Executive summary

The Supreme Court of Denmark, on 31 January 2019, issued its decision on a transfer pricing case regarding Microsoft Denmark ApS (Microsoft Denmark) which is a Danish subsidiary of the United States (US) software company Microsoft Corporation. The decision affirmed prior findings by the Eastern High Court and the National Tax Tribunal in favor of the taxpayer. The key question in the case was whether the marketing activities performed by Microsoft Denmark on behalf of an Irish sister company provided a compensable benefit to a non-Danish group company.

Detailed discussion

Facts of the case

The case concerned Microsoft Denmark that performed marketing services on behalf of the Irish sister company Microsoft Ireland Operation Limited (MIOL). MIOL was responsible for sales, production, distribution and logistics in Europe, the Middle East and Africa (EMEA). According to an agreement between the two companies, Microsoft Denmark was appointed to provide marketing and support services for MIOL in Denmark. The sale of software to Danish customers was executed by MIOL. The group's sale of software licenses was divided between sales to retail dealers and sales to original equipment manufacturers (OEMs).
OEM sales involved that the software was sold to OEMs and preinstalled on personal computers (PCs) before they were sold to end users. Microsoft distinguished between three categories of OEM customers: (1) multinational OEMs (MNA OEMs) that produce more than 100,000 PCs per year; (2) Named Accounts that produce between 5,000 and 100,000 PCs per year; and (3) System Builders that produce up to 5,000 PCs per year. The US group company Microsoft Licensing GP (Microsoft US) was responsible for the sale of OEM licenses to MNA OEMs. In EMEA, there was only one MNA OEM located in Germany.

The marketing services performed by Microsoft Denmark were primarily in the form of education and training of Danish retail dealers and marketing towards a few Named Accounts and System Builders. Microsoft Denmark was remunerated with the largest amount of a commission calculated on the basis of MIOL's sales in Denmark and a fee equal to costs plus 15%. Microsoft Denmark's marketing did not target MNA OEMs. Sales and marketing towards MNA OEMs were performed by Microsoft US.

**Decision of the tax authorities**

For tax years 2004-2007, the Danish tax authorities determined that Microsoft Denmark should be subject to an upward transfer pricing adjustment of DKK307.5 million, because the marketing activities had not been remunerated on an arm's-length basis. The tax authorities did not criticize the contractually agreed commission rates. Instead, the adjustment was justified by a reading of the marketing agreement according to which Microsoft Denmark was considered to be obliged to market all the group's products, and by the fact the company did not receive remuneration from the sale by MNA OEMs of preinstalled software in Denmark. The marketing activities were considered to have the same effect on the sale of OEM licenses and other types of licenses. It was held to be immaterial that the Danish marketing did not specifically target the MNA OEMs, as PC producers as such did not have an interest in purchasing Microsoft's licenses. Thus, it was the consumer preference for Microsoft's software that caused it to be preinstalled on the PCs. The tax authorities also argued that consumers often had the opportunity to choose between licenses from different suppliers for which reason the marketing had the same effect, regardless of whether the software was purchased preinstalled or separately. According to the tax authorities, the main responsibility of the MNA OEMs was to market the hardware, while the main responsibility of Microsoft was to market the software (complementary marketing). This complementary marketing was held to provide a benefit to the group's parent company, but the tax authorities abstained from identifying the counterparty to the transfer pricing adjustment. Subsequently, the tax authorities stated that the counterparty was MIOL. Hence, in their view Microsoft Denmark was contractually obliged to market all of the group's products, see above. It was irrelevant that the group's sales to MNA OEMs were made by Microsoft US rather than MIOL.

According to the taxpayer there was no legal basis for the transfer pricing adjustments. Among other things, the taxpayer argued that Microsoft Denmark was neither contractually obliged to perform marketing towards the MNA OEMs nor contractually entitled to compensation from MIOL for the group's sale of OEM licenses in Denmark. Second, Microsoft Denmark did, in fact, not perform any marketing towards MNA OEMs. Third, the tax authorities had not proven that the remuneration received was not on an arm's-length basis. Fourth, the alleged indirect effect on the sale of OEM licenses was not documented and would, in any case, have no or only insignificant value for the OEM sales.

**Supreme Court decision**

An appeal against the decision was filed and Microsoft prevailed both at the level of the National Tax Tribunal and the Eastern High Court.

The majority of the Supreme Court held that the marketing agreement only required Microsoft Denmark to market those products that were sold directly on the Danish market. The agreement was not considered to oblige the Danish entity to market MNA OEM licenses. According to the majority it could not be ruled out that the marketing activities in Denmark had an indirect effect on the sale of OEM licenses in Denmark. On the other hand, it was held that the marketing of Microsoft products by the OEMs could have an indirect effect on the sale to retailers in Denmark by Microsoft Denmark. The majority did not find it likely that indirect effect of the marketing activities performed by Microsoft Denmark exceeded the indirect effect of the marketing activities performed by the OEMs. The majority noted that the group had implemented a methodology under which it was easy to determine the remuneration of the Danish entity. Furthermore, the Danish entity was secured a minimum income based on a cost plus 15% arrangement. Finally, the majority held that it was unlikely that an independent marketing company would obtain compensation based on the sale of OEM licenses in Denmark that were carried out without the involvement of the
marketing company. On this basis the majority decided that the tax authorities had not proven that the compensation paid to Microsoft Denmark did not accord with the arm's-length principle.

The minority of the Court interpreted the marketing agreement so that it also required Microsoft Denmark to market MNA OEM licenses in Denmark. Moreover, the minority found that the Danish entity in fact had performed marketing activities relating to MNA OEM licenses. On this basis the minority held that independent parties would have agreed that the sale of MNA OEM licenses in Denmark should be taken into account in determining the compensation to Microsoft Denmark. However, the minority found that the Danish entity should not be entitled to the same level of compensation regarding MNA OEM licenses because of the marketing activities of the OEMs. For this reason, the minority would request the tax authorities to determine a lower level of compensation.

Implications

The decision in the Microsoft case is important in view of the fact that the Danish tax authorities' often look to expand the Danish tax base by "identifying" controlled transactions and imposing transfer pricing adjustments on those transactions. In several pending cases, the tax authorities have taken the position that the mere existence of a subsidiary in Denmark constitutes a separate compensable service to the foreign multinational in addition to the sale of goods or services in Denmark. The outcome of the Microsoft case is in line with the OECD Transfer Pricing Guidelines that incidental benefits do not amount to a compensable service transaction.

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