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Taxpayers' Winning Streak Against the IRS in Insurance Cases

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In two recent court decisions involving insurance tax issues, taxpayers prevailed against the IRS. Both cases remain subject to further appeals.

In *Validus Reinsurance, Ltd. v. United States*,[1] the District Court for the District of Columbia held that the excise tax imposed under Section 4371 of the Internal Revenue Code (the "Code") does not apply to certain retrocession transactions.

In *Rent-A-Center, Inc. v. Commissioner*,[2] the U.S. Tax Court upheld the deductibility of premium payments made by members of a U.S. consolidated group to its Bermuda-based captive insurance subsidiary.

Validus

Validus Reinsurance, Ltd., a Bermuda company ("Validus") sold contracts of reinsurance to third party insurers, under which it assumed its counterparties' underlying insurance liabilities. Validus then entered into nine retrocession agreements, under which third party retrocessionaires in turn assumed Validus' reinsurance risks. Each of the retrocessionaires was a non-U.S. company, like Validus itself.

The IRS assessed an excise tax against Validus under Section 4371 on the retrocession premiums that Validus paid to its retrocessionaires. Validus paid the assessment, then filed a claim for refund.

Section 4371 generally imposes (1) a 4% excise tax on premiums paid under policies of casualty insurance or indemnity bonds issued by foreign insurers with respect to certain U.S. risks, (2) a 1% excise tax on premiums paid on policies of life, sickness, accident insurance or annuity contracts issued by foreign insurers with respect to the life or hazards to the person of citizens or residents of the United States, and (3) a 1% excise tax on premiums paid on reinsurance contracts issued by foreign reinsurers covering any of the contracts described in (1) or (2). Validus argued on several grounds that the excise tax does not apply to the premiums paid by Validus under its retrocession agreements, including that (1) Section 4371 does not apply to retrocession agreements under its plain language, (2) Congress did not intend that Section 4371 apply to agreements purely between foreign entities, and (3) imposing the tax on "foreign-to-foreign" reinsurance transactions does not comport with international law or the Due Process Clause of the U.S. Constitution.

The District Court found the first argument dispositive and did not discuss the merits of any of the other arguments advanced by Validus. The District Court held that while Section 4371 reaches reinsurance contracts covering casualty insurance, indemnity bonds, and life, sickness and accident policies, the statute does not, on its face, include retrocession contracts covering *other reinsurance contracts*, even if underlying risk covered by the retrocession is described in Section 4371. While the IRS has long maintained in published guidance and rulings that the excise tax applies to all retrocessions where the underlying

1 2014 WL 462886 (D.D.C. Feb. 5, 2014).

2 142 T.C. 1 (January 14, 2014).

Continued from previous page

risks are described in Section 4371, the District Court concluded that Section 4371 does not provide for this result and the IRS could not override the language of the statute.

On this basis, the District Court granted Validus summary judgment, holding that Section 4371 does not impose an excise tax on retrocession transactions, and that Validus is entitled to a refund of the excise tax and related interest. The District Court's rationale is broad-sweeping and, if applied more broadly, would mean that not only foreign-to-foreign retrocessions (which was the fact pattern in *Validus*) are exempt from the excise tax, but so are U.S.-to-foreign retrocessions, even though the underlying policies cover U.S. risks. It has been suggested that an economic equivalent of a direct policy writer's U.S.-to-foreign reinsurance (which would be subject to the excise tax) could now be accomplished without incurring any excise tax *via* a two-step transaction that involves an "onshore" reinsurance contract between the cedent and an intermediary U.S. reinsurer, followed by an "offshore" retrocession from that reinsurer to a foreign reinsurer. However, such a two-step structure might be subject to scrutiny under Section 845(b) of the Code, which gives the IRS broad authority to "make proper adjustments" with respect to reinsurance contracts that have a "substantial tax avoidance effect."

The *Validus* decision could be a significant event for insurance company taxpayers, particularly if it is ultimately upheld by the D.C. Circuit Court, and subsequent developments should be carefully monitored. Before taking any tax position based on the *Validus* decision, such as applying for a tax refund, failing to pay excise tax on future retrocession premiums or undertaking any tax structuring or restructuring, taxpayers should consider all relevant implications. For example, Treasury Regulations Section 1.1441-2(a)(7) provides that "insurance premiums paid with respect to a contract that is subject to the section 4371 excise tax" are not subject to U.S. federal withholding taxes.

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> "…the District Court granted Validus summary judgment, holding that Section 4371 does not impose an excise tax on retrocession transactions…"

By contrast, in the absence of this exemption, U.S.-sourced insurance premiums might be subject to a 30% withholding tax under Sections 1442 and 861(a)(7) of the Code, unless a treaty applies to reduce or eliminate the tax.

Rent-A-Center

Rent-A-Center, Inc. ("RAC") set up a captive insurance subsidiary in Bermuda (the "Captive") to insure certain risks of its other subsidiaries. RAC's consolidated group of U.S. corporations claimed tax deductions for premiums paid to the Captive. The IRS challenged the deductions, arguing that the Captive was a sham and the arrangement did not involve a true transfer of risk – a key requirement to constitute "insurance" for tax purposes. The Tax Court disagreed, concluding that the Captive was a *bona fide* insurance company and the arrangement constituted insurance.

Prior to *Rent-A-Center*, there was already a well-developed body of tax caselaw involving captive insurers, in which the IRS challenged the deductibility of premium payments, and several rulings on this topic by the IRS. The cases are fact-specific and typically turn on factors such as risk shifting (from insured to insurer), risk distribution (how many different risks does the insurer cover), and the captive insurer's status as a *bona fide* insurance company, which requires analyzing the activities and capitalization of the captive insurer.

One noteworthy aspect of the *Rent-A-Center* case is that RAC guaranteed the "deferred tax assets" and certain liabilities of the Captive in order to bolster the Captive's balance sheet for Bermuda regulatory purposes. A vigorous dissent, signed by a significant minority of the Tax Court justices, argued that this parental guarantee indicated that RAC effectively stepped into the shoes of the Captive so that RAC bore the risks of its subsidiaries, and no "risk transfer" to the Captive had occurred. The Tax Court majority dismissed this argument, based in part on its conclusion that a parent guarantee should only be treated as negating "risk transfer" in situations in which the captive is not adequately capitalized (without taking into account the guarantee) to cover the assumed risk. It is possible that the Tax Court's consideration of this issue could have implications for other captive structures, including reinsurance arrangements, involving parent guarantees.

FFIEC Issues Final Guidance on Social Media Risk Management

David Luigs, Liz Alspector, Naeha Prakash

On December 17, 2013, the Federal Financial Institutions Examination Council ("FFIEC" or "Council") published in the Federal Register its final guidance (the "guidance" or "final guidance"), which describes the risks social media activities may pose to financial institutions and provides guidance on how risk management programs should address such concerns.[1] Although the guidance addresses how federal consumer protection laws applying to a financial institution's social media activities, it expressly states that it does not impose any new requirements on and is not intended to discourage the use of social media by financial institutions. The guidance, which is effective immediately, is largely the same as the proposed guidance of January 2013, (78 Fed. Reg. 4848 (Jan. 23, 2013) (the "proposed guidance"),[2] with certain provisions clarified, as discussed in detail below.

Social Media Risk Management

Under the guidance, financial institutions are advised to ensure their risk management programs address the risks presented by social media activities. The guidance defines social media as interactive online communication where users generate and share content through text, images, audio and/or video. In response to concerns of commenters, the guidance clarifies that while this definition includes messages sent through social media platforms, it does not include traditional emails or text messages, but financial institutions are asked to consider how laws and regulations discussed in the guidance may apply to such communications. The guidance's definition of social media is meant to be illustrative, rather than exhaustive, and financial institutions are encouraged to consider new forms of social media that may emerge as technology evolves.

Rather than requiring a unified approach to risk management among institutions, the guidance points to the "longstanding principle" that financial institutions should take into account size, complexity, activities and third-party relationships when implementing a risk management program that identifies, measures, monitors and controls social media risks. Consumer financial protection laws and regulations listed by the guidance that may be applicable to social media activities, such as the taking of applications *via* social media, include the Truth in Lending Act/Regulation Z, the Telephone Consumer Protection Act and the Controlling the Assault of Non-Solicited Pornography and Marketing Act.

Third-Party Risk Management.

In response to commenters, the guidance clarifies the FFIEC's expectations for third-party risk management, including those parties with which the financial institution "does not have a traditional vendor relationship," presumably a reference to unaffiliated social media platforms such as Facebook or Twitter. The guidance advises financial institutions to conduct evaluations and perform due diligence prior to engaging with such third parties to understand the risks that third parties might pose. Such due diligence should include learning about the third party's reputation in the marketplace and its policies, including those related to collection and handling of consumer information. Additionally, an institution should be aware of the process by which such policies may be modified and whether the institution may have any control over the third party's policies or actions.

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1 Social Media: Consumer Compliance Risk Management Guidance, 78 Fed. Reg. 76297 (Dec. 17, 2013). The FFIEC is an interagency body tasked with coordinating federal financial institution examination principles and standards. Its member agencies are the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration and the Consumer Financial Protection Bureau.

2 We previously described the proposed guidance; *see, Debevoise & Plimpton Financial Institutions Report*, "FFIEC Issues Proposed Guidance on Social Media Risk Management" (Mar. 2013). In the proposed guidance, the FFIEC solicited comments on the scope of the guidance, including uses of social media and relevant consumer financial protection laws, and any impediments that financial institutions face when using social media. The FFIEC received 81 comments on the proposed guidance.

Final Guidance on Social Media Risk Management

Continued from previous page

> "The guidance expressly states that it does not impose any new requirements on and is not intended to discourage the use of social media."

Complaints and Reputational Risk

The guidance addresses how financial institutions should monitor reputational risks related to consumer complaints and other communications on websites other than its own. In response to some commenters' concerns that the proposed guidance suggested that financial institutions had a responsibility to monitor for and respond to complaints across the internet, the guidance clarifies that institutions are not expected to conduct such monitoring and should instead weigh the risks to determine the appropriate approach for monitoring and responding to internet comments.

One such approach, consistent with other applicable legal requirements, is for a financial institution to establish channels for consumers to submit communications directly to the institution. Depending on its size and risk profile, a financial institution might also consider monitoring negative comments on the internet, including by monitoring forums on social media sites to ensure that communications are reviewed, and when appropriate, addressed in a timely manner. Regardless of the approach it takes, a financial institution should consider the impact to its reputation if it chooses to not respond to complaints that were not received in a specified channel or when it responds to customers selectively.

Relatedly, the guidance clarifies that depository institutions subject to the Community Reinvestment Act (the "CRA")[3] are expected to retain comments on the institution's performance in helping meet a community's credit needs (and their responses) only when they are received on sites run by or on behalf of the institution, including social media sites.

Employee Use of Social Media. The guidance also clarifies that an employee's official use of social media may subject the financial institution to compliance, operational and reputational risks. To address this, the final guidance suggests that financial institutions implement policies and training to address employee participation in social media when representing the institution. For example, this may include requiring employees to provide appropriate disclosures when communicating with a customer about a loan product through social media. The guidance expressly states that it "is not intended to impose specific requirements" regarding employees' personal use of social media.

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3 12 U.S.C. § 2901 *et seq.*