

MACFARLANES

APPLE STATE AID DECISION: IRISH TAX RULINGS FOUND ILLEGAL

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NEWS BRIEF

Apple state aid decision: Irish tax rulings found illegal

Ireland has been called on to recover unpaid taxes from Apple of up to €13 billion plus interest, after the European Commission (the Commission) announced on 30 August 2016 that two Irish tax rulings constituted illegal state aid. The rulings were granted in 1991 and 2007, and endorsed a methodology for allocating profits of certain Irish-incorporated subsidiaries of Apple that resulted in only a small proportion of those profits being taxable in Ireland. The announcement follows a state aid investigation launched by the Commission in June 2014.

Apple's Irish subsidiaries

The Commission's investigation concerned two Irish-incorporated subsidiaries of Apple Inc: Apple Sales International (ASI) and Apple Operations Europe (AOE) (together, the Irish companies). Under a cost-sharing agreement, the Irish companies owned rights to Apple's intellectual property outside North and South America. In exchange, the Irish companies funded research and development activities by Apple in the US.

Apple Sales International. Under Irish law at the time, ASI was a so-called "stateless" company. It was incorporated in Ireland but was not tax resident in Ireland or anywhere else. As a result, it was treated as having a branch in Ireland and was taxed in Ireland only on the trading income that arose from that branch.

ASI's activities involved procuring Apple products from third-party manufacturers and selling them to Apple-affiliated companies and other end-user customers. When a customer bought an Apple product it was contractually agreeing to buy it from ASI, rather than from the shops that physically sold the products.

Although ASI made substantial profits from selling Apple products, the Irish authorities agreed that those profits were not fundamentally attributable to its branch in Ireland. The sale of Apple products did not pass through the branch and the intellectual property was economically developed and owned outside Ireland. The Irish branch was responsible only for arranging the

State aid

The Irish tax rulings that were the subject of the European Commission's investigation concerned transfer pricing arrangements, by which profit is allocated between different entities within a corporate group. It is common to seek agreement with tax authorities with respect to these arrangements, and the European Commission has not suggested that they are illegal.

The question was whether the rulings conferred an unfair competitive advantage on Apple, when compared with other undertakings subject to the same rules, by virtue of lowering its tax liability in Ireland. If so, that would comprise state aid under Article 107(1) of the Treaty on the Functioning of the European Union and Apple's Irish subsidiaries would be required to repay the benefit they had received. Under the state aid rules, profits must be allocated between companies in a corporate group in line with arrangements that take place under commercial conditions between independent businesses; that is, the arm's length principle.

procurement and onward sale and supply of goods. The real value of ASI's business was located in its (stateless) head office.

That being the case, the Irish authorities agreed that most of ASI's profits should be allocated to the head office. Only limited amounts, which were calculated by reference to operating costs plus a margin, were allocated to and taxable in the hands of the Irish branch. In 2011, for example, ASI recorded €16 billion of profits but only €50 million was treated as taxable in Ireland.

Apple Operations Europe. AOE, the parent company of ASI, was involved in the manufacture of computer products, as well as providing services to Apple companies in Europe, the Middle East and Africa. AOE was another Irish-incorporated, but "stateless", company and the rulings similarly endorsed the allocation of relatively limited profits to an Irish branch, again calculated by reference to the costs of the branch.

Decision of the Commission

The Commission found that the rulings endorsed an artificial allocation of profits that did not reflect an arm's length basis, and so constituted unlawful state aid (see box "State aid"). For example, the Commission noted that the rulings:

- Were not substantiated by a proper pricing methodology.

- Appeared in some cases to have been reverse engineered to generate a particular income amount.
- Had insufficient regard to the changing economic environment since 1991.

The Commission considered that the rulings endorsed an internal allocation of profits that had no factual or economic justification. The Irish companies' head offices had no substance and only their respective Irish branches had the capacity to generate income from trading. Accordingly, the profits of the Irish companies should have been recorded and taxed in their Irish branches and, by deviating from the arm's length principle, the Irish authorities had selectively benefited Apple. The Commission called on Ireland to recover state aid of up to €13 billion in unpaid tax plus interest.

Apple has, unsurprisingly, strongly criticised the Commission's decision (as has Ireland, concerned about its attractiveness to foreign investors) and has announced that it will appeal.

Consequences of the decision

In a letter dated 11 February 2016, the US Secretary of the Treasury, Jacob Lew, had complained about the sweeping interpretation of EU state aid rules, which could undermine international efforts to curtail the erosion of countries' corporate tax bases. He may have a

point. The Commission has made no secret of the fact that its objective is to compel certain companies to pay their fair share of tax.

The Commission has issued similar decisions in respect of Starbucks in the Netherlands and Fiat in Luxembourg, and has found that Belgium's excess profits tax ruling system constituted state aid (see *News brief "Fiat and Starbucks: tax rulings found to be illegal state aid"*, www.practicallaw.com/7-620-4691). Amazon and McDonalds in Luxembourg are also under investigation by the Commission.

Such unilateral efforts could be counter-productive. The Commission's decision makes bold assertions about the ownership and use of Apple's intellectual property, and how Ireland should have applied its rules, that are not always easy to justify. Meanwhile, jurisdictions such as the US and others might object to the notion that profits from the sale of Apple products across the world are properly allocated to a branch in Ireland.

The Commission has acknowledged that, if profits were taxed elsewhere, that would reduce the taxable profits in Ireland, but it does not adequately explain how this would be consistent with its view that, on an arm's length basis, the profits belong to the Irish branch.

Implications for businesses

The Commission's decision reveals some of the tensions in the ongoing efforts to deal with cross-border taxation. There may be agreement between countries that something needs to be done, but there are strong national interests to be managed and a variety of views as to how it should be done. In the end, the question of international taxation and profit allocation is a wider issue, and the Commission's decision does not indicate a fundamental attack on tax rulings or businesses other than the usual, well-publicised targets.

Nonetheless, a business that depends on transfer pricing rulings may be advised to

consider not just the strength of its underlying transfer pricing analysis, but also how that analysis is presented; for example whether:

- It is substantiated by up-to-date documentation.
- The rulings detail the agreed pricing methodology.
- The rulings have been refreshed on a regular basis, with any new ruling acknowledging changes to the economic environment rather than rubber stamping previous decisions.

At a time when tax arrangements are increasingly being scrutinised, how a business presents its case can be just as important as the arguments it makes.

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