AntitrustConnect Blog

Apple Case Update – Blog 2

Philip Andrews and Seán O'Dea (McCann Fitzgerald) · Tuesday, February 14th, 2017

What light does the European Commission's much anticipated 130-page decision, published Monday, 19 December 2016, shed on the Commission's case and the parties' prospects for appeal?

In the second of a series of short blogs on the Apple case, here's a quick-look review and comment on the Commission's decision.

We know now that the Commission's case is based on two alternate "*lines of reasoning*" – what the Irish side calls "*grossly divergent factual scenarios*." Confirmed also in the published version of the decision is the critical importance of a novel "*arm's length principle*" to the Commission's case.

A Quick Re-Cap

On 30 August 2016, the Commission announced a decision finding that Ireland gave Apple Inc. "up to" €13 billion in State aid by allowing two Apple subsidiaries (Irish registered but non-resident companies, Apple Sales International (ASI) and Apple Operations Europe (AOE)) to determine their corporation tax liabilities in Ireland by applying profit allocation methods, allocating profit between their Irish branches and non-Irish entities, that breached of EU State aid law.

According to the Decision, ASI and AOE were responsible of the procurement, manufacturing, sales and distribution of Apple products outside the Americas.

Under a so-called cost sharing agreement between ASI, AOE and Apple Inc. (the ultimate parent company), each of those companies was responsible for a portion of costs associated with Apple's R&D operations, in return for which Apple Inc. had the right to manufacture and sell Apple products in North and South America, while AOE and ASI had those rights for the rest of the world.

Irish registered but non-resident companies are taxed, like all other companies, based on their profits. However, as they are not tax-resident in Ireland, companies like ASI and AOE were not taxed on all of their profits worldwide, but on the profits earned through their Irish branches. Irish tax administrators confirmed on two occasions, in 1991 and 2007, that Apple's proposed method of determining what profits were attributable to the Irish branches of ASI and AOE complied with Irish tax law. In simplified form, among other things, ASI and AOE calculated their Irish tax bills

by applying the standard rate of tax (12.5%) on a given percentage (*eg* 65%) of their annual operating costs (*eg* €100m) (*eg* 65% x €100m x 12.5% = €8,125,000).

The Commission's First Line of Reasoning

- The first case against Ireland is that it should have taxed ASI and AOE on profits derived from intellectual property, the most valuable part of Apple's business. The Commission contends that Ireland should have assessed the relationship between Apple's Irish branches and the remaining entities within Apple's two Irish entities, ASI and AOE, according to an "*arm's length principle*".
- Applying this principle, the Commission considers that "*ASI and AOE had no physical presence or employees outside of Ireland*". On this basis, the Commission contends that the non-Irish entities of those companies negotiating at "*arm's length*" with their respective Irish branches would not be in a position to claim for themselves all profit associated with the relevant intellectual property.
- As a result, the Commission argues that the intellectual property rights should be allocated in full to the Irish branches and that those branches should be taxed on all profit derived from the intellectual property. While the decision does not explain how the Commission identified Apple's potential exposure of "*up to*" €13bn, for its press release on 30 August 2016 announcing the decision, it appears to be on this basis the Commission calculated the amount of aid.
- The Commission goes further to argue that, even if Ireland was correct to endorse what the Commission calls the "*one-sided profit allocation method*", the specific profit allocation methods endorsed by the Irish tax administrators still fell foul of the "*arm's length principle*". The Commission found that: (i) the Irish authorities' focus should have been placed on the non-Irish entities within the ASI and AOE companies, rather than on the Irish branches; (ii) using a proportion of operating costs as a profit level indicator, rather than total sales or total costs, was not in line with the "*arm's length principle*"; and (iii) the percentage applied to the relevant profit level indicator was too low.

The Commission's Second (Alternate) Line of Reasoning

- If the Commission's first charge against Ireland fails, the Commission's proposition is that there's still a case to justify a finding of State aid. According to the Commission, even if the correct comparator for ASI's and AOE's selectivity analysis was other non-resident companies' Irish branches, the tax paid by ASI and AOE in Ireland was selectively low.
- The Commission says this is the case because either: (i) Irish law incorporates the "*arm's length principle*", with which the Commission says Apple's tax liability calculations are not compliant; or (ii) having compared ASI and AOE's arrangements with 17 comparable advance pricing arrangements of Irish branches of non-resident companies disclosed to Irish tax administrators, the Commission says the ASI and AOE arrangements resulted in an advantage for ASI and AOE relative to those other companies.
- The Commission also states that, as ASI and AOE's tax arrangements are unique to them, the arrangements are presumptively selective, although the Commission acknowledges it must prove an advantage separately from demonstrating

Appeal Grounds and Next Steps

- Ireland lodged its appeal to the Decision on 9 November 2016 and Apple is expected to lodge its appeal within the coming weeks. A summary of Ireland's grounds of appeal can be accessed here.
- Ireland's substantive objections to the Commission's findings are broadly as follows: the Commission misunderstood Irish tax law and relevant facts (including the activities and responsibilities of ASI and AOE's Irish branches); the ASI and AOE arrangements were in line with Irish law and/or the "*arm's length principle*"; and the Commission used a wrong reference system in comparing ASI and AOE to non- resident companies only.
- Ireland also says the Commission's investigation was procedurally flawed as it breached: the right to be heard; legal certainty and legitimate expectations; the duty of impartiality; the limit of the Commission's competence; and the duty to provide reasons.
- A hearing, where both appeals would likely be run together, won't likely take place until 2019, based on the General Court's current timings. An appeal to the Court of Justice could take a further three years.

Comment

Many see a political purpose in the Apple case. In February 2014, when first confirming these own-initiative investigations into "*aggressive tax planning*," then EU Competition Commissioner, Joaquín Almunia, said he had "*a political consideration*" in mind. European Parliament elections were just three months away and the Commissioner was concerned that "*a growing proportion of voters across the EU … may be tempted by anti-European messages*." "*Pro-active policies*" were needed, the Commissioner said, to show voters "*the way forward is more integration, not a beggar-thy-neighbour attitude*." In a number of speeches, the current EU Competition Commissioner, Commissioner Vestager has called for "*fair tax*" policies. A headline grabbing Commission press release on 30 August this year, when the decision was adopted, echoes this approach ("*Ireland gave illegal tax benefits to Apple worth up to €13 billion*").

But does this make the Commission's decision wrong in law?

- By any relevant measure, the decision is well argued and painstakingly crafted. Detailed primary, secondary and alternative reasons in support of a State aid finding are given. But the case may ultimately come down to two or three key aspects.
- First, what evidence, if any, is there of a so-called sweetheart deal? Here's what the decision describes as "*constituting all essential elements supporting the [rulings]*"

I) For the 2007 "*ruling*": two letters, one from Apple's tax advisors explaining the method to determine the profits to be allocated to the Irish branches and a second, a response letter from the Irish authorities endorsing that method. [1] The Commission decision notes that neither letter

"*offer[s] any explanation for the figures*." The Commission decision also notes the "*absence of a profit allocation report*."

II) For the 1991 "*ruling*": three letters and two faxes from Apple's tax advisor, one note of an interview, one note of a meeting prepared by Irish Revenue, and a letter from Irish Revenue (which the Commission decision says endorses the letters from Apple's tax advisor correctly reflect the method for determining the profits to be allocated to the Irish branches of ASI and AOE).

III) Importantly, no commitments or other quid pro quo for these rulings is mentioned in the Commission decision. A single reference to employment by Apple is cited. This involved passing reference by Apple's tax advisor in a meeting in 1991 to the fact that "*Apple was now the largest employer in the Cork area with 1,000 direct employees and 500 persons engaged on a sub-contract basis … and that [Apple] was reviewing its worldwide operations*." The Commission does not rely on this statement as probative or otherwise supportive of its position.

- Second, is the Commission's reliance on the "*arm's length principle*" justifiable? According to the Commission, the "*arm's length principle*" is "*…the principle that transactions between integrated group companies should be remunerated as if they were agreed to by non-integrated standalone companies negotiating under comparable circumstances at arm's length…*" Ireland says that "*applying the arm's length principle as a State aid tool and suggesting that it has been part of Union law since 1958 would constitute a total rewriting of history…*" Other than its own decisions, however, the Commission cites a single Court of Justice judgment in support of its use of the "*arm's length principle*," the *Belgian Coordination Centres* case – which may not be wholly analogous.

- Third, what of Ireland's sovereign right on corporate tax issues, including to negotiate bilateral tax treaties? Ireland says the Commission wrongly found "*Ireland granted aid in relation to profits taxable in other jurisdictions*," while Apple also makes the point that ASI and AOE profit not taxed by Ireland was "*subject to deferred taxation in the US*". There is limited rebuttal of this argument in the Commission's decision. Instead, the Commission suggests that ASI, AOE, and Apple Inc. could retrospectively make intra-group payments (creating corresponding decreases in Irish company profits and increases in US company profits). Nor does the decision substantively address whether the ruling could limit Ireland's freedom (and that of other third party countries) in bilateral tax relations with non-Member States.

In all events, the Apple decision seems to represent further incremental expansion of the notion of State aid. To give context, a recently issued Commission *Notice on the Notion of State Aid*, intended to provide clarity on a single article of the Treaty on the Functioning of the European Union (Article 107 TFEU), runs to 50 pages.

[1.] What the Commission says were "tax rulings" by the authorities here, the Irish side calls opinions. The Irish label may be more accurate: legally, the Irish authorities can't make binding rulings. But the distinction is probably moot. As the Commission decision says, from a State aid perspective, "*[s]ubstantively, the two notions are the same*." The Irish authorities effectively endorsed the view of Apple's tax advisers, whether explicitly in their opinions or tacitly in their acceptance of annual tax returns calculated in the manner endorsed by those opinions. And, from a summary of grounds of appeal published last week, the Irish authorities don't seem to contest the point.

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