2.2.2021

Finnfund's assessment of the implementation, impact of and potential development needs for its responsible tax policy

In the Ownership Steering Memorandum issued by the Ministry for Foreign Affairs on 5 February 2019, Finnfund was requested to prepare an interim assessment of its responsible tax policy, and the implementation, impact and potential development needs of that tax policy, including the tax footprint.

Finnfund carried out the assessment with its internal resources in the autumn of 2020. The information referred to this memorandum was pulled together, reviewed, analysed and compiled mainly by Veera Mäenpää (Legal Counsel) and Kaisa Alavuotunki (Head of Impact). This memorandum was reviewed and commented by a task specific team consisting of Minnamari Marttila (Administration Director), Helena Arlander (Deputy CEO), Katriina Lenkkeri (Chief Legal Counsel) and Mikko Kuuskoski (Associate Director) in addition to the Finnfund Management team. Thereafter the Memorandum was presented to Finnfund's Board of Directors and also to its Supervisory Board as well as to the Ministry for Foreign Affairs.

1. Background

Finnfund's responsible tax policy (**Tax Policy**) was approved by Finnfund's Board of Directors and thereafter its Supervisory Board towards the end of 2017. Finnfund has been implementing the Tax Policy to all its new investments since 1 January 2018.

Finnfund is a development financier which builds a sustainable world by investing in responsible and profitable businesses in developing countries. We expect our projects to be profitable, socially and environmentally responsible, and produce measurable development impacts in our target countries.

Tax revenue and other tax-like fees paid by companies to the public sector in developing countries are Finnfund's development aims which we monitor and report. Finnfund itself is income tax exempted under Finnish law and has no need for tax planning of any kind. Finnfund's focus is on the taxes paid at the developing countries and as stated in the Tax Policy "*One goal of Finnfund's operations is to increase the tax revenue of developing countries*".

Finnfund is legally bound to protect the confidentiality of the information of its clients. In this regard, the Tax Policy states that "*Finnfund seeks to promote transparency of information on tax revenues in the target countries, while respecting the confidentiality of client information.*"

2. Summary of findings

Finnfund has put considerable and tangible effort into developing a clear and meaningful Tax Policy. This is demonstrated by allocation of sufficient internal resources into drafting the policy which took the better part of the year 2017, inviting public and its stakeholders to comment the draft policy and thereafter holding a seminar where the comments received on the draft policy were reviewed and discussed with its stakeholders. It has also exerted effort in putting in place practical and useful tools for implementation of that policy. Especially the investment managers and lawyers have been trained to use the tools. The external assistance that Finnfund from time to time obtains from an external professional tax advisor on particularly technical or complex tax matters is valuable, but Finnfund does not consider itself reliant on such external assistance, as it is only occasionally that such advise is needed. In Finnfund's view, when looking at the structure, the clarity of the analysis and e.g., the depth of the tax analysis, it is clear that the quality and depth of the tax analyses its project team prepare have improved considerably from 2018 when compared to those made in 2019.

3. Implementation of the Tax Policy

3.1 Training and Staffing

Finnfund has built capacity to ensure consistent implementation of its Tax Policy. This has occurred on four levels: (1) all staff have been provided with training on the key issues; (2) an internal tax committee (**Internal Tax Committee**) has been set up to offer advice to investment managers and their transaction teams; (3) a reputable international tax and accounting firm (**External Tax Expert**)) with international tax expertise has been retained to provide counsel when needed; and (4) Finnfund's Board of Directors has been reinforced with a leading expert on international tax issues.

During and since 2018, Finnfund has provided its staff with five formal training sessions to prepare them to implement the Tax Policy. The members of Finnfund's internal bodies, namely its investment committee and the management group also had the opportunity to participate in the trainings. The trainings were provided by the External Tax Expert. The External Tax Expert was chosen as the training provider as it is both an expert in international taxation and has deep knowledge of the Tax Policy and Finnfund's stance on responsible taxation, given that it assisted Finnfund in the preparation of the Tax Policy. The contents of the trainings were coordinated and agreed between Finnfund and the External Tax Expert and the training topics up to date have been: Tax Questions arising in Investment Structures; Tax Planning and Funds; Undercapitalisation and Interpretation of International Tax Treaties and DAC6.

As a rule, the assessment and analysis of tax matters in the potential investments is carried out by Finnfund's investment managers and legal counsels. The tax analysis is done as part of the in-depth due diligence exercise that all investment proposals undergo at Finnfund before they are presented to the Investment Committee first, and thereafter to the Board of Directors for the final approval. Finnfund requires that all its investments are profitable, socially and environmentally sustainable and that they bring about substantive development impacts. The investment decisions are made on the basis of overall consideration of a large number of aspects. In addition to tax aspects, Finnfund assesses the impact the investment may have on the economic and social development, the likelihood of the project's success, human rights, gender equality, carbon footprint, corporate governance and so on. When needed, the project teams can seek advice from the Internal Tax Committee and the External Tax Expert.

3.2 Tools for implementation

Finnfund implements its tax policy through three main instruments:

(i) **Tax due diligence** and **Tax Analysis**: Tax due diligence (**Tax DD**) is done by using questionnaires which potential clients must answer. The questionnaires were prepared in co-operation with the External Tax Expert. The results of the Tax DD are analysed and presented in writing in a separate report/schedule (**Tax Analysis**) which is annexed to the investment memoranda presented to the Board of Directors;

(ii) **Tax Clauses**: The tax clauses are a set of standard clauses relating to responsible tax which Finnfund has drafted with the assistance of the External Tax Expert (**Tax Clauses**). The clauses are incorporated into the financing agreements and serve as a tool to implement the principles of its Tax Policy; and

(iii) **Monitoring by and reporting to Finnfund** by the investees of their tax affairs, including e.g., the amount of taxes and tax-like fees paid by them. Finnfund collects this information and publishes it annually country-by-country.

Finnfund also reports its own tax footprint annually in its corporate responsibility report.

The purpose of the Tax DD is to allow Finnfund to assess the tax practices and the financing and group structures before an investment decision is made.

Tax Analysis for direct investments is prepared by the lawyer and the investment manager allocated to the specific transaction. Tax Analysis for investments made through fund structures are prepared by the External Tax Expert in conjunction with the lawyer and the investment manager.

3.3 Internal Tax Committee

In 2018 Finnfund set up the Tax Committee. The Tax Committee is an informal internal tax committee with the aim of providing support to the transaction teams during the Tax DD and during their preparation of the Tax Analyses. The Tax Committee considers specific questions that may be elevated to it by a transaction manager and/or lawyer. The questions are commonly such that they either arise for the first time or relate to a particularly complex tax issue. The Tax Committee consults the External Tax Expert to obtain information and expertise, if necessary.

The operation of the Tax Committee is also seen as an additional way to facilitate the continuous learning amongst Finnfund staff in respect of responsible taxation matters. Furthermore, the establishment of the Tax Committee aims to develop Finnfund's internal tax capacity and the committee is an important way to ensure that the tax questions which may arise in various transactions are dealt with in a harmonized manner. The decisions of the Tax Committee offer an opportunity for Finnfund to set and follow precedent in the implementation of its Tax Policy.

Since its establishment, the Tax Committee has convened seven times. The Tax Committee currently has four members: two lawyers one of which is the Chief Legal Counsel, a development impact specialist and a senior investment team member.

3.4 Tax expert of the Board of Directors

Since 2018, Finnfund's Board of Directors has included a senior international tax affairs expert nominated by the Ministry of Finance. This valuable input has increased the Board's capacity to evaluate and scrutinize tax matters and the Tax Analyses presented to them. Finnfund and the transaction teams have been provided continuously positive feedback by the Board's tax expert on the Tax Analyses prepared.

4. Impact

Focus of the Tax Analyses

In its Tax DD, Finnfund's assessment centres around making sure that there are no actions or arrangements which would erode tax base or shift profits out of the developing country level where Finnfund's investment is made. Finnfund puts special emphasis on understanding the corporate taxes payable by the investee company in the developing country in question. In addition, Finnfund considers withholding taxes payable at the developing country. In case of equity investments, Finnfund also considers the impact of taxation at its future exit from the investment.

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The specific topics that the transaction team looks into at detail and analyses in the Tax Analysis are fivefold: (i) tax holidays and tax incentives; (ii) existence and potential misuse of holding companies; (iii) transfer pricing and intra-group transactions; (iv) thin capitalisation and potential misuse of intra-group loans; and (v) hybrid structures.

Tax Holidays and Tax Incentives

Some of Finnfund's investee companies were granted tax incentives and tax holidays by local authorities acting in accordance with national regulations. Generally, their purpose has been to attract foreign investment and incentivize business in certain areas of the country or in certain industry sectors, such as renewable energy or socio-economically poor areas.

Finnfund found no particular issues related to these incentives and holidays granted to its investee companies in the transactions which Finnfund's Board approved in 2018 and 2019. They were "*available to everyone on similar grounds in similar situations*", as required by the Tax Policy.

Intra-group loans

Finnfund examines whether there is thin capitalisation and whether the interest on shareholder loans is at arm's length. The intra-group loans that Finnfund observed in the Tax Analyses prepared in 2018 and 2019 were usually either benchmarked to market rates or granted with zero or considerably lower than market rates.

Interest benchmarking exercises are done to ensure that overpriced intra-group loans are not used as part of aggressive tax planning.

The consequence at the developing country level of a lower than market rate interest is that the company operating there is not able to deduct interests from its taxes and therefore ends up paying more corporate taxes.

Holding companies

Finnfund can accept the use of holding companies in the investment structures, if there are sufficient commercial reasons for them and if they are not set up purely for tax purposes. Finnfund is not allowed to make indirect investments through holding companies if the holding company is registered in a country that ranks lower than 'largely compliant' with the progressively tightening standards of OECD's Global Forum on Transparency and Exchange of Information for Tax Purposes (**Global Forum-list**) or if the country is in the list of non-cooperative jurisdictions of the Council of the EU.

Holding company-structures existed in some of the transactions that Finnfund's Board approved in 2018 and 2019. There were good commercial reasons for the existence of a holding company in the group structure. Holding companies had been created for a number of reasons, for example, such as for purposes of separating different business streams and activities under different companies, ringfencing risk or for a historic acquisition; in order to provide a neutral fiscality to shareholders with different countries of origins and different status; to cater for the need to organise an extensive number of subsidiaries under a single holding company; for easing the collecting funding offshore shareholders domiciled in various jurisdictions.

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Transfer Pricing

Transfer pricing was a key focus for Finnfund in the preparation of the Tax Analyses during 2018 and 2019 and is likely going to be so also in the future.

Having carried out quite extensive Tax DDs for two years, Finnfund's view is that its clients have been generally speaking conscientious in ensuring that the transactions they are involved in are carried out at arms' length.

It is possible to make the following rough categorisations of the approach taken by Finnfund's clients in respect of their transfer pricing matters: (i) some structures are so simple that that no TP issues arise at all; (ii) there are groups where services are invoiced at cost; (iii) a large group of clients benchmark their prices either to third party provider's prices, or use the same price intra-group as they use with external purchasers; and (iv) the largest group is clients who carry out transfer pricing studies regularly with a professional TP advisor.

All the investment documentation entered into by Finnfund include e.g., a standard undertaking that all transactions must be at arm's length. To ensure that arm's leght pricing was achieved, in some transactions Finnfund did require the company to prepare a transfer pricing study[1].

Undercapitalisation

In assessing the capitalisation of its investees, Finnfund is interested in the strength of the debt-to-equity ratio of the investee and whether there are thin capitalisation rules in place in the country of its incorporation. If there are, Finnfund finds out what the rules in substance are. The transaction team also finds out what is the position in that country with respect to deduction of interest (e.g., whether it is limited in some way, which often was the case in the 2018 and 2019 transactions) as that indicates that tools to limit tax optimisation are used in the country, and the amount of interest charged. In the Tax Analysis, the team expresses a view whether or not there is a concern over thin capitalisation.

In 2018 and 2019, a number of Finnfund's investees were fully funded by equity. Majority of investees were also funded by loans but looking at the ratios and local thin capitalisation rules, most commonly there was no concern over thin capitalisation. Few projects were found to be thinly capitalised, but in both cases further research was conducted and it was found out that the undercapitalisation was not due to aggressive tax planning but due to operating in sectors that 'burn' large amounts of capital in the early years of the project.

5. Development Needs

The Association of European Development Finance Institutions, EDFI, which is a Europe-based organisation consisting of bilateral development finance institutions based in Europe, also prepared and published joint principles on responsible tax in 2018 that its members, including Finnfund, approved and abide by. These 'EDFI Principles on Responsible Tax in Developing Countries' can be found at https://www.edfi.eu/wp/wp-content/uploads/2018/05/EDFI-Responsible-Tax-Principles_Final-180509.pdf

[1] Transfer pricing study is a document that analyses market value of transferred goods and establishes inter-company pricing accorinding to transfer pricing rules of the countries involved. The study serves as a foundation for determining the transfer prices and demonstrates proper intent to the tax authorities.

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When compared against these joint EDFI principles and also against the current practice of the other development finance institutions within Europe or globally, Finnfund's experience is that questions Finnfund asks during the Tax DD are considerably more detailed and comprehensive than those of its peer institutions. While Finnfund wants to be a frontrunner in promoting responsible tax issues, it risks being excluded from sustainable investment deals if its requirements differ substantially from other development financiers. For Finnfund to meet is impact objectives – also on tax issues – it has to be included in the investment projects.

In terms of keeping up with trends in international taxation, Finnfund convenes regularly with the other European Development Finance Institutions in relation to tax matters specifically. Finnfund also follows news in relation to international taxation and has agreed with the External Tax Expert for a service by which it updates Finnfund at regular intervals on the key developments and upcoming trends in international taxation which may be of interests to Finnfund.

During 2020, the pre-prepared Tax DD questions and the Tax Clauses were reviewed and amended where considered necessary. The aim of this exercise was to streamline them and to make them more user friendly whilst not compromising their standards. This exercise was expected to increase their usefulness both during the due diligence phase and during the implementation of the financing agreements. Also during 2020, Finnfund was familiarising itself with the requirements of the new DAC6 Directive and incorporating those into its responsible taxation processes, as necessary.

All new staff to Finnfund's investment and legal teams receive training on the Tax Policy and the implementation tools upon arrival to Finnfund. Further tax training is organised by the External Tax Expert as and when considered necessary. Some staff, particularly the lawyers also attend external tax trainings when suitable opportunities arise.

Going forward, Finnfund is looking to continuously improve its institutional knowledge and in-house expertise in the matters relating to responsible tax. Finnfund is keen to continue to implement the Tax Policy as it currently stands. Finnfund does not see any need for amending or revising the Tax Policy at this point in time. The Tax Policy is still relatively new and it is working well. When compared to its peers, Finnfund's Tax Policy is comprehensive, stringent and of high quality. Additionally, the progress made in the internal processes of Finnfund relating to the implementation of the Tax Policy (e.g., by way of providing training, creating the tools for implementation of the policy, preparation and inclusion of responsible tax clauses in the financing agreements, establishment of the internal tax committee)is steady and clearly visible to Finnfund.

Finnfund's key development need is to continuously provide learning opportunities to its key staff in tax matters and to continue to concentrate the expertise in the Tax Committee. The Tax Committee needs to be resourced adequately to seek advice from external experts if and when needed. At the same time, Finnfund must also ensure that the knowledgebase of Finnfund in tax matters rests of sufficiently wide group of people.

6. Tax footprint - Private sector contribution to government revenue collection

The focus of reporting tax footprint of companies is often mainly on the Corporate Income Tax (CIT) paid by the company. It is, nevertheless, important to notice that private companies play a significant role in formalizing and mobilizing also other government revenue streams in the developing country context. In addition, companies help governments to formalize the collection of, for example, payroll and income taxes paid by the employees.

This highlights that the private sector and its income/value creation processes are often an underestimated source for government revenue creation and play an important role in achieving SDG 17. The governments of developing countries need revenue from taxes and other fees to build

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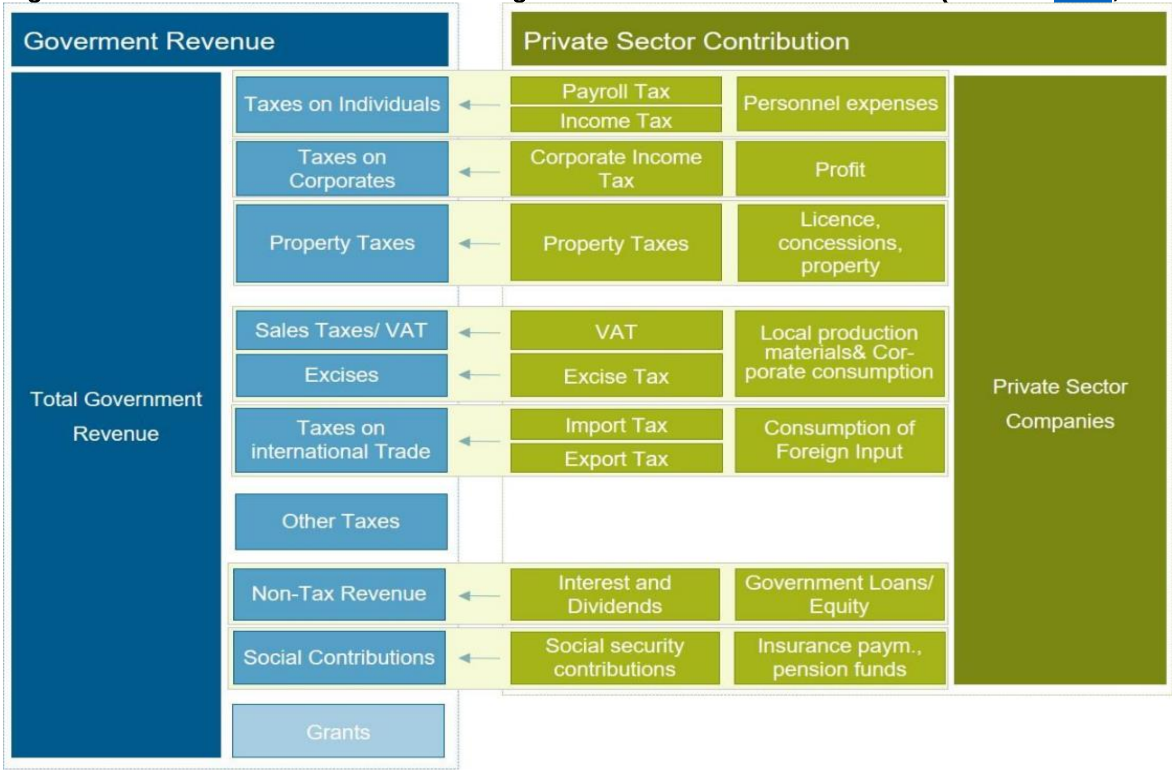
functioning and equitable societies that promote economic and social development. This revenue allows governments to structure and provide services such as education, healthcare and infrastructure to people.

Figure 1 – Private sector contribution to government revenue mobilization (Source: DEG, 2020)



To capture also these other government revenue mobilization effect, Finnfund monitors both CIT paid by the companies and “Other taxes and tax-like fees” that includes other relevant contributions by the company, including for example sales tax, business tax, value added tax, licensing fees and customs duty, dividend tax, as well as different types of administration and public permit fees. The tax systems, principles and enforcement capacity of the poorest developing countries can vary greatly. In many developing countries, the state takes part of its revenue from businesses through various types of fees.

Total contribution of Finnfund’s investee companies is, in fact, 40% larger than CIT payments when taking into account some of the additional revenue sources.

7. Country-by-country reporting

In 2019, our portfolio companies paid a total of EUR 638 million in their respective countries in taxes and tax-like fees. Figure 2 shows the break-down by investment types and Table 1 by countries. Relatively largest share of the taxes was paid in African countries (61%). Established financial institutions contribute 44% of the paid taxes in Finnfund’s portfolio. The amount of taxes paid by a company is determined mainly by level of company’s annual profits or previous losses, the corporate income tax (CIT) rate in the country, and available tax incentives granted to a specific industry by the government. The figures reported here reflect the full amount of taxes paid by the companies each year and are not attributed to the proportion of Finnfund’s investment.

Figure 2 – Taxes and tax-like fees EUR million by type of investment

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Corporate income taxes
Other taxes and tax-like fees to government
Millions
350
300
250
200
150
100
50
0
2015
2016
2017
2018
2019
DI
FI
Fund investees

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Table 1 – corporate taxes and other tax related payments by countries in 2019

Country	# investees	Corporate income tax (MEUR)	Other taxes (MEUR)	Total (MEUR)
Total	**265**	**437**	**201**	**638**
AFRICA	**153**	**290**	**102**	**392**
Kenya	17	23	21	**43**
Ghana	15	14	8	**21**
Tanzania	15	25	10	**35**
South Africa	12	7	11	**18**
Nigeria	12	32	10	**42**
Zambia	11	2	3	**5**
Ethiopia	10	11	13	**23**
Uganda	6	1	3	**4**
Zimbabwe	6	28	1	**29**
Africa LDC	30	126	10	**136**
Africa LMIC	8	8	3	**11**
Africa UMIC	11	14	10	**24**
		-	-	-
ASIA	**51**	**84**	**57**	**141**
India	9	21	1	**22**
Cambodia	8	41	9	**50**
Nepal	7	0	0	**0**
Asia LDC	8	2	12	**13**
Asia LMIC	10	18	25	**43**
Asia UMIC	9	2	10	**12**
		-	-	-
LATIN AMERICA	**37**	**53**	**32**	**85**
Mexico	6	4	11	**15**
Guatemala	5	1	2	**3**
Honduras	5	-	1	**1**
Latin America LMIC	4	39	2	**41**
Latin America UMIC	17	8	17	**25**
		-	-	-
Europe and Turkey	**14**	**1**	**9**	**10**
Europe and Turkey	14	1	9	**10**
		-	-	-
Middle East	**10**	**9**	**0**	**10**
Jordan	8	2	0	**2**
Middle east UMIC	2	7	0	**8**

The table compiles taxes and other tax-like fees by all Finnfund's investee companies (including fund portfolio companies). Any subsidies from the government has been deducted from the figures. If a country has fewer than five investments, data is classified by continent and OECD/DAC income level categories.LDC = least developed countries LIC = other low income countries LMIC = lower middle-income countries and territories UMIC = upper middle income countries and territories

Another way to look at companies' tax footprint is to calculate an effective tax rate which states the amount of CIT paid relative to pre-tax profits. The average effective tax rate for companies with non-negative pre-tax profits in Finnfund's portfolio was 14 % in 2018.

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As Figure 2 shows, the highest amount of taxes (including CIT) is generally paid by the big established companies in the finance sector and they also have the highest effective tax rates, on average 18%.

In contrast, companies directly financed by Finnfund (excluding financial institutions) are still typically early in their growth paths (or even just in the beginning as is the case often with renewable energy project financing). These early stage companies typically pay relatively little in corporate income taxes during Finnfund's investment period, because they require large investments and it takes a long period before making profit. For this reason, the CIT paid by this groups companies with non-negative pre-tax profits the effective tax rate is 13%.