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Apple's tax affairs spark a transatlantic face-off

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Washington calls foul over the EU inquiry — amid anger over a \$1tn offshore cash pile



To remind herself that she will always upset someone with her rulings, Margrethe Vestager keeps a ceramic hand with a raised middle finger on her desk. It was sent to her by an angry trade union during her time as economy minister of Denmark.

Since she became the EU's competition enforcer in late 2014, those irate adversaries have only become more powerful. She is now facing a showdown with the world's richest company and most powerful government.

On January 21, Apple's chief executive, Tim Cook, made a personal appeal to Ms Vestager in Brussels. His aim was to deflect her from issuing a ruling against the technology company's tax arrangements in Ireland, suspected of saving the company billions in international tax payments. If Apple is found to have benefited from a sweetheart deal, in contravention of EU competition rules, it could have to pay back billions of euros of underpaid tax to Dublin.

According to those briefed on the meeting, it was a heated, testy encounter. Mr Cook took aim at the "fairness" with which Ms Vestager conducts her cases — a point of pride for her — and argued that Brussels was pursuing a legally baseless raid on Apple's \$200bn

international cash pile. Mr Cook complained that the EU's probe into Apple undermined the very principles that Europe claimed to stand for.

The impassioned executive from Alabama seemed frustrated by the cool imperturbability of the Dane. She, in turn, resented his interruptions.

Only days after Mr Cook's visit, Jack Lew, the US Treasury secretary, and his team turned their ire on Ms Vestager. They accused the EU of conducting a crusade against tax avoidance that would set "disturbing international tax policy precedents" and argued that its methodology raised "serious concerns about fundamental fairness".

The thrust of the US allegation was that European probes into Apple, Amazon, Starbucks and McDonald's unfairly singled out American companies. They also accused Ms Vestager of applying laws retroactively and of improperly targeting funds that were owed to the US Treasury. There was a danger that the EU's tax campaign could deter US investment in Europe, they warned.

Ms Vestager has already publicly rejected Mr Lew's accusations, but the two are likely to clash again when they meet in Washington later this week in what will probably be the last big diplomatic set piece before the European Commission makes its decision on Apple. A ruling is expected this spring.

The scale of the US lobbying is unsurprising. While the EU's campaign against tax avoidance has drawn in dozens of companies, it is Apple that risks ripping open deeper fissures in the relationship between Washington and Brussels. In part, the sensitivity surrounding Apple is because of the sums at stake, with analysts estimating clawbacks of \$8bn or even more.

Apple itself has warned of unquantifiable but potentially "material" financial damage from the case. And that is before attempting to calculate any reputational hit at a time when Mr Cook is tying Apple's brand with civic and environmental responsibility.

Politically, the fight cuts to the heart of discontent about the size of America's offshore cash pile, and who will ultimately tax it. According to Moody's, a credit-rating agency, the offshore balance for all US companies has ballooned to \$1.1tn, with the largest shares belonging to Apple, Microsoft, Google, Cisco and Oracle.



The Americans argue that European governments have no right to target most of this cash mountain, saying that the tax due on it is simply “deferred”. This means it is logged in the accounts of US companies and, at some unspecified date, will have to be repatriated for taxation.

Ms Vestager gives short shrift to the accusations that she is anti-American, saying she does not care where any company is from, as long as it “plays by the rules”.

Anneliese Dodds, the European parliament’s rapporteur on corporate tax, agrees that Washington’s complaint is wide of the mark, and points out that EU governments have also been forced to recoup money from Italian carmaker Fiat, German chemicals company BASF and Belgium-based multinational brewer Anheuser-Busch InBev.

“The problem here isn’t America versus Europe — **it’s giant multinational firms versus small domestic businesses,**” she says. “No government should be cooking up a sweetheart tax deal for any company — be they American, British or Martian — that they don’t then offer to everyone else.”

Still, the Apple decision could easily jeopardise the relationship between Brussels and Washington. Other flashpoints include a landmark antitrust case against Google and tensions between trade officials over how to strike back against Chinese dumping.

‘Incorporated’ but not ‘resident’

Beyond the **transatlantic politics,** the case will ultimately hinge on arguments over the **EU’s contentious methodology.**

The chief peculiarity of the tax dossier is that Brussels is taking a novel — some would say revolutionary — approach to recouping underpaid tax. Essentially, the European Commission is defining preferential **tax deals granted to multinationals as state aid offered** by EU governments. If it can prove that Ireland offered Apple terms that other companies could not ordinarily expect, this would represent a form of illegal subsidy. Ireland would then have to claw back up to a decade of underpaid tax.



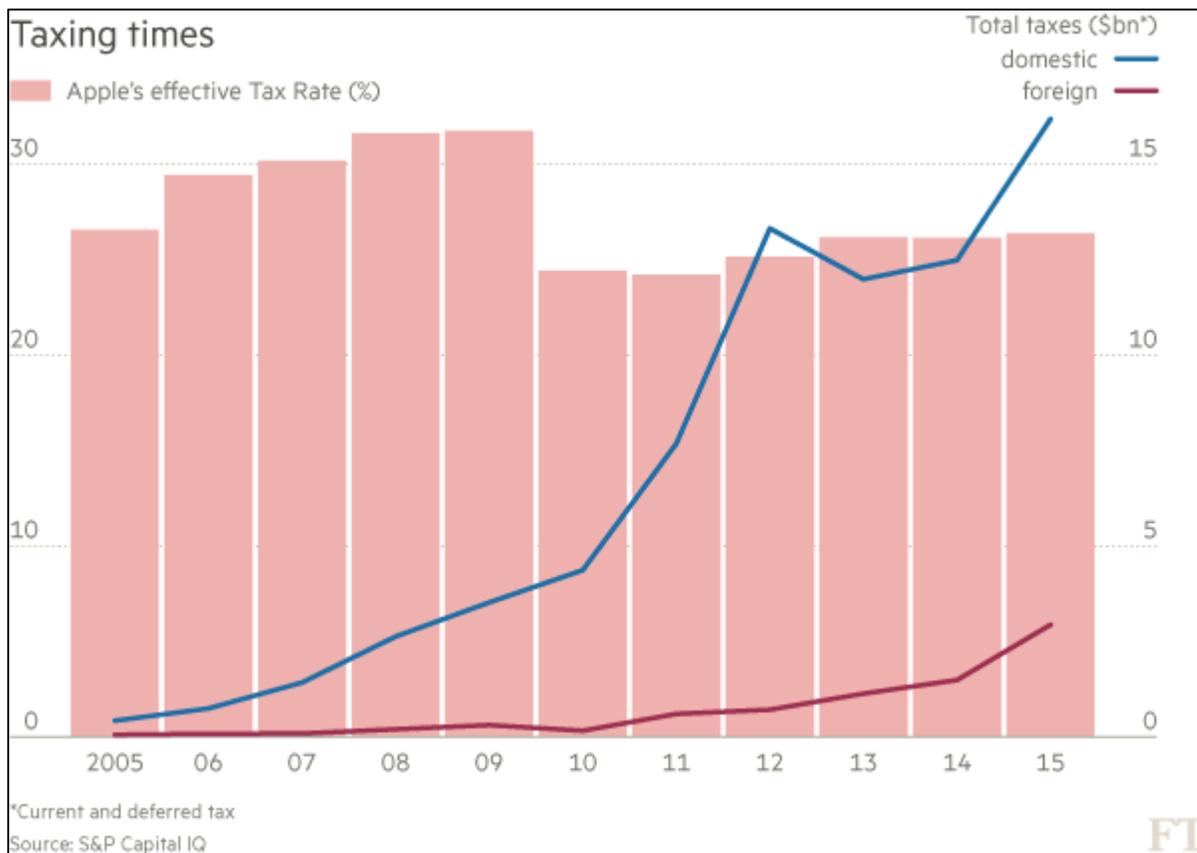
Redefining the tax deals as state aid allows Brussels to delve into fiscal policy, which has normally been the sacrosanct preserve of national capitals. Caught off guard by this

approach, Apple and the US accuse Brussels of using the **state aid rules** retroactively to attack a tax deal that was made in a perfectly legal way with Dublin.

Brussels rejects the accusation that it is acting retroactively. It argues that state aid rules have been around for a long time and that there are precedents, although admittedly not in such high profile cases, for using them to fight tax avoidance.

Mr Cook bristles at any assertion that his Irish business is a brass-plaque enterprise designed to avoid tax. Apple has been in Ireland since 1980, has its European headquarters in Cork and employs more than 5,000 people in the country — although, crucially for its legal argument, no one involved in developing products.

The commission’s case zeros in on arrangements struck with two Apple companies in 1991: Apple Operations Europe and Apple Sales International. These are described as being “incorporated” in Ireland but not resident there for tax purposes.



These kinds of incorporated companies do not pay a regular corporate tax rate, 12.5 per cent in Ireland’s case, but can create a special tax base with the host country.

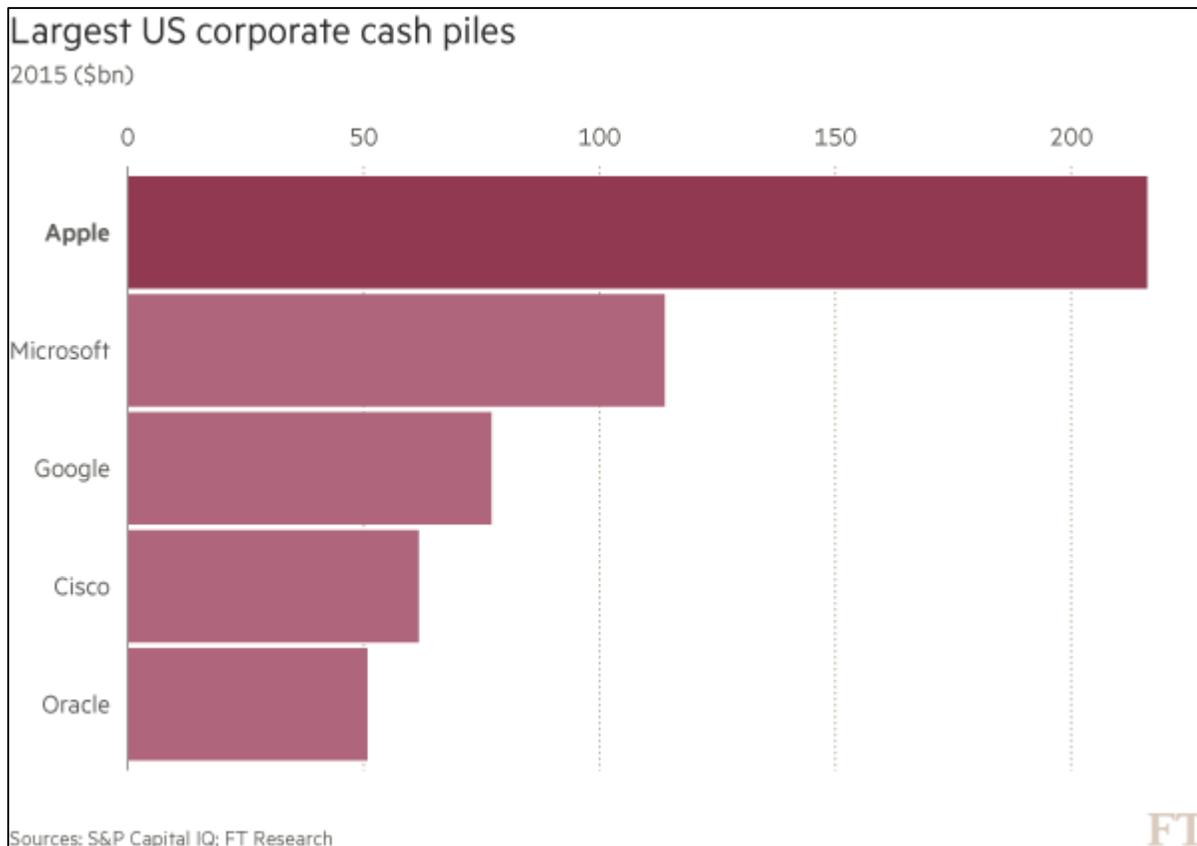
According to a document published by the commission, Apple’s tax adviser helped draw up the arrangement in 1990, pushing for a low tax base with the veiled threat that the company was “reviewing its worldwide operations”. The discussion then focused on locking in a special

\$30m-\$40m bracket on which Apple would pay tax. Apple’s tax adviser “confessed that there was no scientific basis for the figure”, according to the commission’s report.

Ireland insists that the deal was legal and vows to appeal if a decision goes against it. Apple maintains that it pays all the taxes it owes.

During the 1990s — difficult years for Apple — little attention was paid to the Irish tax structure. The arrangement only began to seem egregious when the iPhone and iPad transformed Apple into the world’s richest company, with its ASI unit in Ireland being used as the conduit for the lion’s share of the company’s international sales.

According to the commission, ASI accounted for 64 per cent of Apple’s overall 2011 pre-tax income of \$34.2bn. Despite this, the tax paid in Ireland in 2011 was somewhere between €2m and €20m.



For tax campaigners, that **ultra low tax rate** is selective state aid and Apple should simply pay the standard corporate rate. The most spectacular worst case scenario for Apple is based on that logic. JPMorgan pencils in a \$19bn clawback based on a 12.5 per cent rate on \$153bn of international income over 10 years.

Lawyers in Brussels find that figure implausible. To use this logic, many argue, the commission would have to drop an atomic bomb by ruling that it is overriding the widely

used principle of tax non-residency. Instead it has to focus on the company's two Irish branches, which would be a significantly smaller sum.

Where the profits are

Apple and the US Treasury accuse the commission of being opaque about which money it is targeting, robbing them of the opportunity to defend themselves.

The arguments are highly complex and hinge partly on the taxable income that Apple could have generated thanks to **"transfer pricing"** — the practice of shifting profit to low-tax jurisdictions through intra-company transactions. Bloomberg Intelligence reckons the recovery on that extra cushion of profit, based on gross margins, could still be large, estimating a sum of \$8bn.

People close to Apple say that the EU should not be targeting such a global profit figure.

Most critically, Apple argues that its **massive international earnings will one day be repatriated for tax payment**. This is fair, it continues, because the real engine of profit — intellectual property — is based in the US.

Ireland-incorporated AOE has intellectual property rights under a so-called cost sharing agreement, but Apple says that the IP itself and the profit it generates is America's.



Notes to Apple's 2015 annual report, released in October, hint at the huge scale of its potential repatriation. Out of what was then \$187bn held outside the US, Apple estimated a deferred tax liability of \$30bn related to a cumulative total of \$91.5bn in foreign earnings.

While Apple is holding out for a lower US tax rate than the current 35 per cent, any such move could still incur a tax bill running into billions of dollars.

In response to the repatriation argument, EU officials counter that Apple is booking large profits, not just sales, as being made internationally, so should be paying tax where the income is.

Ms Vestager argues that the US **cannot allow its double taxation agreements with EU countries to become "double non-taxation treaties"** with no tax paid in either country.

Repatriation of the massive overseas earnings has become a presidential election issue in the US. Donald Trump and other Republican candidates have all called for a one-off tax on existing foreign earnings of between 6 and 10 per cent. Unusually, that is similar to the plan President Barack Obama put forward in a budget proposal this month, though with a higher tax rate of 14 per cent.

“I think that there is some more consensus right now in the US about the fact that the system is broken and something needs to be done,” Luca Maestri, Apple’s chief financial officer, told the Financial Times in January.

“We would have to see how the tax code is reformed but we’ve always been very open that if there was a reasonable tax rate applied to our foreign earnings, we would certainly bring it back.”