risk to other offshore reinsurers. Because most reinsurance companies do not have places of business in the United States, the issue could be litigated in the DC District Court by all such taxpayers. As this is the court that decided the Validus case, the decision of the court is directly precedential on the issue to such taxpayers.

Consequently, foreign reinsurance companies that have paid the ‘cascading’ FET on retrocessions should evaluate the statute of limitations with respect to filing refund claims and consider filing such claims where critically necessary to extend the statute. Those who have filed refund claims should generally await further development. Taxpayers should consider the *Validus* decision to determine whether they should continue to pay FET on retrocessions.

Let's talk

For more information on how the decision in *Validus* could affect your business, please contact one of the individuals listed below:

Bermuda

Richard E. Irvine	Managing Director	(441) 299 7136	richard.e.irvine@bm.pwc.com
Scott D. Slater	Senior Manager	(441) 299 7178	scott.slater@bm.pwc.com
Zack Rothman	Senior Manager	(441) 299 7106	zack.rothman@bm.pwc.com

Cayman

Noemi Rodriguez	Manager	(345) 914 8796	noemi.g.rodriguez@ky.pwc.com
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