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Your Homework Will Be Graded: The ECJ's Apple Decision and Its Implications for International Tax

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On September 10, 2024, the European Court of Justice (ECJ or Court) sided with the European Commission (Commission) and ruled that two Irish subsidiaries of Apple Inc. received unlawful state aid from Ireland in the form of a tax advantage (Case C-465/20 P). Ireland has reported that it will now finalise the recovery of approximately €14.1 billion from Apple, representing unpaid taxes and interest, which has been escrowed for the greater part of the past decade.

Key Points

- Tax rulings may give rise to state aid if they provide the company in question with a more advantageous treatment than the normal corporate tax regime in the member state concerned.
- The ECJ previously determined that the benchmark against which a tax measure is assessed should be limited to the domestic tax rules of the member state. Earlier Commission decisions finding that tax rulings amounted to illegal state aid, in cases involving Fiat Chrysler, Amazon and Engie, were annulled by the ECJ because it found the Commission disregarded the provisions of applicable national tax law and the explanations put forward by the state to justify the tax ruling, in some cases choosing instead to apply an "abstract" interpretation of the arm's length principle. (The arm's length principle is, very broadly, the basis on which tax authorities seek to replace the pricing of transactions between related parties with one more closely reflecting that used in a comparable arm's length transaction between unrelated parties, if different.)
- In contrast, the ECJ in *Apple* concluded that the Commission was entitled to interpret Irish law in line with the arm's length principle even though Irish law contained no explicit provision to that effect. In a highly fact-specific judgment, the ECJ in *Apple* adopted the General Court's finding that Ireland had accepted that the Irish law in question "corresponded in essence" to the arm's length principle approach despite no explicit national provision to that effect, and noted that Ireland had put forward no other explanation during the Commission's investigation for the way in which the tax rulings had determined the chargeable profits of the Irish branches. Accordingly,

the ECJ concluded that the Commission was entitled to include the arm's length principle as part of the reference system.
- It remains to be seen whether the new Commission will exploit this judgment to reinvigorate the use of the state aid rules to challenge tax rulings. While addressing perceived unfair tax ruling practices was clearly a priority in the 2010s, competition policy and the international tax arena have both developed new focuses.
- Irrespective of how the Commission chooses to use the *Apple* decision in enforcing state aid rules, the case is consistent with the international trend towards the view that multinational enterprise (MNE) tax transfer pricing policies should be subject to review not just by the countries with primary taxing jurisdiction, but also those countries with an opportunity to tax via the Organisation for Economic Co-operation and Development's (OECD's) Pillar 2 Undertaxed Payments Rule (UTPR) and Income Inclusion Rule (IIR). These represent the newest tools through which a country's application of its own domestic law can be second-guessed by other authorities.

State Aid Prior to *Apple*

The Commission has been targeting the tax practices of member states over the past decade in line with a fresh enforcement policy of defining tax rulings for MNEs as unlawful state aid. Such tax rulings are, in principle, lawful but may give rise to state aid if they provide a company with more advantageous treatment than the normal corporate tax regime in the state concerned. This policy shift represented a move by the Commission into the assessment of tax administration which is, in principle, an exclusive competence of member states. However, the large majority of the Commission's decisions finding that bespoke tax arrangements amount to unlawful aid have been annulled on appeal in recent years.

The appeals prior to *Apple* centred on whether the Commission had correctly identified the "normal" national tax system against which the existence of a potential selective advantage must be assessed.

In the landmark 2022 *Fiat Chrysler*[1] case, which represented the ECJ's first opportunity to consider the state aid methodology employed by the Commission in its tax ruling decisions, the ECJ laid down the fundamental principle that the reference tax system must be the tax law applicable in the member state concerned. This is inherent in the sovereignty enjoyed by member states in the field of tax administration. This means that general principles and guidelines can only be considered to be part of the reference system where they have been explicitly incorporated into national law. The ECJ followed the same line of reasoning adopted in *Fiat* in two subsequent judgments delivered in December 2023; *Engie*[2] and *Amazon*[3].

More specifically, the Court found in *Fiat Chrysler* and *Amazon* that the Commission had manifestly disregarded the provisions of the applicable national tax law and explanations put forward by the state in favour of an abstract interpretation of the arm's length principle. In *Engie*, the Court ruled that disputes over the interpretation of domestic law should be resolved in favour of the member state's interpretation where that interpretation is compatible with the wording of the domestic law.

In all three of the abovementioned cases, the ECJ annulled the Commission's findings on the basis that it had disregarded the applicable national tax law and consequently did not correctly identify the reference tax system, which invalidated the entirety of the reasoning relating to the existence of a selective advantage.

It was largely expected that the ECJ would follow the same line of reasoning in the *Apple* appeal and find that the Commission had wrongly identified the reference system, or alternatively follow the recommendation of Advocate General Giovanni Pitruzzella to refer the case back to the General Court for a new assessment on the merits.[4] In a surprise judgment, however, the ECJ considered itself in a position to give final judgment and upheld the Commission's assessment.

Progress of Key Tax Ruling State Aid Cases Through the EU Courts[5]

***Apple* (Ireland)**	Commission decision **upheld** by the ECJ (2024)
***Amazon* (Luxembourg)**	Commission decision **annulled** by the General Court; General Court upheld by the ECJ (2023)
***Engie* (Luxembourg)**	Commission decision **annulled** by the ECJ (2023)
***Excess Profits* (Belgium)**	Commission decision **upheld** by the General Court (2023); General Court ruling **on appeal** at the ECJ
***Fiat Chrysler* (Luxembourg)**	Commission decision **annulled** by the ECJ (2022)
***Mead Johnson* (UK/Gibraltar)**	Commission decision **partially annulled** by the General Court (2022); no appeal to the ECJ but EC resumed its investigation
***Starbucks* (Netherlands)**	Commission decision **annulled** by the General Court (2019); no appeal to the ECJ but EC resumed its investigation

***Apple* Facts**

Through two tax rulings adopted in 1991 and 2007, the Irish tax authorities confirmed that the greater part of the profits recorded by two Apple group subsidiaries, incorporated but not tax resident in Ireland, were attributable to their head offices outside Ireland rather than to their Irish trading branches. Consistent with the general international tax principle that countries should tax non-residents' business income attributable to a permanent establishment in the country, Ireland only taxed the profits attributable to the Irish trading branches, and Irish tax law was silent as to how the profit attributable to the Irish branches was to be determined.

In 2016, the Commission disagreed with Ireland's understanding of its own domestic law and took the view that the allocation of Apple group intellectual property (IP) licenses and associated profits to the foreign head offices rather than the Irish branches was not in line with normal taxation under Irish law. This, the Commission found, gave Apple an advantage in the European market by reducing its corporate tax liability compared to standalone companies operating under normal market conditions, and amounted to illegal state aid. The reference tax system in this case was found to be a market-based outcome in accordance with the arm's length principle and the authorised OECD approach.[6]

The General Court annulled the Commission's decision in July 2020, finding that the Commission had failed to demonstrate the existence of a selective advantage as a result of the tax arrangements. The Commission appealed this judgment.

The ECJ *Apple* Judgment in Detail

The higher court judges, ruling in Grand Chamber composition, overturned the General Court's conclusion and agreed with the Commission that Ireland's tax rulings provided Apple with an advantage in breach of the state aid rules. The ECJ reinstated the Commission's findings that Ireland incorrectly applied its own national tax laws, including the arm's length principle, by failing to verify whether the Apple IP should have been attributed to the Irish branches instead of the foreign head offices.

The ECJ upheld the Commission's analysis that Irish law required that only the respective functions of the head office and the branches must be compared before allocating profit to the Irish branches. Whereas the Irish branches performed functions justifying the allocation of the IP to them, the head offices were not able to control or manage the relevant IP licences and, as such, they should not have been allocated the profits derived from the use of those licences.

Notably, the Court reached this conclusion despite the fact that the arm's length principle had *not* been explicitly incorporated into Irish tax law at the relevant time, and even though the authorised OECD approach had been introduced after the adoption of the Apple tax rulings.

The ruling raises the important question of how the Court's reasoning can be reconciled with its pre-existing case law, which established that the analysis should be limited to the domestic law system of the state concerned, such that external rules and principles, including the arm's length principle, cannot be taken into account unless the national tax system makes explicit reference to them.

The reasoning in the ECJ *Apple* decision is that — in contrast to the previous appeals — the Commission's definition of the applicable reference system was already endorsed by the General Court and had not been left open for further discussion on appeal.

The ECJ noted the General Court's recognition in *Apple* that there is no autonomous arm's length principle that applies without that principle having been incorporated into national law. This follows the *Fiat Chrysler* line of reasoning. Where the cases differed is on the facts. In *Apple*, in contrast to the other cases, the Commission's interpretation did not conflict with the relevant provisions of the domestic law. Ireland had also confirmed that the tax law in question "corresponded in essence" to the arm's length principle approach and put forward no other suitable explanation during the Commission's investigation for the way in which the tax rulings had determined the chargeable profits of the Irish branches. The Commission was therefore entitled, the ECJ held, to use the arm's length principle as a tool in its assessment in this case.

Accordingly, in our view, the final *Apple* ruling is largely contained to the facts of the case, which means that parallels with other rulings and comparable fact patterns cannot easily be drawn. The case demonstrates that the applicable national law and administrative practice of the tax authority as communicated to the Commission during the administrative stage of the proceedings remains key in the state aid assessment of tax rulings.

What Do We Do With *Apple* in 2024?

Competition Commissioner Margrethe Vestager, who has vigorously led the Commission's state aid strategy on tax rulings since the start of her mandate, was emboldened by the judgment after having faced the setbacks in the other major cases. “It is encouraging for us to do more,” she said following the ECJ’s ruling, “the Commission will continue its work on harmful tax competition and aggressive tax planning.”

As Vestager comes to the end of her second term as Competition Commissioner, it will be for her successor in the new Commission to decide whether and how to proceed with the Commission’s state aid policy on tax rulings. Spanish politician Teresa Ribera has been named as the next commissioner in charge of competition policy (as part of a broader Executive Vice President role leading the EU’s green transition), subject to the approval of the EU Parliament, and is expected to take office later this year.

It remains to be seen whether using the state aid rules to tackle perceived unfair tax practices will be a priority for the incoming commissioner, who faces different political challenges than those met by Vestager at the start of her tenure. Ongoing and future cases may well be deprioritised in light of more immediate challenges such as the push for net-zero, the role of industrial policy and the long-term competitiveness of the European Union (EU). The latter two issues were addressed in a lengthy recent report by former European Central Bank chief and Italian prime minister Mario Draghi, who suggested a need for more state-led investment (or even subsidy) in key sectors of the global economy. Coincidently, his report came out the day before the *Apple* decision.

In conclusion: *Apple* was a surprise, but a good reminder that MNEs should always consider how their tax structures will be judged, not only by the countries with primary taxing jurisdiction, but also by others with the power to second guess application of domestic law. In 2024 and beyond, this is most prominent in the context of recently enacted Pillar 2 rules that permit participating countries to assess tax in addition to that deemed appropriate by the country with primary taxing jurisdiction via the OECD’s IIR or the UTPR regimes, on a theory that the primary country was entitled to more tax than what it collected.

In the European courts, whilst *Apple* was a clear message that the Commission still has the ability to review the application of domestic tax rulings under the state aid rules, our view is that *Apple* may not be the springboard the Commission was waiting for. There are now new, better, and different ways, for multiple jurisdictions, to police other countries’ domestic enforcement, now that the OECD has empowered peer review in the form of Pillar 2.

In other words, your homework will be graded one way or another.

[1] Case C-885/19 P and C-898/19 P, *Fiat Chrysler Finance Europe and others v Commission*, judgment of the ECJ, November 8, 2022. See our 22 November 2022 client alert “EU Court of Justice Faults European Commission for Expansive Interpretation of State Aid in Tax Rulings”.

[2] Case C-451/21 P and C-454/21 P, *Engie SA and others v Commission*, judgment of the ECJ, December 5, 2023.

[3] Case C-457/21 P, *Commission v Amazon.com Inc. and others*, judgment of the ECJ, December 14, 2023.

[4] Opinion of Advocate General Pitruzzella in Case C?465/20 P, *European Commission v Ireland*,

Apple Sales International, Apple Operations International and Others.

[5] Cases concern Commission decisions finding the existence of state aid and ordering the recovery of that aid.

[6] OECD's 2010 Report on the Attribution of Profits to Permanent Establishments.

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