Time for action for companies with large financing costs

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Three sets of rules limit companies when deducting net financing costs. For companies with a financial year following the calendar year, it is time to consider measures to counteract these limitations.

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Companies are limited by three sets of rules when deducting net financing costs. The three sets of rules are:

- The thin capitalization rule
- The asset rule
- The EBITDA rule

While the asset and EBITDA rules are primarily relevant for larger companies because they only affect groups with net financing expenses of DKK 21,300,000 (the asset rule) and DKK 22,313,400 (the EBITDA rule) and above, the rule on thin capitalization also affects some medium-sized companies. Hence, in the following, focus will be on the latter rule.

The thin capitalization rule applies to so-called controlled debt, which includes debt to group companies and debt to external parties for which, group companies have put up collateral.

However, the rule only applies if the controlled debt exceeds DKK 10 million and the equity amounts to less than 20 pct. (4:1 ratio) of the market value of the assets at year end.

If a company has debt in excess of 80 pct. of the market value of the assets, the interest deduction for the excess portion of the debt may be restricted.

In some cases, calculation of the controlled debt must be done at the consolidated level. However, the ultimate parent company and foreign parent companies should not be included.

Consequently, in many Danish groups, where a Danish parent company has only one layer of Danish subsidiaries, each subsidiary must be assessed separately, which is often the reason why interest deduction restrictions are applied in relation to ordinary Danish groups.

In relation to the thin capitalization rule, a possible restriction on the deduction is calculated based on the company's balance sheet on the balance sheet date.

This means that companies can, through various measures, often reduce the adverse effects of the rule or completely eliminate them, but it obviously requires action to be taken before the end of the financial year. Hence, for companies with a financial year following the calendar year, the time for such considerations is now.

In relation to the rule on thin capitalization, the challenge is not so much on intra-group debt to other Danish companies – since the creditor company is not taxed on interest income for

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which the debtor company cannot deduct the corresponding interest expenses – but on debt to external parties where group companies have put up collateral.

Some of the simpler planning measures include reducing debt through the injection of new capital or using available liquidity. Particularly, the latter may be relevant if negative interest rates are applied to bank balances.

Another option could be to have an individual majority shareholder provide loans to the company, as debt to natural persons is not considered controlled debt. Finally, there may also be cases where it is advantageous to consider the group structure itself, as this also has significance in relation to the calculation rules.

The rules on limiting companies' deductions for financing costs are rather complicated. BDO can assist you in calculating whether your company may be affected by the rules and what financial significance this may have, if any, and advise on what measures could be undertaken to counter this.

Check your preliminary tax assessment for 2020

The Danish Tax Agency has issued preliminary tax assessments for 2020. Particularly, if you recently relocated to Denmark, you should check that the preliminary tax assessment reflects your expected income and deductions.

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In Denmark, individual taxpayers pay preliminary taxes during the same year they earn the income.

For example, your Danish employer is required to withhold taxes when paying salary to you. The employer will pay the withholding taxes to the Danish Tax Agency on your behalf.

Depending on the circumstances, you may also be required to pay preliminary taxes yourself in addition to the taxes withheld by your Danish employer.

This is the case if you have recently relocated to Denmark from abroad and earn income from foreign sources – e.g. investment income or if you own a rental property abroad.

As the Danish Tax Agency often has no information on this income, you should check your preliminary tax assessment for 2020 and make the required amendments to ensure the preliminary tax assessment reflects your expected income and deductions for the year.

By amending your preliminary tax assessment, you reduce the risk of accumulating interest-bearing residual taxes by the end of the year.

Any preliminary taxes to be paid directly by you are generally collected in 10 monthly instalments during the income year (no instalments are due in the months of June and December).

It is also possible to make a voluntary payment of additional preliminary taxes for the income year any time during the year.

If you need assistance in reviewing your preliminary tax assessment and amend it if required, BDO can help you.