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Excise Tax Guidance

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The IRS released Rev. Rul. 2008-15, describing the insurance excise tax consequences under section 4371 of insurance premiums paid by one foreign insurer (foreign insurer) to another (foreign reinsurer). In particular, the ruling addresses the excise tax consequences of such payments where the foreign insurer is eligible for a waiver of the excise tax by income tax treaty but the foreign reinsurer is not. The ruling addresses both types of insurance excise tax waivers that may be provided by treaty. Rev. Rul. 2008-15 clarifies and amplifies Rev. Rul. 58-612. The ruling describes the following situations:

Situation 1

Foreign Insurer, a foreign corporation incorporated in Country X, issues policies of casualty insurance to U.S. Corporation, a domestic corporation, with respect to hazards, risks, losses, or liabilities wholly or partly within the United States. Foreign Insurer is not engaged in a trade or business in the United States. Country X does not have an income tax treaty with the United States.

Foreign Insurer enters into a reinsurance agreement with Foreign Reinsurer, a foreign corporation incorporated in Country Y, whereby Foreign Reinsurer agrees to indemnify Foreign Insurer against all or part of the loss that Foreign Insurer may sustain under the policies it has issued to U.S. Corporation. Foreign Reinsurer is not engaged in a trade or business in the United States. Country Y has an income tax treaty with the United States that does not exempt insurance premiums from the excise taxes imposed by section 4371.

Situation 2

Foreign Reinsurer A, a foreign corporation incorporated in Country W, issues policies of reinsurance to Domestic Insurer, a U.S. corporation, that cover casualty insurance contracts issued to or for, or in the name of, an insured as defined in section 4372(d). Foreign Reinsurer A enters into a reinsurance agreement with Foreign Reinsurer B, incorporated in Country Y, whereby Foreign Reinsurer B agrees to indemnify Foreign Reinsurer A against all or part of the loss that Foreign Reinsurer A may sustain under the policies it has issued to Domestic Insurer. Country W and Country Y have income tax treaties with the United States that do not exempt insurance premiums from the excise taxes imposed by section 4371.

Situation 3

The facts are the same as in Situation 1, except that there is an income tax treaty in force between the United States and Country X (the "U.S.-X Treaty") that has a limited excise tax exemption. Foreign Insurer is a resident of Country X for purposes of the U.S.-X Treaty and satisfies the requirements of the limitation on benefits article in that treaty.

Situation 4

The facts are the same as in Situation 1, except that Foreign Insurer is a resident of Country Z and there is an income tax treaty in force between the United States and Country Z (the "U.S.-Z Treaty") that contains a comprehensive limitation on benefits article. Foreign Insurer satisfies the requirements of the limitation on benefits article in that treaty. In Situation 4, the treaty is an anti-conduit treaty where the excise tax will not be imposed on residents unless there is an anti-conduit arrangement.

The IRS assumes for purposes of this revenue ruling that Foreign Insurer has not entered into such policies with U.S. Corporation as part of a conduit arrangement.



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LAW AND ANALYSIS

Section 4371 of the Code imposes an excise tax on each policy of insurance, indemnity bond, annuity contract, or policy of reinsurance issued by any foreign insurer or reinsurer. Section 4371(1) imposes such excise tax at the rate of 4 cents on each dollar, or fractional part thereof, of the premium paid on the policy of casualty insurance or the indemnity bond, if issued to or for, or in the name of, an insured as defined in section 4372(d). Section 4371(2) imposes such excise tax at the rate of 1 cent on each dollar, or fractional part thereof, of the premium paid on the policy of life, sickness, or accident insurance, or annuity contract. Section 4371(3) imposes an excise tax at the rate of 1 cent on each dollar, or fractional part thereof, on reinsurance policies issued by a foreign reinsurer with respect to risks covered by contracts described in section 4371(1).

Section 4372(a), for purposes of Section 4371, defines the term “foreign insurer or reinsurer” as an insurer or reinsurer who is a nonresident alien individual, or a foreign partnership, or a foreign corporation. Section 4372(d)(1) defines the term “insured” to include a domestic corporation or partnership, or an individual resident of the United States, that is insured against, or with respect to, hazards, risks, losses, or liabilities wholly or partly within the United States. Section 4372(d)(2) defines the term “insured” to include also a foreign corporation, foreign partnership, or nonresident individual, engaged in a trade or business within the United States, that is insured against, or with respect to, hazards, risks, losses, or liabilities within the United States. Section 4372(f) defines the term “policy of reinsurance”, for the purposes of Section 4371(3), 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 4373(1) provides an exemption, whereby the tax imposed by section 4371 shall not apply to any amount which is effectively connected with the conduct of a trade or business within the United States unless such amount is exempt from the application of section 882(a) of the Code pursuant to a treaty obligation of the United States. Section 4374 of the Code provides that any tax imposed by section 4371 shall be paid, on the basis of a return, 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.

Revenue Ruling 58-612, 1958-2 C.B. 850, concluded that a policy of reinsurance issued by a foreign insurer covering any of the hazards, risks, losses or liabilities covered by contracts taxable under section 4371(1) and (2) of the Code is subject to the tax imposed on reinsurance policies by section 4371(3) of the Code, regardless of whether the primary insurer was a domestic or foreign insurer.

The ruling also relies on United States v. Northumberland Insurance Co., Ltd., 521 F. Supp. 70 (D. N.J. 1981), where the court held that the premiums ceded for a reinsurance policy issued by a foreign reinsurer are taxable if the underlying policy is issued to an “insured” as defined in section 4372(d), and there is no requirement that the reinsured qualify as an “insured” to be subject to the excise tax.

Situation 1

In Situation 1, the premiums paid by U.S. Corporation on the policies of casualty insurance issued by Foreign Insurer are subject to the four-percent excise tax imposed by section 4371(1), because the policies were issued by Foreign Insurer, a foreign corporation, to U.S. Corporation, an “insured” for purposes of section 4372(d). In addition, premiums paid by Foreign Insurer on the policies of reinsurance issued by Foreign Reinsurer with respect to the foregoing insurance policies are subject to the one-percent excise tax imposed by section 4371(3) because section 4371(3) imposes an excise tax on reinsurance policies issued by a foreign reinsurer with respect to risks covered by contracts described in section 4371(1).



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Situation 2

In Situation 2, the reinsurance premiums paid by Domestic Insurer to Foreign Reinsurer A covering casualty insurance contracts issued by Domestic Insurer are subject to the one-percent excise tax imposed by section 4371(3), because the policies of reinsurance cover contracts described in section 4371(1). The premiums paid by Foreign Reinsurer A to Foreign Reinsurer B are also subject to the one-percent excise tax imposed by section 4371(3) based on the same analysis.

Situation 3

In Situation 3, the premiums paid by U.S. Corporation on the policies of casualty insurance issued by Foreign Insurer would generally be exempt from the section 4371(1) excise tax under the U.S.-X Treaty. However, the U.S.-X Treaty also provides that such premiums are not exempt to the extent that the risks covered by such premiums are reinsured with a foreign reinsurer not entitled to the benefits of a treaty that provides an exemption from insurance excise taxes. Therefore, because the risks are reinsured with Foreign Reinsurer, who is not entitled to the benefits of a treaty that provides an exemption from insurance excise taxes, the insurance premiums received by Foreign Insurer from U.S. Corporation are subject to the four-percent excise tax as of the date the reinsurance premiums are paid by Foreign Insurer to Foreign Reinsurer. In addition, premiums paid by Foreign Insurer to Foreign Reinsurer on the policies of reinsurance covering contracts described in section 4371(1) are subject to the one-percent excise tax imposed by section 4371(3), because Foreign Reinsurer is a resident of Country Y, which has an income tax treaty with the United States that does not exempt insurance premiums from the excise taxes imposed by section 4371.

Situation 4

In Situation 4, the insurance premiums paid by U.S. Corporation on the policies of casualty insurance issued by Foreign Insurer are exempt from the section 4371(1) excise tax after application of the U.S.-Z Treaty because Foreign Insurer satisfies the requirements of the limitation on benefits provision of the U.S.-Z Treaty and the policies were not entered into as part of a conduit arrangement. However, the premiums paid by Foreign Insurer to Foreign Reinsurer on the policies of reinsurance issued by Foreign Reinsurer are subject to the one-percent excise tax imposed by section 4371(3), because Foreign Reinsurer is a resident of Country Y, which has an income tax treaty with the United States that does not exempt insurance premiums from the excise taxes imposed by section 4371. The fact that the original insurance premiums paid by U.S. Corporation to Foreign Insurer are exempt from tax after application of the U.S.-Z Treaty does not preclude imposition of the excise tax under section 4371(3) on premiums paid by Foreign Insurer to Foreign Reinsurer. Such reinsurance premiums are paid on policies of reinsurance covering contracts described in and capable of being taxed under section 4371(1).

CONCLUSION

- The reinsurance excise tax imposed by section 4371(3) on policies of reinsurance covering contracts described in paragraph (1), (2) or (3) of section 4371 applies to reinsurance premiums paid by one foreign insurer or reinsurer to another foreign reinsurer, unless the second foreign reinsurer issuing the policies is itself entitled to an exemption from the excise tax under an income tax treaty with the United States.
- Under the terms of the U.S.-X Treaty in Situation 3 (limited excise tax exemption), the exemption from the excise taxes imposed by section 4371 provided by the U.S.-X Treaty does not apply where a foreign insurer or reinsurer entitled to the benefits of the U.S.-X Treaty reinsures policies covering contracts described in paragraph (1), (2) or (3) of section 4371 with a foreign reinsurer not entitled to an exemption from excise tax under the U.S.-X Treaty or another income tax treaty (the nonqualified foreign reinsurer). Thus, the premiums on the underlying policies of insurance or reinsurance paid to the foreign insurer become subject to the relevant excise taxes imposed by section 4371 upon the payment of the subsequent premiums to the nonqualified foreign reinsurer. In addition, the



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reinsurance premiums paid by the foreign insurer or reinsurer to the nonqualified foreign reinsurer are subject to the one-percent excise tax imposed by section 4371(3) when paid.

- In contrast, under the terms of the U.S.-Z Treaty in Situation 4 (treaties with anti-conduit provisions only), if a foreign insurer or reinsurer entitled to the benefits of the U.S.-Z Treaty reinsures policies covering contracts described in paragraph (1), (2) or (3) of section 4371 with another foreign reinsurer not entitled to an exemption from excise tax under an income tax treaty, the premiums paid on the underlying policies will not become subject to the excise taxes imposed by section 4371, unless such policies were entered into as part of a conduit arrangement, as defined in the U.S.-Z Treaty. Even if there is no conduit arrangement, however, the one-percent excise tax under section 4371(3) still applies when the foreign insurer or reinsurer pays premiums to the nonqualified foreign reinsurer.

PwC Observes:

As indicated above Section 4371 generally imposes an excise tax on each policy of insurance or reinsurance covering US risks issued by any foreign insurer or reinsurer. The Service reads this section as; imposing the tax not only on the first such policy of insurance or reinsurance, but on each such subsequent reinsurance policy as well. (See for example TAM 9621001). This application of the excise tax is commonly referred to as the "cascading" theory.

The issue of whether there is a cascading excise tax has been debated for a number of years. In Rev. Rul. 2008-15 the Service has now clearly announced its position that in fact, the excise tax is imposed on every insurance or reinsurance transaction involving US risk even those involving two foreign parties, presumably two foreign parties that may not have nexus to the US. It is unclear how the IRS will enforce these rules, however, it is possible that they would attempt to obtain information from the US insured, US broker or US insurance company as the case may be. Conceivably in some cases they may also attempt to impose a tax obligation on the US party as a withholding agent.

It is advisable for US companies to evaluate their facts to determine if they have any potential liability and revisit the need to obtain for their files a copy of the closing agreement between the Service and the foreign insurance or reinsurance company.

The Service has also issued contemporaneously with this Ruling, Announcement 2008-18 providing a limited amnesty procedure for companies to voluntarily comply with their excise tax obligations.

Based on this Ruling and Announcement, it should be assumed that the Service intends to focus on this particular area and put an emphasis on examining foreign insurance or reinsurance companies writing U.S. risks and potentially other U.S. participants directly or indirectly involved.

For additional information please call Anthony DiGilio at (202) 414-1702 or contact your local insurance tax professional. Please visit us at: <http://www.pwc.com/us/insurance/tax>

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