

# Corporate Taxation and the International Challenge

## Danish Legal National Report

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### 1 Introduction

It seems clear that the higher degree of economic integration across borders and the international trend towards a reduction of corporate income tax rates have had a significant impact on the Danish corporate tax regime in recent years. Accordingly, during the last ten years the Danish statutory corporate tax rate has been lowered further, while several government actions at the same time have been taken in order to combat international tax avoidance and evasion.

As a result, new anti-avoidance provisions have been introduced and some of the older anti-avoidance provisions have been tightened in order to prevent base erosion and profit shifting. Thus, to some extent Denmark has already tried to address a number of the key pressure areas mentioned in the OECD BEPS report, such as international mismatches in entity and instrument characterization, the tax treatment of related party debt financing, transfer pricing and the effectiveness of anti-avoidance measures.<sup>2</sup> However, in general these anti-avoidance provisions often suffer from being quite complex, very broad in scope and open to criticism from an EU law perspective.<sup>3</sup>

### 2 Corporate Taxation in Denmark

Companies incorporated in Denmark are subject to full Danish taxation. Furthermore, companies incorporated abroad are liable to full Danish taxation, if the seat of a management is located in Denmark.<sup>4</sup>

Danish tax law is based on a principle of worldwide taxation.<sup>5</sup> However, for companies a (limited) principle of territoriality was introduced in 2005. Accordingly, income from permanent establishments and real estate located abroad should as a main rule be excluded from the taxable income.<sup>6</sup> An aim of this amendment was to ensure that Danish companies could not utilize losses – originating from foreign permanent establishments

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<sup>2</sup> Cf. OECD, 2013, *Addressing Base Erosion and Profit Shifting*, and OECD, 2013, *Action Plan on Base Erosion and Profit Shifting*.

<sup>3</sup> See e.g. *Bundgaard & Koerver Schmidt: IFA Cahiers du droit fiscal international*, vol. 95 a, pp. 261-279.

<sup>4</sup> Cf. Sec. 1(1) and 1(6) of the Corporate Tax Act.

<sup>5</sup> Cf. Sec. 4 of the State Tax Act.

<sup>6</sup> Cf. Sec. 8(2) of the Corporate Tax Act. For more on permanent establishments see *Laursen: Fast Driftssted*, 2011 and *Winther-Sørensen: Beskatning af international erhvervsindkomst*, 2000.

and foreign real estate – to reduce the Danish taxable income.<sup>7</sup> Pursuant to domestic Danish rules relief of double taxation is granted according to the ordinary credit method.<sup>8</sup>

As a main rule Danish tax legislation allows for the unlimited and indefinite carrying forward of tax losses.<sup>9</sup> However, in 2012 a restriction in the right to utilise tax losses carried forward was adopted. Accordingly, tax losses may only be used to set off against income up to DKK 7,635,000 (2014).<sup>10</sup> Income exceeding DKK 7,635,000 cannot be set off by more than 60 % by tax losses carried forward. The new rule is inspired by German tax law and the aim of the rule is to ensure a strong tax base and to make sure that businesses – in particular multinational enterprises – contribute more to the funding of the welfare state. Accordingly, the restriction is intended to target so-called “zero-tax companies”.<sup>11</sup>

All companies within a group that are liable to full Danish taxation – as well as permanent establishments and real estate located in Denmark – are subject to mandatory national tax consolidation.<sup>12</sup> A group exists when a (parent) company has the “deciding influence” over one or more subsidiaries.<sup>13</sup> Moreover, it is possible to opt for voluntary international tax consolidation.<sup>14</sup> In that case also all foreign group companies as well as all permanent establishments and real estate in foreign jurisdictions must be included in the consolidation (“the global pooling principle”). This principle was introduced in order to prevent “cherry picking”, i.e. including only the foreign entities with tax losses and not the profitable entities in the Danish international tax consolidation.<sup>15</sup>

In general dividends received by a company on “subsidiary shares” and “group shares” are tax exempt, whereas dividends on “portfolio shares” are taxable.<sup>16</sup> Shares are considered “subsidiary shares” when the shareholder owns at least 10 % of the nominal share capital of the company and the company is Danish or the company is foreign and the taxation of dividends paid by the company is to be waived or reduced under the Parent-Subsidiary Directive (2011/96/EU) or a tax treaty. “Group shares” exist when the shareholder and the company are subject to mandatory national tax consolidation, subject to voluntary Danish international

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<sup>7</sup> Cf. the explanatory notes to Bill L 121 (2004/2005). See also *Wittendorff* in *Winther-Sørensen et al*: *Skatteretten* 3, 2013, p. 296.

<sup>8</sup> Cf. Sec. 33 of the Tax Assessment Act.

<sup>9</sup> Cf. Sec. 12(1) of the Corporate Tax Act.

<sup>10</sup> The basic amount of DKK 7,635,000 also applies in the case of tax consolidation.

<sup>11</sup> Cf. the explanatory notes to Bill L 173 (2011/2012). According to a recent proposal the right to carry forward tax losses is forfeited if the corporate taxpayer does not register these losses at a new central digital register for tax losses, cf. Bill L 144 (2013/2014).

<sup>12</sup> Cf. Sec. 31 of the Corporate Tax Act. The administration company and the wholly-owned companies participating in the consolidation are liable on an unlimited, joint and several basis for all taxes in the consolidated group. The partially-owned companies in the consolidated group are only secondarily liable and the liability is limited, cf. Sec. 31(6) of the Corporate Tax Act. The rules on liability with respect to tax consolidation were tightened in 2012, cf. Bill L 173 (2011/2012). See *Ramskov*, *SR-skat*, 2013, issue 5, p. 265 et seq.

<sup>13</sup> Cf. Sec. 31 C of the Corporate Tax Act.

<sup>14</sup> Cf. Sec. 31 A of the Corporate Tax Act.

<sup>15</sup> Cf. the explanatory notes to Bill L 121 (2004/2005).

<sup>16</sup> Cf. Sec. 13(1)(2) of the Corporate Tax Act and Sec. 16 A(1) of the Tax Assessment Act.

tax consolidation or at least qualify for voluntary Danish international tax consolidation. Capital gains on the sale of “subsidiary shares” and “group shares” are tax exempt whereas losses on the sale of such shares are not deductible. As a main rule the same applies to capital gains on portfolio shares in unlisted companies (“tax exempt portfolio shares”),<sup>17</sup> even though dividends hereof are taxable.<sup>18</sup>

Following the international trend the statutory Danish corporate tax rate has diminished over the years. Accordingly, during the last decade the rate has been reduced from 30 % (2004) to 24.5 % (2014) as shown in the table below. The reductions have partly been financed by broadening the corporate tax base.<sup>19</sup>

Income Year	Statutory Corporate Tax Rate
2004	30 %
2005	28 %
2006	28 %
2007	25 %
2008	25 %
2009	25 %
2010	25 %
2011	25 %
2012	25 %
2013	25 %
2014	24.5 %

Table 1

Moreover, it has already been decided to further reduce the statutory corporate tax rate to 23.5 % in 2015 and to 22 % in 2016 and onwards.<sup>20</sup> The aim of the reduction is to ensure that Denmark has a competitive tax rate and to stimulate investment in Danish businesses and jobs. Furthermore, it is expected that the lower tax rate will reduce Danish businesses’ incentive to perform profit shifting.<sup>21</sup>

### 3 Incentives for Investment

In order to promote commercial research activities, costs incurred in connection with research and development activities related to the tax payer’s business – and costs pertaining to basic research incurred by

<sup>17</sup> Cf. Sec. 8 of the Act on Taxation of Gains on Shares. “Subsidiary shares”, “group shares” and “tax exempt portfolio shares” are defined in Sec. 4 A, 4 B and 4 C. Gains and losses on “taxable portfolio shares” – e.g. shares in listed portfolio companies – are taxable/deductible according to a mark-to-market principle, cf. Sec. 9.

<sup>18</sup> A number of provisions have been adopted in order to prevent minority shareholders from transforming taxable dividends into tax-exempt capital gains through liquidations, share redemptions and repurchase strategies, cf. Sec. 16 A(2)(5) and 16 B(2)(2)(d) of the Tax Assessment Act. See the explanatory notes to Bill L 49 (2012/2013) and Wittendorff, Tax Notes International, 2013, p. 1051-1059.

<sup>19</sup> Cf. [www.skm.dk](http://www.skm.dk), ”Selskabsskatter i EU-landene 1985-2013”.

<sup>20</sup> Cf. Sec. 17(1) of the Corporate Tax Act.

<sup>21</sup> Cf. the explanatory notes to Bill L 218 (2012/2013). See also *Fuglsig Larsen & Birket-Smith*, Danish Economic National Report, 2014, prepared for the seminar of the Nordic Tax Research Council.

an existing business – may be deducted in full in the year the costs are incurred. However, the tax payer may instead choose to amortize such costs by equal annual amounts in the relevant and the subsequent four income years.<sup>22</sup>

The purchase price of machinery, equipment and ships acquired for research and development purposes may be deducted in full in the year of acquisition (accelerated depreciation).<sup>23</sup> Also, costs related to the acquisition of knowhow, patent rights and certain licence rights for use in the taxpayer's business may be deducted in full in the income year in which such costs have been incurred, instead of being amortized pursuant to the general rules for amortization of intellectual property rights.<sup>24</sup>

It is possible for businesses to request a refund equivalent to the tax value of losses originating from research and development activities.<sup>25</sup> The maximum loss for which the refund can be claimed is DKK 25 million (2014).<sup>26</sup> The aim of introducing this possibility was to encourage research and development activities and create growth, as the provision was foreseen to strengthen the liquidity of mainly smaller businesses during the research stage, in which the activities have not yet generated income.<sup>27</sup>

Moreover, in the aftermath of the financial crisis and in order to promote growth, new machinery and equipment may temporarily be depreciated in an amount equal to 115 % of the purchase price ("super depreciation").<sup>28</sup>

Lastly, it should be noted that Denmark does not have an interest box regime or patent box regime. In 2003 it was considered – as a response to the European Court of Justice's judgment in case C-326/00 *Lankhorst-Hohorst* – to make intra-group interest payments tax-exempt and non-deductible.<sup>29</sup> At the end of the day, however, the Danish legislator chose to amend the thin capitalization rules instead.<sup>30</sup> Furthermore, in 2007 it

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<sup>22</sup> Cf. Sec. 8 B(1) of the Tax Assessment Act. Also costs incurred with respect to search for raw materials may be deductible, cf. Sec. 8 B(2) of the Tax Assessment Act. See the explanatory notes to Bill L 173 (1972/1973) and *Hedegaard Eriksen* in *Jane Bolander* (ed.): Yearbook for Nordic Tax Research, 2011, p. 179-180.

<sup>23</sup> Cf. Sec. 6(1)(3) of the Depreciation Act. Amortization on assets to be used in research and development may commence before start-up of the business, cf. Sec. 51 of the Depreciation Tax Act. See *Wittendorff* in *Bolander* (ed.): Yearbook for Nordic Tax Research, 2011, p. 35 et seq.

<sup>24</sup> Cf. Sec. 41 of the Depreciation Act. For more on depreciation rules see also *Fuglsig Larsen & Birket-Smith*, Danish Economic National Report, 2014, prepared for the seminar of the Nordic Tax Research Council.

<sup>25</sup> Cf. Sec. 8 X of the Tax Assessment Act.

<sup>26</sup> Cf. Bill L 103 (2013/2014).

<sup>27</sup> Cf. the explanatory notes to Bill L 29 (2011/2012).

<sup>28</sup> Cf. Sec 5 D of the Depreciation Act. This only applies to assets acquired on or after 30 May 2012 and up to 31 December 2013. See Bill L 192 (2011/2012).

<sup>29</sup> Cf. *Bundgaard* in *Møgelvang-Hansen*: Julebog, 2003, pp. 21-38.

<sup>30</sup> Cf. Bill L 119 (2003/2004).

was considered to introduce a patent box regime,<sup>31</sup> but in the final bill the proposed patent box regime was left out.<sup>32</sup>

#### 4 The Danish Treaty Network and the Approach to Withholding Taxes

Denmark has concluded around 70 full tax treaties with other states.<sup>33</sup> The OECD Model Convention is used as the underlying basis, and Denmark's tax treaties are typically based on the credit method.<sup>34</sup> Usually, the tax treaties also form basis for the exchange of information. However, in addition to the tax treaties Denmark has concluded around 40 tax information exchange agreements (TIEAs).<sup>35</sup>

Denmark generally does not impose withholding tax on interest paid to non-residents. However, under certain circumstances a 25 % withholding tax applies to interest on "controlled debt" paid to foreign related entities if the income of the foreign related entity is subject to substantially lower taxation (3/4) than if the entity had been taxable under Danish law.<sup>36</sup> Royalties are as a main rule subject to 25 % withholding tax.<sup>37</sup>

Historically, Denmark has been widely used as an international holding company location since the domestic dividend withholding tax was abolished for non-resident foreign companies in 1998.<sup>38</sup> However, following critique from other EU Member States the rules were tightened in 2001,<sup>39</sup> and based on more recent amendments and the tax authorities' quite aggressive approach towards dividend distributions to non-resident holding companies (see below), Denmark has become less attractive as a holding company jurisdiction.

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<sup>31</sup> Cf. draft bill of 1 February 2007, journal no. 2007-411-0081.

<sup>32</sup> Cf. Bill L 213 (2006/2007). In the government's plan for growth – "Vækstplan DK", 2013 – it is stated that the government will analyze the possibilities for introducing a Danish patent box regime.

<sup>33</sup> Cf. information received from the Danish Ministry of Taxation. For an overview see the table published in *Skat Udland*, 2014, issue 1, pp. 29-36 (SU 2014, 5). Denmark has also included a number of treaties with a more limited scope i.e. only covering individuals or shipping transport.

<sup>34</sup> Cf. *Handberg & Dalgas*: Cahiers de droit fiscal international, vol. 96b, p. 267 et seq.

<sup>35</sup> Denmark has quite extensive possibilities of procuring information from foreign authorities for the purpose of tax assessments and, likewise, to send information abroad, cf. *Hansen & Christensen*, Cahiers de droit fiscal international, vol. 98b, p. 249 et seq. Denmark implemented the Mutual Assistance Convention by Act no. 132 of 26 February 1992. Moreover, Denmark participates at the EU-level through the Mutual Assistance Directive (2011/16/EU) and the Savings Tax Directive (2003/48/EC). Denmark also has concluded a number of agreements on mutual assistance.

<sup>36</sup> Cf. Sec. 2(1)(d) of the Corporate Tax Act and Sec. 65 D of the Act on Taxation at Source. If taxation should be waived or reduced pursuant to the Interest and Royalties Directive (2003/49/EC) or a double taxation treaty, no withholding tax should be levied, provided that the companies paying and receiving interest are affiliated for at least one year in which period the payment is made. More exceptions apply. See also the quite similar provision concerning capital gains on controlled debt, cf. Sec. 2(1)(g).

<sup>37</sup> Cf. Sec. 2(1)(g) of the Corporate Tax Act and Sec. 65 C of the Act on Taxation at Source. No withholding tax should be levied if the royalty is paid to a foreign entity qualifying under the Interest and Royalties Directive (2003/49/EC), provided that the companies paying and receiving the royalty are affiliated for at least one year in which period the payment is made.

<sup>38</sup> Cf. Bill L 53 (1998/1999).

<sup>39</sup> Cf. the explanatory notes to Bill L 99 (2000/2001). In the Report from the Code of Conduct Group on Business Taxation, SN 49/01, the Danish dividend holding regime was mentioned as a measure with harmful features.

Accordingly, pursuant to the currently applicable rules dividends may be subject to 27 % Danish withholding tax. However, an exemption applies to dividends originating from “subsidiary shares” and “group shares” if certain conditions are fulfilled. Concerning “subsidiary shares” it is a condition for applying the participation exemption that taxation should be eliminated or reduced pursuant to the Parent-Subsidiary Directive (2011/96/EU) or a tax treaty. Concerning “group shares” – that are not “subsidiary shares” – it is a condition that the recipient is domiciled within the EU/EEA and that taxation should have been eliminated or reduced pursuant to the Parent-Subsidiary Directive or a tax treaty if the shares had been “subsidiary shares”.<sup>40</sup> Furthermore, in order to ensure that Danish tax law does not assist taxpayers in avoiding withholding taxes in other countries, the exemption from Danish withholding tax does not apply if the distributing Danish company is used as an intermediary vehicle to channel dividends between nonresident group companies.<sup>41</sup>

Under most of Denmark’s tax treaties as well as under the Interest and Royalties Directive (2003/49/EC), it is a prerequisite for elimination or reduction of taxation that the recipient is the beneficial owner.<sup>42</sup> In recent years the Danish tax authorities have raised a number of cases against Danish interest and/or dividend paying companies for not withholding tax at source. In short the position of the tax authorities is that the immediate recipients cannot be regarded as the beneficial owners of the funds received, as the immediate recipients lack the powers to make decisions in respect of the received funds and as their only function is to simply act as an intermediary or a “conduit company”.

Only one beneficial ownership case has so far been decided by the courts. The case – which had an atypical fact pattern, as the immediate recipient had not re-distributed the dividends up the corporate chain – was won by the taxpayer.<sup>43</sup> However, more cases on beneficial ownership are currently on their way through the Danish legal system, and at level of the National Tax Tribunal the tax authorities have prevailed in a number of cases concerning interest payments.<sup>44</sup> Furthermore, in some of the on-going court cases the Ministry of Taxation has accepted that the High Court makes a reference for a preliminary ruling to the European Court of Justice.<sup>45</sup> Finally, it should be mentioned that a number of new provisions have been enacted in order to ensure that Danish dividend withholding tax cannot be avoided by structuring the transactions differently, i.e.

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<sup>40</sup> Cf. Sec. 2(1)(c) of the Corporate Tax Act. See section 2 for a definition of “subsidiary shares” and “group shares”.

<sup>41</sup> Cf. the explanatory notes to Bill L 10 (2012/2013). It is a condition 1) that the dividend distributed by the Danish company is a redistribution of dividends received, directly or indirectly, from non-resident group companies, and 2) that the Danish company was not the beneficial owner of the dividends received from the non-resident group company. If the non-resident parent company is resident in another EU Member State or a treaty country Denmark is obliged to reduce its taxation to the lower rate. See *Wittendorff*, Tax Notes International, 2013, p. 1051-1059.

<sup>42</sup> In contrast the Parent-Subsidiary Directive does not contain an explicit beneficial owner requirement.

<sup>43</sup> Cf. SKM2012.121.ØLR. The judgment has not been appealed.

<sup>44</sup> Cf. for example SKM2011.57.LSR and SKM2011.485.LSR

<sup>45</sup> For a status report see *Severin Hansen et al*, Bulletin for International Taxation, vol. 67, pp. 192-199.

by migration of a Danish subsidiary, a tax-exempt cross-border merger, a liquidation or share redemption, and other kinds of reorganization of the ownership of a Danish subsidiary.<sup>46</sup>

## 5 Rules to Protect the Danish Tax Base

In Danish tax law a number of doctrines and provisions aim at – or at least help – protecting the Danish corporate tax base. Below, these doctrines and some of these provisions are explained.<sup>47</sup>

### 5.1 General anti-avoidance rules

No statutory general anti-avoidance provision exists under Danish tax law. However, pursuant to a doctrine of “substance over form”, it has been argued that fictitious or artificial transactions may be set aside for tax purposes if the actual substance of the transaction conflicts with its private law form, resulting in a tax advantage.<sup>48</sup> In this case, tax will be imposed in accordance with the actual substance of the transaction based on an overall assessment. The applicability of the doctrine of “substance over form” is limited, however, and in order for the doctrine to apply there must be an evident conflict between form and substance.

In addition to the substance over form doctrine, the doctrine of the “rightful recipient of income” plays a significant role. The doctrine prescribes that the subject having the (legal) right to the basis of the income – e.g. a shareholding, a claim or a business activity – should also be considered the proper recipient for tax purposes of the gain/return on the shares/claim/activity.<sup>49</sup>

The interaction between these doctrines is somewhat unclear, but for many practical purposes they seem to be overlapping.<sup>50</sup> However, the doctrines should normally not be considered a sufficient tool when it comes to preventing erosion of the Danish tax base.

### 5.2 Specific anti-avoidance rules (SAARs)

Danish tax law encompasses a relatively high number of specific anti-avoidance provisions, and the extent of such legislation has increased significantly during the last two decades. Below some of the most significant specific anti-avoidance rules are addressed and the aims of the provisions are briefly explained.

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<sup>46</sup> Cf. Sec. 5(5) and 2 D of the Corporate Tax Act, Sec. 9(2), 15(4), and 15a(10) of the Merger Tax Act, and Sec. 16 A(3)(1) and 16 B(2)(2) of the Tax Assessment Act. See Bill L 202 (2008/2009), Bill L 84 (2010/2011), and Bill L 10 (2012/2013).

<sup>47</sup> See also *Bundgaard & Koerver Schmidt*: IFA Cahiers du droit fiscal international, vol. 95 a, pp. 261-279.

<sup>48</sup> The principle was originally explained by *Pedersen*: Skatteudnyttelse, 1989, p. 435 et seq.

<sup>49</sup> The doctrine – it is argued – can be deduced from Sec. 4 of the State Tax Act. See *Michelsen* in *Michelsen et al.*: Lærebog om indkomstskat, 2013, p. 659 et seq. and *Dam*: Rette indkomstmodtager: Allokering og fiksering, 2005.

<sup>50</sup> Cf. *Bundgaard*: Skatteret & civilret, 2006, p. 558 et seq. In the literature a debate has taken place between proponents for the doctrine of “substance over form” and advocates of the doctrine of the “rightful recipient of income”.

SAAR	Enacted (parliamentary year)
CFC legislation	1994/1995
Exit taxation (migration)	1994/1995
Transfer pricing (reformed)	1997/1998
Thin capitalization	1997/1998
Re-classification of Danish companies (hybrids)	2003/2004
Hybrid financial instruments	2006/2007
Interest deduction limitations (asset-/EBIT-test)	2006/2007
Re-classification of Danish transparent entities (reverse hybrids)	2007/2008

Table 2

### 5.2.1 CFC legislation

According to the Danish CFC regime, a Danish company is liable to tax on the income of a Danish or foreign subsidiary if: (i) the subsidiary is controlled by the affiliated group of companies, (ii) the tainted income (so-called “CFC-income”) of the subsidiary amounts to more than 50 % of the total taxable income and (iii) the financial assets of the subsidiary exceed 10% of the total assets.<sup>51</sup>

If the CFC rules apply, the Danish parent company should include the total income of the subsidiary, provided that the income of the subsidiary is positive. If the parent company does not fully own the subsidiary, only a proportional part of the subsidiary’s income should be attributed to the parent company. Furthermore, only income generated by the subsidiary in the period during which the parent company had “deciding influence” should be included. A tax credit is granted for taxes paid by the subsidiary.

The objective behind the introduction of CFC legislation was to prevent erosion of the Danish tax base caused by the increasing openness of borders to flows of capital.<sup>52</sup> More specifically, the aim was to prevent Danish companies from establishing subsidiaries in low tax countries and moving income and assets hereto.<sup>53</sup>

<sup>51</sup> Cf. Sec. 32 of the Corporate Tax Act. Sec. 8(2) of the Corporate Tax Act contains a “CFC-rule” for foreign permanent establishments.

<sup>52</sup> Cf. the explanatory notes to Bill L 35 (1994/1995).

<sup>53</sup> See *Koerver Schmidt: Dansk CFC-beskatning i et internationalt og komparativt perspektiv*, 2013, and *Koerver Schmidt, Cahiers de droit fiscal international*, vol. 98a, pp. 259-277.

### 5.2.2 Exit taxation

If a resident company ceases to be fully liable to tax in Denmark, or if a resident company becomes resident in another state according to a tax treaty, the company should be considered as having disposed all assets and liabilities that no longer are subject to Danish Taxation. The assets and liabilities should be considered as sold at fair market value at the time of emigration.<sup>54</sup> Likewise, the transfer of assets and liabilities within a company to a foreign permanent establishment or a foreign head quarter, with the result that the assets and liabilities are no longer subject to Danish taxation, is treated as a sale at fair market value at the time of the transfer.<sup>55</sup>

Companies now have the option of deferring payment of the exit tax subject to certain conditions.<sup>56</sup> The exit tax balance must be settled by annual installments equal to the higher of the income relating to the assets multiplied by the applicable Danish corporate tax rate, or 1/7 of the exit tax balance at the time it was established. Accordingly, deferred exit taxes will be paid within a maximum period of seven years. Interest of minimum 3 % is charged on the remaining deferred exit tax every year.

### 5.2.3 Transfer pricing

The Danish transfer pricing legislation was reformed in 1998, following a couple of judgements from the Supreme Court on “interest fixation” which the tax authorities had lost.<sup>57</sup> The aim of the reform was to provide a clear legal basis for transfer pricing adjustments, in order to avoid erosion of the Danish tax base and in order to ensure equal tax treatment of Danish and foreign owned companies.<sup>58</sup>

The current regime sets forth the arm’s length principle, which should be interpreted in line with the art. 9(1) of the OECD Model and the OECD Transfer Pricing Guidelines.<sup>59</sup> The transfer pricing rules apply to “controlled transactions” and cover cross-border transactions as well as domestic transactions.<sup>60</sup>

Moreover, transfer pricing information and documentation requirements apply.<sup>61</sup> Accordingly, when filing the tax return the tax authorities should be informed about the nature and scale of the controlled transactions. In addition the taxpayer is obliged to tax prepare and hold written transfer pricing documentation. On request the transfer pricing documentation must be handed over to the Danish tax authorities.<sup>62</sup> For smaller corporate groups, the documentation requirements are less restrictive.

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<sup>54</sup> Cf. Sec. 5(7) and (8) of the Corporation Tax Act. See Bill L 35 (1994/1995).

<sup>55</sup> Cf. Sec. 8(4) of the Corporation Tax Act. See Bill L 121 (2004/2005).

<sup>56</sup> Cf. Sec. 26 and 27 of the Corporation Tax Act. See Bill L 91 (2013/2014).

<sup>57</sup> Cf. TfS 1996, 642 H, TfS 1998, 199 H and TfS 1998, 238 H.

<sup>58</sup> Cf. the explanatory notes to Bill L 101 (1997/1998).

<sup>59</sup> See *Wittendorff: Armslængdeprincippet i dansk og international skatteret* (2009), p. 262 et seq.

<sup>60</sup> Cf. Sec 2 of the Tax Assessment Act.

<sup>61</sup> Cf. Sec. 3 B of the Tax Control Act.

<sup>62</sup> If sufficient transfer pricing documentation exists, it is the tax authorities who have the burden of proving whether or not the transactions are at arm’s length, cf. *Bolander & Graff Nielsen in Meussen* (ed.): *The Burden of Proof in Tax*

Furthermore, the tax authorities may require a taxpayer to submit an auditor's assurance report on its transfer pricing documentation. The rule targets loss-making companies and companies engaging in transactions with tax havens.<sup>63</sup>

Penalties may be imposed if the transfer pricing documentation is missing or significantly insufficient.<sup>64</sup> In general, it is the impression that the tax authorities' transfer pricing audits have been quite thorough in recent years.<sup>65</sup>

#### 5.2.4 Limitations on deductibility of financing expenses

The deductibility of financing expenses may in general be restricted under three sets of rules for corporate taxpayers:<sup>66</sup>

- The thin capitalisation test; A company is thinly capitalized if the debt-to-equity ratio exceeds 4:1, provided that the controlled debt exceeds DKK 10 million. If a company is considered thinly capitalized, interest expenses and capital losses, on the part of the controlled debt that should have been converted to equity to avoid the limitation, are not deductible. However, if the company is able to substantiate that similar financing could have been obtained without security from other group companies, the company will be allowed to deduct interest expenses even though the 4:1 ratio is exceeded.
- The asset test; net financing expenses may be deducted only to the extent the expenses do not exceed a standard rate of presently 4.2 % (2014) of the tax base of certain qualifying assets.
- The EBIT test; net financing expenses may not exceed 80% of earnings before interest and tax.

All three rules apply domestically as well as cross-border.

The aim of the thin capitalization rules are to counter the shifting of tax revenue from Denmark caused by intra-group loans made from foreign group companies to Danish subsidiaries on terms that could not have been achieved between independent parties.<sup>67</sup> The thin capitalization rules therefore only apply to controlled debt.

The "asset test" and the "EBIT test" were introduced in 2007 as the legislator found that the CFC rules and the thin capitalization rules in force at the time did not provide sufficient protection of the Danish tax base in

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Law, 2011, p. 95. In the recent decision SKM2014.53.LSR the National Tax Tribunal stated that the tax authorities were allowed to disregard the originally applied TP rates as the burden of proof had shifted to the taxpayer, because the transfer pricing documentation was insufficient.

<sup>63</sup> Cf. Sec. 3 B(8) of the Tax Control Act

<sup>64</sup> Cf. Sec 17(3) of the Tax Control Act.

<sup>65</sup> Cf. *Wittendorff*, *International Transfer Pricing Journal*, vol. 19, p. 324-329.

<sup>66</sup> Cf. Sec. 11, 11 B and 11 C of the Corporate Tax Act. See *Tell: Fradragsbeskæring af selskabers finansieringsudgifter*, 2012.

<sup>67</sup> Cf. the explanatory notes to Bill L 101 (1997/1998).

situations where Danish companies were acquired by private equity funds in highly leveraged buyouts.<sup>68</sup> Both the asset test and the EBIT test only apply to net financing expenses exceeding DKK 21.3 million (2014). The two limitations apply to all kinds of debt – not only controlled debt.

### 5.2.5 Hybrid entities and reverse hybrid entities

Denmark has introduced provisions on hybrid as well as reverse hybrid entities, which entail that the domestic tax treatment in some situations depends on the tax treatment in other jurisdictions.<sup>69</sup> Both provisions could be seen as a reaction to tax planning based on the US check-the-box rules.<sup>70</sup>

Accordingly, if a company or association should be treated as a transparent entity according to the tax rules of a foreign state, with the effect that the company's income should be included in the income of an affiliated company in this foreign state, the company should – if certain conditions apply – be reclassified as a transparent entity for Danish tax purposes. The objective of the provision is to mitigate the possibility of “creating” deductible interest expenses in Denmark in situations where the foreign recipient is not taxable of the interest payments, as the interest payments should be considered internal transfers within the same entity pursuant to the tax rules in the foreign state.<sup>71</sup>

Conversely, certain tax transparent entities should be reclassified as separate taxable entities if more than 50 % of the shares or voting rights are held directly by foreign investors and the tax domicile of such foreign investors is in a country in which the Danish entity is treated as a taxable entity or in a non-EU Member State which does not have a tax treaty with Denmark.<sup>72</sup> Here the aim is to prevent tax payers from exploiting different entity qualification to “create” double non-taxation.<sup>73</sup>

### 5.2.5 Hybrid financial instruments

Cross-border tax arbitrage by way of using hybrid financial instruments has been curbed inbound and outbound. Accordingly, if a company or association etc. is indebted or similarly obligated to an individual or company resident in another country and the claim according to foreign tax rules is considered paid in capital, the debt shall also be regarded as equity with respect to the Danish tax computation.<sup>74</sup> The objective

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<sup>68</sup> Cf. the explanatory notes to Bill L 213 (2006/2007).

<sup>69</sup> Cf. Sec. 2 A and 2 C of the Corporation Tax Act.

<sup>70</sup> For more on the Danish rules on hybrid entities and hybrid financial instruments see *Bundgaard*, Bulletin for International Taxation, vol. 67, pp. 200-204, who demonstrates the frequent Danish use of coordination rules based on a principle of correspondence.

<sup>71</sup> Cf. the explanatory notes to Bill L 119 (2003/2004).

<sup>72</sup> Cf. Sec. 2 C of the Corporation Tax Act.

<sup>73</sup> Cf. the explanatory notes to Bill L 181 (2007/2008).

<sup>74</sup> Cf. Sec. 2 B of the Corporation Tax Act. The provision only applies if the foreign individual or company has decisive influence over the Danish company or the companies are considered to be in a group of companies; cf. the principles in Sec. 2 of the Tax Assessment Act. The classification means that interest payments and capital losses are considered to be non-deductible dividend payments. See *Bundgaard* in Bulletin for International Taxation, vol. 62, p. 33 et seq.

of this provision is to abolish the potential asymmetrical tax treatment of certain hybrid financial instruments.<sup>75</sup>

In addition, the applicability of the inbound dividend participation exemption has been limited to situations where the foreign paying company is not allowed under the tax laws of the country of its residence to deduct the payments, which are considered dividends under Danish tax law.<sup>76</sup> The provision shall prevent Danish companies from receiving tax exempt dividends, in situations where the foreign paying company can deduct the payment.<sup>77</sup>

#### 5.2.6 Other

Finally, a number of other provisions protecting the Danish tax base should very briefly be mentioned:

- Companies that are subject to full Danish tax liability, but are domiciled in another country according to the provisions in a tax treaty, can only deduct expenses which concern income that can be taxed in Denmark due to the tax treaty.<sup>78</sup>
- Concerning double taxation relief, unilaterally or according to a double taxation treaty, expenses which relate to the foreign-source gross income must be deducted when computing net foreign-source income (“the net principle”).<sup>79</sup>
- An anti-double dip provision prohibits deduction of expenses which due to foreign tax rules can be deducted from income that is not included when calculating the Danish tax.<sup>80</sup> The provision moreover prevents double dips arising from double depreciation of leasing assets.
- If a debt claim is acquired for borrowed funds, and interest or capital gains on the debt claim should not be included in the income by virtue of a tax treaty, interest, capital losses, commission, premiums and other expenses incurred in connection to the loan cannot be deducted.<sup>81</sup> This also applies if shares are acquired for borrowed funds, provided the shares in question are shares in a company which directly or indirectly holds a significant amount of the aforementioned debt claims.

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<sup>75</sup> Cf. the explanatory notes to Bill L 110 B (2006/2007).

<sup>76</sup> Cf. Sec. 13(1)(2) of the Corporation Tax Act. An exception applies if taxation should be eliminated or reduced pursuant to the Parent-Subsidiary Directive (2011/96/EU.)

<sup>77</sup> Cf. the explanatory notes to Bill L 23 (2008/2009) and to Bill L 84 (2010/2011) where the scope of the provision was expanded to cover situations where a lower-tier foreign subsidiary obtains the deduction. Originally, this rule was introduced in 2006 as part of another provision with regard to declared dividends, cf. the former Sec. 31 D(2) of the Corporate Tax Act. See Bill L 110 A (2006/2007).

<sup>78</sup> Cf. Sec. 9 of the Corporation Tax Act.

<sup>79</sup> Cf. Sec. 33 F of the Tax Assessment Act.

<sup>80</sup> Cf. Sec. 5 G of the Tax Assessment Act.

<sup>81</sup> Cf. Sec. 5 F of the Tax Assessment Act.

- A provision prohibits deduction of payments for accrued interest paid in connection to purchase of interest bearing debt claims if interest or capital gains on the debt claim by virtue of a tax treaty should not be included in the taxable income.<sup>82</sup>
- Losses on debt claims are not deductible if interest or gains related to the debt claim should not be included in the taxable income as a result of a tax treaty.<sup>83</sup>

### 5.3. Relationship with EU law

Whether the Danish specific anti-avoidance provisions should be considered in line with EU law has been subject to considerable debate over the years. Moreover, following judgments from the European Court of Justice – such as case C-324/00 *Lankhorst-Hohorst*, C-196/04 *Cadbury Schweppes* and most recently case C-261/11 *Commission v. Denmark* – the Danish legislator have found it necessary to amend several anti-avoidance provisions in order to comply with EU law, including the thin capitalization rules, the CFC legislation and the exit tax provisions.<sup>84</sup>

A common “reaction” to the EU law challenge has been to expand the scope of the anti-avoidance provisions. For example, both the thin capitalization rules and the CFC rules now apply domestically as well. However, despite this it has still been questioned whether these rules in effect have been brought in line with EU-law.

Concerning the thin capitalization rules one of the arguments is that the interest deduction limitation still mainly becomes relevant with respect to cross-border intra-group debt, as a result of the design of the consolidation principle to be used when applying the rules. Accordingly, it has been argued that different treatment of comparable situations probably still exists and that this restriction cannot be justified.<sup>85</sup>

With respect to the CFC rules the main argument is that different treatment still exists, as the application of the CFC rules only entails an additional tax burden for the Danish parent company, if the subsidiary is resident in another country in which the level of taxation is lower than the Danish level of taxation. The explanation is that the relief granted for taxes paid by a Danish subsidiary should normally fully absorb the parent company’s additional tax on the income from the Danish subsidiary. Moreover, if a subsidiary resident in Denmark forms part of a tax consolidation, CFC taxation should only take place after tax losses are apportioned among the group companies and after taxation of the subsidiary itself. Furthermore, taking into consideration the very wide scope of the CFC rules – including the fact that the rules may apply even in a situation in which a subsidiary resident in another Member State reflects economic reality in that Member State – it seems doubtful whether or not the Danish CFC rules, in general, should be considered justified and

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<sup>82</sup> Cf. Sec. 5 C(3) of the Tax Assessment Act

<sup>83</sup> Cf. Sec. 5 of the Act on Taxation of Gains and Losses on Debt Claims, Debts and Financial Instruments.

<sup>84</sup> Cf. Bill L 119 (2003/2004), Bill L 213 (2006/2007) and Bill L 91 (2013/2014).

<sup>85</sup> Cf. *Tell: Fradragsbeskæring af selskabers finansieringsudgifter*, 2012, pp. 323-331.

in line with the proportionality principle. At a minimum, therefore, it appears reasonable to conclude that the Danish reaction to *Cadbury Schweppes* has led to uncertainty, as the current rules are not immune from criticism in the EU context.<sup>86</sup>

In addition to the discussions on thin capitalization and CFC rules the EU law compatibility of other anti-avoidance provisions has been debated as well. Thus, elements of anti-avoidance rules such as the asset- and EBIT-test,<sup>87</sup> the rules on hybrid financial instruments,<sup>88</sup> and the rules on exit taxation are still subject to criticism in the literature from an EU-law standpoint.<sup>89</sup> Moreover, it has been discussed whether the tax consolidation regime is in line with EU-law.<sup>90</sup>

Irrespective of this development there has been only little case law dealing with the relationship between the Danish anti-avoidance provisions and the fundamental freedoms. An example of such a case, however, is the National Tax Tribunal's decision in a case concerning the Danish CFC-rules.<sup>91</sup> The case concerned a Danish operational company which contemplated to establish a subsidiary in Cyprus. It was the intention that the subsidiary in Cyprus should invest the profits – originating from the Danish parent company's business activities – in securities. The National Tax Tribunal concluded that the current Danish CFC rules do not conflict with EU law. However, the decision was very brief regarding this matter and the tribunal mainly repeated the point of view of the legislator that no different treatment exists, as the rules also apply with respect to Danish subsidiaries.<sup>92</sup>

#### 5.4 Relationship with tax treaties

Specific treaty provisions allowing application of domestic anti-avoidance provisions are not common in Denmark's treaties. Moreover, case law addressing the tax treaty aspects of the vast number of Danish anti-avoidance provisions is modest.<sup>93</sup>

However, in a decision from 2004 the National Tax Tribunal considered the tax treaty aspects of the then applicable Danish CFC regime for companies.<sup>94</sup> The case concerned a Danish company that controlled a

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<sup>86</sup> Cf. *Koerver Schmidt*, *European Taxation*, 2014, vol. 54, pp. 3-9.

<sup>87</sup> Cf. *Tell*: Fradragsbeskæring af selskabers finansieringsudgifter, 2012, pp. 333-357. See also *Rønfeldt*: Skatteværn og EU-frihed, 2010, p. 437-459.

<sup>88</sup> Cf. *Bundgaard*, *European Taxation*, vol. 53, pp. 539-554 and 587-594.

<sup>89</sup> Cf. *Tell*, *European Taxation*, vol. 54, pp. 47-55, who argues that the rules on exit taxation are still incompatible with the freedom of establishment due to the limited deferral period with regard to all types of assets and the randomly determined interest rate. In a letter dated 21 January 2014 to the Danish government the Commission explains that it still finds the Danish rules on exit taxation to be in breach of EU law despite the latest amendments, cf. annex 6 to Bill L 91 (2013/2014).

<sup>90</sup> Cf. *Guldmann Hansen et al.*: Sambeskatning, 2013/2014, 2013, p. 307 et seq.

<sup>91</sup> Cf. the decision dated 6 May 2009, journal-no. 08-02192, published in *Afgørelsesdatabasen for Landsskatteretten og Skatterådet*. At an earlier stage the National Tax Assessment Council had reached the same conclusion, cf. SKM2008.450.SR.

<sup>92</sup> Cf. the explanatory notes to Bill L 213 (2006/2007).

<sup>93</sup> Cf. *Bundgaard & Koerver Schmidt*, *Cahiers de droit fiscal international*, vol. 95a, p. 270 et seq. On treaty override in general see *Michelsen*: *International skatteret*, 2003, p. 52 et seq.

subsidiary in Switzerland, which performed banking activities. Referring to the 2003 commentaries to the OECD Model Tax Convention, the National Tax Tribunal stated that the CFC regime was not contrary to Denmark's obligations according to the tax treaty with Switzerland. Besides the relationship between tax treaties and CFC legislation, the treaty aspects of inter alia the legislation on thin capitalization have also been subject to debate in the Danish tax literature.<sup>95</sup>

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<sup>94</sup> Cf. SKM2004.862.LSR. For an analysis of the decision see *Michelsen*, *Revision & Regnskabsvæsen*, 2005, no. 1, SM, p. 2-5. In TfS 2000, 426 the Eastern High Court rejected the argument that the "net principle" set out in Sec. 33 F of the Tax Assessment Act was in conflict with Denmark's then applicable tax treaty with Portugal.

<sup>95</sup> See e.g. *Koerver Schmidt*, *SR-skat*, 2012, issue 5, pp. 307-327, *Bundgaard*: *Tynd kapitalisering*, 2000, pp. 285-295, og *Cort Hansen*, *Skat Udland*, 1998, issue 9, pp. 416-423 (SU 1998, 236).