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DENMARK — Acquisition Financing

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I. Limitations on Deductibility of Interest and Other Financing Expenses Incurred by Danish Acquisition Vehicle With Respect to Shareholder Loans From Foreign Country Investor and Funds Borrowed From Third-Party Banks

A. General Notes

1. Deductibility in General

Interest and other financial expenses are generally deductible against ordinary corporate income. There are, however, a number of rules that place limitations on the deduction of interest and net financing expenses.

In addition, Danish case law has established that other expenses relating to acquisition financing (namely advisor fees relating to, for example, the negotiation and drafting of terms, general advice on finance structuring and due diligence) are only deductible if they are closely linked to the actual loan transaction.

2. Definitions of Debt and Interest

Since there is no statutory definition of debt in Danish tax law, the definition that applies for tax purposes is the ordinary (non-tax) definition of debt by reference to the obligation of a borrower (debtor) to repay a monetary amount to a lender (creditor). Interest is defined in relatively narrow terms as an amount charged by a lender for the use or retention of money, expressed as a percentage per annum of the principle amount borrowed over a certain period. Interest payments with respect to a debt instrument may thus be recharacterized as gain/loss on the debt without the debt itself being recharacterized.

The Danish tax authorities are generally not able to recharacterize debt as equity if the parties to the arrangement concerned have agreed that the arrangement is a loan. However, the tax authorities may apply the substance-over-form doctrine/abuse of law rule when assessing whether an instrument should be regarded as debt. Further, anti-avoidance rules are in place to counter hybrid mismatches if the lender is a related party of the borrower.

3. Mandatory Danish Tax Consolidation

The mandatory tax consolidation regime requires all Danish resident companies and Danish branches of foreign companies that are members of the same Danish or international group to file a joint group tax return. The definition of a group generally corresponds with the definition of a group for accounting purposes, i.e., in general terms, a group exists where one legal entity controls another legal entity or there

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is a commonality of control between legal entities, control being exercised by voting majority or by other means.

The tax consolidated income is equal to the sum of the taxable income of each individual Danish company and each Danish branch of a foreign company that is a member of the consolidated group.

The Danish acquisition vehicle (Danish Acq) and Danish Target will thus be tax consolidated, which will entail the setting off of tax losses of Danish Acq (arising as a result of the financing costs incurred) against taxable profits of Danish Target (and any other companies that may be members of the Danish tax group).

B. Limits on Deductibility of Interest and Net Financing Expenses

1. Limits on Interest Deductions Based on the Ratio of Debt to Equity (Thin Capitalization)

Denmark has thin capitalization rules but has not implemented the OECD's worldwide ratio.

The Danish thin capitalization rules apply to a legal entity that is tax resident in Denmark and a nonresident legal entity that is subject to limited Danish tax liability because it has a permanent establishment (PE) in Denmark. For the sake of convenience, in the discussion below, each type of entity is referred to as a "Danish Debtor."

The thin capitalization restrictions apply to a Danish Debtor if the following four criteria are satisfied:

- The Danish Debtor owes a debt to a group-related legal entity ("controlled debt");
- The amount of the controlled debt exceeds DKK 10 million;
- The Danish Debtor's debt-to-equity ratio exceeds 4:1 at the end of the tax year; and
- The Danish Debtor cannot prove that a "matching debt" would be available from an unrelated party.

These four criteria are described in further detail in I.B.1.b., below.

If the thin capitalization restrictions apply, the Danish Debtor may not deduct interest expenses and capital losses relating to the controlled debt exceeding the 4:1 ratio. Irrespective of this restriction, capital losses incurred on controlled debt can be carried forward indefinitely and set off against capital gains on the same debt realized in future tax years. The deductibility of interest expenses and capital losses on (unsecured) debts owed to third parties is not affected by the application of the thin capitalization rules. Even where the 4:1 debt-to-equity ratio is exceeded, the thin capitalization restrictions do not apply to interest payments that are subject to Danish withholding tax.

If the deductibility of a Danish Debtor's financial expenses is limited as a result of the application of the thin capitalization regime, the Danish Debtor's controlled debt owed to third parties (see further at I.B.1.b., below for how controlled debt can be owed to third parties) is considered precluded first, followed by its controlled debt owed to group-related entities. Also, the Danish Debtor's controlled debt owed to Danish entities is considered precluded first, followed by its controlled debt owed to foreign entities.

The non-deductible interest expenses are not recharacterized as a distribution of profits for either domestic law or tax treaty purposes. Accordingly, dividend withholding tax is not imposed on the non-deductible interest under either Danish domestic law or an applicable treaty.

a. Example of Thin Capitalization Calculation

The application of the thin capitalization rules may be illustrated by the following example:

- A Danish Debtor has equity of DKK 1 million and debt of DKK 20 million owed to a foreign group-related company (i.e., it is controlled debt). Assuming the Danish Debtor is not a part of a group with other Danish entities and thus subject to tax consolidation, the debt-to-equity ratio of the Danish Debtor is 20:1. In the tax year in question, the Danish Debtor pays DKK 1.5 million interest on the controlled debt to the foreign group-related company.
- DKK 3.2 million of the DKK 20 million debt would have to be converted into equity in order to meet the 4:1 debt-to-equity ratio requirement (i.e., 16.8:4.2).
- Accordingly, the application of the thin capitalization rules precludes the Danish Debtor from deducting the expenses relating to DKK 3.2 million of the DKK 20 million controlled debt, i.e., DKK 0.24 million of the DKK 1.5 million interest expenses. Interest expense of DKK 1.26 million remains deductible for the Danish Debtor.

b. The Four Criteria

The four criteria that must be satisfied for the thin capitalization restrictions to apply to a Danish Debtor are as follows:

Criterion 1 – controlled debt: The term "controlled debt" means debt owed by a Danish Debtor to a Danish or foreign legal entity that: (1) is controlled by the Danish Debtor; (2) controls the Danish Debtor; or (3) is under common control with the Danish Debtor. "Control" for these purposes generally means direct or indirect ownership or control of more than 50% of the shares or voting rights in the controlled entity.

Further, "controlled debt" includes debt owed to a third party if a related legal entity has, directly or indirectly, provided security for the debt. Indirect security includes back-to-back arrangements under which an affiliated company agrees to provide security to a third party that has provided a loan to the Danish Debtor. Indirect security will also be regarded as having been provided if the related legal entity deposits an amount with a bank corresponding to a loan provided by the bank to the Danish Debtor. Letters of intent and similar instruments issued to a third-party lender providing financial security will also result in a loan being considered controlled debt. The crucial question is whether there is a connection between the loan provided to the Danish Debtor and the security provided by a related legal entity.

Where the Danish Debtor is a PE of a foreign company, debt owed by the PE to a third party is considered "controlled debt" if the main office of the foreign

company is (also) liable to pay the debt. Accordingly, most debt owed by a Danish PE of a foreign company is considered "controlled debt."

Criterion 2 – debt threshold: For purposes of determining whether the debt threshold has been exceeded (as well as for purposes of determining the debt-to-equity ratio — see below), the definition of "debt" includes the items identified in the Law on Taxation of Gains and Losses on Debt Claims (in essence, all monetary claims) and convertible bonds.

The debt is assessed at market value at the end of the Danish Debtor's tax year and is calculated as the aggregate sum of the controlled debt and all other debts.

Debt denominated in foreign currency is converted into Danish kroner at the exchange rate applicable at the end of the Danish Debtor's tax year. However, it should be noted that both Danish companies and Danish PEs of foreign companies may choose to use a functional currency (other than Danish "kroner") for Danish income tax purposes.

Criterion 3 – debt-to-equity ratio: For purposes of establishing the debt-to-equity ratio, "equity" means assets less debt. Assets are assessed at their market value at the end of the Danish Debtor's tax year. Equity contributed by foreign shareholders is only included to the extent it remains in the Danish Debtor for at least two years. This rule prevents the owners of a Danish Debtor from making a contribution to the Danish Debtor at the end of a tax year and then withdrawing the contribution at the beginning of the following tax year with the sole purpose of meeting the debt-to-equity ratio requirement for a short period of time.

In the case of a PE of a nonresident company, only assets and liabilities that are related to the PE are taken into account for purposes of computing the debt and equity of the PE.

The debt-to-equity ratio is calculated on a consolidated basis for the Danish Debtor and other controlled Danish entities that can be considered part of the same group.

Criterion 4 – no matching debt available: Even if the Danish Debtor has controlled debt in excess of the 4:1 ratio, the limitation on interest deductions will not apply if such debt would be available from unrelated parties under arm's length conditions ("matching debt"). The burden of proof in this respect lies with the Danish Debtor: the Danish Debtor must demonstrate that, without the credit support of a party related to the Danish Debtor, an unrelated party would be willing to grant debt on similar terms to the Danish Debtor, taking into account the commercial and economic situation of the Danish Debtor. This assessment is made on a case-by-case basis.

2. Limits on Deductibility of Net Financial Expenses Regime (Asset and EBIT Limitation Rules)

As noted above, interest expenses are generally deductible for Danish corporate income tax purposes. However, deductibility may be restricted under the asset and EBIT limitation rules (the "Asset Limitation Rule" and the "EBIT Limitation Rule" of the limitation on financial expenses regime).

Unlike the thin capitalization rules, the Asset Limitation Rule and the EBIT Limitation Rule apply not only to controlled debt but also to debt owed to unrelated parties. As under the thin capitalization rules, non-deductible financing expenses are not reclassified as dividends under the Asset Limitation Rule and the EBIT Limitation Rule.

The Asset Limitation Rule and EBIT Limitation Rule apply to a resident company's net financing expenses, not only the company's isolated interest expenses.

Net financing expenses include:

- Interest income and expenses (excluding interest income and expenses deriving from trade creditors and debtors).
- Net loan commissions and similar expenses/income (excluding commissions relating to trade accounts payable/receivable).
- Taxable capital gains and losses on receivables, debts and financial instruments, except the following:
  (1) Gains and losses on trade accounts payable/receivable;
  (2) A lender's gains and losses on loans, if the lender is a trader in receivables or carries on financing activities as part of its business (and the counterparty is not a group member);
  (3) Gains and losses on bonds issued for purposes of the financing activities referred to above in (2) and gains and losses on financial instruments relating to such activities;
  (4) Gains and losses on futures (and similar instruments) entered into to hedge risks with respect to operating income and operating expenses of the company or other companies in the same tax consolidation group (however, if the company is a trader in receivables or financial contracts or carries on financing activities as part of its business and the counterparty is a group member, this exclusion does not apply); and
  (5) Unrealized gains on interest swaps with respect to loans secured by real estate (however, such gains can be carried forward and offset by any prospective future losses incurred with respect to the same interest swap).
- Estimated finance costs (where the company is a lessee) or estimated finance income (where the company is a lessor) relating to finance leasing arrangements.
- Taxable capital gains and utilized losses on shares or other items taxed under the Capital Gains Tax Act, taxable dividends and taxable gains on sales to the issuing company. However, if the net amount is negative, it is not included in the calculation of the net financing expenses of the year in question. Instead the negative amount is carried forward. This does not apply with respect to equities purchased by a trader for trading purposes and taxed on a mark-to-market basis.

Notwithstanding the inclusions listed above, financial income and expenses are always excluded if derived from controlled foreign company (CFC) taxation or from the special recapture provision applied under the mandatory Danish tax consolidation scheme for corporate entities. In the case of companies that are

part of a Danish tax consolidation, the calculation of net financing expenses is made on a consolidated basis.

Net financing expenses of less than DKK 21.3 million (2018) will always be deductible under the Asset Limitation Rule and/or the EBIT Limitation Rule, but may be subject to limitation under the thin capitalization rules (it should be noted, however, that the thin capitalization rules only apply to controlled debt in excess of DKK 10 million). This threshold is adjusted annually and is calculated on a group basis.

a. Asset Limitation Rule

Net financing expenses (as defined in I.B.2., above) are not deductible if they exceed a cap computed by applying a standard rate of return (2.9 % for 2018) to the tax base of the company's qualifying assets ("Qualifying Assets"). If the company is subject to mandatory Danish tax consolidation, the computation is made on a consolidated basis. Notwithstanding this general limitation rule, the deductibility of finance expenses is not limited to the extent the net financing expenses comprise net capital losses on receivables that exceed positive interest income of the tax year.

If the net financing expenses are limited under the above limitation rule, net losses on debt and financial contracts are considered to be reduced before other expenses (for example, interest expenses).

Qualifying Assets include:

- The tax basis of depreciable assets;
- The acquisition price of non-depreciable assets together with the cost of improvements to the assets concerned;
- The value of any tax losses carried forward (losses carried forward at the end of the accounting period are included before taking into account any limitations under the Asset Limitation Rule and/or the EBIT Limitation Rule);
- The book value of leased assets where the company is the lessee under a finance leasing arrangement (however, in the case of assets subject to finance leasing between group companies, the tax basis value is used rather than the book value);
- The tax basis of assets contributed to a Danish tax consolidated group by a foreign group company if the assets remain in the Danish tax consolidated group for more than two years (however, if the group has elected for international tax consolidation, the two-year ownership requirement does not apply);
- The value of work-in-progress, assets acquired by a trader for trading purposes (with regard to shares, only shares taxed on a mark-to-market basis are included), inventory and receivables, if this value exceeds debt related to acquired work-in-progress, inventory and receivables;
- The net value of work-in-progress carried out at another party's expense; and
- The value (acquisition price) of financial contracts acquired to hedge risks with respect to trade receivables and trade payables.

The balance is made up on a consolidated basis by the administrative company of a tax consolidation group. The balance is reduced by various income items and assets (for example, by any dividend distributions and contributions from the group's foreign subsidiaries).

The following are excluded from Qualifying Assets:

- Shares in Danish companies (however, shares forming part of a financial trading activity may be included in the calculation if they are taxed on a mark-to-market basis);
- Receivables;
- Cash;
- Bonds and financial instruments (futures, swaps, etc.);
- Assets held and leased out by a lessor under a finance lease agreement;
- Assets contributed to a Danish tax consolidated group by a foreign group company if the assets remain in the Danish tax consolidated group for less than two years; and
- Assets subject to taxation under the Danish Tonnage Tax Act.

The value of the assets must be determined at the end of each tax year.

As a general rule, net financing expenses the deduction of which is restricted as a result of the application of the Asset Limitation Rule may not be carried forward. However, net capital losses relating to debts (including foreign exchange losses) and financial instruments reduced under the Asset Limitation Rule may be carried forward for three fiscal years and set off against gains on debts (including foreign exchange gains) and financial instruments. Irrespective of this, unrealized losses on interest swaps with respect to debt secured with collateral in real property can be carried forward during the term of the interest swap and set off against any future realized or unrealized gains on the same interest swap. Net capital losses on receivables that exceed positive interest income of the tax year can be carried forward indefinitely and set off against future gains on receivables and interest earnings in calculating the net financing expenses of future income years.

Where the company has capital losses relating to claims, debts, bonds, financial instruments and foreign currencies as well as interest expenses, the capital losses are reduced first, followed by the interest expenses.

When setting off carried forward losses against future gains, the oldest losses are set off first. When restricting the deductibility of net financial expenses, losses relating to net debts and financial instruments are reduced first. For companies that are part of a Danish tax consolidation, the calculation of the tax base of the assets is made on a consolidated basis. As noted above, Danish group companies are subject to a mandatory tax consolidation regime.

b. EBIT Limitation Rule

In addition to any limitations triggered by the thin capitalization rules and/or the Asset Limitation Rule, net financing expenses must comply with the EBIT Limitation Rule. Under the EBIT Limitation Rule, net financing expenses (as defined in I.B.2., above) may not exceed more than 80% of a resident company's earnings before interest and tax (EBIT).

Net financing expenses the deductibility of which is restricted under the EBIT Limitation Rule may be carried forward in accordance with specific rules. The net financing expenses of tax consolidated companies are reduced proportionally under the EBIT Limitation Rule.

C. Other Issues Affecting Deductibility of Interest Expenses or Their Value

1. Limitations on Hybrid Loan Instruments

Danish tax law contains a specific anti-avoidance provision (Section 2B of the Corporate Tax Act) targeted at structures using hybrid loan instruments. The objective of the provision is to eliminate the potential asymmetrical tax treatment of hybrid loan instruments. To achieve this objective, the provision employs the principle that a prerequisite for the deduction of interest in Denmark is that the corresponding income should be taxable in the hands of the interest recipient. An interest deduction is denied if the debt instrument concerned is treated as equity under the tax legislation of the creditor's country of residence. In the case of back-to-back loan arrangements, the provision applies if the country of residence of even one of the creditors in the chain treats the instrument as equity. In essence, the result of Section 2B is that different Danish tax treatment may be afforded to an inbound hybrid financial instrument depending on its tax treatment in a foreign country.

The requirements for the application of Section 2B of the Corporate Tax Act are as follows:

- The borrower must be either a Danish company fully liable to tax in Denmark or a foreign entity subject to limited tax liability in Denmark because it has a PE in Denmark or real property situated in Denmark (and the debt must be attributed to this "Danish tax entity").
- The Danish tax entity must be "indebted" to a creditor. The hybrid financial instrument concerned must thus be classified and treated as debt according to the general definition of debt applying for Danish tax purposes.
- The foreign creditor (whether an individual or a company) must have "decisive influence" over the Danish tax entity or be considered a group-related company of the Danish tax entity.
- The Danish debt instrument must be treated as equity under the tax legislation of the "creditor's" country of residence.

Where debt falls within the scope of Section 2B of the Corporate Tax Act, it is fully recharacterized as equity for tax purposes, with the consequence, for example, that related interest payments, foreign exchange losses and capital losses are considered to be non-deductible dividend payments or gifts.

2. Withholding Taxes on Interest

Under the general rule, a foreign related lender is subject to Danish withholding tax on interest income derived from a Danish corporate borrower. The withholding tax applies on a gross basis at a rate of 22%. Liability for interest withholding tax arises at the time of accrual (and not at the time of payment) and the tax due must be withheld and paid by the Danish borrowing company. The Danish borrowing company can be held liable for payment of the withholding tax due if the failure to withhold and pay the tax is considered an act of negligence.

There are two major exceptions to the general withholding taxation: the treaty exemption and the directive exemption.

Under the treaty exemption, a foreign related lender is fully exempted from Danish interest withholding tax if the foreign related lender resides in a jurisdiction that has a tax treaty with Denmark and is entitled to a waiver or reduction of Danish withholding tax under that tax treaty. Most of the treaties entered into by Denmark provides for a waiver of withholding tax if the recipient qualifies as the "beneficial owner" of the income received.

Under the directive exemption, a foreign related lender is fully exempted from Danish interest withholding tax if the foreign related lender resides in an EU jurisdiction and is entitled to a waiver or reduction of Danish withholding tax under Council Directive 2003/49/EC of June 3, 2003, as amended (the EU Interest and Royalty Directive). To qualify under the EU Interest and Royalty Directive, both the creditor and debtor must be: associated companies (parent/subsidiary or direct sister relation), EU tax residents, and subject to the taxes listed in the directive. Further, the creditor must be the "beneficial owner" of the interest.

In addition to the treaty and directive exemptions, withholding tax is not applied if the income concerned is subject to CFC taxation at the recipient level or the recipient is subject to a tax equal to three quarters of the Danish equivalent tax.

Under Danish law, a general anti-avoidance rule (GAAR) has been enacted with respect to both the EU Interest and Royalty Directive and Denmark's tax treaties.

a. Beneficial Ownership

The Danish tax authorities' application of the beneficial owner criterion under the treaty exemption and the directive exemption is directed against conduit companies and is intended to curb treaty and directive shopping. The Danish tax authorities have thus applied the criterion to impose withholding tax in cases where interest has been paid to a foreign (holding) company that passes on the interest to an entity resident in an offshore jurisdiction (or to a private equity fund). In such cases, the Danish tax authorities have contended that the foreign interest recipient does not qualify as the beneficial owner of the payment received and that the payment is therefore subject to Danish withholding tax.

The tax authorities contend that the immediate recipient (creditor on the loan) receiving the interest directly from the Danish company must be recognized as the "rightful recipient" of the interest and thus the relevant taxable entity under the withholding tax regimes. However, the concept of "rightful recipient" is not identical to the concept of "beneficial owner".

The Danish tax authorities have taken the position that beneficial ownership must be evaluated with respect to each transaction, and that this evaluation is

intended to determine who has the actual right to dispose of the funds received. The decisive criterion is whether the immediate recipient with respect to each amount received has the full right to use and enjoy the funds unconstrained by a contractual or legal obligation to pass on the payment received to another person.

The application of the beneficial ownership criterion has thus far been considered by the Danish Tax Tribunal (the supreme administrative appeal body), which has decided in favor of the tax authorities. It should be noted that all cases concern fiscal years prior to the adoption of the GAAR. The cases have been appealed to the Danish high courts, where they are now awaiting the outcome of a preliminary ruling from the Court of Justice of the European Union (CJEU) concerning the interpretation and application of the beneficial ownership criterion in the EU Interest and Royalty Directive. The Advocate General's opinion is expected in March 2018 and the CJEU ruling is expected within the next six months after that.

b. The General Anti-Abuse Rules

Denmark has adopted two GAARs — an EU tax directive GAAR and a tax treaty GAAR. The Danish tax authorities have stated that the GAARs will ensure withholding taxation if the immediate recipient is a "mere conduit company" passing on interest to entities not qualified to receive tax-exempt interest.

The EU tax directive GAAR implements the mandatory GAAR of the EU Parent-Subsidiary Directive.[1] The implementation of this GAAR into Danish law has not been confined to the EU Parent-Subsidiary Directive but applies also to the EU Interest and Royalty Directive and the EU Merger Directive.[2] The GAARs have effect with respect to transactions completed on or after May 1, 2015.

The effect of the newly introduced GAARs is that a corporate will not benefit from the EU directives or tax treaties if the principal purpose of an arrangement or series of arrangements that it enters into is to achieve a tax benefit that is not in accordance with the purposes of the directive or tax treaty concerned and that is artificial in nature.

Both the EU framework and comments made by the Danish Ministry of Taxation on the enactment of the GAARs are scant as to guidance on the application of the GAARs.

3. Transfer Pricing

Interest determined by the free market is regarded as interest for tax purposes, regardless of whether the interest rate is considered high or low. Interest rate differentials are simply subject to assessment by the tax authorities if the loan concerned is entered into between related parties (under the transfer pricing rules) and the tax authorities may well reduce interest rates in such transfer pricing cases. The consequence of such a reduction is that the excess interest is (for both domestic and tax treaty purposes) deemed to be a non-deductible dividend or gift to the lender.

II. Additional Limitations Imposed on the Deductibility of Interest Expenses Incurred by Merged Company

The above limitations will apply equally after a merger. No additional limitations apply. It should be noted that due to mandatory Danish tax consolidation and the fact that the limitation rules described above apply on a consolidated basis, it will generally be neither advantageous nor disadvantageous to merge the entities. Losses carried forward will however be affected by a merger.

III. Potential of Any Such Limitations to Compromise the Viability of the Transaction and Availability of Alternative Structures or Financing Arrangements That Would Mitigate or Eliminate Impact of Limitations

In view of the considerations set out above, this section is not applicable.

IV. Restrictions on Deductibility of Interest Based on BEPS Action 4 and/or the EU Anti-Tax Avoidance Directive

Danish tax law is currently believed to be both EU- (the Anti-Tax Avoidance Directives (ATAD and ATAD II)) and OECD BEPS-compliant, so no significant legislative proposals in this respect are expected. Some parts of the Danish limitation regimes may have to be adjusted to ensure that the minimum standards of the EU ATAD Directives are adopted, but potential changes in this respect have not been made public.

NOTES

[1] Amendment by Directive 2015/121/EU of Jan. 27, 2015.

[2] 2009/133.