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RECENT DEVELOPMENTS IN THE FEDERAL EXCISE TAX AND ITS IMPACT ON ALIEN NONADMITTED INSURERS

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Two recent developments regarding the United States federal excise tax on premiums ("FET") paid to foreign (that is, alien) insurers may have an enormous impact on the amount of revenues collected each year by the Internal Revenue Service ("IRS") under 4371 of the Internal Revenue Code (the "Code").

Understanding The FET and Its Applicability

Under the Code and the regulations, the FET is applicable to each policy of insurance, indemnity bond, annuity contract or policy of reinsurance issued by a foreign (that is, an alien) insurer or reinsurer to, or for, or in the name of (i) a domestic corporation, domestic partnership or individual United States resident against hazards, risks or losses or liabilities wholly or partly within the United States, or (ii) a foreign corporation, foreign partnership or non-resident individual, but only if that foreign insured is engaged in a trade or business within the U.S., with respect to hazards, risks, losses or liabilities, within the U.S. With respect to direct casualty insurance and indemnity bonds, the FET rate is 4% of the premium paid on the policy. With respect to life insurance, sickness and accident policies, annuity contracts, and all reinsurance contracts and treaties, the FET rate is 1% of the premium. The term "premium" refers to the consideration charged for assuming and carrying the risk or obligation, and includes any additional charges or assessments, fronting fees, or reinsurance ceding commissions that may be imposed under the contract regardless of whether they are paid in installments or in one lump sum.

The term "insured," for purposes of the FET, includes a foreign corporation, foreign partnership, or non-resident individual, engaged in trade or business within the United States as to coverage against, or with respect to, hazards, risks, losses, or liabilities within the U.S. A foreign government and municipal or other corporation exercising its taxing power is exempt from FET liability under 4372(a) of the Code. However, a financial organization, owned and controlled by several foreign governments and which cannot independently exercise any substantial powers binding on its member countries, is not a foreign government within the meaning of Code 4372. Such an organization may, therefore, be classified as an alien insurer.

The IBM Decision

In the case of *United States v. International Business Machines Corporation*,[1] the United States Supreme Court held that the Export Clause of the United States Constitution prohibits assessment of the FET on insurance premiums remitted to foreign insurers to cover shipments of goods to foreign purchasers.

Pursuant to 4371 of the Code, IBM paid a tax on insurance premiums remitted to foreign insurers to cover shipments of goods to its foreign subsidiaries. When its refund claims were denied, IBM filed suit in the Court of Federal Claims, contending that 4371's application to policies insuring export shipments violated the Export Clause, which states that "no tax or duty shall be laid on articles exported from any state." The Court agreed, rejecting the government's argument that *Thames & Mersey Marine Ins. Co. v. United States*[2] -- in which the Supreme Court held that a federal stamp tax on policies insuring marine risks could not, under the Export Clause, be constitutionally applied to policies covering export shipments -- had been superseded by subsequent decisions interpreting the Export Clause. The Court of Appeals in the *IBM* decision affirmed the

superseded by subsequent decisions interpreting the Export Clause. The Court of Appeals in the *IBM* decision affirmed the decision of the Court of Federal Claims, and the Supreme Court affirmed the Court of Appeals decision, thereby leaving stand IBM's claim for a refund and the prospect of claims for refunds by many multinational corporations who have remitted FET on premiums paid to foreign insurers.

The *IBM* case focused on the issue of whether the high court's 1915 decision in *Thames & Mersey Marine Ins. Co.* should be overruled. The government conceded that the decision, if still good law, would require invalidation of the tax, but argued that subsequent Supreme Court decisions involving the Export Clause required that *Thames & Mersey* be abandoned. The government argued that the Export Clause permits the imposition of generally applicable taxes, notwithstanding the fact that they might affect goods in export transit.

While one may question *Thames & Mersey's* finding that a tax on policies insuring exports is functionally the same as a tax on exportation itself, the government apparently chose not to do so in the *IBM* case. Under the principles that give rise to the policy of *stare decisis*, the Court declined to overrule *Thames & Mersey* and held that prior case law governing the Export Clause does not interpret the clause to permit the assessment of non-discriminatory taxes on imports and exports in transit. What is particularly compelling about the *IBM* decision is that the facts in the Court of Federal Claim's decision suggest that taxpayers applying for a refund of FET in accordance with instructions promulgated by the IRS subsequent to the Supreme Court's opinion should apply for a refund based upon premiums paid in connection with shipments of products from the United States to their foreign customers begun by truck on a common carrier from the manufacturing plant or warehouse inside the United States. During the tax years in issue, IBM products manufactured in the U.S. and sold outside the U.S. through foreign subsidiaries included parts manufactured at various locations inside the United States. The goods generally were destined for a United States airport, but some shipments were by sea. While traveling within the United States, the products would typically be unloaded at one or more intermediate freight forwarder locations, where they would remain for a brief period, but could remain while awaiting space on an airliner for as long as one month. The products would be reloaded at the freight forwarder's facilities and continue ultimately to the point of embarkation, where they were loaded onto an airplane or a ship. Once the products reached the air or sea port in the foreign country, they were unloaded, cleared customs, and loaded onto trucks for shipment to their final destinations. All U.S.-manufactured products IBM sold to foreign subsidiaries were covered by casualty insurance against damage or destruction during shipment. Insurance was "point-to-point," that is, it covered the risk of loss to goods during transportation by surface or air transportation from the IBM plant in the U.S. until delivered to the foreign customer or a foreign consolidation center. Although the basis for the Supreme Court's decision was the issue of whether *Thames & Mersey* was still a viable holding, the decision of the Court of Federal Claims, which was based on the facts as presented to the Court of Federal Claims, was left standing at both the Court of Appeals level and at the Supreme Court level.

Accordingly, further clarification may be required with respect to the applicability of the decision to the premiums allocable to the inland marine portion of the export shipment. The lower court decision appears to suggest that there is no allocation to be made and that to the extent that foreign insurers have been paying insurance premiums relating to export shipments, a refund is due to the taxpayer, regardless of whether the shipment originated at a United States air or sea port or at a location inland. That thinking would be consistent with the IRS's prior rulings to the effect that premiums paid for an insurance policy covering risks partially inside and partially outside the U.S. cannot be apportioned so as to avoid paying the FET for coverage of that portion of the risks which is outside the U.S.

In Revenue Ruling 57-256, 167-1 CB 416, the IRS stated that a policy of insurance covering cargo shipped to the U.S., which was issued to a U.S. domestic corporation and which provided that the insurer's liability ceased upon the discharge of the cargo at the port of destination, was not subject to the FET, but that if the policy were to cover in addition the property beyond the point of unloading, that is, if the policy were to cover the movement of property after unloading, even if only to a warehouse in the port area, the premiums would be entirely subject to the FET.

In Revenue Ruling 69-100, 1969-1 CB 289, the IRS ruled that where a U.S. domestic insured purchased from an alien insurer an ocean marine policy which stated it would be extended to include coverage for risks wholly outside the U.S., and the insured subsequently purchased an endorsement which in fact extended coverage under the policy to include risks wholly outside the U.S., the entire premium paid for the policy and the endorsement was subject to the FET.

Furthermore, Private Letter Ruling 8507003 explicitly states that the IRS will not permit allocation for tax purposes of premiums paid for policies covering both risks inside and outside the U.S. The ruling states that the FET is based on gross premiums and that no statutory authority exists for reducing the gross premiums of taxable insurance contracts.

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Does The Tax "Cascade" To Cover Reinsurance and Retrocession Premiums?

A second important development potentially affects U.S. policyholders and foreign reinsurers. It is important to remember that the U.S. policyholders generally are unaware of the reinsurers (or the concept of reinsurance for that matter) and have no privity of contract with them.

The ruling, which was released in June as Technical Advice 9621001, involves excise tax liability when a United States insured buys a policy of insurance from an insurer outside the United States that in turn cedes some or all of the risk to another insurer domiciled outside the United States. The ruling involved the situation of a United States company buying liability coverage from a Bermuda insurer as to which the 4% FET is correctly imposed on those premiums. Where the Bermuda insurer reinsures the U.S. company's risks with other foreign insurers, the IRS states in the Technical Advice that premiums for that reinsurance are subject to the 1% FET.

It is the Bermuda insurer, which is outside the jurisdiction of the IRS, that is actually primarily liable for the tax. However, the IRS advice says that it could collect the taxes due from the "property" of the Bermuda insurer held by its United States policyholder. The Technical Advice, which is a reflection of the IRS's current thinking on an issue and has no immediate binding authority except on the taxpayer to which it is addressed, does not define "property". However, some prominent tax experts are concerned that the term "property" could be construed to include premiums which a policyholder owes the insurer.

The Technical Advice also states that the imposition of the 1% FET on reinsurance "cascades" so that each time a policy is reinsured with a foreign reinsurer, the reinsurer retroceding the risk would be liable for the 1% FET. In theory, each subsequent retrocession could be subject to the 1% FET no matter how many times the retrocessions take place, as long as the retrocessions can be traced back to a United States risk insured with a foreign insurer. This is the first attempt to enforce a theory which has been discussed within the IRS for a number of years. It is a theory that has questionable legal validity or practicality.

First of all, it is well recognized that absent an enforceable cut-through clause, an insured, which has no privity of contract with a reinsurer (or a retrocessionaire, for that matter) cannot enforce its rights under the direct policy against a reinsurer or a retrocessionaire.[(3)] Therefore, the IRS will be hard pressed to justify its right to enforce imposition of the FET against reinsurers whose existence may neither be known to the original policyholder nor the original ceding insurer nor envisioned by them and at each layer of a reinsurance or retrocession series of transactions.

As a practical matter, when foreign companies cede and retrocede business among themselves, it is unclear how the IRS could even track offshore reinsurance transactions and retrocessions. Reinsurance transactions have become so sophisticated, so multi-layered, and in some cases proportional, that it is difficult to envision how an IRS agent could have the wherewithal or sophistication to enforce the tax, even if it is enforceable. Investments held in the United States by the offshore companies could be the hook that the IRS is looking for. Further, the policyholders themselves could find themselves at the other end of an IRS enforcement action if premiums owed are, in fact, considered "property" of the offshore insurers. Those insurers could be the policyholders' own captives that do third-party business.

In reaching its conclusion, the IRS relied on the decision in *United States v. Northumberland Ins. Co., Ltd*.[(4)] In that case, Northumberland, an Australian insurance company, which was authorized to do business as a surplus lines insurer in New Jersey before becoming insolvent, entered into a reinsurance agreement with AIM Reinsurance Co., Ltd., a Swiss corporation, prior to the insolvency. AIM Re had no office in the U.S. and was not authorized to do business in the U.S. Pursuant to the agreement, AIM Re agreed to reinsure 90% of the reinsurance written by Northumberland through its U.S. branch for a period of ten years. Some of the risks that Northumberland ceded to AIM Re had been written by foreign insurance companies and assumed through reinsurance by Northumberland. Almost 100% of the risks that Northumberland ceded to AIM Re were located in the United States. Northumberland did not report or pay FET on the reinsurance premiums that it paid to AIM Re in 1971 through 1973. The IRS assessed FET on the reinsurance premiums that Northumberland paid to AIM Re. One of Northumberland's arguments was that 4371(3) of the Code, which imposes the FET on reinsurance policies, does not apply to reinsurance policies issued by one foreign insurer to another, and therefore is inapplicable to the reinsurance agreement with AIM Re.

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The court rejected Northumberland's argument and reasoned as follows: (1) Under 4371(1), a casualty insurance policy issued by a foreign insurer is taxable only if the policy is issued to an "insured" as defined in 4372(d). (2) In defining "insured," 4372(d) distinguishes between domestic insureds and foreign insureds. If the insured is a domestic entity, the tax applies to a policy covering a risk situated "wholly or partly within the U.S." If the insured is a foreign entity, the tax applies only to a policy covering a risk wholly within the U.S. (3) In the case of reinsurance, the "reinsured" need not qualify as an "insured." The only requirement is that "the underlying primary policies were issued to "insureds" under 4372(d). (4) The legislative history of the Revenue Act of 1942 indicates that Congress intended to impose tax on foreign insurers or reinsurers that are not subject to U.S. income tax, which is the situation with AIM Re.

Northumberland's argument that 4371 may not apply to the reinsurance contract with AIM Re because the excise tax was previously imposed on the policies of reinsurance issued by Northumberland on the same underlying risks was rejected by the court as follows:

To the contrary, the plain language of 4371 states that the tax is to be imposed on "each" policy of reinsurance issued by any foreign insurer. . . . Had Congress intended to provide an exemption for reinsurance policies issued to foreign reinsureds, "it is reasonable to suppose that Congress would have said so in explicit terms."

By concluding that the IRS may collect the FET with respect to the reinsurance transaction under normal collection procedures from property of the direct insurer that may be held by the policyholder, and by concluding that the FET "cascades," the IRS has taken the most aggressive posture it ever has taken with respect to collection of FET on reinsurance and retrocession transactions. Under 4374, all persons liable for the tax or any unpaid portion thereof are responsible for paying it. With respect to the FET on the direct insurance policy issued by the overseas insurer, the insured, of course, is liable for the tax or any portion thereof which remains unpaid. The insurer is similarly liable for any amount of unpaid taxes. If a broker was involved, e.g., in a surplus lines placement, it too would be liable for any unpaid portion of the tax since it is the one remitting the premium. However, to conclude that the IRS may enforce collection of the FET on the reinsurance or retrocession portion of the transaction against the U.S. insured by attaching property of the reinsurer or retrocessionaire located in the U.S., including such property in the hands of the U.S. insured, the IRS has ignored the lack of privity between insured and reinsurer or retrocessionaire and has taken a position which may not be upheld by a court if and when its position on enforcement is challenged. Clients should be advised to take a "wait and see" attitude since Technical Advice of the IRS has no binding impact except on the taxpayer to which it is addressed. However, the impact of the ruling, if it is ultimately enforced, may be enormous and discourage the use of offshore captives and of other alien nonadmitted insurers.