

The EU's €13 Billion Apple tax recovery order: why it was adopted, its broader context, and initial takeaways

The European Commission (EC) adopted a decision requiring Ireland to recover up to €13 billion in taxes from Apple Inc. This amount, the highest recovery order ever imposed as a result of a finding of state aid, could grow considerably as a result of interest being applied. It is not a fine due to be paid to the EU, but the quantum of taxes that in the EC's view Apple should have paid from 2003 to 2014, and which Ireland will now have to claim back. The EC investigation into the advance tax rulings granted to Apple in Ireland has led the EC to conclude that Apple has been benefitting from a tax advantage in breach of EU state aid rules since 1991.¹

Why Apple may now owe €13 billion in back taxes: the EC's Apple decision in a nutshell

The Apple decision follows on from an in-depth investigation started in June 2014 into two tax rulings issued by Ireland in 1991 and 2007. The EC accuses Ireland of having accepted that Apple implements a mechanism that allocated profits to entities that were not subject to tax in Ireland (or elsewhere) without there being any factual or economic justification for doing so. The EC has concluded that Ireland's agreement to reduce the corporate income tax burden of Apple amounted to granting a selective advantage to Apple in violation of the EU's prohibition on state aid.

Apple's corporate structure

Apple has two entities incorporated in Ireland: Apple Sales International and Apple Operations Europe. Each of these entities has a branch taxable in Ireland and a head office not subject to Irish tax. These entities hold the intellectual property rights to manufacture and sell Apple's products outside of the Americas, pursuant to a cost-sharing agreement with Apple Inc. (the US-incorporated parent company). Under the cost sharing agreement, the Irish entities make yearly payments to a cost pool to fund research and development of the intellectual property rights. These payments are deducted from the profits the Irish entities record in Ireland.

According to the EC, Apple's Irish entities record nearly all EU sales, regardless of where customers actually buy Apple products.

Key Issues

- The EC found that Ireland gave Apple illegal tax benefits since 1991
- Apple has to repay €13 billion (plus interest) in tax due over the past ten years
- Other countries could claim that part of this amount should have been paid in their jurisdiction and not in Ireland
- The decision takes into account the US aspects of Apple's tax structure
- The Apple decision confirms the EC's controversial take on state aid and tax rulings

¹ The EC's decision has not yet been made public, but an extensive press release as well as the text of Commissioner Vestager's statement on the case are available on the Commission's web site.

Apple's tax treatment in Ireland

The contested advance tax rulings concern the allocation of profits between the Irish branch and the non-Irish-resident head office of Apple's two Irish entities. The rulings approved a method whereby Apple allocated a major part of its profit to the head offices, which were not subject to tax in Ireland (or elsewhere, according to the EC). Only a fraction of profits was allocated to the branches, which were subject to tax in Ireland. According to Commissioner Vestager, this split resulted in a considerable portion of Apple's sales recorded in Ireland being subject to an effective tax rate in 2001 of 0.05% and 0.005% (or 50 Euro per one million Euro in profits) in 2014.

The EC found that the "head offices" of Apple's Irish entities had no employees, premises or business activities, and considered that allocating the majority of the profits away from the branches, which were effectively responsible for the generation of the profits, to the head offices' level had no economic or factual justification. In the EC's opinion, the majority of the profits should have remained with the branches, and should have been subject to tax in Ireland. As such, the tax rulings endorsing a mechanism that unduly diminished Apple's tax burden in Ireland were considered to provide an unfair advantage to Apple compared to other companies in Ireland and to constitute illegal state aid.

The order to Ireland to recover taxes due based on the finding of state aid

What is state aid in EU law?

- State aid is defined as an advantage (in any form whatsoever) conferred on a selective basis to undertakings by EU Member States.
- State aid is generally prohibited, although certain aid measures are allowed for policy reasons. State measures granting aid should be notified to the EC prior to their implementation for approval.
- If a State adopts a measure without notification, the EC may open an investigation. If it concludes that the measure grants illegal aid, the EC orders the amount of aid to be repaid. The EC does not impose fines.
- The Member State that adopted the measure (and not the alleged recipient of the aid) is the party under investigation. The recipient is merely a third party with limited procedural rights.
- Findings of illegal state aid in the form of tax measures are not new. However, recently the EC has been interpreting existing state aid law and precedent aggressively to apply it to individual tax rulings that had previously been thought to be legal.

The EC ordered Ireland to recover the amount of state aid granted to Apple in the form of unclaimed taxes. While the EC did not set the precise amount of aid to be recovered, it set out the methodology to determine the value of the advantage received by Apple between 2003 and 2014, estimated at up to €13 billion. The exact amount is left for Ireland to determine (in application of the methodology set out by the EC), and Ireland must claim the amount under the applicable national procedures. Pending an appeal before the EU Courts, the claimed amount may be placed in an escrow account. The total amount determined by Ireland must be increased by compound interest due from the time aid was granted to the time that aid is recovered, which could add billions to the amount to be recovered.

According to the EC, the recovery amount could, however, be lower, if Apple's Irish entities were required to increase their payments under the cost sharing agreement, which governs their contributions to the costs of the development of Apple's

intellectual property, for the past years. These amounts are indeed deducted from the profits to be recorded – and taxed – in Ireland.

Furthermore, the EC suggested that the information uncovered by its investigation could result in other countries claiming jurisdiction over Apple's profits. If other countries consider that Apple's profits should have been recorded in their jurisdiction, this could be taken into account to reduce the amount of unpaid taxes that the Irish authorities should claim from Apple.

Context: EC's state aid investigations into tax rulings

The Apple decision fits within a broader policy initiative to counter perceived corporate tax evasion through an aggressive – yet controversial – enforcement of these rules.

The Apple decision is the third decision finding that individual tax rulings amounted to illegal state aid.

In October 2015, the EC ordered Fiat and Starbucks to repay between €20 million and €30 million each of illegal state aid granted by, respectively, Luxembourg and the Netherlands. The EC also concluded that Belgium had adopted an illegal aid scheme (implemented through individual rulings) that benefitted at least 35 companies. Two investigations against tax rulings granted by Luxembourg to Amazon and McDonald's are still ongoing, and the EC is carrying out informal inquiries into a number of other rulings. More state aid cases are likely to be opened against tax rulings granted to multinational companies.

While the EC has been investigating tax rulings concerning the tax treatment of the corporate structure adopted by multinationals, the focus of the investigations varies. Some cases appear to delve into the transfer pricing of intellectual property

licences or other intra-group transactions (Amazon, Fiat, Starbucks), whereas others home in on international tax aspects, such as double non-taxation (McDonald's).

The EC's approach to go after individual tax rulings that concern the intra-group allocation of profits have been widely criticised for a variety of reasons.

From a legal perspective, the EC's reasoning is subject to controversy. Countries like the Netherlands and Luxembourg have a well-established tax ruling practice. Yet the EC does not seem to take into account national administrative practices when assessing whether a given tax ruling selectively favours a company. Under the EC's approach, an individual ruling reflecting a consistent practice of the national tax authority could still be considered as granting a selective advantage to the beneficiary of that ruling. Furthermore, the EC's

reasoning seems to rest on the fact that profits remain untaxed outside of the Member State under investigation. However, in principle, state aid rules aim at preventing a company from being treated more favourably *within* the Member State. It is unclear why the fact that Apple's head offices were not subject to tax outside of Ireland would be relevant to the state aid assessment. The question of taxation of Apple's entities outside of Ireland was not relevant for the assessment of Apple's ruling requests by the Irish tax authorities.

The EC's second-guessing of the national tax authorities' assessment of factually complex individual situations to pursue a general political agenda regarding tax practices is seen by many Member States as a violation of their sovereign powers in the area of taxation. Moreover, the imposition of retroactive recovery orders, going as far as ten years back

EC's state aid investigations into tax rulings to date

Country	Company	Measure	Beginning of investigation	Decision	Amount to be recovered (EUR)
<i>Issued decisions</i>					
Luxembourg	Fiat	2012 ruling	11 June 2014	21 October 2015	20-30 million
Netherlands	Starbucks	2008 ruling	11 June 2014	21 October 2015	20-30 million
Belgium	At least 35 companies	2004 scheme involving tax rulings between 2004 and 2014	3 February 2015	31 January 2016	Over 700 million
Ireland	Apple	1991 and 2007 rulings	11 June 2014	30 August 2016	13 billion
<i>Formally opened investigations</i>					
Luxembourg	Amazon	2003 ruling	7 October 2014	Pending	-
Luxembourg	McDonald's	2009 ruling	3 December 2015	Pending	-

in time, contributes to the perception of legal and regulatory uncertainty for multinational companies paying taxes within the EU. Ireland and Apple claim that they had no reason to suspect that the rulings were unlawful when they were adopted. The first investigations into the illegal state aid nature of the rulings were only opened over a decade after the first ruling was adopted. The amount to be recovered also appears disproportionate when put in perspective: Ireland's *overall revenues from corporation tax* reached a historically high figure of €6.5 billion in 2015. EU Member States fear that the uncertainty and the perceived bias against the US multinationals might reduce direct foreign investment from US companies in the future.

But the heaviest criticism comes from the US. The imposition of a record recovery on Apple will not silence claims that the EU is unduly targeting US corporations. Moreover, profits of certain US companies are subject to a deferred tax claim under the US tax law, and the EC's decisions ordering companies to pay taxes on these

profits in EU Member States are seen as depriving the US of its tax income. On 24 August 2016, the US Treasury issued a White Paper criticising the EC for undermining years of multilateral efforts in tackling tax avoidance and going back on international consensuses on various aspects of taxation, such as transfer pricing. The US Treasury also hints at the possibility of retaliatory action against EU companies.

Takeaways

The EC's previous decisions concerning tax rulings are currently under appeal before the European Courts, and it is likely that either Ireland or Apple or both will appeal the Apple decision. It remains to be seen whether the EU Courts will endorse the EC's expansive interpretation of tax state aid law. The appellate proceedings will however take several years, and in the meantime the EC's approach to state aid and tax should be taken into account by multinationals evaluating their tax structure or considering tax restructurings.

The highest level of risk is clearly where multinationals have obtained transfer pricing agreements or other tax rulings which depart from the letter of local tax law and/or are more favourable than those generally available to other businesses in similar and comparable circumstances. The EC takes the view such agreements and rulings can be revisited on state aid grounds.

The more difficult issue is the broader EC view that state aid can arise from arrangements a multinational company puts in place that can be said not to reflect economic reality, or lack substance, or result in lower effective tax rates than an independent local company in similar circumstances would achieve. It is unclear quite how far this view can be taken – but all groups that have put sophisticated tax structuring in place may wish to consider how vulnerable they would be to arguments of this kind.

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