

Cascading excise tax

Tighter US federal excise tax regulations could have a big impact on captives and international insurance programmes

by Mike Stalley, chief executive officer of FiscalReps

Moves to tighten federal excise tax (FET) on cross-border insurance programmes in the US are cascading through the global insurance industry. This is complicating international tax compliance processes and bringing uncertainty, and even fear to clients who are in real need of reassurance.

Pressure is already increasing on insurers and brokers to ensure they comply with international tax regimes and satisfy corporate governance requirements. The complexity of the regulations is aggravated by the abundance of insurance premium tax (IPT) jurisdictions. Within the European Union alone there are 21, each with different business classes liable and different methods of payment. Adding to the challenge, the US is making a serious attempt at closing tax loopholes and enforcing stricter tax collection procedures.



Failure to comply with tax regimes on either sides of the Atlantic can result in financial penalties and immeasurable harm to the reputations of insurers, brokers and their clients.

Those exposed to the US face a fundamental challenge in understanding and complying with the FET regime. It is applicable to the premium paid to a non-US insurance company on contracts covering risks located in the US, and to reinsurance premiums paid when any programme covering risks located in the US is 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.

Despite mounting political pressure, a non-US captive insuring US operations generally remains an effective tax-planning tool for companies with significant operations in the US. However, any decisions on non-US captives must consider the role, and cost, of FET. At present, the US imposes FET of 4% on non-life direct insurance premiums and 1% on reinsurance premiums, paid with respect to US risks to reinsurers outside the territory.

It is vital to remember that the US Internal Revenue Service (IRS) considers FET applicable to multiple transactions in which the same underlying US risks are insured and reinsured. The IRS states that FET is due each time a US risk is reinsured or retroceded, even to a party affiliated with the cedant (although that view has yet to be proven in court). 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. Many insurers and brokers therefore incur major costs trying to build proprietary systems that still fail to reassure.

Does Obama really care?

Considering whether international tax abuse is a genuine concern for President Barrak Obama's administration, or whether threats of punishment are just talk, the New York-based consultant, Asher Harris points to the Hiring Incentives to Restore Employment (HIRE) Act. This was enacted into law in March 2010 and gives the IRS broad powers to combat tax evasion by forcing non-US financial institutions to reveal the identities of any Americans who may have assets outside the US banking system.

In a similar vein, Harris says the IRS is tightening FET enforcement procedures and has sent a number of information document requests (IDRs) and notices of deficiency to non-US insurers and reinsurers.

Harris adds: “Of course, the US talking tough about tax collection and tax havens is not new. Nonetheless, when President Obama says the IRS needs to crack down on international tax abuse, 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.”

Qualified exceptions

There are exceptions to the FET rules: for example, if the insurer is a qualified resident of a country that has a tax treaty with the US that includes a FET exemption. It is no surprise, therefore, that there is increasing attention being focused in the insurance industry on ways in which overseas insurers can secure an exemption from FET. The leading captive domiciles without FET-exempt tax treaties include Bermuda, Barbados, the Cayman Islands, the British Virgin Islands, the Channel Islands, the Isle of Man and Gibraltar.

Many insurance businesses are migrating from these domiciles 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 retaining their headquarters in countries with no treaty protection are continually re-examining their corporate structures to ensure they are operating as tax-effectively as possible.

Insurers wishing to qualify for the exemption from FET typically enter into a closing agreement with the IRS, confirming the non-US insurer qualifies under the relevant tax treaty. However, the definition of “qualified resident” is complex and varies from treaty to treaty. As a result,



before applying for a closing agreement, the insurer may need to go through a detailed analysis of its corporate structure and operations to determine whether the exemption will actually be available.

Where now for the IRS?

Lately, IRS activity on FET has been to request information on amounts and sources of insurance and reinsurance premiums ceded and assumed, an attempt to match the FET paid by US insureds and cedants with the FET liability of insurers or assuming companies. Most industry participants have complied with the IDRs and are paying tax as there are no perceived realistic alternatives. There is no forum to contest FET prior to its assessment; the only remedy is to pay the tax and then sue for a refund. However, some participants are de-

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veloping strategies that tighten compliance and transactional practices. Crucially, they are structuring policies so that US risks are centralised into a single policy.

The extreme complexities of cascading FET 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 experts. ●

