EUROPE THINKS DIFFERENTLY: THE AUGMENTED ROLE OF COMPETITION POLICY IN THE EU

CHARLOTTE O'NEILL

Senior Sophister

Charlotte O'Neill's in-depth analysis of the European Commision's landmark ruling against Apple and Ireland underlines the distortive effects of state aid. In this essay, she examines both the legal and economic framework on which this decision was based, and, in doing so, highlights the changing role of competition policy within the European Union.

Introduction

In the era of the stateless enterprise, state aid control has become an ever-more important competition tool at the European Commission's disposal. State aid control is one of the most politically sensitive competition issues because it touches on sovereign states' national fiscal competencies with regard to allocating government funds as they see fit (OECD, 2010). The European Commission's use of state aid control and the political sensitivity surrounding its remit culminated in the landmark ruling against Ireland and Apple, in which advanced transfer pricing arrangements made between Apple and Irish Revenue in 1991 and 2007 were classified as state aid. In this ruling, the Directorate-General (DG) for Competition adopted an uncharacteristically expansive interpretation of state aid rules that may have future implications on the scope of European state aid control, the functioning of the European Union's competitive environment and its interaction with international corporate tax affairs.

A more fundamental issue facing the EU is arguably at play in the Apple case. At the 2016 Tax Congress of the Berlin Tax Forum, Pierre Moscovici, the EU Commissioner for Economic and Financial Affairs, Taxation and Customs, left no doubt that the EU is tackling tax avoidance with renewed rigour (European Commission, 2016a). The prospect of a Common Consolidated Corporate Tax Base (CCCTB) is once more being negotiated after its initial proposal in 2001. The aim of this is to clamp down on base erosion and profit shifting, which costs the EU in the region of fifty to seventy billion euro in revenue every year (European Commission, 2016a). Addressing this issue from a competition perspective has proven most promising, given the significant resources of DG Competition and its clear state aid control mandate. In this context, state aid investigations are a means by which multinational tax avoiders may be legitimately sanctioned due to the resultant distortionary effects on competition within the Single

Market. Hence, the Apple case can be looked at as one piece of a larger European puzzle.

Theoretical justifications for state aid control:

The Support of Inefficient Production

Economic theory posits that the granting of state aid by a single national government can create distortions across the entire Single Market (Friederiszick, Röller, and Verouden, 2006). It is the existence of these distortions or negative externalities that is the primary justification for state aid control being conducted at the supranational level in the EU. State aid reduces effective competition if it supports inefficient production. Subsidies may drive more efficient competitors out of the market entirely, to the detriment of not only the competitor, but also consumers, who may incur higher prices, lower output or lower quality products from the inefficient but subsidized producer (Spector, 2009). The mobile device market offers an interesting example as it generates roughly two-thirds of Apple's total revenue (Mickle, 2017). After a decade of growth, 2016 saw the global market shrink for the first time. This can be attributed to saturation in developed economies and rising competition in emerging markets. (Cheng and Lee, 2016). In theory, as saturation in the mobile market increases as a result of the commoditisation of the smartphone, the distortionary effects of any state aid granted to Apple rises correspondingly. In the international smartphone vendor market, market share is largest for Samsung with 21.9%, Apple is second with 14.6% and is followed by Huawei with 8.8% . This suggests that Apple, although controlling less market share than Samsung, still exerts a degree of market power in the industry that will exaggerate any distortionary effect of state aid. Here, the issue of moral hazard arises as the theoretical 'soft budget constraint' created by the aid erodes Apple's incentive to maintain efficiency. (Spector, 2009).

The Distortion of Dynamic Incentives

The erosion of efficiency leads to the distortion of dynamic incentives. When an undertaking is granted aid that is invested in research and development (R&D) this usually strengthens the presence of that undertaking in the (future) product market and generates greater market power (Spector, 2009). Competitors are likely to expect a reduction in residual demand, which will induce a decrease in investment; this is the crowding-out effect which results in a lower increase or a decrease in overall investment in the market (Spector, 2009). Alternately, competitors respond by maintaining or increasing investment.

For example, Apple and Spotify are competitors in the digital music market (Verbergt and Duxbury, 2016). Apple's favourable tax treatment has freed up financial resources to invest in enhancing the existing Apple Music app, in more aggressive marketing or in developing more advanced music products. In response to fiercer competition, Spotify may anticipate a decline in demand and reduce investment accordingly. This reduces their market power by shifting oligopoly rents to Apple (OECD, 2010). Otherwise, they can maintain or increase investment in order to compete. In theory, the effect on overall societal welfare is ambiguous. However, it is clear that Apple can pre-empt part of the demand which, without the aid, would have been at least partially served by their rival (OECD, 2010). Thus, without state aid control a single government has the ability to distort competition across the Union by altering the behaviour of both recipients of aid and their competitors.

Apple's European Tax Structure

Apple's corporate structure is conducive to transfer pricing within the Apple group. The Apple group includes Apple Inc., which is headquartered in the U.S., and a number of affiliated companies, some of which are incorporated in Ireland (European Commission, 2016b). Of the companies incorporated in Ireland, Apple Operations International (AOI), Apple Sales International (ASI) and Apple Operations Europe (AOE) are non tax-resident in Ireland (European Commission, 2016b). Transfer pricing refers to the prices charged on commercial transactions between companies belonging to the same group or within a company which operates a permanent establishment in a separate jurisdiction. This involves an allocation of that company's profit between its permanent establishment and the other parts of the company (Bernard, Jensen and Schott, 2006). Through this mechanism, multinationals can allocate profit between separate companies within the group. The OECD's 'arm's length principle' stipulates that tax administrations should only accept transfer prices between group companies that are paid as if they were agreed to by independent companies negotiating under comparable circumstances at arm's length (OECD, 2010). This is to prevent multinational companies from manipulating transfer prices, in order to attribute as little profit as possible to jurisdictions with a higher corporate tax rate and as much profit as possible to jurisdictions where profits are taxed at a lower rate, such as Ireland.

Under a cost-sharing agreement ASI and AOE use Apple's intellectual property to sell and manufacture Apple products in markets outside North and South America (European Commission, 2016b). This agreement facilitates payments from ASI and AOE to Apple in the US, which fund R&D activity carried out in the U.S. on their behalf. These transfers funded over half of all research activity conducted by the Apple group in the US to develop its intellectual property worldwide (European Commission, 2016b). Apple further utilised this framework such that, in the European market, when a customer purchased products from a physical store in their Member State they were in fact contractually purchasing the products from ASI in Ireland. Hence all sales and the resulting profits were recorded directly in Ireland. The 1991 and 1997 contested tax rulings allowed the internal allocation of these profits within ASI, making it possible to split these profits (European Commission, 2016b). The majority of the profits were internally allocated away from Ireland to a head office within ASI. This head office did not own a premises, nor did it employ any staff and it was not based in any country - all profits allocated to it were untaxed, essentially creating a so-called *stateless enterprise* in terms of tax obligations. A small remaining fraction of ASI's profits were allocated to its Irish branch and subject to tax in Ireland. Looking at figures from 2011 offers an illustrative example: ASI recorded profits of €16 billion. However, the profit allocation methods endorsed by the 1991 and 1997 rulings meant that only approximately €50 million was taxable in Ireland, which left €15.95 billion of profits untaxed (European Commission, 2016c). AOE, which manufactures certain ranges of computers for the Apple group, benefitted from similar tax arrangements endorsed in the same rulings. Through the same mechanism, most of AOEs profits were allocated to its stateless head office and were, thus, not liable for taxation in any jurisdiction, while the relatively small remainder were taxed in Ireland (European Commission, 2016b).

Establishing the Existence of State Aid

The European Commission is one of the few international competition authorities with the scope to vet the granting of government subsidies to companies or ‘state aids’ in the parlance of the European Union (OECD, 2010). In accordance with Article 107(1) TFEU, any aid granted by a Member State or through State resources that distorts or threatens to distort competition, by favouring certain undertakings or the provision of certain goods, shall be incompatible with the common market, in so far as it affects trade between Member States (European Commission, 2016b). In proving that a measure does in fact qualify as an aid, under Article 107(1) the following cumulative conditions must be met:

(i) the measure must be imputable to the State and financed through State resources;

(i) it must confer an advantage on its recipient;

(iii) that advantage must be selective; and

(iv) the measure must distort or threaten to distort competition and have the potential to affect trade between Member States.

The Commission ultimately found that the contested tax rulings constituted state aid, which is incompatible with the internal market. Firstly, relating to (i), the Commission deemed the tax rulings issued by Irish Revenue to constitute an intervention by the state or through state resources and, hence, are imputable to Ireland. European case law demonstrates that even in cases where there is no positive transfer of state resources, a tax exemption granted by state authorities that puts the recipient in a more beneficial position relative to other taxpayers will constitute state aid .

Secondly, with respect to (ii), the Commission found that Irish Revenue did in fact confer an advantage on Apple, in failing to adhere to the arm’s length principle. The Commission argued that the profit allocation methods endorsed in the rulings did not constitute a remuneration for the Irish branches that an independent operator would accept under normal market conditions. This resulted in the lowering of ASI and AOE's tax liability in Ireland, which they would otherwise have been obliged to pay (European Commission, 2016b). This constitutes operating aid, which strengthened ASI and AOE's financial position relative to competitors by freeing up financial resources for investment in areas such as business operations, R&D, sales and marketing activity etc.

Thirdly, regarding (iii), the Court of Justice has previously held that in the case of an individual aid measure, as opposed to a scheme, *"the identification of the economic advantage is, in principle, sufficient to support the presumption that it is selective"*. Citing this case law, the Commission found that the very fact that the measures provide an advantage to ASI and AOE suffices to assert that the advantage is selective in nature (European Commission, 2016b). Nevertheless, for the sake of completeness the Commission analysed the rulings under the three-step Court of Justice guidelines for selectivity. Again, they were found to be selective as they represented a derogation from the reference system, i.e. they deviated from Ireland's normal applicable tax regime.

Finally, in relation to (iv), ASI and AOE are part of the Apple group, a multinational group operating in all Member States. Thus, any favourable aid granted to them is liable to affect intra-Union trade (European Commission, 2016b). Through this reasoning, the Commission found that the four conditions set forth in Article 107(1) were met. As such, the contested rulings amounted to state aid.

A 'Think Different' Approach

The Commission's approach to state aid regulation has evolved over time, demonstrating the transition to more economically-focussed, as opposed to legally-focussed reasoning (Friederiszick, Röller,and Verouden, 2006). The Apple ruling incorporated a more expansive interpretation of state aid law, and so, in many ways, it epitomises this transition. The decision deviates from past decisions in two ways. Firstly, the concepts of 'advantage' and 'selectivity' have been collapsed (US Treasury, 2016). Usually, the Commission examines the existence of an advantage and the selective character of the measures separately. However, in this instance they looked simply at whether the advanced pricing arrangements conferred 'selective advantage' on Apple (U.S. Treasury, 2016). Secondly, in prior cases the commission attained that disparate treatment based only on whether the company is a multinational or a standalone company has not necessarily led to a tax decision being deemed selective in nature. Usually, the commission compares multinationals which gain from the measure with multinationals which do not. In the case of Apple, the economic benefit provided by the Irish government, through the advanced transfer pricing agreements, which was not extended to any standalone company meets the selectivity requirement (US Treasury, 2016).

In short, the Commission has deemed Apple's transfer pricing rulings as selective, regardless of the fact that any multinational company could have, in theory, obtained them. The significance of this approach means that the Commission can find advantage if it disagrees with the Member State's application of the arm's length principle. Both Apple and Ireland have claimed that this approach expands the Commission's role beyond competition enforcement into that of a supra-national tax authority. Whether this is the case or not will be determined by the European Court of Justice during the appeals process. For now, however, the decision suggests that reviewing Member State transfer price determinations will be increasingly common in future competition investigations, an approach that, until now, has been unchartered territory for DG Competition.

Conclusion

The Apple ruling represents a seminal moment for the DG Competition, in that the investigation deliberately highlighted how a major global corporation aggressively utilised its corporate tax structure to minimize its tax obligations. In addressing this issue under the remit of state aid control, the Commission has emphasized how this practice distorts competition in the Single Market and has signalled that this warrants an enhanced role of competition authorities in international corporate tax affairs. Until a harmonized European corporate tax framework is developed, it is most likely that the Commission will continue on this trajectory. On whether this approach is practicable in the long run, the jury is very much still out.

References

Bernard, A., Jensen, J. and Schott, P. 2006. 'Transfer Pricing by U.S.-Based Multinational Firms'. NBER Working Paper 12493. http://www.nber.org/papers/w12493.pdf [Accessed 8 February 2017].

Cheng, J. and Lee, M. 2016. 'In Smartphone Market, the Squeeze Is On'. The Wall Street Journal https://www.wsj.com/articles/in-smartphone-market-the-squeeze-is-on-1461844808 [Accessed 4 February 2017].

European Commission, 2016a. Speech by Commissioner Pierre Moscovici at the Tax Congress of the Berlin Tax Forum 2016. Europa http://europa.eu/rapid/press-release_SPEECH-16-2263_en.htm [Accessed 15 February 2017].

European Commission, 2016b. Commission Decision of 30.8.2016 on State Aid SA.38373 (2014/C) (ex 2014/NN) (ex 2014/CP) implemented by Ireland to Apple. Europa http://ec.europa.eu/competition/state_aid/cases/253200/253200_1851004_666_2.pdf [Accessed 15 February 2017].

European Commission, 2016c. 'State aid: Ireland gave illegal tax benefits to Apple worth up to €13 billion'. Europa http://europa.eu/rapid/press-release_IP-16-2923_en.htm [Accessed 5 February 2017].

Friederiszick, H., Röller, L. and Verouden, V. 2006. 'European state aid control: an economic framework' in P. Buccirossi (ed.) Handbook of Antitrust Economics. Cambridge: MIT Press.

Hamilton, S.F., and Sandin, R. 1997. 'Subsidies in oligopoly markets: a welfare comparison between symmetric and asymmetric costs'. Public Finance Review 25:6:660-668.

International Data Corporation, 2016. 'Smartphone vendor market share, 2016 Q3'. IDC http://www.idc.com/promo/smartphone-market-share/vendor [Accessed 15 February 2017].

Mickle, T. 2017. Apple Earnings: What to Watch. Wall Street Journal https://www.wsj.com/articles/apple-earnings-what-to-watch-1485874905 [Accessed 7 February 2017].

OECD, 2010. Global forum on competition: roundtable on competition, state aids and subsidies. OECD http://www.oecd.org/competition/sectors/48070736.pdf [Accessed: 8 February 2017].

Russolillo, S. 2017. Apple's secret, but very large profit centre. Wall Street Journal https://www.wsj.com/articles/apples-secret-but-very-large-profit-center-1485806466?mg=id-wsj [Accessed: 8 February 2017].

Spector, D. 2009. 'State aids: economic and practice in the European Union' in V. Vives (ed.) Competition policy in the EU: fifty years on from the Treaty of Rome. Oxford: Oxford University Press.

U.S. Department of the Treasury, 2016. The European Commission's recent investigations of transfer pricing rulings. U.S. Department of the Treasury https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/White-Paper-State-Aid.pdf [Accessed 8 February 2017].

Verbergt, M. and Duxbury, C. 2017. 'Spotify founders blast Sweden's business environment in open letter'. Wall Street Journal https://www.wsj.com/articles/spotify-founders-blast-swedens-business-environment-in-open-letter-1460479684?mg=id-wsj [Accessed 15 February 2017].