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Comparative Tax Law for the International Practitioner

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Tax Reporting Units and Permitted Consolidation

Background

F is an ownership arrangement formed under the laws of a foreign country (and considered a "corporation" for purposes of that country's income tax laws). F has sent its Vice President for Operations to Host Country to promote F's business interests there. In so doing, the Vice President has formed a number of different ownership arrangements under the business law of State X, a political subdivision of Host Country. Some of these ownership arrangements look like typical business law corporations and partnerships (as those terms are generally understood), and some appear to be unique to State X's business law. The Vice President has also entered into, on behalf of some of the newly formed ownership arrangements, a number of informal ownership arrangements with unrelated parties. One such arrangement involves joint ownership of a warehouse. Each owner will use part of the warehouse space to store its own merchandise, and non-allocated space will be leased to non-owners from time to time.

Questions

1. For purposes of Host Country's income tax law, how does one determine whether an ownership arrangement constitutes a tax reporting unit (assuming it has the requisite amount and type of income) and its classification for tax purposes (for example, corporation or partnership) if it does constitute a tax reporting unit?

2. Does Host Country's income tax law permit consolidation of the income/losses of any tax reporting units and, if so, what are the general rules pertaining to: (a) such consolidation; (b) liability for the consolidated tax (for example, do the various units have joint and several liability?); (c) how units must contribute to payment of the consolidated tax; and (d) how units must compensate other units for the use of losses, credits, and other tax attributes that serve to reduce tax?

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DENMARK: Tax Reporting Units

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I. Rules relating to the determination and classification of tax reporting units

The factors that generally have a bearing on the classification of an entity as a separate tax reporting unit for corporate income tax purposes are discussed in I.A.to D., below.

A. Entity established as a Danish company or specifically mentioned

Entities subject to unlimited Danish tax liability, as listed in the Corporate Income Tax Act (CITA)[1] and the Foundations Tax Act (FTA), are tax reporting units.[2] The main group of entities subject to taxation under the CITA or the FTA are entities established in accordance with, respectively, the Danish Companies Act or the Danish Foundation Acts.[3]

In addition, the CITA and FTA list entities that are specifically covered by these acts, for example: certain savings banks; certain utility providers; certain investment funds; mutual insurance associations; employee/employer unions; and any other unions carrying on business.[4]

B. Entity's corporate features

Entities that are not incorporated in accordance with the Danish Companies Act but that share the same features as entities that are so incorporated, with the consequence that they are considered subject to unlimited tax liability at the entity level,[5] are also tax reporting units. The determination is made on a case-by-case basis, but the main criteria are that the participants (members/investors) are not liable for the debts of the entity (except to the extent of any capital they have contributed) and that profits and/or liquidation proceeds are allocated in proportion to the capital contributed by each participant. Additional criteria supporting the view that an entity should be treated as a separate tax reporting unit are, among others, that: (1) the entity has its own articles of association; (2) the entity maintains its own accounts (bookkeeping and annual reports); and (3) the entity has its own management with the power to act on behalf of the entity.

Joint venture vehicles, such as an unlimited partnership (*interessentskab* or I/S) and a limited liability partnership (*kommanditselskab* or K/S, or *kommanditaktieselskab* or P/S) are legal entities but are treated as transparent for corporate income tax purposes. A co-ownership that is not formalized (for example, as an unlimited partnership) would also not be considered a tax reporting unit.

C. Foreign entity with its seat of effective management in Denmark

An entity established outside Denmark is treated as subject to full Danish tax liability if the entity has its seat of effective management in Denmark.[6] The determination is made on a case-by-case basis, taking into account the actual physical place where day-to-day decisions are made on behalf of the entity. Additionally, an entity established outside Denmark may be subject to limited Danish tax liability if it has a Danish permanent establishment (PE) or real property situated in Denmark. Such limited tax liability also entails separate reporting obligations, but these are complied with in the name of the foreign entity.

D. Hybrid entity

It should be noted that Denmark has anti-avoidance rules in place to counter the use of hybrid entities.[7] An entity incorporated under the Danish Companies Act — and thus initially regarded as a separate tax reporting unit — may be reclassified as a tax-transparent entity as a result of its classification for foreign tax purposes (for example, its classification under the U.S. "check-the-box" rules). Conversely, a Danish partnership, which is generally regarded as tax-transparent, may be reclassified as a separate tax reporting entity as a result of its classification as a separate entity for foreign tax purposes.

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II. Rules relating to permitted consolidation

Under the Danish tax consolidation regime, all group-related Danish resident companies and Danish branches or PEs of foreign companies are subject to mandatory tax consolidation ("local tax consolidation").[8]

It is also possible to include foreign group companies in tax consolidation groups ("cross-border tax consolidation"). Cross-border tax consolidation is optional, but once it is opted for, the all-or-none principle applies, i.e., all foreign group entities must be included in the Danish tax consolidation group; otherwise, none can be included.

A. Mandatory local tax consolidation

1. Group relation

All group-related Danish resident companies, Danish branches of foreign companies and Danish real property held by foreign companies are subject to the mandatory local tax consolidation regime.

"Danish entities" (i.e., Danish resident companies, Danish branches of foreign resident companies and Danish real property held by foreign companies) are considered to be group-related if, at any point during the income year, they have been part of the same "group."

A "group" is considered to exist where a company, foundation, association, trust, etc. is the parent company to one or more subsidiaries.[9] Thus, the definition also covers Danish entities that do not have a common Danish parent company but have a common foreign parent company, i.e., Danish sister companies.

A company may have only one direct parent company. If a number of companies meet one or more of the criteria for being a parent company, only the company exercising the actual controlling interest over the relevant subsidiary's financial and operational decisions will be considered the parent company.

A "controlling interest" is the right to control a subsidiary's financial and operational decisions. A controlling interest exists where the parent company, directly or indirectly, owns more than half of the voting rights in a company, unless it is clearly demonstrated that such ownership does not constitute a controlling interest.

A parent company that does not own more than half of the voting rights in a company will still satisfy the controlling interest criterion if it has the right to:

- Dispose of more than half of the voting rights by virtue of an agreement concluded with other investors;
- Control the financial and operational affairs of the company pursuant to articles of association or an agreement;
- Appoint or remove the majority of the members of the company's supreme management body, where that body has a controlling interest in the company; or
- Dispose of the actual majority of the votes at the general meeting or in any similar body, giving it the actual controlling interest in the company.

The existence and impact of potential voting rights, including subscription rights and call options relating to shares that may be immediately exercised or converted, must be taken into consideration when assessing whether a company has a controlling interest. When calculating the voting rights in a subsidiary, any voting rights attaching to shares held by the subsidiary or by its subsidiaries are disregarded.

2. Consolidated income and taxable losses

The taxable income of each entity subject to the mandatory local tax consolidation regime is determined separately and then pooled to arrive at the consolidated income. The final taxes are calculated based on the consolidated income. Before the taxable results are pooled, however, they are adjusted by the setting off of each entity's separate carryforward losses (if any) against that entity's taxable result.

The taxable result of an entity in the group is to be included in the tax-consolidated income irrespective of the percentage of ownership held in that entity by the parent company, i.e. the entire taxable income of a group-entity is to be included even where the parent company has an ownership interest of less than 100% in that entity.[10]

If a qualifying group relationship is established during an income year, only a proportionate share of the income corresponding to the qualifying period is to be included in the tax-consolidated income for that year.[11]

Tax losses can be carried forward with no time constraints. Tax losses cannot reduce taxable income by more than 40% where the taxable income exceeds a threshold of DKK 8,385 (2019).[12] The threshold is applied on a consolidated basis. Thus, tax losses can be applied in full as long as the aggregate taxable income of the group is less than DKK 8,385.

Losses incurred by one entity in a group in the tax year in question are transferred proportionally to profit-making entities in the group. The same applies if the group as a whole is in a loss-making position, i.e., each entity in the group is assigned a proportionate part of the loss, which that entity may then carry forward.

Losses incurred by an entity before the entity is included in a group may be set off only against that entity's own future profits.[13] A similar rule applies where a group of companies is acquired and the companies concerned were subject to tax consolidation prior to the acquisition; in these circumstances, the acquired group of companies maintains this previous tax consolidation with respect to losses incurred before they were acquired (and entered into the new tax consolidation with the acquiring company).

Tax losses of a company that is being liquidated will be forfeited. Similarly, tax losses of a company that is being dissolved in a taxable merger will be forfeited, whereas the tax losses of the surviving company will not be affected.

As a starting point, in a tax-exempt merger, the tax losses of the entities involved are forfeited. In the case of losses that are only deductible against profits from like-kind sources (such as capital losses on real estate incurred before or during a tax consolidation period), there are no exception to this rule, so that these "source-specific" losses will always be forfeited by both parties to a tax-exempt merger even when the losses were incurred during a period of tax consolidation.

The major exception to the main rule that losses are forfeited by both parties to a tax-exempt merger is that ordinary tax losses incurred by companies that were subject to Danish tax consolidation at the time when the losses were incurred are preserved.[14] This means that losses incurred by the merging companies will be carried forward by the surviving company if the losses were incurred during the tax consolidation period. It also means that losses realized prior to the establishment of the tax consolidation are forfeited by both merging companies (but may potentially be carried forward by other members of the tax consolidation group if these companies were tax consolidated at the time when the losses were incurred).

The above ability to preserve losses incurred during a tax consolidation period is conditioned on the surviving company

not having directly or indirectly received assets and liabilities in a tax-exempt restructuring from a company that did not form part of the tax consolidation group when the losses were incurred.

These rather complex rules on losses within a tax consolidation mean that a number of sub-consolidations may exist within a consolidated group. The group is obliged to account for the various losses carried forward and the entities within the sub-consolidation that may utilize these losses. The information must be provided to the tax authorities, who maintain a detailed record of them.

3. Payment of taxes and intra-group payments

One entity in a consolidated group is appointed as an "administration company."[15] If the ultimate parent company of the group is a Danish company, this company will be appointed. If there is no ultimate Danish parent company but there are a number of Danish sister companies, one of the sister companies will be appointed.

The administration company is responsible for filing tax returns for the group and for the actual payment of taxes imposed on the tax-consolidated income, including advance payments of taxes on behalf of the group and any interest, duties or the like levied on the group.

The other entities in the group are, however, required to pay their share of the taxes to the administration company. This means that the profit-making entities in the group must pay to the administration company their *pro rata* share of the taxes imposed on the consolidated income.

If the taxable profit of a group entity is offset by the tax losses of other entities in the group (so that no tax charge arises), the profit-making entity instead pays an amount corresponding to the tax value of the losses utilized for the offset.[16] This latter contribution is also to be paid to the administration company. In turn, the administration company is to pay to a loss-making entity an amount corresponding to the tax value of the loss utilized by other entities in the group.

Payments made to loss-making entities (for the utilization of tax losses) and payments made by profit-making entities to the administration company must be made by the due date applicable to the payment of corporate taxes by the administration company. If the payments are not made by this date, interest (fixed on market terms) must be paid to the loss-making entities.

4. Liability for tax charges

The administration company and all the entities in the tax consolidated group that are directly or indirectly wholly-owned by the ultimate parent at the end of the income year are jointly and severally liable for the tax charges, plus the surcharges and interest, allocated to the company in that income year.[17]

If there is no ultimate Danish parent company and, therefore, one of a number of Danish sister companies has been appointed as the administration company, the sister companies will be jointly and severally liable for the tax charges (from the time of payment by the group members to the administration company).

Entities that are not wholly-owned by the parent ("minority entities") are only secondarily liable for the group tax, i.e., only if the tax due cannot be claimed from the wholly-owned entities can the minority entities be deemed liable, in which case the claim against a minority entity cannot exceed a portion of the tax due *pro rata* to the ownership interest of the parent company in that minority entity.

5. Choice of income year and financial year

The local tax consolidation rules prescribe that all members of a tax consolidation group must have the same income year as the administration company.[18] It is not a requirement under the rules that all members of the group have the same financial year (for accounting purposes). In most cases, however, this requirement would follow from the Danish Financial Statement Act. Under that Act, the general rule is that a Danish parent company and its subsidiaries must have the same financial year.

B. Optional cross-border tax consolidation

1. In general

Cross-border tax consolidation is optional. However, the regime features an all-or-none principle (also referred to as the "global pooling principle"), i.e., all foreign group entities must be included in such a Danish tax consolidation group; otherwise, none can be included.[19] The application of the all-or-none principle is not limited to foreign subsidiaries – the principle applies to all foreign group companies, including foreign parent companies and sister companies.

Foreign entities are considered to be group-related if they meet the group definition set out in the local tax consolidation rules.

The decision to form a cross-border tax consolidation group is binding for a period of 10 years. If the cross-border tax consolidation is discontinued within the 10-year period, recapture rules apply.

As a starting point, the tax-consolidated income is to be determined in accordance with the same principles as apply in the case of local tax consolidation and the same rules apply with respect to the appointment of an administration company, liability for tax charges, etc. However, different rules apply with respect to certain situations.

Tax losses of foreign group members are recaptured in full when tax consolidation is terminated. Complex transitional rules apply to the recapture of losses in connection with the termination of cross-border tax consolidation groups that were established under the former tax consolidation regime.

2. Partial abandonment of the principle of worldwide income taxation

The objective of the all-or-none principle is to prevent a Danish company establishing a cross-border tax consolidation group with its loss-making foreign subsidiaries while leaving its profit-making foreign subsidiaries out of the group.

This objective could potentially be circumvented by a Danish company setting up a PE instead of a subsidiary for loss-making activities abroad. To prevent this, the traditional principle of worldwide income taxation is partially abandoned in relation to Danish resident companies. As a general rule, a Danish company is not taxed on profits and gains generated by a foreign PE or derived from foreign real property. Likewise, losses incurred by a foreign PE or with respect to foreign real property may not be set off against income taxable in Denmark.

An exception to the general rule that income from a foreign PE is disregarded for Danish tax purposes is made with respect to income from a PE that is deemed to constitute a controlled foreign company (CFC) under the Danish CFC regime. Such income remains taxable in Denmark.

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Finally, income from a foreign PE or foreign real property will be subject to Danish taxation if the source state has relinquished its rights to tax the income under a tax treaty or other international agreement with Denmark.

NOTES

[1] Consolidated Act no. 1164 of September 6, 2016 with subsequent amendments (*selskabsskatteloven*).

[2] Consolidated Act no. 961 of August 17, 2015 with subsequent amendments (*fondsbeskatningsloven*).

[3] CITA, section 1.1.1 and FTA, section 1.1.

[4] CITA, sections 1.1.2a-2j and 1.1.3-6.

[5] CITA, section 1.1.2.

[6] CITA, section 1.6 and FTA, section 1.1.4.

[7] CITA, section 2C.

[8] CITA, section 31.

[9] CITA, section 31C.

[10] CITA, section 31.2.

[11] CITA, section 31.5.

[12] CITA, sections 12.2 and 31.3.

[13] CITA, section 31.2.

[14] CITA, section 31.4.

[15] CITA, section 31.6.

[16] CITA, section 31.8.

[17] CITA, section 31.6.

[18] CITA, section 31.7.

[19] CITA, section 31A.