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PIT on partial redemption: the tide has turned

1. Introduction and legal framework

One of the reasons why Portuguese clients are so keen in undertaking Unit-linked life insurance is the fact that the regime under Personal Income Tax (PIT) for the income arising from such contracts has a clear advantage over interest and capital gains.

Has a matter of fact, the regime in force dates back from 1995[1] (a serious case of "stability") and states as follows (loose translation):

> ***Article 5 of the Portuguese PIT Code***
>
> *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;*

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[1] The first law that subjected life insurance products income to PIT was Decree-Law 267/91, August 6th, which entered into force in January 1st, 1992. The present rule was a budget rider. It was inserted, in its present form, in the Portuguese PIT Code by the State Budget Law of 1995 (Lei 39-B/94, December 27th), and had only minor changes since then. The income limit non-subject to tax suffered changes along the years (and also the tax rate did), but the *rationale* remained the same.

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.*

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 General 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 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 which is tax resident in Portugal, it must be dealt with according to article 5/3 of the PIT Code.

Tax is levied via withholding tax at a 28% rate, if the insurance company is tax resident in Portugal; if it is a non-resident insurance company, the insurance owner must declare the income on its annual income tax form (Mod. 3 IRS), which will be taxed at a 28% autonomous tax rate[3]/[4].

2. The partial redemption issue

We did not take part in the group that prepared this law in 1995, but there was access to the works that gave place to such legislation. And, as we can see from the records, even before the law was in place, there was controversy that relates to how to apply article 5/3 on partial redemptions.

At a certain stage, and referring to another issue, representatives of the insurers stated that only when the redemption value would exceed the capital (i.e., the sum of premiums paid)

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[2] Translation available at the Portuguese Tax Authorities website. It is true that article 11/3 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 of the General Tax Law.

[3] Only recently the taxation of foreign life insurance was made equivalent to the taxation of domestic life insurance. For decades, the foreign life insurance was not taxed via an autonomous tax rate, and thus had to be taxed at the normal tax rates on the marginal income, so there was a mismatch which was a clear violation of European Law. We had the opportunity to prepare, on behalf of a client, a complaint to the European Commission regarding this issue. On this subject, RICARDO SEABRA MOURA and FRANCISCO CABRAL MATOS, "O estranho caso da tributação dos seguros de vida", Fiscalidade nr 35.

[4] Effective tax rates are, at this date, 28% - 22,4% - 11,2%.

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there should be a tax implication. This was not the opinion of the Tax Authorities representatives.

The (probable) argument of the insurers was somewhat logic: once the law was an incidence rule, and states that what is subject to tax is the positive difference between capital and the sum insured, only when the insurance owner gets more than the return of the capital the tax is triggered. But this is not how we (and supposedly the tax authorities) looked at it: for us, what triggers the tax is the increment of the patrimonial situation of the insurance owner whenever there is a payment/redemption, so in any redemption one should ascertain what is capital and what is income, and tax it accordingly.

Oddly enough, when the law entered into force, and although tax authorities should be on alert, nothing happened. The insurers position (that only when the redemption(s) value would surmount the sum of premiums paid tax would be due) was the solution adopted by the market, and thus no withholding tax was levied on almost all partial redemptions. And this was the way things were up until a few years ago, when auditors started looking at this issue and took a different approach. Slowly but steadily, the tide started to turn, and today we face a totally different situation: as far as we are aware, all Portuguese resident life insurers levy withholding tax on all partial redemptions.

But this is not the end of the story. To tax partial redemptions may become a total mess, namely when one has to face several premiums paid (and worse if there are several partial redemptions) during the life of the contract. FIFO? LIFO? Should one consider income as a whole or regarding each premium paid? What if there is loss of capital[5]? And (worse) if, at the date of the redemption, there is income but, at the end of the contract, there is loss?

At this date, many of the Portuguese resident insurance companies determine the amount of income in each redemption according to a simple formula:

$$\begin{aligned}&partial\ surrender\ taxable\ basis\\ &\qquad = amount\ of\ partial\ encashment - total\ premiums\ x\,\frac{amount\ of\ partial\ encashment}{total\ policy\ value}\end{aligned}$$

We do not think this to be enough. The complexities of long term contracts, with regular payments and occasional redemptions[6], do not meet this simple formula. We have been advising some insurance companies and some more complex formulas have arisen, but still, at least to our knowledge, there is none that fulfills all demand. Moreover, the law gives no

[5] This rule was enforced long before unit-linked contracts, with capital risk, were introduced to the market, so we guess that, at that stage, no one thought about what happens if, at the date of the redemption, the sum insured is lower than the premiums paid.
[6] Not to mention the fact that there are several rates to consider if the contract is old enough to be subject to the transitional regimes of the 1990's…

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clues on how to deal with this situation, and there is a deafening silence by tax authorities on how to deal with these issues.

Let's look at the tax authorities position on this matter[7].

Back in 2005, there were some positions (non-binding) issued by the tax authorities, which raised some questions that concerned the market. Namely, "Parecer 59/2005" and "Circular 1141/05", which dealt with several questions regarding (i) the nature of unit-linked contracts as insurance, (ii) the problem of partial redemptions, etc. Regarding the latter, the Centre for Tax Studies of the Portuguese Tax Authorities issued Parecer 59/2005 which deals with the problem of partial redemption on life insurance products. According to it, in the law we find no ground for an unequal treatment *"of the total or partial acquisiton of income subject to tax"*.

Thus, it is argued that *"if there is a partial redemption, there will necessarily be a sum to be determined by way of capital income generated by the insurance contract, currently attributable to the value of the portion of the premium that is being redeemed."*[8] In any event, the Parecer states that the technical and actuarial impossibility of determining a return on capital in each partial redemption could not serve as a basis for non-application of the tax regime[9].

Although the Parecer's conclusions were sanctioned by the Secretary of State for Fiscal Affairs (SEAF), there remained doubts as to the operationalization of the scheme, so SEAF Order No. 686/2007-XVII proposed that the mission of a working group already assembled was extended to the analysis of the taxation of partial redemptions, in the sense of clarifying the regime and harmonizing the insurers practices. The final report is not known.

Facing this scenario, and notwithstanding the fact that many of the conclusions of Informação 1141/05 and Parecer 59/2205 are unreasonable (to say the least), one can understand that tax authorities:

a) do think that partial redemptions must be taxed;
b) but seem to have left to the insurers the burden of finding the solution on how to deal with the problem of determining the correct way to levy PIT on partial redemptions of life insurance products.

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[7] On this subject, POÇAS MARTINS, "A tributação dos rendimentos de capitais nos seguros e operações do ramo vida", Cadernos de Justiça Tributária nº 09, p. 42 onwards.

[8] As for the method of calculating interest in each partial redemption, the Parecer points to a solution where taking each premium - or set of premiums - "redeemed" and its income as an autonomous contract, to which the tax regime of article 5/3 of the PIT code would be applicable. However, there is an obvious contradiction between the method proposed and the objective sought, since only the method of proportionality (and not that of actual imputation) necessarily guarantees the taxation of each partial redemption.

[9] This position is based on the unusual view that, if the redemption is partial, the amount of capital not redeemed should be considered as a new premium paid at the time of redemption. I would rather not comment on this creative way of looking at life insurance.

This is not the way to handle things. The lack of information by the tax authorities in this matter leads to intolerable uncertainty; if the problem is hard to solve, why not put together a team of experts to handle it properly and sort out the best solution for the State, the insurers and the insurance owners? If not by means of a change in law, at least in the form of a ruling or a soft law instrument. As things are, it is possible (however unlikely) that tax authorities may challenge the way an insurance company is levying PIT on partial redemptions, with harsh consequences both on the insurance company and on the insurance owner. This is, in our view, unacceptable, namely because we are dealing with savings products that, in many cases, are long term and with tax privilege by the State because they are used for retirement goals. This is too serious to be left unattended.

What to do in Luxembourg

Facing this scenario, how should Lux Life insurance companies approach its Portuguese clients regarding the tax treatment of partial redemption?

The bad news is that they cannot inform their clients on what is the correct tax regime regarding the taxation, under Portuguese PIT, of a partial redemption. They can only say that, to the best of their knowledge, partial redemptions are subject to PIT in Portugal and that Portuguese life insurance companies nowadays levy withholding tax, many of them according to the formula above referred.

The good news is that it's the insurance owner problem: as above stated, Lux Life insurance companies cannot levy Portuguese PIT withholding tax, and it's up to the insurance owner to declare the income on its annual income tax return to be subject to the 28% autonomous rate tax.

But it is not fair nor proper to say it's just the insurance owner problem; if he or she needs to report the income on its tax statement, it is up to the insurance company to inform on the amount of income that is determined in a partial redemption. So, the question remains: what should the Lux Life insurance companies do when such information is requested by the insurance owner?

First of all, one should bear in mind that, regarding Lux Life insurance companies, this is not a tax issue, but a reputational issue. They cannot (at least for the time being) be held liable before the Portuguese tax authorities for any lack of information or misinformation. But there is the possibility of being held liable by the insurance owner if it does not provide information, or if the information is given in a way that may lead the insurance owner in question to understand that the income determined by the Lux Life insurance company is according to

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Portuguese tax law. And most of all, the reputation of the insurance company would probably be seriously injured.

The fact is that, whatever the technique that the Lux Life insurance company uses to determine the amount of income in a partial redemption, it may not match the way that Portuguese tax authorities deem, or will deem, correct. Due to the lack of regulation and information, there is no way that Lux Life insurance companies can tell their Portuguese insurance owners what is the taxable income that they should consider for tax declaration purposes. More: even if one day we have a law, a ruling or soft law on how to determine, for Portuguese PIT tax purposes, the amount of income included in a partial redemption, such instrument would not be mandatory for the Lux Life insurance companies. They are not subject to Portuguese tax law or to the Portuguese tax authorities, so they are free to determine what is capital and what is income.

How to proceed, then?

The answer, in our view, lies on the way such information is given to the insurance owner. The Lux Life insurance company which is requested to identify what is the amount of income considered in a partial redemption should state, at least, the following:

a) The company determines the amount of income considered on a partial redemption according to its own set of internal rules and techniques (which should be disclosed);
b) This calculation does not necessarily match any Portuguese tax rules regarding the determination of income on a partial redemption;
c) At this stage, it is not possible for the insurance company to follow such rules, which are unclear;
d) The insurance owner should seek advice by a local tax advisor in order to fulfill correctly, according to Portuguese tax law and regulations, his/her income tax statement;
e) The company will provide all necessary further info that may be requested by the insurance owner on his/her insurance policy/product to correctly fulfill all tax obligations.

And that is all we believe to be possible at this stage. So, let's hope that, in the near future, the government or the tax authorities clarify this mess. It's bad for business, whether in Luxembourg or Portugal.

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