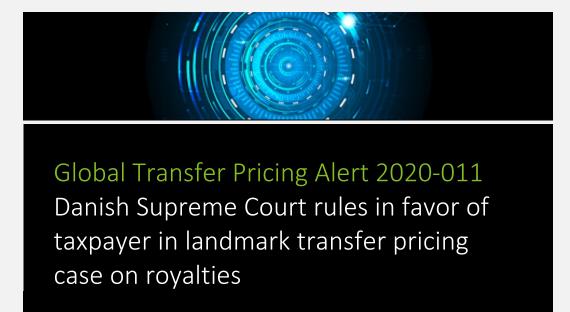
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On 25 June 2020, the Danish Supreme Court handed down its ruling in a landmark transfer pricing case on intercompany royalties. The Supreme Court held that there was no basis for the Danish tax authorities' royalty adjustment, thereby setting aside previous rulings of the Danish National Tax Tribunal and High Court.

Background and facts

The Danish taxpayer, a member of a multinational staffing group headquartered in Switzerland, paid royalties to the Swiss parent company of the group in accordance with an intercompany license agreement. The agreement covered the right to use trademarks legally owned by the parent as well as certain services, including knowhow and access to referred-in customers through the group's network. The taxpayer was loss-making in the years under dispute.

The royalty rate was supported by a comparability analysis using the comparable uncontrolled price (CUP) method. The comparables included franchise agreements subjected to comparability adjustments. The royalty rate was further supported by similar license agreements that the Swiss parent company had entered into with group external licensees in other jurisdictions (internal CUPs). These additional comparables were not part of the taxpayer's

statutory transfer pricing documentation but were presented before the Tax Tribunal and the courts during the course of the appeal to provide further evidence of the arm's length nature of the royalty rate.

Transfer pricing audit

During a transfer pricing audit, the Danish tax authorities disqualified the transfer pricing documentation based on deemed flaws and made a discretionary tax assessment. In the tax authorities' view, the intercompany license arrangement did not adhere to the arm's length principle, for reasons including that the Danish taxpayer:

- Was in a loss-making position; and
- Should have been remunerated for deemed marketing services rendered to the Swiss parent company, which would net out any royalty deduction, effectively resulting in a 0% royalty rate.

In its decision, the tax authorities presented a "sanity check" based on the transactional net margin method with the Danish taxpayer as the tested party and relied on Danish resident companies as comparables.

Appeal proceedings

The Tax Tribunal upheld the tax authorities' royalty adjustment. In the subsequent High Court proceedings, the Danish Ministry of Taxation reiterated the tax authorities' position and also argued that the royalties did not meet the threshold of deductibility for business expenses under Danish domestic law.

The High Court agreed with the Ministry that the taxpayer had failed to prove that the royalties were deductible business expenses, and so—surprisingly the court did not decide the case based on the arm's length principle but rather with reference to the Danish domestic law on deductibility.

Decision of the Supreme Court

The Supreme Court, however, confirmed the taxpayer's position on all items of dispute, rejecting the arguments presented by the Ministry of Taxation, and setting aside the Tax Tribunal's ruling and the High Court judgment.

Royalty deductibility: The court held that the royalties paid to the Swiss parent company were deductible business expenses. Specifically, the court found that the royalties were sufficiently linked to the business earnings of the taxpayer and, based on the evidence presented before the court, that the royalties covered actual value provided to the Danish taxpayer. The court further noted that the loss-making position of the Danish taxpayer could not alter that conclusion.

Discretionary assessment: The court found that the taxpayer's transfer pricing documentation was not flawed to an extent that equated to a lack of documentation. Accordingly, the court deemed that the tax authorities were unauthorized to disqualify the documentation and make a discretionary assessment, thereby shifting the burden of proof back to the Ministry.

The court noted that the fact the tax authorities may disagree with—or reasonably question—the taxpayer's comparability study does not in itself render the documentation inadequate. The court held that the Ministry had failed to demonstrate an actual relation between any potential comparability study insufficiencies and the specific determination of the royalties' adherence to the arm's length standard. Finally, the court noted that the fact that the taxpayer did not present the additional comparables (the internal CUPs) until the National Tax Tribunal hearing did not in itself authorize the tax authorities to make a discretionary assessment.

Royalties at arm's length: The court majority found that the Ministry had failed to prove that the royalty rate did not adhere to the arm's length principle. Specifically, the court did not find any evidence to suggest that the economic and commercial circumstances applicable to the independent licensees differed from those of the Danish taxpayer to an extent that would disqualify these license agreements as applicable comparables. The loss-making position of the taxpayer and any deemed transaction involving marketing services were further rejected by the court as a basis for any royalty rate reduction.

Comments

The Supreme Court judgment reaffirms and extends the decisions in earlier Danish transfer pricing cases. The ruling is explicit in its rejection of the arguments presented by the Ministry of Taxation to deny deductions for royalty payments, and likely will have significant influence on pending and future transfer pricing issues.

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