THE FINNISH NATIONAL REPORT

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UNCERTAIN AND UNSTABLE INCOME IN TAXATION AND FINANCIAL ACCOUNTING

1. Linkages between taxation and financial accounting in Finland

1.1. The present situation

1.1.1 Expenditure-revenue theory as the basis of Finnish accounting and tax law

Finnish accounting practice has been based on the so-called expenditure-revenue theory for decades. Published by Professor Martti Saario in 1945, 1958 and 1959, the theory has been dominant in Finnish accounting legislation, teaching and research until recently.[1]

The expenditure-revenue theory is a dynamic concept which emphasises the role of the profit and loss account as opposed to information contained in the balance sheet. The valuation of assets presented in the balance sheet is therefore of lesser importance than in static approaches represented, for example, by the International Financial Reporting Standards.

[1] Timo Salmi (1993): A Comparative Review of the Finnish Expenditure-Revenue Accounting

The expenditure-revenue accounting approach was developed by taking the total period of an enterprise's life-span into consideration. For practical reasons, however, profit must be determined for periods which are usually much shorter than the total period and this is therefore divided into accounting periods, normally 12 months. In expenditure-revenue accounting, annual profits are considered to be logically-dependent slices of the total profit, and the purpose of accounting is consequently defined as splitting the total profit into annual profits of the correct size.

In expenditure-revenue accounting, the reason given for the need to determine annual profits is the requirement to assess annual distributable profit. The evaluation and further usage of this reported profit is separated from the process of determining profit, and is excluded from expenditure-revenue accounting.

In dividing the total profit into accounting periods, the accrual basis is applied in accordance with the realisation convention. This convention is applied when recognising revenues for an accounting period: income is not recognised until an actual sale has been made and the buyer had a legal obligation to pay the seller. The approach to the calculation of annual profit is therefore a legalistic one.

To determine annual profit, expenditure must be divided into two categories. Expenditure which is deducted from the revenues realised in the current accounting period is called expenses. Other costs which have not yet been deducted from realised revenues are called unexpired expenditure. In the annual closing of accounts, unexpired expenditures become assets. They will be converted into expenses in later accounting periods, at the latest by the end of the total period.

Expenditures are matched, as expenses, against the revenues realised in the different accounting periods. Finally, all expenditures must be thus allocated, in the form of expenses, to the accounting periods making up the total period.

In actual practice it is seldom possible to establish the true linkage between expenditures and revenue. This fact gives rise to a variety of pragmatic rules for assessing which part of the expenditures has expired and should therefore be written off as expenses. In Finnish legislation, the rule adopted is that all expenditure which is no longer expected to produce revenues is considered to be expenses. Assumptions made about knowledge of the future are of necessity critical parts of any accounting model, since by definition they should be based on historical transactions (ex post) rather than on future transactions (ex ante).

In expenditure-revenue accounting, the convention of conservatism is relevant when matching. This convention implies that, given a choice, the higher of any alternative expense figures should be selected. The conventions of consistency and materiality also affect matching.

For a long time, profit calculation in accordance with tax legislation has run parallel to the basis for financial accounting. The expenditure-revenue theory has therefore been relevant in Finnish company taxation since the end of the 1960s. In spite of this common base for both company tax legislation and financial accounting, these two systems have not been linked by a general clause. Conversely, the linkage between the two systems is stated separately for particular items and types of transactions.

Even though there is no general linkage between tax legislation and financial accounting, bookkeeping plays a prominent role in the taxation of business income. The linkage has also been augmented not only as a result of amendments to taxation law, but also through developments in legal practice. In recent times, solutions adopted in financial accounting practice have also often been accorded more importance when resolving problems that have arisen in the field of taxation law. The conclusions made in financial accounting also play a prominent role as indicators of the true intention of the company that is liable to tax.

The most important separate provision through which taxation has been linked to bookkeeping is Section 54 of the Business Taxation Act. According to Section 54, Paragraph 1, a company that is liable to tax has the right to divide a certain revenue item between several tax years and is only able to deduct the cost of inventories, investment assets and provisions as expenses if the corresponding registrations have been made in its bookkeeping. According to Section 54, Paragraph 2, a taxpaying company is not allowed to deduct as (a) depreciation; (b) expenses for research activities aimed at developing the business operations; and (c) index and foreign exchange losses an amount larger than that which has been deducted in the tax year - and earlier - in its financial accounting.

1.1.2. The realisation principle as the basis for recognising revenue

Since the 1960s both the taxation of business income and financial accounting have – until quite recently – been essentially based on the expenditure-revenue theory. In the last few years, however, as a result of international developments, the influence of the theory has diminished, especially in the field of financial accounting. Also, it is quite clear that the gap between the main features of the theory and tax legislation and practice in the field of company taxation is growing.

The traditional starting points for Finland's national Accounting Act differ from the International Financial Reporting Standards (IFRS) which are based on a static approach to defining the economic value of a company and changes in this. These developments will undoubtedly also reflect on taxation due to the partial linkage to bookkeeping.

In company taxation, in the same way as in financial accounting, the income for the total period of an entity is calculated for shorter periods, i.e. for the tax year. The tax year and the financial period are usually of equal length, 12 months. The problem of dividing total profit into shorter periods is resolved on the basis of the two most important principles of the expenditure-revenue theory: the realisation principle and the matching principle. Until recently, interpretation of the realisation moment as being linked to delivery of the good or service has been quite absolute. For example, since the basis for recognising revenue is the delivery of an item, taxation law has not allowed an unrealised revaluation to be regarded as a deductible expense.

1.1.3. Exceptions from the expenditure-revenue theory

One of the salient features of Finnish accounting has been the historical cost convention. The only exception to this convention is the possibility of booking revaluations. Arguments for this possibility are based on practicality. It is now applied only to land ownership and securities classified as non-current assets.

According to the Accounting Act (30.12.1997/1336, as amended 30.12.2004/1304) Chapter 5 Section 17, if the estimated realisable value of land and waters or a security (which is not a financial instrument as defined in Section 2a) recorded under non-current assets is, at the date of the balance sheet, permanently and materially in excess of the original acquisition cost, a revaluation not exceeding the difference between the probable sales price and the undepreciated balance of the acquisition cost may be brought into the balance sheet, if done consistently and prudently, in addition to the undepreciated balance of the acquisition cost. An amount equal to the revaluation must be shown in the revaluation reserve under capital and reserves. The revaluation must be reversed if it can no longer be justified. (30.12.2004/1304).

One of the few exceptions from the accrual principle has been the case of provisions. A clear exception to treatment based on the realisation principle is also the possibility of employing the "percentage-of-completion" method as the basis for recognising income from a contract with a long production or construction period. The percentage-of-completion method has been allowed in Finland since 1993 both in the determination of reported profit and in the calculation of taxable income.

Since 1998, revaluations of investment assets made in the books of insurance companies and pension funds have also been regarded as taxable income. Since 2002, and subject to certain conditions, taxation of derivatives and securities has not been based on the realisation of income.

1.2. IFRS financial accounting

1.2.1. Introduction of IFRS in Finland

IFRS was introduced in Finland in 2005 as a compulsory reporting standard to be used by listed companies at group level when drawing up consolidated financial statements. This legislative change is based on the EU Regulation adopted by the European Council and the European Parliament in 2002. The 2002 IAS Regulation (EU No 1606/2002) requires listed companies, including banks and insurance companies, to prepare their consolidated accounts in accordance with International Accounting Standards (IAS)/International Financial Reporting Standards (IFRS) from 2005 onwards. Furthermore, Member States have the option of extending the requirements of the Regulation to unlisted companies and to the production of separate accounts.

In Finland, the Government chose the option of extending the application of IFRS to all groups of companies and also to the financial accounts of individual companies on a voluntary basis. The “not prevented, not required” principle is therefore applied in Finland and both listed and unlisted companies are free to prepare their separate financial statements according to IFRS as of the financial year 2005. The only condition for the voluntary application of IFRS to financial accounts is that a certified auditor be chosen to audit a company’s accounts.

One result is that IFRS may be applied in some companies to financial statements for the 2005 accounting periods. The effects of IFRS therefore have to be taken into account in the taxation of profits for the 2005 fiscal year.

Introducing the IFRS implies that many unrealised items are included in the calculation of reported profit and consequently raises questions of their treatment in taxation. These unrealised items originate from the changes in valuation rules: more and more assets are being reported at fair value, rather than at cost, on the balance sheet. Fair value accounting in IFRS refers to the following types of assets:

- Financial instruments (IAS 39)
- Biological assets and agricultural produce (IAS 41)

- Investment property (IAS 40, fair value model as alternative for cost model)
- Tangible and intangible assets (IAS 16 and IAS 38, allowed alternative treatment as secondary valuation base).

The accounting treatment of the value changes based on fair value accounting varies according to the type of asset. Part of the value changes is recognised in the profit and loss account for the financial year, and part of them are booked to equity, e.g. the revaluation reserve in the case of tangible and intangible assets and the fair value reserve in the case of financial assets.

1.2.2. National aspects of Fair Value Accounting: valuation of forests

According to Finnish accounting legislation and practice, forest holdings have been valued at acquisition cost plus any subsequent revaluations. Under IFRS, biological assets are valued at their fair value and any change in value is booked to the profit and loss statement. In adopting IAS 41 “Agriculture”, the IASB determined that the fair values of biological assets are more relevant to users of financial statements than the historical costs of those items. IAS 41 therefore requires accounting for such items to be at fair value. According to IAS 41, “Agriculture” all biological assets are measured at their fair value less estimated point-of-sale costs at the point of harvest.

As an example of the order of magnitude of the effect resulting from the change in valuation of forest holdings, the case of the Finnish forest industry group UPM-Kymmene Corporation can be considered[2]. According to UPM-Kymmene’s transition report: “Biological assets (i.e. living trees) are initially recognised at cost which necessitated a reclassification of the carrying values of timberlands that in accordance with Finnish Accounting Standards had previously been included as part of property, plant and equipment. In accordance with IAS 41, biological assets are carried at their fair value less estimated point-of-sale-costs. At the end of 2003, the value of biological assets was EUR 1,093 million in Finland and EUR 34 million in other countries.”

[2] UPM Transition to International Financial Reporting Standards (IFRS), Explanation and comparative IFRS information for years 2003 and 2002

The complexity of accounting for the fair value of forest holdings is further explained as follows: “The fair value of biological assets other than young seedling stands is based on discounted cash flows from continuous operations. The fair value of young seedling stands is the actual reforestation cost of those stands. Continuous operations, the maintenance of currently existing seedling stands and the felling of forests during one rotation, are based on the Company’s forest management guidelines. The calculation takes into account the growth potential and environmental restrictions and other reservations of the forests. Felling revenues and maintenance costs are calculated on the basis of actual costs and prices, taking into account the projection of future price development. Periodic changes resulting from growth, felling, prices, costs and other premise changes are included in operating profit in the income statement.”

For those Finnish listed companies which have forest holdings, the impact of the change in the valuation principles along the introduction of IFRS may be considerable. In the case of UPM-Kymmene, the effect of transition to IFRS associated with biological assets amounted to EUR 1,100 million, while the “IFRS” balance sheet total was EUR 14,500 million at the end of 2003. For such companies, the treatment of these unrealised value changes in taxation is of the utmost importance.

1.2.3. Impact of IFRS on the determination of distributable profits

Extensive reforms to the Finnish Companies Act are expected to come into force in 2006. In this context, a new approach to the defining of distributable profits will also be considered. One aspect connected with defining distributable profits is the impact of IFRS on the financial statements of Finnish companies that choose to use IFRS as the basis for their separate accounts.

A working group set up by the Ministry of Justice drafted a proposal for a new Companies Act in May 2003. The aim is a more flexible measure which would allow companies to arrange their operations as efficiently as possible. The Ministry of Justice published a draft of the government’s proposal for a reformed Companies Act in December 2004. According to this draft, the fair value reserves based on the application of IAS 39 and the optional provision concerning fair value accounting in the Finnish Accounting Act (§ 5: 2 a) would, in principle, have been distributable.

In June 2005, the Ministry of Justice published a press release concerning amendments to the government's proposal for a reformed Companies Act. According to the Ministry of Justice, in financial statements drawn up according to IFRS, reserves based on fair-value accounting would be regarded as undistributable funds. The question of the distribution of funds based on fair-value accounting had emerged during discussions about the probable need to change tax provisions as a result of the introduction of IFRS. Parallel treatment of these unrealised items is expected in both the Companies Act and the Business Taxation Act.

2. Uncertain and unstable income in taxation

2.1 Possibilities for transferring losses in taxation

2.1.1 General

Possibilities for transferring losses to future years are prescribed in Finland's Income Tax Act (1992/1553). Furthermore, some discretionary items, mainly degressive depreciation items and to some extent also provisions, give taxpayers the possibility of profit balancing. These possibilities for profit balancing have consistently been limited in the taxation legislation.

In essence, regulations related to loss balancing concern all taxpayers. In practice, they are most often applied for business activities. The Finnish loss-balancing system is based on the so-called "carry-over principle", according to which losses may be deducted from the profits in the taxation years which follow the year in which the loss was made. The loss-balancing period is limited to ten years. Losses are deducted in the order in which they arose, so older losses are deducted first. The procedure for loss balancing is carried out according to the type of income and the source of income. In Finland, the income of natural persons is divided into two groups: earned income and capital income. Sources of income are: business activity, agriculture, and personal income.

Losses in business activity are deducted from profits in business activity in the ten years following the loss as and when profits are generated. If a loss in business activity by a natural person cannot be deducted from the loss because the business activity concerned has ended, losses that have not been deducted will be deducted from the taxpayer's capital income in the following ten taxation years. The right to deduct losses may be withdrawn if a significant change in ownership of the company occurs. For non-listed companies, the changes in ownership can be no more than half of the number of the shares in order to maintain the deductibility of the losses. When estimating the point at which a line should be drawn, indirect ownership (at least 20 per cent) may also be taken into account. Neither divisions nor mergers terminate the right to deduct losses if the acquiring company or its shareholders have owned, from the beginning of the year when the loss occurs, over a half of the merging or dividing company. Removal of business activity from a permanent establishment in Finland to a corporation established in a EU Member State does not terminate the deduction right.

2.1.2 Profit balancing in corporate groups

In Finland, the taxation of groups is based on individual assessment of companies belonging to the group. The group is not handled as a single taxpayer, each company in the group is counted as a separate taxpayer. Neither the voluntary consolidated taxation is possible in Finland. Consideration of groups as a financial whole is mainly handled via a group contribution system. The Finnish system has strong interests in common with group contribution systems in Sweden and Norway.

The Act on Group Contribution (825/1986) enables open profit balancing within a group. A group contribution is an essential part of a group's tax planning. Contributions by affiliated companies may be deducted in calculating the taxable income of a contributing company and added to the taxable income of the recipient company. Such transfers of profit are allowed between affiliated companies if the group of companies and the transfer of profit meet the following requirements:

- both companies involved are Finnish

- the assignor of a contribution must own at least 90 per cent of the assignee company during the whole of the tax year
- both companies are engaged in business
- the accounting years of both companies end on the same date
- the contribution is recorded in the accounts of the contributing company as well as in the accounts of the recipient company
- the transfer is not a capital investment and is not directly related to mutual business operations by the respective companies
- the contribution does not exceed the amount of the contributing company's profit from business activities

Transmission of profit happens in an open manner - the assignor of a contribution is allowed to deduct the amount of the contribution and the same amount is counted as taxable income by the recipient company. Group contributions are counted as an expense in taxation of the assignor and as profit in taxation of the assignee in the taxation year in which they are made.

Basically, both the assignee and the assignor of a contribution must be Finnish companies, in other words, they must be registered in the trade register in Finland and they must be established in accordance with Finnish legislation. The domicile of the owners is not relevant.

A group contribution cannot be given to a foreign company. When estimating the determination of boundaries for a group, regulations on tax agreements and the EU's regulations banning discrimination must be taken into account. In this connection, the ruling in the Marks & Spencer case may result in a significant need for a reform of the Finnish system of group taxation.

According to legal practice it is obvious that the Finnish affiliated companies of a parent company located in a country with which Finland has a ban on the discrimination clause in a convention for the prevention of double taxation, can use the group contribution as an instrument for profit balancing. It is nevertheless a prerequisite that the other requirements laid down in the Act on the Taxation of Business Profits and Income from Professional Activities (Business Taxation Act) are fulfilled.

From the viewpoint of group contributions, in relations between EU member states, permanent establishments are treated in the same way as subsidiaries. Therefore a group contribution may be given between i.e. a Finnish branch office of a Swedish company and a Finnish subsidiary owned by that Swedish company (KHO 2003:79).

The question of the territorial scope of the Act on Group Contribution is under discussion in The Finnish Supreme Administrative Court (KHO 2005:29). The Court has made reference to the Court of Justice of the European Communities for a preliminary ruling in the case (Case C-231/05). The Supreme Administrative Court has to determine whether Finland has an obligation to accept as a deductible expense a group contribution granted by a Finnish company to a company located in the UK belonging to a same group if all other requirements than the requirement that both companies are Finnish, are fulfilled. The main question is whether Articles 43, 56 and 58 of EC Treaty and the Directive 90/435/EEC on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, is to be interpreted as precluding a system so that the group contribution system is applicable only to the situations where both the assignee and the assignor of the contribution are companies resident in Finland.

Requirements on ownership relating to group contributions do not usually cause particular problems in mergers between subsidiaries and with other companies. Opportunities for making group contributions are determined by the moment when the merger was realised. This is the moment when the permission of a court for the merger has been entered in the Trade register. In a combination merger, it is an additional requirement that the newly founded company is registered.

In group taxation, banks and insurance companies are treated differently to other companies. The Act on Group Contributions in Taxation cannot be applied in cases where either the assignee or the assignor of a contribution is a deposit bank, a credit institution, an insurance company or a pension institution. Banks and insurance companies cannot therefore be recipients of group contributions.

The non-deductibility of group contributions in banking and insurance groups is problematic from the viewpoint of financial market legislation. The restrictions included in the financial market legislation require that different types of financial and insurance services are distributed among separate companies. In recent years, the effect of exceptional tax treatment on competitiveness in the bank and insurance sector has become more pronounced due to the sector's increasingly international character, and also because of changes that have taken place in the regulation of different types of companies that offer financial services.

The provisions concerning tax evasion and hidden dividend distribution do set the limits on possible profit balancing in corporate groups by other means than by group contributions. In this connection, it should also be noted that a possibility to deduct so-called "group support between group companies" was abolished in the company tax reform that was carried out last year. According to the Business Taxation Act, Section 16, Paragraph 7, group support and other similar expenses incurred to improve the financial state of limited companies without a service rendered in return are no longer deductible. Although this legislation does not provide a precise definition of group support, it is a term commonly used for items transferred between entities that are related as parent and subsidiary and which cannot be counted as ordinary capital investments or direct compensation for performance received.

2.2. Provision system

2.2.1 Credit institutions and investment firms

In Finland, the tax regulations applied to banks, other credit institutions and securities companies are essentially the same as those applied to other companies. Functional differences, especially between credit institutions and other companies are, however, reflected in the regulations concerning closing of accounts and financial statements, and also in taxation.

Credit institutions bear the risks involved in financing. In the balance sheets of credit institutions, an essential component is assets and liabilities that are accumulating interest. An example of how these differences show up is that only credit institutions and insurance companies may have properties that are counted in taxation as investment assets. Differences between the taxation of companies handling securities and the taxation of other companies are not so substantive.

From the point of view of the regulations affecting banks it is, for example, essential that banks prepare both adequately and in advance for possible credit losses, and that they book these credit losses at an early enough stage. In this way, the risk of sudden impact on a bank's results can be in part prevented. The importance of preparing for credit losses in accounting is accentuated by the fact that the major part of a bank's receivables has no market value, so bookings concerning possible credit losses can be seen as compensating for this missing market value.

In the tax reform carried out in the beginning of the 1990s, the opportunities open to companies for taking advance action in relation to the uncertainties of income flow were substantially restricted. Credit institutions and insurance companies continue to have more possibilities than other companies in connection with transferring income to future taxation years.

According to Section 46 of the Business Taxation Act, credit institutions are entitled to make a credit loss provision. The highest amount that can be allocated for bad and doubtful debts is 0.6 per cent of receivables outstanding at the end of the tax year. The annual reserve may not exceed this 0.6 per cent and an accumulated unused reserve of five per cent of accounts receivable at the end of the tax year. If the provision for bad debts exceeds the maximum amount in any one year, the excess is regarded as chargeable income for that tax year.

The provision is not tied to possible losses connected with credits, but credit institutions are allowed to set up a provision without regard to the probable risks inherent in their loan portfolio. So, for example, a credit institution that specialises in the financing of public institutions and a credit institution that specialises in the financing of companies starting up in business, are allowed to make equally-large credit loss provisions. The wording of Finnish tax legislation does not take any account of allocated credit loss provisions made in accordance with the international regulations concerning financial statements for credit institutions.

In practice, however, not all credit institutions make the summary credit-loss provisions prescribed by law, they only make the allocated credit-loss provisions recognised in the accounting system. The provisions concerning the credit loss reserve therefore no longer have importance in tax planning that it had earlier.

It is obvious that the credit-loss provision system based on the Business Tax Act must be amended in the near future to make credit-loss provisions that are applied in accordance with international financial reporting practice tax deductible. Because the linkage between taxation and accounting pressures for amendment have been increased in particular by the entry into force of the new IFRS Standards. A provision that does not reflect risks is incompatible with the basis for the international standards.

2.2.2. Insurance companies

In Finland, insurance companies are largely governed by the same tax regulations as other businesses and they are subject to the general Business Taxation Act. Owing to the specific nature of the insurance business, however, the Business Taxation Act includes a number of provisions that relate specifically to insurance. In contrast to the situation with other firms, insurance companies may – like credit institutions - deduct a bad loss provision from their taxable income.

Provisions for bad debts may be deducted for an amount totalling one per cent of the company’s debtors (i.e. debts other than those arising from insurance premiums). If proper evidence is provided, provisions may be deducted for an amount larger than this.

Authorised pension providers engaged in statutory employee pension insurance business are allowed to make a maximum provision for bad debts which equals 0.6 per cent of a particular year’s debtors (other than those arising from insurance premiums or contributions) but which is no more than *five* per cent of the total of debtors (other than those arising from insurance premiums or contributions). Bad-debt provisions for insurance premiums and contributions may be deducted up to a maximum of two per cent of the total for debts arising from these sources. If proper evidence is provided, provisions may he deducted for an amount larger than this. If an authorised pension provider is allowed to deduct part of the provisions for unallocated bonuses in its taxation, it may not deduct any provision for bad debts.

2.3. Option premiums

The Business Tax Act has a number of sections addressing the taxation of financial instruments including derivative instruments held by credit institutions and companies providing investment services. Derivatives held by other companies - including insurance providers - are discussed in other sections, but these latter provisions from year 2002 cover only option premiums received and option premiums paid.

The main rule is that all option premiums received are taxed in the year the option is written. There is however an exception to the rule: premiums received on publicly-traded options that expire within 18 months are taxed in the year that the option is exercised, the position is closed or the option expires. In contrast, option premiums paid are deductible in the fiscal year in which the option is exercised, the position is closed or the option expires. If an option is exercised and the underlying asset is purchased, option premiums received and paid are treated as adjustments to the acquisition cost of the underlying asset as provided for in the Business Taxation Act.

The need for renewal in the taxation of option premiums came about through Resolution 1990 B 511 by the Finnish Supreme Administrative Court. In this decision, the court took the view that the premium received by an investment firm as drawn on a fixed option is taxable income in the year in which the option is signed. This decision was a highly-problematical one, especially from the viewpoint of professional market makers whose whole activity is based on the drawing of options. If an option is open at the turn of an accounting period, premiums received must then, according to the resolution, be recorded as income for taxation during a year different to the one in which the possible item of expenditure was registered in the accounts.

The resolution by the Supreme Administrative Court did not correspond with either the treatment of such options in accounting or with the economic nature of the options. In accounting, only net profit or net loss is considered as influencing the bottom line. The decision meant that tax on the income was fixed before the service was produced. In option arrangements, profit or loss only becomes evident once it is known, i.e. when the owner of an option has utilised it.

In practice, the procedure dictated by the decision of the Supreme Administrative Court made it impossible to hedge against risks associated with an option in a neutral way from the taxation point of view. Hedging in such options is executed by drawing a reverse option. The premium from an option does not represent real profit obtained from that option, even from the theoretical point of view. Income from an option can be out of all proportion to the real profit and result in far too high a tax burden. The possible loss that may be assessed in a later tax year cannot in these cases be deducted from profit earned in subsequent years.

Some problems in Finnish legislation can still be seen because the approach taken by taxation which is consistent with accounting practice is only applied to options with a maturity of no more than 18 months. Premiums received from options that mature in 18 months or more are entered as income for taxation in the year that the option is drawn. In most cases, however, option maturity periods are less than 18 months.

2.4. Interest on non-performing loans

The central objective of banking regulation is to secure the stability of banking and, more broadly, stability of the financial system. This goal can also be achieved in part via tax legislation. In this sense, regulations concerning loan-loss provisions are in the most fundamental position.

From the point of view of stability in banking, the moment when a particular item of income can be considered as non-performing also has relevance. As a departure from the premises underlying the Business Taxation Act, interest from receivables whose capital has been registered as non-performing in the accounts is not considered as taxable income. This interest can be entered as non-performing if, at the balance sheet date, the accrued interest, repayments or rents have been unpaid for at least 90 days or if they, due to the established insolvency of the debtor, are likely to remain unpaid.

The provision concerning interest on non-performing loans has been in force as a fixed term since the beginning of the 1990s. The aim of the provision is to prevent a situation in which credit institutions would be liable to pay taxes on income that they in all probability will never receive.

The taxation of interest on non-performing loans is tied to accounting. Noteworthy from this angle is that taxation is directly bound to regulation by the national authorities. This linkage could be viewed as problematic from the viewpoint of Finland's constitution. According to this, taxes must be governed by an Act: taxation law shall contain provisions on the grounds for tax liability and the amount of tax, as well as on the legal remedies available to the persons or entities liable to taxation.

2.5. The taxation of financial instruments

As a special feature connected with the concept of income, the taxation of financial instruments included in the trading book of a credit institution or an investment service company can be highlighted. The accrual basis principle applied to revenue and expenses in the Finnish Business Tax Act has been tested in the taxation of securities and derivatives. Market practices have changed and new instruments have been created.

According to the realisation principle applied in Finnish tax legislation, only realised gains represent a taxpayer's taxable income. This standpoint does not apply particularly well in the case of financial instruments. Parliament therefore accepted changes in the Business Taxation Act 2002. The amendment resulted in the taxation treatment of unrealised increases and decreases in value being uniform with the treatment of such items in accounting. In essence, the new provisions are roughly in accordance with IFRS principles.

The tax treatment of items included in current assets has become an issue in the taxation of credit institutions and investment firms because the treatment of changes in the value of assets included in the trading book deviated at an earlier time in taxation and accounting. The problem concerning differences in the valuation of items included in the trading book has not arisen in the same way in other enterprises because general accounting norms do not include any provisions concerning the valuation of financial instruments belonging to the trading book.

According to the amendment to the Business Taxation Act, increases in the value of certificates of claim, securities and derivatives which have been recorded as profit in the accounts are considered in taxation to be taxable income. Concurrently, reductions in value which have been recorded as losses in the accounts are considered in taxation to be deductible. The taxation of increases and reductions in value is thus directly linked to entries in accounting.

Under Section 36 of the Credit Institution Act, debt certificates and other securities referred in the Securities Markets Act which are current assets and which are subject to trade by credit institutions, as well as derivative contracts concluded for non-hedging purposes at the balance sheet date, shall be shown in the balance sheet at fair value.

According to the Act on Credit Institutions, the difference between the fair value of the securities referred to above on the balance-sheet date and their book value in the preceding annual accounts, or the acquisition cost if the securities have been acquired during the financial period, shall be shown as either income or an expense for the financial period. If changes in the value of securities, debts or derivative contracts have been efficiently hedged by concluding derivative contracts, issuing debt securities or acquiring securities, changes in such mutually-hedging items shall not be shown in the profit and loss account as income or an expense for the financial period.

The changes made in the Business Taxation Act in 2002 abolished a difference between taxation and accounting which was difficult to justify from a practical point of view. For its part, the amendment reflects the linkage between taxation and accounting. Especially in securities markets, the creation and maintenance of separate control and booking systems for taxation and accounting causes unnecessary work and costs and can even lead to a situation where taxation is linked to accounting through practice. Neither taxpayers nor the tax authorities have the resources to follow the same transactions in different ways for taxation and accounting purposes.

Tax provisions concerning increases and reductions in value of debt certificates, securities and derivatives belonging to the trading book only concern credit institutions and investment firms. Finnish tax legislation lacks specific provisions on the tax treatment of changes in the value of debt certificates, securities and derivative instruments held for trading by taxpayers other than credit institutions and investment service companies.

3. IFRS and the taxation of uncertain and unstable income

3.1 General

The changeover to International Financial Reporting Standards will have an impact on the taxation of Finnish companies in so far as the standards are applied to companies' separate financial statements. In practical terms, the influence of IFRS on taxation must therefore be taken into account in 2005.

The Ministry of Finance has appointed an expert working group to analyse the need for changes to tax legislation as a result of the introduction of IFRS. For the most part, tax questions associated with the application of IFRS are identical for all companies that choose to apply them. The working group will report at the end of 2005.

The most evident problems caused by the matching of IFRS and Finnish company taxation are those caused by the present linkage between Finland's tax system and financial accounting. One problematic item is the so-called "depreciation difference" which arises between taxation and financial accounting when a company chooses to book different amounts of depreciation as planned depreciation to those deducted when calculating taxable income.

Tax legislation requires that this depreciation difference be presented in the profit and loss account and it therefore has an impact on the calculation of reported profit. The accumulated depreciation difference is shown as a credit item in the balance sheet. Since IFRS is based on the hypothesis that the tax system and financial accounting systems are independent, it does not accept the Finnish practice of presenting a depreciation difference in the profit and loss account. IFRS uses the concepts of deferred tax liability and asset as specified in IAS 12 "Income Taxes".

The system of group subsidies used in Finland is also not harmonised with the IFRS system. As has been stated above, the deductibility is contingent on the group contribution being also entered in the financial accounts, and it thus has an impact on the profit reported for the financial year. Based on current tax legislation, such an item is not accepted as an element which can affect the calculation of profit according to IFRS.

When amending the tax legislation as a result of the introduction of IFRS, one essential point will be to secure congruence between tax treatment in different types of companies. In Finland, only limited number of companies will apply IFRS in their separate financial statements. Since it is important to ensure that companies are treated equally, the taxation of a company cannot depend on which financial accounting system is used as the basis for calculating reported profit.

Options for choosing between different alternatives can also cause problems in taxation. One question of principle is whether the optional treatment of some items in accounting can have any effect on their treatment in taxation. This situation concerns how to account for changes in the value of investments: are they reported in the profit or loss account or shown in the balance sheet under a fair-value reserve?

From both the fiscal and the taxpayers' viewpoints, one of the most significant issues connected with the relationship between IFRS and taxation is how to view the taxation of unrealised changes in the value of investments. In many respects, IFRS rules are based on the principle of fair value. This question is an especially hot one for insurance companies. The measurement of investment properties and financial instruments will provide the legislature with food for thought.

3.2. Credit institutions

The introduction of IFRS does not entail major changes in the taxation of credit institutions. There is however a need to change provisions concerning e.g. the depreciation of financial leasing assets. Currently, financial companies can record depreciation items on leasing property - in IFRS this is not possible. Because of the linkage between taxation and accounting there is a need for amendments to the taxation legislation. If amendments are not made neither the lessor nor the leaseholder would be able to enter depreciation on the leased asset.

From the viewpoint of credit institutions, it is noteworthy that from the beginning of 2004, also credit institutions other than those that prepare their financial statements according to IFRS rules have had to apply the fair-value principle to financial instruments in both their separate financial statements and their consolidated financial statements. Financial instruments are considered to be receivables, derivative agreements, shares and other financial instruments booked as current assets in the balance sheet, and also debts included in the trading book or associated derivatives. These rules also apply to investment firms.

The provisions concerning valuation of financial instruments described above are, in outline terms, in correspondence with IFRS. There is, however, a need to make some changes to the applicable legislation. As currently framed, increases and reductions in the value of financial instruments are considered by the law to be taxable income and deductible expenses. The introduction of the IFRS will mean that application of fair-value measurement is in any case to some extent wider than in the current tax legislation. There is therefore a need to reform the provisions concerning financial instruments in the Business Taxation Act.

A need for an amendment could also mean that in some cases, changes in the value of financial instruments could, in accordance with IFRS, be booked to a company's equity. IFRS makes it possible to enter changes in the value of the financial instruments in the profit and loss account or show them in the balance sheet under a fair-value reserve. From the legislators' point of view one could see problematic a situation where the taxpayer could achieve a different result in taxation only on the grounds of the option that is chosen in accounting.

The introduction of the IFRS standards also leads to a need for changes in taxation concerning the interest on the non-performing loans. According to IFRS standards, the fact that the capital of a receivable has been recorded as non-performing does not give grounds to leave the interest unrecorded as income.

3.3 Insurance companies[3]

3.3.1 General

A major factor when estimating the need for amendments to the taxation legislation from insurers' point of view, is that the Insurance Contracts Standard (IFRS 4) will be adopted in two phases. Phase I adoption takes effect in 2005, but Phase II adoption is not expected until 2008 at the earliest, and probably not until 2010. Although Phase II drafting of the standard is still proceeding in respect of its core parts, the intention appears to be to change over to fair-value measurement of both technical provisions and investments. When the final Phase II standard is issued, it is likely that IFRS will also become a compulsory standard for separate financial statements by Finnish insurers. The transition timetable will furthermore be affected by the completion schedule for EU solvency requirements, known as the Solvency II Project, and by how these solvency requirements are synchronised with IFRS, notably the Insurance Contracts Standard.

3.3.2 Asset/liability matching

The most essential items on the balance sheets of insurance companies are, on the one hand, technical provisions and on the other, assets covering these technical provisions. As the balance sheet of an insurance company is large in proportion to both its profits and its solvency capital, even small changes, for example, in interest rates or market prices may have a major impact on both these items. For this reason, it is of prime importance for insurers that income, expenses and cash flow originating from assets and liabilities match in terms of time and quantity. The methods available to insurers for balancing any mismatch include: the matching of assets and liabilities in terms of both duration and currency; hedging against fluctuations in interest rates, exchange rates and prices by means of derivative instruments; and harmonising measurement principles.

There are two basic models for international measurement principles. One says that investments are measured at historical cost and technical provisions are discounted at a fixed rate. IFRS favours the fair-value method in which investments are measured at market value and technical provisions are discounted at market rate. What has turned out to be the biggest problem is that no fair value model for measuring technical

[3] See: Taxation of Finnish Insurers under IFRS, Federation of Finnish Insurance Companies (in Finnish)

provisions is yet in use, or even known, while on the asset side, restrictions have already been imposed on the use of the historical-cost method. When the measurement of assets and liabilities is not in balance in accounting, profit fluctuations will increase and may even pose a threat to the required solvency margin.

Unit-linked insurance is the only business activity in Finland where technical provisions and assets covering technical provisions are already measured at fair value and recognised as profit or loss.

Finnish insurers usually use fixed discount rates. Companies are allowed by legislation to match their assets and liabilities by means of the discretionary revaluation of investment assets in both their accounting and taxation.

An insurer's technical provisions may from time to time be boosted to a considerable extent by a number of things (e.g. changes in mortality assumptions), although the underlying liability may not in reality amount to as high a figure when it is finally discharged after a long time. It is not therefore economically prudent to sell assets when technical provisions grow and there is no need for liquidity, particularly since the funds concerned would have to be immediately invested in a new target to await final repayment of the debt. In this setting, revaluation is a tool insurers can employ to avoid the untimely realisation of assets. Asset/liability matching increases in importance if companies change over to fair-value measurement. As yet, however, there is no accounting practice defined for either technical provisions or investments.

3.3.3. Changes in the value of investments vs. technical provisions

Finnish tax legislation includes separate provisions for the treatment of changes in investments and technical provisions made by insurance companies. If there would be already insurers in Finland who applied IFRS in their separate financial statements in Phase I, the treatment of technical provisions would also change. Such change would primarily involve the equalisation provision, notably its regrouping as part of equity, and the treatment of certain insurance contracts as either financial instruments or provisions in accordance with their substance. Because of the current linkage between taxation and accounting, this could be problematic.

For the above-mentioned companies, measurement of investments would also change to comply with IFRS. Moreover, all insurance companies could decide to measure their investments already in Phase I in accordance with a decree to be issued by the Ministry of Social Affairs and Health on the basis of the Fair Value Directive (2001/65/EC) and the Modernisation Directive (2003151/EC), under which financial instruments and property investments may be measured at fair value.

A matter worth consideration would be the need to change the Business Taxation Act so that for insurance companies, only the revaluation of investments shown on the balance sheet and recognised as unrealised gains on the income statement represent taxable income. In taxation, systematic measurement at fair value under either IFRS or a decree issued by the Ministry of Social Affairs and Health would not be viewed as a measure comparable with revaluation in respect of any other business than unit-linked insurance. In the unit-linked business, both sides of the balance sheet are already measured at fair value. According to this view, only unrealised gains recognised in profit would constitute taxable income. In situations where unrealised gains based on fair-value measurement do not constitute taxable income for the company, they would not be included in the historical cost of assets which is deductible in taxation.

If the taxation legislation were not amended, all changes in the value of investments, both gains and losses, would have a direct impact on taxable income and thus result in unpredictable fluctuations in tax revenue.

3.4.4 Profit balancing in the taxation of insurance companies

Another change prompted by the introduction of IFRS which affects the way in which insurance companies account for technical provisions is removal of the equalisation provision, an item now treated as part of technical provisions. Owing to the long-term nature of the insurance business, equalisation provision is seen as a necessary cushion against fluctuations in insurers' profits resulting from unusually large claims in any single year. In addition to the equalisation provision, there are other means currently in place to offset fluctuations in profits such as valuation gains or losses, i.e. the difference between the current value and book value of investments (shown off balance sheet), and prudence in technical provisions which is supported by provision for unallocated bonuses and a prudent discount rate. All these items will he reshaped or removed under IFRS during Phase II.

The Finnish tax system has accepted loss-offsetting elements as part of technical provisions, deductible in taxation, and by leaving off-balance-sheet valuation gains/losses outside taxation. Since taxation is based on accounting and no specific provisions exist to the contrary, these items have not been taxed up to now.

If, in the future, taxation in Finland is based directly on accounting, all rises and falls in accounting profits will mean associated changes in taxable profits. The removal of equalisation provision from deductible items will mean that stochastic variation in claims is also felt in taxation, unless equalisation provision is replaced by some new mechanism. If insurers increase their use of existing hedging tools such as reinsurance, they will be faced with increasing costs, while the public sector will be left with lower revenues. Furthermore, not all risks can he reinsured. The fair-value measurement of investments in financial statements would also increase fluctuations in profits. In such a setting, insurance companies would see profit fluctuations resulting not only from insurance risks but also from investment risks.

At least two different mechanisms can be considered for avoiding fluctuations in insurers' taxable profits:

- The introduction of a specific reserve in tax legislation. This reserve would he calculated in the same way as the present equalisation provision is calculated for an insurance company's financial statements, or it could he calculated in some reduced formulaic way that would also be able to account for investment risks. The change from the present situation would then be the fact that when companies change over to IFRS, this reserve would no longer be calculated for use in accounting but only for the purpose of defining the amount deductible in taxation.
- Extending the right to offset losses against taxable income so that losses made at a later date can be charged against taxable profits made in earlier financial years (loss carry-back). A threshold for that kind of change could, however, be quite high.