Jakob Bundgaard*

Coordination Rules as a Weapon in the War against Cross-Border Tax Arbitrage – The Case of Hybrid Entities and Hybrid Financial Instruments

In this article, the author describes the Danish experiences in countering cross-border tax arbitrage by considering existing anti-arbitrage provisions, based on the fact that Denmark, like other countries, has, to a great extent, made use of "coordination rules".

1. Introduction

Cross-border tax arbitrage is a very important topic in the international fiscal debate. Countries and international organizations struggle to decide if and what to do about it, and, on this basis, to identify the appropriate technical measures. Most recently, the topic has been addressed by the European Union and the OECD.[1]

One approach in countering cross-border tax arbitrage is the application of "coordination rules" that rely on the "principle of correspondence".[2] Under this principle, tax benefits (deductions or exemptions) are dependent on the tax treatment in another jurisdiction, for example, by requiring corresponding taxation of the same payment, i.e. dividends, interest, etc., in the other jurisdiction.

This article is based on the fact that Denmark has, to a great extent, made use of such rules, as have other countries. The primary focus of the Danish government at the international tax level is to prevent tax avoidance and tax evasion. In line with this objective, several notable provisions have been enacted recently with the objective of countering cross-border arbitrage. Typically, such provisions are presented to the parliament as measures with the purpose of closing "loopholes". Accordingly, for some years now, it has been the fiscal policy in Denmark that the domestic tax treatment of certain transactions can depend on the tax treatment in other jurisdictions.[3]

The purpose of this article is to outline Danish experiences in countering cross-border tax arbitrage by considering the existing anti-arbitrage provisions.

2. Double Dip Structures – 1996

The first anti-arbitrage provision was introduced in 1996 to counter double dip structures. The provision is currently section 5G of the Assessment Law (*Ligningsloven*).[4] This provision contains two rules on double dip structures. Section 5G(1) disallows deductions of costs for Danish corporate taxpayers and Danish permanent establishments (PEs) that are deductible according to foreign tax rules and are not taxable in Denmark. This also applies if the deductible cost according to foreign tax law can be transferred to another group company, where the income of this group company is not taxable to Denmark. In addition, section 5G(2) entails that related party leasing transactions cannot result in Danish deductions and/or depreciation if a foreign related party can depreciate the same asset. These provisions are not frequently used.

3. Countering Cross-Border Arbitrage from the Use of Hybrid Entities

3.1. Introductory remarks

According to domestic Danish tax law, foreign legal entities are classified for tax purposes according to domestic entity classification principles. Based on actual assessments, the application of these principles in the context of legal entities can result in cross-border arbitrage opportunities if different classifications are decided on in the jurisdictions involved. Against this background, Denmark has introduced two specific provisions to deal with this issue (*see* sections 3.2. and 3.3.).

3.2. Danish companies reclassified to transparent entities – 2004

A specific Danish anti arbitrage provision exists in section 2A of the Corporate Income Tax Law (*Selskabsskatteloven*, SEL). This provision was introduced in 2004. The background to this provision was the existence of certain US group structures in which a US parent company established a Danish holding company which was an eligible entity for US check-the-box purposes. The holding company was the

* PhD., and Managing Director, CORIT Advisory LLP and CORIT Academic Foundation, and Honorary Professor, Aarhus University. The author can be contacted at jb@corit.dk.

1. *See* European Commission, Recommendation on aggressive tax planning C(2012) 8806 final (6 Dec. 2012) and OECD, Hybrid Mismatch Arrangements – Tax Policy and Compliance Issues (OECD 2012), International Organizations' Documentation IBFD.
2. On coordination rules in general, *see* V. Thuronyi, *Coordination Rules as a Solution to Tax Arbitrage*, 57 Tax Notes Intl. 12, p. 1053 (22 Mar. 2010).
3. *See*, for example, DK: Corporate Income Tax Law (*Selskabsskatteloven*, SEL), sec. 9(2). Here, it is stated that costs are only deductible for corporate income tax purposes insofar as the source of the income is taxable in Denmark. *See*, in general, A. Michelsen, *Samspillet mellem interne danske skatteregler og interne skatteregler i andre lande*, in *Festskrift til Mattson* (Iustus Förlag 2005).
4. DK: Assessment Law (*Ligningsloven*).

owner of the shares of the Danish operating companies and the US parent company would then inject debt into the holding company. Consequently, the holding company would obtain an interest deduction, which could be set off against operating income of the operating companies through the domestic joint taxation regime applicable at the time. For US tax purposes, the interest payment would not be taxed, as the payment would be considered to be an internal dealing between a PE and its US head office. In sum, this structure would result in a double deduction with no corresponding inclusion in any of the jurisdictions involved. This was considered unacceptable by the Danish legislator.

Under section 2A, a Danish limited liability company, which is normally considered to be a taxable entity, i.e. opaque, for Danish tax purposes, is reclassified to a transparent entity for Danish tax purposes if such a treatment is present in the country in which the parent company is a resident. The foreign owners of the Danish company are per se considered to have a PE in Denmark following such a reclassification. All of the assets and liabilities of owned by the reclassified company are allocated to the Danish PE. Interest and royalty payments to the foreign parent company are not deductible as a result of the provision, as such payments are consequently considered to be internal payments between a PE and its foreign head office.

Despite the general wording of the provision, the practical scope appears to be Danish entities that are eligible for the US check-the-box election. As a practical issue, this includes primarily Danish companies organized in the form of a private limited company (*Anpartsselskab*, ApS). If an election is made according to US law to treat a Danish ApS as a transparent entity for US purposes, this may invoke the provision.

The application of the provision requires the fulfilment of certain criteria. These are described subsequently.

First, the provision requires that a Danish taxable entity is treated as a transparent entity according to the domestic law of another country, whereby the income of the company is included in the tax computation of group companies in that other country. A foreign company that is considered to be transparent by other group companies resident in another country are also considered to be transparent for the purpose of section 2A. This, however, does not apply if the foreign company is a resident of another country other than that of the country of residence of the parent company and this country is a Member State of the European Union and/or the European Economic Area (EEA), or has a tax treaty with Denmark. Interest and royalty payments to such companies are, however, deductible only insofar Danish withholding tax should be reduced or eliminated according to the Interest and Royalties Directive (2003/49)[5] or an applicable tax treaty.

Second, the provision only applies if group companies control the Danish company and the other country is a Member State of the European Union or EEA, or has a tax treaty with Denmark.

The application of the provision does not per se result in a disposal and subsequent acquisition of all of the assets and liabilities of the reclassified Danish company. The assets and liabilities of the company in question that are reclassified are treated for Danish tax purposes as if they had been acquired at the original acquisition date and at the same price as that of the reclassified company. Built-up goodwill or other intellectual property (IP) rights are not considered to have any tax basis in this context.

When the reclassification is ended, all of the assets and liabilities of the entity are considered to have been sold by the owners of the entity at market value. Consequently, the Danish company is considered to have acquired all of the assets and liabilities from group companies. Any losses carried forward are extinct. The owners of the company are also considered to have acquired the shares of the Danish company at market value at the time of the change in the tax status of the Danish company.

It is difficult to assess the effect of section 2A of the SEL. However, from practical experience, the provision has had a significant effect on the structuring of the investments of US multinational enterprises (MNEs) in Denmark. The provision is also complex, as a result of which it is not always possible to foresee the exact position of the tax authorities.

3.3. Danish transparent entities reclassified as taxable entities – 2008

In general, Danish transparent entities, which are typically partnerships, were treated as transparent, regardless of where its owners are domiciled and no matter if the entity is qualified as a taxable entity under foreign rules. Consequently, it was possible to entirely avoid the taxation of the transparent entity's income.

For instance, tax exemption could arise if the US owners of a Danish transparent entity decided to treat this entity as a taxable entity under the US check-the-box rules from a US perspective. At the same time, from a Danish point of view, the entity would be regarded as transparent, but its activities were not deemed to constitute a PE in Denmark. As a result, the profits from the activities would not be taxed in Denmark. The profits would also not be taxed in the United States, as the US owners had decided that the transparent entity was to be considered a taxable entity. A Danish Tax Council binding ruling[6] contains an example of this issue and confirms the preceding description and, consequently, there would be a situation of classic double non-taxation. The introduction of section 2C of the SEL in 2008 should be viewed on this background.

According to the explanatory notes, the concept behind section 2C of the SEL is to counter situations, such as that

5. EU Interest and Royalties Directive (2003): Council Directive 2003/49/EC of 3 June 2003 on a Common System of Taxation Applicable to Interest and Royalty Payments Made Between Associated Companies of Different Member States, OJ L157 (2003), EU Law IBFD.

6. DK: TC, 20 May 2008, SKM 2008.446 SR.

outlined in the previous paragraph, with the effect that the Danish qualification of a partnership can no longer imply that income is not taxed anywhere.

The effect of section 2C is a reclassification of a Danish transparent entity as a taxable entity, i.e. moving from transparency to opaqueness. Consequently, foreign owners generate taxable income in Denmark.

Under this provision, the following two types of transparent entities can be reclassified as taxable entities:
(1) entities that are required to be registered in Denmark and are domiciled in Denmark according to the articles of association or whose management is registered in Denmark; and
(2) branches of foreign companies.

Transparent entities are reclassified as taxable entities when the following conditions are satisfied:
- more than 50% of the shares or the voting rights is held directly by foreign investors; and
- the domicile of the foreign investors is in a country in which the Danish entity is treated as a taxable entity, or
- the tax domicile of the foreign investors is in a country that does not exchange information with the Danish tax authorities in accordance with a tax treaty, another international agreement or a convention or any agreement on mutual assistance in tax matters.

Venture funds contributing capital to small and medium-sized companies (SMEs) or groups are, however, exempt from the scope of section 2C if certain additional requirements are met. The reason for exempting venture funds is the desire to continue to encourage the start-up and growth of small and medium-sized innovative businesses. Private equity funds may also be covered by this exemption.

As a starting point, the owners of the reclassified entity are not deemed to have disposed of assets, equity and liabilities of the transparent entity or branch at the time of its reclassification. However, the reclassified entity is considered to have acquired assets, equity and liabilities when the owners of the reclassified entity acquired them at the prices paid by the owners. Any assets that can be depreciated or amortized and which were not subject to Danish taxation prior to reclassification of the entity are regarded as having been acquired by the reclassified entity when the individual owners acquired it, at the actual acquisition price net of maximum depreciation or amortization.

In determining losses, any dividends received by the owners are considered to have been received by the reclassified entity. Roll-over relief is available for the reclassified entity, which, therefore, succeeds to the owners' tax loss carry-forwards and any unutilized deductible losses from prior income years.

If the relevant assets, equity and liabilities are no longer subject to Danish tax following the requalification, these are considered to have been disposed of at fair value at the time of reclassification.

Any income accruing to the reclassified entity is generally taxed at the rate of 25%. However, this does not apply to dividends received if the reclassified entity meets the requirements under the participation exemption regime.

The disposal of equity interests in the reclassified entity will be comparable to sale of shares. Equity interests are considered to have been acquired for an amount equal to the tax base of the member's share of assets, equity and liabilities at the time of reclassified.

If the reclassified entity is discontinued, such an event is treated as liquidation. This implies that any assets, equity and liabilities remaining at the time of discontinuation are regarded as having been sold by the reclassified entity at fair value at that time. This may result in the taxation of any profits and recaptured depreciation or amortization of the reclassified entity. Any liquidation proceeds received by the owners are also taxed as a capital gain or as dividends, unless the owners fulfil the requirements for receiving capital gains and dividends free of tax.

4. Countering Cross-Border Tax Arbitrage Using Hybrid Financial Instruments

4.1. Introductory remarks

Hybrid financial instruments are not very common in Danish tax law. Danish companies normally issue instruments, such as profit participating loans, convertible bonds and preference shares. However, exotic and innovative variations are not common. In an international setting, hybrid financial instruments are classified according to the generally applicable tax rules in Denmark. This may result in cross-border arbitrage opportunities where certain instruments are classified as debt or equity for Danish purposes, while being classified oppositely in another jurisdiction. The risk of such arbitrage resulted in the Danish legislator introducing two provisions with the objective to prevent such practices (*see* sections 4.2. and 4.3.).

4.2. Unilateral reclassification of debt to equity – 2007

A specific provision intended to counter tax arbitrage structures using hybrid financial instruments was introduced into Danish tax law in 2007. The specific anti-arbitrage provision was included as section 2B of the SEL.[7] In essence, this provision results in a different tax treatment of inbound hybrid financial instruments, depending on the tax treatment in another country.

The objective of section 2B is to counter the potential asymmetrical tax treatment of certain hybrid financial instruments. Such asymmetrical taxation may arise as a result of the different tax classification of an instrument in the countries involved, including the classification for Danish tax purposes as debt resulting in an interest deduction for Danish tax purposes, while the instrument in the country of the investor is considered to be equity, which, depend-

7. *See* J. Bundgaard, *Cross-Border Tax Arbitrage Using Inbound Hybrid Financial Instruments Curbed in Denmark by Unilateral Reclassification of Debt into Equity*, 62 Bull. Intl. Taxn. 1 (2008), Journals IBFD.

ing on the legislation of that counter, may be regarded as tax-exempt dividends.

In order to obtain its objective, the provision is based on a principle under which a Danish interest deduction requires that the corresponding income is not tax exempt in the hands of the recipient. Inspired by German commentary on this principle, it may be referred to as the "principle of correspondence".[8] As already stated previously, this principle is being used more and more frequently in Danish law.

The underlying tax policy rationale has been widely criticized, as by this legislation, Denmark takes on a coordinating role between different countries with regard to the classification of hybrid financial instruments, while similar action does not occur where double taxation arises in cross-border transactions resulting from the different classification of the same financial instrument. The Minister of Taxation has responded to this criticism by stating that it is inappropriate if an interest deduction is allowed in Denmark, while the recipient is not taxed on the "interest payment" because the payment according to foreign legislation is considered to be dividends. It was also stated that such asymmetries may give rise to tax arbitrage and that international tax planning intended to obtain a "free deduction" is prevented by the reclassification under section 2B.[9]

In essence, the provision is as follows. If a Danish taxable company is indebted to an individual or a company, resident in another country, and the claim according to foreign tax rules is considered paid in capital, the debt is also regarded as equity for Danish tax purposes. From a practical point of view, it is important to note that the Danish anti-arbitrage provision only addresses inbound hybrid instruments that may give rise to interest deductions in Denmark. The provision is aimed directly at hybrid financial instruments. However, no examples are provided in the wording or the preparatory work as to what instruments fall under the substantive scope and between which countries the required asymmetry may arise. The applied or underlying definition of hybrid financial instruments is the following: instruments classified as equity in one country while classified as debt in another country. This rather broad definition was criticized in the hearing process, thereby resulting in uncertainty.[10]

The application of the provision requires the simultaneous fulfilment of a number of requirements that can be derived directly from the wording. This includes the fact that the financial instrument is considered to be debt for Danish tax purposes.

The rule only applies if the foreign individual or the foreign company has decisive influence over the Danish company or if the companies are considered to be in a group of companies. The consequence is that the interest payments and capital losses of the company are considered to be dividend payments.

The scope of the anti-arbitrage provision is similar to that of Danish transfer pricing legislation in cross-border situations. However, the scope is limited to situations where a foreign person has decisive influence over a Danish company or group-related companies.

The final requirement that must be met under section 2B is that the Danish debt instrument is treated as equity and/or paid in capital according to the tax legislation of the "creditors" state of residence. Accordingly, the tax treatment of a Danish company henceforth depends on the tax treatment in foreign jurisdictions. This issue was addressed at the hearing process, where it was stated that it seemed unreasonable to require knowledge of foreign tax legislation. In response, the Danish Minister of Taxation simply stated that such a task did not appear to be insurmountable, as the provision is aimed at group-related companies, and controlling individual shareholders, and that it was simply not possible to abstain from using hybrid financial instruments.[11]

The test as to whether or not a hybrid financial instrument exists should be carried out at the time of the establishment of the instrument or when the provision takes effect.

From an overall perspective, the effect of the anti-arbitrage provision is that it is an effective barrier to the use of a hybrid financial instrument in a cross-border setting that has the objective of obtaining tax benefits from tax arbitrage. The specific extent of this barrier with regard to the general application of hybrid finance in Denmark is, however, uncertain.[12]

As a consequence of the application of the provision, the debt instrument is considered to be equity for Danish tax purposes. In detail, this can be clarified by stating that the reclassification results in a tax treatment of interest expenses and capital losses on debt as dividend payments for the Danish debtor company.

The wording of section 2B states that the treatment as "paid in capital" in the state of the investor should result

8. *See* G. Dörfler, O. Heurung & R. Adrian, *Korrespondenzprinzip bei verdeckter Gewinnausschüttung und verdeckter Einlage,* DStR, p. 514 et seq. (2007).
9. *See* enclosure 10 to Bill No. L 110 B (2007).
10. A more appropriate definition may include the economic characteristics of the instruments and not only rely on the tax law classification of the instruments. The difference is not of any legal significance, but, rather, at the level of principle, it appears to be more correct to include in the definition of hybrid financial instruments that are not necessarily classified differently in different countries, but which, in fact, do contain the economic terms and conditions that makes the instrument a hybrid given its economic nature.
11. *See* enclosures 2 and 10 to Bill L 110 B.
12. The enactment of section 2B provides corporate finance economists with a good opportunity to analyse the importance of tax as a main driver behind the use of hybrid financial instruments. Such an analysis has been carried out with regard to the Australian market, where specific anti-arbitrage measures have also been introduced. *See* G. Mackenzie, *Taxation as a Driver for Designing Hybrid Securities,* 1 JARAF 1, p. 31 et seq. (2006). Here, the author concludes that the expectations as to tax arbitrage resulting from a "bright line" test could not be documented. Accordingly, the new types of hybrid financial instruments replacing "income securities" were not ostensibly based on any unintended tax outcomes. However, it was found to be reasonable to suspect that cross-border tax arbitrage may have played a part in increased issuance into overseas markets, even though other explanations may be found for this. Based on this, it is suggested that tax is not a primary driver in the use of hybrid financial instruments but, rather, secondary after accounting treatment, financial regulation and market preferences.

in treatment as "equity" for Danish income tax purposes. Danish tax law does not, however, generally use the term "equity". In fact, only very few provisions make use of the term. However, the Danish Minister of Taxation has stated that section 2B will have an effect on all other provisions in Danish tax legislation, making use of the term "equity" in a way whereby reclassified debt instruments will also be considered to be equity according to these other provisions. It was specifically noted that reclassified debt instruments should be considered to be equity under the Danish thin capitalization regime.[13]

Based on a reading of the wording of section 2B, the provision should most likely be considered to be exhaustive as to the consequences of its application. Accordingly, equity treatment for tax purposes is mostly a matter of dividend taxation and the non-deductibility of interest payments and capital losses on debt. Narrowing the scope of section 2B to the consequences of the provision may be described as a system of partial reclassification. Dividend treatment of the yield of a hybrid financial instrument in Denmark has the immediate consequence that a deduction is not allowed, as dividends are not deductible.

The effects of the application of section 2B can be further developed by stating that the stated consequences apply under the ordinary Danish tax provisions as well as under the application of tax treaties. It was also stated that the provision has the effect that symmetry between the Danish and the foreign classification under tax treaties is realized.[14] The different treaty classification and different treatment of interest and dividends under tax treaties does not have any consequences under Danish law, as the domestic provisions regarding withholding tax result are either a full withholding tax or no withholding tax at all when the payment is covered by a tax treaty.

4.3. Denial of participation exemption – deductible dividends – 2006

Finally, Danish tax law contains a specific provision according to which the scope of the participation regime is limited. This rule was introduced in 2006 as part of another provision with regard to declared dividends. The current provision in section 13 of the SEL was introduced in 2008 and is a specific limitation to the participation exemption regime. Accordingly, the participation exemption is not granted with regard to dividends that are deductible by the paying company, unless the country of residence of the paying company reduces or eliminates withholding tax on the payment in question in accordance with the Parent-Subsidiary Directive (90/435).[15] This broadly scoped provision apparently includes most outbound hybrid financial instruments that are treated as debt in the issuing country and equity and/or dividend in Denmark at the level of a Danish parent company.

5. Conclusions and Reflections on the Use of Coordination Rules

This article should have demonstrated the frequent Danish use of coordination rules as a policy measure to counter cross-border tax arbitrage. In this regard, Denmark adopts a principle of correspondence.

Despite the successes in countering cross-border arbitrage, any genuine analysis of the use of coordination rules is absent. Consequently, a tax policy analysis and impact assessment is required with the objective of answering the question of whether or not unilateral measures in the form of coordination rules work to the benefit of a single jurisdiction. This is especially relevant when that jurisdiction is a small and open economy, such as the Danish one. From working with MNEs, the author is left with the impression that Denmark on this account may have lost foreign direct investment. This appears to be a high price to pay to taking on the leading role as the policeman of the world's tax systems. It is not intended that this presentation should analyse the policy implications of the type of legislation as enacted by Denmark and the general use of the principle of correspondence as a response to challenges arising from the interaction between the tax systems of different countries. It is, however, obvious that such an analysis is an important task that needs to be undertaken.

Accordingly, it is this author's hope that domestic politicians will think twice before placing up even more restrictions in an area such as hybrid finance. Instead, financial innovation could be embraced as a tool to realize benefits other than tax ones. It must be remembered that the use of hybrid financial instruments is, to a great extent, also driven by business reasons in obtaining lower costs of financing, greater financial flexibility and better credit ratings, etc. The creation of a hostile climate for financial innovation, including hybrid financial instruments, may give rise to competitive disadvantages for Danish companies, as the financial opportunities would then, in fact, be less attractive compared to the possibilities offered in other jurisdictions. Based on this, it might appear to be timely to reconsider the zero tolerance policy towards "loopholes" in the tax legislation. Basically, genuine willingness for reform would be refreshing in a Danish context, where unilateral harmonization efforts and the indefatigable closing of loopholes hardly resolve any structural problems and, in the end, may harm the competitiveness of Denmark's economy.

13. *See* enclosure 2 to Bill No L. 110B (2007).
14. *See* the specific remarks on Sec. 1, No. 3 to Bill No. L 110 B (2007).
15. EU Parent-Subsidiary Directive (1990): Council Directive 90/435/EEC of 23 July 1990 on the Common System of Taxation Applicable in the Case of Parent Companies and Subsidiaries of Different Member States, OJ L435 (1990), EU Law IBFD.