

DENMARK

Private Equity Funds and Leveraged Buyouts: Attack on Transparent Entities and Other Controlling Entities

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1. INTRODUCTION

Private equity funds entered business a long time ago, and have since affected Danish business life. Private equity funds have acquired majority shareholding in a number of Danish companies, including the recent example of the acquisition of the majority of the shares in TDC, a major Danish telecom operator. This phenomenon has attracted media attention and, consequently, also the attention of politicians. The subject is of international interest because private equity funds operate internationally.

The presence of private equity funds has given rise to an intense discussion of the motives behind takeovers and the effects on the economy in general. Part of this discussion is based on the fact that the activities of private equity funds may not be explained by conventional economic rationales supporting corporate takeovers. In addition, the ongoing discussions regarding corporate governance have been fuelled as more and more leveraged buyouts (LBOs) are seen.

From a tax policy perspective, the focus has been on the financing techniques widely used by private equity funds. Special attention has been given to debt financing of special purpose vehicle (SPV) companies and/or target companies – in essence the LBO technique.²

The debate has mainly been focused on the fact that many private equity funds are not organized as limited liability companies or other capital companies treated as taxable entities for Danish tax purposes. Instead, private equity funds are often organized as limited partnerships, which are generally treated as transparent entities for Danish tax purposes.

It has been commonly known – and recognized by the Minister of Taxation – that Danish law on thin capitalization³ and on withholding tax on interest payments to related parties⁴ do not apply to debt and interest payments between private equity funds and SPVs or target companies. This is because a controlling party for Danish tax purposes should be considered a “legal person”. This phrase has been interpreted by the tax authorities such that “legal person” was used synonymously with the notion of “taxable entity”. Under this interpretation, the above-mentioned anti-abuse rules apply only if any single participant in a private equity fund controls a Danish debtor company by way of holding more than 50% of the shares or voting rights. This is only rarely the case, as there is often a group of investors involved in private equity funds. As a result, private equity funds have had the opportunity to lever-

age financing without any tax restrictions. Accordingly, the LBO technique has been even more favourable from a tax perspective.

The technique commonly used can be described as follows. One or more Danish holding companies are established. The holding company becomes debt financed in order to be able to acquire the shares in the target. After the acquisition, the holding company and the target company enter into national joint taxation, whereby interest expenses are set off against operating income of the target company.⁵ In addition, the private equity fund is likely to be resident in a tax haven which has entered into an income tax treaty with Denmark, and where the received interest income is either not subject to tax at all or taxed insignificantly.

On the other hand, if the private equity fund is organized as a limited liability company of another corporation treated as a taxable entity, withholding tax on the interest payment will trigger tax on payments to creditors resident in tax havens. In fact, the ratio legis behind the interest withholding tax is to prevent such tax arbitrage,⁶ which would arise as a result of the possibility of no taxation in the hands of the creditor when an interest deduction is allowed at debtor level under Danish tax law.

The above-described scenario has been decried as a totally unfair competitive advantage favouring LBOs and private equity funds vis-à-vis other corporate takeovers. The enactment of Bill L 116 as Act 308 of 19 April 2006 (Act 308) should be viewed in light of these circumstances. The bill was presented on 14 December 2005 with the explicitly stated aim of closing the loophole in the existing legislation.⁷

The new legislation aims at bringing debt-financed equity funds within the scope of the thin capitalization and withholding tax regimes. The general legislative material to Bill L 116 states that the then-existing rules were not appropriate, as there is no doubt that a private

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2. Thus a marked change in capital structure has been observed shortly after the acquisition of Danish companies such as ISS and TDC.

3. Sec. 11 Corporation Tax Act (CTA).

4. Sec. 2(1)(d) and (h) CTA.

5. In 2005, joint taxation became mandatory for national group companies; see Sec. 31 CTA.

6. As defined in *International Tax Glossary*, 5th Ed. (Amsterdam: IBFD, 2005). See also Mark Boyle, *British Tax Review* 5 (2005), at 527.

7. The government must have been aware of this gap since 2000, when the first binding rulings on the subject were issued.

equity fund controls the holding company when the investors in the private equity fund act jointly. Thus, the legislative materials state that debt of the private equity fund should be subject to thin capitalization rules, as there is no actual difference between a typical private equity structure and other corporate structures.

The technical and legal explanations for the changes are found in the former description of the concept of control as stated in the thin capitalization rules⁸ and the rules on withholding tax on interest and capital gains⁹ (which in reality are defined in the transfer pricing rules in Sec. 2 of the Tax Assessment Act (TAA) and Sec. 3B of the Tax Control Act (TCA)). The former states the arm's length principle, while the latter specifies rules on documentation. Until now, the concept of control had been based on legal control and included the direct or indirect ownership of more than 50% of the share capital or voting rights. As mentioned above, the concept of control was partly based on an assumption that control was exercised by a "legal person".

There has been only scattered case law on the interpretation of the concept of control with regard to the concept of "legal person" for tax law purposes. In a 1999 binding ruling from the National Tax Assessment Board, a consortium was not considered as a legal person within the meaning specified in Sec. 3B of the TCA.¹⁰ The consortium was legally comparable to a general partnership. Similar results have been reached in other unpublished rulings.

In a 2001 ruling, the National Tax Assessment Board concluded that debt from a parent limited partnership to a Danish limited liability company was considered a controlled transaction, such that neither transfer pricing rules nor thin capitalization rules were applicable because a limited partnership could not be considered a legal person for tax purposes. This ruling was based on the interpretation that the determination of whether a legal person was a controlling party should be made under Danish tax principles. Thus, it was assumed that the relevant test was whether a taxable entity exists under conventional entity classification principles.

Finally, the concept of "legal person" must have played an important role in a 2003 ruling from the National Tax Court. In this case, the Court concluded that a transaction involving a general partnership could not be considered a controlled transaction (a group company), as one party was a general partnership and could not be considered a group company.¹¹

However, it remains unclear under existing case law whether it is a consequence of the interpretation of a controlling entity not being considered a legal person that the relevant provision simply does not apply, or whether the control test is instead applied at the level of the participants of the controlling entity, which is not considered a legal person. The latter is seemingly the position taken by the Danish tax authorities.¹²

A corresponding understanding is now found in the legislative material for Act 308 of 19 April 2006 (Act 308) (enactment of Bill L 116), where it is stated that the relevant test is whether the foreign private equity fund should be considered a taxable entity for Danish income tax purposes.

Irrespective of the amendments enacted with Act 308, it is the author's opinion that the widespread use of the concept of "legal person" in tax legislation is a bad habit that has resulted in legal uncertainty. The changes have not remedied these adverse effects in general, but rather have provided some certainty as to private equity funds and other transparent entities.¹³

2. GENERAL COMMENTS ON AMENDMENTS TO THE CONCEPT OF CONTROL

The changes enacted by Act 308 have resulted in an expanded concept of control which applies not only to private equity funds, but is generally applicable to a range of issues (including transfer pricing). The most significant amendment is the rewording of Sec. 2 of the TAA and Sec. 3B of the TCA. Para. 1 of both provisions is rewritten, such that companies, associations, etc. which under Danish tax law are not considered taxable entities, are *compared to a legal person* mentioned in the existing concept of control in situations where the circumstances are governed by corporate law, a corporate agreement or articles of association.¹⁴ The initial proposal for Bill L 116 also stated that such transparent entities were considered group companies (thereby also qualifying for the concept of control) insofar as they had common management or if the same circle of participants were in control; however this part of Sec. 2(1) of the TAA and Sec. 3B(1) of the TCA was deleted from the bill that was enacted by the parliament.

Furthermore, as a part of the concept of control, the provision contains a definition of what constitutes a group of companies. Before Act 308, this definition contained an implicit reference to the definition found in Sec. 4(2) of the Capital Gains Tax Act on Claims and Debt. This reference was replaced with a new, broader definition, which is now found in Sec. 2(3) of the TAA and Sec. 3B(3) of the TCA. Thus, a "group of legal persons" is now defined as legal persons where the same circle of participants is in control or where there is common management between the legal persons.

8. Sec. 11 CTA.

9. Art. 2(1)(d) and (h) CTA.

10. *Journal of Danish Tax Law* (TfS) 1999, 976.

11. *Journal of Danish Tax Law* 2003, 44 LSR.

12. In Danish legal theory, it has been argued by Henrik Dam that there is no legal support for such interpretation in legislative material. Cf. *Rette Indkomstmodtager – allokering og fiksering* (2005), at 199. The author instead argues that the relevant test is to examine whether a transparent entity may be considered a legal person regarding the ownership of shares in other companies. From this perspective, even general partnerships and limited partnerships may be considered legal persons within the meaning laid down in the relevant provisions. A similar interpretation is found with Søren Friis Hansen, *Danish Corporate Law I* (2006), at 81 et seq. The author even states that it is beyond doubt that general partnerships should be included in the concept of legal person. These considerations have been obsolete since the presentation of Bill L 116.

13. The Minister of Taxation has stated that he does not consider it prudent to use the concept of "legal person" in the corporate law meaning, as the concept differs within different areas of the law. Thus, it is preferred to use the concept in a strict tax law meaning. See Annex 4 to the Act. However, in the author's opinion, no such tax law meaning exists.

14. Sec. 2(1)(1) TAA ("Taxpayers controlled by physical or legal persons").

In addition, during the second reading of the bill, an amendment was added so that shareholdings and voting rights held by other participants with which the participant in question has agreed upon common control of the Danish corporation, are included.¹⁵

The overall objective of the amendments, as stated in the legislative material to Bill L 116, is that private equity funds should be subject to the same tax rules as Danish and foreign corporations. In general, the amendments have led to an expansion of the following concepts: (1) control by transparent entities, (2) control by agreement of common control and (3) control by inclusion of shareholdings and voting rights from group companies. These different situations will be addressed separately below, where a more in-depth analysis of the amendments will be provided.

3. CONCEPT OF CONTROL AND TRANSPARENT ENTITIES

3.1. In general

Under the wording of the provisions mentioned above, companies, associations, etc. which under Danish tax law are not considered taxable entities, are *compared to a legal person* mentioned in the existing concept of control in situations where the circumstances are governed by corporate law, a corporate agreement or articles of association. The immediate consequence of this is that Danish transfer pricing rules apply. However, as a result, legislation on thin capitalization and interest withholding tax applies, along with other specific (but in this context, less relevant) provisions.

From the wording, in order for the expanded concept of control to apply, three requirements must be met, namely:

- the entity in question must be classified as a corporation, an association, etc.
- which is disregarded for Danish tax purposes (transparent entities)
- and the conditions must be governed by corporate law, a corporate agreement or articles of association.

3.2. Corporations and associations

3.2.1. Positive definition

The expanded personal scope of the provisions implies that the relevant potential controlling entity must be classified as a corporation or association. This requirement is not clarified in the legislative material to Act 308. However, the legislative material states that entities which act as a single entity in dealings fall within the scope of the provisions.

3.2.2. Negative definition: joint ownership

In the legislative material to Act 308, a negative definition is specified regarding entities covered by the amendments. The legislative material states that the provisions do not apply where independent parties jointly own a Danish corporation (*sameje*). This is seen in opposition to the situation where a partnership actually exists, which according to the tax authorities is

characterized by having joint ownership and a unified form. This definition thus necessitates knowledge of the definition of joint ownership and actual partnerships, especially general partnerships. In fact, the definition as pointed out by private law case law is now of relevance in this tax law context. This is due to the fact that a similar definition does not exist under tax law, as the treatment in both situations follows the principle of transparency, under which the participants are taxed directly based on their proportional ownership of the assets of the entity.

A general partnership is defined under company law as an entity with a business purpose and unlimited liability for the participants.¹⁶ Under case law, it is not possible to draw a clear line between general partnerships and joint ownership. However, it is the general opinion (in theory and practice) that different rules govern the different types of ownership.¹⁷ In addition, it is the prevailing opinion that a general partnership is characterized by its *conduct of business*.¹⁸ Further analysis of this legal definition is beyond the scope of this article.

Shares in corporations may be held in joint ownership. This triggers an obligation to execute rights over the shares by proxy.¹⁹ However, it remains unclear whether joint ownership of shares will constitute a business, leading to the existence of a general partnership which falls within the scope of the relevant provisions. However, it cannot be excluded that this may be the case.

It is common to see general partnerships established to achieve a result similar to that of a shareholder agreement (e.g. certain limitations in the shareholder rights regarding ownership of the shares of a target company). The amendments hardly cover situations where two or more private equity funds own shares in a Danish company and have entered into a shareholder agreement defining the terms of ownership of the target company as long as none of the private equity funds control the Danish company and have not established a common entity.²⁰ Of course, this only holds true if there is no agreement regarding common control between the parties. Thus, a shareholder agreement may prove advantageous compared to common transparent entities, as a shareholder agreement does not contain the characteristics that would otherwise cause it to fall within the scope of the new concept of control.

Thus, the distinction between general partnerships and joint ownership is unclear, and this part of the law will

15. Sec. 2(2) TAA and Sec. 3B(2) TCA.

16. An interesting observation was made by Danish Supreme Court Judge Niels Pontoppidan, who as early as 1983 expressed concerns about applying tax law consequences from the private law distinction between general partnerships and joint ownership. See *UfR* 1983 B, at 253 et seq.

17. Danish legal literature on this specific subject is extensive. See e.g. Ulrik Rammeskov Bang-Pedersen, *Sameje om fast ejendom* (2002), at 18; Bernhard Gomard, *Selskabsretten* (1999), at 41 et seq.; Søren Friis Hansen and Jens Valdemar Krenchel, *Dansk Selskabsret III* (2004), at 168; Erik Hørlyck, *Interessentskaber og konsortier* (1996), at 41; Mette Neville, *Boligfællesskaber i selskabsform* (1993), at 85 et seq.

18. See e.g. Erik Hørlyck, *Interessentskaber og Konsortier* (1996), at 40; and Ulrik Rammeskov Bang-Pedersen, *Sameje om Fast Ejendom* (2002), at 24.

19. Cf. Sec. 28 Act on Limited Liability Companies.

20. See Christen Amby, *SU* (2006), at 4 with an initial analysis of the TDC acquisition by Nordic Telephone Company based on publicly available information.

likely be the subject of future case law in order to resolve the uncertainty.

3.3. Transparent entities

An additional requirement directly specified in Sec. 2 of the TAA and Sec. 3B of the TCA is that the relevant potential controlling entities must be disregarded for Danish tax purposes (i.e. must be transparent entities). This determination will hardly cause any problems for resident entities. Thus, the legislative material to Act 308 states that the concept of control covers limited liability partnerships (*partnerselskaber, kommandit-selskaber*), general partnerships (*interessentskaber*) and similar foreign entities. Also, certain transparent associations will fall within the scope of the amendments.

The position is more uncertain when it comes to foreign entities. In such cases, the determination of whether the entity is transparent should be based on general principles of Danish tax law. There is no exhaustive list of entities disregarded for Danish tax purposes, as this determination is made on a case-by-case basis. Danish law follows the *lex fori* method in this regard, and therefore it is commonly acknowledged that the distinction between taxable entities and transparent entities is made based on domestic law principles. Under these principles, it is not decisive whether the entity is considered a taxable entity under the applicable law in the state of residence (i.e. foreign law). The determination is specific and based on the entirety of characteristics of the relevant entity. Important factors in this determination include liability, capital and management. In general, these factors are characteristics of different taxable entities covered by Sec. 1 of the CTA.

3.4. Governed by company law, company agreements or articles of association

A third requirement under the amended concept of control is that the circumstances of the entities in question must be governed by company law, company agreements or articles of association. Under this wording, it remains unclear which circumstances will be covered. Considering the context, however, it seems clear that the usual legal issues (e.g. internal and external relations) must have been in the mind of legislators. However, it has not yet been clarified whether *all* conditions must be so governed, or whether it would be sufficient for some (or even a few) of the circumstances to be so governed.

The expression “corporate law” refers to legislation such as the special legislation in the Act on Limited Liability Companies regarding certain limited liability partnerships (*partnerselskaber* or *kommanditaktieselskaber*), as well as certain non-mandatory rules found in legal theory on the basis of case law. The latter type of regulation is seen regarding Danish limited liability partnerships and general partnerships. The legislative material to Act 308 mentions foreign legislation such as the UK Limited Partnerships Act of 1907.²¹

In areas where there is no corporate law, the company agreement or articles of association will outline the

internal and external relations of the company. The legislative material to Act 308 indicates that it is not significant whether the company agreement is verbal or in writing.

4. CONCEPT OF CONTROL AND AGREEMENTS ON COMMON CONTROL

4.1. In general

An important part of the amendments to the concept of control is the changed wording of Sec. 2(2) of the TAA and Sec. 3B(2) of the TCA. These provisions state that shareholdings and voting rights held by *other participants* with which the participant in question has agreed upon common control over the Danish corporation should be included. The wording can be seen as a significant expansion of the scope of the relevant provisions. Prior to the amendments, only shareholdings and voting rights held by group companies (as defined in 5.) should be included in determining whether control existed. Henceforth, it is also a part of the concept of control if an agreement on common control exists.

The term “other participants” must be understood broadly as referring to any kind of participant, i.e. individual or corporation, disregarded or not.

The background for the insertion of these provisions was that the initial bill was based on an assumption that the wording also covered cases of common control. However, this assumption was not supported by the exact wording of the proposed bill, and, therefore, changes were necessary.²² In fact, this was recognized by the Minister of Taxation.²³ Thus, the enacted provisions should be seen in this light. This gives rise to some uncertainty as to whether the initial legislative material should be given any interpretative value vis-à-vis enacted wording which is placed in another section of law and with different wording.

The enacted amendments apply not only to transparent entities (e.g. private equity funds), but also to taxable entities. Thus, Danish transfer pricing legislation applies in situations where two parties have agreed on common control of a Danish or foreign company and where no single shareholder owns more than 50% of the shares or voting rights.

This version of the concept of control may be seen as *de facto* or subjective control. The now abolished Sec. 12 of the CTA was also based on a *de facto* concept of control,²⁴ as is Art. 9 of the OECD Model Treaty.²⁵

21. See the legislative material to Sec. 6(1) and (2).

22. See the response to the hearing by the National Accountant Association. See also Annexe 7 to Act 308; Christen Amby, note 21.

23. See Annexe 4 to Act 308.

24. In fact, it was argued that the concept of control should be interpreted in accordance with Art. 9 of the OECD Model Treaty.

25. Thus, Art. 9 rejects *de jure* control as a criterion. It is specified as a requirement for applying articles corresponding to Art. 9 of the OECD Model Treaty that the enterprises be “associated”. The OECD commentaries are superficial, but it may be determined that the article applies to related parties (legal persons), carrying out business activities between related parties. The concept of “associated enterprises” undoubtedly has a broad meaning which refers not only to control, but also to direct or indirect participation in management, control or capital of an enterprise in the other state, or whether the same persons participate in both enterprises. See Carmine Rotondaro, *International Transfer Pricing Journal* (2000), at 2.

4.2. Agreement on common control

The legislative material to Act 308 states that the provisions regarding the concept of control will apply only when an agreement on common control exists.²⁶ The provisions do not result in the participants being group companies in general, as they are merely considered jointly to fulfil the concept of control. The provision applies to direct as well as indirect participants. Thus, it is not possible to circumvent the concept of control simply by imposing intermediary holding companies. As a result, the provision will apply to private equity funds as well as interposed holding companies.

The existence of an agreement on common control is based on an actual assessment of the agreement involved.²⁷ This should lead to a determination of whether the agreement results in:

- common control of the majority of voting rights;
- common appointment or removal of the majority of the members of the top management body; or
- common control of operating and financial management.

These factors are generally applicable regarding the concept of control. Specifically regarding private equity funds, the Danish Minister of Taxation has indicated a belief that such agreements often exist and contain guidelines on specific subjects, for example:

- demands regarding minimum investment or shareholding and possibly regarding participation in future increases of capital in order to finance additional acquisitions;
- the right to sell on the same terms as a selling shareholder and an obligation to sell on the same terms as a selling shareholder (commonly referred to as “tag along” and “drag along”);
- consensus on the common strategy regarding the investment (horizon, exit strategy);
- agreement on common appointment of members of the board and the activities of the board (e.g. meetings, quorum and majority requirements); and
- guidelines on the strategy of the target.

In this context, the legislative material to Act 308 states that a shareholder agreement does not, on its own, constitute an agreement on common control.²⁸ The same is said with regard to put options and limitations with regard to pledges.

Finally, it is stated that the concept of control may apply even though the private equity funds are unrelated in a number of regards (e.g. investors, management, business strategies and tax positions), and even though investments in competing businesses may have taken place.

5. CONCEPT OF CONTROL FULFILLED BY SHAREHOLDINGS AND VOTING RIGHTS HELD BY GROUP COMPANIES: CHANGE OF THE CONCEPT OF A GROUP

5.1. In general

Act 308 introduced a new concept of a group of companies for the purpose of e.g. transfer pricing legislation, legislation on thin capitalization and legislation

on withholding tax on interest payments and capital gains on claims.

The concept of a group of companies is now defined in Sec. 2(3) of the TAA and Sec. 3B(3) of the TCA. These provisions define a group of legal persons as legal persons in which the same circle of participants are in control or where there is common management among the shareholding entities. Under the former definition (applicable until now) of the concept of a group company, only the first part of the sentence was included. The amendments introduce another variation of de jure control to the general concept of control under Danish tax law.

The technical implication of this expanded definition is that shareholdings and voting rights held by other participants must be included in the calculation of whether a participant is in control of the company. Henceforth, the concept of group companies also includes agreements regarding common management of the acquired company.

5.2. Common management

As a consequence of the expanded scope of the concept of control, one must determine when common management exists and the extent to which identity in management must be present before common management will be deemed to exist. It is problematic that the legislative material to Act 308 is silent in this regard. Thus, no real guidance exists on the proper understanding of the concept of common management.

In the first presented bill, the concept of common management was addressed with regard to private equity funds organized as transparent entities. Thus, the legislative material was specifically designed to address this situation. It was stated that that the proposal should be seen in the context that general partners in limited partnerships (or a management company appointed by this company) hold the right to manage the company, leaving only decisions on important and far-reaching issues to the limited partners. Thereby, the limited partners, according to the legislative material, are left with very little influence on a limited partnership. In this context, several private equity funds may have the same general partner being able to decide on which acquisitions to make. It is stated that management is deemed to be common when (1) the administrator (being a general partner or a management company) is the same for several private equity funds or (2) the administrator is not identical in more private equity funds, but these administrators are group companies or otherwise related (e.g. related individuals).²⁹

However, the enacted version does not mention transparent entities in the context of common management. Rather, only legal persons are mentioned.

Certain countries apply a similar concept directly in their internal transfer pricing legislation.

26. See Commentaries on Sec. 6(6) of the amended bill.

27. Id.

28. Id.

29. See comments on Sec. 6 in Bill L 116.

The background for the insertion of the mentioned provisions was that the initial proposal of the bill was based on an assumption that the wording would also be applicable in cases of common control. However, this assumption was not supported by the exact wording of the proposed bill, and accordingly, changes were necessary.³⁰ Indeed, this was recognized by the Minister of Taxation.³¹ Thus, the enacted provisions should be seen in this light. This gives rise to some uncertainty as to whether the initial legislative material should be given any interpretative value vis-à-vis enacted wording which is placed in another section of the law and with different wording.

In the author's opinion, no support is found in the enacted wording in support of the argument that the concept of control should also apply in situations of common management between transparent entities not being "legal persons" in the assumed tax law meaning. The initial proposal of the bill was aimed at bringing common management between transparent entities within the scope of the concept of control. This conclusion was reached by reference to the second sentence of Para. 1 of the relevant provisions. This link is not a part of the enacted concept of control. A literal interpretation must lead to the conclusion that common management of transparent entities cannot fall within the scope of the amendments. For further discussion of this interpretation, see 6.

In addition to this conclusion, the wording in the first proposal of the bill applies only to limited partnerships and thus provides no general guidance with regard to the understanding of the concept of common control. Management is likely to be understood as regular management bodies (depending on the legal form involved) for the type of entity in question.

6. PRIVATE EQUITY INVESTMENT STRUCTURES: OUTSIDE THE SCOPE OF THE CONCEPT OF CONTROL?

Due to the wording of the amended concept of control, it is the author's opinion that certain structures do not fall within the scope of the legislation. With regard to the concept of a group of companies, this is seemingly the case with shares or voting rights held by transparent entities. Thus, shareholdings and voting rights held by transparent entities do not fall within the concept of control, more specifically the concept of a group, if the shares' voting rights are held by transparent entities, as the wording covers only legal persons in the sense of taxable entities. Under the definition in Sec. 2(3) of the TAA and Sec. 3B of the TCA, a group may hardly consist of two or more transparent entities or of both taxable and disregarded entities.

There is little doubt as to whether the group definition in Sec. 3 should be understood in the context of the former wording. Under the former definition, the concept of a group was defined with reference to companies, associations, etc. treated as taxable entities. To support the presented interpretation, it must be argued that the principles used for determining a group based on the concept of a common circle of shareholders in control, are not changed by the enactment of Act 308. The same may be said regarding the understanding of the concept

of "legal person", which should then be understood as an entity treated as a taxable entity. The first part of the new definition of a group in Sec. 2(3) of the TAA and Sec. 3B(3) of the TCA accordingly should be read as a reference to the definition in Sec. 4(2) of the Capital Gains Tax Act on Debt and Claims, and transparent entities do not fall within the scope of this definition. The mere presentation of Bill L 116 seems to verify this interpretation.

The introduced concept of common management does not change the result, as the same line of reasoning applies in this regard.

In light of the arguments presented, the concept of control does not apply to situations involving shares and voting rights held partly by taxable entities and partly by transparent entities.

Another situation falling outside the wording of the enacted concept of control seems to be loans provided directly from the participants in a private equity fund to a Danish company. This must hold true if the participants do not control the debtor company on an isolated basis.

The Minister of Taxation was asked about this issue twice during the hearing process before the parliament. When asked to confirm that no Danish withholding tax will be levied on interest payments to participants of a private equity fund, the Minister replied that the proposed interest withholding tax applies to loans where a transparent entity is creditor and where the loan is related to the shareholding through the transparent entity (partnership), including situations where the participants in the partnership are formally creditors, but where the partnership is the actual creditor.³² Neither the question nor the answer provides any clarity as to the subject in question.

The question was reiterated (and developed) in Annexe 7 to the Act. The Minister of Taxation, however, repeated his previous answer, word for word.³³ Thus, the question remains unanswered, and little guidance is provided by the answer from the Minister of Taxation. However, under another amendment by the Act of the existing thin capitalization rules,³⁴ some insight into the position of the Minister of Taxation on the subject seems to be provided. An amendment of the thin capitalization rules has been enacted such that debt of individuals that are participants in transparent entities (now within the scope of the concept of control; see above) should not be considered controlled debt for purposes of the thin capitalization rules. The legislative material indicates that the background is an assumption that the general change in the concept of control will automatically imply that debt of individual participants is covered by the amended concept of control and thus is to be considered controlled debt. Several comments can be made with regard to this assumption.

It is a fact that the thin capitalization rules do not apply to debt from individual shareholders. This has been the

30. See the response to the hearing by the National Accountant Association. See Annexe 7; Christen Amby, *SU* (2006), at 4.

31. Annexe 4 to Bill L 116.

32. Annexe 4 to Act 308.

33. Annexe 9 to Act 308.

34. Sec. 11 CTA.

Figure 1

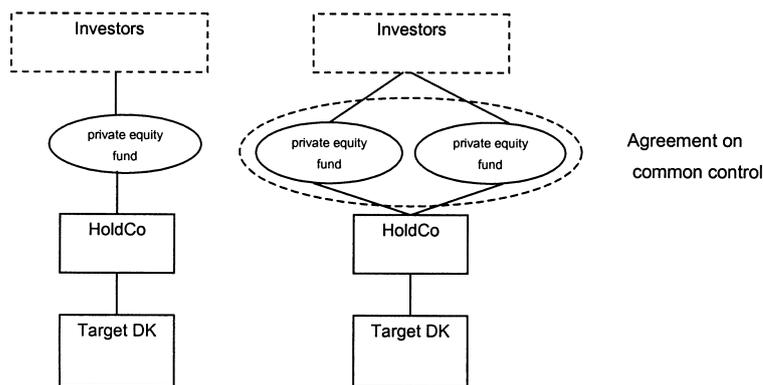
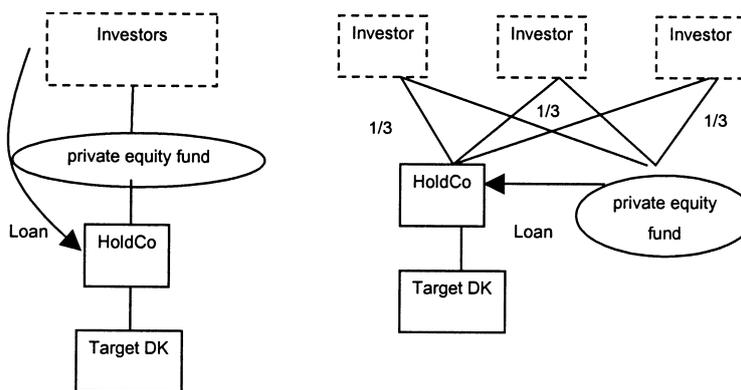


Figure 2



case since Act 221 of 31 March 2004 (Bill L 119). The fact that transparent entities under the amended concept of control are compared to taxable entities being legal persons under the relevant provisions, does not, in the author’s opinion, change the fact that any transparent entity for tax law purposes must be considered the creditor in the loan relationship. This is also the case for private law purposes, where a partnership may be the creditor in a loan relationship. The amendments enacted by Act 308 seemingly do not imply that participants in the creditor entity will fall within the scope of the thin capitalization rules under Sec. 11 of the CTA if the participant does not directly or indirectly control the debtor company.

In the author’s opinion, the assumption underlying the amendment of Sec. 11 of the CTA is wrong and will lead to unlawful restrictions regarding loans from participants. In addition, the wording of Sec. 2 of the TAA and Sec. 3B of the TCA does not provide any support for the interpretation presented in the legislative material.

Despite the above analysis, there is scarcely any doubt that the tax authorities will argue that authority has been provided to consider both mentioned transactions/structures within the scope of the concept of control. Regarding both issues, however, one should bear in mind that any tax law interpretation should be made under traditional interpretation principles. Thus, the wording of any given provision is decisive when the understanding is unambiguous, and no other aspect of the legislative material leads to another result.³⁵ It seems to be a well established fact that the wording of any given provision should have precedence over the

legislative material (*travaux préparatoires*), due to the fact that a stricter demand for legal authority applies within the field of tax law. These statements find support in the recent tendency in Danish case law to give priority to legislative material.

Based on this, it seems doubtful whether the courts will recognize an interpretation put forth by the tax authorities which finds little or no support in the wording of the relevant provisions.

7. EXAMPLE

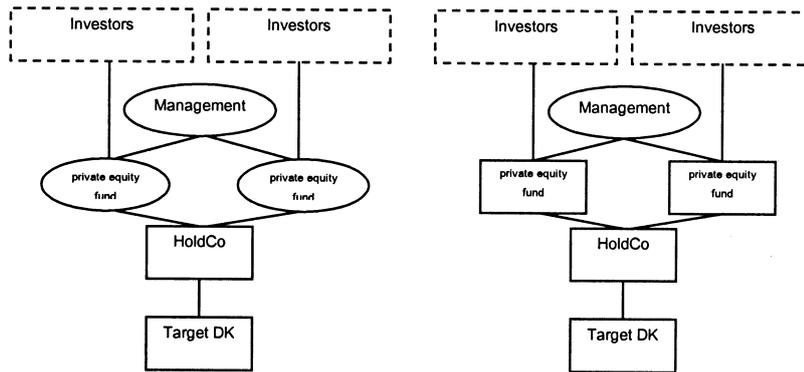
The scope of the amended concept of control as enacted in Act 308 is illustrated in Figure 1.

The two illustrations show typical structures which fall within the scope of the amended concept of control. In the first illustration, the private equity fund will be considered to control HoldCo. In the second illustration, the concept of control will also apply because shareholdings and voting rights held by both private equity funds should be included in the determination of whether control exists.

Figure 2 depicts situations which will hardly fall within the scope of the amended concept of control, based on a literal interpretation. The first illustration is

35. See Jens Garde, *Forvaltningsret – almindelige emner* (1997), at 138. An even more harsh rule of interpretation is presented by Søren H. Mørup, *Danish Journal of Tax Law* (2002), at 665; Jacob Graff Nielsen, *SO* (2002), at 192, 197. These authors propose a rule whereby a deviating meaning in the legislative material is irrelevant insofar as the wording of the provision in question is sufficiently clear.

Figure 3



of the situation where a loan is provided directly from the participants in the private equity fund (and where no single investor can be said to control HoldCo), while the second is of a mixed group of entities where a loan is provided by a transparent private equity fund to a taxable entity (which, under a strict interpretation of Danish tax law, should not be considered a group).

In Figure 3 two situations occur in which common management over private equity funds is deemed to exist. Under the interpretations presented in this article, common management in two transparent entities does not cause a group of companies to fall within the concept of control, while the contrary is the case where common management will trigger the existence of a group of companies when two taxable entities are involved.

8. SPECIFIC COMMENTS REGARDING INTEREST AND CAPITAL GAINS WITHHOLDING TAX

Withholding tax of 30% is generally imposed on interest and capital gains from affiliated companies. An exemption applies if Denmark is required to reduce the withholding under an applicable income tax treaty with the country of residence of the foreign company, or if the transaction falls within the scope of the EU Interest and Royalty Directive. As a consequence of Act 308, the scope of Danish rules on interest withholding tax was expanded.³⁶ Thus, withholding tax on interest and capital gains may be imposed on payments to transparent entities with participants resident in foreign jurisdictions. Under the amended provisions regarding withholding tax on interest and capital gains, withholding tax may be imposed regardless of whether the transparent entity is resident in Denmark or any other country. The withholding tax is still imposed at the level of the participants that become liable to the imposed withholding tax. However, this tax liability will apply only to corporations, associations, etc. mentioned in Sec. 1 of the CTA that are resident in a foreign state. The limited tax liability does not apply to individuals and legal persons resident in Denmark.³⁷

The debtor company must withhold tax on interest or capital gains paid to a transparent entity in cases where a participant in the transparent entity is subject to limited tax liability in Denmark (i.e. a participant resident in a non-treaty state). In these situations, the withholding tax is calculated on the basis of the actual ownership of the participant subject to withholding tax on the interest payment or capital gain.

9. CONCLUSION

Act 308 adds several noteworthy dimensions to Danish tax law. The primary principle in the Act can be described as a mandatory tax liability for transparent entities. Recently, the opposite situation applied. Thus, Act 221 of 31 March 2004 (Bill L 119) introduced mandatory transparency for certain taxable entities, i.e. they are disregarded (in practice the latter applies only to Danish *anpartsselskaber* (private companies)) for US tax purposes under the check-the-box regulations.

One immediate reaction to these amendments is that the shotgun approach has been applied once again. Thus, several other situations now fall within the scope of the concept of control, even though these situations do not fall within the ratio legis of the Act referring specifically to private equity funds. One should take note of the resulting effects of what is seemingly an attack on private equity funds.

The applied legislative method presumably is a result of the political pressure arising when the issue is perceived loopholes in the tax legislation. This political agenda does not serve the overall quality of the tax legislation of any nation. Simultaneously, several uncertainties have arisen which may be viewed as new loopholes. In any case, one must conclude that the legislative quality is not sufficient in the case of the amendments enacted with regard to the concept of control, as analysed in this article.

36. Sec. 2(1)(d) and (h) CTA.

37. See legislative material on Sec. 7(1) of Act 308.