

## **What is FET, and why should I be worried?**

**Chris James, chief executive of FiscalReps, looks at the US Federal Excise Tax (FET) on cross-border insurance programmes' premiums and the resultant cascading effect.**

In the current corporate governance climate, clients are placing increasing levels of pressure on insurers and brokers to deliver assured international tax compliance. Clients know that the regulations are complex. Complexity can lead to uncertainty. Uncertainty can lead to fear. Clients want reassurance.

In Europe, acquiring the knowledge and administrative resources to keep up with the European Union's 21 different Insurance Premium Tax (IPT) regimes, varying widely in terms of business classes liable and methods of payment, is challenging enough. But insurers globally need to be aware that the US is serious about significantly intensifying tax collection procedures and closing tax havens.

The 'Stop Tax Haven Abuse Act', for example, was introduced in March 2009 and sets out to give the US Treasury the power to take "special measures" against overseas jurisdictions and to stiffen the penalties for tax haven promoters.

Of course, the US talking tough about tax collection and tax havens is not new. Nonetheless, when President Obama says stricter proposals will find their way into law, major players believe him. Many companies that use captives organised in one or more low-tax countries are now reviewing the structure of their captive network in the light of the ongoing surge in political opposition to tax havens. Captive structures developed years ago may not be appropriate to the changing legislation and current political climate. Equally, businesses that have not developed captives but have obtained captives through corporate acquisitions may not fully understand all the inherent complexities. Periodic review of the structure of captive operations is always a good idea.

### **The threat of FET**

Insurers must ensure that tax on both sides of the Atlantic is properly calculated. As well as financial penalties, failure to meet the requirements of international tax compliance can damage the reputations of insurers, brokers and clients.

Despite the intensifying political pressure, a non-US captive insuring the US operations generally remains an effective tax-planning tool for companies with significant operations in the US. However, an important factor in this analysis is the cost of the US Federal Excise Tax (FET).

Negotiating US tax treaties can be complex, with the establishment of liability particularly difficult. A key challenge for insurers and reinsurers exposed to the US is to understand and

comply with FET, which applies to the premium paid to a non-US insurance company on contracts covering risks located in the US, as well as to reinsurance premiums paid when any programme covering risks located in the US are ceded to a non-US reinsurance company. With the globalisation of the insurance market, such risks are often covered by non-US insurance companies through reinsurance contracts. A key point to remember is that the US considers FET applicable to multiple transactions in which the same underlying US risks are insured and reinsured. The US Internal Revenue Service (IRS) states that FET is due each time a US risk is reinsured or retroceded, even to a party affiliated with the cedant (although courts may not support the IRS on this point). Some commentators consequently refer to FET as a 'cascading excise tax'.

The complexity of 'Cascading FET', like IPT and other parafiscal taxes, means there is ample scope for miscalculation. Turning to third-party solutions can often be expensive, uncoordinated and unreliable. Many insurers and brokers therefore incur major costs trying to build proprietary systems that still fail to reassure. This failure, however, is no longer an option. As the US government focuses more intently on revenue collection, global tax compliance simply must be addressed by insurance businesses. The key is to unite accurate and trusted global market information with the expertise to interpret and use that data to achieve international tax compliance. Only then can decisions be made with confidence.

### Securing FET exemption

The US imposes FET of 4% on insurance premiums and 1% on reinsurance premiums, paid with respect to US risks to (re)insurers outside the US. Increasing attention is being focused on ways in which overseas insurers can secure an exemption from FET. FET does not apply if the insurer is a qualified resident of a country that has a tax treaty with the US that includes a FET exemption, such as the UK. Insurers wishing to qualify for the exemption from FET typically enter into a closing agreement with the US IRS confirming that the non-US insurer qualifies under the relevant tax treaty. However, the definition of "qualified resident" is complex and varies from treaty to treaty.

Underlining the complexity of this issue, the exemption from FET for UK-headquartered companies only applies if the assuming company does not reinsure with another company that does not qualify for tax treaty relief, and if no conduit arrangement is found to be in place, so this exemption does not necessarily provide complete protection from cascading FET.

At FiscalReps, we work closely with the New York-based Law Offices of Asher Harris on issues of US tax compliance including FET. Harris explains: "The jurisdictions that are currently the leading captive domiciles do not have tax treaties with the US that include FET exemptions. We're talking locations such as Bermuda, Barbados, the British Virgin Islands, the Channel Islands, the Isle of Man and Gibraltar. Inevitably, therefore, we will see businesses relocate to countries with a tax treaty that has a FET waiver. Insurance companies such as ACE, Flagstone and United America Indemnity have already moved from Bermuda (and Caymans) to Switzerland and Ireland. Even those companies that have kept their headquarters in countries with no treaty protection are continually re-examining their corporate structures to ensure that they are operating in a manner that is as tax-effective as possible."

So how do the complexities of cascading FET take effect in practice? Harris says: "Let's assume that a US entity buys insurance from an Irish captive, which qualifies for FET

exemption under the US/Ireland tax treaty. The Irish captive reinsures the risk with a Bermuda affiliate, which receives no FET exemption through a tax treaty with the US. In such a case, the IRS believes that because the Irish insurer reinsured the risk with a reinsurer not qualified for treaty protection, the initial insurance transaction is subject to 4% FET. As the reinsurance transaction involves a US risk, and no tax treaty applies, this transaction is also subject to 1% FET. I would generally advise a client in this situation to analyse thoroughly the costs and benefits of the various elements of the captive structure, including the costs of required capital, as well as the implications for FET, VAT and income tax, in the various jurisdictions in which the captives are located.”

Where next?

The extreme complexities of cascading FET, IPT and other parafiscal taxes, help nobody. The industry will be best served if we can set a global standard for managing insurance tax compliance. Insurers will then be able to focus on doing what they do best, rather than being forced individually to establish uncertain solutions to achieve compliance. Insurers are advised to check each aspect of their possible exposure through reputable third-party expertise.

In Box:

FiscalReps is an independent consultancy that helps insurance businesses to comply with Insurance Premium Tax and parafiscal taxes globally. The company is the European market leader, with a client list that includes many top insurers, brokers and corporate captive owners. Further information is available at [www.fiscalreps.com](http://www.fiscalreps.com).