Nike State Aid Comments

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I have received several requests this July 4th holiday in the U.S. about my initial thoughts on the EU Commission's 56-page published (public version from earlier this week) State Aid preliminary decision with the reasoning that The Netherlands government provided Nike an anti-competitive subsidy via the tax system. My paraphrasing of the following EU Commission statement [para. 87] sums up the situation:

> *The Netherlands operational companies are remunerated with a low, but stable level of profit based on a limited margin on their total revenues reflecting those companies' allegedly "routine" distribution functions. The residual profit generated by those companies in excess of that level of profit is then entirely allocated to Nike Bermuda as an alleged arm's length royalty in return for the license of the Nike brands and other related IP"*

U.S. international tax professionals operating in the nineties know that The Netherlands is a royalty conduit intermediary country because of its good tax treaty system and favorable domestic tax system, with the intangible profits deposited to take advantage of the U.S. tax deferral regime that existed until the TCJA of 2017 (via the Bermuda IP company). Nike U.S., but for the deferral regime, could have done all this directly from its U.S. operations to each country that Nike operates in. No other country could object, pre-BEPs, because profit split and marketing intangibles were not pushed by governments during transfer pricing audits.

The substantial value of Nike (that from which its profits derive) is neither the routine services provided by The Netherlands nor local wholesalers/distributors. The value is the intangible brand created via R&D and marketing/promotion. That brand allows a $10 – $20 retail price sneaker to sell retail for $90 – $200, depending on the country. Converse All-Stars case in point. Same $10 shoe as when I was growing up now sold for $50 – $60 because Converse branded All-Stars as cool kid retro fashion.

Nike has centralized, for purposes of U.S. tax deferral leveraging a good tax treaty network, the revenue flows through NL. The royalty agreement looks non-traditional because instead of a fixed price (e.g. 8%), it sweeps the NL profit account of everything but for the routine rate of return for the grouping of operational services mentioned in the State Aid opinion. If Nike was an actual Dutch public company, or German (like Addidas), or French – then Nike would have a similar result from its home country base because of the way its tax system allows exemption from tax for the operational foreign sourced income of branches. [Having worked back in the mid-nineties on similar type companies that were European, this is what I recall but I will need to research to determine if this has been the case since the nineties.]

I suspect that when I research this issue above that the NL operations will have been compensated within an allowable range based on all other similar situated 3rd parties. I could examine this service by service but that would require much more information and data analysis about the services, and lead to a lesser required margin by Nike. The NL functions include [para 33]: "…*regional headquarter functions*, such as marketing, management, sales management (ordering and warehousing), establishing product pricing and discount policies, adapting designs to local market needs, and distribution activities, as well as bearing the inventory risk, marketing risk and other business risks."

By example, the EU Commission states in its initial Nike news announcement:

> *Nike European Operations Netherlands BV and Converse Netherlands BV have more than 1,000 employees and are involved in the development, management and exploitation of the intellectual property. For example, Nike European Operations Netherlands BV actively advertises and promotes Nike products in the EMEA region, and bears its own costs for the associated marketing and sales activities.*

Nike's internal Advertising, Marketing, and Promotion (AMP) services can be benchmarked to its 3rd party AMP providers. But by no means do the local NL AMP services rise to the level of Nike's chief AMP partner (and arguably a central key to its brand build) Wieden + Kennedy (renown for creating many industry branding campaigns but perhaps most famously for Nike's "Just Do it" – inspired by the last words of death row inmate Gary Gilmore before his execution by firing squad).

There is some value that should be allocated for the headquarters management of the combination of services on top of the service by service approach. Plenty of competing retail industry distributors to examine though. If by example the profit margin range was a low of 2% to a high of 8% for the margin return for the combination of services, then Nike based on the EU Commission's public information falls within that range, being around 5%.

The Commission contends that Nike designed its transfer pricing study to achieve a result to justify the residual sweep to its Bermuda deferral subsidiary. The EU Commission states an interesting piece of evidence that may support its decision [at para 89]: "To the contrary, those documents indicate that comparable uncontrolled transactions may have existed as a result of which the arm's length level of the royalty payment would have been lower…". If it is correct that 3rd party royalty agreements for major brand overly compensate local distributors, by example provide 15% or 20% profit margin for local operations, then Nike must also. [I just made these numbers up to illustrate the issue]

All the services seem, on the face of the EU Commission's public document, routine to me but for "adapting designs to local market needs". That, I think, goes directly to product design which falls under the R&D and Branding. There are 3rd parties that do exactly this service so it can be benchmarked, but its value I suspect is higher than by example 'inventory risk management'. We do not know from the EU document whether this 'adapting product designs to local market' service was consistent with a team of product engineers and market specialists, or was it merely occasional and outsourced. The EU Commission wants, like with Starbucks, Nike to use a profit split method. "…a transfer pricing arrangement based on the Profit Split Method would have been more appropriate to price…". Finally, the EU Commission asserts [para. 90]: "…even if the TNMM was the most appropriate transfer pricing method…. Had a profit level indicator been chosen that properly reflected the functional analysis of NEON and CN BV, that would have led to a lower royalty payment…".

But for the potential product design issue, recognizing I have not yet researched this issue, based on what I know about the fashion industry, seems rather implausible to me that a major brand would give up part of its brand residual to a 3rd party local distributor. In essence, that would be like the parent company of a well-established fashion brand stating "Let me split the brand's value with you for local distribution, even though you have not borne any inputs of creating the value". Perhaps at the onset of a startup trying to create and build a brand? But not Nike in the 1990s. I think that the words of the dissenting Judge in *Altera* (9th Cir June 2019) are appropriate:

> *An 'arm's length result is not simply any result that maximizes one's tax obligations'.*

The EU Commission obviously does not like the Bermuda IP holding subsidiary arrangement that the U.S. tax deferral regime allows (the same issue of its Starbucks state aid attack), but that does not take away from the reality that legally and economically, Bermuda for purposes of the NL companies owns the Nike brand and its associated IP. The new U.S. GILTI regime combined with the FDII export incentive regime addresses the Bermuda structure, making it much somewhat less comparably attractive to operating directly from the U.S. (albeit still produces some tax arbitrage benefit). Perhaps the U.S. tax regime if it survives, in combination with the need for the protection of the IRS Competent Authority for foreign transfer pricing adjustments will lead to fewer Bermuda IP holding subsidiaries and more Delaware ones.

My inevitable problem with the Starbucks and Nike (U.S. IP deferral structures) state aid cases is that looking backward, even if the EU Commission is correct, it is a *de minimis* amount (the EU Commission already alleged a *de minimis* amount for Starbucks but the actual amount will be even less if any amount at all). Post-BEPS, the concept and understanding of marketing intangibles including brands is changing, as well as allowable corporate fiscal operational structures based on look through (GILTI type) regimes. More effective in the long term for these type of U.S. IP deferral structures is for the EU Commission is to spend its compliance resources on a go forward basis from 2015 BEPS to assist the restructuring of corporations and renegotiation of APAs, BAPAs, Multilateral PAs to fit in the new BEPS reality. These two cases seem more about an EU – U.S. tax policy dispute than the actual underlying facts of the cases. And if as I suspect that EU companies pre-BEPS had the same outcome based on domestic tax policy foreign source income exemptions, then the EU Commission's tax policy dispute would appear two-faced. I'll need to undertake a research project or hear back from readers and then I will follow up with Nike Part 2 as a did with Starbucks on this Kluwer blog previously. See Application of TNMM to Starbucks Roasting Operation: Seeking Comparables Through Understanding the Market and then My Starbucks' State Aid Transfer Pricing Analysis: Part II.

See also my comments about Altera: An 'arm's length result is not simply any result that maximizes one's tax obligations'.

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