

Dutch Shell Prevails in Danish Hydrocarbon Tax Case

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HIGHLIGHTS

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The Danish Eastern High Court recently held that interest payments and foreign exchange (FX) gains did not fall under the scope of the Danish Hydrocarbon Tax Act before its amendment in 2009. The landmark decision provides a long-awaited clarification and, more importantly, establishes that any income that is not specifically mentioned in the provision defining the act's ring fence system cannot be included in its scope.

The case, decided March 22, concerned financial income in fiscal years 2002-2006 and involved approximately DKK 2.5 billion (about \$430 million). The taxpayer was a branch of Dutch Shell that is a partner in the Danish Underground Consortium.

The Hydrocarbon Tax Act

The Danish Hydrocarbon Tax Act contains a ring fence system for the taxation of income from exploration and development activities and related income. Income from oil, coal, and gas (hydrocarbon income) is subject to corporate income tax as well as a hydrocarbon tax of 70 percent (for concessions before 2003) or 52 percent (for concessions after 2003 and the sole concession). Corporate income tax is deductible when computing the hydrocarbon tax. The scope of the ring fence system is defined by section 4 of the Hydrocarbon Tax Act. Other income, which is considered hydrocarbon income falling outside the ring fence, is taxable as ordinary corporate income at the rate of 25 percent.

Question of Legal Basis

At issue in the case was whether there was a legal basis to include interest payments and FX gains under the Danish ring fence. This has been debated since the act was introduced in 1982. However, in 2009 a provision was introduced to eliminate the uncertainty of treatment of financial income under the act. From 2009 onward, financial income was specifically included within the ring fence.

This amendment should be seen as evidence that the legal authority to include the financial income compo-

nents within the ring fence did not exist before 2009. Over the years, this conclusion was reached in two official reports prepared by government officials. However, the Danish tax authorities did not share this conclusion, and the courts had to decide on this issue regarding fiscal years before 2009.

Decision of the Eastern High Court

Facts of the Case

The case concerned fiscal years 2002 to 2006 for Shell Olie og Gasudvinding Danmark, the Danish branch of Shell Exploration and Petroleum Holdings B.V., and whether the company's interest payments and FX gains should be subject to the Danish hydrocarbon tax of 70 percent. The interest payments arose from cash deposits in a group financing company, and the FX gains arose from related-party loans and from declared but unpaid dividends.

Shell had requested a reassessment of the fiscal years in question in order to have the financial income treated as other income not subject to the hydrocarbon tax. It made the request because the Danish tax authorities had challenged the deductibility of interest payments and capital gains on claims and, as a consequence, the company did not want to uphold the current level of debt financing.

The Danish tax authorities rejected the request and decided that the income in question should be maintained within the ring fence. The Danish Tax Tribunal upheld this decision.

The Parties' Arguments

The Danish tax authorities supported their decision by referring to the preparatory work of the Hydrocarbon Tax Act, which they claimed contained a specific principle of net computation of interest and capital gains. They said it could not be assumed that the rules were designed to allow the deduction of gross interest and gross FX losses while interest income and FX gains could only be taxed as ordinary income. The attorney to the Danish government supported the argument by stating that:

- the company must have designed its business in order to minimize the tax basis for the Danish Hydrocarbon Tax;
- if the interest payments and FX gains could only be taxed as other income and not as hydrocarbon

income, it would lead to random results in the taxation of hydrocarbon income; and

- the 2009 amendment to the Hydrocarbon Tax Act should be seen as merely a clarification of the already applicable rules rather than as a change in substance — in this respect, section 4 of the act should not be interpreted narrowly or restrictively.

Contrary to this position, the company held that the ring fence system should be interpreted narrowly and that any item of income not specifically mentioned in the relevant provision should not be taxed as hydrocarbon income. The company noted that the legislature had been informed several times of the lack of legal authority to include interest payments and capital gains but for unknown reasons waited until 2009 to amend and extend the act. The company also argued that the Hydrocarbon Tax Act did not by reference to the generally applicable tax rules introduce a net principle regarding the computation of taxable interest income and FX gains. Similarly, it argued that unless specific statutory authority exists, a general principle of symmetry does not apply with the effect that any deductible expense automatically results in taxation of the corresponding income.

The Decision

The technical questions for the Eastern High Court to decide were whether the scope of the Hydrocarbon Tax Act allowed it to include interest payments and FX gains and whether a principle of net computation applied according to which the income could indirectly be included.

Shell prevailed before the Eastern High Court. The court held that the Hydrocarbon Tax Act did not allow for the inclusion of interest income and FX gains for the fiscal years in question. The court noted that interest payments and FX gains were not mentioned in the provision in section 4 and that no support is found elsewhere to include the income under the scope of the act. Moreover, the court found that there must be a solid basis to assume the existence of a principle of symmetry in a situation where there is no support in the wording of the relevant provision or the prepara-

tory remarks. Finally, it referred to the official reports on the subject, where it was stated that symmetry was not established *de lege lata*.

Consequences of the Decision

The decision of the Eastern High Court clarifies a long-existing uncertainty. The court found that there was no basis to include interest payments and FX gains under the historical scope of the Hydrocarbon Tax Act. Moreover, the court confirmed that there is no basis for the application of a principle of net computation based on an unwritten general principle of symmetry.

The decision will primarily affect companies that have been taxed on interest income and capital gains on claims and debt (including FX gains). How many taxpayers this affects is unknown, but there is no doubt that the 2009 amendment significantly reduces the direct practical impact of the decision.

However, the most important lesson from the decision is of a general nature. The decision shed light on the scope of the ring fence. Primarily, the court concluded that any income that is not specifically mentioned in the relevant provision defining the ring fence cannot be included in its scope. This result seems to be in line with the wording of the provisions and the preparatory remarks and generally applicable legal interpretation methods. This important conclusion may affect other types of income not specifically mentioned in the Hydrocarbon Tax Act — for example, take-or-pay payments.

The decision also contributes to the general tax law doctrine, as the tax authorities cannot rely on principles such as the principle of symmetry to obtain specific results in concrete cases unless such a principle is clearly part of the applicable legislation and as such clearly stated by the legislator. This outcome is commendable, as an opposite outcome could allow the tax authorities to refer to vague principles in order to obtain results that are not supported by the wording of the provision in question. ◆

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