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No Permanent Establishment for Foreign Private Equity Funds in Denmark

Lærke Hesselholt and Karsten Gianelli
Grant Thornton Denmark

For some time it has been unclear whether foreign investors in Danish transparent entities were subject to Danish income taxation of their share of the income in the entity. However, the Danish tax authorities have now eliminated this uncertainty and have defined the conditions for establishing investment structures via Danish transparent entities in which foreign investors are not subject to any Danish taxation.

I. Introduction

Tax transparent Danish corporate entities have for years been regarded as suitable for private equity funds in which all investors are foreign (i.e. not Danish) and the investments of the fund are made outside Denmark.

The advantages of these structures are:

- On one hand, to establish a separate entity with full legal capacity to enter into agreements and other obligations and governed by Danish law, which is quite uncomplicated and operational in comparison to many other jurisdictions.
- On the other hand, to ensure that the investments—as a result of the tax transparency—are not taxed separately at the Danish entity, but only on the level of the investors.

Thus, the use of a transparent Danish entity in these structures will only be relevant if it does not result in Danish taxation of the investors. One of the main considerations is, therefore, to ensure that the foreign investors does not establish a permanent establishment in Denmark for income tax purposes.

The Danish Tax Assessment Council (*Skatterdet*) has, in three recent decisions, set out the conditions for that.

II. Tax Transparent Entities

Corporate entities in which all shareholders have limited liability are for Danish tax purposes regarded as separate entities subject to corporate income taxation in Denmark.

However, corporate entities in which one, some or all shareholders have unlimited liability with regard

Lærke Hesselholt is Tax Director and Karsten Gianelli is Senior Tax Manager at Grant Thornton Denmark

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to the obligations of the corporate entity are for Danish tax purposes not regarded as separate entities but as tax transparent entities. Thus, these entities are not taxed separately but the profit/loss of the entity will be —as a result of the transparency—be taxed directly at the level of the shareholders. Distributions from the transparent entity to the shareholders is, consequently, not regarded as a distribution of dividends for Danish tax purposes and will, therefore, not be subject to any Danish withholding tax.

The tax transparent entities include the following:

- The unlimited partnership (*Interessentskab* or *I/S*) in which all partners have unlimited liability for the partnership's obligations. The unlimited partnerships are not subject to the Danish corporate legislation, but primarily based on common law.
- The limited partnership (*kommanditselskab* or *K/S*), normally with one unlimited liability partner (*komplementaren*) and a number of limited liability partners (*kommanditister*). The limited partnerships are not subject to the Danish corporate legislation, but primarily based on common law. The unlimited liability partner will often be a Danish corporation set up for this particular purpose and often owned by the limited partners. The unlimited liability partner does not need to own a share of the limited partnership.
- The partner company (*partnerselskab* or *P/S*) which is similar to a limited partnership with at least on unlimited liability partner and a number of limited liability partners, but subject to most of the Danish corporate legislation pursuant to the Danish Companies Act.

The entity normally used for foreign private equity funds is the limited partnership.

III. Requalification of Transparent Entities

However, the tax transparent entities will—in some cases—be requalified as non-transparent, i.e. as separate entities for Danish tax purposes, pursuant to Section 2 C of the Corporate Tax Act.

The requalification will apply to all Danish transparent entities defined as:

- entities legally registered in Denmark, i.e. registered at the Danish Corporate Authorities;
- entities seated in Denmark pursuant to the Articles of Association; or
- entities having their seat of effective management in Denmark.

The requalification on a Danish transparent entity will apply if direct owners, i.e. shareholders, owning more than 50 percent of the capital or controlling more than 50 percent of the votes in the entity are resident in another tax jurisdiction:

(i) in which the transparent entity is regarded as a separate entity for tax purposes. e.g. pursuant to the U.S. check-the-box rules; or

(ii) which is not a member of the EU and does not have a tax treaty covering dividends with Denmark. This includes shareholders in typical tax haven jurisdictions.

The main effects of the requalification is that the entity will be subject to Danish corporate tax at the rate of 22 percent as other Danish companies, and that distributions from the entity to its shareholders will be regarded as distribution of dividends subject to Danish withholding tax at the rate of 27 percent.

IV. Transparent Entities and Permanent Establishment

The effect of the transparency is—as mentioned above—that the profit/loss of the transparent entity is not taxed at the level of the entity but at the level of the investors. Thus, the income of the transparent entity will, for income tax purposes, will allocated among the shareholders and taxed directly at the level of the shareholders.

This transparency and taxation at the level of the shareholders will apply regardless whether the shareholders are Danish or foreign and regardless whether the shareholders are corporate entities or individuals.

Thus, shareholders not resident in Denmark and, thereby, not subject to unlimited tax liability in Denmark, will only be subject to Danish income taxation if this income is subject to limited tax liability in Denmark, i.e. is derived from a permanent establishment in Denmark. Thus, the income from the transparent entity will only be taxable in Denmark for the foreign investors if the transparent entity in itself constitutes a permanent establish for Danish tax purposes.

Under Danish tax law the term "permanent establishment" is interpreted in accordance with Article 5 in the OECD Model Tax Treaty.

Pursuant to Article 5(1) the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on. Thus, the transparent entity will constitute a permanent establishment for its foreign shareholders if it conducts business activities from a fixed place, i.e. an office etc., in Denmark.

Further, pursuant to Article 5(5) activities via an agent acting on behalf of the principal will constitute a permanent establishment for the principal, provided, however, only if the agent is dependent of and subject to instructions from the principal. Thus, the transparent entity—and its foreign shareholders—will have a permanent establishment in Denmark if a Danish resident dependent agent subject to instructions from the transparent entity/the shareholders carry out business activities on behalf of the transparent entity.

V. Recent Case Law

The Tax Assessment Council have recently issued three binding rulings (SKM2017.12, SKM2017.13 and SKM2017.14) which give quite precise guidelines with

regard to whether foreign investors in a Danish transparent entity are regarded as having a permanent establishment for tax purposes in Denmark.

The facts of all three cases were more or less similar and involved the following parties/entities:

- A private equity fund structured as a Danish limited partnership (K/S) with a number of limited partners, Danish as well as foreign. The limited partnership would:
  - — be making equity investments in Danish and foreign corporations and, in one of the cases, investments in greentech projects outside Denmark;
  - — not have any office premises or any employees;
  - — be a passive investment fund for which all investment decisions were made by the management of the unlimited partner, cf. below, and administered by the management company, cf. below.
- An unlimited partner in the Danish limited partnerships. The unlimited partner were in two of the cases Danish foundations established by Danish the management company and in the third case a Danish corporation owned by the limited partners. The unlimited partner would:
  - — not have any office premises or other employees;
  - — be managed by the Board of Directors or a number of managing directors; and the management of the unlimited partner would:
    - o be financially and legally independent of the limited partners as well as of the management company;
    - o make all investment decisions for the limited partnership;
    - o not be subject to any instructions in this regard from the limited partnership, the limited partners or the management company apart from the general investments strategy determined at the establishment of the limited partnership.
- The management company, which was a Danish company with Danish office premises and a number of Danish employees. The management company would:
  - — provide administrative and investment advisory services to the limited partnership, however, all the management of the unlimited partner would make all investment decisions for the limited partnership;
  - — provide these kind of services to a number of other investments funds;
  - — not be subject to any instructions from the limited partnership or the limited partners.

Based on these facts the Tax Assessment Council found in all three cases that the Danish limited partnership did not have a permanent establishment for tax purposes in Denmark. Thus, foreign limited partners in the limited partnership did not have a permanent establishment in Denmark and would, consequently, not be subject to any Danish income taxation of their share of the profits in the limited partnership.

However, the decisions were, in all three cases, based on the following assumptions:

- That Danish investors or investors resident in jurisdictions with a tax treaty with Denmark covering dividends and not treating the limited partnership as a separate entity would own more than 50 percent of the limited partnership. Thus, that the Danish limited partnership was not requalified as a separate entity pursuant to section 2C of the Corporate Tax Act, cf. above.
- That none of the foreign investors conducts other business activities in Denmark.

Further, the independence of the actual management, i.e. of the transparent entity is a decisive factor. Thus, the Tax Assessment Council have in a decision from 2013 (SKM2013.899) stated that a Danish limited partnership—and thereby its foreign limited partners—did have a permanent establishment in Denmark. The main reason for this decision was the fact that the majority of the members of the management of the unlimited partner, which was making the investment decisions for the partnership, also were partners in the Danish management company. Thus, the limited partnership was regarded as having a permanent establishment at the premises of the Danish management company.

VI. Conclusion

The recent rulings from the Tax Assessment Council has confirmed that the use of Danish transparent entities in private equity funds structures is possible and does not result in any Danish taxation of any foreign investors.

However, this will only be the case if the Danish transparent entity does not set up a permanent establishment in Denmark. A crucial element in this regard is to ensure that the investments decisions are not made by a Danish managing company or by the investors, but by individuals who are financially and legally independent of the foreign investors as well as of a Danish managing company.

Further, it must be noted that the structure will only work if a majority of the investors are either Danish or resident in jurisdictions with a tax treaty covering dividends with Denmark.

Thus, the advice from Danish tax experts is recommended if the use of Danish transparent entities is considered.

Lærke Hesselholt is Tax Director and Karsten Gianelli is Senior Tax Manager at Grant Thornton Denmark

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