Denmark

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Darkness Descends on Danish Tax Law: Supreme Court Decision in *Swiss Re*

On 2 February 2012, the Danish Supreme Court delivered a decision in *Swiss Re*, a case concerning the statute of limitations for making transfer pricing adjustments. This article presents the facts of the case, the relevant tax provisions and the decisions of the various bodies, and provides comments on the decision of the Supreme Court.

1. Introduction

On 2 February 2012, the Danish Supreme Court delivered a decision in a transfer pricing case which may have wide implications for multinational enterprises carrying out business in Denmark. This article presents the facts of the case, the relevant tax provisions and the decisions of the various bodies, and provides comments on the decision of the Supreme Court.

2. Facts

This case concerned the Danish company, Swiss Re Copenhagen Holding ApS, which was wholly owned by the US company, ERC Life Reinsurance Corporation. In the spring of 1999, the group considered transferring the German subsidiary, ERC Frankona Reinsurance Holding GmbH, from the US parent company to the Danish company on 1 July 1999. The value of the German company was determined to be DKK 7.8 billion. The purchase price was to be settled by the Danish company issuing shares with a market value of DKK 4.2 billion and debt with a market value of DKK 3.6 billion.

On 27 May 1999, the parent company and the Danish company agreed to analyse whether the debt could be structured as a subordinated, zero-coupon note. Compensation for the loan would be structured as a built-in capital gain in order to defer recognition of the compensation for the period 1 July 1999 to 30 June 2000 until income year 2000. Hence, the Danish company would be unable to use a deduction in income year 1999. A built-in capital gain should be recognized in 2000 where payment of the first instalment would be made. If compensation were structured as interest payments, the compensation should be recognized on an accrual basis whereby half of the deduction for the initial 12-month period would be recognized in 1999.

On 17 June 1999, a bank provided the Danish company with information about market terms for a zero-coupon loan.

On 21 June 1999, an extraordinary shareholders meeting of the Danish company approved the acquisition of the German company with effect from 1 July 1999. The minutes stated that the debt "should be settled by issuing an instrument of debt from the company to ERC Life Reinsurance Corporation at terms to be specified in more detail".

On 14 September 1999, the parent company informed the Danish company that approval had been obtained for the issuance of the zero-coupon note and that it should state that the loan was made on 30 June 1999.

On 15 October 1999, the parties signed the loan agreement. The principal of the loan was fixed at DKK 4.9 billion corresponding to a market value of DKK 3.6 billion. The effective interest on the loan was 6.1 % per annum. The capital loss associated with the first instalment on 30 June 2000 was DKK 222 million, which was claimed by the Danish company as a deduction in its tax return for 2000.

3. The Law

The provisions of Danish tax law of particular relevance for the case are section 2 of the Tax Assessment Act (*ligningsloven*), section 3B of the Tax Control Act (*skattekontrolloven*) and section 34 of the Tax Administration Act (*skattestyrelsesloven*).[1] The three provisions were enacted in 1998 in connection with a reform of the Danish transfer pricing legislation which should bring it in line with the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (hereinafter OECD Guidelines).[2]

Section 2(1) of the Tax Assessment Act authorizes the tax authorities to make transfer pricing adjustments of controlled transactions on the basis of the arm's length principle. Section 2 does not contain a direct reference to the OECD Guidelines. However, the legislative history leaves no doubt that the provision must be interpreted on the basis of OECD Guidelines.[3]

Section 3B of the Tax Control Act requires taxpayers to provide tax return information and prepare transfer pricing documentation with respect to controlled transactions.

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1. Section 34 of the Tax Administration Act (*skattestyrelsesloven*) is now found in section 26 of the Tax Administration Act (*skatteforvaltningsloven*).
2. Act 131 of 25 February 1998 (Information obligation regarding controlled transactions); Act 432 of 26 June 1998 (Codification of the arm's length principle and safeguards against thin capitalization).
3. J. Wittendorff, *Armslængdeprincippet i dansk og international skatteret*, at 290 et seq, (Thomson Reuters, 2009).

Section 34(1) of the Tax Administration Act provided that the statute of limitations was 1 May in the fourth year after the end of the income year in question. However, section 34(5) extended the deadline by two years for taxpayers covered by section 3B with respect to controlled transactions.

The Denmark–United States Income Tax Treaty (1948) would also have been of relevance for the case, as the parent company was resident in the United States.[4] The wording of article IV of the treaty was quite similar to article 9(1) of the OECD Model and required transfer pricing adjustments to be based on the arm's length principle. However, the tax treaty was not invoked by the taxpayer.

4. Tax Assessment

On 20 April 2005, the tax authorities notified the Danish company about a proposed adjustment to the taxable income for 1999 and 2000. In July 2005, a final decision was made which reduced the taxable income for 1999 by DKK 64.9 million, equal to imputed interest expenses for the initial period from 1 July to 15 October 1999, and increased the taxable income for 2000 by DKK 64.9 million, corresponding to the capital loss claim for the initial period.

The reason given for the adjustment was that a final, binding agreement on the zero-coupon term had not been made before 15 October 1999. On this basis the loan was deemed to be on a free-of-charge basis for the initial period because the 15 October agreement did not have retroactive effect for tax purposes. Hence, an interest deduction should be imputed for the initial period and the capital loss relating to the initial period should be disallowed.[5] The effect of the decision was that the deduction was moved from 2000 to 1999, where it could not be used by the taxpayer.

5. National Tax Tribunal

The National Tax Tribunal noted that the tax authorities had recognized the prices and terms of the loan agreement.[6] In the opinion of the Tribunal, the question as to whether the loan agreement had been made on 1 July or 15 October was not within the scope of the extended deadline in section 34(5). The Tribunal thus ruled in favour of the taxpayer, concluding that the income years 1999 and 2000 were time barred.

6. High Court

The Eastern High Court held that the adjustments were covered by the extended deadline for controlled transactions.[7] Hence, it was undisputed that the parties were covered by section 3B and that the loan agreement qualified as a controlled transaction. Neither the wording of section 34(5) nor the legislative history supported a narrow interpretation of the provision to cover only transfer pricing adjustments under section 2. The Court also held that the facts of the case did not substantiate that a final, binding agreement on the zero-coupon terms of the loan had been made before 15 October. On this basis, the decision of the tax authorities was upheld.

7. Supreme Court

Before the Supreme Court, the tax authorities argued that a final, binding agreement regarding the compensation had not been concluded before 15 October 1999, and that the deadline for reopening the tax returns had not been exceeded. It was primarily submitted that section 34(5) was applicable with respect to all types of adjustments of controlled transactions.

It was also submitted that the decision, in any case, involved transfer pricing adjustments under section 2 of the Tax Assessment Act because interest had been imputed for the initial period and the built-in capital loss relating to the same period had been disallowed.

Furthermore, it was submitted that the adjustment for 2000 was covered by section 35(1)(2) of the Tax Administration Act on extraordinary reopening of tax returns. This provision called for an extraordinary reopening of tax returns if the tax assessment for an income year was a direct consequence of a tax assessment for another income year. The tax assessment for 2000 was held to be a direct consequence of the tax assessment for 1999.

The taxpayer's primary claim was that there was no legal basis for disallowing the tax deduction of DKK 64.9 million. The principal argument in support of this claim was that the income years 1999 and 2000 were time barred because the extended deadline was not applicable. The reference in section 34(5) to section 3B was held to mean that the scope of the extended deadline was limited to adjustments regarding issues addressed by section 3B, i.e. transfer pricing adjustments. This was held to follow from the wording of the provision, the purpose of the provision and the legislative history. According to the taxpayer, an adjustment of the timing recognition of a payment did not qualify as a transfer pricing adjustment under section 2. As the tax authorities had not objected to the pricing of the transaction or the payment form, the adjustment could not be characterized as a transfer pricing adjustment. In reality, the tax authorities had simply recharacterized the payment form from a built-in capital gain to interest income.

The secondary argument in support of the principal claim was that a final agreement on the zero-coupon terms was made on 30 June 1999 at the time of the acquisition of the German company. That Danish tax law does not require controlled transactions to be made in writing, had recently been confirmed by the Supreme Court in *Feri-Lux Dan-*

4. *Convention between Denmark and the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income*, of 6 May 1948. The 1948 treaty was replaced by a tax treaty signed on 19 August 1999. Treaties IBFD.
5. In Danish tax law, transfer pricing adjustment of an interest-free loan between affiliated companies is made in the form of an imputation of interest according to long-standing practice. This approach is also embodied in the legislative history of Sec. 2 of the Tax Assessment Act.
6. TfS 2009.146 (SKM2008.975.LSR).
7. TfS 2010.452 (SKM2010.134.ØLR).

mark.[8] The fact that the loan agreement was formalized at a later stage did not mean that a legally binding agreement had not been made on 30 June.

The alternative claim of the taxpayer was that a final, binding agreement was made no later than 14 September 1999 where the parent company informed the Danish company about the approval of the zero-coupon loan.

The Supreme Court delivered a unanimous opinion by a panel of nine judges.[9] The Court affirmed the opinion of the High Court that section 34(5) covered all types of adjustments of controlled transactions.[10] The income years 1999 and 2000 were thus not time barred. The Court further noted the following (unofficial translation):

> The Supreme Court notes that the provision in section 2(1) of the Tax Assessment Act under which prices and terms of controlled transactions must comply with the "arm's length principle" for tax purposes, according to the legislative history covers all relations between the related parties, e.g. provision of services, loan agreements, transfer of assets, transfer for use of intangibles etc. According to the provision the tax authorities are entitled to make adjustments of transactions between related parties where a transaction does not reflect what could have been obtained between unrelated parties. The authority to make an adjustment covers all economic elements and other terms of relevance for taxation purposes including, for example, due date, recognition of interest and capital losses and the legal qualification of the transaction. A loan agreement on zero-coupon terms concluded between related parties with retroactive effect may thus be adjusted by the tax authorities on the basis of section 2(1) of the Tax Assessment Act. The Supreme Court further concurs that there is no basis to conclude that a final and binding agreement between Swiss Re Copenhagen Holding ApS and the parent company on the terms of the loan had been concluded before the signing of the loan agreement on 15 October 1999. On this basis the Supreme Court upholds the decision.

The Supreme Court thus held that the loan agreement infringed on the arm's length principle as laid down in section 2 of the Tax Assessment Act, and that the adjustment by the tax authorities was warranted.

8. Comments

8.1. Extended statute of limitation

The decision of the Supreme Court clarifies that the extended statute of limitation (1 May of the sixth year after the end of the income year) regarding controlled transactions is applicable with regard to all types of adjustments. For example, an adjustment may concern the classification of a controlled transaction, a determination of the taxpayers of a controlled transaction, application of thin capitalization legislation or determination of the existence of a permanent establishment. The extended deadline applies to both the tax authorities and taxpayers.

The decision is solely based on the wording of section 34(5). The legislative history of the provision does not directly state that the scope of the provision is limited to transfer pricing adjustments. However, the official comments on the bill state that the reason for extending the deadline for controlled transactions is that transfer pricing cases are often complex, time-consuming and require exchange of information, and that an adjustment needs the approval of the central transfer pricing unit of the tax authorities. It is also stated that the statute of limitations in transfer pricing cases will not be longer than in neighbouring countries. It is thus quite clear that the intention underlying the bill was to address transfer pricing cases. However, this was not enough for the Court to adopt a narrow interpretation of the provision.

8.2. Retroactive transfer pricing adjustment

The decision confirms that retroactive agreements are not valid for Danish tax purposes, i.e. tax effects generally arise *ex nunc* from the moment in time where a final, binding agreement is made. In *Swiss Re*, it was undisputed that a loan transaction arose on 30 June 1999. The issue concerned the moment in time at which a final, binding agreement requiring the Danish company to compensate its US parent company for the loan was agreed. According to the Supreme Court, the evidence of the case did not support the taxpayer's contention that a final, binding agreement on the zero-coupon terms was made before 15 October.

The decision of the Court is rather tough considering that the intention of the parties from the outset of the transaction was that arm's length compensation should be paid, that the compensation should be structured as a built-in capital gain, that the agreement on the compensation was formalized shortly after the execution of the transaction and that the actual conduct of the parties was in accordance with the intention. The decision was presumably influenced by the fact that the loan transaction and form of compensation were motivated by tax planning considerations.

This feature of the decision is in line with a decision delivered by the Western High Court in 2010 in the *ACC Invest* case.[11] In this case, related taxpayers reached an agreement on 2 January 2002 to reduce transfer prices paid in 2001 because they were considered to exceed arm's length prices. A similar agreement was reached on 29 January 2003 regarding transfer prices paid in 2002. It was undisputed that the adjusted transfer prices corresponded to arm's length prices. The Court first clarified that application of the transfer pricing provision in section 2 of the Tax Assessment Act is the prerogative of the tax authorities, i.e. the provision does not entitle taxpayers to make self-initiated adjustments. The Court then held that a waiver giving up legal right to income does not have effect for tax purposes, even though the adjusted transfer prices were on an arm's length basis. Hence, a taxpayer-initiated transfer pricing adjustment will have retroactive effect for tax purposes only if the conditions laid down in section 29 of the Tax Administration Act on the reversal of contractual terms are met, or if there is legal basis for integrating the transfer pricing adjustment with the original

8. TfS 2010.147 (SKM2010.26.HR).
9. In most cases the panel of the Supreme Court consists of five judges.
10. TfS 2012.151 (SKM2012.92.HR).
11. TfS 2010.664 (SKM2010.455.VLR). *See* J. Wittendorff, *International skatteret 2010*, SR-Skat (2010), at 212 et seq.; and J. Pedersen, *Afkald på forpagtningsafgift – Armslængdeprincippet*, SKM 2010.455 *V*, Revision & Regnskabsvæsen, 2011, at SM 10.

transaction. The latter would normally require that the contractual terms of the original transaction specify that the transfer price must be subject to adjustment in certain situations. If section 29 is not applied, and if there is no legal basis for integrating a retroactive transfer pricing adjustment with the original transaction, the adjustment will be treated as a separate transaction for tax purposes that will trigger tax consequences on its own. At the time of the price adjustment in 2002, the parties also agreed in writing that future transfer prices should be of a preliminary nature and that year end adjustments should be made in order to ensure compliance with the arm's length principle. The agreement stated that year end adjustments should be made in view of "the competitive situation and other market conditions". In spite of this agreement, the Court decided that a retroactive price adjustment made in 2003 should not be accepted because the wording of the agreement was considered to be too imprecise.[12]

The 2006 transfer pricing guidelines of the Danish tax authorities provide for a more liberal application of retroactive transfer pricing adjustments. The guidelines state that taxpayers are entitled to make retroactive adjustments, provided that this is done before the tax return for the income year in question is filed and that the adjusted transfer prices are on an arm's length basis.[13] The 2006 guidelines cannot be considered to represent current law, and taxpayers should consequently be careful not to place too much reliance thereon.[14]

8.3. Scope of the arm's length principle

The most troublesome aspect of the decision is the reasoning adopted by the Supreme Court regarding the interpretation of section 2 of the Tax Assessment Act (unofficial translation):

> The authority to make an adjustment covers all economic elements and other terms of relevance for taxation purposes including, for example, also due date, recognition of interest and capital losses and the legal qualification of the transaction. A loan agreement on zero-coupon terms concluded between related parties with retroactive effect may thus be adjusted by the tax authorities on the basis of section 2(1) of the Tax Assessment Act.

This argumentation is remarkable for several reasons.

First, the Court does not provide a clear answer to one of the central disputes of the case. The taxpayer submitted that section 2 only authorized transfer pricing adjustments. The tax authorities did not contest this position. There was thus no dispute regarding this crucial principle. The disagreement concerned the nature of the adjustment of the tax authorities. In the opinion of the taxpayer, the decision implied recharacterization of the legal form of payment rather than a transfer pricing adjustment. By contrast, the tax authorities argued that the decision involved a plain transfer pricing adjustment, as interest was imputed on an interest-free loan. The Court does not directly state whether it was of the opinion that the decision involved a transfer pricing adjustment as argued by the tax authorities, or an adjustment of another feature of the controlled transaction as argued by the taxpayer.

Second, the Court does not clearly state whether non-compliance with the arm's length principle of section 2 was due to the zero-coupon terms per se, the retroactive application of those terms or some other issue (*see* the second sentence of the above citation from the decision). As the tax authorities did not generally object to the zero-coupon terms, it must be assumed that the issue was the retroactive application thereof.[15] If this is a correct reading of the decision, the next question is whether section 2 was applied in order to remedy the retroactive application, or to adjust the pricing of the loan. The reasoning may be read as supporting the first interpretation. However, as retroactive application of contractual terms may be adjusted under basic tax law principles (see 8.2.), it would be more logical if section 2 were applied in order to adjust pricing. This would entail an uncontroversial application of section 2 in line with the core argument of the tax authorities.

Third, the reasoning of the Court regarding the scope of section 2 is based on the arguments of the tax authorities regarding the scope of section 34(5). The tax authorities argued as follows regarding the interpretation of section 34(5) (unofficial translation):

> According to the wording [of section 34(5)] the authority for the tax authorities to make an adjustment is thus not solely limited to an adjustment of the prices and terms applied by the parties, but does also cover the taxpayer's legal qualification of the controlled transaction (the nature of the transaction).

The tax authorities did not contest that section 2 only governs transfer pricing adjustments (*see* above). The tax authorities thus distinguish between the authority to make adjustment under section 34(5) dealing with the statute of limitations (all types of adjustments of controlled transactions) and the authority to make adjustment under the arm's length principle of section 2 (transfer pricing adjustments). The principal argument of the tax authorities concerned the interpretation of section 34(5), whereas the alternative argument concerned the interpretation of section 2. On this basis, one inevitably gets the impression that the Supreme Court has mixed up the arguments of the tax authorities.

Fourth, the Court does not mention whether its interpretation of section 2 turns on the wording of the provision, its legislative history or other sources of law. The arm's length principle embodied in section 2 of the Tax Assessment Act must be interpreted on the basis of article 9 of the OECD Model and the OECD Guidelines. This is not stated in section 2, but the legislative history of the provision is unambiguous in this respect. There is consensus about this issue in Danish literature. Against this back-

12. For a critical view of the decision, *see* Wittendorff, *supra* n. 11, at 212 et seq.
13. Para. 5.4.1 *Transfer pricing; Kontrollerede transaktioner; Dokumentationspligt* (Ministry of Taxation, 6 February 2006).
14. Wittendorff, *supra* n. 3, at 553.
15. In TfS 2007.922 (SKM2007.471.LSR) the National Tax Tribunal held that the arm's length principle of Sec. 2 authorized an adjustment of the form of payment replacing a built-in capital gain with imputed interest. For a critical view of this decision, *see* Wittendorff, *supra* n.3, at 511 et seq.; J. Pedersen, *Armslængdeprincippet i dansk og international skatteret – en doktordisputats*, SR-Skat (2009), at 304 et seq.

ground, it is surprising that the Supreme Court embarks on an interpretation of section 2 without making any references to the OECD rules. This is not in line with the view that interpretation of a domestic rule which is based on international cooperation in order to ensure its effectiveness, should include the international legal basis.[16] The OECD Guidelines have precisely been prepared with the goal of creating international consensus.

Fifth, the meaning of the statement that the arm's length principle of section 2 authorizes other types of adjustments than pricing adjustments, is uncertain. The adjustment approved by the Court seems to have entailed an uncontroversial imputation of interest on an interest-free loan (*see* above). Assuming that this is a correct reading of the decision, it is unclear why the Court adopts the statement regarding the scope of section 2. The statement that recognition of income may be adjusted under section 2 adds to the uncertainty because income recognition is an issue governed by law. The prevailing opinion in Danish literature is that section 2 only governs pricing adjustments.[17] If the adjustment approved by the Court, contrary to the reading outlined above, constitutes a non-pricing adjustment, or if the statement is an *obiter dictum* generally approving non-pricing adjustments, the opinion of the Supreme Court gives rise to uncertainty regarding the scope of authority granted under section 2, including the relationship between pricing and non-pricing adjustments and the proper benchmark for non-pricing adjustments. These are issues that the OECD has been struggling with for years and which have most recently been addressed in Chapter IX of the OECD Guidelines on business restructurings.

9. Conclusion

Swiss Re clarifies that the extended statute of limitations is applicable to all types of adjustments regarding controlled transactions, and that contractual terms have tax effect from the moment in time where a final, binding agreement exists. Aside from this, the decision does not provide clarity regarding the application of the arm's length principle in Danish tax law – quite the contrary. The decision is thus open for alternative interpretation regarding the issue of the scope of authority granted by Sec. 2 of the Tax Assessment Act. Due to the ambiguous reasoning of the Court in this respect, the precedential value of the decision must be limited. However, it would not come as a surprise if the tax authorities are encouraged by the decision to take a harder stand on business restructurings and other controlled transactions in order to test the final frontier of Sec. 2.

16. H. Zahle, *Dansk forfatningsret 2,* at 223 (DJØF Forlag, 2001); N. Grubbe, *Årsberetning for Højesteret 2001,* at 15 et seq (Højesteret).
17. Wittendorff, *supra* n. 3, at 389 et seq.; J. Pedersen, *Skatteretten 2,* at 393 (Thomson Reuters, 2009); J. Bundgaard, *Skatteret & Civilret*, at 481(Forlaget Thomson, 2006); B. Ramskov, *Intern selskabsomstrukturering* (Jurist- og Økonomforbundets Forlag, 2001); E. Werlauff, *Selskabsskatteret* 2011/12, at 368. By contrast, K. Skov Nilausen, *Løsning af internationale skattetvister,* at 50 et seq. (Jurist- og Økonomforbundets Forlag, 2005) has argued that the scope of section 2 includes transactional adjustments.