KPMG ACOR TAX

Tax Matters

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Implementation of EU's tax avoidance directives

New Danish draft bill proposes significant changes to a number of important rules, including the rules on CFC taxation and limitations to the deductibility of interest.

On 31 May 2018, the Danish Ministry of Taxation published a new draft bill on amendment of the Danish Corporation Tax Act, Merger Tax Act, Tax Assessment Act and Tax Control Act. In short, the purpose of the proposed changes is to implement EU's tax avoidance directives (Directive 2016/1164 of 12 July 2016 and Directive 2017/952 of 29 May 2017) into Danish law. In the following articles, the two directives will be referred to collectively as the ”Tax Avoidance Directive” or ”Directive”.

The Tax Avoidance Directive must be viewed in the context of the OECD BEPS initiatives, as the Directive is implemented to ensure that the EU States carry out a more or less uniform implementation of selected BEPS recommendations. The Directive is a minimum directive and contains minimum standards for the Member States in the following five areas:

- **rules on limitations to the deductibility of interest**
- **exit taxation rules**
- **general anti-abuse rules (general anti-abuse clause)**
- **controlled foreign company rules (CFC rules)**
- **rules to tackle hybrid mismatches.**

At present, the draft bill has been submitted to a number of different organisations etc., and the consultation period ends on 28 June 2018.

This means that an actual bill is yet to be introduced by the Minster of Taxation, and a future bill will undoubtedly also differ from the existing draft bill in a number of areas.

In practice, the change in the CFC rules will probably trigger the greatest challenges for companies etc. due to significant tightening of many areas, both with regard to exceptions and required inclusion of CFC income. For example, groups must from now on include a recognised royalty income from IP rights in the sales revenue etc. of foreign subsidiaries when determining the CFC income for the use of the CFC test, which creates an additional need for TP analyses of the group's value chain etc. Also in relation to limitations to the deductibility of interest, companies etc. will experience the changes in practice, as the current EBIT rule is to be replaced by an EBITDA rule that both differs with regard to accounting basis and the deductible rate for finance costs. Also, these changes are just around the corner as they are to be effective as of the income year beginning on 1 January 2019.

In the following articles, we have provided a short and overall account of the most relevant elements of the current draft bill. Naturally, we will follow up with a news update when the bill is introduced.

Peter Rose Bjare
Editor in chief
Tax Partner, Corporate Tax
+45 5374 7025
peter.bjare@kpmg.com

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Limitations to the deductibility of interest

What changes have been proposed?

The current EBIT rule in s. 11C of the Danish Corporation Tax Act is replaced by the EBITDA rule included in article 4 of the Tax Avoidance Directive. The current rules on limitation to deductibility of interest regarding thin capitalisation in s. 11 of SEB and the interest ceiling rule in s. 11 B of SEB, respectively, will not change.

It is proposed that the EBITDA rule generally follows the minimum standard established by the Directive – however, without any special exceptions for separate entities, existing loans or certain infrastructure project loans.

The EBITDA rule is designed to allow companies, funds and associations etc. subject to corporation tax to reduce taxable income due to exceeding borrowing costs only by a maximum amount corresponding to 30 pct. of the taxable income before borrowing costs and depreciation and amortisation (EBITDA). Jointly taxed companies must prepare a total statement.

As a maximum, the limitation may only reduce the deductible borrowing costs for the income year to DKK 22,313,400, corresponding to the Directive's amount limit of EUR 3m. The current tax threshold of DKK 21,300,000 regarding the interest ceiling rule remains applicable.

Reduced borrowing costs may be carried forward without any time limitation, and unused interest deductibility capacity may be carried forward for five years.

Instead of applying the 30 pct. percentage rate, companies included in a group may apply the EBITDA rate calculated by dividing the group's total exceeding borrowing costs to persons and companies etc. outside the group by the group's total EBITDA income.

For the calculation, the information from the consolidated financial statements should be applied.

A general exception for financial companies is introduced.

When will the rules take effect?

The new EBITDA rule is take effect as of the income year beginning on 1 January 2019 or later.

What is KPMG Acor Tax' immediate assessment of the impact of the proposed changes?

The change from an EBIT to an EBITDA statement is a significant change, both in relation to accounting basis and the rate reduced from 80 pct. to 30 pct., and this combined could result in either a facilitation or a tightening, depending on capital structure as well as the volume of the depreciable assets. However, to many entities with high financing costs, the interest ceiling rule is still the real burden that they must learn to live with.

The draft bill furthermore includes a number of matters of dispute that need to be clarified during the consultation process. For example, it is unclear whether an existing EBIT balance will be lost at 1 January 2019.

Contact

Peter Rose Bjare
Tax Partner
Corporate Tax
+45 5374 7025
peter.bjare@kpmg.com

Peter Østergaard
Senior Tax Manager
Corporate Tax
+45 5374 7026
peter.oestergaard@kpmg.com

Exit taxation

What changes have been proposed?
Article 5 of the Tax Avoidance Directive includes a rule on taxation of companies on intercompany transfers of assets when the assets are moved out of the relevant country, even if the gain on the assets is not realised at that time. The rule is to ensure that the taxing right accrues to the country in which the value added is created.

In the Ministry of Taxation's opinion, the current Danish exit taxation rules largely correspond to the rules laid down in the Directive, so they only require minor adjustments.

It is proposed that the extension of tax payment is changed to not cover cases where assets and liabilities are transferred to Liechtenstein, if there is no agreement on mutual assistance with collecting tax claims. It is furthermore proposed that companies with permanent establishment in Denmark should be able to obtain extension of exit taxation payment, if their assets and liabilities are transferred to another permanent establishment in the EU, Norway or Iceland.

Next, it is proposed that the extension amount related to the companies' exit taxation should be repaid over the first five income years following the transfer by 1/5 of the calculated extension amount per income year. It is proposed that the current provision requiring payment concurrently with receiving income from the transferred assets and liabilities should no longer apply.

Finally, it is proposed that on the relocation of a company to Denmark entry values should be determined using the fair value of intangible assets and depreciable assets not already subject to Danish taxation, if the relocation of the fiscal domicile has triggered foreign taxation of profits and losses. Furthermore, it is proposed that the same should apply when assets and liabilities become subject to Danish taxation due to a tax-exempt restructuring (merger, demerger or addition of assets).

When will the rules effect?
It is proposed that the adjustments of the exit taxation should have effect for assets and liabilities transferred at 1 January 2020 or later.

What is KPMG Acor Tax' immediate assessment of the impact of the proposed changes?
As the Ministry of Taxation also points out, the current Danish rules do not differ tremendously from those laid down in the Directive, so we do not expect to see any major challenges in relation to the proposed adjustments of the exit taxation. However, it is evident that new rules always require an adaption period and also that there may be minor innovative features that groups etc. may be required to relate to.

Contact

Susanne Dybdahl
Tax Partner
Corporate Tax
+45 5374 7059
susanne.dybdahl@kpmg.com

Birgitte Tandrup
Tax Director
Corporate Tax
+45 5374 7053
birgitte.tandrup@kpmg.com

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General anti-abuse clause

What changes have been proposed?

Article 6 of the Tax Avoidance Directive includes a general anti-abuse clause inserted to close any gaps in the corporation tax law. The rule will be applicable to arrangements not considered real.

Generally, the wording of the anti-abuse clause in the Tax Avoidance Directive corresponds to the anti-abuse clause laid down in the Parent/Subsidiary Directive and as implemented into Danish law by s. 3 of the Tax Assessment Act. The scope of the clause included in the Tax Avoidance Directive is far more comprehensive than the corresponding clause in the Parent/Subsidiary Directive, however, so it is proposed that the current rule in s. 3 of the Tax Assessment Act be replaced by a new – and broader – rule to prevent abuse of the corporation tax law in its entirety.

It is proposed that the anti-abuse clause should apply to companies covered by s. 1 and s. 2 of the Corporation Tax Act and funds and associations etc. covered by s. 1 of the Act on Taxable Nonstock Corporations. Thus, the clause will apply to both Danish companies, funds and associations etc. that are fully tax liable to Denmark and foreign companies, funds and associations etc. that are limited tax liable to Denmark (for example, due to a permanent establishment in Denmark or dividend, interest or royalty payments from Denmark). The clause will also apply to foreign companies that are part of an international joint taxation in Denmark or covered by the CFC rules. Please observe that the proposed clause does not cover cross-border matters. In principle, strictly Danish transactions will therefore also be covered.

With regard to income statements prepared under the Hydrocarbon Tax Act, the general rule is to determine the income according to the corporation tax rules, subject to the amendments to the Hydrocarbon Tax Act. The proposed anti-abuse clause will generally apply to statements prepared under the corporation tax rules. It is also proposed, however, that the anti-abuse clause should apply to any changes made to the income statement as well due to the rules of the Hydrocarbon Tax Act.

It is proposed that the wording of the provision should correspond to the wording of the Directive to the extent possible – and thereby also to the current provision in s. 3(1) and (2) of the Tax Assessment Act.

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In the determination of their taxable income and tax liability, taxable companies should therefore disregard arrangements or series of arrangements that are not real, taking into consideration all relevant facts and circumstances. An arrangement may include several steps or parts.

Arrangements should not be regarded as real if organised with the primary purpose, or with one of the primary purposes, of achieving a tax benefit that is contrary to the purpose and the intention of the tax law. Arrangements or series of arrangements are only considered non-real, however, if not organised out of well-founded commercial reasons reflecting the financial reality.

The draft bill proposes that the changed anti-abuse clause should similarly apply to other taxable participants in an arrangement or a series of arrangements, i.e. participants who are not taxable companies etc. This would be the case, whether the participants are natural persons covered by s.1 of the Withholding Tax Act or estates of a deceased person covered by s. 1(2) of the Taxation of Estates of Deceased Persons Act. Consequently, if for example an arrangement is disregarded where an amount that was due to the shareholders in a company should not be treated as a tax-exempt profit from disposal but should be considered dividend for tax purposes, this would mean that the received amount would have to be treated as dividend with respect to all the shareholders – whether or not the individual shareholder is a company or a natural person.

When will the rules take effect?

It is proposed that the updated anti-abuse clause should be effective as of 1 January 2019. Certain transactions made prior to this date might be covered by this clause, however, if the right to a payment related to this is considered acquired after 1 January 2019.

What is KPMG Acor Tax' immediate assessment of the impact of the proposed changes?

There is no doubt that the updated anti-abuse clause will have great impact on many companies etc. in the future. So far, only the tax directives listed in s. 3 of the Tax Assessment Act as well as the double taxation agreements have been covered by the anti-abuse clause.

In theory, the proposed adjustment would mean that all transactions made by companies and funds etc., including purely Danish companies, could be set aside under the changed provision in s. 3 of the Tax Assessment Act. And in addition to this, several different taxable participants in an arrangement could also be affected.

Therefore, it is a fact that after the first attempt with the current s. 3 of the Tax Assessment Act we are now facing the completely general anti-abuse clause in the corporation tax area etc. that was previously subject to much opposition from many circles because of the due process issues such clause may involve. And naturally, our concern is whether SKAT will apply a very restrictive practice in their interpretation of this, making it harder for the affected companies etc. to focus on their business activities. In all fairness, though, it should be mentioned in this connection that the introduction of s. 3 of the Tax Assessment Act back in 2015 did not result in the much feared increase in anti-abuse cases, so our hope is that something similar will apply to the proposed extension of the provision.

Contact

Ria Falk
Tax Partner
Corporate Tax
+45 5077 0900
ria.falk@kpmg.com

Jesper Buus
Senior Tax Manager
Corporate Tax
+45 5374 7041
jesper.buus@kpmg.com

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CFC taxation

What changes have been proposed?

Articles 7 and 8 of the Tax Avoidance Directive lay down the CFC rules, encouraging compliance with these to a great extent; yet, the Danish draft bill still differs from the Directive in essential areas.

Firstly, the draft bill proposes that parent companies should include their subsidiary's positive income determined according to Danish rules when the CFC income of the subsidiary is more than 1/3 of the total incomes of that subsidiary. Today, the limit is defined as "more than 50 pct.". The Directive, on the other hand, does not define a limit in terms of percentage, and CFC taxation covers all defined financial incomes not distributed.

Secondly, the draft bill proposes removal of the current option in the CFC test that allows the preparation of a consolidated statement of parent companies and their subsidiaries within the same country – along with the current exception for subsidiaries whose financial assets constitute 10 pct. or less of the company's total assets.

In addition, an extension of the CFC income definition is proposed in two areas:

Firstly, the CFC income definition is extended to also cover income from intangible assets (note that goodwill is not defined as an intangible asset under the CFC rules) realised on disposal of goods and/or services, i.e. where the selling price also includes a return on the intangible assets. At the same time, the current exception for royalties received from companies outside the group regarding intangible assets generated by the subsidiary itself is also removed.

Secondly, the CFC income definition is extended to also cover income from invoicing companies that receive income from sales and services relating to goods and services purchased and sold by related persons and that contributes with no or low financial value.

By related persons is meant an independent taxpayer where the parent has direct or indirect control through voting rights or capital ownership of 25 pct. or more, or where the parent has a right to receive 25 pct. or more of the profit in the independent taxpayer. By related persons is furthermore meant a natural person or an independent taxpayer with direct or indirect control through voting rights or capital ownership of 25 pct. or more or with the right to receive 25 pct. or more of the profit in the parent.

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If a natural person or an independent taxpayer directly or indirectly controls 25 pct. or more of the parent or one or more independent taxpayers, all affected entities, including the parent, are considered related persons.

It is proposed that on certain conditions companies etc. may determine a new acquisition price (market value) of their subsidiaries' intangible assets when applying the CFC rules. Intangible assets included under Danish taxation due to the extended definition of CFC income laid down in the Directive (other income from intangible assets) will then have a basis of depreciation determined at the fair value at the time when the proposed rules take effect.

When will the rules take effect?

It is proposed that the adjustments of the CFC rules take effect for income years beginning on 1 January 2019 or later.

What is KPMG Acor Tax' immediate assessment of the impact of the proposed changes?

In our opinion, the proposed changes are quite comprehensive, and there is hardly any doubt that they will impact a number of Danish groups etc.

The mere circumstance that a lower limit is set for when to include the income of a subsidiary in the determination of the CFC income will probably increase the number of groups covered by the CFC rules considerably. And on top of this, you also have e.g. the above-mentioned extension of the CFC income definition, the removal of the option to consolidate within the same country as well as the removal of the 10 pct. limit for subsidiaries with less than 10 pct. financial assets. The Directive does not apply to subsidiaries carrying on significant financial activities that are supported by personnel, equipment, assets and premises in line with the EU judgment in Cadbury Schweppes (C-196/04), but this exception is not included in the Danish draft bill.

In the future, groups must furthermore include a recognised royalty income from IP rights in the sales revenue etc. of foreign subsidiaries when determining the CFC income for the use of the CFC test. This may create an additional need for TP analyses of the group's value chain etc.

Overall, we believe that the proposed rules will have extensive consequences for a number of Danish groups etc.

Contact

Ole Schmidt
Tax Partner
Corporate Tax
+45 5374 7011
ole.schmidt@kpmg.com

Thomas Iversen
Tax Director
Corporate Tax
+45 5374 7075
thomas.iversen@kpmg.com

Hybrid mismatches

What changes have been proposed?

Fundamentally, the way to tackle hybrid mismatches is changing, and the draft bill now proposes to remove the current Danish rules on so-called hybrid mismatches that generally do not resemble the corresponding rules laid down in article 9, 9a and 9b of the Tax Avoidance Directive. The relevant rules are s. 2A and s. 2B of the Corporation Tax Act on hybrid mismatches and hybrid instruments, respectively, both of which are proposed removed and instead replaced by the rules laid down in the Directive.

On the other hand, the current provision in s. 2C of the Corporation Tax Act on so-called reverse hybrid mismatches is only subject to few changes, as it is considered to correspond to the similar provision in the Directive to a great extent. The current exception for venture funds is removed, however, whereas an exception for certain collective investment institutes (CIVs) is introduced.

Because the Directive's provisions on hybrid mismatches are largely implemented in accordance with their wording, a number of definitions will be inserted in s. 8C of the Corporation Tax Act to apply when making future assessments of hybrid mismatches and the tax consequences of applying these. In that connection, it is also stated that it is a hybrid mismatch, only if it occurs 1) between related persons; 2) between a taxpayer and a related person; 3) between an entity and a permanent establishment; 4) between two or more permanent establishments of the same entity; or 5) in connection with a structured arrangement.

The concept "a related person" is specified in s. 8C of the Corporation Tax Act, but corresponds to the Directive's definition of associated enterprises. This will ensure that the rules apply only when a related natural person or an associated enterprise does in fact control the other related person.

According to the draft bill, a related person should have an interest in that other person through voting rights, capital ownership or right to receive dividends of 50 pct. or more (the owner limit is reduced to 25 pct. in relation to financial instruments, however). The determination of the ownership and voting rights should include ownership and rights held by persons acting together with the related person.

In connection with the definitions etc. in s. 8 C of the Corporation Tax Act, rules on the tax consequences in case of hybrid mismatches are inserted in ss. 8D-8E of the Corporation Tax Act. These rules imply, for example, that the Danish qualification generally no longer needs to adjust to the foreign. They also imply that companies etc. will generally not be allowed deduction to the extent that hybrid mismatch results in double deduction. Deduction may be allowed, however, if the payer's jurisdiction is Denmark and deduction is denied in the investor's jurisdiction. Moreover, income included twice may also be deducted.

Another example from the draft bill includes the circumstance that companies etc. are generally not allowed deduction of payments to the extent that a hybrid mismatch results in deduction without so-called inclusion. The concept "inclusion" is another example of wording taken directly from the Directive, and a definition of the concept is therefore also provided in s. 8C of the Corporation Tax Act.

When will the rules take effect if adopted?
It is proposed that the rules take effect as from 1 January 2020.

What is KPMG Acor Tax' immediate assessment of the impact of the proposed changes?
Compared to the existing Danish anti-avoidance rules on taxation of hybrid entities and instruments, the proposed rules are quite an innovation that will probably require some adjustment for most of the Danish groups etc., as the proposed rules differ considerably from the existing ones.

So we are dealing with several completely new concepts and several new ways of tackling the taxation of hybrid mismatches, and both circumstances will undoubtedly result in much uncertainty as to the scope of the rules during a transition period.

Also, there is obviously some risk that group structures not previously covered by the existing Danish rules will be covered by the new rules. We therefore recommend that such matters are addressed as soon as possible to prevent any inappropriate tax surprises.

Contact

Martin Reng
Tax Partner
Corporate Tax
+45 5374 7023
martin.reng@kpmg.com

Morten Bang Mikkelsen
Tax Director
Corporate Tax
+45 5077 0968
morten.mikkelsen@kpmg.com