Government proposal (218/2018 vp) on changing the CFC legislation

The Government proposal on the implementation of the EU ATAD I directive (2016/1164) related CFC legislation has been published on 1st November 2018. The new legislation is coming into force as of 1.1.2019. Due to the changes concerning particularly the control requirement and so-called escape rules, it is likely that Finnish CFC legislation will be applicable to larger number of cases. At least the method of analyzing the applicability of the CFC legislation is changing to great extent.

The main differences between the CFC legislation now and after the reform

The basic logic behind both the current and the changed CFC legislation is similar; if the foreign company is too low taxed in its state of residence, according to the CFC legislation the Finnish partner is taxed in Finland based on the income of that foreign corporation provided that none of the escape rules apply. The Finnish partner must have the control over the foreign company.

The *control* criteria and the so-called *escape rules* face significant changes due to the new legislation.

In addition to the aforementioned central changes, it is worth mentioning that in the future also a Finnish branch/permanent establishment of a non-Finnish company can be subject to CFC taxation in Finland. Also the withholding tax on the dividends distributed by the CFC can be credited in Finland against the CFC income.

The determination of the too low taxation is not in itself facing any changes; also after the reform the rate that is under 3/5 of the Finnish tax rate might trigger the CFC taxation in Finland.

The control

According to the current CFC legislation, the control is established if *Finnish persons* have at least 50% control in the foreign company. According to the renewed CFC legislation, the control is established if the Finnish *either alone or together with related parties* have a control of at least 25%. The residence state of these related parties is irrelevant. Therefore, if a Finnish group company owns any shares in any other group company X, the renewed determination of the control criteria can be fulfilled since the shareholding of other group companies in the same group company X are taken into account when analyzing the fulfillment of the control criteria. Accordingly, in a situation where a Finnish person/company is a minority shareholder in a foreign company/group (e.g. 30% ownership), all of the group companies belonging to that group can trigger Finnish CFC taxation.

Examples:

A Oy owns 40% of a foreign company X. Other shareholders in X are separate from A Oy (not related parties). After the reform, A Oy has the control over X. According to the current legislation, it has not.

A Oy owns 2% of a foreign company X. Other shareholders in X are foreign companies belonging to the same group with A Oy (related parties to A Oy). After the reform, A Oy has the control over X. According to the current legislation, it has not.

So-called escape rules

On the basis of the current escape rule, a company subject to a low taxation does not trigger the Finnish CFC taxation, if it (i) carries out the right kind of business activities, or (ii) is located in a “good” country and does not benefit from a special tax regime, or (iii) is located in a “good” country and is genuinly established there.

After the reform there will be only two so-called escape rules. One applying to EEA-area and the other applying to countries outside the EEA-area.

According to the so-called escape rule applying to EEA-area, the CFC legislation does not apply if the company has genuinely established in the country and in fact carries actual business there. This criteria is valued, taking into account the characteristics of the activity, by considering whether the foreign company has sufficient facilities, equipment and funds, and staff that is competent for the company's business independently and making the decisions regarding the daily activities of the company independently.

Example:

> *Swedish holding company receives dividend income or capital gains that would be taxable income in Finland, but are tax exempt in Sweden based on the local legislation or tax treaty. The company in question does not receive other income. After the reform the Swedish company's income is taxed in Finland as CFC income, unless the company is considered to have genuinely established in Sweden and in fact carrying actual business in Sweden. The current CFC legislation would not be applied because Sweden is a "good country" and the general Swedish legislation regarding taxation of dividends or capital gains cannot be considered as a special tax regime.*

The escape rule applying to countries outside the EEA includes the same requirement for the genuine establishment, but also three additional requirements that all must be met. These three additional requirement are (1) the state of residence cannot be in the EU's so-called black list, (2) Finland must have an active agreement on the exchange of information in tax matters with the country in question (3) The foreign company must carry out business activities that are covered by the business line exception. The business line exception covers mainly industry and production and certain kinds of services. It does not cover e.g. managing investments, centralized owning or transferring of group's intangible assets, unless the company in question itself carries out research and development activities, intra-group financing or assurance activities or administration, management or supervision activities.

Examples:

- *An industrial company residing in e.g. Iraq/Saudi Arabia/Chile that is taxed at a too low tax rate can trigger the CFC taxation in Finland because Finland does not have a tax treaty or possibly another agreement on the exchange of information in tax matters with the countries in question. The current CFC legislation would not apply since an industrial company would be exempt from the CFC taxation regardless of the country of residence.*
- *A parent of the sub-group resides in US. The company employs multiple people responsible for the management, treasury and IP administration. The company in question does not carry out research or development activities. If the company is taxed at a too low rate in US, it might trigger the CFC taxation in Finland because its business does not necessarily fulfill the definition of the business line exception. The current CFC legislation would not probably apply because the company would probably be considered to have in truth settled to US and therefore there would be no need to consider the business line exception.*

Mirva Laaksonen
Corporate Taxation
+358 50 568 5956
mirva.laaksonen@pwc.com

Jarno Laaksonen
Corporate Taxation
+358 40 588 8753
jarno.laaksonen@pwc.com