Government proposal on interest deductibility restrictions

Finland: September 2018

In Brief

The Finnish Government proposal concerning the implementation of EU Anti-Tax Avoidance Directive I (2016/1164 – the "Directive") was issued on 27 September 2018, is currently subject to legislative process, and will come into force 1 January 2019. The scope of the interest deductibility restrictions together with the definition of interest in taxation are covered in the proposal. Interest expenses paid to third parties will be within the scope of the interest deductibility restrictions. Finland will not implement all the exceptions permitted by the Directive.

This represents a major development for the real estate industry as most real estate investors have until now been outside the scope of the Finnish interest capping rules.

Key features of the new legislation

The restrictions on interest deductibility will be extended from interest paid by group companies and permanent establishments to also apply to interest paid by "non-independent" companies and interest paid to third parties.

The definition of related parties will be changed to "group undertakings/ companies"; the definition of group undertakings remains at 50% direct or indirect control.

Independent companies are completely outside the scope of the restrictions, including in respect of external interest. Independent companies are defined as those where no party has a 25% influence or control stake. Further, a natural person as the owner will also be relevant in considering if a company is independent.

The restrictions will also apply to general and limited partnerships.

The restrictions will extend to the sources of income taxed under the Income Tax Act and the Farm Income Tax Act. As a result, the new restrictions will also apply to real estate companies that have in general been outside the scope of interest capping rules until now.

The restrictions will extend to all expenses related to obtaining financing. Therefore, the type of finance expenses subject to restriction will expand from pure interest expenses.

Interest expenses paid to group undertakings will be deductible if total net interest expenses (including group undertakings and third parties) do not exceed €500,000 in a tax year. If net interest expenses exceed this threshold, the limitations will be applied to the total amount and not just the amount exceeding the threshold.

The restrictions will continue to be calculated based on adjusted taxable income and the maximum deduction allowed will be 25% of the adjusted taxable income. The adjusted taxable income is described as "taxable EBITD" and is calculated as taxable income including group contributions, adding back interest expenses and tax depreciation (in practice the change in terminology from taxable EBITDA to taxable EBITD does not affect the calculation as all tax depreciation or amortisation is added back to taxable income).

Annual interest expenses paid to third parties will always be deductible up to €3m (if expenses are otherwise at arm's length and related to the company's business).

As is currently the case, a back-to-back arrangement would mean that a loan taken from a third party will be considered a group loan. Additionally, security for a loan given by another group company in the form of a loan receivable leads to a third party being considered as a group loan.

Non-deductible financing expenses will be carried forward without an expiry date and ownership changes will not effect the carry forward. In practice, the order in which interest expenses carried forward and other interest expenses are deducted will need to be carefully considered.

Exceptions

The financial services sector and certain public infrastructure projects will not be in the scope of the restrictions. The scope of excluded infrastructure projects is still under consideration.

The exemption from the restrictions by comparing the equity ratio (equity divided by gross assets) of the Finnish taxpayer to the group ratio will remain. However, the group's consolidated and the Finnish taxpayer's balance sheet should be prepared using the same accounting standards or the group's balance sheet be converted to be equivalent to the taxpayer's balance sheet in order for the balance sheet comparison test to be applicable.

Grandfathering

Interest expenses on third party loans taken before 17 June 2016 are outside the scope of the new legislation, provided that the terms of the loan remain unchanged from 17 June 2016.

Interest expenses on third party loans, capitalised before 31 December 2018 can be deducted after the change in restrictions.

Changes to the draft legislative proposal issued in January 2018

The financial services sector will not be in the scope of the restrictions.

Certain infrastructure projects are left outside the scope of the restrictions.

The current balance sheet comparison test will not be removed.

Exceptions allowed by the Directive not implement in Finland

The EU Directive would have allowed all interest expenses up to €3m to be deductible. In the Finnish proposal, this threshold is not applied to interest expenses paid to group companies.

The EU Directive would have allowed the threshold of deductible interest expenses to be increased to 30% of EBITDA. The Government Bill leaves the threshold at the current level at 25% of EBITD.

The EU Directive would allow infrastructure projects to be outside of the scope of the restrictions if they produce, develop and/or maintain property of common interest. However, in the Government Bill, infrastructure projects are defined more strictly to exclude only social housing projects from the interest restrictions.

Other observations

Even though the equity test remains, it might in practice be challenging to be exempted based on this test. The balance sheets being compared should be prepared in accordance with the same accounting standards or a bridge conversion needs to be done. In groups where the consolidated balance sheet is prepared according to international accounting standards (eg, IFRS or US GAAP) this conversion might prove to be complicated.

It seems that the definition of interest for taxation will not incorporate finance lease payments.

Financial consideration paid to mutual real estate companies will not be considered as interest income/expense even to the extent it relates to interest payments made at the level of the mutual real estate company.

Our view

The proposed interest deduction restrictions represent a major development in the real estate industry since most real estate investors have until now been outside the scope of the Finnish interest capping rules. The impact will be even more dramatic if interest levels raise in the future.

Fortunately, the proposal includes some further reliefs as compared to the draft rules published in January. These include the introduction of grandfathering rules and maintaining the equity test escape clause.

We recommend that real estate investors analyse the impact of the proposed interest deduction restrictions on all existing and new investments. The proposed rules may also impact the market practises on purchase price discounts required regarding deferred tax liabilities on share deals. Real estate investors should closely monitor the upcoming changes that will likely be introduced as of 2020 to property taxation and the scope of the application of the Finnish Business Income Tax Act.

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