Article

Reijo Knuutinen*

The Nordic model: 25 years of drawing the line between earned and capital income in Finland**

https://doi.org/10.1515/ntaxj-2018-0003
Received Dec 18, 2017; accepted Feb 27, 2018

Abstract: In personal income taxation, Finland had used the dualistic income tax model, known as the Nordic model, since 1993. The basic idea is that taxation of earned income is progressive, whereas taxation of capital income is proportional. Here, the model is reviewed from different perspectives: What kind of tax policy background does it have and how is the distinction between types of income argued for on theoretical grounds? How has the borderline of earned and capital income been drawn in tax legislation, and how is it drawn in the court cases, in particular in those related to tax avoidance? The dualistic model has often been criticized using equity arguments, but there are still strong arguments for the model. In any case, the model has not always worked too well in practice. The distinction has required special tax legislation as well as given rise to many court cases.

Keywords: Nordic model, dualistic income tax, differentiated tax system, earned income, capital income, tax avoidance

1 Introduction

In the late 1980s and early 1990s, big changes took place in the Finnish economy and in many other countries as well. The capital market was liberalized at the end of the 1980s, leading to a wide range of financial activities. The economy overheated and finally led to the recession of the early 1990s. There were also strong winds of change internationally, both politically and economically. In 1991, the Soviet Union collapsed and the bilateral trade with Finland came to a halt. The Finnish markka was devalued, and many firms and investors that had loans in foreign currencies fell. The time of regulated markets and bilateral trade was permanently over. Finland was facing a new international political and economic situation.

During these years, many changes were made to the tax system of Finland, as well. The gradual reformation of the income tax system, during the governments of Prime Ministers Holkeri and Aho, was remarkable. In Finland, as in many other countries, the reforms had two main lines: the tax base was expanded and tax rates were reduced. In many other countries, reforms had been made already earlier. In the United States, a major tax reform was made in 1986. In the Nordic countries, Denmark was heading to the forefront. Sweden and Norway followed and went even further in their reforms.

In Finland, the decision of the changeover to the Nordic dualistic income tax model was made in the autumn of 1992 and the new system was introduced from the beginning of 1993. The issue at this stage was, in particular, the reform of capital income and partly corporate taxation, which sought to achieve a more coherent and neutral taxation of business and its financing.\(^1\) Thus, a system in which the income of a natural person is divided into two different types of taxable income, namely, earned income and capital income, was introduced.\(^2\) The basic idea of the Nordic model is the progressive taxation of earned income and the proportional taxation of capital income.

Thus, our dualistic income tax model has just turned 25 years. In the spirit of this milestone, it is a good time to look at the reasons for which the system was originally introduced and how the system actually has worked in practice from the point of view of tax law. Here, I will not be dealing with the question of whether the model has been a success from the viewpoint of tax revenues or overall economic benefit. Answering such questions would be challenging anyway because we do not know what an alternative development process and path would have been. Even so, it can be said here that the rest of 1990s were a strong

---


---

*Corresponding Author: Reijo Knuutinen: Turku School of Economics at the University of Turku; Email: reijo.knuutinen@utu.fi
** This article is a translated and partially modified version of the article the author has published in Verotus 4/2017 in Finnish

Open Access. © 2018 R. Knuutinen, published by De Gruyter. This work is licensed under the Creative Commons Attribution-NonCommercial-NoDerivatives 4.0 License
time in the Finnish economy and also in the accumulation of tax revenues.

The structure of the article is the following: Section reviews the tax policy background of the dualistic income tax system. Section 3 examines how earned income and capital income differ from each other theoretically. Subsequently, Section 4 considers how the borderline between earned and capital income has been drawn in tax legislation. Section 5 examines the court cases related to this boundary, in particular, the cases related to tax avoidance. Finally, in Section 6, the function and effectiveness of the system in relation to the different tax policy objectives is evaluated.

2 The tax policy background of the dualistic income tax system

2.1 Finland followed the other Nordic countries

In many countries, the capital gains are separately taxed, or a different mechanism is applied for determining and calculating them (see, e.g., Pistone 2016). However, the full differentiation and separation of all capital income of natural persons is characteristic of the Nordic countries. The development began with the 1987 tax reform in Denmark, where progression was almost completely abolished in the taxation of capital income. Sweden and Norway went even further in their reforms. In the following text, the Swedish reform is reviewed, in particular.

In Sweden, the differentiated taxation of earned and capital income was introduced from the beginning of 1991. Previously, capital income (including capital gains) was taxed on the same scale as other income; now they were moved to a proportional 30% tax rate. The lower rate was justified, *inter alia*, by inflation. The reform sought to ensure that all forms of capital income were taxed in a uniform manner. The new tax model was also considered to reduce the scope for tax planning and tax avoidance.

In Sweden, the tax reform was prepared for years. The preparatory work started in June 1987 with the appointment of the committee for the reformation of the income tax system (*utredningen om reformerad inkomstskatt*, RINK). The committee consisting of parliament members was headed by Secretary of State Erik Åsbrink. Naturally, tax experts were also consulted by the committee. The RINK Committee submitted its four-part report in June 1989. Along with the RINK Committee, a separate committee of experts surveyed the question on how inflation should be taken into account within taxation. The IBU Committee was appointed at the end of 1988, and it completed its work by submitting its report in July 1989. The report reviewed inflation within both corporate and personal taxation.

The RINK Committee’s proposal was based on a nominal tax base and schematic account of inflation with a lower nominal rate. The IBU Committee had instead sketched out an alternative system in which inflation was taken into account in a theoretically correct way by dropping it out of the tax base. Thus, only real income would have been taxed. In order to implement the tax reform, a more schematic and also simpler model of the RINK Committee was adopted.

The tax reform was implemented in steps. In the first phase (*Regeringens proposition 1989/90:50*), the reform concerned only the taxation of the year 1990. From the viewpoint of the dualistic income tax system, the second step (*Regeringens proposition 1989/90:110*) was more important, including, among other things, the follow-

6 SOU 1989:33. Reformerad inkomstbeskattning. Betänkande av utredningen om reformerad inkomstbeskattning. Del 1 Skattereformens huvudlinjer; Del 2 Inkomst av kapital; Del 3 Inkomst av tjänst, lagtext och kommentarer; Del 4 Bilagor, expertrapporter.

7 SOU 1989:36. Inflationskorrigerad inkomstbeskattning. Betänkande av utredningen om inflationskorrigerad inkomstbeskattning. The effects of inflation in taxation were also studied earlier in Sweden, see SOU (1982:1) (Betänkande av realbeskattningsutredningen). In addition, earlier in 1950s and 1960s, Sweden taxed capital gains with a scheme that eliminated the effect of inflation in a schematic manner: for shares with less than five years of ownership, the taxable portion of the capital gains was gradually (25% per year) reduced after two years of ownership. See Lodin (1988) and Mutén (2003).

8 See SOU (1989:33 Del I, p. 20): "Kapitalinkomster beskattas med en enhetlig statlig skatt 30 %. Skattesatsen har valts med hänsyn till att den skall tillämpas för nominellt beräknade kapitalinkomster, dvs. även inflationssdelen av räntan och annan kapitalavkastning beskattas." See also p. 25: "Realiserade värdeändringar beskattas fullt ut samma sätt som löpande kapitalavkastning, medan inflationen beaktas genom en förhållandevis låg skattesats. Denna metod för beaktande av inflationen är väsentligt enklare än alternativa [...]."
ing proposal: “Kapitalbeskattningen föreslås bli nominell med en proportionell statlig skattesats på 30 %. Alla kapitalinkomstbeskattas i ett inskomstslag som också utgör en förvärvskälla.”

That is, the taxation of capital income was proposed to be nominal with a proportional state tax rate of 30% and all different forms of capital income were to constitute a distinct source of income.

In the preparation for the reform, taking inflation into account was very important, as evidenced by the fact that the question was examined in a separate committee. In the reports of the RINK Committee, the issue of inflation is also widely discussed and its impact on setting an appropriate capital income tax rate was described as follows:

En skattesats mer än 30 % för kapitalinkomster skulle strida mot vårt mål om att sparande skall stimuleras och att länangande skall motverkas. Vid 4 % inflation, vilket kanske kan vara en realistisk inflationstakt på medelång sikt, och 3 % real ränta uppgår den nominella räntan till 7 %. Vid 30 % skatt för nominellt [beräknade] kapitalinkomster uppgår skatten till 2,1 %, vilket ger en real ränta efter skatt 0,9 %. Vid 6 % inflation blir skatten i stället 2,7 % och den reala räntan efter skatt 0,3 % medan den reala räntan efter skatt blir negativ om inflationstakten överstiger 7 %.

This example presented in the report is based on a long-term 3% real interest rate and 4% inflation rate. From a nominal 7% yield, the share of tax is 2.1 percentage points (30% × 7% = 2.1%), which means a 70% effective tax burden against the real interest rate.

The nominal tax rate for capital income was to be set so that the real effective tax burden would be roughly at the same levels as the marginal tax on the highest earned income. The Swedish law-making material thus illustrates the fact that setting a capital income tax rate was foremost seen as a theoretical and internal tax policy issue, though at the same time, the question also in Sweden was about reacting to capital market developments and the international competitiveness of the tax system.

### 2.2 The preparation of the reform in Finland

The program of Prime Minister Holkeri’s Government, dated April 30, 1987, states that the government would implement a comprehensive tax reform based on the equal taxation of different types of income. The taxation of capital income was to be harmonized and, as part of that, a proposal was made to arrange the taxation of dividend income so that the economic double taxation was abolished but dividends were anyway taxed at once. The program set the target for the government to prepare a total tax reform so that its implementation could be completed by the end of the electoral period. Such an overall tax reform was indeed made between 1989 and 1991: the tax bases were broadened, the tax rates lowered, and the system was developed in a more neutral direction.

However, at this stage, the overall reform was missing the taxation of capital income. Even though the avoir fiscal system was already introduced, the taxation of dividends had remained as part of the progressive income tax.

The reforming process continued as soon as the government changed. In Prime Minister Aho’s government program, dated April 26, 1991, it was stated that the reformation of taxation will continue, given the international competitiveness of the tax system and the fiscal targets set for public finances. Income taxation was further developed, encouraging work, entrepreneurship, and savings. The aim was to further harmonize the taxation of capital income and to reform taxation in the same way as in the other Nordic countries. The corporation tax rate would be reduced but, at the same time, the tax base would be broadened. Preparatory work on taxation of capital income was launched immediately as the Ministry of Finance appointed a high-level working group of tax experts. The working group prepared a memorandum concerning the development strategy of the taxation of capital and corporate income (Valtiovarainministeriö 1991:28). The memorandum examined the taxation of capital income through a versatile, analytical, and clear approach.

According to the assignment, the working group had to pay particular attention to the objectives of harmonizing the taxation of capital income and, when making the proposals, evaluate the possibilities for developing the taxation of capital income in the direction of proportional taxation. The working group was also asked to survey how inflation should be taken into account within the taxation of capital income as well as to assess the advantages and disadvantages of a system in which the taxation of capital is differentiated from other income. In addition, the impact of the model on the income distribution as well as on tax revenues had to be assessed.

The working group drafted a proposal on the reform of the income tax structure into a dualistic income tax system: the taxation of capital income of natural persons...
would be differentiated from the progressive taxation of earned income and capital income would be subject to a uniform and proportional tax rate corresponding to the corporate tax rate. The application of a lower tax rate to capital income, compared to the progressive tax scale of earned income, was argued, among other things, with the fact that that because of inflation only part of the nominal capital income is usually real income.\textsuperscript{13} In addition, it was anticipated that the international tax competition was going to get tighter.\textsuperscript{16} In efficient capital markets, the allocation of the capital is determined by the return requirements, and structural changes in the capital market set stricter prerequisites for the development of capital income taxation in Finland, as well.\textsuperscript{15}

### 2.3 The Government Proposal

The Government Proposal 200/1992 was built based on a working group memorandum. The proposed dualistic model was, therefore, justified by the harmonization of capital income taxation and corporate taxation as a coherent whole and, in particular, by tax competition focusing on financial capital. The economic integration and the international liberalization of capital mobility in the early 1990s had brought new challenges to the development of the tax system. In practice, the real tax burden on the various forms of capital income had fluctuated from full tax exemption to more than 60% marginal taxation in a way that was not desirable in terms of the functioning of capital market and an efficient resource allocation. As a result of the internationalization of business and its financing, such harmful incentive effects were further exacerbated. The steering impacts of the non-neutral taxation of capital income had turned out to be increasingly negative in the overall economy. In the other Nordic countries, the challenges had been quickly addressed, that is, the countries had already shifted to a differentiated system.\textsuperscript{16}

According to the proposal, the benefits of a differentiated income tax system would be strengthened by a structure in which the corporate tax rate is the same as the tax rate for capital income. This would facilitate the harmonization of the tax burden on different capital forms invested in companies and reduce the incentives to transfer revenues or expenditures between the company and the private economy in order to achieve tax benefits.\textsuperscript{17}

In the government’s proposal, the reform was also weighed from the viewpoint of equity in taxation: “Within taxation there is a long tradition with the idea that capital income should be taxed more than earned income. In practice, however, the implementation of this idea has proved to be difficult for many reasons and in many cases the taxation of capital income has been only nominally stricter than the taxation of earned income.”\textsuperscript{18} In other words, the harmonization and broadening of the tax base can actually result in a fairer outcome than before, even though the tax rate of capital income is decreased. At this time, the tax system had been subject to a wide range of tax reliefs and other kinds of deviations regarding the tax base, for which reason the tax revenue from capital had been relatively low. For example, capital gains had been largely excluded from taxation.

The difference of effective tax burdens between the earned and capital income will be large was seen as a risk in the prepared model. Therefore, according to the government’s proposal, efforts should be made in the future to lower the progressive tax rates of earned income, as well. Lowering the tax scale would be necessary so that the large differences in applicable tax rates would not excessively create incentives for the efforts to convert earned income into capital income.\textsuperscript{19}

The nominally lower tax rate of capital income was also justified by inflation, although the impression one gets is that inflation as an advocating argument does not seem as strong as it had been in Sweden. Rather, it appears from the government’s proposal that inflation was in some way treated as a defense argument to deviate from the equity and fairness in taxation. Furthermore, it was stated in the government’s proposal that, in practice, the most important argument for the lower tax rate for capital income might be meeting the challenges of the international tax competition. International examples had shown that once the movement of capital is free, the capital will easily escape the high tax rates to countries where the taxation is

\textsuperscript{13} Valtiovarainministeriö 1991:28 p. 108. About taking inflation into account in capital income taxation, see pp. 11–12. 
\textsuperscript{14} Valtiovarainministeriö 1991:28 p. 6. 
\textsuperscript{15} Valtiovarainministeriö 1991:28 p. 5. 
\textsuperscript{17} Government Proposal 200/1992 pp. 4–5. At first, in 1993, the tax rate for the capital income of natural persons and also the corporate tax rate was 25%. Between 1996 and 1999, the rates were 28%, and from 2000 onwards, they were increased to 29%. In the tax reform of 2005, this structural feature of the system was disbanded when the corporate tax rate was lowered to 26% and the tax rate on capital income to 28%. 
of the business income of a private trader in business and part of the business income of a partner in a general or limited partnership are considered capital income.\footnote{33}

In the earlier years of the differentiated system, the taxation of capital income was fully proportional in Finland. However, since 2012, the taxation of capital income has been based on a two-step tax scale. At present, a tax of 30% is paid on capital income until it exceeds EUR 30,000, and above this, the tax rate will rise to 34%.

From the viewpoint of an economic concept of income, the income types have a different nature. Salary, pension, and other earned income are always obtained at some point in time, in which case the real value of the gain also corresponds to its nominal value (see, e.g., Ylä-Liedenpohja 1999). This is hardly affected by the fact that the salary is paid a little bit afterwards, for example, on a monthly basis. What is essential is that for obtaining earned income, there is no need to tie up capital, whose real value could change. Capital income, on the other hand, typically accumulates over a period of time. For obtaining capital income, at least typically, there is a need to tie up capital, whose real value will change because of inflation, which confuses the measurement of the real income. Even though an item of capital income may be realized at a single point of time, its economic accrual may have taken years or even decades, during which time the value of money would also have changed. Therefore, earned income and capital income have a different nature from the viewpoint of the need to take inflation into account; inflation is a problem in the taxation of capital income but not a big issue in the taxation of earned income.\footnote{34}

3.2 Inflation and measuring the real capital income

One could suppose that when people think about income in everyday life, they usually think about nominal income. However, from the viewpoint of the Haig-Simons theoretical concept of income, only the real return on capital increases the potential for consumption and also the ability to pay tax. Therefore, capital income should basically be

\footnote{33} Sections 38 and 40 of TVL. See also Section 39 of TVL regarding the respective situations in agriculture.

\footnote{34} However, there are some practical problems in the taxation of earned income, for example, regarding the progressivity and tax scale inflation adjustments.
taxed only in real terms. An increase in value because of inflation is not the kind of income that changes the ability to pay taxes, so, in theory, it should not be involved in the tax base either. Theoretically, the right way would be indexing, that is, to use inflation-adjusted values instead of nominal values when calculating the capital gains and some other forms of capital income. Regarding the earned income, indexing is not needed in this sense. In practice, the rise in wages and pensions along with inflation in a manner takes care of this issue automatically; only annual adjustments for tax scales are necessary, to avoid an increase in the tax burden because of inflation.

Taxing the nominal income component based on inflation means, in a sense, the taxation of the real value of the asset itself. If the effect of inflation is ignored, the nominal capital income gives an impression that the real amount of capital income is much higher than it is in reality and, in this case, the real capital income is then actually taxed at a higher effective tax rate. Although inflation has recently been at a relatively low level, it does not really change the basic analysis itself. As a matter of fact, because of the long-lasting low market interest rates, rather, the opposite is true: if the market interest rates are low (or even negative), then many risk-free or low-risk debt instruments do not generate any real income at all. Furthermore, it would be a mistake to think that inflation would distort the income measurement only for long-term investments, although then it might be easier to understand its significance, namely, inflation affects, for example, the short-term and long-term fixed income instruments in the same way; only the real interest is real income.

Despite this clear and indisputable economic and theoretical significance of inflation, income tax systems are usually based on nominalism. This is often justified by the argument that indexing, or another suchlike method to take inflation into account, would complicate the taxation significantly. However, in some countries, indexing has been used in the taxation of capital gains. Looking back on the past decades, the pressures on indexing have typically increased during the times of high inflation. During the years of the earlier currency in Finland, the Finnish markka, inflation was very high on several occasions, but no system that expressly or directly takes inflation into account was ever used for the taxation of capital income in our tax system.

Although the nominalist approach is dominant, the impact of inflation has, in many tax jurisdictions and tax systems, been addressed indirectly by some other means. For example, the lower tax rate of capital income, the lower rate of capital gains in particular, is often justified by the schematic compensation of inflation. In addition to this, the possibility of leaning on the assumed purchase price has been argued for and justified by the implicit consideration of inflation.

### 3.3 Different forms of capital income have an inconsistent effective tax burden

Thus, inflation influences the effective tax burden of capital income. However, this influence is not consistent toward various forms of capital income. For example, concerning capital income items such as dividends or rents, the nominal and the real income are equal. On the other hand, the taxation of interest income and capital gains may result in the effective tax burden exceeding 100%.

---

25 See Haig (1921/1959 p. 75): “Income is the money-value of the net accretion to economic power between two points of time.” About the Haig-Simons concept of income, see Knuutinen (2009, pp. 54–55 and 114).

26 See Weisbach (2004, p. 30): “In a Haig-Simons tax, inflationary returns are not taxed because they do not represent either consumption or an increase in savings.” See Bankman and Griffith (1992, p. 391): “As a practical matter, the treatment of inflationary returns is a major issue in tax policy. As a theoretical matter, however, the treatment of inflationary gain is unproblematic.”

27 See Ylä-Liedenpohja (1990, p. 50), who stated that inflation is a factor that tends to arbitrarily expand the income tax base over the real income concept. In fact, taking inflation into account would also be a relevant issue for capital losses as well: because of inflation, without indexing, the real loss is measured as too low. See Shuldiner (1993, pp. 558–560).


29 Indexing has been used, for example, in the United Kingdom and Australia. See Evans and Sford (1999, p. 401), referring to the high inflation during the 1970s and 1980s as a reason for why indexing was introduced in some states. During the 1990s and thereafter, inflation has been relative low in the United States and Europe. However, in some Latin American countries, it has been high, and there some states have enacted tax legislation to take inflation into account in some way or another (Thuronyi 2003, p. 32). See Shuldiner (1993, p. 552), who highlighted that the significance of inflation in determining and calculating the capital gains may be remarkable even though the level is not high.

30 See Section 46(1) of TVL: Instead of the actual purchase price, a taxable (natural) person can always use the assumed price, which is 20% of the disposal price, or 60% of the disposal price when the asset sold had been owned for at least 10 years.
In the case of dividend income, however, another important factor in our present tax system affects the real tax burden, namely, the economic double taxation of a company and a shareholder. In addition, the overall impact of taxation varies a lot depending on which type of a company pays dividends to which type of a shareholder. For example, in the case of a public listed company and a natural person as shareholder, the combined tax burden is 40.4–43.12%, depending on whether the person’s capital income is below or above EUR 30,000. This is not far from the average level of taxation for earned income. On the other hand, in the case of non-listed companies, the taxation of dividends is considerably lighter, within certain limits. On top of this, instead of paying dividends, the profits may also be kept and accumulated in the company, which in practice is much easier for non-listed than listed companies.

Furthermore, the taxation may vary within one asset class depending on the form of investment or financial instrument used. For example, one may invest in equities by making direct equity investments or then by using funds or different kind of life and pension insurance products. The tax treatment of these different investment instruments is not consistent; the effective tax burden can vary a lot between the different investment forms and cases. Above all, this is due to the fact that by using indirect forms of investment, the taxation will be more or less deferred.

Thus, regarding the investment form and the case, capital income is under single or double taxation. The taxation depends on the investment form or the financial instrument used. The real tax burden varies a lot between the different forms of capital income, in spite of the fact that the same nominal tax rate is mainly applied independently of the form used. As a result, no uniform effective tax rate for capital income exists. Therefore, when comparing the effective tax burdens of earned and capital income, the outcome depends on which form of investment is placed for comparison and in which circumstances.

3.4 The bunching of income and the lock-in-effect

Inflation is not the only theoretical argument for lower and proportional tax rates on capital income. Particularly regarding the capital gains in the realization-based tax system, the capital income does not necessarily accumulate steadily but often comes in one go—when it is realized.

In principle, there are two ways to get capital income, for instance, from a financial instrument. One is to get capital income such as dividend or interest for the instrument. The other is to get capital income, as a form of capital gain or loss, when there is a disposal of the financial instrument itself. It is a common metaphor to illustrate the difference between these two as a tree that bears fruit. In taxation, first, the income is usually recognized when it is realized, and second, the tax treatment for the fruits and the tree itself are not necessarily similar. From an economic perspective, making a difference between the two in taxation is not theoretically tenable.

This can be illustrated, for example, by comparing the accumulation and income units of the mutual fund. For accumulation units, the investment returns such as dividends are reinvested by the fund, while for income units, a yield based on the dividends received by the fund is distributed annually to the investors. In the Finnish tax system, the accumulation units are taxed only once the units are redeemed, while the yield for the income units is taxed annually.

Thus, for tax purposes, the income is received when the income is realized. Regarding the capital gains in a realization-based tax system, this means the moment of the disposal. Economically, the creation of the gain may sometimes have taken a very short time, but in some cases, the accumulation of the gain, for example, regarding one’s own business or investment in a listed company, may have taken decades. Even in the latter case, however, the gain as a result of the sale or other kind of disposal will be recognized at one time, which gives rise to some questions (see Vickrey 1939 and Blum 1957). Economically speaking, the income is accumulating, but in terms of taxation, it is kind of bundled, and, therefore, the process is called bunching of income (see, e.g., Cunningham and Schenk 1993). The bunching effect is a strong argument for the taxation of capital income, and especially that of capital gains, to be proportional, not progressive.

Let us assume that the company’s taxable profit is 100X. When the company pays 20% corporate taxes, or 20X, after this, 80X will be distributed to the shareholders. According to Income Tax Act Section 33 a, 85% of the paid dividend is taxable income, which is 68X. The tax on this taxable part of the dividend is 20.4X or 23.12X, depending again on the total amount of capital income. As a result, the total amount of taxes for the company and a shareholder is 40.4–43.12%, depending on the case.

On the other hand, it has also been considered that the deferral of tax because of the realization requirement compensates for this effect. See Simontacchi (2007, p. 133).
Regarding capital income, proportional taxation reduces the need and opportunities for tax planning.

Furthermore, the lower rate of capital income and, more particularly, the taxation of capital gains can be justified by considerations of economic efficiency, which more precisely means the lock-in effect (see Blum 1957). For tax reasons, investors are reluctant to sell their assets such as shares with a high value increase. The lock-in effect is specifically related to the realization-based tax system, acting as a barrier for transactions. Economic efficiency would require that the profits are realized or left unrealized—regardless of the tax issues—when it is believed to be economically feasible. For tax reasons, the investor may be willing to accept even lower pre-tax expected returns, which distorts the efficient allocation of capital (see Auerbach 1991).

4 The distinction of earned and capital income in tax legislation

4.1 Problems with the distinction were expected

In terms of tax policy, the justification, functioning, and effectiveness of the differentiated income tax system can be assessed at two levels. The previous section looked at whether the different taxation of earned and capital income is generally justified, in terms of horizontal equity in taxation. As noted, the comparison of the actual tax burden of earned and capital income is difficult when the effective tax rates of capital income vary depending on the investment form and the situation. In any case, the low taxation of capital income in general is a kind of myth: in real terms, some forms of the capital income have been subject to strict taxation, others to mild taxation.

The other way to weigh the system is to look at how it works in individual cases. Many practical problems, as well as the borderline issues of tax planning and tax avoidance, will arise especially in situations in which a taxpayer, directly or indirectly, has an overall economic interest in the company or other source of income, and when this overall interest is formally divided into labor input and capital investment. In such situations, the difference between the tax burdens of those two forms may be significant, and so taxpayers often strive to transfer the compensation for work into return on capital.

Thus, the differentiated taxation of earned and capital income has brought a specific challenge: the earnings and the capital income must be kept separate, not only generally but also regarding individual cases. At the level of tax legislation, the need for this separation has required a number of specific provisions that will be dealt with in the later sections. In the next section, the challenges that the separation requirement has brought into the application of the law, especially in cases in which it has been necessary to take a stand on the conversion of the income type from the point of view of the general tax-avoidance clause, are addressed.34

Already at the time when the differentiated system was under preparation, it was apparent that owing to the differences in the tax rates, there would be a tendency for taxpayers to convert earned income into capital income, despite the fact that the law seeks to make a clear distinction between the two income types. Therefore, it has been necessary to determine the capital income in the Income Tax Act as exhaustively as possible. Any other income is then residually considered to be earned income within the progressive taxation. Despite this well-conceived starting point, the separation has not always worked very well in practice.

The working group’s memorandum pointed out that some income items could be linked to both earned and capital income. In particular, the business income of an entrepreneur working in an undertaking that he or she also owns is typically, by its economic nature, partly earned and partly capital income. The different tax scales may create incentives for income conversion also in the relationship between the employer and the employee. In addition, the working group memo discussed in more detail a number of exemplary situations in which an income may have features of both earned and capital income. From this point of view, employee funds, loans from employers, insurance premiums paid by the employer, employee share issues, convertible bonds, and option schemes have been reviewed. Generally for these sit-

uations, it is stated that the solution to the income conversion problem cannot be left only to the possibility of applying a general anti-avoidance clause because the question is mostly about the situations that the new system, that is, the tax legislation, explicitly makes possible and legitimate.\textsuperscript{39}

\subsection*{4.2 Taxation of partnerships}

In the preparation, particular attention was paid to the taxation of partnerships, that is, general partnership and limited partnership, in order to increase the tax neutrality between the different forms of corporate entity. Namely, in the case of Finnish public and private companies limited by shares (referred to later as the “company”), the \textit{avoir fiscal} system was already a well-functioning solution at that time. The working group examined two alternative ways of solving the issue: either with the so-called fence model or the earned income model. In the \textit{fence model}, the revenue reserved within the partnership shell would be taxed at the same rate as the profit reserved in the case of the companies. When the income then would be raised from the partnership, the tax already paid by the partnership would be credited to the entrepreneur. The \textit{earned income model}, in turn, would mean that the partnership is a separate taxpayer, but the entrepreneur who is working actively in it would be taxed for his or her share, regardless of whether or not he or she has withdrawn a salary or profits from the partnership. Furthermore, it was found that reevaluating the taxation of the companies would, in principle, be one of the ways to achieve tax neutrality between the corporate forms.\textsuperscript{40}

After all, the working group considered that the earned income model involved both theoretical and practical problems. Owing to these problems, the working group came to the conclusion that tax neutrality should be developed based on the fence model.\textsuperscript{41} However, in this respect, the later development has been quite different.

The allocation of business income into earned and capital income has been one of the most important, however, also one of the most difficult issues of the differentiated system. From the economic point of view, the business income is often partly return on capital and partly income earned. In the preparation of the Income Tax Act, it was considered that the allocation should not be determined only by the label under which the income is withdrawn. On the other hand, it was considered necessary that the allocation of business income into capital and earned income in practice is made based on the clear and schematic rules.\textsuperscript{42}

In particular, during all these years, the tax treatment of dividends from companies has been subject to various political interests and pressures. The dividend issue has raised questions of the necessary mitigation of double taxation, especially following the abandonment of the \textit{avoir fiscal} system from 2005. Since this change, the taxation has been differentiated in such a way that dividends from listed companies are taxed more strictly than dividends from non-listed companies.

Excluding the listed companies, in the tax treatment of business income, regarding all forms of carrying the business, there is currently a system whereby either the business income or the dividend income is divided into capital or earned income in relation to the capital invested, that is, based on net worth. Still, the numeral parameters for this allocation are somewhat dissimilar for different forms of carrying the business. However, the basic idea is that the share of the capital income is determined based on the presumed return on the net assets invested in an enterprise; the rest of the business income is then earned income. Through this procedure, the taxation of the return on the capital invested in one’s own business is, even though schematic, proportionate to the taxation of the return from portfolio investments in the stock market (Valkonen 2009).

As already mentioned, the norms and parameters vary in the case of a private trader in business, a general or limited partnership, and companies limited by shares. In addition, there is a fundamental difference between them: regarding companies, economic double taxation exists. However, for non-listed companies, there are tax reductions for dividend income, depending on the case, whereas 85% of the dividends paid by listed companies is taxable capital income when the shareholder is a natural person.

\subsection*{4.3 A company as a means to accumulate capital income}

Even before the time of the differentiated income tax system, private individuals had certain tax incentives to channel their investment activities or their labor input into the form of a company. As stated in the working group

\begin{itemize}
\item [39] Valtiovarainministeriö 1991:28 p. 64.
\item [40] Valtiovarainministeriö 1991:28 pp. 70–83.
\item [41] Valtiovarainministeriö 1991:28 p. 73.
\end{itemize}
memorandum in 1991, the question of when the company form can be disregarded in taxation is becoming a growing problem, burdening the tax authorities and the courts. In the economic sense, corporate taxation is also largely an indirect taxation of capital income. The working group considered that a uniform tax rate for capital income and corporate taxation would be needed to prevent tax advantages otherwise related to the artificial channeling of income or reductions into the company’s shells.

In the early days of the differentiated tax model, the elimination of the double taxation of a company and a shareholder was resolved with the avoir fiscal tax system. When the tax paid by the company was taken into account in the taxation for dividends in the hands of a shareholder, there was no economic double taxation. In addition, when the tax rate of capital income and corporate tax rate were set at the same level, this reduced the incentives to channel investment activities into a company form. Since then, however, the capital income tax rate and corporate tax rate have been differentiated. In recent years, the corporate tax rate has been lowered in Finland, whereas, at the same time, the tax rate of capital income has been increased, in addition to which it has become slightly progressive. Such differences are likely to increase the incentives for channeling investment activities into the company’s shells.

With regard to the channeling of labor input, the situation throughout the life cycle of the differentiated system has been that because of the high marginal tax rates of earned income, it has been tempting to try to shift the fruit of work into the company’s shells and thus further within the capital income taxation. It can also be argued that the practice in case law and taxation has for a long time been quite permissive regarding the use of the company form. However, the legislator has intervened in some extreme situations through special tax legislation.

The limits of the acceptable tax planning were tested, for instance, in the case KHO 2008:6, which is described in more details later in this article. In this case, the court had been obliged to accept the scheme described in the application but still implicitly suggested to the legislator the need for change in the tax legislation. As a result of the case, the legislator added a special provision regarding the work-based dividend:

```
Notwithstanding other provisions of the Income Tax Act, the dividend is earned income when the amount of dividend, according to the articles of association, the decision of the general meeting,
```

However, the work-based dividend referred to in the provision does not arise in a typical situation in which the profits of a company are actually largely formed as a result of the labor input of the owners but where the dividend payments are based on shareholdings or other factors that are independent of the amount of labor input. Thus, the special provision applies only to cases in which the amount of the labor input is an explicit allocation criteria for the dividends.

4.4 The employee options and other incentive schemes

Management incentives are areas in which the boundary between earned income and capital income has proved to be difficult to draw. These area have also been subject to changes in the tax legislation. The income from options, convertible loans, and other financial instruments is clearly capital income in the hands of ordinary financiers and investors. However, if the investors work in the company and if they for this reason are entitled to subscribe instruments such as options, on terms other investors are not entitled to, this will significantly change the situation. The fact that employment options have functioned as an incentive scheme or as a bonus for management and experts in the company has always advocated that profits made through these kinds of options and other instruments should be taxed as earned income.

During the first couple of years of the differentiated system, the taxation of the return on employee options was in line with the legal form of the instruments, that is, it was taxed as capital income. In the incentive schemes, options were often linked to a loan instrument. However, in practice, a relatively small amount of loan could be associated with a very large number of options. As a result, the actual investments made by managers were usually relatively low, sometimes really only nominal.

43 Valtiovarainministeriö 1991:28 p. 73.
44 See also Valtiovarainministeriö 1991:28, p. 2.
46 Section 33 b(3) of the Income Tax Act (unofficial translation, by the author, from Finnish to English). See KHO 2016:21, in which the court considered that this special provision is covering only dividend payments, so it cannot be applied to the disposals of the shares.
Nevertheless, the issue of employee options was not widely discussed in the working group’s memorandum. This may be explained by the fact that, at this time, employment options were not yet very common in Finland. In fact, the memorandum states that pure stock option schemes have mainly been used in multinational companies. In the memorandum, the tax issues of convertible loans and option schemes are mainly discussed in the context of share issues directed to the personnel, especially focusing on the question when the personnel discount in the subscription price would constitute a taxable benefit.\(^{48}\)

Some years later, the legislator considered it necessary to intervene and change the tax legislation. According to the government’s proposal of September 16, 1994 (HE 175/1994), the law would be amended so that the income from the disposals of the employee options would be regarded as earned income. At that time, there were already a number of incentive schemes running, which raised the question of the tax treatment of the existing incentive schemes. The debate expanded, especially during the parliamentary proceedings, when it became public knowledge that some listed companies intended to change the conditions of their incentive schemes by allowing options to be used earlier. Therefore, the government proposal was amended in such a way that the new provision would apply to the employment option used immediately following the publication of the proposal, not—as first planned—from the beginning of the following year.\(^{49}\)

This change, in turn, raised the question of the constitutionality of retroactive tax legislation. At a concrete level, the issue of constitutionality came to light in the case KHO 1998:53,\(^{50}\) in which the income from the disposal of the employee options had been taxed as earned income of the taxpayer, because the original terms of the option loan had been changed after the date of the government proposal allowing the disposal. According to the Supreme Administrative Court, the imposition of a tax was not confiscatory in such a way that the right to property or the requirement of equal treatment of taxpayers would have been infringed upon.\(^{51}\)

Under the current provision for employee stock options, an employment-based benefit to receive or subscribe shares or holdings of a corporate entity at a lower price and based on a convertible bond, option loan, stock options, or other similar agreement is also taxable earned income. The value of the benefit is considered to be the fair value of the share or the holding at the time that the employment option is used or disposed of.\(^{52}\) The government’s proposal clarifies that “other similar agreement” can mean, for instance, synthetic option arrangements,\(^ {53}\) an option that was under review in the case KHO 2014:66, which is discussed later in this article.

### 4.5 Voluntary pension insurance

The legislator has also made adjustments between the income types regarding the voluntary pension insurance schemes. Also the voluntary self-paid pension savings, regarding both the deductible payments and the pension benefits received, were earlier on the side of earned income, as compulsory pensions are. With the progressive taxation of earned income, this resulted in tax planning possibilities: it was possible to deduct payments when the income level was high and raise the money as pension later in life when the taxation because of the lower level of progressivity would be lighter. In addition, it was also possible to pay the voluntary pension insurance for a spouse, whereby the progression benefit could be even greater.

In the tax reform of 2005, voluntary pension insurance schemes were transferred to the side of capital income, that is, they were equated with investment instruments in taxation. The pension or other similar payments, as well as the amount received based on the termination of a contract, are taxable capital income for a natural person.\(^ {54}\) The payments for the scheme are deductible for the future pensioner.\(^ {55}\) Therefore, no big differences between the marginal tax rates of the payments and those of the pensions received can exist anymore, as the progressivity is relatively low for capital income.

However, the old system partly remains alongside the new one, because the pension payments that earlier were deducted from the earned income would continue to generate taxable earned income also in the future. In the case of voluntary individual insurance agreements completed

---

\(^{50}\) See Tikka (1999, p. 986), who noted that the Supreme Administrative Court has apparently considered itself able to assess the constitutionality of the law and that this raises some questions from the viewpoint of the separation of powers.
\(^{51}\) Subsequently, the European Court of Human Rights also interpreted the matter in a similar way, in relation to the European Convention on Human Rights.

\(^{52}\) Income Tax Act Section 66(3).
\(^{54}\) Section 34 a of Income Tax Act.
\(^{55}\) Income Tax Act Section 54 d.
before May 6, 2004, the pensions that are based on the payments deducted from the earned income, and the return on them, are taxable earned income.\textsuperscript{56} Thus, in these older agreements between the life insurance company and the policyholders, the pension scheme is divided into two computational parts, one is an earned-income and the other a capital-income component. As a result, the change in 2004 may still extend its impact on drawing the line between the income types within the scope of individual contracts for many years to come.

In addition to the above, there are many other situations in which the line between the income types must have been drawn in tax legislation.\textsuperscript{57} Nevertheless, drawing the line in individual cases has often remained a task of the tax authorities and the courts, ultimately the Supreme Administrative Court (KHO).

5 Conversion of income and tax avoidance

5.1 The general anti-avoidance rule

The distinction between earned income and capital income has also attracted such tax planning that the tax authorities and the courts have had to assess it in the light of the general anti-avoidance rule. The present GAAR concerning income taxation is included in Section 28 of the Act on Tax Procedure (VML):

If a circumstance or an arrangement has been given a legal form, which does not conform to its actual nature or purpose, taxation is carried out as if the proper and correct form [i.e., the form corresponding to the actual nature or purpose] had been adopted. If it is evident that a price, some other kind of compensation, or the time of payment has been agreed on, or another kind of arrangement has been taken in order to avoid tax, the taxable income and capital can be estimated.

If it is evident that taxation should be carried out in accordance with Paragraph 1, all facts and circumstances that may have an impact on how the case is evaluated must be carefully investigated, and the taxpayer must be given the opportunity to present a statement of the facts found. Then, if the taxpayer does not provide the evidence that the legal form used conforms to the actual nature or purpose or that an arrangement has evidently not been taken in order to avoid tax, the taxation must be carried out in accordance with Paragraph 1.\textsuperscript{58}

Regarding the distinction of earned and capital income, the GAAR has been applied in some cases, for instance, disregarding the company form in the taxation.

5.2 Disregarding the company form

The basic structure of a differentiated tax system has created incentives to develop various means, in particular, for converting earned income into capital income. Taxpayers have tried, among other things, to use the company form to convert the fruits of labor input into capital income. As a matter of fact, nowadays, taxpayers such as artists or sportsmen can quite freely use the company form to direct the income of different activities, although it is clear that the company itself does not sing or play golf. On the other hand, as an abstract creature of law, the company can never do anything alone, without human activities, except for passive ownership.

However, in older case law, particularly before the differentiated income tax system, the company form was often disregarded. In the case of KHO 1982/4277, an artist together with his wife and two other persons had established a company engaged in the production, recording, and sale of entertainment programs. The fees charged by the company regarding the artist’s personal appearance were considered to be the artist’s own personal income. In the case of KHO 1989 B 558, the taxpayer had established a company in which he had acted as a trading agent. The commissions received from the agency contract were considered as the taxpayer’s personal income. In the case of KHO 1982 B II 571, the company had earlier paid a salary to its managing director in a normal way but, subsequently, under the agreement, paid fees for similar work to the consultancy company that was established by the director together with his wife. The fees were considered as salary paid to the managing director. Correspondingly, in the case of KHO 1985/1764, the compensation paid to the company owned mainly by an ice-hockey coach was considered as personal income of the coach.\textsuperscript{59}

During the differentiated income tax system, the threshold to disregard the company form has been grow-

\textsuperscript{56} See the transitional provisions of the Act 772/2004.
\textsuperscript{57} For example, compensation for copyright based on the beneficiary’s own creations is earned income. The compensation paid for a copyright granted as a gift is also earned income, but if the copyright has been transferred through an inheritance or a will, or for consideration, the compensation received is capital income. Income Tax Act Section 52.
\textsuperscript{58} Unofficial translation, by the author, from Finnish to English.
\textsuperscript{59} Also see the cases KHO 1987 B 600, KHO 1987 B 601, KHO 1989 B 547, and KHO 1990 B 355.
ing. However, in the case of KHO 2000/3033, directing copyright fees to the company was not accepted for tax purposes. According to the Supreme Administrative Court, a company form was not necessary to receive the fees in question, and the operations of the company were limited in such a way that allocating the fees to the company would have been justified. While the legal form chosen did not conform to its actual nature or purpose, Section 28 of VML was applied and the fees were taxed as the taxpayer’s earned income. Therefore, the court considered the fees as earned income for the company’s main shareholder.

For many highly skilled specialists, such as lawyers, bankers, and doctors, it has become common practice that the key personnel own the company by directly or indirectly using different kinds of holding company structures. The ownership structures and arrangements of expert organizations were under review in the case of KHO 2001/1564. Lawyers (attorneys-at-law) and shareholders in the firm of solicitors had reorganized their holdings by each selling the major part of their shares at their nominal value to a new company they had established. In addition, some of the shares were transferred to the general partnership, in which the lawyers were partners. The argument for the ownership arrangement was that the company’s capital structure was changed to enable conducting an appropriate owner policy and to promote the development of the chosen true partnership model. In the chosen operating model, the profits were paid as dividends to the holding companies owned by the lawyers, aimed at preventing the growth of the company’s net asset value. This enabled taking new entrants without unreasonably large financial investments. The Tax Ombudsman\(^{61}\) considered that the arrangements had been made in order to avoid tax, under Section 28 of the VML, and that the lawyer should be taxed directly for the dividends instead of the holding company. However, the requirements for disregarding the company were rejected. The Supreme Administrative Court considered that the business reasons presented for the arrangement were sufficient and, therefore, the arrangement was not held as tax avoidance.

Instead, in the case KHO 2010/103,\(^{62}\) the company owned by a professional golfer was not disregarded in the taxation, as the Tax Recipients’ Legal Services Unit had required based on Section 28 of the VML. A taxpayer who had been playing golf as his profession for a long time had the purpose of setting up a company to conduct competitive activities, administering necessary support functions as well as administering and exploiting intellectual property rights. The purpose of the company was to exploit the player’s image and to expand the businesses even after the actual career. The arrangement would also clarify the source taxation for the prize money from different countries. In addition to the prize money from the games, the player had received sponsorship income. The purpose was to recruit and employ, at least part-time, a golf coach, a physical trainer, and a caddie. In addition, the company would pay commissions for a sponsorship agreement to an external management company. In its preliminary ruling, the Central Tax Board (keskusverolautakunta, KVL) had considered that the revenues were held to be the company’s income. Taking into account the scope and nature of the activities of the company to be set-up, as well as the economic risk associated with the activities, conducting the activities in a company form should be considered as corresponding to the actual nature and purpose of the business. The Supreme Administrative Court also took the same position.

Nowadays, the threshold for disregarding the company form in situations similar to this is pretty high.\(^{63}\) The Tax Administration’s guideline “Application of the tax avoidance rule” states that, in the past, the entire company could be disregarded in taxation but this is now rare and exceptional. According to the guidelines, exceptionally, a company form may still be completely disregarded in tax-

---

\(^{60}\) The issue of disregarding the company form was discussed in the Government’s proposal 53/1998. It stated that a company may be disregarded for tax purposes pursuant to the general anti-avoidance provision of Section 28 of the Act on Tax Procedure. The company form has been disregarded, for example, in cases in which the only contractor of the company has been a former employer or the number of clients has been otherwise low, the company has had only part-time activities, the company has had a small turnover, the company has not paid salaries, the company has had no premises or other employees besides the shareholder, or the amount of the company’s fixed assets has been small. There had been abundant case law on the issue; however, in several recent decisions, disregarding the company form was not accepted. Also the Tax Administration had instructed tax officers to set the threshold for disregarding the company form high for tax certainty reasons. On the other hand, the Government’s proposal paid attention to the fact that the categorical denial of disregarding the company form by legislative measures would emphasize the problems related to the distinction of earned income and capital income taxation.

\(^{61}\) Representative of the tax recipients. This is currently being done by the Tax Recipients’ Legal Services Unit (Veronsaajien oikeudenvalvontayksikkö, VOVA).

\(^{62}\) Unpublished decision.

\(^{63}\) Also see the case KHO 2009/322 regarding the possibility to disregard the limited partnership form for tax purposes, in which the arrangement was approved, as well.
ation if the revenue channeled to the company is entirely the earnings of a shareholder or another person, or other personal income comparable to such income. The question would be to disregard the entire company form on the ground that the legal form given does not conform to its actual nature or purpose, that is to say, based on the general anti-avoidance rule of Section 28 of VML.

5.3 A company owned by physicians with different types of shares

I will review two more recent precedents, decided by the Supreme Administrative Court, both in part relating to the question of disregarding the company form, as well.

In the case KHO 2008:6, a group of physicians had aimed to establish a new company to own and control a medical center. The physicians would own the shares directly or indirectly through their holding companies. According to the articles of association, the shares in the new company would be divided into ordinary shares and the so-called doctor’s office series of shares. In short, using the latter type of shares would practically mean that the annual net result would be calculated and a dividend would be decided for each physician separately based on the revenues of each office and the contribution of each physician. In practice, this would mean the labor input of each physician.

The Tax Ombudsman considered that the legal form given to this arrangement does not reflect its actual nature or purpose. This kind of dividend should be considered as a salary based on the ordinary interpretation of tax provisions or the GAAR, or then the company structure should be disregarded in the taxation.

Despite the fact that tax reasons were apparently important or even the driving force here, the Supreme Administrative Court, decided that because the basis for dividends was defined in the company’s articles of association, and the shareholders did not actually have any discretion as regards the dividend payments, the income should be classified as dividend income “considering the current state of law,” as the court formulated it. Thus, the arrangement was accepted for taxation.

The decision was based on the fact that the Income Tax Act does not have an independent dividend definition but it leans on the private law concept of dividend.\(^{64}\) Although the dividend described in the advance ruling application was not the kind of return on equity that dividends distributed to shareholders generally mean, the taxation of the fruits of such labor input as dividends was approved when the dividend right was based on the appropriate legal arrangements and the articles of association. The term “current state of the law” in the court’s reasoning could mean that the members of the Supreme Administrative Court did not regard the outcome of their decision as fair but felt that they could not override the content of the valid legislation. The GAAR of Section 28 of VML cannot be used to fix structural problems and the deficiencies in the tax system. The members of the court could also have looked at the case so that this outcome would even further complicate the segregation of earned and capital income, and for this reason, they wanted to send the legislator a signal that the law needed updating. Indeed, the public and political pressure that followed the decision quickly led to the specific regulation on the work-based dividends described in the previous section.

5.4 Holding company of the management as an incentive scheme

In the case of KHO 2014: 66, regarding an arrangement between a listed company and the holding company of the management of that listed company, the Supreme Administrative Court considered the arrangement as a whole as tax avoidance. Therefore, the expected revenue would be earned income to the managers, not capital income, as it would have been if the legal form were followed.

The directors established a holding company (referred to later as the HC). The minority part of the financing of the HC was equity from the directors, whereas the majority was debt financing from the listed company for which they were working (referred to later as the OYJ). With all the funds, the HC acquired shares of the OYJ. The shares would remain in the possession of the HC until the arrangement was dissolved, either by selling the shares or by merging the HC with the OYJ. By this arrangement as a whole, an incentive scheme was created for the management. The management company structure sought to ensure that the management would ultimately obtain the increase in the value of the OYJ as the increase in value of their investment in the HC, and ultimately in the form of capital income, not as more heavily taxed earned income, although the profits of the employee stock options are normally taxed in accordance with the Income Tax Act.

However, the court held that the arrangements could be assessed, as a whole, on the grounds of the tax avoidance rules, both Section 28 of VML and Section 52 h of

\(^{64}\) Also see the guiding of Tax Administration Dnro 1103/32/2009 (January 1, 2010).
EVL,\(^{65}\) to construct a synthetic option incentive scheme, and therefore, the income for directors should, under certain limits, be taxed as earned income, not as capital income. Section 66.3 of the Income Tax Act refers to "other similar treaties" and, moreover, the government’s proposal regarding the provision states that synthetic arrangements would receive a similar tax treatment as the conventional employee options, that is, options also in their legal form.\(^{66}\) Thus, the legislator’s intention was clearly that also the synthetic option schemes were to be taxed as earned income.

Nevertheless, the arrangement in its entirety included many steps and seemed very carefully prepared, so in the light of the regulatory texts, it was not clearly foreseeable on which side of the line of acceptable tax planning the court would settle. An important part of the reasoning was, \textit{inter alia}, that the listed company itself was an integral part of the complex arrangement built with an outside HC.\(^{67}\) Existing valid business reasons for the transaction or the arrangement constitute an obstacle to the application of Section 28 of the VML, even though some tax advantages would be obtained at the same time. There are always good business reasons for the creation and existence of a management incentive system as such, yet the reasons for implementing the incentive scheme using this kind of structure were considered to be relatively thin by the Supreme Administrative Court, so there was no obstacle to the application of the tax avoidance rule.

6 The conclusion: evaluation of the differentiated income tax model

For 25 years now, the borderline between earned and capital income has been drawn in tax policy, for the tax legis-

\(^{65}\) In business income tax legislation, there is also a specific anti-avoidance provision regarding the taxation for business restructurings. The provision, Section 52 h of the Business Income Tax Act (360/1968, \textit{laki elinkeinotulon verotuksesta}, EVL), is based on the EU directive, introducing a common system of taxation for cross-border restructuring operations. According to EVL Section 52 h, the provisions in EVL Section 52 and 52 a-52 g are not applied if it appears to be evident that the arrangements have tax evasion or tax avoidance as their sole or as one of their principal objectives. Sometimes Section 52 h of EVL has been applied together with VML Section 28.


\(^{67}\) The arrangement also included a plan (or possibility) to merge the holding company into a listed company. In such a situation, the realization of income could have been postponed far into the future as well. See Knuutinen (2016, p. 814).

The Nordic model: earned and capital income in Finland

79

model may be considered to be more weight-bearing (see, e.g., Sørensen 2005 and Valkonen 2009).

From the tax theory and tax policy point of view we can, therefore, still present heavy arguments for a differentiated model. Whatever one thinks of these arguments, it is clear that the distinction has not always worked too well in practice. The distinction of the two income types has required fairly detailed and somewhat complicated regulation in comparison to the otherwise abstract style of formulation of tax legislation in Finland. The need for boundaries has given rise to wide-ranging jurisprudence because the distinction between income types has inspired tax-planning innovation to convert the earned income into capital income.

On the other hand, a differentiated tax system also involves some issues of equity and justice in taxation. From the viewpoint of horizontal equity, the question is, inter alia, that in some situations and tasks, there is a possibility to use the company form for optimizing taxation, whereas in some situations and tasks, it is not. Also, the postponement of the income realization is usually possible only for capital income but not for earned income.

With regard to the dimension of vertical equity, the question is not just an internal matter of taxation, but also larger, fundamental questions of equity and justice can be perceived in the background. It is self-evident that people with a lot of wealth, in particular, receive capital income. This starting point makes the taxation of capital income a difficult question when it comes to evaluating the fairness of taxation, and in addition, also a politically discreet issue.

The assessment of the equity and fairness of tax policy should not be just a rational evaluation. It is also important in terms of tax policy, and politics in general, to understand how the equity and fairness of a matter is actually perceived, irrespective of the rational facts. What appears to be a good thing from the viewpoint of the national economy is not necessarily that according to the subjective assessments of people. The issues of the fairness of taxation will ultimately be part of political discretion. Similarly, the tax incentives for entrepreneurship, investments, and risk taking, as well as taking tax competition issues into account, are under political discretion.

Finally, what kind of rating could be given to our differentiated tax system in its entirety? The original pure and streamlined features of the model have deviated in many ways. There have been some problems in drawing the lines as was anticipated in preparation. The model also has some features or shortcomings that can be criticized from a fairness perspective. Therefore, the model as a whole may not deserve an excellent rating, but in my opinion, it is worthy of a satisfactory or even good rating, all in all.

References


Regeringens proposition 1989/90:50 (Sweden).

Regeringens proposition 1989/90:110 (Sweden).


Tikka, Kari S.: Är det motiverat att beskatta kapitalvinster som löpande inkomst? JFT (Tidskrift utgiven av Juridiska Föreningen i Finland) 1993 pp. 582–593.


