The Largest Ever Tax Fine Overturned by the European General Court : A Case Study

On 15 July 2020, the European General Court (Seventh Chamber, Extended Composition) pronounced the much awaited Apple-Ireland judgement overturning the entire tax fine imposed by the European Commission amounting to Euros 13 billion (approximately INR 1.15 lac crores) on the ground that the European Commission failed to demonstrate that an unfair state aid/ selective tax advantage under article 107(1) of the Treaty on the Functioning of the European Union ("TFEU") was granted by the Irish tax authorities to the Irish subsidiaries of Apple Inc. namely Apple Sales International ("ASI") and Apple Operations Europe ("AOE"). Read on...

CA. Mit Gaglani

The author is a member of the Institute. He can be reached at mit.gaglani@gmail.com and eboard@icai.in

To put the facts in right perspective for further discussions, the decision elaborately lays down the history of the Apple Group. It mentions that the Apple Group, founded in 1976 and headquartered in Cupertino, California, U.S is engaged in the designing, manufacturing and marketing of personal computers, mobile communication and media devices and portable digital music players, as well as in sale of related software, services, peripherals, networking solutions and third party digital content and applications worldwide. The Group sells its products worldwide through its online stores, retail stores, third-party wholesalers, resellers, and direct sales force.

Apple Inc. incorporated two subsidiaries in Ireland namely ASI and AOE. While these two subsidiaries were incorporated in Ireland, they were not tax residents of Ireland.

Through a cost sharing arrangement between Apple Inc and ASI and AOE; ASI and AOE agreed to share the research and development costs in relation to the technology/

intellectual property ("IP") incorporated in the products of the Apple Group. In return, Apple Inc. granted royalty free licenses of these IPs to ASI and AOE to manufacture and sell the products of the Apple Group to third party customers in Europe, Middle-East, India and Africa ("EMEIA") as well as Asia-Pacific ("APAC") regions, i.e., practically the entire world except North and South America. The parties to the agreement were required to bear risks resulting from the risks, the main risk being the obligation to pay the development costs relating to the Apple Group's rights.

ASI and AOE further set up branch offices in Ireland

Key functions of ASI's branch included procurement of finished goods of Apple Group from related party as well as third party manufacturers, sales and distribution of those goods under framework agreements (negotiated and concluded outside Ireland), logistics management and providing after sales services to customers.

Key functions of AOE's branch office included assembly and manufacture of iMAC desktops, Macbook laptops and computer accessories and their sale to related party distributors in the assigned territory. Key functions within that branch include production planning and scheduling, process engineering, production and operations, quality assurance and quality control, and refurbishing operations.

ASI and AOE sought two tax rulings ("the disputed tax rulings") from the Irish Tax authorities in 1991 and subsequently updated in 2007 which determined the profits attributable to the activities of the branch offices of ASI and AOE and hence, to be taxed in Ireland. The profit attribution mechanism which was proposed by ASI and AOE and accepted by the Irish tax authorities in these rulings was not based on the arm's length principles. However, these rulings were given to ASI and AOE on the basis of certain advance tax rulings given by the Irish tax authorities to other taxpayers in the past.

The European Commission ("The EC" or "The Commission") opened its investigation against the disputed tax rulings which were applicable during the period 1991-2014 and alleged that through the disputed tax rulings, the Irish Tax authorities had granted an unfair state aid/ selective tax advantage to ASI and AOE for the purposes of Article 107(1) of the TFEU. The EC's allegation was mainly based on the following grounds:

- Through the disputed tax rulings, the Irish Tax authorities agreed to allocate all significant decision making and management functions (and the corresponding profits attributable to these functions) in relation to exploitation of IPs to the head office of ASI and AOE which was for all purposes "stateless", i.e., existed only on paper and had no staff/operating capacity to perform these functions. Only a minuscule amount of profits was attributed to the activities of the branches of ASI and AOE and hence, was taxed in Ireland.

- The argument of the Irish Tax authorities that the decision making/ management functions in relation to the exploitation of these IPs as well as the activities of the branches were undertaken by the Board of Directors of ASI and AOE ("not Irish residents") cannot be accepted as the minutes of the board meetings did not reflect any such decision making functions undertaken by the Board of Directors.

- In the absence of any staff/ operating capacity in the head office of ASI and AOE, the significant decision making/management/ control functions in relation to exploitation of these IPs and the corresponding profits attributable to the same should have been allocated to the branch offices of ASI and AOE and hence taxed in Ireland.

- Through the disputed tax rulings, the Irish Tax authorities accepted a level of profits chargeable to tax for the branches of ASI and AOE which did not reflect a market based outcome as envisaged under the arm's length principle as stated

under the OECD Guidelines and further the allocation was not in accordance with the Authorised OECD Approach on attribution of profits to a permanent establishment. The Commission argued that a comparable enterprise, operating under similar market conditions and covered under the "normal" taxation regime of Ireland would have earned more profits.

- The arm's length principle can be regarded as a benchmark to assess as to whether an unfair state aid or a selective tax advantage was granted by a member state of the EU for the purposes of Article 107(1) of the TFEU (As per the judgment in the case of Belgium and Forum 187 v/s the Commission).

- Lastly, the Commission argued that the allocation mechanism which was agreed in the 1991 and 2007 rulings between the Irish Tax authorities and ASI and AOE was ad-hoc and not backed by any scientific analysis. Also, in the *ex-post facto* reports submitted by ASI and AOE to justify that the profit allocation was at arm's length, there were three methodological errors namely selection of branch offices as the tested parties, selection of berry ratio as the profit level indicator ("PLI") for ASI's branch and selection of operating profit/ operating costs (excluding the cost of materials) as the PLI for AOE's branch (*this argument was a subsidiary argument of the Commission).*

On the other hand, the Irish Tax authorities (supported by ASI and AOE) contended the following:

- As per the European Union ("EU") law, corporate taxation regime falls within the purview of a member state of the EU (Ireland in this case) and therefore, by interfering in a corporate taxation matter of Ireland, the Commission has breached the EU law.

- The disputed rulings were issued to ASI and AOE in 1991 and 2007 respectively and the corporate taxation regime of Ireland did not include the arm's length principle at that time *(Transfer Pricing provisions were formally introduced in Ireland and embedded in the Irish Taxation Regime in 2010).*

- The OECD Guidelines only serve as guidance and are not mandatorily required to be followed by the Irish Tax authorities.

- Without prejudice to the above, The Authorised OECD Approach on profit attribution requires that profit attribution to the activities of a permanent establishment (branch in this case) should be done on the basis of functions performed, assets employed and risks assumed("FAR") by the respective branch. The entire case of the EC was based on an assumption that since the head office of ASI and AOE had no operating capacity/physical staff, the decision making/ management/control functions in relation to IPs must have been necessarily performed by their branch offices without actually proving with evidences that these functions were performed by the branches. The Commission therefore adopted the "exclusion" approach which is neither permissible under the Irish Tax regime nor envisaged under the OECD Guidelines.

- All strategic functions in relation to the IPs namely research and development facilities management, brainstorming in relation to new/enhanced features of the new product/model, design of the product/ model, functionalities of the software to be embedded in the product etc. were taken by Apple Inc (based in California). The management decisions in relation to exploitation of these IPs and executing the strategies formulated by Apple Inc. were taken by the Board of Directors of ASI and AOE (not residents of Ireland) and just because these decisions were not reflected in the minutes of the board meetings, it cannot be assumed that these decisions were not taken by the Board.

- As per the FAR profile of the branch offices of ASI and AOE (as highlighted in the ad-hoc reports submitted by ASI and AOE), it cannot be alleged that significant IP related functions were performed by these branches and hence, more profits should have been allocated to the activities of these branches. Moreover, as per the ex-post facto ad-hoc reports submitted by ASI and AOE, the profit allocation was at arm's length.

- In relation to the subsidiary line of argument regarding the methodological errors in relation to selection of branches as tested party and choice of PLI, again the case of EC was based on the assumption that complex functions were performed at the branches and hence they couldn't be selected as tested parties and this assumption doesn't hold good. Further, the EC in its analysis changed the PLI of ASI's branch from Berry ratio to OP/Sales and the PLI of AOE's branch from OP/VAE to OP/TC without demonstrating as to why the PLIs selected by ASI and AOE were incorrect.

- Having regard to the above, since the profits allocated towards the activities of the branches of ASI and AOE were as per the activities undertaken at these branches, section 25 of the Taxes Consolidation Act, 1997 (Corporate Tax Regime of Ireland) was complied with and hence, no further profit attribution was essential.

The European General Court after observing the arguments of both sides concluded the following:

- Article 107(1) of TFEU gives the Commission the right to check whether the level of profits allocated to the branches of the non-resident entities would correspond to the level of profits that would have been earned had the activity been carried out under normal market conditions.

- The arm's length principle and the Authorised OECD approach were tools used by the Commission to assess whether the profits attribution made to the branches of ASI and AOE was a reasonable approximation of a market based outcome and whether the attribution was made on the basis of the FAR profiles of these branches. The arm's length principle as well as the Authorised OECD approach have international consensus and hence the Commission could not be criticized for using these tools.

- However, the arguments of the Irish Tax authorities (supported by ASI and AOE) were well founded on the aspect that the entire case of the Commission was based on an assumption that merely because the head office of ASI and AOE had no employees/staff/operating capacity, all significant functions in relation to exploitation of these IPs and the corresponding profits in relation to the same should have been allocated to the activities of the branches. The Commission failed to demonstrate that strategic functions in relation to IPs were actually performed by the branches of ASI and AOE. Therefore, in relation to its primary line of reasoning, the Commission failed to prove that the profit attribution as per the disputed tax rulings did not correspond to the FAR profiles of these branches and thus it failed to demonstrate that an unfair state aid a selective tax advantage for the purposes of Article 107(1) of TFEU was granted by the Irish Tax authorities to ASI and AOE.

- As far as the subsidiary line of argument of the Commission is concerned, the arguments of the Irish Tax authorities (supported by ASI and AOE) were again well founded on the aspect that the Commission argued that the branches could not be selected as tested parties only on the assumption that they performed complex functions (which the Commission failed to demonstrate as highlighted above). Further, as far as the choice of PLIs is concerned, the Commission asserted that OP/Sales was the right

PLI for ASI's branch and OP/Total Cost was the right PLI for AOE's branch without demonstrating as to why the PLIs adopted (Berry ratio for ASI's branch and OP/VAE for AOE's branch) in the ad-hoc reports furnished by ASI and AOE were incorrect and unreliable.

- Moreover, even if according to the Commission these methodological errors existed, still the Commission failed to conduct its analysis in a way to demonstrate that on account of these errors there was a reduction in the taxes actually paid by ASI and AOE as compared to what should have been paid under normal rules of taxation without the issue of these disputed rulings. Lastly, mere methodological errors cannot be used as basis to claim that an unfair state aid/selective tax advantage was granted by the Irish Tax authorities to ASI and AOE.

Concluding remarks/key takeaways:

- Despite the fact that Euros 13 billion (approximately INR 1.15 lac crores) plus interest on the same could have gone a long way in boosting the economy of Ireland, Ireland still appealed against the decision of the Commission since Ireland was clear that this appeal was to protect the sovereign status of Ireland as far as its taxation regime was concerned.

- While, the judgment was pronounced in favour of Irish tax authorities (supported by ASI and AOE), the General Court in its ruling highlighted that article 107(1) gave the right to the Commission the right to check whether the level of profits allocated to the branches of the non-resident entities would correspond to the level of profits that would have been earned had the activity been carried out under normal market conditions. This indicates that even in the future, the Commission can interfere in the corporate tax regime of its member states by triggering article 107(1) of TFEU.

- The judgment was pronounced in favour of the Irish Tax authorities because the Commission failed to discharge its burden of proof, i.e., it failed to demonstrate that management/control/decision making functions in relation to exploitation of IPs were being performed by the branch offices of ASI and AOE. Last year, the arguments of the Commission in the Starbucks case were dismissed by the General Court on a similar footing, i.e., the Commission failed to discharge its burden of proof as it failed to demonstrate that an unlawful state aid under article 107(1) of TFEU was granted by the Dutch Tax authorities to Starbucks.

- This case leaves us with a couple of interesting questions. In which country were profits attributable to critical IP exploitation functions taxed? (If not Ireland). Were these profits even taxed at all?

References:

- *Judgment of the General Court (Cases T-778/16 and T-892/16)*