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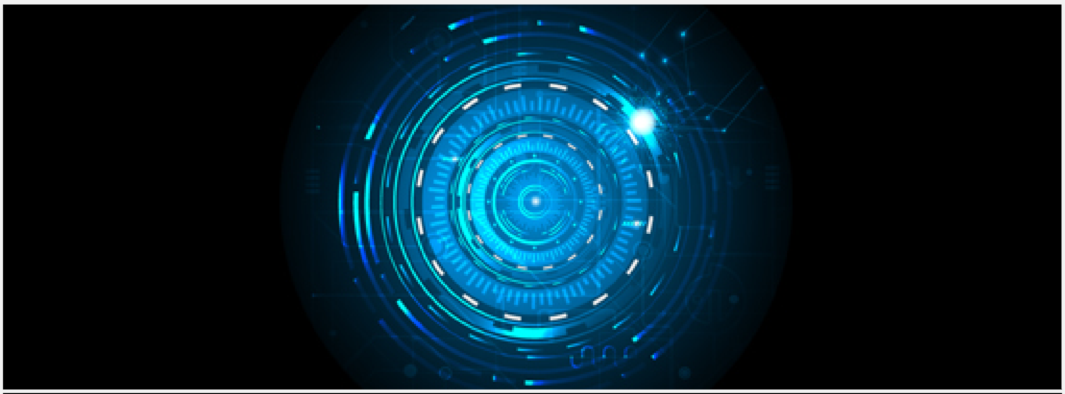

Microsoft wins Danish Supreme Court case

Global Transfer Pricing Alert 2019-014

In a ruling dated 31 January 2019, the Danish Supreme Court upheld the High Court's decision to reject the Danish tax authority's proposed adjustment of commission payments for marketing activities.

The ruling addressed the question whether the Danish tax authorities (Skattestyrelsen) were allowed to perform a discretionary assessment in relation to an intercompany compensation charge for marketing activities performed by a Danish company on behalf of its Irish counterparty.

Case 75/2018 involved Microsoft Denmark ApS, a marketing entity operating in the Danish market and its related party, Microsoft Ireland Operations Limited, which held the licensing rights for the marketed software in the Europe, Middle East, and Africa regions. The Court thoroughly analyzed the arm's length nature of the intercompany remuneration for the marketing activities performed by Microsoft Denmark ApS on Microsoft Ireland Operations Limited's behalf.

On audit, Skattestyrelsen held the position that the commission paid for the services rendered was not in accordance with the arm's length principle because the basis for the calculation of Microsoft Denmark ApS's commission did not include the revenues from sales of Microsoft products, such as preinstalled software (Windows Vista), distributed to Danish end-users by multinational computer manufacturers, such as Dell.

In the tax authorities' view, the marketing efforts undertaken by the Danish entity had a positive effect on the total sales of Microsoft products in the Danish market, including the sales of such preinstalled software (Windows Vista) in computers; thus, these revenues ought to be included in the basis for the calculations of the commission payments. Consequently, Skattestyrelsen argued that it was appropriate to increase the commission charge based on a discretionary assessment that resulted in an increase in the Danish company's taxable income.

Referring to the Tax Control Act para. 5, subsection 3, the tax authorities claimed that the transfer pricing documentation was not prepared within the deadline stipulated in Danish transfer pricing requirements. Further, they stated that even if the transfer pricing documentation had been prepared on time, it would be considered insufficient because it could not serve as the basis on which the tax authorities could assess whether or not the transfer prices and terms were in accordance with the arm's length principle. This, they argued, would allow them to perform a discretionary assessment.

The discretionary assessment was performed by increasing the amount of the commission paid to the Danish company by including an estimate of the revenues from sales of preinstalled software to end-users in the Danish market in the basis for the calculation of the commission payments.

The Danish company claimed that the adjustment should be rejected, as the company claimed to have prepared adequate transfer pricing documentation for its intercompany transactions and further, that the revenues originating from sales directed towards end-users involved third parties, and hence were not controlled transactions.

Legal basis for discretionary assessment

After providing some insights in the premises, the Supreme Court concluded that Skattestyrelsen did not have the legal basis to deem the prepared transfer pricing documentation so insufficient that it could be considered non-existent documentation. Further, the Court emphasized that the sole reason for the tax authority's adjustment was the fact that the commission payments did not include the revenues from sales of Microsoft products via multinational computer manufacturers' sales of computers with preinstalled Microsoft software for end-users in the Danish market. It was clear from the documentation material that those transactions were not included in the calculation basis for the remuneration.

Consequently, the Supreme Court concluded that the tax authorities did not have the legal basis to perform a discretionary assessment of the company's taxable income.

The contractual relationship

The intercompany arrangement was remunerated under the Market Development Agreement, (the MDA agreement), whereby Microsoft Denmark ApS had a duty to maximize the markets for the Group Products in the "Territory", which was defined as Denmark, the Faroe Islands, Greenland, and Iceland. Thus, the Supreme Court agreed with the High Court that the agreement should be interpreted to contain a duty to market products sold directly to the Danish market, i.e. package licenses and OEM licenses to Danish computer manufacturers. Such an interpretation of the agreement did not contradict the wording in the agreement. Accordingly, the Court did not find that the agreement contained an obligation to market sales of computers and preinstalled software, with sales already performed by Microsoft companies in the United States and in other countries outside Denmark.

The effects of Microsoft Denmark ApS's marketing efforts

In the ruling, the Supreme Court mentioned that the adjustment to the taxable income of Microsoft Denmark ApS was performed based on the assumption that the company's marketing efforts had a positive effect on the demand for computers with preinstalled Microsoft software, for the benefit of the Microsoft Group.

The Court stated that it could not be denied that the marketing efforts could have had derivative effects, especially in the period up to and after the launch of the operating system Windows Vista in 2007, which set higher requirements for computers. Conversely, the Court considered it likely that Microsoft Denmark ApS' own sales of separate software package licenses could have benefitted from the discounts provided by Microsoft Denmark ApS' American parent to computer manufacturers such as Dell.

The Supreme Court found it unlikely that the effect of the marketing efforts performed by Microsoft Denmark ApS would exceed the importance of the marketing efforts undertaken by the computer manufacturers and its effect on the sales of e.g. package licenses.

Based on the aforementioned, the Supreme Court concluded that the tax authorities had failed to substantiate their position that the commission payments were not in accordance with the arm's length principle.

The decision was not unanimous, with three judges voting for the decision and two against.

Conclusion

The Supreme Court's ruling illustrates the importance of solid transfer pricing documentation, which may prevent the tax authorities from performing discretionary assessments.

Further, it seems clear that in cases in which the taxpayer has prepared adequate transfer pricing documentation, more than an assumption would be required to substantiate that an intercompany transaction has not been conducted in accordance with the arm's length principle, and consequently the legal basis to perform a discretionary assessment.

The ruling is one of very few transfer pricing cases that have gone all the way in the Danish legal system, and thus sheds some light on the current state of law in this area.

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