Client Update
D.C. Circuit Court Affirms *Validus* on Narrower Grounds

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The U.S. Court of Appeals for the District of Columbia Circuit ruled on May 26, 2015 that the excise tax imposed under Section 4371 of the Internal Revenue Code (the "Code") does not apply to a retrocession contract between two foreign reinsurers. The decision in *Validus Reinsurance, Ltd. v. United States*,[1] which affirms a 2014 holding of the District Court of the District of Columbia (albeit on narrower grounds), is significant because it rejects the IRS's "cascading" excise tax theory, pursuant to which reinsurance or retrocession contracts between foreign reinsurers with respect to underlying U.S.-based risks could be subject to the 1% excise tax even if premiums paid with respect to the same underlying risks had already been subject to the excise tax in connection with prior insurance or reinsurance to a foreign insurer.

BACKGROUND

Validus Reinsurance, Ltd., a Bermuda company ("Validus") sold contracts of reinsurance to third-party insurers, under which it assumed its counterparties' underlying insurance liabilities. These contracts included transactions in which Validus reinsured the U.S.-based risks of U.S. insurers. Validus then entered into nine retrocession agreements, under which third-party retrocessionaires in turn assumed a portion of Validus' reinsurance risks. Each of the retrocessionaires was a foreign company not engaged in business in the United States, like Validus itself.

The IRS assessed an excise tax against Validus under Section 4371 on the retrocession premiums that Validus paid to its retrocessionaires. Section 4371 generally imposes (1) a 4% excise tax on premiums paid under policies of casualty insurance or indemnity bonds issued by foreign insurers with respect to certain U.S. risks, (2) a 1% excise tax on premiums paid on policies of life, sickness, accident insurance or annuity contracts issued by foreign insurers with respect to

[1] No. 14-5081, 2015 WL 3371689 (C.A.D.C. May 26, 2015).

the life or hazards to the person of citizens or residents of the United States, and (3) a 1% excise tax on premiums paid on reinsurance contracts issued by foreign reinsurers *covering* any of the contracts described in (1) or (2) (emphasis added).

In February 2014, the District Court granted Validus summary judgment on the grounds that Section 4371, under its literal language, would not apply to any retrocession because the statute does not include retrocession contracts covering reinsurance contracts, even if the underlying risk covered by the retrocession is described in Section 4371.

THE D.C. CIRCUIT COURT'S RULING

The United States appealed, arguing that the word "covering" in the statute is broad enough to include a retrocession contract, as it protects against the risks insured under the underlying insurance contract. The D.C. Circuit Court found that both Validus and the United States had offered plausible interpretations of how Section 4371 applies by its terms in the case of a retrocession contract, and thus the statute was ambiguous as to whether it should apply only to reinsurance contracts "directly" covering the risks described in (1) or (2) above or, conversely, to retrocession contracts "indirectly" covering such risks.

The D.C. Circuit Court resolved the ambiguity in the statute by applying the presumption against extraterritoriality. The court ruled that there was no clear Congressional indication, either in the text of the statute itself or in the legislative history, that Section 4371 should apply to reinsurance contracts between two foreign reinsurers and thus the statute should not be interpreted to apply to a retrocession contract between two foreign reinsurers. Thus, under the D.C. Circuit Court's ruling, all reinsurance or retrocession agreements between foreign insurance companies that are not engaged in a U.S. trade or business would appear to be exempt from the excise tax imposed by Section 4371.

The D.C. Circuit Court also rejected the District Court's broader holding that Section 4371 does not apply to any retrocession agreement, largely because the District Court's interpretation led to the conclusion that the excise tax would not apply to a direct retrocession from a U.S. reinsurer to a foreign retrocessionaire. The D.C. Circuit Court concluded that the District Court's interpretation of the statute exempting U.S.-to-foreign retrocessions from the excise tax was directly contrary to Congress's express intention to "level the playing field" between U.S. and foreign insurance companies by imposing the excise tax only on the business of insurance companies not otherwise subject to U.S. income tax.

IMPLICATIONS

Absent further review of the *Validus* decision by the full D.C. Circuit Court in an *en banc* proceeding or by the United States Supreme Court or a case arising in another Circuit Court, the *Validus* decision appears to resolve favorably for taxpayers the question of whether the Section 4371 excise tax can be applied to an entirely foreign-to-foreign reinsurance or retrocession transaction. The government has not stated whether or not it will continue to contest the *Validus* decision.

The District Court's ruling that the Section 4371 excise tax did not apply to *any* retrocession contract (even a U.S.-to-foreign retrocession) had created some question as to whether the IRS would assert that the 30% withholding tax on U.S.-source fixed and determinable income under Sections 1441 and 1442 of the Code would apply to U.S.-to-foreign retrocession premiums. The question arose because the Treasury regulations explicitly exempts from the 30% withholding tax only "insurance premiums paid with respect to a contract that is subject to the Section 4371 excise tax." Commentators expressed concern that the District Court's decision had created an implication that the 30% withholding tax could apply to U.S.-to-foreign retrocession premiums that are not subject to the excise tax. Under the D.C. Circuit Court's ruling, U.S.-to-foreign retrocessions are subject to the excise tax and therefore are clearly exempt from the 30% withholding tax. Although the D.C. Circuit Court's opinion does not address whether the 30% withholding tax could be applied on a "cascading" basis to foreign-to-foreign transactions, the application of the 30% withholding tax in these circumstances would clearly be in tension with the D.C. Circuit Court's reasoning, which relies on a presumption against the extraterritorial application of U.S. statutes absent a clear indication of Congressional intent to rebut that presumption.

The *Validus* decision represents a victory for common sense, in that it avoids the potentially onerous "cascading" effect of applying the excise tax multiple times to the same risks, without having to rely on an arguably narrow reading of the statute to exclude all retrocessions from the scope of the tax. Although some uncertainties may remain as to the application of the 30% withholding tax to transactions exempt from the excise tax, the D.C. Circuit Court's opinion nonetheless provides some welcome clarity to a disputed area.

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Please do not hesitate to contact us with any questions.