

Recent Developments

DENMARK

Tax Law on Intra-Group and Shareholder Security from a Transfer Pricing Perspective

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1. INTRODUCTION²

The provision of security by shareholders to their companies or between group companies often occurs in the financing of businesses. The role of the security provider is to enable the company in need of capital to obtain loan capital. In such case, the provision of security can work as an alternative to intra-group lending or lending from a major shareholder. The provision of security presents a number of tax law questions, including the following:³

- How is “security” defined for tax law purposes?
- Must or may the providing company claim payment for the provision of security?
- If so, what is the price?
- Does the price differ depending on the type of security provided?
- Which consequences may arise if no payment is made for the provision of security?
- Is there any access to deductibility for the debtor company when payment is made for the provision of security?
- Under which assumptions may the provider of security deduct costs related to a crystallization of the security to the lender?

Basically, an interest payment can be seen as a payment in financial transactions for making capital available to the debtor. Interest payments thereby consist of payment for the time value of money and the assumption of credit risk. Certain types of security, namely guarantees, may be considered an isolation of the credit risk in lending relationships where the guarantee commission constitutes payment for the provider’s assumption of credit risk. The interest payment on the guaranteed loan subsequently constitutes payment for the timing factor concerning the borrowed funds, as well as a possible residual credit risk.⁴ In addition to this, guarantees and other types of security are to a certain extent related to insurance arrangements.⁵

It is common business practice that in the course of providing security, the tax law implications are not considered, including especially the consequences of a lack of payment for this security. In a number of cases, this issue was recently a focus. Most recently, this resulted in the National Tax Court having fixed a fee for a parent company’s guarantee to its subsidiary’s supplier. This development in practice is the actual reason for this article. As such, this article will discuss the consequences that may be triggered by the internal

provision of security, and will clarify the legal basis for those consequences.

2. VARIOUS TYPES OF SECURITY

Neither Danish tax law nor international tax law provides a general tax law definition of security. Therefore, the concept is to be understood in accordance with its common meaning. Security is accordingly assumed to exist where the receiver of security by legal means may demand that the claim be fulfilled.⁶ Examples of security include third-party guarantee, collateral security, third-party security, back-to-back-loans and other certain letters of support. The characteristic of each right to security seems to be the establishment of a legal claim for the receiver of compliance with its receivable. A tax law use of the concept of security should necessarily be understood as a reference to this issue.

1. Director, associate professor, Copenhagen Business School; Deloitte, Copenhagen. All translations in this article are the author’s.

2. In this article the following abbreviations are used:

UfR – Danish weekly law review;

TfS – Journal of Danish Tax Law;

SU – Danish Journal of International Tax Law;

SpO – Danish Journal of tax policy;

SR-Skat – Danish Tax Journal;

H – Danish Supreme Court,

V – High Court;

LSR – National Tax Court.

3. For a corresponding position under Swedish law specifically concerning letters of support, see Leif Gäverth, *Stödbrev – Borgensliknande handlingar utställda företrädevis för svagt kapitaliserade bolag* (1994), at 14. For a discussion of certain tax law and private law issues regarding intra-group security see Irene J.J. Burgers and Huub M.M. Bierlaagh, “Some Tax Aspects of Guarantees, Letters of Comfort and Keep-well Agreements between Group Companies”, 52 *Bulletin of International Fiscal Documentation* 2 (1998), at 81; Eric D. Ryan, Charles E. Erivona and David G. Chamberlain, *Tax Management Transfer Pricing Report*, Vol. 11, No. 20, (2003), at 850.

4. Cf. Ryan, Erivona and Chamberlain, note 3.

5. The financial rationale behind provision of security in corporate and group structures is illustrated by Ryan, Erivona and Chamberlain, note 3. The model was originally created to address only loan guarantees, but is also deemed to be applicable as an illustration with regard to other types of security.

6. See generally Hans Viggo Godsk Pedersen, *Kaution* [Third-party Guarantees], (Copenhagen: DFØF-Publishing, 2002); Hans Helge Bech Thomsen, *Kaution og andre solidariske skyldforhold* [Third-party Guarantee and Other Joint and Several Debt Relationships], (Copenhagen: Thomson, 2004); Lennart Lyng Andersen and Erik Werlauff, *Kreditretten* [Credit Law], (Copenhagen: Thomson, 2002), at 337; Mads Bryde Andersen, *Enkelte transaktioner – Aftaleretten III* [Individual Transactions – Contract Law III], (Copenhagen: Gjellerup, 2004), at 143.

2.1. Third-party guarantee

A *third-party guarantee* constitutes a promise made by a provider of guarantee to another (creditor) to assume monetary debt which a third party (debtor) owes or will owe to the creditor. The third-party guarantee is thereby a three-party relationship consisting of the debtor, the creditor and the provider of the guarantee. A third-party guarantee means that the provider of guarantee will meet the claim or cover the creditor's loss as a result of the failure if the debtor fails to meet the payment commitment. A third-party guarantee may take various forms. The distinction among these promises is often made based on the time of crystallization of the duty to perform on the part of the provider of the guarantee.

For *third-party security*, the duty of the provider of security does not arise until the creditor proves that the debtor cannot pay, which is the case when all legal means have been used.

2.2. Collateral security

This is characterized by the duty to pay being triggered when the creditor can prove that the debtor has violated the duty to pay under the primary debt relationship. The collateral security can also be drawn up as a loss security, whereby the provider of security must repay losses which the creditor would suffer if the debtor fails to pay. Under so-called call security (a variety of collateral security), the duty to pay on the part of the provider of security arises when a claim for such payment is made from the creditor to the provider of security.

Promises of security are often limited in commercial relationships. If no limitation exists, the duty to pay concerns the entire debt. It is also frequently the case that the creditor sets up a requirement of a statement of all debt, after which the duty to pay includes all which the debtor owes or will owe to the creditor. Promises for security may be limited only by stating the maximum liability for the provider of security in respect of a certain amount. The promise of security may also be limited in a way that the promise concerns only a part of a certain claim (full security for a part).

2.3. Third-party security

Third-party security is related to third-party guarantees, but differs from them in that the provider of security is not personally liable to the debtor's claim but is liable only by its security.⁷

The concept of guarantee is not entirely unambiguous.⁸ In the narrow sense, a guarantee imposes a commitment on the guarantor on equal terms to or in place of that which is guaranteed (actual or independent guarantee). However, the concept can be perceived in a broader sense. Guarantees can be categorized as loan guarantees (guarantee for repayment of a loan), payment guarantees (guarantee for proper payment in contractual relationships), other contractual guarantees (guarantee for proper compliance of actual payment), guarantees for claims governed by public law (guarantee for claims for taxes and duties) and other guaran-

tees. In this regard, loan guarantees are especially interesting. Often, banks will be guarantors. This means that there is a market for bank guarantees where the banks claim payment for providing guarantees. In such cases, it must be possible to compare pricing on the provision of a guarantee between related parties.

2.4. Back-to-back loans

The provision of security may occur directly through so-called back-to-back-loans, under which parent companies, for example, agree with a third party that the third party is to provide a loan to the subsidiary in exchange for the parent company providing a loan to a third party.⁹ Also, a back-to-back loan exists where a parent company's bank provides a loan to a subsidiary at the same time that the parent company deposits a corresponding amount in the lending bank.

2.5. Letters of support

The provision of security may also take place through statements of the creditor's willingness to support a company in the event of financial difficulties. Letters of support are not an unambiguous concept, and they can, for example, cover promises of general support to a company and of support by actual borrowing. The legal effects of letters of support depend on their actual design. There may be statements which are legally binding and statements which are considered to be only morally binding. In order to determine the tax consequences of a provision of security, the legal effects must be determined first. The legal and financial consequences for both group companies are to be included in this determination.

The contents of letters of support may vary significantly, ranging from statements of a confirmatory nature to statements which more precisely contain a liability for the parent company. From a terminology perspective, the concept of letters of support in an international context includes comfort letters, letters of awareness, and letters of intent.¹⁰ The expression "letter of intent" is not suitable in this respect.¹¹ While third-party security is an expression of a dispositive statement intended to be legally binding, a letter of

7. On this issue, see also Bent Iversen, *Right to security in real and personal property*, (Copenhagen: GadJura, 2000), at 44.

8. See Hans Viggo Godsk Pedersen, *Bankgarantier* [Bank Guarantees] (2003), at 15.

9. For more information on back-to-back loans, see e.g. Hans Viggo Godsk Pedersen, *Bankgarantier*, note 8, at 25.

10. See e.g. Hans Viggo Godsk Pedersen, *Kaution*, note 6, at 122; Torsten Iversen, *Støtteerklæringer* [Letters of Support], (Copenhagen: GadJura, 1994); Erik Røsæg, *Garantier eller fattigmandstrøst* [Guarantees or Poverty Consolation] (1992); Lennart Lyng Andersen and Erik Werlauff, note 6, at 396; Erik Werlauff, *Koncernretten – Juridiske grundprincipper for danske og internationale koncerner* [Group law – Basic legal principles for Danish and International Groups], (Copenhagen: GadJura, 1996), at 123; Bernhard Gomard, *Almindelig Kontraktret* [Standard Contract Law] (1996), at 86; Mads Bryde Andersen, note 6, at 172; Christian Harboe Wisum, *UfR* (1986) B., at 340; Peter Blok, *UfR* (1994) B., at 436. For a more in-depth explanation of the legal position with regard to letters of support, etc., see Jonas Christoffersen and Niels Bang Sørensen, *R&R* 1999/11, at 8.

11. See Hans Viggo Godsk Pedersen, *Kaution*, note 6, at 117; Lennart Lyng Andersen and Erik Werlauff, note 3, at 396 (stating that the concept of "letter of intent" is relatively broad and can include a pre-contract for a project for which more detailed contracts are to be prepared subsequently).

support is mainly intended to be an expression of a non-binding statement that normally only expresses something actual.

The courts have only limited experience with this issue, but cases decided to date indicate that not all letters of support commit the provider. In order for this to be the case, the statement must move beyond being morally or commercially obligating, and must include a promise in the legal sense of the word.¹² Statements with security-like effects are often referred to as “strong” or “hard” statements, and they may, depending on their wording, entitle the receiver to damages; statements that are merely commercially or morally committing will not. The trouble occurs in the vast middle ground that includes varieties of these statements without clear borders. It is fair to assume that non-specific statements of a merely informative or historical nature will be unlikely to constitute a promise in legal terms. On the other hand, one could assume that clearly worded and unconditional promises will generally be binding on the provider. This determination is difficult from a civil law perspective. Danish practice can most likely be regarded as more restrictive than other EU countries with regard to the recognition of the binding nature of a letter of support.¹³

A letter of subordination¹⁴ does not constitute security. This is to be understood as a statement under which a creditor (here, the major shareholder or a group company) promises to allow its claim against the debtor to be subordinate to another creditor having a claim against the same debtor. Despite the fact that this does not constitute the provision of security, it cannot be excluded that the statement will lead to improved loan financing options for the debtor. For this reason, in this case it may also be considered whether payment is to be made for the statement to the provider, either as an independent payment or as an increased interest payment.

3. PROVISION OF SECURITY AND THE ARM'S LENGTH PRINCIPLE

The most obvious issue in relation to intra-group and shareholder security is compliance with the arm's length principle. It is typical that there is very little experience in Danish law with regard to the use of the arm's length principle in cases involving the provision of security.¹⁵ Internationally, the picture does not seem markedly different.

3.1. OECD Transfer Pricing Guidelines

The OECD Transfer Pricing Guidelines (OECD Guidelines) do not directly mention intra-group provisions of security. One can assume that Chap. VII on intra-group services also governs intra-group provisions of security, even though that chapter does not include regular statements on the provision of security.

Para. 7.6 of the OECD Guidelines states that the evaluation of whether intra-group services have been provided in cases when a group company has performed an activity for one or several other group companies, should depend on whether the activity financially or

commercially strengthens the respective group company. This may be determined by considering whether an independent enterprise under similar circumstances would have been willing to pay for the activity, had it been performed for the enterprise by an independent party, or if the enterprise would have carried out the activity itself internally. If it was not an activity which the independent enterprise would have been willing to pay for or carry out itself, the activity is generally not to be regarded as an intra-group service for purposes of the arm's length principle.

Para. 7.13. of the OECD Guidelines states that no intra-group service is deemed to have been provided when a company earns ancillary profits that are attributable to its membership in a large group, but which are not attributable to any specific activity performed. The OECD Guidelines indicate that, for example, intra-group services are not deemed to exist in situations where a group company, solely by reason of its group membership, has creditworthiness which is greater than it would have had it not been a member of the group. On the other hand, a service is deemed to have been provided if the increased creditworthiness is the result of a guarantee from another group company.

In this regard, the OECD Guidelines do not distinguish between different types of guarantees (e.g. letters of support are not mentioned). Finally, no distinction is made between obligating and non-obligating securities. Consequently, it remains unclear which criteria are determinative of whether the provision of security under the OECD Guidelines constitutes an intra-group service.

Generally, under the OECD Guidelines, no payment may be claimed if the subject is a shareholder activity. Accordingly, it must be the case that no payment is to be claimed for security provided only as a part of hedging the company's shareholder interests.¹⁶ It is very difficult (if not impossible) to decide whether a provision of security is an expression of a shareholder activity or an intra-group service covered by the arm's length principle.

3.2. Is Sec. 2 of the Tax Assessment Act applicable?

In light of the above, one issue that arises is whether Sec. 2 of the Tax Assessment Act (TAA) is applicable to controlled security. This provision sets forth the gen-

12. See e.g. *UfR* (1998), 1289 H (SCS Holding A/S – letter of comfort to Varde Bank – no basis for making the parent company liable to free the bank of loss). See also *UfR* (1994), at 470 H (Thyholm Tømmerhandel A/S – ordered liability as a result of dispositive letter of intent).

13. See Christoffersen and Sørensen, note 10, which also provides that the choice of law may be decisive regarding how the letter of support becomes binding for the provider. Thus, further difficulties are created for this interesting and nuanced tax law assessment, as such determination requires knowledge of foreign relations.

14. Regarding these statements, see e.g. Mads Bryde Andersen, note 6, at 176 f.

15. For more information on this topic, see Burgers and Bierlaagh, note 3; Leif Gäverth, note 3, at 126; Jakob Bundgaard and Jens Wittendorff, *Arm-slængdeprincippet & Transfer pricing* [The Arm's Length Principle and Transfer Pricing] (2001), at 199 f; Susanne Pedersen and Klaus Okholm, *SU* (1999), at 94; and Ryan, Erivona and Chamberlain, note 3, at 855.

16. Cf. OECD Guidelines, Chap. VII, Sec. 7.9.

eral arm's length principle under Danish law. The answer to this issue is decisive in the determination of whether payment is to be made for the provision of security under Danish law.

The application of Sec. 2 is defined by the statement that controlling and controlled taxpayers, in stating their taxable income, are to apply the arm's length "prices and terms" of "trading or financial" controlled "transactions". This provision has given rise to a certain interpretative activity on the part of taxpayers, as the quoted terms and comments on Sec. 2 of the TAA do not in themselves provide any significant guidance as to their exact meaning. Specifically, in practice the provision has given rise to difficulties in definition by unilateral determinations which are not based on contractual terms between the provider and the receiver, or where the contract does not provide for a trade-off.

The comments on Act 432 of 26 June 1998 (Act 432) state: "The controlled transactions included under the provision concern all relations between the parties. An example could be the supply of services, lending, transfer of assets, making available of intangible assets, etc.". The standard interpretation of this comment is that the wording governs any contractual private law disposition. In addition, for example the ordinary sale of goods, sale of services, intangible assets, lending and financing could be mentioned. It is also assumed that conveyances for ownership, as well as conveyances for use are included, as well as renting, leasing, and outsourcing.

It does not seem apparent that Sec. 2 of the TAA is applicable to the provision of security; arguments could be made in support of its applicability or inapplicability. Some of these arguments are presented below.

On the one hand, it could be argued that there is no direct transaction between the debtor and the provider of security, unless payment is claimed for the provision of security.¹⁷ The actual transaction takes place between an independent lender and debtor. It is also difficult to ascertain differences between this provision of security and situations in which a direct conveyance takes place. The latter situations have not been deemed to be included under Sec. 2 of the TAA by the National Tax Court. Sec. 2 of the TAA is often interpreted as requiring effective reciprocity under the relevant agreements.¹⁸

It appears that administrative practice, through negative definition, has excluded a part of actual dispositions from the application of Sec. 2 of the TAA. An interpretation of the wording of Sec. 2(1) of the TAA does not bring about any clear result. However, a linguistic understanding of the words "prices and terms" and "trading or financial transactions" seems to lead to the need for a trade-off as part of the transaction. To determine a price, there must logically be something to which to relate the price to, and determination of terms must also provide that there is something to which to relate the terms.

In addition, the OECD is generally reluctant to encourage member countries to reclassify the parties' agreements. Sec. 1.36. of the OECD Guidelines therefore emphasizes that only in special cases may the tax

authorities disregard the actual transactions or replace them with other transactions.

On the other hand, it could be argued that a controlled transaction exists because the provider of security provides that security for the benefit of the debtor, such that the necessary controlled transaction specifically exists. Perhaps in line with this, it could be argued that Sec. 2 of the TAA is applicable to security in the same way that it is applicable to interest-free loans. In such cases, the National Tax Court assumes that fixed interest is to be claimed by the creditor, as a mutually binding legal relationship actually exists (even though the trade-off is zero).¹⁹ In each case, the main service has been supplied, which correspondingly must be the case with regard to the provision of security in corporate and group structures.

It does not seem possible to reach an unambiguous conclusion on the basis of the wording of Sec. 2 of the TAA and its preparatory history. In light of former practice, the conclusions of the OECD Guidelines and the purpose behind Sec. 2 of the TAA, in the author's opinion, the arm's length principle is applicable to the provision of security by major shareholders to their companies, as well as between group companies. Thus, the provision of security constitutes a service.

Accordingly, the decisive issue seems to be how to determine arm's length prices and terms with regard to the provision of security.²⁰

4. PRICE OF SECURITY: VALUE IN USE, INCURRED COSTS, FUNCTIONS AND RISKS

4.1. Generally

There is an obvious need to set a price for the provision of security. This price is to be used as that agreed between the parties or for a possible transfer pricing adjustment.²¹

In the OECD Guidelines, the pricing of services is addressed in Chap. VII, Para. 7.19.-7.39. In the case of

17. Compare Ryan, Erivona and Chamberlain, note 3, at 851.

18. This means that the National Tax Court has denied the right to apply Sec. 2(4) of the TAA (regarding the abolishment of secondary adjustments); cf. Subsec. 1 *TjS* (2001), at 176 LSR; *TjS* (2001), at 770 LSR; *TjS* (2001), at 769 LSR; *TjS* (2001), at 829 LSR; and *TjS* (2001), at 771 LSR. All rulings included improper allocation of income contrary to the Danish principles of proper recipient of income or proper bearer of costs. This practice is dealt with by N. Mou Jakobsen, *R&R* (2001) SM 336; Mikkel Falkenberg and Anders Endicott Pedersen, *TjS* (2001), at 888; and Jakob Bundgaard, *SR-Skat* (2003), at 43.

19. *TjS* (2002), 824 LSR.

20. In situations where the subsidiary is also thinly capitalized, there is an interaction between the rules on this in Sec. 11 of the SEL. This, however, is the case only in group relationships, but not when the subject is the provision of security from physical persons as major shareholders. The interaction consists of the fact that the total marketability of the finance fee could lead to inapplicability of the rules on thin capitalization, as it is possible to document only that the financing takes place at market terms.

21. The question of whether payment is to be made for intra-group provision of security is the subject of a brief comparative treatment by Burgers and Bierlaagh, note 3 (containing analysis of German, French, British and Dutch law). The authors concluded that no special rules or practice exist with regard to intra-group security in the noted countries. French law is an exception, as practice there has established an assessment of the financial situation of the beneficiary as decisive.

a supply of services between group companies, the settlement may take place according to a direct or indirect method. The OECD Guidelines recommend that, to the extent possible, the settlement take place according to a direct method (i.e. by invoicing specific services). The OECD Guidelines also recognize that the application of a direct method can be practically impossible or lead to disproportionately high administrative burdens.

In such case, settlement may be made by applying an *indirect method*. An indirect method for settlement of services is to be applied on the basis of an agreement regarding cost allocation. Vital elements of such an agreement include the definition of the relevant costs and the determination of an allocation key for the use in invoicing. According to the OECD Guidelines, an indirect settlement with regard to services should take place based on the *actual* costs incurred in connection with the services²² (as opposed to an indirect settlement based on a fixed percentage of the companies' net revenue or other similar factor).

The actual costs include both direct and indirect costs. If the activities are carried out by employees who also carry out other activities, costs are to be allocated among (i) activities included under the agreement and (ii) the other activities. Accordingly, an indirect allocation should not include costs directly attributable to services supplied to specific group companies, costs concerning shareholder activities or costs relating to the relevant company's own activities.

The OECD Guidelines do not prescribe specific allocation keys, but merely state that the allocation key is to be in accordance with the arm's length principle. The allocation key which most precisely allocates the costs in relation to the benefit of the companies is to be applied.

Para. 7.2.9. of the OECD Guidelines states that both the supplier's and the receiver's situations are to be taken into account. Relevant factors to consider include:

- the value of the services for the receiver;
- how much a comparable, independent enterprise would be willing to pay for this service under similar circumstances; and
- the costs for the supplier of the service.

No guidance has been provided as to how these general guidelines are to be applied in the case of the provision of security. In this regard, Burgers and Bierlaagh state that banking terms for guarantees seem obvious as a comparative factor in cases where a parent company has issued legally binding security.²³ If this method is not applied, the authors suggest a determination of the difference between the interest rate with and without security. In this regard, they state: "Independent parties may be expected to somehow share the benefit from a guarantee, although usually the subsidiary will be in a weaker position than the parent company".²⁴

Several applicable methods can be identified for the pricing of security in corporate and group structures. The most obvious seems to be the application of a method based on the free market price (CUP method). However, it may be difficult to present comparable data on the provision of security. It is likely that the most suitable methods will focus on the value of the

security provided, which is expressed in the terms of the underlying lending relationship. This approach can determine the benefit for the debtor and/or the costs for the provider of security, for use in the calculation of an arm's length range or a profit split.²⁵ It is to be assumed that there is a correlation between the interest rate and the commission. These components in the total payment for loan capital can thereby be documented individually, but the overall result should be in line with the arm's length principle.

4.2. Debtor's benefit

A reasonable starting point would be to look at the debtor's interest saving as a result of the security provided. This is determined by identifying the *benefit*. However, an adjustment should probably be made in this regard, as the beneficiary (debtor) would, as independent party, hardly be willing to relinquish the entire benefit achieved. Under the benefit test, the value is immediately identifiable by assessing the spread in the interest payment. Thus, the primary task is to determine what the arm's length interest payment would be without security. If the debtor company has taken out other loans without the provision of security, they could function as comparative benchmarks. Correspondingly, loan offers from banks with and without the provision of security may function as benchmarks in this respect. The difference in interest rates should most likely be regarded as the value which the bank deems the security to have. If no internal comparable transactions exist, external data may be obtained, for example by determining the credit rating of the debtor company. On such basis, the arm's length interest payment may be determined.

In addition, consideration should be given as to whether the parent company (as shareholder) or the individual shareholder indirectly benefit from the provision of security, as the shares in the debtor company may increase in value by reason of the decreased interest payment.²⁶

In applying the benefit test, the tax authorities should make a transfer pricing adjustment only when all relevant factors are included in the determination, and then by considering the lender's rationale for claiming security. The rationale may thus be that (i) the parent company is in a better financial situation and assets on which to levy execution than the subsidiary or (ii) the parent company/major shareholder de facto controls assets, activities and earnings in the debtor company.²⁷

22. Para. 65 OECD report, "The allocation of central management and service costs, Transfer pricing and multinational enterprises – Three taxation issues" (Paris: OECD, 1984).

23. Burgers and Bierlaagh, note 3, at 87.

24. Id.

25. Ryan, Erivona and Chamberlain, note 3, at 857.

26. Burgers and Bierlaagh, note 3, at 90.

27. Ryan, Erivona and Chamberlain, note 3, at 852. With regard to the first rationale, the authors state as follows: "The lender's first concern is quite relevant to application of the arm's length standard. To the extent the parent puts its more substantial assets and better credit rating at risk by guaranteeing its subsidiary's borrowing, the guarantee enhances the subsidiary's commercial position relative to a similarly situated independent competitor. The parent rightly should receive a guarantee fee for providing this benefit to the subsidiary". On the contrary, with regard to the second rationale, the authors state as follows: "The lender's second concern

On the basis of the practice discussed below, it must be assumed that the Danish tax authorities will focus on the benefit of the provided security. This means that there will almost certainly be a presumption that a benefit exists in cases where security has been provided. Payment is to be made if a benefit is found. However, the determination will be based on the facts and circumstances of each case.

4.3. Costs for the provider of security

If a cost-based approach is applied, the focus may be placed on the expected costs for the provider of security. This determination must involve statistical data regarding the incidences of default or breach on loans to companies with a similar credit rating.²⁸

Application of the cost-based approach is closely related to considerations about risk. The exact assumption of a credit risk accordingly does not seem decisive for the occurrence of costs for the provider of security. A claim for the provision of security, however, is in itself not necessarily indicative of a particularly high-risk on-lending. On the contrary, it must be assumed that the subject is often a standardized risk hedge.

4.4. Arm's length range

In general it must be assumed that the pricing between independent parties is agreed such that the price falls somewhere between the seller's cost and the buyer's benefit. Thus, it is possible to formulate a number of arm's length prices within the range between the cost of the provider of security and the benefit of the debtor. This method is preferable from a theoretical perspective, as application of the arm's length principle is not an exact science.

4.5. Pricing impact of the legally obligating or non-obligating nature of security provided

It is obvious one should consider whether the critical point of the liability to pay under the arm's length principle is whether an obligating or non-obligating security exists.

A *non-obligating letter of support* does typically not give rise to costs and it may not be demanded by the creditor. The company issuing the security will therefore basically not directly incur costs or other financial consequences.²⁹ However, there may be a risk of a change in legal practice so that the statement will become obligating. Furthermore, for commercial reasons, financial losses may arise if there is failure to comply with a letter of support. On the other hand, the debtor company may also gain a financial benefit in the form of, e.g. lower interest.

Despite these issues, it may be argued that no payments are to be made for a non-obligating letter of support, as the provider of support does not directly assume any risk.³⁰ However, it is uncertain whether the tax authorities will acknowledge such an argument, especially if in fact a benefit can be established for the debtor. If the range approach is applied, one of the

extreme points must be 0 (the costs for the provider of security).

An *obligating letter of support* or *third-party security*, however, should normally lead to payment of an arm's length guarantee commission if a benefit therefrom can be proved for the receiver, or if costs can be proved for the provider of security. On application of the benefit test, the tax authorities may make an adjustment only when all relevant factors (including the lender's reasons for claiming security) have been considered.

Pedersen and Okholm argue that generally it is not possible to apply transfer pricing methods to intra-group security.³¹ Accordingly, they state:

However, it becomes more difficult when we speak of letters of support where the group company risks having to inject capital or in other ways to ensure that there is capital in the subsidiary to redeem the Company's obligations for the benefit of which a letter of support has been issued. However, we find it difficult to see which price the group company must continuously set for such future uncertain injection of capital.

In our opinion, no actual market for the above third-party securities exists. Even though one imagines that a third party would provide security for the loan of a subsidiary, it will not provide an actual basis for comparison. A professional provider of security will determine his/her price for the security on the grounds that it is his/her occupation to provide security. The same does not apply to a parent company the occupation of which is not to provide security to subsidiaries. Therefore, the situations are not comparable, and the third-party securities accordingly cannot be applied as a basis for comparison. Based on the same considerations as stated for letters of support, we do not believe that a transfer price should be determined for securities provided for the benefit of the creditors of a group company.³²

This opinion cannot be accepted because it is not in line with the arm's length principle or basic transfer pricing principles. In a transfer pricing context, payment is always to be made for functions and risks. Because a provider of security will be assuming precisely a financial risk and thereby a potential cost, payment must be made. There does not seem to be a way to avoid this, as the provider of security does not provide security as part of his/her occupation. The situation is hardly comparable to the supply of services in the conventional sense, where settlement, with the

arguably is not pertinent to the arm's-length inquiry. To the extent the guarantee merely reassures the lender that the parent will not use its control over the subsidiary in a way that leads to default on the loan, the guarantee does not actually enhance the subsidiary's commercial position. Rather it addresses the 'moral hazard' risk inherent in the control relationship between the parent and subsidiary. For an independent competitor otherwise similarly situated to the subsidiary, the lender might not require an outside guarantee because no comparable moral hazard exists. In this circumstance, it is fully consistent with the arm's-length standard to ignore the parent company guarantee and not require or impute an intercompany guarantee fee".

28. See Ryan, Erivona and Chamberlain, note 3, at 858.

29. Bundgaard and Wittendorff, note 15; Burgers and Bierlaagh, note 3, at 89. See also Susanne Pedersen and Klaus Okholm, note 15, who find that no transfer pricing is to be determined by a group company's issue of a non-obligating letter of support as the group company has no costs in this connection – neither at the time of issue nor presumably at any subsequent time.

30. Cf. Susanne Pedersen and Klaus Okholm, note 15.

31. *Id.*

32. *Id.*, at 217.

exception of employment situations, may be carried out on a cost basis. However, from a financial perspective, the risk element is typically of secondary importance to the supplier compared to the main content of the service. With regard to third-party security, on the contrary, the risk element is the main content of the service, and therefore, the supplier should be paid for the expense of a hypothetical hedge of the risk.³³ In addition to this, a benefit can often be found for the debtor, thereby indicating that payment is to be made for the service.

As can be seen, it is not possible to state in general terms if the liability to pay follows the character of the security's nature as legally obligating or non-obligating. Legal practice has not yet taken a position on this issue. If it becomes decisive whether an obligating security exists, it could be argued that focus thereby, to a certain degree, shifts from tax law to private law. Due to different classification of different statements of security in different jurisdictions, it will be a very difficult exercise to determine whether or not payment is to be made.³⁴

If it is significant whether or not a legally obligating security exists, one should necessarily consider whether the tax authorities will consider this issue under reference to private law. Judging by the legal position in administrative practice concerning thin capitalization, there is good reason to fear a deviating classification. In Sched. 9 to Act 432, the Minister of Taxation supports the position that non-legally-binding security should also result in the deemed existence of controlled debt.³⁵

On this basis, it can therefore hardly be excluded that the tax authorities will deem there to be a payment for the issuance of non-binding statements. However, this does not change the fact that basically, this is a matter of misinterpretation of the concept of security. An additional issue is that evidently, in a tax law context (at least) two different opinions with regard to the concept of letters of support are applied under Danish law.³⁶

5. CONSEQUENCES OF THE ABSENCE OF PAYMENT FOR PROVISION OF SECURITY

If payment is not made for the provision of security as required under the arm's length principle, the tax authorities may effect a transfer pricing adjustment.³⁷ This is also true if the payment made for the provision of security is too high or too low.

If a physical person as shareholder provides security for the company without payment or in exchange for a low payment, an arm's length payment may be deemed for the shareholder (primary adjustment). Simultaneously, a corresponding adjustment is made for the debtor company in the form of a deductible payment of commission. Finally, subsidy tax may arise from a secondary adjustment in the debtor company. If a payment correction is effected by the taxpayer, the secondary correction can be avoided.³⁸

In Danish group structures, the scenario is largely the same. This applies in each situation where a parent company provides security for a subsidiary, or where a

sister company provides security. On the other hand, if a subsidiary provides security for a parent company, the secondary adjustment will be classified as a tax-exempt intra-group dividend payment.³⁹

If a Danish company provides security for a foreign company without payment, a primary adjustment will be effected for the Danish company. When security is provided to a Danish company from a foreign company, a corresponding adjustment may be effected if a primary adjustment is made abroad. Subsidy taxation may arise, irrespective of whether a primary adjustment is made abroad. Sec. 4 of the Corporation Tax Act provides independent legal authority for this.

If an excessive payment is made from a Danish company to its domestic or foreign major shareholder or a group company, a primary adjustment may be effected for the debtor company. Simultaneously, a corresponding adjustment may be effected for the provider of security, along with a secondary adjustment in the form of subsidies or dividends.

6. ADMINISTRATIVE PRACTICE CONCERNING THE ARM'S LENGTH PRINCIPLE AND PROVISION OF SECURITY

It seems that under administrative tax practice, the issue of payments for intra-group security was first considered in the National Assessment Council's binding advance ruling of 21 November 2000.⁴⁰

On 22 July 1999, an Austrian-listed parent company (Parent AG) of a large international group acquired all shares in a Danish company, Finance ApS, which had been established on 1 July 1999. Finance ApS was the only Danish company in the group. After Parent AG's acquisition of shares, Finance ApS had three main tasks:

33. See Bundgaard and Wittendorff, note 15.

34. Cf. Burgers and Bierlaagh, note 3, at 89.

35. For greater detail, see Jakob Bundgaard, *Tynd kapitalisering – en skatteretlig fremstilling* [Thin Capitalization – A Tax Law Presentation], (Copenhagen: Thomson, 2000), at 131.

36. In connection with the hearing of L 139 (act on amendment of various tax laws – trade in loss companies, remission of debt and interest on remission of debt, passed on 1 June 1995), the (then) Minister of Taxation provided an answer in Sched. 15 with regard to the parliamentary Tax Affairs Committee, questions 3 and 4 in Sched. 5, on the interpretation of Sec. 15(4) of the TAA. In this, a different understanding of the concept of "letter of support" is acknowledged than that which appeared in connection with L 101. The Minister of Taxation replied as follows: "A letter of intent may in certain cases be of such nature that it is to be considered a legally binding promise to e.g. contribute capital to a subsidiary so that it is able to meet its obligations. Thus, the provider of the letter of intent may become liable to damages to the creditors of the subsidiary. Irrespective of the fact that the letter of intent is not a third-party security, it will thereby in reality have the same effect as the letter of intent. In relation to a letter of intent, where the legal position is clear and unambiguous, the legal assessment of a letter of intent will, however, be very concrete and depend on the contents of the statement and the circumstances under which it has been issued. This being a matter of a letter of intent will therefore not mean that the issuer of the letter will become liable to damages". On this basis, it was the Minister's opinion that it is not possible in Sec. 15(4) of the TAA to include the payments made by the issuer of a letter of intent. Here, it is seen that the interpretation likely respects the underlying private law circumstances.

37. TAA, Sec. 2.

38. TAA, Sec. 2(4).

39. Corporation Tax Act, Sec. 13(1)(2).

40. J. 99/00-4339-00230.

- it appeared from the presentation of the case that Finance ApS functioned as a financing company in connection with the acquisition of an American group. In this regard, Finance ApS had taken out a loan of EUR 440 million from an Austrian bank consortium;
- it appeared that Finance ApS handled the financing of the group companies. Through this function, long-term loans were granted to group companies, and Finance ApS received deposits from these companies; and
- Finance ApS handled the group's cash pooling and thereby received day-to-day deposits from, and made day-to-day loans to, group companies.

Parent AG had issued an unlimited guarantee (a so-called downstream guarantee) for Finance ApS's debt to the lending bank consortium. Subsequently, Parent AG guaranteed Finance ApS's compliance with the commitments set forth in the loan agreement between Finance ApS and the bank consortium. Also, three other group companies, which directly or indirectly were wholly owned by Parent AG, guaranteed Finance ApS's debt to the bank consortium (a so-called upstream guarantee). These guarantees, however, were limited to the profit which the companies providing security earned in the most recent financial period. Thus, the companies provided guarantees in a manner similar to the Parent AG, as mentioned above.

It appeared that the intention of Finance ApS was to pay a guarantee commission to Parent AG and the three other security-providing group companies. This was assumed as a result of the companies' guaranteeing that Finance ApS met its obligations to the bank consortium. Thereby, it was revealed that Finance ApS contemplated payment of a fixed annual guarantee commission of 0.85% of the guaranteed loan to Parent AG. According to the author's information, the guarantee commission was an expression of the value in use which the credit facility of EUR 440 million provided, as well as the advantage which credit facilities in the bank would give to Finance ApS once they were guaranteed by Parent AG. For the other three companies, Finance ApS intended to pay a commission amounting to 0.15% of the guaranteed amount per year. The guarantee commission was an expression of this actual value which the credit facility of EUR 440 million would provide.

The bank consortium would have required a higher interest than that mentioned in the loan agreement with Finance ApS, if the said guarantees had not been granted. The same applied with regard to other banks. Finance ApS received a statement from an Austrian bank, according to which this bank would charge an interest margin of 0.75% for credit facilities (which would be increased to 1.75% if Parent AG recalled the guarantee). A corresponding statement was received from another bank, according to which the interest would be increased to 6.178% (from 4.928%), if Parent AG recalled the guarantee. Finally, two banks in the bank consortium announced that the interest rate on the loan of EUR 440 million would be increased by 1.25%-1.5% and 1.5%-1.75%, respectively, if Parent AG recalled the issued guarantee. These acknowledgements, however, were based on the financial statements of Finance ApS for 1999, and a binding loan

proposal would require detailed due diligence. It was not possible, or desirable, for Finance ApS to obtain a binding loan proposal, as such proposal would not be used and also would entail considerable costs for Finance ApS.

On the basis of the above information, the National Assessment Council was asked the following questions regarding the provision of security:

- Will Finance ApS be able to deduct the expense for a guarantee commission to Parent AG Austria or a guarantee commission to XX GmbH, YY GmbH Austria and ZZ Co. US?
- If the answer to the first question is affirmative, will a guarantee commission of 0.85% to Parent AG and a guarantee commission of 0.15% to XX GmbH, YY GmbH and ZZ Co. US be deductible?
- If the National Assessment Council is unable to answer the second question, will a guarantee commission be deductible if the size of the guarantee commission approximately corresponds to the interest expenses which Finance ApS has saved by reason of the guarantees?

With regard to these three questions, the National Assessment Council responded that the commission amounts would be deductible.⁴¹ As regards the current guarantee commissions, it was assumed that they were based on the value of the advantage which Finance ApS would gain, just as it would mean higher interest payments if the provision of security had not been made. It is thereby assumed that fixing the annual guarantee commission at the level of the interest expenses saved by Finance ApS in the same year by reason of the security, is to be regarded as an acceptable parameter. Referring to the arm's length principle in Sec. 2(1) of the TAA, the Council found that the total annual deductible guarantee commission should correspond to the saved annual interest expense determined on the basis of the interest increase which the banks, according to their statement, could offer if no guarantee were made for the loan (which would mean an interest increase of between 1.25% and 1.75% per year). On this basis, the Council concluded that, after an actual assessment, the borrower's additional cost of the guarantees should constitute 1.5% per year.

In this regard, the National Assessment Council found that the existing information from the bank consortium was to be regarded as reliable, as the banks were deemed to be independent from the group.

Thus, it seems that this case also concerns the determination of arm's length commission and interest payments. From this case, the simple and correct conclusion can be drawn that proposals from independent parties may be applied as the basis for the determination. If an intra-group commission amount has already been determined, the arm's length commission rate may be calculated by adding the difference between the external loan proposal and the intra-group commission.

The arm's length interest rate represents the rate according to the stated loan proposals, as it is applied as the basis on which Finance ApS could have taken

41. See TAA, Sec. 8(3).

out a loan of similar size from an independent third party without an intra-group provision of security.

This decision will likely be applied to support the position that in the case of intra-group guarantees, payment must be made by an arm's length guarantee commission. In this case, the intra-group guarantee commission was calculated as the difference between the interest expense for loans with and without the intra-group guarantee. The arm's length guarantee commission was accordingly calculated as the financial value advantage to the debtor.

In a 2005 case,⁴² the issue of payment for the provision of security was directly considered in its pure form for the first time. In this case, a parent company (which actually performed a holding function and made investments) provided a personal guarantee for the subsidiary's bank guarantee with regard to a supply of goods. The parent received no payment for this. The local tax authorities accordingly deemed a payment to have been made to the parent company of DKK 25,500 (corresponding to 1.5% of the amount secured of DKK 1.7 million), citing Sec. 2 of the TAA. The amount of the adjustment was determined based on an inquiry to a local bank, from which it was revealed that the practice was to charge a 1.5% commission for the provision of security for third-party security (instead of Danish parent companies). The company's representative argued that the company had acted in line with market terms, as the company could have chosen to let the subsidiary itself handle the provision of security as this was possible based on the subsidiary's equity. It was also stated that a personal guarantee did not result in specific pricing, discounts or other similar incentives with regard to the purchase of goods from the supplier. The representative also argued that the company could have chosen to provide the subsidiary with higher equity, perhaps by holding back dividend distributions. The argument was therefore that payment for the security was already made through dividend distributions. It was also asserted that the subsidiary did not achieve any benefit, as no change occurred in purchase prices as a result of the third-party security.

On the following grounds, the National Tax Court upheld the decision:

The company has provided third-party security free of charge for the subsidiary's liability to the bank in connection with the bank's provision of guarantee to the subsidiary's supplier. The subsidiary is not considered to have been able to obtain third-party security from another party free of charge. It is therefore agreed that a payment is fixed which corresponds to the subsidiary's saving, cf. Sec. 2(1) of the Tax Assessment Act and Sec. 4(a) of the State Tax Act.

As it has not been proven that the subsidiary could obtain a corresponding security from a party outside the group at a lower price than that applied as the basis for the tax authorities' assessment, the tax authorities' assessment is upheld.

This shows that the National Tax Court has acknowledged that this is a service for which payment is to be made. The National Tax Court has furthermore acknowledged that the payment is to reflect the subsidiary's saving (benefit). In other words, the determination of income is made at the level of the parent company, on the grounds of the stated benefit in the

subsidiary. In the author's opinion, it seems correct that the subsidiary received some value for use in the actual situation. It must be decisive whether the group company would be willing to pay for the security if it had been provided from a party outside the group. In certain situations it is to be assumed that the company has no choice because the desired financing is not presentable if security is not provided simultaneously.

Finally, the National Tax Court has recognized that this benefit can be documented by making an enquiry to an individual bank without assessing the comparability. This determination can be performed by applying the CUP method (as was done in this case). However, one could consider whether the full amount of the benefit should be fixed or if the parties agree to split the use, also in tax respects.

Another aspect to be considered in this regard is whether security from a company which is made in the interest of the shareholder may be regarded as a hidden distribution. In *Nordbornholms murerforretning ApS*,⁴³ the shareholder was a personal guarantor for the foreign loan of a private limited company. He let another company deposit bonds as security. The shareholder viewed this as the provision of security in exchange for the consideration of possible jobs from the first said company. The Supreme Court found that the brick-layer business's charge of the relevant bond holding as security for the foreign loan was to be considered as having been made in the interests of the brick-layer business on the basis of ordinary business interests. For this reason, the provision of security and the subsequent realization of the charge did not lead to taxation as a hidden distribution or a denial of the brick-layer business' loss on the claim.

7. DEDUCTIBILITY OF COMMISSIONS AND OTHER PAYMENTS

Another issue related to security in corporate and group structures is whether the debtor may deduct a payment for security. The relevant legal authority in this regard is Sec. 8 of the TAA. Sec. 8(3) of the TAA provides for the deduction of certain premium and commission payments, including continuous commissions or premiums for loans or for the hedging of receivables.⁴⁴ This provision does not regulate the debtor's payment for the provision of security (compare the word "receivable").

Premiums and similar continuous services as security for the debt of the taxpayer are deductible.⁴⁵ As the wording of this provision mentions only third-party security, expenses for other types of security can hardly be included here. It is characteristic of these provisions that they concern continuous services. If instead a one-time service is performed, a deduction is allowed for establishment fees, one-off premiums and similar one-time services for security if the term is less than two years.⁴⁶ This provision is to be viewed in con-

42. *TjS* (2005), at 563 LSR.

43. *TjS* (2002), at 602 H.

44. TAA, Sec. 8(3)(a).

45. *Id.*, Sec. 8(3)(b).

46. *Id.*, Sec. 8(3)(c).

nection with Sec. 5(3) of the TAA. From this is seen that the term is decisive for the deductibility of one-time services concerning security.

If the actual provision of security does not constitute third-party security, the payments are not subject to Sec. 8(3) of the TAA and the possibility of a deduction will accordingly depend on Sec. 6a of the State Tax Act.

If a corresponding adjustment is to be made in a Danish company, whether a deduction will be allowed is also to be determined based on the above legal analysis.

8. DEDUCTIBILITY OF COSTS RELATED TO PROVISION OF SECURITY TO A THIRD PARTY

Assuming an obligation of third-party security or other security does not in itself lead to deductible expenses for the provider of the security.⁴⁷ Redemption of an actualized obligation does not in itself trigger a deductible loss. A loss occurs only when the recourse claim against the debtor is shown to be irrecoverable.

Claims that occur in connection with third-party security are included under the Gains on Securities and Foreign Currency Act.⁴⁸ The assumption itself is not an expression of the provider of security having assumed a debt. Only when the security comes into effect does a claim arise for the provider of security; simultaneously upon the payment of the security there is a recourse claim against the main person. This is the concept of subrogation. The recourse claim is deemed to be acquired at an amount corresponding to what the provider of security has had to pay to the creditor in order for the main person to be relieved of the debt to the creditor.

For physical persons such loss may be deductible if the conditions of Sec. 17 of the Gains on Securities and Foreign Currency Act⁴⁹ are met. This means that the loss must have occurred as part of acquiring, ensuring and maintaining the income of the provider of security, and thereby must have occurred as part of providing financial services.⁵⁰ In other words, this deductibility is effective for business persons. If, on the other hand, the provision of security has been made to ensure capital (including share investments), the loss is not deductible.⁵¹ If Sec. 17 of the Gains on Securities and Foreign Currency Act is not applicable, a deduction may possibly be allowed as an operating loss.⁵² For other private persons, a loss on provision of security will basically be regarded as a non-deductible capital loss.⁵³ See also Sec. 16 of the Gains on Securities and Foreign Currency Act, under which no deduction is allowed for recourse claims acquired on payment of security in foreign currencies.

For companies, the normal rules under the Gains on Securities and Foreign Currency Act apply, such that a loss on a claim is basically deductible.⁵⁴ Within corporate groups, it is necessary to consider whether the group rule under of Sec. 4 of the Gains on Securities and Foreign Currency Act is applicable so as to result in a denial of the deduction. As none of the exceptions under that provision is applicable to the provision of

security, the result must be that group companies may not deduct losses on recourse claims.⁵⁵

If companies are outside of the scope of the group rule, a possible deductibility must be based on Sec. 2 of the Gains on Securities and Foreign Currency Act.

However, it cannot be excluded that a possible loss will be regarded as a subsidy to a group company, such that no deduction will be allowed.⁵⁶ The issue was central in *Egnsbank Han Herred*.⁵⁷ In this 2000 case, the Customs and Tax Region had denied the deduction with regard to a loss guarantee for a leasing company, which the company owned together with five banks. In this regard, reference was made to the fact that a capital increase existed and that the disposition had been made in consideration of the capital interest in the leasing company. The majority of the High Court allowed a deduction under Sec. 6 a of the State Tax Act, reasoning that that there was a sufficient connection to the company's own acquisition of income.

If a third-party security crystallizes, the provider of the security will be able to deduct only the interest accruing after the actualization of the obligation. In assessment practice, a third-party security is deemed to be actualized when the main party allows the date of payment to pass without paying (personal guarantee), or when the main party's lack of ability to pay is determined by the owner of the claim (unsecured guarantee).⁵⁸

9. CONCLUSION

Because there is little doubt as to the fact that the tax authorities will in future pay certain attention to security granted in corporate and group structures, taxpayers and their advisors should also be mindful of this issue. It is anticipated that developments under Danish law will likely follow the same pattern as has been seen in several other countries. It is especially to be assumed that in a number of situations, transfer pricing

47. See Jan Pedersen et al., *Skatteretten 2* [Tax Law 2], (Copenhagen: Thomson, 2004), at 185, Aage Michelsen et al. *Lærebog om indkomstskat* [Textbook on Income Tax], (Copenhagen: DJØF Publishing, 2003), at 247.

48. See the comments on Act 439 of 10 June 1997 (L 194) re Sec. 1.

49. Cf. State Tax Act, Sec. 6a.

50. Regarding the above criteria, see *TfS* (2003), 408 V.

51. See e.g. Erik Werlauff, *Skatteretlig respons* [Tax Law Response] (2001), at 25.

52. See Tax Assessment Guidance 2005 E.A.2.8.2.

53. See e.g. Kjeld Hemmingsen, *Driftsomkostninger i teori og praksis* [Operating expenses in theory and practice], (Copenhagen: Magnus Informatik, 2003), at 125 (stating that the courts have been very reluctant to allow a deduction for losses on securities and guarantees).

54. Gains on Securities and Foreign Currency Act, Sec. 3.

55. See *TfS* (2001), at 743 V, *Henry Stenders Handelsselskab ApS*, in which a parent company suffered a loss on a third-party loss security for the subsidiary's debt to the bank. As it could not be documented that a final agreement to convey half of the company's shares in the subsidiary had been concluded (by which the ownership would become less than the 50% which is required by the group rule), the parent was unable to deduct the loss on the subsidiary. See the then effective Sec. 6B of the Gains on Securities and Foreign Currency Act.

56. For general discussion on subsidies in a tax law construction, see Jakob Bundgaard, *SpO* (2004), at 355.

57. *TfS* (2000), at 243 H.

58. The stated practice appears from LV 2005 A.E. 1.1.4. See, however, LSR (1985), at 162, in which the claim seemingly was decisive as a general condition for unsecured guarantee.

adjustments will be made if there is a lack of payment for the security.

This article has discussed the tax law issues that arise in connection with the provision of security. Also tak-

ing into account the international theory and practice, a better tax law foundation for future rulings and decisions has been presented with regard to the use of security in corporate and group structures.

INDIA

Advance Ruling on Taxability of Fees Paid to Canadian Consultants for Work Done in Canada

Sanjay Sanghvi¹

1. INTRODUCTION

The taxability of fees paid for technical or consultancy services by a resident to a non-resident, especially where the services are rendered outside India, often becomes the subject of doubt and debate. On 9 September 2005 the Authority for Advance Rulings (AAR) delivered a noteworthy ruling in the case of *South West Mining Limited*. That case dealt with the issue of taxability in India of consultancy fees paid to a Canadian consultant for carrying out certain research and analysis studies in Canada.

This article will consider the Court's ruling and its ramifications.

2. FACTS AND BACKGROUND

The applicant is a company registered in India under the Indian Companies Act, 1956, and a tax resident of India. It owns certain mines and is engaged in the business of prospecting and extraction of minerals, metals, ores, etc.; it carries on the business of exporting minerals. For the purpose of its business, the applicant obtains an analysis of samples and ores conducted by a technical lab (a Canadian-based consultant – Met-Chem Canada Inc.).

The Indian company and the Canadian consultant entered into an agreement under which the material required to be analysed and tested in the laboratory in Canada in respect of specific contents would be sent to the consultant in Canada, which from time to time would send its reports to the applicant in India. In exchange for such services, the Canadian consultant was compensated in Canadian dollars in Canada. Further, the Indian company was also required to bear the costs of travel and hotel accommodations incurred by the technical consultants who would visit India at various intervals in order to collect random samples at the mining head of the proposed mining areas of the company. In light of the above facts, the Indian company sought advance rulings from the AAR on the following questions:

- whether the services rendered by the Canadian consultants are to be regarded as rendered inside

- India or outside India for purposes of determining the taxability of fees paid to them in Canada; and
- if the services rendered by the Canadian consultant are to be regarded as rendered in India, what rate of withholding tax will apply in India.

3. ANALYSIS OF THE ADVANCE RULING

3.1. Arguments of the parties

The AAR concluded that services involving sample analyses of ores collected from India and tested in a lab in Canada are to be treated as rendered in India and hence, the related fees are taxable in India.

The Indian company argued that the consultants were carrying out necessary lab tests on iron ore in Canada, and the reports were also prepared in Canada; thus the fees should fall under the exception found in Sec. 9(1)(vii)(b) of the Income Tax Act (the Act). Under that provision, "fees for technical services" (FTS) are not taxable in India if they are payable in respect of services utilized in a business carried on by a person outside India, or for the purpose of making or earning any income from any source outside India.

It was also argued that the fees payable to the Canadian consultants were outside the scope of FTS in view of Circular 786 of 7 February 2000 and Circular 23² of 23 July 1969, issued by the Central Board of Direct Taxes (part of the Ministry of Finance). Accordingly, it was contended that no withholding tax should apply under Sec. 195 of the Act on payment of fees to the Canadian consultants.

The AAR observed that two key questions needed to be answered first in order to determine the taxability of fees paid to the Canadian consultants, namely:

- whether the fees payable by the applicant to the consultant for the analysis and lab testing of samples of iron ore, etc., as well as for sending reports

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2. Circular 23 provides clarification on the taxability of certain transactions effected by a resident of India with a non-resident, such as a non-resident exporter selling goods from abroad to an Indian importer, or a non-resident company selling goods from abroad to its Indian subsidiary.