

Rulings on Deductibility of Acquisition Costs and Management Fees

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1. Introduction

The Danish market for merger and acquisition (M&A) transactions has witnessed a high level of activity in recent years. One of the driving forces has been private equity funds, which have been involved in the take-over of several high-profile Danish companies, the largest so far – and reported to be largest leveraged buy out in Europe ever - being the takeover of a majority of the shares in the listed Danish telecom TDC A/S by a consortium of five private equity funds. As the costs related to an M&A transaction can be quite significant, the tax treatment of acquisition costs is often a significant element in an M&A transaction. Furthermore, as management fees including various forms of incentive schemes seem to be a customary part of almost every M&A transaction, the tax treatment of the such fees is also a significant consideration in M&A transactions.

2. Tax Treatment of Acquisition Costs

As a general rule, Danish tax law distinguishes between operating costs (i.e. costs incurred to earn, secure or maintain income) on the one hand, and capital and establishment costs on the other. Operating costs are for tax purposes deductible, while capital and establishment costs are not. Acquisition costs generally do not fall within the category of operating costs and are therefore generally not deductible.

However, because Danish tax law is based on a net income principle, under which only net income or net gain is taxable, such non-deductible acquisition costs are instead added to the purchase price of the asset in question and therefore may be depreciated (assuming that the asset in question may be depreciated) or may reduce any taxable capital gains realized upon a subsequent sale of the asset. Most types of assets (e.g. operating equipment, goodwill, other intangible assets and land and buildings) may be depreciated, and therefore in asset deal transactions, the acquisition costs may be deducted indirectly as depreciation. Shares may not be depreciated, and capital gains on shares held by a company for at least three years are tax-exempt. Generally, acquisition costs in share deal transactions therefore are effec-

tively lost if the shares are sold after three years or more (assuming, of course, that the seller of the shares is a company).

In 1991, a provision was inserted as Sec. 8J of the Danish Tax Assessment Act¹ (TAA), under which certain acquisition costs may be deducted for tax purposes. Sec. 8J(1) – (3) reads as follows (unofficial translation):

1. Costs for lawyers and auditors incurred in connection with the establishment of a new business or the expansion of an existing business may be deducted from the taxable income. The same applies to fees paid to the Danish Commerce and Companies Agency.
2. Costs incurred before the establishment or expansion of a business may be deducted in the income year in which the establishment or expansion of the business is effected.
3. Costs which are to be considered to be an addition to the purchase price or a deduction from the sales price of an asset, may not be deducted pursuant to section 1.

It follows from the wording of Sec. 8J(1) that the provision applies only to costs for lawyers and auditors. Consequently, other acquisition costs (e.g. fees paid to investment bankers, other financial advisers and consultants) are not deductible under Sec. 8J(1), and such costs therefore may be utilized for tax purposes only to the extent that they are attributable to assets that may be depreciated for tax purposes or may reduce any taxable capital gains realized upon a subsequent sale of the assets in question.

Judging from the number of published rulings, Sec. 8J(1) appears not to have given rise to many disputes in the 1990s. However, this all changed in the beginning of the new millennium when the tax authorities established a practice of denying the deduction of costs under Sec. (J(1) for lawyers and auditors incurred in connection with the purchase of shares. This practice was based on an interpretation of the wording of Sec. 8J(1) according to which the mere holding of shares did not – in the opinion of the tax authorities – constitute a "business" within the meaning of Sec. 8J(1). Therefore, the tax authorities were of the opinion that costs for lawyers and auditors in a share deal did not fall within Sec. 8J(1) because the purchase of shares did not constitute an establishment or expansion of a business. Thus, according to the tax authorities, only costs for lawyers and auditors incurred in asset deal transactions were deductible under Sec. 8J(1).

The tax authorities' interpretation of Sec. 8J(1) was tested in the *Johnson Holding* case.² Johnson Holding ApS was incorporated on 31 October 1997 by way of a tax-exempt exchange of shares and held 100% of the shares in the company Johnson Agency A/S. The National Tax Tribunal found that the mere holding

¹. All statutory references are to the Tax Assessment Act.

². Published in the Danish Journal of Tax Law (TfS) 2004, 542.

of shares did not constitute a "business" within the meaning of Sec. 8J(1) and therefore held that the costs for lawyers and auditors incurred by Johnson Holding ApS in connection with the exchange of shares were not deductible under Sec. 8J(1).

Johnson Holding ApS appealed the ruling to the Eastern High Court, arguing that the holding of shares in other (non-tax) relations is considered a "business" and that Sec. 8J(1) should be interpreted to cover also the holding of shares. However, the Eastern High Court rejected this argument and upheld the ruling of the National Tax Tribunal.

On appeal two out of five Supreme Court judges concurred with the ruling of the Eastern High Court. However, the remaining three judges noted that it follows from the Danish Act on Public Limited Companies and the Danish Act on Private Limited Companies that public and private liability companies must be conducting business, and that this corporate law requirement from a corporate law perspective is considered to be met also in relation to a company which has no activity other than holding shares in another company. Accordingly, the starting point also from a tax law perspective should be that the holding of shares constitutes "business". The three Supreme Court judges then noted that neither the wording of Sec. 8J nor the preparatory works to the provision supported an interpretation where the holding of shares did not constitute "business" and held that the costs for lawyers and auditors incurred in connection with the incorporation of Johnson Holding ApS were incurred in connection with the "establishment or expansion of a business" and were therefore deductible under Sec. 8J(1).

The Supreme Court's ruling in the *Johnson Holding* case has given rise to considerable debate. Some see the ruling as a landmark decision establishing a general doctrine of conformity between civil law and tax law, while others argue that such an interpretation of the ruling is far too broad. However, for purposes of this article it is sufficient to note that the Supreme Court in its ruling rejected the distinction between share deals and assets deals established by the tax authorities with regard to the deductibility of costs for lawyers and auditors under Sec. 8J(1).

Following the Supreme Court's ruling in the *Johnson Holding* case, it appeared that the Supreme Court had cleared the way for full deductibility of costs for lawyers and auditors in both share deals and assets deals. For example, shortly after the Supreme Court's ruling in the *Johnson Holding* case, the National Tax Tribunal held that costs for auditors incurred by a company in connection with the issuance of new shares were deductible under Sec. 8J(1).³ In May 1999, the taxpayer company had acquired another company in a share deal financed by a bridge loan. In November 1999, the acquiring company raised DKK 820 million by way of issuance of new shares, and this amount was used to reduce the bridge loan. The tax authorities, relying on the distinction between share deals and asset deals, denied the deduction

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TFS 2004,770.

of the costs for auditors incurred in connection with the issuance of new shares, reasoning that the issuance of the new shares was a predetermined step in the share deal and that an acquisition of shares did not constitute an establishment or expansion of a business. However, the National Tax Tribunal referred to the Supreme Court's ruling in the *Johnson Holding* case and held that an acquisition of shares did indeed constitute the establishment or expansion of a business and that the disputed costs therefore were deductible under Sec. 8J(1).

However, it did not take long for the tax authorities to establish a second line of defence, this time based on Sec. 8J(3), which states that costs that are to be regarded as an addition to the purchase price or a deduction from the sales price of an asset, may not be deducted under Sec. 8J(1). According to the tax authorities, most types of costs for lawyers and/or auditors in a share deal transaction are to be regarded as an addition to the purchase price paid for the shares and therefore may not be deducted under Sec. 8J(1).

So far the courts have upheld this line of reasoning. For example in TfS 2006, 688, the Eastern High Court considered whether a company engaged in the production of instruments and equipment sold to doctors and hospitals could deduct costs for lawyers and auditors incurred in connection with three separate share deal transactions. The services rendered by the lawyers and auditors consisted of assistance in negotiations with the sellers, due diligence, advice regarding transaction and corporate structure, tax advice and drafting of share purchase agreements and other transaction-related documents. The Eastern High Court held that such costs are typical in share deal transactions and therefore had such a "direct and close connection" to the purchase of the shares that they were to be regarded as an addition to the purchase price under Sec. 8J(3). Consequently, the costs were not deductible.

The Eastern High Court's acceptance of the arguments put forth by the tax authorities in respect of Sec. 8J(3) raises the issue of the scope of application of Sec. 8J(1) with regard to share deals. If costs for due diligence, advice on transaction structure and drafting of transactions documents have such a "direct and close connection" to the purchase of the shares that they are to be regarded as an addition to the purchase price paid for the shares (so as to be non-deductible), it is hard to see how any costs typically incurred for lawyers and auditors in a share deal transaction could be deducted under Sec. 8J(1).

Furthermore, in a number of cases the National Tax Tribunal has previously held that only "directly attributable" costs are to be regarded as an addition to the purchase price in relation to asset deal transactions. Thus, in TfS 2001, 688 the National Tax Tribunal held that under Sec. 8J(1), costs for lawyers and auditors for due diligence and attendance at meetings with the seller were deductible in an asset deal transaction. The local tax authorities had argued that the costs should be regarded as an addition to the purchase price paid for the assets and, as such, were non-deductible. However, the National Tax Tribunal stated that only "directly attributable" costs should be regarded as being covered by Sec. 8J(3) and did not find that the costs in question constituted such "directly attributable" costs. Therefore, the costs were

deductible under Sec. 8J(1). From a practical perspective, the costs incurred by the acquiring company in Tfs 2001, 688 were identical to those incurred by the acquiring company in Tfs 2006, 688, and it is difficult to see why the question of whether costs should be added to the purchase price should depend on whether the costs are incurred in a share deal or in an asset deal. It is therefore possible that Tfs 2006, 688 signals a new course also with regard to asset deal transactions, such that the overwhelming majority of acquisition costs are to be regarded as an addition to the purchase price in both share deals and asset deals.

3. Tax Treatment of Management Fees

Danish tax law does not contain specific provisions governing the deductibility of management fees. Accordingly, the deductibility of such fees will therefore depend on whether they have been incurred in order to earn, secure or maintain the income of the company in question. In this regard, the distinction drawn in the OECD Transfer Pricing Guidelines between (1) the rendering of management services to a group company even though the group company does not need the services (shareholder costs) and (2) the rendering of management services which are useful for the group company and which it would be willing to pay for were it an independent enterprise, also has been applied by the Danish courts in a number of cases.

For example in Tfs 1997, 267, the Western High Court held that a company's payment of the full costs incurred in connection with the listing of the company's shares on a stock exchange constituted a hidden dividend. Even though the case concerned only the taxation of a shareholder of the company, it seems reasonable to assume that the Western High Court considered a portion of the costs to be shareholder costs, and that the company would not have been able to deduct the full costs had these been charged as a management fee instead.

Another example of the distinction between costs incurred in the interest of a company and costs incurred in the interest of shareholders is seen in a recent ruling⁴ concerning a transaction bonus paid to a company's management as a consequence of the sale of the company. In 2000, a bonus agreement was entered into between the company and two members of the company's management, under which the managers were to receive a cash bonus in the event of a sale of the company. The bonus would be calculated as a certain percentage of the sales price for the company, and the bonus would become payable only if a sale of the company were completed. The National Tax Tribunal noted that only costs incurred by a company in order to earn, secure or maintain the income of the company are deductible for tax purposes. The National Tax Tribunal found that the bonus agreement had been entered into in the inter-

⁴. Tfs 2005, 1011.

est of the shareholders of the company rather than in the interest of company, and therefore held that the company could not deduct the payment of the transaction bonus.

Danish transfer pricing legislation is based on the general arm's length principle. Accordingly, all transactions – including management service transactions – between controlled entities must be concluded on general market terms as if the parties to the transactions had been independent entities (the arm's length principle). Consequently, any management fees paid to an affiliated entity will be allowed as a deduction only to the extent that the fees have been determined on the basis of the arm's length principle.

Under transfer pricing documentation rules, Danish companies must prepare written documentation of prices and conditions for controlled transactions in compliance with the requirements set forth in the Statutory Order on the Documentation of Pricing of Controlled Transactions (the Statutory Order).⁵ These requirements are supplemented by guidelines issued by the tax authorities regarding transfer pricing documentation, which states that a company paying a management fee must account for the usefulness of the service paid for. This means that it must be shown that an independent company would have paid for the service, either through procurement from external suppliers or by hiring staff itself to handle the task. It must be documented that no payments are made in the form of a management fee for something that the company handles itself. The documentation of the usefulness of the services received must specify what exactly has been received so that it can be determined whether payment is made twice for the same service.

Prior to the issuance of the Statutory Order, no binding rules on the content of transfer pricing documentation existed. It was therefore often quite difficult for the tax authorities to prove that a company's payment of a management fee did not comply with the arm's length principle.

In TfS 2006, 634 the tax authorities claimed that a management fee paid by a parent company to its subsidiary did not reflect an arm's length consideration. Under a management agreement between the parent company and its subsidiary, the subsidiary received a management fee calculated as 6% of the parent company's turnover as consideration for making management resources concerning production, administration, marketing and sales, available to the parent company. The tax authorities claimed that the real purpose of this management fee was to reduce the taxable income of the parent company by way of transfer of profit to the (loss-making) subsidiary, and argued that the arm's length principle had not been complied with. However, an expert appointed by the National Tax Tribunal stated that, in his opinion, the management fee did in fact reflect an arm's length consideration. As a result, the tax au-

⁵ . Statutory Order 42 of 24 January 2006.

thorities withdrew the case after the Eastern High Court indicated that its ruling would be based on the expert's statement

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