Tax neutrality in corporate financing

Jakob Bundgaard and Michael Tell[1]

1. Introduction

Corporate financing decisions and the tax law effects have played a significant role on the international tax policy agenda in recent years[2]. The overall problem relating to corporate financing in international tax law is basically the different tax treatment of the remuneration on debt and equity. As a general rule the tax treatment of equity financing and debt financing follows the same basic principles around the world[3]. Especially in a Danish context there has been a massive policy focus on tax neutrality in corporate financing in terms of eliminating tax advantages obtained by private equity funds in leveraged buy-out structures. Moreover, the Danish Government has been eager in combating cross border tax arbitrage possibilities which have also occurred in a corporate finance context.

In this article we analyze the present Danish tax regime with a specific focus on corporate financing. More specifically we shall analyze whether the existing corporate tax system can be considered to be in accordance with an overall policy goal of tax neutrality.

Initially we present the existing Danish tax regime with respect to debt financing and equity financing. This also includes a presentation of the specific interest deduction limitation provisions and anti arbitrage provisions which have been adopted during the last few years. The analysis focuses on cross border financing

[1] Jakob Bundgaard, PhD, Partner, Deloitte; and Associate Professor at Copenhagen Research Group on International Taxation (CORIT) and Copenhagen Business School. Michael Tell, PhD Scholar, at Copenhagen Research Group on International Taxation (CORIT) and Copenhagen Business School.

[2] See e.g. Cahiers de Droit Fiscal International (Cahiers) 2007, Volume 93b.

[3] See *Piltz* in Cahiers, 1996, p. 87 et seq. ; OECD, *Thin capitalisation*, 1986, par. 7 et seq., Burmeister, *Unternehmensfinanzierung im Internationalen Steuerrecht*, 2003, p. 36 et seq.

whereby the questions asked concern the taxation of a domestic issuer and a foreign investor or a foreign issuer with a domestic investor. The analysis is not intended to be exhaustive regarding all tax issues raised by the relevant tax legislation and does not go into detail with any technicalities of domestic law nor does it attempt to provide an in depth analysis of the issues of a more general nature relating to issuance of share capital and loan capital. On the basis of this outline we analyze whether the existing regime is in accordance the principle of tax neutrality. In order to carry out this analysis we have defined the tax neutrality concept as applied in this context. Finally, potential EU law infringements of this regime are analyzed.

2. The Present Danish tax regime regarding debt- and equity financing

2.1. Tax Treatment of a Corporation Issuing Equity

Generally corporate earnings from equity are subject to corporation tax in the country of residence of the issuing corporation. Corporate earnings are presently taxed at a rate of 25% in Denmark[4]. As a main rule remuneration on equity (dividends) is not deductible in the calculation of taxable profits. Dividends are not deductible in Danish tax law.

2.2. Tax Treatment of the Investor in a Corporation Issuing Equity

In the country of source of the dividend the shareholder may be subject to a withholding tax on the shareholder's account, which is however frequently reduced as a result of the EU parent/subsidiary directive (PSD)[5] or tax treaties[6]. In the country of residence of the shareholder, dividends are in principle taxable (possibly with a credit for the withholding tax and/or corporation tax levied at the level of

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4 Cf. Sec. 17, par. 1, of the Corporation Tax Act (CTA).

5 Council Directive 2003/123/EC of 22 December 2003 amending Directive 90/435/EEC on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States.

6 See Burmeister, *Unternehmensfinanzierung im Internationalen Steuerrecht*, 2003, p. 36 et seq.

the paying corporation). Under the existence of an international affiliation privilege or participation exemption, they are tax exempt.

In Denmark dividends may also be subject to a *withholding tax* of 28%[7] on the shareholders account if the shareholder is a non-resident[8]. Corporate shareholders qualifying as a parent corporation may be exempt from the dividend withholding tax. The requirements that should be fulfilled in order to obtain the exemption are direct ownership of at least 10% of the shares in the corporation paying dividends. The foreign corporate shareholder should be classified to be of a similar nature as a Danish taxable corporation (broadly defined). Another requirement is that the taxation of the dividend should be reduced or eliminated according to the PSD or a tax treaty. Exemption can also be obtained if the corporation do not fulfil the 10% ownership criteria, but qualify to joint taxation with the Danish subsidiary corporation[9].

The withholding tax will be reduced to 15%, if the corporate shareholder is a resident in a country were the authorities have an agreement with the Danish authorities to exchange information and the corporate shareholder owns less than 10% of the shares[10]. The withholding tax of 28% still applies and the shareholder shall therefore contact the Danish authorities to invoke the reduced taxation.

Corporate shareholders resident in Denmark are generally taxable in Denmark regarding dividends[11]. However, for corporate shareholders meeting the parent corporation test, dividends may be exempt according to the Danish participation exemption regime, which although applicable worldwide is also the Danish implementation of the PSD. Thus, dividends received by Danish parent corporation (specifically mentioned in the wording by reference) are tax exempt if the

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[7] The withholding tax is reduced to 27 % from 1 January 2012.

[8] See Sec 2, par. 1(6) of the Act on Source Taxation; regarding individuals and Sec. 2, par. 1(c), of the CTA; regarding corporations.

[9] Sec. 31 A of the CTA. Sec. 31 A of the CTA refers to the definition of control regarding group corporations in Sec. 31 C of the CTA.

[10] If the corporate shareholder is a resident outside the EU, the ownership by the corporate shareholder and the group corporations (Sec. § 31 C) shall not exceed 10% in total.

[11] Sec. 4(e) of the State Tax Act (STA), Sec. 16A – 16C of the Tax Assessment Act (TAA) and Sec. 17, par. 2 of the CTA.

following conditions are met[12]: (1) The parent corporation should directly own at least 10% of the shares in the corporation paying dividends or qualify to a joint taxation with the Danish subsidiary corporation according to Sec. 31or Sec 31 A of the CTA and (2) the dividends are not tax deductible[13] or subject to a specific tax regime regarding (domestic and foreign) investment corporations as defined in Sec. 19 of the Act on Taxation of Capital Gains and Losses on Shares (GLS).

Dividends received which do not fulfil the participation exemption requirement are taxed at the ordinary corporate tax rate of 25%[14]. Dividends received by physical shareholders are taxed as share income at the rates of 28% (income up to DKK 48.600) and 42% in 2010[15].

Capital gains regarding shares in a subsidiary corporation are tax exempt as well as capital losses are non-deductible, if the investor directly owns minimum 10% of the shares in the subsidiary corporation and the taxation of a dividend should be reduced or eliminated according to the PSD or a tax treaty[16]. Capital gains are tax exempt and capital losses are non-deductible even though the investor does not meet the 10% requirement, if the investor and the corporation are considered a group according to Sec. 31 C of the Corporation Tax Act.

To date, convertible bonds could be disposed of free of tax if a corporation sold the convertible bond after having owned it for at least three years, and any losses were not deductible. As a result convertible bonds have been used in cross-border financing structures. The benefit could be achieved, for instance, if a Danish lender re-lends by means of an interest-free convertible bond to a borrower who is a foreign corporation domiciled in a country that accounts for convertible bonds as claims. In this situation the Danish corporation would be exempt from tax on any gains from the convertible bond after at least three years' ownership while the

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[12] See Sec. 13, par 1, (2) of the CTA.
[13] Deductible dividends are however tax exempt for the creditor if covered by the PSD.
[14] Sec. 4(e) of the STA, Sec. 16A – 16C of the TAA and Sec. 17, par 2 of the CTA.
[15] From 2012 the rates of taxation of share income are 27 % and 42 %.
[16] Sec. 8 of the GLS.

foreign corporation would be eligible for deduction of any capital losses[17]. This type of tax arbitrage was attacked in 2008 by the Danish legislator by way of making gains on convertible bonds generally taxable. This is also the result of the 2009 tax reform[18].

2.3. Tax Treatment of a Corporation Issuing Debt

Internationally, remuneration on debt (interest) is in general considered a deductible expense in the calculation of taxable profits in the country if residence of the debtor/issuing corporation[19]. This leads to the conclusion that the interests are effectively free of corporate income tax, whereas the creditor in both the national and international context is the only person likely to suffer tax on interest payments[20]. However, domestic restrictions on interest deductibility may impose limitations on the deductibility of the interests.

In Denmark interest expenses are tax deductible in the corporate income tax[21]. In general a corporation's capital loss on debt is also tax deductible[22]. However capital losses regarding debt in Danish crones (DKK), which are regulated by an index and if the interest is not below the minimum rate set in Sec. 38 of the ACD are not deductible[23]. Further, a capital loss on debt is not deductible if the redemption is made to a predetermined premium relative to its value at the original issue date and the debt is issued in Danish crones (DKK) and the interest is not below the minimum rate set in Sec. 38 of the ACD[24].

[17] The legal position is explained, for instance, in the Tax Council's binding ruling of 2 July 2007 as published in SKM 2007.464 SR.
[18] See Bill no. L 181 from 2008 and Bill no. L 202 from 2009.
[19] See OECD, *Thin capitalisation*, 1986, par. 8; Piltz in Cahiers, 1996, p. 92 and Burmeister, *Unternehmensfinanzierung im Internationalen Steuerrecht*, 2003, p. 36 et seq.
[20] See OECD: Thin capitalisation, 1986, par. 8 and *Piltz* in Cahiers, 1996, p. 92.
[21] Sec. 6, par 1 (e) of the STA.
[22] Sec. 6 of the ACD.
[23] Sec. 7, par. 1 of the ACD.
[24] Sec. 7, par. 2 of the ACD. Capital losses on debt regarding real estate and ships are deductible; cf. Sec. 7, par. 3 and 4 of the ACD and Sec. 6 of the ACD.

The deductibility of interest and capital losses may be restricted under three sets of rules for corporate taxpayers: 1) the thin capitalisation test, 2) the asset test and 3) the EBIT test[25].

2.3.1. The thin capitalisation test

A corporation is thinly capitalized if the debt-to-equity ratio exceeds 4:1 at the end of an income year[26], provided that the *controlled debt* exceeds DKK 10 million[27]. If a corporation is considered thinly capitalized, interest expenses and capital losses regarding the controlled debt that should be converted to equity so the dept-to-equity ratio is not exceeded, are not deductible. However, the deductibility of capital losses are carried forward, but only deductible regarding capital gains on the same debt[28]. As a main rule, the thin capitalisation test only applies to corporations and only to controlled debt to corporations. The thin capitalisation test does however also apply to a permanent establishment (PE). The debt-to-equity ratio calculation only includes assets and debt related to the PE. The debt of a PE to third parties is considered controlled debt, if the head office is liable for the loan[29], which is often the case.

However there are exceptions, whereby thin capitalised corporations can deduct interest and capital losses. If the corporation is able to substantiate that the financing is at arm's length terms, the corporation will be allowed to deduct interest expenses even though the 4:1 ratio is exceeded. It should also be noted,

[25] See Bundgaard, *Tynd kapitalisering – en skatteretlig fremstilling* (2000) and Bundgaard in *Pedersen et al*.: Skatteretten 3 (2009), p. 331 et seq.
[26] Sec. 11 of the CTA. *Debt* is defined as the aggregate of controlled debt and debt to third parties. *Equity* is defined as the market value of the assets less the market value of the debt.
[27] By *controlled debt* is meant a loan issued by a corporation/shareholder who controls the debtor. The definition of *control* is laid down in Sec. 2 of the TAA. As a starting point, control prevails if more than 50 per cent of the share capital or more than 50 per cent of the voting power directly or indirectly is held. Debt to independent third parties is considered controlled debt if the debt is directly or indirectly secured or guaranteed by a controlling corporation or a corporation affiliated with the controlling corporation, which also applies to back-to-back loan agreements.
[28] Sec. 11, par. 1 of the CTA.
[29] Sec. 11, par. 5 of the CTA.

that the deductibility of interest taxable according to Sec. 2, par 1 (d) (withholding tax) will not be restricted by the thin capitalisation test[30].

The thin capitalisation test shall be applied on a consolidated basis for Danish group corporations[31]. This, among other things, affects the debt-to-equity ratio and the DKK 10 million minimum, but also the controlled debt. Claims and debt between the group corporations is exempt from the thin capitalisation test, which means that the consolidated controlled debt is reduced compared to an accumulation of the group corporations individual controlled debt.

Deductibility restrictions on interest or capital loss according to the thin capitalization test leads to tax exemption regarding the interest or capital gain of the Danish creditor. This does however not imply if the controlled debt is established through an independent third party, if the debt is directly or indirectly secured or guaranteed by a controlling corporation or a corporation affiliated with the controlling corporation[32].

The thin capitalisation tests restrictions on the deductibility of interest and capital losses were thought to be inadequate in 2007 by legislature. As a specific measure to combat private equity funds' leveraged buyouts, Denmark introduced two additional tests regarding the deductibility of corporate interest deductions.

2.3.2. The asset test

Under the asset test net financing expenses may be deducted only if the expenses do not exceed a standard rate of presently 6.5 per cent (2009) of the value of the tax base of certain qualifying assets[33].

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[30] Sec. 11 of the CTA.
[31] However, only Danish companies which, without including foreign shareholders or a Danish ultimate parent corporation, should be considered part of the group, according to the definition in Sec. 4 of the Act on Capital Gains and Losses on Claims and Debt (ACD), should be part of the consolidation; cf. Sec. 11, par. 2 of the CTA.
[32] Sec 11, par. 6 of the CTA.
[33] Sec. 11 B of the CTA.

Net financing expenses are defined as the negative sum of:

1. taxable interest and deductible interest,

2. taxable financial commissions and deductible financial commission[34],

3. taxable capital gains and deductible capital losses regarding claims and debt but not regarding trade debtors and trade creditors. Taxable capital gains and deductible capital losses are not included if the corporation is professionally engaged in lending activities and the debtor is not a group corporation.

4. a calculated financial cost/revenue regarding financial leases and

5. taxable capital gains and deductible capital losses regarding shares including considerations qualified as dividend according to Sec. 16 B of the TAA, when a investor sells shares to the issuing corporation[35].

The value of the tax base consists of the depreciated value of the corporation's assets. Assets, which are not depreciable, are included at the acquisition costs plus improvements. As a main rule, shares and claims are not part of the tax base according to the asset test. Shares in tax consolidated corporations[36] are not included because the assets of these corporations are already included in the tax base, but 17.5% (2010) of the values of directly owned shares in corporations that are group corporations, but not tax consolidated, are included. Joint taxation is mandatory between Danish group corporations[37]. Therefore the 17.5% value rule only regard shares in foreign corporations and the rule is under settlement and does no longer apply from 2017[38]. Further, the value of shares taxed according the mark-to-market principle are included in the tax base. The value of trade debtors are also included in the tax base, but only if the value exceeds the

34 Deductible cf. Sec. 8, par. 3 of the TAA.
35 Sec. 11 B, par. 4 of the CTA. If the sum of taxable capital gains and deductible capital losses regarding shares are negative, the sum is carried forward and not included in this year's net financing expenses.
36 Sec. 31 C of the CTA.
37 See Sec. 31 of the CTA.
38 See Sec. 11 B, par. 12 of the CTA. Every year the percentage is reduced by 2.5 pct. points and is faced out until 2017.

value of trade creditors and only the exceeding value. Further, a carry forward loss is also considered an asset and therefore part of the tax base. Assets from foreign affiliated entities are only included in the tax base if the assets remain in the corporation for at least 2 years or if the parties are jointly taxed.

The deductibility of net financing expenses up to DKK 21.3 million (2010) is not restricted by the asset test. The assets and the net financing expenses are considered on a consolidated basis for group corporations. The minimum rule regarding net financing expenses up to DKK 21.3 million then apply on a group basis. Joint taxed corporations' value of shares is calculated on a joint account.

A restriction of the deductibility of interest and capital losses according to the asset test is secondary to the thin capitalisation test. The asset test is imposed after the thin capitalisation test[39].

2.3.3. The EBIT test

According to the EBIT test, the deductible net financing expenses[40] cannot exceed 80 % of the earnings before interest and tax[41]. As with the asset test, the EBIT test only applies if net financing expenses exceed DKK 21.3 million (2010). The net financing expenses and the EBIT should be considered on a consolidated basis for group corporations. The minimum rule regarding net financing expenses up to DKK 21.3 million apply on a group basis. The EBIT test is applied after the thin capitalisation test and the asset test. The asset test and the EBIT test apply to all debt – not only controlled debt[42].

[39] Sec. 11 B, par. 9 of the CTA.
[40] As defined in the asset test, see Sec. 11 B, par. 4 of the CTA cf. Sec 11 C, par. 1 of the CTA.
[41] Sec. 11 C of the CTA.
[42] Companies which are subject to mandatory Danish tax consolidation or subject to voluntary Danish international tax consolidation should calculate the taxable income, qualifying assets and the net financing expenses on a consolidated basis.

2.4. Tax Treatment of the Investor in a Corporation Issuing Debt

Internationally a repayment of the principal on a loan relationship is usually considered a tax free return of capital in the hands of the creditor/lender/investor. Interests received are as a main rule taxable in the hands of the investor/creditor/lender according to the domestic legislation of the country of residence[43]. However, this conclusion does not include corporations resident in international tax havens, either not subject to income tax or subject to a very limited taxation. Interest is usually not subject to withholding tax or to withholding tax at a lower rate than dividends. The creditor is liable to tax on the interest received, but may claim credit for the withholding tax levied by the source state.

In Danish tax law a repayment of the principal of a loan is considered a tax free return of capital[44]. Interest received by Danish corporations is considered taxable income and is taxed at the ordinary rate of corporate income of 25 %[45]. Interest and capital gains are however tax exempt if the debtor's deductibility is restricted by the thin capitalisation test and the controlled debt is not established through an independent third party and is directly or indirectly secured or guaranteed by a controlling corporation or a corporation affiliated with the controlling corporation[46].

As a main rule no withholding tax on interest payments from Danish debtors is levied. However, an interest withholding tax was introduced in Denmark in 2004 regarding interest payments and capital gains to related parties[47]. Foreign related corporations are liable to Danish withholding tax on interest payments paid from a Danish corporation[48]. It is a prerequisite that the interest payment is connected to debt which has been qualified as "controlled debt" within the meaning of Sec. 3 B

[43] See OECD, *Thin capitalisation*, 1986, par. 8 and Piltz in Cahiers, 1996b, p. 92; Burmeister, *Unternehmensfinanzierung im Internationalen Steuerrecht*, 2003, p. 36 et seq.
[44] Sec. 8, par. 1, CTA; cf. Sec. 5 of the STA.
[45] Sec. 8, par. 1, CTA, Sec. 17, par. 1; cf. Sec. 4 of the STA.
[46] Sec 11, par. 6 of the CTA.
[47] Cf. Sec. 2, par. 1, (d) and (h) of the CTA, as enacted by act no. 221 dated 31 March 2004 (Bill no. L119).
[48] Sec. 2, par. 1 (d), CTA.

of the Danish Tax Control Act. A similar provision is introduced regarding capital gains arising from debt redeemed with a premium agreed in advance[49].

Limited tax liability is not triggered by interest payments and capital gains insofar the one of the following exemptions apply:

- If the interest is effectively connected to a PE in Denmark[50].
- If the taxation shall be reduced or eliminated according to the EU Interest/royalty-directive or a tax treaty with the state of residence of the recipient corporation[51].
- If the receiving corporation is controlled by a Danish corporation[52] (whereby the Danish CFC-rules may apply).
- If the recipient corporation is controlled by a corporation resident in a tax treaty-state, insofar the recipient corporation may be subject to CFC-taxation of the interest in the state of residence, if the conditions are met according to domestic CFC-legislation of the state of residence of the corporation in a tax treaty-state.
- If the recipient corporation proves that foreign taxation of the interests are taxed with at least ¾ of the Danish taxation and that the recipient corporation does not pay on the interests to a foreign corporation which are subject to taxation less than ¾ of the Danish taxation.

In practice a direct loan from a related corporation in a non EU/tax treaty-state to a Danish related corporation will trigger a Danish withholding tax at 25% of the interests or capital gains. This is not the case with payments to related corporations resident in EU/tax treaty-states. In addition is should be noted that

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49 Sec. 2, par. 1 (h), CTA.
50 This only applies to PE's taxable cf. Sec. 2, par. 1 (a) of the CTA.
51 See Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States.
The payment is only tax exempt, if the companies are associated in a continuous period of at least 1 year and if the time of payment is within this period.
52 The payment is only tax exempt, if the companies are associated in a continuous period of at least 1 year and if the time of payment is within this period.

the rules on withholding tax on interest take prejudice over the thin cap rules. Thus, both rules cannot apply at the same time.

A corporation's capital loss on a claim toward a corporation is tax deductible[53]. However, capital losses on a parent corporation's claim toward the subsidiary are not deductible[54]. Capital gains on a (parent) corporation's claim toward a corporation are always taxable[55].

2.5. Overview

The following figure presents a comprehensive overview of the tax treatment of remuneration regarding debt and equity according to Danish tax law as reviewed supra. The figure distinguishes between non-resident corporate investors and resident corporate investors and divides the remunerations into interests, capital gains and losses regarding debt/claims, dividends and capital gains and losses regarding shares.

	Non-resident investor	**Resident investor**	**Issuing Danish corporation**	
			Non-resident investor	**Resident investor**
Interests	As a main rule tax exempt. Only taxable if the investor owns more than 50 pct. of the shares or controls more than 50 pct. of the voting rights and are not tax exmpt or reduced according to a tax treaty or Council Directive	Taxable; cf. Sec. 4 of the STA.	Deductible; cf. Sec. 6(e) of the STA. Limitation rules: - Thin cap; - Asset test; - EBIT test. The thin capitalisation test only applies to	Deductible; cf. Sec. 6(e) of the STA. Limitation rules: - Thin cap; - Asset test; - EBIT test. The thin capitalisation test only applies to

53 Sec. 2 and 3 of the ACD.

54 Sec. 4 of the ACD. The tax exemption applies if the parent corporation owns more than 50 % of the share capital or holds more than 50 % of the voting rights; cf. Sec. 4, par 2 of the ACD.

55 Sec. 2 and 3 of the ACD Sec. 2 and 3 also apply on capital losses on a corporation's claim toward a corporation.

	2003/49/EC; cf. Sec. 2(d) of the CTA. Withholding tax: 25%		controlled debt.	controlled debt.
Capital gains on claims and capital losses on debt	As a main rule tax exempt. Only taxable if the investor owns more than 50 pct. of the shares or controls more than 50 pct. of the voting rights and if to be honored at a predetermined premium relative to its value at the original issue date; cf. Sec. 2(h) of the CTA. Withholding tax: 25%.	Taxable; cf. Sec. 3 of the ACD.	Deductible; cf. Sec. 6 of the ACD. Limitation rules: - Thin cap; - Asset test; - EBIT test. The thin capitalisation test only applies to controlled debt. Non deductible if index debt; cf. Sec. 7 of the ACD.	Deductible; cf. Sec. 6 of the ACD. Limitation rules: - Thin cap; - Asset test; - EBIT test. The thin capitalisation test only applies to controlled debt. Non deductible if index debt; cf. Sec. 7 of the ACD.
Dividends	Taxable; cf. Sec. 2(c) of the CTA. Ai sensi della DMF o di una convenzione internazionale, sono esenti i dividendi percepiti da una società madre residente nello SEE che (1) detiene almeno il 10% del capitale e (2) è tassata congiuntamente con la società distributrice. Ritenuta alla fonte: 28%	Taxable; cf. Sec. 16A, 16B and 16C of the TAA. Dividends received by a parent corporation as defined in Sec. 4A and 4B of the GLS are tax exempt; cf. Sec. 13(2) of the CTA.	Non deductible	Non deductible
Capital gains and losses on shares	Tax exempt	Taxable; cf. Sec. 9 of the GLS. Capital gains regarding shares in subsidiaries as defined in Sec. 4A and 4B of the GLS are tax exempt; cf. Sec. 8 of the GLS.	N.A.	N.A.

As the figure shows the issuing corporation's deductibility of interest and capital losses on debt can be limited by the thin capitalisation test, the asset and the EBIT test. But this is not the only countermeasure that the Danish legislatures have taken to avoid a potential asymmetrical taxation. The following will address legislative measures introduced to combat cross border tax arbitrage.

2.6. Legislative measures introduced to combat cross border tax arbitrage

2.6.1. Hybrid entities

In order to counter tax arbitrage, possible double non-taxation and asymmetrical taxation in general, Denmark has introduced rules on hybrid and reverse hybrid entities, which entails that the domestic tax treatment in some situations depends on the tax treatment in other jurisdictions. Accordingly, if a corporation or association should be treated as a transparent entity according to the tax rules of a foreign state, with the effect that the corporation's income should be included in the income of an affiliated corporation in this foreign state, the corporation should be reclassified as a transparent entity for Danish tax purposes[56].

2.6.2. Hybrid financial instruments

Moreover, cross border tax arbitrage by way of using hybrid financial instruments has been curbed inbound and outbound[57]. If a corporation or association etc. is indebted or similarly obligated to an individual or corporation 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

[56] Cf. Sec. 2A of the CTA. This paragraph only applies if the foreign affiliated corporation has decisive influence over the Danish corporation and the foreign corporation is resident in the EU/EEA or in a country which has concluded a tax treaty with Denmark. See Wittendorff in Danish Journal of International Taxation (2004), no. 204.

[57] Cf. Sec. 2 B of the CTA and Sec. 13 of the CTA.

computation[58]. The objective is to abolish the potential asymmetrical tax treatment of certain hybrid financial instruments. Such an asymmetrical taxation arises by way of different tax classification of an instrument in the countries involved, including the classification for Danish tax purposes as debt resulting in interest deduction for Danish tax purposes while the instrument in the country of the investor is considered equity, which depending of the legislation in that state may be considered as tax-exempt dividends. To obtain this objective, section 2B of the CTA is based on a principle according to which Danish interest deduction requires that the corresponding income is not tax exempt for the recipient. Inspired by German commentary, this principle may be called the "principle of correspondence”. As already stated supra, the application of this principle is far from a novelty in Danish tax law. The underlying tax policy rationale has been widely criticized for the fact that Denmark hereby takes on a coordinating role between different countries regarding the classification of hybrid financial instruments, while a similar effort is not laid down in the case where double taxation occurs in cross-border transactions as a result of different classifications of the same financial instrument. The Minister of Taxation responded to this criticism by stating that it is inappropriate if an interest deduction is allowed in Denmark, while the recipient is not taxed of the "interest payment" because the payment is considered dividends according to foreign legislation[59]. Further, it was stated that such asymmetries may give rise to tax arbitrage and that international tax planning aimed at obtaining a "free deduction" is prevented by the reclassification according to section 2B of the CTA[60].

Sec. 13 of the CTA contains the general participation regime regarding inter-corporation dividends. The applicability of the participation exemption has been limited to situations where the foreign paying corporation is not allowed under the

[58] Cf. Sec. 2B in the CTA. This provision only applies if the foreign individual or corporation has decisive influence over the Danish corporation 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 dividend payments. The provision is similarly applicable to companies that have limited tax liability in Denmark. See Bundgaard in Bulletin for International Taxation (2008), p. 33 et seq.
[59] See enclosure 10 to Bill no. L 110 B.
[60] Id.

tax laws of the country of its residence to deduct the payments, which are considered dividends under Danish tax law. The only remaining exception to this is payment of dividends that are deductible but at the same time paid by corporations resident within the European Union and subject to the benefits of the PSD.

3. Tax neutrality in corporate financing

3.1. In general

Since the topic of the article involves a discussion of taxation of corporate financing in Danish tax law from the perspective of tax neutrality, it is necessary to introduce a concept of neutrality. The neutrality principle is used in the sense that the tax treatment of various alternative courses of actions must be neutral. The concept of neutrality is often used inconsistently and without definitional clarification thereof. The concept of neutrality is generally based on economic reasoning and is also often explained by the principles of fairness. In economic terms neutrality is often used in connection with fiscal policy where the tax neutrality is perceived as a situation where the alternative tax measures do not result in impacts on the societal allocations or incentives for various forms of financing, etc. There can be enumerated different variations of the concept of neutrality, and there may be some important economic neutrality relations, which are numerous.

In this context the neutrality standard is used in the meaning that the tax legislation should not favor debt- or equity financing in corporations. If taxation were neutral, it would be irrelevant from a taxation perspective whether business is financed by debt or equity[61]. The lack of neutrality instead makes it relevant to distinguish between dividends and interest and other income. Thus, the essential problem raised by corporate financing in international tax law is the potential

[61] See Helminen, *The Dividend Concept in International Tax Law : Dividend Payments Between Corporate Entities*, 1999, p. 12.

different characterization of the remuneration from the existing financing alternatives.

At the outset there is a bias towards debt financing in the Danish corporate tax regime since interest payments and capital losses on debt are tax deductible while dividend payments are not. However, this neutrality assessment is far too simple and does not reflect the full picture of tax neutrality in corporate financing.

If no relief is introduced for economic double taxation a bias towards debt financing exist on the corporate tax level. This statement holds true under the assumption that the shareholder wants to increase the overall net return on investment and thus will use debt in the capital structure of the corporation to reduce the corporation's tax burden and increase the profit[62]. The discrepancy in the treatment of shareholder financing is also dependent on the tax rates. A lower corporate tax rate may to some extent compensate for the systematic discrimination on equity financing[63].

Jacobs has carried out a comprehensive study on the corporate financing decision of a German parent corporation between debt and equity financing a domestic, French, Japanese and UK subsidiaries[64]. The author concludes that it is not possible in general to say whether debt or equity financing should be preferred. The conclusion rests on a multitude of factors which may affect the benefit of the financing alternatives dramatically. Such factors include[65]:

- Which taxes are included: taxes in the country of the foreign subsidiary, withholding taxes and shareholder taxation?
- The actual situation of the foreign subsidiary in terms of taxes, i.e. it the subsidiary profitable or lossmaking?

[62] See Jacobs in Intertax 1989, p. 465.
[63] See Jacobs in Intertax 1989, p. 465. See also OECD, *Thin capitalisation*, 1986, par. 10, stating that it sometimes, from a tax point of view, may be more advantageous to arrange the financing by way of loans rather than by way of equity contributions.
[64] See Jacobs, StuW 1996/1, p. 26 et seq.
[65] Id., p. 26 et seq.

- Whether the actual form of financing is classical debt or equity or hybrid financing?
- Are there any foreign limitations according to thin capitalisation rules?
- Is a foreign financing corporation interposed?
- How is double taxation of dividends and interests relieved, by way of exemption (freistellung), indirect credit or ficticious credit (anrechnung)?

In tax systems applying a classical corporation tax system, debt financing is attractive for resident as well as non-resident shareholders since it provides a means of avoiding the economic double taxation burden[66]. In countries applying a "full imputation" or "partial imputation" system, which authorizes (fully or partially) the crediting of the corporation tax paid by the corporation against the personal tax liability of the (resident) shareholder, there is no significant incentive for debt financing. This conclusion may however be different when dealing with non-resident shareholders (non-EU-residents), which may not apply for a credit in effect resulting in a taxation corresponding to a classical corporate tax system. Accordingly an incentive for debt financing may exist in this setting[67]. In general it can be said that the lower the corporation tax rate for distributed profits and the lower the withholding tax rate for dividends, the smaller is the incentive for a foreign shareholder to provide the corporation with loan capital[68]. In addition it may be concluded that debt financing only offers significant tax advantages for a corporation and its shareholders taken together if the shareholder pays no taxes on the income received, e.g. because the shareholder benefits from tax exemption, is making losses[69] or is a resident in a non-tax or low-tax country[70].

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[66] See Piltz in Cahiers, 1996, p. 93.
[67] See Piltz in Cahiers, 1996, p. 93.
[68] See Piltz in Cahiers, 1996, p. 93.
[69] In the absence of cross border tax consolidation a similar result may be obtained in situations where a parent corporation has incurred losses which can only be carried forward for a certain period of time and this date of exhaustion is getting close according to the domestic loss carry forward legislation of the jurisdiction involved. Loan financing may be advantageous by way of obtaining taxable interest payments to the parent corporation which are in fact not effectively taxed while at the same time the subsidiary is allowed interest deduction when calculating the taxable income. Such strategies are known as ″loss utilization strategies.

Domestic corporations and shareholders resident in countries where the shareholder/corporation taxation is integrated do not have an incentive to finance by way of loan capital. In order to assess such an incentive factors in the source state and the state of residence should be observed[71]:

- Corporate tax
- Withholding tax on dividends
- Deductibility of interest?

In the state of residence of the shareholder it is relevant to observe several factors. Dividends are often tax free in the hands of a parent corporation or a credit is allowed for the paid foreign tax. The following factors should be observed in this regard:

- Whether exemption is provided through ”international affiliation privilege” or ”participation exemption” or if the principle of territoriality is applied,
- Whether credit relief is granted directly or indirectly regarding withholding tax and corporate tax.

It is not possible in this context to carry out an extensive analysis including all of the above factors. Accordingly, our analysis will be of a more general nature from the perspective of Danish tax law.

3.2. Assessment of the Danish corporate tax regime in light of the tax neutrality standard

Based on a more comprehensive neutrality standard encompassing the tax treatment of shareholders as well as the corporations’ tax neutrality is generally present in a number of situations under the present Danish corporate tax regime.

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[70] See Piltz in Cahiers, 1996, p. 97, based on calculations.
[71] See e.g. in a domestic context Bundgaard, *Tynd kapitalisering*, 2000, p. 48 analyzing incentives for debt financing in general and with specific regard to Danish tax law.

In recent years the aim of the legislator has been active in neutralizing the playing field even further by way of reducing the debt financing bias in situations where the creditor is not taxable in Denmark on interest income or not taxable at all. Generally there has been a political concern regarding interest deductions in leveraged buy-out financing[72].

At the level of the issuing corporation interest and capital losses regarding debt are tax deductible as a main rule. Dividends are however not deductible. This is regardless of the residence of the investor.

Tax neutrality is therefore obtained in Danish tax law in situations where the investor is a Danish resident and a parent corporation which can receive tax exempt dividends according to Sec. 13, par. 2 of the CTA, since interest and capital gains is always taxable income It should however be noted that the limitation rules can create a tax asymmetry by limiting the deductibility of the financial expenses. If dividends paid to the resident investor are taxable, Danish tax law favors debt financing. This bias is reduced by the interest deduction limitations rules.

If the investor is a non-resident interest and capital gains on claims are tax exempt in Denmark (i.e. not withholding tax) as a main rule, but the interest and capital losses on debt of the issuing corporation are still deductible. Dividends are only tax exempt if the investor meets the requirements of Sec. 2 (c) of the CTA and are not deductible for the issuing corporation. Tax neutrality is therefore not present, but the limitations rules reduces this asymmetry by limiting the deductibility of interest and capital losses on debt of the issuing cooperation, but only in some limited situations[73]. The interest limitation rules can be seen as a step in the right direction to obtain tax neutrality.

In situations with a nonresident controlling investor, tax neutrality can be a complicated issue. Dividends and capital gains on shares are tax exempt in

[72] See e.g. Bundgaard, *Private Equity Funds & Leveraged Buyouts – Danish attack on transparent entities and other controlling entities*, Journal of Derivatives & Financial Instruments, 2006/5, p. 223 et seq.
[73] See supra.

Denmark as a main rule. The issuing corporation can still deduct interest and capital losses on debt, but the limitation rules still applies including the thin capitalization test.

Tax neutrality is not always present in Danish tax law, but a general tax neutrality has moved closer after the introducing of the asset test and the EBIT test. In some cases debt is favored over equity. This does however not imply between a controlling investor and a corporation, where equity is sometimes favored over debt or complete tax neutrality is obtained.

4. Compatibility of the present corporate financing tax regime with EU law

There is no obvious reason generally to question the compatibility of the Danish tax regime regarding corporate financing. However, certain aspects of the overall regime have been questioned.

After the Lankhorst-Hohorst decision[74] of the ECJ, the Danish thin cap regime was amended fundamentally. Irrespective of this the thin capitalization rules in Sec. 11 in the Corporation Tax Act have been criticized for still being in breach of EC law. Of particular interest is the rule according to which a Danish creditor is exempted from being taxed on interest income if the debtor cannot deduct the interest expense according to the thin capitalization rules. Firstly, it can be questioned whether the expansion of the application of the rules to purely domestic situations is necessary at all; cf. the European Court of Justice's decision in *Thin Cap Group Litigation*[75]. Secondly, it can be questioned whether a situation in which a adjustment is made in Denmark – as a consequence of the thin capitalization rules – is in breach of EC law when the interest income is taxed in another Member State at the same time, given that a creditor in a purely Danish group would be

[74] ECJ 12 December 2002, C-324/00, *Lankhorst-Hohorst*.
[75] ECJ 13 March 2007, C-524/04, *Test Claimants in the Thin Cap Group Litigation*.

tax exempt[76]. However, in light of recent ECJ case law, it seems appropriate to conclude that the removal of double taxation that originates from different tax treatment in other Member States should be considered a consequence of the lack of harmonization and accordingly not viewed as discrimination.

Also, the rules on limitations of interest deductions in Sec. 11 B of the CTA have been criticized for violating EC law. Particular elements of the asset test seem to pose problems given the fact that only 17.5% of the purchase price for shareholdings in foreign group corporations can be included in the tax base of the assets qualifying for interest deduction – unless the group has elected to be subject to voluntary Danish international tax consolidation[77] – whereas the value of the assets in Danish group corporations automatically are included[78]. This issue has been even more accentuated as a consequence of the 2009 tax reform which phases out the 17.5% inclusion until 2017[79]. Further, it could be considered a problem that assets contributed from foreign group corporations should only be included in the qualifying assets if the assets remain with the corporation for at least two years, whereas assets contributed from Danish group corporations should always be included.

5. Conclusion

In this article we have analyzed the present Danish corporate finance tax regime to conclude whether the existing corporate tax system can be considered to be in accordance with an overall policy goal of tax neutrality.

[76] See Vinther and Werlauff in Danish Journal of International Taxation (2003), no. 354 and in Journal of Danish Taxation (2004), no. 242. The debate arose as a result of the argumentation put forward by the European Commission during *Lankhorst-Hohorst* (Case C-324/00).

[77] If a Danish corporation opts for voluntary Danish international tax consolidation, all foreign group companies as well as all permanent establishments and real estate in foreign jurisdictions must be included in the consolidation (referred to as the "global pool principle"). This even applies to foreign parent and sister companies.

[78] See Friis Hansen and Rune Stokholm in Cahiers, Volume 93b, pp. 267-275 and Rønfeldt in *Skattepolitisk Oversigt* (2008), no. 65. Before the adoption of Bill no. L 202 on 28 May 2009 20 per cent of the purchase price of shares in foreign companies could be included.

[79] See to this effect Rønfeldt in *Skat Udland* 2009, 338.

Interest and capital losses regarding debt are tax deductible as a main rule regardless of the residence of the corporate investor. Interest and capital gains on claims paid to a domestic corporate investor is taxable income. Dividends are however non-deductible even if the investor cannot receive tax dividends. Domestic tax neutrality is obtained if the corporate investor is a parent corporation which can receive tax exempt dividends according to Sec. 13, par. 2 of the CTA. The interest deduction limitation rules reduce the tax asymmetry and the debt bias.

Interest and capital gains regarding claims paid to a foreign corporate investor and a capital gain regarding claims are tax exempt. Dividends are only tax exempt if the investor meets the exception criteria in Sec. 2 (c) of the CTA. Tax neutrality is therefore not present, even though the interest deduction limitation rules reduces this asymmetry by limiting the deductibility of interest and capital losses on debt of the issuing cooperation. The Danish legislator is aware of the situation and introduced the asset and test and EBIT test and withholding tax on interest and capital gains on claims as a response to this. Basically, the interest withholding tax secures overall neutrality by focusing on the foreign taxation of the interest or capital gains recipient.

In conclusion tax neutrality is secured in a number of situations irrespective of the general tax bias towards debt financing. The introduction of the asset test and the EBIT test has assisted in fulfilling the goal. There is however, still room for a more fundamental tax reform regarding the tax treatment of corporate financing decisions.

Such reform considerations should also address EU law compatibility issues. The existing regime has been criticized. Namely the asset test has been criticized for not including the full value of foreign shareholdings as the underlying value of Danish shareholdings are included in the asset test. It could also be considered an issue that assets contributed from foreign group corporations only are included in the qualifying assets if the assets remain with the corporation for at least two years, whereas assets contributed from Danish group corporations will always be included.