

Global Transfer Pricing Battleground : Danish High Court ruling on shoe manufacturer's TP-documentation

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In a [landmark judgment](#) in the case of ECCO Sko A/S ("ECCO" or "the Company"), the Danish Western High Court ("High Court") has rejected the Danish Revenue Authority's ("SKAT") contention that the Company's transfer pricing documentation was inadequate and that the international transactions with two of its subsidiaries were not at arm's length price. The decision by the High Court (Vestre Landsret) was pronounced on 2 July 2020 and published on 5 October 2020. SKAT initiated the case nearly 14 years ago. It was a long drawn battle for the Danish iconic shoe manufacturer, which ultimately ruled in its favor. The Danish Ministry of Taxation has not further appealed before the Supreme Court, so the High Court's judgment is now final.

Background

The ECCO group was founded in 1963, and the group has since grown from being a small Danish shoe manufacturer to becoming a major global player with around 20,000 employees and with sales and production subsidiaries spread across a wide range of countries. In 2005, the group had a turnover of approx. 3,830 million DKK and was present in 45 markets. Unlike most other shoe manufacturers, it undertakes all phases of shoe production, right from the receipt of raw cowhide, to the distribution of finished shoes to the end consumer.

To support the arm's length nature of its international transactions, the Company had prepared Transfer Pricing documentation according to the Danish Tax Control Act Section 3B. Also, the Company had submitted supplementary documentation after meetings with SKAT in 2011.

The primary international transactions subject matter of the transfer pricing assessment were- sales to related parties, purchases from related parties, and royalties. This article mainly discusses the issue of inadequate transfer pricing documentation and the non-arm's length nature of purchase transactions from two subsidiaries, which was the subject matter of the appeal before the High Court.

In its original transfer pricing documentation for 2005, ECCO had analyzed the sales transaction with the help of the Comparable Uncontrolled Price ("CUP") method. They used the price charged from unrelated parties to benchmark the price charged from related parties. While the parent company's purchases from its related production companies were benchmarked using gross profit earned on externally sourced shoes, using a variant of the resale price method.

The decision of SKAT on 31 August 2011

Flaws in the transfer pricing documentation

There were two different transfer pricing documentation prepared by the Company. Both were made readily available to the SKAT at the time of the assessment. The first documentation was the one prepared in 2005 to comply with section 3B of the Danish Tax Control Act, and the second documentation was as a response to the various questions raised and discussions held with the SKAT during the course of the assessment proceedings. The documentations comprised of an analysis of the ECCO's transfer price determination and comparability analysis.

However, the SKAT disregarded the documentation prepared by ECCO and discretionarily made an addition to ECCO's income.

Related party sales

SKAT increased the income of ECCO for transfers made to its distribution companies. ECCO had

benchmarked these transactions with the help of the CUP method. They used the price charged from unrelated parties to benchmark the price charged from related parties.

Related party purchases

SKAT concluded that the transactional net margin method (“TNMM”) was the most appropriate method for testing the parent’s related-party purchases and that it should be applied using the production companies as the tested parties.

The SKAT argued that its TNMM analysis established an unjustified difference between the parent company's profit from internally and externally sourced shoes, with significantly higher profitability on externally sourced shoes.

In August 2011, the SKAT passed the final assessment order, in which it discretionarily increased ECCO's taxable income for the year 2005. It noted that the transfer pricing documentation maintained by the Company was not satisfactory. It further stated that ECCO's transfer prices with two of the Company's related foreign production companies did not meet the arm's length basis according to section 2 of the Danish Tax Assessment Act. Hence, SKAT increased ECCO's taxable income.

The decision of the National Tax Court

On 21 October 2015, the National Tax Court decided regarding ECCO's appeal against SKAT's decision of 31 August 2011.

In respect of the lack of documentation argument, the National Tax Court upheld the matter favoring SKAT. The SKAT successfully argued that ECCO's transfer pricing documentation was flawed, and hence, the Tax authority could redetermine the group’s transfer prices at its discretion. The Tax Court consequently upheld the SKAT's decision.

In Danish Transfer Pricing disputes, the transfer pricing documentation quality often plays a critical role, as was also seen in Microsoft's prominent case in 2019. The SKAT bears the burden of proving that the taxpayer’s transfer prices are not at an arm’s length if the taxpayer satisfies the documentation standards. However, this burden shifts to the taxpayer if the documentation is absent or is deficient.

Regarding the adjustment made to the production companies' arm's length prices, the National Tax Court concurred with the SKAT's ruling.

The decision of the Danish Western High Court

There were two main questions before the High Court. The first question was whether the transfer pricing documentation of ECCO was inadequate to justify the discretionary assessments made by the tax authority, according to Section 3B of the Danish Tax Control Act. The second question was whether the Tax authority was correct to hold that the two production subsidiaries' transactions were not at an arm’s length.

Concerning the first question, the High Court considered both sets of the transfer pricing documentation while analyzing whether ECCO had prepared acceptable documentation. The High Court even accepted the documentation prepared in response to the transfer pricing assessment submitted in 2011 before the SKAT. In this respect, the High Court held:

“After an overall assessment, the High Court finds that the transfer pricing documentation provided the tax authorities with {forms} a sufficient basis for assessing whether the arm's-length principle was complied with and that the documentation was not deficient to such an extent that it can be equated with lack of documentation.”

Concerning the second argument of the arm's length nature of the purchase of shoes from two subsidiaries, ECCO put strong reasoning to defend the lower profit contribution from the shoes manufactured by the two related production subsidiaries when compared to the shoes manufactured by external parties. The documentation justified this difference in profits by documenting that the group entities in question applied the "injection method" to produce the shoe. However, third party manufacturers used the "cemented method" in which the upper part of the shoe is glued to the sole. The cemented method requires much lesser investment, and hence the documentation provided a higher contribution.

The High court also recognized other differentiating factors between the internal and external production entities in terms of functions performed, risks undertaken, quality assurance, local conditions, and business strategies. The SKAT had undertaken the comparability analysis without considering the functions, risks, and comparables' business profiles. It had included clothes manufacturers and pure distributors in its

comparability analysis, which was ultimately rejected by the High Court.

The High Court held: *"This comprehensive transfer pricing documentation contains a more detailed review of [ECCO's] fixing prices and terms in relation to both internal and external production companies. That it appears that the pricing, etc., takes place according to uniform principles in relation to internal and external production companies so that a price is determined for each shoe model based on the total budgeted production costs plus a profit margin, which may vary for the individual shoe models,".....*

Based on the facts, the High court found that the Tax Ministry had not substantiated that the differences in profitability analysis of internal and external production companies, was evidence of non-arm's length dealing, and could not be explained in light of the overall business strategy and manufacturing planning. The court noted that the differences in profitability between internally and externally sourced shoes were justifiable. *"On this basis, the High Court finds that it has not been established that the mentioned differences in the averages coverage rates can be considered as an indicationthat the differences are not commercially justified in H1 A / S's {ECCO} **overall business strategy and organization of shoe production.**"* This emphasized the importance of business strategy and the business group's planning rather than just a plain vanilla apple to apple comparison.

The High Court held that ECCO's transfer pricing documentation was sufficient to establish the transactions' arm's length nature. It ruled in favor of the Company and deleted the SKAT's increase in ECCO's taxable income.

Key takeaways

This ruling by the Danish High Court is in line with a series of similar Danish Court judgments over the past two years, which reaffirm the importance of having good documentation and rejecting the discretionary Transfer Pricing adjustments made by the Tax Authorities.

In the Indian context, this reaffirms the importance of detailed transfer pricing documentation. Transfer Pricing as a subject is not merely a mechanical exercise; it involves knowledge of economics, business, and industry in which both the Company and its comparables operate. The purpose of economic analysis is to establish the arm's length nature of an international transaction. Before commencing the economic analysis, one first needs to do functional and risk research of the tested party and, after that, identify comparables that closely match the tested party's operational profile. The Indian Transfer Pricing law provides that the documentation on economic analysis shall provide details of the *"data used and data rejected with reasons thereof. Also, different companies follow different accounting policies. There may be differences in terms of sales, etc. These variations call for certain adjustments in the financials to make the data comparable. The reasons and the adjustments so made should also be recorded"*.

In the ECCO ruling, what worked in the Company's favor was that they got a chance to present their case before the High Court over five days. They submitted extensive documentation and supporting to substantiate their business strategy rather than merely rebutting the claims made by the Tax authorities. Hence, it is vital to maintain robust documentation which will be used as a defense while before the Tax courts. In the Indian context, the primary onus is on the assessee to prepare Rule 10D documentation, the Master File, Country by Country Reporting. The documentation has to establish the arm's length. The same has been discussed in various judgments and is well established:

- Bayer Material Science P Ltd Vs ACIT - [\[TS-741-ITAT-2011\(Mum\)\]](#)
- ACIT Vs Toshiba India Pvt Ltd - [\[TS-123-ITAT-2009\(DEL\)\]](#)
- ACIT vs. Progressive Tools & Components Pvt. Ltd - [\[TS-200-ITAT-2017\(DEL\)-TP\]](#)
- Citicorp Maruti Finance Ltd vs DCIT - [\[TS-500-ITAT-2017\(DEL\)-TP\]](#)
- M/s Tata BlueScope Steel Ltd vs. DCIT - [\[TS-319-ITAT-2019\(PUN\)-TP\]](#)
- Astrix Laboratories Ltd v ACIT - [\[TS-30-ITAT-2016\(HYD\)-TP\]](#)

In India, the transfer pricing litigation has genuinely evolved since 2001, with judgments on varied issues. Though the primary ground still remains-selection of comparables, various judicial precedents reaffirm that tax authorities' discretionary adjustments are not acceptable. The Transfer Pricing Officers should avoid a blanket acceptance/rejection of comparables, and dive deeper into the business strategy, functional profiles, risk analysis of each case and pass a reasoned order.

Further, given the current Covid 19 impact on companies' profitability, it would be imperative for the tax

authorities to undertake an audit considering the current economic conditions. The detailed Transfer Pricing documentation and economic analysis will have to factor in the industry changes right up to the company level. Within the same sector, individual companies would be earning profits, while others would be closing operations. Hence, the tax authorities would need to take cognizance of the business strategies appropriately documented and substantiated by the assesseees.