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CLIENT MEMORANDUM

District Court Rejects IRS "Cascading" Tax on Retrocession Premiums

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On February 5, 2014, the United States District Court for the District of Columbia, in *Validus Reinsurance, Ltd. v. U.S.,* granted the taxpayer's motion for summary judgment with respect to the Internal Revenue Service's application of a "cascading" theory to the U.S. federal insurance premiums excise tax ("FET") on retrocession premiums. The court analyzed the statutory provisions that impose the FET and concluded that the FET does not apply to premiums on retrocessions (*i.e.*, reinsurance of reinsurers). However, the court declined to address alternative arguments that were made.

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 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 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 court's focus on the statutory language, and its conclusion that retrocessions are not subject to the FET, leave open a number of questions. For example, if a Bermuda insurer insures a U.S. risk subject to a four percent FET and subsequently reinsures all or part of that risk to a Bermuda reinsurer, would a second FET be payable on the reinsurance transaction? The court expressly noted that it was not ruling on foreign-to-foreign reinsurance transactions. In addition, the decision implies that cessions from a U.S. reinsurer to a Bermuda retrocessionaire should not be subject to the FET, as the cession would be characterized as a retrocession.

The decision clearly provides favorable guidance, and any foreign reinsurer that has paid the FET under the "cascading" theory should file protective claims for refund. However, we would expect that the Internal Revenue Service will appeal the decision, particularly as the court's decision could be broadly interpreted to exempt from the FET transactions that were not considered in the context of *Validus*.

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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