2019 WELCOMES NEW FINNISH INTEREST DEDUCTION LIMITATIONS

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The long-awaited Finnish government proposal[1] concerning new interest limitation rules was published on September 27, 2018. The Finnish parliament responded[2] on December 4, 2018, calling for certain minor changes and accepting the amendment into law. The new limitations took effect as of the beginning of 2019.

BACKGROUND

Before the tax year 2014, only the general anti-avoidance rule ("G.A.A.R.") and transfer pricing adjustments were potentially available to challenge interest deductions in Finland. The tax authorities rarely challenged an interest expense deduction, even in fairly aggressively-leveraged situations.

Following the lead of other European countries, Finland adopted specific E.B.I.T.D.-based rules (*i.e.*, addressing earnings before interest, tax, depreciation[3]) to be applicable in the tax year 2014. Since then, Finland has benefited from a specific interest barrier rule, applicable in both domestic and international situations, affecting the deductibility of intra-group interest payments.

Changes to the Finnish interest barrier regime have been expected since 2016, following the publication of the E.U. Anti-Tax Avoidance Directive[4] ("A.T.A.D."), which sets forth the minimum standards for interest deduction restrictions within the E.U. A.T.A.D. implemented the recommendations set in the O.E.C.D. B.E.P.S. Project, which aims to prevent tax avoidance strategies that exploit gaps and mismatches in tax rules and attempts to find common international rules for combating inappropriate tax avoidance.

The O.E.C.D. countries have been concerned about corporations using debt financing to transfer taxable income to countries that have lower tax rates. The specific recommendations involving interest deductions and other financial payments are included in the B.E.P.S. Action 4.[5]

This article discusses the key elements of the new Finnish interest deduction restrictions, including a brief description of the new rules and some key considerations regarding their impact on Finnish taxpayers and investments in Finland.

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1 Government Proposal HE 150/2018 vp.

2 Response by the Parliament EV 146/2018.

3 The Finnish interest barrier rule does actually not include adjustments for amortizations.

4 Council Directive (E.U.) 2016/1164 of July 12, 2016, laying down rules against tax avoidance practices that directly affect the functioning of the internal market.

5 The B.E.P.S. Actions can be found on the O.E.C.D. website. Action 4 was published in 2015 and was updated in 2016.

INTEREST DEDUCTION RULES IN A NUTSHELL

Compared to the old rules, the new rules included in sections 18a and 18b of the Finnish Business Income Tax Act[6] have a broader scope, mainly in two ways:

- With certain exceptions, the new regime will generally apply to all Finnish-resident corporate taxpayers and partnerships, *i.e.*, not only entities that are deemed to carry on business activities but also other entities. In practice, this means a significant change especially for the Finnish real estate sector, since real estate companies and mutual real estate companies ("M.R.E.C.'s") have, in most cases, fallen outside the scope of the old interest barrier regime.
- Unlike the old restrictions, A.T.A.D. requires the new regime to be applied to all interest expenses, whether paid to a related or unrelated party. Interest payable on a bank loan can also become nondeductible if the amount of interest is high enough to disqualify it from exemptions.

Like the old rules, the new rules include several levels of restrictions and exemptions, which are described below. In that regard, the structures of the old and new regimes are similar.

De Minimis Threshold

The first limitation rule is that if the amount of the company's total net interest payments (*i.e.*, interest expenses less interest income) do not exceed €500,000, the entire amount of net interest expense generally is deductible. The same minimum level existed in the old regime.

"When the net interest expense exceeds €500,000, the deduction is capped at 25% of the adjusted taxable profit."

It should be noted that the €500,000 threshold is lower than its counterpart under A.T.A.D., which is set at net interest payments of €3 million. This stricter approach reflects the Finnish government's view that goal of implementing A.T.A.D. was not to increase allowable deductions under Finnish law in this regard. Thus, the principal of A.T.A.D. was adopted, but the threshold level for imposing restrictions on deductions remained unchanged.

Once the net interest payments exceed the threshold, the following rules apply.

Tax-E.B.I.T.D. Rule

When the net interest expense exceeds €500,000, the deduction is capped at 25% of the adjusted taxable profit ("Tax-E.B.I.T.D.").

Tax-E.B.I.T.D. is calculated by employing the following steps:

1. Starting with the taxable net profit or loss figure, interest expense and tax depreciation are added back into income.
2. Then, any group contributions[7] from affiliates are also added into income.

[6] The Finnish Business Income Tax Act (*laki elinkeinotulon verottamisesta*) 360/1968, as amended.

[7] In absence of a group taxation system or an unlimited consolidation of taxable profits within a group, contributions are the sole opportunity, under Finnish law, to balance taxable profits and losses among Finnish entities in a group. Fairly strict criteria are set for granting group contributions.

3. Finally, group contributions to affiliates are deducted from income.

The Tax-E.B.I.T.D. rule predates the new regime. Under A.T.A.D., deductions could account for up to 30% of E.B.I.T.D. However, Finland has chosen to maintain the preexisting 25% limit.

In practice, the Tax-E.B.I.T.D. rule means that large amounts of interest expense can be deductible if a company is sufficiently profitable.

Safe Harbor for Third-Party Loan Interest Expenses

As mentioned above, pursuant to A.T.A.D., interest barrier rules must apply to third-party interest as well as to related-party interest expense. However, the risk of aggressive tax planning involving interest expense has generally been associated with group related parties. Therefore, in the new Finnish regime it was deemed appropriate to provide more lenient regulations for interest payable to third parties.

If the Tax-E.B.I.T.D. rule would otherwise cap the deduction for interest expense, significant relief remains available for interest payable to parties other than group related parties: Net interest payable to third parties will be deductible up to a cap of €3 million. In comparison to the €500,000 limit, the €3 million limit is a safe harbor rule. Even in cases where the net interest expense payable to parties other than group related parties exceeds €3 million, this amount is always deductible. Further explanation of group related parties appears below.

Balance Sheet Exemption

In cases where the interest ceiling is problematic, notwithstanding the three steps mentioned above, there is still a possibility of avoiding the loss of deductions under the cap.

Finnish tax law provides a balance sheet exemption under which a Finnish company, having a lower debt-to-equity ratio on a separate company basis than the group ratio computed on a consolidated basis, is allowed to deduct the interest expenses that would otherwise be nondeductible. A Finnish entity that has a debt-to-equity ratio that is lower than the consolidated ratio for its group has a greater percentage of its assets funded by equity than the group as a whole. In that set of circumstances, net interest expense of the Finnish company is not viewed to be abusive.

The balance sheet exemption has been extremely beneficial for taxpayers. In 2016, 190 Finnish companies were subject to the interest deduction limitation. The total non-deductible interest expense of all 190 companies amounted to €550 million. The same year, 59 companies were eligible for the balance sheet exemption. This enabled those companies to save a total of €215 million in the aggregate of deductible interest expense, a relatively large amount compared to the aggregate catch of the interest restrictions in that year.[8]

With slight modifications, the balance sheet exemption under current law existed under the old interest barrier restrictions. Under the exemption, the parent of the group must be based in a Member State of the E.U. or the E.E.A., or in a country with which Finland has an income tax treaty in force. In addition, the balance sheets must be prepared in accordance with the I.F.R.S. or legislation applicable in an

[8] Government proposal 150/2018, chapter 2.4.2.

E.U. or E.E.A. country, or in accordance with comparable standards such as U.S. G.A.A.P.

The new rule requires that both the individual company balance sheet and the group balance sheet be prepared in accordance with the same set of accounting principles. If the Finnish company's set of accounts is prepared under I.F.R.S. and the group's consolidated set of accounts is prepared under U.S. G.A.A.P., a reconciliation of one set of accounts can be prepared (either way) so that the computation of the debt-to-equity ratios of the company and the group can be made under the same set of accounting rules.

The balance sheet exemption has been subject to case law regarding the scope of its application. For example, in several cases, the Supreme Administrative Court ruled that only the ultimate group balance sheet may be used in the comparison – not a balance sheet of a sub-group parent company.

GROUP RELATED PARTIES

As explained above, only third-party loan interest may benefit from the €3 million safe harbor rule. In comparison, interest paid on Group Related Party loans may qualify only for the general €500,000 and 25% of Tax-E.B.I.T.D. exemptions. The treatment of the latter is the same as under the old interest barrier rules. However, in the new interest barrier regime, the term is changed from *etuyhteysyritys* (which could be translated as "Related Party") to *konserniyhteydessä oleva osapuoli* (here, we use the term "Group Related Party").

As under prior law, the definition of Group Related Party is the same as the domestic law definition of related parties for transfer pricing purposes found in section 31.2 of the Finnish Act on Taxation Procedures.[9] However, Group Related Party is separate from the definition of Associated Enterprise used in A.T.A.D. when determining exempted Standalone Entities, which are explained below.

The parties are considered group related parties if one party has control over the other party or a third-party, alone or together with associated parties, has control over both parties to the loan transaction.

A party has control over the other party when

- it directly or indirectly holds more than half of the equity of the other party;
- it directly or indirectly holds more than half of the voting rights in the other party;
- it has directly or indirectly the right to appoint more than half of the members of the board of directors or other comparable bodies (or a body having the right to appoint the members in the foregoing) in the other party; or
- it is managed jointly with the other party or it may otherwise *de facto* use control in the other party.

Even though bank loans normally qualify as third-party loans, a bank loan may be recharacterized as Group Related Party debt in back-to-back situations.

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9 The Finnish Act on Taxation Procedures (*laki verotusmenettelystä*) 1558/1995, as amended.

A more complex rule applies when a receivable owned by a Group Related Party is pledged to secure a third-party loan. To the extent of the pledge, the third-party loan is "contaminated" as a Group Related Party loan. In practice, the lender might forego taking a security interest in the receivable in order to enable the borrower to benefit from an interest expense deduction, thereby reducing its tax, which frees up additional funds to service the loan.

ITEMS INCLUDED AS INTEREST

Finnish tax legislation does not include a general definition of interest. Treatment as interest is generally based on case law and general tax practice. Usually, items that compensate the lender for allowing a borrower to use of the borrowed funds are considered to be interest.

To comply with A.T.A.D., the new law includes a specific definition of interest income and expense for purposes of the interest barrier rule. In addition to compensation for the use of debt financing, the definition also covers all expenses incurred in connection with the raising of debt financing. Interest expense and interest income are defined symmetrically.

A.T.A.D. includes an example list of payments that could be considered interest payments. The Finnish government proposal included additional views on which items should be considered interest for Finnish tax purposes:

- Payments under profit participating loans
- (Imputed) interest on zero coupon bonds
- Interest on capital loans, certain interest expenses which are capitalized
- Any interest amount which has been adjusted based on transfer pricing rules

As stated above, expenses incurred in connection with the raising of debt financing will also be considered interest under the new regime. Examples include the following:

- Guarantee fees and fees for granting security
- Arrangement fees and other non-recurring expenses charged in connection with raising debt financing
- Fees for changing loan terms or for premature repayment

The new rules will not affect the tax treatment of expenses from equity financing, such as initial public offerings. In addition, the following items are not considered interest:

- The interest component in a finance lease
- Amounts payable under interest derivatives (*e.g.*, payments based on interest rate swaps)
- Foreign exchange losses

Payments for services that do not constitute a fee for arranging debt financing are not regarded as interest expense even if they are somewhat connected to the debt.

Thus, for example, an advisor’s fee for planning the structure of the debt financing transaction is not considered interest expense.

Financing charges payable by shareholders to M.R.E.C.’s will not fall under the definition of interest (even though, *de facto*, these payments may contain taxable components based on the interest payable by the M.R.E.C. to the bank). An M.R.E.C. is a special type of Finnish limited liability company. The M.R.E.C. owns the underlying real estate assets, but under the articles of association, the owners of the M.R.E.C. are entitled to possess the specified premises or real estate. Consequently, if the premises are leased, the owners of the company will directly receive the rental income. As the M.R.E.C. nevertheless incurs costs (*e.g.*, due to acquisition and ownership of the real estate), the owners must pay maintenance charges and financing charges to the company to cover its costs.

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CARRY FORWARD OF NONDEDUCTIBLE INTEREST EXPENSES

Nondeductible interest expenses continue to be carried forward indefinitely. Also, in the case of a merger or demerger, the nondeductible part of the interest expense will be transferred. However, the nondeductible net interest expense from previous years may not be deducted beyond the limit that is computed for the current fiscal year.

Nondeductible net interest expense should be monitored separately with regard to loans to group related parties and other parties. In addition, if the Finnish entity has another source of income in addition to its business, the non-deductible interest amounts should be allocated to different income baskets, as set out in the law.

Thus, maintaining the “tax asset” for the future requires some administrative work.

EXEMPTIONS

While the scope of the interest barrier rules is broad, some companies remain fully exempt from the restrictions:

Standalone Entities

A.T.A.D. introduces a new definition of “Standalone Entities” (*itsenäinen yritys*), which are exempt from the restrictions based on the assumption that there is lower risk of tax avoidance in such entities. Finland has chosen to utilize the possibility to exclude Standalone Entities from the scope of the interest barrier rules.

A Standalone Entity is an entity that is not part of a consolidated group, does not have a permanent establishment abroad, and is not directly or indirectly entitled to more than 25% of the voting rights, capital, or profits of another entity (or vice versa). Moreover, no entity or natural person has a share of at least 25% in both the entity in question and another entity.

The definition of a Standalone Entity is new to Finnish legislation, and as noted above, it is not the same as a non-Group Related Party. For example, many Finnish residential housing companies will be exempt from the interest barrier rules as Standalone Entities due to their broad ownership base.

Financial Undertakings

The old Finnish interest barrier rules already included an exemption for companies engaged in the financial sector. In implementing A.T.A.D., Finland chose to align the definition to correspond with the definition of "Financial Undertaking" set out in A.T.A.D. in order to avoid any potential claims of illegal State Aid prohibited under E.U. law.

The new law explicitly lists the Financial Undertakings that are fully exempt from the restrictions. Compared to the old law, the definition is broader in certain parts and narrower in other parts. The following Financial Undertakings are exempt under the new regime:

- Credit institutions
- Investment firms
- Alternative investment funds and their managers
- Undertakings for a collective investment in transferable securities and their management companies
- Insurance companies

Certain Long-Term Public Infrastructure Projects

Finland has chosen to implement an A.T.A.D. exemption for certain long-term public infrastructure projects. The old interest barrier rules did not contain such an exemption.

As the current Finnish system for government-supported social housing production was already "approved" as compliant with the E.U. State Aid rules, it was decided that projects qualifying under the Finnish social housing production legislation would also be exempt from the interest barrier rules. This exemption is estimated to cover approximately one-third of all Finnish rental apartments.[10]

Since the exemption in A.T.A.D. is not limited to social housing, the Finnish parliament has, in its response,[11] required that the government and the E.U. Commission continue to assess the possibility of applying a broader exemption to other kinds of Finnish infrastructure projects.

Grandfathering Clauses

As allowed by A.T.A.D., interest expenses payable on certain existing debts are exempt from the restrictions. Interest payments are exempt if paid to parties other than group related parties when the debt is acquired prior to June 17, 2016, provided that no changes to the loan term or loan amount have been made after that date. Also, interest expense that has been activated or included in the acquisition cost of an asset prior to January 1, 2019, falls outside the scope of the new interest barrier rules.

These grandfathering rules strive to ensure that new, stricter rules do not have a harsh retroactive effect, especially on significant long-term investment projects.

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10 Government proposal 150/2018, chapters 4.3.4 and 3.4.3.

11 Response by the Parliament EV 146/2018.

TAKEAWAYS UNDER THE NEW RULES

Although Finland has chosen a fairly broad application of A.T.A.D. exemptions, the new rules are somewhat complex, and they will tighten the Finnish interest deduction regime – especially since the restrictions also cover bank loans and other third-party loans. Here are several points that should be taken into account when contemplating a financing arrangement for a Finnish venture.

"As a result of the new restrictions, it is likely that companies will favor equity financing."

- The limitations will be broadly applicable to limited liability companies and partnerships, including entities that are taxed under the Finnish Income Tax Act,[12] with exceptions for certain existing loans, Financial Undertakings, social housing projects, and Standalone Entities.
- Companies operating in the real estate investment sector should assess the impact of financing structures.
- Companies in other business sectors planning significant leveraged investments in Finland should take into account the interest barrier rules. Infrastructure projects, other than those related to social housing, fall under the restrictions.
- The definition of interest expense will be broader than in prior years and includes expenses that might not be recorded as interest in the accounts of the company.
- The different thresholds for group and third-party loans mean that taxpayers must monitor both categories and maintain separate baskets for possible non-deductible interest expense being carried forward.

As a whole, the interest deduction limitations probably fulfill their goal: to secure the tax base and to prevent overly aggressive tax planning involving interest deductions. As a result of the new restrictions, it is likely that companies will favor equity financing, especially over shareholder loans and other intra-group loans, in order to avoid non-deductible interest expenses, when possible.

In some situations, it may be possible to plan the group structure to optimize the Tax-E.B.I.T.D. base. In other situations, it could be feasible to utilize multiple debtor entities so that the *de minimis* threshold of €500,000 is not exceeded.

The change in law will cause an administrative burden. Taxpayers and their advisers must familiarize themselves with the new rules to ensure compliance and avoid non-deductible interest expenses. While these rules are based on A.T.A.D., the implementation of the directive will vary among the European countries. Thus, multinational groups and investment structures must account for the differences in various countries.

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[12] The Finnish Income Tax Act (*tuloverolaki*) 1535/1992, as amended.