DEDUCTIBILITY OF INTEREST PAYMENTS IN THE FINNISH INCOME TAXATION

BY

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1. BACKGROUND

For the past few years, the Scandinavian tax policy debate has taken a great interest in the structural problems of income taxation.[1] One of the problems discussed has been the tax treatment of interest payments. Here the Finnish experience from legislation limiting the deductibility of interest might be particularly relevant.

The Act on Limitation of Interest Deduction in Income Taxation (1974/953) has been in force since 1975.[2] Prior to this, the general rule applied in Finnish income taxation was that interest was deductible without limitation from the taxpayer's gross income regardless of whether or not the interest payment could be considered as an expense incurred for the purpose of generating income, such as business income.

In the income tax system it is *per se* a natural starting point to consider interest payments generally deductible. Income can be defined, for example, as the amount which the taxpayer is able to spend on consumption without thereby reducing the value of his capital wealth. Thus, if the taxpayer borrows 100 FMK, pays 10 in interest, and invests the money in assets yielding 12 FMK, the resulting amount available for consumption or for saving is 2, rather than 12 FMK. The picture gets more complicated if the money borrowed does not produce income that is included in the taxpayer's tax base. This is the case, for example, when the loan is incurred solely for the purpose of financing an excess of current consumption, or when the money borrowed is invested in an asset which is tax exempt on the basis of some special tax relief provision. In cases like this the deductibility of interest payments from the taxpayer's tax base will be questioned.

The Finnish income tax system contains a number of factors which might result in a situation similar to those mentioned above. Interest on bank

[1] These problems were the object of the seminar of the Nordic Council for Tax Research in Moss in October 1980: *Från nettobeskattning till bruttobeskattning* (From Taxation on Net Base to Taxation on Gross Base), Nordiska skattevetenskapliga forskningsrådets skriftserie no. 8, Stockholm 1981.

[2] This Act is discussed, for instance, in the following papers: Edward Andersson, "Lagstadgad begränsning av ränteavdragsrätten i Finland" (Legal Limitation of the Right to Deduct Interest Payments in Finland), *Skattenytt* 1978, pp. 495–502, and Kari S. Tikka, "Korkojen vähennysoikeuden rajoittamislain soveltamiseen liittyvistä ongelmista" (Problems of the Implementation of the Act on Limitation of Interest Deduction), *Verotus* 1979, pp. 147–61.

deposits and government bonds has, as a rule, been free from tax on the basis of special legislation during most of the post-war era. It was not uncommon for a taxpayer to take up a loan, invest the money in tax-free bonds and deduct the interest from his other income, such as salary income. Of special interest here is the tax relief legislation for the promotion of housing production, in force from 1953 to 1966. This aimed at channelling investment funds into housing production in order to relieve the housing shortage. This gave rise to great tax advantages in the instances where the investor was able to borrow large sums, which he invested in rental housing, because he received the rents free of tax, and was able to deduct his interest payments from his other income. In order to prevent this, a special provision excluding interest on loans incurred for the financing of tax-free dwellings from the general deductibility scheme was inserted in the tax relief law. Borrowed funds may also be invested for the purpose of deriving income primarily in the form of capital gains. One special feature of the Finnish tax system is that capital gains, on certain conditions, are wholly tax exempt. If an individual has owned shares longer than five years or real property longer than ten years, the capital gain from the sale of such capital is wholly tax exempt. Interest deduction seems to lead to an unwarranted tax benefit in the case where an investment is financed by loans; interest paid is deducted from the taxpayer's gross income and the yield is eventually realized in the form of tax-free capital gains.

Interest deductions also serve as a tax expenditure subsidy in financing owner-occupied homes. If the funds borrowed are used for the acquisition of a dwelling used as a home, and the interest is deducted, there arises the problem that the return on this investment under the Finnish tax system generally remains entirely untaxed or at any rate is subject to only slight taxation. This is due to the fact that the taxability of the imputed rent on owner-occupied homes is greatly restricted. In practice most dwellings are not taxed at all on the basis of imputed rent.

These were some of the points brought forth in the tax policy debate, which resulted in the Act on Limitation of Interest Deduction. In addition, there are certain points of a more general nature, which have a bearing on this case. The demand for credit money, and in particular for bank credit, has constantly been in excess of supply. This is probably at least partly due to the low interest level in connection with inflation. So, when a bank extends a loan, it confers a special favour on the borrower. Thus it would not be fair for the banks to extend loans for the financing of luxury housing or portfolio investments, etc., especially as the interest deduction gives rise to a tax benefit.

Another important point was that the tax deductions were said to favour well-to-do individuals, because their higher marginal tax rates result in larger tax cuts. There have been some notorious cases of celebrities paying tax at a rate much below that implied by their incomes. One of the reasons for this, which was also voiced in public, was that these individuals had benefited from large interest deductions from their gross income.

2. THE ACT ON LIMITATION OF INTEREST DEDUCTION

When the Act on Limitation of Interest Deduction was drafted, there were great differences in political opinions. Unanimity was reached only on two points. In the first place, it was considered that interest charges should not be deductible if they are directly connected with the production of income rendered tax-free by law (for example interest on certain bonds). In the second place, it was agreed that interest should be deductible if it is incurred for the purposes of a business or a profession. It was also thought natural that persons engaged in farming or forestry should be allowed to deduct interest incurred in these activities.

Opinions differed regarding the scope of the limitation of interest in other instances. The view that was finally agreed on considered the terms "business" and "profession" to be too narrow to give an adequate description of the different kinds of activities connected with deductible interest. It was, for example, felt that interest should be deductible when a personal loan is incurred for acquiring shares in connection with business activity, or for financing a partnership. It was hard to reach agreement on the scope of the terms. Finally the Government solved the case by introducing the term "economic activity" which is a broader concept than business and professional activity. Interest in connection with "economic activity" remains deductible with no limitation. In order to secure a flexible application of the law it was agreed not to make use of the term "interest incurred for the purposes of a business, profession or other economic activity". Instead, the term "interest connected" with these activities was used. The Government's explanations to the Bill were not very detailed, nor did they give much guidance for practical taxation purposes as to how to distinguish between activities that are subject to limited interest deduction and those that are not.[3]

We now turn to the substance of the law. The taxpayer may deduct all interest on loans connected with a business, profession, farm or other economic activity, without limitation. In addition to this, a provision which grants the taxpayer a deduction of interest up to 15 000 FMK on debts incurred for the purpose of acquiring a home was included in the Act. This provision seeks to

[3] See Bill 110/1974.

exclude the loan financing of luxury dwellings or weekend homes. The taxpayer may further deduct interest up to 5 000 FMK on other debts. This provision grants the deductibility of interest on certain small loans used for financing studies or general living expenses or the like. The maximum deduction is the same for single taxpayers as for married couples jointly.

In 1979 certain amendments were made to the law.[4] The maximum amounts were corrected for inflation, and the right to deduction was fixed at a general maximum of 25 000 FMK. Out of this amount, only 10 000 can be connected with other than housing loans. In this way the inequity inherent in the parallel set of deductions was eliminated. Prior to this, a couple with 20 000 in interest charges could deduct the whole amount if 15 000 was for housing and 5 000 for other purposes, whereas they could deduct only 15 000 if the whole amount was for housing loans.

3. THE IMPLEMENTATION OF DEDUCTIBILITY LIMITATIONS IN TAXATION PRACTICE

a. *General*

The Finnish Constitution provides for taxes to be enacted by statute (Constitution Act, sec. 61). This is the basic principle of legality, according to which the principles guiding taxation should be explicitly stated in law. In practice, however, Finnish tax laws are not made to contain very detailed provisions. Case law, *nota bene* the decisions of the Supreme Administrative Court, plays an important role in shaping practical taxation rules. The role of the Supreme Administrative Court was especially prominent in implementing the law on limitation of interest deductibility.

There are several reasons for this pronounced importance of case law in defining the actual impact of the limitations of interest deductibility. For many reasons the law was drafted in rather vague language. The pivotal term "economic activity" was the result of a political compromise. The supporters of stricter limitations probably had a more restricted view of this term than those members of the lawmaking bodies who were sceptical or negative towards far-reaching limitations to the right of deduction. This may perhaps be called a "hidden delegation" of legislative powers. The tax administration and the Supreme Administrative Court were given this task in order to break the political deadlock. Another reason for the importance of case law was that the Act was prepared by civil servants in a very short time, thus providing less

[4] Act 1979/973.

time for detailed background studies. Nor was there any foreign legislation to pattern the law on.

b. *Portfolio investments of individuals*

Shortly after the Act had entered into force there arose the question of whether the limitation of interest deductibility also concerned the share holding of private persons. The problem was, in other words, whether portfolio investments can be considered to be "economic activity", and the interest incurred to be deductible. The generally held view was that the portfolio investments of individuals cannot be considered to constitute economic activity. Thus interest could be deducted only up to 5 000 FMK. On the other hand, if a private person has large share holdings and for example needs credit financing for his participation in a new issue of shares, the situation was unclear.

The Supreme Administrative Court's standpoint (SAC 1975 II 544) was that share holdings of a portfolio investment nature, even if they are large, cannot be considered to constitute economic activity. The facts in this case, which is a precedent of great importance for the implementation of the law, are as follows: A person holding quoted shares worth some 2 million FMK and other shares worth 2 million FMK had subscribed for new shares in an issue of shares, and taken up a loan of 600 000 FMK for this purpose. The interest on the debt was 69 000 FMK per annum, but the Supreme Administrative Court decided that the taxpayer could deduct only 5 000 FMK. In practice, the non-deductibility of interest in cases like this means that private persons cannot afford to buy shares on credit, as the interest is non-deductible whereas the dividends naturally are taxable income.

c. *Interest connected with the letting-out of flats*

Another problem which emerged soon after the law had come into force was how to treat interest connected with the letting-out of houses or flats. Here, the Supreme Administrative Court took a more "liberal" view than in the case of portfolio investments. In a number of cases, for example in SAC 1975 II 543 and in SAC 1976 II 530, it found that the letting-out of several flats constitutes economic activity. This finding is probably based on the idea that the letting-out involves greater activity on behalf of the taxpayer than do portfolio investments. For some years, however, it was not clear how extensive the letting-out had to be in order to be considered as economic activity. Gradually, the line was formed in case practice. According to SAC 1977 II 550 and SAC

1978 II 550, the letting-out of only one flat does not qualify for economic activity, whereas the letting-out of even two small flats does.

d. *Special cases where a taxpayer owns a material interest in a close company or an enterprise of a similar nature*

On submitting its Bill on the Act on Limitation of Interest Deduction the Government noted that the concept of economic activity has been given such a broad scope in law that it will permit unlimited deductibility in cases where the taxpayer has incurred a personal debt in order to acquire shares in connection with an "enterprising" activity or to finance a partnership.[5]

In practice, exemption from limitation of interest deductibility has generally been granted in cases where a taxpayer acting as a company director or other executive has taken up a loan to finance a substantial share of his company. The acquisition of shares has in one way or the other been connected with securing or retaining this position. In SAC 1976 II 531, the taxpayer's debts were considered to be in connection with economic activity, as he had acquired shares in the family company to confirm his managing directorship.

In some cases, a company director-shareholder has been allowed unlimited deduction of interest on personal debt incurred for the purpose of acquiring a plant or installation which has been leased to the company, even though the mere leasing itself would not have qualified as economic activity. In some other cases, too, the shareholder has been allowed unlimited deduction of interest, if the assets in one way or the other have been channelled into the company. These cases, however, show numerous individual traits. No precise decision rules can be laid down, especially as no more detailed regulations are available.

The director-shareholdership may be a result of the taxpayer's acquiring a gift or inheritance comprising a substantial share of the company. Here, the gift or inheritance tax may be high, and the taxpayer may have to finance the payment of his tax with a loan. The question has been raised in practice of whether the taxpayer should be allowed unlimited deduction of interest in cases like this. There is no general rule granting the deductibility of interest on loans incurred for the purpose of paying taxes. The relevant decision is laid down in SAC 28.2.1979 t. 966. The taxpayer in this case was the assistant managing director of a company who, after having received a gift of shares from his father (the former managing director of the firm), found himself the major shareholder with a 40 per cent interest in the company. In this case, the

[5] See Bill 110/1974, pp. 1–2.

interest on the debt incurred for the payment of the gift tax could be deducted without limitation, as the loan under the circumstances was considered to be in connection with the taxpayer's economic activity. The basis for this solution might be the fact that the interest would have been deductible without limitation in a similar case if the arrangement had been in the form of a sale, where the loan would have been incurred for the purpose of financing a purchase. Thus it is possible that the interest would not have been deductible without limitation if the taxpayer in a similar situation had acquired the shares as an inheritance, and if the loan had been incurred for the purpose of paying the inheritance tax. It is considered that a sale or a gift involves a degree of activity which the acquisition of an inheritance lacks. However, the position of the law on these questions is rather unclear.

e. *Interest paid by holding companies*

The problems connected with the right to deduct interest are accentuated in the case of holding companies. There is no provision in the Act on Limitation of Interest Deduction which would limit the application of the law to individuals only. The Act thus concerns companies as well. The main problem is whether a company whose chief objective is to own shares can be considered to be engaging in business or even "other economic activity".

The Supreme Administrative Court has had to decide in a number of cases on the deductibility of holding companies' interest charges. No clear-cut line can be discerned. In some cases the holding company has been considered to be engaged in business. On the other hand, in several cases the holding company has not even been considered to be engaging in "other economic activity", notwithstanding substantial interest charges on debts. This might be explained by the following line of reasoning: Because an individual is not, in general, allowed unlimited deduction of interest on debts connected with the acquisition of shares, there is no reason to grant him exemption from the limitation merely because he arranges the acquisition of the shares and loan in the name of a holding company. On the other hand, there are examples of holding companies being used for acceptable non-avoidance organisatorial purposes within the framework of a larger corporate group. In such a case, the holding company has been seen as engaged in business, and as a consequence, its interest payments are deductible without limitation.

It has proved difficult in practice to draw a distinct line between the two types of holding companies mentioned above. The holding companies considered to be "in business" are usually the "auxiliary companies" of some large group, or the parent of the group, the subsidiary companies of which are engaged in *bona fide* production, trade or the like. Holding companies that merely hold the investment portfolios of its shareholders are considered "not in business", and may deduct only 10 000 (5 000) FMK in interest payments.

f. *Interest connected with housing financing*

In accordance with the Act on Limitation of Interest Deduction, the upper limit of 25 000 (15 000) applies only to interest connected with the taxpayer's acquisition of a home for himself or for his family. Thus the limit is not applicable to, e.g., the acquisition of a second home for vacation purposes etc. In certain cases, however, it has been decided that a person may deduct interest on debts connected with the acquisition of two separate homes, within the given limits. These special cases usually involve a taxpayer who regularly works in one area and lives in another area, or a husband and wife working in different areas, with a house or a flat in both places.

In some cases, e.g. because of slow construction work, the taxpayer may have to resort to debt financing for the purpose of the acquisition of the new home long before the family can occupy it. In court practice, interest charges have been deemed deductible in such cases.

g. *Loan purpose—continuity*

In practical life various situations arise where the problem is whether there has been such a change in the initial circumstances connected with a loan as to demand a revision of the deductibility status of the interest.

To take an example, one could imagine a case where a trader winds up his business as a result of bankruptcy or on his own accord. If there remain any debts to be borne by this individual trader, the question will arise of whether he should be allowed to deduct interest without limitation, even though the business giving rise to this unlimited deductibility in actual fact has ceased to exist. The relevant precedent is found in the SAC decision 16.1.1979 t. 127. Here, debts connected with a bankrupt business were found to be in connection with economic activity, as the capital had been definitely lost in the course of the taxpayer's business, and thus could not be seen as having been carried over to benefit the taxpayer's other activities, that is, activities that did not qualify for unlimited deductibility.

The solution in the above case seems quite natural. It is obvious, however, that no general conclusions can be drawn from this case. There have been other court decisions where the solution has been different, though the circumstances have been very much the same. In SAC 28.4.1980 t. 2246 the facts of the case were as follows: A widow had inherited a large fortune and some debts. The debts had been incurred for her late husband's company, which he had founded and which had gone bankrupt. The widow was not allowed to deduct all of the interest for the purpose of her own taxation, although the debts had been connected with her deceased husband's former economic activity, thus qualifying for deduction in his taxation. In practice, it is rather problematic to draw a precise border-line in cases like this. The result has not always been fair from the taxpayer's point of view.

h. *Loan purpose—burden of proof*

There is an explicit provision, in sec. 5 of the Act on Limitation of Interest Deduction, concerning the taxpayer's obligation to show for taxation purposes why the debt has been incurred. Before the law had been tested in practice, there was a general feeling that the process of defining and showing the purpose of the debt would prove cumbersome.

It is perhaps somewhat surprising to notice that this question has not caused any great practical problems. Nor is there much evidence of tax court cases where the question of the purpose of the loan has been debated. The disputes have centred rather on the question of how the activity or purpose for which the debt has been incurred should be understood from the standpoint of the law, that is, does the purpose qualify the interest for unlimited deductibility or not.

The fact that the question of showing the purpose for the loan has not proved as difficult as was expected, is probably partly explained by the rather liberal view taken by the tax administration: if the purpose reported has seemed plausible, considering the taxpayer's financial situation, it has usually been accepted.

One might perhaps pose the question of whether it is acceptable to allocate a debt to the acquisition of some particular asset. One might propose that the taxpayer's total debts should be attributed to the totality of his assets, thus attributing a proportionate share of the debts to each separate item. The Act on Limitation of Interest Deduction does not rest on this assumption. Instead, each debt is supposed to have an individually proven purpose. Usually the purpose of the loan can be discerned from its temporal connection with a financial arrangement engaged in for the purpose of acquiring a certain property.

4. NOTE ON THE EFFECTS OF THE LIMITATION OF THE DEDUCTIBILITY OF INTEREST PAYMENTS. SOME PROPOSALS FOR REFORM

The effects of the limitation of the deductibility of interest payments can be assessed from different points of view. The tax statistics suggest that the impact of the limitations enacted by law is not great. According to the figures for the assessment year of 1979, a total of 535 093 taxpayers deducted interest on housing loans, but of these, only 2 005 made the maximum deduction (15 000 FMK). The general interest deduction, which is not bound to any loan purpose requirement, was made by 672 103 taxpayers. Only 7 476 made the maximum deduction, which in that year was 5 000 FMK.[6]

This way of examining the effects of the limitations does not give any answer to the question of how the existing limits have influenced the taxpayers in their financial decision making, though it is obvious that the limitations have had some kind of preventive effect. At any rate the fact that interest is not deductible makes it less attractive financially to acquire luxury housing, expensive vacation homes or large share portfolios with loan financing. The Act on Limitation of Interest Deduction has been criticized during the time it has been in force, among other things, for creating legal uncertainty. In practice it has in many cases been unclear whether the interest has been deductible without limitation or not. It has sometimes been difficult to find a plausible explanation for not accepting interest as deductible in one case which differs only slightly from another, admissible case. The case referred to above, where the letting of one flat and the letting of two (or more) flats are treated differently as regards the deductibility of interest, merely serves to show how unclear the legal position is. The difference in treatment accorded a director-shareholder versus other shareholders in their acquisition of shares is another point which needs clarification.

An amendment to the present situation was proposed in the report of a government-appointed committee.[7] This stated that the Act on Limitation of Interest Deduction should be complemented with a provision extending the concept of economic activity to include, *inter alia,* debts incurred for investing in a corporation or partnership carrying on business or agriculture, as well as debts connected with houses or flats used for letting. So far, the proposal has not led to any new legislation.

The right to deduct interest was being debated in the autumn of 1981. The issue especially at stake is whether it is reasonable to allow a deduction for

[6] Revenue Statistics 1979, Publication of the Finnish National Tax Board 168.

[7] Yritysverotustoimikunnan mietintö (The Report of the Committee for Reform of Taxation of Enterprises and their Owners) 1980: 42, Part 13, Reform of the Act on Limitation of Interest Deduction, pp. 125 ff.

interest on housing loans up to the present limit of 25 000 FMK. The full deduction may certainly lead to a favourable result from the taxpayer's viewpoint. What is referred to as the "imputed income" of an owner-occupied dwelling is taxable only when the taxable value of the dwelling is in excess of 190 000 FMK. Most values are well below this sum. A taxpayer who buys a flat measuring 100 m^2 for a price of 300 000 FMK, 250 000 of which in loans, will probably pay 25 000 FMK in interest charges and all this sum is deductible from his gross income, at the same time as the taxable value of the flat may be, say, 200 000 FMK and the imputed income 300 (3 % of 10 000) FMK.

The right to deduct interest mentioned above has been found to grant an unfair tax subsidy to a taxpayer who owns his own dwelling, compared with one who lives in a hired flat or house. This advantage can be criticized on social and tax policy grounds. The deduction right does not take into account for example family size; thus a single taxpayer has the same deduction right as has a breadwinner with spouse and several children. It has also been argued that the deduction right has a perverting influence on the housing standard of higher-bracket income earners: after the loans taken to finance the present dwelling are paid up, new debts are incurred to finance a more expensive dwelling, at the same time providing deductible interest expenses. This spiralling development might lead to an unnecessarily high standard of housing. It is, however, not possible to make any definite assessment of the impact of this phenomenon.

The present tax policy debate has brought forth some points of a more general nature supporting greater restrictions on the right to interest deduction. The chief argument here is that the real interest burden decreases with higher marginal tax rates. This can hardly be seen as positive from the point of tax policy. The proponents of the interest deduction right point out that the deduction takes into account differences in the ability to pay taxes between taxpayers within the same income bracket—differences that are influenced by the interest expenses incurred. The following alternative solutions, among others, have been proposed: (1) Only part of the interest should be deductible. (2) Only part of the interest should be deductible in those income classes where the marginal tax rates exceed a certain limit (e.g. 50 per cent). (3) Part of the interest should be deductible directly from tax, and not from the tax base, which would give the same result of the interest deduction regardless of income level.

The right to deduct interest to the present extent has been criticized also on the grounds that it does not take into account the impact of inflation on the real interest rate. It has even been suggested that interest should be deductible only to the extent that it exceeds the rate of inflation.

The present lively debate has so far not led to any concrete legislative action.

The interest deduction right is a politically sensitive issue, and many political groups are firmly opposed to further restrictions on the deduction right. When the present statute on the limitation of interest deductibility was enacted, in 1974, the restrictions were largely criticized and they were even held to be incompatible with the income tax system. Today, one can say that the restrictions on the right to deduct interest payments have formed a permanent part of our income tax system, although the Act itself is not so successful from a legal technical point of view. It is necessary to continue to develop the provisions concerning the limitation of interest deductibility. Judging from the tax policy debate, it is not at all impossible that the development could lead to restrictions that in some respects are less generous than the present ones.