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Spain: Does the sun attract unforeseen tax consequences? New obstacles to tax-neutral insurance portability within the EU

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It is a well-known fact that thousands of European citizens – British, German, Danish, Swedish, among others – choose Spain as their retirement destination, attracted by our weather and the quality of our medical services, after a long working life during which they have managed to amass the savings needed to do so.

In many cases, these savings take the form of life insurance/bonds, pension plans and similar products.

Well, this group of people may be hit by a recent ruling from the Directorate General of Taxes (DGT), the Ministry of Finance body charged with interpreting Spanish tax legislation.

Before commenting on the interpretation made by the DGT, let's briefly clarify the tax treatment of life insurance products in Spain.

Privately-purchased life insurance (that is, assurance) products are savings products that yield finance income, taxed in accordance with a progressive rate of up to 27%.

Compared to other "competitive" products, particularly deposits, the main tax advantage of "traditional" life insurance – that is, products in which the financial risk/return is guaranteed by the insurer – is that taxpayers are not taxed before they collect the correspondent benefit (in the form of a lump sum or annuity).

By contrast, in the case of unit-linked products – that is, products in which the financial risk/return is not guaranteed by the insurer – the default timing-of-recognition rule is that taxation on accumulated income is not deferred.

This rule, however, has two exceptions which are defined according to the policyholder's ability to modify the underlying investments and their categorisation, as described in Table 1.

Table 1

	Ability to modify underlying investments	**Categories of underlying investment**
Type A	No	Admitted assets according to applicable regulatory legislation
Type B	Yes	Admitted assets according to Spanish regulatory legislation (except real estate)

In the case of both Type A and B products, the legislation states that "the conditions described in this paragraph h) must be met throughout the term of the contract".

As can be seen, this set-up can be characterised as an anti-abuse regime, as is shown by the fact that, in the DGT's own words (in ruling V2366-08), the purpose of the special timing-of-recognition rule is to prevent taxpayers from enjoying "private portfolio management" through this type of instrument without being taxed accordingly.

Having clarified the tax treatment of life insurance products, we can now make sense of Ruling V0400-13 by the DGT on February 11 2013.

The ruling begins by setting out the following background facts:

"Background facts: The entity requesting the ruling is an insurance undertaking tax resident in the Republic of Ireland and operating in the UK under the freedom to provide services. It has sold single-premium unit-linked insurance products in which the policyholder bears the risks associated with the assets in which the mathematical provision is invested, to policyholders who are UK tax residents. The mathematical provisions for these products were invested in a broader range of assets than those permitted by Spanish legislation, as permitted by British regulatory rules. The entity requesting the ruling does not rule out the possibility that policyholders might change their tax residence in the future to another EU country, like Spain for instance. In such a case, it is proposed to adapt insurance policies so that the assets in which the mathematical provisions are invested are thereafter compliant with Spanish legislation.

Issue on which the ruling is requested: Can it be construed that the requirement that the conditions provided for in paragraph h) of article 14.2 of Law 35/2006 be met throughout the term of the contract applies (only) from the moment in which the policyholder becomes tax resident in Spain? If so, various amendments to the policy are proposed so that it complies with the provisions in letter B) of that article."

The DGT's ruling could hardly be clearer:

"According to the provisions of article 14.2.h) mentioned above, in order for the special timing-of-recognition rule not to apply, the conditions established therein must be met throughout the term of insurance contracts of this type, that is, from the moment they are entered into until the moment they come to an end.

Thus, in the specific case at hand, it must be construed that the conditions referred to in article 14.2.h) of Law 35/2006 have not been met throughout the term of the contract and that, therefore, the special timing-of-recognition rule established therein will apply to policyholders who become tax resident in Spain. And this is irrespective of whether amendments are made to the policy conditions because of the change in tax residence in an attempt to bring the assets into which the mathematical provisions are invested into line with Spanish legislation."

To sum up, according to the DGT's stance, unless it is a chance occurrence, no foreign citizen holding a unit-linked insurance policy and relocating to Spain can qualify for the tax deferral regime provided for products of this type, simply by virtue of the fact that he/she purchased the contract abroad; that is, merely by virtue of his/her having purchased an insurance product which, by no stretch of the imagination – except, as mentioned, by sheer chance –, could be made to fit within the scope of the anti-abuse rule established in Spanish legislation for unit-linked products. Worse still, the foreign citizen is left without any opportunity to somehow correct this self-evident lack of conformity with Spanish legislation.

Unless this interpretation is overturned or corrected by another DGT ruling, it cannot be directly challenged under Spanish legislation. The only recourse that foreign taxpayers will have is to appeal against any tax assessments relying on this ruling.