

MARKET BULLETIN

REF: Y4503

Title	Federal Excise Tax – Indemnity Clauses in reinsurance contracts
Purpose	<i>To inform the Market that it is not appropriate for the above clauses to be included in Lloyd's reinsurance contracts.</i>
Type	
From	Tom Bolt, Director of Performance Management 0207 327 6700, tom.bolt@lloyds.com Juliet Phillips, Head of Tax 0207 327 6839, juliet.phillips@lloyds.com
Date	7 July 2011
Deadline	
Related links	

Introduction

The United States charge Federal Excise Tax ("FET") on premiums paid for policies issued by non U.S. insurers/ reinsurers to domestic insureds/ insurers/ reinsurers with respect to hazards, risks, losses or liabilities partly or wholly within the US ("US risks"). In 2008, the Internal Revenue Service ("IRS") issued Revenue Ruling 2008-15 setting forth its view that the FET should also be imposed on reinsurance and retrocessions of such policies, even where both the ceding company and the reinsurer are not resident in the US and have no nexus with the US. This is referred to as the cascading FET.

It has come to our attention that in some instances clauses are being inserted into reinsurance and insurance contracts, including contracts written by Lloyd's underwriters/syndicates, which seek an indemnity for any FET, interest and/or penalty that the US cedant and/or US broker incurs by reason of the reinsurers failure to comply with the IRS rules (and specifically those rules relating to the cascading FET). These clauses are unnecessary, and in fact are inappropriate, where Lloyd's Underwriters/syndicates are the reinsurers due to the existence of the FET Closing Agreement that Lloyd's has entered into with the IRS and US Treasury. It is possible that such clauses may also be used in

reinsurance contracts where Lloyd's Underwriters/syndicates are placing reinsurance with other non-US reinsurers and this would be equally unnecessary as a consequence of such Closing Agreement. The technical detail related to this issue is set out below.

2008 IRS Revenue Ruling and indemnity clauses

In 2008, the IRS published Revenue Ruling 2008-15 formally stating their interpretation of Section 4371(3) of the Internal Revenue Code which is that FET applies to transactions between foreign reinsurers where the underlying hazards, risks, losses or liabilities covered by the reinsurance contract are US, even where neither party to the contract has any nexus with the US. This is referred to as the "cascading" tax and applies to each subsequent retrocession as well, although in practice, and based on an IRS announcement, we understand that the IRS method of determining the cascading FET results in only a single foreign to foreign leg of the reinsurance being subject to the FET.

At the same time that the Ruling was published, an announcement was also published (2008-18) describing a Voluntary Compliance Initiative encouraging foreign reinsurers to comply with the obligations of the Revenue Ruling in order to avoid any investigation of periods prior to 1 October 2008.

It is this Revenue Ruling which is specifically referred to in indemnity clauses that Lloyd's has seen. These clauses are seeking to obtain the reinsurers agreement that they will comply with the Revenue Ruling referred to above and will indemnify the cedant for any liability or expenses that the cedant incurs as a result of any breach of Ruling 2008-15 by the reinsurer.

Lloyd's FET Closing Agreement

Like many other non US reinsurers, Lloyd's has entered into a Closing Agreement with the IRS and US Treasury that covers all contracts written by all Lloyd's Underwriters/syndicates. These Closing Agreements provide that US cedants and brokers, who would otherwise be required to withhold FET on premiums paid to a foreign insurance or reinsurance company, can treat the premiums as exempt from FET if paid to an insurer or reinsurer who has a Closing Agreement. Such Closing Agreements also require a reinsurer that enters into the Closing Agreement to pay any FET that is due on such transactions.

Therefore, US brokers or US insureds should be satisfied that premiums can be paid gross to Lloyd's Underwriters/Syndicates, without deduction of FET, by virtue of having a Closing Agreement. Lloyd's underwriters are, under the terms of the Closing Agreement, required to pay, and will pay, FET due, if any, on business written by Lloyd's Syndicates, including any tax due under IRS Revenue Ruling 2008-15 as a result of subsequent reinsurance premiums paid by Underwriters reinsuring such business with an unprotected reinsurer. Therefore, there should be no situation where either a US cedant or US broker incurs any loss or liability for FET. In the event that Lloyd's failed to comply with its Closing Agreement the IRS's remedy would lie with Lloyd's, not the US insured or the US broker.

Conclusion

Clauses seeking an indemnity from Lloyd's underwriters/ syndicates for FET, interest and penalties that a US cedant or US broker incurs by reason of Lloyd's failure to comply with IRS rules and inappropriate and unnecessary due to the existence of the Closing Agreement that Lloyd's has entered into with the IRS.

Further Contacts

If you have any queries about this market bulletin, please contact Juliet Phillips (contact details above).