Life insurance and tax planning for Portuguese clients

[The following was written as support text for a conference; simple and directed to people that are not legal professionals, its only scope was to provide the attendants with an overall view of life insurance in Portugal, regarding legal, tax and market framework.

O texto que segue serviu de apoio a uma intervenção numa conferência; simples e destinado a não-juristas, mais não visava do que descrever sumariamente o momento actual do enquadramento legal, fiscal e de mercado dos seguros de vida em Portugal]

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1. Introduction.

In this brief work I will try to provide you with an overall view of life insurance in Portugal, regarding legal, tax and market framework.

I will emphasise on the tax framework, with special notice to tax benefits under Personal and Corporate Income Tax.

I will then conclude with some personal views of what may be some future business opportunities in Portugal, with a particular focus on taxation and social security issues.

2. Legal overview and framework

Portugal has a modern legal framework regarding insurance activity and life insurance contract.

2.1. Insurance activity.

Portugal has transposed to its law system all major EU Directives regarding insurance activity, with the exception of the insurance mediation directive (2002/92/CE).

Insurance activity in Portugal is regulated essentially by Decree-Law nr 94-B/98, April 17, major source of regulation regarding the access to, and exercise of, the insurance industry. Also, in this matter one must also comply with some Regulations issued by the Portuguese supervising authority – the Instituto de Seguros de Portugal (ISP), which is an *independent* entity organically within the Ministry of Finance, namely *Normas* 16/95 and 17/95, both dated December 12.

Entities that may exercise insurance activity in Portugal are:

- Portuguese public (state-owned) companies;
- Portuguese anonymous companies;
- Portuguese insurance mutuality's;
- Branches of non-EU insurance companies authorized in Portugal.

All of which need to file an authorization process before the ISP.

Also able to exercise their activities in Portugal are:

- Branches of EU insurance companies authorized in its residence state.

This kind of entities doesn't need to file an authorization process before the ISP – only to inform the supervising authority of their residence state, which will inform the ISP (its silence for a two month period is equivalent to a non opposition to the opening of the branch).

And off course it is possible for EU insurance companies, authorized in its residence country, to act directly in Portugal (freedom of exercise – livre prestação de serviços – LPS), for which they only need to join and contribute to major indemnities regimes (namely “labour accidents” and “auto insurance” branches), appoint a local representative (which will be responsible for the company’s activity in Portugal and for indirect taxation purposes) and, for those companies acting on “auto insurance”, to issue a statement that guarantees that they will comply to the related obligations.

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Decree-Law nr 94-B/98 is also the major source of prudential rules, which are complemented by a large number of ISP Regulations. The ISP, according to its statute (Decree-Law nr 289/2001, November 13), regulates and supervises insurance and pension funds activity and mediation.

2.2. Life insurance contract

Life insurance contract is regulated by several sources, the main being:

a) the Portuguese Commercial Code, an ageing law dating 1888 but still in force;

b) the referred Decree-Law nr 94-B/98;

c) The also referred ISP Regulation nr 16/95;

d) Decree-Law nr 176/95, July 26.

Portuguese Commercial Code defines life insurance contract for Portuguese law purposes, such definition being very up-to-date and matching the contract types that are designated on EU Directives and (consequently) on Decree-Law nr 94-B/98 (life and death, investment – including unit-linked products, pensions, etc.). Also, it stipulates that the insurance contract must be done in writing (which, however and in my opinion, does not prohibit its celebration via new media – phone, internet, etc.).

In order to determine the rules applicable to the Life insurance proposition terms and life insurance policy terms and regulation, one must combine at least the other three referred sources. It would be tedious to describe all rulings, the general idea being as follows:

a) The insurance company must provide a very large array of pre-contractual information, such provision to be confirmed by the insured person or entity;

b) Life insurance policies must bear also a lot of info and must comply to several mandatory types of clauses;

c) There are specific provisions on both pre-contractual and contractual info regarding investment insurance (directed to consumer rights protection);

d) Insured person as a renouncement right, meaning the right to unilaterally declare the life insurance policy ineffective within 30 days of its reception. This right is only granted to physical persons and does not apply to contracts to be in force for six months or less and to group insurance contracts.

2.3. Summary.

Portugal has a very modern and *European standard* insurance law framework; it is not complicated to sell life insurance in Portugal by EU insurance companies, namely if they choose to open a branch in Portugal or to sell directly from its country of residence.

On the other hand, life insurance regulation is quite complicated, but generally complies with the major EU Directives and it is similar to continental law rules on the matter.

3. Tax overview and framework.

Life insurance has been regarded by the Portuguese legislator as something to be stimulated; not only concurs to provide a level of protection that the Portuguese state is increasingly unable to provide, but it also allows public finances to achieve some of its goals, regarding mostly public debt – once most of the Portuguese insurance companies are encouraged to invest (represent) their technical provisions on public bonds.

Thus, Portuguese tax law has specific and favourable provisions regarding life insurance; and there are also several tax benefits to be considered. It is a somewhat complex regime, so I'll try to put it as simple as possible.

It is true that this favourable regime has known its ups and downs – the current being a down period, once the last right-wing government has revoked important tax benefits on savings through special savings/investment life insurance and pension funds products (Pension and Education Savings Plans – PPR/E). But it seems that, regardless of the catastrophic public deficit, the tide is changing again as the new government has recently appointed a new work group in order to (eventually) reinstate some tax benefits on savings products.

3.1. Personal Income Tax – IRS.

Regarding Personal Income Tax – IRS, we have to deal with two different sets of rules: (i) the first, applicable to insurance policies paid by the insured taxable person and (ii) the second, regarding the tax treatment of the insurance policies paid by their employer.

3.1.1. Personal life insurance.

Tax benefit on premiums paid[1].

Life insurance premiums covering exclusively death, disability or old-age retirement risks, provided that the last mentioned case the beneficiary is covered after 55 years of age and for a period of 5 years, paid by him (or by third parties, provided that in this last case it has been subject to tax as income) can be credited against his final tax liability.

This credit is limited to 25% of the sum paid or to € 57,00 per person (2005), whichever the lowest. The credit limit is the same for premiums paid for accidents insurance in the same year.

Plus, the credit may have to be returned, with interest and penalties, if there is a guarantee of payment of lifetime capital or if it anyhow occurs, namely by means of redemption or advance other than the above-mentioned.

Regarding all its limitations, this tax benefit does not seem to be a very good reason for one to buy life insurance…

Tax regime of life insurance income[2].

The income corresponding to the difference between (i) the premiums paid and (ii) amounts paid as a redemption, advance payment or maturity of a life insurance policy are subject to IRS as an investment income, according to the following rules:

a) Taxable income will be:

    (i) 100% if payment occurs within the first 5 years of the contract;

    (ii) 80% if payment occurs between the first 5 years and 8 years of the contract;

    (iii) 40% if payment occurs after 8 years of the contract.

b) Taxable income reduction will only take place if at least 35% of the premiums are paid in the first half of the contract's enforcement.

c) Taxable income is subject to a 20% final withholding rate[3]/[4].

[1] Article 86 of the IRS Code. Although this rule is found on the IRS Code, in my view it must be considered as a tax benefit and not as a structural IRS rule, once its scope is evidently the incentive of life insurance, which is not a tax goal.

[2] Article 5 nr 3 and article 71 nr 3 c) of the IRS Code.

[3] One can choose to aggregate this taxable income, which is only a benefit if the marginal rate of the person is lower than 20%. In most cases, it does not occur, once IRS progressive tax rates are very high – better yet, taxable income amounts for every rate are very low.

[4] This rule poses a serious practical problem for which I have no answer. In fact, when the insurance company is not Portuguese resident, or does not have a Portuguese branch, it is impossible to subject the taxable income to the Portuguese 20% final withholding tax rate. The solution seems to be the aggregation of the residual taxable income for IRS purposes – which, as far as I can understand, is discriminative according to EU regulations.

Other investment products, namely debt bonds and bank deposits[5], do not benefit from this taxable income reduction, so this is really a competitive tax advantage for life insurance investment products.

Pension plans

All pension income, including pension plans acquired to life insurance companies, are taxed as follows:

a) Capital reimbursement is not taxed (if the capital reimburse amount cannot be determined, IRS Code presumes that 65% of the pension is capital);

b) The pension income benefits from an annual tax allowance of € 8.283,00 (2005).

3.1.2. Employer-paid life insurance[6].

General rule.

Life insurance premiums paid by the employer are subject to IRS as dependent personal service income; they are fringe benefits specifically taxed by the IRS Code[7]. The income/wage is taxable:

a) If the premium paid is an acquired right of the employee (meaning the contract shall supersede the end of the labour relationship), when the premium is paid by the employer;

b) If the premium paid is not an acquired right of the employee but a mere expectation (meaning the insurance contract shall not supersede the end of the labour relationship), when there is any payment to the employee of lifetime capital, namely by means of redemption or advance.

The amount of the premium paid by the employer, regardless of the moment when it becomes taxable, is subject to IRS aggregated to other employment income. It is not subject, though, to withholding tax, final or creditable.

The difference between the premium paid and the amount received by the employer is considered as an investment income, to be taxed as stated above regarding personal life insurance.

Tax benefit – expenses in connection with social utility[8].

When the employer's life insurance policy (i) refers to old-age retirement, disability and life risks and (ii) complies with the rules stipulated on the IRC Code for the acceptance as a tax

[5] Non negotiable bank deposits with a 5 year retention term benefit from a similar regime – article 24 of the Estatuto dos Benefícios Fiscais (EBF).
[6] Article 2 nr 3 b) 3), nr 8 and nr 9 of the IRS Code.
[7] Unless paid under legal mandatory social security systems and regarding life, disability or pension.
[8] Article 15 of the EBF.

cost of the premiums paid (which I will describe on the next point of my work), there are tax benefits to be considered.

Premium paid – Even though considered as an acquired right of the employee, the premium paid will be IRS tax exempt on the year of its payment.

Amounts received by the employee – if the employee receives the insured capital when he gathers all requisites to become a pensioner according to general social security regulations (v.g., 65 years of age), or on any case becomes one, 1/3 of the amount received or € 11.704,70, whichever the lowest, is tax exempt (but it will be aggregated to the rest of the taxable income in order to determine its marginal tax rate).

3.2. Corporate Tax – IRC.

For the same reasons that are the basis for the exceptional life insurance treatment under IRS, even before the present Corporate Tax regime (IRC – 1989) life insurance policies contracted by were given some tax benefits by Portuguese tax law. However, on the first years of the IRC, there were substantial tax evasion issues related to the misuse of life insurance products – so the present set of rules is somewhat stricter than in the recent past.

General rule[9].

Only life insurance premiums paid that are considered acquired rights of the employees (therefore subject to IRS) can be tax deductible.

Tax benefit - expenses in connection with social utility[10].

Exception to the general rule happens when the life insurance contract qualifies as an expense in connection with social utility. Such qualification depends on the compliance of the following set of rules:

a) Life insurance policy must be done in favour of the employees (extendable to members of the board);

b) Benefits set out for all employees in general (or according to collective labour contracts);

c) Benefits set out according to objective and identical criteria to all employees (unless in order to comply with collective labour contracts);

d) Amounts paid by the employer to be delivered and managed to third parties (in the present case, to life insurance companies);

[9] Article 23 nr 4 of the IRC Code.
[10] Article 40 of the IRC Code.

e) Life insurance company has to be Portuguese or EU resident, or to have a branch in Portugal;

f) Risks insured must be only old-age retirement, disability and life.

Also, for life insurance that does not cover only life and disability:

g) At least 2/3 of the insured sum must be paid by means of a life-long monthly instalment (pension);

h) Requisites to become a pensioner according to general social security regulations, regarding age and beneficiaries, must be observed by the insurance clauses.

If all the completion of all this rules is attained, the premium paid by the employer (with all life insurance policies) will be tax deductible, but with a maximum limit of 15% of all personnel costs[11].

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There are special rules that allow surpassing the 15% limit, and others that regulate the changing of insurance company, the reduction of employees and the connected possibility of redemption, etc. However, this does not seem to be the time or the place to elaborate on such.

3.3. Summary regarding Income Tax.

Both personal and corporate income tax dedicate a favourable regime to life insurance, although for 2005 major tax benefits on personal life savings/investment insurance have been revoked (presumably to be resumed on 2006).

The investment income obtained via an investment life insurance benefits from tax exemptions for contracts that last 5 years plus, such exemption being 60% of the income if the contract is 8 years plus.

Insurance plans made by employers that benefit the workers are not only tax deductible but allow the workers to achieve total tax exemption on the year the premium is paid and a considerable tax allowance when the capital insured is paid.

3.4. Stamp tax.

When the life capital insured is paid to the beneficiary *mortis causa*, there is no stamp tax to be considered (10% flat rate), once it is not part of the inheritance but a credit that arises *ex novo* on the beneficiary estate.

Also, stamp tax on life insurance policies (9%) is tax exempt[12].

[11] 25% if the employees do not benefit from state social security.
[12] Article 7 nr 1 b) of the Código do Imposto do Selo.

3.5. VAT.

All insurance activity is tax exempt[13].

3.6. Other indirect taxation issues

Non-investment life insurance (pure risk) must pay 1% tax to the Instituto Nacional de Emergência Médica (National Medical Emergency Institute)[14].

4. Market overview – Credit related life insurance, investment life insurance, *banqueassurance*.

Life insurance activity in Portugal is generally powered by banks, which normally own life insurance companies, and use their agencies network as a sales force for the insurance companies' products.

This is valid not only for savings products designated for mass consumption (as was the case of PPR/E, extinct but with a possible resurrection to take place), but also for more sophisticated products (v.g. unit-linked life insurance), usually offered to a more wealthy *clientele*, namely via private banking.

In my view, Portuguese banks and insurance companies have neglected the massification of life insurance investment/savings products. Regarding PPR/E, for instance, it was offered not for its financial performance, but mainly for the tax benefits associated – they are not competitive without the tax benefit aid, so 2005 has witnessed a severe disinvestment on this issue.

On the other hand, it is common that life insurance investment products are very expensive, once most life insurance companies charge high premium, management and redemption fees. The result is that, even when they are good in pure financial terms, the income effectively earned by the customer is not competitive compared to other investment/savings products.

There are also other reasons that may explain why the Portuguese do not invest in life insurance – regardless the fact that nowadays Portuguese are more consumption oriented than in the past, and that most of us simply don't have any money to save…

One is that insurance companies don't have a good reputation amongst Portuguese consumers. They are usually known to be very expensive and to refuse all indemnity payments unless under court order. Whether this is true or not, fact is that it matches the general point of view of the public.

Another is that in the late 1980's and early 1990's, some companies sold life insurance investment products that were only effective in the long-run (mostly, 20 year diferred capital

[13] Article 9, nr 29, of the Código do IVA.
[14] Decree-Law nr 234/81, August 3, and Decree-Law nr 171/87, April 20.

contracts with all commissions paid on the first year) but that were sold as somewhat equal to a bank deposit. When, after a few years, some clients asked their money back, they got, instead of what was promised, not interest on the capital, but a value considerable lower than the capital itself – and until today this bad image rests to be erased.

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Credit related life insurance is a major product in all life insurance (non-specialised) companies, mainly because the house-owning decision is almost inevitable for all under 40. In fact, for reasons that would be hard to explain, there is no effective housing lease market in Portugal, so everyone that chooses to live on its own is generally compelled to buy a house. This phenomenon has become so evident that today banks are offering 40 year contracts, and some with 30% of the capital to be paid at the end of the contract!

Off course, no credit contract of this nature is done without life insurance associated – which is usually offered by the bank via the group's insurance company. Big business, indeed.

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More recently, life insurance has appeared associated with other forms of credit, namely consumer's credit. It is a different form of life insurance when compared to house-credit contracts – lower capitals, short term contracts, etc. But has most of the Portuguese can only access some kind of goods if they are granted credit (especially cars, furniture, expensive household appliances, etc.), the offering of a life, disability (and unemployment) insurance is usually welcomed by the consumer. I believe all consumer credit specialised financial entities, if not demand, suggest this kind of insurance and, once it is cheap and easy to buy, success rates are high, as far as I know.

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On an overall basis, though, it seems correct to say that today **life insurance industry in Portugal is ruled and powered by** *banqueassurance*.

5. Possible future trends – tax and business opportunities.

Some events that were common knowledge in the near past in Portuguese politics have changed dramatically with the latest parliamentary elections and the change of government from right to left wing.

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First and paradox change is the, already mentioned, announced resurrection of the tax benefits for life insurance savings plans. The revocation of such tax benefits was made for 2005 by the late right-wing government in order to fight the increasing public deficit and based on the fact (?) that only a wealthy few took advantage of the tax benefit. Not a word for the non-tax purpose of those tax benefits, one might add.

The new government, as I also already mentioned, has created a work task force in order to revive tax benefits on savings – so it seems that in the near future, perhaps already in 2006, there will be again strong tax benefits on long-term investment life insurance.

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Second and predictable change relates to the social security Portuguese system. As it is known, such system has recently become almost universal (step-by-step and only after the 1974 revolution) and is founded on a redistribution basis: today's contributions pay today's pensions – individual contributions are not capitalised.

Low funded and in the brink of disaster (which is particularly true for the people that work in the Public Service), the possibility to limit the social security contributions to a maximum limit (thus preventing future pensions to escalate to high and non payable values), however possible according to the Social Security Basis Law (that allows the *plafonamento*), does not seem to be at hand. All money is now welcome, no matter what the future may bring.

Plus, the actual government does not seem to be inclined in such way.

Today, the *plafonamento* is only applicable to members of the board, if they wish to have it, and limited to 12 X the minimum wage (12 X € 374,70) = € 4.496,40. In spite of such a low value, to my knowledge there are no organized sales tactics of individual pension life insurance for this sort of persons.

If the *plafonamento* becomes a universal rule, there will be a whole new market to explore.

Also, it has come to my knowledge a very interesting study made by CARDIF (BNP-Paribas owned insurance company) regarding consumer credit and life insurance related coverage in Portugal. The main conclusions of such study indicate that there is a very large market to explore, once Portuguese consumers have a very practical approach to consumer credit – it is clearly regarded as a means to an end (to enhance quality of life), but needs to be insured (50% of the Portuguese declare that, in the event of death, disability or unemployment, they would cease payments in a mere 3 month delay).

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As a conclusion, one can say that, even though powered by banks, **life insurance has a long way to go in Portugal**:

a) Life insurance is not generalised amongst the population;

b) Banks and insurance companies haven't, until the present date, explored tax planning opportunities that may arouse from the partial non taxation of the investment income obtained via insurance contracts;

c) Also, the tax planning for building up fringe benefits usually disregards the possibilities offered by life insurance paid by the employers;

d) And most of all, life insurance companies in Portugal usually neglect the investment insurance as a potent financial product, charging high for the redemption.

With an economy stalling and low interest rates, life insurance taxation can make the difference.

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