*David A. Munch**

Taxation of Basel III-Compliant Instruments

1. Debt/Equity Characterization for Tax Purposes

With reference to the guidelines of the Basel Committee[1] in the relevant bill, Acts concerning financial institutions were amended by Act 428 of 6 June 2002. In 2003, the rules concerning debt instruments were revised and inserted as one section, namely section 132 of the Financial Business Act, including the addition of conditions based on para. 6 of the above-mentioned press release.

In order for such perpetual instruments to be recognized as debt for tax purposes, section 6B of the Tax Assessment Act was introduced by Act 457 of 9 June 2004. Under section 6B:
- the debt relation must be assessed at the time of the issuance of the debt instrument;
- the debtor must be a state or a credit institution,[2] or one of certain other financial institutions resident within the EU/EAA; and
- the creditor shall be entitled to annual interest.

The terms of the interest may only be changed subsequently due to circumstances over which both the debtor and creditor have no control. Under the relevant bill, but the interest rate may be reduced to 0% in certain periods according to pre-fixed conditions, for example in the circumstance where interest may not be paid during a period in which the financial institution has no free reserves.[3]

In 2009, the National Tax Board issued a binding ruling concerning perpetual bonds.[4] That ruling made reference to section 132 of the Financial Business Act. The terms of the bonds included a fixed interest rate subject to Tier 1 conditions, and a variable additional yield. The National Tax Board found that the bonds were subject to section 6B of the Tax Assessment Act.

Section 132 of the Financial Business Act was repealed by Act 1556 of 21 December 2010, as the Financial Supervisory Authority was authorized to issue a regulation including Tier 1 rules concerning the above-mentioned debt instruments. Regulation 764 of 24 June 2011 has been issued. Basel II[5] has been taken into account, such that, for example the regulation imposes rules on mandatory conversion into equity. To the author's knowledge, the tax authorities have not issued any decisions based on this regulation.

The above-mentioned Basel III requirements arise from the "Eligibility criteria for non-core Tier 1 capital" as specified in the February 2010 public consultation by the Commission services. In the author's opinion, the condition in section 6B of the Tax Assessment Act concerning annual interest would not be regarded as being fulfilled due to item 7 (concerning dividend/coupon discretion) because the debtor's discretion is not limited in any way. Thus, interest may be permanently waived. As a consequence of this determination, the perpetual instrument would not be treated as comprised by section 6B of the Tax Assessment Act.

In recent years, the Danish Supreme Court has concluded that a payment made by way of a *Stille Beteiligung* (agreement entered into in 1994) under German law constituted a capital contribution that was taxable for Danish joint taxation purposes,[6] and that payments made in 2000 as additional capital payments under Polish law constituted capital contributions that were taxable for Danish joint taxation purposes.[7]

In the author's opinion, it is likely that payments that fulfil the above-mentioned requirements would be characterized as capital contributions (equity), which are generally taxable in respect of the receiving Danish bank, and not as debt for Danish tax purposes. The receiving Danish bank is not subject to taxation with respect to certain capital contributions from group companies.[8]

2. Deductibility of Coupon for Corporate Income Tax Purposes

As a consequence of payments being deemed to be capital contributions (see 1.), any subsequent payments by the bank would not be deductible as interest payments for corporate income tax purposes. The question is whether the payments may be regarded as deductible business expenses. In the author's opinion, it is likely that the payments would not be deductible as business expenses because the expenses are related to the capital of the bank and not the customers of the bank.

3. Possible Withholding Taxes on Coupons

Any subsequent payments by the bank in respect of capital contributions (see 1. and 2.) to non-shareholders of the bank would generally not be subject to withholding tax. A contribution to a foreign group company that is a shareholder of the bank would constitute a dividend. If the recipient is a foreign group company[9] that would be

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1. Press release, "Instruments eligible for inclusion in Tier 1 capital" (27 October 1998).
2. Directive 2000/12, as amended by Directive 2000/28.
3. See sec. 132 Financial Business Act.
4. SKM2009.53.SR.
5. Basel Committee, "International Convergence of Capital Measurement and Capital Standards" (June 2006).
6. TfS 2008.1128.
7. TfS 2009.998.
8. Sec. 31D Act on Taxation of Companies.
9. Sec. 31D Act on Taxation of Companies.

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taxed on dividends had the foreign group company been the parent company of the bank, a capital contribution would be treated as a dividend.[10] Dividends to a foreign group company (subject to definitions) are generally not subject to withholding tax if the foreign group company is covered by Directive 90/435 or an applicable tax treaty.

Beneficial ownership is an important topic in Denmark. For 2011, the withholding tax rate is 28%. As from 1 January 2012, the rate will be 27%.

4. Recognition of Income and Expense

Any subsequent payment in respect of capital contributions (see 1. and 2.) would be recognized for tax purposes in the income year during which the payment is decided and paid.

5. Tax Treatment of the Conversion versus Write-Down

As a consequence of the payments being regarded as capital contributions (see 1. and 2.), a mandatory conversion in the event of loss absorption would constitute a contribution by the bank in the form of shares. Such contribution may be treated as a dividend and subject to withholding tax (see 3.). A write-down would not have any Danish tax consequences, as the initial payment that is treated as a capital contribution would be a final tax event.

6. Stamp Duties/Capital Taxes upon Issue and/or Conversion

No such duties or taxes apply.

7. Transfer Pricing Consequences of Intercompany Financing

Assuming that a capital contribution does not constitute a reciprocal agreement and is not part of such agreement, but is a unilateral decision by either party (see 1. and 2.), transfer pricing adjustments would not be relevant due to the unilateral nature of the capital contributions.

10. Sec. 2.1.c. Act on Taxation of Companies.

BOOK

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