

European Life Insurance and the GAAC

Several European life insurance companies are working in Portugal under the Freedom to Provide Services Regime. In general, such companies focus on selling capitalization (unit-linked) products to high net worth individuals, which are invited to transfer its financial assets to the insurance company in order to profit from the favorable tax regime that Portuguese PIT dedicates to income from life insurance products.

This was brought to our attention once some argue that such transfer may trigger the application of the general anti-abuse clause (GAAC), stated on article 38/2 of the Portuguese General Tax Law.

Let's see.

According to article 5, namely nr 3, of the PIT Code (Código do IRS)¹:

1 – The fruits or other economic benefits received directly or indirectly, whether in cash or in kind and irrespective of their nature or designation, from assets, property, rights or legal positions, from their modification, transmission or termination are regarded as investment income, except those gains and income that are taxed in other categories.

2 – (...)

3 - The positive difference between the amounts paid on redemption, advance or maturity of insurance and life assurance policies and the related premiums paid or sums invested is also considered investment income, as well as the positive difference between the amounts paid on redemption, remission or other form of early availability by pension funds or under other supplementary social security schemes, including those made available by credit unions, and the related contributions, without prejudice to the provisions of the following paragraphs, where the amount of premiums, sums or contributions paid in the first half of the term of the contracts represents at least 35% of all of those are also considered investment income:

- a) if the redemption, advance, remission or other form of anticipation of availability, as well as the maturity, occur between the fifth and eighth year of the contract, one-fifth of the income is excluded from taxation;*
- b) if the redemption, advance, remission or other form of anticipation of availability, as well as the maturity, occur after the eighth year of the contract, three-fifths of the income is excluded from taxation.*

¹ Translation by William Cunningham, available at the Portuguese Tax Authorities website.

It is clear that the letter of the law refers expressly to *insurance and life assurance policies*, and no distinction, derogation, specification, etc. is made by the law. We must assume, according to article 9 of the Portuguese Civil Code, that the legislator has expressed itself correctly. Besides, according to article 11/2 of the Generali Tax Law:

Where in tax rules, proper terms are employed in other branches of law, they must be interpreted in the same sense that they have there, unless another meaning arises directly from the law.²

So, the unavoidable conclusion is that the tax regime prescribed on article 5/3 of the PIT Code applies to income arising from life assurance, regardless of type, nature, structure, etc. Or, in other words, if there is income arising from a life assurance policy to a natural person, namely if it is tax resident in Portugal, it must be dealt with according to article 5/3 of the PIT Code.

But there is more – and that relates to the fact that the translation of the body of article 5/3 of PIT Code is not very accurate, when it comes to insurance *technicalities*.

In fact, the text of the law, in Portuguese, is as follows:

Consideram-se ainda rendimentos de capitais a diferença positiva entre os montantes pagos a título de resgate, adiantamento ou vencimento de seguros e operações do ramo 'Vida' e os respectivos prémios pagos ou importâncias investidas, bem como a diferença positiva entre os montantes pagos a título de resgate, remição ou outra forma de antecipação de disponibilidade por fundos de pensões ou no âmbito de outros regimes complementares de segurança social, incluindo os disponibilizados por associações mutualistas, e as respectivas contribuições pagas, sem prejuízo do disposto nas alíneas seguintes, quando o montante dos prémios, importâncias ou contribuições pagas na primeira metade da vigência dos contratos representar pelo menos 35 % da totalidade daqueles

The term used is *seguros e operações do ramo 'Vida'*, which can (and in our view must) be translated as *Life branch insurance and operations...* which is not quite what is said in the translation adopted in the Tax Authorities website.

On the contrary, if we check this expression against the terminology used in Portuguese and European Union Law regarding the type of contracts that Life Insurance companies are allowed to offer, the unavoidable conclusion is that the text of the PIT Code refers to all types of contracts offered by Life insurance companies, namely insurance and capitalization ops.

² Again, translation by William Cunningham, available at the Portuguese Tax Authorities website. It is true that nr 3 of article 11 states that:

Where doubts persist regarding the incidence rules to be applied, regard should be had to the economic substance of the chargeable events.

But terms like *insurance* and *life assurance* can mean no other thing than insurance contracts, so we see no need to resort to article 11/3.

Following European Law, namely Directive 2009/138/EC of the European Parliament and of the Council, of November 25th 2009, the Portuguese Legal Framework of Access and Exercise of Insurance and Reinsurance Activity (LFAEIR - approved by Portuguese Law 147/2015, dated September 9th, which entered into force on January 1st 2016), establishes that under Life Branch companies are allowed to practice insurance and operations, as follows (article 9 – loose translation):

Life Branch includes the following insurance and operations:

a) Life Insurance:

a. In case of death, in case of life, mixed and in case of life with counter-insurance;

b. Rent;

c. Complementary insurance of life insurance, namely, regarding corporal damage, including in the latter incapacity for professional work, death by accident or disability as a consequence of accident or illness;

b) Marriage assurance, birth assurance;

c) Insurance linked to investment funds, comprehending all insurance under points i) and ii) of subheading a), when connected to an investment fund;

d) Capitalization operations, which include all savings operations based on actuarial calculation whereby, in return for single or periodic payments agreed in advance, commitments of specified duration and amount are undertaken;

e) management of group pension funds (...).

We can therefore conclude that there is a match between life insurance law and the tax law when it comes to the fundamental distinction between life insurance and capitalization operations: both are operations performed by life insurance companies, life insurance being contracts where risk is involved and a guarantee is assumed (*alea*), and capitalization ops, where no risk (regarding human life) is guaranteed by the insurance company.

Given our understanding on the subject of the undertaking of capitalization insurance products (v.g. unit-linked insurance or capitalization operation), we believe that such undertaking, *per se*, will not trigger the application of the general anti-abuse clause (GAAC), stated on article 38/2 of the Portuguese. According to this rule³:

Any legal documentation or formalities, aimed by artificial or fraudulent means and by abuse of the legal forms, wholly or mainly at reducing, eliminating or postponing taxes that would be payable as a result of facts, legal documentation or formalities with the

³ Once more, we make use of the translation made by William Cunningham, available at the Portuguese Tax Authorities website.

same economic purpose, or to obtain tax advantages that would not be achieved in whole or in part without the use of these means, shall be ineffective for tax purposes, and taxation shall proceed in accordance with the rules that would have applied in their absence and the tax advantages referred to shall not arise.

It is true that the Portuguese PIT regime applicable to Insurance Contracts, established on the above referred article 5/3 of the PIT Code, is not a tax benefit⁴, but a structural rule that establishes the incidence of tax. However, such incidence rule (which states that, once the conditions foreseen in the law are met, only part of the income will be subject to tax) represents, at least from the economic point of view, a tax advantage that is only granted to life insurance products.

Regardless of that fact, we do not see how the undertaking of an insurance policy, in itself, can be considered as an *artificial or fraudulent mean* or an *abuse of legal form* in order *to obtain tax advantages that would not be achieved in whole or in part without the use of these means*. It is what it is: the undertaking of an insurance. The fact that its income is favorably treated by the PIT Code is a tax policy choice that perhaps could make an investor choose a capitalization insurance instead of another similar financial product – but the choice is legal and desired by the legislator.

This being said, it is paramount that the insurance company and its clients take precautions in order not to fall under the GAAC prevision, which may arise if and when it is possible to understand that the insurance is being used for any other tax relevant purpose which is not the one foreseen by the law. That would be the case if the behavior of the client is such that, for instance, one might understand that, instead of an insurance contract, the arrangement between the insurance company and the policy owner is to allow the latter to continue to manage the assets as if they were not the property of the insurance company – thus achieving the same type of asset management performed before the undertaking of the insurance policy, with the sole difference that the income generated by such assets has its taxation deferred and minimized.

⁴ A tax benefit is not structural to the construction of the tax in question but focus on an extra-tax purpose.