



EU Direct Tax Newsalert

Non-confidential version of the EC's final State aid decision on Apple

On 19 December 2016, the European Commission (EC) published the non-confidential version of its final decision of 30 August 2016 on the formal State aid investigation into the profit attribution arrangements and corporate taxation of Apple in Ireland. In its final decision, the EC concluded that the two rulings granted in 1991 and 2007 on the attribution of profits to the Irish branches of two Irish incorporated, non-resident companies constitute unlawful State aid, and ordered immediate recovery of the aid. Both Ireland and Apple have appealed this EC final decision before the General Court of the European Union on 9 November 2016 and 19 December 2016, respectively.

Background

Apple Sales International (ASI) and Apple Operations Europe (AOE) are two Irish incorporated companies that are ultimately controlled by Apple Inc. Under a 'cost-sharing agreement' ("CSA") with Apple Inc., in exchange for payments, ASI and AOE hold the rights to use Apple's intellectual property to sell and manufacture Apple products outside the Americas.

The determination of the Irish taxable profits of ASI and AOE have been confirmed by tax rulings granted by Ireland in 1991 and 2007. According to the EC, the two tax rulings issued by Ireland endorsed an artificial split of the profits for tax purposes in Ireland, such that, in the EC's view, the profit allocation to the Irish branches could not be reconciled with the activities at head office level, which the EC considered to lack the operating capacity to handle and manage the distribution business.

Key reasons

The EC concluded that the confirmation of the profit allocation methodology grants a selective advantage to Apple and constitutes State aid based on the following arguments:

- **Reference system.** According to the EC, the reference system against which the tax rulings should be examined is the ordinary rules of taxation of corporate profit in Ireland under which all companies and branches are subject to tax in Ireland. Ireland and Apple argued for a narrower view, based primarily on the taxation of non-resident companies only.
- The EC accepts that, as a result of the territoriality principle in Irish tax law, resident and non-resident companies are taxed on different sources of income, but this does not justify the identification of a separate reference system distinct from the ordinary rules of taxation in Ireland. For a non-resident

company that carries on a trade through a branch in Ireland, this legislation does not provide guidance on how to determine the chargeable profits of an Irish branch, but requires the use of a profit allocation method.

- **Selectivity.** In the EC's view, the proper allocation method is the arm's length principle that follows from Article 107(1) TFEU, which in their view is supported by the CJEU. According to the EC, that principle applies independently of whether the Member State in question has incorporated the arm's length principle in its national legal system, negating arguments based on the absence of TP legislation in Ireland at the time. Therefore, in the EC's view, where tax rulings endorse profit allocation methods that depart from a reliable approximation of a market-based outcome, those rulings should be considered to confer a selective advantage on those companies.

- **Transfer pricing methodology:** The EC considers that, in the tax rulings, Irish Revenue endorsed one-sided profit allocation methods for the allocation of profit to the Irish branches. Those methods are premised on the "unsubstantiated assumption", according to the EC, that the Apple IP licenses should not be allocated to the Irish branch. For instance, the remuneration of Apple Inc. by ASI and AOE for the development of the Apple IP has been laid down in the CSA, while the remuneration of Apple Inc. by ASI and AOE for marketing services has been laid down in the Marketing Service Agreement.

- According to the EC, the tax rulings do not, however, cover those or any other intra-group transactions that the branches and Apple Inc. may have entered into. The tax rulings do not address the question whether the agreements were carried out at arm's length, but rather take the terms and conditions of those agreements as given, meaning that no transfer pricing arrangements between the three entities are endorsed by those rulings, which only concern the allocation of ASI's and AOE's profit to their respective Irish branches.

- The EC holds that, it is only after those costs have been deducted from that profit that the remaining profit of ASI and AOE would need to be allocated between the head offices and their respective Irish branches for tax purposes. According to the EC, Ireland's argument that the value generated by Apple products might require expensive investments might well be correct but, as regards ASI's and AOE's contributions to those investments, they are covered by the CSA and the Marketing Service Agreement, which cannot impact profit allocation within those companies.

- Further, according to the EC, the profit allocation methods endorsed in the tax rulings produce an outcome that departs from a

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- reliable approximation of a market-based outcome in line with the arm's length principle. Specifically, the EC considers the following methodological choices to depart from a market-based outcome: (i) the choice of ASI's and AOE's Irish branches as the focus of the one-sided profit allocation methods, (ii) the choice of operating expense as profit level indicator, and (iii) the levels of accepted returns.
- Ireland and Apple argue that the appropriate reference system should be the law dealing with the taxation of non-resident companies only ("Section 25") and that the determination of ASI's and AOE's taxable profit was entirely consistent with normal administrative practice under that provision. The EC does not consider the reference system to be so restricted, but rather that the provision forms an integral and necessary part of the reference system being the taxation of profit of all companies subject to tax in Ireland. However, even if Section 25 were to constitute the appropriate reference system in this case, the EC's view is that the tax rulings grant ASI and AOE a selective advantage in the form of a reduction of their taxable profit upon which corporation tax is levied.
 - *Arm's length principle inherent in Ireland's ruling practices:* The EC observes that the criteria listed by Ireland for determining the chargeable profit of a branch – the functions performed, the assets used and the risks assumed by the branch – are essentially the same criteria laid down by the OECD for allocating profit to a permanent establishment. An analysis of Irish Revenue's ruling practice on the allocation of profit to the Irish branches of non-resident companies by the EC, reveals that in their view the arm's length principle underlies the profit allocation methods endorsed by Irish Revenue. In the absence of any other objective standard put forward by Ireland, the EC submits that the arm's length principle is inherent in the application of Section 25.
 - Finally, Ireland and Apple argue that the EC must show that Apple has been treated favourably as compared to other non-resident companies that have been granted similar tax rulings. In this regard, Ireland and Apple argue that the appropriate reference system is not Section 25 itself, but Irish Revenue's tax ruling practice in relation to non-resident companies.
 - From an examination of the tax rulings Ireland submitted, the EC concluded that it was unable to identify any consistent set of rules that generally apply on the basis of objective criteria to all non-resident companies operating through a branch in Ireland. In other words, in the view of the EC, Irish Revenue's profit allocation ruling practice is too inconsistent to constitute an appropriate reference system against which the tax rulings could be examined.
 - **Recovery.** Based on this decision, the Irish authorities are required to recover the alleged unlawful aid from Apple. The EC has not quantified the amount of the aid but, according to an estimate made by the EC and communicated in its press release on 30 August 2016, the amount of the aid may be as high as €13bn.
 - *EC opens door to recovery by other States:* The EC points out that the profits may also be adjusted following an effective restatement of the accounts or tax returns of ASI and AOE following corresponding payments and adjustments to the accounts of other Apple group companies. According to the decision, such a restatement could result from a retroactive modification of the CSA or of the Marketing Services agreement. The terms of those agreements have not been examined by Irish Revenue in the context of the contested rulings and, if the financial contributions to the R&D or marketing costs carried by ASI and AOE under those agreements were not in line with a level of contribution that would have been agreed between independent companies negotiating at arm's length, such a retroactive modification could give rise to increased ex post payments from ASI and AOE to Apple Inc., provided such payments are in line with the arm's length principle.
 - The EC contends that such a restatement could also result from a retroactive modification of the jurisdiction in which the EMEIA sales of ASI are recorded where Apple considers those recorded sales did not amount to effective risk taking in the distribution of Apple products and that such risks have been effectively borne in jurisdictions where a more substantial economic activity was taking place than in Ireland.

Takeaway

As expected, this decision has been appealed before the General Court and the position taken has been strongly defended in public by both the Irish Government and Apple. The EC's position has been strongly criticised by the U.S. Department of the Treasury in their statement yesterday and in their white paper "The European Commission's Recent State Aid Investigations of Transfer Pricing Rulings" published on 24 August 2016.

This decision should be seen in the light of a number of recent investigations by the EC in respect of the use of tax rulings concerning the application of transfer pricing and the arm's length principle. As with those cases, the decision contains very detailed observations on the TP methodology used. Companies may wish to review these comments in view of their own facts and circumstances.

