Internal Revenue Service

Excise Tax – Foreign Insurance

Audit Techniques Guide (ATG)

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The taxpayer names and addresses shown in this publication are hypothetical. They were chosen at random from a list of names of American colleges and universities as shown in *Webster's Dictionary* or from a list of names of counties in the United States as listed in the *U.S. Government Printing Office Style Manual*.

Department of the Treasury
Internal Revenue Service

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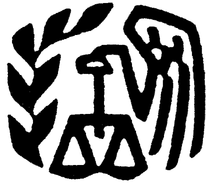

Internal
Revenue
Service

Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

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Ten Core Ethical Principles *

Honesty
Integrity/Principled
Promise-Keeping
Loyalty
Fairness
Caring and Concern for Others
Respect for Others
Civic Duty
Pursuit of Excellence
Personal Responsibility/Accountability

The Five Principles of Public Service Ethics *

Public Interest
Objective Judgment
Accountability
Democratic Leadership
Respectability

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Chapter 1 – Overview

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Introduction

Internal Revenue Code § 4371 requires all of the following three elements for the foreign insurance excise tax to apply. They are:

1. A policy of insurance,
2. Insurance of a United States risk, and
3. Policy issued by a foreign insurer or reinsurer.

Policy of Insurance

A policy of insurance may include a policy of reinsurance, an indemnity bond, or an annuity contract. Generally, a policy is the printed document issued by the insurer presented to the insured which contains the terms of the insurance contract. This document is sometimes referred to as a **treaty**. When the insurer transfers the same risks to another insurer, reinsurance has occurred and the second insurer is termed the **reinsurer**.

Indemnity Bond

An indemnity bond is a contract under which the surety party promises to reimburse a third party, called the obligee, for losses it sustained as a result of the failure of the principal party, called the obligor, to perform under its contract with the obligee.

Annuity Contract

An annuity contract is a contract that provides for periodic payments starting from a certain date and continuing for a fixed period or for the life of the annuitant.

Insurance of a United States Risk

United States risk is defined follows:

1. For life insurance, sickness and accident insurance, and annuity contracts, the policy or contract must be with respect to the life or hazards to the person of a **citizen or resident of the United States**.
2. For casualty insurance or indemnity bonds, the definition depends upon the residency of the insured (in the case of a corporation or partnership, the country in which it is created or organized).

- For a United States insured, the policy must cover risks wholly or partly within the United States.
- For a foreign insured, the insured must be engaged in a trade or business within the United States **and** the covered risks must be **wholly** within the United States. See IRC § 4372.

Policy Issued by a Foreign Insurer or Reinsurer

The policy of insurance must be issued by a foreign insurer or reinsurer. A foreign insurer or reinsurer is defined under I.R.C. § 4372(a) as a nonresident alien individual, a foreign partnership, or a foreign corporation.

Liability for Tax

While the Service generally holds the person making the premium payments liable for the tax, the liability is joint and several. Under I.R.C. § 4374 the tax may be imposed tax on any of the following persons:

- The insured, sometimes referred to as the beneficiary,
- The policyholder, if that person is someone other than the insured,
- The insurance company, or
- The broker obtaining the insurance.

Internal Revenue Code § 4372(d) further defines insured to include any of the following:

- A domestic corporation or partnership, or an individual resident of the United States, or
- A foreign corporation, foreign partnership, or nonresident individual engaged in a trade or business within the United States.

Computation of the Tax Due

The applicable tax rate depends directly on the type of insurance coverage provided in the contract. The table below reflects the rate to be imposed based on the type of coverage in the insurance contract.

Type of Coverage	Rate
Casualty insurance or indemnity bonds	4%
Life insurance, sickness and accident policies or annuity contracts	1%
Reinsurance	1%

Once the tax rate is determined, it is to be applied to the amount of the premiums paid. The amount of premiums paid is defined in Treas. Reg. § 46.4371-3(b) as "the consideration paid for assuming and carrying the risk or obligation [of the insured]." This is the gross amount, not the net amount.

Note: As with any other tax, there are many issues which arise from these concepts. These issues are the topics of the remaining chapters in this text.

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Chapter 2 – Location of Insured Property for Casualty Insurance and Indemnity Bonds

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Introduction

The old real estate adage, "Location! Location! Location!" applies equally to the foreign insurance excise tax. Location of the risk being insured is one element which is to be considered in order to determine whether the foreign insurance excise tax applies.

Domestic vs. Foreign Insureds

Whether the foreign insurance excise tax applies to a policy of casualty insurance or an indemnity bond will depend upon whether the insured is domestic or foreign. If an insured is foreign entity, the foreign entity must have trade or business in the United States and the risk insured must be located **entirely** within the United States. On the other hand, if an insured is a domestic entity, the risks insured may be **wholly or partly** within the United States. Cite: I.R.C. § 4372(d) and Treas. Reg. §§ 46.4371-2(a)(2) and (3).

Domestic Insured

A domestic insured may be a domestic corporation or partnership, or an individual resident of the United States. To be subject to the foreign insurance excise tax, the domestic insured's policy must insure against, or with respect to, hazards, risks, losses, or liabilities **wholly or partly** within the United States.

Example: Casualty insurance on an aircraft which flies domestic and foreign flights would be taxable. However, if the aircraft flew only foreign flights and never entered U.S. airways, it would not be taxable as the risk is wholly outside the United States.

Internal Revenue Code § 7701(a)(9) defines the term "United States" to include only the States and the District of Columbia. However, the Service relies on the Outer Continental Shelf Lands Act to include the subsoil and the seabed of the outer Continental Shelf as a part of the United States within the scope of § 7701(a)(9). Cite: Rev. Rul. 77-197, 1977-1 C.B. 344, amplified, Rev. Rul. 81-257, 1981-2 C.B. 214.

Foreign Insured

A foreign insured can be a foreign corporation, foreign partnership, or nonresident individual, which is engaged in a trade or business within the United States. To be taxable, the foreign insured's policy must insure against, or with respect to, hazards, risks, losses, or liabilities **within the United States**.

Example: A foreign entity's insurance against destruction of a building located within the United States would meet this test for taxability. However, casualty insurance of a building physically located in England would not meet the location test for taxability.

Location of Risk

The location of the risk plays a key role in determining whether a policy is subject to the foreign insurance excise tax. There is a distinct difference as to the location of risk requirement between domestic and foreign insureds. However, determining where the location of the risk is (i.e. within or outside of the United States) is sometimes less clear. Fortunately, there are rulings and cases which provide guidance on some of these issues. The revenue rulings and court cases can be divided into the following categories:

1. Separation in the coverage of risks
2. Policy extensions
3. Continental Shelf and territorial waters
4. Import of products
5. Export of products

Separation in the Coverage of Risks

The location of the risk being insured is determined on a policy by policy basis. If separate insurance policies are used to insure two or more different risks, the policies are considered separately for application of the location of the risk test. However, if one single policy of a domestic insured covers multiple risks, as long as one risk meets the location test discussed above, the whole policy will be deemed to meet the test. This is true even if the location of some of the risks normally would not be taxable.

Separate Policies - Determining location on a policy by policy basis is brought forth in Revenue Ruling 73-362, 1973-2 C.B. 367. The revenue ruling concerns a domestic aviation company with two separate insurance policies covering its aircraft. The first policy insured the aircraft's operations exclusively within the United States and the second policy insured the aircraft's operations exclusively outside the United States. The revenue ruling found that the first policy was subject to tax, while the second was not.

One Policy - Revenue Ruling 73-362 does not address what would happen if one policy covered the aircraft both within and outside of the United States. However, the "wholly or partly within the United States" language of I.R.C. § 4372(d) supports the position that the entire premium of a single policy covering mixed risks would be subject to the excise tax.

The position that the entire premium of a single policy covering mixed risks is subject to the excise tax finds further support in Amtorg Trading Corporation v. United States, 103 F.2d 339, 39-1 USTC ¶ 9454 (2nd Cir. 1939). The Court stated,

Little need be said as to the suggestion [by the taxpayer] that in any event the tax ought to be computed only upon the portion of the premium applicable to the risks while the property was within the territorial waters of the United States. The tax if valid at all is imposed by the terms of the statute on the premiums charged.

Accordingly, for a domestic insured, the tax is to be imposed on the entire premium of a single policy covering multiple risks as long as one or more of the risks meets location of risk test. In other words, there is no allocation of the premiums paid for the taxable and non-taxable portions.

Policy Extensions

Should a policy subject to tax provide the ability for the policy to be extended to include other risks, then the premiums paid for the extended coverage are also subject to tax. If a separate policy is executed for those risks, and the risks do not meet the location test, then the policy for the extended coverage would not be subject to the tax.

In Revenue Ruling 69-100,1969-1 C.B. 289, a policy covering a shipping vessel against risks wholly or partly within the United States was issued to a domestic company by a foreign insurer. Under the terms of the policy, the taxpayer/insured had the option to extend the policy to cover risks incurred in additional areas outside the United States. The taxpayer subsequently elected to extend the coverage and paid the additional premiums.

The Service held that since the insurer was committed to accept the additional coverage, by virtue of the provision in the original policy, the extended coverage endorsements did not constitute a separate policy. Instead, the extension remained a part of the original policy. Therefore, the risk remained "wholly or partly within the United States" and the additional premiums were subject to tax.

Continental Shelf and Territorial Waters

Taxability of policies for the Continental Shelf and the territorial waters depends upon the activity performed.

Continental Shelf - A foreign insurance policy covering oil drilling operations on the Continental Shelf is subject to the excise tax on foreign insurance. This is so even if the drilling operation is located in international waters, beyond the three-nautical mile boundary of the United States, so long as the drilling operations occur on the Continental Shelf. Cite: Rev. Rul. 56-505, 1956-2 C.B. 891.

Further, the tax may apply to semi-submersible and other floating drilling rigs to the extent they are engaged in oil and gas activities on the Continental Shelf. These activities necessarily require at least a temporary attachment to the seabed. Cite: Rev. Rul. 81-257, 1981-2 C.B. 214

Territorial Waters - In Amtorg Trading Corporation v. United States, the tax was not imposed on a policy which covered transportation of goods from a foreign destination through the territorial waters of the United States. The taxpayer was a domestic company importing products from the Soviet Republic. The products were transported via ocean

freight and insured with a foreign company until their arrival at a port within the United States.

The products' movement through the three-mile portion of United States territorial waters prior to their arrival at the United States port was the only portion of the ocean voyage that was within the United States. A separate domestic insurance policy covered the movement of the products within the United States and Canada.

The Second Circuit Court of Appeals held that such movement through the three-mile territorial waters of the United States was merely a "trifling portion" of the entire voyage and thus, no portion of the premiums paid to the foreign insurer was subject to the Federal Excise Tax (FET).

Coverage Continues Past Port of Entry - Revenue Ruling 57-256, 1957-1 C.B. 416, follows Amtorg but only to the extent the insurance coverage terminates at the point of unloading at the port of entry. If the coverage continues beyond the point of unloading, for instance, to a warehouse within the boundaries of the port of entry, the policy will be subject to the excise tax as the risk is wholly or partly within the United States.

Import of Products

Tax is applied based upon who the insured is. The chart below summarizes the application of the tax to products imported into the United States for shipments between the United States and certain of its possessions. Cite: Revenue Ruling 57-257, 1957-1 C.B. 417.

Chart - Revenue Ruling 57-257:

Shipment	Insured	Subject To FET?
From Puerto Rico or Virgin Islands to United States.	Foreign corporation, foreign partnership, or nonresident individual	Not taxable because not wholly within the United States.
From Puerto Rico or Virgin Islands to United States.	Domestic corporation, partnership or individual	Not taxable unless coverage continues past the point of unloading at the U.S. port, in which case the insured risk would be partly within the United States.

The above chart also applies to imports for foreign locations other than possessions of the United States. In essence, for purposes of the foreign insurance excise tax, Puerto Rico and the Virgin Islands are treated as if they are foreign countries. Generally, policies on imports are taxable only when:

1. Purchased by a domestic insured, and
2. Coverage of the policy continues past the point of unloading at the United States port.

Export of Products

Foreign insurance covering goods which are in export transit from the United States to anywhere outside the United States are not subject to the foreign insurance excise tax. Cites: United States v. International Business Machines Corp., 517 U.S. 843, 96-1 USTC, ¶ 70,059 (1996) ("IBM"), and the Export Clause of the United States Constitution (U.S. Const., Art. I, § 9, cl. 5).

Under IBM, no portion of any premiums paid to a foreign insurer to cover goods in export transit from the United States will be subject to the excise tax. This is so even though a portion of the foreign insurance premium paid may include coverage for risks incurred partially within the United States. For instance, coverage may include the period during which the products are being transported or are temporarily stored at an intermediate freight forwarder.

It is important to note that this ruling applies only to goods being exported from the United States. Additionally, the ruling applies only to the extent the insurance covers the export transit of such goods. Accordingly, if a single policy covers risks incurred during export transit, as well as risks incurred in the U.S. prior to export transit, an allocation of the premiums paid for such policy may be made. (It is important to note that this is the only exception to the general rule that no allocation will be made of premiums paid under a single policy.)

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Chapter 3 – Identifying the Parties to an Insurance Contract

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Introduction

The Internal Revenue Code provides a broad definition of who is potentially liable for the excise tax on foreign insurance. Generally, liability is imposed on the last domestic entity which pays the insurance premiums to a taxable foreign insurer. In order to determine the party responsible for filing the Form 720 and remitting the tax, all of parties to the insurance contract should be identified.

Scope of Liability

Section 4374 of the Internal Revenue Code imposes liability for the foreign insurance excise tax on the following persons:

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**. The United States or any agency or instrumentality thereof shall not be liable for the tax. (**Emphasis added.**)

The broad scope of the liability for the foreign insurance excise tax under § 4374 makes it possible for more than one person to be liable for the tax. However, it should be noted that taxpayers have attempted to narrow the liability to only those persons making the premium payment and have cited to Treas. Reg. § 46.4374-1(a) in support of their position. In 2002, this regulation was amended to make clear that there is no such limitation to the liability imposed under § 4374.

Thus, while the Service will generally seek payment of the excise tax from the U.S. person making the premium payment, the Service may, in its discretion, seek payment from other persons, as described in the next section. The Service's ability to seek payment of the excise tax from other persons may be particularly useful where payment of the premiums is made by a non-U.S. person on behalf of a U.S. insured, or if the U.S. person making the payment has failed to pay the excise tax and the statute of limitations has expired with respect to such person.

Joint and Several Liability

The liability for the foreign insurance excise tax is joint and several and under § 4374, may be imposed on any of the following persons:

- The insured, sometimes referred to as the beneficiary,
- The policyholder, if that person is someone other than the insured,
- The insurance company, and
- The broker obtaining the insurance.

Insured/Beneficiary

The insured or beneficiary is the party to the insurance contract to whom, or on behalf of whom, the insurer agrees to pay benefits and is usually named in the policy. In the case of life insurance, the insured is the person on whose life an insurance policy is issued and the beneficiary is the person or entity to whom benefits are paid.

Policyholder

A policyholder is defined as the person who has the insurance policy in his possession or under his control, typically the party who purchased the policy. A common example of when the policyholder and the insured/beneficiary will not be the same person occurs with debts secured by a piece of property where the debtor will be required by the lien holder to purchase casualty insurance on the secured property in the debtor's name. Such is the case with homeowners insurance required by the bank holding the mortgage. You, as the debtor, are the policyholder and the bank is the beneficiary.

Insurance Company

An insurance company is a company whose primary and predominant business activity during the taxable year is the issuance of insurance or annuity contracts. An insurance company can also act as a reinsurer by reinsuring risks underwritten by another insurer.

Broker

A broker is an intermediary who negotiates insurance contracts on behalf of the insured or the insurer. Brokers generally receive their commissions from the insurer.

Effect of Contractual Agreements

The parties to an insurance contract are free to decide among themselves, contractually or otherwise, as to who will file the excise tax return and pay the tax. However, should the excise tax not be paid, the Service is not bound by any such agreement. The Service may then pursue any of the parties to the insurance contract as discussed above for payment.

Identifying the Foreign Insurer

Section 4372(a) of the Internal Revenue Code defines a "foreign insurer or reinsurer" as follows:

For purposes of section 4371, the term "foreign insurer or reinsurer" means an insurer or reinsurer who is a nonresident alien individual, or a foreign partnership, or a foreign corporation. The term includes a nonresident alien individual, foreign partnership, or foreign corporation which shall become bound by an obligation of the nature of an indemnity bond. The term does not include a foreign government, or municipal or other corporation exercising the taxing power.

Thus, a foreign insurer is an insurer or reinsurer who is a nonresident alien individual, or a foreign partnership or a foreign corporation.

Foreign Entity Owned by a Domestic Entity

If an insurer appears to be a foreign entity but is wholly owned by a domestic corporation, it is important to ascertain the nature of the relationship between the insurer and the domestic corporation. The focus is on whether the insurer is merely a foreign branch or division of a domestic corporation, or a subsidiary of a domestic corporation. Field Service Advice 199952018 (September 27, 1999) provides an analysis of these two situations.

Foreign Branch or Division - An unincorporated foreign branch or division is not considered an entity separate and distinct from its domestic owner and therefore, will not be considered a "foreign insurer." Accordingly, premiums paid to a foreign branch or division of a domestic entity will not be subject to the excise tax.

Foreign Subsidiary - If a foreign entity is a subsidiary of a domestic corporation, federal income tax law regards it as a distinct and separate entity. An example would be a subsidiary incorporated in a foreign country. Consequently, a foreign subsidiary of a domestic corporation will generally be considered to be a foreign insurer and the premiums paid to it will be subject to excise tax.

Domestic Entity Owned by a Foreign Entity

The same relationship analysis explained above should be applied where the insurer appears to be a domestic entity but is wholly owned by a foreign entity. Thus, if the domestic entity is a branch or division of a foreign corporation or other entity, premiums paid to such domestic entity will generally be subject to excise tax. (It should be noted there is an exemption under section 4373 for premiums which constitute effectively connected income under I.R.C. section 882(a), unless such income is exempt from income tax pursuant to a tax treaty with the United States.) If the domestic entity is a subsidiary of a foreign corporation, premiums paid to such domestic entity will not be subject to the excise tax.

Identifying the Insured

The insured for casualty and indemnity bonds is defined under IRC § 4372(d) as:

1. a domestic corporation or partnership, or an individual resident of the United States, against, or with respect to, hazards, risks, losses, or liabilities wholly or partly within the United States, or
2. a foreign corporation, foreign partnership, or nonresident individual, engaged in a trade or business within the United States, against or with respect to, hazards, risks, losses, or liabilities within the United States.

Multiple Insureds

Determining whether an individual or entity falls under either of the above definitions for an insured is generally straightforward. However, as the economy becomes more global, the occurrence of a single policy with multiple insureds, which are both domestic and foreign, becomes commonplace. This requires a more involved analysis of the following two items:

1. The structure of the global company, such as whether the company has branches, divisions, or subsidiaries in foreign countries, and
2. Coverage of the single policy.

Structure of the Global Company - If a single foreign policy covers both domestic and foreign offices, and such offices are separate entities, the portion of the premium allocable to the foreign offices will not be subject to the excise tax. However, if the foreign office is engaged in a trade or business within the United States and all of its insured risks are located wholly within the United States, it would be subject to excise tax. Premiums allocable to domestic offices are taxable, whether all or part of the insured risks are located within the United States.

Coverage of the Single Policy - Generally, the parent company will allocate to each office a portion of the premium payment. This may be reflected by a book entry or paid by intercompany fund transfer. If no allocation or billing is made amongst the domestic and foreign offices, then arguably, the entire premium is subject to the excise tax if the single policy is issued to a domestic parent (the same argument cannot be made if the single policy is issued to a foreign parent). The theory behind this position is that the domestic parent company is the insured, and the policy covers the insured's risks which are partly within and without the United States.

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Chapter 4 – Table Premiums

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Definitions

Cede - To transfer liability in connection with a risk, or a portion of it, from the original insurer to a reinsurer.

Reinsurance - A first insurer passes all or a portion of the risks insured to a second insurer who is called the reinsurer.

Settlement Statement - A periodic statement prepared by the ceding insurance company and provided to the reinsurer which reflects the amount of premiums due.

Introduction

The foreign insurance excise tax is applied to the amount of premiums paid per IRC § 4371. Although the definition sounds straightforward, determining the amount of premiums paid can, at times, be difficult. As you will see in this chapter and out in the field, there are reductions to the amount of premiums paid which decrease the amount of tax due. Whether these reductions are allowable is the topic covered in this chapter.

Gross Premiums

The excise tax is based on the gross amount of premiums paid to the foreign insurer or reinsurer for an insurance policy, annuity contract or indemnity bond. This amount includes any additional assessments, charge, or call, paid pursuant to the agreement of the parties. The whole amount is taxed whether payable in one lump sum or installments. Cite: Treas. Reg. § 46.4371-3(b).

In situations involving a domestic insured obtaining insurance from a foreign insurer, the application of the above definition is straightforward. For example, the full amount of the premium paid to the foreign insurer is the amount subject to the tax. However, the determination of the amount of premiums paid becomes complex if return premiums or reinsurance is involved.

The only allowable reductions to gross premiums are for the following:

1. Return premiums,
2. Policy cancellations and overcharges, and
3. Forwarded premiums.

Return Premiums

An allowable reduction in the amount of taxable gross premiums is for return premiums. Return premiums are funds which are returned or credited to the account which are fixed by contract and do not depend only on the experience of the company itself. This term includes experience-rated refunds which are refunds due to an overcharge as calculated at a later date.

Experience-rated Refunds

Experience-rated refunds are based on a comparison of the actual loss experience, usually of either the policyholder or the insurer, and the premiums produced by the covered risk during a given period of time. The refunds are determined by a formula set forth within the insurance contract and are generated when the premiums paid exceed the losses paid for a particular period of time. Experience rating may be either prospective, based on the loss experience of a prior period, or retrospective, based on the loss experience of the period being covered.

An example of this type of contract may be found in workers compensation insurance. In basic terms, at the end of each contract period, the amount of claims actually filed is compared to the amount of claims which were expected to be filed for the period. The difference is entered into a complicated computation which is used to determine the amount refunded back to the insured.

Policy Cancellations and Overcharges

Amounts which are refunded or credited due to an overcharge or cancellation of a policy fall within the definition of return premiums. When the amount of a premium overcharge is refunded, the insured is due a refund of the tax already paid on those premiums. This is an allowable reduction to the amount of gross premiums. The same finding holds true when premiums are refunded due to a cancellation of a policy.

Note that the foreign insurer may not actually send a check to the domestic insured. Instead, the two parties may find it easier to net the refund on the next premium payment. In this case, the agent will determine that the taxpayer is not receiving a double benefit by filing a claim for the tax on the refunded premiums and computing the tax on the net amount on the subsequent premium payment.

Forwarded Premiums

An insurance company will have various contracts for which premium payments are paid to the same foreign insurer. Imbedded within the total premium payment are premiums for which the domestic insurer is merely acting as an agent for another domestic entity. In that case, the other domestic entity may have paid the excise tax and filed a Form 720 itself.

However, the taxed premiums are forwarded from the original entity to the domestic insurer who then pays the taxed premiums to the foreign insurer. Since the foreign insurance excise tax is already paid by another entity, these taxed premiums may be used to reduce the amount of gross premiums used in the computation of the excise tax due by the domestic insurance company.

Reinsurance

It is not uncommon for reinsurance agreements to be structured in such a manner that a very small amount of cash is actually transferred between the parties. In these cases, the agreement typically provides that the ceding insurance company will withhold a significant percentage of the ceded premiums on behalf of the foreign reinsurer. In this case, the tax is still computed on the amount of gross premiums as required by the reinsurance agreement.

Settlement Statements

The agreement may also provide that certain reductions or setoffs, will be made against the ceded premiums owed to the foreign reinsurer for various agreed expenses. A periodic statement, called a settlement statement or a bordereau, is usually prepared by the ceding insurance company and provided to the foreign reinsurer. The settlement statement reflects the premiums due and the reductions made resulting in the net premium paid.

Setoffs

Reductions to the amount of the ceded premiums and include ceding commissions, agent commissions, premium taxes, license taxes, fees, administrative and overhead expenses. These expenses are incurred by the domestic insurer in writing the insurance contract. Setoffs can also include losses or loss adjustment expenses. Cite: Rev. Rul. 79-138, 1979-1 C.B. 359.

There is no reduction to the amount of taxable gross premiums for setoffs. Where ceded premiums are being withheld by the domestic insurance company and used to offset the reinsurer's liabilities, the full amount of gross premiums before the reductions is subject to tax.

Some taxpayers have taken the position that the tax applies only to the net amount of the ceded premiums remaining after the setoffs for the reinsurer's liabilities are taken. In essence, the taxpayers contend that the definition of "premiums paid" encompasses a netting concept. Even more aggressive is the argument made by some taxpayers that the tax applies only if and when the withheld funds are physically transferred to the foreign reinsurer. This is an incorrect position.

Cash vs. Accrual Method of Accounting

In determining when premiums are paid, and thus subject to the tax, the accrual method of accounting, not the cash-basis method of accounting applies. Revenue Ruling 77-453, 1977-2 C.B. 237, and G.C.M. 37,201 (July 26, 1977) support an interpretation of the term "amounts paid for reinsurance" under IRC § 832(b)(4) as including amounts accrued as well as amounts actually paid. Ceded premiums are considered paid to the reinsurer

when all events have occurred that fix the reinsurer's right to the premiums and the amount of such premiums is reasonably ascertainable.

Sources of Information

Premiums ceded to a foreign reinsurer may be reflected in the domestic insurer's National Association of Insurance Commissioners (NAIC) Annual Financial Statements on Schedules F and S. Additionally, information relating to premiums ceded to a foreign reinsurer is reflected on settlement statements or similar documents prepared by either the domestic/ceding insurance company or the foreign reinsurer on a periodic basis.

When reviewing the settlement statements, note that the actual amount transferred to the foreign reinsurer is typically net of expenses, which is less than the gross amount subject to the tax. The insurance contract, along with the settlement statement, in many cases will provide the amount of gross premiums due.

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Chapter 5 – Exemptions

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Introduction

There are a number of statutory and non-statutory exemptions to the foreign insurance excise tax. The statutory exemptions are set forth under I.R.C. §§ 4373 and 953. The non-statutory exemptions are based on either a tax treaty with the United States or the Export Clause of the United States Constitution.

Statutory Exemptions

There are two statutory exemptions under the Internal Revenue Code which specifically exempt premiums paid to foreign insurers from the excise tax on foreign insurance. These statutory exemptions are discussed in detail in this lesson. They include:

1. Internal Revenue Code Section 4373
2. Internal Revenue Code Section 953(c) and (d)

Internal Revenue Code Section 4373

The exemption provided under § 4373(1) applies to premiums which are subject to the United States income tax. Section 4373(1) states that the tax imposed by § 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) pursuant to a treaty obligation of the United States.

This typically arises in the case of premiums paid to a foreign insurer engaged in the business of insurance within the United States and is thus, taxable under § 882(a).

The exemption under § 4373(2) applies to indemnity bonds insuring certain obligations of the United States. This exemption is rarely found in the field. It provides that the tax imposed by § 4371 shall not apply to:

Any indemnity bond required to be filed by any person to secure payment of any pension, allowance, allotment, relief, or insurance by the United States, or to secure a duplicate for, or the payment of, any bond, note, certificate of indebtedness, war-saving certificate, warrant or check, issued by the United States.

Internal Revenue Code Section 953(c) and (d)

Internal Revenue Code § 951 imposes an income tax on the "Subpart F" income attributable to a controlled foreign corporation ("CFC") of certain United States shareholders. Subpart F income includes insurance income such as from premium payments received by the CFC.

Subpart F insurance income under § 953(a) is not income which is effectively connected with the conduct of a trade or business within the United States. Thus, it is not specifically exempt from the excise tax imposed under § 4373. However, such income and/or premium payments may be exempt from the excise tax if an election is made by the foreign insurer under §§ 953(c) or (d). The excise tax exemption available under such election is consistent with the statutory language for exemptions set forth in § 4373.

Section 953(c) Election - A § 953(c) election is applicable to a CFC which is a captive insurance company. Internal Revenue Code § 953(c)(3)(C) provides an election to treat subpart F income, which is related person insurance income, as income effectively connected with the conduct of a trade or business in the United States. Section 953(c)(3)(D)(ii) exempts income subject to the section 953(c) election from the tax imposed by section 4371.

Related person insurance income is defined under I.R.C. § 953(c)(2) as "any insurance income … attributable to a policy of insurance or reinsurance with respect to which the person (directly or indirectly) insured is a United States shareholder in the foreign corporation or a related person to such shareholder". Therefore, only related person insurance income is exempt from the foreign insurance excise tax. All unrelated insurance income is subject to the foreign insurance excise tax. Due to these restrictions, there are few § 953(c) elections.

Section 953(d) Election - Similarly, § 953(d) permits a CFC, meeting the reduced stock ownership threshold and other requirements set forth in § 953(d)(1), to make an election to be treated as a domestic corporation. Unlike a § 953(c) election, under a § 953(d) election, all income of the foreign insurer, including insurance premium income, is treated as the income of a domestic corporation.

Such an election causes the excise tax to be inapplicable since the tax applies only to policies insured with a foreign insurer. After the CFC makes the election, they are treated as a domestic insurer. It does not matter from whom the insurance premium income is from. All income is treated as the income of a domestic corporation. Revenue Procedure 2003-47, I.R.B. 2003-28 (June 20, 2003) provides rules and procedures pertaining to an election under § 953(d).

Important Note: Although a captive may hold a § 953(d) election and premium income to the captive is exempt from the foreign insurance excise tax, the activities of the captive concerning reinsurance premiums paid to other parties should be reviewed to determine if the cascading tax issue is present. Reference Chapter 7, Cascading, for more information on the cascading tax issue.

Treaty Exemptions

Exemptions from the tax under § 4371 may be established based upon tax treaties between the United States and a treaty country. Policies issued by a foreign insurer that is a resident of a treaty country may be exempt from the tax. There are two types of

treaty exemptions; qualified and unqualified. (Appendix A notes a listing of the countries with each type of exemption.)

Qualified Exemptions

Qualified exemptions are the most common type of treaty exemption. Countries with current qualified treaty exemptions with the United States are:

Treaty Country	Effective Date	Treaty Country	Effective Date
Cypress	1-1-86	Japan	1-1-05
Finland	1-1-91	Luxembourg	1-1-01
France	2-1-96	Mexico	1-1-94
Germany	1-1-90	Netherlands	1-1-94
India	1-1-91	Spain	1-1-96
Ireland	1-1-98	Sweden	1-1-98
Israel	1-1-95	Switzerland	1-1-98
Italy	1-1-85	United Kingdom	1-1-04*

* The United Kingdom insurer or reinsurer may elect to have the full provisions of the prior treaty apply for an additional 12 months. Should the United Kingdom insurer or reinsurer make this election, the provisions of the qualified treaty will take effect on January 1, 2005. The extension is allowed if the provisions of the prior treaty provide greater relief to the United Kingdom insurer or reinsurer than the new treaty.

The new UK treaty provisions are discussed in full at the end of the Qualified Treaty section of this Chapter.

Qualified Exemption Requirements - In order for a foreign insurer to be entitled to a qualified excise tax exemption, the following are required:

1. Compliance with the anti-conduit provision, and
2. A valid closing agreement (or proof that the residency and Limitations on Benefits requirements have been satisfied).

Anti-conduit Provision - Tax treaties with a qualified exemption contain an anti-conduit provision which eliminates the excise tax exemption to the extent the foreign insurer reinsures the risks with a person/entity not itself entitled to an excise tax exemption under a treaty with the United States.

In other words, if an insurer located in a qualified treaty country reinsured with a reinsurer located in a non-treaty country, the exemption provided under the treaty with the qualified treaty insurer is lost to the extent of the amount reinsured. The amount of premium payment which was reinsured becomes subject to excise tax. The anti-conduit provision prohibits the qualified treaty country insurer from acting as a front for non-exempt country insurers.

Example: Foreign Insurer A, domiciled in France, accepts premiums for casualty insurance on United States risks from Domestic Company B in the amount of $ 1,000,000. Foreign Insurer A reinsures $ 600,000 of the premiums with Foreign Insurer C located in Bermuda. Foreign Insurer C does not have a valid section 953(d) election and is considered to be a taxable entity for foreign insurance excise tax. The remaining $ 400,000 in premiums remain with Foreign Insurer A. When Foreign Insurer A reinsured with Foreign Insurer C, the provisions of the qualified tax treaty between the United States and France were violated for the amount of premiums reinsured. This results in the $ 600,000 of reinsured premiums becoming subject to the 4% excise tax for the transaction between Foreign Insurer A and Domestic Company B. In addition, the reinsured premiums paid from Foreign Insurer A to Foreign Insurer C are subject to the 1% tax on reinsurance as cascading tax. Cascading tax is discussed further in Chapter 7.

Closing Agreement - The second requirement which must be met, is that the foreign insurer must satisfy the residency and Limitations on Benefits requirements as provided in the treaty. Because of the complexity of these requirements, procedures to obtain a closing agreement are located in Rev. Proc. 2003-78, I.R.B. 2003-45 (October 10, 2003), have been implemented. A closing agreement helps to facilitate the administration of the tax treaty exemptions by ensuring that the residency and Limitations on Benefits provisions have been complied with before a closing agreement is entered into with a foreign insurer.

As part of the closing agreement procedures, the foreign insurer is required to maintain records including items of insurance and reinsurance subject to the treaty exemption. Such records must be maintained for six years and be made available to the Service upon the Service's written request. A letter of credit is also required and serves as a source of payment in the event the foreign insurer violates the anti-conduit provision or otherwise owes excise tax.

The closing agreement procedures set forth in the revenue ruling is not a legal prerequisite for the treaty exemption. However, in practically all cases, a foreign insurer entitled to an excise tax exemption will have followed these procedures. A closing agreement is the only practical means of providing a U.S. insurer/beneficiary with assurance that the premiums are not subject to the tax.

Special Provisions of the Qualified Treaty between the United States and the United Kingdom – The qualified treaty with the United Kingdom has an additional caveat to the anti-conduit position found on the other tax treaties providing qualified exemptions. In the case of a foreign insurer or reinsurer domiciled in the United Kingdom and meeting

all other treaty provisions, the anti-conduit provision of the treaty will not be violated if the United Kingdom insurer reinsures premiums to an entity not exempt for the foreign insurance excise tax unless the United Kingdom insurer acts as a conduit to reduce the amount of tax due.

Example: Foreign Insurer A, domiciled in the United Kingdom and meeting all other provisions of the income tax treaty between the United States and the United Kingdom, accepts premiums for casualty insurance on United States risks from entities in Domestic Affiliated Group B in the amount of $ 1,000,000. Foreign Insurer A reinsures $ 1,000,000 of the premiums with Captive C located in Bermuda. Captive C is owned by the parent company of Domestic Affiliated Group B and does not hold a section 953(d) election. Before the implementation of this insurance arrangement with Foreign Insurer A, Domestic Affiliated Group B paid its insurance premiums directly to Captive C and paid the 4% excise tax on the transaction. After implementation, Domestic Affiliated Group B stopped paying any excise tax on foreign insurance and claimed exemption from the tax based on the tax treaty between the United States and the United Kingdom.

In this case, Foreign Insurer A is acting as a conduit to reduce the amount of excise tax paid on the insurance premium transactions. Therefore, the provisions of the tax treaty between the United States and the United Kingdom have been violated and the premium payments from Domestic Affiliated Group B to Foreign Insurer A are taxable at the 4% casualty insurance rate. In addition, the 1% reinsurance tax is imposed on the transaction of reinsurance between Foreign Insurer A and Captive C as cascading tax. Cascading tax is discussed further in Chapter 7.

Requirements for domestic entity to treat exemption as valid for Qualified Treaties - A person otherwise required to file a return and pay the excise tax may consider the policy exempt from the insurance excise tax under an income tax treaty if:

- The premiums are paid to an insurer or reinsurer that is a resident, for treaty purposes, of a country with which the United States has a treaty containing an excise tax exemption and,
- Prior to filing the return for the taxable period, such person has knowledge that there was in effect for such taxable period a closing agreement between the Internal Revenue Service and the foreign insurer or reinsurer. Cite: Rev. Proc. 2003-78.

Valid and revoked closing agreements are maintained in Washington, D.C. To confirm if a particular foreign insurer has a closing agreement and/or is listed as a resident insurer/reinsurer of a particular treaty country, contact the Foreign Insurance EIS with the name and country of domicile of the foreign insurer or reinsurer in question.

Unqualified Exemptions

Unqualified exemptions have only one requirement for the premium payment to be exempt from the excise tax on foreign insurance. The foreign insurer or reinsurer is

required to be a resident of the treaty country either during the last three months of the calendar year preceding the calendar year in which the taxable period occurs, or during the taxable period.

Countries with tax treaties containing an unqualified excise tax exemption include:

- United Kingdom, (through December 31, 2003*)
- Hungary,
- Romania and
- The Soviet countries of Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyz Republic, Moldova, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan. Russia entered into a separate treaty with the U.S. in 1992, which currently does not contain an insurance premium tax exemption.

* The United Kingdom insurer may elect to have the full treaty provisions apply for an additional period of 12 months. If this election is made, the treaty provisions will apply through December 31, 2004. The extension is allowed if the provisions of the prior treaty provide greater relief to the United Kingdom insurer or reinsurer than the new treaty.

No Anti-conduit Provision - Tax treaties with unqualified exemptions do not contain an anti-conduit provision. Therefore, the foreign insurer or reinsurer may reinsure with a taxable reinsurer and not lose the exempt status of the payment from the domestic entity to the unqualified foreign insurer.

Requirements for Domestic Entity to Treat Exemption as Valid for Unqualified Treaties – As with qualified treaty exemptions, a closing agreement may be entered into by a foreign insurer or reinsurer located in an unqualified treaty country. The closing agreement assists in ensuring that the residency provisions of the unqualified treaty have been complied with before a closing agreement is entered into with a foreign insurer.

If there is no closing agreement, the person relying on the excise tax exemption provided by a tax treaty with an unqualified exemption must have a copy of the certification of residency by the taxing authority of the treaty country. Further, the person required to remit the excise tax may not consider the policy exempt if prior to filing the return for the taxable period, such person has knowledge that the foreign insurer or reinsurer was not a resident of the treaty country during the taxable period. Cite: Rev. Proc. 84-82

Filing Requirements for Treaty-Based Exemptions

Internal Revenue Code § 6114 provides the general rule on the disclosure of treaty-based returns. In particular, § 6114 provides as follows:

a. In general. Each taxpayer who, with respect to any tax imposed by this title, takes the position that a treaty of the United States overrules (or otherwise modifies) an internal revenue law of the United States shall disclose (in such manner as the Secretary may prescribe) such position -

    1. on the return of tax for such tax (or any statement attached to such return), or
    2. if no return of tax is required to be filed, in such form as the Secretary may prescribe.

b. Waiver authority. The Secretary may waive the requirements of subsection (a) with respect to classes of cases for which the Secretary determines that the waiver will not impede the assessment and collection of tax.

Under Treas. Reg. § 301.6114-1(c)(1)(vii), the Secretary has waived the disclosure requirement for treaty-based excise tax exemptions with respect to insureds and insurance brokers. In other words, only the insurer is required to file a treaty-based disclosure under § 6114. This is filed on Form 8833, Treaty Based Position Disclosure Under Section 6114 or 7701(b).

However, if the insurer files an annual Form 720 with the required § 6114 disclosure no later than the date on which the return is due for the first quarter after the end of the calendar year, it will not have to file disclosures for that year. Also, if the insurer has entered into a closing agreement with the Service which exempts the insurer from excise tax, the insurer will then be exempt from the § 6114 disclosure requirement noted above.

It should be noted that in the case of reinsurance, the insurance company reinsuring a policy covering United States risks is considered the insured as contemplated under Treas. Reg. § 301.6114-1(c)(1)(vii)(A). As such, the requirement to file a treaty-based disclosure under § 6114 falls not on the reinsured company but instead, on the foreign reinsurer.

Exemption for Exported Products

The Export Clause of the United States Constitution provides that "No Tax or Duty shall be laid on Articles exported from any State." Therefore, the tax can not be applied to insurance premiums covering the export transit of goods from the United States. Cite: United States v. International Business Machines Corp., 517 U.S. 843, 96-1 USTC ¶ 70,059 (1996).

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For a qualified or an unqualified treaty exemption, a copy of the closing agreement is to be requested from an insured or broker claiming a treaty exemption on premiums paid to a foreign insurer. If a taxpayer is unable to provide a closing agreement, or does not hold a closing agreement with the United States, an information document request should be issued to verify that the foreign insurer satisfies the residency requirements of the treaty.

In addition, for qualified treaty exemptions, the information document request should request that the taxpayer verify that the foreign insurer satisfies the Limitations on Benefits section of the applicable tax treaty. In either case, information is to be obtained as to whether any portion of the premiums paid to the foreign insurer were reinsured with

a taxable reinsurer. This information may affect the exemption status of the premiums paid to the foreign insurer or reinsurer under the treaty and may give rise to cascading tax on the reinsurance premiums paid to the subsequent foreign reinsurer. Cascading tax is discussed further in this Guide.

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Chapter 6 – Captive Insurance Companies

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Introduction

In recent years, the use of captives, both domestic and foreign, has increased dramatically. This is due in part to the global economy. It is also due to corporations structuring transactions to utilize more favorable tax rates and capitalization requirements. Use of captives opens numerous issues which have ramifications not only for excise taxes, but for income taxes as well.

Captive Defined

A captive insurance company is generally defined as a wholly owned insurance subsidiary. The purpose of a captive insurance company is to insure the risks of the parent and affiliated entities. Captives can either be formed as a domestic captive within the United States, or as a foreign captive in another country. When 100% of the insurance risk accepted by the captive is the risk of the parent entity the captive is called a 'pure' captive. Pure captives may not be treated as true insurance companies for purposes of income and excise taxes.

A captive can insure the risks of other entities within the affiliated group (i.e. brother/sister risks) and the risks of unrelated outside third parties. Once brother/sister risks and especially unrelated third party risks are accepted by the insurance subsidiary, there becomes a point where the insurance subsidiary can no longer be called a pure captive. At that point, depending upon the facts and circumstances of the case, namely the percentage of premiums received by the captive from affiliated entities and third party entities, the captive may not be treated as a true insurance company.

Reasons for Captives

The question is often asked why a corporation would go through the start-up costs and the capitalization expense to establish a captive insurance company. The answer depends upon the strategy of the parent corporation, which may include any of the following:

- The parent may wish to reduce the amount of money paid for insurance premiums. By establishing a captive, the parent has control over the amount of premiums paid as the captive will establish its own premium rates.
- The parent retains the profits made on insuring within its corporate structure instead of paying the premiums and the underlying profits to an unrelated third party.
- The parent may want to reduce the amount of risk retained in the affiliated group. By establishing a captive insurance company and acquiring its insurance through the captive, the parent can control the number of outside third party insureds and thereby control the amount of risk involved with its insurance needs.
- Establishment of a foreign captive can be used to funnel income to a country with no or a lower income tax rate than the tax rate in the United States. This offers a substantial savings on income tax expense.

- A domestic captive can be established to reduce the percentage of foreign insurance excise tax paid on premiums paid to foreign insurers or reinsurers.

Captive Issues in General

The main issue for captives is whether the captive insurance entity is a valid insurance entity. This determination must be coordinated closely with the income and/or international agents assigned to the case. The determination has an effect on the income tax expense deduction for the insurance premiums expense paid from the parent and/or related entities to the captive.

Risk-shift and Risk-distribution

In order for the captive to be treated as a true insurance entity for income tax purposes, the elements of risk-shift and risk-distribution must be present. This is established in Helvering v. Le Gierse, 312 U.S. 531(1941), and is further defined in Clougherty Packing Company v. Commissioner, 811 F.2d 1297 (9th Cir. 1987).

Risk-shift - Defined as the transfer of the impact of a potential loss from the insured to the insurer. If the insured has truly shifted the risk, then a loss incurred on the risk does not affect the insured. Instead, the insurer bears the loss in its payment of proceeds to the insured.

Risk-distribution - The spread of the risk of loss to others beyond the insured. Therefore, if the insured suffers a loss, the cost of the loss is distributed to all parties who have paid a premium to the insurer. The more parties which insure their risks and pay insurance premiums to the insurer, the more distribution of risk.

Self-insurance

The concepts of risk-shift and risk-distribution are important in the determination of whether a captive is to be treated as a true insurance company for income and excise tax purposes. When the captive accepts premiums only from the parent entity and does not reinsure the premiums with an unrelated reinsurer, the risk is not shifted or distributed outside the parent-subsidiary relationship. Therefore, the payment for a loss stays within the affiliated group. The net effect to the affiliated group is the loss itself, as the loss has not been shifted outside of the affiliated group. This is self-insurance.

In the case of self-insurance, the insurance premium expenses deducted on the parent's income tax return would be disallowed as capitalization of the subsidiary. For excise tax purposes, the entity would not be treated as an insurance company and would be treated more as an agent or broker.

Note: Per Revenue Ruling 2001-31, I.R.B. 2001-26, (June 04, 2001), the IRS cannot rely on the economic family theory in challenging a captive. Therefore, a captive will not be challenged based solely on the fact that transactions within the economic family occur.

Other factors to consider in challenging a captive will be discussed later in this lesson under Government's Position.

Effect of Pure Captive Reinsurance

If the captive reinsures premiums on United States risks with an unrelated reinsurer, the portion of the premiums reinsured create risk-shift and risk-distribution. This is due to the fact that an outside third party has now accepted a portion or all of the risk initially "insured" with the captive. Should a loss occur, an entity outside of the affiliated group is now responsible for covering all or a portion of the loss incurred. Therefore, the pure captive will be treated as a true insurance company for the amount of premiums reinsured. Cite: FSA 1992-1123-2, Misc-doc, 98ARD 155-4.

Example: Domestic Parent Company A pays $ 2,000,000 in premiums for casualty insurance on buildings located in Los Angeles to Captive B located in Barbados. This premium income is the only premiums received by Captive B. Captive B reinsures 40% of the risk with Foreign Insurer C, an unrelated entity located in the Cayman Islands. Neither Captive B nor Foreign Insurer C holds a section 953(d) election.

The effect of the reinsurance with Foreign Insurer C is to create risk-shift and risk-distribution for the $800,000 in premiums reinsured and Captive B is treated as an insurance company for this portion of the premiums. Therefore, the 4% casualty insurance rate is imposed on the $800,000 in insurance premiums paid from Domestic Parent Company A to Captive B creating $32,000 in tax liability. In addition, the 1% reinsurance tax rate is imposed on the reinsurance premiums paid from Captive B to Foreign Insurer C creating $8,000 in tax liability under the cascading principle. The issue of cascading is discussed further in Chapter 7.

The $1,200,000 (60% times $2,000,000) of premiums paid by Domestic Parent Company A to Captive B is self-insurance and no foreign insurance excise tax is imposed as Captive B is not treated as a true insurance company for this portion of the premiums. The $1,200,000 becomes a capital contribution to Captive B and is to be coordinated with income tax to ensure the income tax adjustments are made to the case.

Effect of Unrelated Third Party Premiums

If the captive subsidiary accepts a significant portion of its premium income from unrelated third parties, risk is determined to be shifted and distributed outside the affiliated group. True insurance would exist and the income tax expense for the premiums paid would be allowable as an income tax deduction. The excise agent would then recognize the insurance captive as a true insurance company and determine any adjustment accordingly.

The amount of unrelated third party insurance needed to transform a captive into a true insurance company has not been fully established. A summary of the court cases surrounding this issue is presented at the end of this lesson. As always, the facts and

circumstances of each case must be taken into consideration in making this determination.

Domestic Captive Issues

Recently, many corporations have established on-shore, or domestic captives. A state must have captive laws which allow for the formation of a captive insurance company. States such as Vermont, Colorado, Arizona, and Hawaii have very favorable captive laws. In fact, the State of Vermont actually markets the establishment of a captive insurance company as an industry.

Use as Intermediaries

Issues concerning domestic captives center around the determination of whether or not the captive is a true insurance company. This determination becomes significant if the captive reinsures with a taxable foreign insurer. By using the domestic captive as an intermediary, the taxpayer can reduce the federal excise tax rate from 4%, for direct insurance, to 1%, for reinsurance. Since the amount of insurance premiums can reach the tens of millions of dollars for large taxpayers, this can be a significant savings.

Multiple Transactions within the United States

A transaction stream must be analyzed before a determination is made. Many transactions within the United States may occur before the premiums are ceded to a taxable offshore insurance company. For example, the parent may pay premiums to an unrelated insurance company who cedes the premiums directly, per contract, to the parent's wholly owned captive in the United States. The captive may then cede the premium to a related or unrelated offshore insurance company. The transactions prior to the cession of the premiums offshore need to be looked at in depth to determine if the unrelated insurance company is merely acting as a conduit to get the premiums to the domestic captive to shield the movement of the premiums off-shore.

Note: Diagramming the flow of premiums often puts the case into perspective when multiple entities are involved.

Related and Unrelated Premiums

Tax issues concerning taxability of insurance premiums paid only by a parent to its captive are fairly straightforward. However, the issues become more difficult once related party (brother/sister), and unrelated third party premiums are accepted by the captive. Depending upon the percentage of premiums accepted from these two types of entities, the premiums may be treated as a true insurance premiums.

In the case of unrelated third party premiums, such amounts are treated as true insurance. On the other hand, premiums from a brother/sister corporation paid to the captive may be treated in full or in part as insurance. The facts and circumstances of the case and the

percentage of related premiums as well as unrelated premiums received by the captive insurance company must be considered in determining whether and to what extent true insurance exists.

IMPORTANT: Close coordination with the Case Coordinator, the Case Manager, International Agent and/or the Insurance Agent on the case is required. The excise issue determination will be based upon the determination made by the above agents on the deductibility of premiums paid to the captive subsidiary for income tax purposes.

Foreign Captive Issues

There are numerous excise tax issues concerning foreign captives. Each issue is a variation on the basic issue of whether the captive is to be recognized as a true insurance company. Once the question as to the viability of the captive is answered, the excise agent can use this information to determine whether an issue with the foreign captive exists.

Recognized as a True Insurance Company

It is important to ensure that the insurance is true insurance, as discussed above with domestic captives. The parent corporation may set up a number of captive subsidiaries in the United States as well as in foreign countries. When a determination is made to recognize the foreign captive as a true insurance company, the following potential issues may exist:

- Premium payments for direct insurance may be taxed at the 4% rate.
- Premium payments for reinsurance may be taxed at the 1% rate.
- The captive may reinsure with another reinsurer located in a taxable country, thereby causing a 1% tax to be imposed on the foreign captive for cascading tax.
- A captive, located in a qualified treaty country with an anti-conduit provision, may reinsure with another reinsurer located in a taxable country. Therefore, the anti-conduit provisions would be violated and the exemption would be lost. The premium payment from the U.S. would then become taxable. In addition, the 1% tax would be imposed on the amount of premiums reinsured.

Not Recognized as a True Insurance Company

If the foreign captive is not recognized as a true insurance company, the potential issues are summarized below:

- The foreign captive will be treated as an agent of the parent company for excise tax purposes. Insurance expense for the premiums paid to the captive will not be allowed as a deduction for income tax purposes, and the amount paid to the captive would be treated as a capital contribution to the captive.

- If the U.S. parent pays premiums directly to a captive, and the captive cedes premiums to another taxable insurer, the premiums ceded would be subject to the 4 percent excise tax. (Assuming the premiums were paid for casualty insurance).
- If the premiums ceded to the foreign captive are for reinsurance, the amount of premiums ceded to a second taxable foreign insurer would be subject to the 1 percent reinsurance excise tax under the principle of cascading. Cascading is discussed in depth in Chapter 7.

Captive Rulings and Court Cases

The concept of risk-shift and risk-distribution as it relates to insurance is discussed in a number of court cases and rulings. Although a majority of the court cases and rulings deal with the disallowance of the income tax deduction for the payment of the insurance premiums between a parent and a captive, the same basic concepts are inherent in making the excise tax determination. Where insurance is not recognized for income tax purposes, an insurance premium payment will not be recognized for excise tax purposes.

Government's Position

The following revenue ruling and cases support the Government's position that a pure captive is not treated as a true insurance company.

Revenue Ruling 2001-31, IRB 2001-26, (June 04, 2001)

Prior to the issuance of Revenue Ruling 2001-31, the Service relied on the "economic family" theory, the theory that transactions between the parent and the captive stay within the affiliated group. The economic family theory was used for analyzing whether the transactions involved risk-shift and risk-distribution thereby constituting true insurance. With the issuance of Rev. Rul. 2001-31, the Service may no longer rely solely on the economic family theory.

However, the Service may continue to challenge captive insurance transactions based upon the facts and circumstances of the case. In making the determination, the source of premium income to the captive is to be analyzed. Each source has its own tax consequence.

Parent to Captive (Subsidiary) Premiums:

No insurance exists when a captive accepts premiums only from the parent company as risk-shift and risk-distribution have not occurred. (However, if the captive reinsures all or a portion of the premiums received, insurance may exist. Reference: Effect of Pure Captive Reinsurance above.)

Brother-Sister Premiums:

Brother-sister premiums need to be evaluated to see if normal insurance practices are present:

- Pricing of premiums.
- Provisions of policy are the same as regular policies.
- Captive is properly capitalized.
- Is there any capitalization indemnification agreement with the parent?
- Does the insurance entity operate as a separate and distinct entity?
- Professional insurance staffing.

If factors are present, then brother-sister premiums are likely to be considered to be insurance.

Outside Third Party Premiums:

If outside third party premium income of the captive is greater than 30%, then **all** of the premiums are likely to be considered insurance. In order for this to happen, all premiums must be pooled (commingled funds). If outside third party premium income of the captive is less than 30%, a close scrutiny of the facts and circumstances of the case as discussed in the prior section on brother-sister premiums. This is due to the fact that outside premiums are not substantial. The percentage of outside third party insurance is determined via the amount of earned premiums of the captive subsidiary.

- Helvering v. LeGierse, 312 U.S. 531 (1941)

Case defines insurance in the terms of risk-shift and risk-distribution. The court said that "these elements of risk-shifting and risk distribution are essential to a life insurance contracts is agreed by courts and commentators."

- Carnation Company v. Commissioner, 640 F.2d 1010 (9th Cir. 1981)

In this case, the parent corporation paid premiums to an unrelated entity which acted as a fronting company. The unrelated entity then "reinsured" 90% of the premiums with the parent company's wholly owned captive insurance company. The Court determined that no insurance existed between the parent and its wholly owned captive insurance company as the risk of loss did not shift.

- Gulf Oil Corp. v. Commissioner, 914 F.2d 396 (3rd Cir. 1990)

Taxpayer paid premiums to an unrelated fronting company which ceded the premiums to the taxpayer's captive foreign insurance company, which was undercapitalized. Taxpayer provided a guarantee to the fronting company that it would indemnity the

fronting company if the captive ever became unable to meet its obligations with respect to the reinsured risks. Because of the taxpayer's guarantee, the Third Circuit Court of Appeals upheld the Tax Court's ruling that no risk-shifting or risk-distribution took place and therefore, the taxpayer was not entitled to an insurance premium deduction. In so holding, the Third Circuit left open the possibility that the existence of unrelated insurance premiums might establish risk-transfer sufficient to justify the deduction of insurance premiums.

Taxpayer's Position

Courts have been reluctant to fully embrace the economic family theory. Accordingly, subsequent to the Gulf Oil Corp. v. Commissioner decision in 1990, various courts began to place weight on the amount of unrelated insurance business accepted by a captive in determining whether true insurance exists. A sample of these cases is set forth below.

Important note: If the federal court of appeals for the State in which the taxpayer is located has rendered an opinion on the issue, such decision is controlling (i.e. it will take precedence over the revenue rulings). Thus, it is important to check if there has been any case law on the issue applicable to the State in which the taxpayer is located.

- Sears Roebuck and Co. v. Commissioner, 972 F. 2d 858 (7th Cir. 1992)

A captive with outside insurance business of 99.75 percent was considered by the courts to be a legitimate insurance company. Therefore, the .25% of the premiums received from the parent was considered insurance.

- AMERCO v. Commissioner, 979 F.2d 162 (9th Cir. 1992)

A third tier wholly owned subsidiary captive insurance company, with outside insurance of at least 52% was considered by the Court to be a legitimate insurance company. The insurance company was also licensed in 45 states and the District of Columbia under the standard state insurance laws.

- Ocean Drilling & Exploration Co. v. United States, 988 F.2d 1135 (Fed. Cir. 1993).

Insurance premiums paid by a parent company to a subsidiary insurance company on behalf of the company's other subsidiaries were valid insurance expenses. Risk-shift and risk-distribution between the parent and the insurance subsidiary were present since the insurer provided insurance to unrelated parties in an amount significant enough to reduce the parent's risk. Unrelated party insurance accounted for 44% one year and 66% the next year of the premiums written by the insurance subsidiary.

- Harper Group v. Commissioner, 979 F.2d 1341 (9th Cir. 1992)

Wholly owned subsidiary with outside business of 29% which received premium payments from related subsidiaries and outside parties was determined to be a legitimate insurance company. Thus, the premiums paid by related subsidiaries in a brother/sister transaction were deductible for income tax purposes.

The Court also considered the argument that the brother/sister subsidiaries might be considered "outside" business, but did not make a determination on this issue as the pure outside business percentage caused the captive's transactions to be recognized as insurance.

- Humana, Inc. v. Commissioner, 881 F.2d 247 (6th Cir. 1989)

A wholly owned subsidiary insurance company received premiums from its parent company and related subsidiaries. Initially, the Tax Court held that the captive was not considered to be an insurance company with respect to the premiums received from both the parent and the brother/sister entities.

The Sixth Circuit Court of Appeals later ruled that premiums received from brother/sister transactions should be considered insurance premiums, but the premiums received from the parent should still be considered as nondeductible. (Remember, the finding of the Court of Appeals applies only to the Sixth Circuit.)

- Malone & Hyde, Inc. v. Commissioner, TC Memo, 1991-585.

Corporation established a wholly owned foreign insurance subsidiary (s1) to reinsure itself and its subsidiaries. There were no unrelated third party premiums accepted by s1. After s1 was established, the corporation insured with a domestic unrelated corporation (d1), which then agreed to cede premiums to s1. The court disallowed the full amount of premiums paid by the parent and subsidiaries to d1 which were reinsured with s1.

The above litigation shows that the courts do consider related party and outside third party premiums received by the captive in their decision. Therefore, the amount of related party and outside third party premiums must be well documented in the case file.

Captive with Multiple Owners

The following ruling and court case deal with a captive which has multiple unrelated shareholders.

- Revenue Ruling 78-338, 1978-2 C.B. 107

Amounts paid by a domestic corporation to a foreign insurance company with 31 unrelated shareholders, none of which own a controlling interest in the insurance company, are deductible premiums as risk of loss can be shifted and distributed between the members.

NOTE: Revenue Ruling 78-338 is modified by Revenue Ruling 2001-31. Other than the economic family theory, the rationale remains the same.

- Black Hills Corp. v. Commissioner, 73 F.3d 799 (8th Cir. 1996)

When each of the owners of the insurance company pay premiums to a separately maintained account for each member, the transaction of premium payment from the owner to the insurance company is not insurance.

Note: It is important that the excise tax examiner coordinate the audit of the foreign insurance excise tax issues with other agents on the case who are responsible for determining the deductibility of premium payments to the captive. Once this determination is made, the applicability of the foreign insurance excise tax is to be considered using the facts and circumstances of the case.

Chart of Cases and Rulings for Captive Issues

The chart below summarizes the revenue rulings and court cases discussed in this chapter.

Scenario	Result	Reference
1. All premiums paid directly from the parent to a captive.	Income Tax-No insurance expense Excise Tax-Potential adj. if captive reinsures with a taxable foreign reinsurer.	Rev. Rul. 2001-31 (Facts & circumstances of case to be considered as guided by case law)
2. All premiums paid from parent to unrelated agent then ceded to captive.	Income Tax-No insurance expense Excise Tax-Potential adj. if captive reinsures with a taxable foreign reinsurer.	Rev. Rul. 2001-31 (Facts & circumstances of case to be considered as guided by case law) Carnation Co.
3. Premiums paid from parent to captive along with brother/sister premiums.	Income Tax- No insurance for parent but may be insurance for relateds. Excise- Potential adj. if captive reinsures.	Humana Harper Group
4. Premiums paid from parent to captive along with unrelated third party premiums.	Income Tax- Possible insurance if percentage of third party premium is significant. Excise Tax-Tax due on foreign premiums if determined to be insurance.	Sears Roebuck AMERCO Ocean Drilling Harper Group

Scenario	Result	Reference
5. Captive is owned by multiple owners.	Income Tax- Insurance Excise Tax- Tax due on foreign premiums.	Rev. Rul. 78-338 (No economic family theory position)
6. Captive owned by multiple owners with separate accounts for each owner.	Income Tax- No Insurance Excise Tax- Potential adj. if captive reinsures.	Black Hills Corp.

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Chapter 7 – Cascading Insurance

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Introduction

Internal Revenue Code Section 4371 imposes a tax of 1 cent on each dollar or fractional part thereof of the premium paid on a policy of reinsurance. Therefore, as long as the underlying risk insured is a United States risk, the tax on reinsurance may be imposed on premiums paid to a reinsurer residing in a taxable foreign country. The issue of cascading takes the above definition one-step further by applying the reinsurance excise tax to each instance of taxable reinsurance.

The Issue of Cascading

An insured pays a premium to a foreign insurance company for either direct insurance or reinsurance, where the initial premium payment is subject to tax. The foreign insurer then reinsures all or part of the risk with another taxable foreign insurance company. In turn, that foreign insurer may reinsure with yet another taxable foreign insurer.

Example: Domestic Corporation A insured its casualty risks located in the United States with Foreign Insurer B, who is a taxable insurer. Foreign Insurer B in turn, reinsured the same risks with Foreign Reinsurer C, a taxable reinsurer. Foreign Reinsurer C reinsured these same risks again with Foreign Reinsurer D, who is also a taxable reinsurer.

In this case, the premiums paid from Domestic Corporation A to Foreign Insurer B would be subject to the 4% tax rate on casualty insurance. The premiums reinsured from Foreign Insurer B to Foreign Insurer C would be subject to the 1% tax rate on reinsurance. In addition, the premiums reinsured from Foreign Insurer C to Foreign Insurer D would also be subject to the 1% tax rate on reinsurance.

The issue is whether each of the transactions of reinsurance, subsequent to the initial taxable premium payment, is subject to the 1% foreign insurance tax. In general, each level of reinsurance with a taxable foreign reinsurer is a taxable event for imposition of the 1% excise tax on the foreign reinsurance. For the tax to be imposed, the insurance must be on a United States risk, the reinsurer must reside in a foreign country, and the reinsurer must not have a valid exemption from the excise tax as discussed in Chapter 5.

As can be expected, the insurance industry does not agree with the imposition of the tax each time a taxable transaction occurs. The remainder of this chapter will review both sides of the controversy as well as present scenarios where imposition and assessment of the tax will be applicable.

Position of the Internal Revenue Service

Revenue Ruling 2008-15

Revenue Ruling 2008-15 directly addresses the issue of cascading foreign insurance excise tax as it applies to foreign insurers and foreign reinsurers. Rev. Rul. 2008-15 contains the following four scenarios:

(1) A non-U.S. insurance company, incorporated in a country that has no income tax treaty with the United States, issues direct insurance policies to a U.S. corporation with respect to risks located wholly or partly within the United States. The non-U.S. insurer then purchases reinsurance, covering all or part of the loss that the non-U.S. insurer may sustain on its policies issued to the U.S. corporation, from a non-U.S. reinsurer that is incorporated in a country that has a U.S. income tax treaty that does not contain an FET waiver. Neither the non-U.S. insurer nor the reinsurer is engaged in a U.S. trade or business. Rev. Rul. 2008-15 holds that the FET will apply to (a) the premium paid by the U.S. corporation to the non-U.S. insurer (the 1st leg FET) at a 4% rate and (b) the premium paid by the non-U.S. insurer to the non-U.S. reinsurer (the 2nd leg FET) at a 1% rate.

The Non-US insurer then reinsures the US risk to another Non US reinsurer that has no FET waiver. The premium paid in this second leg is subject to 1% FET

(2) A non-U.S. reinsurance company, incorporated in a country that has a U.S. income tax treaty that does not contain an FET waiver, issues reinsurance policies to a U.S. insurer with respect to policies the U.S. insurer has issued to insureds (as defined in section 4372(d)), i.e., that cover U.S. risks. The non-U.S. reinsurer then cedes some or all of those risks to another non-U.S. reinsurance company, incorporated in a different country that has a U.S. income tax treaty that does not contain an FET waiver. Rev. Rul. 2008-15 holds that the FET will apply to (a) the premium paid by the U.S. insurer to the first non-U.S. reinsurer at a 1% rate and (b) the premium paid by the first non-U.S. reinsurer to the second non-U.S. reinsurer at a 1% rate.

(3) A non-U.S. insurance company, entitled to the benefits of a U.S. income tax treaty containing a qualified FET waiver issues direct insurance policies to a U.S. corporation with respect to risks located wholly or partly within the United States. The non-U.S. insurer then purchases reinsurance, covering all or part of the loss that the non-U.S. insurer may sustain on its policies issued to the U.S. corporation, from a non-U.S. reinsurer that is incorporated in a country that has a U.S. income tax treaty that does not contain an FET waiver. Neither the non-U.S. insurer nor the reinsurer is engaged in a U.S. trade or business. Since the anti-conduit provision of the qualified FET waiver was violated by the first non-U.S. insurance company with the reinsurance of the U.S. risks to the second non-U.S. reinsurer, the premium paid by the U.S. corporation to the first non-U.S. insurer is subject to excise tax. Rev. Rul. 2008-15 holds that the FET will apply to (a) the premium paid by the U.S. corporation to the non-U.S. insurer (the 1st leg FET) at a 4% rate and (b) the premium paid by the non-U.S. insurer to the non-U.S. reinsurer (the 2nd leg FET) at a 1% rate.

(4) A non-U.S. insurance company, entitled to the benefits of a U.S. income tax treaty containing an FET waiver subject to a conduit arrangement limitation issues direct insurance policies to a U.S. corporation with respect to risks located wholly or partly within the United States. The non-U.S. insurer then purchases reinsurance, covering all or part of the loss that the non-U.S. insurer may sustain on its policies issued to the U.S. corporation, from a non-U.S. reinsurer that is incorporated in a country that has a U.S.

income tax treaty that does not contain an FET waiver. Neither the non-U.S. insurer nor the reinsurer is engaged in a U.S. trade or business, and it is assumed that the non-U.S. insurer has not issued the policies to the U.S. corporation as part of a conduit arrangement. Rev. Rul. 2008-15 Revenue Ruling holds that the FET (a) will not apply to the premium paid by the U.S. corporation to the non-U.S. insurer, but (b) will apply to the premium paid by the non-U.S. insurer to the non-U.S. reinsurer (the 2nd leg FET) at a 1% rate.

It should be noted that the cascading effect of the FET is not limited to the 1st and 2nd legs, but continues with each subsequent retrocession involving underlying U.S. risks.

Voluntary Compliance Initiative

In connection with Revenue Ruling 2008-15, Announcement 2008-18 lays out a voluntary compliance initiative regarding the 2nd leg FET. Pursuant to the Announcement, with respect to those taxpayers otherwise complying with this procedure, the IRS will not examine issues arising under the situations described in Revenue Ruling 2008-15 in respect of premiums paid from one non-U.S. insurer to another non-U.S. reinsurer before October 1, 2008. For these purposes, all premiums relating to a U.S. risk will be treated as received on or after October 1, 2008, if any transaction described in Revenue Ruling 2008-15 occurs with respect to such risk on or after such date.

To participate in the initiative, an eligible non-U.S. person must timely file an applicable Form 720 return and pay any FET due with respect to premiums paid or received on or after October 1, 2008, or timely disclose that it is claiming a treaty-based return position that it is entitled to an exemption with respect to such premiums. The top of such Form 720 must bear in red print the statement: “Election to participate in FET Voluntary Compliance Initiative pursuant to Announcement 2008-18.” If an eligible non-U.S. person is not otherwise required to file a Form 720 return with respect to this quarter, a blank Form 720 bearing the above legend must be filed to participate in the initiative. Participating non-U.S. persons are required to conform to the recordkeeping requirements of Treas. Reg. § 46.4371-4 with respect to premiums paid or received on or after October 1, 2008.

Persons eligible to participate in the initiative include any non-U.S. insurer or reinsurer or any other non-U.S. person liable for the FET that has failed to file timely one or more Form 720 returns and pay or remit any 2nd leg FET due or to timely disclose that it is claiming a treaty based return position that it is entitled to an exemption with respect to premiums paid or received during any quarterly tax period ending before October 1, 2008.

Failures of a non-U.S. person to file or pay the 1st leg FET will not fall within the scope of the initiative. More specifically, if a non-U.S. person that has entered into an FET closing agreement with the IRS fails to pay the 1st leg FET due on premiums it received covering U.S. risks as required under such agreement because either (i) the non-U.S. person is entitled to a qualified FET waiver and such non-U.S. person has reinsured the

U.S. risks with an unprotected reinsurer or (ii) the non-U.S. person is entitled to an FET waiver subject to a conduit arrangement limitation and the policies underlying the U.S. risks were entered into by the non-U.S. person as part of a conduit arrangement, such failures will not be covered by the initiative.

Prior Sources of Support for the Cascading Theory

There are three prior sources which support the position that cascading of premiums is subject to the reinsurance excise tax. The sources are discussed in detail and are as follows:

1. Technical Advice Memorandum 9621001, December 18, 1995
2. United States v. Northumberland Insurance Co, Ltd, 521 F. Supp. 70 (D. N.J. 1981)
3. Revenue Ruling 58-612, 1958-2 C.B. 850

Technical Advice Memorandum 9621001

The current position of the Internal Revenue Service is contained in Technical Advice Memorandum 9621001. While this TAM may not be used or cited as precedent, pursuant to I.R.C. § 6110(k)(3), it is a useful source of reference on the issue of cascading tax. The TAM discusses whether reinsurance premiums paid by a foreign insurer to other foreign insurers on U.S. risks are subject to the 1% excise tax on reinsurance. The TAM concerns premiums paid from Corporation A, a domestic company, to Foreign Insurer E, located in Bermuda. Foreign Insurer E subsequently reinsured the risks with other taxable foreign insurers. The premium payment from Corporation A to Foreign Insurer E is subject to the 4% excise tax for direct insurance.

The TAM held that the 1% tax did apply to the reinsured premiums ceded from Foreign Insurer E to the other foreign insurers. However, the TAM noted that the tax must be collected from Foreign Insurer E, since Foreign Insurer E is the entity for whose use or benefit the reinsurance policy was obtained.

United States v. Northumberland Insurance Co, Ltd.

The holding in TAM 9621001 is based, in part, on the case of Northumberland Insurance Co, Ltd. Northumberland, an Australian insurance company was licensed only as a surplus lines insurer in New Jersey. It was not licensed to perform general insurance business within the United States. Northumberland reinsured a portion of its risk with a Swiss insurance company also not licensed to do business in the United States.

The Service asserted the 1% reinsurance tax on the premiums ceded by Northumberland to the Swiss insurance company. Northumberland objected, noting the following reasons:

1. It did not qualify as an "insured" under IRC Section 4372(d), and

2. The assessment would result in multiple taxation on the same risk, a consequence Congress could not have intended.

The Court determined the following:

1. Northumberland did not have to qualify as an insured so long as the underlying primary policies were issued to insureds.
2. Northumberland did qualify as an insured because it was a foreign corporation engaged in a trade or business in the United States. NOTE: The judge differentiated between "authorized to do business" per § 4373(1) and "engaged in a trade or business" per § 4372(d).
3. Internal Revenue Code § 4371 imposes the tax for reinsurance on **each** policy of reinsurance issued by foreign reinsurers.
   Northumberland states,
   Reimposing the excise tax on the underlying premiums accords with the aforementioned legislative intent, namely, eliminating the competitive advantage afforded foreign insurance companies.

Revenue Ruling 58-612

Revenue Ruling 58-612 also supports the cascading theory. The ruling holds, "a policy of reinsurance issued by a foreign insurer covering [a risk subject to tax under Section 4371(1) or (2)] is subject to the tax imposed on reinsurance policies by Section 4373(3), regardless of whether the primary insurer was a domestic or foreign insurer."

The ruling involved a policy issued by a domestic insurer which in turn, is reinsured with a foreign insurer. Using the wording of the ruling, when a foreign insurer insured a United States risk giving rise to tax under § 4371(1) or (2), and then reinsures the risk with another foreign insurer, the reinsurance would be taxable under § 4371(3). Therefore, a cascading of the tax has occurred.

Industry Position

The industry's position is that the doctrine of cascading was invalidated by the case of SDI Netherlands B.V. v. Commissioner, 107 TC 161 (1996). Although that case involves royalties, as opposed to insurance premiums, the industry believes the same logic applies.

The SDI case involved royalties paid from a U.S. company to a Netherlands company (SDI Netherlands), which were combined with other, non-U.S. royalties. The total royalties were then paid to a Bermuda company (SDI Bermuda). The IRS argued that the royalties paid from SDI Netherlands to SDI Bermuda retained their character as "U.S. sourced income" and were subject to withholding under IRC §§ 1441 and 1442.

SDI Netherlands, on the other hand, argued that its payments to SDI Bermuda were made on a separate and independent basis pursuant to a worldwide licensing agreement between two foreign corporations, and therefore did not constitute U.S. sourced income.

The Tax Court found that the royalties from SDI Netherlands to SDI Bermuda were separate payments and not U.S. sourced income. With regards to the cascading issue, the decision states:

We find support for our conclusion herein that respondent's view of the law could cause a cascading royalty problem, wherein multiple withholding taxes could be paid on the same royalty payment as it is transferred up a chain of licensors.… We are not disposed to conclude, in the absence of any legislative expression on the subject, that Congress intended the statutory provisions to permit "cascading" with the question of relief left to the mercy of the respondent.

Who is the Taxpayer?

As discussed in Chapter 3, the liability for the foreign insurance excise tax is joint and several. The tax may be imposed on the insured, the policyholder, the insurance company, or the broker. The problem with cascading tax arises when tax would be imposed on a foreign entity. When reinsurance occurs, a new "contract" is created. Thus, the original domestic entity is replaced by the foreign insurer. The foreign insurer is now the policyholder and the insured on the new contract. The original foreign insurer is replaced by the reinsurer as the insurance company.

Practical Situations with Cascading

As a practical matter, the tax due on cascading premiums will be difficult to detect and collect from a foreign entity. However, the greatest opportunity for the detection and development of this issue will occur in the following situations:

1. The insurer or reinsurer is a related entity of a United States entity. An example of such an insurer, would be a captive insurance company.
2. The insurer or reinsurer is a resident of a qualified treaty country and has violated the anti-conduit provision of such treaty. In this case, the tax can be obtained via the letter of credit with a closing agreement filed by the insurer with the United States.
3. The insurer or reinsurer has made and received an election to be treated as a United States entity for purposes of income tax. An example would be an election under § 953(c) or (d).
4. A foreign insurer or reinsurer is under examination by an International Excise Agent who is able to request and review the foreign insurer or reinsurer's reinsurance activities.

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Chapter 8 – Consolidated Returns

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Introduction

While technically not correct, it is not uncommon to see a consolidated Form 720 return filed by a domestic parent corporation which may or may not be in the insurance industry. The parent company will consolidate the filing requirements of itself and its insurance subsidiaries in order to minimize the number of returns filed. Consolidated returns pose a number of problems. First, it is difficult to identify the correct taxpayer unless detailed records are maintained. Second, it will appear that the insurance company subsidiaries are not filing returns or remitting the tax due on foreign insurance premiums ceded.

Who is the Taxpayer?

Many times an insurance policy is written for the use and benefit of a number of entities as insureds/policyholders. The parent company makes one lump premium payment to the foreign insurer. The parent company files a consolidated Form 720 reporting the tax on the foreign insurance premiums paid by or on behalf of all of the entities in the affiliated group.

The parent company then uses inter-company accounts to charge each of the subsidiaries their portion of the insurance premiums and related tax. Each of the entities is the taxpayer and is liable for the excise tax. This is due to the fact that each entity is the insured/policyholder. It is important to remember that the taxpayer need not be the party that makes the actual payment to the foreign reinsurer.

Accordingly, a separate Form 720 for the tax should be filed by each of the respective entities. Each of the Forms 720 should reflect the tax applicable to the portion of the total premium paid or allocated to each entity and should be filed under their own EIN.

It is important to remember that although the Service collected the tax, the tax was reported in part by an incorrect entity. This results in the subsidiaries, who did not file returns, to have an open statute. Also, the subsidiaries who have not filed a return reflecting tax paid would not be allowed to claim a refund should a refund situation arise.

Identification of Consolidated Excise Returns

The existence of a consolidated Form 720 can be determined in a number of ways. As part of the preaudit review of a large affiliated group, the Form 851, Affiliations Schedule, is a good resource to determine whether the taxpayer has one or more insurance companies included in its affiliated group. An in-depth interview of the taxpayer concerning any insurance company affiliations as well as a review of the workpapers used to prepare the Form 720 are also excellent ways to determine if a consolidated return has been filed.

Examination of Consolidated Excise Returns

When confronted with the examination of a return which turns out to be a consolidated return, the examiner will need to verify that all the ceded foreign insurance premiums have been reported. The examiner will also need to determine the proper allocation of tax due to all affected entities. In the case of a return filed by a parent insurance company, this may be accomplished by reconciling the foreign premiums ceded per the NAIC Annual Statement to the ceded reinsurance premiums declared on the Form 720.

The NAIC Annual Statement is prepared by the parent insurance company and all the insurance subsidiaries. Foreign reinsurers are listed in Schedule F, Part 3 for property and casualty insurance. Life insurance is reported on Schedule S. In addition, a Form 5471 or 5472 may be attached to the income tax return of an insurance or non-insurance corporation. These two forms may also provide information concerning foreign insurance premium payments and affiliations.

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Chapter 9 – Pooling of Risks

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Introduction

When risks are substantial or unusual, a company may not be able to obtain insurance through a regular insurance company. Pooling arrangements may be used to secure insurance in these situations.

Pooling Defined

Pooling is defined as an organization of insurers or reinsurers through which particular types of risks are underwritten with premiums, losses, expenses, and profits shared in agreed ratios. This is also known as an “association” or “syndicate”. An example of pooling would be a group of six unrelated roofing companies within a geographical area coming together to form an offshore insurance company.

Reasons for Pooling Arrangements

Two reasons why pooling arrangements may be formed are as follows:

1. The type of industry pooled does not lend itself to outside insurance, and/or
2. A refusal of insurance companies to accept certain risks.

Type of Industry

Pooling arrangements are established along an industry line such as in construction, the legal profession, or petroleum. Each of these industries has its own risks which are specific to that type of industry. For example, petroleum companies are exposed to risks of damage from pollution, wild oil or gas well fires, and the transportation of fuel oil, to name a few.

Refusal of Others to Accept Risk

Based upon the type of risk and the probability that the risk will occur, traditional insurance companies may refuse to insure the risk or set the premiums at such a high amount that it is not economically feasible to insure the risk. By grouping together in a pooling arrangement, the risks can be insured and/or lower premiums can be secured.

Pooling Characteristics

In order for a pooling arrangement to be treated as true insurance the following characteristics generally must be present:

1. The pooling arrangement is comprised of economically unrelated shareholders and their subsidiaries and/or affiliates.
2. None of the shareholders own a controlling interest.
3. The risk of loss for each shareholder must be shared with all shareholders.

4. The insurance company provides insurance coverage only to the shareholders and their affiliates. No outside third party coverage is provided.
5. Premium rates are established according to customary industry rating formulas. The insurance company may take into account the unique risks of the insureds in establishing its rates.
6. There must be a shifting of risk and distribution of the risk of loss.

Note: The facts and circumstances of the case along with the six characteristics above are to be considered when determining whether a pooling arrangement is true insurance. Also, coordination with the income tax agent on the case is necessary.

Pooling Example

A pooling arrangement is established in Bermuda to insure the risks of six unrelated bridge construction companies against the damages incurred should a bridge fail due to faulty construction. Each of the six owns an equal amount of the insurance company, and has provided an equal amount of capitalization for the insurance company.

Premiums for casualty insurance are determined in accordance with regular insurance standards with adjustment for the type of bridges being constructed and other industry risks specific to each company. The insurance company accepts only the risks of the six construction companies.

In this example, as long as the risk of loss is shifted and distributed, the arrangement would be treated as true insurance. Excise tax would be imposed on the premium payment from each of the entities to the Bermuda insurance company.

Risk-shift and Risk-distribution

As discussed in Chapter 6 concerning captive insurance companies, in order for insurance to exist, there must be risk-shift and risk-distribution. If the members of the pool do not commingle the premium funds and share in the losses, there is no risk-shift and no risk-distribution. Essentially, each of the members is self-insuring through their personal capital accounts.

This is brought forth in the case of Helvering v. LeGirse, 312 U.S. 531 (1941), and also in Rev. Rul. 60-275, 1960-2 C.B. 43.

In the case of pooling, as long as the risk of each of the insureds is shifted or distributed amongst the other members of the pool, insurance exists. Insurance would not exist if each of the pooling members paid funds into their own capital account and their loss transactions are paid out of only that member's capital account.

In this latter case, none of the members bear any risk of loss for another member's risks. The damage payments would be paid out of the individual member's capital account; therefore, the risk of loss remains with that member. Therefore, it is important to ensure

that there is risk-shift and risk-distribution for all members of the pool. The taxpayer will need to be questioned as to how premium payments are made to the pool (do they go to a commingled account or to the taxpayer's account?) and how losses are paid out (are they paid out of a commingled account or from the taxpayer's account?). A copy of the financial statements of the pool should be requested from the taxpayer and reviewed to verify that the funds are commingled.

Effect on Income Tax

When there is a lack of risk-shift and risk-distribution, no insurance is deemed to exist and the taxpayer is allowed a refund of previously paid excise tax on the premiums paid. Although the adjustments are not in favor of the Government on the excise tax side, adjustments on the income tax side include issues such as the disallowance of the insurance premium expense deduction. Again, it is important that the excise agent work closely with the income agents on the case to coordinate the determination of whether true insurance exists.

Pooling as a Form of Captive Insurance

Pooling arrangements for insurance are a form of captive insurance. Although there is more than one insured and the insureds are not related according to stock ownership, the pool will not accept risks outside the type of industry risks being insured. Thus, it is only the risks of the pooling insureds which are accepted. The number of members in the pool can vary from as few as two to an infinite number depending upon the type of industry and the number of insureds interested.

As long as none of the shareholders owns a controlling interest in the entity and the premium funds are commingled, there is a pool. If one entity owns a controlling interest, there is no pool. Instead, there is a partnership or a parent-subsidiary relationship with outside ownership interests.

Pooling and Section 953(d) Elections

Under the requirements of making a section 953(d) election, the foreign corporation (foreign insurance company) must be a controlled foreign corporation with ownership by a United States shareholder equal to or more than 25 percent. There must be a controlling interest. However, in a pool situation, none of the shareholders can own a controlling interest. Therefore, pools can not obtain and hold a section 953(d) election. Premiums paid to a pool located in a country not holding and meeting the requirements of an exemption under a treaty with the United States are taxable.

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Chapter 10 – Insurance Company Reinsurance

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Introduction

As discussed in Chapter 6, insurance in the generally accepted sense is a contract to transfer the risk of loss from one party to another for payment of consideration. In order for insurance to exist, there must be risk-shift and risk-distribution. There also must be a **pure risk of loss** (loss or no loss) as opposed to a **speculative risk** (gain, loss or no loss). Business risk, investment risk, and asset risk are subcategories of speculative risk.

Reinsurance is a transaction between two insurance companies to transfer risks insured. Reinsurance in this sense is essentially insurance for an insurance company.

Insurance Companies in General

Insurance can generally be classified into two categories: property and casualty insurance, and life insurance. The term “insurance company” means a company whose primary and predominant business activity during the taxable year is the issuance of insurance or annuity contracts. The term also includes a company engaged in the reinsuring of risk underwritten by insurance companies. It is the character of the business, which determines whether a company is taxable as an insurance company under the Internal Revenue Code. Cite: G.C.M. 39146.

Types of Insurance Companies

Insurance is provided by a number of different organizations. The most common types of insurance organizations include stock companies, mutual companies, reciprocal exchanges, Lloyd’s, federal and state governments, and captive insurers.

Stock Company - A company owned by shareholders whose ownership is evidenced by shares of stock. The shareholders participate in any surplus remaining from premium and investment income after insurance losses and the costs of doing business have been paid. Stock companies are prevalent in the life insurance industry.

Mutual Company - A company without stockholders or capital stock. All risks and all profits are the property of the policyholders. Mutual companies are prevalent in the property and casualty insurance industry.

Reciprocal exchange - A group of individuals, corporations, or other organizations, referred to as subscribers, who are exposed to similar insurable risks and wish to share these risks among themselves. For example, a number of independent hospitals that have exposure to professional liability suits may form a reciprocal exchange in order to share these risks. Each subscriber is liable for its proportionate share of the total liability should a claim be presented.

Lloyd’s Association - A kind of organization for underwriting insurance or reinsurance in which a collection of individuals assume policy liabilities as the individual obligations

of each. When spelled with an apostrophe, the term refers to Lloyd’s of London, the formal name of which is “Underwriters at Lloyd’s, London.”

Federal and state governments - Provide insurance protection for certain risks that are beyond the ability or resources of most private insurers to assume. Examples of federal insurance are: the Federal Deposit Insurance Corporation (FDIC) and the Federal Savings and Loan Insurance Corporation (FSLIC). At the State level, the most common type of insurance protection provided is workers’ compensation. These state programs are administered by a state agency under the direction of a state supervisory board.

Captive insurers - Wholly owned corporate subsidiaries that insure the risks of the parent corporation and other entities within the affiliated group. Captives are discussed in depth in Chapter 6.

Discussion of Reinsurance Terms

In order to better understand reinsurance and the terms included in this section, refer to the diagram of the flow of transactions below:

A is the initial insured. B is the insurance Company and C is the Reinsurance Company.

Note: References (example: (B) made in this section are to the entities above.

Reinsurance - A transaction between two insurance companies to transfer risks. The direct or primary insurance company (B) is called the **ceding company** or reinsured. The ceding company may transfer **(cede)** some or all or its risk to a reinsurer (C) which is the assuming company. When a company reinsures, it may cede its risks to authorized companies or to unauthorized companies.

Authorized reinsurance - Insurance placed with a reinsurer who is either licensed or otherwise recognized by a particular state insurance department. On the other hand, **unauthorized reinsurance** is insurance placed with a reinsurer who is not licensed or recognized by a particular state insurance department.

The reinsurer (C) may also transfer or **retrocede** all or a part of the risk it assumes from an insurer (B) to another third party insurer called a retrocessionare. This type of agreement is called a **retrocession agreement**. The risk transferred between insurance companies may be transferred several more times, or **retroceded**.

In order to reimburse the ceding insurer (B) for its expenses, the reinsurer (C) will pay the ceding company (B) a **ceding commission**. Ceding commissions may include agent commissions, premium taxes, license and other fees, and administrative and overhead expenses, which are incurred by the reinsured (B) in underwriting the contract. The ceding commission will also include a profit factor for the ceding insurance company (B).

Reinsurance is created via a **reinsurance contract** between the two insurance companies. There are a number of different types of reinsurance contracts which will be discussed later in this lesson.

Why Insurance Companies Reinsure

An insurer purchases reinsurance for different reasons. The major reasons are to accomplish the following:

- Reduce exposure on a particular risk or class of risk.
- Protect the insurance company against a large accumulation of losses caused by a major catastrophe.
- Obtain an ability to accept risks and policies involving insurance amounts which are larger than they could accept without the reinsurance.
- Stabilize operating results.
- Reduce premium volume and total liabilities to levels appropriate to capital accounts, and
- Obtain assistance with new insurance products and lines of insurance.

Basic Types of Reinsurance

Reinsurance can generally be classified into two broad categories, assumption reinsurance and indemnity reinsurance.

Assumption Reinsurance

Assumption reinsurance is "an arrangement whereby another person (the reinsurer) becomes solely liable to the policyholders on the contracts transferred by the [ceding company]". Cite: Treas. Reg. § 1.809-5(a)(7)(ii).

Under an assumption reinsurance agreement, the reinsurer steps into the ceding company's shoes, becoming directly liable to the policyholders. The reinsurer also receives all premiums directly.

Example: Company A purchases a policy of casualty insurance from Insurer B. Insurer B cedes the risk to Insurer C under an assumption reinsurance contract. Should a loss occur to the risks insured, Insurer C will be responsible for payment on the loss. Also, once the assumption reinsurance agreement is signed, Company A will be aware of the reinsurance agreement, and Company A will pay premiums directly to Insurer C.

Indemnity Reinsurance

Indemnity reinsurance is "an arrangement whereby the [ceding company] remains solely liable to the policyholder, whether all or only a portion of the risk has been transferred to the reinsurer." Cite: Treas. Reg. § 1.809-4(a)(1)(iii)).

Under an indemnity reinsurance agreement, the reinsuring company agrees to accept and to indemnify the issuing (ceding) company for all or a part of the risk of loss under the policies specified in the agreement. Both insurers are co-insurers.

Example: Company A purchases a policy of insurance from Insurer B. Insurer B then transfers the risks insured to Insurer C under an indemnity reinsurance agreement. (After the agreement between Insurer B and Insurer C is executed, Company A will still pay premiums to Insurer B only. Company A may not know of the agreement between Insurer B and Insurer C.) Should a loss occur, Insurer B would be responsible for payment on the loss to Company A. Insurer B would then turn to Insurer C for payment under the terms of the indemnity reinsurance agreement.

With an indemnity reinsurance arrangement, it is not uncommon for the ceding company to establish a "funds held account," sometimes referred to as a "funds withheld," which holds the unearned premium reserve or the outstanding loss reserve. The net balance of the funds withheld increases with additional premiums received or decreases as claims are paid. As profits emerge, the ceding company pays the reinsurer its share. Conversely, the reinsurer reimburses the ceding company for any losses that occur after the funds withheld balance reaches a certain specified amount.Indemnity reinsurance can take two forms, pro-rata reinsurance, (often referred to as co-insurance in the life insurance industry) and excess of loss reinsurance. These terms are discussed below.

Pro-Rata Reinsurance / Co-insurance In pro-rata reinsurance, the reinsurer's participation is predetermined and is proportional. Therefore, the reinsurer is responsible for loss reimbursement based upon the proportions set forth in the contract. In the life insurance industry, this type of reinsurance is typically referred to as coinsurance and if a funds held account is utilized, it is referred to as modified co-insurance. Pro-rata reinsurance contracts can be written as quota share or surplus share arrangements.

Under a **quota share** arrangement, a fixed percentage of the insurance policies written by the insurer is automatically ceded to the reinsurer. Usually the percentage of the reinsurer's share of the risk is the same as the percentage of the written premium it receives.

Example: Company B has issued policies with premiums totaling $10,000,000. According to the terms of the quota share treaty, Company B will cede 60% of its premiums to Company C.

Premiums $10,000,000
Multiplied by Quota Share % .60
Equals Premiums Ceded 6,000,000

Under a **surplus share** arrangement, the assuming insurance company must accept the amount of risk above the net retention of the ceding company. The amount of net retention (the amount retained) of risk by the ceding company is specified in the treaty,

and the percent of participation is based on the type of risk insured. The amount of risk insured in the original policy in excess of the amount of retention is called the surplus.

Example: Company B issues a policy for $500,000 with an insurance premium of $5,000. The reinsurance contract specifies a $100,000 retention level. Company B retains $100,000 and cedes the remaining $400,000 of the risk to Company C.

Original Policy $500,000
Less Ceding Company's Retention (100,000)
Equals Surplus Ceded to Company C $400,000Reinsurance Premium Ceded:
Policy premium times [surplus divided by original risk]
$5,000 times (400,000 divided by 500,000)
Equals 4,000

Excess of loss reinsurance - Does not provide a sharing of all the risk. Under this arrangement, the reinsurer's participation depends on the size of the loss and/or time involved. The reinsurance becomes effective only when losses reach a stipulated amount or retention level, and then only to limits set forth in the contract. Types of excess of loss reinsurance include per risk reinsurance, catastrophe reinsurance, and stop loss reinsurance.

Example: Company B reinsures with Company C. In its excess of loss treaty, Company B must retain the first $100,000 loss on a certain type of negotiated risk. Company C will cover losses up to $500,000.

Total Loss $700,000
Less Company B Retention 100,000
Less Company C Payment 500,000
Equals Balance Paid by Co. B $100,000

Per risk reinsurance or per claim excess reinsurance provides coverage for losses in excess of a predetermined amount on a per risk basis. For example, a building is insured under a policy of casualty insurance and a reinsurance contract is secured under per risk coverage of $100,000. In the case of damages to the building, should the damages exceed the preset amount of $100,000, the reinsurer is responsible for the amount of loss over the $100,000.

Catastrophe reinsurance or per occurrence reinsurance provides coverage for losses in excess of a predetermined amount resulting from a specific catastrophic event or series of events. For example, claims for damages due to hurricanes are reinsured to the extent the accumulated losses due to hurricanes within the coverage period exceed the predetermined amount.

Stop loss reinsurance or aggregate excess of loss reinsurance provides coverage for accumulated losses incurred by the ceding company in excess of a predetermined amount during a specified period. For example the ceding company would absorb all losses in

their entirety until the aggregate losses reach a specific dollar amount or maximum loss ratio. The reinsurer then would reimburse the ceding company to bring the dollar amount of losses or loss ratio down to a specified maximum level.

Types of Reinsurance Contracts

Reinsurance is transacted through a contract or agreement between insurance companies whereby risk is distributed. Reinsurance contracts are generally categorized as facultative reinsurance or treaty reinsurance.

Facultative Reinsurance

Facultative reinsurance gives the reinsurer the option to accept or refuse each risk offered by the ceding company. Usually a binder is prepared by the insurance company and is signed by the reinsurer. The reinsurer subsequently issues a reinsurance certificate.

Treaty Reinsurance

Treaty reinsurance is reinsurance that is not facultative reinsurance. Treaty reinsurance is usually a detailed contract that defines, among other provisions, the type of business reinsured, the exclusions, and the amount covered. Treaty reinsurance automatically reinsures a defined type of business. The reinsurer does not have the right to accept or reject each individual risk within a policy. Treaty reinsurance is the more common type of reinsurance.

Key Elements of a Reinsurance Contract

The reinsurance contract is a detailed agreement that defines the entire reinsurance agreement. Among other things, the reinsurance contract defines the type of business reinsured, the excluded business, ceding commissions, offsets, and premium amounts. It prescribes for the manner in which reports and remittances are to be made. It also provides for redress based on insolvency, errors, and omissions.

Sources of Information for Reinsurance Premiums Ceded

Several sources of information are useful in reconciling foreign insurance premiums ceded:

- Form 720 and supporting workpapers.
- Comparative financials.
- Account details.
- Form 1120-PC, U.S. Property and Casualty Insurance Company Income Tax Return.
- Form 1120-L, U.S. Life Insurance Company Income Tax Return.
- NAIC Annual Statement.
- Bordereaux/Settlement statements.

Form 720 and Supporting Workpapers

Along with copies of the Forms 720 filed for all entities, the supporting workpapers used to prepare the returns are to be requested. Depending upon the detail provided in the workpapers, names of "taxable insurers" and the amount of "taxable premiums" will be listed. Subsequent Information Document Requests can be prepared to verify or clarify this information.

Comparative Financials

A review of comparative financials will give a historical overview of the company's insurance activities; premium income and expense; information concerning parent subsidiaries, and affiliates; and acquisitions and legal proceedings.

Account details

Provide information on ceded premiums, assumed reinsurance, commissions, expenses, and excise tax deposits. Detail on ceded premiums can be reconciled with Forms 720, settlement statements, and the NAIC schedules reporting reinsurance premiums ceded.

Form 1120-PC

Every domestic non-life insurance company and every foreign corporation that would qualify as a non-life insurance company subject to taxation under I.R.C. § 831 as if it were a U.S. corporation, must file Form 1120-PC, U.S. Property and Casualty Insurance Company Income Tax Return. Form 1120-PC, Schedules E and I provide information on net premiums written, the method of accounting, and foreign and domestic affiliates.

Note: An exemption is provided for non-life insurance companies exempt under I.R.C. § 501(c)(15). These companies are required to file Form 990, Return of an Organization Exempt from Income Tax.

Form 1120-L

A life insurance company (LIC) is an insurance company in the business of issuing life insurance and annuity contracts, either separately or combined with health and accident insurance, or non-cancelable contracts of health and accident insurance, that meet the reserves test in I.R.C. § 816(a).

Every domestic LIC and every foreign corporation that would qualify as a LIC if it were a U.S. corporation must file Form 1120-L, U.S. Life Insurance Company Income Tax Return. Form 1120-L, Schedules G and M provide information on gross premiums, return premiums, premiums and other consideration incurred for reinsurance, the method of accounting, and foreign and domestic affiliates.

NAIC Annual Statement

The National Association of Insurance Commissioners (NAIC) is an association of the various state insurance commissioners formed for the purpose of uniformity of regulatory practices and information reporting among the states. While the NAIC has no official power to enforce compliance with any of its recommendations, the NAIC's recommendations and forms are generally adopted and widely accepted by the states.

Treasury Regulation § 1.6012-2(c) requires that the NAIC Annual Statement be filed with Form 1120-L and Form 1120-PC. A schedule which reconciles the NAIC Annual Statement to the tax return is required to be attached to the return. A penalty may be imposed if the annual statement is not included when the income tax return is filed.

Various schedules, not limited to the following, in the **NAIC Property/Casualty Annual Statement** provide data and background information on reinsurance activities:

- Underwriting and Investment Exhibit - Part 2B, Premiums WrittenSchedule F - Part 1, Assumed Reinsurance
- Schedule F - Part 2, Premiums Portfolio Reinsurance Effected or (Cancelled) during Current Year
- Schedule F - Part 3, Ceded Reinsurance
- General Interrogatories
- Supplemental Exhibits and Schedules Interrogatories
- Notes to Financial Statement
- Schedule Y, Information Concerning Activities of Insurer Members of a Holding Group
- Part 1, Organization Chart
- Part 2, Summary of Insurer's Transactions with Any Affiliates

Bordereaux/Settlement Statement

The bordereau (singular) or bordereaux (plural) is a periodic report or settlement statement that accounts for the reinsurance premiums paid from the initial insurer to the reinsurer. It is usually prepared by the ceding company (initial insurer) and is provided at interim periods to the reinsurer. A bordereau reflects the following items:

- Ceded premiums.
- Ceding commissions.
- Losses and loss adjustment expenses (LAE's).
- Case reserves.
- Incurred but not reported (IBNR) losses.
- Losses incurred.
- Amounts due to/from reinsurer.

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Chapter 11– Claims

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Introduction

Taxpayers are aware of their rights in receiving refund of excise taxes paid. This chapter includes a discussion of the various types of foreign insurance claims. The chapter also includes steps to aid in the determination of the validity of each type of claim.

Procedures for All Claims

Certain information is required for all types of claims. First, determine whether the person filing the claim is the person who filed the Form 720 and remitted the foreign insurance excise tax on the original premium payment to the foreign insurer. If the person filing the claim is other than the person who filed the Form 720 and remitted the tax, determine whether the specific treaty, an IRS notice, or revenue procedure permits such person to file the claim. Second, confirm that the claim was timely filed. Third, verify the amount of the claim. Ensure the computation of the original tax paid and the tax claimed utilize the correct tax rates.

Types of Claims

There are five types of foreign insurance claims:

- Claims based on treaties with the United States.
- Claims based on the election to treat a controlled foreign corporation as a domestic corporation (Section 953(d) election).
- Claims based on a captive subsidiary.
- Claims for foreign insurance policy coverage not subject to excise tax.
- Claims for foreign insurance covering products exported from the United States.

Specific procedures to determine the accuracy of a claim for foreign insurance excise tax differ depending upon the type of claim filed. Once the type of claim is determined, the excise agent may use the guide below to determine whether the claim is to be allowed, disallowed in part, or disallowed in full. Each step taken is to be documented in the agent's workpapers.

Claim Based on Treaties with the United States

A claim will occur when a taxpayer has paid premiums to a foreign insurer located in a treaty country. Subject to the foreign insurer meeting all requirements, the transaction would be exempt from foreign insurance excise tax. However, the excise tax on these premiums was reported and paid to the Government at the time of the premium payment. Therefore, the taxpayer is allowed a refund for the error in paying tax on exempt premiums. A change in the excise tax treaty status of the country where the insurer is residing would also create a claim situation.

In order to file a claim for refund of foreign insurance excise tax, the insurer or reinsurer must be a resident of a treaty country. It is important to determine whether the tax

exemption for the country in question is in effect as well as determining the type of exemption. This is done either by a review of the tax treaty itself or by a review of the treaty reference sheet.

For a qualified treaty exemption, verify that the insurer or reinsurer has satisfied the Residency and the Limitations on Benefit provisions in the applicable treaty or has a closing agreement applicable for the claim period.

Claim for Election to be Treated as a Domestic Corporation

A claim will be filed when a foreign insurer or reinsurer elects and receives permission to be treated as a United States corporation for income tax purposes under IRC § 953(d). Another election is available under IRC § 953(c), but is seldom used by foreign insurers. Either election must be requested from and granted by the Internal Revenue Service. Once accepted, the election is valid starting in the income tax year for which it is made. A copy of the § 953(d) election statement stamped as accepted by the Internal Revenue Service is to be requested to verify the claim. In addition, ensure that the period of the claim is within the time frame that the election is valid.

An agent may contact the Foreign Insurance EIS to verify that a § 953(d) election is valid. However, it is the responsibility of the claimant to have the proper documentation in their possession when filing the claim.

Claim Based on Examination of a Captive Subsidiary

A parent company establishes a wholly owned captive insurance company in a taxable foreign country. During the course of the income examination, the income agent determines that the risks insured by the insurance subsidiary are actually self-insurance. The insurance subsidiary is not considered to be a true insurance company. Therefore, the premiums paid to the insurance subsidiary are not taxable as no insurance exists.

If the taxpayer does not agree, the taxpayer will file a protective claim for the excise taxes paid on the original payment of the insurance premiums to the captive. If the taxpayer does agree with the income tax determination, the taxpayer will file a claim for refund of the excise taxes paid with the original premium payments to the captive for the quarters affected by the income tax examination.

For both agreed and unagreed claims with this issue, the following steps are to be taken to verify the validity of the claim. Each step is to be documented in the agent's workpapers.

First, ensure that the time period of the claim is within the time period that the captive is not treated as an insurance company.

Second, verify with the income agent and/or the international agent that the income deduction for the premiums paid to the captive foreign subsidiary are disallowed. This

must be coordinated with the agent on the case. **Do not disallow or allow the claim without this verification.** It is also important to determine whether the income issue is agreed or unagreed.

For unagreed income cases, the case will be forwarded to Appeals. Appeals will consider whether the premiums paid to the captive are allowable expense deductions for the parent, thereby determining whether the premiums are paid for true insurance and are subject to excise tax. Therefore, the taxpayer will file a protective claim for the excise taxes previously paid to the captive. If the premium deductions are not allowed, such premiums are not subject to excise tax.

If the income issue is still in Appeals, the claims should not be suspended until the issue is resolved. All such claims should be disallowed in full and closed for processing, by securing a signature on Form 5384 or Form 3363, and on Form 2297 waiver.

To protect the taxpayer's interest in case the transactions are later held to be self-insurance, a Form 907, Agreement to Extend the Time to Bring Suit, is secured from the taxpayer. Authority for use of the Form 907 is in IRM Handbook No. 4.24.8.10.4.

Foreign Insurance Policy Not Subject to Tax

These types of claims assert that the insurance risk is not subject to the foreign insurance excise tax based on an exemption. An example is where the premiums are subject to U.S. income taxes under IRC § 4373. Documentation establishing that the insurance policy is exempt from the excise tax on foreign insurance is to be secured from the claimant.

Foreign Insurance Covering Products Exported from the United States

These claims are based on the 1996 Supreme Court ruling in United States v. International Business Machines, 517 U.S. 843, 96-1 USTC ¶ 70,059 (1996) ("IBM" claims). The IBM case held that the excise tax may not be applied to foreign insurance premiums paid with respect to insurance covering risks associated with goods actually in export transit from the United States.

Per IRS Notice 96-37, 1996-2 CB 208, filing Form 8849 is the **only** means by which a taxpayer may claim a refund for an IBM claim. A refund may not be claimed by means of a credit against another tax liability, or as an adjustment on Form 720.

To verify the claim, documentation establishing that the insurance policy is exempt from the excise tax on foreign insurance is to be secured. In the case of a policy covering risks in addition to goods in export transit, the claim for refund must be accompanied by documentation establishing the portion of the excise tax attributable to premiums paid only for insuring goods in actual export transit from the United States. Cite: Notice 96-37.

In addition, verify that the goods were actually exported. Review the export documents filed with Customs. Request and review the insurance policy to ensure that the policy covers goods during export transit.

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Chapter 12 – Insurance Company Reinsurance

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Introduction

This chapter will discuss various items which can be used as audit tools to ensure that the information received from taxpayers is correct and current. Just like any other audit, the agent may use other sources of information, both internal and external, to verify information received or to strengthen the Government's position. These sources include:

- National Association of Insurance Commissioners (NAIC)
- Section 953(d) Election Information
- Closing Agreement Information
- Income Tax Return Sources
- Insurance Publications and Websites

National Association of Insurance Commissioners

The NAIC is an organization of insurance regulators headquartered in Kansas City. Members include insurance regulators from the 50 states, the District of Columbia, and the four United States territories.

History

The NAIC was created in 1871. At that time state insurance regulators were concerned with establishing uniformity of regulation for multi-state insurers. Today, state insurance regulators use information forwarded from the NAIC to protect consumers through the implementation of solvency and market regulations. Solvency regulation involves protecting policyholders against the risk that the insurer will not be able to meet obligations. Market regulation is involved with ensuring fair and reasonable insurance prices, products and practices.

NAIC Standards

The NAIC has minimum standards that are issued to provide assurances that the oversight of domestic insurers is adequate. They require individual states to have the authority to conduct exams of all licensed United States insurers that are domiciled in the respective states.

The NAIC also requires states to establish risk-based capital requirements and to institute the NAIC financial reporting requirements. Further, CPA audits and actuarial opinions are required for financial statements issued by insurers. State insurance departments are also required to maintain controls and resources to monitor licensed insurers domiciled in their state.

The NAIC is involved with the codification of Statutory Accounting Principles (SAP) designed to standardize accounting rules across states as well as provide definitions where they have previously been lacking. SAP rules differ from GAAP and the NAIC attempts to clarify these differences.

Annual Statement - The NAIC requires all licensed United States insurers to file an annual statement, prepared under SAP standards, in the state within which they are domiciled. The annual statements are prepared uniformly under NAIC-SAP reporting requirements. As a result, regardless of the state within which an insurer is domiciled, information detailed is consistent and is reported on the following schedules:

- Property & Casualty Insurers outline reinsurance premiums ceded on Schedule F, Part 3.
- Health and Life Insurers reflect reinsurance premiums ceded on Schedule S.

Both Schedule F, Part 3 and Schedule S contain the name, domicile, and premium ceded to each foreign reinsurer.

The annual statements are maintained by the state insurance commissioner in the state of domicile and are public records available for review. Any time an insurer is under exam, the agent may request the NAIC Annual Statements to review premiums ceded to foreign reinsurers. By doing so, potential taxable reinsurers can be identified.

Note: Activity on NAIC Annual Statements includes two types of ceded premiums: premiums ceded directly to insurers and premiums ceded through an intermediary. When an intermediary is used, the intermediary cedes the premium payment to the foreign reinsurer. As a result, the intermediary is typically the party remitting tax on the transaction.

Based on these facts, a portion of taxable premiums outlined in the annual statements could be the tax obligation of an intermediary rather than the insurer. Request verification from the intermediaries that the tax has been paid, either through the taxpayer or with a third party contact.

If the tax obligation has not been paid, the Service is not bound by the private agreement of the parties as to who is liable to file the return and pay the tax. In this situation, refer to Chapter 3 concerning upon whom the liability can be imposed.

NAIC and Pure Captives - As previously noted in Lesson 6, several states allow the formation of domestic pure captives. Because pure captives are involved with providing coverage for parents and affiliates, protection of consumers is not an issue. Therefore, uniformity of regulations is not deemed necessary and pure captives may not be required to file NAIC statements.

Section 953(d) Election Information

When a taxpayer makes an election under IRC § 953(c) or (d), they are required to file a request for election with the Internal Revenue Service. The Service reviews the application and approves or denies the request. The application is then filed and retained by the Internal Revenue Service. Agents may contact the Foreign Insurance EIS for verification that an election was made if the taxpayer is unable to provide substantiation

of the election. Given that the taxpayer has relied upon a section 953(d) election in filing or not filing an excise tax return. It is the taxpayer's responsibility to maintain substantiation of the election relied upon.

Closing Agreement Information

Closing agreements, letters of credit and residency lists are obtained and maintained by the Internal Revenue Service. However, because of concern over the restrictions on the disclosure of tax return information, the Service does not publish this information, either internally or externally. If an agent needs to verify whether a foreign insurer has a closing agreement or letter of credit, contact the Foreign Insurance EIS. Provide the EIS with the name, city, and country of residence of the foreign insurer as well as the taxable year(s) at issue.

Income Tax Return Sources

There are three sources included in income tax returns. Each source provides information which may be used to determine the issues to be reviewed in a foreign insurance excise audit.

Form 5471

Form 5471, Information Return of U.S. Persons with Respect to Certain Foreign Corporations. Schedule M, Line 1, reports sales of foreign products (inventory) from the Controlled Foreign Corporation to its domestic affiliated companies. These transactions could include foreign insurance premiums within cost of goods sold for insurance while the product is in transit. Schedule M, Line 11, contains premiums received for insurance or reinsurance. Schedule M, Line 23 contains premiums paid for insurance or reinsurance. The Form 5471 is attached to the corporate income tax return.

Form 5472

Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business. Part IV, Line 12, reports purchases of the U.S. reporting corporation from its foreign related party. These purchases may include foreign insurance premiums within cost of goods sold for insurance while the product is in transit. Part IV, Line 20, contains premiums paid for insurance or reinsurance. The Form 5472 is attached to the corporate income tax return.

Form 851

Form 851, Affiliations Schedule, is attached to the corporate income tax return and lists all affiliates, as well as the type of business of each affiliate, of the parent company.

Form 1120F

Form 1120F, U.S. Income Tax Return of a Foreign Corporation. The form notes the country of incorporation of a foreign insurer. Even if the country is not a taxable country, the foreign insurer may reinsure and be subject to cascading tax.

Insurance Resources

This section includes various resources for further information concerning foreign insurance excise tax.

Internal Resources

- LMSB Industry Overview Series - Property and Casualty Insurance (July , 2000)
- Internal Revenue Manual Handbook 4.23.2.1: Techniques Handbook for Specialized Industries - Insurance. The property and casualty handbook has not been revised since 1980. The property and casualty handbook was not transferred to the new IRM, however, it can still be found on CARTS. It is not available on CCH or LEXIS.
  The life insurance handbook was revised and was moved to the new IRM. It is located at Handbook, IRM, No.4.42 - Insurance Industry Handbook. Both the property and casualty, and the life insurance handbooks provide a helpful description of the terms, records, procedures and definitions unique to the insurance industry.

Texts and Trade Publications

- Best's Insurance Reports, A.M. Best Company, Ambest Road, Oldwick, N.J. 08858, telephone number 908-439-2200. Best's Insurance Reports are available in most public libraries. Best's publishes an annual rating and evaluation of insurance companies. The evaluation is based on the company's filings of the NAIC Annual And Quarterly statements, along with other public and confidential documents, such as Best's Supplementary Rating Questionnaires. The Best reports are published in two separate volumes: Casualty and Property Insurance, and Life and Health Insurance.
  Best rates the insurance companies on a scale of "A++," superior performance, to F, in liquidation. The Best reports give the insurance company's rating, rating rationale, key operating figures, balance sheet, and firm history. Each volume has a series of appendixes. One appendix lists the insurance companies by state of residence of their home office. Another appendix lists insurance companies and the group of companies belonging to each firm.
- Federal Taxation of Insurance Companies, KPMG Peat Marwick, published by Insurance Research Institute of America (RIA).
- Federal Income Taxation of Life Insurance Companies, Ernst & Young, published by Mathew Bender, 1990.
- Reinsurance, Robert W. Strain, 4th Printing, March, 1987.

Websites

There are a number of websites which discuss the topic of insurance/reinsurance and the insurance industry. Some of the more pertinent websites are noted below.

- http://www.naic.org/ : This is the official website for the National Association of Insurance Commissioners.
- http://www.captive.com : Provides information on captive formation and trade conferences.
- http://www.insure.com: Articles relating to insurance companies and the insurance industry.
- http://www3.ambest.com: Information and articles concerning insurance companies and the insurance industry. Also available online is A.M. Best Company's ratings of insurance companies.

Treaty Country Listing as of April 2008

QUALIFIED TREATIES		
Treaty Country	**Effective Date**	**Limited by Anti-Conduit Provision**
Cyprus	1-1-86	Yes
Finland	1-1-91	Yes
France	2-1-96	Yes
Germany	1-1-90	Yes
India	1-1-91	Yes
Ireland	1-1-98	Yes
Israel	1-1-95	Yes
Italy	1-1-85	Yes
Japan	1-1-05	Yes
Luxembourg	1-1-01	Yes
Mexico	1-1-94	Yes
Netherlands	1-1-94	Yes
Sweden	1-1-96	Yes
Switzerland	1-1-98	Yes
Spain	1-1-91	Yes

QUALIFIED TREATIES		
Treaty Country	**Effective Date**	**Limited by Anti-Conduit Provision**
United Kingdom	1-1-04**	Yes***

UNQUALIFIED TREATIES		
Treaty Country	**Effective Date**	**Limited by Anti-Conduit Provision**
Hungary	1-1-80 to Current	No
Romania	1-1-74 to Current	No
United Kingdom	1-1-75 to 12-31-03**	No
USSR *	1-1-76 to Current	No

* In effect for Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyz Republic, Moldova, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan. Although Russia entered into a separate treaty with the United States in 1992, it does not contain an insurance premium excise tax exemption.

** Effective date is extended one year to 1-1-05 for U.K. entities which elect to have the provisions of the old treaty apply for the first 12 months.

*** The transaction is exempt unless the policies are entered into as a part of a conduit arranged to reduce the tax due.