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TP CASE SUMMARY

EAC vs DENMARK

DENMARK - OCTOBER 2021

ACADEMY OF TAX LAW

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HEAD OF ACADEMICS

Welcome to the Academy of Tax Law's case and judgment summaries. These documents have been carefully curated to support professionals, students, and researchers navigating the complex landscape of international tax and transfer pricing. At the Academy, we understand that tax law is ever-evolving, with key rulings continuously shaping its practice.

Each summary you'll find here is designed to provide not just the facts, but the context and implications of pivotal legal decisions. These case summaries are created to serve as a valuable resource for legal teams, multinationals, revenue authorities, and academics, offering insights that go beyond the surface. Our goal is to ensure you remain informed and prepared, whether you are dealing with tax planning, dispute resolution, or risk management.

We believe that knowledge is the foundation of sound decision-making, and with these resources, we hope to empower you in your professional journey. As you delve into the analysis, remember that staying ahead in tax law requires not just understanding the rules but how to apply them in a dynamic, global environment.

Thank you for choosing the Academy of Tax Law as your partner in this ongoing learning experience.

Sincerely,
Dr. Daniel N Erasmus

PART 1

SUMMARY

JUDGEMENT SUMMARY

CASE OVERVIEW

Court:	Østre Landsret
Case No:	BS-12642/2020 and BS-25280/2020
Applicant:	Ministry of Taxation
Defendant:	H1, H2
Judgment Date:	20 October 2021
Full Judgment:	https://tpcases.com/wp-content/uploads/Denmark-vs-EAC-October-2021-ENGNW.htm
View Online:	https://academyoftaxlaw.com/denmark-vs-eac-transfer-pricing-case/

JUDGMENT SUMMARY

This case revolves around whether the taxable income of H1 and H2 should be increased under Denmark's Tax Assessment Act, Section 2, by reclassifying payments between related entities as interest or royalties. The case encompasses two separate tax disputes, one involving whether interest should be applied to royalties due between a Danish parent company and its Venezuelan subsidiary, and another focusing on the classification of extraordinary dividends as royalty payments.

The court ruled that the extraordinary circumstances of Venezuela's currency restrictions and force majeure provisions in the licensing agreements negated the Ministry of Taxation's attempt to increase H1's taxable income for several years. The court found that the Venezuelan subsidiary had made all efforts to remit royalties but was impeded by governmental restrictions beyond its control. The case also involved the classification of dividends as royalty payments, where the court similarly ruled that the Ministry had not sufficiently proven that an independent party would have acted differently under comparable circumstances. As a result, the court dismissed the Ministry's claim for both cases, reducing the proposed tax increases to DKK 0 for the respective years.

KEY POINTS

OF THE JUDGMENT

BACKGROUND

The case involves the Danish Ministry of Taxation's claims against the multinational group H1 (formerly G1-A/S) and its subsidiary H2. The core issue spans two different tax disputes for the income years 2008-2011 and 2012-2013. H1, the Danish parent company, had a subsidiary (G2-virksomhed) in Venezuela, which was subject to strict currency control regulations under Venezuelan law, making it difficult to remit royalties to H1 in Denmark.

The first dispute, Case BS-12642/2020-OLR, concerns whether the Ministry of Taxation was justified in increasing H1's taxable income by fixing interest on royalties receivable from G2 for the income years 2008-2011, which H1 claimed were unpaid due to Venezuelan currency restrictions. The Ministry argued that H1 should have accrued interest on these amounts in compliance with the arm's length principle as per Section 2(1) of the Danish Tax Assessment Act.

The second dispute, Case BS-25280/2020-OLR, pertains to the reclassification of extraordinary dividends paid by G2 to H1 in 2012-2013 as royalty payments. The Ministry of Taxation argued that, had the parties been independent, royalties would have been prioritised over dividend payments. Thus, the Ministry sought to increase the taxable income of H1 and H2 for these years.

KEY POINTS
OF THE JUDGMENT

KEY POINTS
OF THE JUDGMENT

CORE DISPUTE

The core dispute in both cases centres on the application of the arm's length principle and the question of whether H1's taxable income should be increased due to royalty and interest payments that were either unpaid or reclassified as dividends. The Ministry of Taxation claimed that independent entities in similar circumstances would have made these payments, and therefore, H1 should be taxed on these amounts.

In the first case, the Ministry argued that H1 should have accrued interest on unpaid royalties from G2 for the years 2008-2011. The Ministry claimed that under the arm's length principle, the interest should have been accrued and taxed in Denmark. However, H1 argued that G2's inability to pay royalties was due to Venezuelan currency restrictions and that no independent party would have been able to make these payments.

In the second case, the Ministry sought to reclassify dividends paid by G2 in 2012-2013 as royalty payments. The Ministry's position was that an independent party would have prioritised paying off royalties due before distributing dividends. H1 argued that the payments were made as dividends with the approval of the Venezuelan government and that these could not be classified as royalties under Venezuelan law.

COURT FINDINGS

The court ruled in favour of H1 and H2 in both disputes. It found that the Ministry of Taxation had failed to prove that the transactions between H1 and G2 did not comply with the arm's length principle. In the first case, the court accepted that the unpaid royalties were a result of exceptional currency restrictions imposed by the Venezuelan government, which constituted a force majeure event under the licensing agreements. It was ruled that no interest could be applied under these circumstances, as no independent party would have acted differently.

For the second case, the court held that the Ministry had not sufficiently demonstrated that the dividends paid by G2 should be reclassified as royalty payments. The court noted that the payments had been made legally under Venezuelan law with the necessary government approvals, and therefore, they could not be reclassified as royalties.

The court further observed that the force majeure clauses in the agreements between H1 and G2 shielded G2 from liability for non-payment of royalties due to factors beyond its control, such as the severe currency restrictions in Venezuela.

KEY POINTS

OF THE JUDGMENT

OUTCOME

The outcome of the case was a complete victory for H1 and H2. In both disputes, the court ruled that the Ministry of Taxation's claims were unfounded, and the proposed increases in taxable income were reduced to DKK 0. In Case BS-12642/2020-OLR, the court ruled that no interest should be applied to the unpaid royalties from G2 to H1, as the payments were not made due to external circumstances beyond G2's control, notably the Venezuelan currency restrictions. Therefore, the Ministry's claim to increase taxable income for the years 2008-2011 was dismissed.

In Case BS-25280/2020-OLR, the court found that the dividends paid by G2 in 2012-2013 were not disguised royalty payments and that they had been lawfully distributed under Venezuelan law. The court concluded that the Ministry had not demonstrated that an independent party would have made different decisions regarding the prioritisation of payments, dismissing the claim to reclassify the dividends as royalty payments.

TP METHOD

HIGHLIGHTED (IF ANY)

In both cases, the Ministry of Taxation relied on the arm's length principle, as outlined in the OECD Transfer Pricing Guidelines, to argue that the transactions between H1 and G2 should be adjusted for tax purposes. However, the court found that the Ministry had not proven that the arm's length principle was violated, given the unique circumstances surrounding the Venezuelan currency restrictions.

PART 2

SIGNIFICANCE

MAJOR ISSUES

AREAS OF CONTENTION

The main area of contention in this case was the interpretation and application of the arm's length principle in light of the extreme currency controls and economic instability in Venezuela. The Ministry of Taxation argued that independent entities would have behaved differently, particularly in relation to the timing and prioritisation of payments. The Ministry also questioned whether the force majeure clauses in the licensing agreements should relieve G2 of its obligations to pay royalties.

Another significant issue was whether the Ministry had the authority to reclassify dividends as royalty payments. The Ministry contended that, under normal circumstances, an independent party would have prioritised settling royalty obligations before paying dividends to shareholders. However, H1 successfully argued that the payments were made legally under Venezuelan law and were approved by the Venezuelan government.

EXPECTED
OR CONTROVERSIAL?

The decision was somewhat expected, given the unique circumstances surrounding Venezuelan currency restrictions, but it was controversial in tax circles. The application of the arm's length principle in such extraordinary circumstances, where government-imposed restrictions prevent normal business operations, posed a significant challenge for both the Ministry of Taxation and the court.

While the Ministry's arguments were grounded in the OECD Transfer Pricing Guidelines, the court emphasised the real-world complexities that companies face in countries with restrictive foreign exchange regimes. The court's reliance on the force majeure clauses in the licensing agreements further strengthened the decision in favour of H1. This case highlighted the difficulties

SIGNIFICANCE
FOR MULTINATIONALS

This judgment is highly significant for multinational enterprises (MNEs) operating in jurisdictions with restrictive currency controls or other government-imposed limitations. It reaffirms that force majeure provisions in contracts can provide relief from certain obligations, such as interest payments on royalties, where external factors prevent performance. MNEs operating in countries with unstable political and economic environments should carefully draft force majeure clauses to ensure they are protected in case of government actions that affect their ability to transfer funds.

Furthermore, the judgment illustrates that tax authorities may face difficulties in applying the arm's length principle rigidly in such environments. MNEs can take comfort in knowing that courts may take a pragmatic approach, considering the broader context and external factors beyond the company's control.

SIGNIFICANCE

FOR REVENUE SERVICES

For revenue services, this judgment serves as a cautionary tale. It highlights the importance of understanding the economic and political context of the jurisdictions in which multinationals operate. The Ministry of Taxation's attempt to apply a strict interpretation of the arm's length principle without considering the severe currency restrictions in Venezuela ultimately led to the dismissal of their claims.

Revenue authorities must ensure that their transfer pricing adjustments are supported by sufficient evidence that independent parties would have acted differently under similar circumstances. This case also underscores the need for tax authorities to engage in constructive dialogue with MNEs operating in high-risk jurisdictions and to consider the practical difficulties they face in complying with transfer pricing regulations.

SIMILAR CASES

UK VS CADBURY SCHWEPPES (C-196/04)

This landmark case involved the application of the UK's Controlled Foreign Company (CFC) rules and whether they restricted the freedom of establishment. The ECJ ruled that restrictions could be justified to prevent wholly artificial arrangements, setting a precedent for anti-abuse rules.

https://academyoftaxlaw.com/cadbury-schweppes-cfc-case/

SWEDEN VS LEXEL (C-484/19)

In this case, the ECJ considered Swedish tax legislation that restricted interest deductions on intra-group loans. The Court ruled that even transactions conducted on arm's length terms could be restricted if part of a wholly artificial arrangement.

https://academyoftaxlaw.com/lexel-ab-v-sweden-interest-deductions/

X BV VS NETHERLANDS (CASE C-337/08)

This case involved the consolidation of profits and losses within a group and whether a parent company could form a tax group with a subsidiary in another Member State. The CJEU ruled that restrictions on forming cross-border tax groups were justified by the need to maintain a balanced allocation of tax powers between Member States.

https://academyoftaxlaw.com/wholly-artificial-arrangement-tax-case/

PART 3

PREVENTION

ENGAGING EXPERTS

Given the complexity and increased scrutiny surrounding cross-border transactions, it is crucial for MNEs to engage transfer pricing experts. These experts can help ensure that intra-group transactions are not only priced at arm's length but also supported by genuine economic substance, reducing the risk of tax disputes. Transfer pricing experts play a critical role in:

- Structuring transactions in a way that complies with both transfer pricing regulations and anti-abuse rules.
- Preparing robust documentation that demonstrates the commercial rationale behind cross-border transactions.
- Helping businesses navigate the complex web of national and international tax laws to avoid potential tax risks.

PREVENTATIVE

MEASURES TO AVOID SIMILAR CASES

TAX RISK MANAGEMENT PROCESS

Implementing a comprehensive tax risk management process is essential to identify, assess, and mitigate tax risks associated with cross-border transactions. This process should involve:

- Regular reviews of intra-group transactions to ensure they have genuine economic substance.
- Proactive engagement with tax authorities to seek clarity on the application of anti-abuse rules.
- Thorough documentation of the business rationale for each transaction to support

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TAX INTELLIGENCE: THE 7 HABITUAL TAX MISTAKES MADE BY COMPANIES

Tax Intelligence: The 7 Habitual Tax Mistakes Made by Companies" by Dr. Daniel N. Erasmus is a must-read for businesses seeking to navigate the intricate world of tax compliance and risk management. By highlighting common pitfalls and offering strategic solutions, Erasmus equips companies with the knowledge to improve their tax practices and secure financial stability.

https://support.academyoftaxlaw.com/product/tax-intelligence-by-prof-dr-daniel-n-erasmus/

PREVENTATIVE

MEASURES TO AVOID SIMILAR CASES

TAX STEERING COMMITTEE

Establishing a tax steering committee can help ensure that tax policies are aligned with the broader business strategy and that transactions are vetted for both commercial and tax implications. A tax steering committee can:

- Review all significant cross-border transactions before they are executed.
- Ensure that tax decisions are made in the context of overall business objectives, not solely for tax savings.
- Monitor changes in international tax laws to ensure ongoing compliance and avoid disputes like the X BV case.

DOWNLOAD FREE E-BOOK

DRIVING TAX COMPLIANCE: THE ESSENTIAL ROLE OF THE TAX STEERING COMMITTEE

The eBook "Driving Tax Compliance: The Essential Role of a Tax Steering Committee" by Prof. Dr. Daniel N. Erasmus, Renier van Rensburg, and Gilbert Ferreira, emphasizes the critical importance of establishing a Tax Steering Committee (TSC) within multinational corporations to ensure tax compliance and manage tax-related risks effectively.

https://support.academyoftaxlaw.com/product/essential-role-of-the-tax-steering-committee/

TP CASE
SUMMARY

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