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Episode: **How to pay tax: Business taxation in a nutshell**
Podcast guest: Risto Walden, CEO and Senior Tax Advisor, Bilanssi Oy.
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Transcription notes:

N1: Narrator 1
N2: Narrator 2
N3: Narrator 3
Host 1: Moritz Scherleitner
Host 2: Kalle Airo
Episode guest: Risto Walden

Other information about the text:

[text] = a sounds or not transcribed parts are written with square brackets e.g. [laughs] or [interview paused due to a phone call]

[recording starts]

N1: Aalto University podcast.

[Intro music 00:00:03]

N2: In the Adventures in entrepreneurship law podcast series, Petra Hietanen-Kunwald and Kalle Airo from Aalto University explore business law from an entrepreneurial point of view with expert guests. In some episodes, their co-host is Moritz Scherleitner. The podcast content is meant for education and is not intended to constitute legal advice.

How to pay tax: business taxation in a nutshell. Our guest is Risto Walden, C.E.O and senior tax advisor Bilanssi Oy. Entrepreneurship law with Petra and Kalle.

Already Benjamin Franklin knew, in this world, nothing is certain, but death and taxes. Yet the questions as to what, when and how much tax to be paid, can be tricky. In this episode, Kalle and Moritz talk with Risto Walden about the key principles of business taxation. We learn about the key tax consequences of running a business via a limited liability company, partnership or sole proprietor. Furthermore, we explore some key accounting principles and briefly touch on international taxation.

Moritz Scherleitner: Different forms of businesses going [?? 00:01:27] with different tax implications. Today, we speak about the key tax consequences of doing business in two major forms: the sole proprietorship, toiminimi and the limited liability company, osakeyhtiö. Our guest today is Risto Walden, a tax and accounting specialist from a researcher at Aalto University. Risto, welcome to our course. Could you, please, introduce yourself?

Risto Walden: Thank you. I am thankful to have a possibility to tell about these important things. I am a tax and accounting specialist, and I am working here [?? 00:02:04] and entrepreneur in Bilanssi company now for the last 13 years. Before that, I used to work for 10 years in Aalto University in the Helsinki School of Economics, and before that, in tax government as tax inspection functions. I write a lot. I teach a lot, mainly tax professionals and accounting professionals. I must say that I am nowadays absolutely one of the slickest tax specialists in Finland.

Moritz: Why is entrepreneurship important to you?

Risto: In my work, I work mainly with small and medium-sized enterprises. For me, it is very fascinating to see all different kinds of professionals and all those skills, how they differ, and to see and realise that in every line of business there are certain kinds of skills and knowledge which you do not understand if you are not working deep inside of that business. And that is fascinating in my job, to help those entrepreneurs and companies to continue and somehow manage in competition. For me, in my work, it is kind of the main joy.

Kalle Airo: What are the main types of companies or kinds of legal entities that entrepreneurs use as tools and what are the tax implications of those main types?

Risto: I would say that according to this company law, company act, those company types can be divided into two groups. First one is kind of the personal companies. They are not separated from the entrepreneur, and those are these sole proprietors, toiminimi and avoin yhtiö, kommandiittiyhtiö. And the meaning of those company types is that they are actually just accounting entities inside of that one person's wholeness. So, they are not separate companies separated from the private person's own property, income and costs. And then, we have this second type which is kind of the capital companies, which are these limited liability companies, as in most cases. And also, these kind of osuuskunta type of companies. But it is important to realise that there are two different types. The idea is that you choose according to this company act. You choose kind of the most suitable, lightest and practically easy company view. But in practice, the taxation disturbs this choosing of the company form, because the taxation implications are so different between these two types of companies.

Moritz: So, there are companies which are kind of their own companies, capital companies, limited liability companies, osakeyhtiö in Finnish, and then there are companies like partnerships and sole proprietorships which are not their own tax subjects?

Risto: Exactly. And that is, I would say, the problem with these. Because besides these taxation issues, there are also more and more of those risks and responsibilities. So, in these capital limited liability companies, there is a possibility that you separate the risk of the loans and losses from your private life. And also, it means that in taxation you can make it separate, how much you take out from your capital company. That is the most important thing which affects your private taxation. And if you do not take anything out of that, there are no tax implications in your private life. None. But in these private person companies, you cannot divide that life and results and profits and taxable income from your private life. Because you are the taxpayer anyhow.

Moritz: So, that means that an entrepreneur that acts via a capital company, limited liability company, does not pay tax based on the earning of the companies because the income is taxed at the level of the company, and he or she then, only when he or she takes out money or gets money from the company, pays tax by him or herself. Whilst in case of a partnership or sole proprietorship, the income of the partnership or sole proprietorship is taxed immediately at the level of the entrepreneur, him or herself.

Risto: Exactly. And that happens once a year, and you have to accept it. Whether it is loss or profit, anyhow the income comes to your private life. And also, that other thing, for example, if you take a high risk loan from the bank, and you might make losses and lose the money. Or you buy something in debt. In these private companies, it means that you pay the losses from your own money. Because you cannot divide those risks. And that is too difficult, for example, to have a company with many owners or more complicated risks. And therefore, these limited liability companies, osakeyhtiö, are kind of now the major and the main form of making business. And also, it makes it possible to have this very effective tax planning at the same time.

Kalle: Did I understand correctly that if Risto here would be a customer and Moritz on this side would be the entrepreneur, in this toiminimi format, he would do business with you, and he would be then taxed based on that business and whatever other income he would have? But if he started a limited liability company, as in myself here, the business would happen between you the customer and the company here, and he could then kind of adjust the taxable income based on what happens here between the entrepreneur and the limited liability company.

Risto: Exactly. And that is a good example. Because then we make a contract. I buy something, from whom, I buy it from the company. And then the owner of the company doesn't know anything about it and is not a part of our agreement. He is just the owner. And that is exactly what happens. And it separates the owner from the activities.

Moritz: And from a tax perspective, the difference is that in case there is no company in between the income which I earn as a person, the entrepreneur is taxed directly on my level, in my personal taxation. Whilst here, if we have a company, then the income earned by the company is taxed at that level of the company. And if I do not take out any income, then I am not taxed on it. Because it just remains in the company. But once I take it out, then I am taxed as well. So, we have here two levels of taxation, and in the case of the sole proprietorship and the partnership, we have only one level of taxation.

Risto: Yes, that is exactly how it goes.

Moritz: Let us focus on the limited liability company. What is the income of the company and how is it determined?

Risto: From the income taxation point of view, the accounting principle, this accrual basis, not cash basis. And it means that what you have earned during the, let's say, one year or this financial statement period, and what you have cost, as a cost. But when you have paid and when you have got the money, it is not an important thing. And this goes through accounting. So, all the companies, as well as toiminimi and this osakeyhtiö, they have accounting responsibilities. And it means that all that has happened with that entity must be in accounts. And it means that it is either income or cost or some funds or some liabilities. All the agreements on all the activities must be in the accounting. Also in this toiminimi world. But there, the accounting rules are much lighter and it is easier and not so bureaucratic, this accounting side, but also in the small companies nowadays, it is not kind of a big issue.

Moritz: Does this mean that for limited liability companies, I have to do this double-entry bookkeeping where I have to make a so-called balance sheet where I have the assets and the liabilities, and then I record the costs and the income in a profit and loss statement. And what comes out of the profit and loss statement is the income which I have to tax. Does it work this way?

Risto: Yes. And that is the first step. And according to accounting law, all the activities must be in accounting, even if they are tax-free or even if they are not deductible. They must be in accounting. Because this accounting is a base for this taxable income calculation. And then comes into the picture some differences between tax law and accounting. So, all the costs which you have to put into your accounting may not be fully deductible in taxation. And all the income which you have to put into the accounting might not be taxable income. But in a first step, accounting, you have to do it. And with those recordings, you fulfil this taxable income calculation, where comes some differences.

Kalle: And for the students, remember now that we are talking about income taxation here, and we have a separate session on value-added tax and how that works.

Risto: Yes. And value-added taxation differs from this income taxation. Value-added tax, as well as salary taxes, are going through the company. And so, it means that they are not this company's income tax, but the real taxpayers are at the end in different places.

Moritz: So, the company administers value-added tax and salaries. But it does not bear them, at least to some extent.

Can you once again explain? We are speaking about assets and expenses. So, this is something which the company pays. But they are treated differently in accounting and those are for tax purposes in a consequence. Could you explain in a bit more detail what is the principle difference between assets of the company, which are to be recorded in the balance sheet, and expenses, which are to be recorded in the profit and loss statement?

Risto: Yes. The asset actually means that the company is expecting some future income of that. So, it is not yet used or unuseful, but you are expecting that it's somehow useful in the future. Either that you use it by yourself or it is possible to sell all it earns, separate income, like rental income or something like that. And then, it means that the asset is kind of showing that the company is expecting some benefits out of that. It is not yet used. But this expense means that in this year we lost this benefit or we lost this kind of money. We are not expecting any more. That kind of thing. That amount to come again into our bank account, for example.

Moritz: So, that means that if I buy a machine, for instance, which serves my company. Say, I pay a million for this machine and it will serve my company longer, so I write it into the balance sheet. And if I pay my employee a salary, that is an expense. The employee has done his or her job and that is it. Could that be a difference?

Risto: Yes. In this first point, buying, for example, a machine which lasts, let's say, an average of 10 years, and then you kind of deduct that purchase price, let's say, 1 000 000, so that you put depreciations. So, partly. For example, 10th part of that 1 000 000 for every year. Or in a separate depreciation plan, how do you feel that it will flow into the expenses. And that is also that the company kind of in first hand makes its own decision. But the accounting laws, as well as taxation laws, say some kind of minimum and maximum levels. So, you have to make a decision between those levels, but anyhow, it gives the company some possibilities to make their own choice.

Moritz: So, the depreciation kind of reflects the decrease in value of the asset for the company every year. And based on a certain depreciation scheme. And there are separate rules in the tax code. Let's say, how such a depreciation has to look like for taxation purposes. I assume for the entrepreneur or for the company it would be more attractive to have as much depreciation as early as possible. Is this the case?

Risto: Yes. And that is exactly the competition between the tax government and the entrepreneur's view. But maybe one good example is that it is quite easy if you buy, for example, a machine. We can imagine that normally it lasts some years or so. But in these intellectual properties, it is very complicated. For example, you start a startup company. You hire 10 workers who start to do this kind of research and development work. Nobody knows if something useful happens at the end. It might be just not worthy of any work. But in this case, it is possible maybe to activate those wages out from the cost side up to assets. But only in very strict rules. So, it is against the law if you activate because it means that you show much better profit and too high in assets. If you do not have documentation that we really made something useful and we really have reasons to believe that these assets will be of some benefit in the future, you have a problem. Because you have showed in your financial statement kind of too bright a future for the other stakeholders, like investors or banks. And that is against accounting law.

Moritz: So, the idea of depreciations is to reflect the value loss in the asset? And the expenses are just immediate expenses which you can immediately deduct from the tax repays. Would it not be sensible, as a company, to strive towards making as many depreciations as early as possible?

Risto: Yes, exactly. From the lowering a taxable income point of view, exactly like that. And that is the reason why the tax laws say what the maximum depreciation in different types of assets is. But we can also say that there are no income taxation issues, but maybe in some cases, for example in startup, if you are making losses too much, you might lose your own capital and there might come some other problems. And then, it might be also the aim to do as little depreciation as possible. But that is not a taxable income issue. It is then kind of the company act issue.

Kalle: If I start a company and I do a kind of research and development projects, I develop software. Can I somehow activate this cost so that it's actually my balance sheet and not direct cost to when I pay the salaries, for example?

Risto: It is a good question. In first hand, all the salaries are yearly cost and expenses. But if you have some kind of proof or documentation that you have achieved something useful for the future, some incomes that you expect, then you might have a possibility to activate those wages up to the balance sheet assets. But then, you must be quite sure that something useful has really happened. So, it is possible, but you do not have to activate in your assets.

Moritz: So, expenses can be deducted from the taxpayers immediately. What are expenses and what are not expenses?

Risto: From the company income taxation view, all the expenses which have been cost in aim of achieving taxable income, they are deductible expenses. It can be in a short term or in a long term the aim, kind of approved. But in other hand, all the private life costs of the entrepreneur are not deductible. They are not deductible even if they have been paid with a business card or from the company's bank account. That is not approved for deductibility. So, behind those costs, you have to show somehow the meaning of that cost.

Moritz: So, that means that the costs that are associated with doing business are deductible, and the costs that are associated with the entrepreneur's private life are not deductible from the taxpays. Are there any special rules? For instance, if I remember correctly, there is a rule on how much of restaurant expenses you can deduct. Are there some special rules or maybe some guidance where you can look up what kind of private or semi-private expenses can be deducted?

Risto: There's some special rules in the tax law. For example, you can deduct 50 percent of a certain kind of cost. And of course there is a lot of guidance from the tax government. But at the end, it is a question of how you can prove it. Like, typical expenses which are in between these lines are travelling costs, restaurant costs and those kinds of things which are in some parts mainly private life costs, but they might be also costs in the aim of achieving taxable income for the company.

Kalle: Let's go into more practical details. When should you declare your taxes? And how is that done in practice?

Risto: In practice, we follow the every year rule. As a private person, it is taxed every year. And it means that every company, like toiminimi or osakeyhtiö, must fulfil tax declaration every year. And in that tax declaration, you make your decisions which have been shown in your accounting. First, you make every year accounting, like the financial statement, and with those figures you fulfil your tax declaration where those differences between accounting decisions and taxable income calculations are realised. But every year. And according to these tax laws, it is a four-month time when a period has been ended. You must remember that a company might have a different fiscal period than a calendar year. For example, the financial period might end on the last day of September. It means that you have to fulfil your tax declaration at latest in January. So, four months after the end of your period.

Kalle: Also on a practical level, do entrepreneurs do this taxation work themselves or do they use some kind of help, outsourced services? How does this happens?

Risto: I would say that most small companies use accounting offices to help them. It is possible to make it by yourself. You do not have to use anybody else. But nowadays, I would say that it is more and more complicated to report, and there are also other reporting responsibilities than only taxation. And they are changing a bit every year. I would say that in small companies it is totally possible to make it by yourself, but, for example, salary payments, dividend payments, any other more detailed activities, it may be better to use professionals.

Kalle: So, the entrepreneur and the limited liability company are separate from each other. How can the entrepreneur receive money from the limited liability company?

Risto: As we discussed earlier, they are separate decisions. The company has to make a decision to pay for some reason money to the entrepreneur. So, all the money transfers into the private life have to be explained. And the possibilities are salary, which right away affects those salary payment regulations and social security payments and so on. Maybe the dividend, which is kind of a decision, and will be taxed according to the dividend taxation rules. It might be a loan. And shareholder loans also have special taxation rules. It might be an interest. It might be a rent. Anything. But it must have an explanation. And that explanation must be given yearly to the tax government according to your tax filings. And with that decision, the tax law realises how it will be taxed.

Moritz: So, I guess a typical way could be that the entrepreneur is simply employed by the company and receives salary, which the company deducts from the taxpays, and then the entrepreneur, him or herself, has to tax, as personal income. And then, you just talked about dividend, so it is also possible to receive dividends out of the company. How are they taxed and is there tax planning which can be done to optimize the overall tax burden?

Risto: Different types of income from your company, it is just exactly the place for tax planning. For example, if you do not take anything, there is no taxation in your private life. But you do not get any money out of your company, which might be a problem for funding your private life. And if you take wages, it goes to the progressive income taxation. The more you take, the higher the rate. And, for example, dividends are taxed in between capital income level. And maybe if you take too much dividend, it goes also to this progressive tax rate. So, it is kind of tax planning of the wholeness, how and in which terms and how often, how much you take out of your company. Also, it is important to remember that you cannot take dividends if the company is not making profit. So, it is out of the question. Then you might have a right to take salary. But dividend is possible only, according to the company act, when you have made profit. But it's absolutely a place of tax planning of the wholeness. I would say that also if you do not take any money, even if it is making profit, it means that the money stays in the company and you might sell the shares at the end, with all the funds, unpaid salaries, unpaid dividends, and then you get all the funds in the exit way. And then it is kind of capital income because you sold the shares.

Kalle: So, in essence, the entrepreneur can harvest the value, so to speak. And that has been built either as getting salaries, dividends, this kind of cashflow from the company, or the different way by selling the shares and then receiving the capital gain from somebody who wants to buy those shares.

Risto: Yes, exactly. And then the taxation. I would even say that in a fundamental way it is the same income. You earn something or something you did not earn. But in taxation so formal, taxation is only based on what kind of income it was formally. Did you sell shares? Did you get salary? Did you get dividends? And then the taxation law is realised. But it is true that you can make a huge tax planning. Normally, the problem is how you fund your private life. That is a practical issue in these cases. Because you are not taking money out in fear of high taxation. But in the end, how do you fund your private life? It might lead to a shareholder's loan, which might be also a big problem next year, for example. So, it is important to plan this wholeness. Company taxation and your private life funding cannot be separate if you do not have a lot of money already in your private life. We can also describe this taxation system as delayed consumption. If you take money out of the company, the law says that it goes out of the markets, out of the risk-based useful entrepreneur, and it comes to your private consumption, and then you lose all the benefits instead of that money staying in those markets. And it is risk-based activities.

Moritz: Let us switch to the sole proprietorship. We have said that this is you from a taxpay. So, this is not a separate level. But it is still a business, and the business has to determine its profits, too. How is the profit of a sole proprietorship or a partnership determined?

Risto: According to the same principles as in limited liability companies. So, according to what the cost of the company is and the cost of aiming for this kind of profit for the company. But the main difference is that you do not have to do any separate transfers of funds to your private life. Because already all the profit is your money. And the losses are already from you. So, you do not have to take a salary or dividend or any kind of loan. Because all the funds of the company already are your money in a good and bad way. So, it is much easier. Normally, we say that in these cases if you have simple activities and you anyhow need all the funds to your private consumption, then maybe you cannot achieve with the limited liability company any benefits. Because you anyhow have to take all the money right away to your private consumption. Then maybe this toiminimi is easier and a more practical form of business for you.

Kalle: So, for freelancing, it often makes sense to be this toiminimi and not set up at different companies for billing or invoicing.

Risto: Yes, exactly. Because then you avoid these kinds of separate decisions on what kind of income it was for me. And normally, you do not achieve any kind of tax benefits from that because you cannot delay your consumption.

Kalle: Are there any simplifications of how to determine the profit for this freelancing kind of business?

Risto: Yes. Also, in a side of accounting, there are some accounting laws which are lighter, easier and more simple, such as cash-based accounting for small activities. And also, in limited liability small activities, there are some kind of lightened rules. And that is maybe the one base why it might be a good reason with lower income levels, lower activity levels, to just use this kind of toiminimi instead of a limited liability company.

Moritz: From a tax perspective, you have the situation that the income made by the company is taxed first at the level of the company, 20 percent, and then once it is distributed to the owner, it is taxed again as a dividend. So, you have two levels of taxation. Whilst in the case of sole proprietorship or partnership, you have only this one level of taxation, which is then of course progressively taxed. But the overall tax burden with these two levels of taxation can be, I assume, much higher, especially when the income is low. Because with low income, you have a rather low progression rate. Meaning that this kind of problem of the progression really pushes through once you earn much more income.

Risto: Yes. That is true. For example, if the limited liability company makes one-euro profit, it will be taxed in 20 percent. And if it makes 1 000 000 000, it will be taxed in 20. But in these other types of companies, it is this progressive rate. You can earn some amounts and your progressive tax rate is still below 20. And so, it means that it does not make sense to make profit in a limited liability company if your total profit income deducted with expenses and the profit stay in a lower level. Nowadays, it means about 20 000 euros per year with the progressive tax rate below 20 percent. And also, kind of private deductions in your private life as a detail after that. But anyhow, it is not so simple. It means that in lower income levels, maybe these other types of companies are just even lower taxed than in these limited liability companies' cases.

Kalle: What if I do business abroad or in several different countries? What are the tax implications?

Risto: Many times it is a problem when you have been in Finland for one or two years. And then, it is a question of when those other countries let you go or when Finland lets you go. You move away from Finland. You have been living in another country for one or two or three years. It is a question of when Finland lets you go. And that is a different type of issue where it is more detailed. Where is your home? Where do you have your family? Where are your company activities? Where are your main private life functions? Do you have a cottage in Finland? Do you have some other fixed properties in Finland? It is a different type of question. Activities happening in two different countries. The decision is made according to the tax treaty between those countries. So, it means where you have those main functions of the company, for example. For example, if the Finnish company has the main activities in another country, then the other country has the right to tax that income. And the terms in that tax treaty world are such as a permanent establishment. It means what kind of functions you have in real life. And according to this term, it might turn the taxation right to the other country. Also, for a private person, when you move away from Finland, how long a time will Finland still tax you when will Finland let you go to be taxed in another country? Also, one important term is where the situation of leadership is. It is a part of that permanent establishment term.

Moritz: So, that means that if a Finnish company does business abroad, then it can be that it triggers a so-called permanent establishment in the other country, meaning that it has to file a tax return, with respect to the income that is attributable to this permanent establishment in the other country.

Risto: Yes, exactly. Normal exploring and visiting is not the trigger. But the trigger is that if you have personal offices and factories and some functions in a permanent way in another country, that might be the proof to be taxed also partly or wholly in that other country.

Kalle: What are the key takeaways you want us to remember out of this discussion?

Risto: I would say that the main question is, what plans do you have? If your plan is just simple, kind of selling your work part-time or in some kind of narrow atmosphere, maybe it is better just to start the business with this kind of sole propriety. But if you have an idea to make other partners or some funds and maybe longer-term entrepreneurship, then for sure the limited liability company is better for you. Also, the higher risks you have in your business, it means that it is not a taxable income question. Then, the limited liability company again is for sure your choice. But maybe it is a question of what kind of plans you have. Only selling your own work alone or making it somehow bigger or more complicated. That is the first question.

Moritz: Thank you very much for being our guest here.

Risto: Thank you. It was my pleasure.

[Outro music]

[Recording ends]