
DANISH SUPREME COURT RULES AGAINST MINISTRY OF TAXATION IN LANDMARK TRANSFER PRICING CASE

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Kromann Reumert's tax team successfully defended Microsoft in the first substantial transfer pricing case to reach the Danish Supreme Court. The Ministry of Taxation's claims were based on substantive as well as procedural allegations, raising legal questions of principle and of general importance for Danish transfer pricing matters.

The legal issues

The Ministry of Taxation claimed that Microsoft Denmark's taxable income should be increased by several hundred million DKK or, alternatively, that the assessment of the company's taxable income should be remitted to the tax authorities for renewed processing.

First, it was argued, the company did not ensure timely preparation of the statutory TP documentation, and the documentation – had it been submitted in due time – was compromised by omissions so essential as to effectively render the tax authorities unable to assess, on the basis of the documentation, whether intragroup commission paid to Microsoft Denmark for local marketing was at arm's length.

Secondly, the Ministry of Taxation alleged, Microsoft Denmark's marketing commission should reflect the sales of Microsoft software that occurred through the sale of computers by multinational computer manufacturers with pre-installed Microsoft software (OEM software) to end users in Denmark. It was undisputed that the OEM software was sold to third party multinational computer manufacturers by Microsoft companies in the United States and other countries outside Denmark.

The judgement of the Danish Supreme Court

Transfer pricing requirements

The Supreme Court clarified that the tax authorities can only justify transfer pricing income assessments with reference to the quality of the transfer pricing documentation, insofar that the documentation is so flawed that it does not provide the tax authorities with an adequate basis for assessing whether the arm's length principle is met, at the time of the assessment.

Concretely, the Supreme Court concluded, Microsoft Denmark's transfer pricing documentation did not in itself necessitate – and thus not justify – an income assessment merely because there was no information about third party multinational computer manufacturers' sales into Denmark. The documentation had not been challenged in other respects.

The alleged marketing effects

The Supreme Court's majority rejected the Ministry of Taxation's allegation that

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Microsoft Denmark was obliged to market the sale of computers with pre-installed software, when the software sales to multinational computer manufacturers were made by Microsoft companies in the United States and other countries outside Denmark.

It could not be ruled out that there may be some derived (indirect) effects of the local Danish marketing on the mentioned sales, the Supreme Court concluded. However, other Microsoft companies paid the multinational computer manufacturers to market Microsoft software to their end users. This, in turn, could also have an effect on the sales of software in Denmark and those sales were included in the basis for calculating the marketing commission to Microsoft Denmark.

The significance of the various group companies' marketing efforts and the interaction between them had not been clarified during the case, and the Supreme Court found it unlikely that Microsoft Denmark's local marketing had an effect on the sales of software to multinational computer manufacturers in the United States that exceeded any benefit to Microsoft Denmark.

The Ministry of Taxation had thus not substantiated that Microsoft Denmark's marketing commission was not at arm's length.

Comments by Kromann Reumert

The Danish tax authorities aggressively pursue procedural arguments to substantiate very significant transfer pricing adjustments. It is, in itself, an important clarification for Danish transfer pricing cases generally that the tax authorities can only justify transfer pricing income assessments with reference to the quality of the transfer pricing documentation, insofar that the documentation is sufficiently flawed. Sufficiently flawed means that the documentation does not provide the tax authorities with an adequate basis for assessing whether the arm's length principle is met, at the time of the assessment.

It is also clear from the Supreme Court judgment that in case of adequate transfer pricing documentation, the tax authorities shall substantiate that there is a basis for arm's length adjustments.

The Ministry of Taxation's alleged substantive justification, i.e., that non-measurable, potential marketing effects at group level should be remunerated, was extremely far-fetched and would have constituted a solitary Danish position in international tax law, had it been accepted by the Supreme Court.