PUERTO RICO INTERNATIONAL INSURERS REVIEW

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THE CASE FOR EXEMPTING PUERTO RICO FROM THE FEDERAL EXCISE TAX ON INSURANCE. The "FET"

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Puerto Rico, a U.S. jurisdiction whose insurance regulator—the Office of the Commissioner of Insurance—is NAIC-accredited, enacted an "International Insurance Center" legislation in mid-2004 to attract insurers and reinsurers serving world-wide markets, as an alternative to foreign domiciles such as Bermuda or the Caymans. The legislation, which offers a combination of tax incentives with a flexible regulatory framework that follows the pattern of those alternative domiciles, has started to achieve significant success throughout this decade, and especially in the last few years.

Thirty-three "international insurers and reinsurers" are presently licensed, operating 520 "segregated asset plans" (Puerto Rico's version of the "protected cell" concept); written premiums exceeded $1 billion in 2017, and the total assets of those entities exceeded $3.7 billion by the end of that year.

Nevertheless, the overall potential of the International Insurance Center as a platform for revitalizing Puerto Rico's financial sector is affected by the fact that the island's insurers and reinsurers are subject to a special tax—known as the "Federal Excise Tax," or "FET"—generally applicable under Section 4371 of the U.S. Internal Revenue Code ("I.R.C.") to U.S. insurance or reinsurance risks underwritten by foreign insurers. Puerto Rico insurers, in other words, are treated as "foreign insurers" for such purposes; a situation that largely parallels the general treatment of Puerto Rico-domiciled corporations as "foreign corporations" under the I.R.C., but that in the specific context of the FET results in a highly unfair and costly disadvantage for Puerto Rico's economic development objectives, given the fact that many foreign nations have entered into tax treaties with the United States that exempt their insurers and reinsurers from the tax.

Discussions have been under way in Washington regarding the need to remedy the above situation, and last year—for the first time ever—a bill with bipartisan support was filed in the U.S. House of Representatives with the specific objective of eliminating the applicability of the FET to insurers and reinsurers organized in any territory or possession of the United States.

The bill, H.R. 5651, was filed on April 27, 2018 by Congresswoman Jenniffer González (Puerto Rico's Resident Commissioner in the U.S. Congress), Congressman Darren Soto of Florida, Congressman Peter King of New York, and Congressman Robert Brady of Pennsylvania. Although the bill did not get to be approved last year, the proposal to remove Puerto Rico from the applicability of the FET was officially placed on the discussion table, at long last. If such a proposal is finally approved as part of some future legislation, Puerto Rico insurers and reinsurers will essentially be treated similarly to those domiciled in any State of the United States, or in any of the several sovereign nations that have executed tax treaties with the United States that result in exemption from the FET.

PRESENT LAW: THE FET

Under Section 4371 of the I.R.C., an excise tax (i.e., the FET) is generally imposed on insurance, indemnity bond, annuity, or reinsurance contracts issued by foreign insurers or reinsurers to, for, or in the name of a U.S. person with respect to risks wholly or partly within the United States, or issued to a foreign person engaged in a trade or business within the United States with respect to risks within the United States.

The excise tax, which is applied on the gross premiums paid to the foreign insurer, is levied at a rate of 4% in the case of casualty insurance policies or indemnity bonds; 1% in the case of life, sickness, or accident

insurance policies and annuity contracts (with respect to the life or hazards of U.S. persons), and 1% in the case of reinsurance.

Under Section 4372 of the I.R.C., the term "foreign insurer or reinsurer" means an insurer or reinsurer who is a non-resident alien individual, a foreign partnership, or a foreign corporation (but does not include a foreign government or a municipal or other corporation exercising taxing power). Since Puerto Rico corporations are generally deemed as "foreign" corporations under the I.R.C., the FET has been interpreted to apply to insurance or reinsurance premiums paid on U.S. risks underwritten by Puerto Rico-domiciled insurers or reinsurers.

Specifically, the U.S. Internal Revenue Service ("I.R.S.") reached such conclusion in Rev. Rul. 59-148, 1959-CB 446, and in Rev. Rul. 79-193, 1979-1 CB 359; more recently, the I.R.S. reaffirmed its interpretation in a response letter of March 27, 2015 sent to the Hon. Alejandro J. García Padilla, who was at the time the Governor of Puerto Rico, and who had requested from the I.R.S. the reconsideration of such conclusion.

The Governor's reconsideration request had been primarily based on the fact that Treasury Regulation Sec. 46.4371-2(b)(1) provides that the FET is inapplicable to insurance or reinsurance underwritten by a foreign insurer if "the policy or other instrument is signed or countersigned by an officer or agent of the Insurer in a State, Territory, or the District of Columbia in which such insurer is authorized to do business."

Insofar as Puerto Rico is a U.S. "Territory" from the standpoint of the U.S. Constitution, and is even expressly defined as such in multiple statutes and regulations (including tax statutes and regulations) of the United States, reconsideration of such I.R.S. rulings seemed warranted on the basis of the above-cited regulatory text, aside from the no less important policy considerations that should justify exempting Puerto Rico insurers and reinsurers from the FET.

Yet the I.R.S., in its letter to then Governor García Padilla, reaffirmed its previous position by interpreting that the word "Territory," as used in Treasury Regulation Sec. 46.4371-2(b)(1), had been intended to refer to the territories of Alaska and Hawaii, which had been "incorporated" into the United States for income tax purposes when said regulation was enacted, and not to "unincorporated" territories or possessions such as Puerto Rico.

Unless the I.R.S. were to be willing to change such interpretation, and to thus reconsider its prior revenue rulings, its official position continues to be that the FET applies to premiums paid to a Puerto Rico insurer for underwriting U.S. insurance or reinsurance risks. Under such circumstances, a statutory amendment becomes the necessary alternative for remedying the unfair position in which Puerto Rico is placed.

REASONS FOR THE PROPOSED STATUTORY AMENDMENT

Not less than 25 income tax treaties entered into by the United States have exempted premiums paid to insurers and reinsurers of the treaty country from application of the FET. This includes treaties with countries such as Cyprus, Finland, France, Germany, Hungary, India, Ireland, Israel, Italy, Mexico, the Netherlands, Spain, Sweden, Switzerland, Romania, and the United Kingdom. The exemption does not apply to the extent that, depending on the treaty, the premiums are reinsured with a person not entitled to the benefits of a similar tax treaty of the United States (i.e., a treaty that provides exemption from the FET).

Consequently, notwithstanding the fact that Puerto Rico is a U.S. jurisdiction, Puerto Rico-domiciled insurers and reinsurers are placed at a disadvantage for underwriting U.S. risks not only when compared to insurers or reinsurers domiciled in States of the United States—which are excluded ab initio from the reach of the FET statute—but also when compared with insurers or reinsurers domiciled in sovereign nations that, unlike Puerto Rico, can enter into tax treaties with the United States.

Significantly, Puerto Rico does not levy a premium tax on the reinsurance of Puerto Rico risks by U.S.-domiciled reinsurers; yet no reciprocal exemption exists from the U.S. taxing side. This is highly important, because due to regulatory and market considerations it is precisely in the realm of reinsurance that a jurisdiction like Puerto Rico has greater potential as an operational venue for companies that have traditionally opted instead for long established non-U.S. domiciles such as Bermuda or the Cayman Islands. In this latter respect, insofar as Puerto Rico financial institutions are federally regulated, exempting Puerto Rico from the FET could become a way to maintain within the U.S. financial system substantial premium amounts that at present flow away from it.

No less importantly, such an exemption could become an invaluable tool for revitalizing the island's financial and professional services platform. Thanks to the flexible but prudent regulatory provisions and the attractive tax incentives provided under the International Insurance Center legislation, which include a flat local income tax rate of 4% that only applies to net income in excess of $1.2 million (income below such amount is fully exempt).

Puerto Rico has been attracting over the last decade a variety of insurers and reinsurers serving worldwide markets and is already becoming recognized as a competitive jurisdiction for such activities. Premiums written by the international insurers and reinsurers were $1,008,420,468 in 2017 (up from $851,605,896 in 2016, and $444,698,297 in 2015), while their total assets were $3,704,375,322 at year-end 2017

services—legal, accounting, administrative, brokerage, back-office, and others—both through direct employment or by third-party contractors.

- An increase in the rent and/or purchase of real estate for the commercial operations of the licensed insurers and reinsurers, and for the residential needs of their executives, helping to improve real estate values on the island.

- An increase in other more indirect forms of local hiring and spending, on a range of services that would be required by the licensed insurers and their officers, contractors, investors and clients; such as hotels, restaurants and other hospitality and entertainment services.

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- An increase in local government application and license fees, and in income taxes paid by the insurers and reinsurers pursuant to the applicable 4% Puerto Rico income tax rate.

- Synergistic effects with other areas of the Puerto Rico economy: the exposure and visibility of the island to high level insurance investors would trigger interest in other activities for which it has competitive advantages not sufficiently known in international markets, such as manufacturing and distribution, agri-business and tourism, international banking, or services for export.

CONCLUSION

To the extent that eliminating the applicability of the FET would trigger a favorable momentum for the island's financial and professional services sector, other areas of the economy could benefit as well. The long perception of economic decline stemming from a recession that has lasted over a decade and that climaxed in the María aftermath would begin to be offset, boosting confidence in the prospects for local industry categories other than insurance and finance. Against the above considerations, no valid counter-argument seems to exist for keeping Puerto Rico insurers and reinsurers subject to the FET. The applicability of such excise tax burdens the island with an unfair disadvantage relative to States of the United States, and to the dozens of countries that have entered tax treaties with the U.S. Passing any legislative initiative through Congress is always a very uphill battle. The case for exempting Puerto Rico from the applicability of the FET, however, is clearly worthy of such effort. Hopefully, the overwhelming merit of this proposition will become increasingly recognized, and in due course the repeal of such applicability will provide an important boost for the island's financial sector and general economy.

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