

Advantages of Puerto Rico Issued International Private Placement Life Insurance and Private Placement Variable Annuities

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Act No. 399 of September 22, 2004, as amended, known as the Puerto Rico International Insurers and Reinsurers Act, and as now complemented by the relevant tax incentive provisions of Act No. 60 of July 1, 2019, known as the Puerto Rico Incentives Code, has established the main legal framework for the development of Puerto Rico as an International Insurance Center, oriented towards the export of insurance and reinsurance services to international markets.

The International Insurers and Reinsurers Division of the Office of the Commissioner of Insurance (“OCI”) was created with the specific focus and goal of developing Puerto Rico into an important member of the international insurance arena. The Government of Puerto Rico expressly adopted this new initiative and incorporated it as part of its economic agenda for the 21st Century. The International Insurers and Reinsurers Division is under the supervision of the OCI. The Department of Economic Development and Commerce (“DDEC”) oversees the promotion of this facility and the extension of applicable tax decrees that are an important part of the international insurance initiative.

Puerto Rico International Insurers are subject to a preferred income tax rate of 4%, applicable to their net income, with exclusion of the first \$1.2 million of such net income (which is fully tax exempt). For property and casualty International Insurers, their segregated asset plans are subject to a similar regime of 4% tax applicable to net income in excess of \$1.2 million, yet the segregated asset plans of Puerto Rico “Class 5” International Insurers—which are the issuers of international private placement life insurance (“PPLI”) and international private placement annuity products (“PPVA”)—are specifically excluded from any income taxation in Puerto Rico. Exemptions are also provided in the law with respect to premium taxes, withholding taxes, and taxes on dividend distributions; insurers licensed prior to the full effectiveness of Act No 60 of 2019 are also fully exempt from municipal license taxes and property taxes, while insurers licensed subsequently are partially exempt in those respects. The result is exceptional cost savings for a Puerto Rico international insurance company as compared to the regular situation for a US or Latin American or European domestic insurer.

Puerto Rico-issued PPLI and PPVA policies are expressly exempt from any Puerto Rico gift or estate taxation, and additionally are not US situated and thus not subject to any US gift or estate taxation if owned by an international client, even if the underlying separate account assets include US investment securities or real property.

A private placement variable annuity or variable life insurance policy issued by a Puerto Rico international insurer can provide significant advantages:

A. Low-cost. Puerto Rico’s International Insurers can usually provide a wealthy and sophisticated investor access to reasonably priced variable annuities and life insurance policies. These companies are not subject to the significant overheads typically associated with U.S. domestic life insurers, such as a large distribution system, sales commissions, and relatively complex layers of government regulation. This is in addition to the exceptional tax efficiency that we have already described as applicable to a Puerto Rico International Insurer, including the flat income tax rate of 4%, the exemption for the first \$1.2 million of the insurer’s net income, and the full income tax exemption applicable to segregated asset plans of Class 5 International Insurers. This combination of factors can result in a great operational cost and pricing advantage when compared to a similar insurance company licensed in any of the 50 US States.

B. Investment Flexibility. Provided that the investments meet with certain diversification requirements and the Policyowner does not exercise prohibited “investor control” over the selection of the securities comprising the Separate Account (applicable to US taxpayers), there is generally no limitation on the type of investments that can be held in the Separate Account. Under customary practices, as part of the policy application process the investment manager(s) of the Separate Account are selected, and the investment arrangements and fees

are finalized. Accordingly, a Policyowner can take advantage of the investment expertise of a specialized investment manager or insurance dedicated investment fund, instead of having to settle for the limited and expensive investment options commonly offered by traditional domestic insurance companies.

C. Separate Account Protection. Separate account legislation in the jurisdiction where the insurance company is domiciled should provide that the policy assets in the separate account formed by the insurance company to fund the annuity or insurance policy are not subject to the claims of creditors or of other Policyowners of the insurance company and are available only to satisfy the company's obligation to the Policyowner.

This protection from unrelated creditors' claims is granted by Puerto Rico law and activated by the Commissioner's approval of the Segregated Assets Plan. Article 61.160 of the Insurance Code provides that "[w]ith prior approval from the Commissioner, an International Insurer may establish and operate one or more segregated assets plans." P.R. Laws Ann. tit. 26, §4316(1). It further provides that:

The assets of a Segregated Assets Plan approved by the Commissioner shall be available solely for the payment of obligations specifically identified in the corresponding Operational Plan and shall not be available for the payment of the obligations of other segregated assets plans or of the general obligations of the International Insurer. Art. 61.160(4) of the Code, P.R. Laws Ann. tit. 26, §4316(4).

This protection holds even if the international insurer becomes insolvent:

In the case of the liquidation or rehabilitation of an International Insurer under the provisions set forth in Chapter 40 of this Code, the Segregated Assets Plan shall not be available for the payment of the general obligations of the insurer [...]. Art. 61.160(6) of the Code, P.R. Laws Ann. tit. 26, §4316(6).

In addition, Rule No. 81 of the OCI, Art. 7, §2, establishes that recourse with respect to an obligation arising from or related to a Segregated Account is limited to that Segregated Account's assets, and does not extend to the assets of any other Segregated Account or the International Insurer's general account. Similarly, recourse with respect to an obligation arising from or related solely to the company's general account is limited to the assets of the general account. See Rule No. 81, Art. 7, §3. Rule No. 81, Art. 4, §1, §2.

In sum, the Commissioner's approval of the Segregated Assets Plan not only allows a Puerto Rico International Insurer to establish and operate a separate account for each variable life insurance and/or annuity contract that the Puerto Rico International Insurer

issues or assumes, but it also grants the assets and income in each such separate account legal protection against claims arising from or related to obligations to creditors other than the creditors of the separate account itself.

D. Policy Owner and Beneficiary Asset Protection. For private placement life insurance and annuity policies issued by a Puerto Rico International Insurer, Puerto Rico law expressly limits the rights of creditors of the policy owner or policy beneficiary as against the policy, as follows:

“Article 61.241. – Benefits Exempt from Seizure

- (1) Except as provided under paragraph (3), any benefits (including the cash value or proceeds) to be provided to the owner, insured or beneficiary under a life insurance or annuity contract issued by an International Insurer shall:
 - (a) Inure exclusively to the benefit of the person for whose use and benefit the insurance or annuity contract is designated in the contract; and
 - (b) Be fully exempt from and not subject to:
 - (i) Attachment, execution, or other seizure;
 - (ii) appropriation or application by any legal or equitable process or by operation of law to pay a debt or other liability of the owner, insured or beneficiary, either before or after the benefits are provided; and
 - (iii) a demand in a bankruptcy proceeding of the owner, insured or beneficiary.
 - (2) The exemptions provided under paragraph (1) shall apply regardless of whether:
 - (a) The power to change the beneficiary is reserved to the owner or insured; or beneficiary.
 - (b) The owner or insured or his/her estate is a contingent beneficiary.
 - (3) The exemptions provided under paragraph (1) do not apply to:
 - (a) a premium payment made in fraud of a creditor, subject to the applicable statute of limitations for recovering the payment;
 - (b) a debt of the owner, insured or beneficiary secured by a pledge of the insurance policy or the proceeds of the policy; or
 - (c) a child support lien or levy established pursuant to applicable law, or
 - (d) a debt of the person for whose use and benefit the insurance or annuity has been designated under the contract, if such debt has been incurred by the person after the date on which the benefit under the contract was made available for his/her use.
 - (4) This article does not prevent an insured, owner, or annuitant from assigning, in accordance with the terms of the life insurance or annuity contract:
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- (a) Any benefits to be provided under an insurance policy or annuity contract, or
 - (b) any other rights under the policy or contract.
- (5) If a life insurance or annuity contract issued by an International Insurer prohibits a beneficiary from assigning or commuting benefits to be provided or other rights under the contract, any assignment or commutation or attempted assignment or commutation of the benefits or rights by the beneficiary is void.

This broad statutory asset protection is especially attractive given Puerto Rico's status as a United States jurisdiction, with full participation in the US federal legal system, the same as in any of the 50 US States.

E. Special Income Tax Recognition of Puerto Rico Issued PPLI and PPVA. Variable life insurance and annuity policies are required to meet specific diversification requirements under U.S. tax law provisions. Section 817(h) of the Internal Revenue Code provides that the investments of each separate account underlying a variable annuity policy or variable life insurance contract must be "adequately diversified" in accordance with Treasury regulations for the Policy to qualify for income taxation as an annuity or life insurance policy.

The Treasury Department has issued regulations prescribing the diversification requirements in connection with variable policies. See Treas. Reg. 1.817-5. The regulations generally require that at the end of the first policy year and thereafter on the last day of each quarter of a calendar year no more than 55% of the value of a Separate Account's assets be represented by any one investment, no more than 70% be represented by any two investments, no more than 80% by any three investments, and no more than 90% by any four investments.

Critical to the Code §817(h) approach is the concept of insurance dedicated funds, which allow for collective investment management of segregated account variable insurance policies that pass the diversification testing, because the segregated account is allowed to "look through" the insurance dedicated fund to diversified underlying investments of the fund.

It is here that Puerto Rico yet again presents a significant advantage for PPLI policies with a US connection, as the Treasury Regulations specifically allow a Puerto Rico insurer to invest in an insurance dedicated fund in the same manner as insurers domiciled in the 50 States. The regulations expressly provide that for purposes of 1.817-5(f)(3)(vi), which is the requirement that the account be segregated pursuant to State law or regulation, Puerto Rico receives the same treatment as the 50 States. No other international jurisdiction has been granted this unique and important treatment for variable insurance policies.

F. United States FBAR Reporting. Under the “FBAR” rules (F90-22.1), Report of Foreign Bank and Financial Account, each U.S. person having a financial interest in, or signatory authority over, any foreign financial accounts with an aggregate value exceeding \$10,000.00 at any time must file the FBAR by June 30th of the following year. Financial accounts include insurance policies with a cash value and annuity policies with a cash value. However, Puerto Rico is defined as being in the United States for the FBAR rules, such that there is no FBAR filing obligation for a Puerto Rico bank account or securities account or cash value insurance policy.

G. United States FATCA Reporting. The Foreign Account Tax Compliance Act (FATCA) is a 2010 United States federal law to enforce the requirement for United States persons including those living outside the U.S. to file yearly reports on their non-U.S. financial accounts. It requires all non-U.S. (foreign) financial institutions (FFIs) to search their records for indicia indicating U.S. person-status and to report the assets and identities of such persons to the U.S. Department of the Treasury. Since Puerto Rico is a U.S. Territory, the FACTA rules and requirements by express statute language do not treat Puerto Rico banks or Puerto Rico insurance companies that issue cash value insurance contracts or annuity contracts as an FFI that must endure the expense and complications of FATCA reporting by a foreign financial institution.

H. International CRS Reporting. The Common Reporting Standard (CRS), developed in response to the G20 request and approved by the OECD Council on July 15, 2014, calls on jurisdictions to obtain information from their financial institutions and automatically exchange that information with other jurisdictions on an annual basis. It sets out the financial account information to be exchanged, the financial institutions required to report, the different types of accounts and taxpayers covered, as well as common due diligence procedures to be followed by financial institutions. The scope and breadth of CRS is significant. For purposes of Puerto Rico, however, it is a non-event, as the United States has not elected to participate in the CRS, and Puerto Rico as a US jurisdiction accordingly is not part of the CRS or any CRS reporting. This again provides significant cost and operation efficiencies and savings for a Puerto Rico International Insurer. ■

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