DISCRIMINATORY TAX TREATMENT ON LIFE INSURANCE POLICIES - VDA

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In recent years, several income tax law provisions of EU member states were challenged by the European Court of Justice (ECJ) on the grounds of infringement of freedom of movement for goods, services, persons, and capital.

In line with these court decisions the purpose of this article aims to highlight a discriminatory treatment on life insurance policies. Portuguese tax law does not provide any specific mechanism to allow the individual resident to benefit from the different final withholding tax rates on the foreign income obtained whenever an insurance policy is executed before an insurance company resident in another Member State on the same terms as if such policy was executed with a Portuguese resident insurance company.

The issue therefore is, can or does this regime represent an obstacle to the free provision of services and free movement of capital?

Portuguese resident insurance companies

Regarding investment income paid to Portuguese resident taxpayers by Portuguese resident insurance companies, according to the Portuguese Personal Income (PIT) Code, the positive difference between:
(i) the value paid as redemption, early termination or maturity payment of life policies or life-related transactions, and
(ii) the premium paid or the amounts invested,
are taxable as capital income whenever the amounts paid in the first half of the term of the insurance policy represent at least 35% of the total amount of payments due. Despite the above, depending on the term of each insurance policy, a final withholding tax of 20%, 16% or 8%, may be applicable to this type of income.

Insurance companies resident in other Member States

However, the Portuguese withholding tax obligation described above is not applicable to insurance companies resident in other Member States as they are not subject to Portuguese law. In addition, there is no domestic mechanism that allows the resident policy holder to benefit from the final withholding tax rates described above whenever insurance policies are executed with such insurance companies.

Consequently, although the PIT Code does not expressly foresee a tax discriminatory treatment (such as specific reference or other restriction whenever Portuguese resident individuals execute insurance policies with EU insurance companies), in the absence of specific provisions and of a current mechanism provided by the domestic tax law, income paid under an insurance policy executed between a Portuguese resident policy holder and an insurance company resident in another Member State is subject to general PIT provisions. This means that the foreign income obtained by the individual resident in Portugal shall be aggregated in the taxpayer's global taxable income and thus subject to PIT progressive rates from 10.5% to 42%.

Furthermore, the reduction of the taxable income, as provided in the PIT Code, is not available to Portuguese resident individuals. Therefore, instead of the 8%, 16% or 20% final withholding tax rates, income paid by insurance companies resident in other Member States will attract a burdensome taxation – since such income will be subject to a progressive PIT rate of up to 42% – when compared with the income paid by resident insurance companies.

ECJ's understanding

Although the non-tax discrimination principle is initially based on the EC treaty and on the OECD Model Convention, its scope should currently be understood in light of the decisions issued by the ECJ.

The Portuguese tax framework under scrutiny is similar to the one examined by ECJ in Case C-334/02, Commission v. France. In this case, the ECJ analysed French taxation on certain types of foreign-source investment income, which were, in the end, deemed incompatible with the EC Treaty. According to the tax provisions under examination, individuals receiving interest income from domestic capital investments could opt to apply an autonomous tax that was normally lower than the rates of ordinary income tax. However, this option was not available if income was derived from foreign sources.

Following the European Commission's conclusions within a previous infringement procedure, the ECJ judged that French provisions were not in accordance with the EC Treaty since the unequal treatment of payments according to their origin was undoubtedly discouraging taxpayers from contracting with foreign financial service providers and therefore infringing the freedom to provide services and the free movement of capital.

In this regard, the ECJ has doggedly pointed out the fact that Member States' legislation shall not imply a restrictive effect as regards companies established in other Member States, as it prevents them from raising capital in that Member State, given that "the proceeds of contracts taken out with those companies are treated less favorably from a tax point of view than proceeds payable by a company which is established in [the relevant Member State]" (see Case C-35/98, Verkooijen, paragraph 35 and Case C-478/98, Commission v Belgium, paragraph 18).

As a conclusion, the ECJ considered that such provisions were restrictive under the rules governing freedom to provide services under Article 49 EC and on the free movement of capital under Article 56 EC, being therefore incompatible with EC Law.

The same reasoning applies to the Portuguese case described above. We therefore believe that the Portuguese tax framework applicable on income paid by an insurance company resident in another Member State should be deemed incompatible with the EC Treaty. Fortunately, such cases have been taken into account and domestic law will be amended according to the Portuguese State Budget for 2010. The amendment emphasises the previous discriminatory treatments and therefore such cases may be challenged.

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