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by Jakob Bundgaard

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FEATURED PERSPECTIVES

Danish Case Law Developments on Beneficial Ownership

by Jakob Bundgaard

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In recent years there has been a significant development in Danish case law on beneficial ownership. This article follows up on the development in case law on beneficial ownership since the topic was first reported on in 2008.[1]

Clarification of the notion of beneficial ownership is one of the most intriguing issues in international tax law of our time. The issue is particularly relevant because of the acquisition models used by private equity funds, but also because of other acquisition and holding company structures.

The subject of beneficial ownership has attracted much attention in international financial and tax circles. Since 2007, the Danish tax authorities have put significant auditing efforts into the acquisition models of international private equity funds. Consequently, it is estimated that a large number of cases (allegedly more than 30) are pending regarding beneficial ownership and even more are expected in the following years.[2]

The Danish Withholding Tax Regime

Danish withholding tax applies to dividends paid to foreign companies.[3] One exception to this rule is the participation exemption, which requires that the receiving company own at least 10 percent of the share capital of the paying company for a concurrent period of at least one year. Moreover, it is required that the taxation be reduced or eliminated according to the EU parent-subsidiary directive, or the applicable tax treaty. The payer is obliged to withhold tax if the above requirements are not met.

Interest withholding tax was introduced in Denmark in 2004 on related-party debt.[4] Foreign related companies are liable for Danish withholding tax on interest payments paid from a Danish company. The interest payment must be connected to debt that has been qualified as "controlled debt" within the meaning of

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[1] *See* "Beneficial Ownership in International Financing Structures," *Tax Notes Int'l*, May 19, 2008, p. 587, *Doc 2008-6898*, or *2008 WTD 99-8*.

[2] *See* J. Bundgaard and N. Winther-Sørensen, "Retmæssige-jerved international Koncernfinansiering," *SR-Skat* 2007/5 and *SR-Skat* 2007/6, and "Beneficial Ownership in International Financing Structures," *id.*; M. Severin Hansen, "Beneficial Owner," *TfS* 2010.10; J. Bundgaard, *SU* 2011.31, *SU* 2010.384, *SU* 2010.384, and *SU* 2012.99; Bundgaard, *Kapitalfonde i dansk og international skatteret*, 2010, p. 225; B. Tolstrup and N. Bjørnholm, *BIT* 2011/9, p. 503; T. Booker, *SU* 2011.415; and J. Wittendorff, *Tax Notes Int'l*, Feb. 7, 2011, p. 410, *Doc 2011-1987*, or *2011 WTD 20-4*. *See also* J. Ravnkilde, *SpO* 2011, p. 487, on the potential legal aftermath in terms of professional liability; and B. Tolstrup and A. Becker-Christensen, *SU* 2011.370. Finally, the cases have been criticized from a policy perspective by H. Severin Hansen, *TfS* 2011.26.

(Footnote continued in next column.)

[3] *See* CTA section 2(1)(c).

[4] *See* CTA section 2, para. 1(d), as enacted by Act No. 221 of Mar. 31, 2004 (Bill No. 119).

section 3B of the Danish Tax Control Act (CTA). A similar provision was introduced regarding capital gains on claims arising from debt redeemed with a premium agreed in advance, which under domestic Danish tax law is characterized as capital gains.[5]

The withholding tax is not triggered by interest payments if one of the following exemptions applies:[6]

- If the interest is effectively connected to a permanent establishment in Denmark.
- If the taxation is reduced or eliminated according to the EU interest and royalty directive or a tax treaty with the state of residence of the recipient company.
- If the receiving company is controlled by a Danish company (the Danish CFC rules may apply).
- If the recipient company is controlled by a company resident in a tax treaty state, insofar as the recipient company may be subject to CFC taxation of the interest in the state of residence, if the conditions are met according to domestic CFC legislation of the state of residence of the company in a tax treaty state.
- If the recipient company proves that the foreign corporate taxation of the interest payments received is at least three-fourths of the Danish corporate tax (currently 25 percent) and that the recipient company does not pay on the interest to foreign companies, which are subject to company taxation of the received interest that is less than three-fourths of the Danish corporate taxation.

In practice, a direct loan from a related company in a non-EU tax treaty state to a Danish related company will trigger a Danish withholding tax of 30 percent of the interest paid or capital gains realized. This is not the case with payments to related companies resident in EU tax treaty states.

Also note that the rules on withholding tax on interest take precedence over the thin cap rules in section 11 of the CTA. Thus, both rules cannot apply at the same time. However, the recently introduced interest deductibility limitation legislation under the so-called asset test and the earnings before interest and taxes (EBIT) test may apply simultaneously with the withholding tax.[7]

The provision implies that the withholding tax on interest is totally abolished even if the withholding tax is only reduced under a tax treaty.[8]

The notion of beneficial ownership has not been clarified in the preparatory work to the bill introducing Danish withholding tax on interest.

The company on whose behalf payment of interest or redemption of debt is made is obliged to levy withholding tax.[9] Under section 66B(1) of the Danish Withholding Tax Act, payment of withholding tax falls due on payment or crediting of interest. The party making the payment or the crediting must, concurrently with the payment of the withholding tax, provide information on a statement.[10]

The paying company must assess whether the requirements for not withholding interest tax have been fulfilled.

Income Allocation

For several years, Danish tax law literature has held that the notion of beneficial owner has no noteworthy importance in the Danish tax treaties, as it is possible to fulfill the requirement of beneficial ownership without any difficulty by observing the necessary legal formalities.[11] On this background, Aage Michelsen states that the provisions in the tax treaties will affect pro forma cases only and that they may prove superfluous, as the same result can be achieved by applying ordinary legal principles.[12]

Against this background the surprise was significant once the tax authorities initiated their campaign against holding company structures.

The First Decision in the ISS Case

Introduction

The first high court decision was made on December 20, 2011, by the Eastern High Court.[13] The decision upholds the previous decision by the Danish Tax

[5]*See* CTA section 2, para. 1(h).

[6]*See* CTA section 2, para. 1(d) and (h). The exemptions also apply to capital gains on claims arising from debt redeemed with a premium agreed in advance. The terms in CTA section 2, para. 1(d), paras. 5-7 have been rephrased by Act No. 540 of June 6, 2007 (Bill No. 213).

[7]*See* CTA section 11B and 11C.

[8]*See* A. Holberg and A. K. Føgh, *Skat Udland* 2004, p. 208.

[9]*See* section 65D of the Danish Withholding Tax Act.

[10]*See* form 06.026 regarding interest withholding tax.

[11]*See* A. Michelsen, *International Skatteret*, 2003, p. 427; S. Askholdt, *Cahiers de droit fiscal international*, 1987, p. 281; H. Calum Nielsen, *R&R* 1986, p. 304; N. Bjørnholm and A. Oreby Hansen, *Lempelse af dobbeltbeskatning*, 2002, p. 449; and J. Quiste and J.F. Avery Jones, *R&R* 1985, p. 241. The latter does, however, seem to let the question depend on the individual person's rights and duties and refers to the ownership concept's character dependent on relation. *See also* H. Dam et al., *Skat Udland* 2007, p. 293, and further, *Cahiers de droit fiscal international*, Vol. 92b, 2007, p. 210. However, M. Rasmussen and D. Bernhardt, *SR-Skat* 2000, p. 316, find that the notion is not entirely obsolete.

[12]*See* A. Michelsen, *International Skatteret*, 3rd ed., 2003, p. 427.

[13]*See* SKM 2012.121 Ø.

Tribunal in the same case,[14] but also sharpens the response to the Danish tax authorities.[15] However, the decision does not shed sufficient light on the notion of beneficial ownership in general because of a fact pattern that does not represent the typical structure in these cases. Accordingly, the case must be considered a poorly chosen test case by the Danish tax authorities.

Facts of the Case

The case concerns the question of withholding tax liability on a dividend payment from a Danish company to a Luxembourg Sarl parent company. The structure was an acquisition structure commonly used by private equity funds in leveraged buyout transactions. The investors in the structure were Goldman Sachs and EQT.

A Danish company (HoldCo S A/S) paid dividends to its foreign parent (HoldCo H1 Sarl). Subsequently, the parent lent a larger part of the dividends back to the Danish company. Concurrently, HoldCo S A/S effected a capital increase in one of its Danish subsidiaries, by contributing the money borrowed from HoldCo H1 Sarl. D2 then used that money to acquire a third Danish company. At the end of the accounting year, the loan from HoldCo H1 Sarl to HoldCo S A/S was converted into stock of the latter.

The issue was whether HoldCo H1 Sarl was a mere conduit whose sole purpose was to avoid withholding, or whether it was the beneficial owner of the money received from the Danish company. The intermediate holding companies did not carry out any other activities than those related to the shareholding of the Danish group. The companies were formally registered in Luxembourg and did not have any employees. The day-to-day management of the companies was carried out by the management companies of the private equity funds. The company structure and the relevant cash flow may generally be illustrated as shown in Figure 1.

The Eastern High Court's Decision

The Danish National Tax Tribunal had decided in favor of the private equity fund, stating that taxes should not be withheld on dividends. However, the Danish Ministry of Taxation brought the decision before the City Court, claiming that taxes should be withheld. The City Court referred the case to the Eastern High Court because of its character of general public importance.

The Eastern High Court clearly and unambiguously upheld the Tax Tribunal decision.

Paying attention to the OECD commentary on the notion of beneficial ownership and to the purposes of the OECD model tax treaty, according to the Eastern High Court a uniform application of tax treaties should be pursued. Accordingly, it stated that the notion of beneficial ownership should be understood in accordance with an international fiscal meaning, for example, as stated in the OECD commentary. Reference was made to the *Indofood* case.[16]

The court, moreover, found that the 2003 changes to the OECD commentary should be viewed as clarifications and as such should be included in the interpretation of the notion of beneficial ownership used in older tax treaties.

The court referred to the 1986 OECD report from the Committee on Fiscal Affairs and the commentaries from 2003 and stated that it should be recognized that the notion of beneficial ownership cannot be used to combat all types of treaty abuse. Accordingly, in the view of the court, holding companies that receive dividends and when the management of the companies is authorized under corporate law to manage the company and to decide on the use of received dividends should as a general rule not be disregarded as the beneficial owner of the dividends. According to the court, this should also apply when one or more holding companies are interposed in a tax treaty state but the ultimate owners of the holding companies are residents of a non-treaty state. In order to disregard such a holding company as the beneficial owner, the owner must exercise control over the company, which exceeds the planning and control at a group level that usually occurs in international groups of companies.

Finally and most importantly, the court did not consider it relevant to apply the above mentioned test in the actual case at hand. This was based on the understanding of the notion of beneficial ownership that an intermediate should be interposed between the payer and the actual beneficiary, and that the interposed entity should pay on the payment in question to the recipient in a non-tax-treaty state. The court found that any limitation of the exemption from withholding tax requires that the payment be paid on to persons in a non-treaty state. This requirement was not fulfilled in this case, in which the dividend paid from Denmark was not paid on from the Luxembourg recipient company but instead paid back to the Danish company in the form of a loan. Moreover, the Court found that there was no obligation to pay forward the dividends to the investors at a later time. Accordingly, the Luxembourg holding company should be considered the beneficial owner of the dividends in question.

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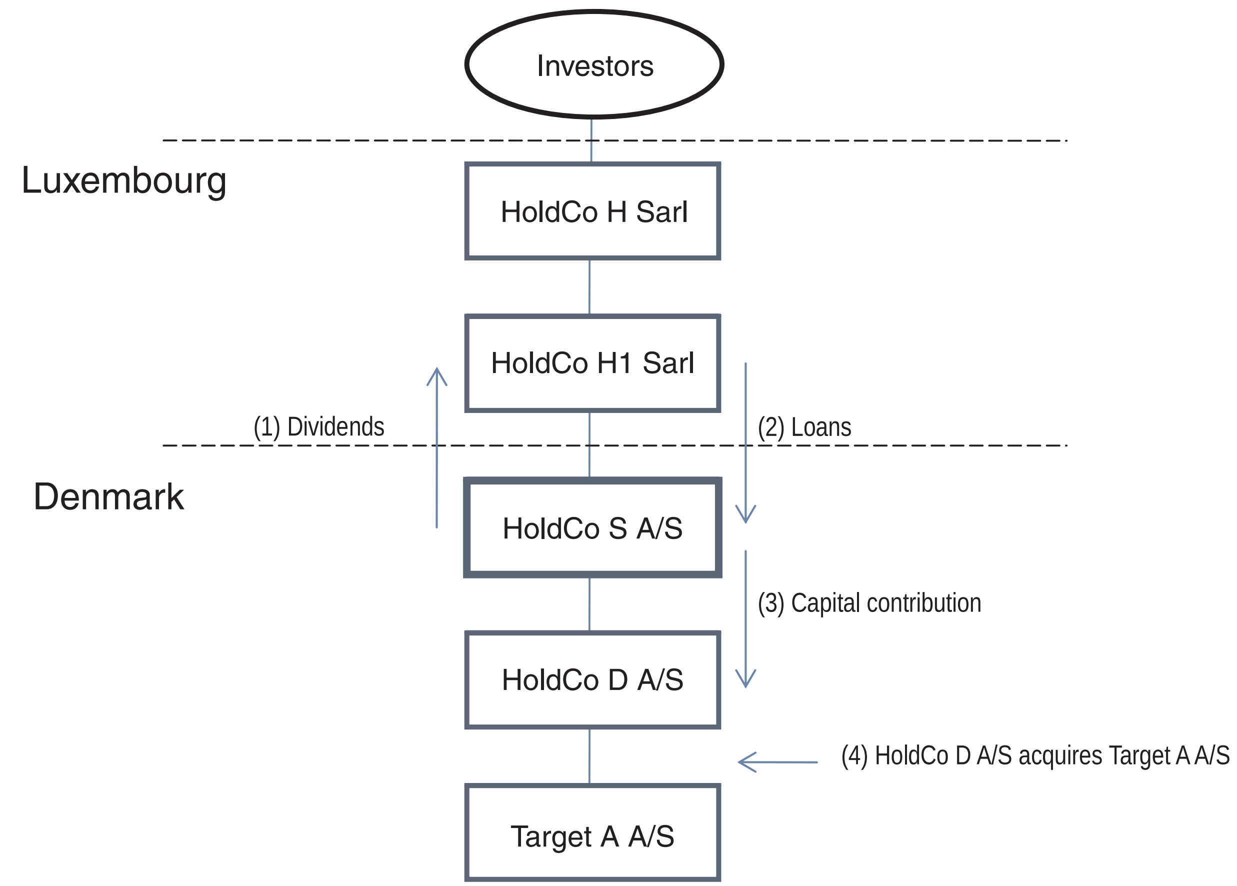
[14] SKM 2010.268 LSR.

[15] For commentary to the earlier decision from the National Tax Tribunal, see J. Bundgaard, *SU* 2010.144, and *Kapitalfonde i dansk og international skatteret*, 2010, p. 230; L. Engdal, *SR-Skat* 2010, p. 148; and J. Wittendorff, *SR-Skat* 2010, p. 212.

[16] *Indofood International Finance Ltd. v. JP Morgan Chase Bank N.A. London Branch*, [2006] EWCA Civ 158.

Figure 1. The ISS Case



Comments on the Court's Reasoning

A number of issues should be addressed regarding the interpretation of the notion of beneficial ownership in Danish tax law:

- The reasoning of the Eastern High Court is very strict in its response to the Danish tax authorities as the court does not even find it relevant to engage in a test of whether the Luxembourg holding company is the beneficial owner. I believe the result of the decision is correct as there does not seem to be room in the notion of beneficial ownership to include payments that are not forwarded.
- The Eastern High Court has accepted an autonomous fiscal understanding of the notion of beneficial ownership in tax treaties. A reference to an autonomous interpretation does not bring clarity to the field, and great uncertainty remains regarding future cases.
- Evidently, the Eastern High Court supports a dynamic interpretation of tax treaties, in that it refers to the OECD's commentary to article 10 of the 2003 treaty, even though the case involved the interpretation of a treaty from 1980.
- No actual guidelines can be extracted from the decision regarding other cases that do not have a similar fact pattern. Even though the decision deals with atypical circumstances in classical beneficial owner/conduit situations, the decision may be relevant for the private equity sector, in that it is common practice in this sector that dividends are not forwarded to the ultimate owners, but are instead used to service bank debt in the holding company. For this reason, the decision may be of practical importance.
- The real issue on which control requirements should be present in order to disqualify the recipient as beneficial owner remains to be clarified.
- The Eastern High Court made some very interesting remarks on the holding companies in general. Accordingly, in the view of the court, holding

> companies that receive dividends and the management of the companies are authorized under corporate law to manage the company and to decide on the use of received dividends should as a general rule not be disregarded as the beneficial owner of the dividends. In order to disregard such a holding company as the beneficial owner, the owner must exercise control over the company, which exceeds the planning and control at a group level that usually occurs in international groups of companies. I believe that these remarks should be praised.

The Danish Ministry of Taxation in SKM 2012.100 DEP stated that the decision will not be appealed to the Supreme Court because of the clarity of the decision based on the factual situation. The Ministry of Taxation stated that a possible appeal would not shed sufficient light on other related questions, and that the other pending cases involve a fact pattern in which the payments in question are actually forwarded to the ultimate investors in the structures.

The Second ISS Case

Introduction

The ISS structure also gave rise to an interest withholding tax case.[17] This issue has not been decided by the Eastern High Court, only the Danish Tax Tribunal.

Facts of the Case

The facts of this case are similar to the above dividend case regarding the same acquisition structure. The only difference is that this case concerns interest payments.

The Tax Tribunal's Decision

The Danish Tax Tribunal initially referred to its own decision in the first ISS case. Accordingly, the facts of the case could not give rise to withholding tax since the interest payments were not forwarded from the Luxembourg holding company to another company in a non-tax-treaty state. Therefore, it was not possible to disregard the recipient of the interest payments as the beneficial owner.

The Tax Tribunal also stated that the interpretation of the notion of beneficial ownership in the EU interest and royalty directive should be interpreted in accordance with the tax treaties.

Comments on the Tax Tribunal's Reasoning

Bearing in mind that the interest payments were not transferred to the ultimate owners, the decision is correct. The term ''conduit'' makes little sense, unless the entity in fact acts as a mere conduit in channeling payments to the ultimate owners.

In the first decision, the tribunal supports a dynamic interpretation of the tax treaties, in that it referred to the OECD's commentary to article 10 of the 2003 treaty, even though the case involved the interpretation of a treaty from 1980. Moreover, by referring to the OECD commentary, the tribunal also supports the notion that the term ''beneficial owner'' must be interpreted autonomously. This is also the result of this decision.

No additional guidance is provided regarding the actual content of the notion of beneficial ownership. Specific questions were raised in the case that were not addressed by the tribunal.

First, the company argued that no withholding requirement could apply if the idea of beneficial ownership is followed exactly. Even though the question did not affect the outcome of the dispute, it is possible that it may be relevant for other disputes with different facts.

Second, the tax authorities argued that the existence of tax arbitrage should result in increased scrutiny. Even though the tribunal did not address the issue, it would be surprising if the mere use of asymmetries between two countries should result in a more stringent application of the rules.

One issue of interest is that the case concerned interest rolled into the principal followed by a conversion into share capital. The Danish withholding tax regime on interest payments also applies to interest rolled into the principal and subsequently converted into equity. However, in light of the reasoning of the Eastern High Court and the Danish Tax Tribunal, it is hard to imagine how the notion of beneficial ownership could apply to such a scenario when the interest is rolled into the principal of the debt and maybe even converted into equity.

The HHU Case

Introduction

In SKM 2011.57 LSR, the Danish Tax Tribunal delivered the first decision against the taxpayers. The Tax Tribunal agreed with the tax authorities in ruling that a Danish withholding tax obligation existed on an interest payment from a Danish company paid to a Swedish holding company.

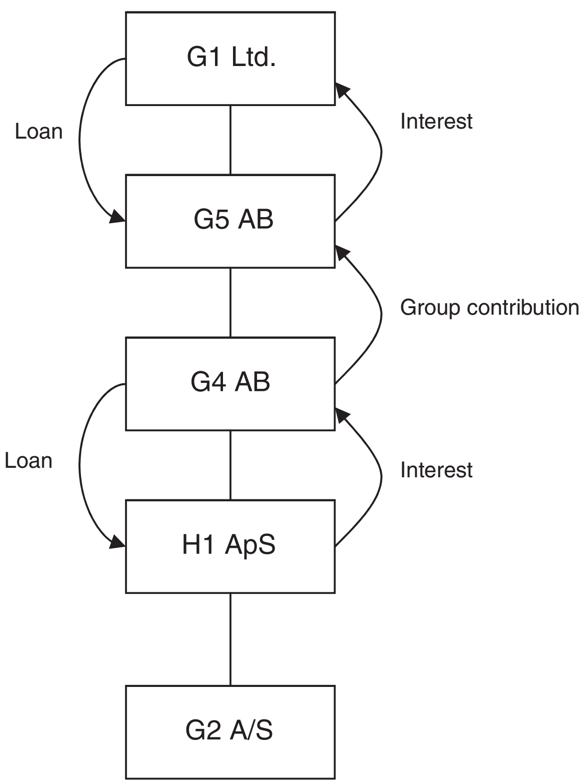
Facts of the Case

In 2002 a Danish group was acquired by G1 Ltd. (Jersey). In 2003 the shares in the Danish company were transferred to a double Swedish holding company structure (G4 AB and G5 AB). Two loan notes occurred as a part of the transaction: one from G1 Ltd. to the top Swedish holding company (G5 AB) and one from the Danish company to the lower-tier Swedish holding company (G4 AB).

The structure can be illustrated as shown in Figure 2.

[17]*See* SKM 2010.729 LSR.

Figure 2. The HHU Case



The loan notes were identical regarding the agreed interest rate. No repayment plan was agreed. For G4 AB and G5 AB, it was informed that the only activity of these companies was the ownership of shares in H1 ApS and G4 AB. The holding companies did not have any employees and were managed by a special management company. The interest payments from G5 AB were financed by a transfer of interest payments received by G4 AB through a group contribution (*koncernbidrag* — which is deductible for G4 AB and taxable for G5 AB).

The Tax Tribunal's Decision

The Tax Tribunal upheld the decision of the Danish tax authorities' ruling that G4 AB was liable for Danish withholding tax on the interest payments because the company should not be considered the beneficial owner of the payments in question, either based on the Nordic tax treaty or the EU interest and royalty directive.

Initially the Tax Tribunal stated that the notion of beneficial ownership should not be understood in accordance with the notion of rightful recipient as applied in domestic law. Instead, the Tax Tribunal once again favored an international meaning of the notion of beneficial ownership.

In the decision, the Tax Tribunal emphasized the construction made between related parties in which G4 AB would transfer the interest payments received from H1 ApS to G5 AB by way of application of the Swedish legislation on group contributions and from G5 AB further to G1 Ltd. as interest payments.

Moreover, the Tax Tribunal stated that the taxpayer must have expected an introduction of interest withholding tax in Denmark based on the previous introduction of the interest and royalty directive in 2003.

The Tax Tribunal held that there was no net taxable income in the Swedish companies on an overall basis. This fact was seemingly sufficient for the Tax Tribunal to conclude that the lower-tier Swedish holding company should be considered a conduit company without any real authority and possibly to decide how to dispose of the income received. Accordingly, the company should be accepted as the beneficial owner of the interest payments.

That the transfers between the Swedish companies were carried out as group contributions and not as interest payments was not given any weight.

The Tax Tribunal also found that the establishment of the Swedish holding companies was based on an intention to avoid taxation of the interest in question while maintaining the interest deductibility in Denmark.

Comments on the Tax Tribunal's Reasoning

SKM 2011.57 LSR is the first decision in favor of the Danish tax authorities on the basis of beneficial ownership. The following seems to have been decisive for the result:

- that the parties involved in the restructuring leading to the loan notes were related;
- that a certain automatism was present in the channeling of the funds from the Danish company through the Swedish companies and further on to the ultimate parent company and that there were no other possibilities to forward the payments;
- that the purpose of the structure was to avoid Danish withholding tax;
- that no tax was due in Sweden; and
- that there were no business activities in Sweden — no employees, office, or administration.

Based on these circumstances, the Tax Tribunal concluded that the Swedish companies as shareholders did not have the possibility to perform management decisions regarding the interest payments in question. Based on publicly available information, it is hard to see exactly how this conclusion is reached. The Tax Tribunal neglects to clarify which actual facts led to this conclusion. Possibly the Tax Tribunal was in possession of additional information that is not a part of the publicly available summary of the case. Consequently, it is not possible to assess whether the Swedish holding company actually was in a position to use and enjoy the payments involved.

In line with the previous cases, the Tax Tribunal decided in favor of an autonomous understanding of the notion of beneficial ownership.

The subjective intent pointed out by the Tax Tribunal relates to the alleged expectation of the introduction of interest withholding tax in Denmark based on the implementation of the interest and royalty directive. This reasoning is troublesome. The introduction of the interest and royalty directive with the aim to abolish international double taxation on interest and royalty payments should not give rise to an expectation on the simultaneous introduction of a domestic interest withholding tax outside the scope of the directive. Moreover, there is no tradition in Danish tax law to let the subjective intent of the taxpayers determine the tax treatment of a transaction.

The Tax Tribunal seemingly requires a certain amount of taxable income in the holding company to be recognized as the beneficial owner of the payments in question. Whether this should be understood so that the allocation of a certain spread in the holding company will suffice or whether such a spread is merely a single factor in an overall evaluation of structure in place is uncertain.

The COOK Case

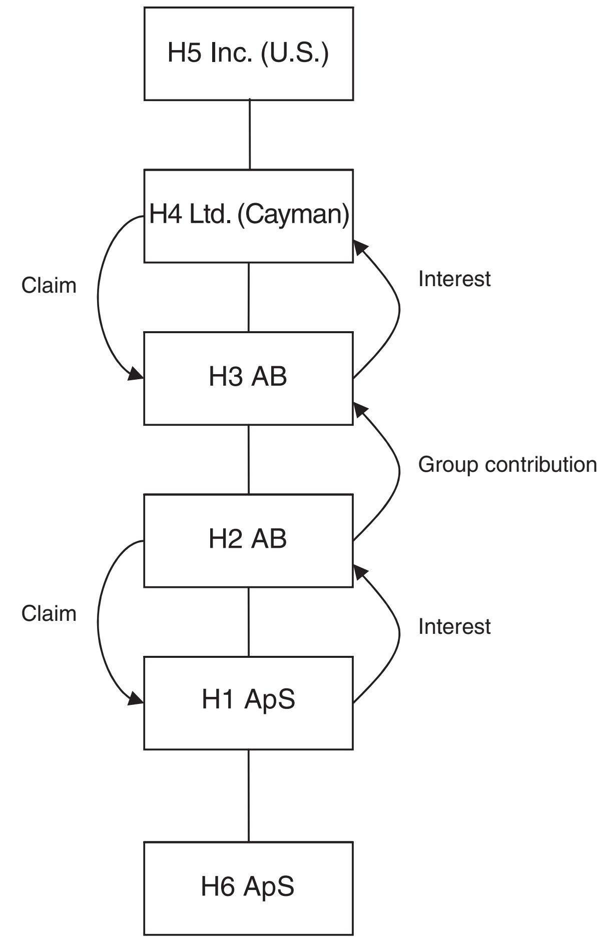
Introduction

In SKM 2011.485 LSR, the Danish Tax Tribunal for the second time agreed with the Danish tax authorities that the recipient of interest payments should not be considered the beneficial owner of the payments in question.

Facts of the Case

The group structure of the case can be illustrated as shown in Figure 3.

Figure 3. SKM 2011.485 LSR



Before a group reorganization, H6 ApS was the ultimate Danish parent company for the underlying group. H6 ApS was directly owned by H4 Ltd. (Cayman). The restructuring resulted in a structure in which two Swedish holding companies and H1 ApS were inserted. A note arose from the restructuring with H4 Ltd. as the creditor and H3 AB as the debtor and from H2 AB with H1 ApS as the debtor. The terms of the notes were identical. The only activities of the holding companies were the holding of shares in the Danish companies. The case concerned whether H2 AB was subject to Danish withholding tax on the interest payments.

The Tax Tribunal's Decision

Once again the Danish Tax Tribunal stated that the notion of beneficial ownership must be understood autonomously according to an international fiscal meaning.

The Danish Tax Tribunal also stated that the restructuring carried out and the notes arising in this context resulted in a transfer of the interest payments to H4 Ltd. through the Swedish rules on group contributions and, consequently, did not suffer any tax leakage.

The Tax Tribunal concluded that none of the companies that were established under the restructuring carried out activities other than holding activities and that only income related to the holding activities was anticipated in the companies. The Tax Tribunal stated that it must have been anticipated from the establishment of the loans that the debtor companies should receive additional funds from other group companies in order to service the debt obligations. Solely because of this, the Tax Tribunal concluded that H2 AB was a conduit company with very little authority regarding the received payments. Accordingly, H2 AB was not considered the beneficial owner of the interest payments in question either according to the Nordic tax treaty or under the EU interest and royalty directive.

The company argued that the obvious consequence of the application of the notion of beneficial ownership would be that H5 Inc. (U.S.) should be considered the recipient of the interest payments in question. Accordingly, the company argued that the Danish withholding tax should not apply if the beneficial owner was H5 Inc., a U.S. resident company. On this specific issue, the Tax Tribunal stated that the Nordic tax treaty (and not the Denmark-U.S. treaty) was the applicable tax treaty since the interest payments were initially paid to H2 AB in Sweden.

Comments on the Tax Tribunal's Reasoning

Based on the publicly available information, it seems as if the Danish Tax Tribunal made a lesser effort in crystallizing which factors led to concluding that the recipient company should not be considered the beneficial owner of the interest in question.

Based on the wording of the decision, it seems that the following played a crucial role in the outcome of the case:

- that the transactions leading to the structure in question were made between related parties;
- that no net income was taxed in Sweden and that the interest payments were passed on to the Cayman Islands without a tax leakage;
- that none of the holding companies were engaged in activities other than holding shares, and that no other income than such income anticipated from the holding of shares was expected; and
- that no additional funds were contributed from other group companies with the purpose of servicing the debt of the companies.

That latter argument seems hard to contemplate. It seems to be a traditional business model that a holding company obtains debt and provides service to the debt using dividends received from the underlying subsidiaries.

The facts of the case deviate from the above referred decision in the HHU case in that the ultimate parent company of the group was a U.S. resident. This fact was given very little attention by the Tax Tribunal. As mentioned, the Tax Tribunal stated that the determination of the rightful recipient under domestic law in principle could differ from the determination of the beneficial owner for tax treaty purposes. In other words, the rightful recipient for domestic tax purposes can be a foreign intermediate holding company whereas this company for tax treaty and EU directive purposes should not be considered the beneficial owner.

SKM 2012.409 LSR

Introduction

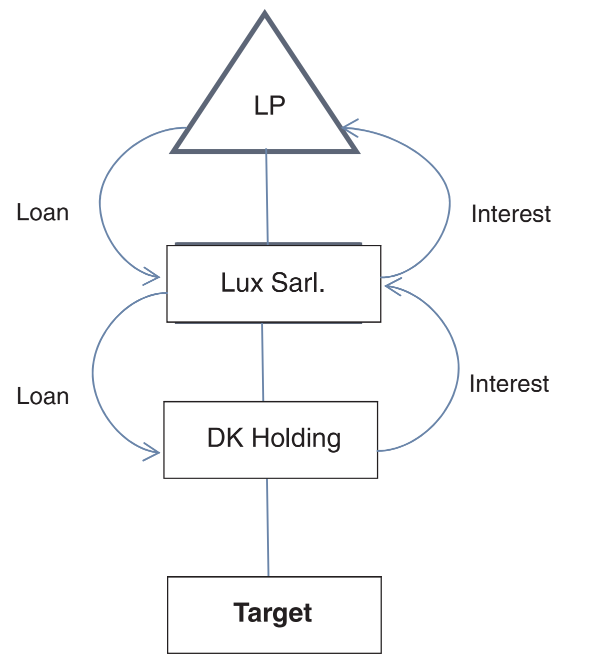
The most recent Danish case is published as SKM 2012.409 LSR, in which the Danish Tax Tribunal upheld the decision of the tax authorities.

Facts of the Case

In the case, a Danish company was acquired by a Danish SPV owned by a foreign private equity fund that was organized with a limited partnership in Jersey. The Danish SPV financed its acquisition of the Danish target by a subordinated loan with an annual interest rate of 9 percent. Subsequently, a Luxembourg holding company was interposed. The Luxembourg holding company acquired the shares in Danish SPV and the original claim. Moreover, the Luxembourg holding company financed its acquisition of the Danish SPV through a loan from the Jersey LP with an annual interest rate of 9.875 percent. The interest payments on both loans were rolled into the principal and both loans were repaid with the principal on the same date.

The group structure in the case can be illustrated as shown in Figure 4.

Figure 4. SKM 2012.409 LSR



The Tax Tribunal's Decision

Initially the Tax Tribunal referred to the OECD commentary to article 11 of the model tax treaty and to the notion of beneficial ownership in the EU interest and royalty directive. Based on this, the Tax Tribunal did not find the Luxembourg holding company to be the beneficial owner of the interest payments in question. The Tax Tribunal paid attention to the actual construction, in which the Luxembourg holding company forwarded the received interest payments to the investors of the private equity fund. Moreover, attention was paid to the fact that the two loans were almost identical in size and terms, and any taxation in

Luxembourg was neutralized by the offsetting interest deduction. The Tax Tribunal concluded that the Luxembourg holding company did not have any right to use and enjoy the income in question. The Tax Tribunal refused to answer the question regarding a possible tax treaty with the country of residence of the investors of the private equity fund, because no documentation was provided regarding the existence of double taxation.

Moreover, the Tax Tribunal rejected the argument that the Danish interest tax should be considered an infringement of the freedom of establishment and the free movement of capital in the EU. The rejection was based on a referral to the European Court of Justice's *Cadbury Schweppes* decision (C-196/04) and the European abuse of right doctrine. The Tax Tribunal in effect stated that because a domestic restrictive measure may be justified on the basis that it prevents abuse, this consequently means that the Danish interest withholding tax is not a violation of the freedom of establishment or the free movement of capital.

Finally, the Danish Tax Tribunal held the Danish holding company liable for the withholding tax based on negligence. Accordingly, the company should have been aware that the interest payments most likely would have triggered the Danish withholding tax.

Comments on the Tax Tribunal's Reasoning

The decision is not surprising and seems in line with previous decisions. The most interesting part is the Tax Tribunal's reasoning on the EU law conformity. In essence the Tax Tribunal must have reasoned that the interposition of the Luxembourg holding company should be considered an abusive practice for EU law purposes. Such a conclusion is, however, uncertain, and the question does not seem to be clarified by the ECJ.

Parent-Subsidiary Directive

Introduction

One of the most interesting issues in the pending cases concerning international holding company structures and the notion of beneficial ownership is the determination of the scope and impact of the parent-subsidiary directive. In a recent decision in SKM 2012.26 LSR, the Tax Tribunal ruled on the scope of the parent-subsidiary directive in this context.

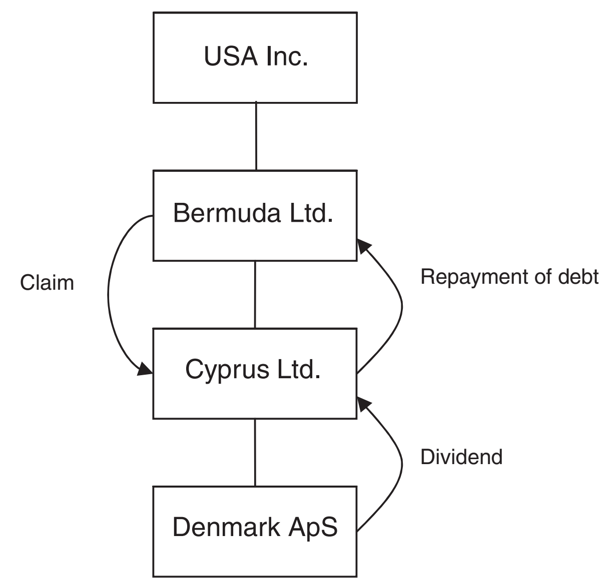
Before this decision, the Tax Tribunal made a few relevant remarks in another case (SKM 2010.268 LSR) that gave the impression that article 1(2) of the directive will not apply in traditional beneficial owner cases. This reading of the decision has now been finally verified by SKM 2012.26 LSR.

Facts of the Case

Denmark ApS (the company) was part of a large multinational group. Until September 2005 the company was owned by Bermuda Ltd. (Bermuda). The ultimate parent company of the group was USA Inc., which is a listed U.S. company. In September 2005 Bermuda Ltd. established Cyprus Ltd. (Cyprus) by way of an intragroup restructuring inserting Cyprus between the Danish company and Bermuda Ltd.

The structure can be illustrated as shown in Figure 5.

Figure 5. SKM 2012.26 LSR



In September 2005 and 2006 the company distributed dividends to Cyprus Ltd. According to the company, the dividends were used to pay back the debt from Cyprus Ltd. to the parent company, Bermuda Ltd., originating from the purchase of the shares in Denmark ApS. Cyprus Ltd. was a traditional holding company with no functions other than that of owning shares. Cyprus Ltd. did not have any physical premises or staff.

The Danish tax authorities ruled that the company was obligated to withhold tax on the dividends.

The Tax Tribunal's Decision

Based on the Cyprus-Denmark tax treaty, the Tax Tribunal did not find Cyprus Ltd. to be the beneficial owner of the dividends. The Tax Tribunal paid specific attention to the fact that the transactions were carried out between related parties and that the distribution was used to repay the debt to the Bermuda parent company and further on to the ultimate U.S. parent company. Moreover, the lack of physical premises, staff, and operating expenses in Cyprus was mentioned. Interestingly, the Tax Tribunal stated that the burden of proof for the status as beneficial owner rested on the companies.

To the question of which tax treaty should apply, the Tax Tribunal stated that the Cyprus-Denmark tax treaty should apply because Cyprus Ltd. was legally established and registered in Cyprus and was taxable in Cyprus. Based on this, the Tax Tribunal considered Cyprus Ltd. the rightful recipient according to domestic tax law and consequently found that the Cyprus-Denmark tax treaty should apply and that no support in the opinion of the Tax Tribunal was found to apply another tax treaty.

The Tax Tribunal specifically addressed the question of the scope of the parent-subsidiary directive. The Tax Tribunal stated:

> According to directive 90/435/EEC article 5, dividends paid from a subsidiary to its parent company are exempt for withholding tax. No principle of abuse can be interpreted in the general provisions of the directive. However, article 1(2) of the directive grants the member states the opportunity to deny the benefits of the directive in cases of abuse etc. According to article 1(2), the directive does not prevent the member states from applying domestic provisions or treaties, which are necessary to prevent fraud and abuse. Denmark has not introduced specific provisions with this aim, but legal basis to disqualify formally legal and correct dispositions exists in the form of general legal principles including case law. The Danish Supreme Court has, however, not allowed a reclassification of an existing company on the basis that the company was established to save tax. Consequently, the Cyprus company of this case, which was legally established and operating, which also owns the shares of the Danish company, should be considered the rightful recipient of the dividends distributed from the Danish company. The fact that the only activity of the company was to own the shares of the Danish company does not change the fact that the company should be considered as conducting a business for tax purposes. Consequently, the dividends are exempt from Danish withholding tax according to article 5 of the directive.[18]

Comments on the Tax Tribunal's Reasoning

My comments to the case fall into four categories.

First, this case seems to be the first case introducing a reverse burden of proof regarding the denial of treaty benefits. Such a principle does not have a solid basis in Danish legal tradition. Traditionally it is expected that the tax authority should provide the proof that a taxpayer is not the beneficial owner of a given payment.

Second, the decision is in line with previous decisions in which the Tax Tribunal has disqualified a taxpayer as the beneficial owner. This decision is seemingly based on a few objective facts alone, which do not include a precise assessment of whether the recipient actually has a right to use and enjoy the payments in question. The Tax Tribunal emphasizes the fact that the dividends have been forwarded and that the holding company did not have any physical premises, staff, and only limited operating expenses.

Third, the decision clearly states which tax treaty should apply. As a consequence, it seems possible to apply the notion of beneficial ownership even when the ultimate recipient and owner is a resident of a tax treaty state.

Fourth, and even more essential, the Tax Tribunal has now specifically addressed the question of the scope of the parent-subsidiary directive. I believe this decision is correct. However, I believe that the question should be referred to the ECJ, as it has not directly been ruled on whether a foreign holding company may constitute an abuse of law in the context of the parent-subsidiary directive.[19] The application of the fraud and abuse provision of the directive requires a specific implementation or domestic principles of a similar content.[20] Article 1(2) has not been implemented in Danish law and the principle of substance over form and the doctrine of rightful recipient cannot result in disregarding a foreign holding company from benefiting from the parent-subsidiary directive. Referring to paragraph 52 of *Rewe Zentralfinanze G* (C-347/04), it can be argued that the establishment of a company in another member state should not be considered abusive. Moreover, it is far from obvious that *Cadbury Schweppes* should be interpreted broadly to expand the scope of the decision to other areas of business — from a finance company to a holding company.[21] This has been doubted by the European Commission in COM (2007) 785, p. 5.[22]

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[18] This is an unofficial translation.

[19] *See, e.g.*, Bundgaard, *SU* 2010.111.

[20] *See Kofoed* (C-321/05), para. 46.

[21] *See* Evers and de Graaf, *EC Tax Rev.* (2009), p. 279, 296:

> It is also not clear whether Member States where an EU conduit is established are allowed to eliminate double taxation under the Parent-Subsidiary Directive in respect of dividends being received by the EU conduit company concerned. . . . Member States have substantial discretion as regards combating artificial arrangements that are intended to minimize taxation on capital payments and/or capital gains.

See also E. Robert and D. Tof, *Eur'n Tax'n* (Nov. 2011) (concluding that the test should include a significant time span).

[22] *See also* E. Picq, *Eur'n Tax'n* (2009), p. 474:

> It is submitted that the required level of substance depends on the functions of the EU holding company. A holding company does not necessarily need to have its own premises and salaried personnel to carry out genuine economic activity; the company can effectively be run by its directors.

Binding Rulings and Tax Planning

As a consequence of the legal uncertainty arising from the fierce campaign against foreign holding companies from the Danish Tax Administration, the companies have tried to address the risk. A number of binding rulings have been published regarding companies that are seeking to clarify an interest payment or a distribution of dividends before a restructuring.

The National Tax Assessment Council did not answer a question regarding beneficial ownership in one case.[23] The reasoning was that the assessment of beneficial ownership depends on a number of factors that the case did not shed light on.

In another case,[24] the National Tax Assessment Council found that there was no Danish withholding tax on an anticipated distribution of a claim in a U.S.-owned group. However, the National Tax Assessment Council does not rule out the possibility that withholding tax could be imposed on the basis of an actual assessment based on the notion of beneficial ownership.

In another case,[25] the National Tax Assessment Council did not find a Luxembourg holding company to be the beneficial owner of an anticipated dividend payment. In this context, the National Tax Assessment Council paid attention to the information that the dividend was intended to flow through two tiers of holdings companies and further to the ultimate investors.

Moreover, the National Tax Assessment Council stated[26] that the beneficial ownership test is a test based on the facts and circumstances of a specific transaction with the objective to conclude who has the right to use and enjoy the distribution in question. In the specific case, the National Tax Assessment Council concluded that the recipient was the beneficial owner so no Danish withholding tax was triggered. The decisive factor seems to have been that no dividends were forwarded from a Swedish holding company and that the received payments were reinvested from the recipient company. Moreover, the company was not subject to any instructions from investors that were considered passive investors without any influence on the daily business of the investment company, including actual investments and the use of investment profits.

Finally, the National Tax Assessment Council confirmed[27] that a distribution in kind was not subject to Danish dividend withholding tax. This was primarily based on the fact that the shares distributed were not forwarded.

[23]*See* SKM 2011.47 SR.

[24]*See* SKM 2011.142 SR.

[25]*See* SKM 2011.441 SR.

[26]*See* SKM 2011.738 SR.

[27]*See* SKM 2012.320 SR.

Liability Issues

In several of the Danish beneficial owner cases the Danish tax authorities have held the Danish payer liable for the interest and dividend withholding tax.[28] The tax authorities argued that the paying Danish companies should carry out specific activities in order to assess the applicability of the Danish holding tax regime and that because the parties are related should increase the caution from the Danish payer. The argument is understandable as it is considered unrealistic to collect any taxes from foreign private equity funds and their investors.

It follows from section 69 of the Danish Withholding Tax Act that anyone who neglects to withhold tax is liable for the withholding tax, unless proof is provided to demonstrate that the payer has not been negligent. In one case, the Tax Tribunal concluded that the Danish payer had been negligent and accordingly was liable for the withholding tax.[29] The curious argument in this case was that the Tax Tribunal found that the Danish company should have been aware that a Danish regime on withholding tax on interest payments would be introduced as a consequence of the implementation of the EU interest and royalty directive. The Danish company was also held liable in other cases.[30]

I agree with the Danish companies and their Danish counsel in stating that negligence is a surprising argument against the fact that no case law has existed historically and that the general opinion in tax commentary and in preparatory work was that it was fully acceptable under Danish law to interpose intermediate holding companies as a way of avoiding Danish withholding taxes. Accordingly, it was impossible for the companies and their advisers to foresee that the tax authorities would change the view on such structures.

Beneficial Ownership in Legislation

As a final comment, I address recent legislative measures in which the notion of beneficial ownership plays an important role.

Bill No. L 84 2010[31] introduced a number of specific antiabuse provisions aimed at planning techniques used to address the general uncertainty arising from the current scrutiny of holding company structures based on the notion of beneficial ownership. One technique that was implemented by a number of companies was to carry out a cross-border vertical merger of a Danish company with a foreign parent company. The gains

[28]Section 65D of the Danish Withholding Tax Act; *see* A. Becker-Christensen, *SU* 2010.386; J. Bundgaard, *SU* 2010.387.

[29]*See* SKM 2011.59 LSR.

[30]*See* SKM 2011.485 LSR and SKM 2012.409 LSR.

[31]Act No. 254, dated Mar. 30, 2011.

according to domestic law were treated as liquidation proceeds and capital gains on shares are not subject to Danish withholding tax.

According to the bill, the distribution from the cancellation of subsidiary shares should be treated as dividends for tax purposes if a dividend would have been subject to withholding tax and would not have been reduced or eliminated under a tax treaty or the parent-subsidiary directive. A similar provision is introduced if the recipient company owns less than 10 percent of the share capital of the Danish contributing company, but the receiving company holds a controlling influence on the contributing company.[32]

As a consequence of the legislative changes, the notion of beneficial ownership has gained an increased importance as the relevant test in order to determine the exact tax treatment of a cross-border merger.

Moreover, specific measures were introduced by Bill No. L 84 to the use of interposed holding companies in order to avoid the consequences of the specific Danish provision on inbound hybrid financial instruments.[33] This could be the case if the tax treatment of a hybrid instrument in the country of the direct recipient does not treat the income as income from equity, but when the recipient has a debt obligation to another group company resident in a country where the instrument is treated as equity. As a consequence, the provision was expanded to cover situations when the state of residence of the immediate creditor does not classify the instrument as equity but when an instrument exists with another entity in another country in which the instrument is treated as equity. This applies regardless of the number of tiers, but the provision is not applicable if a tax treaty or the interest and royalty directive applies to the payment.

A similar provision is introduced regarding outbound hybrid financing. Accordingly, the Danish tax exemption does not apply to dividends when a lower tier subsidiary is able to deduct the distributions and the deduction does not result in taxation in an intermediate tier, and the withholding tax in any of the intermediate tiers should be reduced or eliminated under the parent-subsidiary directive.

The beneficial ownership test in the context of hybrid financing is an inherent part of these provisions. Accordingly, the relevance of the notion of beneficial ownership has increased further as a consequence of the provisions.

Conclusion

The notion of beneficial ownership is placed highly on the tax agenda in Denmark. A significant number of cases are pending, and more cases are expected to follow. This article has analyzed the status in case law so far and presented which areas have been clarified by the courts and the Danish Tax Tribunal. We still await Supreme Court case law to define the actual content and application of the notion of beneficial ownership. Until this happens, legal uncertainty is a part of the daily life for companies receiving and paying dividends and interest in and out of Denmark. If the Supreme Court decides that there is little room under domestic law to apply the notion of beneficial ownership in Danish structures (which I expect to be the case), the result may be that Denmark will actually implement article 1(2) of the parent-subsidiary directive as seen in other member states. ◆

[32]Section 2 of the Danish Tax Assessment Act.

[33]Section 2B of the CTA.