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Associate professor Jakob Bundgaard, Ph.D., and professor Niels Winther-Sørensen, dr.jur., Law Department, Copenhagen Business School

Direct tax rules and the EU fundamental freedoms: origin and scope of the problem; national and Community responses and solutions

The Danish tax system

Individuals with full tax liability to Denmark are taxed on global income. Foreign losses may be deducted in taxable income, including losses from foreign permanent establishments and immovable property.

As a main rule, companies with full tax liability are also taxed on global income, but with the important exeption that gains and losses from foreign permanent establishments and immovable property are not included in taxable income to Denmark.

Individuals and companies with limited tax liability are taxed on certain types of income with source in Denmark.

The Danish Courts

In Denmark, tax cases are tried by the ordinary courts. Unlike for example Sweden and Finland, Denmark does not have special administrative courts. Cases on direct taxation before the courts are tried by one of the two High Courts with an option to appeal to the Supreme Court.

The Danish National Tax Tribunal is the supreme administrative appeals body, e.g. in cases on direct taxation.

The National Tax Tribunal is independent from the government. The National Tax Tribunal itself, as well as the Minister for Taxation, presumes that the Tribunal is a court competent of presenting preliminary questions before The European Court of Justice[1]. The question has, however, not been tried by the European Court of Justice.

In cases of direct taxation, the Supreme Court has presented a preliminary ruling before the European Court of Justice in the case of *Bent Vestergaard* (C-55/98) concerning an accountant's right to deduct the costs relating to participation in a course on the island of Crete. Based on the Court's decision, the Ministry of Taxation withdrew the appeal to the Supreme Court, thereby granting Bent Vestergaard the right to deduct his expenses connected to participation in the course. Except for this case, the Danish courts have not presented preliminary rulings before the European Court of Justice in cases of direct taxation regarding interpretation of the provisions on free movement in the EC Treaty.

Until now, the Danish Courts have not agreed with any tax payer with reference to the provisions on free movement. The provisions have been submitted by tax payers in a few cases.[2]

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1 Cf. The National Tax Tribunal's president *Erik Hansen* and presiding judge *Kjeld Lund-Andersen* i Retssikkerheds-rapporten 1993, published by Kommunernes Landsforening and Foreningen af Danske Skatteankenævn, p. 27-31, especially p. 28, and the Minister for Taxation's remarks to bill L110 of 24 February 2005, General provisions, section *4.3.2.* For support see *Karsten Engsig Sørensen and Poul Runge Nielsen*: EU-retten, 2nd edition, p. 207.

2 E.g. TfS 2005, 422 Ø (appealed to the Supreme Court) and TfS 2005, 504 Ø (appealed to the Supreme Court).

In the practise of the National Tax Tribunal, there are a few examples of internal Danish tax rules being found in conflict with the Treaty's provisions on free movement.[3]

There are, however, also several examples of the National Tax Tribunal rejecting the violation by the Danish tax rules of the provisions on free movement.[4]

In our opinion, Danish tax advisors have put substantially more focus on the connection to the Treaty's provision on free movement. We have, however, not assessed the frequency of specific claims that the Danish rules violate the provisions on free movement in the EC Treaty.

As mentioned above, only one example of the Danish Courts presenting a preliminary ruling to the Court of Justice is present. So far there have been no examples of the National Tax Tribunal presenting preliminary rulings to the Court of Justice, although it has been relevant in several cases, e.g. the Danish rules on exit-tax, CFC-taxation and joint taxation (see below).

Areas of potential conflict

Dividends and capital gains.

A characteristic feature of the Danish system of dividends and capital gains is that there is no distinction between taxation of foreign and domestic dividends and gains. This is the case for companies as well as individuals.

Based on this, the Danish dividend taxation regime does not give rise to comments in relation to EC law. No differences in the tax treatment of national and international stock investments have been identified. Furthermore, no initiatives based on EC law have been made or planned.

In our opinion, the Danish system for taxation of dividends and capital gain fundamentally meets the demands following the fundamental freedoms in the EC treaty.

Until 2004, a provision in Danish law implied that dividends and capital gains from financial companies in countries with low-rate taxation could not be tax exempt no matter whether the recipient was a company or an individual[5]. This was the case unless the Danish rules on CFC-taxation were applicable. The treatment was contrary to the treatment of internal Danish dividends and capital gain. Following the *Lenz*-decision (C-315/02), the Danish government passed a change in the provisions resulting in the definition of low-rate taxated financial companies being replaced with a general provision on investment companies[6]. This provision is applicable to Danish as well as foreign companies[7]

Group taxation

Following an amendment in 2005, income from a foreign permanent establishment or foreign

[3] Cf. TfS 2005, 859 LSR, TfS 2004, 522 LSR, TfS 2003, 250 LSR, TfS 2002, 280LSR, TfS 2001, 548 LSR.

[4] Cf. TfS 2006, 163 LSR, TfS 2004, 218 LSR and TfS 1998, 221 LSR.

[5] In The Capital Gains Tax Act, section 2 a.

[6] Cf. Act no. 407 of 1 June 2005.

[7] Cf. The Capital Gains Act, section 19.

immovable property is exempt for Danish Companies.[8]

As a consequence, *profits* from a foreign permanent establishment or immovable property is tax exempt in Denmark, while *losses* cannot be deducted in the companies remaining income. As a main rule, income from foreign group companies is exempted as well.

In regard to Danish group companies (not including the foreign permanent establishments and immovable property) and foreign group companies' permanent establishments and immovable property in Denmark, mandatory national joint taxation is triggered.[9] Simply put, mandatory national joint taxation is only applicable to business on Danish territory and as a consequence a group company's losses in Denmark are automatically deducted in the company's Danish profits.

The mandatory national joint taxation is supplemented by an option to choose international joint taxation. It is voluntary whether international joint taxation is chosen, but the choice of international joint taxation has wide consequences:[10]

- When choosing international joint taxation, *global pooling* is mandatory for all Danish and foreign group companies, including foreign permanent establishments and immovable property of all Danish and foreign group companies. Even if the ultimate parent company is a resident in Denmark, global pooling results in all group companies being included in the joint taxation. The real consequence is, that when choosing international joint taxation the group must accept that the total income – from profitable as well as losing activities – is taxed according to the Danish rules of income statement and with Danish rates of company taxation.
- As a main rule, the choice of international joint taxation is binding for a 10-year period with the option to choose another 10-year period at the end of the first.[11] It is possible for the parent company to break off the international joint taxation before the end of the 10 year vesting period. The foreign tax losses previously deducted will, however, be recaptured in full when the international joint taxation is terminated.

The disadvantages of choosing international joint taxation with mandatory global pooling are so substantial that is it is assumed that large Danish and foreign groups will not choose international joint taxation. This was also predicted by the government in proposing the amendment.[12]

As a starting point, national joint taxation in a member state without concurrent international joint taxation is not in violation of EC law, following the *Marks & Spencer* decision (case C-446/03). Due to the principle of proportionality, however, a member state must grant a right of deduction for final losses in a foreign subsidiary.[13]

The Danish tax legislation does not contain special rules on deduction of final losses in foreign companies. A Danish group company's right to deduction for losses in foreign companies or foreign permanent establishments or immovable property implies the choice of international joint taxation.

Technically, the Danish tax legislation does not prevent a Danish parent company from deducting

[8] Cf. The Corporation Tax Act, section 8 (2).

[9] Cf. The Corporation Tax Act, section 31.

[10] Cf. The Corporation Tax Act, section 31 A.

[11] Cf. The Corporation Tax Act, section 31 A (3).

[12] Cf. The Minister for Taxation's remarks to Bill L121 of 2 March 2005, General provisions, section 5.1.2. on revenue-related consequences.

[13] Cf. the decision of the Court of Justice of 13 December 2005 (*Marks & Spencer*), case C-446/03, premise 55 ff.

losses in a foreign subsidiary. The Danish parent can choose international joint taxation and thereby gain access to deduction of the losses in the foreign subsidiary.

From a practical point of view, however, the choice of international joint taxation is not possible due to the demand for global pooling and the 10-year vesting period, cf. above.

The main question is: Will a Danish parent company be excluded from considering the final loss when the formal access to deduction of losses in international joint taxation practically leads to increased taxation due to other profitable activities abroad?

The choice of international joint taxation with global pooling will typically lead to a tax burden for a large group, because typically the group will have established profitable activities abroad and the income from these activities are subject to corporation tax at a lower rate than in Denmark. The demand for a parent company to choose international joint taxation in order to receive a right of deduction for final losses from a foreign subsidiary leads to such a company being punished in terms of taxation for also having profitable activities outside Denmark, e.g. in foreign group companies.

With reference hereto and to the fact that the Court of Justice in practise has a clear tendency to emphasize how a rule works rather than a theoretical possibility, it is in our opinion likely that the Court of Justice will not find the theoretical option of international joint taxation sufficient. Or in other words: It must be considered likely that the Court of Justice will find the Danish rules in violation of the EC Treaty article 43, cf. article 48, as there is no real access to deduction of final losses in foreign subsidiaries.[14]

Treatment of crossborder losses (in general)

As mentioned above, an amendment in 2005 has resulted in income from foreign permanent establishment or foreign immovable property being exempted. Should a Danish company suffer a final loss from a foreign permanent establishment or immovable property the loss may only be deducted if joint international taxation is chosen. As mentioned, this is most likely not in accordance with the EC Treaty art. 43, cf. art 48.

Should an individual suffer a loss from a foreign permanent establishment or immovable property this loss may be deducted in the additional income, no matter whether relief under a Double Taxation Treaty is to be given due to the credit or exemption methods. If relief in Denmark is to be given due to the exemption method (e.g. under the double taxation treaty with France) formerly deducted losses will be recaptured if the foreign permanent establishment or immovable property later proves profitable.[15] In our opinion, such recapturing of earlier deducted losses is hardly in violation of the EC Treaty art. 43, cf. art 48.

Taxation of transfer of assets

Danish law contains rules on exit taxation. Individuals will be taxated on unrealised capital gain on shares in connection to transfer[16]. Similar rules exist regarding capital gains on debts and claims, options and warrants and bank deposits for accumulated gains in the so-called business scheme.

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14 Cf. *Niels Winther-Sørensen* in Skat Udland 2006, 2. In a reply to the Folketing, The Danish Minister for Taxation has argued that the Danish rules are not in violation of EC law; cf. the Minister for Taxation’s reply to the Parliament, General provision, answer to question 182.

15 Cf. The Tax Assessment Act, section 33 D.

16 Cf. The Capital Gains Tax Act, section 38.

Following case C-9/02 *Hughes de Lasteyrie du Saillant*, the Danish rules on transfer taxation were changed as it was realized that the rules in their earlier wording presumably were not in accordance with the EC Treaty provisions of freedom of movement and labour, cf, art 39 EC and freedom of establishment, cf. art. 43 and 48 EC[17].

According to the existing wording, the rules of transfer taxation imply these main points:

The rules only apply to individuals with full tax liablity to Denmark for more than 7 years within the final 10 years prior to the termination of their tax liablity or the transfer of their fiscal residence. Gains on shares etc., which the individual in question owns at the time of the termination of tax liability or transfer of the fiscal residence, are taxed as if the shares had been disposed of at that time[18].

The shares are considered sold at an amount equal to their value on the time of the transfer of residence. It is possible to achieve extension for payment of taxes.[19]. Extension is granted upon application and it is a condition for the extension that a new self-assessment tax form is filed in connection to the transfer and again at the time of the change in residence[20]. At the time of the change in residence, the tax payer may choose to recalculate the tax so that taxation is carried out on the basis of the actual ownership period and the actual value at the time of assignment. At the time of assignment, a reduction in the Danish tax is granted at the same level as the amount collected by the country of residence based on the taxable Danish profits.

The sole change from previously is that a demand for security for the payment of taxes as a condition for extension has been cancelled as well as a previously collected additional tax.

The Danish government finds that the current system is in full compliance with EC law, because the purpose is not to prevent tax avoidance but to distribute the right to tax between the source state and the new state of residence. So the argument seems to be that the transfer scheme upholds a principle of territoriality. The latter, however, is not directly consistent with the circumstance that the rules were applied in 1987 as a part of the so-called ‘Tax avoidance package’, which was meant to prevent a loss of Danish tax yield in cases of tax avoidance.

In our opinion, the crucial point is not the intent of the rules, but whether the rules de facto result in a restriction or discrimination when applied to other EU member states.

In connection to this, the central question is whether it is restricting or discriminating that the assignment is considered to have taken place at the change of residence. The question is, in other words, whether it is a restriction that Denmark generally taxes at the time of the transfer. In connection to this, it is crucial to decide, whether it is the demand for security that is the only problem in a European context.

In our opinion, it cannot be said with certainty whether the current system is in compliance with EC law. The reason is that the Court of Justice in case C-9/02 *Hughes de Lasteyrie du Saillant* does not consider the question of security substantially, but instead comment in general terms on the national transfer tax provisions. It may therefore be argued that future transfers will still be taxed with

[17] Cf. Act no 221 of 31 March 2004 (L119)

[18] Cf. The Capital Gains Tax Act, section 38 (1).

[19] Cf. The Capital Gains Tax Act, section 38 (6).

[20] Cf. The Withholding Tax Act, section 73 E.

transfer tax that must be paid. Thus a potential immigrant is prevented from free movement[21].

Further specific conditions that may contain a restriction are: drafting an extension request, withdrawal of extension in cases of a missing request, submitting a self-assesment form, broad perspective on taxable conditions, expenses connected to statement of profits in the self-assesment form at the time of transfer, a reduction in the right to deduct losses in relation to other shares and cancellation of the possibility of letting the shares be included in a tax-exempt restructuring as the shares are considered assigned. It will most likely be clarified in case C-470/04 *Van Dijk* whether these conditions are in violation of the freedom of establishment.

Administratively, it has been acknowledged that the former rules regarding exit tax were in violation of EC law. The rules in their current form have, however, not been assessed. Specifically, this has caused a few tax payers, affected by the rules on transfer tax in the previous form, to be granted resumption. In a decision published in TfS 2005, 859 LSR, the National Tax Tribunal commented that the existing rules in The Gains on Securities and Foreign Currency Act, section 37, were not in compliance with the principle of free movement of labour and the principle of freedom of establishment.

In one specific decision, published in TfS, 2006, 163 LSR, the National Tax Tribunal did not find that the provisions on the free movement of labour were preventing the rules of transfer tax on shares as the individual in question only received retirement benefits.

When assets and liabilities from a Danish company's head office are transferred to a foreign permanent establishment, the assets and liabilities in question must be regarded as disposed of on an arms-length basis at that point in time. The same applies to the transfer of assets from the permanent establishment of a foreign company or a foreign individual to a foreign country.[22] The reason for the rule is that the assets and liabilities in question no longer fall under Danish tax liability. At least in theory, it would be possible to create the rules so the time of taxation was the actual time of realising the assets and liabilities (e.g. so that the taxation considered the value of the transferred assets and liabilities at the time of transfer). Considering the Court of Justice's decision in the *Marks & Spencer* decision it must, however, at this point be regarded as undecided, whether the Court of Justice will recognize this tax as being in violation of the EC Treaty art. 43.

Thin Capitalization

Following case C-324/00 *Lankhorst-Hohorst*, the Danish rules on thin capitalization were changed[23]. The overall aim behind the passed amendments on thin capitalization was to extend the rules to include inter-company lending between Danish companies to ensure compliance with EC law.

The changes lead to:

- Expansion of the scope to include national company group structures.
- A lower limit of DKK 10 million in controlled debt
- Neutrality in case creditor has full or limited tax liability to Denmark while debtor is subject to a deduction limitation.

[21] Cf. Hereto *Lise M. Aagaard* & *Benedicte Wiberg* in Skat Udland 2004, 206.

[22] Cf. The Company Tax Act, section 8 (3) and The Withholding Tax Act, section 8A.

23 Cf. Act no. 221 of 31.March 2004. The rules on thin capitalization are found in The Company Tax Act, section 11.

Generally, it is assumed that the chosen method for creating conformity with EC Law has served its purpose. However, it has been considered in legal theory whether the potential double taxation, which may arise as a result of the national rules on thin capitalization, is in violation of the freedom rights in the Treaty. The question is whether EC law is violated in cases where an adjustment in Denmark (or other EU countries) takes place a result of the rules on thin capitalization while interest income is taxated in another EU country[24]. A purely Danish group would achieve tax exemption with a creditor in a similar situation.

The issue may be presented in a general EU tax-related context as it is the classic issue of whether a national measure indicates discrimination or a non-discriminative restriction caused by differences in the Member states' fiscal laws due to lack of tax harmonisation. Similar cases tried before the Court of Justice has lead to difficult demarcation. It is hardly possible to form precise conclusions on the basis of the existing case law from the Court of Justice.

An immediate reaction would be that Danish rules do not cause the discrimination (the financial double taxation), but the foreign tax rules on tax obligation are to blame as a Danish debtor company in fact no longer has the right to deduct the interest expense/capital loss[25].

The Minister for Taxation dismissed the argument based on EC law[26]. The argument is, however, not to be dismissed without further discussion. It is still an unresolved issue whether national rules on thin capitalizion following the principle of proportionality must ensure elimination of a potential economic double taxation.

The main reason for the question is the Commision's arguments in the *Lankhorst-Hohorst* case, cf. premis 35, where it was specified: '*The Commission adds that Paragraph 8a(1), Head 2, of the KStG does indeed provided for an exception in the case of a company which proves that it could have obtained the loan capital from a third party on the same conditions, and fixes the permissible amount of loan capital in comparison with equity capital. However, the Commission points to the existence, in the present case, of a risk of double taxation since the German subsidiary is subject to German taxation on interest paid, whereas the non-resident parent company must still declare the interest received as income in the Netherlands. The principle of proportionality requires that the two Member States in question reach an agreement in order to avoid double taxation'*[27]. However, the Court did not decide upon this argument.

Furthermore the issue has been discussed in German law. *Otmar Thömmes* doubts that member states may uphold unilateral rules on thin capitalization without consideration for taxation in the

24 Such a point is made by Advokatrådet in their statement on the first draft of the EU-Package, FSR in enclosure 16 to L119 and *Nikolaj Vinther & Erik Werlauff* in Skat Udland 2003, 354. The latter is mainly based on an example of German road toll to point out that changes in rules that as a net effect only applies to foreign actors is unacceptable in an EU law context. The Authors have repeated this statement in a later question to the Minister for Taxation, cf. Enclosure 16 and later in TfS 2004, 242.

25 The road example in *Vinther & Werlauff* op.cit. is the result of the german toll and not foreign taxes. As a result the example only offers limited guidance a question such as this.

26 Cf. enclosure 21 til L 119.

27 The same ideas are touched in advocate-generale *Mischo*'s proposal to decision of 22 September 2002, premise 68-69. However, of this proposal it is clear that risk of double taxation may arise, but that this may be resolved according to Art. 9 in the double taxation treaties according to the OECD model as this provision may secure a correct distribution of the right to tax and at the same time uphold the continued tax profit of the involved memberstates. These two statements appear unidentical.

creditor state[28]. *Wolfgang Kessler* reaches the same conclusion, but focuses on company instead of the potential double taxation following a consecutive taxation in the country of the parent company[29].

In light of this, it can hardly be completely denied that there are still certain EU law-related complications in the Danish thin cap provisions. The conclusion is, however, not obvious. In particular, it is necessary to consider the derived consequences of the fact that potential double taxation of cross-border transactions is in violation of the freedom of establishment. Such a conclusion would have extensive consequences beyond the rules on thin capitalization.

The current case C 524/00 *Test Claimants in the Thin Cap Group Litigation versus Commissioners of Inland Revenue* does not seem to influence the Danish rules on thin capitalization as the cases referred concern former UK rules involving discrimination depending on whether the creditor was registered in the UK or in another country.

Transfer pricing

Formal rules on documentation and information exist in Danish law, cf. section 3 B in the Tax Control Act. Since their application in 1998, these rules have been criticised for resulting in irrelevant discrimination as the rules alone include controlled cross-border transactions.

Most likely in recognition of this critique, the Danish Parliament passed Act no. 408 of 1 June 2005. Consequently following section 3 in the Tax Control Act, a general duty of documentation and information in national as well as international controlled transactions was introduced. This extension of the rules was to bring compliance with EC law.

As a part of the amendment to the rules, a SME-exemption for group companies with less that 250 employees and total assets below DKK 125 million or a turnover below DKK 250 million was created. This exemption is only for transaction with companies or permanent establishments in EU, EEA or countries with a double taxation agreement with Denmark.

Presumeably, the amendment has brought the Danish transfer pricing rules in compliance with EC law. The rules have, however, been subject to a some criticism in tax literature[30] as it has been claimed that the tax-related consequences in cases of missing or incomplete documentation following procedural damage will lead to discrimination. As a reason for this, it is claimed that only in exceptional cases will an adjustment in a Danish group due to mandatory national joint taxation and legal claims for payment adjustments lead to tax consequences[31].

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28 Cf. Der Betrieb 2002, p. 2397 ff (p. 2402). *Otmar Thömmes, Robert Stricof & Katja Nakhai* reach the same conclusion in Intertax 2004, p. 126 ff (p. 135 ff), where it is commented that the Court must be expected to include potential double taxation as a restriction in future practise.

29 Cf. Der Betrieb 2003, p. 2507 ff (p. 2512 f). The writer comments specifically on the German regulation resulting in a German parent company being automatically tax exempt for 95% of the interests in internal group structure in cases of thin capitalization in a German subsidiary company. On the contrary the writer comments that German parent companies with foreign subsidiaries are taxed on the interests. In the author's opinion, the result is differentiation to the extent that parent companies with foreign subsidiaries are exposed to unfavourable treatment compared to parent companies with domestic subsidiaries. In the author's opinion, there is still no reasoned statement for this and thus the German rule seems in violation of EC law, for which reason other EU-interests should be tax-exempt as well. The author reaches the same conclusion in the original proposal for the Danish rules of 28 August 2003 (p. 2513).

30 Cf. *Jan Guldmand Hansen & Nikolaj Vinther* in TfS 2005, 512.

31 This option includes the right to conclude a transaction causing the avoidance of, The Tax Assessment Act, section 2(5).

CFC-taxation

When examining the Danish CFC-rules[32], it must be examined whether different treatment of similar conditions takes place. There are strong arguments that discrimination of the etablishment of subsidiaries in other EU-states instead of in Denmark has taken place if CFC-taxation of financial income from these companies is carried through. Subsidiaries registered in Denmark do not automatically imply that financial profits in such companies must be taxed at the level of the parent company. The same is the case for 2005 and later, despite the mandatory joint taxation in Danish corporate groups applied in 2005, cf. The Danish Corporation Tax Act section 31. Situations creating CFC-taxation are subsequently still different from situations where a Danish company controls a foreign company, if control exist at more than 25 % ownership. Mandatory Danish joint taxation takes place at more than 50 % ownership[33]. Furthermore, in reference to the purpose of the CFC-rules in the Danish Corporation Tax Act section 32, which is to prevent mobile (financial) income from being moved to countries with low-rate taxation, it seems obvious that there is a restriction on the free movement of capital and also the right of establishment.

The British CFC-rules have been brought before the European Court of Justice on several occasions, cf. Case 196/04 *Cadbury Schweppes and Cadbury Schweppes Overseas*[34] as well as an initial test cases in a line of complaints against the British tax autorities, cf case C-201/05 *Test Claimants in the CFC and Dividend Group Litigation mod Commissioners of Inland Revenue.* See also case C-203/05 *Vodafone 2*. Finally, the German rules in AstG, section 20 on disregard of double taxation treaties in cases of low-rate taxated financial branches have been brought for the Court of Justice[35].

National courts have found national CFC-rules in violation of EC law on several occasions. In particular the French Conseil d´Etat have found the French CFC-rules in violation of EC law on two occasions.

In conclusion, the Danish rules on CFC-tax constitute a restriction as far as establishment of subsidiaries in other EU/EEA states, as far as capital flow in the form of company investments between Denmark and other EU/EEA countries. Furthermore, direct discrimination in the establishment of and investment in companies in other EU/EEA states takes place as direct discrimination on establishment of and investment in other EU/EEA states, as discrimination of similar conditions take place. Subsequently, the Danish CFC-rules discourage companies registerered in Denmark from investing in other countries in EU/EEA. At the same time the CFC-rules form a hindrance for companies registered in other EU-states from raising capital from Denmark.

The recognized restriciton of the freedom of establishment and/or the free movement of capital may be in compliance with the Treaty if the discrimination concerns situations without objective comparison or justified on ground of public interest.

The Danish CFC-rules affect investor as well as the companies as the rules make it difficult for companies registered in other member countries to transfer equity from Denmark. In addition

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32 Cf. The Company Tax Act, section 32.

33 Cf. the term group company in The Company Tax Act, section 31 C.

34 See *Thomas Rödder & Jens Schönfeld* in Tax Notes International 2006, p. 185 ff for a reference to the hearing in the case.

35 Cf. *Andreas Körner* in Intertax 2006, p. 32 ff. The writer finds that if the German rules are disregarded this will apply to the actual CFC-rules.

investor is discouraged from controlling the company and discouraged from establishing and investing in certain memberstates instead of others.

As far as possible, justifications for the Danish state to claim none of the ECJ-recognized justifications seem important in relation to CFC-rules. The Danish CFC-rules aim at that tax evasions/tax misuse that consists of financial income being placed in countries with low-rate taxation. The Danish CFC-rules form a guard againt tax benefits from mobile income being placed in countries with low-rate taxation. It is recognized that aim of the Danish CFC-rules to a large extent may prevent tax evasion/misuse.

Furthermore tax saving may occur in establishment of financial companies in foreign countries, including EU/EEA countries despite these countries generally not being recognized by taxing financial income low compared to the Danish level of taxation. Such tax saving is, however, not an indication of tax evasion or misuse. In other words, low-rate taxation in another EU/EEA country is not automatically tax evasion/misuse.

In *Lankhorst-Hohorst* (C-324/00), the Court of Justice has established that it is acceptable to apply national rules preventing tax avoidance. However, the Court only recognizes rules drafted in such a way that they only apply to artificial arrangements designed to evade national tax laws. This is not the case if the rules generally apply to foreign subsidiaries. Correspondingly, it must be stated that the Danish CFC-rules are not open to a case by case assessment.

The rules have a much broader scope than is permissible under EC law. As such, the Court of Justice does not recognize general rules of protective measures with broad scopes that are objectively worded without recognition of situations lacking tax evasion/avoidance. Instead, the rules should encourage subjective evaluation of the given situation. Objectively and generally worded, the Danish CFC-rules cannot be to such situations. Consequently, the Danish CFC rules are not in compliance with the principle of proportionality under EC law that is enforced by the Court of Justice not acknowledging rules that are objective and general.

According to recognised ECJ principles, loss of tax revenue is not one of the justifications worth safeguarding described in YEC artikel 46. This means the regard is not acknowledged as a necessary general regard to be claimed as a reason for discrimination of the right of establishment or the free movement of capital. In connection to this, it is noted that the Danish legislature has presented this argument as the main argument for applying CFC-rules.

Former pratice has shown that the regard to effective tax control may be an imperative general justification for limitation of the fundamental freedoms, ensured in the Treaty. The argument must be rejected as far as the Danish CFC-rules goes as it is hardly provable that the rules enable the Danish Tax Authorities to monitor the size of the taxable income og secure efficient control hereof. The purpose is instead completely different: to prevent loss of tax revenue.

In the case C-315/02 *Annelise Lenz* the Austrian and Danish governments presented the argument that it is relevant to include the level of taxation for companies registered in other member states in the evaluation of whether discrimination was based on justification. Following the Court’s brief remarks the argument cannot be upheld as the basis for applying the Danish CFC-rules. In other words, it is up to the individual EU/EEA-member states to decide which rate of income tax and which level of taxation is desired without this leading to other member states putting up hindrances for investments in member states with a low-tax taxation.

As a result, it must be concluded that the Danish CFC rules in the Danish Corporate Tax Act section 32 are in violation of article 43 and/or article 56. The rules form a restriction and/or a discrimination of the freedom of establishment and/or the free movement of capital. There is no general regard that justifies the hindrance. At the same time the Danish rules are not proportional in their wording[36].

Taxation of pensions

The issue in the action brought by the Commission of the European Communities versus the *Kingdom of Denmark* (Case C-150/04) is whether it is contrary to the provisions governing the fundamental freedoms enshrined in the EC Treaty when Denmark does not allow tax deductions for payments into foreign pension schemes but allows deductions for payments into Danish pension schemes.

The Danish rules distinguish between those schemes that are tax-privileged and those that are not.

The fundamental principle of tax-privileged schemes is that the time of taxation is deferred from the time of contribution to the time pension benefits are received. Accordingly, an employee does not pay tax on the share of his earnings that is paid as a contribution to a pension scheme, but the employee is liable to pay tax on the benefits received. The employer may treat the contribution as a deduction for tax purposes, whereas the employee is not liable to pay tax on the share of the pension contribution paid by the employer, nor his own share of the pension contribution.

In the individual private pension schemes that enjoy tax privilege, the contributor is entitled to tax relief on the contributions and liable to pay tax on the pension benefits. Consequently, the time of taxation is deferred from the time of contribution to the time the benefits are received in a manner similar to that applying to occupational pension schemes.

The tax-privileged schemes may be referred to as ET. Income paid into a pension scheme is exempt from tax or is deductible (i.e. E = Exempt), whereas pension benefits are taxable (i.e. T = Tax).

As for schemes that do not enjoy tax privilege, no tax relief is granted on contributions and benefits are not subject to tax. In such schemes taxation is not deferred to the time when benefits are received. Such schemes may therefore be referred to as TE schemes (i.e. Tax-Exempt).

Formally, no distinction is made between Danish and foreign pension schemes, but between those schemes that are tax-privileged (ET) and those that are not (TE). However, foreign pension institutions will not be able to satisfy the requirements for providing tax-privileged schemes (ET) unless they are established in Denmark. The Danish rules de facto affect foreign pension institutions.

Before the *Danner* case, Denmark had amended the applicable law in 1998 to ensure the connection between non-deductibility of payments in and tax exemption on payments out.[37] In relation to the connection between deductibility and taxation, respectively non-deductibility and tax exemption, referred to by the Court in its judgment in the *Bachmann* case, the Danish rules are now very

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36 On a closing note, the conclusion is substantially supported in national and international law. See for at similar conklusion on the Danish CFC rules: *Michael Kirkegaard Nielsen m.fl.* in Skat Udland 2003, 384 and *Nikolaj Bjørnholm & Anders Rubinstein* in Tax Notes International 2004, no. 25, p. 286 ff, *Jeppe Rune Stokholm* in Skat Udland 2004, 330 and same in Juridiske emner ved Syddansk Universitet 2003, Jurist- og Økonomforbundets Forlag, p. 293 ff, *Erik Werlauff*: Selskabsskatteret, 2005/06, p. 390. Further reference to *Maarjaana Helminen* in Intertax 2005, p. 117 ff, *Michael Lang m.fl. (red.)*: CFC Legislation, Tax Treaties and EC law, 2004, *Aage Michelsen* in R&R 2005 SM 2 ff, *Murray Clayson* in Intertax 1998, p. 326 ff, *Wolfgang Schön* in British Tax Review 2001, p. 250 ff, *Emilio Cencerrado* in EC Tax Review 2004/3, p. 102 ff. Apparently the only argumentation that the CFC-rules are in compliance with theTreaty is found in *Christen Amby* in Skat Udland 2003, 220.

37 See Danish Act no. 429 of 26 June 1998 amending sections 53A and 53B of the Danish Pension Tax Act. For a detailed discussion see Niels Winther-Sørensen in Skat Udland 2001, p. 357.

similar to the Belgian rules that were tried by the Court in the *Bachmann* case.[38]

The Danish Government has argued in particular that the Danish rules can be justified by the need to ensure effective fiscal supervision and the need to ensure the cohesion of the tax system. There can be no doubt that the central issue is whether the Danish rules can be justified.

Taken in isolation, the Commission's arguments in the action against Denmark automatically lead one to call the case 'Bachmann 2'. The Commission only finds it important whether payments into the pension scheme are deductible or not, and whether there is a connection between deductions and taxation (TE/ET).

It is not yet clear whether the Court of Justice will accept the arguments of the Commission. On one hand, the judgment in the *Bachmann* case is difficult to understand when it is compared with the Court's subsequent case law, in particular its judgment in the *Wielockx* case. On the other hand, the Court has, on numerous occasions, referred to its judgment in the *Bachmann* case as an example where the cohesion of the tax system may justify discriminatory rules.

Apparently, the Commission has not considered the taxation of the investment returns (appreciation in value) – often called yield tax – on the pension schemes concerned. The Danish tax levied on the investment returns de facto discriminate against TE schemes compared to ET schemes. And as indicated above, foreign pension institutions may only offer TE schemes to individuals in Denmark. If the Court of Justice also addresses the issue of taxation of investment returns, there is little doubt, in my opinion, that the Danish rules will be found to be contrary to the provisions of the EC Treaty governing the fundamental freedoms. This is the case regardless of whether the judgment in the Bachmann case is considered correct or wrong.

Under the Danish rules, investment returns are, in principle, taxed whether the scheme is tax-privileged (ET) or not tax-privileged (TE). But where the returns on an ET scheme is "only" taxed at a rate of 15% (yield tax),[39] the return on a TE scheme is treated as investment income and subject to tax at a rate ranging from 32% to 59%.[40] In addition the owner or the beneficiary is liable to pay tax on the return on an ET scheme, which places heavy demands on liquidity.

The difference in the tax levied on the investment return on an ET scheme and a TE scheme constitutes a significant restriction for individuals in Denmark who want to set up TE schemes. As indicated above, foreign pension institutions can only set up tax-privileged schemes (ET schemes) if they are established in Denmark and foreign pension institutions cannot offer schemes where returns are subject to the low tax at 15%.

This difference in the taxation of the investment returns cannot reasonable be justified by reference to the cohesion of the tax system. In relation to the connection between deductions and taxation, there is both an advantage and a disadvantage. In relation to the taxation of the investment returns, there is only a disadvantage (i.e. increased taxation).

Taxation of migrant and frontier workers

Out of regard for progressive taxation, there was an earlier demand for conversion to year-round income if an indvidual was tax liable to Denmark for only part of the year due to migration. This was changed in 2004, so that an individual may instead choose to form a statement of taxable

[38] Judgment of 28 January 1992 in Case C-204/90 *Bachmann* [1992] ECR I-249.

[39] See section 2 of the Danish Pension Investment Returns Tax Act.

[40] See section 53A(3) of the Danish Pension Tax Act, and section 4(1), no. 15, of the Danish Personal Tax Act.

income based on his factual income throughout the year. This removed a discrimination found in violation of the Treaty by the National Tax Tribunal.

A few rules on migration will still lead to discrimination in violation of the Treaty. As an example hereof is the provision that deductible assets, not already connected to a permanent establishment or immovable property in Denmark, at the time of the migration must be stated at a fictional low value as the factual acquisition price is reduced with the maximum deduction that would have taken place under Danish rules until the time of the migration[41] This will reduce the deduction possibilities for the individual in question in comparison to an individual that has always had full tax liability to Denmark and has not used up all options for deduction.

Generally, individuals with limited tax liability are not entitled to deduction concerning personal or household-related issues, including personal deductibles that in reality functions as a bottom line for tax exemption. If a tax payer has at least 75 % of his income from Denmark it is, however, possible to choose taxation according to the same rules as tax payers with full liability[42].The Danish Tax legislation on taxation of individuals with limited tax liability seems to be in compliance with the principles following the case law from the European Court of Justice.

Bilateral tax treaties

In Danish administrative practise, it is assumed that a permanent establishment in Denmark is entitled to relief according to the method *ordinary credit* following the internal Danish rules[43]. On the other hand, a permanent establishment in Denmark cannot receive relief according to a double taxation treaty. This is often without any practical impact, as Denmark, according to most double taxation treaties, must be admitted relief according to the method ordinary credit. Following the *Saint-Gobain* case (C-307/97), however, it could be a violation of EC Treaty article 43 to refuse relief leading to tax benefits according to a double taxation treaty.

An amendment in 2004 secured the beneficial rules on taxation of dividends paid to companies[44] to include dividends paid to a foreign company's permanent establishment in Denmark.

Remedial Action

As mentioned above, the Danish government has sought to adjust the Danish tax rules to EC law following the practise of the Court of Justice.

One of the aims of the so-called EU-package was to arrange part of Danish tax legislation to be in compliance with EC law[45].

As a result, the rules on thin capitalization were changed following case C-324/00 *Lankhorst Hohorst*. At the same time, the rules on exit tax were changed following case C C-9/02 *Hughes de Lastyirie du Saillant*. Finally, the existing rules on voluntary joint taxation were changed to include affiliated companies and branches.

The rules on conversion to full-year income with reference to upholding progression in taxation of

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[41] The Witholding Tax Act, section 9 (2).

[42] The Withholding Tax Act, sections 5 A- 5 D.

[43] The Tax Assessment Act, section 33.

[44] E.g. tax exemption on profits from subsidiaries and taxation of 66 % of received profits in other cases, cf. The Company Tax Act, sections 13 (1, (2)) and 13 (3)

[45] Cf. Act no. 221 of 31 March 2004 (L 119).

migrated individuals were changed in recognition of decisions of the National Tax Tribunal[46]. It was questioned whether it is in compliance with the Treaty to uphold a theoretically calculated yearly income if this income differs significantly from the yearly actual income of the person in question.

A consequence of the amendment was an expansion of the possibility to avoid taxation of capital gains on real estate by replacing investments in another piece of real estate within the EU[47]. Earlier this option was only available in cases of reinvestment in Danish real estate.

It has been emphasized, that amendments following the *Lenz*-decision has taken place as the previous rules on taxation of shares in low-rate taxated financial companies and profits from these[48].

The change in the formal rules on transfer pricing documentation, cf. Law nr. 408 from 1 June 2005 is noted. Following this, the Danish documentation and information provision has been extended to also apply domestically in Denmark.

It is a general feature of the above-mentioned changes that the scope of the rules has been enlarged by creating certain benefits to also include transactions/individuals within the EU, i.e. replacement of capital gains in EU-property.

Additionally, changes have extended certain rules to national issues, i.e. thin capitalization and transfer pricing.

Furthermore, general changes that completely change the form of the earlier rules and at the same time extend the rules to national cases are found. This is the case for the existing rules on investment in specific investment companies[49].

In several cases, the distinction between the EU and other countries is relevant in Danish fiscal legislation resulting, for instance, in Danish withholding tax on profits, interests, capital gain and royalties not being withheld in payment to EU-companies in the parent/subsidiary directive or interest/royalty directive. Similar rules apply to other countries, where payment is included in a double taxation agreement with the countries in question. Withholding tax is levied on other types of income.

Another example is the access to resumption of tax assessment, where the rules on thin capitalization have resulted in a limitation of deduction. From the interim provisions it is clear that resumption of controlled debt from foreign individuals or companies within EU/EEA and controlled debt to a third person, that foreign individuals or companies within the EU, has placed securities for is accepted.

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46 Cf. TfS 2002, 280 LSR and TfS 2003, 250 LSR.

47 Cf. The Property Profits Tax Act, section 6 A.

48 Cf. Act no. 407 af 1 June 2005 (L 98).

49 Cf. The Capital Gains Tax Act, section 19.