On 26 February 2018, the Danish Minister of Taxation (the Minister) published draft legislation that would amend Danish corporate taxation as follows:

1. Provide an exemption from permanent establishment (PE) taxation for investments in Danish private equity funds.
2. Prevent the economic double taxation of dividends received by Danish PEs.
3. Relax the taxation of foreign pension funds’ investments in Danish real estate.
4. Relax the thin capitalization rule.
5. Close the loophole in the dividend recharacterizing rule (section 2 D).

On 23 February 2018, the Minister also proposed an increase in the tax deduction for research and development (R&D) expenses.

The proposals are expected to be enacted by June 2018.

This Alert summarizes the key provisions of the proposed measures.

**Exemption from PE taxation for private equity investments in Danish transparent partnerships**

Nonresident investors in Danish private equity funds are subject to Danish taxation if the fund qualifies as a PE. A PE may arise if the fund has an office in Denmark through which its business is carried on or the fund has a dependent
agent in Denmark that concludes binding agreements on behalf of the fund. However, binding rulings have confirmed that the creation of a PE may be prevented if the partnership and management is properly structured.

To make it easier for Danish private equity funds to attract foreign investors, the proposal will introduce a specific exemption according to which investments made by foreign investors in a Danish limited partnership will not give rise to a taxable PE in Denmark. The proposal specifically states that an activity that involves investments in shares, receivables and financial instruments is exempt from PE taxation. The exemption is applicable to nonresident individuals, corporations, and other types of investors. The following two conditions must be satisfied:

- The individual investor is not trading in shares, receivables, and financial instruments
- The individual investor and affiliated companies do not carry on business in Denmark that is linked to the investment business of the partnership

The proposal will be effective from income year 2017.

**Prevention of economic double taxation of dividends received by Danish PEs**

Resident taxpayers may offset dividend tax withheld by a resident company against their final tax liability thereby avoiding economic double taxation. The proposal expands the rule to cover dividends received by PEs of nonresident individuals and companies. The proposal will be effective from 1 July 2018.

**Relaxation of the taxation of foreign pension funds’ investments in Danish real estate**

Resident pension funds are subject to Danish taxation on real estate income and capital gains at a rate of 15.3%. Capital gains and losses are recognized on a mark-to-market basis. By contrast, nonresident pension funds are subject to Danish taxation at a rate of 22% of real estate income and capital gains on a realization basis. According to the European Union (EU) Commission, the difference in taxation is in breach of the free movement of capital laid down in Article 63 of the Treaty on the Functioning of the European Union (TFEU) and Article 40 of the European Economic Area (EEA) Agreement. Against this background the proposal will make Danish real estate income and capital gains derived by a nonresident pension fund from another EU or EEA Member State subject to Danish taxation in the same manner as resident pension funds, i.e., a 15.3% tax rate and mark-to-market principle. The proposal will be effective from income years that commence from 1 July 2018. Nonresident pension funds may elect to apply the new rules retroactively from income year 2013. Such an election must be made no later than 1 August 2019.

**Relaxation of the thin capitalization rule**

The Danish rule on thin capitalization applies a debt:equity ratio of 4:1. If the interest deduction of a resident company is restricted under this rule, the corresponding interest income is exempt from Danish taxation in the hands of a resident creditor or a nonresident creditor with a PE in Denmark. The EU Court of Justice has decided that the rule is in breach of the freedom of establishment in Article 49 TFEU because the tax exemption for the creditor is not applicable when the interest deduction is restricted under thin capitalization rules of other EU Member States (see case C-583/14, Masco Denmark).

The proposal expands the rule on tax exemption for the creditor to cover situations where the interest deduction of a nonresident subsidiary has been restricted under thin capitalization rules in another EU or EEA Member State. However, the exemption cannot exceed the interest deduction restriction that would have been applicable if both companies had been tax resident in Denmark.

The proposal will be effective from income years that commence from 1 July 2018. However, the tax authorities expect to publish a circular that will allow affected companies to apply the rules for earlier income years.

**Closing of the loophole in dividend recharacterizing rules (section 2 D)**

Capital gains from the sale of shares by a nonresident taxpayer will normally receive capital gains treatment in Denmark. This means that the nonresident taxpayer will be exempt from Danish taxation, unless the shares must be allocated to a PE in Denmark. By contrast, nonresidents are subject to 27% withholding tax on dividends received from Danish companies. In order to prevent that dividends are artificially disguised as capital gains through internal group reorganizations, section 2 D of the Danish corporate tax act treats the proceeds from certain sale of shares as dividends. The proposal is targeting section 2 D(2), second sentence, according to which cash remuneration received by a seller of shares in a target company receives dividend treatment if the seller subsequently owns shares in the target company.
or a company that is affiliated with the target company. The proposal will expand the rule so that it will be applicable if the seller, or an affiliated company, subsequently owns shares in the target company or a company that is affiliated with the target company. A similar law change is proposed regarding certain cross-border mergers.

The proposal will be effective from 1 July 2018. According to the commentary to the proposal the Danish court-based substance over form rule may potentially be applicable to cases where taxpayers have made use of the loophole.

Increase of tax deduction for R&D expenses

Taxpayers are currently entitled to claim a 100% deduction of R&D expenses. The proposal would gradually increase the deduction from 100% to 110% as follows: income years 2018 and 2019 = 101.5%; income year 2020 = 103%; income years 2021 and 2022 = 105%; income years 2023-2025 = 108%; and income years 2026 and onwards = 110%.

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