THE ALLOCATION OF FATCA WITHHOLDING RISK IN CROSS-BORDER REINSURANCE AGREEMENTS

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IN BRIEF

Enacted in 2010 (but with phased implementation), the Foreign Account Tax Compliance Act (FATCA) is an information reporting regime that is enforced through a 30 percent gross basis withholding tax on "withholdable payments" made to foreign non-compliant entities. FATCA is part of an overall U.S. enforcement effort intended to help "close the tax gap" by identifying U.S. citizens and U.S. residents who beneficially own financial accounts at foreign financial institutions (FFIs) or interests in non-financial foreign entities (NFFEs) but do not disclose such holdings (or report the associated income) on their U.S. tax returns.

FATCA's implementation raises potentially significant issues in cross-border reinsurance transactions. Unless an exemption is established, FATCA withholding applies to U.S. source premiums paid to a foreign reinsurer regardless of whether the underlying policies have a cash value or investment component of the type subject to FATCA information reporting.[1] Although these premiums may be subject to a 1 percent U.S. federal excise tax under Internal Revenue Code section 4371 (the FET),[2] they typically are exempt from 30 percent U.S. withholding tax otherwise imposed under Internal Revenue Code section 1442 on payments to a foreign corporation.[3] Over industry objections, final Treasury regulations relating to the implementation of FATCA do not similarly exempt premium income from FATCA withholding because of FET.

This article summarizes key contractual provisions that should be considered in cross-border reinsurance agreements in light of FATCA's implementation, including the commencement of FATCA withholding on July 1, 2014.[4]

OVERVIEW OF FATCA AS APPLIED TO FOREIGN REINSURERS

The aspect of FATCA that is most problematic in a typical cross-border reinsurance transaction is the requirement that U.S. payors of withholdable payments withhold 30 percent of such amounts unless the payee establishes an exemption. Withholdable payments include interest, dividends, rents, royalties, salaries, wages, annuities, premiums and other fixed or determinable annual or periodical (FDAP) income, gains, and profits, provided such payments are considered U.S. source income. Reinsurance premiums relating to underlying U.S. risks are treated as U.S. source FDAP income and considered withholdable payments. The final FATCA Treasury regulations exclude certain "financial services" payments from the definition of withholdable payments, but premiums are not treated as financial services payments.

"SPECIFIED INSURANCE COMPANY"

An FFI is defined broadly by final Treasury regulations and includes traditional deposit taking entities such as banks, custodial entities that hold financial assets on behalf of others, and investment funds that are primarily in the business of investing, reinvesting, or trading in securities or other financial assets. Insurance companies generally are not considered investment entities because the bona fide reserves of an insurance company are not treated as financial assets for FATCA classification purposes. But an insurance company issuing or obligated to make payments with respect to cash value insurance or annuity contracts is classified as an FFI (a "Specified Insurance Company").[5] A cash value insurance contract for FATCA purposes is an insurance contract (other than an indemnity reinsurance contract between two insurance companies and a term life insurance contract) that has an aggregate cash value greater than U.S. $50,000 at any time during the calendar year.[6]

Specified Insurance Companies may avoid being subject to FATCA withholding on U.S. source premiums by complying with FATCA's account due diligence, documentation and information reporting requirements; registering with the IRS to obtain a Global Intermediary Identification Number (GIIN); and providing certifications on U.S. tax forms or other documentary evidence of FATCA compliant status. These requirements may be altered for FFIs resident in jurisdictions that have entered into an Intergovernmental Agreement (IGA) with the United States.[7]

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FOREIGN REINSURERS NOT CLASSIFIED AS SPECIFIED INSURANCE COMPANIES

Foreign reinsurers not classified as Specified Insurance Companies are treated as non-financial foreign entities (NFFEs). There are two basic categories of NFFEs—"exempt" and "passive." Exempt NFFEs include "active" NFFEs that are primarily engaged in business activity other than holding assets that produce passive income and NFFEs having publicly traded shares. NFFEs are not required to register with the IRS or comply with FATCA's account due diligence and information reporting requirements, but exempt NFFEs may be required to certify their FATCA exempt status on appropriate U.S. tax forms.

Foreign reinsurers that are not Specified Insurance Companies generally are classified as passive NFFEs because the investment assets supporting their reserves are treated as passive assets that produce passive income. (This rule differs from the approach taken under the passive foreign investment company (PFIC) rules in that the PFIC rules do not treat as passive income derived in the active conduct of an insurance business by a corporation which is predominantly engaged in an insurance business and that would be subject to tax under Subchapter L of the Internal Revenue Code if it were a domestic corporation.) To avoid FATCA withholding on payments of U.S. source premiums, passive NFFEs are required to disclose on appropriate U.S. tax forms "substantial U.S. owners" or certify that no "substantial U.S. owners" exist.[8]

FATCA'S IMPACT ON THE DOCUMENTATION OF CROSS-BORDER REINSURANCE TRANSACTIONS:

U.S. MARKET APPROACH

In the authors' experience, the evolving market position on allocation of FATCA withholding risk in reinsurance transactions is to shift the risk to the foreign reinsurer. This generally is consistent with the approach taken in financial transactions including loan, swap and derivatives transactions. For example, the Loan Syndication and Trading Association (LSTA) model credit agreement provisions exclude U.S. federal withholding taxes imposed on payments by reason of FATCA from the tax gross-up. Accordingly, the foreign lender bears the risk of any FATCA withholding on payments of interest and principal as a borrower will not be required to "gross-up" or pay additional amounts if the borrower is required to withhold under FATCA. The International Swaps and Derivatives Association (ISDA) has followed a similar approach to the LSTA, and recommends a FATCA carve-out on payments subject to the tax gross-up.[9]

FOREIGN MARKET APPROACH

The foreign market's response in allocating FATCA withholding risk in financial transactions arguably is not as settled as the U.S. market. For example, the Loan Market Association (LMA), a leading foreign trade association focused on improving liquidity, efficiency and transparency in the primary and secondary syndicated loan markets in Europe, the Middle East and Africa, has issued three riders to standard loan documentation taking various approaches to FATCA. The LMA riders allocate FATCA withholding risk entirely to the: (i) borrower, or (ii) lender either in a limited manner (allocation of the FATCA risk assuming the obligation is "grandfathered" with a right of termination if grandfathering status is lost, e.g., by reason of a "material modification") or unlimited manner (whereby the lender bears the risk of FATCA withholding, although in such cases the borrower may represent that no payments are U.S. source). The LMA issued a further statement adopting the "lender unlimited" approach in its default LMA model agreements (accordingly, payments pursuant to default LMA loan agreements can be made net of any deduction for FATCA withholding).[10]

ALLOCATION OF FATCA WITHHOLDING RISK TO FOREIGN REINSURER

Assuming that the foreign reinsurer agrees to bear the risk of FATCA withholding, the following contractual provisions should be considered in the reinsurance agreement:

- **Provision for U.S. Tax Forms.** The reinsurance agreement should require the foreign reinsurer to provide IRS Form W-8BEN-E, or other required U.S. tax forms or certifications, prior to any payment of premiums to certify its FATCA exempt status. An ongoing contractual requirement for the reinsurer to update such information is desirable (although the applicable U.S. federal tax rules require the updating of such forms if there is a change in status or if the form expires).

- **Requiring FATCA Compliance.** How and to what extent does the U.S. cedent have the right to force the FFI or NFFE reinsurer to comply with FATCA throughout the duration of the reinsurance agreement? In this respect, it may be useful to include both a representation in the reinsurance agreement whereby the reinsurer represents that it is presently FATCA compliant and a covenant that the reinsurer will continue to be FATCA compliant during the term of the reinsurance agreement. This should protect the cedent in the event it suffers losses as a result of the reinsurer's non-compliance with FATCA.

- **Right to Withhold.** The U.S. cedent should have the right to withhold FATCA tax should any payments of premium become subject to FATCA withholding by reason of the foreign reinsurer's failure to provide the U.S. cedent with the necessary documentation establishing an exemption from withholding.

- **No Right of Set-Off.** The U.S. cedent's withholding of any amounts under the reinsurance agreement should not be subject to a right of set-off. To allow set-off would essentially shift the burden of FATCA withholding to the U.S. cedent in many instances.

- **No Cancellation or Defense.** Any amounts required to be withheld pursuant to FATCA should not provide the foreign reinsurer with any right to cancel or terminate the reinsurance agreement and withholding should not be a defense to payment of losses or treated as a breach of the agreement.

THE ALLOCATION OF FATCA WITHHOLDING RISK WHERE A BROKER IS INVOLVED—THE FATCA SELF-EXECUTING SOLUTION

Prior to the release of the final FATCA regulations, the rule for withholding in arrangements that involved brokers required the U.S. cedent to look through the broker to the ultimate payee (the foreign reinsurer) to determine the foreign reinsurer's FATCA status (and obtain appropriate U.S. tax forms claiming an exemption from FATCA withholding). Under the final Treasury regulations, U.S. brokers are considered payees (unless the insured has reason to know that the broker is not complying with its FATCA withholding obligations). As a result of the final rule, U.S. brokers have FATCA withholding responsibility as the last U.S. party in the chain of payment. In the authors' experience, the current trend in the reinsurance marketplace is for U.S. brokers to place reinsurance only with FATCA compliant reinsurers.

Given the revisions in the final Treasury regulations, reinsurance arrangements involving a U.S. broker should include an intermediary clause whereby payments made to the broker are deemed to be payments made to the reinsurer. Such a provision protects the U.S. cedent from the possibility that FATCA withholdings deducted by the broker from premium payments would give rise to a termination or cancellation of the contract by reason of failure to pay the full amount of premiums due.

If the broker is foreign, the U.S. cedent may be required to obtain the FATCA exemption documentation from the reinsurer and may bear FATCA withholding risk as the last U.S. party in the chain of payment.

Brokers are not treated as intermediaries with respect to "offshore obligations" (generally, a contract maintained and executed at an office of the withholding agent outside of the United States or in a U.S. territory). Consequently, FATCA's transition rule for offshore obligations (which defers withholding through the end of 2016 for payments made in respect of offshore obligations, unless made through an intermediary) should apply. The IRS has indicated informally that any doubt as to whether insurance qualifies as an offshore obligation for this purpose will be clarified. ◂

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END NOTES

1 Contracts issued after June 30, 2014 are not covered by the "grandfathering" rules.

2 FATCA is separate from the federal excise tax under Code section 4371. If the excise tax applies under Code section 4371, FATCA may still apply and require 30 percent withholding in addition to any applicable excise tax.

3 Treas. Reg. § 1.1441-2(a)(7) (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).

4 The relevant FATCA citations to the Code and U.S. Treasury Regulations are omitted. The relevant FATCA Code sections (and corresponding Treasury regulations), unless otherwise noted, are at sections 1471 through 1474 of the Code.

5 An "insurance company" for FATCA purposes includes any entity or arrangement that is (i) regulated as an insurance business under the laws, regulations, or practices of any jurisdiction in which the company does business, (ii) the gross income of which arising from insurance, reinsurance, and annuity contracts for the immediately preceding calendar year exceeds 50 percent of total gross income for such year, or (iii) the aggregate value of the assets of such entity or arrangement associated with insurance, reinsurance, and annuity contracts at any time during the immediately preceding calendar year exceeds 50 percent of total assets at any time during such year. This definition differs from the rule applicable to U.S. life insurance companies under Code section 816(a) which provides that the term "life insurance company" means an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with accident and health insurance), or non-cancellable contracts of health and accident insurance, if (i) its life insurance reserves, plus (ii) unearned premiums, and unpaid losses (whether or not ascertained), on non-cancellable life, accident, or health policies not included in life insurance reserves, comprise more than 50 percent of its total reserves. For purposes of Code section 816(a), the term "insurance company" means any company more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.

6 Final FATCA regulations issued Feb. 20, 2014 provide that foreign insurance companies electing under Code section 953(d) to be treated as U.S. persons for U.S. tax purposes may be treated as U.S. persons for FATCA purposes if the foreign insurance company is not a Specified Insurance Company or is a Specified Insurance Company licensed to do business in any state in the United States. The consequence of being treated as a U.S. person is that the 953(d) company may avoid being withheld upon under FATCA.

7 There are four alternative possibilities with respect to the FATCA status of a foreign reinsurer that is an FFI, the: (i) foreign reinsurer is located in a Model 1 IGA country (e.g., Cayman Islands); (ii) foreign reinsurer is located in a Model 2 IGA country (e.g., Bermuda); (iii) foreign reinsurer is located in a country with no IGA, but registers and enters into an FFI Agreement with the IRS; or (iv) foreign reinsurer is located in a country with no IGA and it neither registers nor enters into an FFI Agreement with the IRS.

8 "Substantial U.S. ownership" includes any specified U.S. person owning, directly or indirectly, more than 10 percent of the (i) stock of a foreign corporation (by vote or value), (ii) profits or capital interests of a foreign partnership, or (iii) beneficial interests of a foreign trust. To address industry concerns about disclosure of U.S. owners to brokers and ceding companies, the IRS will allow a passive NFFE to directly report certain information to the IRS in lieu of providing ownership information to third party payors, provided that requirements specified in the applicable Treasury regulations are satisfied.

9 ISDA is a trade association that publishes a standard agreement for privately negotiated derivatives transactions.

10 2014 Summary Note on FATCA (released June 9, 2014).