THE FINNISH NATIONAL REPORT

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ISSUES IN THE TAXATION OF PENSIONS IN FINLAND

1. Contributions and benefits in the Finnish pension system

The Finnish pension system is largely based on the first pillar – i.e., on the compulsory system of occupational pensions. The voluntary collective pensions of the second pillar are rather rare. The third pillar or the private pension insurance has been increasing since the beginning of the 1990s.

The Finnish system of mandatory occupational pensions is rather comprehensive. It covers all employees. There are also similar pension systems for self-employed, entrepreneurs and farmers. So practically everybody with working history is covered by the pension system in Finland.

The mandatory occupational pension system is based on defined benefits. Occupational pensions depend on earnings and the length of working career. Each working year adds 1,5 percent of annual earnings to pension so that after a 40 year working life one is entitled to a pension which is 60 percent of average annual earnings (or so called retirement wage which is computed by indexing the previous earnings). The full pension can be obtained at the age of 65 years. However, according to the pensions reform of 2005, it is possible to retire at 62 with lower pension. A higher pension can be earned if retirement is postponed till 68 years.

The current system of mandatory occupational pensions was established in the beginning of the 1960s. As a consequence of that there are not yet many pensioners with full 60 percent pensions; most of the retired people have not managed to work for 40 years. Hence the current average occupational pension is ca. 1200 euros per month, which is less than 50 percent of average wage level. However, when the pension system matures, the average replacement ratio of occupational pensions will increase although it cannot ever reach the level of 60 percent (because the old pensions will always lag behind the current wage level due to insufficient indexation of pension income).[1]

The Finnish pension system is exceptional because it does not have any ceilings. There is no upper limit for occupational pensions. The full pension is 60 percent of retirement wage in all cases. It follows, that people with high earnings like former managers, top lawyers and doctors can have very high pension income within the compulsory pension system. Absence of ceilings means also that there is less need for additional pension insurance schemes in Finland than in many other countries.

There is no lower limit in the occupational pensions either. If the working career has been sporadic (e.g. due to many years outside the labour market) and the earnings have been low (due to part-time work), then the computed retirement wage can be very low. However, people without sufficient work history (e.g. houseviwes or those with only very low earnings) are entitled to basic pension (so called 'Folk pension') after the age of 65 years. The basic pension is paid by state and it is financed from general tax revenue on pay-as-you-go principle. The monthly basic pension is currently ca. 500 euros.

Although the Finnish pension system is based on defined-benefit principle, it has also defined contributions. The contributions paid by employees and employers are fixed in medium term. In longer term they are subject to changes, but so are benefits, too.

The occupational pensions are financed by contributions from employers and employees. The contribution of employees is currently ca. 4 percent of gross wages. The contribution is deductable in income taxation. The employers' contributions are not uniform (they vary depending on the size of the company, and public sector employers pay higher contributions) but on average they are ca. 20 percent of gross wages. The contributions are not taxable income. In business sector the contributions are channelled to some of the occupational pension insurance companies (it is up to employers to choose the company). State and municipal sectors have their own pension funds. The occupational pension system is partly funded. The current pension funds of more than 100 billion euros cover about 25-30 percent of the future liabilities of the system. Employees cannot make any choices regarding the insurance company or the investment strategy of pension funds.

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[1] The so called retirement wage which is the basis of pension determination is linked to nominal wage index. However, after retirement the pension income is adjusted annually to a combination of consumer price and nominal wage indexes so that the relative weight of nominal wages is only 20 percent. It follows that pensions lag behind wages as long as real wages increase.

Entrepreneurs and self-employed do have their own system of occupational pensions. It is compulsory, but entrepreneurs (and self-employed and farmers) can choose the desired level of their retirement wage. The level of contributions are tied to the level of desired retirement wage. Usually entrepreneurs choose lower pension level in order to avoid high contributions – although contributions are deductable as business expenses. The contributions of farmers are subsidised by state because of the diminishing number of farmers.

Since the first pillar of the Finnish pension system is very strong there has not been much need to develop or maintain alternative or additional voluntary collective pension systems. That is why the second pillar institutions in Finland are rare.

The third pillar consists of private voluntary pension insurance. The voluntary private pensions are clearly of defined contribution type and they are fully funded. The popularity of private pension insurance schemes has been increasing in recent years and currently almost 10 percent of Finns are to some extent covered by third pillar schemes. The main reasons for that are likely short working careers (which reduce the occupational pensions), wishes for early retirement, fears that the first pillar systems may be subject to political risk (future politicians may decide to cut benefits)[2], and tax incentives. Previously it was possible to start raising private pension incomes at the age of 58. However, the minimum retirement age even in the third pillar schemes has been raised gradually to 62 years. It can be argued that private pension insurance is mainly a device for tax-favoured long–term saving because most of the people with private insurance do not retire earlier than those without private insurance. The pension insurances available in Finland are not pure pensions either since there are no annuities on offer, just fixed income.

2. Demographic trends

Today people are expected to enter working life at 18 years and retire at 65 years. However, in reality the length of employment period is shorter. More than 50 percent of young people continue their studies after the age of 18. That will take three to five years. There is also compulsory military service for men which takes 6 to 12 months. On average, Finnish women give birth to 1,9 children, and they are entitled to almost 6 years of subsidised child care period (3 years per child). In the other end the employment periods are shortened by early retirement. The average retirement age is currently 60 years, which two years below the minimum mandatory retirement age of the old-age

[2] Significant reductions in pension benefits were decided in the mid-1990s as part of fiscal consolidation during an economic crisis.

pension. The early retirement is usually due to disability or long-term unemployment. Thus on average the employment period is less than 40 years. It also means that people typically are not entitled to the full 60 percent pension.

The average length of pension period is the difference between life expectancy (of those who have achieved retirement age) and retirement age. It is currently close to 20 years. The objective of pension policy is to encourage people to work longer in order to limit the pension period. In recent years there has been some progress in that; the average retirement age has increased by one year over a decade. However, at the same time the life expectancy has also increased by a year.

TABLE: Labour force participation rates by age in 2005

age	participation rate
15-19	29.9 %
20-24	67.5 %
25-54	87.6 %
55-59	70.9 %
60-64	34.9 %
ALL	74.3 %

There have always been in-built incentives to work longer (at least up to 65 years) in the Finnish pension system. The pension increases by each additional year at work. In the latest pension reform of 2005 these incentives were sharpened, and it become possible to continue working up to 68 years. The new minimum retirement age is now 62 years.

3. Tax treatment and life cycle period

In most cases the taxation of pensions is based on EET-principle in Finland: this means that

(i) pensions insurance contributions are deductible,

(ii) the returns of pension insurance funds are tax free before retirement; and

(iii) pension income is taxable.

Individuals pay pension contributions during their employment period. Assume for simplicity that the employment period corresponds to the contribution period. The typical treatment is that pension contributions are exempt from income taxation. During the contribution period, a pension portfolio grows partly due to current contributions partly due to interest, dividend, and other capital income. After retirement, the individual receives the benefits in the form of a pension income.

These rules hold for the mandatory occupational pensions of the first pillar, and also to the voluntary collective systems belonging to the second pillar. In those cases the contributions are tax free. Taxes are paid only after retirement. Income from occupational pensions (both in first and second pillar systems) and also from the basic pension is taxed using the rules of ordinary income taxation. However, there are some specific exemptions for pension income, and the pensioners need not pay the same social insurance contributions as those receiving labour income.

The taxation of private pension insurance income is different. The contributions can be deducted but only up to a certain limit. For many years the limit has been €8,500.00 per year. Until the end of 2004 the deduction was made from labour income using progressive scale which meant that those with highest marginal tax rates were eligible to biggest tax deduction (up to 60 percent of contribution). However, in the reform of 2005 the deduction was shifted to be made from capital income implying that only 28 percent of the contribution could be deducted.

Prior 2005 the income from private pension insurance was taxable under progressive income taxation. If the insured individual had some other income at the same time, the marginal tax of pension insurance income could turn out to be relatively high. Since 2005, the insurance income from new policies will be taxed as capital income.

3.a. Main principles

1st pillar: Arrangement, financing and tax treatment of mandatory pensions

It is the obligation of every employer to arrange for the necessary insurance contracts, to organize and pay for the minimum-level mandatory pension plans. The contracts should be valid so as to cover each person on the payroll (hereinafter in this report: 'workers'). They should be made with a domestic pension insurance institution.

Contributions paid out to these institutions are deductible against the income tax of the employer company (§ 8.1, § 8.4, Business Income Tax Act). Workers on the payroll pay a part of the contribution, which it is withheld from their pay. In this way, the employer pays one part and the worker pays the other part, so they share the burden of financing. And the amount withheld from the pay of the worker is deductible against his income tax, i.e. against the income tax on the earned income of the individual taxpayer (§ 96.1, Income Tax Act).

Self-employed persons, shareholders of joint partnerships, and shareholder-entrepreneurs – with more than 50% of the shares – of small limited-liability joint-stock companies arrange and pay for their pension plans themselves. Other laws, not employment legislation, govern them. The contributions are fully deductible against income tax. After retirement, the pension income is regarded as taxable earned income.

There are some differences in the taxation of pension and labour income although the income tax scales are the same for both groups. There are fixed basic exemptions for both groups which reduce the tax rates of those with low incomes. On one hand, there is a special pension income exemption which reduces significantly the taxes of those receiving lowest pensions (i.e., those with basic pension). On the other hand, there is a special fixed labour income exemption and an additional fixed travel (and other work-related) cost exemption which are made only from labour income (see Table 2).

Those exemptions do not benefit those earning lowest incomes but instead are targeted to groups with labour incomes closer to median income level. Moreover, there are social insurance contributions (very much like proportional income tax) which only wage earners have to pay. As a result, the taxation of labour and pension income is differentiated. The result is not very logical. Clearly those with very low pension income (less than €1,000 per month) pay much less taxes than those with equal labour income. Then most pensioners with occupational pensions (with pension income in the range €1,000 to €2,500 per month) pay slightly more taxes than those with equal labour income. Then again, those with high labour income (more than €4,000 per month) pay higher taxes than pensioners.

TABLE 2

PENSIONER	WAGE EARNER
Universal exemptions in income taxation	
• Basic exemption (max. 1480€ p.a.)	• Basic exemption (max. 1480€ p.a.)
• Pension income exemptions in municipal and state income taxation	• Labour income exemption
	• Travel cost exemption (620 € p.a.)
Contributions	
• Sickness benefit contribution 1,5%	• Sickness benefit contribution 2,1%
	• Occupational pension contribution 4,3% (for those older than 53 years 5,4%)[3]
	• Unemployment insurance contribution 0,58%[1]

Description of the impact of the 2005 tax reform

The tax treatment of voluntary pension plans (schemes representing the 2nd and 3rd pillars) was changed several times during the 1990's. Nevertheless, this report will only discuss the current treatment, based on the laws applicable since January 2005. The tax reform included several transition periods and transition rules. The following description will leave out the details, and concentrate on the new rules, applicable as of the 2005 taxable year.

2nd pillar: Occupational pension schemes, their financing, their tax treatment

Occupational pension plans are voluntary, collective, and additional by nature. The employer arranges them for a collective group of workers. It is required that the 'group' is defined according

[3] Työeläke- ja työttömyysvakuutusmaksut ovat muussa tuloverotuksessa vähennyskelpoisia (tulosta), joten niiden lopullinen vaikutus verotuksen tasoon on pienempi kuin taulukossa esitetyt prosentit, yleensä hieman yli 50 prosenttia taulukon luvuista.

to the type of work, or according to some other collective factor, because the arrangement is not allowed to favour any known and identifiable individual workers. In this way, pension schemes intended only to cover just one worker at a time cannot be viewed as occupational pension plans (§ 96a.2, Income Tax Act).

The practical arrangement is the following: The employer company signs an additional pension insurance contract with a life insurance company.

The Income Tax Act does not stipulate a lowest possible retirement age for situations where the employer company pays for the insurance contribution fully. The guideline of the National Board of Taxes refers to the age of 55 as the earliest retirement age[4].

The employer's costs for the maintenance of an employer-provided occupational pension plan are not regarded as income in the taxation of the worker. It is not important what the relevant retirement age is or what the amounts of pension benefits or employer-paid contributions are. The employer is entitled to full, unrestricted deductions against income tax for all the costs for contributing to the occupational pension plans.

If a collective, voluntary, and additional occupational pension plan is in existence, the worker can join his employer to participate in its financing. The contributions will be deductible against the worker's income tax (§ 96a, Income Tax Act), on the condition that the lowest retirement age is 60 years. The ceiling for this deduction is, as a percentage, 5% of the gross wages, and as an amount, €5,000.00 per year. Additionally, there is another ceiling rule that says that deduction of the entire worker-paid amount will not be possible if the actual pension insurance contribution paid by the employer is lower than the amount paid by the worker.

Pension benefits: After retirement, the pension benefits from the collective occupational pension plan are regarded as taxable earned income.

3rd pillar: Voluntary individual retirement pension, their financing, their tax treatment

Definition

Either an employer or a worker can supplement the mandatory pension insurance plan by signing an insurance contract for a voluntary individual retirement pension. Thus either the employer or the worker can be the client of the insurance company.

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[4] Guideline of the National Board of Taxes (Finland): Eläkevakuutukset uudessa verojärjestelmässä (Impact of the recent tax reform on pensions), record no 266/32/2005, released 5 April 2005.

The details of the insurance contract can include:

- Payment of pension benefits based on age,
- Payment of pension benefits based on the death of a spouse, and
- As associated with the above, payment of pension benefits based on disability, and
- As associated with the above, payment of pension benefits based on unemployment.

And after retirement, the outpayments (of pension benefits) should take place in recurring amounts, with the maximum interval between payments of six months, during the remainder of the insured person's life, or at least during a two-year period (§ 34a.3, Income Tax Act).

The above definition is applicable to the tax treatment of both contributions and benefits.

Individual retirement pension taken out by the individual himself

If the individual himself is the client of the insurance company, and has signed the contract for an individual retirement pension insurance scheme, the tax treatment will involve the capital (investment) income tax system, not the earned income tax system. Contributions will be deductible against capital income, and benefits will be taxable as capital income in the hands of the individual, assessed at the flat 28-percent tax rate.

The rules governing the definition of this pension plan category are set out in § 34a, Income Tax Act, and the rules governing deductibility – in § 54d and § 131a, Income Tax Act.

The individual is entitled to deduct a maximum of €5,000.00 of the contributions to the pension plan per year. The deduction only concerns his taxes on capital income. However, the maximum deductible amount is reduced to €2,500.00, if his employer has also paid contributions to a voluntary individual retirement pension plan. The decisive factor is whether the employer has made *payments* to the pension plan during the tax year — merely the fact that the employer has taken out an insurance contract does not reduce the deductibility.

Even if the taxpayer has no capital income during the tax year, or only little capital income, he can still get the deduction. The deduction will then take the form of 'tax credit for the deficit in capital income'. This means that an amount can be credited from the tax payable. So, if the taxpayer only has to pay income tax on earned income and not on capital income, the tax authority will give a tax credit, which will reduce that income tax. The maximum credit is €1,400.00 (consisting of €5,000.00 **x** the capital-income rate 28%). In the theoretical situation that the taxpayer does not have any income tax to pay, not on capital income, and not on earned income either, then this tax credit could be transferred to the taxpayer's spouse. But if such a transfer is not possible, the contribution payments will not be deductible at all. Taxpayers cannot carry them forward to subsequent tax years.

Further preconditions for the deductibility: the lowest possible retirement age is 62 years, and there can be no repurchase before the insured person reaches 62, unless the reason for repurchase is unemployment for at least a year, permanent incapacity for work, death of the spouse, or divorce.

Benefits are taxed as capital income. If the benefit period is shorter than two years, or if the insured person starts receiving benefits before the age of 62, or if he repurchases the insurance contract without a good reason, the amount of benefit will be considered 50% higher, which will be added to the tax.

Individual retirement pension taken out by the employer

Usually, if the employer has agreed with the insurance company for an individual retirement pension plan for a named, identifiable individual worker, the contributions paid to the insurance company are regarded as the worker's taxable earned income. However, if the terms and conditions (such as retirement age clause, and repurchase clause) are similar to the terms and conditions above, in the case of the individual himself taking out the insurance, only contribution amounts above €8,500.00 will be regarded as the worker's taxable earned income (§ 68, Income Tax Act).

It should be noted that this particular rule only concerns an employer-provided insurance contract. If the employer were to pay contributions for a contract that the worker has taken out, all such payments would be regarded as wages paid to the worker.

These rules are also valid for the taxation of shareholders of joint partnerships, and shareholder-entrepreneurs – with more than 50% of the shares – of small limited-liability joint-stock companies. In this case, the rules governing the relations between employers and workers are applicable to small companies and their shareholder-entrepreneurs.

If the employer pays contributions above €8,500.00, the excess will be regarded as wages paid to the worker. So, even though the money is being paid to an insurance company as a pension insurance contribution, the worker cannot claim a deduction for amounts above €8,500.00.

The employer is entitled to full, unrestricted deductions against income tax for all the contributions paid.

In the theoretical case that several employers were to pay contributions for the same worker's voluntary individual retirement pension insurance, the tax authority would count up all the payments and regard any amount in excess of €8,500.00 as wages paid to the worker.

No importance would be attached to the transfer of title of the insurance contract from one employer to another. The excess payment would still be considered wages, and thus the resulting tax treatment would be the same as in the case of only one employer. In other words, transfer from one employer to another will not create a tax advantage for the worker.

The fact that the employer has taken out voluntary individual retirement pension insurance will reduce the worker's maximum deductible amount to €2,500.00 (for any other additional pension plan that the worker has arranged individually). As noted above, the reduction will only take place if the employer indeed has made payments during the tax year. The amount of the employer-paid contribution is not important. So, in this way, even a small payment by the employer will be enough to reduce the worker's own right of deduction.

Later, in the hands of the worker, the pension benefits will be considered taxable earned income when the worker retires and starts receiving them from an employer-provided voluntary individual retirement pension plan.

Tax on insurance premiums

As opposed to accident insurance, personal insurance contracts do not entail the collection of tax on insurance premiums (premium tax) in Finland.

No VAT is payable on the sales and brokerage of personal and other insurance contracts.

3.b. Situations of tax asymmetry

Reciprocity is the general rule

Both mandatory and voluntary pension plans follow the principle of reciprocity: the contributions are deductible for the party who pays them, and the benefits are taxable in the hands of the retired person. Nevertheless, tax asymmetry may sometimes occur, and the most relevant conceivable situations of asymmetry are briefly listed in the following.

Tax treatment of one-off payments of contributions

If a private individual arranges for a pension plan involving a one-off payment of contributions to the insurance company, no deduction is given (§ 54d.2, Income Tax Act). However, the benefits will be taxable (§ 34a.2 and § 81, Income Tax Act).

But only a portion of the benefits is taxable. There is an age-based declining schedule. The maximum taxable portion according to the schedule is 60% (if payments of pension benefits take place when the recipient's age is under 44 years) and the minimum is 10% (if payments of pension benefits take place when the recipient's age is 92 years or older). The rules do not include a lower limit to the age when the person can start receiving the pension benefits, but on the other hand, the declining taxable portion is a strong incentive for using this type of pension plan as late in life as possible.

Voluntary individual retirement pension plans that diverge from the legal definition

The precondition for deductibility is that the terms and conditions of a voluntary pension plan fulfill the requirements described in paragraph 3.a above, regardless of whether the contract with the pension insurance company is the employer's or the worker's. Then the contributions will be deductible, and the benefits taxable.

If the plan has terms and conditions that diverge from the requirements of law, the contributions will not be deductible, and the benefits will be taxed as earned income, not capital income. However, this example of tax asymmetry occurs very rarely in real life, because the insurance companies offering pension plans always design their products with the relevant tax rules and legal requirements in mind.

Employer-provided voluntary pension plans

If the employer pays contributions above €8,500.00, the excess will be regarded as wages paid to the worker. This restriction applies to several kinds of pension plans.

The employer company is usually entitled to full, unrestricted deductions against income tax for all the contributions paid. But the worker does not have any chance to get a deduction for the excess amount. So, in the theoretical case that a retired person's pension income would materially consist of pension benefits based on the contribution in excess of the 8,500-euro ceiling, economic double taxation of the individual's earned income would take place. However, this example of tax asymmetry occurs very rarely in real life, because the employer-paid portion of the contribution seldom exceeds the 8,500-euro ceiling.

3.c. Yield tax and voluntary pension plans

During the period of validity of the insurance contract, the profits generated from the collection and reinvestment of contributions for voluntary pension plans (2nd and 3rd pillars) are not regarded as taxable income. As a result, the portfolio profits add to the amount saved, and there is no tax. It will not be taxed until the stage is reached that the insured person retires, and the insurance company starts paying out pension benefits to him. Then the tax will be assessed at the flat 28-percent capital-income rate for individuals' own pension plans, and at the earned-income rate for employer-provided pension plans. In this way, an economic deferment of tax takes place for the portion consisting of profits.

No importance is attached to the specific ways or details of how the reinvestment of the portfolio is carried out.

3.d. Voluntary pension plans carry a tax shelter against the progressive scale

Previously, taxpayers signing up for voluntary pension plans could alleviate the economic effect of the progressive scale. Because this was undesirable from the point of view of assessment of earned income, new tax rules were adopted. So today, voluntary plans are subject to tax according to the rules applicable to capital income – not earned income.

Nevertheless, old plans (dated prior to 6 May 2004) including their accumulated portfolio capital and profits up to December 2005 will continue to be taxed according to the rules applicable to earned income. Thus, these plans continue to include the possibility for the taxpayer to alleviate the progressive scale (because of the deductibility of the contributions, and because of the tax assessment of the pension benefits).

New rules govern newer pension plans (dated 6 May 2004 or later): the shelter against progression is now prevented, because the deductibility is only 28 percent and the capital income tax levied on the future pension benefit will also invariably be 28 percent, and there is no progressive scale. Of course, any future changes in the capital income tax rate of 28 percent will mean that the recipient of the pension benefit will pay tax at a different rate than what was used for the deductions. As of January 2006, not only newer plans (dated 6 May 2004 or later) but also old plans (dated prior to 6 May 2004) will be taxed according to these new rules.

It should be noted – as a possibility for tax asymmetry – that if the taxpayer's pension contributions had been deducted in Finnish taxation, and then he moves away from Finland at retirement, so Finnish income tax will not be payable on his pension benefits, there will always be the chance of a tax advantage to materialize (see section 6 below).

3.e. Ceilings on deductibility of contributions

For mandatory pension plans, the contributions for mandatory pension plans are always fully deductible regardless of their amounts.

For voluntary pension plans the ceiling on deductibility is €5,000.00 in the case of individual retirement pension plans for which the individual signs up. As noted above, the ceiling will be lowered to €2,500.00 if during the tax year his employer has made payments of contributions to another voluntary pension plan.

If an employer has signed up for a voluntary individual pension plan, contributions in excess of €8,500.00 will be regarded as wages paid to the individual worker.

If an employer has signed up for a collective, additional occupational pension plan for his workers, and a worker is paying contributions to this plan, he will be entitled to a deduction. The ceiling is 5 percent of the wages, and no more than €5,000.00 per year. However, there is additionally another ceiling rule that says that deduction of the entire worker-paid amount will not be possible if the actual pension insurance contribution paid by the employer is lower than the amount paid by the worker.

3.f, 3.g and 3.h. Rules on retirement age, lengths of contribution period and benefit period

The Finnish tax rules do not include any restrictions of the contribution period for voluntary individual pension plans. Individuals of any age can sign up – also minors, on the one hand, and elderly persons, on the other hand. Contributions are deductible regardless of the person's age.

The contract between the individual client and the insurance company defines the benefit period. The restriction based on Finnish tax rules is that the insured person must have reached the age of 62 years before the benefit period can begin.

Length and setup of the benefit period: Finnish tax rules only stipulate that benefits should be payable in annuities, with the maximum interval of six months, during the remainder of the insured person's life, or at least during a two-year period.

Because the insurance companies have designed their standard contracts according to the current tax rules, the usual framework of existing pension plans entails the start of the benefit period at 62 years, and length as agreed, years 62-70 for example. It is also possible to split up the benefit period: then the insured person will receive a part of the benefits at age 62 and the rest starting at age 65.

The tax rules do not prevent adjustments of the contract to delay the start of the benefit period from age 62 onwards. In this way, an insured person approaching the age of 62 can contact his insurance company to put off the start date to, say, age 64, and redefine the benefit period as years 64 to 68. Readjustments of this type will usually result in changes in the amounts of the contribution.

In the future, a few years into the period after the recent tax reform, when benefits are taxed as capital income, assessed at the flat 28-percent rate, taxpayers will most probably respond by requesting their insurance companies to shorten their benefit periods from their original lengths. Nevertheless, the law has stipulated a minimum length of two years. Benefits based on an old pension plan are earned income, and the progressive scale is used. This has so far made the taxpayers prefer long benefit periods instead of short ones.

Repurchases of pension insurance contracts are permissible in the circumstances listed in 3.a above (such as divorce or death of spouse). But the repurchase will not change the original character of the contract as a pension plan: the authorities will not retroactively change the insured person's right of deduction. Receipts of repurchased capital are considered capital income. But if repurchase takes place without a valid reason as defined by law, the receipt of repurchased capital will be viewed as increased by 50 percent, and taxed as capital income.

3.i. Tax treatment of indemnities paid at the insured person's death

If the insured person dies before the start of the benefit period or during the benefit period, the heirs of his estate will inherit the remaining pension capital of the voluntary individual pension plans. This must specifically be agreed with the insurance company. The tax treatment of this payment to the heirs equals that of an inheritance, if the heir is a close family relation, such as a child or the spouse (§ 7a, Inheritance and Gift Tax Act). But if the heir is a less close relative such as a brother or a sister, the tax treatment of the indemnity payment from the insurance company will equal that of capital income (§ 36, Income Tax Act) and will not concern itself with the rules on inheritance tax.

Furthermore, special de minimis rules apply to receipts of life insurance indemnities. In this way, each beneficiary or heir will not have to pay inheritance tax for it if the amount is below €35,000.00. The de minimis for surviving spouses is always at least €35,000.00, or 50% of the indemnity paid, whichever is higher.

The mandatory occupational pension plans provided by the employers do include a share of the pension which is payable to dependent children when they are less than 18 years old. Based on other legislation, employers have the obligation to take out group life insurance for their workers, and when indemnities are paid out, their tax treatment in the hands of the beneficiaries is similar to that described above. The amounts usually stay below the de minimis of €35,000.00 so the rules on inheritance tax are seldom applicable.

4. Mandatory and voluntary pensions in Finland

The most important pension system in Finland is the occupational system. It is mandatory and it covers more than 90 percent of working age population. There are no pension ceilings in that system and the pensions are not reduced in the case of supplementary income. The size of the mandatory occupational pension depends positively on the length of working career and the retirement age.

The mandatory occupational pensions are managed by a group of private sector pension funds (pension insurance companies). Additionally, state and the municipal sector have their own pension funds. The functioning of theses funds is coordinated by the Finnish Center for Pensions. It is a central authority which maintains accounts of individual earnings, contributions, work histories and pension entitlements.

The wide coverage of the mandatory pensions has previously clearly crowded out voluntary pensions arrangements – there has not been much need for them. In this respect the situation changed in the 1990s. A deep economic crisis led to increased risk of unemployment and also politically decided measures to curb the expected pension expenditures. On one hand, increased unemployment and the related rise of atypical and temporary jobs meant that it became more difficult to achieve long work careers and the desired level of occupational pension. On the other hand, the savings measures reduced future pensions by changing the rule by which their were indexed to wages and prices. These changes have resulted in increasing demand for additional private pension insurance schemes.

5. Fiscal sustainability of the public pension system

Ageing of the population enforces the weight of the pension burden on the public sector. That is expected to happen in Finland after year 2010. The current fiscal position of the Finnish public sector (consisting of central and local government and pension funds) is relatively strong.

In the 1990s there was a relatively deep fiscal deficit (7 percent of GDP in 1992-94) when the rate of unemployment was highest. The deficit was however cured rapidly by increased unemployment, lower interest rates and budgetary savings. After six years of rapid growth and falling unemployment, Finland had a record high (7 percent of GDP) fiscal surplus in 2000. In 2001-2005 the fiscal surplus has been lower than that (mostly due to cyclical reasons). Most of the surplus has been due to the pension system, which is running an annual surplus equivalent to 2.5 percent of GDP. In medium term the public sector is expected to maintain its finances in surplus.

In longer term the public pension expenditure (consisting of mandatory occupational pensions and basic state pension) is expected to increase from the current level of 8 percent of GDP to 10-11 percent of GDP. There will be some increased tax revenues from the higher pension incomes but that will be of minor importance due to low tax rates. The public sector is expected to maintain its balance in surplus also in long term. However, that requires a rise in gross tax rate. How much taxes need to be raised depends on a multitude of variables like population growth, life expectancy, employment rate and productivity growth.

At the moment the relative size of gross public debt is about 40 percent of GDP. Due to budget surpluses that figure is expected to decrease to less than 30 percent by 2010. The interest payment of that debt are circa 1.5 % of GDP. The Finnish public sector does not have any net debt. Instead, it has large net assets. The public sector financial assets consist mainly of the funds of the mandatory pension system. In 2005 those funds were equal to 65 percent of GDP (more than 100 billion euros). Because of the large annual surplus of the pension system those funds are going to increase steadily not only in absolute terms but also as a share of GDP.

The future tax burden on pension payments enters into calculations of fiscal sustainability continuously. The figures are revised annually.

6. International mobility of labour and capital

Free movement of people and capital has strong implications for tax systems. During their employment period, thousands of income earners have jobs in several countries. They might choose to move from one Nordic country to another but they might also seek work in other European countries or overseas. People may also prefer to enjoy their pension rights in a country different from the country in which they have saved for retirement. People have of course an interest in preserving their pension rights irrespective of in which country they have earned their income and paid their pension contributions. Pension providers compete in order to attract customers. It is natural that the customers want to choose the pension provider that offers the highest (safe) return on the pension portfolio after tax. In the Nordic countries, individuals can choose pension arrangements that allow them to have portfolios with a mix of domestic and foreign bonds and shares.

6.a. Deductions for contributions to foreign pension insurance companies in the case of voluntary or additional pension plans (2nd and 3rd pillars)

If the foreign pension institution has its tax domicile outside of the EU/EEA, the contributions are not deductible (§ 54d.4, § 68.5 and §96a.3, Income Tax Act).

The tax rules stipulate that deductions are given for the payment of contributions to a pension institution *identifiable as a taxable person* in the EU/EEA. Moreover, deductions are given for the payment of contributions to a pension institution *with a permanent establishment in one of the member states* of the EU/EEA. Exactly the same principles and rules as govern the deductibility of contributions in Finland are applicable to the EU/EEA contributions.

The Finnish legislation had to be changed compulsorily after the ruling of the European Court of Justice was released for the case Danner (C-136/00, 3 October 2002). The earlier legislation had been in conflict with Article 49 of the EC Treaty.

Some situations make it possible for taxpayers from overseas to get deductions for contributions paid to a pension institution outside the EU/EEA. This special rule concerns the year of arrival in Finland and three subsequent years. The pension plan has to be arranged for at least one year in advance of the date when the taxpayer arrived in Finland. But this right of deduction is not applicable to individuals who have been tax residents of Finland during the five years preceding their arrival.

Tax residents do not lose their right of deduction even if their stay in Finland during the tax year only amounts to a short period of time.

Tax treaties made between Finland and other countries do not include any special provisions governing the treatment of contributions paid to foreign pension institutions.

6.b. Finnish tax residents' foreign-sourced pension income

Finnish internal legislation

If a tax resident receives pension benefits from overseas, the Finnish internal law stipulates that they should be taxable as earned income, similarly as Finland-sourced benefits, with the usual progressive scale in use. Furthermore, a tax resident is entitled to a special pension income deduction (eläketulovähennys/pensioninkomstavdrag), the size of which is equally affected by domestic and foreign pensions alike. No importance is attached to who the payer of contributions had been, when the payments took place, or to whether or not the relevant deductions in the past had concerned Finnish taxation or the taxation in another country.

If the pension benefits are based on a voluntary individual pension plan arranged by the taxpayer himself, it will be taxed as capital income, not earned income, exactly as a similar Finland-sourced pension income.

The usual six-month rule governing foreign-sourced wage income is not applicable to pension, even in cases where the pension benefits are expressly based on work that had taken place outside Finland. In this way, pension income received on the basis of employment contracts in other countries, based either on mandatory or voluntary pension plans, are always considered taxable earned income in the hands of the tax resident.

The credit system is applied when any double taxation of foreign-sourced pension income is being eliminated. The foreign tax paid on the same income will be credited to the taxpayer. But if a voluntary individual pension plan has been in effect, and a foreign yield tax has been payable for the pension portfolio return, the Finnish tax authorities do not credit this, because only the amount net of the yield taxes is considered pension income in the first place. It should also be pointed out that crediting can only concern the taxes that another country has imposed for the same tax period (the same tax year) as Finland has or would have.

Effects of tax treaties on the taxation of residents' pension income

In general, tax treaties have a very important restrictive impact on the taxation of residents' foreign-sourced pension income by the Finnish tax authorities.

When pension benefits are based on an employment contract with a public body, the tax treaties usually stipulate that only the state from which the payment of these benefits is taking place be the state of taxation. Similarly, pension benefits based on the social legislation of a contracting state are taxed only by the state of source. Therefore, Finland will not impose tax on either one of these pension incomes (applying the exemption system). Nevertheless, some deviations from this general rule can be found in some of the existing tax treaties.

When pension benefits are based on voluntary pension plans, such as additional pension arrangements not based on social legislation, taxpayer-initiated voluntary and additional pension plans, and benefits based on motor traffic insurance, the tax treaties usually stipulate that the state of residence be the state of taxation. For this reason, Finland mostly enjoys exclusive rights to tax the pension incomes of Finnish tax residents that are based on voluntary pension plans.

If the tax treaties do not specifically prevent it, the exemption system is applicable in Finland, so that progression is taken into account, even in cases where the tax treaty is preventing the income taxation of the pension benefits by Finland. This procedure is followed in the assessment of pension income sourced in other Nordic countries. In this system, the foreign-sourced pension income (which is not subject to income tax in Finland at the first place) has an impact on the progressive income tax rate of the taxpayer's other earned income. Similarly, it has an impact on the pension income deduction (eläketulovähennys/pensioninkomstavdrag). However, a special tax rule has been adopted in order to reduce the impact on progression (§ 136.3, Income Tax Act): the maximum permissible income tax amount, consisting of another country's and Finland's taxes added together, cannot be higher than the theoretical amount of income tax if the entire pension income were Finland-sourced. This special rule is usually applicable only to situations where the foreign tax rate is higher than the Finnish tax rate. It ensures that the person will only end up paying as much tax, and not a different – in this case, higher – amount than if his entire taxable income were fully sourced in Finland. As noted above, it usually only concerns Nordic situations, because the Nordic Tax Treaty specifies that pension incomes are to be taxed exclusively in the payer's state of residence (Art. 18; exception - Art. 26.2).

More examples of situations where tax treaties can prevent the taxation by Finland of pension income concern taxpayers who leave Finland. They continue to be tax residents of Finland, but from the point of view of the tax treaty, they live in the other contracting state (i.e. the double residency problem). In these cases, Finland's right to tax can only be based on the source state's right to tax.

6.c. Pension benefits paid from Finland to individuals living outside Finland

Finnish internal legislation

Nonresidents pay tax on the income derived from Finnish sources (§ 9.1, Income Tax Act). Pension benefits are always regarded as Finland-sourced income, if they are based on employment with the State, towns and cities or rural communes or with another public body. Similarly, pension is regarded Finland-sourced if it is directly or indirectly based on such assignments, jobs or services that have resulted in Finland-sourced fees or wages (§ 10-5, Income Tax Act). In conclusion, the source of the income is Finland for any pension benefits based on work, which entirely or almost entirely took place in Finland, for an employer or client who was resident in Finland. The same rule concerns pension based on directors' or board members' fees, artists' fees, and sportsmen's fees, as long as their original source was Finland at the time when they were paid. Moreover, mandatory pension benefits for self-employed businessmen are regarded as Finland-sourced, and so is, of course, the national old-age pension. In addition, equally Finland-sourced are pension benefits based on motor traffic insurance contracts and pension insurance contracts in which a Finnish insurance company is the counterpart (for further elaboration, see sections 6.g and 6.h below).

From the point of view of Finland's right to tax, no importance is attached to the question whether the contributions had been deductible in Finland, and whether they indeed were deducted in Finland, and whether the recipient of the pension benefits had previously been a tax resident in Finland.

As of the 2006 taxable year, receipts of pension benefits in the hands of nonresidents are no longer subject to tax at source. Instead, a new system as defined in the Act of Assessment Procedure will be applied. This means that pension benefits that fall into the earned income category will be taxed according to the progressive scale, and in addition to state income tax, they will also be subject to municipal income tax, assessed at an artificial average rate reflecting the combined tax rate of all Finnish towns, cities and rural communes.

If a nonresident receives income subject to tax at source, it will not have any impact on the progressive scale. It should also be noted that a nonresident qualifies for the same deductions as a resident. One of the relevant deductions is the pension income deduction (eläketulovähennys/pensioninkomstavdrag). And pension benefits based on a voluntary individual retirement pension plan can be regarded as capital income in the same way for a nonresident as for a resident.

The tax reform adopted for 2006 was a direct consequence and response to the statement of the European Commission that the previous Finnish tax at source contradicted the provisions of Article 39 of the EC Treaty.

Impact of tax treaties on the taxation of Finland-sourced pension income received by a nonresident

In tax treaties, the question of right to tax is usually agreed as dependent of whether the employer was a public-sector employer or a private-sector employer (Art. 18 and Art. 19.2, OECD model tax convention). Nevertheless, in the more recent tax treaties, the right to tax is increasingly reserved to the state of source. This has been viewed as a measure to reduce the attractiveness of leaving the country. There is less of an incentive to leave the country for another country with lower taxes.

Pursuant to the standard provisions of the tax treaties between Finland and other states, the state of taxation for public-sector pensions is exclusively the state of source. In this way, these tax treaties are in line with the OECD model tax convention (Art. 19.2) as far as the distribution of the right to tax is concerned. However, the existing tax treaties with France, Spain, and Portugal stipulate that the right to tax only belongs to the state of residence, if the pension benefits are based on employment with a business organization representing the public sector. And the existing tax treaty with Spain stipulates expressly that the right to tax also belongs to the state of residence in situations where the recipient is a citizen of the state of residence. At the same time, the existing tax treaty with Morocco does not provide the right to tax to the state of source under any circumstances. More deviations from the general rule can be found in some of the other existing tax treaties.

Compared with the above, there is much more variation in respect of the distribution of the right to tax pension benefits based on the laws on social security, and based on employment in the private sector. The majority of the existing tax treaties give the right to tax to the state of source. However, the existing tax treaties with France, Spain, and Portugal are important exceptions, because they stipulate that the right to tax only belongs to the state of residence. Other tax treaties include other exceptions. In general, pension benefits resulting from a voluntary pension plan are only taxable in the state of residence.

Pursuant to the provisions of the Nordic double taxation treaty, pension benefits paid from one Nordic state to another are taxable only in the state of source.

6.d. Exit tax rules

During the years preceding the year when the taxpayer leaves Finland, the taxpayer has paid contributions. No exit tax rules are in force that would govern the treatment of these. Furthermore, after relocation, he starts receiving Finland-sourced pension benefits. And no exit tax rules are in force that would govern the treatment of these. No importance is attached to whether he relocates to another EU/EEA country or to countries outside the EU/EEA.

6.e. Treatment of voluntary pension plans: cross-border workers resident in another Nordic country and working in Finland

The tax reform that became effective in January 2006 had an impact on the taxation of wage and pension income sourced in Finland and received by a nonresident. The definition of a tax nonresident is that the taxpayer's main home is not located in Finland, and that the taxpayer does not stay in Finland for longer than six months.

For wage income sourced in Finland, the nonresident pays tax at source, withheld on payment at the 35-percent rate. Nevertheless, a de minimis amount of €510.00 per month – corresponding to €17.00 per day – is in force. A nonresident paying tax within this scheme is not entitled to any other deductions. For this reason, the nonresident does not qualify for deductions for contributions to a voluntary pension plan.

Nevertheless, the procedure is different for nonresidents living in EU/EEA whose annual Finland-sourced earned income amounts to at least 75% of their gross earned income. In this situation, the nonresident can request that he will be considered a tax resident in respect of the earned income *the source of which was Finland.* This procedure only concerns Finland-sourced income, which according to the relevant tax treaty, fall within Finland's right to tax. Thus, the overall assessment of a nonresident is conducted in exactly the same way, and under the same rules as that of a Finnish tax resident. The income derived from Finnish sources is divided into earned and capital income in the usual way, and all the deductions on income that are relevant will be granted. So the nonresident not only qualifies for all other otherwise allowable deductions but also for the deduction for the paid contributions to a voluntary individual pension plan that he has signed up e.g. for with a Finnish insurance company.

Earned income is subject to state income tax according to the progressive scale, and subject to municipal income tax, assessed at an artificial average rate reflecting the combined tax rate of all Finnish towns, cities, and rural communes. From the point of view of the right to tax of the state of residence, this procedure has no impact. If the state of residence uses the credit system, it will credit the tax imposed by Finland.

Those who relocate to Finland can sign up for a voluntary individual retirement pension plan with a Finnish insurance company and pay contributions as they earn wages. The pension capital portfolio return will be exempt from tax also in this situation. But the question of how the state of tax residency of the person who has relocated to Finland imposes tax on the pension capital portfolio is entirely dependent on the legislation of that state. Later, when the person starts receiving pension benefits, they will be subject to tax as described above in 6.c. If the insurance company is Finnish, the pension income will be regarded as Finland-sourced. And if the situation is Nordic, the Nordic double taxation treaty instructs that pension benefits paid from one Nordic state to another are taxable only in the state of source.

If an individual stays in Finland on a continuous basis for longer than six months, Finland will regard him as a tax resident. So, his tax assessment will almost exactly be the same as that of any other residents. What follows from this principle is that a foreign citizen who has become a tax resident in Finland will qualify for the same deductions as everybody else. So, he will also be able to deduct the contributions to a voluntary pension plan (see 3. and 6.a.).

6.f. Assessment of an individual living in Finland but working in another Nordic country

An individual living in Finland as a tax resident is subject to tax on his worldwide income. He is able to deduct the contributions to a voluntary individual pension plan as described in 3.a above. During the period of validity of the pension insurance contract, the profits derived from the pension fund portfolio capital will not be taxable in Finland.

If the individual's income entirely consists of income categories that are foreign, and on which Finland cannot impose any tax because of Finnish laws or because of tax treaties (an example of this type of income is foreign wages, pursuant to § 77, Income Tax Act), the right to deduct the contributions can become useless from the taxpayer's point of view. Because there would be no taxable income, the subtraction of the contribution payment would result in a negative sum, but an individual taxpayer cannot have an annual loss that would be confirmed in the assessment, and because there is no carryforward, the contributions will not be deductible during the current tax year, nor during the subsequent tax years.

Pension benefits resulting from a voluntary pension plan of a tax resident are taxable as described in 6.c above. As far as the assessment of pension income is concerned, no importance will be attached to the question of whether the contributions were or were not deducted in Finnish taxation or in the taxation of any other country.

6.g. and 6.h. EU/EEA law on the forming of the taxation of pensions

Finnish income-based health insurance contribution in the case of foreign-sourced pension

In spring 2001, the European Court of Justice issued the ruling Rundgren (C-389/99). The case had to do with an individual who relocated to Finland from Sweden where he had lived, having previously lived in Finland a long time ago, and his entire earned income consisted of pension income pursuant to the Social Security Regulation (EEC) No 1408/71, the source of which was Sweden. The Court ruled that Finland should not impose the income-based health insurance contribution or the mandatory pension contribution under the circumstances. In the opinion of the court, no importance was to be attached to the fact whether the individual had or did not have the right to receive pension from Finland. The decisive factor was that no Finnish pension was being paid. The practical impact of this ECJ ruling has been that Finland has recently refrained from collecting the health insurance contribution in similar situations, and furthermore, that the Finnish tax authorities pre-emptively readjusted the assessments concerning the 1995-1999 taxable years for all individual taxpayers in like circumstances.

At the present time, the ECJ is examining the Nikula case (C-50/05) where an individual has had both Sweden-sourced and Finland-sourced pension income. The Finnish tax authorities have considered the individual's total taxable income to determine the amount of the health insurance contribution. The Advocate General has issued his opinion on the case on 16 February 2006. His statement maintains that the Finnish procedure can be justifiable under a specific set of conditions. At the time of this writing, the European Court of Justice has not yet given a ruling.

In July 2006, the ECJ issued the ruling Nikula (C-50/05). The case had to do with the situation in which the person has a pension income both from Sweden and Finland. The health insurance contribution was determined in Finland on the basis of the total number of the pension incomes. According to the ruling, the health insurance contribution may be determined in this kind of a situation on the basis of the pension that has been received also from the second member country. However, the payment cannot be determined if the pensioner already has paid health insurance contributions in the country in question during his working years.

Taxation of Finland-sourced pension income received by a nonresident

In April 2001, the European Commission gave an official note to Finland stating that Article 39 of the EC Treaty, Directive 90/365/EEC, and Article 28 of the EEA agreement possibly prevent Finland from maintaining its internal legislation in force concerning the Finnish state income tax brackets applicable to individuals living outside Finland. The European Commission noted that Finnish law provides a more lenient tax treatment for individuals who live in Finland and have income from Finnish sources than for individuals who live in other countries and have income from Finnish sources. This poses an obstacle to the free movement of persons, especially for pensioners, because those recipients of pension income who have decided to live in another country have a heavier tax burden (than those who stay in Finland). The smaller the pension income, the greater the difference. The same problem is currently processed at the European Court of Justice, in connection with the Turpeinen (C-520/04) case, which is yet to be finalized.

Because of these reasons, Finland carried out a tax reform, effective January 2006, to introduce the necessary changes. The reform especially has an impact on the taxation of nonresidents with earned income from Finnish sources (including pension income). Reference is made to section 6.e above where the current tax treatment is explained.

Right to deduct contributions for a pension plan with a foreign pension institution

The Danner ruling (EU Court of Justice, C-136/00, 3 October 2002) had to do with the individuals' rights to deduct contributions for a voluntary retirement pension plan arranged with a foreign pension institution. The practical impact of this ECJ ruling has been that Finland changed its tax rules, effective January 2005, as explained above in 6.a.

Pension plans provided by a Finnish pension institution – Possible EC Treaty conflict

In section 6.c above, we observed that pension benefits based on motor traffic insurance contracts and pension insurance contracts in which a Finnish insurance company is the counterpart have their source in Finland (§ 10-5, Income Tax Act). But to use the expression ”Finnish insurance company” is ambiguous, because today, the business processes and legal entity forms of insurance companies have a cross-border character. In Finnish legal drafting, the Government proposal (62/1991) for a relevant law defines the pension income as derived from Finnish sources if the payer is Finnish, e.g. a Finnish insurance company. Another definition can be found in the same proposal, saying that the source of pension income is Finland, if the insurance contract was signed with an insurance company with business activities in Finland. The probable interpretation of this legal document is that it covers both the insurance companies that are registered in Finland

and the insurance companies that only have a permanent establishment in Finland. For the latter, the question of source will have to be determined by whether the permanent establishment existed or not at the date of signing the contract. If it did not, and the company sets up it Finnish activities not until later, the source of the pension benefits cannot in all likelihood be Finland.

An insurance company with a tax domicile in EU/EEA, with a license issued by an EU/EEA state, can directly offer insurance contract to clients in all of the EU/EEA – it no longer has to resort to intermediaries, partners in cooperation, or separate permanent establishment in each country. The procedure requires that the insurance company report to the controlling authority in its own country that it will be offering insurance to individuals in another country, and the controlling authority is then expected to notify e.g. the Finnish controlling authority. And a Finnish individual can use electronic communications i.e. the telephone, the Internet, the e-mail to confirm acceptance. The contributions will be deductible in Finland (§ 54d, Income Tax Act). But it remains unclear whether such insurance can be considered Finnish by the definition of law, when the question of source of the pension benefits should be judged. As demonstrated above, the wording of our laws and legal drafting encourage us to regard the insurance contract as not involving a Finnish insurance company as the counterpart. If in the future, the insured individual will be a tax nonresident of Finland at the time when pension benefits are paid, the internal legislation would prevent the taxation of this pension income by Finland. If this were to be correct, it would create an unfavourable situation for Finnish insurance companies, because foreign insurance companies would have an advantage. This would be problematic in light of Article 49 of the EC Treaty governing the freedom to provide services.

6.i. Are there tax incentives to take out domestic or foreign pension insurance?

The tax reform adopted for January 2005 on the treatment of voluntary pension plans reduced the differences between Finnish and non-Finnish pension plans. Previously, there were many differences. And even today, no deductions are given to residents who pay contributions to a voluntary pension plan that they have signed up for outside the EU/EEA (for further elaboration, see 6.a above). However, residents receiving pension benefits from such a plan must pay income tax on them. In this way, persons seeking to obtain a voluntary individual retirement pension plan make a good choice if they turn to an insurance institution based in the EU/EEA.

In sections 6.g and 6.h above, we discussed the definition of a pension plan, its counterpart, the concept of source, and the impact of these on the right to tax. As for possible incentives, the interpretation shown above in sections 6.g and 6.h makes it beneficial for taxpayers to take out voluntary individual retirement pension insurance with providers located in the EU/EEA – but without a permanent establishment in our country.

6.j. Do the existing tax rules governing pensions give incentives to leave Finland or do they give incentives to relocate to Finland?

As a rule, most pension income falls into the category of earned income. If taxed as earned income, it will be subject to progressive income tax. It should be noted that a special pension income deduction (eläketulovähennys/pensioninkomstavdrag) further reduces the income tax on small pension incomes. If the taxpayer himself has signed up for a voluntary individual retirement pension plan, the benefits will be capital income (assessed at the flat 28% rate).

Regarding incentives, the tax treatment of pensions always constitutes an incentive to leave Finland whenever the tax on pension income is smaller in the other country (the state of residence), on the condition that Finland, being the state of source, does not have the right to tax the pension income. The decisive factors are the character of the pension income, and the overall income tax level on earned income. Is it lower or higher than in Finland? If the pension benefits are based on employment in the private sector, and the destination country is e.g. Spain or Portugal, the tax system does give an incentive to leave Finland. The incentive is at its highest in a situation where the individual has worked for the private sector, lost his ability to work due to illness or an accident, thus entitled to a disability pension, and his new state of residence is Spain. Pension benefits of this type qualify for a special additional tax relief in Spain.

One of the reasons for the tax reform that changed the tax treatment of voluntary individual retirement pension plans was to reduce the tax incentive to leave Finland. Now that the reform changed the system from earned-income based to capital-income based, and from progressive tax to flat tax, it is obvious that the incentive is less important. The income tax rate in Finland for this type of pension benefits is 28 percent.

Regarding incentives for relocating to Finland, our country can unfortunately not be characterized as an attractive destination for residents of other states who are nearing retirement. Not only is the overall income tax level high, there are also several important geographical constraints and problems with the climate. Nevertheless, there are many Finns who have worked in other countries as expatriates. When they give up work, they think about relocating to Finland to spend their retirement years.

7. Capital markets and financial stability

The pension funds in Finland have assets of more than 100 billion euros (65 percent of GDP). It is obvious that they are the biggest owners and investors in the Finnish economy. However, legislation prescribes portfolio diversification for institutional investors and especially requires pension funds to avoid large risks. That is why there are de facto ceilings on the number of shares and bonds issued by an individual company that can be owned by a pension fund or an insurance company. The pension funds have also adopted their own risk management and diversification rules. This means that do not buy only shares but also other assets. They try to avoid excessive holdings of Finnish assets and hence invest a lot abroad to international equity and bond markets. These strategies reduce the impact of pension funds on the functioning of domestic financial market.

However, more than 90 percent of listed shares in Finland are owned by institutional investors. This fact is not caused by domestic pension funds. About 50 percent of Finnish listed shares are owned by foreign institutional investors. Foreign ownership in Finnish companies is exceptionally high in international comparison.

An important reason for the strong institutional ownership in Finland is the lack of financial assets of households and tax deductability which gives people a strong incentive to save for their old age through institutions in order to obtain the favorable tax treatment. Individual saving outside the tax-favored arrangements is not very competitive.