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THE INTERSECTION OF EU STATE AID AND U.S. TAX DEFERRAL: A SPECTACLE OF FIREWORKS, SMOKE, AND MIRRORS

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ABSTRACT

The Advance Pricing Agreements or transfer pricing rulings granted to U.S. multinationals by Ireland, the Netherlands, and Luxembourg were principally designed to achieve U.S. tax deferral and not EU tax avoidance. Adverse BEPS effects within the European Union would be immaterial in comparison to the deferral of U.S. tax on residual IP-related profits, and would have occurred primarily in countries other than those charged with the granting of unlawful State aid. The Irish, Dutch, and Luxembourgish treasuries have not foregone tax revenues in favor of the U.S. multinationals they allegedly aided, which is a requirement for a finding of prohibited State aid. However, the conduct of these low-tax EU States, which enables the deferral of U.S. tax and facilitates the accumulation of financial capital within

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the European Union may benefit such countries possibly at the expense of other EU Member States, and can therefore be viewed as a form of tax competition that is questionable in light of the EU Code of Conduct. Conversely, if the retroactive State aid charges were to prevail, the U.S. Treasury would forfeit its claim over unrepatriated earnings of U.S. multinationals. The significant tax policy implications for both Europe and the United States resulting from the State aid decisions by the EU Commission are explored here in detail.

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I. INTRODUCTION

The U.S. Senate investigations and hearings[1] chaired by Senator Carl Levin in 2012 "to examine billions of dollars in U.S. tax avoidance by

1. *See Offshore Profit Shifting and the U.S. Tax Code—Part 1 (Microsoft and Hewlett–Packard): Hearing Before the Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs*, 112th Cong. (2012), https://www.gpo.gov/fdsys/pkg/CHRG-112shrg76071/pdf/CHRG-112shrg76071.pdf; *Offshore Profit Shifting and the U.S.*

multinational corporations,"[2] sparked a global debate over the complex international tax affairs of U.S. multinationals. The U.K. House of Commons Committee of Public Accounts,[3] chaired by the Right Honorable Margaret Hodge, echoed the U.S. debate and effectively turned it into a heated inquiry over U.K. tax avoidance effects resulting from the same structures that were scrutinized by the U.S. Senate. The United Kingdom inquiries fueled public outrage in the European Union, with the implication that U.K. tax avoidance would represent merely one instance of "source country" abuse perpetrated by U.S. multinationals; abusive practices would be widespread, affecting other countries throughout Europe and across the world.

Detailed information, facts and figures pertaining to the operations and tax affairs of highly visible U.S. companies, such as Apple and Starbucks and the allegation that these firms avoided billions of dollars of U.S. (and possibly non-U.S.) tax, was documented and brought to the public eye by the U.S. and U.K. legislatures in 2012. These events and resulting public outrage have prompted G20 leaders to call on the OECD in November 2012 for a Report on Base Erosion and Profits Shifting (BEPS), effectively triggering the launch of the G20-OECD BEPS Project.[4] Nonetheless, the facts and structures disclosed and debated in the U.S. and U.K. investigations also triggered the opening of investigations by the EU Commission over whether certain EU Member States involved in the structures implemented by U.S. multinationals

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Code—Part 2 (Apple, Inc.): *Hearing Before the Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs*, 113th Cong. (2013), https://www.gpo.gov/fdsys/pkg/CHRG-113shrg81657/pdf/CHRG-113shrg81657.pdf (hearing), www.hsgac.senate.gov/download/?id=B2F27D33-856B-4B2A-8B55-D045DC285978 (exhibits) [hereinafter Senate Apple Report].

2. *See* Press Release, Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs, Subcommittee Hearing to Examine Billions of Dollars in U.S. Tax Avoidance by Multinational Corporations (Sept. 20, 2012), https://www.hsgac.senate.gov/subcommittees/investigations/media/subcommittee-hearing-to-examine_billions-of-dollars-in-us-tax-avoidance-by-multinational-corporations-.

3. *See* COMMITTEE OF PUBLIC ACCOUNTS, HM REVENUE AND CUSTOMS: ANNUAL REPORT AND ACCOUNTS 2011–12, 2012-3, H.C. 716 (U.K.), http://www.publications.parliament.uk/pa/cm201213/cmselect/cmpubacc/716/716.pdf.

4. *See* OECD, ADDRESSING BASE EROSION AND PROFIT SHIFTING (2013), http://dx.doi.org/10.1787/9789264192744-en; OECD, ACTION PLAN ON BASE EROSION AND PROFIT SHIFTING (2013), http://dx.doi.org/10.1787/9789264202719-en [hereinafter BEPS ACTION PLAN].

and disclosed to the U.S. Senate and U.K. House of Commons, were actually granting "unlawful state aid"[5] to such U.S. companies.

As such, what started off as a debate over U.S. tax avoidance on offshore income earned by U.S. firms and legislative reform (in the United States and abroad) turned into an inquiry over whether such offshore income should have been taxed in *source countries* in the first place, before arriving at low-tax offshore entities and hence before falling into the U.S. tax net. Senator Levin's 2012 investigations and Letter[6] of October 5, 2012, to the U.S. Senate Committee on Finance, which lists "ten offshore abuses," U.S. tax "loopholes and gimmicks," and aimed to reinstate U.S. residual taxing rights over income recorded offshore by U.S. multinationals (perhaps inadvertently) triggered an international response and guided many of the "actions" under the G20-OECD BEPS Project. Absent U.S. tax reform to effectively reinstate U.S. residual taxing rights, the continuing pressure by public opinion and the potential implementation of unilateral or disproportionate "anti-BEPS" measures by source countries (or by the EU Commission) may materialize not only into substantial tax reforms, but also into *retroactive tax assessments* in Europe and across the world. Such uncoordinated or unilateral anti-BEPS actions, as noted by Senator Orrin Hatch and Representative David Camp in their Joint Statement[7] of June 2, 2014, would increase source-country claims and thus reduce U.S. residual taxing rights over offshore income earned by U.S. multinationals. However, it is not clear that the current attempt by the EU Commission to enforce a retroactive tax assessment against U.S. multinationals is legitimate through the construct of the current State aid cases discussed here. Leaving aside the political debate over tax policy implications,

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5. Under the Treaty on the Functioning of the European Union (TFEU) Articles 107-108, any form of "State aid" would be unlawful if granted by a member state without prior authorization of the EU Commission. *See* Consolidated Version of the Treaty on the Functioning of the European Union arts. 107–08, Oct. 26, 2012, 2012 O.J. (C 326) 47, 90 [hereinafter TFEU].

6. Letter from Carl Levin, U.S. Sen., to the U.S. Senate Comm. on Fin. (Oct. 5, 2012), http://www.hsgac.senate.gov/download/levin-letter-re-10-offshore-tax-loopholes-october-5-2012.

7. *See* Press Release, Comm. on Fin., Hatch, Camp Statement on 2014 OECD Tax Conference (June 2, 2014), http://www.finance.senate.gov/ranking-members-news/hatch-camp-statement-on-2014-oecd-tax-conference; *see also* David Ernick, *OECD: How Base Erosion and Profit Shifting Project Affected International Tax*, Commentary/Current and Quotable, TAX NOTES (Aug. 10, 2015), https://www.aei.org/wp-content/uploads/2015/11/How-Base-Erosion-and-Profit-Shifting-Project-Affected-International-Tax-Ernick.pdf (giving keynote speech at the 5th annual Transfer Pricing Symposium of the National Association for Business Economics).

through an analysis of the facts presented strictly from a conceptual perspective under EU Law and under contemporaneous OECD Transfer Pricing Guidelines, the European Court of Justice should not uphold the allegations of the EU Commission. No "State aid" should be deemed to exist.

A. *Procedural Context: EU Commission Investigations and Decisions, ECJ Litigation*[8]

On May 21, 2013, the U.S. Senate published details pertaining to Apple's structure in Ireland and the EU. No later than June 12, 2013, the EU Commission initiated its preliminary investigation of the Apple case by sending a letter to the Republic of Ireland concerning the same facts and structure disclosed by the U.S. Senate. Similar letters were sent by the EU Commission to the Netherlands on July 30, 2013, concerning the Starbucks structure unveiled by the U.K. House of Commons in December 2012. In the case of Luxembourg, the EU Commission started its investigation on June 19, 2013, concerning general tax ruling practices, and on June 24, 2014, it expanded its investigation to specifically address the Amazon structure that was disclosed by the U.K. House of Commons.

The EU Commission initiated "preliminary investigations" in 2013 concerning the cases and rulings at issue in which it only gathered information through dealings with the Member States in question. Additionally, in June 2014, the EU Commission launched "in-depth" or "formal investigation procedures" in which the multinationals in question became directly involved. The letters issued by the EU Commission to Ireland, Luxembourg, and the Netherlands to formally initiate the in-depth investigations were made public[9] and are grounded on the detailed facts that are discussed in this paper.

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8. *See* COMPETITION: STATE AID PROCEDURES, EUROPEAN COMMISSION (2013), http://ec.europa.eu/competition/publications/factsheets/state_aid_procedures_en.pdf (describing a simplified version of EU State aid procedures) [hereinafter State Aid Procedures].

9. *See* Letter from European Commission to Ireland (June 11, 2014), 2014 O.J. (C 369) 24, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:C:2014:369:FULL&from=EN (notifying Ireland of its decision to initiate the procedure of Article 108(2) of the Treaty on the Functioning of the European Union concerning State aid) [hereinafter Apple Irish State Aid Letter]; Letter from European Commission to the Netherlands (Nov. 6, 2014), 2014 O.J. (C 460) 13, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:C:2014:460:FULL&from=EN (official version), http://ec.europa.eu/competition/state_aid/cases/253201/253201_1596706_60_2.pdf (English version) (notifying the Netherlands of its decision to initiate the procedure of Article 108(2) of the Treaty on the Functioning of the European Union concerning State aid) [hereinafter Starbucks Netherlands State Aid

On October 21, 2015, the EU Commission announced its long-awaited decisions on the cases against Starbucks and Fiat.[10] The EU Commission also noted that the other long-awaited decisions with regard to Amazon and Apple would be forthcoming only when they were ready. The full decision was not made public and only a press release is publicly available at this time. In the press release, the EU Commission ascertains that the transactions entered into by the companies, sheltered by the rulings of the countries in question, are not priced at arm's length. In the case of Starbucks, the royalties charged by a U.K. entity to a Dutch coffee roasting company are deemed to be excessive and unjustified, as well as the price paid by such operating entity for coffee beans supplied by a Swiss entity. The European Commission announced that the Netherlands and Luxembourg must recover back taxes from Starbucks and Fiat for the last ten years, according to a methodology which is not yet publicly available, and estimated the resulting tax assessments for each company in the same range of 20 to 30 million Euro, whereas the exact amounts would ostensibly be determined by the local tax authorities through the application of the methodology determined by the EU Commission.

The Netherlands immediately announced its intention to appeal the decision against Starbucks and reiterated its commitment to the arm's length principle of transfer pricing, and lodged its Action for Annulment on December 23, 2015.[11] If the royalties charged were reversed and the coffee

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Letter]; Letter from European Commission to Luxembourg (July 10, 2014), 2015 O.J. (C 044) 15, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:C:2015:044:FULL&from=EN (official version), http://ec.europa.eu/competition/state_aid/cases/254685/254685_1614265_70_2.pdf (English version) (notifying Luxembourg of its decision to initiate the procedure of Article 108(2) of the Treaty on the Functioning of the European Union concerning State aid) [hereinafter Amazon Luxembourg State Aid Letter].

10. Press Release, European Commission, Commission decides selective tax advantages for Fiat in Luxembourg and Starbucks in the Netherlands are illegal under EU state aid rules (Oct. 21, 2015), http://europa.eu/rapid/press-release_IP-15-5880_en.htm [hereinafter Commission Press Release Fiat & Starbucks].

11. *See* Press Release, Government of the Netherlands, Reaction of the Dutch Authorities on the Commission decision on Starbucks, https://www.government.nl/latest/news/2015/10/21/reaction-of-the-dutch-authorities-to-the-commission-decision-on-starbucks; *see also Netherlands v. Commission*, CURIA, http://curia.europa.eu/juris/document/document.jsf?text=&docid=174409&pageIndex=0&doclang=en&mode=lst&dir=&occ=first&part=1&cid=197527. Such Action for Annulment was docketed on January 29, 2016, and published in the EU Official Journal, OJ C 59, on February 15, 2016. Among other pleas in law and main arguments, the Netherlands ascertains that there is no distinct arm's length principle

bean transactions adjusted, the ultimate assessment against Starbucks would likely be far greater than the estimates published by the EU Commission. In the case of Apple, for instance, if a similar reversal of royalty charges were implemented, the potential tax liability could surpass 2 billion USD.[12]

As noted by the Commission itself, "all decisions and procedural conduct of the Commission are subject to review by the General Court and ultimately by the European Court of Justice."[13] Meanwhile, Robert Stack of U.S. Treasury issued statements to express his "concerns" and noted that "any retroactive tax would be borne by U.S. taxpayers in the form of a credit," whilst "a purely prospective remedy would alleviate these concerns."[14] On December 1, 2015, Mr. Stack testified at a Hearing of the House Ways and Means Tax Policy Subcommittee on BEPS and on the matter of State aid to reiterate his "concerns that these taxes [were] being imposed retroactively under circumstances in which [he did] not believe companies, countries, tax advisers, or auditors ever expected"[15] while the U.S. Treasury would end up footing the bill for the extra taxes paid abroad, a concern that was shared by Finance Committee Ranking Democrat Ron Wyden and others.[16] Mr. Stack

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in EU law, and insists that the Commission "in no way demonstrates that the better—in its view—application of the 'Transactional Net Margin Method' leads to a higher taxable income and the absence of an advantage."

12. The U.S. Senate estimates that Apple avoids 2 to 3 billion USD worth of U.S. taxes each year through its Irish tax deferral structure. *See* Senate Apple Report, *supra* note 1, at Exhibit 1L. If the effective rate of foreign taxes on such foreign earnings is in the two to five percent range and if the residual U.S. corporate tax subject to deferral would therefore not be greater than thirty percent, we can estimate a residual annual tax base of 6 to 9 billion USD. If one third of that amount was recast to Ireland and the Irish tax rate of 12.5 percent was to be applied to the same base, an Irish tax liability in excess of 200 million USD per year could be ascertained.

13. *See* State Aid Procedures, *supra* note 8, at 2.

14. See Vanessa Houlder & Christian Oliver, *US Treasury Voices Fears over Corporate Tax Probe by Brussels*, FINANCIAL TIMES, Sept. 30, 2015, http://www.ft.com/intl/cms/s/0/899a9c6e-6750-11e5-97d0-1456a776a4f5.html#axzz448Eya52A.

15. Erich Kroh, *Treasury Official Says EU Tax Investigations Strain US Ties*, LAW 360, Dec. 1, 2015, http://www.law360.com/articles/732333/treasury-official-says-eu-tax-investigations-strain-us-ties.

16. *See* Press Release, Comm. on Fin., Finance Committee Members Push for Fairness in EU State Aid Investigations (Jan. 15, 2016), http://www.finance.senate.gov/chairmans-news/finance-committee-members-push-for-fairness-in-eu-state-aid-investigations- (presenting letter to Treasury Secretary Jack Lew in which Ron Wyden and accompanying co-authors support Robert Stack's testimony, and calling for the application of doubled U.S. federal tax rates under IRC sec. 891 in retaliation for any retroactive claims triggered by the EU state aid investigations); *see also* Press Release, U.S. House of Representatives Comm. on

further noted that the effort appears to be disproportionately targeting U.S. companies to tax income that no member state had the right to tax under internationally accepted standards and that he believed the target of the effort was unrepatriated foreign earnings that U.S. companies hold overseas.[17]

B. The Facts at Issue: Amazon, Starbucks, and Amazon Cases

In all cases involving U.S. companies, a similar structure and fact pattern is at issue. In the Apple case, the illustrations, facts, and figures used by the EU Commission were *reproduced* from and cite to the *Exhibits* published by the U.S. Senate in 2013.[18] Similarly, the information disclosed by the U.K. House of Commons concerning Starbucks and Amazon is cited in the opening of the so-called "in-depth investigations" of EU Commission in 2014.[19]

The Starbucks case was illustrated in the press release as follows:[20]

Ways and Means, Chairman Bostany Opening Statement: Examining the OECD Base Erosion and Profit Shifting (BEPS) Project (Oct. 1, 2015), http://waysandmeans.house.gov/chairman-boustany-opening-statement-examining-the-oecd-base-erosion-and-profit-shifting-beps-project/. Secretary Lew raised U.S. objections in a February 11, 2016, letter to the EU Competition Commissioner Margrethe Vestager, who responded in February 29, 2016, dismissing the U.S. objections as based on "misunderstandings" of the EU legal and institutional framework. *See* Ryan Finley, *Vestager Dismisses U.S. Objections to State Aid Probes*, 81 TAX NOTES INT'L 825 (Mar. 7, 2016).

17. *US Committees hold BEPS Hearings*, GLOBAL TAX ALERT (Ernst & Young, Washington D.C.), Dec. 2, 2015, http://www.ey.com/Publication/vwLUAssets/US_Tax_Committees_hold_BEPS_Hearings/$FILE/2015G_CM6016_US%20Tax%20Committees%20hold%20BEPS%20Hearings.pdf; *see also*, Richard Rubin, *Treasury Department Reviewing Retaliatory Tax Law Against EU*, WALL ST. J., Mar. 4, 2016, http://www.wsj.com/articles/treasury-department-reviewing-retaliatory-tax-law-against-eu-1457120228.

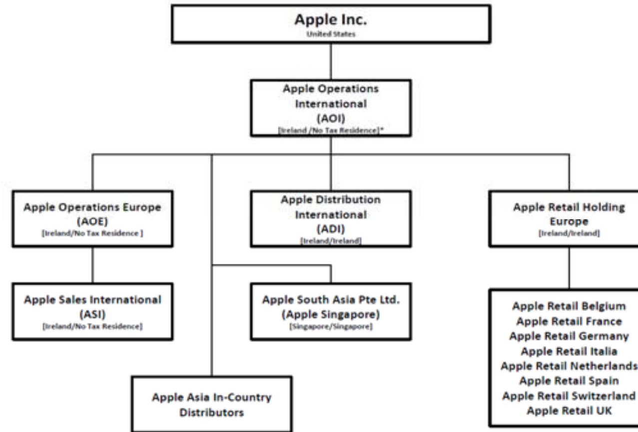
18. The U.S. Senate Subcommittee findings are referenced and cited by the EU Commission in its letters to the Republic of Ireland and the U.K. House of Commons findings are referenced by the EU Commission in its letters to the Netherlands. *See* Apple Irish State Aid Letter, *supra* note 9, at 27, 30; Starbucks Netherlands State Aid Letter, *supra* note 9, at 28; Amazon Luxembourg State Aid Letter, *supra* note 9, at 17, 19.

19. *See* Apple Irish State Aid Letter, *supra* note 9, at 27, 30.

20. *See* Commission Press Release Fiat & Starbucks, *supra* note 10. Note: in this illustration, the rendering of the royalty recipient as an artificial "letterbox" and no reference to the U.S. entities.

The simplified structure above omits critical details that are relevant to the analysis and which are discussed at length in Sections II and III below. However, what is critical is that the U.K. entity depicted in this illustration in fact represents a "reverse hybrid" partnership, which is not a tax resident in the EU and yet is treated, for United States purposes, as a separate corporate entity entitled to defer U.S. corporate tax on active foreign income. That entity holds the ownership of valuable intangibles developed by Starbucks in the United States, which are licensed to third party retailers and also assumes marketing and distribution risks for the EU. Through such structure, Starbucks not only transferred the ownership of pre-existing intangibles out of the United States, but also holds substantial capital and assumes substantial risk in the United Kingdom and in Switzerland. The Swiss entity performs significant functions in the selection and blending of coffee beans, all guided by the United States and guaranteed by the United Kingdom. The Dutch coffee roaster, therefore, plays no role in the selection of coffee beans or the creation of coffee blends and roasts coffee according to know-how developed in the United States and supplied through the U.K. structure. The United Kingdom controls all marketing intangibles, including distribution network, thereby leaving the Dutch coffee roaster to function, in essence, as a limited-risk contractor.

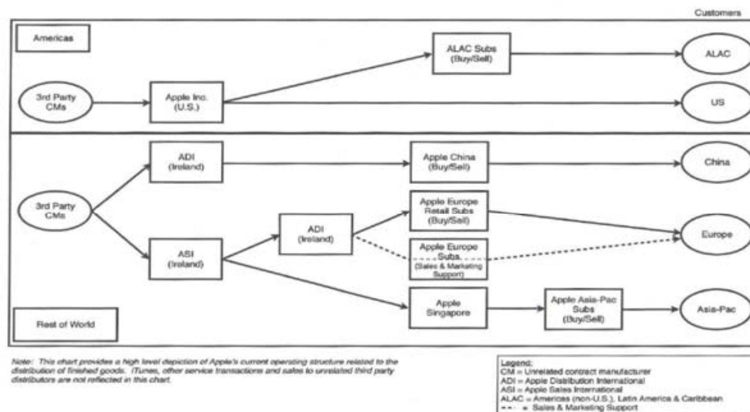
In essence, the Apple structure is no different. The illustrations, facts and figures presented by Apple to the U.S. Senate are rather clear. Instead of a U.K. partnership, Apple uses Irish non-resident entities to achieve U.S. tax deferral, in apparent compliance with U.S. tax law and transfer pricing regulations. Apple's corporate structure is as follows:



Prepared by the Permanent Subcommittee on Investigations, May 2013. Source: Materials received from Apple Inc.

Apple's operational model uses non-resident Irish entities as the owners of valuable intangibles developed in the United States. Such non-resident Irish entities are also the holders of substantial capital and bearers of substantial risks associated with Apple's European value chain, while significant functions and activities relevant to such operations remain performed by Apple's personnel in California.

Apple's operational structure is depicted as follows:



Source: Apple chart, prepared by Apple at the Subcommittee's request.

With this introduction, this Article will proceed by first introducing a framework for analysis of the cases which combines EU State aid rules, transfer pricing, and U.S. tax deferral. Second, using that integrated framework, it offers a brief description and analysis of the ongoing State aid investigations and decisions by the European Commission concerning Apple and Ireland, Starbucks and the Netherlands, and Amazon and Luxembourg. Third, discussing "private rulings" and "advance pricing agreements" in light of transfer pricing laws and the arm's length principle. Finally, addressing the issue of taxing rights over the "residual profits" that were channeled through Ireland, Luxembourg, and the Netherlands.

II. CONCEPTUAL FRAMEWORK OF ANALYSIS

The investigations and decisions of the European Commission herein discussed in detail relate specifically to the advance rulings on transfer pricing matters (Advance Pricing Agreements (APAs)) unilaterally agreed to by Ireland, the Netherlands, and Luxembourg each with certain U.S. multinational enterprises (MNEs).[21] The terms of the advance ruling are alleged to grant a *direct concession*; that is, a reduction of Irish, Dutch, or Luxembourgish tax through "mispricing" by the multinational firms rather than reflect the operation of the tax system of these countries. The primary issue of whether "fiscal aid" was provided through "transfer mispricing," therefore, relates to the specific facts of each case and the terms of the advance rulings.

However, there is a common fact pattern to all of these cases that are now facing the scrutiny of the EU Commission. Through legal construct, the beneficial ownership of United States developed intellectual property (IP) was transferred out of the United States and attributed to entities structured within the European Union—but that are not tax residents anywhere. Therefore, *royalty income* that would be taxed in the United States, whether specified as such or simply earned as gross operational margins from the sales of products and services, would accumulate in Europe and no longer be taxed anywhere; provided the U.S. corporate tax on such income is avoided or deferred.[22]

Nevertheless, the EU Commission does not view the non-resident EU legal entity set-up under which substantial *royalty income* is earned and accumulated within the European Union tax-free, as a form of unlawful "State

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21. *See* Apple Irish State Aid Letter, *supra* note 9; Starbucks Netherlands State Aid Letter, *supra* note 9; Amazon Luxembourg State Aid Letter, *supra* note 9.

22. For an overview of issues and limitations of the U.S. anti-deferral rules, *see* J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Worse than Exemption*, 59 EMORY L. J. 79 (2009); *see also* Robert J. Peroni, J. Clifton Fleming, Jr., & Stephen E. Shay, *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. REV. 455 (1999).

aid." Rather, the EU Commission considered as unlawful aid the recognition, via APAs, of *royalty deductions* by certain intermediary entities that are tax residents in Ireland, the Netherlands, and Luxembourg. The resident entities that allegedly received State aid by claiming royalty deductions, nonetheless, recorded revenues that included the value of such United States developed IP, which they do not own, did not fund, and did not co-develop, yet these entities operate under IP licensing agreements granted by IP owners.

Such non-resident and untaxed EU entities accumulated financial capital and assumed further entrepreneurial risks related to the funding, development, use, and value chain through such IP is deployed. As such, incremental IP-related variable returns or "residual profits" accrued to such IP owners; that is, the resident taxpaying entities operated in a "limited-risk" capacity *through their licensing agreements* via a *contingent* or *reverse* royalty model. Royalty income streams included both, the remuneration for the use of United States developed IP, as well as incremental "residual profits" from IP-related entrepreneurial risks contractually stripped out of the United States, and to a lesser extent, also shifted out of the EU Internal Market. Still, the EU Commission seeks the *full reversal* of EU royalty deductions effectively channeled through *certain* intermediary entities.

The State aid claim, therefore, challenges not only the valuation of royalties and the risk-shifting clause, but the very existence of the underlying IP. In addition, it views the contingent royalty model as irrefutable evidence of "transfer mispricing" aided or funded by the treasuries of the intermediary countries in question, which would be a *harmful tax preference* detrimental to the EU Internal Market. Accordingly, the alleged "transfer mispricing," along with certain formalistic issues concerning the ruling process, served as grounds to fully *disregard* the IP licenses and to render the APAs invalid.

A. *Is U.S. Tax Deferral State Aid?*

The definition of what constitutes harmful tax preferences against the internal market is the *existential* question of EU State aid enforcement. This factor will determine the scope of any potential judgement by the European Commission against the offending Member State.[23] Since Apple was able to *channel* over 64 billion USD per year through Ireland as a result of its favorable transfer pricing ruling,[24] for instance, it is necessary to ascertain

23. *See generally* Tracy A. Kaye, *Direct Taxation in the European Union: Past Trends and Future Developments*, 16 ILSA J. INT'L & COMP. L. 423 (2010).

24. *See* Apple Irish State Aid Letter, *supra* note 9, at 27 (noting that Apple's net worldwide sales in 2012 amounted to 156.5 billion USD in which 63.9 billion USD were routed through Ireland).

whether such channeling was detrimental to the EU Internal Market *and* whether it was financially supported or "aided" by the treasury of Ireland.

However, the most significant tax avoidance relates to the initial transfer of the intellectual property from the United States[25] into the EU affiliates (whether or not EU tax residents), which reduced the potential for immediate recognition of corporate taxable income in the United States. Conversely, a less significant portion of the corporate taxes hypothetically avoided through the operating models noted here would have been at the expense of the EU Internal Market and any such hypothetical EU base erosion would have occurred primarily in European "source countries" and consumer markets *other than* Ireland, the Netherlands, and Luxembourg. Accordingly, EU tax "avoidance" effects cannot be regarded as one and the same as the deduction of royalties owed for the use of United States developed IP. Significant royalties should have been deducted from the "European tax base" in any event, and, absent the structures in question, would have been immediately taxed in the United States. Whether or when the United States exercises its taxing rights was thought to be a separate matter, but perhaps no longer.

If the IP in question is "mispriced," much higher base erosion effects would be triggered in other countries that acquire goods and services from the interposed entities in question. Such base erosion would be commensurate with an undue increase of the U.S. tax-deferred base. Ireland, the Netherlands, and Luxembourg would be *the messengers* or conduits of such transfer pricing effects and not their cause. As such, the transfer pricing strategies employed by U.S. multinationals were designed first and foremost to defer (not defeat) application of the U.S. corporate income tax on their foreign source *royalty income* and risk-related residual profits, and the fact that such practices also attract (or retain) massive capital to Europe may be viewed as not threatening, but *fostering* the EU Internal Market.[26]

To place the tax avoidance practices of U.S. multinationals in perspective, we must first consider the corporate tax system of the United States. The United States applies a worldwide system of corporate taxation, which is in stark contrast to the prototypical European practice of territorial taxation. Notably, where application of the U.S. corporate income tax against Apple vis-à-vis its Irish affiliates is deferred, corporate-level taxation by the United States is not defeated. The U.S. Treasury Department has not given up

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25. *See* Edward D. Kleinbard, *Stateless Income*, 11 FLA. TAX REV. 699 (2011) (discussing how transfer of intellectual property motivated the oft-mentioned "double-dutch sandwich" structure found to be used by Google in the past).

26. *See* Romero J.S. Tavares & Bret N. Bogenschneider, *The New De Minimus Anti-Abuse Rule in the Parent Subsidiary Directive: Validating EU Tax Competition and Corporate Tax Avoidance?* 43 INTERTAX 484 (2015) [hereinafter Tavares & Bogenschneider, *The New De Minimus Anti-Abuse Rule*].

its taxing rights to income outside of its "territory" as would typically be the case in a territorial system. Hence, the interests of the United States in allowing tax deferral on U.S. multinationals to occur is inherent to the design of the U.S. tax system, particularly where foreign taxes are also reduced through the same scheme. Such reduction of foreign taxes effectively increases potential U.S. taxes on residual profits, and is deemed under U.S. law to be a legitimate "business purpose" for U.S. MNEs to engage in restructurings which also defer U.S. tax.[27]

The "transparent" EU entities can be regarded as foreign corporations under U.S. tax law at the election of U.S. shareholders.[28] Such entities would be consolidated for U.S. tax purposes with other non-U.S. entities or branches in the same country or even across borders. This U.S. legal entity classification fiction enables the deferral of U.S. tax on royalties and "residual profits" arising from IP ownership and is openly acknowledged by the European Commission.[29] However, such U.S. tax deferral is effectively what seems to entice the current debate as to whether any untaxed residual profits earned by U.S. shareholders should instead be reallocated to certain legal entities, which are regarded as corporate resident taxpayers of Luxembourg, Ireland, or the Netherlands and effectively paid royalties for the use of the IP they do not own. Thus, the overriding question would be, *how much, if any, of the U.S. MNE's worldwide profits*[30] should be ultimately taxed within Europe *and* by

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27. *See* P.L.R. 2006–26–037; *see also* Jasper L. Cummings, Jr., *Reorganization Business Purpose*, 136 TAX NOTES 1069 (Aug. 27, 2012) [hereinafter Cummings, *Reorganization Business Purpose*].

28. I.R.C. § 7701(a)(3); Reg. § 301.7701-3.

29. *See, e.g.*, Amazon Luxembourg State Aid Letter, *supra* note 9, at 19 and n. 21 (official version), at 8 and n. 21 (English version).

> In principle not Lux SCS itself will be subject to Luxembourg corporate income tax and net wealth tax, but only the participating partners to which the profits of Lux SCS will be allocated on a yearly basis. However, due to a mismatch in the classification of Lux SCS (transparent or non-transparent due to US check-the-box rules) between Luxembourg and the US, the taxation of the partners in the US can be deferred indefinitely as long as none of the profit is repatriated to the US.

Id.

30. *See* Apple Irish State Aid Letter, *supra* note 9; Starbucks Netherlands State Aid Letter, *supra* note 9; Amazon Luxembourg State Aid Letter, *supra* note 9; *see also* Letter from European Commission to Luxembourg (June 11, 2014), 2014 O.J. (C 369) 39, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:C:2014

the interposed EU Member States? Therefore, this is a matter of U.S. tax policy.

B. *EU State Aid versus Transfer "Mispricing"*

A system of "fiscal aid" is a "selective" state measure that discriminates in favor[31] of certain firms or activities *and* which is funded by the treasury of the granting state. Article 107(1) of the Treaty on the Functioning of the European Union (TFEU) declares as incompatible with the

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:369:FULL&from=EN (official version), http://ec.europa.eu/competition/state_aid/cases/253203/253203_1590108_107_2.pdf (English version) (notifying Luxembourg of its decision to initiate the procedure of Article 108(2) of the Treaty on the Functioning of the European Union concerning State aid to Fiat).

31. A classic example of favoring multinational firms in comparison with domestic firms is illustrated in the *Gibraltar* case. *See Commission v. Gibraltar*, CURIA, http://curia.europa.eu/juris/document/document. jsf?text=&docid=81898&pageIndex=0&doclang=EN&mode=lst&dir=&occ=first&part=1&cid=511671; Wolfgang Schön, *Taxation and State Aid Law in the European Union*, 36 COMMON MKT. L. REV. 911, 919 (1999) [hereinafter Schön, Taxation and State Aid]. Noting the relevant issue of the granting of a preference to foreign based capital or companies and whether such preferences constitute "fiscal aid":

> If a tax incentive is offered to a single foreign company or to foreign companies engaged in a certain trade, the tax incentive will fall within the scope of Article 87 et seq. But it is doubtful whether a tax rule which offers preferential treatment to foreign investors irrespective of their activities must be regarded as selective State aid within the context of Article 87 et seq. This is where the newly established 'Code of Conduct' leads beyond the beaten path.

See also Pierpaolo Rossi-Maccanico, *Fiscal Aid, Tax Competition, and BEPS*, 75 TAX NOTES INT'L 857 (Sept. 8, 2014) [Rossi-Maccanico, *Fiscal Aid, Tax Competition*].

> The Court concluded that while the bases of assessment were of general applicability, the system had the practical effect of excusing nonresident businesses from corporate income tax, because they had no local employees or business premises. According to the Court, a selective scheme does not need to be explicitly drafted as a derogation from another provision to be considered state aid. Thus, the Court endorsed the commission's theory that a scheme can be inherently selective without deviating from a regular tax.

Id.; *see, e.g.*, Apple Irish State Aid Letter, *supra* note 9; Starbucks Netherlands State Aid Letter, *supra* note 9; Amazon Luxembourg State Aid Letter, *supra* note 9.

EU Internal Market any such aid threatening to distort competition in so far as it affects trade between the Member States.[32] Therefore, the rendering of "State aid" refers to fiscal aid granted by the treasury of an EU Member State and affecting the EU Internal Market.[33] Article 108 further sets the procedures through which State aid may be challenged or justified and also refers directly to the "functioning" of the EU Internal Market as the relevant consideration of EU law.[34]

A preliminary legal question to be addressed would be whether, from the viewpoint of EU law, *any* intercompany pricing result sanctioned by unilateral APAs can be deemed as "mispricing" by default given the historical[35] or inherent[36] limitations of the arm's length principle enshrined in

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32. Schön, Taxation and State Aid, *supra* note 31, at 916–17.

> Art 87(1) EC prohibits aid which distorts or threatens to distort competition by 'favouring certain undertakings or the production of certain goods.' Thus, it is of essential importance to identify 'selective' tax incentives as opposed to general rules which are neither 'aids' at all or which apply not only to 'certain' undertakings or goods but to the whole economy.

Id.

33. *See* TFEU, *supra* note 5, at art. 107(1).

> Save as otherwise provided in the Treaties, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market.

Id.

34. *See id.* at art. 108(1) ("The Commission shall, in cooperation with Member States, keep under constant review all systems of aid existing in those States. It shall propose to the latter any appropriate measures required by the progressive development or by the functioning of the internal market.").

35. The limitations of the current system and methods are the very core of the massive effort to reform the rules, most noticeably through the G20-OECD BEPS Project launched in 2013, which has not managed to reach consensus for a significant reform of transfer pricing rules. *See* BEPS ACTION PLAN, *supra* note 4; *see also* Wolfgang Schön, *International Tax Coordination for a Second-Best World (Part III)*, 2 WORLD TAX J. 227 (2010).

36. However, advocates of alternative methods such as "global formulary apportionment" posit that the arm's length principle cannot yield accurate, non-

the OECD Transfer Pricing Guidelines.[37] A second legal question would be whether intercompany pricing that *is* compatible with OECD Guidelines, yet results in the shifting of profits out of the United States and out of the European tax base with the acknowledgement and "blessing" of "intermediary" low-tax EU Member States through an APA is legitimate and compatible with EU law. The EU Commission in its assertion of State aid, however, considers as "mispricing" only the results that are not in conformity with the OECD Guidelines, and hence, it is such alleged "mispricing" that would serve as grounds for the State aid allegations.

Accordingly, some factual questions must be addressed as part of the legal analysis following the path chosen by the EU Commission. First, one should consider whether there really appears to be any significant "mispricing" in the cases under scrutiny under the arm's length principle and OECD Guidelines. Second, whether such "mispricing" would necessarily result in the taxation of royalties and IP-related "residual profits" within Europe at all. Lastly, whether through the alleged "mispricing" of the APAs in question, the national treasuries of Ireland, the Netherlands, and Luxembourg have foregone tax revenues otherwise collectible from Apple, Starbucks, and Amazon.[38]

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distortionary results. *See, e.g.*, Reuven Avi-Yonah, *The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation*, 15 VA. TAX REV. 89 (1995); Yariv Brauner, *Value in the Eye of the Beholder: The Valuation of Intangibles for Transfer Pricing Purposes*, 28 VA. TAX REV. 79 (2008); J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Formulary Apportionment in the U.S. International Income Tax System: Putting Lipstick on a Pig?*, 36 MICH. J. INT'L L. 1 (2015).

37. *See* OECD, TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS (2010), http://www.oecd-ilibrary.org/taxation/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-2010_tpg-2010-en [hereafter, OECD, TRANSFER PRICING GUIDELINES].

38. Belgium previously argued in a state aid proceeding that in the absence of its special tax regime designed to grant rulings based on the U.S. Foreign Sales Corporation statutes, the capital investment by the multinational, which led to a net increase in its collection of revenue would not otherwise have taken place. *See* Vanessa Hernández Guerrero, *Defining the Balance between Free Competition and Tax Sovereignty in EC and WTO Law: The "due respect" to the General Tax System*, 5 GERMAN L. J. 87 (2004) [hereinafter Guerrero, *Defining the Balance*]; *see also* Pierpaolo Rossi-Maccanico, *Fiscal Aid Review and Cross-Border Tax Distortions*, 40 INTERTAX 92 (2012) [hereinafter Rossi-Maccanico, *Fiscal Aid Review*].

> The Commission's decision in the state aid case of the Belgian system of tax ruling for U.S. foreign sales corporations provides an illustration of the application of these principles. The scheme consisted of a tax ruling system for transfer pricing purposes, granting to the Belgian permanent establishments of a

It should be noted that the facts observed in prior "State aid" cases[39] regarding selective regimes, which favored multinationals, are not equivalent to the forced reallocation of IP income and residual profits that results from the current State aid charges. If the primary tax advantage arising from the APAs in question is the deferral of U.S. corporate tax on royalty income and residual profits otherwise attributable to U.S. taxpayers, the current State aid cases would be absolutely distinguishable from the prior decisions where the Member State entered into tax competition to attract foreign capital investment *from other EU Member States* (not the United States), *and* reduced their own tax revenues as a result. Here, such intra-EU competition is not the primary objective or the result of treating contingent royalties as deductible under APAs since the IP ownership and entrepreneurial risk in question was formally transferred into transparent non-resident entities not scrutinized by the EU Commission, and thus, was deemed from an EU perspective to remain held by U.S. shareholders. Indeed, U.S. shareholders effectively funded and developed the IP through the transparent legal entities and functioned as entrepreneurial risk-takers; hence, any taxes otherwise imposed on IP income and related residual profits would have been owed to the U.S. Treasury.

C. *State Aid and the EU Code of Conduct*

In addition to their primary aim of U.S. tax deferral, the structures implemented by U.S. MNEs almost invariably also involve the restructuring of operations in high-tax EU countries that are large consumer markets. Entities in high-tax countries are often "converted" or restructured into low-risk distributors, commissionaires, contract manufacturers, or toll manufacturers acting under an "EU Principal" entity that is often the owner or primary licensee of the same United States developed IP that significantly

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> U.S. resident FSC a forfeit determination of its tax base in Belgium, based on a cost-plus system with fixed costs of [eight] percent . . . . These subsidiaries were formally subject to Belgian corporate income tax, but the tax authorities would make no adjustments when reported profits were at least [eight] percent of eligible costs . . . . The commission found that the special system to determine the taxable base of subsidiaries and branches of U.S. resident FSCs in Belgium was an unjustified aid . . . . The commission noted that the resulting profits were not taxed in Belgium or the United States.

Rossi-Maccanico, *Fiscal Aid, Tax Competition*, *supra* note 31, at 861.

39. *Belgium v. Commission*, CURIA, ¶¶ 80–83, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:62003CJ0182&from=EN.

drives enterprise-wide residual profits. Absent the interposed "EU Principal" entity, *which is not the object of the State aid allegations of the EU Commission*, the aforementioned *conversion* of European entities into low-risk operators would cause the *increase of residual profits* subject to U.S. tax commensurate with the entrepreneurial risks borne by U.S. shareholders. Given the legal construct with the interposed non-resident entities that own IP and hold substantial financial capital, such inflated residual profits accrue to the interposed "EU Principal" and are not taxed in the United States. Such complex operating models and their international tax results are at the core of the G20-OECD BEPS Project and debate.[40]

The accumulation of untaxed royalty income derived from "hybrid entity mismatches" *within Europe*, however, was not challenged by the European Commission in its State aid allegations. Instead, the Commission decided to challenge the deductibility of royalty payments by certain specific resident corporate entities that perform specific (and arguably limited) functions and activities within Europe, and question several formal aspects related to the APAs in dispute. Quite strikingly, it is the *existence and worth* of United States developed IP and United States owned capital (which are not held by resident EU taxpaying entities) that are now under scrutiny by the EU Commission without regard to the functions performed in the United States. Such IP and capital are implicitly deemed worthless in comparison with the specific functions performed by certain intermediary taxpaying entities resident in Luxembourg, Ireland, and the Netherlands. In a sense, it is as if some of the most radical reforms considered under the realm of the G20-OECD BEPS debate (i.e., disregard of intercompany contracts), which are unlikely to materialize into law within the scope of such Project,[41] were historically enforceable as standards of international tax law within Europe. Further, even in light of new post-BEPS standards, any re-characterization would necessarily "look through" the contractual structure implemented and ascertain that the substance of "value creation" would appear to be in the United States given that the United States developed IP exists and is primarily maintained through activities performed within the United States. The State aid charge of the EU Commission would disregard the non-resident entities *and* essentially deem the selected EU operating entities (and not the U.S. entities and shareholders) to be the "risk-taking entrepreneurs and IP owners" of the Apple, Starbucks, and Amazon worldwide groups.

Irrespective of whether the non-taxation of royalty income or the deductibility of royalty expenses is considered, the conduct of the EU Member

40. *See* BEPS ACTION PLAN, *supra* note 4.

41. *See* Romero J.S. Tavares & Jeffrey Owens, *Human Capital in Value Creation and Post-BEPS Tax Policy: An Outlook*, 69 IBFD BULL. INT'L. TAX'N. 590 (2015) [hereinafter Tavares & Owens, *Human Capital in Value Creation*].

States that are implicated involves not only the potential granting of State aid (under Arts. 107-108 TFEU), but also a potential infringement of the EU Code of Conduct on "harmful tax competition."[42] The EU Code of Conduct was first established by the EU Economy and Finance Council in 1998.[43] It is certainly possible for a "selective measure" to constitute unlawful State aid while also being in violation of the Code of Conduct.[44] Also, it is true that the term "harmful tax competition" relates particularly to OECD pronouncements and contemplates tax competition against other OECD members, including the United States.[45]

Still, if these intermediary states facilitated the unlawful diversion of profits out of other high-tax EU countries through transfer "mispricing,"[46] even though these profits would never fall into their own tax net (but instead into that of the U.S. or other non-EU jurisdictions), their role as *enablers* of such schemes could be called into question under the EU Code of Conduct. Again, no State aid would be involved here since the tax illegally reduced would have been owed to high-tax EU countries and to the United States, and

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42. Rossi-Maccanico, *Fiscal Aid Review*, *supra* note 38, at 95, 96.

> At issue was whether the [Gibraltar] regime . . . afforded lower rates of taxation to certain companies vis-à-vis others in a comparable fiscal situation . . . . There is no reason to exclude from state aid review the harmful tax regimes considered under the Code of Conduct, in as far as these are selective. Even before the *Gibraltar* judgement, the [E]CJ had expressly confirmed in *Forum 187* the superposition between the categories of fiscal aids and harmful tax measures, with reference to the preferential tax regime for Belgian Coordination Centres, a harmful tax regime within the meaning of the Code.

Id.

43. Conclusions of the ECOFIN Council Meeting of December 1, 1997, concerning taxation policy, 1998 O.J. (C 2) 1, 1.

44. *See* Miranda Stewart, *The David R Tillinghast Lecture: Commentary*, 54 TAX L. REV. 111, 130 (2000) ("The Code of Conduct will not apply in isolation but will have an effect that is cumulative with other developments elsewhere, including OECD initiative on harmful tax regimes.") [hereinafter Stewart, *Commentary*].

45. *See generally* Claudio M. Radaelli, *The Code of Conduct against Harmful Tax Competition: Open Method of Coordination in Disguise*?, 81 J. PUB. ADMIN. 513 (2003).

46. This would be the case, for example, if the "restructured" operations of Apple, Starbucks, and Amazon in high-tax EU countries should not be viewed as "low-risk" or if the restructurings in question were not legitimately executed.

not to the low-tax intermediary countries which granted the rulings. Nonetheless, the actions of the countries could be viewed as detrimental to the EU Internal Market from this specific (and rather limited) perspective.[47]

The EU Code of Conduct, however, does not limit an EU Member Country's ability to engage in tax competition which adversely affects non-EU countries, such as the United States, particularly when such practice can potentially attract capital investment into Europe, and create employment within the European Union. Conversely, it is by no means clear whether the "tax competition" by Luxembourg, the Netherlands, and Ireland would be "harmful" [48] to the tax interests of the United States if it can be assumed that the EU tax base is also eroded as part of these schemes. This is because the U.S. corporate tax otherwise imposed on profits shifted out of the United States is deferred, and the EU tax permanently avoided through these arrangements would not give rise to "foreign tax credits,"[49] thus increasing the amount of deferred revenues of the U.S. Treasury. Effectively, residual profits may be increased through these operating models, which theoretically increase U.S. residual taxing rights. In fact, U.S. law views foreign tax savings as a legitimate "business purpose,"[50] which entices the foreign tax risk appetites of U.S. MNEs, and incentivizes U.S. tax deferral planning, which is effected in tandem with the reduction of foreign taxes as the U.S. operating entities themselves are often restructured as part of these international restructuring arrangements (thus "stripping" the U.S. corporate tax base and amplifying the deferral scheme put in place). Thus, the question under EU tax law is whether such "harmful tax competition" unduly relocates capital or employment within

47. A legitimate defense to the infringement charges should consider whether all incremental capital, cash, and employment is actually attracted into Europe by such countries "at the expense of" the United States or other non-EU countries—the question would then become whether the European Union and its "Internal Market" ultimately "gains or loses" through the activities of these countries. *See* Tavares & Bogenschneider, *The New De Minimus Anti-Abuse Rule*, *supra* note 26; *see also* Ruth Mason, *Common Markets, Common Tax Problems*, 8 FLA. TAX. REV. 599 (2007) ("[T]he ECJ recently approved use of [Limitation on Benefit] clauses in tax treaties, at least when both contracting states are EU Member States. Its decision suggests that the ECJ´s attitude toward Member State tax treaties will be deferential.").

48. Tracy A. Kaye, *The Gentle Art of Corporate Seduction: Tax Incentives in the United States and the European Union*, 57 U. KAN. L. REV. 93, 110 (2008) ("Article J of the Code of Conduct urged the Commission to strictly apply the state aid rules to those measures that were deemed to be harmful. Classifying a measure as harmful under the Code does not qualify that measure as state aid because the two criteria differ.").

49. *See generally* DANIEL N. SHAVIRO, FIXING U.S. INTERNATIONAL TAXATION (2014).

50. Cummings, *Reorganization Business Purpose*, *supra* note 27, at 1037.

Europe and whether it erodes the tax base of other EU countries, even if in a lesser scale as compared to the potential base erosion effect outside of Europe.

It would appear, therefore, that the arrangements effected through these rulings ultimately had three objectives: (1) to restructure MNE operations in high-tax countries within Europe and throughout the world so as to minimize their functions, activities, and risks borne within such high-tax jurisdictions, and thus, increase the amount of "residual profits" that would be channeled through low-tax jurisdictions and ultimately taxed in the United States; (2) to restructure U.S. entities, assets, and risks, along with such foreign tax avoidance, so as to defer any incremental U.S. corporate tax on all "residual profits," which are deemed to arise from United States developed IP and corresponds with entrepreneurial risks that are ultimately borne by investors in the U.S. capital markets; and (3) to ensure through the rulings in question that the intermediary countries concur that the IP income and "residual profits" should not be attributable to their jurisdictions as such profits do not correspond with the functions performed, assets owned, and risks ultimately borne within their taxable entities.

The pending European Commission investigations into the advance ruling practices of Ireland, the Netherlands, and Luxembourg ought to be strictly an investigation into tax competition by these jurisdictions affecting the EU Internal Market,[51] as opposed to an endeavor to tax income that is

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51. Guerrero, *Defining the Balance*, *supra* note 38, at 94.

> The case dealing with the Irish exemption scheme as a *measure to avoid double taxation* has revealed that a given tax scheme might provide an advantage, not with respect to the general system, but with reference to other States´ legal systems . . . . However, from the State aid point of view, it does not constitute an appropriate analysis. As has been emphasised, the appraisal of the advantage is to be done with respect to the general system of the State in question.

Id. See generally Commission Decision No. 2003/601/EC (Ireland—Foreign Income), 2003 O.J. (L 204) 51, 55.

> [W]here the domestic tax liability is greater than the tax paid in the foreign source jurisdiction, under a credit system, further tax is payable whereas under an exemption system, no further tax is due. Therefore, where a specific tax exemption for foreign income is granted under a system where the general rule provides for a credit, this exemption constitutes an advantage and reduces the beneficiary company´s tax burden.

attributable to the United States. In fact, these low-tax countries most likely enabled substantial shifting of profits that would otherwise have been accrued to U.S. operating entities or to the ultimate U.S. parent entity and shareholders, as well as out of non-European Union and non-United States high-tax countries throughout the world, thus enabling the accumulation of substantial cash within Europe—which, in fact, may be viewed as a contribution to the EU Internal Market. These would be the results of the first and second objectives listed above, and there would be absolutely no European tax imposed on such profits absent the arrangements; the rulings in question seem to confirm there continues to be no (or very little) European taxes imposed on such profits (irrespective of whether legitimately shifted or illegitimately "diverted").

Whereas, to a lesser scale, these arrangements may also have enabled the legitimate shifting or the illegitimate diversion of profits out of high-tax EU countries, and through these low-tax countries into untaxed "stateless entities," (entities that are EU residents under corporate law, but not residents for tax purposes) that end up as the owners of United States developed IP and United States raised capital used within the MNE. However, the hypothetically adverse EU effects tantamount to transfer mispricing, harmful tax competition, or State aid are not disentangled through the course of action chosen by the European Commission. Instead, the EU Commission seems to ascertain that all residual or IP-related profits that are "channeled through" Ireland, the Netherlands, and Luxembourg should have been recognized as fully taxable by certain operating companies or specific branches in these three low-tax countries and, hence, subject to tax there. Consequently, by not imposing such taxes, these EU Member States would have allegedly granted unlawful State aid to Apple, Starbucks, and Amazon. The role of non-resident or "stateless entities" (and "hybridity" advantages obtained through such entities) is neither specifically addressed nor is the proportionate measurement of the alleged aid. Rather, the entire amount of royalty-like deductions or payments made by the operating entities (i.e., the transfer pricing related to non-EU IP and capital) is questioned.

As such, the EU Commission seems to be aiming in the wrong direction and worse, it seems to overshoot its misconceived and misconstrued target. It is highly unlikely that, through the "substance" considerations and transfer pricing allegations of the EU Commission in the State aid infringement notices, all "residual profits" and all IP-related profits of Apple, Starbucks, and Amazon would be attributable to specific taxable entities in Ireland, the Netherlands, and Luxembourg. These are not the countries that should result with the ultimate right to tax. Rather, through closer and more diligent scrutiny, the lion's share of such tax base would most likely end up

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Id.

with the U.S. Treasury, whereas only a smaller portion could hypothetically be found to be diverted out of high-tax EU countries. Again, this would not be the theoretical matter of whether transfer mispricing could be State aid, but whether the low-tax operating companies in question would be entitled to tax the results of such mispricing at all. Thus, using the line of action and argumentation adopted by the EU Commission, it is highly unlikely that any Irish, Dutch, or Luxembourgish tax revenue whatsoever could be deemed foregone through these ruling proceedings, thereby rendering the allegation of unlawful State aid completely defeated.

The State aid "route," however, may have been chosen by the EU Commission not because of its legal merits and likelihood of success, but for political reasons. Hypothetically, substantial amounts of Dutch, Irish, and Luxembourgish taxes would have to be paid by Apple, Amazon, and Starbucks if these proceedings were ever successful, which can quite simply be viewed as a political statement that appeases public opinion: naming and shaming "with a price tag," whereas under the Code of Conduct proceedings, no back-taxes would ever be at stake and a greater degree of "consensus" would need to exist regarding the harmful effects of these country practices.[52] As such, it is conceivable that a greater degree of political pressure can be exerted through the State aid dispute.

A concurrent tax avoidance that could have adverse effects to the EU Internal Market would exist where the same structures used primarily for U.S.

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52. Schön, Taxation and State Aid, *supra* note 31 at 936 (arguing that eliminating all "tax incentives from the map of the European Union might well drive investors to attractive industrialized countries like Switzerland, the [United States,] and Japan, not to mention the easily available tax havens of the world which will never submit to the most carefully drafted 'Codes of Conduct'."). Similarly, in the Tillinghast Lecture at NYU, Oliver noted that the European Union resembles a managerial market state (as compared to a mercantilist or entrepreneurial state) that tries to maximize its position both absolutely and relatively by regional, formal means, such as trading blocs. *See* David B. Oliver, *The David R. Tillinghast Lecture Tax Treaties and the Market-State*, 56 TAX L. REV. 587, 588 (2003).

> With the first two choices I do not see that the position of the state in relation to its tax treaties, what it hopes to achieve and is able to achieve by the negotiation or renegotiation of them, is likely to differ very much from the current position. But what is the position where the state has made the third choice and has become a member of a trading bloc or is negotiating with a state that has made the third choice?

Id.

tax deferral are further extended within the European Union to erode the tax bases of "source countries,"[53] a practice which serves to add further "substance" to the structure and safeguard the U.S. corporate income tax deferral and U.S. tax treaty entitlement,[54] in addition to supporting the "business purpose" of business reorganizations under U.S. tax law.[55] The extension of these structures within Europe is now the issue under investigation by the European Commission, yet the infringement notices seem to overshoot their target.

Nonetheless, the U.S. tax system does include unique provisions for the taxation of accumulated earnings (referred to as the Accumulated Earnings Tax), which is often applied in a domestic setting only; such provision of tax law is not present in Europe and could hypothetically be applied against Apple, Amazon, or Starbucks.[56] Reduced U.S. corporate taxation of undistributed earnings as an "incentive for repatriation" allegedly aimed at boosting the U.S. economy, such as George W. Bush's "American Jobs Creation Act" of 2004 (which included the "U.S. Homeland Investment Act" that effectively reduced the U.S. tax on foreign-source income from 35 percent to as low as 5.25 percent),[57] are often considered in the U.S. tax policy debate as alternatives to

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53. This would occur, for example, through the combination of "treaty shopping" and "directive shopping." *See* Tavares & Bogenschneider, *The New De Minimus Anti-Abuse Rule*, *supra* note 26.

54. *See* Romero J.S. Tavares, *The 'Active Trade or Business' Exception of the Limitation on Benefits Clause, in Base Erosion and Profit Shifting: The Proposals to Revise the OECD Model Convention* (Michael Lang ed., IBFD, forthcoming, 2015) (citing Reg. § 1.954-3(a)) [hereinafter Tavares, *Active Trade or Business Exception*].

55. *See supra* notes 22, 25, 27, & 54 (noting several entity classification "strategies" under the U.S. check-the-box rules must qualify as tax-free "business reorganizations" via section 368(a)(1), which requires a "business purpose" that is deemed legitimate under U.S. law, such as foreign tax avoidance).

56. A tax on accumulated earnings (AET) refers to a supplemental corporate income tax (currently twenty percent) levied on the incremental earnings of a corporation in the situation where such earnings are not reinvested into an active corporate business or distributed as dividends to shareholders—all as part of a tax avoidance strategy. The AET is currently part of the Code beginning at section 531 and applies only to the extent the accumulation of earnings is determined to be "unreasonable" and in excess of the amount that a "prudent businessman" would consider appropriate for the "reasonably anticipated future needs of the business." *See* Bret N. Bogenschneider, *A Proposal for Equal Enforcement of the AET*, 147 TAX NOTES 931.

57. American Job Creation Act of 2004, Pub. L. No. 108-357, § 422, 118 Stat. 1418, 1514 (2004) 422, (amending Subpart F of part III of subchapter N of chapter 1 (relating to controlled foreign corporations) of the Code to insert section 965 (Temporary Dividends Received Deduction)). The incentives could effectively reduce the U.S. tax imposed on foreign source income to a mere 5.25 percent (on effective

broader international tax reform focused on the "competitiveness" of U.S. MNEs. Such "repatriation incentives" are again proposed by the Obama Administration in the 2016 U.S. Budget, consistent with a bipartisan U.S. Senate proposal for a one-time, reduced fourteen percent tax on foreign-accumulated earnings, which would be introduced ostensibly to replenish the U.S. Highway Trust Fund.[58] We now observe the State aid investigation by the European Commission, but not a parallel investigation of the taxing authority and competitive stance of the United States.

The State aid investigations now underway seem to imply that not all transfer pricing by multinational firms can be deemed State aid. The prior assertion that all transfer pricing is "selective" remains misleading, in the least.[59] In fact, if the arm's length principle is properly applied (i.e., if no "transfer mispricing" is perpetrated), the commercial terms that trigger tax consequences would be, by definition, comparable with what unrelated third parties would use; hence, differences in profitability would have less to do with the condition of companies as "multinationals" are more to do with other aspects that dictate their bargaining power (e.g., differences in size or scale, and diversification). A small multinational firm would, thus, obtain less favorable pricing from a large, diversified third-party supplier as compared to what could be obtained by a large, diversified national firm. However, multinationals do have a greater ability to perpetrate transfer mispricing.[60] That is, a small domestic business can be at a potential disadvantage exactly because it cannot perpetrate such transfer mispricing.[61] If any such mispricing was attained through the special ruling practices of Ireland, the Netherlands,

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and construed dividends, provided certain U.S. expenditures were made). *See* Richard M. Hammer & William H. Green, *The U.S. Tax Incentives for Exports – To Be or Not To Be*, 55 IBFD BULL. INT'L TAX'N 513 (2001); C. Micheau, *WTO Law and Tax Subsidies: Towards Establishing Jurisprudential Standards*, 61 IBFD BULL. INT'L TAX'N 550 (2007).

58. *See* OFFICE OF MANAGEMENT AND BUDGET, FISCAL YEAR 2016 BUDGET OF THE U.S. GOVERNMENT, https://www.whitehouse.gov/sites/default/files/omb/budget/fy2016/assets/budget.pdf.

59. Rossi-Maccanico, *Fiscal Aid, Tax* Competition, *supra* note 31, at 857 ("Cross-border tax planning and arbitrage techniques are only available to MNE's and therefore are by nature selective.").

60. Others may argue that smaller businesses have a greater ability to underreport sales and income and evade taxes.

61. *See* Bret N. Bogenschneider, *A Theory of Small Business Tax Neutrality* (FSU BUS. REV., forthcoming, 2015) ("A 'neutral' tax policy potentially depends on the structural differential in effective tax rates accruing in favor of multinational firms operating in domestic competition with small business. The potential for profit shifting by multinational firms is averred to give rise to the 'crowding out' effect of foreign direct investment.").

and Luxembourg, such distortion to the Internal Market could disproportionately affect small and medium national firms and should also be purged through the proper work of the EU Commission.

III. FACTUAL ANALYSIS

The key issue raised by the EU Commission relates to variants of essentially the same "royalty set-up" (or equivalent IP residual profit allocation and cost-sharing arrangements) through low-tax EU Members States, which, under the centrally-led models implemented by such U.S. MNEs, would accumulate tax-free IP-related "residual profits" within Europe. The EU Commission believes these untaxed "residual profits" are not in conformity with the arm's length principle of transfer pricing and the granting of "rulings" in the form of APAs would be a form of State aid under EU law. Although the cases differ in terms of factual arrangements, all have in common the same issue of residual profit allocation into Europe.

Taking the OECD Guidelines as an overriding basis to assess the commercial arrangements and related transfer prices under the rulings in question,[62] the EU Commission argues that the transfer pricing methods approved by the different countries in all cases presently under analysis were utterly inadequate and not in line with the arm's length principle. That is, the EU Commission ascertains that the commercial terms accepted by the entities that are resident taxpayers in the countries in question would never be acceptable by a third party (or "depart from conditions prevailing between prudent independent operators"),[63] and yet, were perceived as adequate by the tax authorities in these countries. Consequently, the EU Commission ascertains that such irrational and exotic arrangements served only to shift residual profits out of European source countries whereas such residual profits, the EU Commission alleges, would be commensurate with the tax bases of Ireland, Luxembourg, and the Netherlands. Under the rulings that are being challenged, such residual profits and alleged Irish, Luxembourgish, and Dutch tax bases were diverted into untaxed legal entities (i.e., legal entities and arrangements that were formed under the corporate laws of the countries in questions, and yet, that are not regarded as taxpayers in such countries, and effectively not taxable anywhere) under the coverage of the allegedly unlawful rulings.

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62. *See* Apple Irish State Aid Letter, *supra* note 9, at 24–26; Starbucks Netherlands State Aid Letter, *supra* note 9, at 13–15; Amazon Luxembourg State Aid Letter*, supra* note 9, at 15–17.

63. Amazon Luxembourg State Aid Letter, *supra* note 9, at 24. The term "prudent independent operator" is considered to correspond to the term "third party guided by the principle of prudent management" (i.e., no moral hazard or adverse selection.

From the perspective of the EU Commission, the rulings issued by Luxembourg, the Netherlands, and Ireland provide for an unlawful "selective advantage" since the authorities in these countries allegedly failed to apply the arm's length principle to assess their taxable bases by failing to compare or "benchmark" the taxable income that would allegedly accrue within their countries had the authorities considered a hypothetical taxable income arising from the "prudent behavior of a hypothetical market operator." That is, an approval of a transfer pricing arrangement which does not reflect a market outcome (i.e., mispricing) and which favors a particular undertaking would have to be considered as *prima facie* selective. The Court of Justice has confirmed that if the method of taxation for intragroup transfers does not comply with the arm's length principle, then a selective advantage exists.

The issue, however, that the EU Commission fails to acknowledge is that under the current OECD Guidelines and transfer pricing laws of all countries involved (separate and aside from any advantage obtained via ruling), it would be unreasonable to ascertain that the "residual profits" of such U.S. MNEs should be reassessed as arising from the activities of the low-tax intermediary countries in question expressed by economic functions carried out, assets owned, and risks incurred by the assessed entities—which seem to be rather of a routine nature. The Commission seems to deny the fact that the IP in question (i.e., the knowledge-based capital (KBC)[64] developed and accumulated by Apple, Starbucks, and Amazon) *does exist* and is highly unique and valuable. Quite likely, such unique and valuable IP drives most if not all "residual profits" in question for these MNEs; such IP is simply not owned by the intermediary entities assessed by the EU Commission. Accordingly, the residual profits in question should most likely be

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64. *See* OECD, SUPPORTING INVESTMENT IN KNOWLEDGE CAPITAL, GROWTH AND INNOVATION 22 (2013), http://www.oecd-ilibrary.org/industry-and-services/supporting-investment-in-knowledge-capital-growth-and-innovation_9789264193307-en.

> Knowledge-based capital comprises a variety of assets . . . . This non-tangible form of capital is, increasingly, the largest form of business investment and a key contributor to growth in advanced economies. One widely accepted classification groups KBC into three types: computerized information (software and databases); innovative property (patents, copyrights, designs, trademarks); and economic competencies (including brand equity, firm-specific human capital, networks of people and institutions, and organisational know-how that increases enterprise efficiency).

Id., *see also* Tavares & Owens, *Human Capital in Value Creation*, *supra* note 41.

commensurate with the functions performed, assets owned, and risks borne within the United States, as opposed to the intermediary EU entities based in Luxembourg, Ireland, and the Netherlands. Therefore, the alleged taxable base of the hypothetical "State aid" ascertained by the EU Commission against such intermediary low-tax countries in respect to the operating branches located therein is most likely overstated or, quite simply, wrong.

Nonetheless, it is conceivable that some amount of taxable base of associated enterprises that are residents in other EU source-countries (in the ultimate consumer markets) and acquire goods and services from the low-tax intermediary countries in question may be unduly shifted out of such source-countries and into the low-tax (or no-tax) structure under scrutiny. The EU Commission, however, does not seem to question why the authorities of such end-markets would have failed to assess their share of the taxable base.[65] Instead, the State aid charge seems to confirm that the taxable base of the source-countries in question is not unduly reduced or seems to affirm that such profits should have been legitimately shifted out of all European high-tax consumer markets and into the intermediary low-tax entities in Ireland, Luxembourg, and the Netherlands—albeit, according to the EU Commission, never out of the Dutch, Irish, and Luxembourgish tax net. Hence, in a distorted way, the EU Commission seems to put its seal of approval on all other aspects of the transfer pricing arrangements of these corporate groups within Europe (except the tax deductions within Ireland, Luxembourg, and the Netherlands of items that are recorded as income by non-resident entities) by assessing that the jurisdiction that had an obligation to tax such European profits were the countries which are charged with unlawful State aid.

The approach used by the EU Commission reinforces the understanding that the current OECD Guidelines and the transfer pricing laws that are in force throughout Europe would not likely reassess all "residual profits" of such U.S. MNEs, arising from EU sales, as attributable to any high-tax European entity. These are profits that should have been recognized by the U.S. parents of such MNE conglomerates and that, instead, through convoluted planning, ended up accumulated by legal entities that are not tax residents within Europe. In the tax rulings (or unilateral APAs) granted by Ireland, the Netherlands, and Luxembourg, a royalty or cost-sharing set-up related to United States developed IP was used as a channel for the allocation of the residual profit of Amazon, Starbucks, and Apple to such untaxed legal entities. However, the arrangements were challenged by the EU Commission from a transfer pricing perspective, not to reassess the taxable base of the ultimate source-countries or end-markets in question, rather, to reassess the taxable base of the intermediary low-tax entities that do not own highly-

65. It would not be far-fetched to expect several other APAs to exist, involving high-tax "source" countries and their recognition that only routine profits would arise from the routine functions carried out within their tax jurisdictions.

valuable IP and that perform certain managerial, administrative, or operational functions and activities.

All three rulings are very-fact specific and apart from transfer pricing also raise potential issues of treaty abuse or EU Directive misapplication. This contribution, however, does not elaborate on all aspects of the arrangements, but analyzes the facts and transfer pricing methodology applied therein[66] and its likely compliance with the arm's length principle. To provide the necessary background for such analysis, the fact patterns of each case are briefly summarized below.

A. *Ireland and Apple*[67]

Apple established three Irish entities that were not tax residents under Irish tax law. *Apple Operations International* (AOI) was directly held by Apple, Inc., the U.S. parent corporation, while *Apple Operations Europe* (AOE) was wholly owned by AOI, and *Apple Sales International* (ASI) was wholly owned by AOE. These are legal entities formed under Irish corporate law, but not "managed and controlled" from within Ireland. However, two of these entities AOE and ASI, owned and operated Irish branches, and the EU Commission alleges that such branches benefited from unlawful State aid.

Legal title to Apple's IP remains held by Apple, Inc., the U.S. parent. However, AOE is party to a "cost sharing agreement" related to R&D costs and risks of developing certain Apple products, along with other Apple subsidiaries. Accordingly, AOE does have "certain IP rights" over Apple's highly valuable IP. Nevertheless, the EU Commission acknowledges that "no rights in relation to the IP concerned are attributed to the Irish branch of AOE."[68] Similarly, no IP ownership is attributable to ASI's Irish branch.

AOE's Irish branch, nonetheless, manufactures Apple computers for the EU market, whereas ASI's Irish branch performs "procurement of Apple's finished goods from third-party manufacturers (including a third-party manufacturer in China),"[69] then sells such products to Apple-affiliated

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66. *See supra* note 9. The facts pertaining to each case, including references to transfer pricing methods applied, are taken from the public version of the letters issued by the EU Commission.

67. The state aid investigation with respect to Apple was initiated by the EU Commission on June 10, 2013, by issuing an info request to Ireland with respect to the rulings provided by the Irish competent authorities to Apple in 1991 and 2007. On November 6, 2014, the EU Commission issued a preliminary decision that state aid occurred together with a request for additional information. *See supra* note 9.

68. *See* Apple Irish State Aid Letter, *supra* note 9, at 28.

69. *Id.*

companies and customers and carries out corresponding logistics operations. The magnitude of such "procurement and onward selling" by ASI is, therefore, determinative of the U.S. tax deferral benefits sought through this operating model, while the nature of combined "manufacturing" operations conducted within AOE or by third-parties contractors would secure U.S. treaty entitlement and avoid U.S. anti-deferral rules.[70] Again, Apple's highly valuable IP was not attributed to any of the Irish operating branches, and yet, such branches used or benefited from Apple's IP in the conduct of their operations. However, if it can be assumed that the beneficial or economic ownership of Apple's highly valuable IP was "split" from the bare legal title held in the United States and was attributed to a non-resident Irish entity "managed and controlled" outside of Ireland (like AOI or AOE), such assets had to be equally managed and controlled outside of Ireland in order to avoid a recast into Irish tax residency. It would be fair to assume that such management and control functions and activities were, to a great extent, performed by Apple personnel located in the United States and employed by such an entity.

This IP ownership and management model would not attract the residency of the Irish entity to the U.S. territory (given that the United States uses the "place of legal entity incorporation" as determinative of residence instead of "mind and management" or "place of effective management"), a result that is further reinforced by U.S. entity classification rules[71] and by the application of the U.S. limitation on benefits clause.[72] As such, this model would simply require the "management services" rendered by U.S. personnel

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70. *See* Tavares, *Active Trade or Business Exception*, *supra* note 54.

71. The Irish entities AOI, AOE, and ASI are most likely all treated for United States purposes as one and the same through application of the check-the-box rules. *See* Tavares, *Active Trade or Business Exception*, *supra* note 54 (providing an additional analysis of the interrelation between U.S. anti-deferral rules under Subpart F and U.S. tax treaty policy). If AOI, AOE, and ASI were regarded as separate controlled foreign corporations (CFCs), their same-country dealings would not trigger U.S. anti-deferral rules under Subpart F; however, ASI's "foreign-base sales" (i.e., purchases of finished goods from China for resale outside of Ireland) would be sheltered under Subpart F's "manufacturing exception" with greater certainty if it can be considered that all Irish activities, including those carried out by AOE's Irish branch, form part of a single treaty-entitled CFC. Additionally, treaty entitlement for purposes of the cost sharing arrangement, and the lesser allocation of profits to United States based "services" would likely be more certain if these Irish entities were considered as one and the same through the combination of the U.S. check-the-box rules and the U.S.-Irish tax treaty LOB, and thus, carrying on an "active trade or business," which includes manufacturing within Ireland (irrespective of the relative size of such manufacturing operations).

72. *Id.*

to be remunerated in accordance with U.S. Transfer Pricing Law.[73] The margin attributed to the economic ownership of the IP in question (via capital and risk allocation), as per U.S. rules and OECD Guidelines, would be far greater than the margin attributed to such "management services," and hence, the model permits the accumulation of substantial IP-related "residual profits" by the IP owner with ample deferral of U.S. taxation.

Over time, AOE's manufacturing branch did develop some manufacturing process IP of its own, which entitled it to an incremental return. Such manufacturing process IP and corresponding return was, by far, not as valuable as all other Apple IP owned by AOE and not attributed to the branch, whereas ASI continued to buy-and-resell finished goods as part of a concerted, enterprise-wide supply chain model and owned no IP. ASI benefited from the right to buy and sell Apple-branded products at the enterprise-wide terms negotiated with the third-party Chinese manufacturer and resold such products without investing in Apple's marketing intangibles without designing Apple's customer-centric strategies and without taking inventory risks related to such arrangements. Accordingly, ASI was regarded as equivalent to a "captive" provider of logistics services.

Royalties for the right to use Apple's highly valuable IP that was embedded in the price of Apple products sold by AOE and ASI were, thus, owed by both Irish branches and were deducted from the Irish tax base of such branches. Such royalties effectively accrued as revenues to the Irish-incorporated non-resident legal entities not allocable to their Irish branches and were not subject to tax in Ireland. Given the interplay of U.S. entity classification rules, anti-deferral rules (i.e., "manufacturing exception" and "same country exception" under "Subpart F"), and treaty interpretation (i.e., trade or business exception under the limitation on benefits clause), the royalty income earned by the Irish non-resident legal entity was not subject to U.S. tax. These royalties were "variable" (i.e., measured *in reverse* through the establishment of a "targeted return" that the parties expected to be earned by the taxable Irish branches based on the transactional net margin method (TNMM) as implemented through to various formulas).

ASI acquires finished products from third parties—ultimately Apple's global contract manufacturers—which also produce for the U.S. market and maintain substantial operations in China (e.g., Foxconn). It would be fair to assume that ASI also contracted services out to third parties (e.g., logistics service providers), which are most likely subject to global oversight and management. Additionally, Apple clearly uses third-party retailers to distribute its products to consumers worldwide. It would be reasonable to

73. The U.S. transfer pricing rules under section 482 and accompanying regulations are in-line with OECD Guidelines; however, with an even greater consideration for entrepreneurial risk and capital allocations.

expect that even AOE and its manufacturing branch would also contract with third-party service providers and suppliers that serve Apple in other countries throughout the world.

All such outsourcing and supply arrangements are likely concerted efforts that are heavily dependent upon central management and upon functions and activities performed within the United States (as explicitly referenced in the "Designed in California, Assembled in China" tagline that brands Apple devices). Accordingly, it can be assumed that Apple's United States based global management exerts significant functions and activities, which include operational oversight and would ultimately decide global commercial terms with said global suppliers. As such, from an Irish tax perspective, the United States is not only the ultimate IP owner (through the non-resident Irish entity that is likely "managed and controlled" by U.S. personnel) and not only the provider of capital that cushions IP development costs and risks, but U.S. personnel also performs substantial enterprise-wide functions and activities, which support the management and control of "operational risks" related to all such IP, of manufacturing and distribution functions, and operations (through the management of contractual arrangements for intercompany services and cost sharing that were structured, and through the global supply or outsourcing arrangements entered into with third parties).

In this sense, it would not be surprising at all if the targeted returns established to the Irish branches would be comparable with (or slightly higher than) the targeted "routine" returns established to the many third party providers of manufacturing and distribution services that are similarly engaged in the Apple global value chain. In fact, under the first ruling issued by the Irish tax authorities in 1991 (1991 ruling), a net profit attributable to the manufacturing branch was fixed at the lower of the following: (1) 65 percent of operating expenses up to 60 to 70 million USD and 20 percent of operating expenses in excess of 60 to 70 million USD; or (2) overall profit from the Irish operations. Additionally, a target net profit of the distribution branch was calculated as 12.5 percent of all branch operating costs (also excluding any royalties, which effectively limits the royalty charge in case of potential losses incurred in the distribution of Apple products).

Such arrangements effectively *limited* the consideration for the IP that was developed in the United States and used by the Irish branches (i.e., limited the potential charge of royalties otherwise owed by the Irish branches for the use of Apple's IP) and, thus, limited the entrepreneurial risk borne by such branches. If the branches incurred losses, no royalties would be charged; however, if they earned profits in excess to what was deemed to be an adequate remuneration for their functions, such excess profits would be added to the royalties and accrue to the IP owner. Absent such limitations (and effective risk-shifting) to the IP owner, it would be fair to assume that substantial royalties would be charged by the IP owner based on revenues recorded by the

Irish branches irrespective of their profitability and simply based on turnover, which in the hypothesis of business downturns and reduced profits could substantially increase the amount of losses incurred in Ireland and potentially lead the Irish branches to insolvency.

Either way, substantial royalties would have to be owed to the IP owner of highly-valuable intangibles. Higher if the IP owner undertakes all entrepreneurial risk related to the application of such IP (and limits the risks of service providers to their operational costs excluding royalties and inventories), or lower if the IP owner does not undertake inventory risks and charges royalties based on turnover and irrespective of the profitability of the licensee. Both set-ups are economically neutral, and hence, would most likely find comparable third-party "operators" (even from within Apple's own global value chain), which would have to be viewed as "prudent" and realistic alternatives were the arm's length principle to be fully applied in a proper transfer pricing study. Under no circumstance would there be a full denial of royalty deductions—no IP owner would ever license such high-value IP without receiving high-value consideration for the use of such IP.[74] Such denial, which effectively results from the State aid allegation of the EU Commission as presented, seems to be contrary to the arm's length principle, and hence, contrary to the explicit justification for the infringement allegation by the EU Commission.

It would serve reason to assume, nonetheless, that the structure was not set up with the expectation that losses would be incurred by either party, and instead, the arrangement was structured to treat the Irish branches as limited-risk service providers, much like Apple's third-party suppliers of manufacturing or supply-chain services. Hence, in the first alternative formula, i.e., a fixed "net profit" equal to 20 to 65 percent of OPEX (for AOE's manufacturing branch) or 12.5 percent of operating costs (for ASI's distribution branch), it guaranteed significant returns to such branches in case the overall Apple business is highly profitable, whereas if the overall Apple business was not very profitable, such fixed returns would not be applicable, and instead, only the lower operating profits earned (or the operating losses effectively incurred) within Ireland would accrue to the Irish branches *and would not include any royalty charges for Apple's highly valuable IP that was effectively used by the branches.* As such, it should be evident that the Irish branches' exposure to Apple's entrepreneurial risks was rather limited and quite likely comparable with that of third party service providers engaged in the Apple global value chain.

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74. Hypothetically, this assertion would not hold only in exceptional or marginal situations of distress (e.g., an IP owner on the brink of bankruptcy) or information asymmetry (e.g., expected IP devaluation or imminent disruption).

Notwithstanding, under the second ruling issued in 2007 (2007 ruling), AOE's manufacturing branch would be remunerated by a revised ten to twenty percent margin on branch operating costs, plus an "IP return" of one to nine percent of branch turnover. The IP return was introduced to grant the branch with an incremental return arising from the manufacturing process technology deemed to be developed by the branch over the years. The much larger distribution branch owned and operated by ASI, however, was supposed to receive the eight to eighteen percent margin on branch operating costs.[75]

Conversely, the capital investment and entrepreneurial risk assumed by the non-resident IP owner (that bears all of Apple's IP development costs and agrees not to charge royalties in case the IP does not produce profits) was evidently far greater than that assumed by the resident Irish branches or by any Apple contractor. If any losses ever materialized or if the Irish profits equaled zero or were in any event less than the OPEX returns cited in the ruling, no royalties would be charged for all of Apple's IP used to manufacture or sell Apple products, which drives the sales of such branches. This is a substantial risk effectively undertaken by Apple U.S., and shifted out of the operating branches and into the non-resident Irish entities. If the operating branches were instead bearers of greater entrepreneurial risks as implicitly alleged by the EU Commission and were not entitled to a guaranteed return on their expenditures (which triggers the reverse-royalty charge in base of high overall profitability), such branches would have been subject to a proportionately high revenue-based royalty charge. Using the figures published by the EU Commission, such royalty charges would have to be a significant percentage of the massive revenues recorded by such branches (i.e., there would have to exist a substantial royalty deduction at the operating branches instead of the outright

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75. The enterprise-wide profit margins of Foxconn (Hon Hai Precision Ind. Co. Ltd., a listed company in Taiwan), Apple's main third-party contract manufacturer, oscillated from the third quarter of 2013 through the second quarter of 2015 between 2.2 percent and 3.8 percent. *See* Foxconn Annual Reports 2013–15, http://www.foxconn.com/Investors_En/Financial_Information.html?index=1. The net income margin earned by logistics operator Fedex Corporation (a U.S. company listed in the NYSE) in 2014 also approximates 2.2 percent. *See* Fedex 10-K Annual Report 2015, http://s1.q4cdn.com/714383399/files/doc_financials/quarterly/2015/Q4FY15-10K.pdf. Flex, Ltd. (formerly Flextronics International Ltd. a Singapore company listed in the NASDAQ) a diversified supply-chain solutions company that operates in the same segment as Foxconn, also posted a 2.3 percent net income margin on its 2014–2015 sales. *See* Flex, Ltd. Annual Reports 2014–15, http://investors.flextronics.com/investor-relations/financials/annual-reports/default.aspx. These are examples of entities that, much like Apple's operating branches in Ireland, do not own any of the product-related IP (or marketing intangibles) for the inventory they manufacture or distribute, are typically not exposed to inventory risks (other than for their handling and processing), and are typically remunerated through a cost-plus formula.

denial of deductions resulting from the State aid allegations of the EU Commission).

If the Irish branches charged adequate transfer prices for the Apple products that are sold into Europe (or sold elsewhere throughout the world) at arm's length and in full accordance with OECD Guidelines, then the value of all intangibles and of all IP developed by Apple in the United States, which remains owned and controlled by Apple U.S. (be it directly or through its non-resident Irish entity) and is not attributable to the branches, would be embedded in Apple's product prices and in the revenues recorded by the Irish branches—including the value of the Apple brand and marketing strategy, along with all entrepreneurial risks ultimately borne by Apple's shareholders and all corresponding residual profits. By disregarding the reverse royalty charge, this entire amount is what the EU Commission now argues should have been taxed in Ireland as the entirety of royalty deductions effectively claimed by the Irish branches under the AOE and ASI APAs are alleged by the EU Commission to be a form of State aid.

Additionally, if it can be assumed the buyers of such products sold through Ireland are either third-party or related-party "limited risk distributors" or "resellers" (be them in buy-sell arrangements or as commissionaires), such "residual profits" would be further increased while end-market returns would be decreased, which would further add to the pre-royalty profit margin accrued in Ireland. Such incremental residual profits, which should be commensurate with the reduction or "stripping" of functions and risks in the operations of EU source-countries could have been the object of mispricing within the EU (i.e., the price of Apple products charged to related-party EU distributor entities by the Irish branches could hypothetically have been unduly inflated). Nonetheless, such hypothetical mispricing was never raised by the EU Commission, which instead chose to challenge the royalty deductions in Ireland to challenge the Irish APA, and quite simply, to question the value of Apple's IP, which is ultimately embedded in the price of all Apple products distributed throughout Europe (and the world), while effectively suggesting that the Irish branches of AOE and ASI are the true entrepreneurs of the Apple business who should have kept all IP returns and all residual profits that are commensurate to Apple's enterprise-wide risks. Thus, the alleged infringement to EU law assessed through an imputation of all IP income and all residual profits to the Irish branches would be, at a minimum, grossly disproportionate.

One could wonder what technical views, if any, may have influenced the stance of the EU Commission, aside from the evident political posturing and pressure and aside from the "naming and shaming" inherent to the issuance of such infringement notices. Perhaps the EU Commission may view that the risks assumed by the non-resident Irish entity are irrelevant given

Apple's success in recent years. In fact, the EU Commission expressly noted that Apple's sales channeled through ASI have increased by 415 percent from 2009 to 2012 (from 12.4 billion USD to 63.9 billion USD),[76] but due to the TNMM-fixed OPEX return formula accepted in the 2007 ruling, such incremental sales and related profits had no impact on the recognized revenues and taxable income of the Irish branches given that the OPEX and distribution costs of AOE and ASI have not increased in the same proportion.

However, it should be self-evident that Apple's business segment (high-technology consumer products) is significantly exposed to competition and to innovative disruption and is sensitive to consumer behavior, thus requiring massive and constant investment in IP, marketing, and branding; all of which represent significant capital requirements, functions, and risks that are simply not attributable to the Irish branches as recognized by the EU Commission.[77] Alternatively, the EU Commission may believe that the significance of Apple's non-Irish capital, non-Irish IP, and non-Irish functions are negligible in comparison with the assets owned and with functions and activities performed within the Irish branches (which would seem counter-intuitive in the least).

Effectively, the EU Commission questioned the above-mentioned rulings mostly based on the certain formal criteria, and through its own denial of certain facts, which ought to be self-evident, such as the existence of highly valuable IP within Apple (be it product related or marketing intangibles) and the fact that such IP is not owned by the assessed branches. Still, the formal questions remain: the 1991 ruling was issued for an unlimited period and effectively was valid through 2007, which is a much longer period than any other tax ruling issued by other Member States and viewed as "similar" by the EU Commission. Moreover, no transfer pricing study was provided by Apple for such ruling and, as such, the 1991 ruling was claimed by the EU Commission as "negotiated" by the tax authorities and Apple rather than concluded based on the transfer pricing principles.[78] With respect to the 2007

76. *See* Apple Irish State Aid Letter, *supra* note 9, at 27.

77. *Id.* at 29.

78. The EU Commission sees as evidence of such "negotiation" the debate between the taxpayer's advisors and the Irish tax authorities regarding the "mark-up" percentage on operating costs, whereas the action of the EU Commission implies that no such "negotiation" could have occurred under any circumstance, and that no such "negotiations" took place within the APA process, an outright denial of the "reverse royalty" model would necessarily result; the implication of such allegations is that such "reverse royalty" would, in it of itself and by definition, be contrary to the arm's length principle. A full transfer pricing study, however, would not likely result in the denial of the "reverse royalty" formula. Instead, such study would likely support a refined profit percentage for the application of the same TNMM method, which could theoretically have been higher, but would, in light of the facts of the case, most likely

ruling, no explanation was provided to the Commission as to why TNMM, with the applied profit level indicator (PLI—a branch return on operating costs), was deemed appropriate by the Irish authorities.

B. *The Netherlands and Starbucks*[79]

The State aid investigation with respect to Starbucks relates to two rulings issued by the Dutch tax authorities in 2008 (2008 rulings or APAs) regarding the Dutch entities *Starbucks Coffee BV* (SCBV)[80] and its wholly owned subsidiary *Starbucks Manufacturing BV* (SMBV), which comprise a Dutch fiscal unity. Only the SMBV APA, however, was challenged in the State aid infringement allegations of the EU Commission studied here. Nonetheless, given the effects of the Dutch fiscal unity, the relevance of the ownership structure and the interrelation of activities that were carried on by SCBV and SMBV, it is necessary to address the functions and activities that both entities seem to perform in the Starbucks value chain. As represented by the EU Commission:

> [SCBV] functions as the head office for the EMEA. In this capacity [SCBV] licenses certain Starbucks trademarks, the Starbucks shop format and the Starbucks corporate identity to related and unrelated operators of Starbucks shops. [SCBV] holds these intellectual property rights (hereinafter "IP") in license of its shareholder, Alki LP, against payment of a royalty. In the system applied by Starbucks worldwide, the companies that operate the shops pay a royalty for the use of IP and a royalty for the supply of coffee. These distributor companies may be related or unrelated parties. Both parties pay the same royalty. Starbucks thus maintains that a CUP [comparable uncontrolled pricing] is applied to determine the arm's length price of intra-group royalty payments to [SCBV]. Also in the EMEA, similar

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be lower than that used in the APAs. The variance, however, would not be equivalent to the denial "reverse royalties," and would quite possibly be immaterial as compared to ASI's sales figures and to the "royalty" deductions.

79. *See* Starbucks Netherlands State Aid Letter, *supra* note 9. The state aid investigation with respect to Starbucks was initiated by the EU Commission on July 30, 2013, by issuing an information request to the Netherlands with respect to the ruling provided by the Dutch competent authorities to the local entity of Starbucks in 2008. On November 6, 2014, the EU Commission issued a preliminary decision that state aid occurred together with a request for additional information.

80. *Id.* at 16.

> royalties are paid by related as well as unrelated distributor companies to the EMEA-head office [SCBV].[81]

SMBV, however, was characterized as a toll manufacturer of roasted coffee by the taxpayer and by the Dutch tax authorities. It roasted coffee for the EU market, as a contractor for and with green beans supplied by a Swiss "principal" entity (*Starbucks Coffee Trading Company SARL* (Swiss Principal or Swiss Entity)), *"which buys beans for the benefit of the entire Starbucks corporate group worldwide and its independent licensees*,"[82] would bear inventory sourcing risks, thus, reaping the bulk of inventory returns.[83] Presumably, the Swiss Principal operated at a low rate of corporate taxation; however, oddly enough, its ownership structure and functional profile is not addressed by the EU Commission as part of the State aid case. The Swiss company, although referred to as a "principal" in the arrangement with SMBV, seems to be an agent-contractor for another non-Dutch Starbucks entity and is effectively remunerated at "cost plus." Thus, SMBV would function as a "subcontractor." Swiss returns are effectively fixed at cost plus twenty percent, which implies a high-function and significant activities of risk management and control.

SMBV sold such roasted coffee to affiliated Starbucks entities (i.e., wholly-owned stores), as well as to unrelated parties. SMBV then paid a "royalty" to a UK Limited Partnership (Alki LP), which held legal title to the shares of SCBV. Similar to the Apple case studied hereinabove, the royalty was variable (comprising a portion of the IP-related "residual profits" channeled through SMBV) and aimed to leave a targeted TNMM return to Dutch toll manufacturer, whereas Alki LP was not a taxable entity in the Netherlands or the United Kingdom. Contrary to the Apple case, however, Starbucks most likely accumulated substantial foreign-source income in Switzerland. In the event of windfall profits from coffee sales, however, not all inventory returns would result in Switzerland—any returns in excess of the cost-plus twenty percent formula would be effectively channeled through SMBV and ultimately shifted into the United Kingdom.

Alki LP was held under a U.S.-Dutch structure, wherein two Dutch limited partnerships, *commanditaire vennootschap* (CV entities), were interposed in the ownership chain.[84] As in the previous case, Alki LP was party

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81. *Id.*

82. *Id.*

83. *Id.* at 27–28.

84. *Id.* Starbucks Corp, the U.S. parent corporation, wholly owned (directly or indirectly) four other U.S. legal entities relevant for this case; one of which (SCI, Inc.) was a greater than ninety-five percent "limited partner" in the Dutch "CV1," which was a greater than ninety-five percent "limited partner" in the Dutch CV2,

to a cost sharing agreement, along with U.S. entities, while it "makes payments to a U.S. Starbucks company."[85] From a Dutch and United Kingdom perspective, such limited partnerships are not regarded as taxpayers (much like Apple's non-resident Irish entities). U.S. "partners" were deemed to receive any income channeled through the CV-LP structure. It would be reasonable to assume that the Swiss entity would be held under the same Dutch-U.K. "reverse-hybrid"[86] structure, and perhaps its activities would be deemed for United States purposes as one and the same as SCBV and Alki LP. As in the Apple case, this structure would permit the accumulation of IP-related residual profits within Europe, primarily in Switzerland and the United Kingdom, *instead of the United States*; this is income that would have been earned by U.S. entities (not by the Dutch BV entities), absent the interposition of the "CV-LP" structure noted here and "Swiss contractor" model, and it would be related with both the sourcing and roasting of coffee beans, as well as with Starbucks's marketing intangibles. Therefore, the effect of U.S. tax deferral is most likely the most significant outcome of the structure, accomplished through the shifting of United States base into Switzerland and the United Kingdom, and not the saving of any Dutch taxes; an assertion that would render the Dutch "State aid" allegation virtually moot.

One way or the other, the Dutch-U.K. CV-LP-BV (and Swiss) structure above was most likely "consolidated" for U.S. tax purposes via check-the-box.[87] From a United States perspective, Alki LP and SCBV were most likely viewed as the ultimate "principal entrepreneurs," under which both the low-function, low-risk subcontractor SMBV, and the high-function Swiss contractor would operate. The structure secured benefits under the EU Parent-Subsidiary and Interest and Royalty Directives,[88] thus also conferring it with "business purpose" from a United States perspective through foreign tax

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which in turn was a greater than ninety-five percent "limited partner" in Alki LP. The other three U.S. entities were less than five percent "limited partners" in each of the "partnership" entities.

85. It would be reasonable to assume that such payments could be for the rendering of services by U.S. personnel.

86. In U.S. tax parlance, a "hybrid entity" is one that is regarded as a corporate entity for foreign tax purposes, but viewed as a "transparent" branch or partnership from a United States tax perspective, whereas a "reverse hybrid" is an entity viewed as "transparent" for foreign tax purposes, but regarded as a corporation for United States tax purposes.

87. The result is similar to the Apple analysis.

88. *See* Tavares & Bogenschneider, *The New De Minimus Anti-Abuse Rule*, *supra* note 26.

savings.[89] Accordingly, the cross-border royalty payments that would appear to flow out of the Netherlands (SCBV and SMBV) and other European consumer markets into the United Kingdom (Alki LP), or the coffee trading activities of the Swiss entity would be disregarded under U.S. anti-deferral rules and considered as internal dealings of the same CFC or were otherwise characterized as part of the same active income-generating activity (qualified through the "manufacturing activities" of both SMBV and SCBV).[90]

The EU Commission represented that SCBV and SMBV employed 143 persons in 2007, but 176 in by 2011 (97 at SCBV and 79 at SMBV).[91] Under the contract manufacturing arrangement SMBV maintains with the Swiss Principal, SMBV roasts and packages the coffee beans it buys under that same contract. After roasting and packaging, the beans are stored in a warehouse located in the Netherlands. SMBV neither selects the coffee beans nor decides on the blending of such coffee beans, and it does not own the proprietary knowledge of recipes and flavor profiles; it performs the roasting activities following the manufacturing processes supplied under the license it receives from Alkin LP. As noted by the EU Commission, "[SMBV] licenses IP from Alki LP which is necessary for the production process or for the delivery of coffee to shop operators in return for which it pays Alki LP a royalty."[92] Additionally, "[t]he delivery of coffee to Starbucks branches is made on the basis of contracts concluded by those branches with [SCBV, which] allegedly does not carry out any sales activities."[93]

However, SMBV formally "buys and sells" Starbucks coffee. It does not decide what to buy, how to blend and roast, and it does not perform sales and marketing functions. Most SMBV full-time equivalent employees (forty to sixty) work in the roasting, packaging, maintenance, and warehousing operations, while many work on related supply-chain operations (SCO).[94]

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89. *See supra* note 55.
90. Again, the U.S. tax results are quite similar to Apple's.
91. *See* Starbucks Netherlands State Aid Letter, *supra* note 9, at 6.
92. *Id.* at 7.
93. *Id.*
94. *Id.* at 20.

> [SMBV] also operates an intermediary distribution network for a variety of non-coffee items (such as category products for resale, paper cups, napkins, syrups, and equipment). It also has a relationship with a consignment manufacturer which is primarily driven by capacity and capability considerations . . . . [c]urrently . . . [with] an unaffiliated company with operations in Switzerland and Malaysia.

Id.

Nonetheless, its buying occurs under the direction of its Swiss Principal (which presumably operates in tandem with SCBV), while its manufacturing follows the guideline supplied by the U.K. entity and its selling occurs under the direction of its Dutch parent SCBV. Accordingly, SMBV does not manage, control, or undertake inventory risks—such risks are assumed by the Swiss Principal or SCBV.[95] Moreover, SMBV does not undertake IP risks since it does not invest and develop any blending, roasting, and flavoring IP, and as the U.K. royalty charges are contingent (i.e., would simply not occur if SMBV's fixed level of return on operating costs does not materialize).

Notwithstanding, SMBV sells Starbucks coffee to related and unrelated parties at the same market (arm's length) price. Therefore, any returns on such purchases and sales of Starbucks coffee are not earned by SMBV through the activities of its seventy-nine employees who follow instructions received from the Swiss Principal, from Alkin LP, and from SCBV. Also, such returns on coffee sales would be quite variable (more volatile than revenues as it would mix the effects of supply and demand markets) and would be recorded in SMBV's books absent the "reverse royalty" arrangement. However, absent the arrangements with the Swiss Principal, the U.K. IP owner, and SCBV, SMBV would not be capable of buying, blending, roasting, or selling coffee at the volumes and prices it buys and sells; hence, it would not earn the revenues and the pre-royalty income it earned. SMBV would remain a roasting and warehousing facility since it is not only stripped of any IP, but functionally thin and heavily dependent upon management personnel employed by other Starbucks entities.

SMBV should, thus, be perceived as a "service provider" for the activities performed by its seventy-nine employees using the assets owned and, under the limited risks borne by such entity, it would be quite reasonable to expect that it would be remunerated through a cost-plus arrangement or through a TNMM approach as recognized in the APA. Accordingly, the ruling provided for a certain level of profitability calculated based on TNMM, as a mark-up of nine to twelve percent[96] on a certain cost base, which included

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95. *Id.* at 32. The EU Commission pointed to the existence of a clear contractual clause used for inventory risk-shifting, contained in a toll manufacturing arrangement covered by another Dutch APA supplied by the Dutch authorities. The absence of a similar "toll" or "consignment" contractual clause in an instrument between SMBV and the Swiss "principal" (or not explicitly addressed in the "license" between SMBV and Alki LP) was perceived by the EU Commission as evidence that SMBV would not be equivalent to a limited-risk toll manufacturer. However, the measurement of the "reverse royalty" limits such inventory risks for SMBV, and therefore, is comparable with the alternative contractual clause suggested by the EU Commission.

96. *Id.* at 26.

only costs reflecting the value added by the Dutch entity, which excluded inventory costs (and excluded certain costs such as the cost of outsourcing to third parties, regarded as a separate service other than manufacturing). A royalty payment to Alki LP was calculated as the excess of such mark-up, and it was payable by the Dutch entity for manufacturing-related IP. Quite possibly, such "reverse royalty" included other IP-related "residual profits," which is essentially channeled through the Netherlands and otherwise taxable in the United States, yet never earned by SMBV.

Similar to the Irish operating branches in the Apple case, the EU Commission contested the characterization of SMBV as a low-risk toll manufacturer and challenged, for instance, the partial inclusion of costs in the TNMM calculation seeing such partial inclusion as inconsistent with the taxpayer's representation (and with the ruling of the Dutch authorities) that the entity does not exercise control or bear any risk in relation to such excluded costs and functions. Also, the EU Commission doubted the correctness of certain transfer pricing adjustments made in the comparability analysis partially reproduced in the infringement notice. Whether some additional costs would be included and whether the comparability analysis would be adjusted, it is rather clear and acknowledged by the EU Commission itself that inventory costs would not be included in the calculation and that sales (and marketing) activities related to such inventory are not performed by SMBV. Hence, it would be ludicrous to assume that these rather formal and hypothetical transfer pricing adjustments would serve to justify the full recast of SMBV as an entrepreneur of the Starbucks coffee sales within Europe, thereby causing the full denial of substantial IP-related deductions at SMBV as intended in the State aid charges of the EU Commission.

Apart from the relatively unimportant and rather formal issues raised by the EU Commission, the critical challenge here again is against the entire "reverse royalty" set-up. Since the APA provided for the fluctuating royalty payments to fix the profitability of the Dutch entity at the certain level, the EU Commission argued that the royalty amount was not linked to the value of the IP in question and that an independent operator would necessarily retain the inventory risk otherwise shifted through the royalty formula. In the EU Commission's view, the royalty payment of the Dutch manufacturer was, in fact, a mechanism to transfer residual profits and not a remuneration for the specific IP rights used by SMBV in its manufacturing process; consequently, the royalty set-up would, as alleged by the EU Commission, not correspond to the economic reality of the underlying transaction and the risks associated with the activity of the Dutch manufacturer.

The main flaws of this rationale, however, derive from the interconnection of two elements. First, Starbucks does own substantial IP (product-related, market-related, organizational knowledge-based capital) outside of the Netherlands, supported by substantial non-Dutch capital investments and such IP substantially contributes to the revenues and profits

of all Dutch entities. As such, SCBV and SMBV would ultimately owe the United States (or its surrogate, the United Kingdom) a significant amount of royalties for the use of such IP, and the outright denial of royalty deductions, be them calculated "in reverse" (so as to guarantee a low-risk TNMM return to the interposed Dutch entities) or be them calculated through a "forward" formula (e.g., at varying percentages based on revenues and yet "adjusted" to a TNMM return), as intended by the EU Commission it its State aid allegation, would not be an arm's length result, which is contrary to what is alleged by the EU Commission in the justification of its decision. Second, SMBV does record revenues from the sale of coffee and realizes operational income on such inventory, while, as acknowledged by the EU Commission, it neither decide on sourcing, blending, flavoring, roasting, and distributing coffee, nor does it perform selling and marketing activities—SMBV simply does not employ the personnel or own the financial capital or IP within the Netherlands necessary to perform these functions and to own inventory, which would presuppose the undertaking of related entrepreneurial risks and the earning of related residual profits. Hence, if a proper return can be established for the activities *that are* effectively performed by SMBV within the Netherlands, it is absolutely reasonable to expect that an "excess" profit would be recorded by SMBV in its accounting books, but such income would not correspond to the economic reality of SMBV (i.e., it would not be earned by SMBV, and hence, it should not have been taxed at SMBV). Such "excess" profit relates to the conjunction of all functions, IP, capital, and risks that are foreign to SMBV. The conjunction of all such functions, IP, capital, and risks can be embedded in and remunerated through a "royalty" or "franchise" income stream, which can go both ways and would include a risk-term and residual profits[97] with no offense to the OECD Guidelines. Such excess profits would include the "residual returns on inventory" (profits or losses), as well from IP, and any uncertain IP-related returns commensurate with Starbucks' non-Dutch capital-at-risk profits, which would have been earned by U.S. entities absent the structure and operating model studied here.

In fact, the Dutch authorities even pointed out to the historical occurrence of "negative royalties" that *were paid to SMBV*[98] when lower

97. Accordingly, if the Starbucks business is not successful in Europe, then a symmetrical "loss" could be incurred by SMBV on coffee sales; and yet, such "loss" would not be augmented by a revenue-based royalty charge from Alki LP (suggested by the EU Commission as adequate), which could either be reduced through the dealings with the Swiss Principal (through the supply of green coffee) or via the "refund" or payment of "negative royalties." *See id.* at 27–28. Thus, SMBV "risks of losses" are indeed substantially reduced through the reverse royalty (and inventory risk-shifting) model reported by the EU Commission.

98. *Id.* at 28.

inventory returns (possibly losses) eroded the fixed net income margin that was effectively guaranteed to SMBV through the reverse royalty. Therefore, the Dutch authorities, in accepting a substantial "reverse royalty" deduction, do not appear to have foregone any taxing right or granted any fiscal aid to Starbucks. Rather, Dutch laws, along with U.K. and Swiss laws, seem to have enabled a grand scheme to defer U.S. taxation of IP income (and residual profits).

Similar to the Apple case, however, it is quite possible that in the European consumer markets where Starbucks operates its stores, such retail operations are deemed to be "low-function and low-risk," which would result in further shifting of profits out of such European countries through the Dutch entities SCBV and SMBV and into the untaxed CV-LP structure and UK entity. To the extent such "shifting" would be tantamount to "transfer mispricing" adversely affecting the Internal Market, it should be further investigated. Nonetheless, contrary to Apple, the Starbucks model also entails the shifting of income through the supply side (i.e., through the Swiss sourcing entity that acts as a Principal entrepreneur). This means that throughout the European Union, Starbucks profits accumulate in low-tax Switzerland and in no-tax United Kingdom, whereas the Netherlands merely serves as a "channel" and, in fact, it appears to collect its "fair share" of a tax "toll charge" that it would otherwise not collect. Given that the EU Commission does not seem to question these two aspects of the model, but instead targeted the royalty deductions claimed by SMBV, one is left to wonder whether such stance of the EU Commission is indeed an oversight, whether it demonstrates a political choice or jurisdictional limitation of the EU Commission not to question Switzerland or the United Kingdom, or whether it can be interpreted as a tacit recognition that other aspects of the model are perceived as legitimate and compatible under EU law.

C. Luxembourg and Amazon[99]

The investigation concerns a tax ruling or APA issued in 2003 to *Amazon EU Societé Sarl*, Amazon's operating company in Luxembourg (LuxOpCo). LuxOpCo also served as a regional holding company and controlled several other entities both within Luxembourg and throughout

99. *See* Amazon Luxembourg State Aid Letter, *supra* note 9. The state aid investigation with respect to Amazon was initiated by the EU Commission on June 19, 2013, by issuing an info request to Luxembourg with respect to the rulings provided by the Luxembourgish competent authorities to Amazon operating company in 2003. On October 7, 2014, the EU Commission issued a preliminary decision that state aid occurred together with a request for additional information.

Europe.[100] All of Amazon's United States developed IP, all its software algorithms, business and consumer analytics tools, trademark, brand, and so forth, all contained in its virtual platform "www.amazon.com," were reproduced and contained in the European versions of its websites (e.g., "amazon.co.uk," "amazon.de," and "amazon.fr") that were hosted in LuxOpCo's servers. LuxOpCo evidently benefited from such IP that does exist since it conducted sales and earned profits through the web platforms developed by Amazon U.S., and hence, it is owed royalties for the use of such highly valuable and quite unique intangibles.

As in the prior cases, Amazon U.S. allowed another non-U.S. entity, which is incorporated in Luxembourg, but not regarded as a resident taxpayer under Luxembourgish tax law, to become a "beneficial owner" of its United States developed IP. As noted by the EU Commission in its partial reproduction of the ruling,[101] Amazon Europe Technologies Holdings SCS (Lux SCS), a Luxembourgish limited liability partnership (much like Starbuck's British limited partnership and Apple's non-resident Irish entities),

> functions as an intangibles holding company and assists in the on-going development of certain intangible property used in the operation of the European websites through a buy-in license and cost-sharing agreement with Amazon.com, Inc. and other US affiliates if the Amazon group. Lux SCS licenses this IP to LuxOpCo in return for a tax deductible royalty payment (License Fee). Lux SCS will retain all risk associated with the ownership of the IP rights. Lux SCS also enters into loan agreements with LuxOpCo and other group companies.[102]

Lux SCS, nonetheless, is held by U.S. entities, and while viewed as "fiscally transparent" from a Luxembourgish perspective, it was most likely regarded as a corporate entity for U.S. tax purposes ("checked" under the U.S. check-the-box rules); i.e., a "reverse hybrid." Essentially, U.S. partners were

100. Notably, the EU Commission also uses information provided by Amazon to the U.K. House of Commons Committee on Public Accounts to ascertain that "*Amazon EU Sarl owns the inventory, earns the profits associated with the selling of products to end customers, and bears the risk of any loss.*" *Id.* at 17. This statement, nonetheless, appears to be taken out of context since it misleads one to conclude that Amazon EU Sarl is the ultimate "principal entrepreneur" of the Amazon business in Europe, which would imply it taking ownership or substantial risk over the highly valuable IP, which is the key driver of profits at Amazon.

101. *Id.* at 17–18, 20.

102. *Id.* at 19.

deemed, from a Luxembourgish perspective, to earn all income that flows through such entity, while from a United States perspective, all such income was deemed to be earned by a controlled foreign corporation, and thus, could benefit from deferral of the U.S. corporate tax. Still, in order to defend such "active business" stance of Lux SCS from a United States perspective, Amazon not only had such entity hold financial capital and IP, but it endowed such entity with some "functionality" (be it IP-related or treasury-related). Furthermore, Amazon U.S. also used such entity to hold the shares of LuxOpCo, which indicates that LuxOpCo and, most likely, many if not all of its subsidiaries were treated as fiscally transparent from a U.S. tax perspective under check-the-box so that all intra-Europe "royalties" and operational trade flows that benefit from EU Primary and Secondary Law (fundamental freedoms, tax-free dividends, interests, and royalties) do not trigger U.S. anti-deferral rules under Subpart F.[103] The benefits arising from U.S. tax deferral most likely dwarf any European tax savings arising from the structure, whereas any such savings (e.g., elimination of intra-EU withholding taxation) provides "business purpose" arguments to defend the structure from a United States perspective.

The EU Commission, whether knowingly or not, chose not to challenge the result of the "hybrid mismatch" issue that allows for IP income to flow into EU entities (i.e., Apple's Irish non-residents, Starbuck's UK limited partnership, and Lux SCS) tax-free. It is not the tax-free accumulation of cash at Lux SCS that was perceived as a problem by the Commission, instead, the EU Commission decided to challenge the deductibility of royalties at certain intermediary operating companies, which effectively use and benefit from high-value IP that they do not own (i.e., Apple's operating branches in Ireland, Starbucks' SMBV in the Netherlands, and Amazon's LuxOpCo). The approach seems counter-intuitive, if not utterly mistaken or, in fact, misleading.

As in the Irish and Dutch rulings, and in order to maximize the income related to Amazon's IP (which benefited from U.S. tax deferral) through "risk-shifting," the Luxembourgish arrangement provided for a "reverse royalty," a variable royalty formula designed to guarantee a small return for LuxOpCo allegedly commensurate with the functions performed, assets owned, and risks borne by such entity. Similar to the Apple and Starbucks cases, such "reverse royalty" as a variable and contingent payment effectively limits the entrepreneurial risk in which LuxOpCo is exposed since no royalties would be charged if the profitability of Amazon does not reach certain levels within Europe. Again, the EU Commission acknowledges that LuxOpCo does not

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103. The result is similar to the Apple and Starbucks U.S. tax deferral results. *See supra* note 55; *see also* Tavares & Bogenschneider, *The New De Minimus Anti-Abuse Rule*, supra note 26.

own any IP and does not perform any IP functions or carry IP development risks. Rather, it operates the website platforms supplied by Amazon U.S. via Lux SCS while LuxOpCo performs multiple managerial functions and activities within Luxembourg.[104] However, in alleging that Luxembourg's recognition via APA of the deductibility of such royalties at LuxOpCo is what equates to State aid (instead of the non-taxation of the royalty stream at Lux SCS), the EU Commission questions the nature and challenges the high-value of the IP of a business which is notoriously built on and operated through a website platform. Amazon is an emblem of the digital economy; it is a losing proposition to deny that most of Amazon's value is created by its vast knowledge-based capital and IP, which includes the software technology it owns and web platforms that run it.

LuxOpCo was expected to employ no more than fifty workers.[105] Up to twenty workers would be in management (none of which focused on IP development or holding IP-related functions) and others would perform clerical activities in areas such as marketing, accounts payable, and technology. Over time, it appears that LuxOpCo also came to serve as a "treasury center" financing the activities of several Amazon entities and possibly as a "shared services center" supporting back-office activities throughout the organization, whereas it also owns operating entities across Europe, as well as the other Luxemburgish entities that comprise a "fiscal unity" under LuxOpCo (Amazon Media Sarl, Amazon Luxembourg Sarl, Amazon Services Europe Sarl, FinLux Sarl, and Amazon Payments SCA). Considering all such activities and entities, Amazon employs nearly 1,000 people in Luxembourg, including management functions (other than IP development, management, and control). Each of the separate entities operates separate complementary businesses. The EU Commission notes that "the target structure described in the ruling request seems to have been effectively put in place and did not substantially change before the end of 2013."[106]

Similar to the Apple and Starbucks models, LuxOpCo would benefit from licensing Amazon's United States developed IP, and yet consideration for the use of such IP was "contingent," effectively limiting entrepreneurial risks to which LuxOpCo was exposed. The parties fixed a target "LuxOpCo

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104. *See* Amazon Luxembourg State Aid Letter, *supra* note 9, at 19. The ruling also recognizes that Lux SCS does not have a permanent establishment (PE) in Luxembourg and confirmed that the activities of LuxOpCo do not attract such PE characterization. This aspect of the ruling, however, is not questioned by the EU Commission and does not form the grounds to allege infringement to EU State aid rules.

105. *Id.*

106. *Id.* at 19.

Return,"[107] which turned the royalty payment into a contingent, reverse charge. A baseline calculation and an overriding "floor and ceiling" was established. The baseline calculation established a first alternative: (a) a mark-up of four to six percent over LuxOpCo's OPEX (whereas such OPEX excluded royalty charges and inventory costs); or (b) actual EU Operating Profit (which included inventory but excluded royalty charges).

In essence, regarding these baseline set of alternatives, if the inventory trading operation is highly successful, LuxOpCo would retain no more than the four to six percent mark-up over its adjusted OPEX and the royalty would include inventory returns, whereas if the inventory trading operations are not successful, LuxOpCo would incur losses that included its OPEX (and inventory costs), *but it would not owe any royalties*. Such "contingent" royalty formulation effectively reduces the potential loss LuxOpCo would otherwise incur if a royalty charge applied on its turnover (including substantial inventory sales) irrespective of its profitability. Considering the nature of such IP and of LuxOpCo's "digital" operations, not owing any royalty at all for the use of Amazon's United States developed IP in case of losses represents a massive shift of entrepreneurial risk to the IP owner.

Nonetheless, the baseline formulation may not be determinative—an overriding condition is established between LuxOpCo and Lux SCS through the royalty agreement: LuxOpCo Return shall not be less than 0.45 percent or greater than 0.55 percent of EU Revenue unless total EU Profits are lower. This clause adjusts the baseline as follows: in the event of high inventory profits, if the 0.45 percent "commission" is greater than the 4 to 6 percent OPEX mark-up, the higher 0.45 percent amount would prevail as a "floor," whereas if inventory profits are high and if LuxOpCo's OPEX increases disproportionately (excluding inventory costs) such that the 4 to 6 percent OPEX mark-up becomes greater than 0.55 percent, then the prevailing return would be capped at 0.55 percent. This incentivizes LuxOpCo to control and limit its OPEX in relation to revenues that flow through the websites it runs, and guarantees a return, whereas if the actual income from EU operations is lower than 0.45 to 0.55 percent of sales, no royalty would be charged by Lux SCS, again significantly limiting LuxOpCo's risks.

In both the baseline formulation and the overriding "floor and cap," however, no "negative royalty" (as cited in the Starbucks case[108]) would materialize. Nevertheless, the alternative formulation suggested by the EU Commission of a revenue-based royalty for Amazon's high-value IP would result in high royalty charges anyway (without the equivalent risk-shifting) in spite of LuxOpCo's apparently high functionality; additionally, not in the denial of royalty deductions considering that Amazon's IP related to the functionality and operation of its United States developed web platforms under

107. *Id.* at 21.
108. *Supra* notes 97–98.

its global brand most certainly exists. Also, considering that LuxOpCo does not employ any personnel to manage and control Amazon's IP and that it does not own sufficient capital to cushion Amazon's IP risks, the risk-shifting model wherein the IP owner carries such IP risk is entitled to earn commensurate variable returns, and wherein LuxOpCo functions as a limited-risk distributor and service provider appears to be quite reasonable and in line with the arm's length principle. This is in stark contrast to what is alleged by the EU Commission.[109]

The EU Commission quotes the Luxembourgish authorities in that

> an analysis was conducted . . . based on agreements between Amazon and non-related third parties, from which it would result that the same or substantially the same IP was made available to third parties. On the basis of that analysis, an arm's length royalty was determined, expressed as a percentage of the sales of LuxOpCo . . . . [I]n parallel, the profit split method was applied to analyse the functions and risks of LuxOpCO and Lux SCS. Luxembourg claims that LuxOpCo is the entity with the functions and risks that are most obvious. The functions of LuxOpCo were compared to determine an appropriate level of remuneration. The residual profits would be then attributed to Lux SCS in the form of a royalty. According to the Luxembourgish authorities, the two methods produced analogous results and the profit split method was chosen.[110]

Absent the "risk-shifting" effect of the variable and contingent royalty set-up, a substantial royalty charge would still apply at arm's length and the risk-shifting simply adds further IP-risk-related "residual profits" to the IP income stream. Thus, all European IP-related income *and* residual profits that would otherwise be earned by Amazon U.S. and taxed in the United States was, therefore, channeled through LuxOpCo and accumulated at Lux SCS.

Taking a very formalistic perspective, the EU Commission pointed out the very short period of time within which the ruling was issued (eleven business days after formally requested) and the absence of a term of expiration or renewal of the APA. The EU Commission also questioned the appropriateness of remuneration over the years with no requirement of its reconsideration in spite of changes to the economic environment. In addition, the EU Commission questioned the lawfulness of the Luxembourgish ruling

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109. *See* Amazon Luxembourg State Aid Letter, *supra* note 9, at 25

110. *Id.* at 12–13.

based on the lack of a transfer pricing report in the State aid investigation files (a report that allegedly exists, but was not delivered to the EU Commission by Luxembourg) and accordingly alleged that the APA does not provide sufficient information about the nature and value of Amazon's IP as compared to the value of LuxOpCo functions.[111]

The main issue that was raised by the EU Commission in both preceding rulings was that the royalty payable by LuxOpCo to Lux SCS was solely a transfer of residual profits instead of remuneration for the use of IP. The reverse calculation bothered the EU Commission and seemed to strike them as, by definition, not at arm's length. The EU Commission claimed that since the royalty was not computed by reference to sales, the method of computing non-IP related profits for LuxOpCo so as to arrive at a variable royalty, which was approved in the ruling, would allegedly not conform to any method endorsed by the OECD Guidelines. However, the risk-shifting element embedded in the reverse royalty charge would seem commensurate with the IP risk and with the uncertainty of IP investments and returns that can only accrue to the IP's beneficial owner, risks and returns that should have accrued to Amazon U.S., but instead accrued to its surrogate Lux SCS. Such IP income stream would appear to be commensurate with the IP risk managed by the IP owner or by U.S. entities ultimately borne by U.S. shareholders, and is represented in the right to earn residual profits (or the obligation not to charge royalties in case of losses). Accordingly, it would seem to be contrary to the arm's length principle to allocate such IP income and residual profits to an operating entity that neither owns nor manages any IP, as well as not undertaking related IP risks.

IV. TRANSFER PRICING UNDER THE ARM'S LENGTH PRINCIPLE VS. EU STATE AID "SELECTIVITY"

The arm's length principle is codified in Article 9[112] of the OECD

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111. In its investigation, the EU Commission relied in part on information Amazon provided to U.K. House of Commons Committee of Public Accounts in 2012. As investigated by the EU Commission, LuxOpCo assumed certain strategic management functions, which included commercial decision-making and assumed commercial risk regarding inventories while the EU Commission alleged that Lux SCS seemed to only have as its function the sublicensing of IP that it had not developed.

112. Jens Wittendorf, The Object of Art. 9(1) of the OECD Model Convention: Commercial or Financial Relations, 17 INT'L TRANSFER PRICING J. 200 (IBFD, 2010).

Model Tax Convention (OECD Model)[113] and aims to ensure that entities which enter into contracts within a corporate group establish conditions that do not differ from those of unrelated parties, in order to protect the relevant taxable base from a potentially distortive influence of the group relations.[114] As an indispensable part of tax treaties, Article 9 of the OECD Model provides the legal background for cross-border allocation of intra-group profits and restricts taxing rights with regard to transactions between related enterprises. Its primary purpose is not to create a tax liability,[115] but to provide an arm's length framework for domestic law with the objective of mitigating economic double taxation.

It is important to note, however, that jurisdictions apply the arm's length principle in their own way and take different approaches. For example, the United States adopts complex statutory and regulatory frameworks; however, other jurisdictions, like Canada, rely on a much less prescriptive approach focusing on income-earning activities observably taking place, as well as the connotations of parties' legal rights and obligations as determined by the general law and by the contracts between these parties.[116] In the European Union context, the arm's length principle is endorsed in the 2001 Company Tax Study of the EU Commission[117] where the EU Commission

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113. *See* OECD, MODEL CONVENTION WITH RESPECT TO TAXES ON INCOME AND ON CAPITAL 29–30, http://www.oecd.org/ctp/treaties/2014-model-tax-convention-articles.pdf.

> [Where] conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

Id.

114. Wolfgang Schön, Transfer Pricing, the Arm's Length Standard and European Union Law (Max Planck Institute for Tax Law, Working Paper 2011-08, 2011).

115. MICHAEL LANG, INTRODUCTION TO THE LAW OF DOUBLE TAXATION CONVENTIONS 139 (2010).

116. J. Scott Wilkie, *Policy Forum: BEPS One Year In – Taking Stock*, 62 CAN. TAX J. 455 (2014).

117. European Commission, Company Taxation in the Internal Market, SEC (2001) 1681, 1 http://ec.europa.eu/taxation_customs/resources/documents/company_tax_study_en.pdf.

identified the increasing importance of transfer pricing tax problems as an Internal Market issue, whilst recognizing that the separate entity approach and the arm's length principle are globally accepted principles in the area of international taxation: "The arm's length standard is evoked in Article 9 of the OECD Model Convention, and maintained and developed in the 1995 OECD Transfer Pricing Guidelines (Guidelines). The practical application of the arm's length principle is complex and the Guidelines provide guidance for its application by tax administrations and taxpayers."[118] At the same time, the EU Commission acknowledges that: "Although all Member States apply and recognize the merits of the [Guidelines], the different interpretations given to these Guidelines often give rise to cross border disputes which are detrimental to the smooth functioning of the Internal Market and which create additional costs both for business and national tax administrations."[119]

Despite all of its limitations or perceived shortcomings,[120] the OECD Guidelines have become the model[121] for developing transfer pricing rules (for both EU and non-EU countries)[122] and aim to provide guidance for domestic legislators on practical application of the arm's length principle. One may still argue that transfer prices are inherently set *only* between related entities[123] and, as such, any transfer pricing method, even in compliance with the OECD

118. *Id.* at 256–57.

119. European Commission, *Transfer Pricing in the EU Context*, http://ec.europa.eu/taxation_customs/taxation/company_tax/transfer_pricing/index_en.htm.

120. *See supra* notes 35–36.

121. Guerrero, *Defining the* Balance, *supra* note 38, at 93 ("In order to use the OECD guidelines as a yardstick, these should have been adopted by the State in question, either through an express provision in their national legislation or by alleging them in their defense of the contested measure.").

122. *See* UN DEPARTMENT OF SOCIAL AND ECONOMIC AFFAIRS, UNITED NATIONS PRACTICAL MANUAL ON TRANSFER PRICING FOR DEVELOPING COUNTRIES 191 (2013), http://www.un.org/esa/ffd/documents/UN_Manual_TransferPricing.pdf. Even in the "UN Manual," the arm's length principle is not officially discarded.

123. *See* OECD, Model Convention with Respect to Taxes on Income and on Capital 29, http://www.oecd.org/ctp/treaties/2014-model-tax-convention-articles.pdf,

> Where a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State.

Id.

Guidelines, would be "selective" by nature. Nonetheless, through the arm's length principle, related entities are placed on the equal footing with unrelated (domestic) parties, which eliminates *prima facie* the selectivity argument.[124] Thus, the only legitimate argument for the EU Commission to scrutinize the tax rulings is to prove that the transfer prices are not set at arm's length.

In fact, in view of recent years' tax trend to see transfer pricing as a source to finance large governmental spending, "it will be key that the arm's length standard is consistently applied by the relevant countries with a view to avoiding double taxation and not only to safeguard double non-taxation,[125] a minimum taxation or simply raising revenue."[126] This may appear to be an underlying motivation here, but such assertion would be quite naive and superficial. Something else is at play: it remains to be seen to what extent the matter is legal and technical or merely political.

As previously discussed, it would seem that the EU Commission has not considered several elements of a proper transfer pricing analysis that substantially weaken the State aid allegations. The risk-shifting effect of the reverse royalty models was not properly considered and was simply taken as evidence of mispricing. Additionally, the EU Commission seems to ignore the

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124. *See* Lee A. Shephard, *Twilight of the International Consensus: How Multinationals Squandered Their Tax Privileges*, 44 WASH. U. J.L. & POL'Y 61, 62 (2014) [hereinafter Shephard, *Twilight of International Consensus*] ("Of course, multinationals are vertically integrated and don't transact with their affiliates at market prices. So an economic philosophy—which appears nowhere in the OECD model treaty—that multinationals should transact with their affiliates at hypothetical arm's-length market prices was grafted-on later."); *see also* Schön, Taxation and State Aid, *supra* note 31, at 932 ("The 'selectivity' requirement is easily fulfilled, if a tax provision leaves it to the discretion of the tax administration to grant the incentive as it sees fit."). According to Schön, the most effective way of fighting tax incentives would be to elaborate from a community perspective an autonomous general description of a "normal" tax system regardless of the individual traditions and policies of the Member States in order to provide the Commission and the Court with a fixed starting point.

125. *See* Marjaana Helminen, *The Problem of Double Non-Taxation in the European Union–To what Extent could this be Resolved through a Multilateral EU Tax Treaty Based on the Nordic Convention*, 53 EUROPEAN TAX'N 306 (2013) ("The application of tax treaties may lead to non-taxation, if either the source state or the state of residence does not exercise its taxing right over a certain item of income in a situation in which the applicable tax treaty prevents the other state from taxing the item.") [hereinafter Helminen, *The Problem of Double Non-Taxation*].

126. *See generally* Alfred Storck, *The Financing of Multinational Companies and Taxes: An Overview of the Issues and Suggestions for Solutions and Improvements*, 65 IBFD BULL. INT'L TAX'N 27, 28.

notorious existence of highly-valuable, United States developed IP that is not owned by the assessed entities, but it is used by such entities and significantly contributes to their revenues and recorded (pre-royalty) profits. The recognition of substantial royalty deductions cannot, therefore, be viewed as a form of State aid considering the facts and circumstances represented by the EU Commission. Any adjustments to transfer pricing would likely be immaterial and a small fraction of the overall State aid charges pressed by the EU Commission, whereas the U.S. tax deferral result of the structures cannot be interpreted as State aid and is certainly massive—far greater than any local effect.

A. *Tax Rulings and APAs*

Upon launching the investigation of the "tax rulings"[127] or APA[128] practices of Apple, Starbucks, and Amazon, the EU Commission in its press release on June 11, 2014, stated that "if tax authorities, when accepting the calculation of the taxable basis proposed by a company, insist on a remuneration of a subsidiary or a branch on market terms, reflecting normal conditions of competition, this would exclude the presence of state aid."[129] On the contrary, the arrangement may constitute a state aid if "the calculation is not based on remuneration on market terms [and thus, the tax ruling could give] a more favourable treatment of the company compared to the treatment other taxpayers would normally receive under the Member States' tax rules."[130] Therefore, the allegations of the EU Commission could be analyzed from two perspectives: formalistic (what is a tax ruling or APA and how it should be viewed in a state aid investigation) and substantive (what content of a tax ruling or APA may raise a state aid issue).

To begin with the *formalistic* perspective, the OECD defines APA as

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127. The Belgian "excess profit" tax system may have combined preferential rulings with a "selective" tax system to render both aspects of fiscal aid applicable at once. *See* Press Release, European Commission, State aid: Commission opens in-depth investigation into the Belgian excess profit ruling system (Feb. 3, 2015), http://europa.eu/rapid/press-release_IP-15-4080_en.htm. The Belgian case is not otherwise covered in the present discussion.

128. At least in its communications the EU Commission specifically refers to APAs, although an APA and a tax ruling may not always be used interchangeably. For the purposes of this Article, however, we follow the terminology applied by the EU Commission and refer to the tax rulings in question as unilateral APAs.

129. *See* Press Release, European Commission Press, State aid: Commission investigates transfer pricing arrangements on corporate taxation of Apple (Ireland) Starbucks (Netherlands) and Fiat Finance and Trade (Luxembourg) (June 11, 2014), http://europa.eu/rapid/press-release_IP-14-663_en.htm.

130. *Id.*

> An arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g.[,] method, comparables and appropriate adjustments thereto, and critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time. An [APA] may be unilateral involving one tax administration and a taxpayer or multilateral involving the agreement of two or more tax administrations.[131]

More broadly an "advance ruling" is defined by the International Fiscal Association as a legal interpretation of an existing law to a proposed transaction.[132] Being first designed and applied in the United States in 1991, APAs were then imported by other both developed and developing countries.

In tax literature, APAs are seen as a solution for uncertainty associated with practical application of the arm's length principle.[133] For example, Picciotto[134] defines an APA as one of the methods to deal with "the vast

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131. *See* OECD, TRANSFER PRICING GUIDELINES, *supra* note 37, at 23.

132. Kimberly A. Butlak, *All's Fair in Love, War, and Taxes: Does the United States Promote Fair Tax Competition in a Global Marketplace Consistent with European Community and Organisation for Economic Co-Operation and Development Recommendations through its Advance Ruling Program?*, 13 IND. INT'L & COMP. L. REV. 99 (2002).

133. Diane M. Ring, *On the Frontier of Procedural Innovation: Advance Pricing Agreements and the Struggle to Allocate Income for Cross Border Taxation*, 21 MICH. J. INT'L L. 143, 147 (2000)

> [A]n alternative to the standard taxpayer path of doing the transactions, filing a return, facing audit . . . and, finally, possible appeal with settlement or litigation. The taxpayer initiates the APA process . . . [and] voluntarily provides detailed information to the government regarding its business activities, plans, competitors, market conditions, and prior tax circumstances. The critical piece of this presentation is the taxpayer's explanation of its planned pricing method.

Id.

134. Sol Picciotto, *Towards Unitary Taxation of Transnational Corporations*, TAX JUST. NETWORK 1, (2012), http://www.taxjustice.net/cms/upload/pdf/Towards_Unitary_Taxation_1-1.pdf. In Picciotto's view, two categories of problems would be most prominent: (1) the time

administrative problems of applying the arm's length principle in practice." One way of dealing with these problems is to adopt "safe harbors" or "bright line" rules, which are often deemed more suitable for smaller taxpayers. Another method, which according to Picciotto is more appropriate for large multinationals, is the adoption of APAs. An APA gives the MNE prior approval of its pricing scheme, but requires submission of detailed documentation and negotiation with the tax authorities, often of several countries. As such, the time and expense involved means that they are mainly useful for large firms.

APAs are "not considered extraordinary or derogatory from *normal* taxation because the tax administration applies *normal* rules."[135] APAs are concluded as unilateral, bilateral, or multilateral agreements, where the latter two represent a procedural methodology more effective than a unilateral APA for preventing international double taxation because the positions of all tax jurisdictions involved in a given case are represented in the same procedural setting.[136]

Therefore, the tax exemption form can only be deemed to exist under the current cases if it is proved that the fixed level of the profits set in the APAs granted by Luxembourg, the Netherlands, and Ireland does not conform to the arm's length principle, and such exemption would have to be measured as an adjustment to such fixed profits as opposed to a full reversal of the royalty deduction. At the same time, to the extent the APAs were concluded by the tax authorities following the *normal* rules, such advance agreements cannot be considered as constituting a state aid *per se*.

B. *What if no specific transfer pricing laws are in place?*

One of the arguments voiced in the current state aid investigations was that it would be inappropriate to claim a violation of the arm's length principle when no domestic transfer pricing law existed in the period of APA conclusion.[137] However, it is clear that the mere fact that a specific law

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and special expertise needed to carry out the checks on transaction prices; and (2) the difficulty of achieving consistency due to the complex and often subjective nature of the judgments involved.

135. Rossi-Maccanico, *Fiscal Aid, Tax Competition*, *supra* note 31, at 866.

136. Eduardo Baistrocchi, *The Arm's Length Standard in the 21st Century: A Proposal for Both Developed and Developing Countries*, 36 TAX NOTES INT'L 241 (2004) [hereinafter Baistrocchi, *The Arm's Length Standard*].

137. The Irish ruling (APA) under scrutiny by the EU Commission was granted in 1991 and amended in 2007, and the EU Commission highlights that no transfer pricing report in the format prescribed by the OECD Guidelines was submitted by Apple to the Irish authorities in 1991 or in 2007. *See* Apple Irish State Aid Letter, *supra* note 9, at 33–34. Ireland, however, only adopted the OECD Guidelines in 2010

regulating transfer pricing does not exist should not preclude the taxpayer or the tax authorities from the obligation to make sure the intercompany arrangement is at arm's length. While some tax scholars argue that where there are no tax treaties in force, national laws should contain provisions to regulate the taxation of the related party arrangements,[138] yet others contend that the arm's length principle functions as an autonomous international norm,[139] which is embodied in the treaties and grounded on customary international law, and therefore, binding, even in the absence of a treaty.[140]

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while its domestic laws governing transfer pricing in 1991 and in 2007 did not include the specified documentation requirements and methods contained in such Guidelines, even though the Irish authorities express the historical compliance of Irish tax law with the arm's length principle. *See* Irish Tax & Customs, Finance Bill 2010 Section 38 – Transfer Pricing: Some Questions and Answers, http://www.revenue.ie/en/practitioner/law/bills/archive/finance-bill-2010/transfer-pricing.pdf; *see also* PRICEWATERHOUSECOOPERS, INTERNATIONAL TRANSFER PRICING 2015/16 567–81, http://www.pwc.com/internationaltp.

138. *See* Reuven S. Avi-Yonah & Zachee Pouga Tinhaga, *Unitary Taxation and International Tax Rules*, (ICTD, Working Paper No. 26, 2014).

139. Hugh J. Ault, *Reflections on the Role of the OECD in Developing International Tax Norms*, 34 BROOK. J. INT'L L. 757 (2009).

140. Pasquale Pistone, *Tax Treaties* with *Developing Countries: A Plea for New Allocation Rules and a Combined Legal and Economic Approach* in TAX TREATIES: BUILDING BRIDGES BETWEEN LAW & ECONOMICS 413, 413 (Lang et al. eds., 2010) ("The OECD [Model Tax Convention's] provisions have in fact become a settled body of-soft-law"); *see also* C. ROMANO, ADVANCE TAX RULINGS AND PRINCIPLES OF LAW: TOWARDS A EUROPEAN TAX RULING SYSTEM? 12–13 (2002).

> The role of sovereign powers during the Roman period was limited to the collection of taxes in order to finance . . . public . . . needs. For many centuries, first the censor, and then the tax administrations could directly decide the amount of public revenue needed and the taxes due by the citizens . . . . The functions and activities of the tax administrations have deeply evolved during the centuries . . . [and] the functions of the tax administrations of most legal systems became 'limited' to the administration of the tax law in all its aspects, including the interpretation of tax law provisions. *It is within the interpretative function of the tax administration that the advance tax rulings systems should be seen*.

Id. (emphasis added).

In practice, in the absence of a tax treaty or specific domestic law, APA regulations are usually in place[141] and provide legal grounds for the APA proceedings, which would usually contain references to the OECD Guidelines, whereas the latter constitutes procedural guidance on the application of the arm's length principle. Effectively, the OECD Guidelines provide a model legal framework to facilitate the administration of the arm's length principle. At the same time, the Guidelines cannot enforce the principle unless they are included into domestic law. If no transfer pricing law is in place and the arm's length principle exists only under Article 9 of the OECD Model in the respective tax treaties, taxpayers would be unable to understand the limits of their intercompany pricing, and to determine their pricing behavior in the legal system in which they operate. Therefore, a natural response to the problem of the enforcement of the arm's length principle in light of such uncertainty is seen in the interpretational instruments under the tax treaties, particularly in the emergence of confidential[142] APAs, which provide certainty to both taxpayers and tax authorities, and have made litigation a relatively rare occurrence in transfer pricing.[143]

By way of example, the absence of the specific transfer pricing law does not preclude from the application of the arm's length principle and cannot be used as an argument for impossibility to assert the arm's length nature of the transfer pricing methodology applied under Apple's Irish APA. Rather, such methodology should be justified following the normal path of interpretation under the relevant tax treaty and by applying the OECD Guidelines as the point of reference in evaluating the intragroup arrangements.

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141. No such APA regulations are, however, in place in Switzerland; the only legal background for concluding an APA is Article 25 of the OECD Model as per respective tax treaty. If Switzerland does not have a tax treaty concluded with a particular country, a transfer pricing adjustment would be granted unilaterally in the form of a tax credit.

142. Helminen, *The Problem of Double Non-Taxation*, *supra* note 125, at 306.

> Finally, non-taxation may be the result of a lack of information. The tax authorities of the state of residence may not know that their resident taxpayers are receiving income from another state or the tax authorities of the source state may not know that non-residents are receiving income from their territory. If the taxpayer does not provide the tax authorities with the necessary information, it might be impossible to receive the necessary information, for example, because of strict banking secrecy rules.

Id.

143. Baistrocchi, *The Arm's Length* Standard, *supra* note 136.

According to this line of reasoning, the EU Commission correctly bases its argumentation on the provisions of the OECD Guidelines in respect to transfer pricing rules and methodology. Nevertheless, for the transfer pricing rules to be applied correctly, one should understand the business reasoning of an intercompany set-up and how it should be assessed in light of the arm's length principle. In other words, having properly characterized each entity within the group, for the profits to be taxed, they should first be assessed and allocated at arm's length. It seems the EU Commission fell short of substantiating its claims through this exercise.

C. Understanding the "Residual Profit" Allocation

The application of the arm's length principle is generally based on a comparison of the conditions in a controlled transaction with the conditions in transactions between independent enterprises.[144] The OECD Guidelines provide for the transfer pricing methods and the attributes, or "factors,"[145] that must be considered when determining "comparability," including: the characteristics of the property or services transferred, the functions performed by the parties (taking into account assets used and risks assumed), the contractual terms, the economic circumstances of the parties, and the business strategies pursued by the parties. However, the establishment of arm's length conditions and the pricing of specific intragroup transactions are most intractable when it comes to intangibles. Intangibles are "likely to be distinct, if not unique, throwing into doubt the validity of comparisons with similar items, if any are available on the market."[146]

From an economic point of view, the total profit of a multinational group can be split into three categories:[147] (1) risk-free returns for suppliers of capital and normal, low-risk returns for routine profits derived from the performance of normal tasks by employing normal tangible assets or non-proprietary knowledge; (2) above-normal returns for capital invested in high-risk assets or exposed to high uncertainty, which generate non-routine profits that represent returns on unique and valuable intangible assets; and (3) economic rents. Regarding the first category, comparable third-party

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144. OECD, TRANSFER PRICING GUIDELINES, *supra* note 37, at 41.

145. *Id.* at 43.

146. C. John Taylor, *Twilight of the Neanderthals, or are Bilateral Double Taxation Treaty Networks Sustainable,* 34 MELB. U. L. REV. 268, 304–05 (2010) (citing SOL PICCIOTTI, INTERNATIONAL BUSINESS TAXATION: A STUDY IN THE INTERNATIONALIZATION OF BUSINESS REGULATION 215 (1992)).

147. *See* Wolfgang Schön, *International Taxation of Risk*, 68 IBFD BULL. INT'L. TAX'N. 280 (2014).

transactions or similarly situated third-parties are usually available, such benchmarking is often impossible regarding risky IP-KBC returns and economic rents—categories in which a residual profit is essentially attributable.

In transfer pricing practice, the anticipation of reasonable simplicity and certainty[148] by MNEs in their transfer pricing structures has led to widespread adoption of what is often called "principal" or "entrepreneurial" structures in early 1990s. Under the principal structure, the valuable intangibles and key investment and operational risks of a multinational group, as well as the profits and loss potential linked thereto, are centralized at the level of "principal" (usually the lead entity or parent of MNEs) with a wider web of limited risk distributors or commissioners or contract or toll manufactures.[149] The principal usually performs a coordination of value chain and largely determines the location of high-value activities and the conditions under which other entities participate in such global value chains.[150] The intended result is that the taxable incomes of the limited-risk components of the group will be both relatively limited and relatively predictable; however, the income of the principal company or companies will fluctuate significantly with the fortunes of the global business (typically, it is also expected to be higher than the incomes of the limited-risk companies since it is the principals

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148. ANUSCHKA BAKKER, TRANSFER PRICING AND BUSINESS RESTRUCTURINGS: STREAMLINING ALL THE WAY vi (IBFD, 2009).

> The perception that business restructuring involves abuse engages another central conflict in legal systems and the rule of law. The balance between legal certainty on the one hand—which is essential to maintain and prevent arbitrary or unfair administrative action - and the need to ensure that the rules are not artificially circumvented emerges in Issues Note 4 of the OECD Discussion Draft on Transfer Pricing Aspects of Business Restructurings, published on 19 September 2008.

Id.

149. Joseph Andrus & Michael Durst, *Standing on "Principal": Transfer Pricing Structures Using Limited-Risk Manufacturers and Distributors*, Transfer Pricing Perspectives* 56 (2006), https://www.pwc.com/us/en/transfer-pricing-strategies/assets/transfer-pricing-perspectives.pdf [hereinafter Andrus & Durst, *Standing on Principal*]; *see also* Tavares & Owens, *Human Capital in Value Creation*, *supra* note 41.

150. *See* OECD, INTERCONNECTED ECONOMIES: BENEFITING FROM GLOBAL VALUE CHAINS (2013); OECD, IMPLICATIONS OF GLOBAL VALUE CHAINS FOR TRADE, INVESTMENT, DEVELOPMENT AND JOBS (2013); OECD, GLOBAL VALUE CHAINS: CHALLENGES, OPPORTUNITIES, AND IMPLICATIONS FOR POLICY (2014).

that bear the significant financial risks of the business. and therefore, would expect higher returns on average).[151]

The above-mentioned value chain analysis itself is the process of analysing where and how value is added to the given product or service, (i.e., to find out *what* is done at each stage of the process), *who* does it, and *what* benefit each entity derives from its efforts. These factors are crucial for determining each entity's "functional positioning in the chain," likewise recognizing that a given activity can take place within a single firm or can be distributed among multiple firms, often on a global scale.[152] Having properly characterized an entity within the group, the profits should be assessed and allocated based on the arm's length principle. For such profit allocation and its subsequent taxation, it is important to identify the entrepreneurial functions within the value chain of a multinational group as the party performing such functions would generally be entitled to the residual profit or loss with respect to the intercompany transaction(s) under review. Based on the OECD Guidelines, the outcome of transfer pricing is dependent on the facts and circumstances in each individual case, and in certain cases resulting from a lack of specific guidance by the OECD Guidelines, professional judgment may be used in reaching a reasonable conclusion[153]—it would not be implausible for taxpayers and tax authorities to engage in discussions or "negotiations" before settling within an acceptable range of comparable parameters such as profitability indicators.

All three rulings or APAs in question represent the principal structures where the entities benefiting from the ruling are mere *intermediaries* within the global value chain of the Apple, Starbucks, and Amazon groups. The IP owners and the U.S. entities involved are the ultimate entrepreneurs of these global ventures. As a practical matter, it can be argued that the principal structures, which are largely based on the use of limited-risk entities, are in many instances the only means by which a complex MNE can gain reasonable confidence that its transfer pricing arrangements will be respected.[154] From a value chain perspective and following the OECD Guidelines, the royalty set-up under such principal structures reflects the limited nature of activities of

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151. Andrus & Durst, *Standing on Principal*, *supra* note 149.

152. Kevin Sobel-Read, *Global Value Chains: A Framework for Analysis*, 5 TRANSNAT'L LEGAL THEORY 364 (2014).

153. *See* Loek Helderman, Eduard Sporken, Rezan Okten, & Marc Kanter, *A New Era in Determining Arm's Length Compensation for Intangibles? A Comparative Overview of Existing and Possible Future Transfer Pricing Principles*, 20 INT'L TRANSFER PRICING J. 539 (2013), http://online2.ibfd.org/kbase/index.jsp#topic=doc&url=/collections/itpj/html/itpj_2013_06_int_1.html&hash=itpj_2013_06_int_1.

154. *See* OECD, TRANSFER PRICING GUIDELINES, *supra* note 37, at 23.

intermediary entities, which should be appropriately remunerated based on the contribution they make to the group value, respectively.

As previously discussed, due to their limited-risk profile, the remuneration of such entities is usually predictable and fixed, and can normally be benchmarked with the unrelated entities on the market, whereas the income of principal company depends on the market conditions and fluctuates significantly. The contingent nature of royalty charges significantly limits the risk of such intermediary entities incurring incremental IP-related losses; thus, it is economically sound to attribute uncertain IP returns to the IP owner, IP risk-bearer, and entrepreneur. Therefore, in order to properly allocate profits within the MNEs, the principal entrepreneur (be it the ultimate parent or its surrogate IP owner) should be attributed the residual income, after assessing the income of all the intermediary affiliates. In effect, the allocation of such residual income transfers the synergistic "super" rent of such MNEs (an item of income that cannot be earned by independent firms) along with the remuneration for other highly valuable IP which is embedded in the price of Apple, Starbucks, and Amazon products and services. A "super royalty" or "service charge" would need to accrue as expenses to all intermediary entities in accordance with the ALP. In the present cases, the IP-royalty set-up has been applied.

In all three cases under the EU investigation, APAs were concluded unilaterally. This means that the agreed methodology between each taxpayer in question and the relevant tax authorities should not necessarily be accepted by the tax authorities of their counterparties in other EU Member States or even the United States. However, the transfer pricing methods under the APAs granted by Ireland, the Netherlands, and Luxembourg have not been challenged by their counterparties in other countries since early 1990s, which may already serve as evidence that the methodology is deemed to be in line with the arm's length principle.

Generally, companies that have adopted principal structures have done so while relying on what they perceive to be straightforward readings of the U.S. transfer pricing regulations and the OECD Guidelines.[155] In practice, however, principal structures have given rise to substantial controversy[156] between taxpayers and the tax authorities. With the increase of complexity of the MNE groups and "digitalization" of the global economy, the

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155. *Id.* at 123–25.

156. Stewart, *Commentary*, *supra* note 44, at 112 ("More recent work confirms the finding that MNEs are sensitive to corporate tax systems and in particular to both 'production' and 'headquarters' tax incentives in their investment location decisionmaking.") (citing Michael P. Devereux & Rachel Griffith, *Taxes and the Location of Production: Evidence from a Panel of U.S. Multinationals*, 68 J. PUB. ECON. 335 (1998)).

entrepreneurial or principal models have started representing the major problems for the application of the arm's length principle. Due to the high integration of MNEs through the way they operate—mainly through control rather than through the contracts[157] and their ability to internalize costs and risks—it has become difficult to trace the value creation within the value chain and to identify the key profitability drivers for tax purposes.

It is not coincidental that addressing international tax issues in the digital economy and revisiting the OECD transfer pricing framework in particular, as it pertains to intangibles, is at the core of G20-OECD BEPS Project.[158] In the 2014 issue of the "Digital Economy" Report under the realm of the BEPS Project, it is recognized that in the area of transfer pricing, "attention should therefore be devoted to the implications of this increased integration in MNEs and evaluate the need for greater reliance on value chain analyses and profit split methods"[159] in order to align returns with value creation.[160] In fact, it seems that the transfer pricing set-up under all three investigated cases has also been recognized by the OECD in its recent Discussion Draft on BEPS Action 10: Use of Profit Splits in the Context of Global Value Chains, where it is recognized the *flexible* profit set-up:

> In cases where available comparables for the application of a one-sided method may not reliably reflect the level of functions or risk in the tested party, concepts of a

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157. Shephard, *Twilight of International Consensus*, *supra* note 124, at 77 ("[C]ontracts are a real problem. Certainly, if affiliates do not behave according to contractual terms and payments are not made, contracts can be ignored. But proving that entails a trip to court on the part of the tax administrator, and well-advised multinationals do spend money to babysit their contracts.").

158. *See* BEPS ACTION PLAN, *supra* note 4.

159. OECD, ADDRESSING THE CHALLENGES OF THE DIGITAL ECONOMY 16 (2014), http://www.oecd-ilibrary.org/taxation/addressing-the-tax-challenges-of-the-digital-economy_9789264218789-en.

160. Shephard, *Twilight of International Consensus*, *supra* note 124, at 76–77.

> The OECD wants to define the concept of intangibles broadly, with the aim of discouraging transfers to tax havens while continuing to recognize self-serving contracts between multinational affiliates. The idea is that legal ownership would be subsumed in a set of factors gauging whether the tax haven entity participated in the development of the transferred intangible. The OECD wants to allocate excess returns to where value is created.

Id.

> transactional profit split approach may sometimes offer the means to vary or flex the results under a one-sided method. For example, application of a one-sided method may result in establishing a range of operating margins of [four to ten percent] for one of the parties to the transaction: a baseline return of [seven percent] is adopted which would vary in accordance with a pre-determined computation upwards to [ten percent] and downwards to [four percent] depending on the levels of consolidated profits or sales achieved by the parties to the transaction.[161]

Based on the above analysis, it seems reasonable to conclude that the royalty set-up of Apple, Starbucks, and Amazon should be deemed to be generally compatible with the arm's length principle, especially given the IP ownership and capital-at-risk structure depicted in the State aid cases, as long as the facts disclosed in the proceedings correspond to the genuine activities of the group in terms of functions, risks, and assets of all the entities involved in the value chain. The EU Commission argument, *inter alia*, that the royalty payment should be computed *only* by reference to the output, sales, or profits of the entity benefiting from the parent's IP is superficial as it misses the vital understanding of the MNE group nature—an intermediary entity cannot earn a return that is above its abilities to contribute to the group overall value. It also does not address the risk-shifting feature of the contingent royalty set-up. As such, the transfer of residual income via "reverse royalty" would serve as an appropriate approach not only to allocate the substantial IP income that is undoubtedly embedded in the values in question and that would otherwise be earned by U.S. entities, but also the residual income allocation related to entrepreneurial risk assumption and overall group synergies primarily funded by U.S. shareholders. All such items of income are in essence related to the capital raised, intangibles developed, and functions performed within the United States, and are channelled through certain taxable entities in Ireland, the Netherlands, or Luxembourg as a means to achieve U.S. tax deferral; therefore, reallocating such income to the intermediary entities in question or treating all royalty deductions recognized by the authorities in such intermediary countries as "State aid," does not appear to be a feasible stance.

V. CONCLUSION

Apple, Starbucks, and Amazon all implemented U.S. tax deferral structures using their European affiliates. Whether such structures are viewed as legitimate from a United States perspective or induced by U.S. policy, these

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161. OECD, BEPS ACTION 10: DISCUSSION DRAFT ON THE USE OF PROFIT SPLITS IN THE CONTEXT OF GLOBAL VALUE CHAINS 9 (2014).

structures can also enable the shifting of profits within the European Union. However, the extent to which any fiscal aid was granted by Ireland, the Netherlands, and Luxembourg remains unclear from both a legal and factual perspective.

State aid investigations are well-established under EU law, but tax-specific investigations based on tax rulings have only recently been considered by the EU Commission and were mostly driven by the political climate surrounding the G20-OECD BEPS Project. An integral part of the investigations into tax ruling practices are the applied transfer pricing rules. Although the investigated cases do not undermine the legitimacy of APAs, given their magnitude and publicity, a more comprehensive transfer pricing analysis would likely be required for future tax rulings by EU Member States in favor of U.S. multinationals and for the tax settlement of cases so as to mitigate risks of similar questioning by the EU Commission.

Based on the factual background of all three cases and the above analysis, the State aid argument is limited to the (potential) "transfer mispricing" allegedly blessed by the APAs in question given the recognition of substantial royalty deductions, which the EU Commission alleges should have been entirely denied. Allegedly, such deductions would have unduly reduced the tax paid by certain intermediary entities, selected by the EU Commission in its challenge, even though such entities were not the owners, but benefited from using the highly valuable IP that was and continues to be developed by Apple, Starbucks, and Amazon in the United States.

The international sales that flow through the structures in question originate within the European Union, in high-tax "source countries" other than those charged with the granting of unlawful State aid. If any mispricing is indeed perpetrated through these structures, it follows that EU income hypothetically attributable to high-tax EU countries—or even, to a lesser extent, to the low-tax intermediaries that are charged with unlawful State aid—could have been unduly reduced. It is only the hypothetical portion which affects the Internal Market *and* represents a concession of the intermediary EU Member States that constitutes State aid. This would certainly be a small portion of the overall amount of IP-related residual profits at issue in the pending cases. In fact, the *royalty deductions* challenged as State aid merely *channel* IP income and residual profits earned by U.S. shareholders through multiple operating entities within the European Union, whereas the untaxed and unchallenged *royalty income* received by EU "reverse-hybrid" entities *consolidates* all such income of U.S. shareholders with additional income from several operating entities throughout the world. Therefore, challenging the royalty deductions of the intermediary entities singled out in the State aid cases

and measuring the potential aid in terms of the overall royalty income that was channeled through such entities would be, in the least, disproportionate.[162]

Even in post-BEPS[163] context, it is unlikely that the fundamental rules of transfer pricing would change to yield a materially different result, such as to reallocate IP and residual profits out of the United States and into the EU tax net. If anything, the United States would reinstate its claim over such income and address the exacerbated use of U.S. tax deferral, as well as the incongruences of U.S. hybrid entity treatment.

The seemingly strict stance of the EU Commission against U.S. multinationals using State aid rules, as it attempts to retroactively challenge the transfer pricing methodology contained in such APAs, can be viewed as an attempt to influence the behavior of companies and countries.[164] However, the final outcome of the ECJ judicial review of these cases would be more determinative of such behavioral influence. The applicable legal framework of the arm's length principle, absent further post-BEPS revisions to international tax laws with prospective effects, seems to indicate that the current State aid battle is one that the EU Commission simply cannot win at the ECJ.

This begs the question of whether the EU Commission is really engaged in a battle to curb U.S. MNE tax avoidance at all or whether the State aid claims simply serves as political statements aimed at forming public opinion concerning prospective changes, such as the adoption of a common consolidated tax base in Europe. Actions to curb avoidance would instead have directly addressed the excessive use of EU "reverse hybrid" structures that serve as surrogate IP owners and are deemed to be risk-taking entrepreneurs instead of their U.S. shareholders. These are the structures that facilitate U.S. tax deferral and foster intra-EU tax competition, the inappropriate use of EU Directives or even of intra-EU tax treaties, and often lead to incoherent

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162. The potential tax exposure in the state aid allegation of the EU Commission would effectively be the equivalent of full Irish, Dutch, or Luxembourgish corporate taxes on "residual profits," which includes all IP-related income of Apple, Starbucks, and Amazon, and includes income earned throughout Europe and possibly beyond. Such enlarged, hypothetical tax exposure would effectively burden U.S. source income and could reach back ten years, and it would be calculated as the difference between the taxes actually paid and the amount that would allegedly have been paid to the Irish, Dutch, or Luxembourgish Treasuries by the resident entities in question if they were ultimately and fully denied deductions for "royalties" owed for their use of all United States developed IP, which they do not own, do not fund, and do not co-develop.

163. *See* Tavares & Owens, *Human Capital in Value Creation*, *supra* note 41.

164. *See* Allison Christians, *Friends With Tax Benefits: Apple's Cautionary Tale*, 78 TAX NOTES INT'L 1031–34 (2015).

results.[165] Therefore, it would seem that the State aid claims were pressed at times against the wrong entities or the wrong countries, as well as for the wrong reasons. These highly visible State aid investigations and allegations are surely spectacular and loud, and their noise reverberated across the Atlantic. However, the recent decisions and ongoing investigations by the EU Commission, however, appear to be misconstrued. Thus, the charges will likely blow up in smoke upon review by the ECJ and turn into immaterial adjustments.

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165. *See* Tavares & Bogenschneider, *The New De Minimus Anti-Abuse Rule*, *supra* note 26 (discussing disproportionate EU Directive entitlements); *see also* Tavares, *Active Trade or Business Exception*, *supra* note 54 (discussing disproportionate U.S. treaty entitlement).