

RECHARACTERIZATION OF TRANSACTIONS BETWEEN RELATED PARTIES

Danish-Swedish Tax Network



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20 AUGUST 2024

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INTRODUCTION

Recharacterization of transactions between related parties

- Transactions between related parties?
- Recharacterization?



AN ILLUSTRATIVE CASE FROM REAL LIFE

THE MOGASCASE

MOGAS conducted **preliminary investigations** in various parts of the world until 2018 to discover new oil fields.

Any further oil exploration and initiation of oil production took place in **subsidiaries/branches** established following the preliminary investigations, including in Algeria and Qatar.

MOGAS provided technical and administrative services (**timewriting**) to companies within the group, including to APMM and its subsidiaries.

In Algeria, MOGAS' oil activities began after preliminary investigations in 1990.

MOGAS' subsidiary, Mærsk Oil Algeria A/S, acquired rights and obligations under a license agreement with Sonatrach, and MOGAS provided a **performance guarantee** to Sonatrach:

MOGAS "will support Mærsk Oil, Algeria AS with the full technical and financial capacities needed by Mærsk Oil, Algeria AS in order to commit and comply with its share of obligations under the Sonatrach Agreement ...".

Mærsk Oil Algeria consisted of a branch in Algeria with no employees and did not undertake operator tasks in connection with the oil project.

- In **Qatar**, MOGAS' oil activities began after preliminary investigations in 1992 with the establishment of a local branch of MOGAS' subsidiary, Mærsk Oil Qatar A/S, and the conclusion of an agreement between the subsidiary and Qatar for oil extraction (EPSA).
- MOGAS provided a **performance guarantee** to Qatar:
- MOGAS guarantees "the due and timely performance of all the obligations of the Subsidiary under and arising out of the EPSA" and to "provide the Subsidiary with all technology and specialist personnel necessary for the Subsidiary to fulfill its obligations under the EPSA."
- The subsidiary's branch in Qatar acted as the operator in connection with the oil project.
- MOGAS has **not received payment** from the subsidiaries for the **preliminary investigations or the performance guarantees** .
- MOGAS has **received payment** from the subsidiaries equivalent to cost price for the technical and administrative assistance (**timewriting**).

AN ILLUSTRATIVE CASE FROM REAL LIFE

THE ISSUES IN A NUTSHELL

In 2012, the Danish tax authority conducted a discretionary assessment of MOGAS's income for providing valuable know-how to its subsidiary's foreign branches in Algeria and Qatar. The tax authority held the opinion that MOGAS (in the years preceding the incorporation of subsidiaries in Algeria and Qatar in the early 1990s) had incurred expenses for preliminary investigations, which constituted controlled transactions for the income years 2006-2008.

The transfer pricing documentation provided by MOGAS only covered the provision of time writing and did not include the expenses incurred for the initial investigations or the provision of performance guarantees.

- Essentially, the Danish Tax Agency concluded that MOGAS's business model implies that the company would never be able to generate a profit from its activities due to its structure. They viewed the persistent losses of a group entity as an indication of additional controlled transactions, which they were authorized to adjust. As a result, the tax agency adjusted the consolidated group income for the same income years.



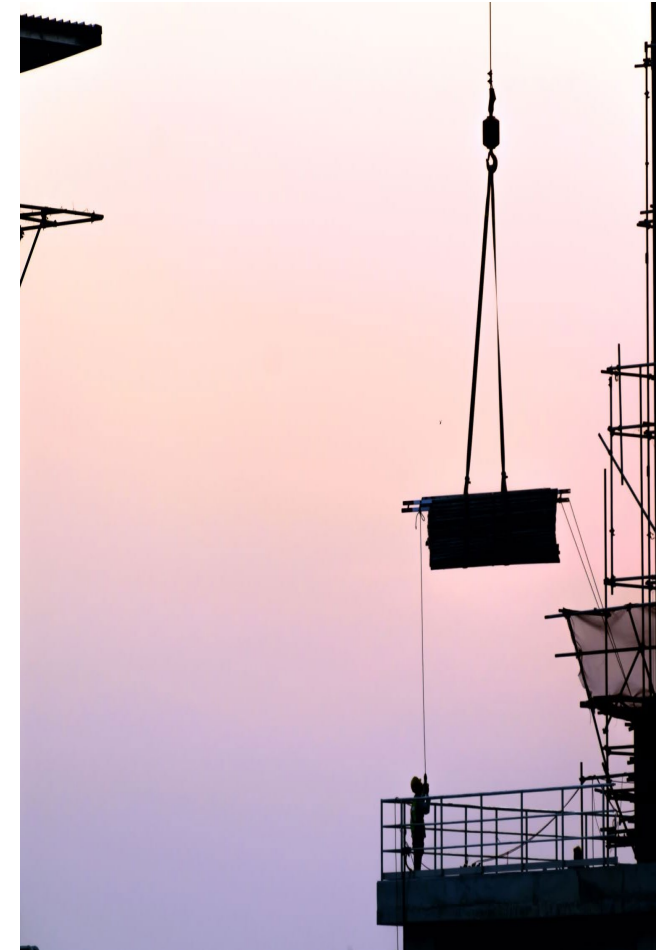
AN ILLUSTRATIVE CASE FROM REAL LIFE SUPREME COURT JUDGMENT

Preliminary investigations and performance guarantees

Controlled transactions or not?

Prior to the establishment of the subsidiaries and the acquisition of licenses in Algeria and Qatar, MOGAS conducted necessary preliminary investigations to assess whether oil exploration and possible subsequent oil or gas extraction should be established.

- MOGAS played a significant role in the negotiation of contracts in these countries, and the subsidiaries only entered into the contracts because MOGAS undertook to guarantee and provide its technical and financial capacity.
- MOGAS had special knowledge and experience (knowhow) regarding, among other things, horizontal drilling, which MOGAS continuously made available to the subsidiaries.
- → Preliminary investigations and performance guarantees, along with associated knowhow, have economic value for the subsidiaries, which an independent party would require ongoing payment for in the form of profit sharing, royalties, or similar.
- It is not considered relevant that the preliminary investigations were completed by MOGAS in 1990 and 1992 (long before the relevant income years).
- It is not considered relevant that potential oil extraction required significant exploration expenses in the subsidiaries, or that the occurrence of oil and its exploitation were associated with uncertainty.
- Preliminary investigations and performance guarantees constitute controlled transactions covered by section 2 of the Danish Tax Assessment Act, also for the income years 2006-2008.
- Thus, the Danish tax authorities could only estimate the income by assessment.



AN ILLUSTRATIVE CASE FROM REAL LIFE SUPREME COURT JUDGMENT

Timewriting

- For the reasons stated by the Eastern High Court, MOGAS' income related to time writing could not be estimated as a result of the lack of transfer pricing documentation.
- For the reasons stated by the Eastern High Court, the Danish Ministry of Taxation has demonstrated that MOGAS' provision of time writing to its subsidiaries at cost price falls outside the scope of what could have been achieved if the agreement had been made between independent parties, cf. section 2 of the Tax Assessment Act.
- Since MOGAS has not received payment for time writing at arm's length terms, the Agency has correctly estimated the taxable income related to time writing by assessment.



AN ILLUSTRATIVE CASE FROM REAL LIFE SUPREME COURT JUDGMENT

The Danish Tax Agency's assessment–Aggregated transactions

- Subsequently, the basis for the discretionary assessment of MOGAS's taxable income for the years 2006-2008 regarding preliminary investigations, performance guarantees, and time writing is established.
- Discretionary assessments, according to the preparatory work, are made on the best possible basis that tax authorities can find and in accordance with the principles of the OECD guidelines.
- The implications of relevant preparatory work indicate that the discretionary determination of a firm's length compensation ideally should be carried out on individual transactions, but these transactions may be so closely connected that they must be assessed together.
- The Danish Tax Agency based its assessment on the profit realized by group-affiliated entities in Algeria and Qatar and subsequently distributed the profit among the affiliated companies based on an analysis of the functions each company contributed. This is a model recognized in the OECD guidelines in situations where more traditional methods cannot be applied due to the nature and interdependence of transactions.
- The transactions in question are so closely related that in the discretionary determination of economic compensation, they must be assessed together.
- MOGAS has not provided calculations, valuations, or similar evidence to refute the Agency's assessment; this is confirmed by the information in the Danish Ministry of Taxation's benchmark report submitted to the High Court.
- Hence, there is no basis for refuting the agency's discretionary increase in APMM's taxable consolidated income for the years 2006-2008.



PARTS OF MY PROJECT

- Legal basis for recharacterization?
 - Substance over form (realitet grundsaetningen) or interpretation of material rules (especially the Danish Act on Taxation of Income and Property §§ 4-6)
 - The Danish Tax Assessment act § 2?
 - The Danish Tax Assessment act § 3?
- Recognition of the accurately delineated transaction
- Conditions to be met to recharacterize?

