32E29000 European and international tax law

Finnish international tax law & tax treaties

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Finnish international tax law

Unlimited tax liability

- The taxing rights of Finland are created in domestic tax law (Income Tax Act, TVL)

- **Unlimited** (= worldwide income) **tax liability** in Finland (Income Tax Act (TVL) 9 § (1))
    - Finnish resident individual
    - Finnish corporate entity
        - A corporate entity is Finnish if it is incorporated or otherwise established under domestic law
        - Finnish corporate entities include i.e. limited liability company (osakeyhtiö)

Limited tax liability

- **Limited tax liability** in Finland (TVL 9 § (2))
  - Individual who is resident in another state than Finland (”non-resident individual”)
  - Corporate entity which is incorporated in another state than Finland (”foreign corporation or company”)
- Limited tax liability covers only income received from Finnish-sources (TVL 10 §)
  - Includes e.g. business income, dividend, royalty, real estate income
  - Interest is Finnish-source income but is exempt from tax if received by a non-resident (TVL 9.2 §)
- Taxation is based on assessment (e.g. business income) or withholding tax (e.g. dividend, royalties)

Permanent establishment (PE)

- If a foreign (= non-resident) company has **a permanent establishment (PE)** in Finland, all income connected to the PE are subject to tax in Finland (TVL 9.3 §)
- A PE of a foreign corporation in Finland is taxed in the same way as a domestic corporation on the income connected to a PE
- Existence of a PE typically also leads to VAT and employer obligations in Finland

Permanent establishment (PE)

- Definition of a PE (TVL 13a §)
    - A **fixed place of business**
    - through which the **business** of an enterprise **is** wholly or partly **carried on**…
- Fixed place of business includes e.g.
    - place of management
    - a branch or an office or a factory
    - also "home office" may be fixed place of business
- Carrying on business
    - typically requires personnel but not always (e.g. business may be carried on through a server)

Permanent establishment (PE)

- however, mere preparatory or auxiliary business activities do not constitute a PE
- A foreign corporation may operate in Finland also through an agent (e.g. a Finnish resident company)
  - If the agent is not independent, it may constitute a PE for a foreign corporation although the foreign company has no fixed place of business in Finland (dependent agent PE)

- The existence, or non-existence, of a PE is one of the most important (and trickiest) issues in international taxation

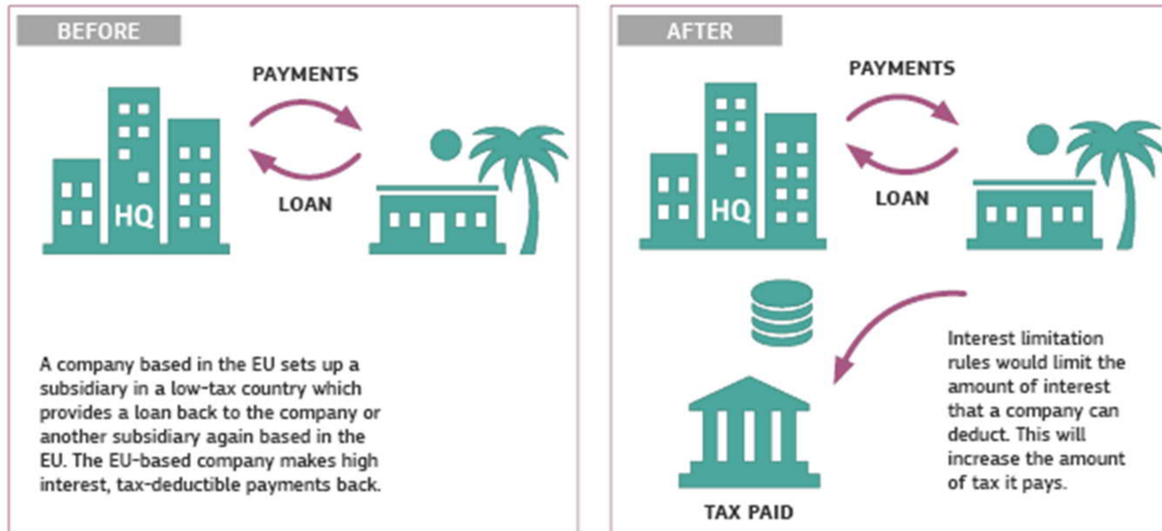
Finnish anti-tax avoidance rules

- Anti-tax avoidance rules seek to prevent tax avoidance by residents or non-residents resulting in international double non-taxation or low taxation
- Finland has e.g. the following anti-tax avoidance rules
  - Interest deduction limitation rules
  - CFC (controlled foreign company) rules
  - GAAR (general anti-avoidance rule)
  - Transfer pricing rules (arm's length principle)
- Anti-tax avoidance rules have been tightened up in almost all countries in recent years partly due to OECD and EU measures that have been implemented

Finnish anti-tax avoidance rules

- Interest deduction limitation rules
  - Purpose is to counteract tax planning by loan arrangements
  - Apply both to resident companies and non-resident companies having a PE in Finland
  - Limit the amount of deductible interest up to 25% of the company's adjusted taxable income, unless an exception applies
  - As of 1.1.2019 interest deduction limitation rules are covered by the EU Anti-Tax Avoidance Directive (ATAD)

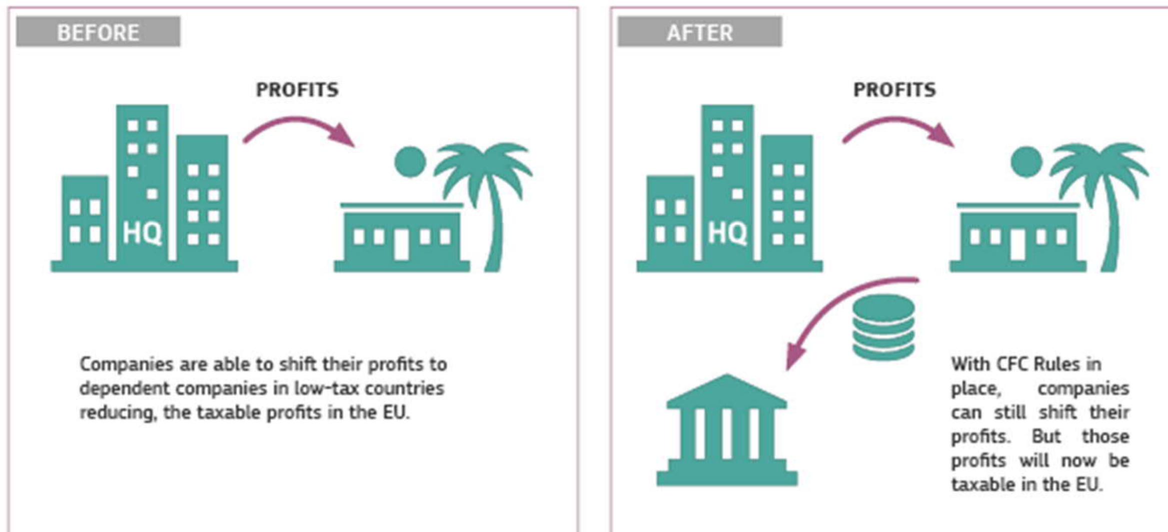
Interest limitation rules



Finnish anti-tax avoidance rules

- CFC rules
  - Purpose is to counteract profit shifting from Finland to low-tax countries
  - Applies to resident companies setting up subsidiaries in low-tax countries (called as CFC) unless an exception applies
  - Allows the taxation of the profits of a CFC as income of the Finnish resident company even though the corporation does not make a profit distribution
  - As of 1.1.2019 CFC rules are covered by the EU Anti-Tax Avoidance Directive (ATAD)

Controlled foreign companies (CFC) rules



Tax treaties (double tax agreements, DTAs)

Double tax agreements (DTAs)

- Concluded between contracting states (usually two states = bilateral, Nordic Tax Treaty = multilateral) in order to eliminate double taxation and to prevent tax avoidance
- May limit, but not extend taxing rights, based on domestic tax laws of a state → ”golden rule of tax treaties”
- Main sources of interpretation: the OECD Model Commentary and the OECD Transfer Pricing Guidelines

Finnish DTAs

- DTA with 77 states incl. all EU member states, USA, Canada, China, India, Japan, Australia…
- DTAs follow the OECD Model Convention but each treaty is negotiated between the contracting countries and may differ in detail
- OECD Model Convention and its Commentary is in practice the most important source of interpretation when a DTA is interpreted and applied

  → It is important to get familiar with the structure and key contents of the OECD Model Convention and its Commentary!

Limitation to taxing right

- DTAs contain limitations to Finland's taxing right as a **source state**
  - Limitations depend on the income type in question
  - Finland may have full taxing right as provided for in the Finnish domestic law
  - Finland may have limited taxing right at a specified tax rate
  - Finland may have no taxing right at all
  - Limitations vary: always check the limitations in the actual DTA that is applicable
  - Note: interest income is already exempt under Finnish domestic taw → no taxing right even if a DTA would allow Finland to tax interest → reason: golden rule of tax treaties i.e. tax treaty does not create taxing right!

Obligation to eliminate juridical double taxation

- DTAs contain obligation on Finland to eliminate juridical double taxation as a **residence state** in cases where the same income of the Finnish resident company has already been taxed in the other state

Structure of a DTA - OECD Model Convention

- Scope of the convention (Art. 1, 2)
- Definitions (Art. 3 – 5)
- Allocation rules: income (Art. 6 – 19)
  - from certain activities
  - from certain assets
  - capital gains
  - students (Art. 20)
  - catch-all clause (Art. 21)
- Allocation rule: capital (Art. 22)
- Elimination of double taxation (Art. 23)
- Special provisions (Art. 24 – 28)
- Final provisions (Art. 29, 30)
- Frequently: Protocol

Application of DTA - Steps

- Step 1 Does a tax treaty apply (scope)?
- Step 2 What is the nature of the income (income type)?
- Step 3 Determine which article applies?
- Step 4 How are taxation rights assigned?
- Step 5 Determine the tax in the source state?
- Step 6 Tax credit or exemption in the residence state?

Step 1 - Scope

- Applied to persons who are residents of one or both of the Contracting States
  - Typically (but not always) a company is resident in the state under whose laws it is established
- Finnish tax treaties usually cover income taxes imposed on behalf of the contracting state or its political subdivision (e.g. province)

Steps 2-5 Allocation of taxing rights based on income type

- **Business profits** (OECD MC Art. 7, 9)
  - Generally all income from business such as from sale of products and services unless the income in question is covered by other articles
  - Taxation only in the residence state of a company
  - Taxation also in the source state provided that a PE established therein
  - Art. 5 contains the definition of the PE: A fixed place of business through which the business of an enterprise is wholly or partly carried on…
  - Profits of the PE should be determined in accordance with the arm's length principle

Steps 2-5 Main allocation rules regarding income from business activities

- **Dividends** (Art. 10)
  - Return on equity
  - Taxation in the residence state
  - Taxation also in the source state but limited to 5-15%, exceptionally 0%, often the rate depends on the level of ownership (portfolio vs. direct dividends)
- **Interest** (Art. 11)
  - Return on debt
  - Taxation in the residence state
  - Taxation also in the source state but limited to 5-10%

Steps 2-5 Main allocation rules regarding income from business activities

- **Royalties** (Art. 12)
  - Fees for the use of intellectual property such as patents and trademarks
  - Taxation in the residence state
  - (In older treaties, often also in the source state limited to 5-10 %)
- In practice, there are situations where it is difficult to classify the income correctly
  - For example, fees received from the use of software may sometimes be treated as business profits or royalties
  - If countries take different views, classification conflict arises and potentially juridical double taxation

Step 6 Exemption or credit method

- If the taxing right is divided between the source state and residence state, the residence state is obliged to eliminate juridical double taxation
- There are two different methods
- **Exemption method** (Art. 23A)
  - Income taxed in the source state is exempted from tax in the residence state
- **Credit method** (Art. 23B)
  - Deduction for the tax paid in the source state against the tax payable in the residence state on the same income

Step 6 Exemption or credit method

- The applicable method must always be checked from the applicable DTA
- Finland prefers the credit method, but there are also countries that prefer the exemption method e.g. in the case of business profits of a PE
- DTAs do not contain more accurate rules on how the exemption and credit method are in practice applied, such rules are found in domestic tax laws of countries
- In Finland the application of exemption and credit methods are governed by a specific tax act (Act on the Elimination of International Double Taxation)

Step 6 Exemption or credit method

- Most countries incl. Finland apply so-called ordinary credit method
  - the amount of credit for source state taxes in the residence state is limited to the amount of the taxes payable in the residence state for the same income
  - If the source state tax is higher than the residence state tax, some double taxation may not be eliminated
- So-called full credit method is rarely used
  - The source state taxes may be deducted even if they would be higher than the taxes payable in the taxpayer's state of residence for the same income

Example.

- Company A is resident in Finland under the tax laws of Finland. How are the taxing rights allocated in the following situations? You may assume that the DTA between Finland and the Source State follow the OECD Model Tax Convention.
- 1) Company A receives business profits from the Source State and does not have a PE in the Source State?
- 2) Company A business profits from the Source State and has a PE in the Source State?
- 3) Company A has a 100 % owned subsidiary company in the Source State and receives dividends from its subsidiary?