



Proposed Changes to Danish Tax Laws

Neil Smith
February 2007

On January 26 the Danish government announced a wide ranging proposal regarding changes to the system of corporate taxation.

The government said that it has worked on the package as a response to the decision of the European Court of Justice (ECJ) in *Cadbury Schweppes* in relation to CFC rules, and following a number of high profile instances of private equity funds purchasing large Danish companies via debt, thus reducing or totally eliminating the tax paid in Denmark. This has generally been done by incorporating a specific Danish investment vehicle and gearing this heavily with debt to pay for the purchase of the company. As Danish tax law provides for mandatory national consolidation, the interest on the debt in the investment vehicle is used to reduce the tax paid with regard to the profitable subsidiary.

The bill is going into a hearing stage where interested parties give their thoughts on the effect of it. There have been some comments by prominent business leaders and it is therefore possible that the bill will be modified before being passed by Parliament.

The main aspects of the proposal are:-

A. A reduction in the rate of Corporation Tax

There will be a reduction in the rate of corporation tax from 28 percent to 22 percent. This will give Denmark one of the lowest rates of corporation tax in Western Europe.

B. Adjustments to Deductibility of Financing Costs

Where net financing costs are over DKK 10 million (approximately EUR 1.35 million) the Danish company will only get a deduction equivalent to 55 percent of the financing costs. Net financing costs are the difference between financing income and financing expenses. To clarify, a company with net financing costs of DKK 20 million will get the full deduction for the first DKK 10 million, but will get only 55 percent of the final DKK 10 million. Thus, it will get a total deduction of around DKK 15.55 million.

At the same time, there will be no deduction for net financing costs above a set percentage (calculated at 2.5 percent over the average bond rate on the Copenhagen Stock Exchange during a period in December the preceding year) of the relevant company's operating assets. The rate will be 6.5 percent in the first year. In short, the definition of operating assets is fixed assets less depreciation. Not to be included are financial contracts, cash, shares etc. which are covered by The Capital Gains Tax and The Gains on Securities and Foreign Currency Act. Thus, a company with DKK 100 million worth of operating assets could get a

maximum deduction of around DKK 6.5 million (notwithstanding that this amount is under the DKK10 million detailed in the previous paragraph).

For companies using the joint taxation rules the values will be assessed at the level of joint taxation rather than for each company.

C. CFC Rules

The previous Danish controlled foreign corporation (CFC) rules will now apply to both Danish and foreign subsidiaries. In practice this will make no difference as Danish subsidiaries will be governed by the same tax rules as the parent company and will thus never be classified as "low-taxed". It does, though, give the government an argument that they treat Danish and foreign subsidiaries equally and these rules are therefore compliant with the ECJ's judgement of Cadburys Schweppes.

Further, there will be some adjustments to the rules. To be a CFC in Denmark, a company must be classified as both "low-taxed" and "financial". Previously the test of being financial was if one-third of income of the subsidiary was financial: this is planned to increase to one half.

Also, in terms of the control the parent company must have, the previous rule regarding 25 percent of the share capital of the subsidiary is planned to be abolished, and instead the test will be whether the parent has control over the subsidiary's decisions. These changes can be viewed as positive from the international viewpoint in that they reduce the number of times where CFC will apply, whereas retaining the requirement that the subsidiary must be *both* "low taxed" and "financial".

D. Receipt of Dividends in a Danish Co

A new requirement in the participation exemption is planned that dividends received in a Danish company be from a company which is resident in the European Economic Area or a country which Denmark has a tax treaty with for the dividend to be exempt in Denmark. There is though provision for a deduction in Denmark for the tax paid at subsidiary level by use of the credit method. It is also planned that the special rate of 18.48 percent applied to dividends received which do not meet the participation exemption is abolished.

E. Rules Regarding Payments of Liquidation Dividends

These rules have been altered so that withholding tax can be applied if the receiving company owns at least 15 percent (2007 rate, which will be reduced to 10 percent from January 2009) of the Danish company being liquidated, and the receiving company is not resident in the European Economic Area or a country with a tax treaty with Denmark.

F. Specific Rules Regarding Takeovers

There were also rules introduced specifically relating to takeovers of large companies including the fact that agreements regarding bonus payments should not be made with board members around the time of the takeover; that a target company should not pay dividends in the 12 month period after the takeover unless it was provided for in the tender offer; and share option schemes for listed companies should be approved by the shareholders at a general meeting.

G. Alteration to Depreciation Rules

Ships (above 20 tons), aeroplanes and oil rigs can be depreciated up to a yearly maximum of 12 percent of the depreciable value (i.e. a form of reducing balance depreciation). Railways, transport, distribution, radio and telecommunications installations can be depreciated up to a yearly maximum of 5 percent of the depreciable value.

It is also planned to reduce the depreciation available for buildings from 5 percent yearly straight line to 4 percent yearly straight line.

H. Special Tax Rate for Patents

Income from patents is to be subject to a special rate of 12.1 percent with a matching limited deductibility of the related expenses. This option is voluntary as the company can still decide to use the existing rules with a 22 percent corporate tax rate.

I. Time Period

The law is planned to come in force on 1 April 2007. The rules regarding interest deduction will be effective from income year 2007 with the DKK 10 million threshold apportioned according to the length of time between 1 April and the year end. The lower tax rate will be effective from income year 2008.

The exact effect of the law will vary from company to company. The average holding company with substantial onshore investments will experience no real change as its income would generally be exempt. Most operating companies (particularly those with limited debt) are likely to gain as a result of the deduction in the corporation tax rate. The biggest losers will be private equity funds who have geared their investments planning on significant deductions.

Neil Smith, LLB (Hons), Dip LP works at Equinor A/S in Copenhagen advising on international tax matters and cross-border structuring. He can be contacted by email at: n.smith@equinor.eu