Enforcing Taxation on International Investments
- The Possibilities of Ensuring Effective Taxation of International Portfolio Income From a Finnish Perspective

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1 Introduction

A characteristic feature of the last ten years period has been the intensive globalisation of the Finnish economy. Finland removed the last restrictions on international capital movements at the beginning of the 1990s and became a member of the European Union as of 1 January 1995. Moreover, Finland joined the EMU in 1999 and the common currency, the euro, was introduced at the beginning of 2002.

Globalisation has resulted in a significant increase in mobility of financial assets and financial services across national borders. In addition to the removal of legislative barriers, cross-border transactions have been facilitated by the significant developments in information technology and especially the introduction of internet. To illustrate the explosive growth of cross-border financial transactions, outbound portfolio investments from Finland increased during the period 1995-2001 from EUR 2.000 million to EUR 62.000 million.[1]

Globalisation has had a positive impact on the economy and the general welfare in many respects. On the other hand, it has posed great challenges to the national tax systems. The basic dilemma is that tax systems are local while the tax bases, i.e. capital, labour and products, are globally mobile. Lack of sufficient coordination of national tax systems may result either in double taxation or in non-taxation of international economic transactions.

This article deals with the problems of ensuring the effective taxation of yields from internationally mobile capital. The focus is on the income taxation of dividends, interest and capital gains derived from cross-border portfolio investments by private persons as investors. The basic question is whether it is possible under the existing legal system to tax international portfolio

1 Source: Bank of Finland, Balance of payments and international investment position 6/2002.

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investments effectively. In particular, the purpose is to examine the legal rules for securing the Finnish taxing rights in respect of cross-border investments. These legal rules are domestic legislation on tax enforcement and international conventions on cooperation between tax administrations.[2]

The structure of the article is as follows. Chapter 2 deals with the concept of effectiveness of taxation at the general level and Chapter 3 with the scope of Finland's material taxing powers with respect to portfolio investments. The regulatory systems, which aim at an effective implementation of the material taxing powers, are examined in chapters 4 and 5. Chapter 4 deals with the Finnish provisions on enforcement of tax laws and chapter 5 with international treaties on exchange of information. Chapter 5 also reviews the differences between tax enforcement regulations in different countries involved in investment transactions. In chapter 6 international initiatives to improve the effectiveness of international capital income taxation are examined. Finally chapter 7 contains the concluding remarks.

2 The Concept of Effectiveness of Taxation

2.1 The Classical Concept of a Good Tax System

According to the classical tax theories the concept of a good tax system includes at least the following criteria: economic efficiency, equity and legal effectiveness, i.e. effectiveness of taxation.[3] The objective of economic efficiency is generally considered to imply that taxation should not influence economic decisions; i.e. taxation should be as neutral as possible. As regards international taxation, the distinction is made between capital export neutrality (CEN) and capital import neutrality (CIN). Regarding portfolio investments the mainstream opinion is that CEN is preferable to CIN. When CEN is applied taxation has no influence on the taxpayers' choice between foreign and domestic investment. Thus, the allocation of capital is efficient in the global economy.[4]

With respect to equity as a criterion of a good tax system, the distinction is made between horizontal and vertical equity. Horizontal equity addresses the question of a fair tax base, while vertical equity refers to the question of fair distribution of income after tax. There are also certain specific aspects of equity

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2 These problems have been discussed in the doctoral thesis, Juusela, Janne, *Kansainväliset sijoitukset ja verotuksen tehokkuus,* Kauppakaari, Helsinki, 1998.

3 *See* Musgrave, R. and Musgrave, P., *Public Finance in Theory and Practice* (fifth ed, McGraw-Hill, New York 1989) at. 216. Herman uses a term "administrability of tax rules". *See* Herman, D., *Taxing Portfolio Income in Global Financial Markets* (IBFD Doctoral Series 2002), at 138-139.

4 *See* Ståhl, K., *Dividend Taxation in a Free Capital Market*, EC Tax Review 1997, at 231-233; Harris, P., *Corporate / Shareholder Income Taxation and Allocating Taxing Rights between Countries* (IBFD Publications 1996), at 312-319 *and* Jeffery, R.J., *The Impact of State Sovereignty on Global Trade and International Taxation* (Kluwer Law International 1999) at 4-9.

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in international taxation, i.e. inter-individual equity and inter-nation equity.[5] A widely accepted principle is that inter-individual equity implies the determination of the tax treatment of individual taxpayers by the country of residence. A general principle regarding inter-nation equity is that the source country should receive its fair share of the revenue.[6]

These features of a good tax system are problematic as such. In particular, views on equity are ultimately based on subjective values. The biggest theoretical problem concerning a good tax system is, however, the relative weight given to different principles, since they are often in conflict with each other. For example the objective of equity of a tax system is often in conflict with the objectives of economic efficiency, cost minimizing and legal efficiency. A specific problem in international taxation is the conflicting basic principles of national tax systems; the states involved may have varying opinions regarding those principles. Moreover, the actual implementation of the principles is always considered from the point of view of the state concerned.

2.2 *Effectiveness of Taxation*

In legal theory the effectiveness of a legal rule is basically regarded as a precondition for a valid legal norm. The validity of a norm implies firstly that it has been enacted by due procedure, i.e. according to the applicable legislative procedure, and secondly that it is also actually obeyed in the society. This means that totally ineffective legal norms cannot even be regarded as law in force.[7]

Also in tax law effectiveness is a very important criterion. It can actually be regarded as a fundamental quality of a good tax system. The fiscal aspect is predominant, because the main purpose of the tax system is to raise revenue for financing public expenditure. The ineffectiveness of a tax system is prejudicial to this basic function. At worst the ineffectiveness of a tax system may result in a crisis of the public economy. Some developing countries, as well as transit economies, have faced these kinds of problems.

In addition to the fiscal point of view, the effectiveness of taxation has a great impact on the achievement of the equity and neutrality objectives of the tax system. This is mainly due to the fact that ineffectiveness is not divided evenly between tax bases and taxpayers. If taxation of certain investment income, for example interest income, is ineffective, neutrality between different kinds of investments is not realized. Correspondingly, the equity principles are not achieved if certain categories of income, for example capital income, are taxed

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5 *See* Musgrave, P., *Interjurisdictional Coordination of Taxes on Capital Income*, Cnossen , S. (ed.), Tax Coordination in the European Community (Kluwer, Deventer 1987), at 197-225.

6 One important criterion of a good tax system is the objective of minimizing costs of taxation. Costs of taxation are regularly divided into the costs of tax administration and the costs of taxpayers. Generally speaking, the simpler and more juridically unambiguous the tax system is, the less it costs.

7 *See* MacCormick N. and Weinberger, O., *An Institutional Theory of Law* (Second edition. D. Reidel Publishing company, Dordrecht 1992), at 37-41.

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less effectively than some other categories of income, for example labour income, because of the defective tax enforcement system.[8]

With respect to international taxation, effectiveness is a precondition for the achievement of the principles of capital export neutrality (CEN) or capital import neutrality (CIN) as well as inter-individual equity and inter-nation equity. For example CEN is not realized if domestic income is subject to effective taxation while foreign income is to a great extent "exempt" due to the defective international tax enforcement system. [9]

Various elements influence the effectiveness of tax legislation. They can be divided into internal and external factors. Internal factors mean the taxpayers' moral stance , i.e. their willingness to obey tax rules voluntarily. As a general rule the more acceptable the tax laws are, the more conscientiously they are obeyed. However, non-compliance occurs also with respect to acceptable tax laws due to the free-riding problem. For an individual taxpayer the choice not to pay taxes might after all seem to be more tempting than the choice to pay taxes.[10]

External factors are the tax enforcement system and the sanction system. The tax enforcement system means the legislation and administrative practices, which aim at ensuring an effective taxation. The sanction system functions as a deterrence for a rational individual to disobey the law.

All the internal and external factors determining the effectiveness of taxation mutually influence each other. As a general conclusion, based also on empirical findings, it can be said that effective external regulatory elements, i.e. an effective tax enforcement system, are an absolute prerequisite for an effective tax system.[11]

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8 *See* OECD, *Improving Access to Bank Information for Tax Purposes* (Paris 2000).

9 *See* Cnossen, S., *The case for tax diversity in the European Communities*, European Economic Review 1990, at 471-479 *and* Kaplow,L., *How tax complexity and enforcement affect the equity and efficiency of the income tax*, NBER working paper 5391, Cambridge 1995.

10 *See e.g.* Carroll, J.S., *How Taxpayers Think about Their Taxes: Frames and Values*, Slemrod, J. (ed.), Why People Pay Taxes, Tax Compliance and Enforcement (The University of Michigan Press 1992), at 48; Elffers, H., *Income Tax Evasion, Theory and Measurement* (Kluwer 1991), at 210-211 *and* Lewis, A., *The Psychology of Taxation* (Oxford 1982), at 5-7.

11 *See* Slemrod, J. and Yitzhaki, S., *The Costs of Taxation and the Marginal Efficiency Cost of Funds*, IMF Staff Papers 3/1996, at 180, *and* James, S., Hasseldine, J., Hite, P., Toumi, M., *Developing a Tax Compliance Strategy for Revenue Services*, Bulletin for International Fiscal Documentation 2001, at 158-164.

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3 The Scope of Finland’s Taxing Powers Regarding International Investments

3.1 General Taxation Principles

3.1.1 Taxation of Resident Investors

Taxpayers resident in Finland are liable to income taxation also on their income from abroad.[12] All investment income from foreign sources, such as dividends, interest and capital gains, are taxable. Income from international portfolio investments is classified as capital income and currently taxed at the rate of 29 %.

Taxable income from foreign sources is determined according to the same rules that apply to domestic income. Taxable capital gain is calculated by deducting the acquisition costs and sales costs from the selling price. A schematic minimum deduction of 20 per cent of the selling price is applied. If the investment has been held for at least ten years, the minimum deduction is 50 per cent. All expenses incurred in acquiring and maintaining investment income are deductible. As regards dividends, no imputation credit is granted for dividends received from foreign companies. Therefore, dividends from foreign sources are subject to double taxation, contrary to domestic dividends.

Finland has a comprehensive network of double taxation agreements (59 treaties in all). According to the Finnish tax treaties the country of residence always has the primary taxing rights on portfolio income. However, most tax treaties provide a right for the source country to levy a withholding tax of 5-15 % on interest and dividends. In the Finnish tax treaties the primary method for eliminating double taxation is "ordinary credit". Credit is granted for taxes which have been paid on the same income to a foreign state. Other taxes paid in a foreign state are credited only on the basis of a specific rule as part of a treaty. The maximum credit equals the Finnish tax payable on the income from a foreign state. If the investment income is derived from a state with which Finland has not concluded any tax treaty double taxation is eliminated unilaterally by the Act on Elimination of International Double Taxation.

3.1.2 Taxation of Non-resident Investors

Basically non-residents are taxed in Finland according to the Act on the Taxation of Non-residents. Unless lower rates are provided for in a tax treaty, the rate of withholding tax for investment income is 29 %. This tax rate is the same as the tax rate for investment income of residents.

As regards portfolio investment income, this basic principle is applied to dividends. Finland levies a withholding tax, usually between 5 to 15 % according to the tax treaties. The residence country of an investor usually credits the tax in the final assessment. As regards dividends, imputation credits are not granted to non-resident shareholders. The only exception is an Irish investor:

[12] Income Tax Act (TVL) 9 §.

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according to the tax treaty with Ireland an Irish portfolio investor is entitled to a partial imputation credit.

With respect to interest and capital gains there are considerable restrictions of Finland's taxing rights as a source country. According to Article 9, paragraph 2 of the Income Tax Act interest received by non residents on bonds, debentures, loans, deposits and accounts is exempt. Hence, in practice all interest income paid to non-resident portfolio investors is exempt from taxation in Finland. Because the exemption is granted unilaterally in domestic law, interest is exempt in Finland even if the recipient is a resident in a non-treaty country, e.g. a tax haven.[13]

Capital gains on the sale of Finnish securities are also exempt from taxation in Finland. However, there is no general exemption rule for capital gains. Article 10 of the Income Tax Act contains examples of items that are considered as income received from Finland. This list does not include capital gains from financial investments, but it includes, inter alia, capital gains on the sale of shares in Finnish housing companies. In legal praxis and in taxation proceedings the list has been interpreted e contrario in respect of other securities, i.e. securities not mentioned in the list are not considered as income received from Finland. Thus, with respect to capital gains on Finnish securities the same situation prevails as with respect to interest income: Capital gains from Finnish securities are exempt from taxation in Finland regardless of the residence country of an investor, for example a resident in a tax haven.[14]

Most OECD countries have also implemented in their domestic legislation provisions exempting interest income paid abroad and capital gains derived by non-residents. The main reason for this kind of unilateral exemption is the fear that a tax at source may turn out to be the final tax burden for an investment. This is due to the problems of enforcing the taxation in the residence countries of investors and also due to the fact that many major investors, such as funds, foundations etc, are exempt from taxation in their country of domicile. According to this argumentation a tax at source could result in an increase in interest rates. It would be prejudicial to the competitiveness of the tax system and have negative effects on the financial market.[15] On the other hand, some countries have not unilaterally exempted interest and capital gains in domestic law, but the exclusive taxing right of the residence country has been implemented in tax treaties. This prevents the tax-free accrual of investment income in tax haven companies.[16]

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13 Additionally, almost 30 Finnish tax treaties deny the right of the source country to levy a withholding tax on interest.

14 Almost all the Finnish tax treaties deny the right of the source country to levy a withholding tax on capital gains derived from portfolio investments.

15 *See* Herman, D., *Taxing Portfolio Income in Global Financial Markets*, (IBFD Doctoral Series 2002), at 173-174.

16 *See* Tanzi, V. and Bovenberg, L.A., *Is there a need for Harmonising Capital Income Taxes within EC countries?,* Siebert, H. (ed.), Reforming Capital Income Taxation (Tübingen 1990), at 186 *and* Hufbauer, G.C., *U.S. Taxation of International Income*, Blueprint for Reform. Institute for International Economics, (Washington D.C. 1992), at 66 *and* McLure, C.E. Jr, *Globalization, Tax Rules and National Sovereignity*, Bulletin for International Fiscal Documentation 2001 at 329.

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3.2 Specific Rules to Prevent International Tax Avoidance

Finland, like most other OECD countries, has supplemented the general taxation principles by specific legal rules in order to prevent international tax avoidance. The so called three-year rule and the Controlled Foreign Company (CFC) legislation are complementary rules applicable especially to international investments. In addition, a general tax avoidance rule, namely Article 28 of the Act on Assessment Proceedings, also applies to international transactions.

The three-year rule set out in Article 11, paragraph 1 of the Income Tax Act has the specific purpose of preventing fictional changes of fiscal residence. A person is deemed to be resident in Finland for tax purposes if he/she has his/her main abode in Finland or if he/she stays in Finland for a continuous period of more than six months. However, a resident national who has left Finland and does not stay here for a six months period is considered to be resident in Finland until three years have elapsed from the end of the year in which he/she left the country. The taxpayer may nullify this presumption by producing evidence that he/she has not maintained substantial ties with Finland during the three year period. The three-year rule is normally not applicable when the other country involved is one with which Finland has a tax treaty. However, the rule prevents the sort of tax planning whereby a taxpayer changes his/her fiscal residence to a non-treaty country, e.g. a tax haven, for a short period, for example one tax year, just in order to realize investment income.[17]

The CFC Act, which took effect on 1 January 1995, is the only legislation in Finland with the primary purpose of limiting the use of tax havens and low-tax regimes. It broadens Finland's taxing powers to cover undistributed investment income of a tax haven company (CFC) owned by Finnish residents. The policy objective of the Act is to prevent the diversion and accrual of income to foreign companies in tax havens. According to the general rule, the Act applies if the effective tax of the CFC is less than 3/5 of the tax of a Finnish company, i.e. currently 17,4 %. If a foreign entity is classified as a CFC all its income is attributable to its resident shareholders (entity approach).

A foreign entity is considered to be a CFC if one or several resident shareholders directly or indirectly either own at least 50% of the capital of or the voting rights in the entity , or are entitled to at least 50% of the yield of the net wealth of the entity. A resident shareholder may be taxed on the undistributed income of the CFC only if the shareholder directly or indirectly owns at least 10% of the capital, or is entitled to at least 10 % of the yield of the net wealth of the entity. Companies whose income is mainly derived from industrial activity, any other comparable production activity or ship-owning, or sales and marketing related to those activities are not deemed to be CFCs.[18] When effectively applied the CFC legislation prevents the tax free accrual of portfolio investment income from Finland and from foreign sources to tax haven companies. There are,

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17 *See* Helminen, M., *Finnish International Taxation*, (WSOY 2002), at 56-61.

18 *See* Juusela, J., *Limits on the use of low-tax regimes by multinational businesses: current measures and emerging trends*, National Report of Finland, Cahiers de droit fiscal international (Kluwer Law International 2001), at 482-484.

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however, plenty of ways of legally avoiding the application of the CFC Act, for instance by splitting the ownership of an offshore company.[19]

3.3 Taxation Principles from the Point of View of Effectiveness of Taxation

The material taxation principles are the basis of the tax enforcement system. Therefore these principles have significant influence on the actual effectiveness of taxation. Taxation at source by a withholding mechanism is the simplest and the most effective method for collecting taxes. When the income is taxed at source by the payer or paying agent the taxpayer does not have a concrete opportunity of tax evasion.[20] An indication of the favour accorded to the withholding tax mechanism is the fact that it is the main method of collecting taxes on domestic income in most countries. Taxes are collected by some kind of withholding tax mechanism, i.e. by the pay as you earn principle, on almost all types of domestic income; e.g. salaries, pensions, interest income, dividends etc. From the point of view of international taxation an advantage of the source-based taxation over residence-based taxation is that the tax authorities of the state having the power of taxation have judicial competence in respect of the payer or paying agents of the income.[21]

In addition to the effective collecting of taxes, the withholding tax procedure normally produces information of importance for the tax authorities of the taxpayer's country of residence. For that information to be useful for the residence country there must be an exchange of information between the tax authorities of the countries involved.

Correspondingly, pure residence country taxation is a problematic taxation principle from the point of view of effectiveness, mainly because taxpayers have a concrete opportunity to evade taxes by simply neglecting the duty to file a tax return.[22] Moreover the tax authorities of the state vested with the taxing power have no judicial competence in respect of the payers and/or paying agents of the income. An effective international exchange of information is an absolute prerequisite for an effective implementation of residence country taxation.[23]

The specific legal rules designed for preventing international tax avoidance, e.g. CFC legislation, are an expression of the residence country principle. These particular tax rules result in particularly significant tax enforcement problems. The fundamental problem again is the judicial incompetence of the authorities of

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[19] In Finland the CFC legislation has not been complemented by corresponding regulations on international investment funds.

[20] *See* Herman, D., *Taxing Portfolio Income in Global Financial Markets*, (IBFD Doctoral Series 2002), at 160 and 203, *and* Pires, M., *The wrong path of the European Union or do the stork and the fox have the same possibilities?*, EC tax Review 2002 at 160-161.

[21] *See* Vanistendael, F., *Reinventing source taxation*, EC Tax Review 1997, at 160 *and* Williams, D.W., *Trends in Anti-Avoidance, Repent What's Past, Avoid What Is to Come*, Bulletin for International Fiscal Documentation 1996, at 502-507.

[22] *See* Herman, D., *Taxing Portfolio Income in Global Financial Markets*, (IBFD Doctoral Series 2002), at 192.

[23] *See* Lassen D.D. and Sörensen, P.B., *Financing the Nordic Welfare States: The Challenges of Globalization to Taxation in the Nordic Countries*, (University of Copenhagen 2002), at 5.

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the state possessing taxing power with respect to the countries and companies in which the activities take place, usually tax havens.[24]

Despite these aspects of effectiveness, taxation at source, i.e. withholding taxation, is actually quite an uncommon taxation mechanism with respect to international portfolio income. As described above the internationally prevailing taxation principle, based on the domestic tax laws and tax treaties, is pure residence country taxation. I.e the residence country of an investor has exclusive authority to tax income; the source country usually levies a withholding tax only with respect to dividends.

The prevalence of the pure residence country taxation seems to be due to several reasons. Taxation by the country of residence fulfils the principles of domestic neutrality and equity, since all residents are taxed equally, regardless of the source of the income. However, a low withholding tax at source, accompanied to a method of elimination of double taxation, does not prevent the implementation of the residence country principle, because the final tax burden would still be measured according to the tax laws of the residence country. Therefore a substantial explanation for the dominance of the pure residence country principle is international tax competition. There is a general fear that withholding taxes on mobile capital investments could seriously damage the competitiveness of the tax system and thus end up in capital flight to other countries.[25]

4 National Tax Enforcement Systems

4.1 Enforcement Systems Regarding Resident Investors

4.1.1 Obligation of a Taxpayer to File a Tax Return

The main problem in the enforcement of resident taxpayers' obligation to pay tax is the identification of international income. In order to determine the correct amount of taxable income for a resident taxpayer the tax administration need information about income from abroad. The difficulties of identifying international income arise from the fact that the source of income, i.e. the payer or the paying agent, is outside the jurisdiction of the state.[26]

The duty of the taxpayers to file a tax return is the basis for the tax enforcement system. In Finland taxpayers have a comprehensive declaration duty. According to the general provision of Article 7 of the Act on Assessment Proceedings all income and property, including international income and

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24 *See* Li, J., *Withholding Tax on Domestic Interest and Dividends*, Canadian Tax Journal 1995, at 567-576 *and* S. James and I. Wallschutzky*, The Shape of Future Tax Administration*, Bulletin for International Fiscal Documentation 1995, at 213-214 *and* Tanzi, V. and Shome, P.*, A Primer on Tax Evasion*, Bulletin for International Fiscal Documentation 1994, at 332.

25 *See* above footnote 15.

26 *See* Baker, P.*, The Transnational Enforcement of Tax Liabilities*, British Tax Review 1993, at 313-318 *and* S. Picciotto*, International Business Taxation*, Qureshi, A.H. (ed.), The Public International Law of Taxation: Texts, cases & materials (Graham & Trotman / Martinus Nijhoff 1994), at 321-325.

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property abroad, must be declared in the tax return. Declaration duties are specified in the Decree issued by the Ministry of Finance.[27]

The CFC Act includes a specific declaration duty for Finnish shareholders of a CFC.[28] According to these provisions direct and indirect interests in CFCs must be declared. There are, however, no other specific obligations to declare international investment activities. Many other OECD countries, such as other Nordic countries, have enacted such specific declaration duties, e.g. the duty to declare accounts abroad.[29]

As regards procedural tax provisions there is one rule, namely Article 26 paragraph 4 of the Act on Assessment Procedure, which deals specifically with international tax enforcement. According to this provision a taxpayer is mainly responsible for providing information on a transaction if the other party is located in a country from which Finnish tax authorities are not able to receive sufficient information. Their inability may be due to the lack of a tax treaty or ineffectiveness in the exchange of information. The commonest situations where the authorities cannot obtain information are operations relating to low tax countries. There are, however, no specific sanctions for breaches of this obligation.[30]

4.1.2 Reporting Duties of Third Parties, e.g. the Banking Sector

The reporting duties of third parties can be regarded as a corner stone for determining and collecting the right amount of taxes. By receiving information on payments from the payers and paying agents the tax authorities are able to audit the declarations of the taxpayers.

As regards income from international portfolio investments the most important third party is the foreign payer or paying agent of the income concerned. Whether or not information is received from them depends on the reporting system in the foreign country concerned and on the effectiveness of the exchange of information between tax administrations.[31] However, domestic third parties too, especially the banking sector have an important role in the

27 VvMp 1995/1760.

28 Article 7 of the CFC Act *and* Article 3 of the Decision 1995/1760 of the Ministry of Finance.

29 Sweden and Denmark also require taxpayers to file a power of attorney with the tax authorities to allow them to examine the foreign bank account and a declaration from the foreign bank that it has agreed to submit an annual report to tax authorities with information on the transactions etc. *See* OECD, *Improving Access to Bank Information for Tax Purposes* (Paris 2000).

30 Tax audits are an essential element of national tax enforcement systems. In Finland the tax authorities have extensive powers to conduct tax audits with taxpayers. There are no specific requirements concerning the necessity of an audit, and the tax authorities have the right to obtain all the material which may have relevance in the assessment of taxes. The sanctions for violations of tax law in Finland are of average level, in international comparison. The maximum administrative sanction for taxpayers is thirty percent of the income. The maximum criminal sanction is four years imprisonment for gross tax fraud. It is worth noting that in practice, administrative sanctions are much commoner than criminal sanctions.

31 *See* below chapter 5.

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enforcement of resident investors' obligation to pay tax. This is because international investments are often negotiated by domestic banks and brokers. Moreover, payment transactions abroad are usually transmitted by the domestic banking sector.

The third parties may have two kinds of reporting duties, automatic duty (without a request from the tax authorities) and a specific duty (at the request of tax authorities). In Finland third parties have an extensive specific reporting duty. At the express request of a tax authority a third party, e.g. a bank, is obliged to provide all information at its disposal concerning the specific matter subject to the request.[32] The subject of the request may be specified, inter alia by providing the third party with the name of the person concerned, his/her bank account number or bank account transaction. The third party may refuse to provide the information only if Finnish procedural law entitles a person to refuse to testify in court in such a case.

An automatic reporting duty is obviously a more efficient tax control method than a specific reporting duty. In order to be able to make a specific request tax authorities must already possess information on the issue concerned, while automatic reporting generates a volume of information to be utilized for various purposes.

Article 15 of the Act on Assessment Procedure contains provisions on automatic reporting duties.[33] This article imposes a general obligation of automatic reporting on the payers and paying agents of income. Furthermore, the provision lists items of income that, inter alia, have to be reported, e.g. salaries, pensions, interests and rents. Generally speaking, domestic income is extensively covered by the automatic reporting duty.

Article 15 of the Act on Assessment Procedures does not include any specific reference to international investment activities. However, according to Article 15. 4 of the Act stock dealer companies have a reporting duty on sales of securities. This obligation is interpreted to cover also sales of foreign securities, i.e. it covers also Finnish stock dealers operating as distance dealers in foreign stock exchanges. Moreover, a general obligation to report interest income obtained as an intermediary is interpreted to cover also interest income from abroad.

According to Finnish administrative and legal praxis, the provision concerning automatic reporting duties in Article 15 of the Act cannot be interpreted extensively. Therefore items of income not explicitly mentioned in the provision do not fall within the scope of automatic reporting. This means that many types of information important for international tax enforcement are outside the scope of the automatic reporting duty. Finnish tax authorities do not automatically receive information neither on e.g. payment transactions to or from abroad, or on financial assets, such as foreign securities, deposited on behalf of a Finnish investor.

Information from third parties may be obtained, automatically and upon request, for the purposes of exchange of information under tax treaties, in the same way as information obtained for domestic tax purposes. Hence, a Finnish

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32 VML § 19.

33 A Decision given by the National Board of Taxes contains further details.

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bank cannot refuse to report on the grounds that such information would be used for the purposes of taxation in a foreign country.[34]

4.2 Enforcement Systems Regarding Non-resident Investors

4.2.1 General Remarks

The main problem with respect to tax control of non-resident taxpayers is the identification of the recipients of the income, i.e. their identity and residence, because foreign recipients are outside Finnish jurisdiction. Although Finland does not have extensive taxing powers on non-resident investors (only dividends are subject to withholding tax in Finland), the identification of non-residents is nevertheless of great importance, mainly due to the information needs of the country of residence of an investor. Identification of the recipient of income is, by definition, a prerequisite for international exchange of information. Furthermore, identification of non-resident recipients is important in order to prevent tax evasion of resident taxpayers. Since Finland does not tax non-resident investors on interest and capital gains there is an incentive for resident taxpayers to pretend to be non-residents, or to allocate domestic income to non-resident bodies or agents under their control.[35]

4.2.2 Interest Income and Dividends - Withholding Tax Act

Interest and dividends paid abroad from Finland fall within the scope of the Withholding Tax Act and Decree. Tax control of these types of income is based on the procedure of withholding taxation, and thus the main responsibilities lie on the paying agents.

The basis for the identification of a taxpayer is a burden of proof procedure, i.e. a non-resident recipient must prove his/her fiscal status by giving his/her name, address and date of birth. Otherwise the paying agent is obliged to levy a withholding tax. However, there is no provision on how the fiscal status should be proved. The prevailing banking practice is that a personal declaration is sufficient evidence of fiscal status. The recipient does not have any obligation to present official documents to prove his/her fiscal residence.[36]

A specific control problem regarding the Withholding Tax Act is the identification of the ultimate recipients, i.e. the beneficial owners, when the settlement is made to foreign banks or other bodies, which are operating as agents of investors. The prevailing practice is that the ultimate recipients behind

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34 *See* the Supreme Administrative Court case KHO 1996 A 4: Based on tax treaty with Estonia a Finnish bank was obliged to provide information on a bank account when this information was necessary for the tax administration of Estonia.

35 *See also* Gammie, M., *The global future of income tax*, Bulletin for International Fiscal Documentation 1996, at 478.

36 *See* Saarinen, O., *Practical issues in application of double tax conventions*, National report of Finland, Cahiers de droit fiscal international (Kluwer Law International 1998), at 341.

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foreign banks are not effectively investigated. The problems regarding identification of the ultimate recipients of income are enhanced by the nominee registration system: non-resident beneficial owners of Finnish securities, i.e. bonds, stock etc, do not have to register as owners for civil law purposes.

If a non-resident investor wishes to open a bank account in Finland a more comprehensive identification procedure is applied. According to the money laundering provisions a Finnish bank must require sufficient information about the person opening the account, the person entitled to use it and the owner of the account. For both individuals and legal persons a document to verify the Taxpayer Identification Number (TIN) is required.[37]

4.2.3 Capital Gains - the Act on Assessment Procedure

Profits from sales of Finnish securities are not subject to the withholding tax procedure. The tax control and identification of non-resident recipients of capital gains are based on the reporting duties of stockbrokers, which are regulated in the Act on Assessment Procedure. According to the provisions of Articles 15.4. and 22 of the Act stockbrokers have an obligation to report the name, address and date of birth of the party involved in security trading. As is the case with interest and dividends, the identification is in practice based on a personal declaration; i.e. stockbrokers do not require any official documents from foreign parties.

The problems of identifying the ultimate beneficial owners behind foreign banks or other agents also concern the control provided for in the Act on Assessment Procedure. Likewise, the nominee registration system for civil law purposes further increases the problems of identification for tax purposes.

4.2.4 Review on International Practices

As described above inefficient identification of beneficial owners can be regarded as the biggest problem of withholding taxation. The judicial situation in Finland with respect to the identification of non-resident recipients of capital income does not differ much from the situation in other OECD countries. The prevailing international banking practice is that a personal declaration is enough to prove fiscal residence and no official documents are required. Likewise, it is a common international practice that the ultimate recipients behind foreign agent banks are not efficiently examined.[38]

The main explanation for the prevailing practice can be considered to be, again, the international competition between tax systems. Obligations with respect to the withholding procedure, e.g. obligations on identification, always

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37 *See* OECD, *Improving Access to Bank Information for Tax Purposes* (Paris 2000).

38 *See* Williams, D.W., *Practical issues in application of double tax conventions*, General report, Cahiers de droit fiscal international (Kluwer Law International 1998), at 47 *and* Tanenbaum, E., *US withholding tax issues under section 1441*, Bulletin for International Fiscal Documentation 1995, at 352-354.

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cause costs to the withholding agents (banks). Banking business is characteristically an activity with high volumes but low margins. Hence, even minor additional obligations compared to the reference countries may trigger a migration of banking activities to other jurisdictions. Additionally, strict identification obligations may deter certain investors from participating in the market. Due to this competitive situation the current practices on identification have been partly formed by such international financial centres which basically ignore the strive for the enforcement of tax rules of other jurisdictions.[39]

5 International Cooperation Between Tax Authorities

5.1 Treaties on Exchange of Information

Purely national legislation is inevitably insufficient to secure effective taxation of globally mobile financial investments. As described above, the prevailing material taxation principle for international portfolio investment income is pure residence-country taxation. The most important source of information for the effective implementation of this principle is the foreign payer or paying agent of the income. Therefore, a prerequisite for ensuring the effective taxation of international investments is international exchange of information between tax authorities.[40]

Several international conventions concern international cooperation between tax authorities. The most important provisions ratified by Finland, i.e. the provisions applied by the Finnish tax authorities, are: exchange of information clauses in bilateral tax treaties, the Nordic Convention on Mutual Administrative Assistance in Tax Matters, the joint OECD/Council of Europe Multilateral Convention on Mutual Administrative Assistance in Tax Matters and the EC Directive 77/799 on Mutual Assistance in Tax Matters.

Exchange of information clauses in bilateral tax treaties constitute the traditional and even currently the most common legal basis for international cooperation of tax authorities. In August 2002 the total number of Finnish bilateral tax treaties in force is 59. A basic principle of Finland’s tax treaty policy is that a treaty should always include an exchange of information article. All the treaties currently in force include such a clause. With a few exceptions, the exchange of information articles in the Finnish tax treaties are based on Article 26 of the OECD Model Tax Convention. The treaty with Switzerland[41] contains a so called narrow exchange of information clause, which means that exchange of information covers only information which facilitates the

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39 *See* Herman, D., *Taxing Portfolio Income in Global Financial Markets*, (IBFD Doctoral Series 2002), at 162-164.

40 *See* Guttentag, J.H., *Key Issues and Options in International Taxation: Taxation in an Interdependent World*, Bulletin for International Fiscal Documentation 2001, at 546-556 *and* Tanzi, V., Zee, H.H., *Taxation in a Borderless World: The Role of Information Exchange*, Intertax 2000 at 62-63.

41 1993/1296, SopS 90.

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implementation of tax treaty provisions. All the other treaties concern exchange of information also for the application of domestic tax provisions.

The Nordic Convention on Mutual Administrative Assistance in Tax Matters[42], concluded between Finland, Sweden, Norway, Denmark and Iceland, can be seen as an pioneering measure as regards multilateral cooperation in mutual tax assistance. [43] This treaty was initially concluded as early as 1972. The present treaty came into force in Finland in 1991. In addition to the exchange of information, the convention covers also other means of cooperation; such as mutual assistance in the service of documents and in the recovery of tax claims. The joint OECD/Council of Europe Multilateral Convention came into force in 1995.[44] To date this instrument has been ratified by Finland, Sweden, Norway, Denmark, Iceland, the United States, the Netherlands and Poland. This convention too covers a wide range of means of cooperation.

EC Directive 77/799 on mutual tax assistance[45] was the first Directive approved by the Council, which deals with direct taxation. Its scope has since been widened to cover also indirect taxes. The Directive concerns only the exchange of information on the assessment of taxes, but not e.g. recovery of taxes, service of documents or prosecution for tax offences.

As described above, Finland, like many other countries, has many overlapping treaties on mutual assistance. Some treaties and other rules, e.g. the EC Directive and the joint convention of OECD and the Council of Europe, include an explicit conflict of laws provision. According to these provisions the Treaty does not prevent the application of wider-ranging assistance under domestic law or other treaties. For instance, article 11 of the EC Directive states as follows: "The foregoing provisions shall not impede the fulfilment of any wider obligations to exchange information which might flow from other legal acts". Without this provision EC Law would have precedence, i.e. the EU member states would have to apply the Directive regardless of the existence of wider-ranging treaties. The principle of wider-ranging assistance can even be considered to be a general interpretation principle of tax assistance treaties. I.e. it can be applied also to situations where a conflict between assistance treaties cannot be solved by an explicit conflict of law article.[46]

On the other hand, there are also several countries and autonomous areas with which Finland, like most of the other industrialized countries, has no tax agreements. This means that there are no legal possibilities for cooperation in tax matters with such states. It should be noted that there are many important international financial centres among these non-treaty countries.

In international legal cooperation, i.e. both in tax treaty law and in European tax law, the unanimity principle applies in the enactment of legal rules. When the interests of the countries concerned differ much from each other the

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42 1991/772, SopS 37.

43 There is a separate treaty between Nordic countries on material tax issues.

44 Act 358/1995 *and* Decree 359/1995.

45 Act 1220/1994 *and* Decree 1542/1994.

46 *See* Vogel, *On Double Taxation Conventions*, (Kluwer Law International 1997), at 1418-1419 *and* Terra, B. and Wattel, P., *European Tax Law*, (Kluwer Law International 2001), at 473-475.

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unanimity principle effectively prevents the enactment of treaties or Directives. European tax law differs from tax treaty law in respect of the enforcement of prescribed rules. The EC Commission has general authority to control the compliance with EC law, and it has the power to take action in the EC Court of Justice against Member States which have failed to implement EC law.[47]

5.2 Types of Exchange of Information

The types of exchange of information in tax conventions are exchange of information on request, automatic exchange of information and spontaneous exchange of information.[48] Exchange of information on request is the traditional type of international cooperation between tax authorities. All the international treaties described above include an article concerning exchange of information on request. A request must always relate to a specific case. For example concerning bank information the applicant authority usually has to provide the name of the account holder or the bank account number.[49] Hence, the authorities of the applicant state must already have some basic information on the taxpayer (the tax subject) or his/her income (the tax object) concerned. If necessary for obtaining the information required, the requested state is obliged to conduct enquiries, including tax audit.

Automatic exchange of information means the exchange of bulk data on cash flows, such as payment transactions etc. Exchange of such bulk data is carried out on the tax authorities' own initiative; without specific requests from another country. Especially for ensuring effective taxation of portfolio income automatic exchange of information is the most effective type of cooperation, since it provides the tax authorities with basic information on the international transactions of their resident taxpayers.[50]

Article 26 (Commentary) of the OECD Model Convention, the joint OECD/Council of Europe Multilateral Convention, and EC Directive 77/799 on mutual assistance include a reference to automatic exchange of information. These treaties and provisions do not, however, include any explicit provision to impose automatic exchange. Instead separate agreements between treaty partners are required. The Nordic Tax Assistance Treaty is different, in so far as it includes an explicit provision on the automatic exchange of information. According to Article 11 of this Treaty the tax authorities are obliged to automatically exchange information on for instance cross-border interest payments. It is worth noting that the proposal on an EU Savings Directive is also

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47 *See e.g.* Rivier, J-M, *The formation of a common tax law in the European Union and Switzerland*, EC Tax Review 1996, at 81.

48 One type of cooperation is the exchange of information concerning tax audits.

49 *See* OECD, *Improving Access to Bank Information for Tax Purposes* (Paris 2000).

50 *See* Cole, R.T., and Gordon, R.A., *Exchange of information and assistance in tax collection (part I)*, Tax Management International Journal 1994, at 605-608 *and* Wisselink, A., *International exchange of information between European and other countries*, EC Tax Review 1997, at 108-115.

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based on the principle of automatic exchange of information between Member States concerning interest payments. (See further chapter 6 below).

Spontaneous exchange of information means an exchange of information provided by the tax authority on its own initiative, i.e. without prior request. Any information of use to the authorities of another country may be exchanged spontaneously. All the treaties on exchange of information permit spontaneous exchange of information. In practice it is, however, quite rarely used.

In practice tax cooperation varies significantly between different countries. Finland has the most active cooperation with the Nordic countries, Germany, the United Kingdom, Spain, Estonia and the United States. The volume of exchange of information is, however, relatively small, especially in comparison with the volume of international financial transactions. The statistics of the National Board of Taxes indicate that in 2001 the Finnish tax authorities received 148 information requests from the authorities of other countries and sent 105 information requests to other countries.[51]

5.3 Limitations to the Exchange of Information and Grounds for Refusal of Cooperation

5.3.1 Limitation Clauses

The volume of actual exchange of information is still rather low, despite several international treaties. This low volume of exchange has several reasons, such as practical problems relating to technical formats, or different languages. In addition to the practical problems, there are also legal obstacles to a free flow of information across national borders. All the treaties on exchange of information include articles on grounds for refusal of cooperation. Limitation clauses concern trade and business secrets, public order, reciprocity, national legislation and administrative practices.[52]

All the treaties include a limitation clause concerning reciprocity of cooperation. A tax authority may refuse to provide information where the applicant state concerned is unable, to provide similar information for practical or legal reasons. Thus, one country cannot benefit from the wider information system of another country. For example, there is no obligation to provide banking information to a country which maintains strict bank secrecy itself.[53]

All the treaties also include limitation clauses concerning trade and business secrets and public order. Tax authorities may refuse to exchange information if it would imply the disclosure of commercial, industrial or professional secrets or

[51] Finland is rather active in automatic exchange of information. In 1995 the Finnish tax authorities automatically sent more than 10.000 items of information to the tax authorities of other EU Member States. *See also* Supreme Audit Institutions of Member States of the European Union, *Mutual assistance in the field of direct taxation, Overall Report*. A coordinated audit by 12 Supreme Audit Institutions of Member States of the European Union (1997).

[52] *See e.g.* Gangemi, B., *International mutual assistance through exchange of information*, General report, Cahiers de droit fiscal international (Kluwer 1990), at 31-32.

[53] Finland exchange information automatically with its treaty partners without any limitations.

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of information whose disclosure would be contrary to public policy. The concepts of trade and business secrets and public order are defined according to domestic legislation and administrative practices. The content of these concepts therefore varies considerably from country to country. Information relevant for ensuring effective taxation of portfolio investments, such as information from banks, does not normally fall within these categories.[54]

5.3.2 National Legislation and Administrative Practices

The most important limitation clause in all treaties is the clause concerning national legislation and administrative practices. According to this clause a state has no obligation to carry out measures at variance with its own laws and administrative practices. Thus, a contracting state has full sovereignty over its internal laws and administrative practices and it is not bound to go beyond them in providing information to another state.

National laws and administrative practices on bank secrecy are very important in respect of tax enforcement of international portfolio income. As described above, the reporting duties of the banking sector are an essential element for ensuring effective taxation of international investments. Limitation clauses concerning national legislation and administrative practices mean that an international treaty on exchange of information does not override domestic bank secrecy.[55]

Bank secrecy varies considerably from country to country. A crude classification can be made into countries with wide information obligations for banks, i.e. light bank secrecy, and countries with restricted information obligations for banks, i.e. strict bank secrecy. The Nordic countries are examples of countries with wide information obligations on banks. In these countries it is not possible to open anonymous or numbered accounts, since a documentary evidence of TIN is required when opening a bank account. For taxation purposes the banking sector has wide automatic reporting duties to the tax administration. Those duties include reports on interest payments to taxpayers. Tax administrations may also obtain information without limits from banks upon a specific request. Generally speaking, no bank secrecy exists vis-á-vis tax authorities in these countries. All the Nordic countries have a comprehensive network of treaties on exchange of information. Bank information is exchanged with their treaty partners both on request and automatically.[56]

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54 However, in Switzerland bank information is considered a trade, business, industrial, commercial or professional secret under Article 26(2) of the OECD Model Tax Convention. *See* OECD, *Improving Access to Bank Information for Tax Purposes* (Paris 2000).

55 *See* Makhlouf, G., *Transparency in Tax Systems: Keeping Pace with the information Age*, Intertax 2000 at 64-66 *and* J. Owens, *Tax Administration in the New Millenium*, Liber Amicorum for Sven-Olof Lodin:Andersson, Meltz and Silverberg (Kluwer 2001), at 198-210.

56 *See* OECD, *Improving Access to Bank Information for Tax Purposes* (Paris 2000).

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Luxemburg and Switzerland are probably the best known examples of countries which give priority to the privacy of taxpayers over fiscal interests.[57] Contrary to the tax havens, these countries have a comprehensive network of tax treaties, including treaties on exchange of information. However, limitation clauses concerning national legislation and administrative practices restrict, to a large extent, the actual participation of these countries in international cooperation in tax matters. The main principle for bank secrecy in Luxemburg and Switzerland is that in tax matters it can be lifted only for judicial proceedings of serious tax offences.[58] For the purposes of tax assessment banks have no obligations to provide information, either on request or automatically. Therefore it is in practice impossible for the tax authorities of the investor's residence country to obtain information on investment activities within the jurisdiction of a country with a strict bank secrecy. This means that the implementation of taxing rights of the residence country depends in practice on the taxpayer's own declaration.

6 International Initiatives to Improve the Effectiveness of Internationnal Capital Income Taxation

6.1 The EU Savings Tax Directive

During the last few years initiatives have been launched at international level, especially in the EU and OECD to improve the effectiveness of capital income taxation. These initiatives are part of a more general project to tackle harmful tax competition.

The most concrete international initiative with the specific purpose of improving the effectiveness of taxation of international portfolio investments is the EU proposal for a Directive on Taxation of Savings. This Savings Directive is part of the so called Tax Package, pending in the Council since December 1997.[59] Other parts of the Tax Package are the Code of Conduct for Business Taxation[60] and the proposal for a Directive on Interest and Royalty Payments.

The purpose of the Savings Directive is to ensure that interest income paid from one Member State to individuals resident in another Member State will be subject to effective taxation in the latter Member State. In other words, the objective is to ensure effective implementation of the residence country taxation on interest income. Originally in 1997 the proposal was based on the idea of a

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57 In Luxemburg and Switzerland it is possible for an investor to open a numbered account. However the identity of the account holder is known by the bank.

58 *See* OECD, *Improving Access to Bank Information for Tax Purposes* (Paris 2000). *See also e.g.* Ginsberg, A., *International Tax Planning, Offshore Finance Centers and the European Community*, (Kluwer 1994), at 156-167 *and* Harles, G., *Bank Secrecy in Luxembourg*. International Bank Secrecy (London 1992), at 471-476.

59 *See* conclusions of ECOFIN Council meeting on 1 December 1997.

60 The Code of Conduct aims at removing such business tax measures that can be regarded as harmful tax competition. Lack of transparency and exchange of information are important indications of harmfulness of the tax measures. Thus, the Code of Conduct project can be considered to improve the general environment of international tax control by recommending transparency and exchange of information as qualifications of the tax system.

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co-existence principle. A Member State could choose either to exchange information on interest payments, or to withhold a minimum tax at source.[61] Later on, in 2000, the co-existence model was abandoned by the Council and currently the proposal is wholly based on the idea of exchange of information.[62]

The main principle of the Directive is automatic exchange of information between the competent tax authorities of the Member States. As shown above, automatic exchange of information can be regarded as the most effective type of cooperation. However, a transitional period of 7 years has been accorded to three Member States; Austria, Belgium and Luxemburg. During the transitional period these countries will not be obliged to exchange information, but they will be required to levy a withholding tax[63] on cross-border interest payments.

The Directive also imposes wide obligations on paying agents to provide information on interest payments to domestic tax authorities. In the Directive "paying agent" means any economic operator who pays interest to, or secures the payment of interest for the immediate benefit of, the beneficial owner. If the interest payment is made via a number of intermediaries, paying agent means only the last intermediary which pays and/or secures interest directly to the beneficial owner.[64]

Reporting obligations of paying agents include inter alia information on the identity and residence of beneficial owners. The Directive contains detailed provisions on the minimum standards for identifying the beneficial owners. These standards are based on the duties of paying agents to make enquiries. For example, a paying agent must demand an official residence certificate from citizens of a EU Member State who declare themselves to be residents in a third country.[65]

As described above, ineffective identification of final recipients of income can be regarded as one of the biggest problems for international tax control. If effectively implemented, The Directive would create an international identification standard at EU level, and thus make the identification practices more effective.

According to the current timetable, the Savings Directive, as well as the whole Tax Package, should be adopted by the end of the year 2002. The precondition for the final approval of the Directive is that EU has obtained sufficient reassurances with regard to the application of the same measures in all relevant dependent or associated territories and of equivalent measures in certain key third countries, i.e. the United States, Switzerland, Monaco, Andorra, San Marino, and Liechtenstein. The reason for the requirement to take the same/ equivalent measures in outside territories and key third countries is to prevent capital flight out of the EU due to the introduction of the Directive.

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61 *See* COM (1998) 295 final *and* Dourado, A.P., *The EC draft Directive on interest from savings from a perspective of international Tax Law*, EC Tax Review 2000 at 144-152.

62 *See* Report on the Tax Package by the ECOFIN Council 9034/00 FISC 75.

63 Withholding tax rate is 15 % during the first three years of the transitional period and 20 % for the remainder of the period.

64 *See* COM(2001) 400 final, at 7 *and* Larking, B., *Another go at the Savings Directive – third time lucky?*, EC Tax Review 2001 at 220-234.

65 *See* COM(2001) 400 final.

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6.2 The OECD Forum on Harmful Tax Practices

The OECD Forum on Harmful Tax Practices, established in 1998, constitutes an important project in order to improve international tax enforcement of international portfolio income. It has many features similar to those of the EU Code of Conduct, since the purpose of the Forum also is the elimination of harmful business tax practices in Member States. Furthermore, the Forum comprises a project for counteracting harmful tax competition by tax havens.[66]

The basic idea in the Forum's work on tax havens is that they should commit themselves to the principles of fair and non-harmful tax competition. According to the OECD, one key factor of fair tax competition is that there is effective exchange of information. A prerequisite for the effective exchange of information is that the authorities of a tax haven have access to the information relevant for the tax authorities of other countries, i.e. that there are no secrecy laws or practices, such as bank secrecy, which prevent the tax authorities from obtaining information. Furthermore, that information must actually be exchanged with authorities of other countries. The Forum has drawn up a model agreement for tax havens on exchange of information. This model reflects the opinion of the Forum on effective exchange of information.[67]

By the summer of 2002 great number of tax havens, i.e. 31 territories out of 38, had given an official commitment to the OECD to obey the principles formulated by the Forum. These jurisdictions have undertaken to establish effective exchange of information on tax matters by the end of 2005. The OECD will in the future apply common countermeasures against jurisdictions not committed to working with the Forum, i.e. against uncooperative tax havens. Such countermeasures could be the termination of tax treaties with them and the imposition of a withholding tax on transactions connected to them.

If the requirements of the OECD were implemented by the committed tax havens there would be quite a remarkable improvement in international exchange of information. In particular, it would become much more effective with respect to the key countries involved in international investment activities, i.e. offshore financial centres.

Separately from the Forum, the OECD Committee of Fiscal Affairs has an ongoing project on improving access to bank information for tax purposes. The aim is to improve international cooperation in the exchange of information held by banks and other financial institutions for tax purposes. Most OECD countries wish to extend the reporting obligations of banks in all OECD countries to cover also tax assessment purposes and not only criminal tax prosecutions.[68]

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66 *See* OECD*, Harmful tax Competition: An emerging Global Issue*, April 1998.

67 *See The OECD's project on Harmful Tax Practices: The 2001 Progress Report*, 14 November 2001 *and* Pinto, C., *The OECD 2001 Progress Report on Harmful Tax Competition*, European Taxation 2002, at 41-45.

68 *See* OECD*, Improving Access to Bank Information for Tax Purposes* (Paris 2000).

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7 Conclusion

The scope of Finland's material taxing powers with respect to international portfolio income is quite extensive. As regards resident investors, all investment income from foreign sources is taxable. Additionally, taxing powers have been extended to cover also income of tax haven companies owned by resident investors, by virtue of the CFC Act. Nevertheless, the considerations examined above justify the conclusion that due to the defectiveness of the international tax enforcement system the taxation of international portfolio investment income is ineffective. Finland, like other industrialized countries, is not able to take effective advantage of its taxation authority.

The biggest problem for Finland in enforcing its tax laws is the lack of effective exchange of information between tax authorities. That lack is partly due to the unwillingness of tax havens to agree on provisions to exchange information, i.e. there is no legal basis for cooperation in the form of a tax treaty. Another important reason for the insufficient exchange of information is the strict bank secrecy provisions and practices in many countries, including many tax treaty countries. The international treaties on exchange of information do not override domestic legislation and administrative practices. Thus, there are major difficulties in enforcing the residence principle when investment activities are handled by a bank or agent located in a country with strict bank secrecy.

It is obvious that purely national measures are not sufficient to improve the effectiveness of capital income taxation. The inefficiency is partly due to the lack of competence of national authorities outside the borders of the country. Tax authorities have no power to require information from foreign banks, or other entities. Furthermore, the domestic methods available may turn out to be unrealistic due to the international competition between tax systems. An extensive and effective tax control system, implying wider reporting and other obligations than in reference countries, could lead to massive capital flight. The aspect of international competitiveness is highlighted in the field of highly mobile financial instruments.

However, some aspects of the Finnish tax system could be re-examined. As regards material taxing powers, the unilateral exemptions of interest income paid abroad to non-residents and capital gains derived by non-residents are problematic. International tax control might be improved - both in Finland and in tax treaty countries as well – if these unilateral exemptions were removed and reciprocal exemptions proved for in tax treaties. Then there would be no withholding tax on interest and capital gains received by an investor resident in a tax treaty country, but a withholding tax would be levied with respect to the transactions to non-treaty countries (non-cooperative tax havens). Removing unilateral exemptions would be, however, against the current international tendency.

The Finnish tax enforcement system is quite similar to the systems of the majority of industrialized countries. However, certain provisions and practices could be improved, for example expanding the automatic declaration duty of third parties and intensifying cooperation between national authorities. Removal of the nominee registration system for non-resident security holders could also render the tax enforcement system more effective.

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Substantially more effective taxation of international investment income will inevitably require measures at the international level. One possibility would be a reconsideration of material taxation principles. As regards capital income, the current main principle, i.e. pure residence country taxation of interest and capital gains, is not an optimal principle for ensuring effective taxation.[69] Withholding taxation would be the most effective method for collecting taxes on investment income. [70] However, the international trend seems to be away from withholding taxes. For example the EU proposal for a directive on taxation of interest income was originally, in 1989, based on withholding taxation. Later, in 1997, the withholding tax model was replaced by a co-existence model, i.e. a choice of either withholding taxation or exchange of information. In 2000, the coexistence model was replaced by a pure exchange of information model.

Current international plans and projects to improve the effectiveness of international taxation are aimed at intensifying the national tax enforcement systems, especially the reporting duties of the banking sector, and at cooperation between national tax administrations. If effectively implemented, the EU Savings Directive and the OECD Forum on Harmful Tax Practices would much improve domestic tax enforcement systems all over the world, i.e. in both EU and OECD Member States, and also in tax havens. It would also extend and intensify exchange of information between tax authorities. It is no exaggeration to say that at least some success in international cooperation is required in order to maintain investment income in the future tax base.[71]

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69 *See e.g.* Lodin, S-O., *International Tax Issues in a Rapidly Changing World*, Bulletin for International Fiscal Documentation 2001, at 2-7.

70 In theory one possibility to improve the effectiveness of taxation is to abandon income as the basis for taxation. Academic and political circles have been discussing international transaction tax models (*e.g.* Tobin tax) and a comprehensive business income tax model, to give two examples. However, no concrete political initiatives involving these kinds of models have yet to be put forward. *See* Garber, P.M., *Issues of Enforcement and Evasion in a Tax on Foreign Exchange Transactions*, Haq, M. and Kaul, I. and Grunberg, I. (ed.), *The Tobin Tax, Coping with Financial Volatility*, (Oxford University Press 1996), at 129-142 *and* Spahn, P.B., *International financial flows and transaction taxes: survey and options*, IMF Fiscal Affairs Department 1995, at 29.

71 The basic problems of international tax cooperation are structural, i.e. conflicting interests of the States and the unanimity rule in international and in European tax law. *See e.g.* McLure, C.E., *Tax Policies for the 21st Century. Visions of the Tax Systems of the XXI Century*. Jubilee Symposium. International Fiscal Association (Geneve 1996), at 28-67, Vanistendael, F., *Redistribution of tax law-making power in EMU*, EC Tax Review 1998 at 74-79 *and* Schön, W., *Tax competition in Europe – the legal perspective*, EC Tax Review 2000 at 90-105.

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