Closing agreements and the Federal Excise Tax

Why are foreign insurers and reinsurers entering into Closing Agreements with the IRS?

This bulletin examines why many foreign (i.e. non-U.S.) insurance and reinsurance companies, who write direct business in the U.S., or reinsure U.S. risk, are entering into Closing Agreements with the Internal Revenue Service ("IRS") in order to secure an exemption from Federal Excise Tax ("FET") on their U.S. lines of business, a benefit granted by certain U.S. income tax treaties. This bulletin also addresses some frequently asked questions about the Closing Agreement procedure, including the timeframe and the various benefits of entering into a Closing Agreement with the IRS.

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I. Introduction

Section 4371 of the Internal Revenue Code ("IRC") imposes an excise tax on each policy of insurance or reinsurance covering United States ("U.S.") risks issued by any foreign insurer or reinsurer, unless the premiums paid are subject to U.S. income tax as being income effectively connected with the conduct of a U.S. trade or business. IRC Section 4374 provides that the insurance FET shall be paid by any person who makes, signs, issues or sells any of the documents and instruments subject to the tax, or for whose use or benefit the same are made, signed, issued or sold. This means that the last person in the US to pay the insurance/reinsurance premium overseas, including the U.S. insurance company ceding the risk to the foreign reinsurer, an insured or a broker, may potentially be liable to pay the FET.

Some foreign insurance companies have, for many years, been able to write U.S. business without FET liability by virtue of exemptions granted pursuant to income tax treaties between the U.S. and several countries. In the past, a few of these treaties provided an automatic FET exemption, whereby the foreign insurance company simply had to be resident in a particular overseas jurisdiction in order to qualify for treaty benefit.

However, under most treaties now in force with the U.S., residency is no longer a guarantee that the FET exemption will apply; stricter exemption tests apply, some of which include anti-conduit rules (explained below). Certain foreign insurers who, under old tax treaties, were previously eligible for the FET exemption, may now (unknowingly) be liable to FET on their U.S. business because they do not satisfy the stricter exemption tests that have since been introduced (either by treaty protocol or by the enactment of a new treaty).

Most treaties contain a "qualified exemption", such as the U.S.-France Income Tax Treaty, whereby premiums paid to a French insurer or reinsurer will be exempt from the FET to the extent the premiums are not subsequently reinsured to a second non-qualifying foreign insurer. Other specific exemptions to the FET apply to foreign insurers who make an election under either IRC Section 953(d), electing to treat a foreign insurance company as a domestic insurance company for federal income tax purposes, or an election under IRC Section 953(c)(Related Person Insurance Income). In addition, although the income of a controlled foreign corporation ("CFC") that is an insurance company is already taxable to its U.S. shareholders, U.S. risk premiums paid to the company will still be subject to the FET unless a specific treaty or other exemption applies.

The FET is computed on the basis of gross premiums paid to the foreign insurer or reinsurer. The relevant Treasury Regulations define "premium payment" as the consideration paid for assuming and carrying the risk, including any additional assessments or charges paid under the contract, less return premiums. Therefore, as a general matter, the FET applies to premiums paid without any reduction for expenses incurred. For example, in Revenue Ruling 79-138 the Internal Revenue Service ("IRS") ruled that the FET base was the gross amount of premiums paid to the reinsurer, without reduction for expenses, commissions, or losses, even though a contract may provide for payment of a net amount.

The rate of FET on contracts covering U.S. risks is generally 4% on direct business and 1% on life insurance and reinsurance business. Since the amount of gross premium is often substantial, loss of the exemption could represent a real and significant cost to foreign insurers or reinsurers. In light of this exposure, many foreign issuers have sought to secure their exemption entitlement by entering into a Closing Agreement with the IRS.

Limitation on benefits article and anti-conduit provisions

Most U.S. income tax treaties that have an FET exemption also contain Limitation on Benefits ("LOB") provisions and anti-conduit provisions outlining specific criteria which must be satisfied, thus, limiting treaty benefits to treaty country residents that have a sufficient nexus to the treaty country. The LOB article restricts the availability of potential treaty benefits to "qualifying persons" (as defined), or, alternatively, entities that pass either a derivative benefits test, active trade or business test or if discretionary approval is given by the competent authority.

A conduit arrangement is an arrangement whereby transactions are structured such that one of the main purposes of the arrangement is to allow parties not otherwise entitled to treaty benefits to obtain such benefits. However, determining

what is and is not a conduit arrangement can be complicated. For example, in the case of a UK life company ("Life Co") that writes U.S. business of which 90% is subsequently reinsured to Life Co's parent company, a resident in Hong Kong (i.e. a territory with no U.S. tax treaty), the reinsurance arrangement may be considered to be a conduit arrangement (i.e. not eligible for treaty benefit). However, arguably it would not be viewed as a conduit arrangement if only 10% of the business was reinsured to the parent for a good business purpose and 40% with unrelated parties exempt under a treaty. A Closing Agreement can provide certainty that the LOB article and anti-conduit provisions will not prevent the taxpayer from claiming treaty benefits.

II. What is a closing agreement?

A Closing Agreement is an agreement between a foreign insurer/reinsurer and the IRS in which the foreign insurer/reinsurer represents that it is eligible for FET treaty benefits because it satisfies the criteria under the LOB provisions of the treaty between the U.S. and the foreign country. Under the terms of the Closing Agreement the taxpayer (i.e. the foreign insurance or reinsurance company) is bound by a number of specific obligations, the key ones being:

- The taxpayer agrees that it shall be liable to pay any FET due and will comply with the filing requirements to the extent the taxpayer is not covered under the FET exemption.
- As security for any failure to deduct the FET, in the event it applies, the taxpayer is usually required to place an irrevocable $75,000 letter of credit with the IRS.
- The taxpayer agrees to promptly notify the Competent Authority of the Treaty Country and the IRS of any change that results in the taxpayer no longer qualifying for benefits under the treaty with respect to the FET.

III. The benefits of a closing agreement

- Tax certainty: A Closing Agreement may provide the taxpayer with certainty that the IRS will uphold the treaty benefits sought.
- Eliminates FET exposure: A Closing Agreement will promote that foreign insurers, reinsurers and brokers/underwriters are not liable for FET, either now or retrospectively.
- FET withholding: A US person, otherwise liable to FET, may rely on a Closing Agreement to avoid a withholding tax liability for the failure to withhold FET. Hence, a Closing Agreement should promote that US insurers, reinsurers and brokers/underwriters do not withhold any FET going forward (hence avoiding the administrative burden and cost involved in filing an FET refund reclaim). A number of U.S. brokers are beginning to tighten their policies and insist on a Closing Agreement before they will agree not to withhold FET at source.
- IRS challenge: A Closing Agreement reduces the risk of the IRS challenging a foreign insurer or reinsurer's eligibility to claim treaty benefits. Such challenges are typically more expensive to defend/refute than the cost of putting in place a Closing Agreement at the outset.
- Treaty-Based Return Positions: The regulations under IRC Section 6114 require a taxpayer to report, on a tax return, certain treaty-based positions that effect any provision of the Internal Revenue Code. This reporting requirement is waived if a Closing Agreement is entered into with the IRS.

IV. Frequently asked questions

How does a company obtain a Closing Agreement?

Prior to entering into a Closing Agreement, a company must first determine whether it is eligible for benefits under the income tax treaty between the U.S. and the foreign country. The limitation on benefits provisions must be thoroughly analyzed based on the specific facts and circumstances of the company's business and organizational structure in order to determine eligibility. In the case of the UK/US Treaty the anti- conduit provisions must also be analyzed based on the company's current ceding structure.

Once it is determined that the treaty provisions have been met, the company prepares a document under penalties of perjury certifying that the company qualifies for treaty benefits under the terms of the applicable tax treaty and is requesting to enter into a Closing Agreement with the IRS enabling the company to qualify for an FET exemption. As part of this process, the company is usually required to obtain various documents including obtaining letters of credit as discussed above.

How long does the Closing Agreement process take?

It usually takes the IRS approximately 4-5 months to issue a ruling and to sign an FET Closing Agreement with the taxpayer. The period may be delayed if the IRS has any follow-up questions or requests additional information, although, if the company prepares all the required documents precisely following IRS guidelines, the IRS may respond more quickly.

What information would be required from a company in order to apply for a Closing Agreement?

The information needed will depend on the facts and circumstances of the company seeking the FET exemption. However, in general the following information is required:

- A statement that the foreign insurer or reinsurer is a treaty resident and is entitled to an exemption from the FET on insurance/reinsurance premiums under the provisions of a U.S. tax treaty
- A letter of credit in the amount of $75,000
- A completed Form SS-4, Application for Employer Identification Number (EIN), if the company does not have a US EIN
- A list of individuals who will be responsible for performance under the Closing Agreement

Is it necessary to apply annually for the Closing Agreement or is it a one time event?

Generally, once the company enters into a Closing Agreement with the IRS, it does not have to apply again, however, if the circumstances change, the IRS must be notified immediately.

V. How can PwC help?

At PwC, we have helped prepare numerous Closing Agreements for clients with foreign affiliates in the UK, France, Ireland, Netherlands, Spain and other jurisdictions. We can assist in researching and analyzing the LOB provisions and anti-conduit provisions of the relevant treaty and in collating the necessary information and documentation, as well as preparing the request.

Obtaining refunds

Once the IRS has agreed to enter into a Closing Agreement, the taxpayer may be entitled to file for a FET refund (to the extent that FET has previously been withheld). Generally, the person who remitted the tax to the IRS must file the claim on behalf of the person who bore the tax. We can provide assistance with this process as well.

VI. Further information

For further information or to discuss the implications of this bulletin, please call your usual PricewaterhouseCoopers contact or one of the following professionals in the New York Insurance Tax Team:

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Summary of US income tax treaties containing exemptions from section 4371 Excise Tax.

Income Tax Treaty With	LOB Article	Qualified Exemption	Effective Date of Treaty
Aruba	✓	✓	Not yet Effective
Bangladesh	✓	✓	Not yet Effective
Cyprus	✓	✓	12/31/1985
Finland	✓	✓	12/30/1990
France	✓	✓	12/30/1995
Germany	✓	✓	8/21/1991
Hungary	✗	✗	9/18/1979
India	✓	✓	12/18/1990
Ireland	✓	✓	12/17/1997
Israel	✓	✓	12/30/1994
Italy	✗	✓	12/30/1985
Luxembourg	✓	✓	12/20/2000
Mexico	✓	✓	12/28/1993
Netherlands	✓	✓	12/31/1993
Netherlands Antilles	✓	✓	Not yet Effective
Romania	✗	X	2/26/1976
Spain	✓	✓	11/21/1990
Sri Lanka	✓	✓	7/12/2004
Sweden	✓	✓	10/26/1995
Switzerland	✓	✓	12/19/1997
UK	✓	✓	3/31/2003

*The UK/US treaty is unique in that it contains an anti-conduit rule which must be satisfied for treaty entitlement. The anti-conduit rules operate to deny treaty benefits to a recipient that is determined to be a conduit to parties not entitled to similar treaty benefits if one of the main purposes of the arrangement was to obtain treaty benefits. In each case the facts and circumstances of the company's situation must be carefully analyzed to determine whether the anti-conduit rule is likely to apply.

LOB article

Note, the scope of the LOB article varies between each treaty. As such, the above table is intended to provide general guidance only. In each case the terms of the relevant tax treaty and the scope of each LOB article must be individually assessed with regard to the facts and circumstances of the foreign insurance company in order to determine whether the FET exemption is likely to apply.

Qualified exemption

Certain treaties contain a qualified exemption whereby the FET exemption will not apply if the U.S. situs risk is subsequently reinsured to a person who is not entitled to the benefits of the treaty under which the FET exemption is sought, or any other U.S. tax treaties. Under a few treaties, the exemption is not limited even where the U.S. risk is reinsured to a person who is not entitled to any U.S. treaty benefits

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