WAIT NO LONGER, THE OTHER SHOE WON'T DROP IN DENMARK

Author
Michael Peggs

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INTRODUCTION

Imagine you are in a Lower East Side tenement in the 19th century. It is 2:00 a.m. and the building is totally quiet. Then, a sound from above. It is a shoe dropping on the floor. You wait for the inevitable follow-up: the sound of a second shoe landing on the floor.

In October, the Danish Tax Agency received a decision[1] from the Western High Court concerning an appeal originating from a transfer pricing audit commenced in 2006. The audit outcome and the lower court decision was the sound of the first shoe. Where is the sound of the second shoe?[2]

Understanding that inevitable has a different meaning for companies and tax authorities, we summarize a recent decision concerning the price of finished shoes and shoe shafts[3] paid by Ecco Sko A/S to its foreign controlled producers. It seems in the world of transfer pricing litigation, a pattern of mutual expectations has emerged. Companies expect tax authorities to take revenue-maximizing positions and expect courts see the issue more clearly and vacate or substantially vary the assessment of the tax authority. At the same time, tax authorities expect that courts will uphold audit findings of material transfer pricing income adjustments using methods and data overlooked or ignored by companies.

Here Ecco Sko A/S prevailed on appeal from an adverse National Tax Court decision, showing that litigation continues to highlight how companies and tax authorities remain at odds over several fundamental matters.[4]

A STUDY IN TRANSACTION PRICING

In the case of Ecco Sko A/S ("Ecco"), the company is the Danish parent of a group that is the designer and producer of various styles of leather shoes sold around the world. The group produces shoes and shoe components (shafts and handles) in controlled and uncontrolled production companies, purchases all finished product that meets its quality standards, and then sells finished shoes to both controlled

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1 Sagsnummer/Case number BS-714/2016, Vestre Landsret.

2 Wait for the other shoe to drop, a term believed to have an origin on the Lower East Side, is defined as "To defer action or decision until another matter is finished or resolved" in the *American Heritage dictionary of the English language (5th ed.)*. 2011. New York: Houghton Mifflin Harcourt,

3 The portion of a boot between the top of the heel and the top of the boot.

4 Ecco Sko A/S was represented by Plesner Advokatpartnerselskab. Plesner has written a case summary available here.

and uncontrolled sales companies. The Danish parent performs the functions of company headquarters, with the exception of purchasing that is a split responsibility with another group company.

We don't need to know many more facts to make an informed guess at which broad transfer pricing questions will be critical to the ultimate finding of whether products were priced at arm's length. The important questions are:

1. Were shoes purchased from controlled and uncontrolled producers on comparable terms and under comparable conditions?

2. Were shoes sold to controlled and uncontrolled sales companies on comparable terms and under comparable conditions?

Ecco answered these questions in its 2005 transfer pricing documentation and supplemented its response with other data and analysis submitted to the Danish tax authority during the course of the audit. Its answers were perhaps not as expected by the tax authority, as they had much to do with the operation of an industry standard used to set prices and the process by which these prices are set. It is apparent that Ecco's initial 2005 transfer pricing documentation was neither comprehensive nor comprehensible to the tax authority owing to several contradictions and shortcomings. This appears to have made the verification process difficult from the get-go.

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Ecco explained that shoe producers and buyers negotiate prices for each season using producer information on expected production costs, volumes, production efficiency, and technology. Ecco, as the buyer, had to consider its product pricing at various market levels (wholesale, retail, own-stores), demand for various styles, and discounts to intermediaries (both controlled and uncontrolled). Between Ecco and its controlled and uncontrolled producers, annual price negotiations took place that appeared to treat all producers the same despite Ecco's information advantage when negotiating with a controlled producer.

In a purposeful way, Ecco set prices and output targets to provide an incentive for all producers (both controlled and uncontrolled) to increase productive efficiency, lower production costs, and retain any profit resulting from exceeding agreed targets. Ecco explained this was an industry norm demonstrated by its 3rd party producer negotiations and transactions. Producers and buyers divide the risk encountered at the various stages in the supply chain at arm's length, and no pricing adjustments are made throughout the year. Importantly, Ecco showed that negotiations with controlled producers approximated arm's length negotiations in part by virtue of the alignment of producer productivity and efficiency targets with managerial compensation and the general company philosophies of continuous improvement and openness. It is well known that hard bargaining is not evidence of arm's length terms, but Ecco appears to have offered a more structured explanation based on the known business practices of its industry.

Ecco's position was therefore based on the O.E.C.D. transactional net margin method, with operating profit measured in the most reliable way, at the transaction level. In addition to measuring the transactional profit of the producer, Ecco employed a secondary transfer pricing method to examine its resale margins on sales of shoes purchased from controlled and uncontrolled producers. As was the case with its primary transfer pricing method, detailed knowledge of the business and the economic conditions prevailing in the controlled and uncontrolled transactions was needed to

reliably check the outcome of the company transfer pricing policy. Interpretation of resale margin variations caused by different product types and product market conditions (children's shoes earned relatively low margins while women's shoes and golf shoes earn higher margins), and different manufacturing techniques and cost structures (injection-molded soles versus glued or cemented soles) later became important in argumentation concerning the correct application of the resale price method.

TAX AUTHORITY POSITION

The tax authority position was based primarily on its finding that Ecco's transfer pricing documentation was deficient. The finding of deficiency allowed the tax authority to use its discretion to adjust the transfer prices in both the purchase and sale transactions carried on by Ecco during the 2005 tax year. The finding of deficiency depended on the date of the transfer pricing documentation, with the tax authority having determined that supplementary documentation and analysis submitted by Ecco during the audit could be disregarded. The appeal before the High Court concerned only the purchase transactions, as the tax authority agreed not to pursue an adjustment of the sale prices.

The income adjustment to two transaction series, purchases from Thai and Indonesian controlled producers, was estimated using the transactional net margin method and a rate of return on producer cost derived from a set of general manufacturers identified in a database search. The tax authority found that the cost markups reported by the Thai and Indonesian controlled producers was greater than its derived rate of profit, and reassessed tax on Ecco by lowering its cost of purchased inventory.

A further adjustment to another controlled producer was determined after the tax authority noted its relatively high level of profitability. In this instance, the tax authority attributed royalty income to Ecco from the controlled producer, arguing that Ecco had inappropriately allowed its intangible property to be used by the controlled producer at no charge. As this producer supplied an Ecco affiliate with finished shoes and shafts, the practical result of the transfer pricing adjustment was an increase in the producer's total cost of production. It is less clear which Ecco affiliate other than the producer should be given inventory cost relief.

HIGH COURT DECISION

The case before the High Court concerned only the legal questions of the exercise of discretion by the tax authority in setting aside Ecco's transfer pricing documentation and estimating an income adjustment, and the appropriateness of this income adjustment under Danish tax law. Ecco requested that its case be heard by a panel of judges made up of three High Court justices and two expert judges, but was denied this request. Aside from the number of judges hearing the matter, the appeal proceeded somewhat like transfer pricing litigation in the U.S. Tax Court, in that the panel of judges had wide discretion in interpreting the substance of the transfer pricing issues at hand.

Ecco was successful in convincing the Court of the reliable use of budgeted transfer prices without year-end adjustment using actual company results over the objection of the tax authority that relied on the O.E.C.D. guidance that advises against using

budget figures to apply a transfer pricing method. It was instead the evidence of Ecco's budgeting and price-setting process as an arm's length process that convinced the Court that Ecco's transactional net margin method based on budgeted costs and revenues produced an arm's length outcome in the 2005 tax year.

The Court also disagreed with the tax authority positions concerning the Ecco secondary method in large part because of its finding that more detailed product-specific analysis submitted during the audit should not have been disregarded. This richer information source appears to have demonstrated the employment of a reasonable level of business logic by Ecco in ensuring that the purchase price it paid to controlled producers was arm's length from the perspective of both the purchaser and the seller in the transaction.

While the High Court decision does not evaluate the Ecco position on the purchase price of shoes explicitly, it does evaluate the qualitative factors that affect comparability analysis to reach a conclusion that there was no evidence the company did not price its transactions at arm's length during the 2005 tax year. In the instant case, the High Court did not have to determine whether the petitioner's expert or the tax authority's expert was relatively more reliable, as there were no expert reports. The High Court justices therefore interpreted and weighed the evidence themselves and rendered a decision referencing many of the factors that are ordinarily identified, explained, and quantified in expert reports.

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BUILDING A BETTER HAMMER

From the U.S. perspective, it is somewhat puzzling how this dispute reached an appellate court on its technical merits. In U.S. transfer pricing disputes it is more typical to see the methodological shoes on opposite feet, with a company arguing for an application of the C.P.M. (the typically less transactional American cousin of the transactional net margin method), and the I.R.S. relying on transactional evidence previously unexamined or discounted by the company. Alternatively, a poorly-supported initial position like Ecco's would likely result in a settlement with the I.R.S. In the case of Ecco, the tax authority had abundant transactional data at hand to use in verifying and critiquing the taxpayer's approach but opted instead to rely on a relatively uninformative application of the transactional net margin method. The Danish tax authority's arguments were even somewhat American-accented, with emphasis placed on tested party selection, transaction aggregation, and a commensurate-with-income approach used in a licensing transaction.

Reading commentary from Ecco's counsel, it becomes clear that limitations to the mandate of lower tax tribunals left Ecco little choice in resolving the dispute. Denmark's growing body of transfer pricing jurisprudence is proving increasingly helpful to dispute resolution, but administrative questions, such as those litigated in *Altera*,[5] remain unresolved in the Danish and broader European context.

Assuming that the case progressed as it did largely as a result of poor quality in the initial taxpayer documentation, one would hope that the improved documentation standard resulting from B.E.P.S. Action 13 now summarized in the O.E.C.D. Transfer Pricing Guidelines will make better information available to tax authorities

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5 *Altera Corp. v. Commr.,* 926 F.3d 1061 (9th Cir. 2019), *revg*. 145 T.C. 91 (2015), *cert. den*. 207 L. Ed. 2d 1078 (U.S. 2020).

so that disputes such as this one can be resolved at the audit level. Also notable is the change since 2005 in the capacity of non-O.E.C.D. tax administrations to contend with double tax matters, thereby reducing the incentive of all tax authorities to argue for their thinly supported transfer pricing adjustments with foreign competent authorities.

The Danish tax authority's approach recalls a previous *Insights* article[6] that examined Maslov's hammer as a cognitive bias, summarized in the old adage "if all you have is a hammer, everything looks like a nail." It appears it is time to build a better hammer, or to try some of the other unused tools in the audit toolkit. Time marches on however, as the arm's length principle is under revision at the O.E.C.D. Analog tools found in a box are being refashioned at warp speed for use in pricing transactions or splitting company profit in the digital economy as a policy alternative to a constellation of digital services taxes. Is a positive technology shock on the way for those that wield Maslov's hammer, or will the new methods amount to a codification of the law of the instrument?

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6 Peggs, Michael. "Managing a Transfer Pricing Exam? Wash Your Hands with Soap and Water." *Insights* Volume 5, Number 5, June 2018

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