

Taxation of Bonds and Other Financial Instruments Held by Individuals

This article is in line with two previous articles published in this journal in 2009: "An Introduction to the Taxation of Financial Instruments" (Vol. 11, issue 1) and "Update: An Introduction to the Taxation of Financial Instruments" (Vol. 11, issue 4). The article concerns Bill 112, which passed in the Danish parliament on 1 June 2010 (Act 724 of 25 June 2010).

1. Introduction

Prior to the presentation of Bill 112 to the parliament on 27 January 2010, gains on bonds in Danish kroner held by individuals resident in Denmark were tax exempt, provided that the terms of the bonds were in accordance with the rules concerning minimum interest. Losses on such bonds were not deductible. Gains on bonds in foreign currency held by resident individuals were generally taxable and losses generally deductible.

The bill was proposed as a consequence of a letter from the EU Commission stating that the different tax treatment of resident individuals' bonds in Danish kroner and resident individuals' bonds in foreign currency is in contravention of the rules on the free movement of capital. Under the bill, the favourable treatment of bonds in Danish kroner has been repealed, other provisions have been amended as a consequence thereof and new amendments to provisions have been introduced, including a decrease of the maximum tax rate applicable to the capital income of resident individuals from 51.5% to 49.5% (2010), 47.5% (2011), 45.5% (2012), 43.5% (2013) and 42% effective as from the income year 2014, resulting in a maximum tax rate of 42% applicable to capital income and share income, respectively. However, the taxation of bonds and shares will not be fully harmonized because the deductibility of losses on shares is restricted compared to the deductibility of losses on bonds. Capital income is a much broader income category than share income only. Furthermore, bonds acquired before 27 January 2010 are not subject to the repeal of the favourable treatment.

2. Bonds Held by Resident Individuals

Gains on bonds acquired on or after 27 January 2010 are taxable irrespective of the currency, provided that the annual gains, including other gains and losses, exceed DKK 2,000. In addition, losses on such bonds are deductible, provided that (1) the annual losses, including other gains and losses, exceed DKK 2,000, (2) the bonds are not on controlled companies or certain family mem-

bers, and (3) the acquisition of listed bonds has been reported to the tax authorities in due time.¹

The exempted amount of DKK 2,000 also includes gains and losses on debts in foreign currency and gains and losses on shares in distributing bond-based investment associations. For the purpose of calculating gains and losses on debts in foreign currency, debts in Danish kroner adjusted on the basis of foreign currencies, and debts in foreign currency adjusted on the basis of Danish kroner, are treated as debts in foreign currency and debts in Danish kroner, respectively.²

As a consequence of the repeal of the favourable treatment of bonds in Danish kroner, special rules relating to the distinction between the favourable bonds in Danish kroner and other bonds have been amended or repealed. Thus, rules for the purpose of preventing circumvention have been repealed and rules concerning only other bonds have been amended to include the bonds covered by the repeal.

3. Adjusted Bonds Held by Resident Individuals

The rules governing adjusted bonds under the Act on Capital Gains³ have been amended as a consequence of the equal treatment of bonds in Danish kroner and in foreign currency. Sec. 29(3), second through sixth sentences, of the Act on Capital Gains, prior to the amendments, can be summarized as follows:

The tax rules governing adjusted bonds do not apply, if [any individual's gain is covered by Sec. 16 of the Act or] the bond is adjusted only in accordance with certain Danish public price indexes. Furthermore, the tax rules do not apply to bonds that are adjusted only according to certain public price indexes within the European Union. The tax rules always apply to bonds that are adjusted on the basis of currency and price indexes as mentioned that do not relate to the same area. [Issuance in foreign currency is treated as an adjustment on the basis of the currency in question.] A price index in a country that participates in the euro and the euro currency are deemed to relate to the same area.⁴

The text in brackets has been deleted. Sec. 16 of the Act concerned an individual's bonds in foreign currency,

* Partner, Eversheds Advokataktieselskab, Copenhagen. The author can be reached at davidmunch@eversheds.com.

1. New Secs. 14 and 15 Capital Gains Act.
2. Sec. 23 Capital Gains Act.
3. Sec. 29(3).
4. Author's translation.

including bonds in Danish kroner adjusted only in accordance with the development of foreign currencies.⁵

Thus, the amendments imply that bonds held by resident individuals and issued in Danish or foreign currency are treated equally in respect of the special rules in Sec. 29(3), concerning currencies and price indexes.

The taxation of bonds not adjusted to assets, etc., other than currency and certain price indexes, after the amendments, can be summarized as follows:

Bonds that are adjusted only according to the development of a currency other than the currency in which they are issued, are treated as adjusted bonds. Bonds that are adjusted only in accordance with the development of certain public price indexes are not treated as adjusted bonds. Bonds that are adjusted to certain price indexes and another currency, are treated as adjusted bonds irrespective of whether the currency and the index relate to the same country (area). The latter is not commented upon in the explanatory remarks of the bill. However, now that issuance in foreign currency is not treated as an adjustment, the sentences in Sec. 29(3) concerning currency and price indexes (see "The tax rules always apply...", above) have been made redundant because a bond adjusted to a currency other than the currency in which it is issued will always be treated as an adjusted bond, irrespective of the bond also being adjusted according to a price index.

4. Shares in Investment Associations Held by Resident Individuals

Prior to Bill 112, shares in distributing investment associations were, for capital gains purposes, divided into four different categories: based on shares, based on shares and bonds (mixed), based on Danish bonds and based on foreign bonds, the latter being due to the different treatment of bonds in Danish kroner and bonds in foreign currency.

Under the bill, there are only two different categories, namely based on shares (if at least 50% shares) and based on bonds (if less than 50% shares), effective for disposals on or after 1 January 2011. The share percentage is calculated as the part of the association's assets that is placed in securities, etc. covered by the Act on Capital Gains on Shares, excluding shares in investment companies and shares in distributing investment associations. It is further required that the remaining part of the association's assets be placed in securities, etc. and in the administrative building of the association. Forward contracts as well as put and call options that are taxed separately under Secs. 29-33 of the Act on Capital Gains are included in the calculations according to the value of the underlying asset. The calculations are made based on average values during the income year of the association.

If the tax status of an association is amended from being bond-based to share-based, such amendment does not imply that the shares in the association are deemed to be disposed of for tax purposes. If the tax status of an association is amended from being share-based to bond-

based, the shares in the association are deemed to be disposed of for tax purposes at the market price at the time the amendment has effect. Consequently, the shares in the association acquired for tax purposes are treated under the rules governing bond-based associations as from that time. The amendment from share-based to bond-based status has effect as from the expiry of the income year (of the association) in question.

5. Share-Based Financial Contracts Held by Resident Individuals

Separate from the amendments regarding bonds, a special provision concerning the deduction of losses on share-based financial contracts that are taxed separately from the underlying shares has been inserted in Sec. 32 of the Capital Gains Act, which includes the rules on the deduction of losses on financial contracts held by individuals.

The purpose of this amendment is to ensure that individuals who realize a gain on shares may deduct a corresponding loss (on a contract hedging the risk for a loss on the shares in question) from the gain on the shares. It is a condition that the shares and the financial contract be listed. During the legislative process of the bill, the Danish Bankers Association (*Finansrådet*) questioned the fact that the rules were to be confined to including listed contracts, as many contracts were entered into with a bank as the counterparty. An expansion of the rules on the basis thereof was refused.

A loss on a share-based financial contract must be deducted from gains on financial contracts under the general rules, before it may be deducted from gains on listed shares. Furthermore, losses on listed shares in the income year in question⁶ must be included in the calculation of share income, before a loss on a share-based financial contract may be deducted from gains on listed shares. Under the rules in Sec. 13A, losses on listed shares are deducted from the share income of the income year, including dividends, gains and transfer sums deriving from the sale of shares back to the issuing company. If the individual has share income deriving from dividends and transfer sums from which a loss on listed shares must be deducted, there is no rule allocating a loss on listed shares on gains, dividends⁷ and transfer sums for purposes of the special rule in Sec. 32 of the Act on Capital Gains.

Consider the following example (all figures in Danish kroner):

loss on listed shares	400
loss on a listed share-based financial contract	200
gains on listed shares	300
dividends on listed shares	300

5. Repealed Sec. 1(2) of the Act, under which bonds in Danish kroner adjusted on the basis of foreign currencies, and bonds in foreign currency adjusted on the basis of Danish kroner, were treated as bonds in foreign currency and bonds in Danish kroner, respectively, for the purposes of the Act.

6. Sec. 13A Act on Capital Gains on Shares.

7. Withheld Danish tax and foreign tax, respectively, are also relevant to the tax assessment of the individual.

Under Sec. 13A, the loss on listed shares must be deducted from the total of the positive income, i.e. $600 - 400 = 200$. The loss on the share-based financial contract may not be deducted from the result of 200; it may be deducted only from the gain of 300. If the loss on listed shares must be deducted proportionally, the 2 times 300 are reduced to 2 times 100 and, consequently, the loss of the share-based financial contract may be utilized by 100; the result is 100 instead of 200 and the remaining loss on the contract may be carried forward. If the loss must be deducted from dividends before gains, the 2 times 300 are amended to 200 (gains) and 0 (dividends); the loss on the contract may be utilized fully by 200; and the result is 0 instead of 100. If the loss on listed shares must be deducted from gains before dividends, the loss of the financial contract cannot be utilized and the result is 200.

Losses on listed share-based financial contracts that may not be deducted from gains on financial contracts under the general rules may be carried forward. It is not a condition that excess losses have been deducted from gains on listed shares, i.e. the investor may choose to deduct such excess losses from gains on listed shares or to carry them forward.

The amended Sec. 32 of the Act on Capital Gains has effect for losses in the income year 2010.

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