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TAX COMPETITION IN EUROPE
FINLAND
National Report

1. General aspects of the domestic tax situation

The idea of the welfare state is well-established in Finland. Many polls have shown that most people strongly support social services and transfers, and prefer the maintenance of a high standard of health care and other social services to tax cuts. However, one consequence of these attitudes is high public expenditure. In Finland, public expenditure in ratio to GDP is above the EU average. Another consequence is heavy taxation. The total tax revenue as percentage of GDP in Finland (46.2 per cent in 1999) is the third largest in the OECD and well over the EU average (41.3 per cent).

In our globalised economy, one big fiscal policy issue is the challenge being posed by tax competition to large public sectors. Finland is currently studying how international tax competition will affect our future tax policy. Just recently, the Ministry of Finance published a report on Finnish competitiveness (Suomen kilpailukyky ja sen kehittämistarve 2002) which pays a lot of attention to tax issues. The summary is that our corporate tax is fairly competitive but our high total tax burden and the less encouraging level of tax on earned income are the big challenges to future tax policy. Currently, there are two governmental commissions with a mandate to examine the Finnish tax system with respect to tax competition, one consisting of legal experts, the other of economists. These two groups are cooperating with each other and will give

their reports and reform proposals in October, 2002. After that and before the next parliamentary election in March 2003, there may be a lively debate on tax reform issues. After the election, the new government will issue a statement on main policy matters, and new tax legislation, if considered to be needed, will not come into force until 2004.

Distinction between „fair“ and „unfair“ („harmful“) competition is not emphasised in common tax policy debate, but tax experts in Finland understand these concepts in the same way they are used in the EC Code of Conduct and in the OECD report on Harmful Tax Competition.

So far not much research data is available on the economic effects of tax competition. The forthcoming report of the commission of economists will give more information about these issues. The quite favourable economic development in recent years has perhaps to some extent overshadowed the negative effects of tax competition.

No country can escape international tax competition. Finland is not an aggressive player, but it is an alert observer, skilled at reacting defensively. Finland introduced a remarkable tax reform in 1993 in reaction to the USA tax reform of 1986 and to the following international tax developments, including reforms in Sweden in 1991 and in Norway in 1992. A so-called dual tax system with low nominal tax rates (25 per cent) for capital and corporate income was adopted. The flat rate on capital and corporate income was 25 per cent during 1993-95 and 28 per cent during 1996-99. Since 2000 the rate has been 29 per cent. Significantly, the development of tax rates in Finland has been contrary to that in many other countries. In a dual system there is a big difference between the flat rate on capital income and progressive rates on earned income. The increase of the flat rate can be explained by fiscal and equity considerations.

Today, the reform in Germany (2001-2005) is regarded important for the tax policy climate in Europe. In Finland, two special features in the German reform are being given special attention: the future of the imputation (avoir fiscal) system and whether it is wise or possible to tax capital gains received by corporations.

2. Elements of tax competition in the domestic tax system

2.1. Tax rates. Current policy issues

2.1.1. Corporate tax rates

A characteristic feature of the Finnish corporate and capital taxation is a combination of a fairly low tax rate and a broad tax base. According to the present tax policy thinking, the formal tax rate is more essential for the competitiveness of the system than various forms of relief in tax base. Low tax rates give a clear message to investors.

The corporate tax rate in Finland is 29 per cent. This figure is below the EU average of 32.53 % (2002; KPMG report) and the OECD average of 31.39 per cent. The relative position of the Finnish corporate rate can be seen in the following table:

Corporate tax rate. 2002.

USA	40%
Germany	38.36%
The Netherlands	34.5% (29%)
Great Britain	30%
Denmark	30%
<i>Finland</i>	29%
Sweden	28%
Norway	28%
Poland	28%
Estonia	(26%)
Russia	24%
Hungary	18%
Ireland	16%

The EU member states are not the only participants in tax competition. Especially future EU member states can provide international investors and enterprises with appealing alternatives for locating their investments.

The competitiveness of a tax system is affected also by the tax base. The Finnish corporate tax system appears to be quite competitive from the point of view of effective tax rates, as well. This conclusion can be drawn from the EU Commission's report 'Company Taxation in the Internal Market' (COM(2001)582 final). The following table gives the average effective tax rates for domestic investments.

Effective tax rates. 2001. Domestic investments. (Nominal tax rate)

Portugal	37,0%	(35.20%)
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Germany	34,9%	(39.35%)
France	34,7%	(36.43%)
Belgium	34,5%	(40.17%)
Luxemburg	32,2%	(37.45%)
Spain	31,0%	(35.00%)
The Netherlands	31,0%	(35.00%)
Great Britain	28,3%	(30.00%)
Greece	28,0%	(37.50%)
Austria	27,9%	(34.00%)
Italy	27,6%	(40.25%)
Denmark	27,3%	(30.00%)
<i>Finland</i>	26,6%	(29.00%)
Sweden	22,9%	(28.00%)
Ireland	10,5%	(10.00%)

The Finnish corporate tax system is generally considered to be internationally competitive. It is interesting to note that the Finnish corporate tax as a percentage of GDP (4.%, 1998) is above the EU average (3.%). The Finnish corporate tax reform (1993) with a lower tax rate and a broader tax base seems to be a success story from the fiscal point of view, as well. One could even ask whether tax relief, which narrows the tax base, and preferential tax treatment of retained profits decrease tax revenues more than they increase the competitiveness of the tax system.

There are no special tax rates for foreign investments in Finland. As far as bonds and other interest bearing instruments are concerned, a domestic regulation provides that no withholding tax is levied on interest income of foreign receivers. The idea - perhaps obsolete today - is that the favourable tax treatment would lead to a lower interest rate level for domestic borrowers .

2.1.2 Capital gains of corporations

Capital gains of corporations are fully taxable under Finnish tax law. A hot topic in Finnish tax policy debates is whether Finland can maintain this kind of tax treatment. In the Netherlands capital gains received from participation holdings have been and are tax-exempt. Capital gains realised on the sale of both domestic and foreign shareholdings by German corporations are tax-exempt from 2002 onwards. Sweden

is considering a similar reform. One might guess that similar adjustments in Finland's tax treatment of capital gains of corporations is unavoidable. One side of the reform would be tax exemption of capital gains and the other that capital losses or write-downs of the value of the investment would not be deductible. This kind of reform would remove tax obstacles for corporate restructuring and would perhaps not decrease tax revenues significantly.

2.1.3 Shipping taxation

In 2002, Finland introduced a special tax regime for shipping based on the model of tonnage tax. The new law has passed the Finnish legislative process and is awaiting EU approval. Taxation of shipping income for qualifying taxpayers is deferred until profits are distributed as dividends. Instead, a tonnage tax is levied..

The new shipping tax regime can be seen solely as a defensive tax policy measure. The legislation intends to prevent ship owners from moving their operations out of Finland. Tax experts predict that the tonnage tax will not get much use. The preferential tax treatment includes only retained profits and does not give any final tax advantages to ship owner corporations distributing profits. Dividends are covered by the imputation system and a complementary tax can be levied.

2.1.4 The future of the imputation system

In Germany, the imputation system has been abolished. A big tax policy issue is whether the imputation system can prevail or whether its sun is setting. Imputation systems have severe neutrality problems with respect to cross-border dividends. In the Finnish system as well, no imputation covers dividends received from abroad or paid to foreign shareholders. One must confess that such a system has discriminatory elements and can be seen as an unjustified obstacle to the free movement of capital. Concerning the European Tax Law, it is hard to say what the relevance of Article 58 of the Treaty is in this connection.

In the Supreme Administrative Court, a case dealing with this question is pending. A Finnish taxpayer is arguing that the tax treatment of dividends received from a Swedish company is discriminatory and against the principle of free movement of capital. The Court is now considering whether it will ask the EC Court for a precedent.

2.1.5 Special tax regime for foreign experts

In international comparison, earned income is heavily taxed in Finland. There is a special legislation to make Finland's tax system a little bit more competitive in its efforts to attract „key persons“ from abroad to work in Finland. The Act on Foreign Experts' Income applies to persons who come to work in Finland and become residents as a result of staying in Finland. The salary for the employment must be at least 5 800 _ a month. Teaching in universities and scientific research for the public good are covered by the special Act, even though the salary is below 5 800 _.

A withholding tax of 35 per cent is levied on the gross amount of the salary instead of the progressive income tax on earned income. A taxpayer is deemed to be a foreign expert for a maximum of 24 months. After that period the expert is taxed as any other Finnish taxpayer. The restrictions sharply limit the economic importance of the Act.

2. 2. Tax accounting

In Finland, there are no special tax accounting rules for foreign businesses. The tax base is calculated in the same way as for Finnish taxpayers. There are no tax deferrals for foreign investments.

2.3. Double taxation relief. Exchange of information. Transfer pricing.

Finland has a double taxation treaty in force with 60 countries. Generally speaking, these treaties are in accordance with the OECD Model Treaty. Double taxation is usually eliminated in international contexts on the grounds of a treaty. In non-treaty situations, Finland has eliminated international juridical double taxation with respect to Finnish residents by implementing a special domestic act. Elimination of international double taxation is not seen as a measure to engage in international tax competition.

With respect to tax treaties and obligations as an EU Member State, Finland prefers a policy on far reaching exchange of information. Passivity in this field is not used as a competitive measure.

Finnish domestic tax law contains a general transfer pricing provision. In treaty situations, the special article is applied. There are no detailed administrative regulations.

The Finnish tax administration is improving its capacity to handle transfer pricing cases and it cannot be said that the administration has shown a reluctance to implement transfer pricing provisions.

2.4. Procedural advantages

There are no tailor-made decisions for taxpayers operating in international business. On the other hand, Finland has a well-developed system to obtain advance rulings. An international enterprise can apply for an advance ruling on a transfer pricing issue as well, although this possibility is not much used.

Finland's tax administration emphasises the importance of high administrative standards as a factor affecting the competitiveness of the tax system. There is a special taxation unit for bigger groups of companies and international enterprises (Tax Office for Major Corporations).

3. Measures against „unfair“ competition in the domestic tax system

3.1. General anti-avoidance rules

The Finnish tax legislation includes a general anti-avoidance clause reflecting form over substance thinking and a business purpose requirement. This clause has a significant practical importance and there are many precedents of the Supreme Administrative Court where the clause has been implemented. The clause applies also to international step transactions and other operations. However there are not many cases in this field, to some extent because of special controlled foreign corporations legislation.

3.2 CFC legislation

Finnish domestic legislation includes a special controlled foreign corporation regime, the Act on the Taxation of the Shareholders in Controlled Foreign Corporations. The Act applies to foreign corporate entities located in low tax states but controlled by Finnish residents. Finnish corporations or resident individuals must directly or indirectly control the foreign corporation in order to qualify under the Finnish CFC regime.

One requirement is that the foreign corporation has a low tax burden. The actual income tax burden of CFC in its state of residence must be lower than 3/5 of the tax burden of a Finnish resident corporation in Finland. The single comparison of tax rates is not enough but it suggests that the critical level is 17.4 per cent (3/5x29).

Certain business activities are excluded from the scope of application of the CFC Act. The CFC regime does not apply if the profits of the foreign corporation are mostly from industrial production or shipping conducted in the state of residence of the corporation.

The Act includes special provisions concerning treaty situations. A corporation that resides in a treaty state does not fall under the application of the CFC Act if (1) the tax burden under the general corporate tax system of the state is comparable to the corporate tax burden in Finland and (2) the corporation has not been subject to a special tax benefit in its state of residence.

The Finnish shareholders are liable for tax on that portion of the profits of the controlled foreign corporation corresponding to each proportionate ownership. However, a person with a share of less than 10 per cent is not liable to taxation based on the CFC regime.

The idea of the CFC regime is to ensure Finnish tax levels with respect to tax haven operations, not to produce double taxation. The state income taxes paid by a CFC in its state of residence or in other states are deductible from the tax payable in Finland. Dividends from a CFC are tax-exempt to the extent they are covered by the CFC income taxed as income of the dividend recipient in the same year or five preceding tax years.

On occasion, the Finnish CFC regime may apply to the Finnish resident shareholders of a corporation resident in a treaty state or an EU Member State. The compliance of domestic CFC regimes with tax treaties and EC tax law has been widely discussed. In a fresh precedent (20.3.2002:26), the Supreme Administrative Court has ruled that the Finnish CFC Act is compatible with a tax treaty and the EC Treaty. The CFC Act could be applied to a finance company in Belgium.

3.3. Residence Rules

Any individual is treated as a resident of Finland if he has his main home in Finland. Thus, Finland does not apply the nationality principle. However, a special rule (the three year rule) applies to Finnish nationals who have left Finland. During the three year period a national may be treated as a non-resident only if he gives proof that he has not maintained substantial ties with Finland during the tax year in question. After the three year period a Finnish national will be considered to be a non-resident unless the tax authority or the taxpayer himself require that he is treated as a resident and shows the existence of strong substantial ties with Finland.

The existence of substantial ties may be evidenced by facts such as that (1) the taxpayer has no permanent home abroad, (2) he stays abroad solely because of studies or health care, (3) he conducts a business or owns real estate in Finland or (4) the family of the taxpayer has its main home in Finland.

3.4. Restrictions of deduction of payments to tax-haven entities

There are no special restrictions on deductions concerning payments made to tax-haven entities. However, there are special provisions on burden of proof. The primary duty to provide information on a specific issue belongs to the party that has a better chance to do so. The taxpayer has better possibilities to provide information concerning its own economic situation, and the tax administration has better access, for example, to the reference material. The both parties must contribute to the resolution of the actual question. However, if the case concerns tax haven operations or if the purpose of tax avoidance is obvious, the taxpayer has the primary duty to provide information.

4. Measures against „unfair“ competition at the international level

4.1. Double taxation agreements

According to the Finnish treaty policy, Finland does not conclude treaties with tax havens. However, there are some exceptions, especially among the older treaties. In connection with the implementation of the CFC Act, the National Tax Board has published a list of the treaty states which are regarded to have a tax system that is not comparable to the Finnish system. The list includes The Arab Emirates, Barbados, Malaysia, Malta, Pakistan, Singapore and Switzerland.

4.2 Code of Conduct

The Code of Conduct is designed to curb those business tax measures which affect, or may affect, in a significant way the location of business activity within the EU. There is only one measure in Finland listed in the report of the Primarolo group. The province of Åland has a limited tax autonomy. Åland is an island with 25 000 inhabitants. Åland grants a special tax advantage to captive insurance companies. This special regime has no fiscal relevance.

Under the Code, member countries have committed themselves, not legally but politically, not to introduce new harmful measures („standstill“) and to examine the existing laws in order to eliminate any harmful measures („rollback“). This development favours the international competitiveness of Finnish business taxation.

4.3 OECD

As a welfare state, Finland welcomes the efforts of the OECD to identify and eliminate harmful tax practices. The report 'Harmful Tax Competition' (1998) addresses harmful tax practices and includes the recommendations of the OECD Council to counteract harmful tax practices. The subsequent report 'Towards Global Tax Co-operation' (2000) indicates that progress has been made in identifying and eliminating harmful tax practices.

The latter report includes a list of the preferential tax regimes identified as potentially harmful. The Åland captive insurance regime is also on the OECD list. In theory, this preferential tax regime is harmful but in practice, it causes no harm because it has not attracted captive insurance companies to reside in Åland.

5. Conclusion

It is unavoidable that globalisation will limit a country's ability to impose higher taxes than other countries, especially on mobile factors such as capital and high-skilled labour. The result of tax competition will be downward pressure on public revenues. In coming years Finland faces fiscal constraints which will force it to consider how its welfare programmes can be maintained. On the other hand, there is no reason to

underestimate the positive impact of public services and transfers on the competitiveness of a welfare state. A good public educational system produces a talented work force. Well-organised care for children and people who need assistance promotes quality of life. A low crime rate and social stability are also factors to take into account. On the other hand, as a state that has such a highly-developed welfare system, Finland must improve the efficiency of its public sector.

Finland is a fair competitor in the field of international tax competition and is accustomed to adopting a defensive role in the game. At the same time, Finland welcomes international efforts to curb harmful tax competition and will be an active participant in this work within the EU and OECD.

Publications related to this topic

Helminen, Marjaana, Finnish International Taxation, WSOY 2002. ISBN 951-0-26465-2
Tikka, Kari S., Tax Competition and the Welfare State: Time to Surrender or to Reconsider, in Liber Amicorum Sven-Olof Lodin, p. 269-282. Kluwer 2001. ISBN 90-411-9850-4.

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