ALERT MEMORANDUM

EU General Court Strikes Down Commission's €14 billion State Aid Decision against Apple and Ireland

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On July 15, 2020, the European Union's second-highest court, the General Court (the "Court"), annulled the 2016 decision of the European Commission (the "Commission") ordering Ireland to recover €13 billion (€14.3 billion with interest) in back-taxes from Apple which the Commission considered to be illegal State aid.[1] The Court ruled that the Commission had not proven to the required standard that Ireland had granted any selective advantage to Apple.[2]

The *Apple* judgment, which annuls the Commission's largest ever State aid recovery order, follows a similar annulment in *Starbucks* in 2019[3] and represents a further setback to Competition Commissioner Margrethe Vestager's strategy of using EU Sate aid rules to target what are perceived to be sweetheart tax deals given to multinational companies.

In its 2016 decision, the Commission had considered that two tax rulings granted by Ireland to two Apple subsidiaries incorporated in Ireland, Apple Sales International ("ASI") and Apple Operations Europe ("AOE") granted these companies, which were not tax resident in Ireland, a selective advantage because they allocated these companies (as opposed to their taxable local branches) most of the taxable profits, including revenues attributable to Apple's IP.[4] In addition, the Commission took the view that the allocation of profits to ASI's and AOE's head offices did not correspond to economic reality because they were not based in any country, did not have any employees or premises and so could not have generated the said profit (see our past alert memorandum covering the *Apple* decision here).[5]

1 *Aid to Apple* (Case COMP/SA.38373) – Commission decision of August 30, 2016 (the "*Apple* decision").
2 *Ireland and Apple v. Commission* (Cases T-778/16 and T-892/16) EU:T:2020:338 (the "*Apple* judgment").
3 *Starbucks* (Case T-760/15) EU:T:2019:669 ("*Starbucks* judgment").
4 *Apple* decision, para. 223 and Section 8.2.2 (advantage criterion); para. 224 and Section 8.2 (selectivity criterion).
5 *Apple* decision, Section 8.2.2.2., paras. 264 et seq.

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The *Apple* decision was just one among at least 11 State aid investigations and decisions by the Commission since 2013 in relation to tax rulings.[6] Of these other cases, three had already been decided on by the General Court, with one being upheld (*Fiat*[7]) and two others annulled (*Excess Profits (Belgium)*[8] and *Starbucks*[9]). There are also two other decisions currently under appeal before the General Court (*Engie*[10] and *Amazon*[11]), and a further three confirmed ongoing investigations (*Huhtamäki*[12], *IKEA,*[13] *and Nike*[14]).

In this memo, we examine (i) the legal principles applied by the Commission in State aid reviews of tax rulings which were upheld by the Court, (ii) the main grounds on which the Court struck down the *Apple* decision, and (iii) the likely and potential implications of the *Apple* judgment.

I. The Court confirms key legal principles applying to the Commission's review of tax rulings

a) The Commission has jurisdiction to investigate tax rulings under State aid rules

The Court first tackled the question of whether the Commission has jurisdiction to investigate tax rulings in light of the principle of fiscal autonomy of the Member States, which was argued by Ireland and Apple. The Court reiterated settled case law that *"while direct taxation, as EU law currently stands, falls within the competence of the Member States, they must nonetheless exercise that competence consistently with EU [State aid] law*".[15] The Court went on to confirm that the Commission may consider that a national tax measure, such as a tax ruling, constitutes illegal State aid if that ruling gives a selective advantage to a particular company compared to similarly situated companies. In addition, in order to prove the existence of an advantage, the Court confirmed that the Commission is entitled to analyse the national tax rules in order to determine if there was any deviation from 'normal' tax treatment.

b) Confirmation of the classic three-pronged test to determine the existence of a selective advantage

The Court also reaffirmed the Commission's use of the long-established three-pronged test to determine if a selective advantage exists in situations when Member States adopt broad measures that may be applicable to a range of companies that are not specifically identified in the measure (such as tax exemptions).[16] The test requires the Commission to (i) identify "the reference framework" (*i.e.*, the national tax rules that would normally apply to a given situation); (ii) determine whether the measure constitutes a derogation from the reference

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6 For an illustrative overview of the Commission's activities with respect to tax rulings, see here. See also our past alert memorandums here, here, here and here.

7 *Fiat* (Case COMP/SA.38375) – Commission decision of November 21, 2015; and *Fiat* (Case T-755/15) EU:T:2019:670 ("*Fiat* judgment"). The *Fiat* judgment has been appealed by Fiat and Ireland (see Cases C-885/19 P and C-898/19 P, respectively).

8 *Excess Profits* (Case COMP/SA.37667) – Commission decision of January 11, 2016; and *Excessive Profits* (Cases T-131 and T-263/16) EU:T:2019:91 ("*Excessive Profits* judgment"). The *Excessive Profits* judgment has been appealed by the Commission to the EU's highest court, the Court of Justice (see Case C-337/19 P).

9 *Starbucks* (Case COMP/SA.38374) – Commission decision of November 21, 2015; and *Starbucks* (Case T-760/15) EU:T:2019:669 ("*Starbucks* judgment").

10 *Engie* (Case COMP/SA.44888) - Commission decision of June 20, 2018; and *Engie* (Case T-516/18 and T-525/18), pending judgment.

11 *Amazon* (Case COMP/SA.38944) – Commission decision of November 4, 2017; and *Amazon* (Cases T-816/17 and T-318/18).

12 *Huhtamäki* (Case COMP/SA.50400) – Commission decision of March 7, 2019, initiating the formal investigation procedure. Tax ruling disclosed as part of the "Luxleaks" investigation.

13 *IKEA* (Case COMP/SA.46470) – Commission decision of December 18, 2017, initiating the formal investigation procedure.

14 *Nike* (Case COMP/SA.51284) – Commission decision of January 10, 2019, initiating the formal investigation procedure.

15 *Apple* judgment, para. 105, and *Commission v Spain* (Case C-269/09) EU:C:2012:439, para. 47.

16 *Paint Graphos* (Cases C-78 to 80/08) EU:C:2011:550, paras. 53-65; *World Duty Free* (Cases C-20/15 P and C-21/15 P) EU:C:2016:981, paras. 53-60 and 67.

framework; and (iii) examine whether that derogation is justified by the nature or the general scheme of the (reference) system.

The Court also confirmed that the Commission had correctly identified the reference framework as being the ordinary rules of taxation of corporate profits in Ireland (which applied to both resident companies and to non-resident companies carrying on a trade in Ireland through a branch).[17]

c) *Court approves the Commission's use of the arms' length principle in establishing existence of an advantage*

To assess whether a tax ruling on transfer pricing amounts to an advantage under State aid rules, the Commission relied on the "arms' length principle" (the "ALP").[18] The ALP requires that financial relations between associated companies should not differ from those made between independent companies under market conditions.[19] The Court, reaffirming its previous findings in its *Fiat* and *Starbucks* judgments[20], held that the Commission was entitled to use the ALP as a tool to determine whether the level of chargeable profits allocated to the Irish branches of ASI and AOE, as endorsed by the contested tax rulings, corresponded to the level of profit that would have been obtained by those branches under normal market conditions.[21]

d) *Court approves the Commission's use of the Authorised OECD approach*

In a similar vein, the Court, reaffirming its findings in *Fiat* and *Starbucks,* held that the Commission could use the 'Authorised OECD Approach' to allocate the profits of the Irish branches of ASI and AOE. The Authorised OECD Approach is a widely-accepted, objective method for determining the proportion of a non-resident company's overall profits to allocate to a national branch of that company for taxation purposes which involves identifying the assets, functions and risks that must be allocated to the branch on the basis of the activities actually performed by that branch.[22]

e) *The open question of selectivity*

As further explained below, the Court, having concluded that the Commission failed to prove that the relevant tax rulings gave an advantage to Apple (which was sufficient to annul the Commission's decision), opted not to address Ireland's and Apple's standalone arguments regarding the Commission's assessment of the selectivity of the contested tax rulings.[23]

II. The Court strikes down the application of these principles by the Commission

a) *The Commission did not prove that Apple IP and associated profits should have been attributed to Apple's Irish branches*

In the *Apple* decision, the Commission considered that since the head offices of ASI and AOE did not have a physical presence or employees, they would have been unable to manage the relevant Apple Group IP licences and should therefore not have been allocated the profits derived from those licences. Instead, the Commission concluded that the IP and associated profits should have been allocated to the Irish branches of ASI and AOE (and therefore taxed in Ireland) on the basis that these branches were the only entities capable of performing the functions related to the IP.

In the Court's view, the question of whether the relevant IP licences should have been allocated to ASI's and AOE's Irish branches depended on whether those branches "actually controlled" the IP licences in question. The Court concluded that the

17 *Apple* judgment, paras. 140-165.

18 Commission Working Paper on State Aid and Tax Rulings, para. 3.

19 Commission Working Paper on State Aid and Tax Rulings, para. 3.

20 See our past alert memorandum covering the *Starbucks* and *Fiat* judgments here.

21 *Apple* judgment, paras. 224-225. This was the case because, even though it accepted that ALP was not a self-standing principle of EU State aid law and had not been formally been incorporated into Irish tax law, the applicable Irish provisions and case law did endorse an approach which is equivalent to the ALP, and it was used in certain of Ireland's double taxation treaties.

22 *Apple* judgment, paras. 240 and 241.

23 Ireland and Apple argued that the Commission wrongly ignored the distinction between resident and non-resident companies. *See* Ireland's pleas available here and Apple's pleas available here.

Commission had wrongly limited itself to using "*an 'exclusion' approach*", *i.e.*, the Commission assumed that since the head offices of ASI and AOE had no presence or employees, they could not have controlled the relevant IP, and therefore all associated profits must be allocated by default to the Irish branches.

The Court held that this assumption was inconsistent with Irish tax provisions (*i.e.*, the reference framework) as well as with the Approved OECD Approach. It also observed that the Commission misapplied the ALP by not attempting to demonstrate that the Irish branches of ASI and AOE had in fact controlled the relevant IP licences, nor that activities actually performed by those Irish branches followed from the use of that IP in a way that would justify allocating all trading income of ASI and AOE to their Irish branches.[24]

Rather, the Court considered that strategic decisions, in particular regarding R&D (*i.e.*, "*the functional area behind the Apple Group's IP*") were taken at the company headquarters in Cupertino, California on behalf of the Apple Group as a whole.[25]

b) *The Commission did not prove that insufficient profits were allocated to Apple's Irish branches*

As a subsidiary line of reasoning, the Commission had considered that, even if the relevant Apple IP licences should be allocated to the head offices of ASI and AOE, the methodology used to allocate profits to the Irish branches nonetheless understated the taxable profits that should have been attributed to those Irish branches. The Court rejected this finding on the three grounds.

First, the Court held that the Commission could not limit itself to pointing to methodological defects in the profit allocation or profit calculation method ("regrettable" as those defects may be in the Court's words) used in the rulings but must actively show that the method led to a reduction in the tax burden compared to a situation where the tax rulings had not been issued. The Court noted that the functions of Irish branches were "not particularly complex", which cast doubt on whether the ruling actually granted Apple an advantage.[26]

In the same vein, according to the Court the Commission's criticism of the choice of operating costs (as opposed to revenues or total costs) as a proxy for calculating taxable profit did not demonstrate that the ruling reduced ASI's or AOE's tax liability in Ireland. [27]

Third, the Court held that the Commission's comparability analysis, which benchmarked the estimated profit in the ruling with that of a sample of companies also did not establish an advantage.[28]

c) *The Commission did not prove that the Irish tax rulings involved the exercise of discretion*

Finally, the Commission had claimed that since the Irish tax provisions did not lay down any objective criteria for allocating profits to different parts of a non-resident company, this broad discretion as applied in the rulings necessarily conferred a selective advantage on Apple in breach of EU State aid rules.

The Court rejected this reasoning and held that even if such discretion existed, this could not allow the Commission to simply presume an advantage under EU State aid rules. In addition, the Commission itself had conceded that Irish tax legislation required an objective analysis of the activities or functions of the relevant Irish branch of a non-resident company, which precluded the sort of discretionary power the Commission was relying on in its reasoning.[29]

d) *No selective advantage proven*

Accordingly, the Court held that the Commission failed—under all three main lines of reasoning —to prove to the required standard that, by issuing the contested tax rulings, the Irish tax authorities had granted Apple a selective advantage contrary to EU State aid rules.

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24 *Apple* judgment, paras. 186 and 228-241.
25 *Apple* judgment, paras. 300-302.
26 *Apple* judgment, paras. 340, 343, 348, 446.
27 *Apple* judgment, paras. 376, 413-414.
28 *Apple* judgment, para. 477.
29 *Apple* judgment, paras. 493-499.

III. Comments and practical consequences

Possibility of an appeal. The judgment represents a heavy political and PR defeat for the Commission, and arguably for Commissioner Vestager personally. It remains to be seen if the Commission will appeal. For instance, the Commission refrained from appealing another annulment decision in the *Starbucks* case. In a press statement following the ruling, Commissioner Vestager noted only that the Commission will "*reflect on possible next steps*."[30] One difficulty for the Commission is that an appeal would in principle be limited to points of law (or manifest distortion of facts), and the *Apple* judgment is very much focused on factual assessments relating to the Commission's misapplication of the relevant tests, or of evidence brought by the Commission.

State aid investigations into tax rulings likely to continue. Despite this setback, since the Court confirmed the validity of the Commission's general approach to State aid investigations into tax rulings, including the use of the ALP and the Approved OECD Approach, the *Apple* judgement will likely not mark the end of such reviews.[31] Going forward, the Commission will likely carry out a more meticulous and thorough factual assessment, and rely to a much lesser extent on legal presumptions to discharge its burden of proof, in particular where there may be inaccuracies, inconsistencies or missing information in relation to the decision-making process of the relevant tax authorities, as was the case here and in *Starbucks*. The additional resources that this would require may result in a reduction in numbers of new State aid investigations the Commission takes, especially in light of the additional burden on resources generated by the many COVID 19-related State aid approval applications.[32] International groups should nonetheless remain vigilant, and carefully review the quality of any tax rulings they may have received from tax authorities in the EU (*i.e.*, to confirm that they uphold a reasonable appreciation of the facts and a defensible interpretation of tax rules), as suggested in our previous alert memoranda.[33]

Question of where IP profits should have been taxed left open. The *Apple* judgment is consistent with internationally accepted principles, including the above-mentioned Authorised OECD Approach, in that it concludes that revenues and profits generated from IP should be allocated to the place where that IP rights are effectively controlled. The Court rejected the fiction that two Irish branches with minimal resources, and readily identifiable functions which were "*not particularly complex*" had control over the Apple IP rights. While the judgment stops short of saying where the revenues and profits generated by the Apple Group's IP should have been allocated (to not overstep its jurisdiction) the subtext of the judgment points to the Apple Group headquarters in Cupertino, United States, which is where the Court noted that strategic decisions relating to research and development and new product launches were made. If the IP profits should have been taxed in the United States (as hinted at by the Court), they would therefore fall outside the scope of EU State aid rules. This raises the further question of whether these untaxed revenues could be considered as a foreign subsidy, which is a topic that is high on the Commission agenda at present.[34]

Potential for EU legislative action. Faced with this defeat, the Commission may now look to other mechanisms to combat perceived tax advantages given to multinational companies by certain Member States. The day before the *Apple* judgment, it was reported that the Commission was considering using a far-reaching, and so far unused treaty provision,

30 Statement by Executive Vice-President Margrethe Vestager following today's Court judgment on the Apple tax State aid case in Ireland, 15. July 2020, Statement 20/1356

31 As outlined above, the Commission has at least three ongoing State aid investigations into tax arrangements, namely *Huhtamäki, IKEA, and Nike*.

32 See our alert memorandum on the Commission's Temporary Framework in our COVID-19 Resource Center.

33 See our past alert memoranda here and here.

34 See Commission's White Paper on levelling the playing field as regards foreign subsidies, COM(2020) 253 final, available here, which notes that "*[f]oreign states may also give a subsidy to a parent company located outside the EU (e.g. corporate tax regimes providing selective incentives), which then in turn finances the subsidiary located in the EU through intragroup transactions"); See* also our alert memorandum on the topic here.

Article 116 TFEU, which allows it to enact legislation to eliminate distortions of competition due to, for example, different tax rules between Member States.[35] Legislation under Article 116 TFEU can be passed by a qualified majority (rather than unanimity[36]), meaning no single Member State (nor even a grouping of the smaller Member States that had been the subject of the Commission's State aid decisions on tax rulings, *i.e.*, Ireland, the Netherlands, Luxembourg and Belgium) would be able to block such legislation. More details may become available in the autumn when the Commission is expected to present an action plan on business taxation that is likely to include proposals for setting a minimum level of effective taxation for business profits. Global discussions on minimum effective taxation are being led by the OECD, but the Commission has stated that it is ready to act if no global agreement is reached[37].

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[35] *See* Financial Times, "Brussels plans attack on low-tax member states", July 14, 2020, available here. *See* also Communication from the Commission to the European Parliament, the European Council and the Council, 'Towards a more efficient and democratic decision making in EU tax policy, January 15, 2019, available here, which contains a brief section on the potential use of Article 116 TFEU.

[36] Articles 113 and 115 TFEU provide the EU can only enact that tax harmonisation legislation by unanimity.

[37] Indicated in the *Action Plan for fair and simple taxation supporting the recovery* and the *Questions and Answers on the Tax Package* released by the Commission on July 15, 2020 as part of their *Package for fair and simple taxation*, available here and here.