Denmark

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Cross-Border Tax Arbitrage Using Inbound Hybrid Financial Instruments Curbed in Denmark by Unilateral Reclassification of Debt into Equity

This article analyses a recently introduced provision in Danish tax law aimed at curbing cross-border tax arbitrage through the use of hybrid financial instruments. The effect of the provision is that debt between group companies is reclassified as equity, and thus interest into dividends. The article examines the requirements for applying Sec. 2B of the Danish Corporation Tax Act and provides a comprehensive analysis of the consequences of applying Sec. 2B.

1. Background: Hybrid Financial Instruments, Tax Arbitrage and Tax Policy

The use of hybrid financial instruments has increased dramatically in recent years in both the private and public sectors.[1] It is a well-known fact that hybrid financial instruments give rise to some difficult problems in the field of international tax law. One such problem is cross-border tax arbitrage.[2] Tax arbitrage and possible double non-taxation are important challenges and topics of discussion in international tax law.[3] National tax systems are bound to come under pressure in a globalized world where boundaries do not significantly impede businesses activities. National tax laws naturally vary from country to country, and the differences in them may result in advantages or disadvantages for taxpayers. Based on this, some countries have chosen to legislate directly against the benefits obtained by taxpayers from using hybrid financial instruments in a cross-border context.[4]

For some years now, the tax policy in Denmark has been that the domestic tax treatment of certain transactions could depend on the tax treatment in other jurisdictions.[5] A specific anti-arbitrage provision aimed at tax arbitrage structures using hybrid financial instruments was recently introduced into Danish tax law – namely, Sec. 2B[6] of the Danish Corporation Tax Act (CTA). Sec. 2B is merely the latest example of the development described. In essence, Sec. 2B results in a different tax treatment of inbound hybrid financial instruments depending on the tax treatment in another country.

This article examines the substantive aspects of CTA Sec. 2B.[7] Part 2 presents the objective of Sec. 2B, and Part 3 identifies some general issues regarding the provision. Part 4 analyses the requirements for applying Sec. 2B,

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1. Even though hybrid instruments were used as early as the 16th century by the first English companies, such instruments cannot generally be defined. It can be said that a hybrid financial instrument is a financial instrument that has economic characteristics which are partly or fully inconsistent with the classification implied by its legal form. See Duncan, General Reporter on Subject I: Tax treatment of hybrid financial instruments in cross-border transactions, *Cahiers de droit fiscal international*, Vol. 85a (2000), at 21, 22 et seq. (54th Congress of the International Fiscal Association, Munich, 2000). Such an instrument may have characteristics which are consistent with more than one tax classification (in more than one jurisdiction) or which are not clearly consistent with any classification. See id. Thus, the term is used for an array of financial instruments which have debt and equity features. See Nelken (ed.), *Handbook of Hybrid Instruments* (2000); Mackenzie, 1 *JARAF* 31 (No. 1, 2006); Eberhartinger, in Bischoff and Eberhartinger (eds.), *Hybride Finanzierungsinstrumente* (2005), at 121 et seq.; Connors and Woll, 553 *PLI/Tax* 175 (2002); Coyle, *Hybrid Financial Instruments* (2002), at 2; Committee of European Banking Supervisors (CEBS), *Report on a quantitative analysis of the characteristics of hybrids in the European Economic Area (EEA)* (2007), at 6; Eber-Huber, in *Hybrid Financing* (1996), at 8; and McCormick and Creamer (eds.), *Hybrid Corporate Securities: International Legal Aspects* (1987), at 2.
2. "International tax arbitrage" has been defined as "... taking advantage of inconsistencies between different countries' tax rules to achieve a more favourable result than which would have resulted from investing in a single jurisdiction ..."; Boyle, "Cross-Border Arbitrage – Policy Choices and Political Motivations", [2005] *British Tax Review*, No. 5, at 528, citing Rosenbloom, "International Tax Arbitrage and the International Tax System", 53 *Tax Law Review* 137 (2000).
3. This article does not analyse the policy rationale of legislation aimed at curbing tax arbitrage and the interesting policy discussions to which tax arbitrage gives rise. The international literature on the subject is growing rapidly; see e.g. Avi-Yonah, in *Bulletin for International Taxation* 4 (2007), at 130; Rosenbloom, supra note 2; Ring, in *Boston College Law Review* (2002), at 102; Boyle, supra note 2 and in *International Tax Review* 10 (October 2006); and Dell'Anese (ed.), *Tax Arbitrage and the Changing Structure of International Tax Law* (2006).
4. For a brief review of this development, see Bundgaard, in *SU* 2006/12.
5. In line with Sec. 2B (regarding hybrid financial instruments) of the Danish Corporation Tax Act (CTA) are: CTA Sec. 2A regarding Danish limited liability companies which are considered transparent in other countries; Sec. 5G of the Tax Assessment Act regarding the double-dip of expenses; and CTA Secs. 2(1)(d)(5)-(7) regarding the inapplicability of the interest withholding tax if the interest recipient is effectively taxed on the interest income. In fact, the policy also underlay the former CFC (controlled foreign company) legislation since CFC taxation in Denmark was triggered if the level of taxation in another country was below a certain level. After the decision of the European Court of Justice in *Cadbury Schweppes* (Case C-196/04), Denmark's CFC legislation was amended and now applies generally irrespective of the level of taxation of the CFC. Regarding tax legislation that depends on the tax treatment in other countries, see generally Michelsen, in *Festskrift til Mattson* (2005).
6. Act No. 344 enacted on 18 April 2007, based on Bill No. L 110 B. Sec. 2B applies to interest accrued and capital gains and losses realized on or after 31 December 2006.
7. The article does not consider the interaction of CTA Sec. 2B with EU law or double taxation treaties. Nor does the article present the general issues regarding the tax treatment of hybrid financial instruments outside the scope of Sec. 2B, which is limited to intra-group cross-border tax arbitrage.

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and Part 5 discusses the consequences of doing so. Part 6 briefly considers whether the new legislation in Denmark regarding intra-group contributions may change the current law on outbound hybrid financial instruments. Finally, Part 7 summarizes the results and assesses the impact of Sec. 2B.

2. Policy Objective of CTA Sec. 2B – Principle of Correspondence

The objective of CTA Sec. 2B is to abolish the potential asymmetrical tax treatment of certain hybrid financial instruments.[8] Such asymmetrical tax treatment may arise due to the different tax classification of an instrument in the countries involved. For example, the instrument could be classified as debt for Danish tax purposes, resulting in an interest deduction in Denmark, while the instrument could be classified as equity in the investor's residence country, in which case, depending on the legislation of the residence country, the income from the instrument could be considered to be tax-exempt dividends.[9]

To achieve this objective, Sec. 2B is based on the principle that a prerequisite for the interest deduction in Denmark is that the corresponding income is taxable in the hands of the interest recipient. Inspired by the literature on German law, this principle may be called the "principle of correspondence".[10] As stated above, this principle is far from a novelty in Danish tax law.

The tax policy rationale has been widely criticized on the basis that Denmark thereby takes on a coordinating role between different countries regarding the classification of hybrid financial instruments, while a similar effort is not made where double taxation occurs in cross-border transactions as a result of the different classification of the same financial instrument. The Minister of Taxation responded to this criticism by saying that it is inappropriate for an interest deduction to be allowed in Denmark if the recipient is not taxed on the interest payment, which could be the case if, under the foreign legislation, the payment is considered to be a dividend.[11] Further, the Minister stated that such asymmetry may give rise to tax arbitrage and that international tax planning aimed at obtaining a "free deduction" is prevented by the reclassification provided by CTA Sec. 2B.[12]

At present, there is no publicly available information to explain the introduction of this anti-arbitrage provision in Denmark. The use of hybrid financial instruments by Danish companies has historically been infrequent, but reportedly increasing. One possible reason for introducing the provision is that the increasing control efforts aimed at the activities of private equity funds have unveiled the use of various hybrid financial instruments. In addition, hybrid financial instruments are a hot topic internationally, which has resulted in the introduction of specific regimes in other European countries, such as the United Kingdom and Germany. Being a small country, Denmark may be obliged to simply follow the example of larger countries in the region. Finally, the political climate in Denmark is very sensitive to anything that may be seen as a "loophole", which is defined as anything that has not yet been subject to legislation.

3. General Remarks on CTA Sec. 2B and its Wording

CTA Sec. 2B may be translated into English as follows (author's translation):

Para. 1: If a company, association, etc., as mentioned in CTA Sec. 1 is indebted or similarly obligated to an individual or company resident in another country and the claim according to foreign tax rules is considered paid-in capital, the debt shall also be regarded as equity with respect to the Danish tax computation. This paragraph applies only if the foreign individual or foreign company has decisive influence over the Danish company or if the companies are considered to be in a group of companies according to the principles in Sec. 2 of the Tax Assessment Act.[13]

Para. 2: The classification according to Para. 1 means that the interest payments and capital losses of the company are considered to be dividend payments.

Para. 3: Paras. 1 and 2 are similarly applicable to companies that have limited tax liability in Denmark according to CTA Secs. 2(1)(a) and (b).

The enactment of Sec. 2B confirms the obvious – that Danish tax law did not already contain the principle of correspondence regarding interest deductibility under Sec. 6e of the State Tax Act and that financial instruments cannot be reclassified simply because their use results in a tax saving. The first point holds true even though the policy rationale of the deductibility of interest is probably found in the reasoning that income from capital should be taxed only once at the level of the creditor/investor, applying the net calculation principle, which in turn results in an interest deduction at the level of the debtor.[14] The fundamental provisions of Danish tax law – in Secs. 4 to 6 of the State Tax Act defining "taxable income" for corporation tax purposes – should therefore most likely be understood objectively to mean that a denial of the interest deduction requires specific statutory authority, irrespective of whether asymmetries may arise, if the investor is not taxed on the interest received.[15]

CTA Sec. 2B is aimed directly at hybrid financial instruments. No examples, however, are provided in the wording or preparatory work as to which instruments fall

8. See the general remarks on Bill No. L 110 B.
9. See the general remarks on Bill No. L 110 B Sec. 1(iii).
10. Dörfler, Heurung and Adrian, in *DStR* 2007, at 514.
11. See Enclosure 10 to Bill No. L 110 B.
12. Id.
13. Enclosure 3 to Bill No. 110 B stated that the wording of CTA Sec. 2B should be reformulated since, as a matter of definition, a "claim" cannot be equity, but is instead an asset. This criticism resulted in changing the wording of Para. 1 from "the claim according to foreign tax rules is considered equity" to "the claim according to foreign tax rules is considered paid-in capital".
14. See Hemmingsen, in *SkatteOrientering 4.14.* (1982), at 5.
15. Id. at 5-6.

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within the substantive scope of Sec. 2B and between which countries the required asymmetry may arise. The applicable or underlying definition of hybrid financial instruments is: "instruments classified as equity in one country while classified as debt in another country". This rather broad definition was criticized in the hearing process on the basis that it could lead to uncertainty.[16] The Minister of Taxation, however, declined to provide a more specific definition because a further clarification would lead to new "loopholes".[17]

From a practical point of view, it is important to note that the anti-arbitrage provision in CTA Sec. 2B only addresses inbound hybrid instruments that may give rise to an interest deduction in Denmark. Sec. 2B does not address outbound hybrid instruments that give rise to a foreign deduction but no corresponding inclusion of income in Denmark.

The scope of CTA Sec. 2B is analysed below. The provision can be applied only if certain requirements, which can be derived directly from the wording of Sec. 2B, are satisfied simultaneously.

4. Requirements for Applying CTA Sec. 2B

4.1. Taxable company in Denmark as debtor

The first requirement for applying CTA Sec. 2B is that a fully taxable Danish company be "indebted or similarly obligated". CTA Sec. 1 lists the companies that are fully taxable in Denmark; the list covers all the common types of corporate entities such as limited liability companies, associations of a cooperative nature and entities similar to foundations. Moreover, foreign companies effectively managed from Denmark are fully taxable according to CTA Sec. 1(6) and thus fall under CTA Sec. 2B. In addition, foreign companies included in a Danish international tax consolidation under CTA Sec. 31A are most likely considered to be covered.[18]

It is unclear whether CTA Sec. 2B applies to controlled foreign companies (CFCs) or operates in conjunction with the CFC legislation in CTA Sec. 32. Other anti-avoidance provisions have specifically excluded CFCs from their scope, but with no explanation why this was done. No official guidelines are available on the issue.[19] It appears that no firm conclusion can be drawn regarding this issue.

According to CTA Sec. 2B(3), Sec. 2B also applies to foreign companies that have limited tax liability in Denmark due to the presence of a permanent establishment (PE) or immovable property (CTA Secs. 1(1)(a) and 2(1)(b)). The existence of a PE or immovable property is to be determined on the basis of the ordinary applicable principles and should not give rise to any practical problems. Sec. 2B does not, however, apply to foreign individuals who have limited tax liability in Denmark due to the presence of a PE or immovable property even though the individuals may be considered shareholders with decisive influence within the meaning of Sec. 2 of the Tax Assessment Act. This again may lead to the result that Danish companies owned by foreign individuals fall within the scope of CTA Sec. 2B, but PEs and immovable property do not.

4.2. Indebtedness

The second requirement for applying CTA Sec. 2B is that a company described above must be "indebted" to a creditor.[20] As a starting point, there is hardly any doubt as to the meaning of this part of Sec. 2B, being that the hybrid financial instrument in question must be classified and treated as debt according to the general definition of debt in Danish tax law. The critical element is whether a *legal claim for payment in the form of money exists*. The preparatory work on the Act on Taxation of Gains and Losses on Debt Claims, Debts and Financial Instruments (1997) follows the definitions of claim and debt in Circular Letter No. 134 dated 29 July 1992, sentence 4, regarding the former version of the Act. According to the prevailing view, the notion of claim, and thus of debt, is based on the private law meaning of those terms. The private law definition of a creditor's claim is "a claim on a money payment". A debt obligation arises from such claims, but there is no definition of debt for private law purposes. A loan agreement is traditionally defined as an

16. A better definition could include the economic characteristics of hybrid financial instruments and not only follow their tax law classification. The difference has no legal significance, but as a matter of principle, it seems more accurate to include in the definition of hybrid financial instruments those instruments which are not necessarily classified differently in different countries, but which in fact contain the economic terms and conditions that make an instrument a hybrid by its economic nature.

17. See Enclosure 2 to Bill No. L 110 B.

18. According to CTA Sec. 31(2), taxable income under tax consolidation is the sum of the taxable income of each company in the tax consolidation calculated on the basis of the ordinary rules in Danish tax law, with only those exceptions which apply to companies in a tax consolidation. The preparatory work on CTA Sec. 31A (regarding international tax consolidation) stated that the principles in CTA Sec. 31 (regarding mandatory domestic tax consolidation) are similarly applicable, with the additions and omissions specifically stated in CTA Sec. 31A. See Bill No. L 121 (2005). Thus, the Danish legislature now specifically presumes that all Danish tax provisions apply for purposes of calculating consolidated income unless a different result is specifically provided by law. Prior to this clarification, the Minister of Taxation on several occasions considered foreign companies in a Danish tax consolidation to be fully taxable companies in Denmark even though, in a strictly legal sense, such foreign companies are not fully taxable according to CTA Sec. 1 and are not mentioned in that provision. See e.g. Enclosures 21 and 39 to Act No. 321 of 31 March 2004.

19. It may be argued that CTA Sec. 2B *does not apply* to CFCs because CFCs are not taxable in Denmark according to CTA Sec. 1 or 2. Moreover, it should be noted that the thin capitalization legislation in CTA Sec. 11 explicitly does not apply. See the remarks on Bill No. 101 introducing CTA Sec. 11. Similarly, CFCs are not mentioned in the administrative guidelines on formal transfer pricing documentation. See Para. 2.1.7 of the Transfer Pricing Documentation Guidance (*dokumentationsvejledningen*), which mentions only foreign companies that are in a voluntary tax consolidation under CTA Sec. 31C, but not CFCs. In this regard, it should be noted that the personal scope of the transfer pricing legislation in Sec. 3B of the Tax Control Act and Sec. 2 of the Tax Assessment Act is identical.

On the other hand, it may also be argued that CTA Sec. 2B *does apply* to foreign CFCs. For example, CTA Sec. 32(5) states that CFC income is the sum of the specifically mentioned taxable income/gains and deductible expenses/losses. CFC income should be calculated according to Danish tax law, but the question is whether all of the domestic provisions apply. The preparatory work on Denmark's former CFC legislation (CTA Sec. 32; Bill No. L 99 (2002)) repeated several times that the ordinary Danish tax rules apply. Such a statement is also included in CTA Sec. 2B. Moreover, it may be said that the clarification reported above regarding foreign companies in a Danish tax consolidation is of general importance.

20. For requirements pertaining to creditors, see 4.3.

agreement between a lender and a borrower whereby the lender puts a cash amount or credit facility at the borrower's disposal for a certain period of time.[21] For tax law purposes, the notion of debt is traditionally summarized as: (1) a legal obligation (2) which is real and (3) which obliges the borrower to repay the amount advanced (4) based on an exchange of promises and payments between the parties.[22] This notion of debt is mostly in line with the private law concept of debt. However, the specific substantive requirement is more relevant for tax law purposes, and there are numerous cases dealing with this specific requirement in tax avoidance situations where the taxpayer has taken on formal debt obligations which involve no real economic risk. Such tax avoidance schemes have generally been struck down by the Danish courts.

Based on the freedom of contract, the terms and conditions of a loan agreement can vary as regards the maturity, yield, repayment, etc. An important task still outstanding pertains to the tax classification and general treatment of hybrid financial instruments, but this task is beyond the scope of this article. Instead, it should be noted that CTA Sec. 2B requires that the instrument in question be considered debt according to the principles of Danish tax classification even though the classification is not always easy.

For example, one question under discussion is whether perpetual debt should be considered debt under Danish tax law absent of the central debt characteristic of maturity.[23] In addition, it is still uncertain whether hybrid financial instruments that allow the debtor to *repay the debt by any means other than money* (*realydelser*) fall under the notion of debt. This question is of great importance for hybrid financial instruments which obligate the debtor to repay in shares, other securities, or value in kind.[24]

Several types of hybrid financial instruments have so far been classified as debt according to domestic tax law. The list includes perpetual loans,[25] "super maturity" loans, mandatory convertibles and convertible bonds.[26] Based on the different principles that apply in different countries, there is a risk that such instruments fall under CTA Sec. 2B.

It not entirely clear what the Danish legislature intended by the reference to situations "similar" to indebtedness in CTA Sec. 2B(1). The specific remarks on Bill No. L 110 B, regarding Sec. 1(iii), stated that the notion of "debt or similar" (in Danish "*gæld eller lignende*") should be understood broadly, including all financing alternatives which, for tax purposes, are treated in a way similar to debt, i.e. with a deduction for interest payments and/or capital losses. It is, however, not clear which financial instruments are intended.

4.3. Foreign individual or company as investor – notions of "decisive influence" and "group of companies"

The scope of the anti-arbitrage provision in CTA Sec. 2B is similar to that of Denmark's transfer pricing legislation in cross-border situations. The scope of Sec. 2B, however, is limited to situations where a foreign person has decisive influence over a Danish company or group-related companies. Sec. 2B does not apply where a Danish company has decisive influence over a foreign company. But the result may be similar if a Danish parent company and a foreign subsidiary are considered to constitute a group of companies.

The term "decisive influence" is defined in Sec. 2(2) of the Tax Assessment Act as ownership of, or the right to dispose of, voting rights by foreign corporations or individuals that directly or indirectly own or dispose of more than 50% of the share capital or voting rights.[27] Following a 2006 amendment to the personal scope of the transfer pricing legislation, certain foreign entities which would normally be considered transparent under the Danish entity classification principles and which are regulated by company law or articles of association are also included within the scope of Sec. 2 of the Tax Assessment Act. The wording of CTA Sec. 2B includes "individuals and companies" as controlling shareholders. The Minister of Taxation has clearly interpreted this as also including transparent entities.[28] But it is legitimate to ask whether this interpretation has sufficient support in the wording of the provision. A strict reading of CTA Sec. 2B in conjunction with Sec. 2 of the Tax Assessment Act may lead to the interpretation that CTA Sec. 2B refers only to Secs. 2(2) and (3) of the Tax Assessment

21. See e.g. Bryde Andersen, *Enkelte transaktioner – Aftaleretten III* (2004), at 126; and Bryde Andersen and Lookofsky, *Lærebog i obligationsret I* (2000), at 107.
22. For an extensive analysis of the notion of debt in Danish tax law, see Ramskov, *Intern selskabsomstrukturering* (2001), at 333 et seq.
23. See the memo prepared by the legal adviser to the Danish government printed as Enclosure 92 to Act No. 457 dated 9 June 2004 (Bill No. L 60).
24. According to Skouby et al., *Kursgevinstloven – en lovkommentar* (2000), at 37, claims allowing alternatives to cash payments fall under the Act on Taxation of Gains and Losses on Debt Claims, Debts and Financial Instruments only if the creditor is free to choose the means of payment. This interpretation may result in certain mandatory convertibles not being classified as debt for Danish tax purposes.
25. Caution should be taken with such instruments, however, since the Minister of Taxation has repeatedly refused to recognize perpetual debt as debt, but this issue was not finally clarified in CTA Sec. 2B.
26. This has been confirmed by the Minister of Taxation; see Enclosure 2 to Bill No. L 110 B.
27. The notion of decisive influence has been thoroughly analysed in the literature on the subject. For the most recent changes to the notion of decisive influence and the concepts of control and group, see Bundgaard, in *DFI* 2006/5, at 223; Ottosen and Nørremark, in *Bulletin for International Taxation* 10 (2006), at 402; Bjørnholm and Becker-Christensen, in *European Taxation* 10 (2006), at 504; and Josephsen and Dettman Nielsen, in *DFI* 2006, at 274.
28. In Enclosure 2 to Bill No. L 110 B, the Minister of Taxation stated that the essential issue regarding transparent entities under CTA Sec. 2B is whether the transparent entity can be said to have decisive influence over the Danish debtor company. As mentioned below, the Minister of Taxation further stated that the classification of a hybrid financial instrument in the hands of the participants in a transparent entity is crucial and that pro rata calculations should be made if the classification differs among the different participants in the transparent entity.

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Act regarding the definitions, respectively, of decisive influence and group-related companies, but does not refer to Sec. 2(1) of the Tax Assessment Act which defines the entities, including transparent entities, that can have decisive influence over the debtor entity. The question then is whether the terms "company" and "legal person" are understood to be identical. The latter is directly supplemented, in Sec. 2(1) of the Tax Assessment Act, by transparent entities, which further raises the question whether the term "company" can be defined so as to include both taxable and non-taxable entities. Once again, it would be preferable if the Danish legislature minimized the use of different terms for items/entities that were perhaps thought to be the same. It should be noted that individuals are included in the wording of both provisions. If it is assumed that the courts will also find that the personal scope of "creditor" in CTA Sec. 2B and Sec. 2 of the Tax Assessment Act is identical, it is relevant to analyse the scope of Sec. 2 of the Tax Assessment Act in this context.

Shares or voting rights held by or disposed of by group-related companies, individual shareholders and closely-related individuals, as well as foundations or trusts established by these individuals, are included in applying the decisive influence test (see Sec. 2(2) of the Tax Assessment Act). Moreover, shares or voting rights held by or disposed of by other participants in the Danish company with whom the participant in question has entered into an agreement on the common exercise of decisive influence over the Danish company should be included in the test (see Sec. 2(2) of the Tax Assessment Act). Act No. 308 of 19 April 2006 introduced a new concept of "group of companies" for purposes of the transfer pricing and thin capitalization legislation, the withholding tax on interest payments and capital gains on claims, etc.

The term "group of companies" is now defined in Secs. 2(3) and 3B(3) of the Tax Control Act, which define "group of legal persons" as legal persons in which the same circle of participants is in control or where there is common management among the shareholding entities.[29]

Thus, the scope of CTA Sec. 2B, through the use of the concept of group of companies in Sec. 2(3) of the Tax Assessment Act, is actually broader than one would expect. Thus, foreign subsidiaries of Danish companies are included under CTA Sec. 2B whether or not a Danish parent company has decisive influence over a foreign company. Regarding Sec. 2B, therefore, the relevant test for foreign subsidiaries is whether there is a common group of shareholders in the Danish parent company and foreign subsidiary which owns more than 50% of the shares in both (or more) companies or disposes of more than 50% of the voting rights in both (or more) companies. It should be noted, however, that these situations are not of great practical importance since investments from foreign subsidiaries in Danish parent companies by way of hybrid financial instruments which are treated as equity in the subsidiary's residence country would probably result in a cross-holding situation.

By including foreign individuals as controlling creditors within the scope of CTA Sec. 2B, Sec. 2B is broader than the thin capitalization legislation in CTA Sec. 11, which does not apply to shareholder loans provided by individuals or to third-party loans secured by individual shareholders.[30]

4.4. Treatment of debt instrument as equity in the investor's residence country

The final requirement in CTA Sec. 2B is that the Danish debt instrument must be treated as equity/paid-in capital under the tax legislation of the "creditor's" residence country. Thus, the tax treatment of a Danish company now depends on the tax treatment in the foreign jurisdiction; this requires knowledge of the foreign tax legislation in order to fulfil the obligation to provide proper and correct tax accounts under Danish law. This issue was addressed in the hearing process, where it was stated that it seemed unreasonable to demand knowledge of foreign tax legislation.[31] In response, the Minister of Taxation simply said that such a task did not seem insurmountable since CTA Sec. 2B is aimed at group-related companies (and controlling individual shareholders, not to forget) and that one could simply abstain from using hybrid financial instruments.[32]

The question arises as to the meaning of "foreign tax legislation" in the test of equity/paid-in capital treatment. In some countries, the debt/equity classification is based on case law, and the tax treatment depends on the general tax legislation regarding dividends and interest payments. Other countries have introduced specific legislation containing a "bright line" test for distinguishing between debt and equity. Still other countries have enacted legislation specifically aimed at hybrid financial instruments. The wording of CTA Sec. 2B should most likely be interpreted as including all the different approaches even if no guidance has been provided on the issue.

There has been no clear guidance on which attributes of a hybrid financial instrument should be considered when applying the test of equity/paid-in capital treatment in the creditor's residence country. As stated in the general remarks on Bill No. L 110 B, the legislature clearly aimed at the situation where the creditor benefits from a participation exemption regime. Foreign tax credit regimes may also be relevant if the corporation

29. The former definition of "group of companies" included only the first part of the sentence. The amendments added another variation of de jure control to the general concept of control in Danish tax law. The technical implication for the meaning of "group of companies" is that the shareholdings and voting rights held by other participants must be included in determining whether a participant is in control of the company. The definition of "group of companies" now also includes agreements on common management of a Danish company.
30. See e.g. Bundgaard, in *SU* 2004/209.
31. See Enclosures 2 and 3 to Bill No. L 110 B.
32. See Enclosures 2 and 10 to Bill No. L 110 B.

tax was paid in Denmark, which should result in a foreign tax credit. There may, however, be no tax saving at the group level if there is no taxable income in Denmark due to the large interest deductions arising from the hybrid debt instruments.

It is not clear whether the other parts of a foreign tax regime regarding the tax treatment of equity should apply before CTA Sec. 2B can be invoked. Thus, it is uncertain whether the equity test should be read in conjunction with the equity treatment prescribed by CTA Sec. 2B for companies that fall under it and must accept a reclassification of debt into equity (see CTA Secs. 2B(1) and (2)). As stated above, it seems obvious to interpret Sec. 2B as being exhaustive regarding the consequences of applying it. Due to the uncertain nature of this interpretation, it is considered which other parts of a foreign tax regime regarding the treatment of equity may be relevant. One example is the capital gains tax regime relating to shares and similar securities. Thus, it may be considered whether CTA Sec. 2B requires that a capital gains tax regime in the investor's residence country apply to the hybrid financial instrument in question in order for the equity test to be met.

Moreover, the question is whether the treatment of the yield (dividend) of the hybrid financial instrument is caused by the treatment as paid-in capital under foreign tax rules. In some countries, the domestic tax legislation provides that the yield of certain hybrid financial instruments is treated as dividends and thus may benefit from the participation exemption even though the instrument is generally not considered equity.

There seems to be no authority to support the Danish tax authorities in requiring that two positive requirements be satisfied, including the classification as debt and the taxation of interest in the hands of the creditor, in order to maintain the classification as debt in Denmark. Such an interpretation would automatically result in a reclassification in Denmark if (a) the interest is paid to creditors resident in low/no-tax jurisdictions or to creditors that are tax exempt in their residence country, and (b) the other requirements of CTA Sec. 2B are met. Sec. 2B does not support such an interpretation; for this reason, the Danish tax authorities are compelled to rely on the interest withholding tax or the thin capitalization legislation if they want to impose tax with respect to a debtor/creditor relationship where the creditor is in a low/no-tax jurisdiction. Arguably, CTA Sec. 2B should be read as containing a negative requirement to the effect that the instrument in question should not be treated as equity under the laws of another country if the instrument at the same time is considered debt under Danish tax law. This requirement is further developed in 5.

The boundary between debt/equity instruments and other financial instruments is not always clear. In practice, some instruments are used which do not rely on the debt/equity classification in all the participating countries. From the present wording of CTA Sec. 2B, there is little doubt that other financial instruments which may be considered debt under Danish tax law, but considered a financial instrument not being an equity instrument in the creditor's country (e.g. a future, option, warrant or repo), do not fall under CTA Sec. 2B.

Moreover, it is not clear whether CTA Sec. 2B is applicable if the hybrid financial instrument in the creditor's residence country is treated based on a *bifurcation approach*, resulting in partly debt treatment and partly equity treatment. Under such circumstances, the instrument is certainly treated as equity for foreign tax purposes, but only partly. The only reasonable response under CTA Sec. 2B to such situations would be to adopt the foreign bifurcation approach when reclassifying the instrument in Denmark, whereby only the part of the instrument that is equity under foreign law is reclassified as equity for Danish tax purposes. This approach seems to find support in the answer of the Minister of Taxation in Enclosure 2 to Bill No. L 110 B, as discussed below. According to the current wording of CTA Sec. 2B, however, the Danish tax authorities could probably reclassify the whole instrument under it, irrespective of the partial equity treatment in the investor's residence country. This result is not in line with the underlying policy rationale of CTA Sec. 2B.

As a practical matter, the requirement of equity treatment at the level of the creditor may give rise to problems if the shareholder in the Danish debtor company is a *transparent entity* or a structure of *transparent entities*. In this situation, it should be considered at which level it must be determined whether the hybrid financial instrument is in fact considered equity in the investor's country.[33] The Minister of Taxation did not fully answer this question and stated that, when dealing with transparent entities as investors in hybrid financial instruments issued by Danish companies, one should simply consider the classification in the hands of the participants in the transparent entity.[34] In his answer, the Minister also stated that if the hybrid financial instrument is considered equity only in the hands of some of the participants, a pro rata reclassification should be made. The essential issue in this respect is whether the transparent entity can be said to have decisive influence over the Danish debtor company. The practical implications of such a pro rata reclassification have not been considered.

The test of whether a hybrid financial instrument actually exists should be *applied* at the time the instrument is created or when CTA Sec. 2B took effect.[35] The Minister of Taxation stated that if the creditor moves to another jurisdiction during an income year, the test should be applied again in order to determine whether CTA Sec. 2B is applicable in the new setting.

33. This issue was raised by DI (the association of Danish Industry) in the hearing process; see Enclosure 2 to Bill No. L 110 B.
34. See id.
35. See id.

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Interpretative guidelines have been provided regarding subordinated loans. In Enclosure 3 to Bill No. L 110 B, the Minister of Taxation was asked to confirm that subordinated loans (*ansvarlig lånekapital*) would not be considered equity for Danish tax purposes under CTA Sec. 2B. The Minister responded that subordinated loans would still be regarded as loans if the advance under foreign rules is considered a claim and the recipient is taxed on the yield as interest. The first part of the answer is not surprising, but the second part is. There seems to be no authority for the second part in the wording of CTA Sec. 2B and the preparatory work relating to it. Sec. 2B gives specific authority to reclassify a debt instrument if it is considered equity/paid-in capital in another country (a negative requirement). This, however, is not the same as saying that the advance should be considered equity/paid-in capital *and* that the yield of the advance should be taxed as interest income (a double positive requirement). In other words, a change in the wording seems to be necessary to enforce a dual requirement consisting of debt classification and actual taxation of interest income in a foreign jurisdiction in order not to be considered equity for Danish tax purposes.

5. Consequences of Reclassifying Debt into Equity

From an overall perspective, CTA Sec. 2B is an effective barrier to using hybrid financial instruments in a cross-border setting with the aim of obtaining benefits from tax arbitrage. The specific extent of this barrier as regards the increased use of hybrid finance in Denmark is uncertain.[36]

As a consequence of applying CTA Sec. 2B, the debt instrument is considered equity for purposes of the Danish income tax computation (see CTA Sec. 2B(1)). CTA Sec. 2B(2) clarifies this consequence. It provides that, as a result of the reclassification, the interest expenses and capital losses on debt are treated as dividend payments made by the Danish debtor company. The effect of this reclassification is based on the following.

CTA Sec. 2B states that the treatment as "paid-in capital" in the investor's country should result in the treatment as "equity" for Danish income tax purposes. Danish tax law, however, does not generally use the term "equity"; in fact, only very few provisions use the term.[37] The Minister of Taxation said, however, that Sec. 2B will have an impact on all the other provisions in Danish tax legislation which use the term "equity" so that reclassified debt instruments will also be considered equity under the other provisions.[38] It was specifically mentioned that reclassified debt instruments should be considered equity under the thin capitalization legislation in CTA Sec. 11, even though the definition in Sec. 11(3) cannot be said to admit reclassified debt as equity without actually changing the existing definition of equity. This is not a practical problem, however, because of the limited use of the term "equity" in Danish tax legislation.

Uncertain of the reason, the legislature chose to describe the full consequences of applying CTA Sec. 2B by elaborating in Sec. 2B(2) the consequences set forth in Sec 2B(1). Thus, reclassification under Sec. 2B results in treating interest payments and capital losses on debt as dividends for purposes of the Danish tax computation.

Based on the wording of CTA Sec. 2B, Sec. 2B should most likely be considered *exhaustive* regarding the consequences of its application. Thus, equity treatment for tax purposes is mostly a matter of dividend taxation and the non-deductibility of interest payments and capital losses on debt. If the consequences of applying Sec. 2B are narrowed this way, the consequences may be described as a *partial reclassification*. The dividend treatment of the yield of a hybrid financial instrument in Denmark has the immediate consequence that a deduction is denied since dividends are not deductible.[39] Other immediate consequences are that the possible withholding tax on the payment is reduced from 30% (see Sec. 65(1) of the Tax at Source Act regarding interest and capital gains on claims) to 28% (see Sec. 65D of the Tax at Source Act regarding dividends) and that the requirements for an exemption from the Danish dividend withholding tax (according to CTA Sec. 2(1)(c)) are different from those applicable to interest payments and capital gains (according to CTA Secs. 2(1)(d) and (h)).

As a matter of interpretation, it should also be mentioned that interest on hybrid debt instruments is not actually covered by the wording of Sec. 16A of the Tax Assessment Act (the main provision on the taxation of dividends which contains the definition of dividends for Danish tax purposes). This issue was raised in the hearing process (see Enclosure 3 to Bill No. L 110 B). The Minister of Taxation answered that payments under a reclassified instrument are considered dividends and thus may be subject to withholding tax under CTA Sec. 2(1)(c).[40]

36. CTA Sec. 2B provides corporate finance economists a good opportunity to analyse the importance of taxation as a main driver in the use of hybrid financial instruments. Such an analysis was made regarding the Australian market, where specific anti-arbitrage measures were introduced; see Mackenzie, supra note 1. Mackenzie concluded that the expectations regarding tax arbitrage resulting from a "bright line" test could not be documented. Thus, the new types of hybrid financial instruments replacing "income securities" were not ostensibly based on any unintended tax outcomes. However, it was found reasonable to suspect that cross-border tax arbitrage may have played a part in the increased issuance into overseas markets, even though other explanations could also be found for this. Based on this, it is suggested that taxation is not a primary driver in the use of hybrid financial instruments, but rather a secondary driver after the accounting treatment, financial regulation and market preferences.

37. The primary example is the thin capitalization legislation in CTA Sec. 11. Sec. 11(3) defines "equity" as the total booked and non-booked assets at their fair market value of the debtor company after deducting the company's debt. The only other provision that comes to mind is Sec. 14 of the Tonnage Tax Act regarding overcapitalization of shipping companies which would otherwise occur because of the non-deductibility of interest expenses. Sec. 14 does not define equity, but says that the value should be based on the accounting values and should probably be understood in line with the equity stated in the company's accounts.

38. See Enclosure 2 to Bill No. L 110 B.

39. See Sec. 6e of the State Tax Act *e contrario*.

40. See Enclosure 10 to Bill No. L 110 B.

According to CTA Sec. 2(1)(c), a foreign company owning at least 10% (15% in 2007 and 2008) (a parent company) of the share capital of the paying company (the subsidiary) for a period of at least one year is not subject to withholding tax on the dividends. Another requirement for this treatment is that the dividends must be exempt from tax or subject to a reduced tax rate under the EU Parent-Subsidiary Directive (90/435/EEC) or a double taxation treaty between Denmark and the residence country of the parent company. Moreover, the withholding tax does not apply to certain transparent companies covered by the EU Parent-Subsidiary Directive (Art. 2(1)(a)).

The interest withholding tax was introduced in Denmark in 2004 and applies to interest payments and capital gains to related parties.[41] According to CTA Sec. 2(1)(d), foreign related companies are subject to the Danish withholding tax on interest paid by a Danish company, but only if the interest is connected to debt that is a "controlled debt" within the meaning of Sec. 3B of the Tax Control Act. A similar provision has been introduced regarding capital gains on claims arising from debt redeemed with a premium agreed in advance (see CTA Sec. 2(1)(h)). Interest payments and capital gains are not subject to the full Danish withholding tax if one of the following exemptions applies:

- the interest is effectively connected to a PE in Denmark;
- the tax is be reduced or eliminated under to the EU Interest/Royalties Directive or the tax treaty between Denmark and the recipient company's residence country;
- the recipient company is under the decisive influence of a Danish company according to CTA Sec. 31C (whereby Denmark's CFC rules in CTA Sec. 32 may apply);
- the recipient company is controlled by a company resident in a treaty country and the controlling company may be subject to CFC taxation on the interest if the applicable conditions are met under the CFC legislation of the company's residence country; or
- the recipient company proves that the foreign corporation tax on the interest is at least three quarters of the Danish corporation tax and that the recipient company does not pay the interest to foreign companies which are taxed on the interest at a level below three quarters of the Danish corporation tax.

It should be assumed that the interest payments that are not deductible as a consequence of CTA Sec. 2B are identical to those that may be subject to withholding tax under CTA Sec. 2(1)(d) because the latter aims at interest as normally understood under Danish law.[42] In practice, a direct loan from a related company in a non-EU/treaty country to a Danish related company will trigger a 30% withholding tax in Denmark on the paid interest or realized capital gains. This is not the case with payments to related companies resident in the European Union or a treaty country.

As a consequence of CTA Sec. 2B read in conjunction with CTA Sec. 2(1)(c) (regarding the dividend withholding tax), in many situations where debt is reclassified as equity, the dividend payments will not be subject to withholding tax in Denmark because the controlling company is considered to be a parent company according to CTA Sec. 2(1)(c) if it owns 10% (15% in 2007 and 2008) or more of the share capital of the Danish company. If, however, the parent company is not resident in an EU Member State or in a country with which Denmark has a tax treaty, the dividend withholding tax may be levied. The result may be the same if CTA Sec. 2B applies to companies which are group-related because of an overlapping group of shareholders or if the decisive influence test is met by way of voting rights. Under these circumstances, the exemption from the dividend withholding tax in CTA Sec. 2(1)(c) does not apply because direct ownership of at least 10% (15% in 2007 and 2008) of the dividend-paying company is not present.

As mentioned above, the consequences of applying CTA Sec. 2B are directly and exhaustively enumerated in the provision. If, however, this reading is not correct, there may be further consequences of treating hybrid financial instruments as equity. If CTA Sec. 2B is viewed this way, it may be described as a *full reclassification*. The possible consequences of this interpretation are presented below.

One further consequence beside the consequences described above is that any capital gains on debt are no longer taxable for the issuer (debtor) under the general rule in Sec. 6 of the Danish Gains on Securities and Foreign Currency Act. This interpretation is uncertain, however, because the wording of CTA Sec. 2B seems to be exhaustive in that it states the consequences of treating interest payments and capital losses as dividends. But the intent of Sec. 2B as interpreted by the Minister of Taxation may be broader that what can be read directly from the wording of Sec. 2B. The Minister of Taxation has interpreted the provision to cover aspects not expressly stated in the wording.[43]

As regards the investor, there is no authority for levying a withholding tax on any capital gains realized on the disposal of an equity instrument.[44] It may be argued, however, that any capital gains realized should be treated as dividends on which a withholding tax can be levied. In conclusion, in the author's opinion, the Danish courts will most likely conclude that CTA Sec. 2B is exhaustive.

The *amounts* subject to equity treatment are interest payments actually paid and capital losses suffered by the repayment of principal. Thus, regarding capital losses, the amount treated as dividends should be calculated based on the general rules for calculating capital gains in

41. See CTA Sec. 2(1)(d), enacted by Act No. 221 of 31 March 2004 (Bill No. L 119).
42. See Enclosure 21 to Bill No. L 119.
43. See the above discussion regarding the knock-on effect of interpreting the notion of equity for tax law purposes.
44. See CTA Sec. 2e *e contrario*.

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Sec. 26 of the Gains on Securities and Foreign Currency Act. The wording of CTA Sec. 2B implies that "interest payments" are treated as dividends. But it is not clear if this also applies to interest not actually paid that is *accumulated and/or rolled into* the principal of the advance which at some point in time may be settled by the issuance of shares in the issuing company or another company or may not be payable at all. Interest on such instruments has on some occasions been accepted as interest for Danish tax purposes. According to Sec. 5(4) of the Tax Assessment Act, Danish companies realize income/expenses on an accrual basis; thus, interest may be deducted even if no interest is actually paid. The question is whether such "interest", which is considered interest under Sec. 6e of the State Tax Act and Sec. 5(5) of the Tax Assessment Act, is also considered an "interest payment" under CTA Sec. 2B. There is little doubt in this author's mind that the Danish tax authorities will interpret Sec. 2B broadly, resulting in the denial of interest deductions. This interpretation is supported by the general notion of interest payments and the provisions on the entry into force in Bill No. L 110 B, which mentions "incurred interest".

In the specific remarks on Sec. 1, No. 3, of Bill No. L 110 B, the consequences of applying CTA Sec. 2B are developed further by saying that the stated consequences apply under the ordinary Danish tax provisions as well as under double taxation treaties. It is stated that CTA Sec. 2B thereby has the effect of achieving symmetry between the Danish and foreign classifications under a double taxation treaty. The different treaty classification and different treatment of interest and dividends under tax treaties do not have any consequences under Danish law because the domestic provisions on withholding tax result in either a full withholding tax or no withholding tax at all if the payment is covered by a treaty (see CTA Secs. 2(1)(c), (d) and (h)), irrespective of whether Denmark as the source country has partial taxing rights.

In this context, it need not be analysed whether the unilateral reclassification results in a treaty override, which should be considered a violation of the principle of *pacta sunt servanda*. It should be noted, however, that Denmark does not force a situation of double taxation, but rather ensures single taxation.

6. Brief Note on Outbound Hybrid Financial Instruments – Danish Investor and Foreign Issuer

The main focus of this article has been the anti-arbitrage provision in CTA Sec. 2B. Nevertheless, it is highly relevant to consider whether a recent provision on group contributions will lead to the same result regarding outbound hybrid financial instruments.[45]

According to CTA Sec. 31D(1), the recipient of a group contribution is tax exempt on the contribution if it is made between companies which could opt for international tax consolidation (see CTA Sec. 31C). This, however, applies only if the contributing company is a direct or indirect parent company of the receiving company or if the receiving and contributing companies directly or indirectly have a common parent company (see CTA Sec. 31D(1)). Moreover, it follows from CTA Sec. 31D(2) that the general rule on group contributions does not apply to declared dividend payments made to shareholders. Further, this also applies to other dividend payments according to CTA Sec. 31D(2). According to the wording of CTA Sec. 31D(2), however, it does not apply if the paying company can deduct the contribution under foreign tax law. In such cases, CTA Secs. 31D(1) and (6) apply instead. If follows from CTA Sec. 31D(6) that group contributions are taxable for a Danish recipient if the contribution is deductible for the foreign paying company.

The policy objective of CTA Sec. 31D(6) is to prevent an asymmetrical tax treatment if a deduction is allowed under foreign tax law while the corresponding contribution is not taxed in Denmark. In other words, once again the principle of correspondence.

The legislation on group contributions and the interaction with the tax legislation on dividend payments give rise to the question whether a specific regime has been introduced through the back door – curbing cross-border tax arbitrage regarding outbound hybrid financial instruments.[46] When the Bill was considered in the parliament, it was stated that the Bill seemed to introduce a very broad possibility for reclassification and the impression was that the Minister of Taxation sought by CTA Sec. 31D to introduce a legislative counterpart to CTA Sec. 2B whereby dividend payments to a Danish company by a foreign company could risk being reclassified into taxable contributions. This was criticized on the basis that such an intent was not clearly stated in the Bill or in the preparatory work.[47] Finally, when the Minister of Taxation was requested to clarify the intent of the legislation on this point, the Minister did not give a clear or principled answer.[48] Based on this, the discussion below analyses whether such a broad possibility for reclassifying dividends exists and what impact, if any, it may have on cross-border hybrid financial instruments.

Following the wording of CTA Sec. 31D(1), it is seen that the provision applies only to contributions (*tilskud*). The remarks on Sec. 1, No. 29 of Bill No. L 110 A (2007) stated that the term "contributions" is defined only negatively as not covering arm's length payments between group companies. It was also stated that CTA Sec. 31D applies only to "pure" contributions, which one commentator defined as "advances paid to corporations without consideration in the form of shares".[49] It seems that the legislature intended "contributions" to include dividends

45. Act No. 343 dated 17 April 2007 (based on Bill No. L 110 A).
46. Such a provision was recently introduced in German law as Sec. 8b KStG; see *JStG* 2007. For commentary, see e.g. Kolruss, in *Betriebs-Berater* 2007, at 467; Neumann, in *GmbH-StB* 2007, at 112, Dörfler, Heurung and Adrian, in *DStR* 2007, at 514; and Dötsch and Pung, in *Der Betrieb* 2007/1, at 11.
47. See Enclosure 3 to Bill No. L 110 A.
48. See the answer in Enclosure 10 to Bill No. L 110 A.
49. See Bundgaard, in *SpO* 2004, at 355.

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as well. According to the preparatory work on CTA Sec. 31(6), it applies where contributions are deductible under foreign law. The only example given was the Swedish "*Koncernbidrag*" model.[50] The term "contributions" also seems to include the yield of certain hybrid financial instruments which is considered to be a dividend according to the generally applicable principles. This applies irrespective of whether CTA Sec. 31D specifically mentions that it also applies to hybrid financial instruments.

The preparatory work on the Bill states that the tax rules on dividends take precedence over CTA Sec. 31D and that the provisions on ordinary dividend taxation in Secs. 16A and 16B of the Tax Assessment Act and CTA Sec. 13 still apply. Moreover, Enclosure 10 to Bill No. L 110 A sheds light on the interpretation of the scope of CTA Sec. 31D. The Minister of Taxation stated, among other things, that the general rule is that CTA Sec. 31D applies only with respect to contributions from parent companies to subsidiaries (downward in the group) and between sister companies. According to the Minister, *declared dividends* never fall under CTA Sec. 31D because such dividends are subject to ordinary dividend taxation. As regards other dividend payments, the starting point is said to be the same, but subject to the important modification that such dividends are considered contributions and thus potentially taxable for the recipient if the paying company deducts the contribution under foreign tax law.[51]

It may therefore be concluded that CTA Secs. 31D(1) and (6) are applicable if an intra-group payment which, according to Danish tax law, is classified as a dividend payment is deductible under the tax legislation of the paying company's country and the payment is not considered a declared dividend. The consequence of this interpretation, based on the wording of CTA Sec. 31D and the preparatory work on it, is that dividends are taxable in the hands of the Danish company as a taxable contribution according to Sec. 31D(6).

The question remains whether CTA Sec. 31D should be interpreted as *lex specialis* vis-à-vis CTA Sec. 13(1)(2), which provides a tax exemption for dividends received from subsidiaries, simply because such dividends are not declared and resulted in a deduction in the country of the paying company.

If this interpretation is correct, it seems fair to say that an inappropriate legal situation has resulted where the Danish government, through the back door, tried to introduce a provision along the lines of the German rewording of Sec. 8b KStG. It is unacceptable to restrict the scope of important provisions in Denmark's tax regime (in admittedly a limited number of situations), such as the participation exemption and the general provision on dividends, without expressly stating the restriction in the legislation or the preparatory work. Moreover, the result raises the legal question whether, based on the preparatory work on one provision in the tax legislation, it is possible to restrict the scope of another objectively worded provision which is not amended simultaneously. If for no other reason, this approach should be criticized because it disregards the principle of legal certainty. Further, it should also be noted that hybrid financial instruments are not mentioned in the preparatory work on CTA Sec. 31D.

In addition, it should at least be considered whether the result, as described above, is in accordance with the EU Parent-Subsidiary Directive. This was not considered when CTA Sec. 31D was introduced. The term "distributed profits" in the Directive should clearly be understood broadly, whereby certain payments may fall under the Directive even though they are not considered declared dividends under CTA Sec. 31D. To this author's best knowledge, this question has not been analysed, but this is little excuse to disregard the Directive when apparently changing the scope of the participation regime.

Finally, it is also worth commenting on the interaction with the fundamental freedoms of the EC Treaty. As stated above, this question is beyond the scope of this article, but it should be mentioned that the question seems to have been debated to some extent in the German tax literature.[52]

7. Final Remarks and Assessment

CTA Sec. 2B is another interesting provision that has been added to Denmark's foreign tax law, providing for the unilateral reclassification of hybrid financial instruments from debt into equity depending on the classification of the instrument under foreign law. The principle of correspondence has once again been applied, and it confirms Denmark's tax policy in cases of cross-border tax arbitrage.

The purpose of this article has been to describe the background to the introduction of CTA Sec. 2B and the technical requirements for applying it and to analyse the consequences of doing so. It appears that several questions regarding the interpretation of Sec. 2B remain unanswered. Hopefully, some of these questions will be answered in the future. It is suspected, however, that Sec. 2B is not intended to be enforced, but simply to discourage companies from engaging in cross-border tax arbitrage through the use of hybrid financial instruments.

It has not been the intention here to analyse the policy implication of the type of legislation exemplified by CTA Sec. 2B and the general use of the principle of correspondence as a response to the challenges caused by the interaction between the tax systems of different countries. It is obvious, however, that such an analysis is an important task that needs to be done.

50. See the remarks on Sec. 1, No. 29 of Bill No. L 110 A.
51. Id.
52. See e.g. Kolruss, in *Betriebs-Berater* 2007, at 467; and Dörfler, Heurung and Adrian, in *DStR* 2007, at 514.

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CTA Sec. 2B should clearly curb tax arbitrage in many international financing structures. But it is the author's hope that politicians will think twice before introducing even more restrictions on hybrid finance and that they will reject the notion that financial innovation is motivated only by the tax consequences. It must be borne in mind that, to a great extent, hybrid financial instruments are also driven by business reasons – e.g. to obtain lower costs of financing, greater financial flexibility and a better credit rating. Creating a hostile climate for financial innovation, including hybrid financial instruments, may cause competitive setbacks for Danish companies because the financial opportunities will be less attractive as compared to those offered by other jurisdictions. Based on this, it would seem timely to reconsider the zero tolerance policy towards loopholes in the tax legislation. For example, Belgium's attitude regarding the introduction of the notional interest deduction offers a refreshing perspective in this context. Thus, deductibility of equity/dividends neutralizes the financing decision for the issuing company and thus reduces the need for complicated anti-abuse and anti-arbitrage legislation.[53] Iceland's system of dividend deductions is also interesting in this context. These approaches and the willingness to reform would be refreshing in Denmark, where the unilateral efforts at harmonization and the indefatigable search for loopholes hardly solve any structural problems and, in the end, may harm Denmark's competitiveness and the notion of legislative stability among foreign investors.

53. In the United States, such a system has been proposed several times over the years. The model presently most popular is the "COCA" or "cost of capital allowance" system. This model has been advocated primarily by Kleinbard; see *Tax Notes*, 3 January 2005, at 101; and *Taxes* 1989, at 943.

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