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Transfer Pricing Meets State Aid: Conflicting Arm's-Length Standards and Other Lessons From the Apple Saga

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In this article, the authors discuss transfer pricing, state aid, the Apple case, and how multinational enterprises should manage risk.

A quote widely attributed to Benjamin Franklin is that "in this world nothing can be said to be certain, except death and taxes." However, in recent years risk and uncertainty regarding the appropriate levels of tax for multinational enterprises have increased because of substantial changes in the tax and state aid environments.

There are two key drivers of the increase in MNEs' tax risks. The first arises as a result of a series of reports published by the OECD as part of its ongoing base erosion and profit-shifting project. The second arises from the European Commission's decisions finding illegal state aid in connection with MNEs' individual tax rulings.

The different, expanding roles of those two supranational organizations, combined with a new global emphasis on tax transparency and more active enforcement of transfer pricing regulations, have dramatically increased the risks MNEs face for their tax positions and the associated reputational risks.

This article reviews and analyzes the interaction and dissonance between the OECD BEPS project and EU state aid law, as best demonstrated by the European Commission's final decision in the Apple case.

I. Transfer Pricing and the OECD BEPS Project

A. Transfer Prices and Declared Profits

MNEs typically operate multiple companies across many tax jurisdictions, with a range of intercompany agreements and operational links among them. Those agreements and links can include:

- purchases and sales of tangible goods between companies;
- payments for intangibles, such as for the use of intellectual property rights, including via royalty rates;
- group charges for various head office services and shared services across companies (such as management, finance and reporting, and IT services); and
- intercompany debt and financing agreements.

Those arrangements affect the profits declared, and thus the taxes paid, by specific companies. Accordingly, while transfer pricing arrangements are unavoidable (services, goods, and financing supplied on an intergroup basis are not costless), tax authorities understandably want to avoid MNEs artificially transferring profits through their transfer pricing arrangements to low- (or no-) tax jurisdictions to avoid paying tax in high-tax jurisdictions.

B. The OECD's Role and Transfer Pricing Methods

International consensus is important for transfer pricing regulations, not least because inconsistent rules could lead to companies facing double taxation and legal uncertainty.

For more than 20 years, the OECD has been producing transfer pricing guidelines that are used by both OECD members and nonmembers.[1] The OECD's transfer pricing guidelines center around the requirement that transfer prices be arm's length. The OECD guidelines apply the arm's-length principle to many related-party transactions. There are various methods that taxpayers can use to test their transfer prices for arm's-length equivalence. These methods fall into two categories: traditional transaction methods, which include the comparable uncontrolled price, resale price, and cost-plus methods; and transactional profit methods, which include the transactional net margin method (TNMM) and the profit-split method.

C. The BEPS Project

Even though regulations based on the OECD guidelines have long existed to test the arm's-length nature of MNEs' transfer pricing, concerns have remained. Indeed, according to the OECD, aggressive tax planning has caused $240 billion, or up to 10 percent of global corporate income tax revenue, in annual tax avoidance.[2] As a result, in 2013 the OECD began a multiyear initiative to fight BEPS by identifying 15 actions[3] to reduce tax avoidance and forming various working parties to study the problem and produce new guidance. The OECD has described the BEPS action plan as:

> structured around three fundamental pillars: introducing coherence in the domestic rules that affect cross-border activities; reinforcing substance requirements in the existing international standards, to ensure alignment of taxation with the location of economic activity and value creation; and improving transparency, as well as certainty for businesses and governments.[4]

Several BEPS reports are of particular interest: Action 5 is intended to counter harmful tax practices more effectively, actions 8-10 attempt to align transfer pricing outcomes with value creation, and action 13 covers transfer pricing documentation and country-by-country reporting. In short, the BEPS action plan emphasizes that transfer pricing should reflect value creation or economic substance (so that tax liabilities reflect underlying economic profits based on the economic activities being carried out by various group companies) and increases MNEs' obligations to document transfer pricing arrangements and be transparent regarding where they are reporting their profits.

Following the BEPS project, the OECD guidelines now address concerns that MNEs might shift intangible rights, such as the right to use IP, to low- or no-tax jurisdictions. The concern is that by shifting those rights, MNEs might try to justify booking excessively large profits in jurisdictions with low tax rates, even when they are not performing economic activities that would justify booking those profits there. A lack of economic substance in the location where IP rights were purchased and excess profits were booked was not widely identified as a problem until the BEPS reports and the 2017 OECD guidelines.

The BEPS reports and 2017 guidelines also addressed the creation of a principal company or head office with no economic activities, also known as a "cash box," in a low-tax jurisdiction, as well as corporate inversions. Moving headquarters is acceptable from a tax liability perspective, but not if the new headquarters lack economic substance. In some instances, MNEs have used stateless entities that do not pay any tax.

The BEPS project was substantially completed in 2015 and has already gone into effect or will go

[1] The OECD's transfer pricing guidelines were first published in 1979 and adopted by the OECD Council in 1995. The guidelines have been revised several times — most recently in July 2017 to reflect changes resulting from the BEPS project. The 2017 edition incorporates substantial revisions made in 2016 to reflect the clarifications and revisions agreed to in the base erosion and profit-shifting reports on actions 8-10 and 13.

[2] OECD release regarding discussion topics for the G-20 finance ministers meeting (Oct. 5, 2015).

[3] OECD, "Action Plan on Base Erosion and Profit Shifting" (July 19, 2013).

[4] *Supra* note 2.

into effect in many major jurisdictions.[5] For example, the United States has agreed to annual CbC reporting for tax years beginning on or after June 30, 2016, for U.S. entities that are the ultimate parents of a multinational group, making 2017 the first reportable period for calendar-year MNEs.[6]

D. Documentation and Reporting

The action 13 BEPS report and the 2017 OECD guidelines call for a three-tiered approach to transfer pricing documentation:

- a master file covering the totality of a MNE's operations and its transfer pricing policies;
- a local file providing information about the relevant related-party transactions and amounts involved at the local affiliate; and
- a new CbC template for reporting revenues, profits (or losses), taxes paid and accrued, assets, and employees in every country where the MNE operates.[7]

The CbC report is the OECD's attempt at full transparency and for the first time requires the parent of every MNE group exceeding a revenue threshold to annually provide pertinent data to tax authorities for its entire global operation, rather than just for operations that occur in one particular jurisdiction. That global picture will show tax authorities whether MNEs' recorded profits (and thus the tax base) are different for similar operations at different locations and whether taxes paid are potentially out of sync with the economic substance of the supply chain.

For example, if the CbC report indicates that a taxpayer derives significant income from an entity with little economic substance in a low-tax jurisdiction, a local tax examiner can explore whether the taxpayer's affiliate in the examiner's jurisdiction is making transfer payments to an affiliate in the low-tax jurisdiction. Merely paying royalties, service fees, or other payments to the low-tax jurisdiction does not necessarily indicate tax avoidance, but the examiner can use those data to ask the taxpayer more targeted questions. The reverse is also true: For example, if a local tax examiner realizes that a taxpayer with substantial operations in his jurisdiction is booking relatively little income, he can investigate.[8]

While CbC reporting information may be used only by tax authorities and is disseminated through a government-to-government exchange mechanism, there is speculation that it will ultimately become public in some form. In particular, the European Commission has said it wants the reports to become public.[9] If the appearance or fact of tax avoidance becomes public through media reporting, that will further raise reputational concerns associated with transfer pricing arrangements.

Moreover, MNEs must also contend with another supranational authority besides the OECD that makes decisions about transfer pricing — namely, the very same European Commission. The OECD has stated that the commission was fully engaged in and provided its views throughout the BEPS project:

> The parallel work carried out by the EU Commission, and in particular the Action Plan on Corporate Taxation unveiled in June 2015, complements the BEPS Project by closing existing loopholes in EU rules. It also provides a swift mechanism for the

[5] Some BEPS measures can be implemented through OECD guidance, but others must be implemented via domestic legislation or treaty amendments. The OECD has provided a multilateral instrument to rapidly amend treaties to help prevent tax avoidance. OECD, "Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting" (Nov. 24, 2016). Based on the jurisdictions that have signed the MLI, tax authorities expect that more than 1,100 bilateral tax treaties will be amended. The first modifications are expected to take effect in January 2018, but given the anticipated time needed for ratification, most treaty changes will not be effective until 2019.

[6] *See* final CbC regulations (T.D. 9773).

[7] The CbC reporting template does not apply to groups with annual consolidated revenue in the preceding fiscal year of less than €750 million. Different countries have different threshold requirements. For example, the U.S. threshold for reporting is annual revenue of at least $850 million.

[8] However, recent OECD guidance states that because the financial and employee data required by CbC reporting do not reflect risk allocations or provide entity-level detail for multiple entities operating in the same country, CbC reports alone do not give tax officials sufficient information to definitively assess the appropriateness of a group's tax arrangements. The guidance adds that while CbC reports should be used only to determine whether a more detailed investigation into a group's transfer pricing arrangements or other BEPS-related risks is necessary, tax administrations are not restricted from further inquiry into questions raised by CbC data.

[9] Six months after the final BEPS reports were released, the commission released a proposed council directive requiring public CbC reporting for companies meeting the OECD's threshold revenue requirements (COM(2016) 198/2).

implementation of domestic law measures at the EU level.[10]

II. State Aid Cases and the U.S. Response

At the outset, it is important to appreciate that the commission's remit for transfer pricing is very different from that of the OECD. The commission's focus is on enforcing the state aid rules in the Treaty on the Functioning of the European Union (TFEU). The TFEU generally prohibits EU state aid in any form[11] because companies that selectively benefit from government support gain an unfair potential or actual advantage over their competitors.

State aid is broadly defined as an advantage in any form conferred on a selective basis to companies by public authorities,[12] but there are further requirements — namely, that competition has been or may be distorted and that the intervention may affect trade between member states. However, at least one commentator has observed that the definition of state aid does not require that the distortion of competition or effect on trade be significant or material: "[Any] advantage granted to an undertaking operating in a market which is open to competition will normally be assumed to distort competition and also be liable to affect trade between Member States."[13]

The state aid rules require that the European Commission be notified in advance of all new aid, with some exceptions. If the commission reaches a negative decision regarding state aid that has already been paid, it can require the recovery of those subsidies plus interest. Accordingly, businesses that may benefit from state aid are often advised to consider whether any proposed measures may require notification before the aid is granted. Aid may be recovered from businesses if they are subsequently sold, thus making questions about state aid fairly routine in mergers and acquisition due diligence.

Favorable tax treatment is a kind of advantage that can be granted by a member state to a company. EU states can set general company tax levels. However, if an individual company's tax ruling contravenes market principles in a way that confers a selective advantage, that could be considered state aid.[14]

In 2001 the commission began investigating member states' tax schemes that benefited only particular companies, but ramped up investigations in summer 2013 with the establishment of a task force to investigate EU member states' tax rulings.[15] The 2013 investigations started with an inquiry into the tax ruling practices of seven member states that was extended to all member states in December 2014 following the LuxLeaks scandal a month earlier.

According to press reports, companies (other than Apple Inc.) potentially targeted by the commission include Google, Walt Disney Co., Facebook, IKEA, and Koch Industries Inc.[16]

According to a working paper on state aid and tax rulings by the Directorate-General for Competition, as of June 2016 the commission had reviewed more than 1,000 specific tax rulings, with nearly 600 from the LuxLeaks files.[17] The commission has also gathered tax information on more than 300 companies, searching for favorable tax treatment by governments across the EU.

[10] OECD, "Information Brief for Journalists," at 4.

[11] For a good overview of the state aid regime, see Cyrus Mehta, "Competition Regime: State Aids," CMS Cameron McKenna Nabarro Olswang LLP. Some narrowly defined aid is always compatible with the Treaty on the Functioning of the European Union, other categories may be compatible, and conditions may be attached to the granting of state aid (such as the closure or divestment of some business activities). For example, the commission approved the granting of extensive state aid following the financial crisis.

[12] "Consolidated Version of the Treaty on the Functioning of the European Union," article 107(1), 2016 O.J. C 202/47.

[13] *Supra* note 11.

[14] Fiscal measures of a general nature that apply to all companies without distinction fall under the authority of the member states and cannot constitute state aid. Further, despite the general prohibition of state aid, the commission has said that in some circumstances, government intervention is necessary for a well-functioning and equitable economy and for general economic development. Therefore, the TFEU identifies several policy objectives for which state aid can be considered compatible.

[15] That task force has become a separate unit of the commission's Directorate-General for Competition.

[16] *See* Reuters, "Apple, Google, McDonald's and IKEA Are All on the Hook for Their Tax Deals," Fortune.com (Mar. 14, 2016); Kelly Couturier, "How Europe Is Going After Apple, Google, and Other U.S. Tech Giants," *The New York Times* (Dec. 20, 2016); and Alison Fitzgerald and Marina Walker Guevara, "New Leak Reveals Luxembourg Tax Deals for Disney, Koch Brothers Empire," *International Consortium of Investigative Journalists* (Dec. 9, 2014).

[17] Most LuxLeaks tax rulings are confirmatory, or simple rulings containing no calculation of profits and unlikely to give rise to state aid concerns. However, some confirmatory rulings can raise state aid issues. *See* Julie Martin, "More Tax Rulings Under EU Scrutiny for Illegal State Aid," *MNE Tax* (Apr. 5, 2016).

Commission Allegations and Decisions in Major State Aid Tax Cases

Case and Country Case Number	Commission Decision	Commission Allegation
Amazon.com Inc. — Luxembourg SA.38944	Commission final decision October 4, 2017, ordered recovery of €250 million; appeal under consideration.	APA* allowed payment of tax-deductible royalties to limited partnership not subject to tax. (1)
Apple Inc. — Ireland SA.38373	Commission final decision August 30, 2016, ordered recovery of €13.4 billion; under appeal.	Two APAs allowed bulk of profit to be allocated to two Irish entities not tax resident in Ireland. (2)
Belgian excess profits tax exemption Article 185(2)(b) of the Belgian Income Tax Code of 1992 SA.37667	Commission final decision January 11, 2016, involved 36 companies and €700 million; under appeal. Companies include Anheuser-Busch and BP.	Belgium allowed MNEs to reduce their corporate tax base by 50 to 90 percent to discount for "excess profits." (1)
Engie S.A. (formerly GDF Suez Group) — Luxembourg SA.44888	Commission preliminary decision September 19, 2016.	Tax ruling allowed the same financial transaction to be treated as both debt and equity. (3)
Fiat Chrysler Automobiles N.V. — Luxembourg SA.38375	Commission final decision October 21, 2015, amounting to €20 million to €30 million; under appeal.	APA allowed financing unit to receive below-market compensation; affected intragroup interest rates. (1)
McDonalds Corp. — Luxembourg SA.38945	Commission preliminary decision December 3, 2015.	Tax ruling allowed receipt of royalty income for U.S. rights to be not subject to tax. (3)
Starbucks — Netherlands SA.38374	Commission final decision October 21, 2015, amounting to €20 million to €30 million; under appeal.	APA allowed Dutch unit to pay royalties to U.K. affiliate not at market level; similar issue regarding payments to Swiss affiliate. (1)

*An APA is an advance pricing agreement between a MNE and one or more governments.

(1) Transfer pricing is not arm's length.

(2) Profit allocation does not reflect a market outcome.

(3) Inconsistent application of national laws.

The commission's working paper states that the commission is not calling into question the granting of tax rulings, with advance rulings providing certainty to taxpayers, but is instead concerned about rulings that endorse transfer pricing arrangements that provide a selective advantage in the form of reduced taxable profits — and thus, reduced corporate taxes.

The table summarizes final and preliminary commission decisions in recent major state aid tax cases. As indicated, every final decision is under appeal. The cases all involve one of three issues: the commission concluded that transfer pricing is not arm's length, the profit allocation does not reflect a market outcome, or there has been an inconsistent application of national laws.

On August 24, 2016, shortly before the final decision in Apple, the U.S. Treasury Department released a white paper on the commission's state aid investigations expressing its disapproval of the commission's approach. It focused primarily on concerns that the commission's approach is new, departs from prior commission decisions and EU case law, and is inconsistent with international norms and undermines the international tax system. Treasury also said the commission should not seek retroactive recoveries under its new approach.

Treasury made several other important points specific to the United States and its companies. First, according to the white paper, the commission's actions undermine U.S. efforts to develop transfer pricing norms and implement BEPS recommendations. It can be argued that the validity of those concerns depends on whether the commission's assessment of arm's-length transfer pricing corresponds with the OECD's guidelines.

Second, there is a possibility that any repayments ordered by the commission will not be considered foreign income taxes creditable against U.S. taxes owed by U.S. companies. Treasury said it might be unwilling to accept foreign tax credits resulting from state aid cases because that "would effectively constitute a transfer of revenue to the EU from the U.S. government and its taxpayers."

That is a politically sensitive topic. For example, one of the points made by Apple in its appeal is that the commission failed to recognize that Apple's profit-driving activities, particularly IP development and commercialization, were controlled and managed in the United States. If that is correct, the logical conclusion is that from a transfer pricing perspective, those associated profits should be taxed in the United States, not Ireland, a finding contrary to that made by the commission.

Third, if the commission pursues additional cases against U.S. companies, that may have a chilling effect on U.S.-EU cross-border investment.

Fourth, the adoption of new enforcement regimes with retroactive effect will hinder U.S. and other companies' abilities to assess risks and make plans, and sets a bad precedent for tax authorities worldwide.

In a June 2016 letter to Commission President Jean-Claude Juncker, then-U.S. Treasury Secretary Jacob Lew expressed concern that the commission's investigations seemed to be "targeting U.S. companies disproportionately."[18]

Treasury's response should not be interpreted as meaning the department is not concerned with preventing tax avoidance; it is actually quite the opposite — namely, that transfer prices should be closely regulated through enforcement of arm's-length requirements. Indeed, the United States has increased its investigations of tax avoidance through transfer pricing abuse and its filings before the U.S. Tax Court.

One IRS tool is to designate for litigation high-value matters that could establish helpful precedent. The IRS is attempting to establish through litigation its authority over critical transfer pricing issues. If a matter is designated for litigation, the taxpayer cannot seek relief through avenues such as the appeals process or the advance pricing agreement program, and must either pay the additional tax specified in the notice of deficiency or argue its case in court.

Companies targeted by the IRS with matters designated for litigation include Amazon.com Inc., Altera Corp., Microsoft Corp., and the Coca-Cola Co. Some have also been targeted by the commission for having received illegal state aid, which is unlikely to be a coincidence.

The U.S. Congress is expected to challenge the commission more forcefully. The U.S. government is likely to look for ways to generate additional tax revenue, including repatriating overseas profits, and will continue to fight corporate tax avoidance. Substantive corporate income tax reform is also under consideration by the U.S. Congress. In the meantime, the U.S. government has apparently decided to intervene in Apple's appeal to the EU General Court, which is expected to hear the case in late 2018.[19]

III. The Commission's Analysis in Apple

The commission argued in the Apple case that it is sufficient to find that a company secured an advantage to conclude that the advantage is selective. Even so, it applied the three-step analysis used by the Court of Justice of the European Union to assess fiscal aid schemes to

[18] European Commissioner for Competition Margrethe Vestager responded to Lew on behalf of Juncker on February 29, 2016.

[19] An unnamed source has confirmed that "the United States filed an application with the European Union General Court to intervene in the case involving the retroactive application of state aid rules to Apple." Tim Worstall, "Difficult to Disagree, EU Commission Is Using Apple, Tax Cases, to Political Ends," Forbes.com (July 5, 2017).

confirm the selectivity of the aid, asserting that a deviation from standard tax treatment produces selective advantage.

The first step in the analysis is to identify the common or normal tax regime in the member state (the reference system) based on the ordinary rules of taxation of corporate profits. Second, one must determine whether the relevant tax measure is a derogation or deviation from that reference system that differentiates between (or gives different tax treatment to) comparable businesses.[20] Third, if a derogation exists, one must determine whether the measure is justified by the nature or general scheme of the reference system.

Apple argued that transactions between unrelated companies are not comparable to those between related, integrated companies. The commission rejected that argument, emphasizing that the objective of transfer pricing rules is to ensure that transactions among groups or associated companies are comparable to transactions among independent companies. Apple and Ireland also argued that resident and nonresident companies are not comparable because resident companies are taxed on their worldwide income, whereas nonresident companies are taxed on their locally sourced income. The commission did not dispute that point, but instead asserted that the objective of the tax rules is to apply the same standard tax rates for worldwide income of resident companies to the income of Irish agencies or branches of nonresident companies.

The commission appears to view any derogation from the arm's-length principle as automatically conferring a selective advantage, unless justified by the reference system. In short, the substantive question is whether the transfer pricing is arm's length; however, the commission makes that assessment itself and not purely by reference to the OECD guidelines.

[20]The commission has said that domestic and nonresident companies are comparable, as are nonintegrated and integrated companies.

In support of this view, the commission cited a 2006 CJEU judgment[21] holding that a reduction in the taxable base resulting from a tax measure that enables a taxpayer to use transfer prices in intragroup transactions that do not resemble prices that would be charged between independent parties under comparable circumstances at arm's length confers a selective advantage on the taxpayer. It is then a quick step in that logic to conclude that a selective advantage conferred on a taxpayer, by enabling the taxpayer to set transfer prices inconsistent with the arm's-length standard, is indicative of unlawful state aid.

The commission also argued that even if the relevant Irish tax law is not governed by the arm's-length principle (which the commission disputed), the contested tax rulings still conferred a selective tax advantage because they would then be the result of discretion exercised by Irish Revenue in the absence of objective, tax-related criteria.

Apple and Ireland dispute those points in their appeals.[22] First, Ireland observes that the commission's decision wrongly asserts that the 1991 and 2007 opinions by Irish Revenue "renounced" tax revenue that Ireland would have otherwise been entitled to collect from the Irish branches of Apple Sales International (ASI) and Apple Operations Europe (AOE). It also argues that the opinions followed the ordinary tax rules applicable to Irish branches of nonresident companies under Irish law, which tax only the profits attributable to the branch, not the non-Irish profits of the company.

Second, Ireland says the opinions did not depart from normal taxation, and thus, no selective advantage was granted to ASI or AOE. It claims the commission ignored the distinction

[21]*Belgium and Forum 187 ASBL v. Commission*, joined cases C-182/03 and C-217/03 (CJEU 2006). The CJEU said that to determine whether a selective advantage was present, the commission had to compare the challenged tax regime in the member state "with the ordinary tax system, based on the difference between profits and outgoings of an undertaking carrying on its activities in conditions of free competition," a comparison to be made with reference to the OECD arm's-length standard.

[22]Case T-892/16, *Apple Sales International and Apple Operations Europe v. Commission*, OJ 2017 C-53/37 (Feb. 3, 2017), and *Ireland v. Commission*, OJ 2017/C-038/48 (Feb. 2, 2017). The description adopted in the main body of the text more closely follows Ireland's formulation of the summary of its appeal.

between resident and nonresident companies and accuses the commission of seeking to rewrite Irish corporation tax rules so that Irish Revenue should have applied the commission's version of the arm's-length principle in the rulings. According to Ireland, that principle is not part of EU or Irish law regarding branch profit attribution, and the commission's claim is inconsistent with member state sovereignty in direct taxation.

The CJEU has taken a broad approach to selective advantage. For example, it overruled a verdict from the General Court of the European Union that the commission had incorrectly judged the receipt of tax breaks by Spanish companies resulting from the purchase of shares in foreign entities to be state aid.[23] According to the CJEU, that indeed was state aid: A benefit can still be selective even if available to all companies and relatively easy to qualify for. In this case, because only large acquisitions were eligible for the tax break, the benefit was selective.

Ireland's third point on appeal is that even if the commission's arm's-length principle were legally relevant (which Ireland does not accept), the commission has failed to apply it consistently or to have examined the overall situation of the Apple group.

In its working paper, the commission said a tax ruling in compliance with the OECD guidelines is unlikely to constitute state aid. However, it also said that although it may refer to the OECD arm's-length principle, it is not bound by it.

The commission made those points in similar terms in Apple, and its statements must be judged by reference to the actual analysis in its decisions. The analysis in Apple raises questions regarding whether the commission is seeking to apply OECD methods. It can also be strongly argued that the commission is retroactively applying current OECD methods. Indeed, Ireland says in its appeal that the commission has infringed the principles of legal certainty and legitimate expectation by invoking OECD documents from 2010 that could not have been foreseen in 1991 or 2007.

In short, the commission's analysis is based on its view of state aid and its own unique definition of arm's-length pricing.

Apple and Ireland raise other points on appeal, including that the commission breached essential procedural requirements, TFEU article 296, and article 41(2)(c) of the Charter of Fundamental Rights of the European Union.

A. Were Apple's Transfer Prices at Arm's Length?

In its assessment of whether Apple's transfer prices met its definition of the arm's-length standard, the commission disregarded Apple's and Ireland's arguments that:

- Apple was treated the same way as other nonresident taxpayers in Ireland and thus was not granted any selective advantage; and
- the state aid rules do not require Ireland to calculate Apple's taxable profits in accordance with the commission's arm's-length principle.

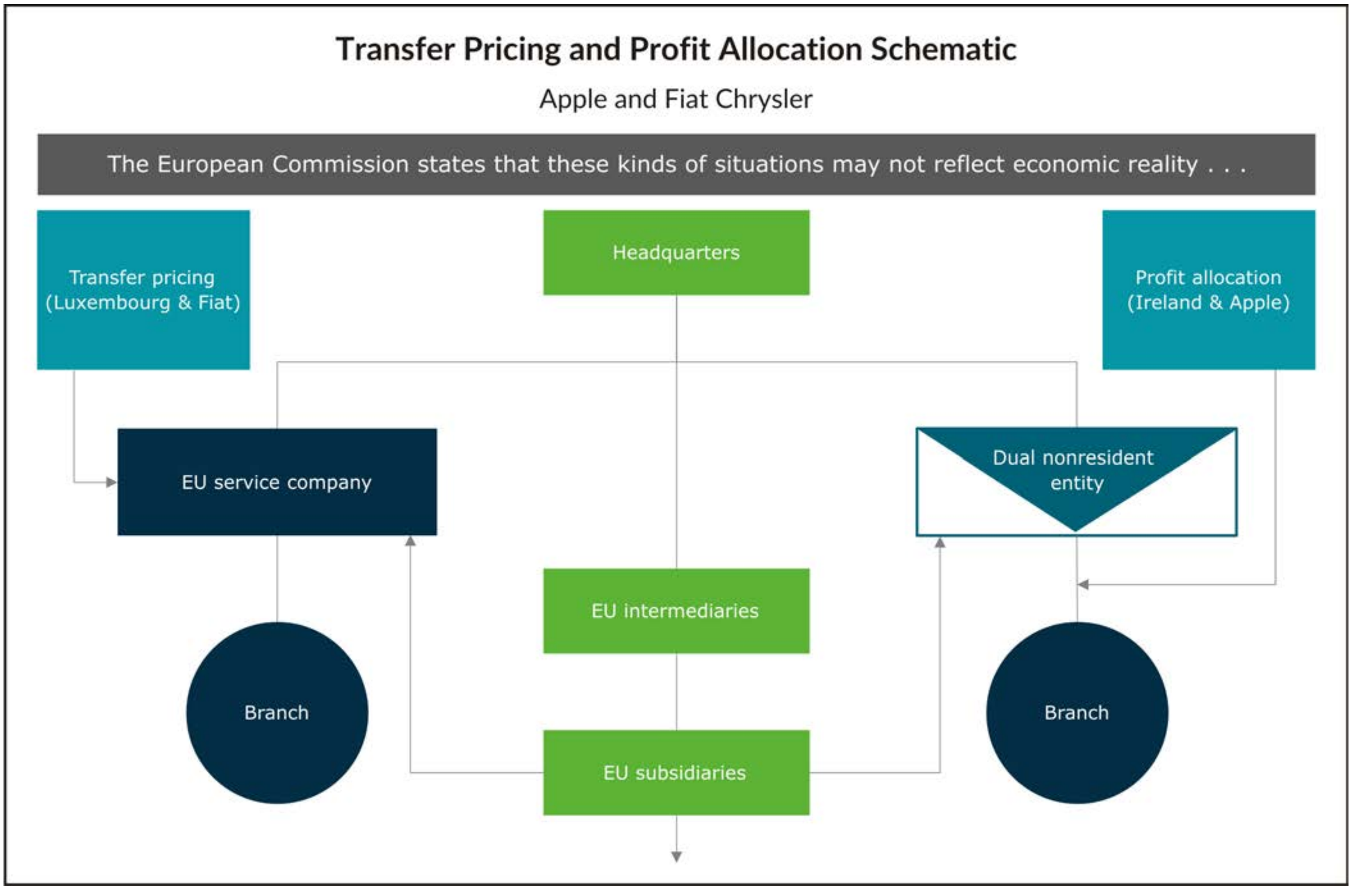
As is well known to followers of Apple's tax planning, ASI and AOE were both Irish corporations but were not tax resident in Ireland. Before changing its tax laws in 2013, Ireland had treated these entities as U.S. tax resident, but as the United States did not treat them as such, ASI and AOE were effectively rendered "stateless entities." They were both owned by a Bermuda holding company, and Apple's asset management company managed both companies' cash in accounts located outside of Ireland.

Apple refers to both ASI and AOE as "head offices," but they can also be described as "cash boxes" because of their utter lack of operations, physical assets, or employees.

ASI's and AOE's operating branches were also Irish corporations, but were tax resident in Ireland. They performed routine operations; booked routine, low levels of returns per the tax rulings; and paid taxes to the Irish tax authority.

The figure shows the profit allocation in Apple, as compared with a more common pure transfer pricing situation, demonstrated using the

[23] Combined decision in *Autogrill España SA v. Commission*, T-219/10 (2014); and *Banco Santander SA and Santusa Holding SL v. Commission*, T-399/11 (2014).



state aid case against Fiat.[24] In both cases, subsidiaries in the EU and elsewhere sell into the market and make transfer pricing payments to related parties. In the Apple case, those payments were allocated between ASI's and AOE's nonresident head offices (cash boxes) and their Irish branches (that allocation is the focus of the case). In a standard case (Fiat), the question involves the actual level of the related-party payments; specifically, whether the transfer prices paid to an EU service company (in Luxembourg for Fiat) are equivalent to arm's-length prices.

The Irish operating branches played no role in managing, creating, or acquiring Apple IP. A key element of that historic tax planning was the existence of legal contracts between parent company Apple Inc. and ASI and AOE dating back to 1980 in the form of a cost-sharing agreement (CSA), which was amended many times.

Today, in a typical CSA, two entities in an MNE agree to share the costs of development of intangibles in a manner consistent with the relative revenues generated or profit uplift resulting from the intangibles. CSAs are often entered into as a replacement for a system of related-party royalty payments flowing back and forth. A key element is that the CSA must be between two entities that each contribute assets, employees, and knowledge to the joint research and development platform.

In 1980, however, when the Apple CSA was signed, U.S. and OECD guidance did not have this requirement.[25] It was sufficient for one entity to

[24] The commission found that Fiat Finance & Trade, a financing arm of Fiat Chrysler in Luxembourg, was receiving below-market transfer pricing payments from related companies in Europe and thus booking taxable income at below-market levels. An APA with Luxembourg specified the method for setting Fiat Finance & Trade's taxable income, which the commission viewed as providing a favorable tax ruling and thus illegal state aid.

[25] Although the CSA concept dates to 1966, the IRS first issued comprehensive regulations addressing those agreements in 1995. The European version, a cost-contribution arrangement, first appeared in OECD guidance issued in 1997.

contribute assets, employees, and knowledge, and the other to contribute money only. The contract could be structured such that the entity contributing money would be entitled to both the rights to manufacture or sell products with embedded IP and to a part of the excess profits because of its capital contribution, despite its limited activities. In other words, the high-value-added activities that create the valuable IP rights may effectively transfer profits to other group entities regardless of whether that is economically justified by their more limited and lower-value-added activities.

Under the CSA, Apple shared R&D costs with ASI and AOE in proportion to sales in their respective regions. Although Apple retained legal ownership of all IP and used its right to manufacture and sell Apple products in the Americas, the CSA gave ASI and AOE the beneficial ownership of rights outside the Americas. With the rights to manufacture and sell in their designated markets, the material profits that were ultimately earned by Apple in those markets could remain within those cash boxes after allowing the Irish branches to keep the routine profits associated with their limited assembly and distribution activities, and after paying Apple to help fund R&D as per the CSA.

The annual payments to Apple, which were deducted from profits generated by the Irish subsidiaries, amounted to about $2 billion in 2011 and increased significantly in 2014. They contributed to more than half of all the Apple group's R&D efforts worldwide, according to the commission. The net profits remained with ASI and AOE as the return for their monetary contributions.

As discussed, the BEPS project has significantly changed the transfer pricing landscape. Most pertinent to the Apple case is the OECD's determination that an intercompany contract that is not supported by economic substance is invalid. Given today's OECD guidelines, the 1980 CSA would be invalid because the ASI and AOE head offices were in fact paper companies that lacked economic substance. However, before the outcome of the OECD's BEPS initiative, deference was paid to legal contracts regardless of economic substance. If a company — even if just a cash box — funded intangible development through a CSA, it was entitled to its share of the profit uplift, which could be well above a return for funding.[26]

Apple also set up its European sales operations in such a way that customers were contractually buying products from ASI, rather than from the stores that physically sold the products. The commission said that by doing that, Apple could record all its sales and profits in Ireland, and those taxable profits were governed by the favorable tax rulings Ireland granted to Apple in 1991 and 2007.

Under the terms of ASI's APA, net profit was calculated as a specific percentage of branch operating costs, excluding some charges. Under the terms of AOE's APA, net profit was also calculated as a specified percentage of branch operating costs with some added provisions in the 2007 APA. Taxes owed to Ireland were based on those net profit calculations.

Apple revised its corporate structure in Ireland before the commission's decision to reflect changes in Ireland's tax legislation, so that companies incorporated in Ireland (such as ASI and AOE) can no longer declare their tax residency outside Ireland without having tax residency anywhere else. Thus, the 2007 tax ruling would no longer be used to determine the taxable base of ASI and AOE in Ireland after September 27, 2014.

B. The Commission's Analysis of State Aid

The commission announced its final decision in Apple on August 30, 2016 (C(2016) 5605 final).[27] It concluded that Ireland had granted Apple illegal state amounting to approximately €13.4 billion, plus interest of about €1.5 billion.

The commission's decision is argued on several alternate grounds. First, the commission

[26]Numerous observers have considered form versus substance in transfer pricing. *See, e.g.*, Lee A. Sheppard, "When Should Transfer Pricing Disregard Contracts?" *Tax Notes Int'l*, Apr. 21, 2014, p. 222; and Mindy Herzfeld, "The Economic Substance Doctrine: Lessons for BEPS," *Tax Notes Int'l*, May 11, 2015, p. 503. Kevin A. Bell and Rick Mitchell, "BEPS Transfer Pricing Report Aligns Outcomes, Value Creation," Bloomberg BNA, 24 *Transfer Pricing Report* 752 (Oct. 15, 2015) ("[Pascal] Saint-Amans said that before the BEPS project, it was possible to put $1 billion of capital and a cost-sharing arrangement in a zero-tax jurisdiction, such as Bermuda, and then locate all the returns to that cash box").

[27]The redacted final decision was released December 19, 2016.

rejected Irish Revenue's acceptance that the Apple IP licenses held by ASI and AOE should be held outside Ireland. It then said that even if those licenses were properly held outside Ireland, inappropriate profit allocations that departed from the arm's-length principle were applied. It rejected the determination of the entities' taxable profit using a transfer pricing method that resembles the TNMM, with the Irish branches being treated as the tested party and the residual profit of ASI and AOE being allocated outside Ireland. The commission also rejected the analysis carried out based on that approach and said its adverse conclusions were supported by the facts that the contested tax rulings were produced without a profit allocation report and were not time limited.

1. Apple's IP Licenses

Regarding its first point, the commission said it appeared that the head offices of ASI and AOE "existed on paper only," and that the Apple IP licenses should thus have been allocated to the Irish branches for tax purposes. It also said the existing allocation was not one that would have been agreed to between unaffiliated companies.

Given that the commission rejected the claim that the Apple IP was located outside Ireland, it also rejected Ireland's argument that the profits derived from the Apple IP should be subtracted from Irish taxable profits. It said the income recorded by ASI and AOE was trading income from Irish branch activities, not income from IP royalties, and this trading income should be taxed in Ireland.

Ireland and Apple argued that ASI's and AOE's profits were driven by Apple's U.S. contributions to R&D and the management of Apple IP, making Irish Revenue right to exclude the profits from those contributions from the taxable profits of ASI's and AOE's branches.

The commission rejected that argument, saying ASI and AOE had already contributed to the cost of R&D under the CSA and that the contested tax rulings take those agreements as given. The substantive point the commission seemed to make was that while contributions by ASI and AOE to Apple reduced their profits, those contributions could not affect the subsequent allocation of profits between ASI and AOE and their Irish branches.

The commission concluded that the IP licenses held by ASI and AOE should have been allocated to their Irish branches and that all their profits from sales activities (barring normal interest income) should have been allocated to the Irish branches. It further concluded that this advantage was selective because it lowered the taxes faced by ASI and AOE as compared with nonintegrated companies.

In support, the commission referred to the 2010 OECD profit attribution report, which points to the physical presence of employees or people performing functions on behalf of the head office as a first step in the profit allocation process, as an objective means to allocate assets used, functions performed, and risks assumed between the head office and its place of permanent establishment. The commission observed that ASI and AOE had no employees or people performing functions on behalf of those companies outside the branches.

The commission also referred to the language in the 2010 OECD report specifying that active decision-making taken below the senior management level is determinative regarding the ownership of intangibles, noting that ASI's and AOE's head offices had no employees below the senior management level. It dismissed two expert opinions, one authored by Apple's tax adviser and the other by PwC for Ireland, that apparently did not question the allocation of the IP licenses to ASI and AOE as head offices.[28]

Both Apple and Ireland argue in their appeals that the commission made fundamental errors by failing to recognize the applicants' profit-driving activities — particularly, that the development and commercialization of Apple IP were controlled and managed in the United States. The profits from those activities were therefore attributable to the United States, not Ireland.

In other words, Apple and Ireland argue that the excess profit is the property of the parent company, because the development and commercialization of the valuable IP were controlled and managed in the United States, and the low recorded Irish branch profits were

[28]The commission referred to the two expert opinions as "ad hoc" reports to indicate that they had been prepared ex post facto for its investigation. Apple had not previously prepared a transfer pricing report or profit allocation study regarding either tax ruling or other topics.

consistent with the arm's-length standard as that term is generally understood under the OECD guidelines. They say Apple's Irish branches played no role in IP development and commercialization and performed routine functions for which they received appropriate remuneration.

The commission, on the other hand, chose to reallocate profits to entities in the EU — namely the Irish branches — that, although they had operations on the ground, did not have the economic substance to generate those profits. It took as a given the allocation of profits under the CSA between the U.S. parent and the stateless head offices, and looked only at the allocation of profits between those head offices and the Irish branches. That is problematic, because economic-substance-based transfer pricing — if that is the right legal standard to apply — would not assess economic profitability partially (for example, between ASI and AOE and their Irish branches), but across the MNE as a whole.

In short, the commission did not ask the core question of whether the excess profits of U.S. multinational Apple really lived in the United States or Ireland, which would have required it to analyze value drivers at different locations to examine where profit is being generated. By limiting its focus only to EU member states, it can be argued that the commission ignored the reality of the situation. For example, would the commission have reached a different conclusion if the United States were part of the EU?

2. Inappropriate Profit Allocations

Without prejudice to its core argument rejecting the proposition that the Apple IP licenses held by AOE and ASI should have been allocated outside Ireland, the commission also advanced an important subsidiary line of reasoning that the profit allocations endorsed in the contested tax rulings depart from the arm's-length principle. Even if the commission does not prevail on its first argument regarding the allocation of Apple's IP licenses, it is still necessary to consider whether appropriate remuneration was applied for considering the tax liabilities of the Irish branches.

The first point made by the commission is that the whole basis of a one-sided profit test, such as the TNMM, is to identify the least complex function. The transfer pricing method then considers the margin that would be required for that company based on comparisons with other companies undertaking similar activities and facing similar risks. The commission rightly referred to the OECD's 2010 guidelines in making that point — but disregards the fact that the rulings in question predate those guidelines.

The next stage of the commission's analysis is more controversial. The commission argued that choosing the branches as the tested parties as they performed the less complex function would imply that the activities of the head offices were more complex. However, that is not the case, because the commission asserted that those activities were limited to board meetings and moreover, the mere fact of owning an intangible asset does not necessarily mean that the asset's owner performs a more complex function. On the other hand, the commission said the Irish branches did perform activities for which use of the IP licenses was crucial and that there were indications that they did perform IP-related functions associated with branding in Europe, the Middle East, India, and Africa. Accordingly, the commission concluded that the tax rulings' use of the Irish branches as the tested parties departed from the arm's-length principle and conferred a selective advantage on ASI and AOE.

That raises questions whether a proper transfer pricing assessment should have considered solely ASI and AOE and their Irish branches. In the commission's view, ASI and AOE exist only on paper and were incapable of performing a critical role in IP development as compared with the branches; however, the branches were simple supply chain and assembly operations, whereas the Apple IP was developed and managed in the United States. In short, it seems very likely that the limited activities of the Irish branches were less complex than those associated with the IP development of Apple's products, so it can be strongly argued that the tested parties should be the Irish branches.

The second point raised by the commission is that a markup on operating expenses, as accepted in the contested rulings, is not an appropriate basis for assessing the remuneration of the Irish branches. Again referring to the 2010 OECD guidelines, the commission suggested that sales would have been a more appropriate benchmark for ASI's Irish branch (which performed procurement, sales, and distribution, but is arguably not a low-risk distributor for which operating expenses may be an appropriate basis for remuneration), and total costs a more appropriate benchmark for AOE's Irish branch (which manufactured and assembled). The commission said the approach adopted in the rulings reduced the taxable bases of ASI and AOE, thereby conferring a selective advantage.

The appropriate basis for remuneration is a factual question that must be judged by reference to:

- The precise situation of the companies, their activities, and the risks they bear. It is puzzling that the commission's decision records no comments from Apple on these points.
- The margin above operating expenses allowed by the rulings, and how that compares with that obtained by other companies undertaking similar activities on a market basis for third parties.

Accordingly, this point alone is insufficient to quantify either the extent or existence of any selective advantage, which leads to the commission's third point that the returns permitted for ASI and AOE to determine their taxable profits were too low.

The commission began its assessment of whether ASI's and AOE's taxable profits were too low, not by considering any benchmarking against comparable companies (which would be the normal transfer pricing approach), but by examining the structure of the calculations of taxable profits for AOE. It noted that the margin above operating expenses allowed for AOE fell from 65 percent to 20 percent once AOE's operating expenses increased above 20 percent. The commission objected to that on several grounds, including that:

- a rational economic operator — that is, if AOE were not part of the Apple group — would seek to maximize its profits and not accept lower profits simply because it had made sufficient returns; and
- it would be "alien" to the tax system.

However, an arm's-length market price for the routine services performed by a computer manufacturing or assembly operation could be structured on a volume-related basis, reflecting the fixed element of those costs. Indeed, third-party manufacturing contracts often vary prices based on volume. It is therefore possible that arm's-length transfer prices could vary with volume, and it is too strong a statement that an arrangement like that would be alien to the tax system. Obviously, any benchmarking would need to consider how returns might vary with volume, so appropriate comparables might need to be similar in size.

Turning to the identification of normal arm's-length returns, it is necessary to identify companies comparable to the Irish branches and establish their arm's-length equivalent profits. That requires a benchmarking exercise considering other companies' activities and functions, the risks they bear, and any other pertinent factors (such as location). Benchmarking creates a minimum and maximum level to reasonable market-level returns, which may be carried out on various financial bases (such as a markup on operating expenses or total costs, and a margin on sales). One way to do that is to rank the comparable companies based on their returns and then establish the median return and the upper and lower quartile returns.

The expert opinion authored by PwC contained such a benchmarking exercise for both ASI and AOE. The commission states that the PwC ad hoc report (as well as Apple's tax adviser's opinion) misinterprets the authorized OECD approach as it does not first question the allocation of the Apple licenses to the head offices but, instead, presents a benchmarking analysis with arm's-length ranges. Notwithstanding that initial error, the commission claims that the PwC report erred by choosing the Irish branches as the tested parties premised on the unsubstantiated assumption that ASI's and AOE's branches perform the less complex function as discussed above.

In addition to its contention that the Irish branches were unjustified as tested parties, the commission proceeds to criticize the choice of profit-level indicator for ASI (which was the Berry ratio), finds the use of a comparability study based only on a comparables database search to be inappropriate for estimating an arm's-length range, and takes specific issue with several of the companies chosen by PwC as comparables as well as finding fault for neglecting to identify additional comparables. For example, some of the companies had gone into liquidation, and the commission queried whether their activities were in fact comparable to those carried out by the Irish branches. The merits of the criticism are difficult to judge because the decision does not indicate a response by the experts or by Apple, which is again puzzling.

Despite criticizing PwC's choice of comparable companies, the commission compared the return on sales and the markup on costs achieved by the ASI comparables. Taking the lower quartile of that range suggested that the taxable profits of ASI (and thus its taxes) should have been almost 20 times higher than those paid. However, ASI's taxable profits were close to the lower quartile of the range, but the commission questioned whether the lower quartile was the appropriate benchmark, given its concerns regarding PwC's choice of comparable companies.

The commission's subsidiary arguments regarding returns being too low could theoretically justify some increase in the tax payments made by the Irish branches — subject to facts not found in the commission's decision — but they are unlikely to justify a tax repayment of €13 billion.

IV. Conclusion

It is clear that multinationals' tax and transfer pricing strategies are under attack from all sides.

The OECD's new formal emphasis on economic substance stemming from the BEPS project is helping tax authorities perform adjustments when taxable income is not aligned with substance, regardless of the form of the MNE arrangements and the existence of intercompany contracts.

Moreover, the OECD's BEPS project, through its new CbC reporting requirements, is making tax transparency a reality for MNEs and tax authorities. Those authorities will be able to see MNEs' taxable income reported in their jurisdictions relative to what is reported elsewhere and relative to operations in each jurisdiction and thus can more easily claim unfair treatment if the circumstances warrant. The knowledge that income is being booked at any low- or no-tax jurisdiction, or that stateless income exists, is likely to jumpstart examinations in high-tax jurisdictions and by the European Commission. Government tax litigators are more active than ever, and more notices of tax deficiency based on alleged transfer pricing abuse are being issued.

The lack of a harmonized approach to address MNE tax planning and implementation by governments and supranational authorities creates considerable risks for MNEs. Those risks are increased by national tax authorities and the commission scrutinizing tax and transfer pricing arrangements under different criteria with limited overlap, as exemplified by the different interpretations and applications of the arm's-length standard by the OECD and commission.

As discussed, it is striking that despite the various references to the OECD guidelines, the commission's decision in Apple seeks to allocate Apple's IP licenses to the Irish branches, even though those branches did not control or develop the IP. It is also controversial that in assessing the application of the OECD guidelines to one-sided testing methods, the commission argued that the simpler tested parties, whose returns can be measured and benchmarked against, are not the Irish branches — although, again, they did not develop or control Apple IP.

The commission's brief comments regarding the amount of unlawful aid that may be recovered raise further complexities. The commission indicated that the trading profits subject to taxation may be adjusted if ASI's and AOE's accounts are restated to reflect (the commission's version of) the arm's-length principle. The commission mentioned the retrospective modification of the CSA, which it took as a given for assessing the contested tax rulings, but where that leads is unclear.

The greater risks faced by MNEs create an increased potential for challenges to transfer pricing as not arm's length (variously defined); voiding of APAs and other tax rulings; outsized tax adjustments by national tax authorities or the commission; double taxation with no tax credit or offset, particularly between the United States and EU; interest on additional tax and nondeductible penalties; and negative publicity and reputational damage.

Although realizing that the days of aggressive tax planning are largely over, other than ending aggressive planning and reversing their more egregious decisions, what can MNEs do to face the uncertainty and manage the risks? For starters, they must pay close attention to the new environment and understand that they must be able to show that profits are fully aligned with functions and risks.

One place to start is with an MNE's own CbC report, which the MNE can use as a roadmap to what tax authorities or the commission might view as problematic, or as instructive regarding what it can do to alter its own structure to ensure that profits are allocated within the group in sync with relative values. The IP structure in particular should be reevaluated in light of BEPS and potential state aid allegations. If the location of IP cannot be justified, it should be migrated to meet economic substance requirements.

The location of key employees should also be reevaluated to ensure their locations are aligned with taxable income. Head office functions should be justified as providing benefits to affiliates before being charged out. Services should also be analyzed — especially marketing and advertising — to ensure that the correct amounts are being charged and paid. A final area MNEs should consider is financing costs, because tax authorities often examine intercompany financing and cash management.

Despite all the new risk and uncertainty, transfer pricing and tax planning opportunities still exist. Additional opportunities will present themselves when corporate tax rates are reduced. Properly designed transfer pricing can align functions and value, mitigate risk, and support tax efficiency. Room to maneuver in transfer pricing will continue to exist around the choice of prices, fees, and royalty rates if they reflect economic substance. MNEs are advised to be much more aware of the importance of economic substance and to create detailed documentation supporting the absolute and relative levels of taxable income booked by their various group companies.

The commission's investigations into tax rulings is calling into question government-approved transfer pricing agreements based on its own interpretation of the arm's-length standard and addressing potential tax favoritism through retroactive corrections. The outcome of various appeals might help address the retrospective application of transfer pricing interpretations involving substance.

Finally, the pursuit of an APA with the relevant tax authority continues to be an effective risk mitigation technique, although in many situations unilateral APAs should be avoided in favor of bilateral APAs to reduce any risk of state aid concerns. Certainly, situations will occur in which proactively obtaining the commission's approval of an APA or other particular tax arrangement or structure would be advisable. ■