FINNISH SUPREME ADMINISTRATIVE COURT RULING IN A LANDMARK CASE REGARDING RECLASSIFICATION OF AN INTRA-GROUP LOAN

D&I Tax Update

July 2014

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The Finnish Supreme Administrative Court provided its ruling on 3 July 2014 in a landmark case regarding the reclassification of an intra-group debt into equity by virtue of the domestic transfer pricing provision in Section 31 of the Tax Assessment Procedure Act. The Supreme Administrative Court dismissed the argumentation of the tax authorities and upheld the earlier decision of the Administrative Court.

The rule in Section 31 provides generally that all transactions between related parties are to reflect the arm's length principle. Section 31 does not, however, include a specific provision regarding the reclassification of the legal form of an instrument in circumstances where the legal form agreed between related parties would deviate from that what would have been agreed between unrelated parties.

The case involved a Finnish company that had received a subordinated accounting hybrid loan from its Luxembourg parent company. The Finnish company had recorded the subordinated loan as equity in its IFRS accounts. The hybrid loan beared interest at a rate of 30 percent. The company had determined the interest rate based on a benchmark study of comparable loans on the market.

The tax authorities had claimed that the legal form of the loan agreed between related parties was to be disregarded, and that the loan was to be reclassified as equity pursuant to the domestic transfer pricing rule and the OECD Transfer Pricing Guidelines. In such case, the interest on the loan would have become non-deductible for the Finnish company.

The Supreme Administrative Court stated a reclassification of the loan into equity was not possible under the domestic transfer pricing provision alone. Further, the Supreme Administrative Court noted that it had not been demonstrated or even alleged by the tax authorities that the case was to regarded as tax avoidance. The fact that the OECD Transfer Pricing Guidelines (Sections 1.65, 1.66 and 1.68) could in theory have allowed a reclassification of the legal form of the loan into equity was not relevant because a tax treaty cannot broaden the tax base from that determined under the domestic tax provisions. Consequently, the arm's length principle included in Article 9 of the tax treaty between Finland and Luxembourg only regarded the arm's length pricing of the instrument, not the classification of the instrument.

The case is likely to provide considerable support for Finnish companies in comparable situations, and it is expected to have material precedential value for many of the currently pending transfer pricing disputes.

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