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Apple case: EU judges confirm that the European Commission had it wrong

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On 15 July 2020, in the Apple case, the EU judges (General Court) concluded for the second time in less than one year that the EU Commission failed to demonstrate that by issuing a tax ruling dealing with transfer pricing matters, local tax authorities had granted illegal state aid to a multinational company. As a result, the decision of the European Commission of 30 August 2016 according to which Ireland granted undue tax benefits of up to 13 billion euros to Apple was annulled.

Back in September 2019, the General Court already concluded in the Starbucks case that the European Commission was unable to demonstrate the existence of an advantage granted by the Dutch tax authorities in favour of Starbucks. Here as well, the decision of the Commission was annulled.

An appeal to the Court of Justice of the European Union is still possible.

The Apple Case

On 11 June 2014, the Commission initiated an investigation of two tax rulings granted by the Irish tax authorities in 1991 and 2007 to two Irish-incorporated companies that are fully-owned by the Apple Group and ultimately controlled by Apple Inc. The tax rulings concerned the attribution of profits to an Irish branch of the Irish incorporated company which was, under Irish law, treated as a non-resident for Irish tax purposes because it was not managed and controlled in Ireland. The part of the income that was attributed to the company's head office was not subject to tax in Ireland. In August 2016, the Commission concluded that Ireland granted undue tax benefits of up to 13 billion euros to Apple (plus interest).

The Commission's primary line of reasoning was based on a series of assessments concerning the normal taxation of profits under Irish tax law and the Authorised OECD Approach on the arm's length principle. The reasoning was based on the argument that the IP licences held by two Apple companies ("ASI and AOE") should have been allocated to their Irish branches because, aside from those branches, ASI and AOE had no physical presence and no employees capable of performing key functions and managing the licences in question, whereas the branches were the only part of those companies with a tangible presence and employees.

According to the General Court, the Commission was right when it identified the Irish ordinary rules of taxation of corporate profit as the reference framework in the present instance and when it relied on the arm's length principle as a tool in order to check whether the level of profit allocated to the branches for their trading activity in Ireland, as accepted in the disputed tax rulings, corresponded to the level of profit that would have been obtained by carrying on that trading activity under market conditions. However, the General Court concluded that the Commission **made errors concerning the application of the ordinary rules of taxation, the arm's length principle and the Authorised OECD Approach**. As a result, the General Court concluded that the Commission's **primary line of reasoning was based on erroneous assessments of normal taxation under the Irish tax law** applicable in the present instance.

Regarding the Commission's factual assessments concerning the activities within the Apple Group, the General Court also concluded that the Commission has not succeeded in showing that, in the light of the activities and functions actually performed by the Irish branches and of the strategic decisions taken and implemented outside of those branches, the Apple Group's IP licences should have been allocated to those Irish branches when determining the annual chargeable profits of the companies in Ireland.

As a result, the Commission failed in showing that, by issuing the disputed tax rulings, the Irish tax authorities granted Apple a selective advantage that could constitute a prohibited State aid.

In connection with its <u>subsidiary line of reasoning</u>, the Commission opposed that the profit allocation methods endorsed in the disputed tax rulings had led to a result departing from a reliable approximation of a market-based outcome in line with the arm's length principle, because those methods undervalued the annual chargeable profits of ASI and AOE in Ireland.

However, according to the General Court, the Commission **failed in demonstrating** that the choice of the operating costs of the Irish branches of ASI and AOE as the profit level indicator when applying a one-sided profit allocation method was inappropriate and that such a choice, as such, necessarily had to lead to the conclusion that the contested tax rulings had reduced ASI and AOE's tax liability in Ireland.

The General Court also recalled that even where there are inconsistencies which show defects in the methodology used to calculate the chargeable profits in the disputed tax rulings, **the Commission cannot confine itself to invoking a methodological error but must prove that an advantage has actually been granted**, inasmuch as such an error has actually led to a reduction in the tax burden of the companies in question as compared to the burden which they would have borne, had the normal rules of taxation been applied. In particular, according to the General Court:

- even if there is no sufficient explanation of the exact reason for the indicators and figures used to calculate the chargeable profits and concrete and contemporary piece of evidence explaining the reasons for the level of the percentages of the operating costs accepted in the contested tax rulings and in case of lack of profit allocation reports, <u>the Commission must conduct its analysis in such a way as to demonstrate that, as a result of that calculation, the tax actually paid by ASI and AOE on the basis of the contested tax rulings was less than that which should have been paid under the normal rules of taxation, had the contested tax rulings not been issued</u>.
- even assuming that the errors concerning the comparability of the companies chosen in the comparability study with the Irish branch identified by the Commission regarding the ad hoc reports submitted by Ireland and Apple Inc. ex post facto are proved and that they invalidate the conclusions in those reports, <u>the Commission could not infer therefrom that the contested tax rulings had led to a reduction in ASI and AOE's tax liability in Ireland</u>.

On the contrary, the General Court reaffirmed that the burden of proof concerning the existence of an advantage rests with the Commission. And in the Apple case, the Commission

- <u>**did not succeed** in demonstrating that the levels of return established under the tax ruling had been too low to remunerate the functions actually performed by the Irish branches of ASI and AOE</u>, in view of their assets and their risks.

- **did not succeed** in calling in question the reliability of the comparability studies on which the ad hoc reports submitted by Ireland and Apple Inc. are based and, accordingly, in establishing that those reports are not reliable.

Last but not least, the Commission conducted its own comparability analysis, which may be designated as 'the corrected comparability analysis', in order to assess whether the remuneration for the Irish branches of ASI and AOE as endorsed by the contested tax rulings fell within arm's length ranges. And the results of the analysis conducted by the Commission, in essence, confirm the conclusions derived from the ad hoc reports submitted by Ireland and by Apple Inc., according to which the profits allocated to the Irish branch of AOE fell within arm's length ranges.

As a result, in connection with its subsidiary line of reasoning, the Commission failed in showing that, by issuing the disputed tax rulings, the Irish tax authorities granted Apple a selective advantage that could constitute a prohibited State aid.

Finally, in its alternative line of reasoning, the Commission concluded that the contested tax rulings had been issued on the basis of the Irish tax authorities' discretion in the absence of objective criteria related to the tax system and that, therefore, those rulings had to be considered to confer a selective advantage to ASI and AOE. However, according to the General Court, in so far as the Commission **did not succeed** in showing that there was an advantage through its primary and subsidiary lines of reasoning, it cannot, solely through its alternative line of reasoning, show that there is a selective advantage in the present instance. In addition, even assuming that it were established that the tax authorities had discretion but the Commission did not, the existence of such discretion does not necessarily mean that it was used to reduce the tax liability of the recipient of the tax ruling as compared with the liability to which that recipient would normally have been subject.

As a result, in connection with its alternative line of reasoning, the Commission failed in showing that, by issuing the disputed tax rulings, the Irish tax authorities granted Apple a selective advantage that could constitute a prohibited State aid.

The General Court thus concluded that the Commission did not succeed in showing, in the present instance, that, by issuing the disputed tax rulings, the Irish tax authorities had granted ASI and AOE a selective advantage for the purposes of Article 107(1) Treaty on the Functioning of the European Union**.**

Implications

In both the Apple and the Starbucks case, the European Commission challenged the transfer pricing approach adopted by the taxpayer, as confirmed by its local tax authorities in tax rulings. What are the lessons to be learned from this new decision? Does it mean that tax rulings in transfer pricing matters are now safe from an EU state aid perspective?

Unfortunately, most probably not:

- On the same day as in the Starbucks case, the General Court took a totally opposite decision and confirmed the decision of the European Commission in the FIAT case which involved also a tax ruling dealing with transfer pricing matters, this time granted by the Luxembourg tax authorities.

- In all 3 cases (Starbucks, Fiat and Apple), the Court confirmed that the Commission was entitled to rely on the arm's length principle as a tool in order to determine whether there was a selective advantage and so check whether the level of remuneration endorsed by the local tax authorities corresponded to the level of remuneration which would have been obtained under market conditions.

- This means that the European Commission may conclude that a transfer pricing methodology covered by a tax ruling results in an allocation of profits which violates the arm's length principle and constitutes illegal state aid to the extent that it is selective, meaning that it constitutes an advantage for certain undertakings only. However, the burden of proof is on the European Commission to demonstrate that there is a selective advantage and the Commission cannot simply conclude on a selective advantage just because of methodology and/or documentation issues.

- In the case of tax measures, the very existence of an advantage can be established only by comparison with so-called "normal" taxation. In this respect, the Court confirms that the Commission is right that the reference framework are the ordinary rules of taxation of corporate profits, thus a very broad reference framework which makes it easier for the European Commission to conclude on the existence of a selective advantage.

- In both the Starbucks and the Apple case, the Court concluded that the Commission did not manage to demonstrate that there was a selective advantage. However, it was a matter of burden of proof, specific to these cases, and does not mean that the Court shares the approach taken in the tax ruling: in the Apple case, as mentioned in the press release, "although the General Court regrets the incomplete and occasionally inconsistent nature of the contested tax rulings, the defects identified by the Commission are not, in themselves, sufficient to prove the existence of an advantage…"

More time will be needed to review and analyse in details the implications of this 61 page decision and its potential impact on other pending (Luxembourg) state aid cases concerning tax rulings (like the Huhtamäki case). In addition, it remains to be seen whether the decision will be appealed by the Commission or not, meaning that a different outcome may still come.

However, the following can already be said: the decision of the Court is positive since it shows that the Court analyses critically the position taken by the Commission. Transfer pricing is not an easy game and given the numerous errors made by the European Commission in the Apple case, as reflected in the decision of the Court, there is still a lot of room for improvement on the side of the European Commission in challenging the transfer pricing position of taxpayers. Still, the power granted to the Commission as a principle to challenge the transfer pricing position of taxpayers may still create a lot of legal uncertainty for them. The European Commission acts as a transfer pricing expert, giving its own interpretation of the arm's length principle in very complex transfer pricing cases, often without much consideration of whether the same decision would have been taken in comparable circumstances.

While the Court is here to make sure that the European Commission does not misuse EU rules in the name of tax justice, competition commissioner Margrethe Vestager is not giving up the fight and said once again, as it already did after the FIAT and the Starbucks case that "the Commission will continue to look at aggressive tax planning measures under EU state aid rules to assess whether they result in illegal state aid".

At a more political level, this case also adds weight to the view that the correct way to redress flaws in the international tax system is by multilateral tax reform such as the BEPS project and not by unilateral actions in this case based on a competition law framework not originally designed for this purpose. It is worth noting that since the commencement of these cases, the perceived "unfairness" of Apple-like structures has essentially been "fixed" in the EU by the implementation of BEPS.

Do you have further questions?

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