REINSURANCE CASE INVALIDATES TAX ON FOREIGN-TO-FOREIGN WITHHOLDING TRANSACTIONS

Authors
Philip R. Hirschfeld
Kenneth Lobo

Tags
Cascade Tax
F.D.A.P.
Foreign-to-Foreign Transaction
Insurance Excise Tax
Withholding

A "cascading tax" is a tax that is enforced more than once on the income from the same transaction or related transactions. A common example involves a back to back license in which:

- A non-U.S. individual or corporation ("A Co.") licenses the rights to use intellectual property ("I.P.") in the U.S. to another non-U.S. corporation ("B Co."); and
- B Co. then sub-licenses the same rights to use the I.P. to a U.S. corporation ("C Co.").

Neither A Co. nor B Co. are engaged in a U.S. trade or business. C Co. pays a royalty to B Co., and then, B Co. pays a royalty to A Co. for the use of the same I.P. The 30% U.S. withholding tax on fixed or determinable annual or periodic ("F.D.A.P.") income technically applies to both royalties even though they are paid for the use of the same I.P., which results in double taxation, *i.e.*, a cascading tax. From the U.S. point of view, the much-contested issue is whether such withholding tax should be applied and, if so, whether anyone is collecting it. In the recent case *Validus Reinsurance, Ltd. v. United States*,[1] the U.S. Court of Appeals for the District of Columbia Circuit (herein the "Federal Court of Appeals") held that a cascading "federal excise tax" should not apply to reinsurance on a foreign-to-foreign transaction on the grounds that the statute did not have an extraterritorial reach. The consequences of this determination may affect the application of 30% U.S. withholding tax on "F.D.A.P." income such as royalties involving entities that are not engaged in a U.S. trade or business.

INTRODUCTION: FOREIGN-TO-FOREIGN WITHHOLDING ON F.D.A.P. INCOME

If income generated by a foreign person is from U.S. sources but is not "effectively connected" with a U.S. trade or business, it is generally subject to a 30% withholding tax if it is F.D.A.P. income. F.D.A.P. income consists of items of income such as interest, dividends, and royalties. Treaty relief may be available to reduce F.D.A.P. withholding, and F.D.A.P. income can also be reduced or eliminated through various means specified in the Internal Revenue Code (the "Code").

The I.P. example described above is a case where both royalty payments are U.S.-source and therefore subject to 30% withholding tax. This treatment is confirmed by Rev. Rul. 80-362,[2] wherein the I.R.S. confirmed that both royalties are subject to

---

1 Ct. Cl. No.14-5081 (May 26, 2015), aff'd 19 F. Supp. 3d 225 (February 5, 2014)

2 1980-2 C.B. 208.

the 30% tax. In *SDI Netherlands*,[3] the U.S. Tax Court addressed another back-to-back license arrangement, but in this case, the parties were all related. Additionally, the license from A Co. to B Co. was for the worldwide rights to the I.P., but most of the use by B Co. was in the sublicense of the U.S. I.P. rights to C Co. The U.S. Tax Court held that Rev. Rul. 80-362 had no "significant support" and the 30% foreign-to-foreign withholding did not apply because the court refused to trace any of the worldwide royalties paid by B Co. to A Co. back to the U.S. The anti-conduit regulations issued by the I.R.S. after SDI Netherlands did not apply to the years under review in this case; those regulations did not follow *SDI Netherlands* and Rev. Rul. 80-362.[4] Code §871(m)(6) also seems to permit a foreign-to-foreign withholding in the case of dividend equivalents if the dividend equivalent is based on an underlying U.S. stock. Accordingly, the F.D.A.P. withholding regulations seem to permit withholding on certain foreign to foreign transactions, but only if the underlying income is sourced in the U.S.

" The consequences of this determination may affect the application of 30% U.S. withholding tax on 'F.D.A.P.' income such as royalties involving entities that are not engaged in a U.S. trade or business."

INSURANCE EXCISE TAX

What about non-F.D.A.P. taxes? Under the Code, there exists a 1% excise tax on reinsurance of a "casualty insurance policy" or an "indemnity bond."[5] The excise tax does not apply to the extent that the premium paid to the foreign insurer is effectively connected with the conduct of a U.S. trade or business by the insurer.[6] The earlier case *U.S. v. Northumberland Insurance Co. Ltd.*[7] held that the excise tax applied on reinsurance from an Australian insurance company to a Swiss reinsurance company because it reinsured U.S. risk – even though neither entity was engaged in a U.S. trade or business. The holding clarified that even though the "reinsured" was a foreign entity, the excise tax applied because the underlying policy was issued to a foreign person who insures a risk in the U.S – thus rendering the entity liable for the tax under the court's interpretation of the statute.

THE *VALIDUS* DECISION

In the recent *Validus* decision, the taxpayer was a Bermuda reinsurance company, Validus Reinsurance, Ltd. ("Validus"), that was not engaged in U.S. trade or business. The decision involved two different, but similar, insurance policies. First, Validus entered into a reinsurance policy with a U.S. insurance company. The reinsurance policy provided that if the U.S. insurance company had to pay a claim from a customer then Validus would pay the U.S. insurance company that same amount. In consideration for this benefit, the U.S. insurance company paid a reinsurance premium to Validus, which all parties agreed was subject to a 1% excise

---

3 *SDI Netherlands B.V. v. Commr.*, 107 T.C. 161 (1996).

4 Example 11 of Reg. §1.881-3(e) in effect restates Rev. Rul. 80-362.

5 Code §§4372(b)-(c). "Casualty insurance" is defined as any policy or other instrument by whatever name called whereby a contract of insurance is made." An "indemnity bond" is defined as any "instrument by whatever named called whereby an obligation of the nature of an indemnity, fidelity or surety bond is made."

6 Unless the premium is exempted from U.S. tax pursuant to an income tax treaty as per Code §4373(1).

7 82-2 USTC, 521 F. Supp 70 (D.N.J. 1981).

tax. Second, Validus entered into a retrocession policy with another foreign company. The retrocession policy provided that if Validus had to pay a U.S. insurance company under its reinsurance policy, then the other foreign company would pay Validus that same amount. In consideration for this benefit, Validus would pay the other insurance company a retrocession premium (*i.e.*, a cash payment). The issue was whether the 1% excise tax applies to this retrocession premium when both parties are not engaged in a U.S. trade or business.

The Federal Court of Appeals held that the excise tax would not apply to the retrocession premium even though the tax should apply under a literal reading of the Code. The court applied a non-tax law doctrine called the "doctrine of the presumption against extraterritoriality," which they said applied since this related to a payment from one foreign company to another foreign company. The appellate court refused to follow the holding of *Northumerland* and held that the extraterritoriality of a tax (*i.e.*, the application of the tax in a foreign-to-foreign transaction) can only apply if congressional intent was expressly written into the statute. In this case, the statute was written in a broad manner that did not justify extraterritoriality, and therefore the insurance excise tax did not apply.

CONCLUSIONS & UNANSWERED QUESTIONS

Based on the *Validus* decision, an argument can be made that a foreign-to-foreign tax cannot apply unless congressional intent is clear in the statute. Even though the tax in question was an insurance excise tax, the reasoning may be applicable to the F.D.A.P. withholding rules. Both *SDI Netherlands* and Code §871(m) preceded the *Validus* decision, and accordingly, neither addresses the "congressional intent" reasoning found in *Validus*. Thus, some questions remain unanswered, namely: Will a future court apply the "congressional intent" and "extraterritoriality" reasoning in its interpretation of F.D.A.P. withholding regulations? Will Code §871(m) be overturned? Time will tell.