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Federal Tax ADVISORY ■

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Extraterritorial Taxation

Rev. Rul. 2016-03

Not a State Tax

State tax disputes commonly involve claims that a state cannot tax beyond its geographical boundaries. That principle is at the root of *Quill Corp. v. N.D.*, 504 U.S. 298 (1992), requiring that a taxpayer have some sort of physical presence in a state to justify state taxation. The principle is rarely seen in federal tax disputes, but appeared in an important excise tax decision in 2015, which the IRS now has agreed to follow.

The Foreign Insurance Excise Tax

Rev. Rul. 2016-03 agreed to follow *Validus Reinsurance, Ltd. v. United States*, 786 F.3d 1039 (D.C. Cir. 2015). It ruled that 26 U.S.C. § 4371 cannot apply to impose an excise tax of 1 percent on the premium paid by one foreign insurance company to another for reinsurance, when the first insurance company does not do business in the United States.

Example: Y is a foreign reinsurer that pays income tax on its effectively connected reinsurance premiums received from X, a U.S. insurer. Y buys re-reinsurance from Z, a foreign reinsurer. Y must pay the 1 percent tax on the premium it pays to Z. But if Y does not pay income tax on its effectively connected reinsurance premiums received, it will not owe the 1 percent tax on the premium it pays to Z.

Congress adopted this excise tax in 1942 specifically to try to make sure that foreign reinsurers paid some U.S. tax. Reinsurance was mostly sold by foreign reinsurers (think London). The war disrupted many of the reinsurance regimes, but also made it even more important to try to tax foreign reinsurers.

The tax does not apply to a premium paid to a foreign insurer that is effectively connected income. It also does not apply when the underlying primary insurance is not on a U.S. located risk. Therefore, the tax applies to the primary insurance premium paid to a foreign insurer that is not engaged in a U.S. trade or business and to reinsurance obtained by that insurer.

The *Validus* Case

Validus was not engaged in a U.S. trade or business and only wrote reinsurance, which it reinsured abroad. So the premium at issue was paid on a foreign-to-foreign contract whose beneficiary was not engaged in a U.S. trade or business and so did not file an income tax return.

The statute could have been interpreted to apply to such premiums but for one thing: the circuit court chose to apply the so-called presumption against extraterritoriality. The court said the meaning of the statute could not be clearly established, and so the presumption had to apply.

The holding is curious in that its reasoning would allow the tax to apply to another foreign-to-foreign reinsurance, where the facts were slightly different: the reinsured company was foreign, but engaged in a U.S. trade or business.

Other Applications

While Bermuda-based reinsurers are very interested in this case, it may seem to have little impact on tax generally, but it might. For example, the Foreign Account Tax Compliance Act (FATCA) imposes tax duties on foreign persons having no other contact with the U.S. tax system. FATCA is safe from the presumption because Congress made it clear that it wanted the provisions to apply to foreign persons.

But where a tax statute simply speaks generally, the presumption might apply. One example is foreign withholding under Section 1441. More broadly, it is commonly assumed that all foreign persons accumulate U.S. tax attributes before they ever become subject to the Code by virtue of their ownership or their business. That assumption might be attacked under the presumption.

Conclusion

All taxpayers engaged in international transactions know that the IRS has become much more aggressive in asserting federal authority and tax liability. This usually follows various types of aggressiveness on the part of international taxpayers. In turn, those taxpayers may now have to turn to more aggressive defensive arguments against the IRS.

For additional information, call Jack Cummings at 919.862.2302.

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