TAX DEDUCTIBILITY OF INSURANCE PREMIUMS : A CASE OF STATE AID FOR INSURANCE COMPANIES?

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Foreword : The Background to the *Bachmann* Case

In a number of Member States of the European Community, there exists a variety of tax incentives the purpose of which is to reduce the after-tax cost of life insurance and/or group insurance for the policyholders and, in the case of group insurance, their employers.

The traditional justification for the grant of these incentives is that they entice private individuals, and their employers, to save towards a "private" pension, thus relieving pressure on the overextended, publicly funded, State pension system.

To achieve this purpose, a number of Member States have traditionally allowed individual policyholders (and, in the case of group insurance, their employers) to treat, up to a maximum amount, life or group insurance premiums as a deductible expense for income tax (or, in the case of employers, for corporation tax) purposes. Alternatively, a tax credit may be granted to the policyholder, again up to a maximum amount, in respect of premiums paid pursuant to an individual life insurance policy or pursuant to a group insurance policy.

A condition often found in the tax law of Member States for the grant of these tax incentives is that the relevant insurance premiums must be paid to a locally established insurance company, that is to a locally incorporated insurer, or to a local branch of a foreign (EC or non-EC incorporated) insurer.

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A number of justifications, some more credible than others, have been officially advanced for this type of restriction :

- the administrative difficulty for the national tax authorities to check the reality of the payment allegedly made to a foreign insurer (i.e., to an insurer established outside their jurisdiction) if such payment were to qualify for the same tax benefit as a payment made to a local insurer;

- the need to insure protection of the policyholder in the name of the "general good", by limiting the grant of the tax benefits to life or group insurance coverage granted by locally established, and hence locally policed, insurers;

- the wish to insure that the tax benefit granted to the policyholder during the currency of the contract can be clawed back, when the policyholder dies or reaches retirement age, by levying a tax on the proceeds of the insurance contract.

Another, unavowed justification can presumably be found in the fact that, if the life or group insurance contract is entered into with a locally established insurer, the said insurer can - or rather could[2] - be forced, to invest the premiums during the currency of the contract, at least for a given minimum percentage, into bonds issued by the Member State which has granted the tax incentives designed to encourage the taking out of the life or group insurance contract in the first place.

In the wake of the "Single Act" and of the Commission's subsequent "1992" initiative, attention started to concentrate on the compatibility with EC law of the conditions restricting life or group insurance tax benefits to those premiums which have been paid to locally established insurers.

What is the point, or so the argument ran, of guaranteeing the freedom of movement of workers wishing to take up employment in another Member State if they are obliged to renounce the life or group insurance policy taken out in their country of origin and take out instead a "new" (and, in practice, more onerous) policy with a locally established insurer in the Member State to which they are moving, in order to qualify for the tax benefits available in respect of such contracts?

Also, what is the point of adopting at Community level a Second and a Third Life Insurance Directive, granting any life insurance company incorporated in one Member State a "single passport" allowing it, among others, to provide its services

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2 The position is now different as a result of the Maastricht Treaty and of the entry into force of the Third Life Insurance Directive.

throughout the Community without the need of a local establishment if, by so doing, that insurance company prices itself out of the market because local policy-holders doing business with it will forego the tax advantages for which they qualify when they deal with a locally established insurer?

The Lessons of the *Bachmann* Case

It was thus with great expectations - or sometimes, with great anxiety - that many observers were waiting in January 1992 for the answers to be given by the European Court of Justice (ECJ) to these two questions, which had been referred to it by the Belgian Supreme Court in the so-called *Bachmann* Case.[3]

As many readers of this *Journal* will be well aware, the position adopted by the ECJ came as a great disappointment for many, and a godsend for some.

Since the purpose of this article is not to make an in depth analysis of the *Bachmann* judgment, let it suffice to recall here that the ECJ:

- rejected the argument of administrative inconvenience as an adequate justification for refusing to extend to premiums paid to non-locally established insurers, the tax benefits granted by Belgian tax law in respect of premiums paid to locally established insurers;

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3 On 28th January 1992, the ECJ handed down two nearly identical judgments concerning the compatibility with EC law of Belgian tax regulations governing the deductibility of certain insurance premiums, namely:

- judgment in case C-300/90 - *Commission v Kingdom of Belgium*, pursuant to infringement proceedings initiated by the Commission against that Member State; and

- judgment in case C-204/90 - *Bachmann v Belgian Tax Authorities*, pursuant to a request for a preliminary ruling made by the Belgian Supreme Court before adjudicating on the merits of a claim made by a German national resident in Belgium, Mr Bachmann, against the Belgian tax authorities.

For a detailed analysis of the two judgments, see, amongst others, M Dassesse, "The *Bachmann* case: a major setback for the Single Market in financial services?", *Butterworths Journal of International Banking and Financial Law*, 1992, p 257 to 262, B Knobbe-Keuk; "Restrictions on the fundamental freedoms enshrined in the EC Treaty by discriminatory tax provisions - Ban and justification", *EC Tax Review*, 1994, p 74, Section VII; L Hinnekens & D Schelpe, *EC Tax Review*, 1992, p 58.

- rejected the "general good" argument as a valid justification, in terms of EC law, for the restriction which was in dispute before it;

- held that the tax provision in dispute constituted a restriction on the free movement of workers within the Community in as far as it imposed on a worker moving from Germany to Belgium at best an administrative inconvenience, and at worst a hefty premium increase, as a result of the need to give up the insurance policy taken out in his country of origin, and to take out a new insurance policy with a local Belgian insurer, in order to qualify for the relevant tax benefit; and

- held that the tax provision also imposed a restriction on the free provision of insurance services on a cross-border basis in Belgium by foreign (EC-incorporated) insurers. Indeed, to quote the Court, "provisions requiring an insurer to be established in a Member State as a condition of the eligibility of insured persons to benefit from certain tax deductions in that State **operate to deter those seeking insurance from approaching insurers established in another Member State, and thus constitute a restriction on the latter's freedom to provide services**".[4]

Yet the Court held that the restrictions thus imposed by the Belgian tax rules in dispute on two of the fundamental freedoms guaranteed by the Treaty of Rome were nonetheless permissible because, in the Court's opinion, they were indispensable to preserve the "coherence" of the Belgian tax regime applicable to life insurance and to group insurance policies. This "coherence" was held to exist, in the opinion of the Court, because sums paid pursuant to a life or group insurance contract were taxable if, during the currency of the contract, the premium paid by the policyholder had been deducted by him from his taxable income.[5]

Again, we shall not reiterate here the criticisms which we have addressed along with a number of other commentators, to the reasoning that led the Court to this

4 See *Bachmann* judgment referred to in footnote 3 above, at para 31.

5 As pointed out by David Hinds, ("Discrimination post Commerzbank", *The Tax Journal*, 12th May 1994, p 14), in the official English translation of the judgment, the French word "cohérence" is incorrectly translated as "coherence".

surprising conclusion.[6] Let it suffice to say that, in the present state of Community law, attempts to force Member States to extend to policyholders dealing on a cross-border basis with a foreign (EC-incorporated) insurer the tax advantages which are available to them when they deal, instead, with a locally established insurer have ended in a "cul de sac".

At the same time, it is beyond dispute that as long as such a situation continues, the cross-border provision of life and group insurance services is unlikely to flourish, to use an understatement.

Query, therefore, whether another approach is not possible in order to achieve a "level playing field" between locally established and non-locally established insurers?

Tax benefits granted to a policyholder: a prohibited State aid for his insurer?

Whereas the traditional, "*Bachmann*-like" approach, to achieve a "level playing field" between local and foreign insurers has been to attempt to extend, in respect of the latter category, the tax concessions granted in respect of the first category, the same result can obviously also be achieved by prohibiting the grant of tax benefits in respect of the first category which are not available (be it on the ground of fiscal "coherence" or other grounds) in respect of the second category.

The initial reaction to such an alternative approach is no doubt to point out that the tax concessions are granted not to the insurers as such but to their clients instead.

It is submitted, however, that such an objection is ill-founded.

Indeed, as we shall endeavour to demonstrate hereafter :

- tax concessions qualify, in terms of EC law, as State aid;
- said State aid, in a *Bachmann*-like situation, favours locally established insurers to the detriment of non-locally established EC insurers competing with them in the same Member State;

6 Let it suffice to say that the Belgian tax regime, the "coherence" of which the Court set out to preserve in its judgment of January 1992, was discarded that very same year by Belgium . . . while keeping in force, as part of the new regime put in its place, the condition whereby policyholders are only eligible for tax benefits in respect of premiums paid to locally established insurers. For a critical analysis see, amongst others, M Dassesse, "L'arrêt Bachmann et la loi du 28 décembre 1992 : Une victoire à la Pyrrhus?", *Journal de Droit Fiscal* (Bruylant, Brussels), 1992, p 321.

- in terms of Community law, the said State aid is, as a rule, prohibited, precisely because of the distortion of competition which it creates between the undertakings which are "favoured" by the aid, and the competing undertakings which are not.

Tax concessions qualify, in terms of EC law, as State aid

Attention must be drawn, in this respect, to the recent judgment of the ECJ of 15th March 1994[7] in *re Banco Exterior de Espana*.

In that case, the Court showed no hesitation in coming to the conclusion that the concept of State aid referred to in Article 92 of the Treaty (as to which, see hereafter) is a broad one: it includes not only outright subsidies but also all measures which, in various forms, "mitigate the charges which are normally included in the budget of an undertaking and which, without therefore being subsidies in the strict meaning of the word, are similar in character and have the same effect."[8]

Consequently, a measure whereby the public authorities grant a tax exemption to certain undertakings must be seen as a State aid within the meaning of Article 92 of the Treaty: even though such measure does not entail a transfer of public funds from the State to said undertaking, it nonetheless places the beneficiary undertaking in a more favourable financial position than the other, competing undertakings.[9]

Said State aid is, as a rule, incompatible with the common market to the extent that it may affect trade between Member States.

***Bachmann*-like tax benefits constitute State aid which favours locally established insurers to the detriment of non-locally established insurers competing with them in the same Member State**

Even though the tax concessions in dispute in the *Bachmann* case were granted to the policyholders and not to locally established insurers, it is beyond doubt that the effect of such a concession is to distort competition between insurers, since it makes a premium paid to a locally established insurer (much) less expensive in after-tax terms for the policyholder than an identical premium paid by the policyholder to an insurer which does have a local establishment.

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7 Case C-387/92.

8 Judgment, at para 13.

9 See judgment, at para 14.

It is precisely because of the existence of this distortion of competition that the Court held in *Bachmann* that the Belgian tax concessions in dispute imposed a restriction on the free provision of services by foreign insurers in Belgium: if the foreign insurer and the locally established insurer apply the same scale of premium (say 1,000) and the rate of income tax (or corporation tax) applicable to the policyholder (or his employer) is 50%, the net after-tax cost is 500 for the policyholder when dealing with a local insurer, as against 1,000 when dealing with a non-locally established insurer.

In other words, the locally established insurer enjoys, in the aforementioned example, a subsidy of 1,000 in pre-tax terms (equivalent to 500 in tax savings, i.e., the amount of tax "saved" by the policyholder when doing business with a locally established insurer, and concomitantly "lost" by the national tax authorities).

Indeed, the locally established insurer can push up his premium (and hence his profit margin) to 2,000 before the cost thereof, in after-tax terms, for the policyholder equals the cost to the same policyholder of the premium of 1,000 paid to a non-locally established insurer.

That the grant of a tax advantage to the consumer of a given product can have the same effect, in terms of distortion of competition, as an outright subsidy paid to the manufacturer of the said product, has been taken into account by Community law for a long time.

Indeed, Article 92, para 2 of the Treaty, which contains a list of those categories of aid which "shall be compatible with the common market", lists, amongst others, "aid having a social character, granted to individual consumers, **provided that such aid is granted without discrimination related to the origin of the product concerned**".

It is precisely because the economic beneficiary of the aid can be different from the legal beneficiary of the same that Article 92, para 1 of the Treaty, to which we shall turn hereafter, defines (prohibited) State aid **not** by reference to the legal beneficiary thereof but instead by reference to the undertakings which are "**favoured**" by the said aid.

***Bachmann*-like tax concessions constitute State aid which is, as a rule, prohibited, precisely because of the distortion of competition which it creates to the detriment of non-locally established insurers**

As will be recalled, Article 92, para 1 of the Treaty reads as follows:

> "Save as otherwise provided in this Treaty, any aid granted by a Member State or through State resources in **any form whatsoever**, which distorts

> or threatens to distort competition **by favouring certain undertakings** or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the common market."

For the avoidance of doubt, it should be stressed, at the outset, that the aforementioned legal provision applies not only to State aid distorting competition among manufacturers of goods, but also to State aid distorting competition among undertakings active in the services industry. Indeed, the *Banco Exterior* case, as its very name implies, concerned a tax exemption granted by the Kingdom of Spain to a publicly owned **bank**, thus favouring it vis-à-vis private sector banks with which it was competing.

One is therefore led to conclude that the grant of *Bachmann*-like tax benefits comes within the ambit of the general prohibition contained in Article 92, para 1 on the ground that such benefits constitute "aid granted . . . through State resources which distorts, or threatens to distort, competition by favouring [locally established insurers vis-à-vis foreign EC incorporated insurers operating on a cross-border basis in the same Member State]".

True, Article 92, para 1 provides, additionally, that the distortion of competition must affect "trade between Member States" in order for it to be "incompatible with the common market".

However, in the case of aid granted by way of tax benefits to locally resident policyholders when they deal with locally established insurers only, to the exclusion of "foreign" EC insurers operating on **a cross-border basis**, the requirement that "trade between Member States" be affected will always be fulfilled. This is because, as stated by the Court of Justice in *Bachmann*, the relevant tax benefits, by their very nature, "**discourage**" locally resident customers from dealing with non-locally established insurers rather than with locally established insurers.

Distinction between "old aid" and "new aid"

As was recalled by the ECJ in the *Banco Exterior* case, a distinction must be made, for the purpose of Article 92, para 1 of the Treaty, between aid systems which were in force in a Member State at the time when it joined the Community (so-called "old aid"), and aid systems introduced after that date (so-called "new aid").

In terms of Article 93, para 1 of the Treaty, "the Commission shall, in co-operation with Member States, keep under constant review all systems of aid **existing** in the Member States [at the time when they joined the Community, i.e., all "old aid" systems]. It shall propose to [said Member States] any appropriate measures required by the progressive development or by the functioning of the common market."

Furthermore, in terms of Article 93, para 2, "if, after giving notice to the parties concerned . . . the Commission finds that aid granted by a State or through State resources is not compatible with the common market having regard to Article 92, or that such aid is being misused, it shall decide that the State concerned shall abolish or alter such aid within a period of time to be determined by the Commission."

For new aid, however, the position is radically different. Indeed, in terms of Article 93, para 3, "the Commission shall be informed . . . of any **plans** to grant or alter aid. If it considers that any such plan is not compatible with the Common Market having regard to Article 92, it shall without delay initiate the [examination] procedure provided for in para 2. **The Member state concerned shall not put its proposed measures into effect until this procedure has resulted in a final decision.**"

Implications of Article 93, para 3 for *Bachmann*-like tax benefits which Qualify as new Aid. Right of action of aggrieved insurers before the national Courts.

A key difference between the regime of old aid and the regime of new aid lies in the fact that any **proposed** new aid, **even if** it is susceptible of being eventually declared by the Commission to be "compatible with the common market", **must** be notified by the Member State concerned to the Commission **and** may not be put into effect by the said Member State until the examination of the same by the Commission has resulted in a favourable decision on its part.

In its landmark *"Salmon"* judgment of 21st December 1991,[10] the ECJ has given far-reaching practical effect to the prohibition to put into effect "any plans to grant or alter [new] aid" until such time as the said plans have been notified to, and approved by, the Commission.

Namely, the Court held that when new aid is put into effect without regard for this prohibition, any undertaking which is (potentially) prejudiced by the distortion of competition arising as a result thereof may request the competent national courts to annul the illegal aid and order the reimbursement of any sums already paid pursuant to it.

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10 Case 354/90 *Fédération Nationale du Commerce Extérieur des Produits Alimentaires et Syndicat National des Négociants et Transformateurs de Saumon v France*.

Indeed, to quote the Court:

> "National courts must offer to individuals [which invoke the breach of the prohibition contained in the last sentence of Article 93.3] the certain prospect that all necessary inferences will be drawn, in accordance with their national law, as regards the validity of measures giving effect to the aid, the recovery of financial support granted in disregard of that provision and possible interim measures."[11]

General conclusion

In its *Bachmann* judgment, the ECJ has acknowledged that the Belgian tax benefits at issue constitute, amongst others, a restriction on the free provision of services on a cross-border basis in the relevant Member State by EC-incorporated insurers, because they discourage local policyholders from dealing with them rather than with locally established insurers.

In other words, according to the Court, the said tax benefits *favour* locally established insurers to the detriment of non-locally established insurers competing with them in the same Member State.

The Court nonetheless took the view that this restriction was justifiable, in terms of EC law, because, in its opinion, there were no other, less burdensome means to preserve the "coherence" of the Belgian tax regime applicable to life insurance and group insurance contracts.

The question may however be asked whether another approach is not possible when assessing the compatibility of *Bachmann*-like tax benefits with EC law.

Indeed, the finding of the Court in *Bachmann* that the tax benefits at issue result in a competitive advantage for locally established insurers, combined with its ruling in the *Banco Exterior* case that tax concessions qualify as State aid, inevitably imply that *Bachmann*-like tax benefits constitute State aid which is susceptible of affecting trade within the Community by distorting competition between locally established and non-locally established insurers competing within the same Member State.

In terms of the *"Salmon"* judgment of the Court, non-locally established insurers can, if the relevant tax benefits have been introduced by a Member State after it has joined the Community, petition the national courts of the relevant Member State to seek the suspension of the said tax benefits until such time as they have

11 para 12.

been notified to, and approved by, the Commission pursuant to the procedure provided for by Article 92 of the Treaty.

Additionally, the said insurers can lodge a complaint with the Commission.

Should the Commission, in such a scenario, take a decision approving the said aid (which, it is submitted, is unlikely in terms of its earlier practice in the field), the aggrieved insurance companies could attempt to challenge the Commission's decision before the European Court of First Instance . . . and thus reopen, on a new basis, the whole *Bachmann* debate before the judicial authorities of the European Community.

All hopes that a level playing field will eventually be achieved between locally established and non-locally established insurers in a *Bachmann* like situation should thus not be given up yet.