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April 23, 1990

No. 445

BULLETIN TO ALL MEMBERS:

RE: Federal Excise Tax on Insurance Premiums - Reporting of Certain Exemptions.

For your information, we draw your attention to the enclosed memorandum dated April 19, 1990 from Leboeuf, Lamb, Leiby and MacRae and a pro forma disclosure statement titled Exhibit one.

June 12, 1990 is the deadline for complying with the reporting requirements with respect to F. E. T. for the last quarter of 1988 and all quarters in 1989. Notice that there is a $10,000 penalty for each failure to report.

We are aware that Tax counsel for major brokerages in New York have approached congress under auspices of NAIB to eliminate the insurance disclosure requirement under Section 6114. Failing that, they hope to delay its adoption beyond the present June 12, 1990 deadline. However, the political process takes time and because of the penalties involved for noncompliance, members are well advised not to rely on the success of NAIB's negotiations.

We strongly advise you to consult your tax advisors immediately to determine your responsibilities concerning the reporting of these exemptions.

Should you have any questions, please contact the following:

John W. Weber
Cynthia R. Shoss
Leboeuf, Lamb, Leiby and MacRae
520 Madison Avenue
New York, NY 10022
(212) 715-8000

Very truly yours,

A. D. Freeman, Jr.
Manager

ADF:mfq

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SAN FRANCISCO, CA 94111

April 24, 1990

**MEMORANDUM**

**TO:** Surplus Line Association of California

**FROM:** LeBoeuf, Lamb, Leiby & MacRae

**SUBJECT:** Federal Excise Tax on Insurance Premiums - Reporting of Certain Exemptions

The Internal Revenue Service issued new final regulations on March 13, 1990 which require disclosure of certain information relating to, among other things, premiums remitted to certain alien insurers and reinsurers which claim exemption from the Federal Excise Tax (FET) on policies issued by alien insurers and reinsurers.

Where the regulations require disclosure, California surplus line brokers are responsible for filing disclosure statements (in the form attached hereto as Exhibit One). The surplus line broker will be liable for a $10,000 penalty for each failure to report.

June 12, 1990 is the deadline for complying with the reporting requirements with respect to F.E.T. for the last quarter of 1988 and all quarters in 1989. Reporting for calendar year 1990 F.E.T. and thereafter will be due on the due date of, and must be attached to, the Form 720 for the last quarter of such years.

How to determine whether you need to file:

The filing requirement applies with respect to a limited class of insurers and reinsurers, generally those which are domiciled in the U.K. (but not Lloyd's), Hungary, Romania, or the U.S.S.R, which claim exemptions from the F.E.T. but have not entered into closing agreements with the I.R.S. establishing their entitlement to the F.E.T. exemptions. The following "rules of thumb" should help you determine whether you need to file with respect to a particular insurer or reinsurer:

- If the insurer pays a U.S. income tax on the premiums remitted by the surplus line broker, the surplus line

broker does not need to file with respect to those premiums.

- If the surplus line broker pays an F.E.T. on the premiums remitted to the insurer, the surplus line broker does not need to file with respect to those premiums.

- If the surplus line broker pays no F.E.T. but the alien insurer or reinsurer has a "closing agreement" with the I.R.S. which establishes its entitlement to the F.E.T. exemption, the surplus line broker does not need to file with respect to that insurer. (If the insurer or reinsurer has such a closing agreement, they would have informed the surplus line broker or the surplus line broker's tax department that such closing agreement is the basis for paying no F.E.T.)

- The surplus line broker must file if no income tax or F.E.T. is paid and the insurer has no closing agreement with the I.R.S.[1] For the surplus line broker's protection, we recommend obtaining a copy of the closing agreement or a certification from the insurer that the insurer has entered into a closing agreement which is currently in effect.

If filing is required, what information must be reported:

By completing the attached sample disclosure statement with the specific data called for therein, the disclosure statement should substantially comply with the I.R.S. regulations as to format and will provide the relevant treaty provisions and footnotes.

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[1] The existence of these "closing agreements" with the I.R.S. are a prerequisite to obtaining an F.E.T. exemption for insurers domiciled in any country with a treaty which provides "qualifed" F.E.T. exemption, i.e., France, Italy, Cyprus, Bermuda and Barbados. At the present time, there are a number of pending treaties which would provide qualified F.E.T. exemptions with additional countries. If an F.E.T. exemption is claimed for an insurer from a "qualified treaty" country and the insurer does not have a closing agreement, you should consult your tax advisor immediately to determine whether your position is appropriate.

To obtain a copy of the regulations or a summary of their provisions, or if you have any questions concerning your responsibility under these regulations, please contact John W. Weber or Cynthia R. Shoss, tax partners in the New York office of LeBoeuf, Lamb, Leiby & MacRae (212) 715-8000.

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**TREATY-BASED RETURN POSITION DISCLOSURE**
**UNDER CODE SECTION 6114**

1. NAME: [Insert name of surplus line broker]
ADDRESS: Street Address
City, State Zip Code
Employer Identification Number: [Insert Number]

2. Not applicable.[1]

3. [Insert name of surplus line broker] is a corporation incorporated in the United States under the laws of the State of [Insert state of incorporation].

4. [Insert name of surplus line broker] is a surplus line insurance broker. [Insert name of surplus line broker] acts as an intermediary between United States insureds and alien insurers. As a surplus line broker, [insert name of surplus line broker] places insurance business with insurers in many different countries, some of which are entitled to treat their insurance policies as exempt from the excise tax imposed by Code Section 4371 (the "FET") pursuant to various treaties with the United States.

In the calendar year ended December 31, 19--, [insert name of surplus line broker] remitted $Y of insurance premiums to alien insurers which were exempt from the FET and are required to be disclosed pursuant to Code Section 6114 and the Treasury Regulations promulgated thereunder.[2]

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[1] Pursuant to Treas. Reg. §301.6114-1(d), disclosure of the name, address and taxpayer identification number of the payors of treaty income must be reported if such income is "fixed, determinable, annual or periodic" ("FDAP" income). Insurance premiums are not FDAP income. See Rev. Rul. 80-222, 1980-2 C.B. 211 as modified by Rev. Rul. 89-91, 1989-31 I.R.B. 5. Further, income from sales or services by an alien enterprise within the U.S., either directly or through an agent (dependent or independent) are permitted to be treated as a single item or payment of income. Treas. Reg. §301.6114-1(d). Based on the above, no disclosure of the names, addresses and taxpayer identification numbers of the insureds need be made.

[2] Pursuant to Treas. Reg. §301.6114-1(c)(7)(iii), a taxpayer need not report its position that a treaty exempts insurance premiums from the FET if the alien insurance company that is the beneficial recipient of the premium has entered into a closing agreement with the Internal Revenue Service (the "Service") with respect to its entitlement to the exemption from the FET. Accordingly, [insert name of surplus line broker] has disclosed herein only those premiums remitted to

(continued...)

$A of these premiums were placed with insurers resident in the United Kingdom (See Exhibit A). Articles 2(2)(a) and 7(1) of the U.S./U.K. tax treaty operate to override Section 4371 of the Code by exempting from the U.S. income and excise taxation income which is not attributable to a U.S. permanent establishment. There are no limitations on benefits provisions applicable to the treaty provisions relevant here.

$B of these premiums were placed with insurers resident in Hungary (See Exhibit B). Articles 2(2)(a) and 7(1) of the U.S./Hungary tax treaty operate to override Section 4371 of the Code by exempting from U.S. income and excise taxation income which is not attributable to a U.S. permanent establishment. There are no limitations on benefits provisions applicable to the treaty provisions relevant here.

$C of these premiums were placed with insurers resident in Romania (See Exhibit C). Articles 1(3) and 7(5) of the U.S./Romania tax treaty operate to override Section 4371 of the Code by exempting from U.S. income and excise taxation insurance and reinsurance premiums which are not attributable to a U.S. permanent establishment. There are no limitations on benefits provisions applicable to the treaty provisions relevant here.

$D of these premiums were placed with insurers resident in the Union of Soviet Socialist Republics ("USSR") (See Exhibit D). Articles I(b), IV and IX of the U.S./USSR tax treaty operate to override Section 4371 of the Code by exempting from U.S. income and excise taxation income which is not attributable to a representation (i.e., the equivalent of a permanent establishment) in the U.S. There are no limitations on benefits provisions applicable to the treaty provisions relevant here.

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[2](...continued)
insurers entitled to treat their insurance policies as exempt from the FET and which have not entered into closing agreements with the Service with respect to their entitlement to such exemption.

**EXHIBIT A**

| Name of U.K. Insurer | Address | Employer Identification Number (if available) | Gross Taxable Premiums Remitted |
|---|---|---|---|
| | | | |
| Total | | | $ A |

# New Reporting Requirement For Tax Treaties

By TED O. HALL
Ernst & Young, San Francisco

On March 14, final regulations were published in the Federal Register relating to the information reporting requirements of taxpayers who take a position that a tax treaty overrules or modifies a provision of the Internal Revenue Code. These regulations may have a serious impact on direct writers, reinsurers, brokers and agents paying direct or reinsurance premiums to foreign insurers and reinsurers where those premiums are exempt by treaty from the U.S excise tax. Action is required on or before June 12, 1990 for returns filed after Dec. 31, 1988 and before March 10, 1990 which did not contain the required disclosures. Significant penalties may be imposed for failure to comply with these regulations.

### General Overview

Generally, premium payments made to foreign insurers or reinsurers are subject to a federal excise tax under Code Section 4371 which is collected and paid by the U.S. taxpayer making the premium payment. A number of foreign insurers and reinsurers are or have been exempt from this tax because of a tax treaty between their country of residence and the United States.

Under Code Section 6114 a taxpayer must disclose in a tax return that a position was taken based on reliance upon a tax treaty which overrules or modifies U.S. tax law, regardless of whether the law in question was enacted before or after the ratification of the treaty. Thus, even though a taxpayer would not otherwise be required to file a tax return due to a treaty-based position, a return must be filed simply to satisfy the disclosure requirement. Code Section 6712 provides for a $10,000 penalty for taxpayers failing to comply with the disclosure requirements of Section 6114. Multiple $10,000 penalties may apply for separate failures to disclose under Section 6114.

### Excise Taxes

A little known result of Section 6114 was its applicability to the excise tax exemption of a number of U.S. tax treaties. The final regulations clearly state that the exemption from the excise tax is a treaty-based return position requiring disclosure. Under the regulations, the nature and amount (or reasonable estimate) of each separate payment for which treaty benefit is claimed is required to be reported. Premium payments of the same type (for instance where the payor and payee are the same) may be aggregated in the disclosure statement.

It must be noted, however, that for purposes of assessing the penalty for failure to disclose, separate payments of the same type made to the same payee will be treated as separate events and not aggregated.

For example, a U.S. company making monthly payments to a foreign reinsurer which is exempt from the excise tax may be subject to a $120,000 penalty per year ($10,000 × 12 payments) if these premiums are not reported as exempt from the excise tax. If there are 10 such reinsurers to which monthly premiums are paid, the potential penalty escalates to $1.2 million. There is joint and several liability for this penalty by any party to the reinsurance contract, including the U.S. payor, the foreign payee, and any agents or brokers.

However, the reporting requirement is waived when a person who is liable for the tax properly reports the information. Therefore, the penalty is mitigated for all parties when one party makes the required disclosure. Disclosure is made on the Federal excise tax return Form 720 when the U.S. payor makes the required disclosures.

### Waiver of Reporting Requirements

The final regulations waive the basic disclosure requirements where certain conditions are met.

1. Reporting under Section 6114 is not required on quarterly excise tax returns where the taxpayer makes the required disclosure in the excise tax return Form 720 for the last quarter of the taxpayer's taxable year. Under this provision, the taxpayer effectively aggregates the required premium payment information for each foreign insurer or reinsurer for the year.

2. The disclosure requirement will be waived if a person, other than the taxpayer making the payment who is also liable for the excise tax on the same premium, properly provides disclosure information. Thus, if a foreign payee receiving the premium payment (which could be a foreign insurer or reinsurer or a non-resident agent, solicitor, or broker) or an agent or broker of the U.S. payor makes a proper disclosure to the Internal Revenue Service, the U.S. payor is not required to also disclose.

3. The disclosure requirement will be waived if a Closing Agreement relating to entitlement of the exemption from the excise tax has been made with the Internal Revenue Service by the foreign insurance company that is the beneficial recipient of the premium that is subject to the excise tax. Such Closing Agreements are currently required where certain foreign insurers or reinsurers wish to have their policies exempt from the Federal excise tax under a treaty.

However, this requirement for a Closing Agreement is restricted to situations where the exemption is "qualified"; i.e., it is only allowed to the extent that the business is not

*Ted O. Hall is a tax partner in the San Francisco office of Ernst & Young and a member of the firm's insurance tax specialization committee. He has extensive experience in the taxation of domestic property/casualty and life insurance companies, insurance captives, and insurance agencies and administrators. He has lectured around the country on the taxation of life insurance companies and their products and co-authored a book on the same subject. He has lectured for the Hartford Institute on Insurance Taxation. He has also lectured in Bermuda and Barbados regarding the impact of the 1986 amendments to the Internal Revenue Code and Risk Retention Act on offshore captives. He is a participant in the Annual Insurance Accounting and Systems Association and Risk and Insurance Management Society National Conventions.*

*He has a doctor of jurisprudence degree from Golden Gate University School of Law and a master of business administration and bachelor of science degree from San Jose State University. He is a Certified Public Accountant and a member of the California Society of Certified Public Accountants and the American Institute of Certified Public Accountants.*

reinsured with a non-exempt country. For example, if a premium is paid to a reinsurer which is resident in France (which is exempt from the excise tax), the premium will not be exempt if it is subsequently retroceded to an insurer or reinsurer which is not exempt from the excise tax. A U.S. payor who has knowledge of a Closing Agreement between the French insurer or reinsurer and the Internal Revenue Service will not be liable for excise taxes resulting from such retrocession.

An insurer or reinsurer, however, which is an unqualified exemption from the tax does not need to enter into a Closing Agreement with the Service. Thus, it appears that this waiver may not apply to the premiums paid to the United Kingdom, which has an unqualified exemption from the excise tax.

### Effective Date of Regulations

Under the final regulations, both the reporting and penalty regulations are effective for taxable years of the taxpayer for which the due date for filing returns (without extension) occurs after Dec. 31, 1988. Since the liability for the Section 4371 excise tax is imposed on all parties to the contract, a fundamental issue arises as to the proper tax year used to determine the filing deadline of the Section 6114 statements. The final regulations do not address this problem directly; however, there is an assumption that the U.S. person who files the Form 720 will also file the Section 6114 statement.

Special catch up disclosure is required by June 12, 1990 for returns with due dates (without extension) that fall between Jan. 1, 1989 and March 10, 1990. Assuming that the U.S. payor is the taxpayer required to report, the fourth quarter 1988 excise tax return (due on Jan. 31, 1989) would be subject to this catch-up disclosure requirement. Note that only the last quarter of 1988 is subject to this new reporting requirement and, therefore, annual information for 1988 need not be filed. Again assuming that the U.S. payor is the taxpayer required to report the four quarters of 1989 would likewise be subject to this filing deadline.

Note that the excise tax returns (Form 720) are due quarterly based on a calendar year regardless of the U.S. payor's taxable year. That information may be aggregated on an annual basis and reported on the fourth quarter return.

If a return has been previously filed, a catch-up disclosure is accomplished by filing the Section 6114 statement only, and not by amending returns. The statement should be signed, under penalties of perjury, by an officer of the corporation and sent to the Internal Revenue Service, P.O. Box 2108, Philadelphia, PA 19114. If a return has not been previously filed, then the Section 6114 statement must be attached to a Form 720.

### Conclusion

In respect to the disclosure requirements for premiums exempt from excise taxes under Section 6114, the effort required by U.S. insurers could be significant. Certain information may be required from foreign insurers or reinsurers or non-resident agents or brokers (e.g., a copy of a Closing Agreement with the IRS). Capturing the necessary information from premium reporting systems could be difficult. As a result, these reporting requirements need the careful and immediate attention of management.

Ernst & Young has followed the development of these regulations and has been instrumental in voicing the concerns of the insurance industry to the writers of the regulations. We would be pleased to respond to any questions, assist in the preparation of required disclosures, or discuss other concerns you may have regarding the disclosure requirements.

## National Group Reports Revenue, Earnings

SAN BRUNO, Calif. — National Insurance Group, a leading provider of computer delivered forced order insurance and flood hazard area identification, has announced that revenues for the fourth quarter ended Dec. 31, 1989, were $4,283,000, a decrease of 6.6 per cent from revenues of $4,584,000 for the same quarter of the previous year.

Net income for the quarter decreased 55.8 per cent to 467,000 or 11 cents per share from $1,058,000 or 25 cents per share for the same quarter of 1988. The weighted average shares for the fourth quarter decreased to 4,269,611, compared with 4,273,824 for the previous year.

Revenues for the year ended Dec. 31, 1989, were $16,574,000, a decrease of 3.8 per cent from revenues of $17,234,000 for the year ended Dec. 31, 1988. The company reported net income decreased 27.4 per cent for the year to $2,780,000 compared with $3,830,000 for 1988. Net income per share was 65 cents, compared with 90 cents per share for the previous year. The weighted average shares for the year was 4,272,764 compared with 4,269,293 for the previous year.

In the fourth quarter, revenues from the company's computerized flood hazard area identification system increased to $91,000 from $40,000 in the third quarter.

The company's board of directors also declared its quarterly dividend of 5 cents per share of common stock outstanding which was payable to the holders of record on Feb. 19. Such dividend was paid on March 2.

During the quarter the company's wholly owned subsidiary, Great Pacific Insurance Co., was admitted to conduct business by the State of North Dakota.



### RICHTER-ROBB EXPANDS CONTRACTOR PROGRAM

William Cuellar, of Richter-Robb/San Francisco, has announced that its material handling contractors program, crane, riggers and millwright, now in its eighth successful year, has been expanded to include scaffolding contractors as well as other construction equipment rental contractors.

The program provides comprehensive general liability (1973) occurrence form including care, custody and control and completed