TAX ALERT
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The Apple (State Aid) Case: Ireland and Apple vs. European Commission (T-778/16 and T-892/16)

A. Background: the European Commission decision

Following an in-depth state aid investigation launched in June 2014, the European Commission ("**EU Commission**") has concluded, in its decision SA. 38373 of 30 August 2016 ("**Decision**"), that two tax rulings issued by Ireland to Apple (in 1991 and 2007) have substantially and artificially lowered the tax paid by Apple in Ireland since 1991.

The rulings at hand endorsed a way to establish the taxable profits for two Irish incorporated companies of the Apple group (namely Apple Sales International – "**ASI**" and Apple Operations Europe – "**AOE**"), which – according the EU Commission view – did not correspond to economic reality.

Indeed, at the time of the 1991 and 2007 tax rulings, according to Irish Revenue standpoint, ASI and AOE were not considered to be tax resident in Ireland. In this respect, as non-tax resident companies, ASI and AOE were liable to pay corporate tax in Ireland on their chargeable profits only (i.e. on income arising directly or indirectly from the Irish branches).

Moreover, under Irish Revenue's approach, Apple's intellectual property ("**IP**") licenses held by ASI and AOE were not allocated to the Irish branches for tax purposes. This was on the basis that the Irish branches did not undertake any management activities relating to the IP, and instead the research and development and the management of Apple's IP was directed from Apple's headquarters in the U.S.A..

Notwithstanding the above, according to the different position adopted by the EU Commission, as reflected in the Decision:

(i) almost all sales profits recorded by the two companies (ASI and AOE) were internally attributed to "head offices" existing only on paper and not subject to tax in any country under specific provisions of the Irish tax law;

(ii) Apple's IP licenses should be allocated to Irish branches (i.e. it was not appropriate for

the IP licenses to be allocated outside of Ireland);

(iii) the approach and the profit allocation methods adopted in the tax rulings led to significant underestimation of AOE and ASI's taxable profit in Ireland, not in line with the arm's length principle;

(iv) as a result of the allocation method endorsed in the 1991 and 2007 tax rulings, Apple only paid an effective corporate tax rate that declined from 1% in 2003 to 0.005% in 2014 on the profits of ASI.

On the basis of the foregoing, the EU Commission concluded in its Decision that the "selective" tax treatment of Apple in Ireland is illegal under European state aid rules (i.e. Article 107 TFUE), because it would have given Apple a significant advantage over other businesses that are subject to the same national taxation rules. In this respect, according to the EU Commission Decision, Ireland should have recovered the unpaid taxes in Ireland from Apple for the years 2003 to 2014 (of up to €13 billion, plus interest).

The Decision has been appealed both by Ireland (Case T-778/16) and the two Apple Irish incorporated companies (Case T-892/16) before the General Court of the European Union ("**General Court**"), which yesterday has issued its relevant decisions.

B. The appeal proposed by Ireland and Apple group companies (ASI and AOE)

In supporting their actions and requesting the annulment of the Decision before the General Court, Ireland, ASI and AOE rose 9 and 14 pleas in law respectively, which overlap for the most part. Such pleas in law were aimed to counteract the three "line of reasonings" developed by the Commission in its Decision, according to which:

(i) Irish tax authorities have granted ASI and AOE an advantage as a result of <u>not</u> having allocated the Apple Group IP licences held by ASI and AOE, and, consequently, all of ASI and AOE's trading income, obtained from the Apple Group's sales outside North and South America, to their Irish branches (so called "primary line of reasoning");

(ii) even if the Irish tax authorities had been correct in accepting the assumption that the Apple IP licences held by ASI and AOE had to be allocated outside Ireland, methodological errors in the two contested tax rulings have led to a reduction in ASI and AOE's chargeable profits in Ireland (so called "subsidiary line of reasoning");

(iii) even assuming that the application of section 25 of the Irish Taxes Consolidation Act 1997 ("**TCA 97**") was not governed by the arm's length principle, the contested tax rulings were the result of discretion exercised by the Irish tax authorities and, accordingly, ASI and AOE have been granted a "selective advantage" (so called "alternative line of reasoning")

Among the arguments raised against the above EU Commission's line of reasonings, Ireland, ASI and AOE challenged: (i) the assessment of the existence of a "selective advantage" and the assessment relating to the concept of "State intervention"; (ii) the incorrect identification by the EU Commission of the reference legal framework, also with respect to the application of the arm's length principle and (in any case) the appropriate application of the OECD guidelines; (iii) the assessments relating to the "selective nature" of the contested tax rulings; (iv) the EU Commission's assessments relating to activities within the Apple group.

C. The General Curt judgment

The judgment issued yesterday annuls the contested Decision because – according to the General Court – the EU Commission did not succeed in showing to the requisite legal standard that there was an advantage for the purposes of Article 107(1) TFEU.

Indeed, in General Court view, the Commission was wrong to declare that ASI and AOE had been granted a "selective economic advantage" and, as a consequence, a State aid.

More in detail, the General Court found that the Commission incorrectly concluded, in its "primary line of reasoning", that Ireland had granted to ASI and AOE an advantage as result of not having allocated to their Irish branches certain Apple IP licenses and all ASI and AOE's profits deriving from Apple's sales outside Americas. Indeed, under General Court conclusion, the EU Commission – instead of following an "exclusion" approach based on the lack of employees and "physical presence" to manage the IPs – should have shown that those profits represented the value of the activities actually carried out by the Irish branches themselves, in view of, inter alia, the activities and functions actually performed by the Irish branches (of ASI and AOE), on the one hand, and the strategic decisions taken and implemented outside of those branches, on the other (i.e. a profit allocation on the basis of a proper factual and functional analysis).

In addition, the General Court also concluded that the EU Commission did not succeed in demonstrating, in its "subsidiary line of reasoning", methodological errors in the contested tax rulings, which would have led to a reduction in ASI and AOE's chargeable profits in Ireland. In this respect, it's worth noting as the General Court has outlined that the incomplete and occasionally inconsistent nature of the contested tax rulings and the defects identified by the EU Commission are not, in themselves, sufficient to prove the existence of an advantage for the purposes of Article 107(1) TFEU.

Finally, the General Court considered that the Commission did not prove, in its "alternative line of reasoning", that the contested tax rulings were the result of "discretion" exercised by the Irish Revenue and that, accordingly, ASI and AOE had been granted a "selective advantage".

D. Preliminary remarks

Notwithstanding the positive outcome of this judgment for Apple, it's worth noting how the General Court has endorsed the EU Commission's assessments relating to "normal taxation" under the Irish tax law, in particular having regard to the tools developed within the OECD, such as the arm's length principle, in order to check whether the level of chargeable profits endorsed by the Irish tax authorities corresponds to that which would have been obtained under market conditions.

In this respect, considering the lack of an explicit reference of section 25 of TCA 97 to the "arm's length principle", we have to note how this approach could lead to higher risk of "uncertainty" for taxpayers, although this judgement is related to a tool as the "tax ruling" that is usually claimed in order to seek tax "certainty".

On the other hand, is however appreciable how the General Court has carried out a deep technical analysis in order to check whether a "selective advantage" was granted (through the two tax rulings) by the Irish Revenue to ASI and AOE.

By way of example, is interesting how in the Decision of the EU Commission also contended, among other things, the choice of "operating costs" as profit level indicator and the use of the "Berry ratio". In this respect, as a result of the analysis carried out, the General Court has concluded that "*conditions for applying the Berry ratio, as stated in the OECD Transfer Pricing Guidelines, are satisfied in the case of ASI's Irish branch*" (par. 372).

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