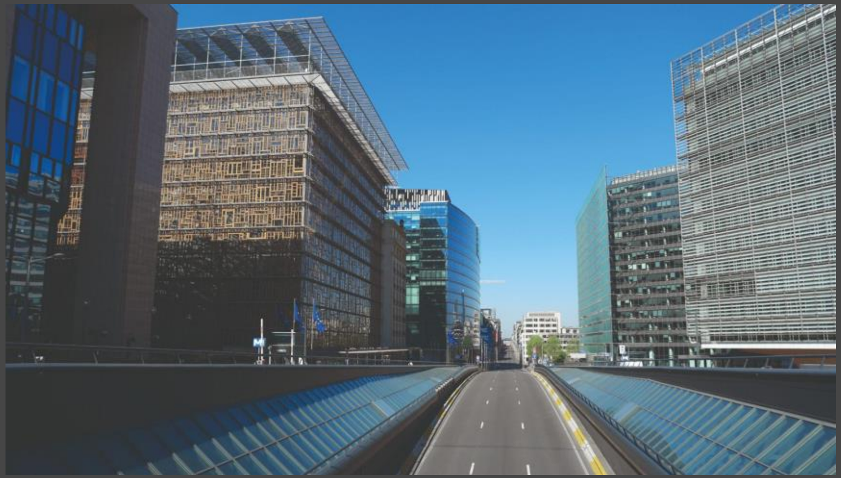
Proposed introduction of mark-to-market taxation of Danish rental properties

30 August 2022



Agenda

- Welcome
- The published draft bill and the political agreement
- Taxation of Danish real estate today
- Legislative proposal on mark-to-market taxation of Danish real estate from 1 January 2023
- Implications for other tax legislation
- Summary
- Questions

Welcome

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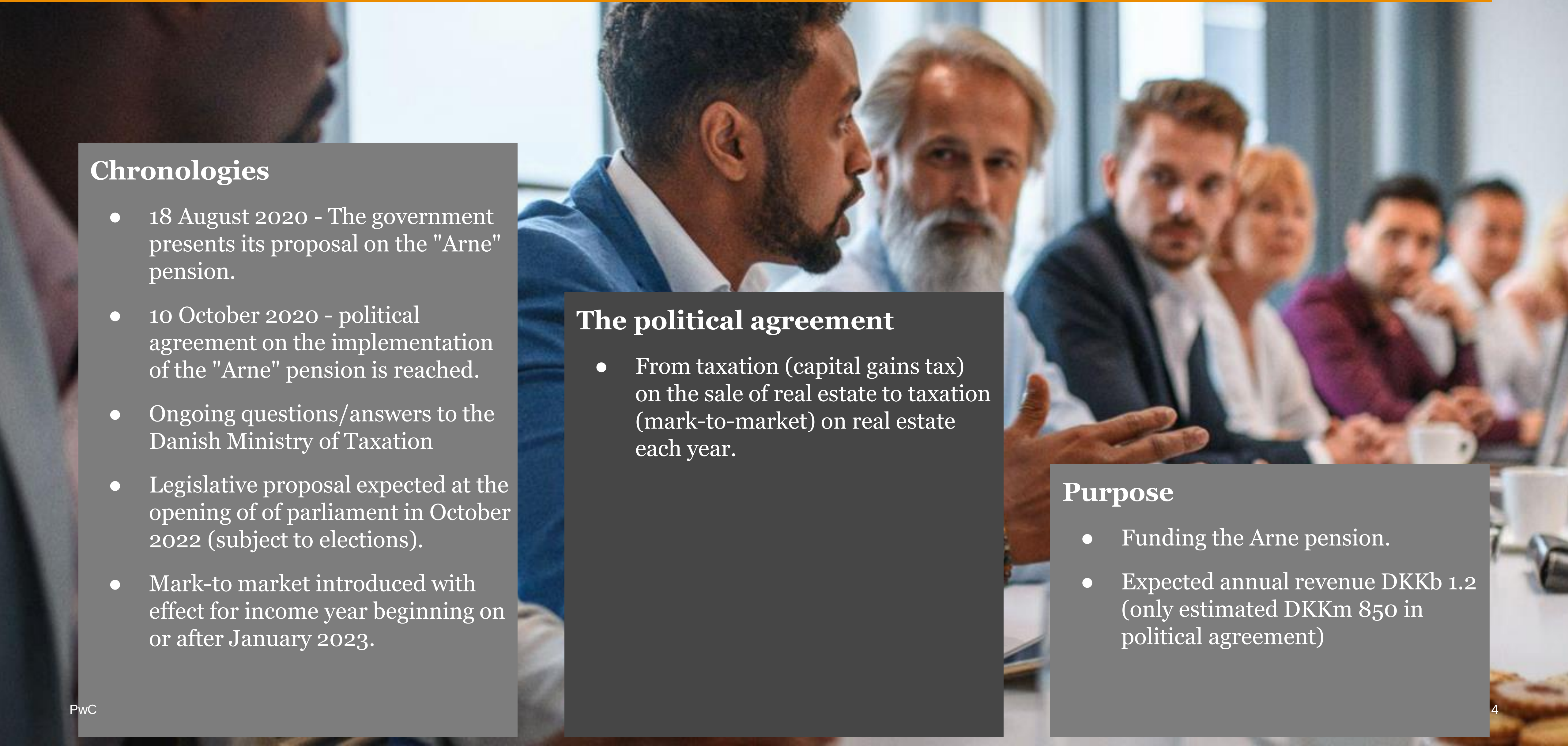
The published draft bill and the political agreement



Chronologies

- 18 August 2020 - The government presents its proposal on the "Arne" pension.
- 10 October 2020 - political agreement on the implementation of the "Arne" pension is reached.
- Ongoing questions/answers to the Danish Ministry of Taxation
- Legislative proposal expected at the opening of of parliament in October 2022 (subject to elections).
- Mark-to market introduced with effect for income year beginning on or after January 2023.

The political agreement

- From taxation (capital gains tax) on the sale of real estate to taxation (mark-to-market) on real estate each year.

Purpose

- Funding the Arne pension.
- Expected annual revenue DKKb 1.2 (only estimated DKKm 850 in political agreement)

Taxation of Danish real estate today - capital gains taxation

Capital gains taxation

- Capital gain and recaptured depreciation on Danish real estate is currently taxable solely upon realisation in an asset deals
- Currently, a Danish property can, accordingly, be disposed of indirectly in a share deal without triggering any Danish capital gains tax

If the bill is implemented - mark-to-market taxation

Mark-to-market taxation

- With mark-to-market taxation the gain/loss during the income year is calculated as the difference between the value of the asset at the end of the income year and at the beginning of the income year.
- Thus, there is a continuous taxation of increases in value, i.e. both realised and unrealised gains. At the same time, any losses will also be tax deductible on an mark-to-market principle.
- For assets acquired during the tax year, the acquisition cost is used as basis instead of the value at the beginning of the tax year. For assets disposed of during the tax year, the disposal value is applied instead of the value at the end of the tax year.

Which taxpayers will be covered according to the draft bill?

Covered

- Danish companies subject to the statutory corporate income tax rate of 22%
- Foreign companies subject to Danish corporate income taxation based on DK real estate or permanent establishment
- Including subsidiaries of foundations
- Danish and foreign companies owning real estate through tax transparent entities (P/S, K/S and I/S)

Not covered

- Business operated by an individual
- Foundations
- Entities subject to certain special Danish tax regimes (tax-exempt companies, other entities not subject to 22% corporate tax (e.g. pension funds)

Partially covered

- Cooperative societies and other entities taxed as associations (taxed only on income from business activities with non-members)

- Rent to members of the association is exempt

Which properties will be covered according to the draft bill?

For a property to be covered by the proposed legislation, the following conditions must be fulfilled (both conditions must be met):

1. The property has predominantly (at some point) in the taxpayer's income year been rented out (rental properties)

1. The market value of properties under Danish taxation that are rented out predominantly exceeds DKKm 100 at the end of the income year

The following principle will apply in the future

- Once a property is subject to mark-to-market taxation, it remains subject to mark-to-market taxation
- Even if a comprised property ceases to be rented out, it remains subject to mark-to-market taxation
- Even if the DKKm 100 threshold is no longer met, a property remains subject to mark-to-market taxation if once comprised
- Mark-to-market tax also applies to taxpayers deemed professionally trading in real estate

Condition 1 - predominantly rented out

The property has predominantly (at some point) in the taxpayer's income year been rented out (rental properties)

- A property is considered to be predominantly rented out if more than 50% of the total floorage of the building/buildings, ***or*** more than 50% of the land is rented out
- The property is considered to be rented out as of the date, where the tenant occupies the rented property, i.e. not from the date, where the rental agreement is signed (relevant especially for newly developed properties).
- If existing property change status during the income year from not being predominantly rented to being predominantly rented, mark-to-market taxation kicks in from the beginning of the income year.

Excluded properties - all other properties, for example

- Properties used predominantly in the company's or a jointly taxed company's own business (domicile properties) are exempt from mark-to-market taxation.
    - **Note:** Rentals between related entities (broad scope following the definition from transfer pricing rules) are comprised if outside the joint taxation group.

Unresolved issues, e.g

- Renting vs. leasing
- Financial leasing
- Parking

Condition 1

Example - Letting on a predominant basis:

	Property A	Property B
Letting to an independent party	**40%**	**60%**
Letting to a jointly taxed company using the rented property for its own business	**30%**	**10%**
Used by the owner company itself, or canact premises	**30%**	**30%**

- **Property A** is not subject to mark-to-market taxation as only 40% is rented out externally, while the remaining part of the property is used in the joint taxation group's own operations or is vacant.

- **Property B** on the other hand, will be subject to mark-to-market taxation as 60% of the property is rented to parties outside the group.

Condition 1 - Building plots and development sites

Properties that are neither rented out nor used in the owner's own business, such as building plots and development sites, would not be subject to mark-to-market taxation until they are predominantly let out

Note: Challenge for property conversion cases!

Example: A predominantly rented property is purchased by a property company, with the aim of demolishing buildings etc. and transforming the property/the whole area into, for example, a new urban area for residential usage.

In the construction phase of perhaps 2-3 years, the property - which is now just a building site - will potentially be subject to mark-to-market taxation, even though the property is not yet (no longer) generating rental income.

Similar problems may arise if a real estate company buys a plot of land which is predominantly rented out eg. for parking, with a view to terminating the lease and constructing buildings on the site.

Condition 2
- DKKm 100 limit

The market value of properties under Danish taxation that are rented out to a predominant extent exceeds DKKm 100 at the end of the income year

- Determination of market value?
  - No requirement to use specific valuation method.
  - The taxpayer must use a method that is recognised and correct (e.g. the value applied for accounting purposes).
  - The taxpayer must document the basis for the valuation if requested by the Tax Administration (more on this later).
  - Any change in the method used from one tax year to the next must be specifically justified.

Relevant date for the assessment

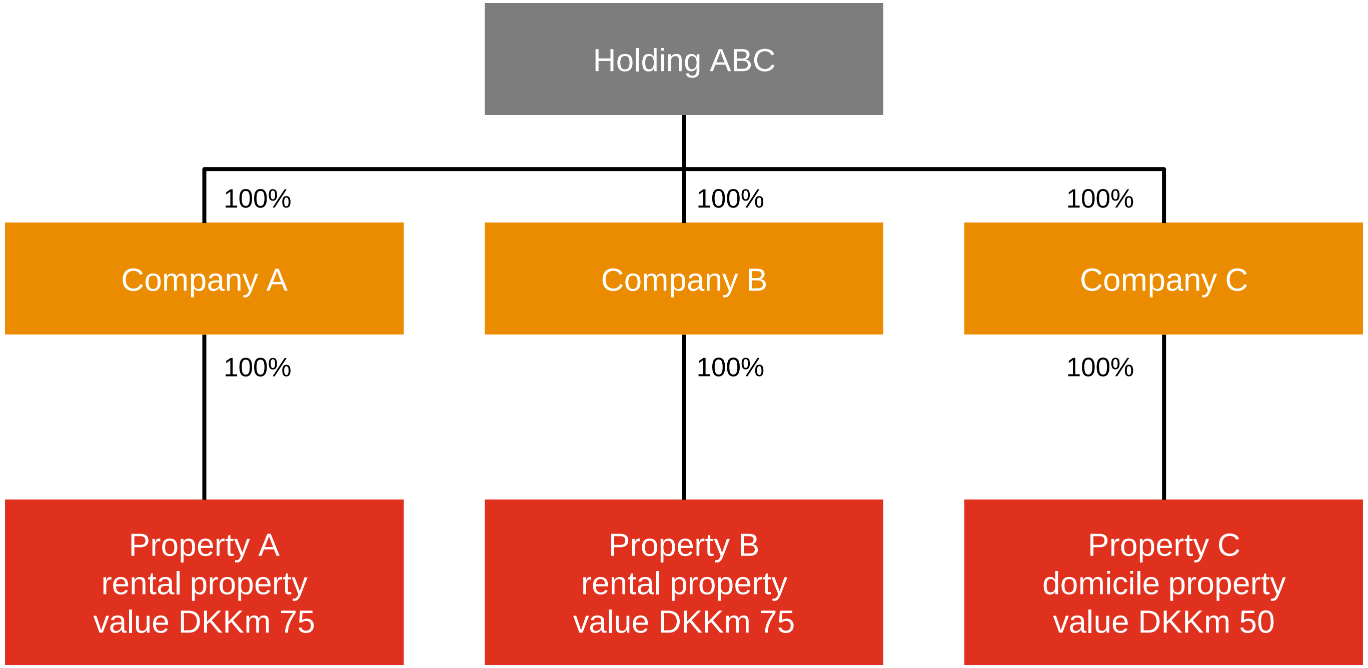
- The assessment must be made at the end of the income year

Unresolved issues

- When is a property considered transferred in the case of transfer agreements concluded during a tax year?

Condition 2
- Example

- Property A and B are subject to mark-to-market taxation - total market value DKKm 150.
- Property C <u>not</u> included - domicile property



Condition 2
- DKKm 100 limit

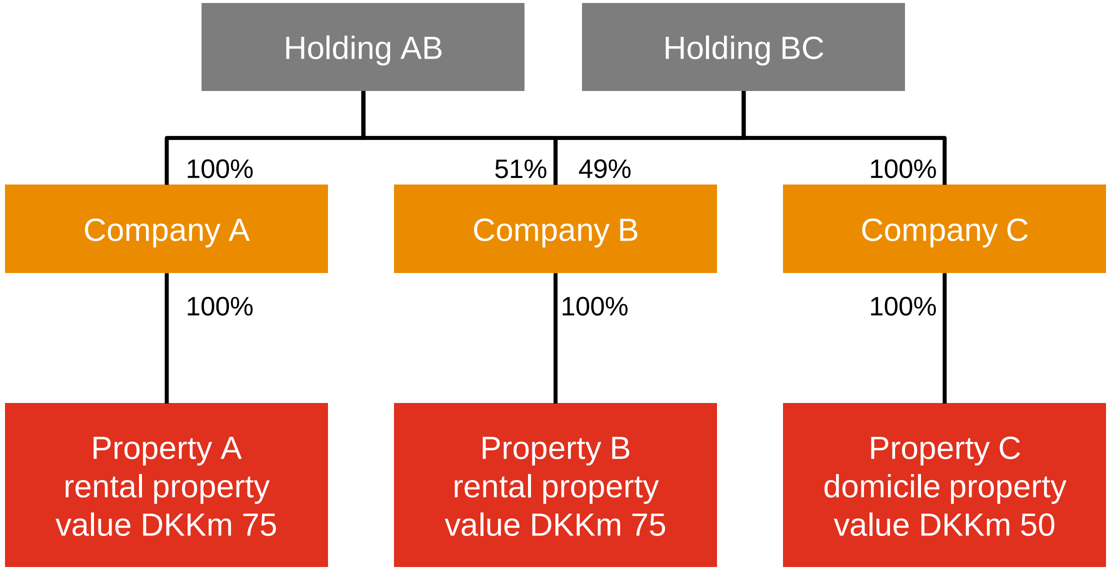
When applying the DKKm 100 limit, the value of properties owned by the relevant company as well as property owned by related companies etc. as defined in section 2 of the Danish Tax Assessment Act are taken into account

- The Danish Tax Assessment Act section 2 - broad definition of related entities
  - May include companies outside the joint taxation group

- Intra-group rentals, but not to jointly taxed companies:
  - Counted towards the DKKm 100 limit.
  - Not covered by the intra-group letting exemption.

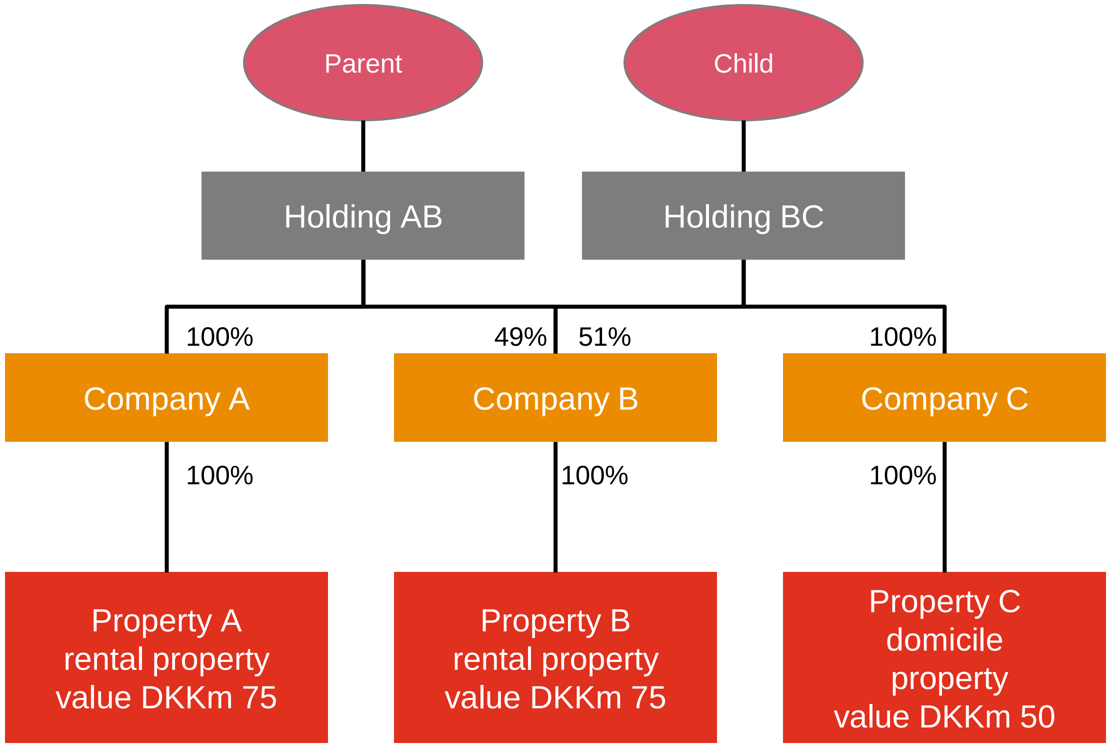
Example - Property owned by a group of taxpayers - not being related as defined in the Tax Assessment Act section 2

- Property B is indirectly owned by both holding companies, but Holding AB has a controlling influence.
- No link between Holding AB and Holding BC.
- Companies A and B subject to mark-to-market taxation on their property gains, due to the controlling influence of Holding AB.
- Company C <u>not</u> subject to mark-to-market taxation



Example - Property owned by a group of taxpayers being related as defined in the Tax Assessment Act section 2

- The ultimate shareholders here are related
- Property A and B are subject to mark-to-market taxation, notwithstanding that Holding AB does not have a controlling influence in Company B.
- The same will apply even if Holding AB has no ownership in Company B at all.



Transition to mark-to-market taxation

- When a property becomes subject to mark-to-market taxation, an entry value must be determined for the property = market value for mark-to-market taxation purposes.
- In addition, a realisation balance must be calculated for the property on the basis of the same market value and the acquisition price for such property.
- This applies in particular to properties that are subject to mark-to-market taxation in the first income year after the effective date of the act (income years beginning on or after 1 January 2023).

Realisation balance

- A realisation balance is a balance of the untaxed capital gain/or loss on a property that becomes subject to mark-to-market taxation. The balance must be calculated at the time of transition.
- A realisation balance is required for each property that is subject to mark-to-market taxation.
- A realisation balance is based on a calculation of capital gain/- loss on each property in the same way as if the property had been sold at market value. The calculation includes both recaptured depreciation for tax purposes and capital gains tax.

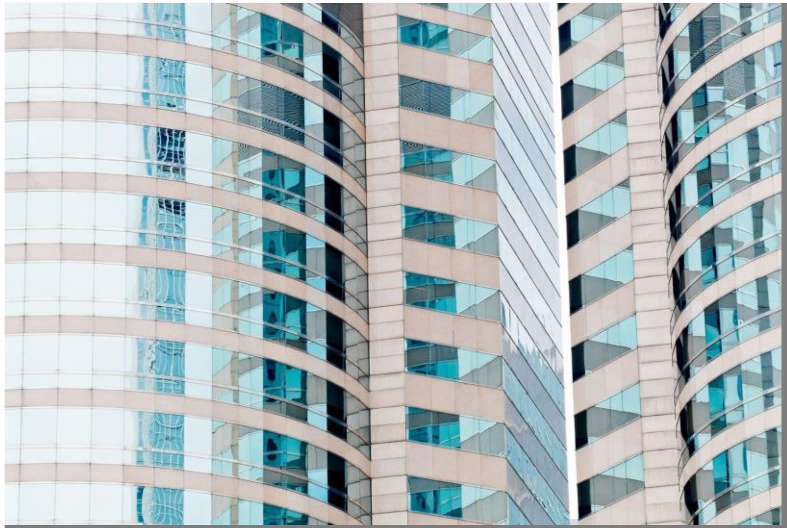
Transition to mark-to-market taxation

Positive realisation balance - example

- Upon transition to mark-to-market taxation, depreciation of DKKm 10 and a capital gain of DKKm 50 is calculated - the realisation balance amounts to the total of DKKm 60.

- The consequence of a positive realisation balance is that unrealised losses under the mark-to-market tax regime cannot be deducted for tax purposes until the positive realisation balance has been reduced to nil by setting of such losses.

In the event of a sale of the property, any (remaining) positive realisation balance is taxed.



Transition to mark-to-market taxation

Example - Treatment of gains and losses with a positive realisation balance

1. The property becomes subject to mark-to-market taxation at the beginning of 2023 with a market value of DKKm 120.
2. The property is sold in 2027 for DKKm 110.

	Income year				
DKKm	2023	2024	2025	2026	2027
Realisation balance beginning of the income year	60	60	50	50	45
Market value of the property at year-end	120	110	120	115	110
Property gain/loss for the year	0	-10	10	-5	-5
Property gain/loss included in the income statement based on the mark-to-market taxation	0	0	10	0	40

Remaining positive realisation balance (40)

Transition to mark-to-market taxation

Additional example - Treatment of capital gains and losses upon positive realisation balance

- The property becomes subject to mark-to-market taxation at the beginning of 2023 with a market value of DKKm 120.

	Income year				
DKKm	**2023**	**2024**	**2025**	**2026**	**2027**
Realisation balance beginning of the income year	60	60	60	60	45
Market value of the property at year-end	120	130	150	135	120
Property gain/loss for the year	0	10	20	-15	-15
Property gain/loss included in the income statement based on the mark-to-market taxation	0	10	20	0	0

Remaining positive realisation balance (30)

Transition to mark-to-market taxation

Negative realisation balance - example

- Upon transition to mark-to-market taxation, a capital loss of DKKm 20 is calculated - the realisation balance is minus DKKm 20.

- The consequence of a negative realisation balance is that there is no taxation of gains under the mark-to-market taxation regime before the negative balance is reduced to nil (by set of).

In the event of a sale of the property, a deduction is made for any (remaining) negative realisation balance.

- Neither losses under the mark-to-market taxation regime nor the deduction for negative realisation balance upon sale of the property is a ring-fences loss/deduction.

Transition to mark-to-market taxation

Example - Treatment of gains and losses upon negative realisation balance

1. The property becomes subject to mark-to-market taxation at the beginning of 2023 with a market value of DKKm 120.
2. The property is sold in 2027 for DKKm 125.

	Income year				
DKKm	**2023**	**2024**	**2025**	**2026**	**2027**
Realisation balance Opening balance	-20	-20	-10	-10	-5
Market value of the property at year-end	120	130	125	130	125
Property gain/loss for the year	0	10	-5	5	-5
Property gain/loss included in the income statement based on the mark-to-market taxation	0	0	-5	0	-10

Mark-to-market losses (5) and remaining negative realisation balance (5)

Depreciation and improvement/maintenance costs

Tax depreciation is abolished for comprised properties

- Transition into mark-to-market taxation means no depreciation on the relevant properties going forward, including buildings, installations, etc.

Full deduction for improvement and maintenance costs

- Expenses for both improvement and maintenance of properties subject to mark-to-market taxation can, instead, be deducted for tax purposes in the year in which they are incurred.

Restructuring, etc.

Tax succession

- Tax exempt mergers, demergers and contribution of assets entail succession for tax purposes.

Mark-to-market taxation with the transferring company

- A property subject to mark-to-market tax with the transferring company continues being subject to mark-to-market taxation with the receiving company. Accordingly, the precipice of “once subject to mark-to-market taxation, always subject to mark-to-market taxation”, also applies to tax-free restructurings.
    - If the transferring company has a positive realisation balance, the receiving company succeeds for tax purposes.
    - If the transferring company has a negative realisation balance, the receiving company does not succeed for tax purposes.

Realisation taxation with the transferring company

- A property subject to realisation taxation with the transferring company must - as a rule - also continue being subject to realisation taxation with the receiving company.
    - However, the decisive factor is whether the conditions for mark-to-market taxation are met for the receiving company.
- If the property becomes subject to mark-to-market taxation in the context of the tax-free restructuring, the receiving company cannot establish a negative realisation balance for the transferred property. However, if a positive realisation balance is established, the receiving company must treat it according to the general rules.

Documentation requirements

- Companies owning properties subject to mark-to-market taxation must be able to document the following (and submit it to the Tax Administration if requested):

    - How the market value of the properties for the purpose of mark-to-market taxation has been assessed,
    - The valuation method(s) (cost-based, income-based or market-based) used, including how the various parameters of the model are determined.

- There is no requirement for a specific methodology as long as it represents an appropriate assessment of the market value of the real estate.

- The company must be consistent in its use of the valuation method and if the company chooses to change the method from one year to the next, it must be able to give specific reasons for such change.
- The information to be documented/possibly submitted could be the information (economic parameters) that may affect the valuation, such as the yield requirement applied and its estimation, growth expectations in rental levels and operating costs as well as expected inflation, etc.

Implications for interest deduction limitation rules

- The bill does not address the consequences of mark-to-market taxation for the calculation of interest deductibility limitations under the interest ceiling rule and/or the EBITDA rule.

Immediate points for attention

Interest ceiling rule
It needs to be considered at which value a property subject to the proposed mark-to-market taxation should be included in the interest ceiling calculation

  - The market value at the end of the tax year applied for mark-to-market taxation?
  - Should adjustments be made for any value increases which have been subject to mark-to-market taxation?
  - Cost of acquisition plus improvements? (corporate income tax act sect. 11B,(5),(3) "Assets that are not depreciable are included at cost plus the cost of improvements").

EBITDA rule
It needs to be considered whether gains or losses on properties subject to mark-to-market taxation are included as (unrealised) gain/loss in the EBITDA for the purpose of applying the EBITDA interest restriction rule.

Other issues raised during the hearing phase

- Can existing carry-forward losses under the Capital Gains Tax Act for Real Estate (from previously sold properties) be set off against future gains calculated under the mark-to-market tax rules?
    - Either when calculating a positive realisation balance.
    - Or when gains are calculated under the mark-to-market taxation rules.
- A carry forward tax loss can be triggered based on an unrealised loss on real estate under the mark-to-market taxation regime
    - The 60/40 rule for utilization of tax losses carried forward should then apply, eg. when the carried forward tax loss is utilized against subsequent gains based on the mark-to-market taxation on real estate.
- Different principles of taxation going forward, when Denmark applies mark-to-market tax and other countries apply realization principle - may cause problems with double tax treaty reliefs

Summary

Two conditions must be met for a property to be subject to mark-to-market tax

1. The property has predominantly (at some point) in the taxpayer's income year been rented out (rental properties) and if
2. The market value of properties under Danish taxation that are rented out to a predominant extent exceeds DKKm 100 at the end of the income year.

The consequences of a property's transition to mark-to-market taxation are

- An initial value (market value) must be established and a realisation balance (profit and loss account) must be calculated.
- A valuation of the property must be prepared each year for the purpose of calculating taxable income.
- The mark-to-market gain/loss for the year is taxed (realised or unrealised) at 22% (subject to realisation balance).
- Possibility of depreciation for tax purposes is abolished.
- In return, full deduction for improvements/maintenance costs.
- Once mark-to-market taxed - always mark-to-market taxed.

Questions?

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