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Taxation of partnerships and partners in Finland: a short economic retrospective

1. Some general remarks

The multidimensional nature of small business firms sets obviously difficult requirements for the tax system. This fact has also been recognized in Finland. However, it should be noted that the recent Finnish income and company tax reforms have mostly dismissed the specific tax issues of certain small business forms, particularly partnerships (in Finnish henkilöyhtiöt, the so-called "person(al)companies", personbolag).

Small businesses include both self-employed entrepreneurs and partnerships, which are in Finland currently taxed inside the boundaries of individual tax rules (Income Tax Act, taxation of the owners), and also small incorporated firms (small limited companies and co-ops), which are normally taxed separately (tax subjects) from their owners (Business Income Tax Act) as companies.[1] Many economic activities can be carried out either by an employee working for a company or by a self-employed individual. Similarly, many activities can be undertaken either by a self-employed person or by an individual who is the owner. If the tax treatment of the income derived from these activities differs substantially depending on the legal form in which they are conducted, the tax system is likely to have impact on the ways in which small businesses are structured.

[1] The current details of the Finnish tax system are described and discussed in the legal report (Järvenoja 2015).

It should be noted that the possible asymmetric treatment of profits and losses may affect the tax incentives of partnerships. When taxable profits are positive, they are taxed (as personal income of the owners), but when taxable profits are negative (tax loss situation), they generally do not produce a full tax rebate even though at least partial rebate is possible also in the personal income taxation of the owners. In Finland the losses are only carried forward (max 10 years) and there is no compensation for the time delay before they can be used to reduce future tax payments. This implies that the value of future tax reductions associated with an additional 1 euro of tax losses today may be considerably lower than the tax paid on an additional 1 euro of positive taxable profits. This asymmetric treatment of losses can discourage risk-taking by firms.

Another fundamental reason why partnerships may present challenges for the tax system is that income derived from small business activities generally reflects a mix of rewards for labor supplied by those who work for the business and returns to capital supplied by those who invest in the business. With a small, owner-managed company (the basic case in Finland) the owner-partner has considerable discretion over the way in which he derives taxable income from the firm. If the partner chooses to pay himself a lower salary, he can increase the profits of the firm; and by choosing to distribute these profits, he can increase the share of his income that comes in the form of dividends.

When the tax treatments of earned income and capital income are different (the situation in Finland), the tax system has a significant impact on the ways in which small business proprietors choose to take their remuneration. If, at the margin, the taxation of distributed profits is lower than the tax rate that applies to labor income, this ability to reclassify income for tax purposes can result in owner-partners of small firms paying less tax than self-employed individuals or ordinary employees who perform similar tasks for the same gross remuneration. Obviously in some situations it may be preferable to transform or reclassify capital income into earned income (wage or something else) if the tax level of capital income (currently nominal rate 30/33 %) is higher than the tax rate on (relatively) small wages.

2. The tax system and the role of partnerships in the Finnish business structure

As described in the Finnish legal report (Järvenoja 2015) the partnerships are regarded in taxation as non-taxable transparent entities. The partnership as a business firm is not a tax paying entity. If the owners (partners) are normal Finnish individuals, the partnership income is taxed at the partner level either as capital income at a flat tax rate of 30 or 33 per cent or as earned income at progressive tax rates. The distinction between capital and earned income is made on basis of partnership´s net wealth (net wealth of business wealth). A 20 per cent interest of the partner´s share of the partnership´s net wealth (imputed rate of return) is determined as capital income and the rest of the share of the partnership income is taxed as earned income. Limited partner´s share of the partnership´s net wealth is usually determined equal as the capital contribution made by the limited partner. The same income taxation principle is applied also on taxation of the limited partner´s income share. Additionally, one very important concept in the Finnish partnership taxation is the asset transfers from partnership to partner´s private use (private drawings, privatuttag). A partner can transfer the assets into private use with an amount of more than his or her investments and undistributed profit shares are without triggering taxable income. Thus the partner´s equity share can become negative without income taxation. The negativity will be added into capital gain when the partnership interest is alienated or the partner resigns from the partnership. The basic tax elements of small enterprises in Finland have been summarized in the table 1.

Table 1. Taxation of various small business entities in Finland 2015.

	Enskilda näringsidkare	**Personbolag**	**Icke-noterat aktiebolag**
Förvärvskällor	Näringsverksamhet	Näringsverksamhet Inkomst från lantbruk Personlig inkomst	Näringsverksamhet Inkomst från lantbruk Personlig inkomst
Kapitalunderlag	Nettoförmögenhet i slutet av föregående inkomståret+ 30 % av lönesumman (näringsverksamhet)	Nettoförmögenhet i slutet av föregående inkomståret + 30 % av lönesumman (näringsverksamhet)	Aktiens matematiska värde (grundar sig på nettoförmögenheten), hela verksamhet
Avdrag från nettoförmögenhet		Värdet av bostad där delägaren har bott,	Värdet av bostad där aktieägaren har bott
Avkastningsprocent	0, 10 eller 20 %	20 %	8 % (max 150 000 e)
Övrig kapitalinkomst	Försäljningsvinster av fastigheter och värdepapper (anläggningstillgångar), om de överstiger kapitalinkomstandelen	Personlig inkomst	
Löner till företagaren	Inte möjligt, inte heller till maken eller barnen under 14 år	Möjligt (ett reellt arbete, en rimlig lön)	Möjligt
Skattereserveringar		Driftsreservering	
Förvärvsinkomst	Annan än kapitalinkomst	Annan än kapitalinkomst	Annan än kapitalinkomst, förtäckt aktieutdelning

The legal structure of the Finnish business sector has been relatively stable during the last 15 years (see Statistics Finland and also Kari et al. 2004). The structure is characterized by the prominent role of incorporated firms. The importance of partnerships has slowly decreased (see also table 2). The possible dividend tax reform (further increase of partial double taxation of corporate profits) can improve the relative attractiveness of partnerships and sole proprietors compared to corporations.

Table 2

	31.3.2015	**31.12.14**	**31.12.13**	**31.12.12**
Enterprise forms Finland				
Osakeyhtiö	253 778	251 421	245 363	232 258
Yksityinen elinkeinonharjoittaja	210 346	209 123	202 250	195 416
Asunto-osakeyhtiö	86 186	86 016	85 083	84 121
Kommandiittiyhtiö	**34 112**	**34 315**	**34 802**	**35 099**
Avoin yhtiö	**12 081**	**12 221**	**12 437**	**12 671**
Osuuskunta	4 763	4 718	4 530	4 379
Sivuliike	1 254	1 238	1 201	1 127
Aatteellinen yhdistys (*)	407	403	384	357
Julkinen osakeyhtiö	224	223	212	204
Osuuspankki	215	215	218	232
Säätiö (*)	37	36	32	31
Keskinäinen vakuutusyhtiö	35	36	36	36
Säästöpankki	25	25	26	28
Vakuutusyhdistys	22	22	21	23
Vakuutusosakeyhtiö	20	20	21	23
Asumisoikeusyhdistys	17	16	15	11
Valtion liikelaitos	3	3	3	3
Eurooppayhtiö	2	2	1	1
Eurooppalainen taloudellinen etuyhtymä	1	1	1	1
Eurooppalaisen taloudellisen etuyhtymän sivuliike	1	1	1	1
Hypoteekkiyhdistys	1	1	1	1
Taloudellinen yhdistys	1	1	1	1
Total	**603 531**	**600 057**	**585 640**	**566 995**

31.3.2015

*Partnerships (avoin yhtiö, kommandiittiyhtiö) 46 193, only 7,7 % of the total amount

*Limited companies 42 %

*NOTE: these numbers include all enterprises, active and non-activ

3. The effects of the Finnish tax system on incentives to finance and invest

The Finnish dual income taxation creates directly incentives for income shifting between earned income and capital income (min tax level 0 against 30, max tax level 55 agains 33). The current income splitting rules try to control and diminish this kind of tax planning activity. The tax payment of the partner (based on the partnership profit) can be calculated as: (see Kari 1998, Kari et al. 2004)

T = t(c)(NP), if NP is less or equal than b*NW*

*T = t(c)*bNW + t(e)*(NP-b*NW), NP is more than b*NW*

Where T = tax, t(c)=capital income tax rate (30/33 %), t(e)= earned income tax rate (0-55 %), NW=net wealth, the basis of the capital income part of the income and b=is the capital income percent rate (currently 20 %). With the current numbers the tax equation is (below income limit 30 000 euros)

T = 0,3 x net profit

Or

T = 0,3 x 0,2 x NW + t(e)(net profit- 0,08*NW)*

It should be noted that the NW-variable here includes 30 % of the paid wages. The capital income tax base increases by wealth and wages (0,3*wages). If the partners optimize their net tax situation, they should balance between amount of wages (earned income, can be deducted from the gross profit) and the amount of capital income. 20 percent of the NW is taxed as capital income. The sole proprietors can choose between 0 %, 10 % and 20 % but this option cannot be used by the partners of a partnership.

Additionally it should be remembered that the (effective) net tax rate of the partner can be decreased by the use of operational reserve (toimintavaraus, driftsreservering, 30 %). If the partnership pays out reasonable wages, the reserve can be deducted from the gross taxable income of the firm. There is an incentive to have partner wage payments plus normal personnel wage payments. The tax diminishing effect of operational reserve has been relatively small because of the limited amount of wage payment at the partnerships. In practice the partners tend to take out the most part of the firm’s profit as private transfers (drawings).

The incentive and behavioral effects of tax systems are normally also presented with the help of the cost of capital-variable. Based on Kari (1998) and Kari et al. 2004) the firms' cost of capital for investment financed by retained earnings is determined as follows (the basic tax system of partnerships has remained the same for the period 1998-2015):

$$p_{PB} = \frac{1-\tau_k}{1-\tau_f} i - \frac{\tau_f - \tau_k}{1-\tau_f} b$$

Where t(k) is tax rate for capital income, t(f) is MTR on earned income, i is the owner's gross rate of return requirement on investment and b is the rate of return applied in calculating the imputed capital income.

The incentive to transform income can be seen from the second terms on the right hand side of the formula. If the owner's marginal tax rate on earned income exceeds tax rate on capital income this tax saving reduces the firm's cost of capital. The formula can be compared with a neutral tax system (same tax level for all business income). If this tax rate would be the capital income tax rate, then we would have tax case p = i. If we have equation level b=i, the tax system of partnerships is neutral towards investments. With higher marginal tax rates the partners have incentive to invest if gross rate of investment is less than b. In Finland the imputed rate of return is currently 20 % (0,20).

4. The current tax reform debate around the Finnish SME's

Twenty years ago the taxation of partnerships was pondered actively in the Finnish tax reform debate. But afterwards the tax reform debate has only touched the closely-held corporations. The Finnish tax debate seems to provide (on general level) more active tax reform plans better tax terms for small limited companies than for the non-incorporated firms. The sole proprietors and partnerships may however get (2016) a specific entrepreneur tax allowance (extra tax deduction from the business income) but this is at this point only one option. The basic system (taxation of partners, not the firm) continues.