Who will win the historic international tax war, US(Apple) or EU?

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The fierce tax battle between states was actualized after the mobilization of OECD BEPS Project. On August 30, 2016 the European Commission came to a conclusion that Ireland allowed ‘Apple’ an unjustified tax benefit amounting to €13 billion which is approximately 16 trillion Korean Won. It is the largest tax dispute between states after OECD introduced BEPS Project in order to resolve the tax-avoidance activities caused by Google UK which is a multinational enterprise. The ultimate headquarters of Apple is located in the Unites States. Thus, the severe taxing rights competition between US and EU is expected. Where Apple pays €13 billion of taxes to Ireland, the tax amount which Apple should pay to the US government decreases accordingly. The largest tax war started.

Dr. Han, Sung-Soo who is a Ph.D. in international tax and was admitted to the Washington D.C. Bar gives his opinion concerning what the key issues are and who will win this largest tax war. [Note of Editor]

Largest scale of tax war after BEPS Project

Under Article 107 of Treaty Provisions on State Aid, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods comes under an illegal activity where it affects trade between Member States.

The European Commission concluded that Ireland granted illegal tax benefits to Apple and as a result Apple paid taxes in an effective corporate tax rate of 1 percent on its European profits in 2003 down to 0.005 percent in 2014. Following an in-depth state aid investigation launched in June 2014, the European Commission has concluded that two tax rulings issued by Ireland to Apple have substantially and artificially lowered the tax paid by Apple in Ireland since 1991. That is to say, the European Commission is of opinion that because Ireland allowed state aid to Apple by disregarding Article 107 of Treaty Provisions on State Aid and such state aid activity made it possible for Apple to pay the substantially law tax, the Ireland government should collect the unpaid taxes from Apple.
Tax rulings are against the EU State Aid Rule

Thanks to the two tax rulings, Apple could establish Apple Sales International ("ASI") and Apple Operations Europe ("AOE") which are not in accordance with economic substance. Under the agreed method between Ireland and Apple, most profits were internally allocated away from Ireland to a "head office" within ASI where they remained untaxed. The allocation process was just a paper work. As a result, Apple could pay taxes in an effective corporate tax rate of 1 percent to 0.005% on its European profits.

The European Commission is of opinion that these two tax rulings are directly against the EU State Aid Rule as they grant Apple substantial tax benefits compared to other enterprises doing business in Ireland. Further it noted that as the tax rulings issued by Ireland endorsed an artificial allocation of both ASI and AOE's sales profits to their head offices outside EU member country jurisdiction where Apple's products were actually sold and Apple got the benefits of tax avoidance, it cannot be justified.

The European Commission can only order the recovery of illegal state aid for a ten year period preceding the Commission's first request for information in this matter, which dates back to 2013. Thus, Ireland must recover from Apple the unpaid tax amounting to up to €13 billion plus interest since 2003.

Apple's tax structure in Europe

ASI and AOE are two Irish incorporated companies that are fully-owned by the Apple group, ultimately controlled by the US parent, Apple Inc. They hold the rights to use Apple's intellectual property to sell and manufacture Apple products outside North and South America under a so-called 'cost-sharing agreement' with Apple Inc. Under the this agreement, both ASI and AOE make yearly payments to Apple in the US to fund research and development efforts conducted on behalf of the Irish companies in the US. These payments amounted to about US$2 billion in 2011 and significantly increased in 2014. These expenses, mainly borne by ASI, contributed to fund more than half of all research efforts by the Apple group in the US to develop its intellectual property worldwide. These expenses are deducted from the profits recorded by ASI and AOE in Ireland each year.

ASI is responsible for buying Apple products from equipment manufacturers around the world and selling these products in Europe as well as in the Middle East, Africa and India. Apple set up their sales operations in Europe in such a way that customers were contractually buying products from
Apple Sales International in Ireland rather than from the shops that physically sold the products to customers. In this way Apple recorded all sales and profits stemming from these sales directly in Ireland.

The two tax rulings issued by Ireland concerned the internal allocation of these profits within ASI rather than the wider set-up of Apple's sales operations in Europe. Specifically, they endorsed a split of the profits for tax purposes in Ireland. Under the agreed method, most profits were internally allocated away from Ireland to ASI's head office which has no any substance from the tax perspective.

The "head office" did not have any employees or own premises and is just a kind of paper company. As a result, only a fraction of the profits of ASI were allocated to its Irish branch and subject to taxation in Ireland. The remaining vast majority of profits were allocated to the "head office" where they remained untaxed.

In 2011, for example (according to figures released at US Senate public hearings), ASI recorded profits of US$22 billion (€16 billion) but under the terms of the tax rulings only around €50 million were considered taxable in Ireland, leaving €15.95 billion of profits untaxed. As a result, ASI paid less than €10 million of corporate tax in Ireland in 2011 in an effective tax rate of about 0.05%. In subsequent years, ASI’s recorded profits continued to increase but the profit considered taxable in Ireland under the terms of the tax rulings did not. Thus this effective tax rate decreased further to only 0.005% in 2014.
Position of European Commission and Recovery

The role of EU State Aid Rule is to ensure Member States do not give selected companies a better tax treatment than others, via tax rulings or otherwise. Profits must be allocated between companies in a corporate group, and between different parts of the same company, in a way that reflects economic reality (so-called arm's length principle). The two consecutive tax rulings issued by Ireland endorsed a method to internally allocate profits within ASI and AOE, and it is not in accordance with economic substance. Only the Irish branch of ASI had the capacity to generate any income from trading, i.e., from the distribution of Apple products. Therefore, the sales profits of ASI should have been recorded with the Irish branch and taxed there. The only activities that can be associated with the "head offices" should be limited decisions taken by its directors (many of which were at the same time working full-time as executives for Apple Inc.) on the distribution of dividends, administrative arrangements and cash management. The same principle should be applied also to AOE.

This decision does not call into question Ireland's general tax system or its corporate tax rate. Furthermore, Apple's tax structure in Europe as such, and whether profits could have been recorded in the countries where the sales effectively took place, are not issues covered by EU state aid rules.

As a matter of principle, EU state aid rules require that incompatible state aid is recovered in order to remove the distortion of competition created by the aid. There are no fines under EU State aid rules and recovery does not penalize the company in question. It simply restores equal treatment with other companies.

The Commission can only order recovery of illegal state aid for a ten-year period preceding the Commission's first request for information in this matter, which dates back to 2013. Ireland must therefore recover from Apple the unpaid tax for the period since 2003, which amounts to up to €13 billion, plus interest. The recovery period stops in 2014, as Apple changed its structure in Ireland as of 2015 and the ruling of 2007 no longer applies. The amount of unpaid taxes to be recovered by the Irish authorities would also be reduced if the US authorities were to require Apple to pay larger amounts of money to their US parent company for this period to finance research and development efforts.

All Commission decisions are subject to scrutiny by EU courts. If a Member State decides to appeal a Commission decision, it must still recover the illegal state aid but could, for example, place the recovered amount in an escrow account pending the outcome of the EU court procedures.
Since June 2013, the Commission has been investigating the tax ruling practices of Member States. It extended this information inquiry to all Member States in December 2014. In October 2015, the Commission concluded that Luxembourg and the Netherlands had granted selective tax advantages to Fiat and Starbucks, respectively. In January 2016, the Commission concluded that selective tax advantages granted by Belgium to least 35 multinationals, mainly from the EU, under its "excess profit" tax scheme are illegal under EU state aid rules. The Commission also has two ongoing in-depth investigations into concerns that tax rulings may give rise to state aid issues in Luxembourg, as regards Amazon and McDonald's.

This Commission has pursued a far-reaching strategy towards fair taxation and greater transparency and we have recently seen major progress. Following our proposals on tax transparency of March 2015, Member States reached a political agreement already in October 2015 on automatic exchange of information on tax rulings.

**Could we forecast the outcome of court litigation?**

The European Commission ordered the recovery of illegal state aid against Ireland according to the EU State Aid Rule. Under Article 107 of Treaty Provisions on State Aid, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods comes under an illegal activity where it affects trade between Member States.

The European Commission is of opinion that as Ireland granted more favorable tax benefits (state aid) to Apple than other enterprises in a way which is not in accordance with the above EU State Aid Rule and it distorted competition within the internal market, Ireland must make a recovery to maintain a status of fair competition according to the related rules.

The fact that Ireland granted tax benefits to Apple can come under ① the "aid through States resources" and the fact that Ireland helped Apple's business activities through tax benefits can come under ② the "activities favouring certain undertakings or the production of certain goods". Accordingly, where two factors are satisfied, we can come to a conclusion that the competition within the internal market was distorted.

The European Commission does not call into question Ireland's general tax system or its corporate tax rate. Furthermore, it made clear that Apple's tax structure in Europe as such, and whether profits could
have been recorded in the countries where the sales effectively took place, are not issues covered by EU state aid rules. That is to say, the European Commission is of opinion that the purpose of EU State Aid Rule is to regulate the activities which distort competition by favouring certain undertakings or the production of certain goods. Thus, it does not raise an issue against the normal tax principles which are generally acknowledged.

As the tax law and the EU State Aid Rule are different with each other in light of their character, one cannot infringe upon the area of another. Thus the European Commission's issue approach is persuasive from the legal perspective.

What the European Commission calls into question is not the Irish tax law itself. Rather, the European Commission raises an issue against the activities of granting a special benefit to a specific taxpayer through a tax ruling that allows the tax benefit which is not in accordance with the EU State Aid Rule. If Ireland does not make a clear rebuttal against the position of the European Commission, it is expected that Ireland will experience a very difficult litigation process in the court.

Ireland could argue it should not be subject to the EU State Aid Rule since the tax ruling is related to the construction of the Irish tax law and the construction of the Irish tax law is the inherent authority of the Irish government. However, that ASI and AOE allocated the most of profits to their head offices which have no any employees or premises cannot be justified from the standpoint of international tax principle. That is, the issuance of tax rulings by the Irish tax authority which allows an arbitrary allocation of profit between a branch and a head office is not in accordance with the international tax principle.

The fact that the Irish tax authority did issue the tax rulings which are not in accordance with the international tax principle can be regarded as intentionally having granted tax benefits (State Aid) to Apple. Thus, it seems that the court would not accept Ireland’s such argumentation.

According the press report, Apple currently owns US$2,150 of cash overseas, not within the United States. If Apple remits this cash to the United States, it must pay taxes according to the US tax law. It is thought that Apple can own a huge amount of cash overseas since the Controlled Foreign Corporation (CFC) Rule of the US IRC does not apply to the overseas affiliates and as a result the profits of these affiliates are not subject to taxation within the United States.

If the overseas affiliates of Apple were subject to taxation within the US under the CFC Rule and paid
taxes to the US government every year, the European Commission would not have made a recovery order against the Irish government because there would be no effect of tax benefit on Apple in case where the US CFC Rule is applied to both ASI and AOE. If the tax benefit through the tax rulings were not available, Apple would not have planned this kind of unreasonable cross-border transactions from the beginning.

Seeking a solution through the mutual agreement procedure between the US and Ireland

Where the Irish government loses the case in the court, it must collect the unpaid taxes from Apple and Apple could not help paying taxes. However, the European Commission stated that the amount of unpaid taxes to be recovered by the Irish authorities would also be reduced if the US authorities were to require Apple to pay larger amounts of money to their US parent company for this period to finance research and development efforts. Thus, it is thought that the European Commission suggested a kind of alternative solution for Ireland to avoid the worst situation.

ASI and AOE hold the rights to use Apple's intellectual property to sell and manufacture Apple products outside North and South America under a so-called 'cost-sharing agreement' with Apple Inc. Under this agreement, both ASI and AOE make yearly payments to Apple in the US to fund research and development efforts conducted on behalf of the Irish companies in the US. Thus, the European Commission is of opinion that if the Irish government acknowledges that ASI and AOE must have paid more R&D expenses to Apple Inc., the taxable income of both entities decreases and the tax amount to be paid to the Irish government can also decrease.

Accordingly, in case where this case boils down to the problem of determining the appropriateness of cross-border transaction between related parties, the tax authorities of both the US and Ireland can perform a negotiation according to the mutual agreement procedure of the US-Ireland tax treaty to determine the arm's length profit of ASI and AOE. Thus, the recovery amount from Apple can be decreased depending upon the results of negotiation.

Lesson of this historic case

The European Commission made a recovery order by applying the EU State Aid Rule, but not a tax law or a tax treaty. However, as the state aid through tax benefit ultimately distorts a fair competition within the internal market, the European Commission is giving a warning that multinational enterprises must perform cross-border transactions according to a fair and established international
rule. As the government of each state protects residents or enterprises within its territory, they pay taxes to the government as a consideration of its protection. Accordingly, regardless of whether it is a domestic enterprise or a foreign enterprise, they should pay the same tax if they earn the same income. This is the equity of taxation which a democratic tax system should pursue. Otherwise a fair competition can be impaired.

In the past, only the equity of taxation between taxpayers was emphasized. But we are now in a stage where we should actively discuss the equity of taxation between states as the global community is being changed into the one-day life zone and the active cross-border transactions by multinational enterprises significantly affect the taxing rights of related states.

Along with the introduction of BEPS Project whose purpose is to pursue the transparency and reasonableness of cross-border transactions, multinational enterprises should make much more efforts to maintain the appropriateness of cross-border transactions. If they don't appropriately cope with the changing circumstance, they can face the severe challenge from related tax authorities.

As Apple has enough funds and will be strongly supported by the US government, it is thought that Apple would be able to manage the worst situation. Nevertheless, its business image can be damaged greatly. I wonder what if our Korean multinational enterprises are placed under this kind of difficult situation. If they lack transparency, it would be very difficult for them to overcome a risky situation caused by the BEPS Project.

In case where multinational enterprises performs the unreasonable cross-border transactions and receive suspicious and detestable attentions from the tax authorities of several states, they could experience fatal damage. Accordingly it is very important to clearly understand the international rule and actually implement it into their business activities. It is the only way to improve the competitiveness of enterprises in the global age. [THE END]