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John Paul
CUNY Brooklyn College, john.paul@brooklyn.cuny.edu

GLOBAL TAX GOVERNANCE OR NATIONAL TAX DISCRIMINATION: THE CASE OF THE EU VS. APPLE

by

John Paul*

I. INTRODUCTION

On August 30, 2016, the European Commission (EC) concluded that Ireland and Apple Inc. (Apple) had violated the European Union (EU) state aid rules when Ireland granted tax advantages to Apple; therefore, the EC ordered Ireland to collect up to €13 billion euros ($15.3 billion U.S. dollars) in tax underpayments from Apple for the 2003 to 2014 period.[1] The amount at issue makes this case one of the largest tax controversies in history and has generated a lot of press as a result.[2]

While the amount in the EC vs. Apple case is unprecedented, it is only one of several EC Decisions dealing with the taxation of multinational transfer pricing activities issued recently, possibly in response to both a United States (U.S.) Senate investigation into U.S. multinational tax practices and the "Luxembourg Leaks" documents released by the International Consortium of Investigative Journalists.[3] Arguing that each multinational firm received illegal state aid, the EC has

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* Assistant Professor of Accounting, Law & Taxation, Koppelman School of Business, Brooklyn College/City University of New York

recently initiated or finalized decisions adverse to Google[4], Starbucks,[5] Apple[6] and Amazon[7] based on the specific transfer pricing methodologies each used with the endorsement of tax authorities in several EU member states.[8]

Each of the EC's Decisions finds that a EU Member State granted state aid in violation of the Treaty on the Function of the European Union (TFEU), Article: 107(1).[9] The EC found that each of the rulings at issue provided an advantage to a specific taxpayer or class taxpayers.[10] While it is clear that the EC can examine EU Member State tax ruling practices for the type of "selectivity" or discrimination that would constitute illegal state aid in contravention of the TFEU,[11] the recent EC decisions exceeded the scope of the EC's authority by questioning the general relevant principles and provisions of Member State law without showing that the challenged practices were selective.

The EC's Decisions have been harshly criticized by multinational firms and regulators but appear to reflect prior criticism that some experts have levied against multinational companies and low-tax jurisdictions.[12] It is probable that the EC's power to review Member State tax laws and tax ruling practices under state aid principles will be decided by the European Court of Justice (ECJ) over the next decade.

The issue is whether the EC has the right to override state sovereignty in order to enforce a global tax governance structure based on the EC's tax sovereignty principles. Under ECJ case law, a finding of state aid requires a finding of selectivity and a finding of advantage.[13] In the rulings at issue, however, the EC has conflated the selectivity and advantage criterion into a single concept of selective advantage, thereby minimizing the selectivity requirement despite the fact that selectivity is an important part of state aid jurisprudence.[14] Basically, the EC is violating state sovereignty by creating its own interpretation of tax sovereignty in order to enforce its own brand of global tax governance.

This article theorizes that the EC's enforcement initiative could harm the global economy through the erosion of tax certainty and that the EC's retroactive application of the EC's interpretive tax sovereignty principle is not supported by ECJ law. The EC's version of tax sovereignty will likely exacerbate the very harms that the state aid rules were implemented to prevent. Instead of creating a structure of global tax governance, the EC appears to be creating a global chaos of tax uncertainty by overriding state sovereignty.

II. EVALUATING GLOBAL TAX GOVERNANCE

The international economy raises important questions about the structure of global tax governance systems intended to protect markets where globalization implies the erosion of national boundaries.[15] In this respect, it can be argued that the power to implement national regulations within those boundaries declines because people can easily leave their jurisdictions and because the flows of capital are too large and sudden for any one regulator to control.[16]

In contrast, the liberal globalist response to the concern about the erosion of state regulatory power is to build a larger global apparatus, such as the United Nations or EC systems constituted by a legally binding treaty, with expanding governance powers.[17] With the globalization of tax transactions and increasing interdependence among nation-states, there is a growing conflict between the conventional notion of state sovereignty and the flow of tax activity, which disrupts coherence of the state. In the meantime, the various agencies and institutions within the state, such as independent central banks, develop a high degree of independence reflecting the fragmentation or desegregation of the nation-state.[18]

When it came to tax issues, Westphalian sovereignty at one time was largely respected. The basic rule of Westphalian sovereignty is non-intervention in the internal affairs of other states, guaranteeing the autonomy of the national political authorities over a nation-state's territory.[19] Non-intervention is closely linked to the idea of self-determination, which many felt was necessary to the growth and development of a nation-state.[20] In recent decades, Westphalian sovereignty has been undermined due to the increasing mobility of the tax base, especially capital. Regulatory changes such as the discontinuation of capital controls in one nation-state can affect not only the economies of the surrounding nation-states but even the nation-states in other parts of the world. Economic agents can now move their various forms of capital between nations and shop for the lowest tax burden and this led to calls for more global tax governance.[21]

Global governance establishes rules dealing with issues that each nation already regulates within its territorial boundaries such as crime, pollution, securities fraud and tax evasion. In contrast, traditional international law requires nation-states to implement the international obligations they incur through their own domestic law[22]. Transgovernmentalism supporters claim that the enforcement of domestic law has been made more difficult due to globalization propelled by the information revolution.[23] The transgovernmentalist view stresses that regulators potentially reap the benefits from coordinating their enforcement efforts with those of their foreign peers and from ensuring that other nation-states adopt similar approaches.[24]

Transgovernmentalists likewise argue that the domestic order fragmentation of the nation-state is essential to the development of the global regulatory governance system. They claim that the global governance of the economy requires the globalization of state agencies as long as these agencies maintain a high degree of autonomy and independence. To transgovernmentalists, the transformation of state sovereignty represents the regulatory harmonization through "the nationalization of international law."[25] Transgovernmentalists highlight that each nation-state will be better able to enforce its domestic law by implementing the agreement if foreign peers do likewise in accordance with regulatory agreements that are pledges of self-enforcing good faith.[26]

In 2009, a U.S. federal court in Florida ruled that the Swiss bank UBS had to provide client information for up to 52,000 U.S. citizens to the U.S. Internal Revenue Service (IRS). Before this case was finally settled, a Swiss government official stated that "the court would be substituting its own authority for that of the competent Swiss authorities, and therefore would violate Swiss sovereignty and international law."[27] It seems that nations are now expected to shift fiscal competencies up the ladder of governance and is incompatible with the notion of state sovereignty. Shifting fiscal competencies in such a way endows supra-national institutions, such as the EC, with the power to govern nations based on their own principles, which may run counter to the principles of the sovereign nations.[28]

III. IRELAND AND THE EU

With regard to the EC vs. Apple and Ireland case, the argument can be made that Ireland decided to enter into an agreement with Apple based on Irish values and needs. To the

Irish, employment opportunities may be more important than massive taxes. If the Irish feel that the only way to lure a large, global company such as Apple to its borders is by reducing the tax burden the global company has to pay, why does the EC have the ethical duty to override the Irish belief regarding taxes? Does the EC provide job opportunities to the local Irish citizens? If the answer is no, then who is the EC to decide what Irish agreements should be upheld and what Irish agreements should be overruled?

In the U.S., there is a Federal tax code that is applicable to all U.S. citizens and residents regardless of where they reside.[29] The IRS is responsible for enforcing and collecting Federal taxes.[30] Each state in the U.S. has its own tax code in addition to the Federal tax code. State taxes are only applicable to the residents of that particular state and there is no uniformed collection agency for state taxes.[31] When there is a conflict between Federal tax and State tax, the Federal tax code prevails under the supremacy clause of the US Constitution.[32]

While the U.S. operates under federalism, the EU does not. Although the EU founders wanted federalism, years of negotiations ultimately resulted in the rejection of such a system.[33] As a result, the EU does not impose a tax on EU citizens and each EU citizen is taxed in her/his respective member state.[34]

After a failed attempt to establish an EU Constitution,[35] the Treaty of Lisbon was pushed forward to incorporate many of the EU Constitutional principles.[36] All of the EU member states agreed to ratify the treaty through their respective legislatures, except for Ireland. Due to concerns over the loss of Irish sovereignty, two-thirds of the Irish public voted against the Treaty of Lisbon.[37] Since the incorporation of a treaty into EU law requires the unanimous agreement of all the member states, the Treaty of Lisbon was not ratified and failed to become part of EU law; therefore, the EU was forced to make specific concessions to Ireland to encourage a "yes" vote in a second referendum.[38]

The major concession made to Ireland was regarding its tax law. In exchange for a "yes" vote, Ireland and the other European leaders agreed to a special protocol,[39] specific only to Ireland and having no effect on the other EU member states.[40] Ireland was provided several guarantees including competence over its own tax laws. After receiving this protocol from the EU, the Irish public voted two-thirds in favor to ratify the Treaty of Lisbon.[41] While the EU still lacks competence over the tax codes of the member states, it participates in the Organization for Economic Cooperation and Development (OECD).[42]

IV. THE OECD

The OECD provides tax policies and guidelines that have facilitated the elimination of harmful tax laws.[43] Over thirty nations, including several EU members, participate in the OECD and contribute to the development of policies and practices for greater economic cooperation. The release of the OECD's Model Convention with Respect to Taxes on Income and on Capital (OECD Model) facilitated the growth of bilateral tax agreements – from less than one-hundred prior to its release, to over 3,000 and many nations rely on it for treaty text.[44]

One of the OECD's most astute contributions to global tax has been its transfer pricing guidelines. Transfer pricing is the process multinational corporations use to assign values to goods and services that involve global transactions between related corporations. The OECD's 1979 Transfer Pricing and

Multinational Enterprises Report (OECD Report) created the arm's length principle, which provides that transactions between related corporations "should not be treated differently for tax purposes from similar transactions between independent parties solely by virtue of the fact that the enterprises are associated."[45] Although the OECD Report was officially repealed in 1995, the arm's length principle remained the standard in evaluating transfer pricing agreements.

Following the 2008 global crisis, the OECD issued the 2010 Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines). The OECD Guidelines reaffirmed the arm's length principle as the appropriate standard for evaluating transfer pricing.[46] Many OECD member nations formally adopted the OECD Guidelines into their national laws even though the were not required to do so.[47]

As many nations continued to face fiscal crises after 2008, the OECD identified Base Erosion and Profit Shifting (BEPS) as a problem and created the BEPS Project to address the mismatches in tax rules that allow a corporation to pay low tax or no tax on its profits. The BEPS Project held its first meeting in 2016 and more than eighty nations participated including Ireland and the US. While the BEPS Project strives to reduce global tax avoidance, many multinational corporations take advantage of the differences between nations' tax systems, including Apple, which utilized the difference between the US and Irish tax systems.[48]

V. U.S. VS. IRELAND TAX LAW

The difference between U.S. corporate tax law and Irish corporate tax law creates a tax haven for multinational corporations. Under the U.S. incorporation system, a corporation is subject to U.S. tax only when it is incorporated in the U.S. Under the Irish incorporation system, a corporation is subject to Irish tax only when it resides in Ireland.[49] As an example, suppose DEF Corp. is incorporated in New York, which subjects it to the U.S. corporate tax rate of 35 percent. Now suppose DEF Corp. is also incorporated in Ireland. The fact that DEF Corp. is incorporated in Ireland does not automatically subject it to the Irish corporate tax of 12.5%; in order for DEF Corp. to be subjected to the Irish tax, it would need to meet the Irish residency requirements.

The Irish tax residence definition differs from the global tax residence definition. Under the global tax law, residence is decided by the taxpayer's physical and economic state presence.[50] Ireland does not define tax residence in its tax code and instead adopted the United Kingdom's judicially-created residency test.[51] In De Beers Consolidated Mines Ltd. Vs Howe, De Beers was incorporated in South Africa where it operated diamond mines but maintained an office in the United Kingdom where nine of De Beers' sixteen board members were located. The court found that a corporation is a resident where its central management and control were located and concluded that De Beers was a resident of the United Kingdom.[52]

Now suppose DEF Corp. is incorporated in Ireland with its central management and control is based in its New York office. Under Irish tax law, the fact that DEF Corp.'s central management and control is in New York means that DEF Corp. could avoid paying the Irish corporate tax of 12.5 percent. The difference between the Irish and global tax systems helped

Ireland attract some of the largest multinational corporations in the world, including Apple.

Apple's tax loophole in Ireland was codified by applying the OECD Model as well as the 1997 US Tax Convention with Ireland. Since Apple's subsidiaries were incorporated in Ireland, none of them were subject to U.S. corporate tax. Furthermore, since the central management and control of Apple's subsidiaries were located in Apple's headquarters in the US, the subsidiaries were not subject to Irish corporate tax.[53] Basically, Apple legitimized its tax-free structure through the OECD Model and a bilateral tax treaty between the US and Ireland.

Another tax arrangement between Apple and Ireland involved one of Apple's subsidiaries, Apple Sales International (ASI). In 1991, Apple created the Irish subsidiary of ASI, which recorded all of Apple's profits in Europe, Africa, the Middle East and India. If someone bought a phone in Spain for example, the sale would be recorded by ASI in Ireland, not in Spain. ASI then paid the annual Irish tax rates that were in the range of .005 percent and 1 percent until 2014, according to the profit-sharing agreement between Ireland and Apple. Ireland had one of the lowest corporate tax rates in the EU – 12.5 percent – while most of the other EU member states had corporate tax rates of over 16 percent with the Belgium tax rate rising as high as 33.9 percent.[54]

Although Apple was one of the top technology companies during the 1980s, the stiff competition from Microsoft and Windows during the 1990s caused Apple to restructure pricing allocation among its Irish subsidiaries.[55] In 1991, Apple received a ruling from the Irish government which allowed Apple to allocate 65% of its operating expenses to its subsidiary, Apple Operations Europe (AOE), for revenue up to $60 - $70 million and 20% of operating expenses for any excess revenue. In 2007, Apple received another ruling that approved

Apple's reduced operating expenses allocation of 10-20% and it inclusion of a 1% to 9% Intellectual Property return to its AOE subsidiary. The 1991 Irish government ruling stated that all revenue attributed to ASI would be taxed at 12.5% and the 2007 Irish government ruling allocated 8% to 18% of operating costs to ASI. These rulings caught the attention of the US government.[56]

In 2013, the Permanent Subcommittee on Investigations of the U.S. Senate Committee on Homeland Security and Governmental Affairs (Subcommittee) started to investigate Apple's off-shore profit sharing arrangements. Apple denied the use of illegal tax schemes and suggested that US corporate tax law be updated in light of the new digital age. While the Subcommittee eventually found that current US laws did not prohibit Apple's tax structure in Ireland, the investigation caught the attention of the EC.[57]

VI. THE EC VS. APPLE

In 2014, the EC opened an investigation to determine if the 1991 and 1997 Irish tax rulings granted to Apple constituted state aid in violation of the TFEU.[58] According to the EU, state aid is illegal when a Member State provides a company a selective advantage that distorts or attempts to distort competition. All EU member states are required to receive EC approval prior to granting state aid. If an EU member state grants state aid that violates the TFEU, then the EC must recover the illegal state aid from the recipient.[59]

In the U.S., there is no equivalent for EU state aid; in fact, the U.S. has a different policy regarding corporate subsidies. US corporations enjoy subsidies in the form of grants, loans and/or tax breaks from both the federal and state governments.[60] Federal government grants and tax credits often total billions of dollars, while federal loans and bailouts exceed trillions. Unlike the EU, the U.S. had not adopted strict guidelines on the use of government subsidies to corporations.[61]

The EU scrutinizes corporate subsidies that the US commonly provides, such as agriculture, energy and transportation.[62] State aid rules are difficult for U.S. multinationals to navigate, especially since they come from a nation that provides corporations generous tax credits.[63] This may explain why the EC's decision was unchartered territory for Apple.

In reviewing the Irish tax rulings, the EC found that Apple received illegal state aid in violation of the TFEU. According to the EC, the tax rulings allowed Apple to engage in transfer pricing that did not reflect the economic realities of the transactions. This allowed Apple to allocate millions in profits to specific Apple subsidiaries in Ireland that were not subject to taxes in any nation.

In deciding that Apple's transfer pricing was not proper, the EC relied on the 2010 OECD Report Guidelines. The EC found that Apple did not provide the proper documentation supporting its transfer pricing tax proposal to the Office of the Revenue Commissioners as required by Section V of the OECD Report Guidelines. Furthermore, the EC found that one of Apple's subsidiaries in Ireland had no real activities demonstrating the lack of economic justification for the transfer pricing allocation.

It was apparent to the EC that Apple received state aid from Ireland. The Irish tax rulings were selective because they were directed solely towards Apple. These rulings also provided

Apple with an advantage in the EU since it paid significantly lower taxes, allowing it to allocate more money to advancing its global operations. This tax avoidance allowed Apple to receive a substantial benefit compared to other businesses, which distorted competition in the internal market.

VII. THE VIOLATION OF STATE SOVEREIGNTY AND DISCRIMINATION

As stated earlier, the EU granted concessions to Ireland in exchange for Ireland voting "yes" to accepting the Treaty of Lisbon. One of these concessions was allowing Ireland to retain competence over its own tax laws.[64] This means that Ireland shouldn't need to obtain approval from the EC in order to grant state aid to Apple or any other company. It seems that the EU is ignoring the protocol it granted to Ireland in exchange for its vote. If the EU can ignore the agreements it creates with member nations, it means that the EU can violate the sovereignty of those nations.

Again, the EU does not practice federalism as the US does. Federalism was attempted by the EU but rejected by the member states. The EU does not impose taxes EU citizens and each EU citizen is taxed in her/his own member state.[65] So, since the EU does not have the power to tax EU citizens, the EU shouldn't be imposing a retrospective tax on Apple for doing business in Ireland.

Apple's tax arrangement in Ireland did not constitute state aid within the meaning of the TFEU since it failed to meet the "selective advantage" requirement.[66] Just as Apple did, Irish corporations could have avoided paying the Irish corporate tax by incorporating in Ireland and establishing management and control in another country; this arrangement was not limited to Apple. Furthermore, even if the Irish tax rulings did meet the "selective advantage" requirement, they can't be deemed to distort or attempt to distort competition since there is no unified EU tax system. Since there is no unified EU tax sovereignty, the EU is once again violating the state sovereignty of Ireland.

Many US government officials have condemned the EC's decision against Apple. The US Treasury Department announced that it believed the EU was reaching into US corporations in order to take US tax revenue.[67] Other sources have examined the EC's investigations into US corporation tax structures in EU member nations as discriminatory litigation. While many recognize the longstanding concept of state aid, they find that pursuing civil investigations primarily against US companies under a new interpretation of state aid creates disturbing global tax policy precedents.[68] Many also feel that imposing a giant tax bill on company years after the fact sends the wrong message to global job creators.[69]

Indicative of the EC's discriminatory practices against US firms are the recent investigations into Google and Amazon.[70] Google was investigated by the EC for alleged antitrust and data privacy violations and is now being investigated for violating the tax policies of France, Spain and the United Kingdom. In 2016, Google's offices in France and Spain were raided by the EC as part of the investigation. Amazon is being investigated for the alleged violation of state aid in Luxembourg.[71]

The EC's investigations into US corporations has prompted US retaliation against the EU. The US Treasury and the IRS issued Notice 2016-52 addressing proposed regulations for foreign tax credits used to offset US tax obligations. The US is concerned that US corporations will now be able to offset current US tax obligations to a greater extent since the EC is assessing tax years that are more than two years prior to the current tax year. If the EC continues to target US corporations and assess back taxes on the basis of illegal state aid, the US will have major tax revenue losses stemming from foreign tax credits.[72]

To avoid the major foreign tax credit loss, the US Treasury and the IRS are reducing foreign tax credits. The reduction of foreign tax credits could in turn reduce foreign investment since US corporations may be faced with the possibility of paying double taxation on certain foreign earnings. Since both the EU and the US can't really afford reductions in their respective economies, the ECJ should reject the EC's decision against Apple in order to discourage the EC's discriminatory practice against US corporations.

VIII. CONCLUSION

The EC's recent actions regarding US multinational corporations raises important questions about the structure of global tax governance systems intended to protect markets where globalization implies the erosion of national boundaries. With the globalization of tax transactions and increasing interdependence among nations, there is a growing conflict between the traditional notion of state sovereignty and tax sovereignty, which disrupts coherence of the state.

The EU member-states rejected the notion of the EU serving in a federal capacity; therefore, the EU does not impose a tax on EU citizens and each EU citizen is taxed in his or her respective member state. Furthermore, the EU does not negotiate member state tax treaties or implement member state tax policies for each member state -- that is left to each of the member states to decide as sovereign nations. Yet, the EC is now imposing retrospective taxes on US multinational companies as if the EC is a federal EU tax sovereignty. Since the EU does not have the right to override state sovereignty and impose its own discriminatory judgments against multinational companies, the Member States should challenge the authority of the EU.

It seems as if sovereign nations must now shift their fiscal competencies up the ladder of governance and this is a violation of state sovereignty. But if the EC can override a sovereign nation's tax policy, then it will cause confusion among corporations as to what tax law should be followed. Apple can enter into a tax agreement with the Irish government but not with the EC so the EC should not be allowed to erode the integrity of the Irish government.

The EC's example of retrospective taxation sends a wrong signal to the global business community since any tax breaks awarded by a sovereign member nation could be reversed by the EC. The entire investment made by a company could be forfeited just because the EC deems a tax arrangement to be unfair. These cases do not set a good precedent and may discourage companies from investing in EU nations if there are better alternatives in other parts of the world. Accordingly, the ECJ should respect state sovereignty and reject discriminatory practices; therefore, the ECJ should reject the EC's case against Apple.

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[10] *See* Fiat Decision, *supra note 4,* at para. 346; Starbucks Decision, *supra note 5,* at para. 360; Apple Decision, *supra note 6,* at para. 321.
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