Tax treatment of debt and equity financing in Finland

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1. Equity financing

1.1. Resident recipients

1.1.1. The taxation of dividends depends on whether the recipient is an individual or a company and whether the distributing company is publicly listed or not.

1.1.2. For individual shareholders 70% of dividend from publicly listed companies is taxed as investment income at a flat rate of 28% and 30% is tax exempt.

1.1.3. If the distributing company is not listed more complicate rules apply. An annual return of 9% is calculated on the value of the shares in a non-listed company. The dividend is fully tax exempt up to an amount of 90,000€ of such return. The amount of such dividend that exceeds 90,000€ is taxed by applying 70/30% rule, so that 70% of the dividend is taxed as investment income at a rate of 28% and 30% is tax exempt. The amount that exceeds the 9% is also taxed by applying 70/30%, so that 70% is taxed as earned income subject to progressive income tax rates and 30% is tax exempt.

1.1.4. Dividends received from a non-resident company is taxed in the same way as domestic dividend provided that the distributing company is a

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company within the meaning of the EU Parent–Subsidiary Directive[2] or there is in that tax year in force a tax treaty between Finland and the country of residence of the distributing company which is applied to the dividend distributed by that company.[3]

1.1.5. Dividends paid between domestic companies are as a general rule tax exempt. There are some exceptions to this rule. First 75% of a dividend received by financial, insurance or pension institutions is taxable at the corporate tax rate of 26%. Second, 75% of a dividend is taxable where the distributing company is a publicly listed company but the recipient company is a non-listed company which does not hold directly at least 10% of the share capital of the distributing company. Dividends received from companies resident in the EU are treated in the same way as dividends from Finnish companies.

1.1.6. Dividends received from companies resident in a country with which Finland has concluded a double taxation agreement are treated as 75% taxable income subject to the corporate tax rate of 26%. If no double taxation agreement is applicable or exists, dividend is fully taxable at 26%.

1.1.7. It should also be noted that Finland's double taxation agreements often include unilateral exemption of dividends in the case that the Finnish company holds at least 10% participation in the voting power of the distributing company.

1.1.8. Capital gains on the sale of shares are generally taxable income. However, for limited companies (*osakeyhtiö*) capital gains are tax exempt provided that shares are part of the fixed assets and the seller has hold at least 10% of the capital of the company whose shares are sold for at least one year. The exemption does not apply to the shares of real estate

[2] Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States.
[3] For more details, see MARJAANA HELMINEN, Tax Treatment of Cross-Border Dividends and Finland's Tax Reform of 2005, Bulletin for International Taxation, p. 487 et seq.

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companies. A loss incurred on the sale of shares is not deductible if a gain on the sale of such shares would have been tax exempt.

1.1.9. For individuals the taxable capital gain is calculated by deducting the acquisition costs and sales costs from the sales price. A minimum deduction of 20% of the sales price is applied. If the property has been held for at least ten years, the minimum deduction is 40%. Losses are deductible only from capital gains within the same and following three years (from 2010 extended to five years).

1.2. Non-resident recipients

1.2.1. Dividends are as a rule subject to 28% withholding tax but several exemptions apply.

1.2.2. First under the EU Parent-Subsidiary Directive[4] an EU resident company having a holding of at least 10% in the capital of the Finnish distributing company is exempt from dividend withholding tax.

1.2.3. Second, companies resident in the EU and EEA member states qualify for the same tax exemptions as Finnish companies provided that there is an information exchange agreement between Finland and the residence state of the recipient and proof that withholding tax cannot be credited in that state if levied in Finland.

1.2.4. Third individuals resident in the EU or EEA member states may apply the same taxing rules as Finnish resident individuals provided that there is an information exchange agreement between Finland and the residence state of the recipient and proof that withholding tax cannot be credited in that state if levied in Finland. There is an information exchange agreement with all EU and EEA member states with the exception of Liechtenstein.

[4] Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States.

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1.2.5. It should also be noted that Finland's double taxation agreements often limit the applicable withholding tax on dividends to a maximum of 0-15% in the case of portfolio dividends and 0-5% in the case of direct dividends.

1.2.6. Capital gains on the sale of shares in Finnish companies are not considered taxable income for non-residents. Exceptions may apply in the case of shares in real estate companies.

1.3. Distributing company

1.3.1. Paid dividends are not deductible for the distributing company. Effective from 1.1.2010 there is an exemption to this rule but it is not relevant for the purposes of this article.

2. Debt financing

2.1. Deductibility of interest

2.1.1. Interest on debt incurred for the purpose of business activity is generally tax deductible. According to Business Income Tax Act interest is deductible even if it is contingent on the profit of the debtor (participating loan).

2.1.2. If interest is paid on debt incurred for the purpose of non-business activity, it may be deductible if the debt is incurred for the purpose of acquiring taxable income in accordance with the Income Tax Act.

2.1.3. Expenses relating to an activity for which the taxpayer is required to keep books are allocated in accordance with the Business Income Tax Act even in the case where the income is taxed under the Income Tax Act. Consequently, companies are generally required to deduct interest on

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an accrual basis. For example, interest on a zero bond is allocated over its maturity period.[5]

2.1.4. Only the real interest expense is deductible. There are no tax provisions providing for deductions exceeding the real interest expense or for the possibility of making a notional interest deduction. However, interest paid on a zero-coupon convertible loan is considered to be interest until conversion. Therefore the issuer may deduct the interest on zero-coupon convertible loans on accruals, even if the payment of interest is not effected due to conversion before maturity.[6]

2.2. Taxation of interest

2.2.1. Interest income is subject to comprehensive taxation. No inflation adjustments may be made to the amount of taxable interest. Interest income received by a corporate lender resident in Finland is always taxable income at the rate of 26% irrespective of whether the borrower is a resident or non-resident company. For individuals interest income is either subject to final withholding tax of 28% or treated as investment income subject to 28% flat tax.[7]

2.2.2. Interest paid to non-residents is generally exempt from withholding tax under Finnish domestic tax law. In the rare case that withholding tax would be applicable, the rate could generally be reduced to a maximum of 10% or abolished altogether under an applicable double taxation agreement. To the extent the conditions for the application of the EC

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[5] Supreme Administrative Court (SCA) 1986 T 5701

[6] For more details, see TOMI VIITALA, New tendencies in tax treatment of cross-border interest of corporations/Branch report Finland, Cahiers de droit fiscal international, Volume 93b, p. 280-284.

[7] See TOMI VIITALA, op.cit., p. 284-285.

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Interest-Royalty Directive[8] are fulfilled, no withholding tax is imposed on interest in any case.[9]

2.3. Treatment of shareholder and non-shareholder loans

2.3.1. Finnish tax law does not distinguish between shareholder and non-shareholder loans as far as creditor is concerned. However, there are specific tax rules in the Income Tax Act for the case where a company grants a loan for its individual shareholder.

2.3.2. The Finnish Companies Act does not limit the types of loans granted to a company either by shareholders or non-shareholders. The only type of loan that is specifically regulated in the Companies Act is the capital loan. The capital loan is, in accordance with the Companies Act, debt-rated financing, but can in certain situations be comparable to an equity item. The loan is usually unsecured, but can have a security provided by a parent company or another subsidiary company in the same group. The Companies Act provides that the debtor may pay interest and capital back only to the extent that the company's free equity and outstanding loans exceed its losses. The capital loan must also be subordinated to all other types of debt.

2.3.3. There is no express definition of interest in the Finnish income tax legislation. As a general rule, interest may be defined as compensation paid on debt. The amount, which is determined as a function of time, interest rate and debt, is treated as interest irrespective of whether the payment is defined as interest by the creditor and debtor.

[8] Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States.
[9] See TOMI VIITALA, op.cit., p. 285.

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2.4. Classification issues

2.4.1. In practice the most important issue from the perspective of the debtor is whether the financing instrument is classified as debt or equity. The starting point of classification is the treatment under civil law. Also the treatment for company law and accounting purposes may be taken into account. It can also be stated that debt is characterized by the debtor–creditor relationship and the absence of participation rights.

2.4.2. In practice, loans with hybrid character have been treated as debt in Finland. As mentioned above, interest on a profit-participating loan is deductible based on the express provision in the Business Income Tax Act. In addition, convertible loans have been considered to be debt until the conversion. In SCA 1995 T 3932 interest paid on a convertible loan with a maturity of 50 years subject to extension or conversion into perpetual loan at the debtor's discretion was considered to be deductible.

2.4.3. There is only scarce case law on the tax treatment of modern types of financing instruments such as mezzanine financing. In a recent published advance ruling 57/2009 of the Central Board of Taxation a perpetual loan was classified as debt and compensation therefore as deductible interest. The debtor had the right to redeem the loan back under certain circumstances. The creditors were not granted any participation rights to the creditor based on the loan and had no right to convert the loan into the shares in the debtor company. The loan was a type of hybrid loan which is treated as equity for the IFRS purposes. The ruling has been appealed to the Supreme Administrative Court.

2.5. Arm's length interest

2.5.1. In the case of shareholder loans the issues regarding the arm's length conditions of the financing are of particular importance.

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2.5.2. Section 31 of the Act of Taxing Procedures provides for the adjustment of intra-group transfer prices. According to it, any profits, which would have accrued, but for the reason of non-arm's length conditions applied in dealings with an associated party, have not so accrued, may be included in the profits of the Finnish resident taxpayer or the permanent establishment and taxed accordingly. Since 2007 its scope covers both domestic and cross-border transactions. Prior to that, only cross-border transactions were covered.

2.5.3. There's only scarce case law on how the arm's length principle and transfer pricing adjustments are applied in the case of financing arrangements. In the case CSA 1990 T 483 concerning the old Section 31 of the Act of Taxing Procedures the Finnish subsidiary was required to include in its taxable income the amount of late interest which it had failed to charge from its Swedish parent company.

2.5.4. In practice there are two methods which Finnish tax authorities use to determine the arm's length interest. The comparable uncontrolled price method (CUP) is the primary method. The CUP includes a comparison of used intra-group interest rate with market interest rates. A synthetic (simulated) credit rating of a group company may be carried out to establish a comparable market interest rate. Another method used the cost plus method, but its scope of application is rather limited. This type of method could be applied, for example, in the case of a group financing company. The method includes determining an applicable market interest rate and profit margin.

2.6. Other limitations

2.6.1. There are no formal thin capitalization rules in Finland. Over the years several working groups have considered whether such rules should be implemented in Finland but so far the proposals have not lead to any

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legislative actions. Recently a study on the need for interest deductibility limitations in Finland was issued by the Ministry of Finance was issued. The study concluded that there is a need for some limitations in certain cross-border situations particularly relating to intra-group reorganisations. However, due to the current economic and financial crisis any actions would be postponed beyond 2012 when a new government will have stepped in.

3. Neutrality and other tax policy issues

3.1. Cross-border situations

3.1.1. For the purposes of evaluating the neutrality of debt and equity financing, one must distinguish between domestic and cross-border situations.

3.1.2. To the extent cross-border situations are concerned, it is clear that there is a bias towards debt financing. By using debt, the tax burden at the level of Finnish group companies may be reduced significantly, or mitigated altogether, and profits being repatriated without withholding tax in Finland to the owners of the Finnish companies.

3.1.3. The study issued by the Ministry of Finance referred to earlier addressed several situations where companies can benefit from the lenient interest deductibility rules and practice particularly in the cross-border situations. It is widely expected that the next Government will tackle at least some of the situations addressed in the study by introducing specific limitation rules. The rules are likely to follow the Swedish example, so that only intra-group financing relating to intra-group restructurings will be tackled in cases where there are no sufficient business motives and interest income be repatriated to a low-taxed subsidiary abroad.

3.1.4. From time to time the necessity of unilateral withholding tax exemption for cross-border interest has also been questioned. In particular, the

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exemption is applied without any respect to the residence country of the lender, and is applicable even if interest is paid to so-called tax havens. However, so far no measures have been proposed to narrow the scope of the exemption.

3.2. Domestic situations

3.2.1. In the domestic situations, one must distinguish between widely-held (or public) and closely-held (or family) companies.

3.2.2. In the case of closely-held companies, debt and equity financing are often neutral from the perspective of the owner. While interest on debt is deductible for the company, it is fully taxable in the hands of the owner. Dividends are not deductible for the company, but are tax free for the owner subject to certain conditions and limits as discussed earlier.

3.2.3. Although one may say that the current tax treatment of debt and equity is neutral under the current regime, there is other tax policy issues which may lead to changes in the current tax regime. There is a rather widespread impression that owners of closely-held companies can transform employment income subject to progressive tax rates up to 55% into tax free or low-taxed dividends.

3.2.4. In 2008, the Ministry of Finance set up a working group to consider the future tax structure in Finland. Corporate taxation and tax treatment of dividends are among the most urgent topics on the agenda. It is expected that the working group will present its proposal for a new dividend taxation model within the next year. The proposal will serve as a base for political discussions for the 2011 parliamentary election.

3.2.5. A hot debate is going on whether the current tax regime fulfils the ability to pay and horizontal equality among taxpayers. This is because tax burden at the level of an individual taxpayer differs drastically depending on whether the income takes the form of earned income (salary) or investment income (dividend). While a taxpayer may receive dividends

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tax free up to 90 000€ annually, the tax burden on the same amount of salary would total almost 45%. Of course the amount received as dividend has already been subject to corporation tax of 26% at the level of the distributing company, but even taking this into account the difference in tax burdens is substantial.

3.2.6. The rationale behind the 90 000€ dividend tax exemption is to provide incentive for entrepreneurship as well as strong balance sheets by making the exemption dependable on the amount of net assets in the distributing company. However, it is expected that the working group will question whether these motives should at all be achieved through tax measures.

3.2.7. In the case of widely-held companies the situation is different. Dividends received from publicly listed companies are almost always taxable in the hands of shareholders with no tax deduction at the level of the company. Interest received is also taxed in the hands of creditors, but a corresponding deduction is also granted at the level of the debtor company. Therefore equity financing is subject to double taxation in most cases, though not fully owing to the 30% tax exemption at the level of the shareholder.

3.2.8. In the case of widely-held companies the ability to pay and equality principles have not been raised. This is because dividends are subject to 19,6% tax (70 % taxable at 28%), and taking into account corporation tax paid by the distributing company the tax burden is 40,5%. The total tax burden on dividends therefore corresponds, and often may even exceed, the tax burden on salary income.

3.2.9. The structural reason behind the differences in tax burdens on salaries and dividends is the dual income tax system applied in Finland. While the latter is subject to 28% flat tax for investment income, salaries are subject to progressive tax rates up to 55%. However, it is not expected that the working group suggest the abolition of the dual income tax system. Instead there is an increased pressure to narrow the difference

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between the applicable tax rates. Due to current economic situation in Finland, there are expectations that the 28% flat tax rate for investment income will be raised at least to 30% in near future.

3.3. Future perspectives

3.3.1. It is widely expected that the working group referred to above will propose significant amendments to the current dividend taxation model in favour of a more neutral and simple regime.

3.3.2. The working group has made international comparisons with the purpose of finding suitable models for Finland. The "Norwegian model", broadly where dividends are tax exempt up to the amount of so called risk free return, is considered to have many attractive features such as neutrality between debt and equity financing. However, there is strong opposition against this model because of the administrative difficulties associated to it. Also the "Belgian model", broadly where a fictive deduction on company's equity capital is allowed at the company level, is considered to be attractive in terms of neutrality. The price tag estimated for the Belgian model is however too high.

3.3.3. Based on international comparisons, it seems that the classical model, broadly where both the company and the shareholder are taxed on the same profits, is the most prevalent model. If proposed by the working group and accepted by the next government, it would mean that the distinction between dividends from publicly listed and non-listed companies would disappear. The classical model will face strong opposition from small and medium sized family companies whose owners would lose the 90 000€ tax exemption for dividends.

3.3.4. From financing neutrality perspective, a switch to the classical model would also mean an increased bias towards debt financing for family companies. However, in the political discussions viewpoints relating to

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ability to pay and equality among taxpayers will be superior to neutrality of financing. It is also likely that such switch would lead to shareholders in family companies to extract income from their companies in the form of different types of fringe or other benefits such as housing which often involve tax savings.

4. EC law issues

4.1. Equity financing

4.1.1. During the last few years, Finland has amended its dividend and withholding tax rules so that they are generally compatible with EC law. The remaining problems concern the situations where the non-resident recipient is an entity with special tax status in its residence country such as an investment fund, charitable entity or comparable.

4.1.2. With respect to special tax status entities, the Finnish tax authorities issued in 2008 a guidance letter on the amendments to the taxation of dividend paid to non-residents in EU and EEA member states. According to the guidance letter charitable entities from EU and EEA member states (with the exception of Liechtenstein owing to lack of information exchange) are entitled to tax exemption for dividends under the same conditions as comparable Finnish charities.

4.1.3. As regards investment funds, the case C-303/07 Aberdeen Property Fininvest Alpha Oy[10] decided by the ECJ is still pending at the Supreme Administrative Court. In the decision the ECJ determined that Finnish withholding taxes on dividends paid by a Finnish company to its Luxembourg SICAV (society d'investissement à capital variable) parent company were incompatible with articles 43 EC and 48 EC[11], in

[10] European Court of Justice, Judgment 18 June 2009, case C-303/07, Aberdeen Property Fininvest Alpha Oy.
[11] EC Treaty.

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circumstances in which similar dividends paid to a Finnish parent company were exempt from taxation. Effectively the decision means that Finland cannot anymore place dividend withholding tax on investment funds established in the EU and EEA member states as Finnish investment funds are fully exempt from taxation. There are also vast amount of pending reclaims from non-resident investment fund for paid withholding taxes. As soon as the Supreme Administrative Court gives its ruling, the rules on dividend withholding taxation must be changed either through legislative changes or guidance from the tax authorities.[12]

4.2. Debt financing

4.2.1. There are no EC law issues regarding the taxation of interest income in Finland. This is because for non-residents interest income is not considered to be taxable income in Finland, and for residents interest income is always taxable whether received from Finnish sources or abroad.

4.2.2. As regards deductibility of interest, Finnish tax laws require taxpayers to follow the arm's length principle both in domestic and cross-border situations. Therefore no conflict with EC law should arise, provided that the tax rules are also in practice applied equally both in domestic and cross-border situations. To the author's knowledge this has been the case. Since 2007 when the arm's length principle and transfer pricing adjustments were extended to cover also domestic situations, the tax authorities have, for example, required Finnish parents companies to charge arm's length interest on intra-group loans to resident subsidiaries.

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[12] See also MARJAANA HELMINEN, The Future of Source State Dividend Withholding Taxes in Finland and the European Union, European Taxation July 2008, p. 354 et seq.

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