THE DANNER CASE AND THE TAX TREATMENT OF FOREIGN PENSION INSURANCE SCHEMES

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1 Introduction

The details of the pension insurance schemes available in different Member States as well as the tax treatment of them may be very different. Many states encourage pension insurance saving with special tax incentives. Often, either pension insurance premiums paid by an insured taxpayer are tax deductible or the future pension payments are tax-exempt.

The differences in the tax treatment of pension insurances may create problems when insured taxpayers move from one country to another. A taxpayer who paid non-deductible premiums in a country which would exempt the future pension payments, may move before retirement to a country in which pension payments are taxable and pension premiums deductible. The tax burden of the taxpayer thus becomes higher, because he moved from one country to another, than it would have been if he had lived in only one of the countries. On the other hand a taxpayer may also enjoy a double benefit by moving from one country to another. A taxpayer, who has benefited from the tax deductibility of pension insurance premiums in one country, may later move to a country which exempts income from voluntary pension insurances.

The possibility of enjoying a double benefit by moving from one country to another generally goes beyond the purpose of the different states to encourage pension insurance saving. For example, the tax deductibility of insurance premiums is based in many countries on the assumption that the related pension

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will later be taxed in the same state. The idea is not to give a total tax exemption. Instead, the idea of the tax-deductibility of the insurance premiums is to encourage pension insurance saving by shifting a part of the tax burden of the active life time of the taxpayer to the time after his retirement. It is, therefore, understandable that the tax systems of many states include rules that limit the tax benefits in a cross-border situation. Depending on the national system, a pension premium paid within a foreign pension insurance scheme may not be deductible or pension payments based on a foreign insurance may not be tax-exempt, despite the fact that similar payments within domestic schemes would be respectively deductible or tax-exempt.

Even though the different tax treatment of pure domestic pension insurance schemes and foreign insurance schemes is understandable from a fiscal point of view, it is very questionable from the EC law perspective. The different treatment of domestic and cross-border pension insurance premiums and pension payments may conflict with the EC Treaty. This problem was dealt with in the judgment of the European Court of 3rd October 2002 in the so-called *Danner Case*[2].

The judgment was given as an answer to a question asked by the Administrative Court of Kuopio (Finland)[3] concerning the tax deductibility of pension insurance premiums. The question was, whether the restriction in the Finnish Income Tax Act ('TVL') paragraph 96(6) on the right to deduct for tax purposes pension insurance contributions paid by a Finnish resident to a foreign institution is contrary to article 49 of the EC Treaty (freedom to provide services), or to other articles of the EC Treaty (articles 12, 50, 56, 58 and 87).

As expected, the European Court found the type of tax provisions included in the Finnish domestic tax law that involve different treatment of pension insurance premiums paid within Finnish and foreign insurance schemes to be contrary to the EC Treaty. According to the Court, Article 49 of the Treaty is to be interpreted as precluding a Member State's tax legislation from restricting or disallowing the deductibility for income tax purposes of contributions to voluntary pension schemes paid to pension providers in other Member States, while allowing such contributions to be deducted when they are paid to institutions in the first-mentioned Member State, if that legislation does not at the same time preclude taxation of the pensions paid by the above-mentioned pension providers.

2 (C-136/00).

3 *Kuopion Hallinto-Oikeus*.

2 The Facts of the Danner Case

The *Danner Case* concerned a doctor with both German and Finnish nationality who lived and worked in Germany until 1977 when he moved to Finland. After moving to Finland Mr. Danner continued to pay pension insurance contributions to two German schemes[4] and began to pay contributions also to a Finnish institution. A major part of the contributions that were paid under the German schemes was regarded as non-deductible for Finnish income tax purposes. Mr. Danner, therefore, submitted that the Finnish rules that preclude or limit the deductibility of contributions for a voluntary pension insurance taken out with a foreign insurance institution are contrary to Community law.

3 The Finnish Provisions on the Deductibility of Pension Insurance Contributions

Pension insurance contributions to certain compulsory or statutory schemes are fully deductible from taxable income under section 96(1) TVL. The rule is regarded as applying also to contributions to analogous foreign schemes. Contributions to voluntary pension insurance schemes, instead, are subject to different treatment depending on whether the insurance is from a Finnish or foreign insurance institution.

Contributions to voluntary pension schemes run by Finnish insurance institutions are, under certain conditions and within certain limits, either fully or partially deductible under paragraphs 96(2) to 96(6) of the TVL. A full deduction of contributions is, for example, allowed within a limit of €8,500 if the pension is payable as an old age pension at the earliest when the insured reaches the age of 58 and the insured can prove that his theoretical pension cover does not exceed a certain percentage of his income.

Until 1996 the rules applied without distinction to contributions to both Finnish and foreign insurance institutions. TVL paragraph 96(9) (after revision TVL paragraph 96(10)) now excludes the deductibility of contributions for voluntary pension insurance taken out with a foreign insurance institution. Contributions to a foreign pension insurance institution are deductible only if:

- The insurance is granted by a permanent establishment of a foreign insurance institution located in Finland, or

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4 One of them was a general pension insurance scheme that is in principle compulsory for all employees employed in Germany. The other one was a supplementary pension insurance scheme set up by a professional organisation of doctors.

- The taxpayer has moved to Finland from abroad and was not subject to unlimited tax liability in Finland during the five years preceding the removal.

In the latter case the contributions are deductible in the year of removal and the following three years.

TVL paragraph 96(9) is subject to transitional provisions. For the tax years 1996 and 1997 contributions for voluntary pension insurance taken out with foreign institutions before 1st September 1995 were deductible under the provisions that were in force in 1995, but only up to FIM 15,000 (€2,523) a year. Payments made within an insurance policy taken out before 1st October 1992 are deductible up to 10% of the net annual salary of the insured up to a ceiling of €8,500. Contributions to Finnish institutions are not subject to similar ceilings.[5]

The enactment of TVL paragraph 96(9) was based on the argument that it was necessary to prohibit the deduction of contributions to foreign voluntary pension insurances because the pension to be received would in practice often be excluded from taxation in Finland. The pension would not be taxed, either because the recipient had moved abroad or because of lack of information about the foreign source pension payments. The idea was that the tax regime concerning voluntary pension insurances would form a coherent whole in which the deductibility of pension insurance contributions was based on the assumption that at a later stage the related pension benefits would be subject to tax. The different treatment of foreign and Finnish schemes was regarded to be justified because it is impossible to ensure that pensions provided by foreign institutions would be taxed in Finland or to verify that they meet the various conditions for deductibility.[6]

4 The Freedom to Provide Services

4.1 Scope of Article 49

Article 49 of the EC Treaty protects the freedom to provide services. It protects both the provider of services and the purchaser of services. The provider has the right to enter the market of another Member State and to be treated in the same manner as a national there. The purchaser has the right to go to any Member State, to receive services there and to get national treatment there.[7]

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5 TVL § 143(5).

6 See HE 76/1995 (The Government proposal for Amending TVL § 96).

7 See for example Case C-55/98 Vestergraad [1999] ECR I-7641.

The provisions on the freedom to provide services generally apply to services that are normally provided for remuneration, i.e. for a consideration for the service in question.[8] An example may be an insurance contribution, like in the *Danner Case*, that is related to the future pension of the payer of the contribution. Services provided by private pension providers are clearly within the scope of article 49.[9]

4.2 Restriction on the Freedom to Provide Services

According to TVL paragraph 96, contributions for voluntary pension insurance taken out with a foreign insurance institution are not deductible unlike similar contributions to Finnish institutions. This different treatment clearly constitutes a restriction on the freedom to provide services. TVL paragraph 96 has the effect of making the provision of pension insurance services between Member States more difficult than the provision of such services purely within one Member State.[10]

The availability of fiscal advantages is one of the most important factors in an individual's choice of a pension insurance institution. In practice, no Finnish resident wishes to take out insurance with a foreign institution without a permanent establishment in Finland. TVL paragraph 96 basically hinders Finnish resident individuals from taking out voluntary pension insurance with foreign institutions and foreign institutions from offering their services on the Finnish market.[11] The refusal to allow the deduction of contributions for pension insurance taken out with foreign institutions discriminates on grounds of nationality against foreign insurance providers.

4.3 Grounds of Justification for the Restrictions

4.3.1 Introduction

A measure restricting freedom to provide services may be justified either on the basis of a ground expressly provided for by the EC Treaty[12] or on

8 Article 50 of the EC Treaty, Case 263/86 Belgian State v Humbel [1988] ECR 5365, paragraph 17 and Case C-157/99 Geraets-Smits and Peerbooms [2001] ECR I-5473, paragraph 58.

9 See Case C-118/96 Safir [1998] ECR I-1897, paragraph 22.

10 See for example Case C-381/93 Commission v France [1994] ECR I-5145, paragraph 17.

11 See for example Case C-118/96 Safir [1998] ECR I-1897, paragraph 30.

12 e.g. Articles 45 and 46 that are applicable pursuant to Article 55.

the basis of other grounds that have been recognized by the European Court and have been accepted by it as overriding requirements in the general interest. It is, however, somewhat unclear as to what is the relevance of the type of grounds that are not expressly mentioned in the EC Treaty in a case of overt and direct discrimination.

Some cases of the European Court seem to indicate that national rules that discriminate as regards the origin of the service in question are compatible with Community law only if they fall under the scope of an express exemption in the EC Treaty. For example in the *Royal Bank of Scotland Case*, which involved direct and overt discrimination on grounds of nationality in the field of freedom of establishment, the Court refused to examine those grounds of justification that were not expressly mentioned in the Treaty.[13] The same approach was adopted in the *Ciola Case*.[14]

In some other cases the Court has examined grounds of justification not expressly mentioned in the Treaty. The Court has referred to a difference in treatment that may be justified on grounds not mentioned in the Treaty.[15] The *Bachmann Case*[16] and *Commission v Belgium*[17] are examples of cases where the measures at issue were regarded to be justified by the need to preserve the coherence of the Belgian tax system. As Advocate General Jacobs mentioned in his opinion in the *Danner Case*, there may be general interest aims not expressly provided for in the EC Treaty (e.g. protection of the environment, consumer protection) that may be no less legitimate and no less powerful than those mentioned in the Treaty.[18]

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13 Case C-311/97 [1999] ECR I-2451, paragraph 32.

14 Case C-224/97 [1999] ECR I-2517, paragraph 16.

15 See Case C-200/98 X and Y [1999] ECR I-8261, paragraph 28, Case C-55/98 Vestergaard [1999] ECR I-7641, paragraph 22 and Case C-294/97 Eurowings [1999] ECR I-7447, paragraph 36.

16 C-204/90 [1992] ECR I-249.

17 C-300/90 [1992] ECR I-305.

18 See Opinion of Advocate General Jacobs 21.3.2002, paragraph 40.

4.3.2 The Need to Preserve the Coherence of the Finnish Tax System

In the *Bachmann Case*[19] and *Commission v Belgium*[20] the European Court accepted that restricting the deductibility of contributions paid to foreign institutions may be justified by the need to preserve the fiscal coherence of the tax system. The judgments were based on the assumption that there was a direct connection between the deductibility of contributions and the taxability of sums paid by the insurers under insurance contracts.[21] The Member States, thus, may rely on the need to preserve fiscal coherence only if there is a direct link between any fiscal advantage and a corresponding disadvantage. Further, there are no subsequent cases where the European Court would have allowed a Member State to rely on fiscal coherence.

In the Finnish tax system there is a certain connection between the deductibility of voluntary pension insurance contributions and the tax liability of the pensions paid by the insurers. The loss of revenue resulting from the deduction of contributions is in principle offset by the taxation of pensions at a later stage. There is, however, no similar direct link between the deductibility of contributions and the taxation of pensions under the Finnish tax system as under the Belgian system.

Under the Finnish tax system the pensions that will be paid by foreign insurance companies to Finnish residents will be taxed, independently of whether the contributions paid to those companies were deductible. If Mr. Danner stays in Finland, the pensions he will receive from the two German schemes will be subject to Finnish income tax despite the fact that he would not have been allowed to deduct the contributions paid to those schemes. The need to preserve fiscal coherence, thus, is not a sufficient reason for justification of the different treatment.[22] In order for the Finnish domestic law system to form a coherent whole, pensions related to premiums that have not been deductible should be tax-exempt

19 C-204/90 [1992] ECR I-249.

20 C-300/90 [1992] ECR I-305.

21 Under the Belgian system the loss of revenue resulting from the deduction of insurance contributions was offset by the taxation of pensions, annuities or capital sums payable by the insurers. If the contributions had not been deducted the sums payable by the insurers were tax-exempt.

22 See paragraph 48 of the Opinion of Advocate General Jacobs 21.3.2002 and paragraph 38 of the Judgment of 3 October 2002 on the Danner Case.

and pensions related to premiums that have been deductible should be taxable.

The fact that Finland has agreed on the tax treatment of pensions in a tax treaty with Germany must also be taken into account. In the *Wielockx Case*[23] the European Court stated that:

> 'The effect of double-taxation conventions which... ...follow the OECD Model is that the State taxes all pensions received by residents in its territory, whatever the State in which the contributions were paid, but conversely waives the right to tax pensions received abroad even if they derive from contributions paid in its territory which it treated as deductible. Fiscal cohesion has not therefore been established in relation to one and the same person by a strict correlation between the deductibility of contributions and the taxation of pensions but is shifted to another level, that of the reciprocity of the rules applicable in the Contracting States. Since fiscal cohesion is secured by a bilateral convention concluded with another Member State, that principle may not be invoked to justify the refusal of a deduction such as that in issue.'[24]

The fiscal coherence of the tax treatment of cross-border pensions between Germany and Finland is secured by an income tax treaty between Germany and Finland in the same way as in the *Wielockx Case*.[25] According to article 18(2) of the treaty, benefits that a resident of a contracting state receives under the social security legislation of the other contracting state are exempt from tax in the recipient's state of residence. Pensions paid under voluntary insurance contracts, instead, fall under article 21 of the treaty and are taxable only in the recipient's state of residence. By concluding the convention with Germany, Finland has waived its right to tax pensions paid by Finnish voluntary pension insurance companies to German resident recipients whereas Finland may tax all the pensions based by voluntary schemes received by Finnish residents. Benefits received under the social security legislation of the other contracting state, instead, are exempt from tax in the recipient's state of residence.

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23 Case C-80/94 [1995] ECR I-2493.

24 See Paragraphs 24 and 25 of the Judgment. See also Paragraph 41 of the Judgment of 3 October 2002 on the Danner Case.

25 Convention for the avoidance of double taxation on income and capital of 5 July 1979.

Based on the *Wielockx Case*, even though there would be a direct relation between the deductibility of premiums and the taxability of pensions under Finnish domestic tax law as described above, it would not justify a restriction to the freedom to provide services in a situation where a tax treaty corresponding to the OECD Model is applicable. Because of the tax treaty it may not be claimed that a tax system is coherent in the way that a pension payment is always taxable if the premium was deductible and that the pension is tax-exempt if the premium was not deductible. Because of the tax treaty Finland exempts pensions related to the social security legislation of Germany no matter whether the premiums were deductible or not.

4.3.3 The Need to Ensure the Effectiveness of Fiscal Supervision and to Prevent Tax Evasion

It may be argued that the refusal to allow deduction of contributions to schemes operated by foreign insurance institutions should be justified by the need to ensure the effectiveness of fiscal supervision and to prevent tax evasion. It is difficult to verify whether the foreign schemes meet the various conditions for deductibility under the domestic law provisions. Similarly, it is difficult to monitor and tax effectively the payment of pension or other benefits from foreign schemes to residents. However, in any case the principle of proportionality must be taken into account. It is possible to attain the objectives of ensuring the effectiveness of fiscal controls and preventing tax evasion by means much less restrictive than a general refusal of deductibility for all contributions to foreign insurance institutions.[26]

A Member State may invoke the Mutual Assistance Directive[27] in order to check whether payments have been made in another Member State. The authorities of a Member State may invoke the Directive in order to obtain from the competent authorities of another Member State all the information that is necessary to determine the correct amount of income tax payable by a taxpayer in relation to the legislation that they have to apply.[28] The tax authorities may also require the taxpayer to provide proof of the payment of the contributions and of the conditions of the

26 See Paragraph 62 of the opinion of Advocate General Jacobs 21.3.2002.

27 Council Directive 77/799/EEC of 19 December 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation OJ 1977 L 336, p. 15.

28 See Case C-55/98 Vestergaard [1999] ECR I-7641, paragraph 28 and paragraph 49 of the Judgment of 3 October 2002 on the Danner Case.

pension insurance and deny the deduction where proof is not provided.[29] The difficulty in obtaining information does not justify the non-deductibility of pension insurance contributions paid to foreign institutions.[30]

In the *Bachmann Case* and *Commission v Belgium* the European Court accepted that the measures concerned were proportionate because it was not possible to ensure the coherence of the Belgian system by less restrictive measures. The Finnish provisions, however, do not constitute only a measure to ensure effective control of cross-border insurance provision, but in fact exclude cross-border provision of services altogether on the assumption that no effective control is possible. A less restrictive means should be applied.[31] Consequently, the Finnish rules cannot be justified by the need to ensure effective fiscal supervision or to prevent tax evasion.

4.3.4 The Need to Preserve the Integrity of the Tax Base

It may be argued that the restriction of the right to deduct contributions paid to foreign institutions should be justified because of the need to preserve the integrity of the tax base. However, the need to ensure the integrity of the tax base has not been accepted as a legitimate ground of justification. The European Court has held that preventing a reduction of tax revenue is not one of the grounds listed in article 46 of the EC Treaty and cannot be regarded as an overriding requirement in the general interest.[32]

5 Conclusions

5.1 Relevance of the Danner Judgment

In conclusion it is clear that the Finnish tax treatment of voluntary pension insurances, the same way as the treatment in many other countries, restrict the freedom to provide services. In the case of the Finnish rules there are no

29 See paragraph 50 of the Judgment of 3 October 2002 on the Danner Case.

30 See Case C-204/90 Bachmann [1992] ECR I-249, paragraphs 18 to 20.

31 See paragraph 51 of the Judgment of 3 October 2002 on the Danner Case.

32 Case C-307/97 St Gobain [1999] ECR I-6161, paragraph 51.

sufficient grounds that would make the restrictions justified and in any case less restrictive provisions should be possible. The same conclusion may have to be made with respect to the tax treatment of voluntary pension insurances in other countries. However, depending on the details of a specific tax system, certain rules that restrict the freedom to provide services may be found justified.

The judgment in the *Danner Case* does not rule out the possibility that the need to preserve the coherence of a tax system may justify a restrictive treatment. In fact, the judgment expressly seems to leave room for this possibility. This conclusion may be made from the last sentence of the judgment. According to the judgment, the Finnish domestic law type of restrictions conflict with article 49 of the EC Treaty 'if that legislation does not at the same time preclude taxation of the pensions paid by the abovementioned pension providers'.[33] This last sentence must be interpreted as meaning that if there is a direct connection, like in the *Bachmann Case*[34], between the deductibility/non-deductibility of voluntary pension insurance contributions and the taxability/tax-exemption of pensions based on voluntary pension insurances, different treatment may be justified.

The judgment in *Danner*, however, should not be interpreted as replying that a denial of a deduction with respect to a foreign insurance would be justified in any case, if the pensions based on the same insurance would later be tax-exempt. The fact, whether the tax-exemption of pensions is relevant with respect to the non-deductibility of the contributions, depends on whether the direct connection between the deductibility and taxability is a coherent part of the tax system as a whole. A comparison must be made to the treatment of a pure domestic situation. In order for the system to be coherent the same treatment should apply to cross-border situations and domestic situations. A system where pensions are taxable only if the related premiums were deductible and pensions are tax-exempt if the related premiums were not deductible both in cross-border situations and in pure domestic situations may be accepted. The requirements for a system to be coherent in the way that a restrictive treatment is justified, however, seem to be quite strict.

In a situation where there is a tax treaty between the two Member States involved, the fact that a tax system of a state would be coherent from the perspective of the national legislation alone is not sufficient. As concluded in the *Wielockx Case*[35] in a tax treaty situation fiscal cohesion is not anymore

33 This last sentence was not included in the Opinion of Advocate General Jacobs 21.3.2002.

34 C-204/90 [1992] ECR I-249.

35 Case C-80/94 [1995] ECR I-2493.

established in relation to one and the same person by a strict correlation between the deductibility of contributions and the taxation of pensions but is shifted to another level, that of the reciprocity of the rules applicable in the two contracting states. If fiscal cohesion is secured by a tax treaty, that principle may not be invoked to justify the refusal of a deduction.[36]

The effect of tax treaties that follow the OECD Model is that a state may tax all pensions received by residents in its territory, whatever the state in which the contributions were paid. Conversely, the state waives the right to tax pensions received abroad even if they derive from contributions paid in its territory which it treated as deductible. Therefore, in a tax treaty situation the fact that there would be a direct connection between non-deductibility of contributions and taxability of pensions under pure domestic law of one country, normally does not justify the non-deductibility of foreign payments.

Basically it is rather only in a non-treaty situation where the deductibility/non-deductibility of voluntary pension insurance contributions and the taxability/tax-exemption of pensions based on voluntary pension insurances may form such a coherent system that a different treatment may be justified. Because of the quite extensive treaty-network among the Member States, this possibility has very limited relevance in practice. In a tax treaty situation it may be imagined that a sufficient coherence could exist basically only if the applicable tax treaty is different from the OECD Model. A pension article of a tax treaty could be formulated in the way that the coherence established under the tax treaty, taking into account the domestic law provisions of the contracting parties, requires the non-deductibility.

5.2 Proposed Amendments to the Finnish Tax System

It is proposed in Finland, by a committee set up by the Ministry of Finance for a reform of the Finnish tax system in November 2002, that the Finnish tax rules on voluntary pension insurances would be amended. The proposed amendments are based partly on the outcome of the *Danner Case* and partly on pure domestic tax policy reasons.

In order to comply with the EC Treaty, the same rules would apply to insurances taken out in Finland or in other Member States. Insurance premiums paid to foreign insurance providers would be deductible in Finland for a Finnish resident taxpayer under the same conditions as premiums paid to domestic insurance providers. It is, however, proposed that insurance premiums would be deductible

36 See Paragraphs 24 and 25 of the Judgment. See also Paragraph 41 of the Judgment of 3 October 2002 on the Danner Case.

only if the insurance provider has agreed to provide all the information to the Finnish tax authorities, which is relevant for determining whether a premium is deductible or not. The agreement to provide information should be included in the insurance contract.

The requirement of the agreement of the insurance provider to provide information basically applies to Finnish and foreign insurance providers alike. In practice, however, it is clear that such an agreement will be included in all contracts made with Finnish insurance providers and may be lacking in the contracts made with foreign insurance providers. Therefore, a better or clearer option could be to make the deductibility dependent on the fact that the taxpayer himself provides the tax authorities with sufficient information. In any case, even though the deductibility would depend on the insurance provider's agreement to provide information and even though there would be no such agreement, the taxpayer should be entitled to the deduction if he himself provides the information.

The problem of the possible loss of tax revenues in the case of emigration of a taxpayer was tackled by the committee by reducing the tax benefit of the insurance premium deduction to correspond to the 25% flat tax rate instead of the high progressive rates. Voluntary pension insurance premiums and pension payments based on voluntary insurances would be treated as a part of the Finnish tax rules concerning investment income and not earned income as presently. This amendment would decrease the relevance of the tax-deductibility of insurance premiums for taxpayers with high income, because the tax benefit would then correspond to the proposed 25% flat rate tax and not the very high Finnish progressive tax rates on earned income.

Alternatively the possible loss of tax revenues could be tackled by implementing certain exit-tax-type provisions in the domestic law. The deduction of the insurance premiums could for example be recaptured if the taxpayer moves abroad. The committee, however, did not deal with this possibility. The EC tax compatibility of this kind of exit-tax-type treatment is also far from self-evident.

5.3 Need for Harmonisation

Finally, it is worth noting that investment in a foreign insurance scheme may in fact lead to a higher tax burden than an investment in a domestic one, even though a tax system would be coherent, that a non-deductibility of contributions paid to a foreign insurance provider would be accepted because the future pension income from the same insurance would be tax-exempt. If for example the insured person moves abroad to a third country, which does not exempt pension income from voluntary pension insurances, the pension will be taxed even though the contributions would have been non-deductible. Abolishing this problem would require the harmonisation of the tax treatment of voluntary pension insurances in different Member States.