Apple, State Aid, and Arm’s Length: 
EU General Court’s Failure of Imagination

by David G. Chamberlain

David G. Chamberlain is an assistant professor of accounting and tax at California Polytechnic State University in San Luis Obispo. He thanks Stephen Daly for his helpful comments.

In this article, Chamberlain analyzes the EU General Court ruling in Apple, and examines state aid and transfer pricing in the EU, with a focus on (and as an advocate for) the existence of an autonomous arm’s-length principle.

All opinions and errors are solely the author’s.

By any measure, Apple is at the top of the barrel. Its current market capitalization is $2 trillion. Global sales for 2019 topped $260 billion, and its pretax profit was nearly $66 billion. When it comes to aggressive tax planning, Apple has long been a trailblazer. In early 2013 Sens. Carl Levin and John McCain led a bipartisan blame-and-shame campaign, leading to the release of their now-infamous subcommittee report on Apple’s profit shifting in May 2013. Tipped off, the European Commission soon followed suit, launching a state aid investigation that resulted in a claim that Apple had underpaid its Irish taxes by €13 billion between 2003 and 2014. The commission’s August 2016 decision seeking to compel Apple to repay those taxes marks by far the largest state aid recovery ever pursued.

Moral judgments aside, few observers would deny that Apple’s tax structuring has been very aggressive. The European Commission alleged that Ireland aided and abetted Apple through its advance ruling practice, which purportedly gave Apple an unfair advantage over and above that offered by Ireland’s porous general tax regime. Apple worked its magic by setting up a pair of Irish-incorporated subsidiaries that were not tax-resident anywhere in the world. And those nonresident Irish companies had branch operations in Ireland that were subject to Ireland’s headline 12.5 percent tax rate. However, the tax rulings that the commission challenged — advance rulings that Ireland issued in 1991 and 2007 — allocated only a paltry share of the companies’ profits to the Irish branches, leaving the lion’s share of the profits with the so-called head offices that did not pay taxes in Ireland, the United States, or anywhere. To give just one example, according to paragraph 97 in the Apple commission decision, in 2011 one of the Irish subsidiaries paid the equivalent of $9 million in Irish taxes on $22 billion of pretax profit — a tax rate of just 0.041 percent.

On July 15 the General Court of the European Union annulled the commission’s decision. If the court’s decision is upheld after appeal to the Court of Justice of the European Union, Apple will get back €13 billion that is being held in an escrow account. At the end of the day, Treasury is the real winner here. Even though the IRS never challenged Apple’s machinations or attempted to collect U.S. taxes on the shifted profits at the then-

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applied 35 percent corporate tax rate, the entire amount has presumably been deemed repatriated and taxed at a 15.5 percent rate under section 965 in accordance with the Tax Cuts and Jobs Act. In contrast, if Ireland kept the tax windfall, Treasury would have to provide Apple with a refund in the form of foreign tax credits.

The commission lost its case before the General Court despite prevailing on the recently created and much-maligned theory that an “autonomous” arm’s-length principle is inherent in European competition law. The arm’s-length principle is, of course, the foundation of transfer pricing law in most countries. However, at the time the Apple rulings were issued, Ireland was a notable exception: Ireland did not adopt comprehensive transfer pricing legislation until the Finance Act of 2010. The commission’s leap of imagination in the state aid cases — that is, the recent disputes involving Apple, Fiat, and Starbucks (discussed further in this section) — is its view that the EU’s founding treaties require EU nations to follow the arm’s-length principle irrespective of whether they have formally adopted it in their national tax law.

The arm’s-length principle requires companies that are part of a multinational enterprise to transact with each other on the same terms and at the same prices as unrelated parties would in similar circumstances. Without the arm’s-length principle, a group could shift profits from a highly taxed affiliate that owns valuable intangibles to an affiliate in a tax haven by licensing the intangibles to the tax-haven affiliate at a below-market royalty rate. With the principle, however, if tax authorities in the high-tax country detected profit shifting, they could invoke the arm’s-length principle to adjust the royalty rate and tax the related-party licensor on the royalty income it should have received.

But what if the high-tax country — say, Ireland — does not want the forgone tax revenue? Perhaps the country has decided that it values encouraging foreign investment more highly than collecting tax revenue. What if the Irish tax authorities give the local licensor a sweetheart deal and bless the below-market royalty, arm’s-length principle be damned? In the eyes of the European Commission, Ireland would be illegally subsidizing the taxpayer — that is, providing state aid in violation of article 107 of the Treaty on the Functioning of the European Union — and giving the taxpayer an unfair competitive advantage over all other enterprises operating in the EU.

In last year’s Fiat and Starbucks cases, the General Court handed the commission a decisive win on the question of whether there is an autonomous arm’s-length principle. That is, the court endorsed the notion that the arm’s-length principle is embedded in EU competition law and then proceeded to consider whether the commission had applied the principle correctly. In Fiat, the court concluded that the commission applied the arm’s-length principle properly, and it found that Luxembourg had indeed given illegal state aid to Fiat’s financing subsidiary. No more than €30 million was at stake — less than 0.3 percent of the money at stake in Apple — but the precedent is important. While Starbucks won its case, the court did not fault the commission for trying to apply the arm’s-length principle — just for doing a bad job of it.

The rationale for the autonomous arm’s-length principle is that a nation’s income tax should not favor members of affiliated groups over stand-alone companies by virtue of how their taxable profits are measured. Operating in a free and competitive market, stand-alone

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6 For an argument that an autonomous arm’s-length principle is not valid, see Stephen Daly, “The Constitutional Implications of an EU Arm’s Length Principle,” 60(2/3) Eur. Tax’n 70 (2020).

7 Commission Notice on the Notion of State Aid as Referred to in Article 107(1) of the Treaty on the Functioning of the European Union, 2016/C 262/01, at paras. 167-174 (July 19, 2016).

8 While this hypothetical bears similarities to the Apple case, it differs in significant ways. Most notably, the example deals with transfer pricing between affiliated companies rather than allocation of profits between a head office and a branch.

9 That is to say, with its highly competitive 12.5 percent tax rate, Ireland is still a high-tax country compared with a tax haven that collects no corporate tax at all.


companies necessarily engage in transactions on an arm’s-length basis. The court in *Fiat* and *Starbucks* agreed with the commission that transactions between affiliated companies must be undertaken as if they were at arm’s-length to ensure that the affiliates do not gain a competitive advantage. And, thus, the autonomous arm’s-length principle was born.

The *Apple* court does not dispute the *Starbucks* precedent. But the *Apple* court’s imagination begins to falter when deciding whether the autonomous arm’s-length principle should also apply to the allocation of profits between a head office and a branch. The court’s discussion on this point is ambiguous. It should not be. The case for the arm’s-length principle in the branch context is every bit as strong as in the context of transfer pricing between affiliated companies. If a branch could understimate its profits compared with an independent competitor, the branch would enjoy an unfair advantage.

Key to applying the arm’s-length principle to branch profit determinations is the allocation of assets, such as Apple’s valuable intangible property, between the head office and the branch. International guidance on this question — specifically, the authorized OECD approach (AOA) — makes clear that the allocation depends on a comparison of functions performed by the head office with those performed by the branch. Equally importantly, the AOA would not automatically assign contracts, like Apple’s cost-sharing and marketing services agreements, to the head office. Rather, a similar allocation process would be required.

An autonomous arm’s-length principle would demand such a comparison of functions, but the court’s imagination failed entirely here. Instead, the court looked to Irish case law — specifically, the *Dataproducts* case — to allocate profits to the branches based on a unilateral review of their functions and to automatically allocate contracts and intangible property to the head office. This brings us to the crucial question raised by *Apple*: For purposes of EU competition law, are branch profit determinations based on each nation’s interpretation of the arm’s-length principle or are they based on an autonomous arm’s-length principle and guided by international best practices?

Perhaps the General Court has flinched and seeks to back away from the autonomous arm’s-length principle. The CJEU has not officially spoken on the existence of the autonomous principle. Moreover, an autonomous principle is not strictly necessary to reach the end results of the *Fiat* and *Starbucks* rulings; they could just as well have been based on the domestic laws in Luxembourg and the Netherlands, which incorporate the arm’s-length principle. Arguably, the problems that the state aid cases sought to remedy have already been fixed — at least, on a prospective basis — through the OECD’s base erosion and profit-shifting project and the tax reform efforts in Ireland and the United States. In the final verdict, it may be that the European Commission simply asked for too much, too soon.

I. Apple’s Profit Shifting

A. The U.S. Perspective

When Levin and McCain investigated Apple’s aggressive tax planning, they did not mince words. On page 5 of their report, they state: Apple’s “actions disadvantage Apple’s domestic competitors, force other taxpayers to shoulder the tax burden Apple has cast off, and undermine the fairness of the U.S. tax code.” The senators’ preferred remedies called for strengthening the tax code’s transfer pricing rules and enforcing existing rules to subject the Irish subsidiaries’ profits to current U.S. taxation.

The crux of the senators’ transfer pricing complaints was that U.S. cost-sharing rules made it too easy to transfer ownership of valuable intangibles to foreign subsidiaries that have little substance. Apple’s Irish subsidiaries were the poster children for low-substance cost-sharing participants. Considerable profits from cost-shared intangibles were retained by head offices that had no employees, no tangible assets, and no physical presence anywhere in the world. Under the cost-sharing agreement, the Irish subsidiaries
obtained ownership of 60 percent of Apple’s worldwide intangibles\textsuperscript{14} even though the U.S. parent, Apple Inc., performed 95 percent of worldwide research and development.

Cost-sharing participants like the Irish subsidiaries obtain intangible ownership rights through two types of payments: buy-in and cost-sharing.

Buy-in payments — now formally known as platform contribution transactions — are payments to acquire rights to preexisting intangibles.\textsuperscript{15} For instance, the Irish subsidiaries needed to obtain rights to use any intangibles that Apple Inc. had developed before the cost-sharing arrangement began. Aggressive valuations that lowball the amount of buy-in payments frequently play a major role in profit shifting. The Veritas case with a tenfold difference in valuations — the taxpayer valued the buy-in at $166 million while the IRS’s valuation came in at $1.68 billion — demonstrates the magnitude of the stakes involved.\textsuperscript{16} The buy-in amounts in Apple are not public information. Notably, Apple’s original cost-sharing arrangement dates back to 1980, which is four years before buy-in payments even became mandatory.\textsuperscript{17} There were likely additional transfers of intangibles later for which buy-ins were made, but a great deal of time has passed since the bulk of the transfers, and the statute of limitations almost certainly expired long ago.

Suffice it to say, if the European Commission fails in claiming Apple’s shifted profits for Europe, the IRS will not succeed in claiming them for the treasury either — at least not at the 35 percent corporate tax rate applicable when the rights were shifted.

Using cost-sharing payments to shift profits is also common, but the scale of profit shifting is much less significant. Because Apple’s Irish subsidiaries performed very little R&D, they were required to make payments to Apple Inc. to fund their share of the R&D program. In exchange, the subsidiaries obtained ownership interests and the right to exploit any intangibles developed. As owners of the rights, they would not have to pay a royalty to Apple Inc. When R&D efforts are wildly successful — as in Apple’s case — the cost-sharing payments would be far less expensive than the royalties that the subsidiaries would have had to pay if they licensed the intangibles instead. It is quite possible that Apple pushed the envelope and minimized the size of cost-sharing payments. On the other hand, it is also possible that the IRS adjusted Apple’s cost-sharing payments upon audit and successfully exacted the proverbial pound of flesh. In any event, if Apple succeeded in shifting any profit through cost sharing, the tax on the shifted profit would be a small fraction of the €13 billion sought by the European Commission.

In short, the U.S. transfer pricing rules were not up to the task of reining in Apple’s tax planning. What about the other remedy the senators proposed: Could existing rules be used to subject the Irish subsidiaries’ profits to current U.S. taxation? There are two primary routes that could be used to achieve this: taxing Apple Inc. on the subsidiaries’ subpart F income, or taxing the subsidiaries themselves on income effectively connected with a U.S. trade or business. Lee A. Sheppard explored both approaches in great detail in a recent article,\textsuperscript{18} and I will not address them at length here. The statute of limitations has certainly run on the subpart F approach, but the U.S. trade or business approach may still be viable if the Irish subsidiaries did not file U.S. tax returns on a protective basis. Under either of these approaches, the 35 percent corporate tax rate — that is, the rate that was in effect at the time the profits were earned — would apply.

Before moving on to the European perspective on Apple’s profit shifting, it is worth noting a quote from former Treasury official Robert Stack:

We are greatly concerned that the EU commission is reaching out to tax income that no member state has the right to tax under internationally accepted standards. The mere fact that the U.S. system has left

\textsuperscript{14} Specifically, the intangibles related to 60 percent of Apple’s sales.

\textsuperscript{15} Reg. section 1.482-7.

\textsuperscript{16} Veritas Software Corp. v. Commissioner, 133 T.C. 297 (2009).

\textsuperscript{17} The United States enacted the current version of section 367(d) in 1984. Previously, in accordance with a ruling process, intangible property that was to be used in a foreign business could generally be contributed to a foreign subsidiary tax-free.

these amounts untaxed until repatriated does not provide under international tax standards a right for another jurisdiction to tax those amounts.19

This argument sounds plausible but does not hold water. Stack was referring to the longstanding U.S. tax principle known as deferral: If a foreign subsidiary of a U.S. corporation earned income that was not subpart F income, neither the foreign subsidiary nor the U.S. parent was subject to U.S. tax until the subsidiary paid a dividend to the parent out of those earnings. By allowing deferral, the United States essentially conceded that the income was earned abroad; otherwise, a transfer pricing adjustment should have been made to bring the income home immediately. If the income was earned abroad, then internationally accepted standards would allow the country where the income was earned to tax it. The fact that the TCJA ended deferral and treated deferred income as repatriated as of the end of 2017 does not change this reality.

B. The EU Perspective

The European Commission took Apple at its word. Apple’s story was that intangible property related to business in the Americas belonged to Apple Inc., while intangible property related to the rest of the world belonged to the Irish subsidiaries. It was a simple story. From a perspective of substance over form, the natural conclusion was that Ireland should have the right to tax profits from the intangible property. Under state aid rules, the commission goes a step further and contends that Ireland had the responsibility to tax those profits.

Apple told different stories to Ireland and the United States. Under Irish law at the time, the general rule was that corporations were taxable on their worldwide income either if they were managed and controlled in Ireland or if they were formally incorporated in Ireland. The major loophole that Apple exploited was that a company incorporated in Ireland that was not managed in Ireland would not be subject to Irish taxation if its ultimate parent was from a country that had a tax treaty with Ireland and the parent had a taxable branch in Ireland.20 Because the United States was a treaty partner of Ireland, the head offices of Apple’s Irish subsidiaries were not taxable despite Ireland’s general system of worldwide taxation. The story Apple told Ireland was that the subsidiaries were not managed in Ireland, implying that they were managed in the United States. The story Apple told Levin and McCain was that “Apple has not made a determination regarding the location of [the Irish subsidiaries’] central management and control.”21

The European Commission is the executive branch of the EU. Its Directorate-General for Competition is responsible for enforcing competition law, including antitrust law and state aid rules, based on the EU’s founding treaties. In the state aid cases, the commission’s role is similar to the Federal Trade Commission; to the extent it asserts authority over tax matters, you could consider the commission akin to the IRS. Therefore, a commission decision is in no sense legally binding. The opinion of the General Court is the first word on what rule of law applies.

When Apple told Ireland that the subsidiaries were managed and controlled outside of Ireland, it made the same claim about the management and control of Apple’s intangible property. Apple claimed that the head offices of the subsidiaries controlled the intangibles and were entitled to the massive profits generated by them even though the head offices had no employees, business assets, or physical presence. The story was that the intangibles were managed by the members of the subsidiaries’ boards of directors, most of whom were Americans employed by Apple Inc. Managing the cost-sharing arrangement — a task that primarily involved approving periodic changes to the agreements — was a central part of the directors’ responsibilities.

The employees of the Irish subsidiaries performed a variety of functions.22 All of these employees were located in Ireland and were

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20 See Apple commission decision, supra note 4, at paras. 48-49.
21 Senate report, supra note 3, at 23.
22 Apple judgment, supra note 5, at paras. 9-10.
indisputably performing functions related to the operations of the taxable branches rather than to the head offices. One subsidiary was responsible for the sales and distribution of Apple products throughout the world (except for in the Americas), including procurement, sales and distribution, logistics, and after-sales service functions. The other subsidiary was responsible for the manufacture and assembly of a specialized range of computer products, with key tasks including planning and scheduling, process engineering, production and operations, quality assurance, and quality control. Although these functions were nowhere near as important to Apple’s global success as the tasks performed by Apple Inc., they did play an important role. Both Ireland and Apple argued that they were essentially routine functions and could be benchmarked by reference to independent companies. Applying the transactional net margin method — the OECD’s equivalent to the U.S. comparable profits method in reg. section 1.482-5 — the Irish rulings allocated enough profit to the branches to provide them with a markup on their operating costs. For our purposes, we can assume that these profits would be adequate if no profit from Apple’s intangibles were allocated to the branches.

By allocating profits to the branches using a cost-plus method, the Irish rulings effectively allocated the remaining profits — in excess of €100 billion over the 10-year period at issue — to the head offices. In contrast, the European Commission argued that all of these profits should be allocated to the branches and taxed by Ireland; since the head offices had no substance or activities, the commission suggested that allocating any profit at all to them would be sanctioning profit shifting.

II. Brief Overview of State Aid Rules

Article 107 of the TFEU prevents member states from providing financial aid that “distorts or threatens to distort” competition by favoring some companies over others. Illegal state aid requires four elements:

- an intervention using state resources;
- that is liable to affect trade between member states;
- confers an advantage on a particular beneficiary; and
- threatens to distort competition.

The classic case of state aid is when a country provides a direct subsidy to a local corporation to promote it as a national champion in a particular industry.

A potential stumbling block for the European Commission in the recent state aid cases is that income taxation is the province of the individual member states under EU law. Generally, EU institutions lack the authority to attempt to harmonize taxation among the member states. However, because forgoing the collection of tax that a local enterprise would otherwise owe is the economic equivalent of providing a subsidy, the state aid rules must be able to reach some matters of taxation. EU case law puts some guardrails around state aid investigations of tax matters. Proving state aid in taxation requires three steps:

- establishing a reference system that represents the normal rules of taxation under national law;
- demonstrating that an action by the member state is a derogation from the reference system; and
- showing that the derogation selectively favors a specific enterprise.

III. An Autonomous Arm’s-Length Principle?

In the state aid cases, the beleaguered nations — including Ireland as an intervenor in Fiat and the Netherlands as a party in Starbucks — argued that they have sole authority to determine whether and how the arm’s-length principle should be applied. More specifically, the states argued that the reference system should be the country’s overall system of taxation, including the transfer pricing rules as they are actually applied. Under this view, there would be no autonomous arm’s-length principle. Instead, the arm’s-length principle would only apply to the extent it was incorporated into national law.

The European Commission countered that the reference system should be the country’s general system of corporate taxation, which aims to tax

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23 See article 114(2) TFEU.
both integrated and stand-alone companies on their corporate profits. The commission focused on the tax base, concluding that corporate profits must reflect a market-based outcome for both types of companies, which meant that a group member’s profits must comport with the arm’s-length principle whether or not the country had explicitly incorporated the principle in its national tax system. In both Starbucks and Fiat, the commission contended that if a given measure in a member state’s tax law allows a group company to calculate taxable profits that are lower than those that would result from arm’s-length pricing, then that measure is a derogation from the reference system and violates article 107 of the TFEU by giving a selective advantage to the company. The commission argued that this conclusion necessarily flows from the CJEU’s opinion in Belgium and Forum 187 — a proposition that is debatable (and is discussed below).

The General Court agreed with the commission on each of these points, using similar — and at times identical — language in both Fiat and Starbucks. In paragraph 141 of the Fiat judgment and paragraph 149 of the Starbucks judgment, the court writes:

Where national tax law does not make a distinction between integrated undertakings and stand-alone undertakings for the purposes of their liability to corporate income tax, that law is intended to tax the profit arising from the economic activity of such an integrated undertaking as though it had arisen from transactions carried out at market prices.

In both opinions, the court explicitly cites the Belgium judgment as authority for this proposition. Using nearly identical language in Fiat (paragraph 143) and Starbucks (paragraph 151) judgments, the court approves of the commission’s use of the arm’s-length principle to exercise its powers under article 107 TFEU, calling the principle a tool that the commission can use to establish a benchmark to determine whether an integrated company is receiving a selective advantage.25

It is unambiguously clear that the court bases both decisions on an autonomous arm’s-length principle. Because the principle derives from EU competition law rather than from national tax law or treaties, the court notes that the commission is not formally bound by the OECD transfer pricing guidelines. The court does, however, acknowledge their persuasive value. In paragraph 147 of the Fiat judgment (and with nearly identical language in paragraph 155 of the Starbucks judgment), the General Court states:

The fact remains that those guidelines are based on important work carried out by groups of renowned experts, that they reflect the international consensus achieved with regard to transfer pricing and that they thus have a certain practical significance in the interpretation of issues relating to transfer pricing.

Of course, the General Court does not have the final word on the law of the European Union. That is the province of the CJEU. And Fiat has appealed the decision against it to that authoritative tribunal. So the question becomes: How will the autonomous arm’s-length principle fare in that appeal?

Some have argued that contrary to the General Court’s conclusion, the CJEU did not establish an autonomous principle in its Belgium judgment.26 It is true that the CJEU found that the relevant Belgian tax regime violated state aid rules because it was not consistent with the arm’s-length principle. However, it is not clear whether the Court considered the arm’s-length principle to be part of the reference system because the principle was already part of Belgium’s ordinary corporate tax law or whether the Court relied on an autonomous EU principle.

Similarly, it could be argued that the General Court’s conclusion in both Fiat and Starbucks that there is an autonomous arm’s-length principle was superfluous because, as the court recognizes in each case, both Luxembourg and the

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24 Belgium and Forum 187 ASBL v. Commission, joined cases C-182/03 and C-217/03 (CJEU 2006) (hereinafter, Belgium judgment).
25 Fiat judgment, supra note 10, at para. 143; Starbucks judgment, supra note 10, para. 151.
26 See, e.g., Daly, supra note 6.
Netherlands incorporate the arm’s-length principle in their general corporate tax systems. Indeed, the court inoculated itself against reversal in paragraphs 297 to 299 of the Fiat opinion by agreeing with the commission’s subsidiary argument that Luxembourg granted state aid because its ruling violated the arm’s-length principle as incorporated in Luxembourg’s own general tax system.

IV. The Leap to Branch Profit Allocations

Reaching the conclusion that the arm’s-length principle is embedded in the TFEU’s prohibition against state aid required the European Commission and the General Court to take a leap of imagination. Unlike national tax laws and treaties governing the setting of transfer prices between affiliated companies, article 107 of the TFEU makes no mention of the arm’s-length principle. The leap of imagination is the conclusion that a group entity that doesn’t need to ensure that it conducts transactions with affiliates at arm’s length would have a competitive advantage over stand-alone companies that can only engage in arm’s-length transactions. That is, the integrated company could report profits that are smaller than the stand-alone competitor and thereby incur a lower tax burden.

To be more precise, the competitive advantage arises from the ability of the affiliated group to shift the profits that the integrated affiliate should have earned out of the tax environment in which the potential competitor operates and into a lower-tax environment. If profits were shifted between two affiliated companies that bear similar tax burdens, the group would not achieve any competitive advantage over its competitors, whether those competitors happen to be affiliated groups or stand-alone companies. State aid rules do not put the burden on the commission to show this level of detail. It is sufficient to show that the country under investigation has given an unjustified tax break.

Both Fiat and Starbucks involved transfer prices for transactions between affiliated companies. The situation in Apple is different because it involves the allocation of profits between the head office and a branch of a single corporation (or, more precisely, the allocation of profits between two companies’ head offices and a branch of each). The same reasoning that led the General Court to apply the arm’s-length principle to transactions between affiliates applies with equal force to the allocation of profits to a branch. That is, if the branch could report lower taxable profits on its dealings than a stand-alone company undertaking similar dealings, the branch would have a competitive advantage over the stand-alone competitor. The European Commission was prepared to take a similar leap of imagination in Apple’s case to that reflected in Fiat and Starbucks, but the General Court seems to be more reluctant. As we will see, the court’s opinion on this point is not entirely clear. Hopefully, the CJEU will be more decisive on appeal.

The Apple court does not dispute the Starbucks holding that an autonomous arm’s-length principle exists in the case of transfer pricing between affiliates. Rather, paragraph 205 of the Apple judgment merely notes that Apple’s situation is different than that at issue in Starbucks. Further, the following paragraph recognizes that the arm’s-length principle may lend itself to being applied by analogy to branch profit determinations. But the court strongly states that there is no free-standing obligation under article 107 TFEU to apply the arm’s-length principle to branch profits if the national law does not specify that branches should be taxed as if they were operating under market conditions. It seems clear that the court is refusing to extend the autonomous arm’s-length principle to branches.

Or is it? The court seems to equivocate with paragraph 214 stating:

Article 107(1) TFEU allows the Commission to check whether that level of profit corresponds to the level that would have been obtained through carrying on that trade under market conditions. The arm’s length principle, as described by the Commission in the contested decision,
is thus a tool enabling the Commission to make that determination in the exercise of its powers under Article 107(1) TFEU.

While the court seems to contradict itself, it may be possible to reconcile the seemingly conflicting holdings. The court might be saying that member states are not required to apply the arm’s-length principle, but that if states choose to apply it, then the commission is fully empowered to apply the principle independently — without deferring to how national authorities do so. Even though Ireland had not formally adopted the arm’s-length principle in legislation at the time it issued the Apple rulings, the court finds that Ireland had effectively adopted the principle through administrative practice, case law, and tax treaties.

Whether it springs from Irish law or stems from the EU’s founding treaties, the court does indeed apply a version of the arm’s-length principle to assessing whether the Irish branch profits were correct. It is axiomatic that profits under the arm’s-length principle must be consistent with functions performed, assets employed, and risks assumed by the enterprises involved. The court approves of the advance tax rulings that Ireland provided to Apple based on a unilateral review of the functions performed by the branches and a benchmarking of market returns earned by companies performing similar functions. While this unilateral approach may be consistent with Irish law, it does not reflect international best practices. The approach has two defects: It does not include a comparative review of the functions performed by the head offices, and it does not give adequate consideration to the assets used in the business.

V. Allocation of Assets and Contracts

Before considering how assets would be allocated between a head office and a branch under an autonomous arm’s-length principle, let us recap how we got to this point. In Fiat and Starbucks, the General Court took a leap and found an autonomous arm’s-length principle for transfer pricing between affiliates in the EU. Ambiguities in the Apple opinion suggest that the court’s imagination may be wavering on extending the autonomous arm’s-length principle to branch profit determinations. To apply the principle autonomously, the court must be willing to give international guidance on the topic precedence over the idiosyncratic approach of a member nation. Ambiguities aside, the Apple court shows some willingness to apply the internationally accepted AOA in the branch profits context. However, when it comes to actually allocating assets and contracts between a head office and a branch in practice, the court’s imagination fails. The court relies on Irish law — the Dataproducts decision, in particular — to make the actual allocation rather than the AOA.

The OECD formally adopted the AOA in its 2010 permanent establishment profits report, which addresses the attribution of profits to PEs. Before the 2010 report, there was considerable variation and confusion among countries regarding how they approached branch profits. The report definitively adopted the AOA — which is based on the arm’s-length principle — as the preferred approach. Although the General Court recognizes the significance of the AOA in its Apple opinion, the court fails to follow through with its application.

First and foremost, a head office and a branch are not separate legal entities that transact business with each other — they are two parts of one legal entity. As the OECD explains in paragraph 14 of the 2010 PE profits report, “there is no single part of an enterprise which legally ‘owns’ the assets, assumes the risks, possesses the capital or contracts with separate enterprises.” To properly apply the arm’s-length principle, it is necessary to allocate the assets, risks, capital, and contracts of the larger enterprise to its constituent parts. This allocation is the first step of the AOA. There is no a priori reason to allocate any item to the head office or to a branch. Instead, under the AOA, items must be allocated based on a

30 Id. at para. 217.
31 Id. at paras. 218-220.
comparison of the “significant people functions” that each part of the enterprise performs.  

Ultimately, Apple’s case turns entirely on whether the intangible property rights that the Irish subsidiaries own should be allocated to the head offices or to the branches. There is no serious dispute that the Irish rulings allocated adequate profits to the branches to compensate them for their routine functions. Lacking any employees, the head offices had no routine functions to compensate. The residual profits — the profits at issue in the case — were wholly attributable to the intangibles. The General Court quite compellingly demonstrates that the most important significant people functions involved in management and exploitation of the intangibles were performed by employees of Apple Inc.  

Considering that Apple Inc. employees performed these functions in accordance with contracts between their employer and the Irish subsidiaries — examples of such contracts include the cost-sharing agreement and a marketing services agreement — the decisive issue is whether these contracts should be allocated to the head offices or to the branches.

In paragraph 186, the court faults the European Commission for using a so-called exclusion approach to allocate ownership of the intangibles to the branches. That is, according to the court, the commission automatically allocated the intangibles to the branches because the head offices had neither employees nor physical presence to manage them. However, the court actually uses an exclusion approach of its own. The court, in paragraph 181, automatically allocates the intangibles to the head offices because the staff and directors of the branches did not control the intangibles.

The court achieves this result by asserting that the companies as a whole, acting through their boards of directors, control the intangibles. This is not unreasonable insofar as the boards approved the contracts with Apple Inc., essentially delegating control functions to U.S. employees. Implicit in the court’s reasoning is the belief that the actions of the branch should be attributed to the head office — a proposition that Dataproducts supports at least as long as the members of the board are not residents of Ireland. However, under the AOA, there is no stronger reason for attributing the board’s actions to the head office instead of the branch than there is for allocating the assets or contracts in that manner.

Rather than an exclusion approach, the proper application of the AOA would require comparing the functions of the branch to those of the head office. While the court seems to minimize the importance of the branches’ activities, it is undeniable that branch employees work with Apple Inc. employees to implement technical developments and execute marketing plans. Since the head offices do nothing, the AOA’s comparison approach clearly calls for allocating the contracts entirely to the branches. The allocation of the intangible property would follow the contracts as would the allocation of the residual profits derived from the intangible property. In short, if the court followed the AOA, it would uphold the commission’s decision rather than annulling it. And Ireland would be forced to accept the disputed €13 billion from Apple.

Two final points are worth making. First, the commission was correct in taking an all-or-

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33 See id. at para. 309 (arguing that the boards performed their functions through delegation of powers to executives who were not Irish).

34 The applicability of Dataproducts is questionable. In that case, the Irish High Court decided that Ireland could not tax interest income from a bank account of a company that was incorporated in Ireland, tax-resident in Holland, and managed by Dutch directors, even though some of the interest was used to fund the operations of the company’s Irish branch. It is quite a stretch to compare “management” of a bank account to management of intangible property that is critical to the global business of the Apple sales branch.

35 Apple judgment, supra note 5, at para. 181 (“property belonging to a company that is not resident in Ireland and controlled by the executives of that company, who are also not resident in Ireland, cannot be allocated to that company’s Irish branch”). Notably, each of the Irish subsidiaries had one Irish resident board member. See Apple commission decision, supra note 4, at para. 114. Therefore, applying the court’s reasoning, should a proportionate share of the intangible property rights be allocated to the Irish branches?

36 The irony of Ireland keeping the disputed €13 billion despite being the “bad actor” that granted the illegal state aid in the first place cannot be lost on any observer.
nothing approach. Second, final resolution of the case does not turn on the burden on proof but on a point of law. In his recent article, Robert Goulder missed the point when he argued that the commission was foolhardy to not present an alternative transfer pricing analysis that would support a partial recovery. If, as the commission argues, the intangible rights are fully allocable to the branches, then no further analysis is necessary: All profits must be allocated to the branches and none to the head offices. The commission is clearly not interested in quibbling over the amount of profit that should be allocated to the branches if this point were conceded. The resolution of the issue turns on a point of law: Should the actions of the boards be automatically attributed to the head offices? Because a point of law is at issue, appeal to the CJEU is well founded. I agree wholeheartedly with Goulder that the commission “must” undertake the appeal.

VI. Concluding Thoughts: New World Order

What’s done is done. The General Court is not going to reconsider its position. Still, assuming the European Commission appeals the case to the CJEU, Apple’s €13 billion will likely remain in escrow for now. So what will the CJEU do? Just because the CJEU could reverse the General Court does not mean it should.

Much has changed since the commission initially brought the case against Apple and Ireland. BEPS reforms, implemented to a large extent in Europe and elsewhere, have made the use of hybrid mismatches difficult. Ireland itself closed the nonresident company loophole in 2014. Concerns about corporate reputation have slowed aggressive tax planning in general. Perhaps most importantly, the introduction of the global intangible low-taxed income regime—which is effectively a global minimum tax—has greatly limited the benefits of aggressive planning for U.S.-based multinationals.

Nonetheless, I believe that the autonomous arm’s-length principle deserves its place in EU competition law. Allowing each member state to apply the arm’s-length principle in its own idiosyncratic way—or to not apply it at all—is an invitation for abuse. If the CJEU agrees with this conclusion but is disinclined to approve the commission’s decision in full, I believe that there is a palatable solution available to the CJEU. Recognizing that international guidance in the form of the AOA was not available at the time Ireland gave Apple the contested rulings, the CJEU could hold that member states are only under an obligation to apply international best practices after they have been formally articulated. That is, the CJEU could hold that the principles advanced by this article should only apply prospectively—and, thereby, find that Ireland was blameless in granting the contested tax rulings.

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40 See Apple commission decision, supra note 4, at 9.
41 Section 951A.