# Interest Limitation Rules – an Analysis of the Danish Legislation

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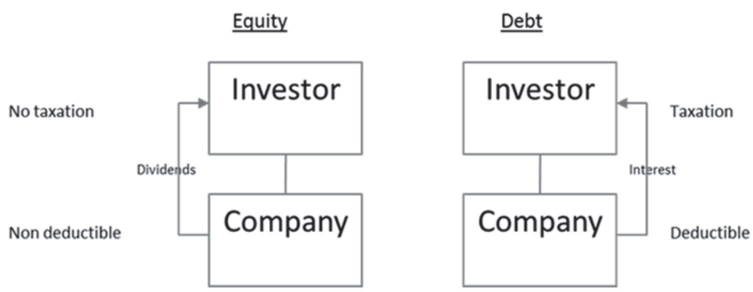
The topic of the dissertation is the complex Danish interest limitation rules in the Corporate Tax Act (Selskabsskatteloven) §§ 11, 11B and 11C. The dissertation firstly analyses the basis behind debt vs. equity financing (in order) to explain the purpose of the interest limitation rules. The dissertation secondly analyses the complex Danish interest limitation rules in the Corporate Tax Act (SEL §§ 11, 11B and 11C), hereunder the compatibility with EU law. The dissertation thirdly discusses alternative methods to evaluate the Danish interest limitation rules. These matters are elaborated below.

Corporate financing consists of a choice between debt versus equity, which have very different tax consequences. From an overall perspective, debt shifts the taxation from corporate level to investor level whereas equity maintains the taxation at corporate level. This can be illustrated as follows:




Corporate taxation versus investor taxation is therefore crucial for the tax incentives in the choice between equity financing and debt financing. A lower taxation of the investor, for example of a non-resident investor, creates incentives for a higher debt ratio at the corporate level, whereby taxable income is

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transferred abroad. The Interest deduction limitation rules in SEL §§ 11, 11B and 11C is to prevent that kind of relocation of the taxable income.

SEL § 11 discourages reallocation of taxable income from Danish corporations in regard to debt which is not considered to be at arm’s length. By nature, such debt can only exist between associated parties. The company’s solvency ratio (thin capitalization) at the end of the income year is used to establish whether (or not) the debt is at arm’s length (excessive debt). It is therefore necessary not only to identify the associated parties, between whom “non arm’s length debt” can exist, but also to account for all assets and debt in a special tax valuation assessment and interest expenses derived from the excessive debt. This can be a very complex and costly task for both the taxpayer and tax authorities. A more direct and individual arm’s length approach is taken in the United Kingdom and in the proposal for the CCCTB directive (COM(2011) 121/4). Also such solvency based limitation rules has been replaced in both Italy and Germany. However, in Denmark, the solvency based method is still applicable even though two new interest limitation rules (SEL §§ 11B and 11C) were introduced in 2007.

SEL § 11B discourages finance expenses not related to assets creating taxable income by limiting the deductibility hereof. The interest cap is basically calculated as the tax value of the corporations operating assets multiplied by a standard rate (3 % in 2013). This is a very complex and unique approach, which firstly seeks to identify the financing needs of the assets creating taxable income and secondly the financing cost related to the assets creating taxable income. The excessive net financing costs are not deductible. Hence, there is assumed to be a close correlation between the tax value of the operating assets and the financing needs of the company. It should also be noted that the used standard rate is based on *last* year’s average interest rate for non-financial companies and thereby used to calculate the maximum finance expenses attributed to the operating assets in the *current* income year. It is therefore doubtful whether SEL § 11B is targeting with enough precision.

SEL § 11C also discourages finance expenses not related to taxable income by limiting the deductibility hereof. The taxable income before the net financing expenses can only be reduced by a maximum of 80 per cent due to net financing expenses. This implies that the debt-financed activities not only must be expected to generate taxable income, but have to actually create taxable income. A similar regulation has been introduced in both Italy and Germany.

Legislation to discourage reallocation of the taxable income abroad might create EU issues. This is also the case in regards to SEL §§ 11, 11B and 11C, particularly in relation to the aggregated (group) accounts after which a possible limitation cannot be reduced by non-resident subsidiaries, but only by resident subsidiaries. Such obstacles to the freedom of establishment in art. 49 TFEU cannot be upheld. The regulation must therefore be extended to include corporations resident in other Member States. Which significantly reduces the effect of SEL §§ 11, 11B and 11C.

Despite the complexity of SEL §§ 11, 11B and 11C and the EU issues, no obvious alternative approaches seem to be available. The general problem regarding debt financing shifting taxable income abroad is relatively easy to understand, but appropriate solutions are very difficult to implement. This is the case in relation to the achievement of neutrality in corporate financing but also in relation to specific anti-abusive rules which is to prevent reallocation of taxable income.

The Interest and Royalties directive (2003/49/EC) and art. 11 of the OECD Model Convention limit the source state's taxing right to interest payment whereby it seems impossible to create tax neutrality in corporate financing in the state of source. The lack of neutrality in corporate financing and reallocation of taxable income therefore needs to be addressed by specific regulation in the source state.

In Belgium, a NID-deduction is calculated on the basis of the corporation's equity, whereby any payment reduces the NID-deduction, including finance expenses. This ensures that the capital remains in the company, which makes debt relatively more expensive than equity. However the NID-deduction does not generally contribute to neutrality in corporate financing, but reduces the corporate taxation.

The United Kingdom introduced the Worldwide Debt Cap rule, whereby the deductibility of net financing expenses is maximized to the group's total gross external financing, so there can be no reallocation of taxable income. However, the Worldwide Debt Cap rule does not prevent reallocation of taxable income regarding debt financing from third parties, and may also not be compatible with the freedom of establishment in art. 49 TFEU.

Recently, the European Commission made a proposal for a council directive on a Common Consolidated Corporate Tax Base (CCCTB) which only vaguely addresses neutrality in corporate financing. This is probably due to the fact that according to the proposed tax-exempt income, such as dividends, activates a deduction limitation of 5 percent of the tax-exempt, income. The need for interest limitation rules is thereby reduced. If such regulation was introduced at national level without a Directive to support this, it may not be compatible with the Parent-Subsidiary Directive (2011/96/EU)

Overall, the current interest limitation rules in both Denmark and other countries is expected to change significantly in the future in order to achieve a greater resilience towards the transfer of taxable income abroad. An international coordination and exchange of ideas seem to be to the benefit of both legislature, tax authorities and taxpayers all over, so that the legislation neither encourages nor discourages debt financing.