



Business restructuring in context of the Recent Danish National Court ruling

Foreword

A business restructuring may typically be defined as a cross-border redeployment of functions, assets, and/or risks by a Multi-National Enterprise (MNE). High degree of globalisation, competition, digitisation, political changes, trade war, and the 'new normal' ushered in by the pandemic, has led to heightened focus for MNEs across the globe to identify various alternatives to optimise their supply chain.

The current pandemic situation may have had an adverse impact on profitability of MNE groups, which operate in various jurisdictions. In such a scenario, most Boardroom conversations focused on ways to bring back business to usual and continue with the pre-pandemic growth trajectory. One of the paths is the effective re-organisation of global supply chains through business restructuring.

These include re-aligning supply chains by shifting manufacturing facilities from one location to another; renegotiating existing arrangements, i.e., change in pricing model/remuneration; creating alternative supply sources, thereby reducing the dependence on one country; re-organising contractual relationship with the Associated Enterprises (AE), i.e., conversion of full-fledged manufacturers to contract manufacturers, distributors to commission agents, or vice versa etc.

These activities contribute to increased profits and shareholder value, but MNEs also need to be cautious of the potential impact these may have on the existing transfer pricing arrangements in multiple jurisdictions, which are a part of the supply chain.

Business restructuring may impact the profits and consequently tax payments in their respective jurisdictions and hence has been receiving increased focus by the tax authorities.

Some of the questions that may arise in this connection include the following:

- Whether in substance the restructuring involves re-deployment of functions, assets, and/or risks, or is it a mere change in contractual arrangement
- Whether the business restructuring was undertaken on arm's length terms
- Whether the restructuring involves transfer of 'something of value' (For example, intangibles) and if so, the manner of valuation of such intangibles transferred and
- Whether such transfer of intangibles (e.g., customer lists) are adequately compensated post restructuring

Business restructuring in context of the Recent Danish National Court ruling

The Organisation for Economic Co-operation and Development (OECD) has provided the guidance in Chapter IX of the OECD transfer pricing guidelines for multinational enterprises and tax administrations, 2017 (OECD guidelines). It defines business restructuring as the “cross-border re-organisation of the commercial or financial relations between associated enterprises”.

The aforementioned aspects were dealt in detail in a recent Danish National Tax Court Ruling wherein a Danish Company ('H1 Co'/taxpayer) was converted from a full-fledged distributor to a commission agent. The said case is discussed in detail in the following paragraphs.

Facts of the case¹

The taxpayer, a Danish Company, was part of an international group (the Group) engaged in provision of software solutions and operated as a distributor of software products of the Group. It was performing three categories of activities through its employees:

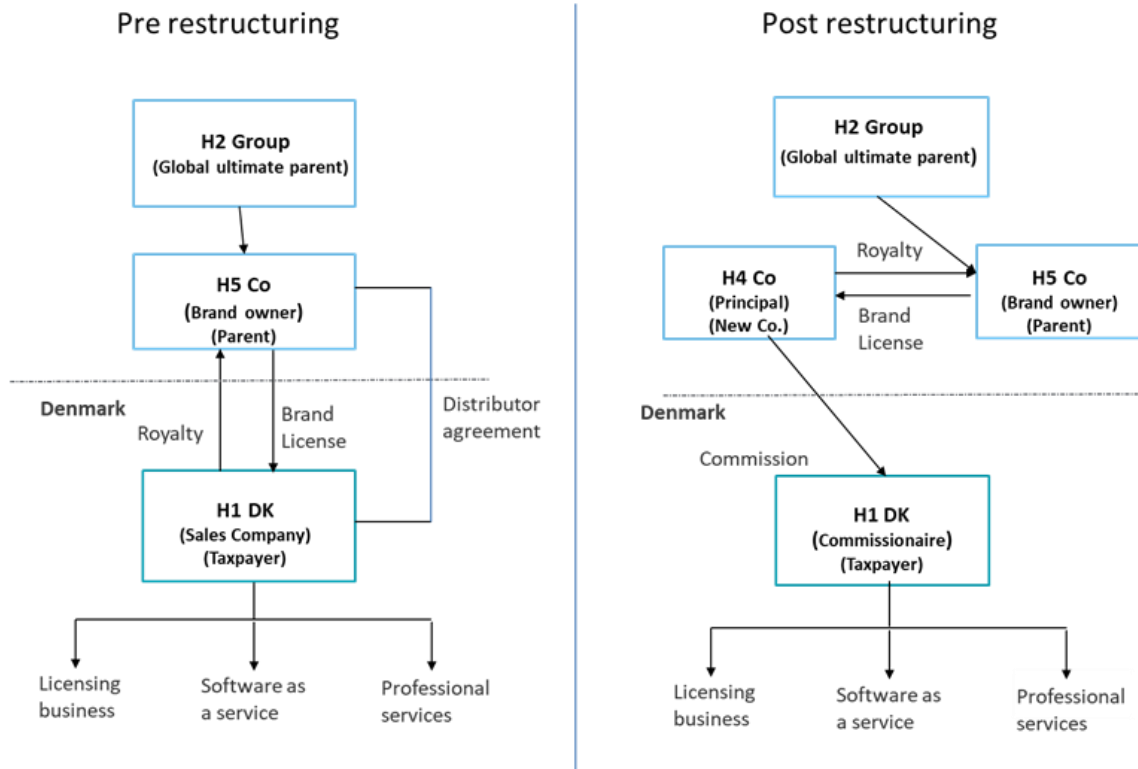
- i. Sales personnel managed
 - a. Distribution of Group's license
 - b. Distribution of access to IT solution through its Software as a Service (SaaS) division
- ii. Core technical personnel managed
 - a. Implementation support for Group software solutions

Under the Distributor agreement between the taxpayer and the Group, the taxpayer was granted right to use Group's trademark and sell software licenses for which it paid royalty to H5 (Parent). According to the agreement, the customer lists were considered to be the proprietary property of the Parent and shall be returned to it on termination of the distributor agreement. The key functions performed by the taxpayer include the following:

- Entering into customer contracts directly and sale/license of the software in its own name
- Executing global and regional marketing advertising and sales policies/strategy established by the Group
- Maintaining customer relations, staying in constant contact with customers, and cultivating familiarity between the Group and customer

On 1 October 2010, the Group as part of Global re-organisation converted its sales companies in various countries into commissionaires. Consequently, the taxpayer's distributor agreement was terminated and replaced by commissionaire agreement where the remuneration to taxpayer was a costs reimbursement and a return on total net invoicing by the taxpayer.

The arrangement amongst the entities pre- and post-restructuring is depicted below:



The restructuring entailed the following changes:

- A new entity (H4 Co/New entity) in another country was formed to handle Group's operations in Europe, the Middle East and Africa (EMEA) region and its function include devising overall strategy and policy for EMEA region in terms of sales, financial targets, budgets etc.

- Accordingly, all the strategies and policies for Danish market such as sales, marketing, brand management, pricing, discounts, contract approval, etc., will be done by the new entity.
- No major change in the functions performed by taxpayer (listed in preceding paragraphs), however as a commission agent, it will act on behalf of New entity. All risks, i.e., market risk, price risk, operational risk, credit risk, currency risk, and inventory risk

¹ Denmark vs. Software A/S, September 2020, Tax Court, Case no SKM2020.387.LSR

Business restructuring in context of the Recent Danish National Court ruling

moved to New entity.

- New entity would enter new customer contracts with the taxpayer retaining the legacy contracts until their termination.
- New entity will pay the royalty to the Parent instead of the taxpayer.

Contentions of the Danish tax authorities (SKAT)

SKAT contented that the taxpayer has not prepared transfer pricing documentation regarding transfer of intangibles and, thereby it conducted a discretionary assessment for the transfer of intangibles.

The key contentions of SKAT include the following:

- The taxpayer has made extensive sales and marketing efforts, built strong relationship with customers, majority of marketing efforts are embedded in the activities of sales personnel, as the feet on ground are considered to offer greatest marketing success.
- Pursuant to restructuring, the taxpayer transferred its intangible assets in the form of customer relationship and market know-how, which was accumulated over many years through its consistent marketing efforts and customer contacts.
- Though there are no changes in the functions performed by the taxpayer before and after the restructuring, the profit margin earned by the taxpayer would drop, whereas the benefit of intangible assets accrues to the New entity without it providing any compensation payment.
- Both the taxpayer and the Parent make valuable contributions in the form of intangible assets and hence, are mutually dependent on each other's contributions. In support of this claim SKAT draws reference to the profit split arrangement between taxpayer and the Parent, wherein the Royalty percent paid to its Parent and the profit margin earned by the taxpayer are similar.
- However, without any such marketing efforts, the New entity would reap the benefits of intangible assets in the form of increased earnings.

Based on the harmonious analysis of the commissionaire agreement, transfer pricing documentation and the actual conduct of the parties, SKAT held that the taxpayer has transferred intangible assets to the New entity without compensation. Accordingly, it valued the intangible based on the present value of the future expected cash flow of taxpayer that it would have earned as sales and distribution company Less present value of future cash flows to be earned by it as a commission agent.

Issues before National Tax Tribunal and its findings

Aggrieved by the decision of SKAT, the taxpayer appealed before the National Tax Tribunal with the following averments:

- The taxpayer was of the view that it did not transfer any intangible to the New entity and accordingly does not warrant any compensation. Its skilled employees can be replaced in the New entity and therefore, workforce is not irreplaceable.
- It also claimed that the customers were given technical support by other Group entities and the taxpayer did not have specialised technical knowledge.
- It also draws reference to Danish law, which states customer relations constitute intangible assets² and that ownership of accumulated goodwill belongs to a person who actually controls and disposes of the clientele and therefore, the intangible assets built in the form of customer relationship accrue to the Group only and not to the taxpayer.

- The burden of proof is on SKAT to document that the restructuring was not carried out on arm's length terms and according to the taxpayer this was not met.
- Further, the assumptions used by SKAT in valuation of the intangibles such as infinite useful life, low Weighted Average Cost of Capital (WACC), etc., were inappropriate and not aligned with the facts of the taxpayer.

Considering the above claim, the National Tax Tribunal (NTT) held:

- Though per the Danish regulations discretionary assessment conducted by SKAT was unwarranted, per Section 2(1) of the Tax assessment Act, SKAT was justified in re-determining arm's length price.
- NTT places reliance on Chapter IX of OECD Guidelines (para 9.45 to 9.47) and observed that an independent distributor with a high future profit potential will not be willing to give up its profit potential in favour of lower stable earnings without compensation.
- The profit earning ratio of the taxpayer is higher than the profit potential of a commissionaire (post restructuring). Hence, NTT upheld SKAT's stand that restructuring of the taxpayer has not taken place on an arm's length basis.
- The customer relationship and market know-how built by the taxpayer over the past years can be covered under the ambit of intangible asset per OECD Guidelines, and accordingly NTT held that the transfer of intangible assets by the taxpayer to the New entity must be valued at arm's length.
- The fact that post restructuring the taxpayer no longer enters into new customer contracts with existing customers and on the other hand the New entity enters into new contracts with the same customers qualifies as 'transfer of contract rights' per para 9.67 of OECD Guidelines, 2017.
- However, NTT did not agree with the use of infinite useful life for estimating the future cash flows adopted by SKAT and held that since software industry is exposed to technological advancements and high risk of the taxpayer's products getting replaced by new entrants, a useful life of 10 years would be appropriate.

Our thoughts

Whilst doing a deep dive into the facts and findings of the aforementioned ruling, the following aspects warrant further consideration:

- Whether the key personnel of the taxpayer were retained even after the restructuring and if so, what were their roles post the restructuring?
- It was mentioned that all strategy and policies for the Danish market such as sales, marketing, brand management, pricing, discounts, contract approval, etc., that were carried out by the Parent will be taken over by the New entity post restructuring. In this regard, the following points need attention:
 - How the said functions were taken over by the New entity? Considering the number of people in the New entity, was there a possibility of moving key resources from the Parent? However, it is not visible from the facts of the ruling.
 - Considering that the New entity was newly formed, the possibility of undertaking such functions is highly debatable.
- Furthermore, what were the inputs the taxpayer received from the New entity in relation to carrying out taxpayer's functions

² cf. the legal guide 2017-1, section CB3.5.4.5

Business restructuring in context of the Recent Danish National Court ruling

post restructuring?

- SKAT is of the view that the taxpayer ought to be compensated for transfer of intangibles (something of value) in the form of customer relationship and contractual rights to the New entity. Considering that the taxpayer would perform same functions post restructuring, it would be construed as though the taxpayer continues to perform functions related to the development, enhancement, maintenance, protection, or exploitation of local intangible transferred³ and hence, the taxpayer is eligible for additional compensation.
- In any restructuring, the MNEs determine the anticipated profitability (ex ante) on a presumptive basis. Such ex ante pricing analysis should ideally take into account risks of different outcomes and in case of any difference between ex ante and ex post value (in excess of 20 percent), it may be construed to be due to non-arm's length pricing assumptions made by the taxpayer.⁴ As a result, the tax administrations may disregard the ex ante analysis and resort to the ex post profitability (actuals) for arm's length determination of the compensation.
- Upon establishing that there is a business restructuring and it requires compensation, deciding on the valuation technique for intangibles assumes prime importance and it is essential to ensure that such technique is consistent with arm's length principle.⁵ The taxpayer needs to be cautious while formulating the assumptions as it is subject to dispute.

The issue dealt in the present case is straight forward and therefore, it did not pose much challenge to the NTT in holding that the taxpayer ought to have been compensated for transfer of intangibles to the New entity.

Takeaways: Relevance in the Indian context

Flipping of structures

In the recent past, some of the Indian startups have established their companies and developed their product/IP in India using the people's capabilities in the Indian entity. As they grow, in order to meet the capital needs they have flipped their holding structure making the foreign entity as the holding company with an intention to attract more foreign investment, at the behest of their investors. Such flipping of structures has now grabbed the Indian tax authorities' attention and would hence, need evaluation from a business restructuring perspective.

Treatment of assembled workforce

In the present ruling, the taxpayer placed an argument that workforce is not unique as the same skill set is present with competition as well. In support of its claim, it placed reliance on the definition of "Assembled workforce per OECD guidelines, wherein prima facie assembled workforce is not treated as an intangible", rather it enhances the value of the intangible asset in certain circumstances. On the contrary the definition of intangible property per Section 92B(2)(ii) of the Income Tax Act, 1961 (the Act) specifically includes human capital, being trained and organised work force.

Given the differences in views on workforce by OECD and India, faced with a similar situation, the Indian tax authorities may be inclined to conclude that assembled workforce is an intangible. Hence, in any business restructuring in India, due consideration needs to be given to cases involving transfer of assembled

workforce.

Commissionaire Vs Commission agent

In the above ruling, the taxpayer post the restructuring is converted from a distributor to a 'Commissionaire' wherein it sells the software to third-party customers in its own name, but for the account of the New entity. The concept of commissionaire arrangement is prevalent only in Civil Law countries and India being a common law country, this model cannot be legally implemented.

Therefore, in India, if there was a requirement of conversion from a distributor, the alternative arrangement would be that of a commission agent. Under that scenario, the following aspects warrants attention:

- a. Transition of contracts
Unlike in the commissionaire arrangement where the third-party customers may not be aware/impacted in the event of change of principals resulting in seamless transition in contracting parties (i.e., taxpayer to New entity), which ensures transfer of 'something of value', in India it poses a challenge. The commission arrangement necessitates change in contracting parties, and as a result it would require concurrence from third-party customers (on account of legal, tax, and other implications). Hence, there is a contingency attached to the renewal of contracts and accordingly it necessitates a change in the valuation of such transfer of contract rights as the preference of the customers may also need to be factored while arriving at such value.
- b. Creation of Permanent Establishment (PE)
In the current case, the taxpayer post restructuring, while operating as a 'Commissionaire', may not have created a PE as the contracts entered by the Commissionaire with third parties does not legally bind the principal. However, in a commission agent model, the agent binds the principal to the third-party contracts, thereby increasing the risk of creation of PE.

One needs to consider the changes in the definition of 'Permanent Establishment' brought in by the Base Erosion Profit Shifting (BEPS) Action Plan 7, and both the models may need to be reconsidered in light of the changes envisaged in implementing the BEPS proposals in the various tax treaties.

Robust documentation

Due to the introduction of the BEPS Action Plan 13, the documentation requirements (in terms of local file, Masterfile, and Country-by-Country report) have been standardised, which will provide the required data to the tax authorities to evaluate the profit drivers, and understand the value chain of the Group, the entities that create value, and the various business restructuring transactions that happen in a year. Consequently, all these transactions are easily detectable by the tax authorities and accordingly, all MNE groups have to maintain proper transfer pricing documents wherein, the decisions regarding business restructuring, the details of significant risks transferred to the restructured entity are adequately documented. Furthermore, the rationale for restructuring, method adopted, valuation technique, and the choice of estimates, etc., to justify the business reasoning and commercial

³ Para 9.65 of the OECD Guidelines, 2017

⁴ Para 6.186 & 6.193 of OECD Guidelines, 2017

⁵ Para 6.154 of OECD Guidelines, 2017

Business restructuring in context of the Recent Danish National Court ruling

rationale for undertaking the restructuring needs to be documented.

The manner in which the tax authorities have dealt with this case and outcome of the ruling exemplify that re-deployment of functions/risks resulting in transfer of 'something of value', might

attract the attention of the tax authorities and may result in demand for compensation in the form of exit charges.



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