

Surety Insurance

## Hard times for surety insurance – Insurance tax liability in surety reinsurance and its consequences

### 1. INTRODUCTION

In the past, surety reinsurance contracts were not subject to insurance tax. The fiscal authority changed this practice exerted for decades – by now confirmed by the Federal Court of Finance (“BFH”).<sup>1</sup> The amended taxation practice has impacts on the insurance industry and the policy holding industry.

### 2. SURETY INSURANCE

Companies often agree with their customers (buyer/purchaser) to secure the risk of the own ability (of the company) to perform. Securities in this meaning are guarantees, deposits, guarantee promises and other liability declarations (so-called sureties). Companies may insure the risk of not being able to perform towards their own customers (buyer/purchaser) via surety insurance in favor of the customer. The policy holder (the company) and the surety insurer agree that the insurer provides the securities the policy holder has to provide to its customer.

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<sup>1</sup> Cf. About amendment of taxation practice *BMF*, document about insurance tax, insurance tax liability of insurance premium for so-called surety reinsurance of 17 July 2007 (Federal Tax Gazette “BStBl.” I p. 570) effective per 1 August 2008; Federal Court of Finance „BFH”, judgment of 19 June 2013, File II R 26/11, German Taxation Directive „DStR” 2013, 1730.

If the policy holder fails to perform, the security provides that the customer receives the performance owed by the company – thus e.g. the completion of a plant or the repair of a defect at the ordered item. From the policy holder's point of view, the surety insurance implies that the policy holder receives the return from the customer independent of its own ability to perform.<sup>2</sup>

Surety insurance in its original form implies economic advantages for the companies as policy holders. Surety insurance offers competitive and cheaper conditions than a bank guarantee. It may offer additional liquidity to the company because it avoids to burden the credit line at the house bank with the guarantee volume.

### 3. SURETY REINSURANCE

If the policy holder is economically not able to render the service to the customer, the surety insurer has to perform based on the security. As soon as the surety insurer has performed, he can take recourse towards the policy holder. This is a particularity of the surety insurance. The surety reinsurer secures the risk of the surety insurer as direct insurer to fail with the right of recourse towards its policy holder. The reinsurer thus covers the loss the direct insurer suffers.

### 4. THE PROBLEM OF INSURANCE TAX

#### 4.1 Starting point: Insurance tax in insurance relationship

The Insurance Tax Act stipulates that insurance relationships are principally subject to taxation. The insurance tax is based on the payment of an insurance premium for an insurance relationship (cf. sec. 1 para. 1 and sec. 2 para. 1 Insurance Tax Act).

#### 4.2 No insurance tax liability of surety insurances

The law excludes specific insurance relationships from taxation. Sec. 2 para. 2 Insurance Tax Act determines:

*„An insurance contract under which the insurer undertakes to provide suretyship or other security for the policyholder shall not be deemed to constitute an insurance contract.“*

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<sup>2</sup> Cf. for example presentation by *Rind/Wendt*, Insurance Law „VersR“ 2008, 1601.

Such exemption applies for surety insurance. The surety insurer secures the interest of the policy holder's purchasers or customers in the policy holder's ability to perform, especially by guarantee.<sup>3</sup> Thus, the surety insurance is not treated as an insurance with regard to the insurance tax. For this reason, the insurance fee – thus in particular premium payments – by the policy holder to the surety insurer are not subject to insurance tax.

#### 4.3 Problem: Insurance tax liability of surety reinsurers

According to the financial authority and the Federal Court of Finance ("BFH"), this does not apply for surety reinsurance.

##### 4.3.1 Contrary to surety insurances, surety reinsurances are not excluded from tax liability

According to the BFH, surety reinsurances do – other than surety insurances – not fall within the scope of the exemption of sec. 2 para. 2 Insurance Tax Act. The requirements of the exemption are not fulfilled. Other than required by sec. 2 para. 2 Insurance Tax Act, the surety reinsurer does not oblige himself *towards the policy holder* of the direct insurer to make guarantees. Surety reinsurance contracts were thus not excluded from taxability.<sup>4</sup>

##### 4.3.2 Principle – Reinsurance contracts are exempted from insurance tax

Reinsurance contracts are insurance relationships in the meaning of sec. 1 para. 1 Insurance Tax Act. The Insurance Tax Act does though provide for a tax exemption for reinsurance contracts. The payment of insurance premiums for the reinsurance is exempt from taxation (sec. 4 No. 1 Insurance Tax Act).

##### 4.3.3 Federal Court of Finance "BFH": Surety reinsurance is no reinsurance in the meaning of insurance tax law – insurance premiums are therefore exempt from taxation

As reinsurance, the surety reinsurance is exempt from taxation – one should think. The financial authority and the Federal Court of Finance are of a different opinion. The Fed-

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<sup>3</sup> Cf. *Rind/Wendt*, reference as above 1603, 1604.

<sup>4</sup> *BFH*, reference as above (FN 1), note 23.

eral Court of Finance decided that the payment of premiums for a surety reinsurance are subject to taxation. The surety reinsurance contract would accordingly be

*„no reinsurance exempt from taxation, but a direct insurance subject to taxation.“<sup>5</sup>*

#### 4.3.3.1 Interpretation of the BFH pursuant to the wording of the law

The Insurance Tax Act does not define the term reinsurance. The BFH distinguishes a classification of surety reinsurance in terms of *insurance law* and in terms of *insurance tax law*. The understanding of surety reinsurance pursuant to insurance tax law would therefore be decisive.<sup>6</sup>

The BFH correctly held that reinsurance conceptually requires a *different insurance* since the reinsurer covers specific risks of the direct insurer. According to the BFH, a reinsurance is only a direct insurance in the meaning of sec. 4 No. 1 Insurance Tax Act, if the reinsurance insures the risk from *a different taxable insurance*. Surety insurance as direct insurance would in itself not be taxable. It would rather (in terms of tax law) not be deemed as insurance (according to sec. 2 para. 2 VerStG, mentioned above 4.2). If no direct insurance exists, there can be no reinsurance – so the idea of the BFH.

A „characteristic feature of the reinsurance in terms of sec. 4 No. 1 Insurance Tax Act“ would be missing. The surety reinsurance would thus be no reinsurance in the meaning of sec. 4 No. 1 Insurance Tax Act and therefore not exempt from insurance tax.

#### 4.3.3.2 Interpretation of the BFH in terms of intent and purpose and history of the law

According to the BFH, the tax exemption of reinsurances has the (sole) purpose to avoid a double burden with insurance tax. If the direct insurance is subject to taxation, no (double) burden by taxation of the reinsurance shall incur. The surety insurance as direct insurance was not taxable according to sec. 2 para. 2 Insurance Tax Act. Thus, no double burden would arise if the surety insurance was taxable.

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<sup>5</sup> BFH, reference as above, note 34.

<sup>6</sup> BFH, reference as above, note 13, 15, 22, 27.

#### 4.3.4 Critical review of BFH's view

In legal terms, BFH's view and the respective taxation practice do not convince for the reasons presented in the following.

##### 4.3.4.1 Wording of the law does not speak for tax liability of surety reinsurance

Other than the argumentation of the BFH might suggest, the wording of the Insurance Tax Act does not provide clarification about the question whether surety reinsurance is a reinsurance in terms of tax exemption according to sec. 4 No. 1 Insurance Tax Act or not – also not in case of an understanding pursuant to insurance tax law.

The BFH confirms correctly that surety reinsurance is reinsurance in terms of insurance law. The principle of the unity of the legal system implies that tax law means reinsurance (in general insurance law terms) when it speaks of reinsurance. The BFH only argues that the fact that surety reinsurance is reinsurance in terms of insurance law is not sufficient for the assumption that surety reinsurance is also reinsurance in terms of insurance tax law. The court does not further explain why the term reinsurance according to *the wording of the Insurance Tax Act* should have a different meaning than the general insurance law meaning. The Insurance Tax Act does not conceptually clarify that it has an (own) deviating understanding of the term "reinsurance". The Insurance Tax Act does not provide for any characteristic feature with the meaning: "*reinsurance is only classified as reinsurance if the direct insurance secured is taxable*".

The wording of the law is not unambiguous. It does though not speak for BFH's understanding of the term "reinsurance".

##### 4.3.4.2 Systematic speaks against tax liability of surety reinsurance

According to the BFH, surety reinsurance is liable to tax since surety insurance is *no direct insurance liable to tax* (cf. above 4.2).

Principally, every direct insurance is liable to tax. The legislator though did not want to impose a tax on surety insurance. In order to avoid tax liability, the law stipulates, that surety insurance is no insurance (sec. 2 para. 2 Insurance Tax Act). This provision is a regulatory fiction. This means that the law treats two things equally though it is clear that they are not the same. The law in a way pretends that surety insurance is in fact no insurance ("*is considered not to be an insurance*"). The argumentation of the Federal Court of Finance is based on the fiction described. In other words: A *taxable* direct in-

insurance is not existent only due to the fiction, thus because the law pretends the surety insurance was no insurance. The legislator created this fiction with the target to exclude the surety insurance from tax. He did though not create it to provide the possibility to treat surety reinsurance differently in terms of tax compared with any other reinsurance – with the argument that a direct insurance was missing. The systematic and the purpose of the fiction (no taxation of surety insurance) are opposed to the view of the Federal Court of Finance.

Systematically, the following regulation of the Insurance Tax Act speaks against a tax liability of surety reinsurance.

According to sec. 7 para. 1 Insurance Tax Act, the debtor is the *policy holder*. Policy holder is the one who is granted insurance coverage by the direct insurer. An insurer is already conceptually no policy holder according to the Insurance Tax Act. The Insurance Tax Act

- contains on the level of reinsurance no separate provision about tax liability – consequently as it exempts reinsurance from tax liability (sec. 4 No. 1 Insurance Tax Act), but
- principally stipulates tax liability only for direct insurance („policy holder“, sec. 7 para. 1).

There may only be a tax debtor where there is a liability to pay taxes. If the law though regulates tax liability conceptually only for direct insurers (“policy holder”), this shows that the law itself assumes that a liability to pay taxes exists only for direct insurance. The Insurance Tax Act thus shows that it intends to exclude reinsurances from the liability to pay tax – and thus also surety reinsurance. The Federal Court of Finance in so far argues contradictorily: surety reinsurance would not be principally exempt from tax (according to sec. 2 para. 2 Insurance Tax Act), *because* the surety reinsurer does not oblige himself towards the policy holders of the direct insurer to the provision of guarantees<sup>7</sup>, but renders performance to the direct insurer. The surety reinsurance is though not supposed to be a reinsurance exempt from tax (according to sec. 4 no. 1 Insurance Tax Act), *although* the surety reinsurer does not oblige himself towards the policy holder of the direct insurer to the provision of guarantees but renders performance

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<sup>7</sup> BFH, reference as above, note 24.

to the direct insurer. The interpretation of the Federal Court of Finance is in so far contradictory.

#### 4.3.4.3 Intent and purpose and historical origin of the Insurance Tax Act argue against a tax liability of surety reinsurance

The Federal Court of Finance correctly assumes that reinsurance was exempt from tax in order to avoid a double burden in the insurance chain (cf. above 4.3.3.2). In fact, a double burden cannot occur, since surety insurance is not considered to be a (taxable) insurance.

The Federal Court of Finance though passes over the significant initial decision of the legislator: banks provide comparable surety positions without those being liable to tax or being insurances. Surety insurances should therefore be exempt from tax as well. It shall be made sure that the insurance industry is taxed neutrally in its effect on competition in relationship to the banking industry. The legislator therefore exempted surety insurance from tax liability. This initial decision does not only apply for direct insurance, but also for reinsurance.<sup>8</sup> The Federal Court of Finance correctly assumes that reinsurance is exposed to the same economic risk as direct insurance.<sup>9</sup> The risk covered by surety insurance shall, according to the legislator, not be liable to tax at all. This purpose is ignored by taxation practice and the interpretation of the Federal Court of Finance if they intend to impose tax on reinsurance (for the first time).

#### 4.4 No clarity by legislation

The draft of the Insurance Tax Amendment Law intended – as the Federal Court of Finance has now decided – to limit the exemption of taxation of reinsurances in sec. 4 No. 1 Insurance Tax Act to cases based on taxable direct insurance.<sup>10</sup> The legislator did not include the amendments into the law. According to the opinion of the financial authority, the amendment to the law would only have served to clarify. The fact that the clarification has not been realized would not change the taxability of surety reinsurance.

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<sup>8</sup> Cf. *Rind/Wendt*, reference as above, 1605, 1606, with reference to justification about sec. 2 para. 2 Insurance Tax Act „Insurance Tax Act§ and constitutional guidelines.

<sup>9</sup> *BFH*, reference as above note 32.

<sup>10</sup> Cf. *Medert*, German Tax Guideline „DStR“ 2013, 496, 497.

## 5. IMPACTS OF THE INSURANCE TAX LIABILITY OF SURETY REINSURANCE

The tax liability of surety reinsurance has serious economic impacts on the insurance industry and the policy holders.

### 5.1 Impacts for reinsurers

In economic terms, surety reinsurance will simply become more expensive due to the legal situation determined by the Federal Court of Finance. Reinsurers have to provide their services to surety insurers increased by the margin of the insurance tax of 19 percent. In the case described, decided by the Federal Court of Finance, a surety reinsurer filed the claim. The tax assessment was made to the surety reinsurer, because the surety reinsurer is responsible for the payment of insurance tax (cf. sec. 7 para. 2 s. 1 Insurance Tax Act).

### 5.2 Impacts for direct insurers

The insurance tax payable by the surety reinsurer directly burdens the surety insurer. The surety insurer can provide services to the policy holder tax-free (see above 4.2). The increased price of the reinsurance though means a severe cost burden for the surety insurer, which will then result in a price increase of surety insurance.

In order to avoid the price increase of surety insurance following the taxation of the surety reinsurance, surety insurers choose to terminate surety reinsurance contracts. Surety insurance is partially bought abroad where no insurance tax incurs. If this risk is then insured by surety reinsurance, the risk decisive for the insurance tax lies abroad – at the office of the direct insurer - and no insurance tax incurs.<sup>11</sup>

### 5.3 Impacts for the policy holder

#### 5.3.1 Cost burden through increased surety insurance premiums

Where surety insurers increase premiums, increased surety insurance premiums hit policy holders. The increased cost burden forces companies to increase the price of their services. This especially affects the construction industry, but also the mechanical and plant engineering and thus the export economy.

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<sup>11</sup> Cf. German Insurance Association „GDV“ in their statement of 20 September 2012 about the draft of the insurance tax amendment law, downloaded on 9 December 2013: <http://www.gdv.de/2012/09/gdv-stellungnahme-zur-geplanten-reform-des-versicherungsteuergesetzes/>.

## 5.3.2 No planning security – examination of alternative safeguarding

Policy holding companies find themselves in a position where they are not able to foresee the further development of surety insurance. Changes in premiums and terms and conditions by the surety insurer to the detriment of the policy holder appear possible.

From the policy holder's point of view there is a reason to examine existing surety insurance contracts and their continuation as well as alternative possibilities to secure guarantees.

## 6. CONCLUSION

Whether and to what extent the product "surety insurance" will remain economically reasonable and sustainable appears questionable. The economically decisive factor for securing by surety insurance is the possibility to provide guarantees via the insurance sector instead of the banking sector. The taxation practice disrupts this insurance possibility. A price increase of the surety insurance due to taxation leads to disproportions in the competitive situation between banks and insurers.

The policy holding industry finds itself confronted with increased premiums for surety insurance or has to fear those. Companies should examine existing surety insurance policies and possibilities of alternative risk transfer.

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