

An Introduction to the Taxation of Financial Instruments

This article provides an overview of the taxation of financial instruments in Denmark. A wide range of such instruments is considered, from the perspective of individuals, companies and pension funds.

1. Introduction

This article will consider the following financial instruments:

- options, forward contracts and swaps;
- bonds adjusted based on developments in prices etc.;
- bonds (general rules);
- convertible bonds;
- shares in companies (general rules);
- shares in controlled foreign companies (CFCs);
- shares in investment companies;
- shares in investment associations;
- share lending; and
- shares in transparent entities.

The holders/parties in respect of the above-mentioned financial instruments include:

- individuals who are not traders;
- companies that are non-transparent for Danish tax purposes and not traders or insurance companies; and
- pension funds, i.e. pension institutions and pension schemes subject to the Act on Taxation of Pension Yields.

Pension funds that are not subject to full tax liability in Denmark and do not have a permanent establishment in Denmark as defined in the Act on Taxation of Pension Yields are not covered by that Act, i.e. the tax rules governing individuals and companies as applicable are relevant to foreign pension funds possessing assets in Denmark.

The tax rates applicable to resident holders/parties can be summarized as follows:

	Individuals (%)	Companies (%)	Pension funds (%)
options, forward contracts and swaps	up to 59	25	15
bonds adjusted based on developments in prices etc.	up to 59	25	15
bonds: general rules	up to 59 or 0	25	15
convertible bonds	up to 59, or 28, 43 or 45	25	15
shares: general rules	28, 43 or 45	25, 16.5 or 0	15
shares in a CFC	25 on CFC income	25 on CFC income	no direct taxation of CFC income
shares in investment companies	up to 59	25	15
shares in investment associations	up to 59	25	15
share lending	up to 59	25	15

The taxation of non-resident individuals and companies can be summarized as follows:

	Individuals (%)	Companies (%)
options, forward contracts and swaps	0	0
bonds adjusted based on developments in prices etc.	0	0
bonds: general rules	0	0
convertible bonds	0	0
shares: general rules	0 or 28	0 or 28
shares in a CFC	0 on CFC income	0 on CFC income
shares in investment companies	0 or 28	0 or 28
shares in investment associations	0 or 28	0 or 28
share lending	0 or 28	0 or 28

* Eversheds, Copenhagen. This article is not exhaustive and is only for information purposes. It does not constitute legal advice and this introduction is not to be relied upon in connection with any transaction.

The effective tax rate may be less than 28%.

Comments are offered with regard to the following:

- options, forward contracts and swaps;
- bonds adjusted based on developments in prices etc.;
- bonds (general rules);
- convertible bonds;
- shares in companies (general rules);
- shares in CFCs;
- shares in investment companies;
- shares in investment associations;
- share lending;
- shares in transparent entities; and
- general comments.

2. Options, Forward Contracts and Swaps

Forward contracts as well as put and call options are generally taxed separately according to a mark-to-market principle (such contracts taxed separately are referred to as financial contracts). Such contracts with shares as the underlying asset are exempt from separate taxation if:

- the agreement can be settled only by delivery of shares;
- no disposal of the agreement has taken place; and
- no reverse contracts have been entered into.

Furthermore, such contracts with real estate as the underlying asset are generally exempt from separate taxation. No law contains provisions specifically concerning the tax treatment of swaps. The tax treatment of swaps is determined on the basis of the concrete terms of the swap in question. This may result in separate taxation of forward contracts or put or call options deemed to be part of the swap.

2.1. Individuals

Gains calculated annually according to a mark-to-market principle are taxed as capital income at a rate of up to 59%. Any loss on a financial contract may be deducted to the extent that the loss does not exceed the aggregate net gains on financial contracts in the income years 2002 until the year before the relevant income year. Any excess loss on the financial contract may be deducted from net gains on financial contracts in the relevant income year and in future income years. If the financial contract has been entered into in connection with the business of the individual, these restrictions do not apply. Individuals who are not subject to full tax liability in Denmark are not taxed on financial contracts.

2.2. Companies

Gains calculated annually according to a mark-to-market principle are taxed at a flat rate of 25%. Losses are deductible. However, a loss on a financial contract including a right or obligation to dispose of shares may be deducted to the extent the loss does not exceed the aggregate net gains on the financial contract in the income years 2002 until the year before the relevant income year where no deduction of losses on other such financial contracts has already been made. Any excess

loss on the financial contract may be deducted from net gains on all such financial contracts in the relevant income year and in future income years. These rules also apply to a loss on a financial contract based on a share index. Companies that are not subject to full tax liability in Denmark are not taxed on financial contracts.

It also follows from the chapter of the Act on Capital Gains on financial contracts, that the above rules apply to gains and losses on bonds taxed as financial contracts. See 3.

2.3. Pension funds

Gains calculated annually according to a mark-to-market principle are taxed at a flat rate of 15%. Losses are deductible. If taxable income is negative, 15% of the negative taxable income may be deducted in future taxes.

3. Bonds Adjusted Based on Developments in Prices etc.

Under Sec. 29, Subsec. 3 of the Act on Capital Gains, the general rule is that bonds adjusted based on developments in prices or other aspects or characteristics relevant to the securities, goods or other assets on which a financial contract may be based (referred to as adjusted bonds), are taxed as financial contracts, i.e. annually according to a mark-to-market principle. There are a number of exceptions; see 4. The tax authorities have published several Binding Statements regarding the interpretation of this definition.

3.1. Individuals

Gains calculated annually according to a mark-to-market principle are taxed as capital income at a rate of up to 59%. The deductibility of losses is restricted; see 2. Individuals who are not subject to full tax liability in Denmark are not liable to Danish taxation in respect of such bonds.

3.2. Companies

Gains calculated annually according to a mark-to-market principle are taxed at a flat rate of 25%. As regards losses, see 2. Companies that are not subject to full tax liability in Denmark are generally not subject to Danish taxation in respect of such bonds.

3.3. Pension funds

Gains calculated annually according to a mark-to-market principle are taxed at a flat rate of 15%. Losses are deductible. If taxable income is negative, 15% of the negative taxable income may be deducted in future taxes.

Regarding interest on the above bonds, see 4.

4. Bonds: General Rules

Bonds that are not taxed as financial contracts include adjusted bonds (see 3.) that are issued by group related companies and adjusted bonds that are exclusively adjusted due to the bonds being issued in a foreign cur-

rency or due to adjustments in certain public price indexes (e.g. a public consumer price index). However, it is a condition that the currency and the price index must relate to the same country (area). A price index in a country that is part of the Eurozone, and the Euro currency are deemed to be related to the same country (area).

4.1. Individuals

Gains are generally taxed as capital income at a rate of up to 59%, unless the bond is issued in Danish kroner and complies with the other conditions for a minimum interest rate in which case gains are tax-exempt. The current minimum interest rate is 4%. Losses on bonds not subject to the minimum interest rate exemption are generally deductible only if the bond is in a foreign currency or acquired in the course of business. Interest is taxed as capital income. Individuals who are not subject to full tax liability in Denmark are not subject to Danish taxation in respect of bonds.

4.2. Companies

Gains and interest are taxed at a flat rate of 25%. Losses are generally deductible. Losses on bonds issued by group related companies, not taking currency fluctuations into account, are generally not deductible. Companies that are not subject to full tax liability in Denmark are generally not subject to Danish taxation in respect of bonds.

4.3. Pension funds

Gains calculated annually according to a mark-to-market principle are taxed at a flat rate of 15%. Losses are deductible. Interest is taxed at a flat rate of 15%. If taxable income is negative, 15% of the negative taxable income may be deducted in future taxes.

5. Convertible Bonds

Bonds that may be converted into shares in the debtor company are treated under the rules on the disposal of shares, provided that any redemption is made at a predetermined time and amount. If a redemption does not comply with this criterion, the redemption is treated as a share buy-back; see 6.

5.1. Individuals

Gains on convertible bonds are taxed as share income at the rate of 28%, 43% or 45% depending on the total share income. Losses may be deducted from gains on other convertible bonds or shares; see 6. Individuals not subject to full tax liability in Denmark are not taxed on the disposal of convertible bonds.

5.2. Companies

Gains on convertible bonds are taxed at a flat rate of 25%. Losses on convertible bonds held for less than three years are deductible and the losses are ring fenced, i.e. the losses may be deducted only from taxable gains on con-

vertible bonds or shares held for less than three years. Losses on convertible bonds held for three years or more may be deducted from taxable gains on convertible bonds held for three years or more. Further losses on convertible bonds held for three years or more may be deducted from net gains on shares held for less than three years, and remaining losses may be carried forward and deducted in the same order. Shares acquired through conversion are considered to be acquired at the time of conversion (and not at the time of acquisition of the convertible bond). Companies not subject to full tax liability in Denmark are generally not taxed on the disposal of convertible bonds.

5.3. Pension funds

Gains calculated annually according to a mark-to-market principle are taxed at a flat rate of 15%. Losses are deductible. If taxable income is negative, 15% of the negative taxable income may be deducted in future taxes.

6. Shares in Companies: General Rules

6.1. Individuals

Gains on shares and dividends are taxed as share income at the rate of 28%, 43% or 45%, depending of the total share income. Losses on unlisted shares may be deducted from share income and other income, if the share income calculation results in a loss. Losses on listed shares may be deducted from share income deriving from listed shares in the income year in question and subsequent income years. Share income deriving from listed shares includes dividends, gains and proceeds in connection with the sale of shares back to the issuing listed company. Individuals not subject to full tax liability in Denmark are generally not taxed on gains on shares. Dividends are subject to withholding tax at a flat rate of 28%, unless an applicable tax treaty provides for a lower rate or there is a reduction to effectively 15% due to an obligation to exchange information. As regards liquidation proceeds and proceeds in connection with a share decrease or a share buy-back, see below regarding companies, general rules.

6.2. Companies

Gains on shares held for less than three years are taxed at a flat rate of 25%, as opposed to gains on shares held for three years or more, which are tax exempt. Losses on shares held for less than three years may be deducted from taxable gains on such shares to the extent that the loss exceeds the total sum of tax-exempt dividends received during the ownership period by the shareholder as defined in Sec. 8 of the Act on Capital Gains on Shares. Such losses may be carried forward. Losses on part of a shareholding in connection with a share decrease or a share buy-back realized by companies that are exempt from dividend taxation (see below) may not be deducted, as such losses are added to the acquisition sum of the remaining shares. Companies not subject to full tax liability in Denmark are generally not taxed on gains on shares.

Dividends received by Danish or foreign companies owning shares in a Danish company are tax exempt, if the receiving company owns at least 15% of the share capital for a consecutive period of at least 12 months. If a company owning shares in a Danish company is not subject to full tax liability in Denmark, it is further required that the Danish taxation be reduced under an applicable tax treaty or EU Directive 90/435. Companies subject to full tax liability in Denmark are also exempted if the paying company is part of a group subject to Danish international joint taxation, or if the parent company, directly or indirectly, controls the paying company. This ownership percentage will be lowered to 10% with effect from 2009. Companies subject to these exemption rules are taxed on liquidation proceeds distributed before the final calendar year of the liquidating company and on proceeds in connection with a capital decrease under the rules concerning the disposal of shares, and not in accordance with the rules concerning dividends that are generally applicable to such distributions.

Dividends received by a company not subject to full tax liability in Denmark that does not comply with the above exemption rules are subject to withholding tax at a flat rate of 28%, unless an applicable tax treaty provides for a lower rate or there is a reduction to effectively 15% due to an obligation to exchange information. A company subject to full tax liability in Denmark that does not comply with the above exemption rules is subject to tax on only 66% of the gross dividend income if:

- if the ownership percentage is lower than stated above;
- the dividend-paying company is resident in Denmark, the European Union, the EEA, or in a country with which Denmark has entered into a tax treaty; or
- the dividend-paying company is part of a group subject to Danish international joint taxation.

Liquidation proceeds paid in the final calendar year of a liquidating company are generally treated under the rules concerning the disposal of shares. However, if (1) the receiving company fulfils the above ownership condition regarding tax-exempt dividends but not the condition regarding residency or (2) the receiving company owns less than 15% of the share capital (10% from 2009) and is group related to the liquidating company, such liquidation proceeds are treated as dividends.

Proceeds in connection with a buy-back of unlisted shares are generally treated as dividends, whereas a buy-back of listed shares is treated as a disposal of shares. As regards a buy-back of unlisted shares in the final year of a liquidating company, the above-mentioned rules regarding liquidation proceeds in the final calendar year also apply, i.e. such proceeds are generally treated under the rules concerning the disposal of shares. Furthermore, companies subject to the above exemption rules regarding dividends are taxed on a buy-back of unlisted shares under the general rules concerning the disposal of shares. In the event of a buy-back of listed shares where a similar buy-back of unlisted shares would not have been covered by the general rule on buy-back of unlisted

shares in the final year of a liquidating company and not covered by the rule regarding tax-exempt dividends, the shareholder may opt to have the buy-back of listed shares be treated as a dividend.

6.3. Pension funds

Gains calculated annually according to a mark-to-market principle are taxed at a flat rate of 15%. Losses are deductible. If taxable income is negative, 15% of the negative taxable income may be deducted in future taxes. Liquidation proceeds paid in the final calendar year of the liquidating company are treated as sales proceeds as opposed to dividends. Dividends are taxed at a flat rate of 15%.

7. Shares in Controlled Foreign Companies

A CFC is a controlled company that fulfils the following two conditions in respect of an income year:

- the CFC income of the company constitutes more than 50% of its total taxable income under Danish tax rules; and
- in case of individuals, the total foreign income tax is less than three-fourths of the tax calculated on the basis of the Danish companies tax rate, i.e. 25%, including the total taxable income under Danish tax rules; or in the case of companies, the financial assets of the company, the yield of which is CFC income, constitute more than 10% of the company's total assets.

CFC income includes interest; gains on claims, debt, shares and financial contracts; gains and remuneration in respect of intangible assets; taxable income in respect of financial leasing (including gains on such assets); and taxable income in respect of insurance business or other financial business. As regards the definition of control, it is a condition, when only taking direct ownership of shares into account, that a parent company possess the majority of the votes in the company. The scope of the CFC rules has been expanded to apply to Danish companies due to the *Cadbury Schweppes* decision of the European Court of Justice, although in practice the CFC rules are generally relevant only in respect of CFCs not subject to full tax liability in Denmark. Investment companies, (see 8.) are excluded from the CFC rules. As regards gains, losses and dividends, the general rules (see 6.) apply as a starting point in respect of individuals and companies, as there are special rules due to the CFC tax rules.

7.1. Individuals

The part of CFC income corresponding to the average ownership percentage during the income year is taxed at a flat rate of 25%. An individual may be exempted on request from CFC taxation in respect of companies resident within the European Union or EEA if:

- the individual can document that the company is established "in substance" in the state in question and that the company in the state pursues "real economic business" regarding the CFC income; and

- it is possible for the Danish tax authorities to verify this by obtaining information from the relevant foreign authorities under an applicable tax treaty, the EU Directive on assistance or some other agreement.

Individuals not subject to full tax liability in Denmark are not subject to Danish CFC rules.

7.2. Companies

The part of the total taxable income of a CFC corresponding to the average ownership percentage during the income year is included in the Danish taxable income of the parent company and is taxed at a flat rate of 25%. Companies not subject to full tax liability in Denmark are not subject to the Danish CFC rules.

7.3. Pension funds

There is no direct taxation of CFC income. Gains calculated annually according to a mark-to-market principle are taxed at a flat rate of 15%. Losses are deductible. Dividends are taxed at a flat rate of 15%. If taxable income is negative, 15% of the negative taxable income may be deducted in future taxes.

8. Shares in Investment Companies

The definition of investment companies includes investment entities according to EU Directive 85/611 and similar companies where shares will be purchased on request by the issuing company or a third party. There are exceptions concerning holding companies and distributing investment associations. Investment associations on account are excluded; see 9. Investment companies are exempt from Danish taxation as the tax rules reflect the tax rules applicable to bonds taxed as financial contracts; see 3. However, dividends and proceeds deriving from share buy-backs treated as dividends, paid by companies resident in Denmark and received by investment companies are taxed at a flat rate of 15%. There are exceptions concerning bond-based distributing investment associations relevant to corporate shareholders (see 9.) and other distributing investment associations and investment companies that may not invest in shares in companies resident in Denmark, not including shares in the company that is in charge of the administration of the entity. The buy-back of shares in an investment company is treated as a disposal of shares and not as a dividend.

8.1. Individuals

Gains calculated annually according to a mark-to-market principle are taxed as capital income at a rate of up to 59%. Losses are deductible when calculating capital income. Dividends are taxed as capital income. Regarding individuals who are not subject to full tax liability in Denmark, see 6.

8.2. Companies

Gains calculated annually according to a mark-to-market principle are taxed at a flat rate of 25%; losses are

deductible. Dividends are taxed at a flat rate of 25%. Regarding companies that are not subject to full tax liability in Denmark, see 6.

8.3. Pension funds

Gains calculated annually according to a mark-to-market principle are taxed at a flat rate of 15%. Losses are deductible. Dividends are taxed at a flat rate of 15%. If taxable income is negative, 15% of the negative taxable income may be deducted in future taxes.

9. Shares in Investment Associations

The Act on Capital Gains on Shares generally refers to shares in five different investment associations, namely:

- in accumulating investment associations that are taxed as shares in investment companies (see 8.);
- in other accumulating investment associations;
- in share-based and distributing investment associations;
- in bond-based and distributing investment associations; and
- in other distributing investment associations.

Furthermore, there are shares in investment associations on account (no transferable shares).

Share-based distributing investment associations are defined by the allocation of their assets and a minimum annual distribution. Broadly, assets may include the administration building of the investment association and shares, and cash and derivatives not exceeding 25% of the other assets. The minimum distribution is calculated on the basis of certain income deriving from shares, claims, financial contracts and share lending. The investment association may as an alternative opt to determine the minimum distribution according to a mark-to-market principle.

Bond-based distributing investment associations are defined differently depending on the type of owner. In respect of individuals, the assets of the distributing investment association may only constitute claims in foreign currency (comprised by Sec. 16 of the Act on Capital Gains); in respect of companies, the assets of the distributing investment association may only constitute claims comprised by the Act on Capital Gains. However, certain other assets regarding administration and derivatives are allowed in addition to the above-mentioned assets.

Other distributing investment associations are subject to the rules on minimum distribution and not subject to allocation rules for tax purposes.

Shares in investment associations on account may only be transferred back to the investment association. Such investment associations are transparent for Danish tax purposes under a special law. The Act on Capital Gains also applies in respect of pension funds. Individuals and companies that are not subject to full tax liability in Denmark may be subject to a limited tax liability depending on the income of the investment association.

9.1. Individuals

Gains on shares in distributing investment associations are taxed as capital income at a rate of up to 59%. Losses on such shares are not deductible, except for shares in bond-based distributing investment associations. Gains and losses may be taxed under the rules applicable to shares in general (see 6.), subject to election by the investment association. The shareholders are taxed on the income of the investment association under the rules governing distributing investment associations, i.e. the investment association is transparent in this regard. If the investment association has opted for mark-to-market assessment of the minimum distribution, see above, such minimum distribution is taxed as capital income at a rate of up to 59%. A buy-back of shares in distributing investment associations is treated as a disposal of shares (and not as a dividend). Regarding individuals who are not subject to full tax liability in Denmark, see 6.

9.2. Companies

The above-mentioned rules on shares in distributing investment associations which apply to individuals subject to full tax liability in Denmark, apply equally to companies, except for the tax rate which is 25% and the different definition of bond-based distributing investment associations. Regarding companies that are not subject to full tax liability in Denmark, see 6.

9.3. Pension funds

Gains on shares in distributing investment associations are calculated annually according to a mark-to-market principle, and are taxed at a flat rate of 15%. Losses are deductible. Distributions are taxed at a flat rate of 15%. If taxable income is negative, 15% of the negative taxable income may be deducted in future taxes.

10. Share Lending

The Danish tax authorities have recognized that share lending where the borrower obtains an ownership right to the borrowed shares will be treated as a loan and not a disposal of shares for Danish tax purposes, provided that the shares are listed and that the time of the lending is restricted to a maximum of 6 months. In respect of the terms of share lending, the Danish tax authorities have accepted standard terms provided by Danish financial representatives including the Copenhagen Stock Exchange. Furthermore, the tax authorities have accepted share lending according to the OSLA agreement and ISLA agreement.

The National Tax Tribunal has decided that income deriving from share lending in respect of a borrower is to be treated under a provision in the State Tax Act concerning gambling, and consequently, remuneration and dividend compensation paid to the share lender should be included in the calculation of a gain or a loss together with the borrower's sale and repurchase of shares, and any loss by the borrower due to the share lending may be

deducted only from gains deriving from similar agreements in the same income year. Furthermore, in a case regarding a situation where a borrower had not sold the borrowed shares, the National Tax Tribunal held that the borrower was not subject to taxation in respect of dividends that were to be allocated to the lender under the agreements, as the borrower had not obtained an ownership right to the shares.

10.1. The share lender

Individuals are taxed on remuneration as personal income at a rate of up to 59%, whereas companies are taxed at a flat rate of 25%. Taxation of dividend compensation and dividends received on collateral depends on the terms of the agreement. Tax subjects that are not subject to full tax liability in Denmark are not taxed on remuneration, whereas any income that is deemed to be a dividend for tax purposes is treated under the rules governing dividends.

10.2. The share borrower

Individuals are taxed on the gain on a transaction as personal income at a rate of up to 59%, whereas companies are taxed at a flat rate of 25%. Remuneration is included in the calculation. Any loss on a transaction including remuneration paid in the event of no sale and repurchase of shares may be deducted only from gains on similar transactions in the same income year. The taxation of dividends received depends on the terms of the agreement. Tax subjects that are not subject to full tax liability in Denmark are generally not taxed on a transaction. However, any income that is deemed to be a dividend for tax purposes is treated under the rules governing dividends.

10.3. Pension funds

There is no special provision in the Act on Taxation of Pension Yields concerning share lending. However, the Act is based on the yield of investments, and therefore it is the starting point that income deriving from share lending is included.

11. Shares in Transparent Entities

Danish partnerships and limited partnerships are generally fully transparent, i.e. such entities do not exist for tax purposes. The same applies to foreign partnerships and limited partnerships, provided that they do not fulfil the conditions for falling under the scope of the Act on Taxation of Companies. As regards distributing investment associations and investment associations on account, see 9. Special comments are offered below regarding transparent entities.

11.1. Individuals

A limitation applies in respect of the deductibility of losses, as taxable income deriving from a transparent entity with more than ten owners is taxed as capital income and not personal income if the individual does

not substantially participate in the business. A similar restriction applies regardless of the number of owners to taxable income deriving from the lending of depreciable assets and ships, and a similar restriction applies in respect of certain business concerning plants in cases where there are more than two owners.

11.2. Companies

The exemption rules regarding dividends paid by Danish companies to parent companies that are not subject to full tax liability in Denmark (see 6.) also apply in respect of parent companies that are transparent for Danish tax purposes, provided that the parent company is included in the list of companies referred to in Art. 2.1.(a) of EU Directive 90/435.

11.3. Pension funds

Certain pension institutions may opt for an annual mark-to-market taxation in respect of shares in transparent entities. Individual pension schemes are generally subject to annual mark-to-market taxation on investments in limited partnerships.

12. General Comments

Denmark has enacted anti-avoidance rules concerning cross-border financial instruments including double dips, hybrid instruments, non-transparent entities treated as transparent entities for foreign tax purposes, transparent entities treated as non-transparent entities for foreign tax purposes, liquidation proceeds (see 6.), interest payments and certain gains on claims. The rules regarding the two latter types of income are generally

relevant only to offshore companies receiving the income from group related companies in Denmark.

Individuals may have opted to have their business taxed under Sec. I of the special Act on Taxation of Independent Business, the aim of which is to treat the individual as if he or she had pursued the business in a company. Thus, any surplus remaining within the business is taxed at a flat rate of 25%. The financial assets that may be included under this scheme are restricted. However, bonds with an interest, convertible bonds, shares in investment companies and indexed bonds that are subject to annual mark-to-market taxation may be included in the scheme.

This article does not address tax calculation rules or transition rules including special rules applying to spouses. It is assumed here that assets held by tax subjects not answerable to full tax liability in Denmark are not held through a permanent establishment in Denmark of the tax subject in question. As regards shares in companies, see 6. Denmark has enacted mandatory national joint taxation legislation covering activities in Denmark.

Furthermore, this article does not provide a full overview of rules and regulations relating to pension funds. Rather, the tax rules described in respect of pension funds are limited to specific rules concerning taxation of each of the financial instruments considered in this article, and the holders/parties referred to in this article are not exhaustive.

It is possible to request binding answers from the tax authorities in respect of questions relating to the tax treatment of financial instruments.