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CLIENT MEMORANDUM

U.S. Court of Appeals Rejects IRS "Cascading" Tax on Foreign-to-Foreign Retrocessions

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On May 26, 2015, the United States Court of Appeals for the District of Columbia Circuit, in *Validus Reinsurance, Ltd. v. U.S.*, affirmed the grant of summary judgment by the United States District Court for the District of Columbia in favor of the taxpayer with respect to the IRS's application of a "cascading" theory to the U.S. federal insurance premiums excise tax ("FET") on narrower grounds, concluding that the FET would not be imposed on a retrocession from one foreign reinsurer to another. The appeals court reached this result by applying the presumption against extraterritoriality − that is, a court must presume that a statute has no extraterritorial application absent a clearly expressed affirmative intention of Congress to give the statute extraterritorial effect.

As discussed in an earlier client memorandum, the taxpayer in *Validus* was a Bermuda reinsurance corporation that entered into "retrocession" transactions whereby it bought reinsurance from other foreign reinsurers to protect itself in the event that it is required to pay claims under one or more reinsurance policies which it had issued to direct insurers. Based on the IRS's FET "cascading" theory (which imposes the FET on every insurance and reinsurance contract covering certain U.S. situs risks even if premiums related to such risks were previously subject to the FET), the taxpayer paid the FET on certain retrocession contracts it entered into with other non-U.S. reinsurers. The district court ruled that the plain language of both the FET active taxing provision and the definition of "policy of reinsurance" in the relevant sections of the

Internal Revenue Code restricts the application of the FET to reinsurance transactions that cover certain insurance contracts, and not to retrocession transactions that cover reinsurance contracts.

The appeals court found that the government and the taxpayer offered plausible interpretations of the application of the FET to wholly foreign retrocessions and, consequently, concluded that the statute was ambiguous in this regard. The appeals court, relying on the presumption enunciated by the U.S. Supreme Court against extraterritorial application of a statute absent a clearly expressed affirmative intention of Congress to apply the statute extraterritorially, found that the text, context, purpose and legislative history of the FET did not evince an unambiguous congressional intent to apply the FET to wholly foreign retrocessions.

Although the decision of the appeals court reached a favorable result for the taxpayer, the decision continues to leave a number of questions unanswered. For example, it is not clear whether the appeals court would have reached the same result in a foreign-to-foreign reinsurance transaction, although it would appear that the presumption against extraterritorial application should apply in the context of wholly foreign reinsurance transactions. It is difficult to predict how the IRS will proceed in the wake of the appeals court decision.

If you have any questions regarding this memorandum, please contact Arthur J. Lynch (212 728-8225, alynch@willkie.com) or the Willkie attorney with whom you regularly work.

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