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Marloes Smit

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Supervisor: Prof. Dr. H.T.P.M. van den Hurk

Ending the current income shifting practices of U.S.-based multinational companies, a feasible objective?

With special attention to the role of the OECD BEPS Action Plan and the proposals of the United States to reform the U.S. international system of corporate taxation

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Chapter 1 Introduction

A number of high profile multinationals recently have received serious criticism from governments and the public for diminishing their tax burden after shifting their assets to low tax jurisdictions and their losses to high tax jurisdictions.[1] The reason for the growing awareness of these practices of numerous multinational companies can be viewed as the result of the recent financial crisis, as the contributions to the federal revenue have come under increasing pressure. Due to the methods that multinationals adopt to lower their tax burden the federal deficit is further expanded. Since the contributions that corporate taxes make to the federal revenue are declined, at the same time the tax burden on American families is raised. This situation leads to the rise of public frustrations.[2]

1.1 Core problem

Because of the antiquated composition of international tax regimes, it is possible for multinational corporations to shift profits from high-tax-, to low-tax jurisdictions. The tax systems of this day and age were not drafted to deal with highly mobile intellectual property and intangible assets. Patents, trademarks, and algorithms can be simply transferred from one country to another with little or no change in real economic activity, taking along the income they generate. Furthermore, discrepancies and lack of coordination between nations' tax systems can grant opportunities for companies to participate in tax minimization strategies. Finally, there are numerous items in countries' tax codes and regulations that provides some kind of preferential tax treatment to specific income earned abroad, or that grants some space for legal maneuvering.[3]

As taxation on the income of foreign subsidiaries (except for certain passive income) is postponed until the moment of repatriation, this income can avoid current U.S. taxes and might avoid U.S. taxation altogether. The taxation of passive income (called Subpart F income) has dwindled, possibly substantially, as a consequence of the use of "hybrid" entities.

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[1] V. Houlder, *Taxation: Unsafe Offshore,* Financial Times, January 13, 2013
[2] C. Levin (Senator), *Statement before U.S. Permanent Subcommittee On Investigations On Offshore Profit Shifting And The U.S. Tax Code- Part 2 (Apple Inc.),* May 21, 2013
[3] M.P. Keightley & J.M. Stupak, *U.S. International Corporate Taxation: Basic Concepts and Policy Issues,* Congressional Research Service (CRS), December 2, 2014

These entities are treated in contrasting ways in different jurisdictions. Through the adoption of a new regulation called “check-the-box” in the late 1990s, the use of hybrid entities increased steeply. Moreover, earnings from income that is liable to taxation can often be safeguarded by foreign tax credits on other income. This practice is called “cross-crediting”. All these methods have in common that taxes are hardly paid on the foreign source income of U.S. firms. Multinational firms can thus artificially shift profits from high-tax to low-tax jurisdictions by means of adopting an array of tactics.[4]

A lot of criticism has been expressed with regard to the U.S. rules for the taxation of cross-border income. Critics have various wide-ranging, occasionally conflicting, policy concerns. On the one hand, critics defend that the U.S. tax burden on the foreign business income of U.S. companies is too high, especially when U.S. multinational companies are competing in foreign markets with foreign multinational companies that are subject to little or no home-country taxation on foreign income. On the other hand, critics have expressed their fears about the current situation including the present U.S. rules for taxing cross-border income. Both U.S. and foreign multinational companies diminish the sum of U.S. taxes they pay through the shifting of profits abroad with the intent to lower the tax burden in the United States. In some situations, the manufacturing, headquarters, and other business activities are also relocated outside the United States to further minimize the U.S. tax burden.[5]

There have been various proposals in the United States to reform the U.S. international corporate tax system in order to close the loopholes that now are exploited by U.S. multinational firms.[6] On November 19, 2013, Senator Max Baucus, former chair of the U.S. Senate Finance Committee on Finance, issued a discussion draft of a bill to reform international business taxation.[7] Also Chairman Camp’s Tax Reform Act of 2014 contains a part with foreign corporate income taxation reform proposals.[8]

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[4] J.G. Gravelle, *Tax Havens: International Tax Avoidance and Evasion,* Congressional Research Service (CRS), January 23, 2013, pp. 8-13

[5] Joint Committee on Taxation, *Present Law and Background Related to Proposals to Reform the Taxation of Income of Multinational Enterprises (JCX-90-14),* July 21, 2014

[6] R.B. Stack, Deputy Assistant Secretary (International Tax Affairs), U.S. Department of the Treasury, *Testimony before the Senate Finance Committee,* July 22, 2014

[7] Joint Committee on Taxation, *Technical Explanation of the Senate Committee on Finance Chairman’s Staff Discussion Draft of Provisions to Reform International Business Taxation (JCX-15-13),* November 19, 2013

[8] Joint Committee on Taxation, *Technical Explanation of the Tax Reform Act of 2014, A Discussion Draft of the Chairman of the House Committee on Ways and Means to Reform the Internal Revenue Code (JCX-15-14),* February 26, 2014

Furthermore, the Obama Administration presented a proposal to reform the U.S. international tax system in its budget outline for the fiscal years of 2015 and 2016.[9] All these tax reform proposals have one important feature in common, the objective to address base erosion and profit shifting. It however remains to be seen which of these initiatives ultimately becomes law.

1.2 The Action Plan on Base Erosion and Profit Shifting

The frustration on the side of the public and the national governments has been translated in the participation of the G-20 leaders in the G-20/ "Organization for Economic Cooperation and Development"[10] "Base Erosion and Profit Shifting"[11] Project.[12] This Action Plan has the primary goal to make corporate income taxation internationally coherent, beneficial, and transparent through international cooperation.[13]

The "BEPS Action Plan",[14] introduced in 2013, is a framework that comprises fifteen specific areas. The fifteen actions can be divided into five comprehensive categories: 1) addressing the digital economy's tax challenges, 2) securing the international coherence of corporate income taxation, 3) reinforcing the full effects and benefits of international tax standards, 4) guaranteeing transparency, and 5) the implementation of these measures in a rapid fashion.[15]

While companies should not be expected to pay more taxes than they owe, governments should devote significant attention to change their rules in order to impede the effect of multinational companies shifting their income at the expense of the global tax base. The general aim of the action items is to provide guidance and at the same time develop recommendations to help countries to fight BEPS.

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[9] Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals,* March 2014, p. 9 and pp. 42-65 & Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals,* February 2015, pp. 10-37
[10] Organization for Economic Cooperation and Development, hereafter: OECD
[11] Base Erosion and Profit Shifting, hereafter: BEPS
[12] R.B. Stack, Deputy Assistant Secretary (International Tax Affairs), U.S. Department of the Treasury, *Testimony before the Senate Finance Committee*, July 22, 2014
[13] S. Rosenthal, Review of Banking & Financial Law, Volume 33, Chapter 3, *The OECD's International Tax Proposal: The Action Plan,* 2013-2014, pp. 20-29
[14] OECD (2013), *Action Plan on Base Erosion and Profit Shifting,* OECD Publishing
[15] PricewaterhouseCoopers, *Base Erosion and Profit Shifting (BEPS): OECD and Ways & Means Start Taking Action*, August 2, 2013 & S. Rosenthal, Review of Banking & Financial Law, Volume 33, Chapter 3, *The OECD's International Tax Proposal: The Action Plan,* 2013-2014, pp. 20-29

The BEPS project is expected to be accomplished at the end of 2015 with final recommendations under all of the action items.[16] The Action Plan has the intention to harmonize the tax codes across the world in order to reduce the inefficiencies, distortions, and unfairness. Even though the Action Plan acknowledges the importance of avoiding double taxation of the same income by multiple countries, it underlines the specific matter of double non taxation: situations in which the correlation of international tax laws enables corporations to avoid taxation of earnings by any country.[17] The OECD emphasizes that many techniques adopted by multinational corporations are presumably legal. To grant some context for the BEPS project, it is crucial to examine a number of factors that created the urgency of this matter.

1.3 Apple Inc.

The heart of the global interest consists of the activities of U.S.-based multinational companies. As with global household names, their activities gained a great deal of publicity. Furthermore, numerous government inquiries all over the world have focused on the techniques of multinational corporations. In chapter three of this thesis the focus will be on the practices of Apple Inc. For this company is chosen as U.S. Congress held a hearing to criticize Apple for its techniques in order to reduce its United States tax obligations.[18] Many multinational corporations in the U.S. adopt the same tax reduction techniques as Apple implements, therefore Apple Inc. can be considered as a representative of many multinational companies.[19]

1.4 Thesis and chapter outline

This master thesis is dedicated to the investigation of the following question: to what extent are the OECD BEPS Action Plan and the recent proposals to reform the U.S. international corporate tax system feasible to end the current artificial income shifting practices of U.S. multinationals? Special attention is paid to the techniques implemented by Apple Inc.

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[16] R.B. Stack, Deputy Assistant Secretary (International Tax Affairs), U.S. Department of the Treasury, *Testimony before the Senate Finance Committee,* July 22, 2014

[17] S. Rosenthal, Review of Banking & Financial Law, Volume 33, Chapter 3, *The OECD's International Tax Proposal: The Action Plan,* 2013-2014, pp. 20-29

[18] *Offshore Profit Shifting and the U.S. Tax Code- Part 2 (Apple Inc.): Hearing Before the Permanent Subcomm. on Investigations of the S. Comm. on Homeland Sec. And Gov. Affairs,* 113th Cong. (2013)

[19] S. Rosenthal, Review of Banking & Financial Law, Volume 33, Chapter 3, *The OECD's International Tax Proposal: The Action Plan,* 2013-2014, pp. 20-29

In order to answer this question in a complete manner, this thesis will examine a number of different subjects in each subsequent chapter.

To begin with, it is necessary to get an understanding of the U.S. planning structures that are used by U.S. multinationals, and how these multinationals are currently taxed. Subsequently, an overview is provided of the current policy concerns in the U.S. connected with the taxation of U.S. multinational companies. Additionally, a short general overview of the BEPS Action Plan is presented in this second chapter.

The third chapter discusses the expected consequences of the BEPS Action Plan on the American structures that are currently used to artificially shift profits from high-tax to low-tax jurisdictions. The focus in this chapter is on Apple Inc. There are many different kinds of multinational companies and each sector has its own specific profit shifting methods. Because it is impossible to cover all of these techniques in an extensive manner, the practices implemented by Apple Inc. are investigated in this thesis, as this company owns highly mobile intellectual property and other intangible assets. Because these highly valuable intangibles constitute a significant problem in the process of tackling BEPS, the practices of this company are therefore examined in greater detail. Further, the connection between the Action Points of the BEPS Action Plan and the planning structures of Apple Inc. are discussed in this part of the thesis. Finally, the possible consequences of these BEPS Action Points are considered.

Chapter four deals with the initiatives taken by the U.S. government with the intention of reforming the international taxation of U.S.-based companies. The reactions and the views of different parties on these tax reforms are also addressed. The second part of this chapter pays attention to the opinions of U.S. stakeholders on those OECD BEPS Actions Points, which were discussed in the previous chapter.

The final chapter concludes with an answer to the research question whereby the topics as discussed in the previous chapters serve to support the completeness of this answer.

Chapter 2

This chapter provides an introduction to the basic concepts and issues relevant to the U.S. international corporate tax system. This part deals with questions as how the current system of taxation of U.S. multinational companies works, and what kind of planning structures U.S. multinationals enforce. Subsequently the current policy concerns in the U.S. connected with the taxation of multinational companies are investigated. The chapter concludes with an introduction to the "OECD"[20] "BEPS"[21] "Action Plan"[22].

2.1 The taxation of multinational companies

2.1.1 Worldwide versus territorial taxation and the system of deferral

The United States has a worldwide, or resident-based tax system in which U.S. citizens, resident individuals and domestic corporations are commonly taxed on all income, either originated in the U.S. or abroad. The U.S. does not levy an income tax on foreign corporations on income derived from foreign activities. In this context it is irrelevant whether some or all of its shareholders are U.S. persons.

Ordinarily, income derived by a domestic parent corporation from foreign activities operated by foreign corporate subsidiaries –known as controlled foreign corporations, or CFCs-,[23] is subject to U.S. taxation at the moment of distribution of the income as a dividend to the domestic parent corporation. An exception has been made when the income falls under "Subpart F", as this income is immediately taxed. Until the moment of repatriation, the U.S. taxation on the concerning income is in most cases postponed.[24]

The U.S. taxes U.S. shareholders of foreign corporations at the stage of distribution of the foreign earnings as dividends by the foreign corporations or at the moment when the U.S. shareholders market their stock at a gain.[25]

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[20] Organization for Economic Co-operation and Development, hereafter: OECD
[21] Base Erosion and Profit Shifting, hereafter BEPS
[22] OECD (2013), *Action Plan on Base Erosion and Profit Shifting,* OECD Publishing
[23] Controlled Foreign Corporations, hereafter: CFCs
[24] D.G. Noren, *The Subpart F "Look-Through" Rule of Section 954(c)(6): Tax Policy Considerations,* April 2012, pp. 1-12
[25] Joint Committee on Taxation, *Present Law and Background Related to Proposals to Reform the Taxation of Income of Multinational Enterprises (JCX-90-14),* July 21, 2014, p. 24

2.1.2 The U.S. "CFC" regime

A CFC can be characterized as any foreign corporation on the condition that U.S. persons own (directly, indirectly or constructively) more than 50 percent of the corporation's stock (by vote or value) whereby only those U.S. persons that own at least 10 percent of the stock (measured by vote only) are taken into consideration.[26]

In a pure worldwide system of taxation, active foreign-source income would be taxed at the applicable U.S. tax rates at the moment it is earned. On the other hand in a pure territorial tax system a country entirely refrains from taxing any of the income earned abroad by the domestically located corporation.

Countries have divergent methods of taxing multinational corporations. The majority of countries have a hybrid system of taxation that is a mixture of the two systems. This means that each country taxes to a certain extent the corporate income earned outside the country.[27]

The current system of taxation in the United States is also a mixture of the two systems: as stated earlier, active income of foreign subsidiaries of U.S. parent multinational corporations is only taxed when this income is repatriated or paid to the U.S. parent corporation as a dividend. Taxes are thus not imposed on the income that is held abroad and this is called deferral as the taxes are postponed until the moment when the income is repatriated.[28]

The U.S. introduced its CFC regime in 1962 and was the first country in history with such a system. It was designed to limit the tax deferral on certain passive or highly mobile income, including intra-group dividend, interest and royalty payments, and intra-group sales income. A CFC-regime is an anti-avoidance measure designed to prevent deferral, or to impede denial of taxation by shifting profits to a CFC. It thus imposes immediate taxation on certain income of the CFC.

There is a challenging tradeoff between the policy objectives of anti-avoidance and competitiveness. In light of competitiveness, a tax system should safeguard the support of economic growth rather than frustrating normal business activities. Therefore CFC-systems are dedicated to make sure that specific types of income are included, and at the same time specific exclusions for certain types of income are provided.

[26] Internal Revenue Code, IRC Sections 951(b), 957 & 958

[27] M.P. Keightly & J.M. Stupak, *U.S. International Corporate Taxation: Basic Concepts and Policy Issues*, Congressional Research Service (CRS), December 2, 2014, pp. 1-2

[28] T.L. Hungerford, *The simple fix to the problem of how to tax multinational corporations- ending deferral,* Economic Policy Institute (EPI), March 31, 2014, pp. 1-3

One such an exception is known as the “manufacturing exception” which has the original intent to exempt income of a CFC from immediate taxation provided that the CFC itself was the manufacturer and added “substantial value” to the goods produced. The idea behind this exception was that a CFC regime should not hinder multinational corporations in the choice of expanding their manufacturing activities abroad.[29]

The U.S. check-the-box regime was launched in 1997,[30] it grants taxpayers the freedom to determine the classification of a qualified entity as a corporation or as a pass-through entity. The regulations were designed to simplify tax rules connected with the classification of subsidiaries for tax reasons, for both the taxpayer and the Internal Revenue Service.[31]

The regulations permits multinational corporations to convert a foreign subsidiary into a hybrid entity – a CFC that is recognized as a corporation in the U.S. (and taxed correspondingly) but as a flow-through disregarded entity in another jurisdiction, for so called “reverse hybrids” the exact opposite is applicable.[32]

Specific entities are considered as “per se corporations” whereby an election is not authorized. Usually, these entities are domestic entities formed under a State corporation statute. Also several other categories of foreign business entities are recognized as “per se corporations”, which are broadly speaking, corporations that are not closely held and the shares of these corporations can be traded on a securities exchange.[33] An example of a “per se corporation” is a Societas Europeaea.[34]

It is argued that the CFC regime is “effectively gutted” by the check-the-box regime, because multinational companies are using hybrid entities to circumvent the CFC system. This policy concern will be discussed later in more detail.[35]

[29] A. Ting, *Apple’s International Tax Structure and the Double Non-Taxation Issue*, British Tax Review (BTR), Number 1, Thomson Reuters, 2014, pp. 40-71

[30] Treasury Regulations s.301.7701-1, et seq.

[31] Internal Revenue Service, hereafter: IRS

[32] T.L. Hungerford, *The simple fix to the problem of how to tax multinational corporations- ending deferral*, Economic Policy Institute (EPI), March 31, 2014, p. 4

[33] Joint Committee on Taxation, *Technical Explanation of the Senate Committee on Finance Chairman’s Staff Discussion Draft of Provisions to Reform International Business Taxation (JCX-15-13)*, November 19, 2013, pp. 5-7

[34] Societas Europeaea, hereafter: SE, a “SE” can choose to register in any member state of the European Union and can freely transfer to other member states.

[35] A. Ting, *Apple’s International Tax Structure and the Double Non-Taxation Issue*, British Tax Review (BTR), Number 1, Thomson Reuters, 2014, pp. 40-71

2.1.3 Anti-deferral regimes: Subpart F income

Subpart F is applicable to CFCs and their shareholders, and forms the key anti-deferral regime of importance for a U.S.-based multinational corporate group. No deferral is allowed for particular categories of this income, the so-called "Subpart F income".

Subpart F income carries the name of the section in the Internal Revenue Code where this type of income can be found.[36] Specific anti-deferral regimes may result in the taxation of the domestic parent corporation in the U.S. at the stage when certain income is generated. One can think of certain types of passive income, such as interest, dividends, annuities or rents or highly mobile income. This income is generated by the foreign corporate subsidiaries and it is irrelevant whether this income has been distributed as a dividend to the parent corporation.[37]

Subpart F income comprises foreign base company income,[38] insurance income,[39] and specific income connected with international boycotts and other violations of public policy.[40] Foreign base company income encompasses foreign personal holding company income, which covers passive income, certain kinds of income from business activities, including foreign base company sales income, foreign base company services income, and foreign base company oil-related income.[41]

2.1.4 Subpart F exceptions

2.1.4.1 The "CFC-look-through rule"

A provision which is recognized as the "CFC look-through rule"[42] grants U.S.-based companies the possibility to redistribute their active foreign income outside the United States without levying current U.S. taxation on these earnings under Subpart F.[43]

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[36] Internal Revenue Code, IRC Sections 951-964

[37] M.P. Keightly & J.M. Stupak, *U.S. International Corporate Taxation: Basic Concepts and Policy Issues*, Congressional Research Service (CRS), December 2, 2014, pp. 2-3

[38] Internal Revenue Code, IRC Section 954

[39] Internal Revenue Code, IRC Section 953

[40] Internal Revenue Code, IRC Section 952(a)(3)-(5)

[41] Internal Revenue Code, IRC Section 954 & Joint Committee on Taxation, *Present Law and Background Related to Proposals to Reform the Taxation of Income of Multinational Enterprises (JCX-90-14)*, July 21, 2014, pp. 24-26

[42] Internal Revenue Code, IRC Section 954(c)(6)

[43] The Look-Through Rule achieves this outcome by granting that dividends, interests, rents and royalties received or accrued by one CFC from an associated CFC are not subject to current taxation under Subpart F

The rule is only relevant to the degree that such payments are connected with active, non-Subpart F income of the related CFC.[44] The rule is applicable for taxable years from 2005 and before 2014.

The U.S. Congress established the "look-through" rule with the aim of removing obstacles that could hinder the settlement of efficient business decisions regarding the redeployment of active foreign earnings within a U.S.-based multinational group. Concerns were raised that these obstacles were harming the U.S.-based multinationals because these companies could end up at a competitive disadvantage in comparison with foreign-based multinationals.[45]

2.1.4.2 "Active financing income"

Another provision, which forms an exception to the Subpart F income regulation, is known as "active financing income". This exception is connected with income earned by U.S. corporations that conduct banking, financing and insurance activities abroad. Even though certain parts of this income can be characterized as passive, they nevertheless do not fall under Subpart F on the condition that the income is generated as a consequence of active business activities. When certain income qualifies as "active financing income" it is thus deferred for tax purposes until the moment of repatriation to the U.S.[46]

2.1.4.3 The "same-country exception"

The so-called "same country exception"[47] forms an exclusion from foreign personal holding company income. This exclusion is applicable to dividends and interest obtained by a CFC from a connected corporation, which is organized and is conducting business activities in the same country as the CFC.

[44] D.G. Noren, *The Subpart F "Look-Through" Rule Section 954(c)(6): Tax Policy Considerations,* April 2012, pp. 1-12

[45] Joint Committee on Taxation, *Present Law and Background Related to Proposals to Reform the Taxation of Income of Multinational Enterprises (JCX-90-14),* July 21, 2014, pp. 27-28

[46] M.P. Keightly & J.M. Stupak, *U.S. International Corporate Taxation: Basic Concepts and Policy Issues,* Congressional Research Service (CRS), December 2, 2014, pp. 2-3

[47] Internal Revenue Code, IRC, Section 954(c)(3)

Also, rents and royalties received by a CFC from a related corporation in connection with the use of property within the country in which the CFC is established are excluded from foreign personal holding income. In the situation where the payments diminish the Subpart F income of the payor, the exclusions do however not apply.[48]

Previously taxed earnings and profits are also excluded from the income of a 10-percent U.S. shareholder of a CFC, on the condition that they were earlier included in the 10-percent U.S. shareholder's income under Subpart F.[49]

2.1.5 Other anti-deferral rules: the Foreign Tax Credit

Despite the fact that the United States taxes worldwide income of U.S. nationals (individuals and corporations), it also takes into account that the country where the income is generated possibly taxes the income as well. The U.S. therefore grants a credit for foreign taxes paid to prevent the possibility of double taxation.[50]

In order to protect the U.S. tax base, the amount of foreign tax credits is restricted to the amount of what the taxpayer's tax liability would be on the foreign-source income under the U.S. tax code.[51] This limit has the aim to safeguard the purpose of the credit, to alleviate double taxation of foreign source income without compensating U.S. taxes on U.S. income.[52] Since 2004, the foreign tax credits are determined individually for two distinct categories called "baskets" of income, -passive income and general income (regularly active income). Foreign tax credits can give rise to corporate tax avoidance. These opportunities and the existence of cross crediting are dealt with in detail hereafter.

[48] D.G. Noren, *The Subpart F "Look-Through" Rule Section 954(c)(6): Tax Policy Considerations,* April 2012, pp. 1-12 & Joint Committee on Taxation, *Present Law and Background Related to Proposals to Reform the Taxation of Income of Multinational Enterprises (JCX-90-14),* July 21, 2014, p. 28

[49] Internal Revenue Code, IRC, Section 959(a)(1)

[50] Internal Revenue Code, IRC, Sections 901-909 & 960

[51] T.L. Hungerford, *The simple fix to the problem of how to tax multinational corporations- ending deferral,* Economic Policy Institute (EPI), March 31, 2014, p. 4

[52] Internal Revenue Code, IRC, Section 901 and 904 & Joint Committee on Taxation, *Present Law and Background Related to Proposals to Reform the Taxation of Income of Multinational Enterprises (JCX-90-14),* July 21, 2014, pp. 30-32

2.2 Methods of corporate tax avoidance

A corporation can shift profits from a high-tax jurisdiction to a low-tax jurisdiction. Without influencing other elements of the company the overall taxes will be diminished.[53] In this part of the master thesis attention is paid to the methods utilized by U.S. multinational companies in the process of this so called "artificial profit shifting".

2.2.1 Debt allocation and earnings stripping

One way to shift profits from a high-tax to a low-tax jurisdiction is to shift the debt. This can be achieved by borrowing more in a high-tax jurisdiction and less in a low-tax one. In this situation the global debt liability remains unaffected. A domestic corporation may diminish the U.S. taxes from its activities by means of paying deductible amounts such as interests, rents, royalties, premiums, and management service fees to foreign related companies. These companies are not subject to U.S. taxes on the reception of these payments. Achieving extensive U.S. tax deductions through this method is known as "earnings stripping".[54] Usually, earnings stripping produce a net tax benefit only in the situation where the foreign recipient of the interest income is subject to a lower sum of foreign taxes on such income than the net value of the U.S. tax deduction applicable to the interest.[55]

2.2.2 Transfer Pricing

The pricing of goods and services sold between related parties can also serve as an opportunity for artificial profit shifting. To reflect the income in a correct manner, prices of goods and services sold by affiliated companies should be "at arm's length". This means that the prices between related companies should be the same prices that unrelated parties would pay.

[53] J.G. Gravelle, *Tax Havens: International Tax Avoidance and Evasion,* Congressional Research Service (CRS), January 23, 2013, pp. 9-12

[54] For U.S. controlled corporations, this category of tax planning is restricted by the anti-deferral rules of Subpart F

[55] Joint Committee on Taxation, *Technical Explanation of the Senate Committee on Finance Chairman's Staff Discussion Draft of Provisions to Reform International Business Taxation (JCX-15-13),* November 19, 2013, p. 22

By altering the prices of goods- and services sold and the prices of the purchases, income can be shifted from high-tax jurisdictions to low-tax jurisdictions.[56] When the prices of goods and services sold by parents and related entities in high-tax jurisdictions are reduced, and the prices of the acquired products in a jurisdiction with lower taxes are increased, income can be shifted from high-tax to low-tax jurisdictions.

The transfer pricing rules of “Section 482”[57] and the connected Treasury regulations are designed to safeguard the U.S. tax base by making sure that taxpayers do not shift income that is actually connected with the United States to an affiliated foreign company through pricing that does not result in an “at arm’s length” outcome. These regulations also empower the Secretary of the Treasury to assign income, deductions, credits, or allowances between affiliated business entities.[58]

Intercompany transfers of rights to intellectual property or intangible assets forms an important segment in the transfer pricing area.[59] For income from intangible property, section 482 states that “In the case of any transfer or license of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible”.[60] Income can be shifted from a high-tax to a low-tax jurisdiction by means of licensing a patent from the U.S. to a related party in a low-tax country in the case where the royalty payment is lower than the true value of the license.

Due to the fact that in many circumstances intangibles have no comparables it is extremely difficult to determine the arm’s length price for a royalty. Therefore the “arm’s length” pricing of intangibles forms an important distinct problem. Also the existence of so-called “cost sharing agreements”, where different associates are partly responsible for the cost, further complicates the problem. In the situation where a parent company already partially developed an intangible, the problem of “buy-in payments” is significant.

[56] J.G. Gravelle, *Tax Havens: International Tax Avoidance and Evasion*, Congressional Research Service (CRS), January 23, 2013, pp. 10-11

[57] Internal Revenue Code, IRC, Section 482

[58] Joint Committee on Taxation, *Technical Explanation of the Senate Committee on Finance Chairman’s Staff Discussion Draft of Provisions to Reform International Business Taxation (JCX-15-13)*, November 19, 2013, pp. 19-20

[59] M.P. Keightly & J.M. Stupak, *U.S. International Corporate Taxation: Basic Concepts and Policy Issues*, Congressional Research Service (CRS), December 2, 2014, p. 5

[60] Internal Revenue Code, IRC, Sections 482 and 936(h)(3)(B)

Establishing an at "arm's-length" price can be extremely challenging in the case of a technology that has not yet been completed and where a considerable amount of risk is involved with the possible outcome. Therefore, it can be necessary in these situations to conclude an Advanced Pricing Agreement, an APA,[61] with the tax authorities. In the case of an APA or any other tax ruling, such as an ATR,[62] there is no longer a legal risk associated with the transaction.

Apple Inc. and the U.S. Treasury, the IRS, reached an Advanced Pricing Agreement whereby it determines how the IRS treats a particular transaction between related parties for tax objectives before both parties decide to participate in the specific transaction. In the case of Apple the particular transaction consisted of a "cost sharing agreement" between Apple Inc. and its Irish affiliates. These affiliates would share in the cost of funding the R&D of Apple Inc. The Irish associates would obtain the benefits of the IP rights of Apple Inc. for goods and services sold outside the Americas in return.

The tax authorities of different jurisdictions offer the possibility of obtaining an APA. Companies argue that these kind of arrangements with the tax authorities are crucial to support the international trade and investment. Critics however argue that tax authorities have been too lenient in accepting the pricing arrangement requested by the companies.[63]

Because of the advantageous treatment of the investment in intangibles, there are various reasons to make these kinds of investments in the U.S. However, the problem for the U.S. treasury is that the benefit of tax deductions or credits for the companies, while making the investment are likely to outweigh the future taxes on the return to the investment. The comprehensive treatments of intangibles for taxation purposes are likely to produce an effective low, zero, or negative tax rate for the global investment in intangibles. Nevertheless, in case investments tend to be profitable, it is beneficial to shift the profits to low-tax jurisdictions to realize tax savings on investment and little or no taxation on future returns. As a consequence, the investments can be subject to negative taxes, or to subsidies, which can have considerable effects for the corporation in question.

A last important remark is about the problem with shifting profits to particular "tax haven jurisdictions" where real activity is crucial to produce the particular intangible, but these countries do not possess the required resources to carry out the activity.

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[61] Advanced Pricing Agreement, hereafter: APA
[62] Advance Tax Ruling, hereafter: ATR
[63] P. Gupta & P. Halpin, *Apple enjoyed Irish tax holiday from the start*, Reuters, May 23, 2013

Companies however, have realized methods to exploit the tax laws in other countries to attain a productive operation and being able to shift profits to low-, or no-tax jurisdictions at the same time.[64]

2.2.3 Contract manufacturing

In the situation where a sales company (the entrepreneur) is located in a low-tax country and profit shifting takes place, another problem can emerge. The low-tax jurisdiction might not be the ideal location to manufacture and sell the particular product. The entrepreneur in the low-tax jurisdiction can sign up a contract with a country of choice, whereby this other country becomes a "contract manufacturer" who will produce the items for a fixed fee above the cost price.[65] By means of this construction, the entrepreneur in the low tax jurisdiction can still generate the greatest part of the profits and is taxed at an attractive rate.

2.2.4 Check-the-box and hybrids

When the "check-the-box" provisions were enacted, another approach to shifting profits emerged. As explained earlier, the original aim of these provisions was the simplification of the entity classification process.

Nevertheless, the regulations approved that multinational corporations are able to convert a foreign subsidiary into a "hybrid entity". As a result of the check-the-box regulations, a U.S. parent can appoint a foreign subsidiary (the CFC), with the result that the CFC will be treated as a disregarded entity. This can be achieved by means of checking some boxes on the IRS8832 form.[66]

As a consequence, the CFC is now treated as a branch of the U.S. parent for U.S. tax purposes. The two CFCs, CFC-high (the U.S. parent), and CFC-low (the foreign subsidiary) are treated as one single entity.[67]

[64] J.G. Gravelle, *Tax Havens: International Tax Avoidance and Evasion,* Congressional Research Service (CRS), January 23, 2013, pp. 10-11

[65] W.W. Chip, *"Manufacturing" Foreign Base Company Sales Income",* Tax Notes, November 19, 2007, pp. 803-808 & J.G. Gravelle, *Tax Havens: International Tax Avoidance and Evasion,* Congressional Research Service (CRS), January 23, 2013, p. 11

[66] Internal Revenue Service of the United States, hereafter: IRS

[67] T.L. Hungerford, *The simple fix to the problem of how to tax multinational corporations- ending deferral,* Economic Policy Institute (EPI), March 31, 2014, p. 4

The U.S. parent is regarded as the owner of the assets of the foreign subsidiary, is bearing all of the liabilities of the foreign subsidiary and is also carrying out all the activities of the subsidiary. This is the reason why transactions between the U.S. parent and the foreign subsidiary are disregarded for U.S. tax purposes.[68]

Check-the-box and the complementary hybrid entity procedures can also be operated to circumvent other kinds of Subpart F income.[69] As a result of the choice of entity classification of domestic and foreign entities and as a consequence of disparities between U.S. and foreign law, the probability arises for an entity that conducts business cross-border, to elect into a "hybrid status". As mentioned before, a hybrid entity is a CFC that is recognized as a corporation in the U.S. (and taxed correspondingly) but as a flow-through disregarded entity in another jurisdiction, for so called "reverse hybrids" the exact opposite is applicable.[70]

For instance, when the box is "checked" for a Dutch Besloten Vennootschap,[71] a BV, which is a private limited liability company, this BV is taxed in The Netherlands but the U.S. allocates the revenues of the BV to the entity above, which has not been checked.

The presence of these hybrids and reverse hybrids can influence the situation wherein a taxpayer can use foreign tax credits in connection with deferred foreign-source income or whether income is liable to taxation in the U.S., just as if the income is presently incorporated under Subpart F.[72] The existence of the check-the-box provisions together with the "look-through" rules have the tendency to weaken the envisioned aim of Subpart F.[73]

2.2.5 Foreign tax credits and the existence of cross-crediting

As mentioned before, corporations estimate their foreign tax credits for two distinct "baskets" of income, passive income and general income.

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[68] D.G. Noren, *The Subpart F "Look-Through" Rule Section 954(c)(6): Tax Policy Considerations,* April 2012, p. 5

[69] J.G. Gravelle, *Tax Havens: International Tax Avoidance and Evasion,* Congressional Research Service (CRS), January 23, 2013, pp. 11-12

[70] T.L. Hungerford, *The simple fix to the problem of how to tax multinational corporations- ending deferral,* Economic Policy Institute (EPI), March 31, 2014, p. 4

[71] Besloten Vennootschap, a Dutch private limited liability company, hereafter: BV

[72] Joint Committee on Taxation, *Technical Explanation of the Senate Committee on Finance Chairman's Staff Discussion Draft of Provisions to Reform International Business Taxation (JCX-15-13),* November 19, 2013, pp. 6-7

[73] T.L. Hungerford, *The simple fix to the problem of how to tax multinational corporations- ending deferral,* Economic Policy Institute (EPI), March 31, 2014, p. 3

Passive income consists of portfolio interest, dividend income and other particular sorts of income. The general kind of income comprises all other income.

Passive income is considered as general type of income in the situation where it is earned by a certified financial services entity. Also highly taxed passive income is treated as general income. A 10 percent U.S. shareholder that receives dividends, interest, rents, and royalties from a CFC are allocated to a separate limitation category.[74]

Dividends obtained by a 10-percent corporate shareholder of a foreign corporation that is not a CFC are also classified following the "look through" principle.[75] Within each basket the surplus of credits generated in high-tax countries, -where credits cannot be used due to the fact that the foreign tax liability is higher than the amount that would be incurred under the U.S. tax code-, can be utilized to offset U.S. taxes outstanding on income earned in low-tax countries.

Surplus credits can adequately offset a great part of the U.S. tax obligations on income repatriated from tax havens. These practices are known as "cross-crediting" and this method has become more wide ranging over time.[76] In the past, it was suggested that the limitation on foreign tax credits was fixed per country. The country-by-country basis demonstrated to be challenging to adopt because of the potential to use holding companies.

Because corporations have the freedom to decide about the time when they repatriate the income, they can determine the realizations in order to expand the benefits of the comprehensive limit on the foreign tax credits.[77]

2.3 Prevalent policy concerns of the United States associated with the taxation of multinational companies

As in the rest of the world, the U.S. devotes a lot of effort to the field of drafting tax regulations to increase the capacity of home-country multinational corporations to compete in the worldwide economy. A number of U.S. policymakers are concerned about the capacity of U.S. corporations to postpone U.S. taxation on foreign earnings as this may impede investment in the United States.

[74] Internal Revenue Code, IRC, Section 904(d)(3)

[75] Joint Committee on Taxation, *Present Law and Background Related to Proposals to Reform the Taxation of Income of Multinational Enterprises (JCX-90-14),* July 21, 2014, pp. 31-32 & Internal Revenue Code, IRC, Section 904(d)(4)

[76] T.L. Hungerford, *The simple fix to the problem of how to tax multinational corporations- ending deferral,* Economic Policy Institute (EPI), March 31, 2014, pp. 4-5

[77] J.G. Gravelle, *Tax Havens: International Tax Avoidance and Evasion,* Congressional Research Service (CRS), January 23, 2013, pp. 12-13

Deferral may influence companies in their investment decisions and may result in less productive investments than in a situation without deferral. Deferral induces multinational corporations to retain foreign-sourced active income offshore due to the fact that corporate taxes are not payable until the moment of repatriation.

Because of the existence of deferral there is an impetus to move income to low tax jurisdictions and to keep it there, this is called the “lock-out effect”. This effect refers to the situation whereby a probability exists where foreign earnings of U.S. corporations are being “locked out” and not reinvested in the United States.

There are different situations wherein the “lock-out effect” can occur. The effect can take place considering that corporations have the power to decrease the present value of their remaining U.S. tax liability on foreign earnings by means of deferring those earnings. This effect can also occur when corporations prefer to make foreign investments instead of domestic investments.

As a result of the capacity to postpone the payment of remaining U.S. tax liability on the yield to the foreign investments, this may make foreign investments more appealing on an after-tax basis, even in the situation where they have the same pre-tax revenue as a domestic investment. The effect dwindles in the case where repatriation of foreign earnings no longer has an effect on taxation, for example in a situation where foreign earnings are exempt from U.S. taxation or when those earnings are subject to current U.S. taxation.

Even though the phasing out of deferral of U.S. taxation and the present taxation of the returns on foreign investments would eliminate the tax distortion connected with the repatriation choices of U.S. corporations, there is still another matter that has not received attention.

Policymakers fear that U.S. companies are not capable to compete effectively in foreign local markets with foreign companies who are on a limited basis, -or not at all-, subject to residual home-country taxation on their foreign investments. As numerous countries have enacted some type of a territorial tax system, the competitive disadvantage that might challenge U.S. corporations may be significant. This is due to the fact that their capacity to grow in foreign markets in comparison to foreign corporations may be more restricted.[78]

[78] T.L. Hungerford, *The simple fix to the problem of how to tax multinational corporations- ending deferral*, Economic Policy Institute (EPI), March 31, 2014, p. 3 & Joint Committee on Taxation, *Present Law and Background Related to Proposals to Reform the Taxation of Income of Multinational Enterprises (JCX-90-14)*, July 21, 2014, pp. 33-41

2.4 The BEPS project, a short introduction

To conclude this chapter in a complete manner, a short introduction about the BEPS project, which is hosted by the OECD, is provided. In this chapter, the many different methods that multinational companies can adopt in order to artificially shift profits to where they are taxed at lower rates and the expenses to a location where they are relieved at higher rates, were explained.

The BEPS report highlights a number of crucial principles for the taxation of cross-border activities. It also connects these principles with the possibilities for BEPS practices.[79] Jurisdiction to tax serves as a starting point where each country has the freedom to organize the corporate tax system as desired.

The BEPS report notes that it is unclear whether the current taxation rules result in a fair allocation of taxing rights, as there are many cases where the profits from some transactions are not taxed anywhere at all, due to gaps in interacting domestic tax systems.[80] However, there are also cases of "double-taxation" as a result of overlaps between different tax structures. The matter of jurisdiction to tax is closely connected to the principle of the measurement of profits.

As noted earlier, the "arms-length" principle connected with transfer pricing can give rise to BEPS. One of the underlying assumptions of the arm's-length principle is that the more extensive the functions, assets or risks of one party to the transactions are, the higher is the expected compensation for that party. This situation can give rise to the impetus to shift the connected functions, assets and risks of a transaction to a jurisdiction where their returns are taxed in a more advantageous fashion.[81]

Also, the significant distinct treatment between debt and equity that most jurisdictions apply for tax purposes might induce BEPS practices. The payments of interest are usually deductible for tax reasons whereas the payments of dividends usually do not qualify for a tax deduction. The beneficiary of the income is in most cases obliged to include the interest in the taxable base. Dividends on the other hand, are in most cases eliminated from the taxable income.

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[79] Joint Committee on Taxation, *Present Law and Background Related to Proposals to Reform the Taxation of Income of Multinational Enterprises (JCX-90-14),* July 21, 2014, pp. 42-52 & OECD (2013), *Addressing Base Erosion and Profit Shifting,* OECD Publishing

[80] OECD (2013), *Addressing Base Erosion and Profit Shifting,* OECD Publishing, pp. 33-36 & 39-41

[81] Ibid, 36-37 & 42-43

This distinct treatment of debt and equity might contribute to a preference for debt financing. The possibility also can arise where attempts will be made to classify the payments as deductible interest in the country of the payer and as dividends,- which remains untaxed in most cases-, at the location of the beneficiary.[82]

Many countries have several anti-avoidance procedures in place to safeguard the fairness and effectiveness of their corporate tax systems. These procedures are charged with the impediment of aggressive tax planning, the observation of these structures and the endeavors to react to aggressive tax planning in an effective manner. Nevertheless, as clarified in this chapter, there has been established several techniques to circumvent these “anti-avoidance” rules.

The BEPS report concludes that it is often the interaction between various principles and practices of more than one taxing jurisdiction that can lead to the unintended occurrence of BEPS. Therefore, an extensive action plan has been put into place to grant countries some instruments in order to achieve better alignment of taxing rights with the reality of the economic activity.[83] As it is out of the scope of this essay to observe each Action Point separately, attention is paid in the next chapters, only to those Action Points that are of considerable significance to the thesis.

[82] OECD (2013), *Addressing Base Erosion and Profit Shifting,* OECD Publishing, pp. 37 + 43
[83] Ibid, pp. 37-38 & 43-44

Chapter 3

As emphasized earlier in the thesis, Apple Inc. can be considered as a representative of many multinational companies because of its particular profit shifting methods. Since the company also owns highly mobile intangible assets, which constitutes a large problem in tackling BEPS, this chapter is dedicated to further examine the practices of this company.

These kinds of assets are easily movable from one jurisdiction to another without changing the real economic activity connected with the intangibles. Also the income that these types of assets generate is shifted to the jurisdiction where the intangible is moved. The various methods that Apple Inc. operates in order to shift profits to low tax jurisdictions are scrutinized first to come to a general understanding of the framework adopted by this company. In the second part of this chapter, the Action points of the BEPS report that are considered as elements of great significance to the current structure of Apple Inc. are carefully examined

Finally the possible consequences of the BEPS Action Points in connection with the planning structures of Apple Inc. are considered.

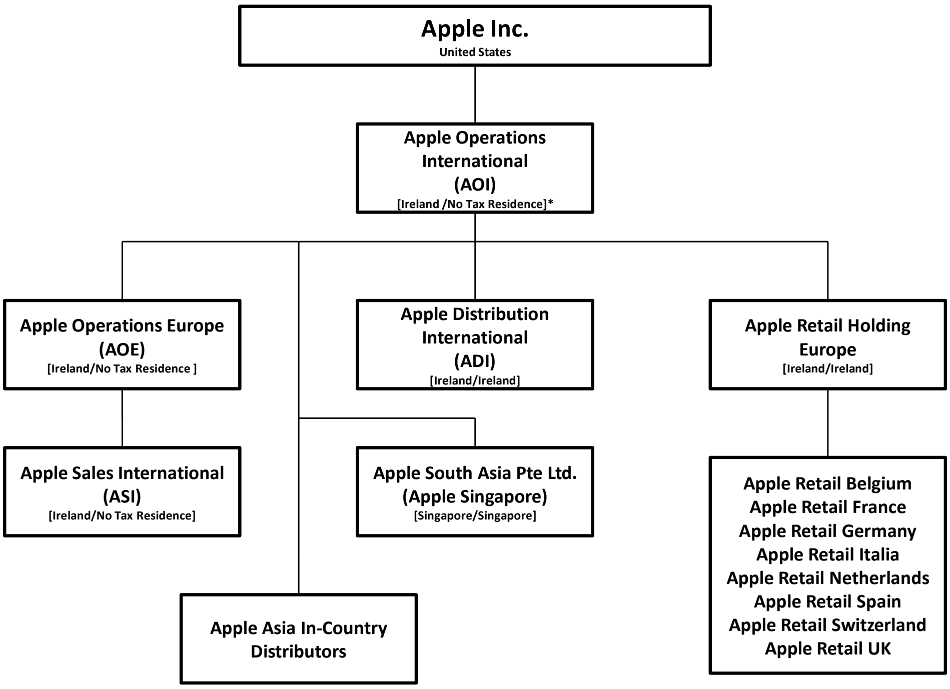
3.1 The profit shifting framework of Apple Inc.

3.1.1 The establishment of offshore associates in Ireland

In 1980, Apple Inc. founded three 100 percent owned subsidiaries in Ireland: Apple Operations International (hereafter AOI), Apple Operations Europe (hereafter AOE) and Apple Sales International (hereafter ASI). The choice for Ireland was not a random one, at that time the corporate income tax rate was 12 percent. Apple affiliates however, were granted an exceptionally low rate, much less than the statutory rate. The company had been able to settle an exclusive tax rate with the Irish government of two percent and at times paid even less.[84]

[84] C. Levin & J. McCain, *Report on Offshore Profit Shifting and the U.S. Tax Code – Part 2 (Apple Inc.),* May 21, 2013, pp. 20-21 & Subcommittee interview of Philip Bullock, Apple Inc. Tax Operations Head (5/15/2013) & Based on information supplied to the Subcommittee by Apple, PSI-Apple-02-004

Apple's Offshore Organizational Structure



*Listed countries indicate country of incorporation and country of tax residence, respectively.

Prepared by the Permanent Subcommittee on Investigations, May 2013. Source: Materials received from Apple Inc.

Source: C. Levin & J. McCain, *Report on Offshore Profit Shifting and the U.S. Tax Code – Part 2 (Apple Inc.),* May 21, 2013

3.1.2 Apple Operations International

Even though Apple Operations International (AOI) is incorporated in Ireland, its central management and control are located in the United States. AOI is not a resident of Ireland, as in this jurisdiction the place of central management and control is decisive in the determination of the corporate tax residence of a company. In the U.S. on the other hand, the place of incorporation decides where the company is located. The outcome of the differences in classification between Ireland and the U.S. leads to the attracting circumstance where AOI is neither a U.S. resident for corporate taxation purposes, nor in Ireland.

AOI functions as an intermediate holding between Apple Inc. in the U.S. and the overseas activities of the company. Apple Inc. owns 100 percent of AOI in a direct-, or indirect manner through other CFCs. This enterprise owns the major part of Apple's offshore entities. An important asset of AOI is cash, it therefore operates as a cash consolidation center for its subsidiaries and its associates.

For the provision of funds it receives a dividend in return. However, the business objective for the formation of AOI and the reason for its incorporation in Ireland remain unclear. As it also has no physical presence or employees, Apple Inc. can be regarded as exclusively managing and controlling the assets and functions of AOI in the U.S. Apple took advantage of disparities between Irish and U.S. tax residency regulations.

After a thorough investigation by the U.S. Subcommittee, which has been presented in a report to the public,[85] it became clear that AOI gains a significant amount of dividends, which it receives, from lower-tiered offshore Apple affiliates but it nevertheless did not pay any corporate income taxes to any government for a substantial period of time.[86]

3.1.3 Apple Sales International

Apple Sales International which is also incorporated in Ireland, is a subsidiary of Apple Operations Europe -which is in turn a subsidiary of AOI-, also conducted its activities without having a tax residency and it therefore takes advantage of the same discrepancies between the U.S. and the Irish tax residency rules as AOI. It approaches third party contract manufacturers in China to assemble the Apple products and arranges contracts with these entities. When the products are assembled in China ASI takes the title of the finished products and then sells them to the distribution entity in Europe, Apple Distribution International (ADI) and to Apple Singapore for sales in Asia.

In most cases, these products do not enter Ireland after the title transfer between the Chinese manufacturer and ASI but are directly transferred from China to the country of ultimate sale. As ASI asks its related parties a price, which is higher than it initially paid for the products, it is able to receive a sizeable amount of income. ASI in turn pays dividends to its parent AOE, and AOE distributes dividends to its parent AOI.

The structuring of Apple's distribution operations actually manifests that the location of the Irish associates does not form an essential part in the sales and distribution activities they execute. The location in Ireland tends to be chosen with the objective of consolidating the profits in a low tax jurisdiction. Apple Inc. employees established in the U.S. are the actual persons to conclude the contracts on behalf of ASI.

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[85] C. Levin & J. McCain, *Report on Offshore Profit Shifting and the U.S. Tax Code – Part 2 (Apple Inc.),* May 21, 2013

[86] Ibid, pp. 21-24 & A. Ting, *ITax-Apple's International Tax Structure and the Double Non-Taxation Issue,* British Tax Review Nr. 1, 2014

Until 2012, there were no employees at ASI, but in this year 250 employees were appointed to from AOE, the parent company of ASI. Before 2012, ASI performed its functions by means of a U.S.-based board of Directors.

Although ASI receives these new employees in 2012, it emphasizes that the management and control is still established outside Ireland. It nevertheless filed a corporate tax return in Ireland with regard to the activities in that country. The payments to the Irish Treasury are nonetheless negligible and questions are raised whether ASI declared on its Irish tax returns the total value of the income it has obtained from other Apple affiliates or just the income connected with the sales to Irish customers.[87]

3.1.4 Apple's cost-sharing agreements and connected transfer pricing practices to avoid U.S. taxation

The Irish associates also contributed to the diminishment of the U.S. tax burden by means of the application of a cost-sharing agreement and associated transfer-pricing practices. ASI and AOE took part in these kind of arrangements with Apple Inc., where it was agreed upon that these parties share in the development of products and that the intellectual property rights that emerge from this development where allocated among the parties. As a result, ASI does not have to pay royalties to Apple Inc. because of the division of the economic ownership of the intangible assets.

Hence, economic rights to Apple's intellectual property where partly shifted outside the U.S. but the legal ownership of the intellectual property remained with Apple Inc. in the United States, since the U.S. legal system provides for the protection of the legal ownership of the intangible.

Nevertheless, almost all the research that Apple undertakes was still carried out by Apple Inc. employees in California and under the cost sharing agreement, an excessive amount of the resulting profits were kept outside the U.S. Further, the relocation of IP rights to Ireland by means of the cost-sharing agreement did not seem to influence the process of Apple managing its commercial activities.

[87] C. Levin & J. McCain, *Report on Offshore Profit Shifting and the U.S. Tax Code – Part 2 (Apple Inc.),* May 21, 2013, pp. 21-25 & A. Ting, *ITax-Apple's International Tax Structure and the Double Non-Taxation Issue,* British Tax Review Nr. 1, 2014

In the end, the cost-sharing agreement did not lead to the transfer of risks or benefits away from Apple Inc. as a whole, but it only led to the deviation of the place of the tax liability for Apple's profits. All things considered, these offshore associates thus facilitate Apple Inc. to keep a great part of the worldwide sales income outside the U.S. and in Ireland, where Apple benefits from an extremely low tax rate.

Cost sharing agreements are not new or exceptional, these type of arrangements were introduced by the U.S. Treasury at the beginning of the 1990s. The U.S. government had the assumption that because it is difficult to estimate the chances of success of specific R&D activities beforehand, it wanted to protect multinational corporations from losing their deduction of the R&D costs in the situation where the research activities turn out to be fruitless.

For that reason it was initially believed by the U.S. government that multinational companies would not engage in cost sharing agreements with the main purpose of tax avoidance. As there is a so called "information assymmetry" between the tax authorities and the multinational corporations, the corporations are usually in a better position to evaluate the risk of the research project, while the tax authorities lack this vital information.

The information assymmetry would explain why multinationals generally hold a stronger position in disputes concerning transfer pricing valutions in comparison to the tax authorities. Multinational corporations tend to participate in these kind of agreemeents only on the condition that there is a significant chance of success.[88]

The part of the worldwide sales in a particular location determines the amount of Research and Development costs that each location should contribute to the group's total R&D costs.[89] By means of grouping the intellectual property rights and the distribution activities in the chosen approach, Apple Inc. was able to circumvent the taxation in the U.S. on the worldwide Apple sales profits connected to its part of the intellectual property. In the U.S., this income would normally be subject to taxation in the year it was earned.

As a substantial share of the worldwide Apple sales income is assigned to ASI in Ireland the question is raised whether Apple Inc. has chosen for Ireland because of the extremely low income taxation rates or by reason of the discrepancy between Irish and U.S. tax residency rules. The last option this has the consequence of avoiding the payment of income taxes altogether instead of profit shifting to a low tax jurisdiction.

[88] A. Ting, *ITax-Apple's International Tax Structure and the Double Non-Taxation Issue,* British Tax Review Nr. 1, 2014

[89] Research and Development, hereafter: R&D

As a result of the introduction of the cost sharing mechanism by the U.S. Treasury, the transfer-pricing regime has appeared to be inadequate in a number of cases to invoke the arm's length doctrine on the transfers. The initial aim of the cost-sharing rule is based on the assumption that a multinational was unable to verify in advance the success rate of the R&D activities. However, the mechanism has also led in some circumstances to multinationals entering into a cost sharing agreement with the main objective of tax avoidance.[90]

3.1.5 Exploiting "tax loopholes" with the aim of avoiding U.S. taxes on foreign income

As examined thoroughly earlier in the thesis, Subpart F income has the aim to impede U.S. companies from transferring income to tax havens in order to lower their tax rate without undertaking actual economic activities. No deferral is allowed for particular categories of this "Subpart F income", which includes certain types of sales revenue and passive foreign income.

Nevertheless, the intended effect of Subpart F has been significantly undermined by specific regulations, temporary statutory changes, and statutory exemptions. The U.S. Subcommittee scrutinized the practices of Apple Inc. over a period of 4 years, from 2009 to 2012. During that term Apple generated two distinct kinds of offshore income that should have been subject to immediate taxation under Subpart F.

The first category of income consisted of Foreign Base Company Sales income,[91] the part of the sales income that Apple designated to Ireland in order to accumulate the profits in that jurisdiction. These FBCS-rules coordinate the taxation of products sold through an entity in one country to an affiliate entity for the eventual consumption in another jurisdiction.

To prevent multinational companies from organizing intermediary entities in tax havens just to buy finished goods and to sell them onwards to affiliates for use in another country with the aim of gathering the sales revenues in tax havens, the FBCS section of Subpart F was enacted.

In the situation of Apple, ASI was the buyer of the finished Apple products that had been assembled in China and sells products right away to the distributors, Apple Distribution International and to Apple Singapore, which consecutively sold the products around the globe.

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[90] C. Levin & J. McCain, *Report on Offshore Profit Shifting and the U.S. Tax Code – Part 2 (Apple Inc.),* May 21, 2013, pp. 25-31 & A. Ting, *ITax-Apple's International Tax Structure and the Double Non-Taxation Issue,* British Tax Review Nr. 1, 2014

[91] Internal Revenue Code, IRC, Section 954(d), Foreign Base Company Sales income, hereafter: FBCS

ASI did not contribute to the manufacturing of these products and it also did not take the physical ownership of the products. The title was transferred at the moment of transportation of the goods to the country of sale, this granted Apple Inc. the opportunity to preserve the greatest part of its profits in Ireland and to reduce the income disclosed in the non-tax haven jurisdictions where Apple carries out the greater part of its business.

Normally, this income would be taxed under Subpart F in the year it is earned, however, because of the possibility of checking the box, Apple is in the position to avoid all U.S. taxation on the FBCS-income. Because of the ability of "checking the box" the reciprocal sales transactions are no longer visible, and therefore there is no FBCS-income. Also taxation of Foreign Personal Holding Company income,[92] which comprises passive foreign income like dividends, royalties' fees, and interest, was avoided by Apple Inc. as a result of operating diverse regulatory and statutory tax loopholes.[93]

3.1.6 Adopting the check-the-box system

By means of checking the box under the regulations of the Internal Revenue Service,[94] all the subsidiaries of Apple Operations International (AOI) are regarded as divisions of AOI for taxation objectives. As a result of this election, the IRS does not notice transactions between disregarded entities due to the fact that the transactions are considered taking place within the same company. Because the IRS only views AOI, the sales income is assumed to be received directly by this company from the end consumers. This sort of income falls in the category of active business income and is therefore not taxable under Subpart F.

3.1.7 The conversion of passive income into active income through the adoption of the check-the-box regime

In the situation where an offshore subsidiary of a multinational company earns dividends, royalties or other related payments from an affiliated subsidiary, this income is treated as FPHC-income. This kind of passive income is usually subject to immediate taxation.

[92] Internal Revenue Code, IRC, Section 954(c), Foreign Personal Holding Company income, hereafter: FPHC
[93] C. Levin & J. McCain, *Report on Offshore Profit Shifting and the U.S. Tax Code – Part 2 (Apple Inc.),* May 21, 2013, pp. 31-34 & A. Ting, *ITax-Apple's International Tax Structure and the Double Non-Taxation Issue,* British Tax Review Nr. 1, 2014
[94] Internal Revenue Service, hereafter: IRS

Also in this situation, by means of the application of the check-the-box regulations, the dividends, interest, royalties and related payments of Apple Inc. were considered as taking place within one individual entity. Correspondingly, the IRS did not treat the payments as occurring between two independent entities or as taxable income under Subpart F.[95]

3.1.8 Other loopholes in the avoidance of Subpart F taxation

Even in the situation where the check-the-box regime and the look-through rules would be phased out, Apple could benefit from other tax loopholes to maintain the avoidance of Subpart F taxation. Two prominent loopholes are the "same country exception" and the "manufacturing exception" which are both discussed more intensively.

3.1.8.1 Same country exception

This exception to Subpart F taxation grants the possibility to prevent taxation on transactions between related parties that are organized in the same jurisdiction and execute their business activities within the same borders.[96]

The idea behind the exception was to devote attention to the circumstance in which affiliated entities are situated in the same jurisdiction whereby these entities are subject to the same tax rate, therefore it was assumed that there would be little reason to participate in tax-driven transactions.

It should however be noted that not every taxpayer may have been able to engage in same-country CFC-to-CFC transactions without stimulating current U.S. taxation under Subpart F. This is due to the fact that the statute and regulations did not follow the developments in international business and the current regulatory landscape. Same-country transactions can also be confronted with difficulties under Subpart F when modern business models are involved.[97]

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[95] C. Levin & J. McCain, *Report on Offshore Profit Shifting and the U.S. Tax Code – Part 2 (Apple Inc.),* May 21, 2013, p. 36 & A. Ting, *ITax-Apple's International Tax Structure and the Double Non-Taxation Issue,* British Tax Review Nr. 1, 2014

[96] Same country exception, Internal Revenue Code, IRC, Section 954(d)(1)(A); Reg. Paragraph 1.954-3(a)(2)

[97] D.G. Noren, *The Subpart F "look through" rule of Section 954(c)(6): Tax Policy Considerations,* April 2012, p. 6 & C. Levin & C. Levin & J. McCain, *Report on Offshore Profit Shifting and the U.S. Tax Code – Part 2 (Apple Inc.),* May 21, 2013, pp. 36- 37

3.1.8.2 Manufacturing exception

Usually, Foreign Base Company Sales income,[98] which is currently taxed under Subpart F, includes income connected with the sale of personal property between affiliated entities through a CFC, provided that the CFC's country of incorporation is not the source or the destination of the products and it also did not "manufacture" the goods in question. Consequently, FBCS-income does not include income from the sale of products manufactured in a CFC's country of organization, it should however be noted that it is not required that the CFC itself produces the goods.

The exception is applicable to the situation wherein goods are sold to an affiliated party that converts, or adds "substantive value" to the products. It should be kept in mind that in 2008, the appropriate procedures to the manufacturing exception were relaxed that made it extremely easy for corporations to request for the specific exemption.[99]

3.2 Probable changes as a result of the BEPS Action Plan and the potential effects on Apple Inc.

3.2.1 Action Points of presumable significance to the current profit-shifting structure

Because of the arrival of the BEPS Action Plan, the current structures used by Apple Inc. might be brought to a halt. The following points that could have significant consequences for the present framework of Apple Inc. are described in more detail in this paragraph.

- Addressing the existing transfer pricing rules that enable the nonresident Irish companies (In the case of Apple Inc.: ASI, AOI and AOE) to generate IP profits whereby this company does not operate or controls development tasks connected with these profits by means of its own employees. It purely funds or carries the development risks. Action Points 8, 9 and 10 are concerned with the topic of transfer pricing in accordance with value creation.

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[98] Foreign Base Company Sales income, hereafter: FBCS-income

[99] C. Levin & J. McCain, *Report on Offshore Profit Shifting and the U.S. Tax Code – Part 2 (Apple Inc.),* May 21, 2013, p. 37 & L.D. Yoder, *Subpart F Same-Country-of-Manufacture Exception Applied To Products Manufactured in Two Countries,* Tax Management International Journal, 2012, pp. 302-304

- Addressing the “hybrid mismatch” rules wherewith the United States could change its current “check-the-box” rules through which it grants the appointment of entities to be disregarded for U.S. tax reasons. Also Ireland could change its existing national laws in order to tax nonresident Irish companies like tax residents, particularly in the situation where these entities are not taxed in their jurisdictions of residence. Action Point 2 is connected to the topic of the hybrid mismatch arrangements with the intention of neutralizing the impact of these structures.

- The possibility of the United States to toughen its Controlled Foreign Corporation (CFC) regime whereby the IP revenues of the resident Irish company will become liable to taxation. Action Point 3 is engaged with the strengthening of CFC rules.

- There might be a risk for Apple Inc., as a service provider which also operates via the Internet, that its nonresident Irish subsidiaries and partners are deemed to have a taxable nexus with the location where their customers are situated and where the location of its work force is no longer of main importance.[100] Action Point 1 is involved in the tax challenges of the digital economy.

On September 16, the Organization for Economic Co-operation and Development (OECD) presented its highly anticipated “deliverables”, the so-called “2014 Deliverables”, which focuses on seven areas of the Action Plan.[101] This output of the OECD can be regarded as some sort of preliminary report of the BEPS Action Plan. Only these deliverables connected with the Action Points that are examined in connection with structures of Apple Inc. are dealt with.

3.2.2 Action Points 8, 9 and 10 on the present deferral structure

As it is stated in the BEPS Action Plan,[102] transfer pricing and the application of the at “arm’s length” principle can create significant problems. Multinationals as Apple Inc. have implemented these standards in order to split profits from economic activities, which generate these profits, and to transfer the revenues into low-tax jurisdictions.

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[100] J. Carr, J. Hoerner, V. Sorokina & S.Y. Wu, *BEPS Action Plan: A Case Study of The Potential Implications for a U.S.-Based Multinational,* Tax Notes International, March 17, 2014, p. 1032
[101] OECD (2013), *Action Plan on Base Erosion and Profit Shifting,* OECD Publishing
[102] Ibid.

This frequently takes shape in sub-licensing of intangibles and other mobile assets for a smaller amount than the real value. Because of the importance of sub-licensing intangibles for their real value, many corporations decide to obtain a preliminary ruling at the tax authorities, such as an APA or an ATR, in the country in question. This is done with the aim to avoid substantial correcting tax assessments.

Also over-capitalization of group companies that are low-taxed and the contractual allotment of risks to low-tax jurisdictions occur in order to shift profits to jurisdictions where they are taxed at the lowest possible rate.[103]

The following suggestions that are introduced in Action Points 8, 9 and 10 might have a great impact on the Irish deferral structure that Apple Inc. currently operates:

- Guaranteeing that the profits connected with the relocation and the operation of intangibles are properly assigned in line with value creation.[104]
- Establish transfer pricing methods or appropriate standards for transfers of intangibles in the situation where values are difficult to assess.[105]
- Modernize the guiding principles on cost contribution arrangements.[106]
- Endorse transfer-pricing regulations or specific standards in order to guarantee that disproportionate returns will not accumulate to an entity merely as a result of contractually acquired risks or due to the fact it has contributed capital.[107]
- Define the conditions in which transactions will be re-characterized in the situation wherein the same transactions are not inclined to take place between third parties.[108]
- Resolve the operation of transfer pricing mechanisms, specifically profit splits, in the framework of global value chains.[109]

These Action Points presented in the OECD BEPS Action Plan entail an important change in the transfer pricing features connected with the Irish deferral framework.

[103] OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing, pp. 19-20
[104] Ibid, Action 8 (ii), p. 20
[105] Ibid, Action 8 (iii), p. 20
[106] Ibid, Action 8 (iv), p. 20
[107] Ibid, Action 9, p. 20
[108] Ibid, Action 10(i), p. 20
[109] Ibid, Action 10(ii), pp. 20-21

Important modifications are expected in the situation where the non-resident Irish companies, (in the case of Apple Inc.: ASI and AOE), [110] mainly fund and carry the related risk in connection with the IP development, but does not operate any significant function by way of its own personnel or via contractors which stand under the guidance and supervision of the particular entity. In this case, under the new principles, the non-resident Irish company should be limited to receive a risk-conform level of expected profit on its investment. It should not be allowed to share in the residual revenues associated with the valuable intangibles regardless of engaging in a cost sharing agreement where it has provided a contribution to Apple Inc.[111]

3.2.3 Deliverables to date on Action Point 8

The effort on the transfer pricing elements of intangibles will lead to the review of the Transfer Pricing Guidelines. The definitions of intangibles are formulated, guidance is granted in order to establish transactions comprising intangibles. Also, additional guidance concerning the determination of the arm's length provisions for agreements, which include intangibles, is given.

This guidance in connection with additional work that will be finished in 2015 guarantees that revenues related with the transfer and use of intangibles are allotted in line with value creation. BEPS frameworks depending on the allocation of intangibles with the sole purpose of taking advantage of low tax jurisdictions will be impeded.[112]

3.2.4 Action Point 2 on "hybrid mismatch" arrangements

Action Point 2 deals with the need for the expansion of model treaty provisions and guidance concerning the draft of domestic rules to compensate for the effect of "hybrid mismatch arrangements". These arrangements can be adopted to realize the undesirable event of double non-taxation or long-term tax deferral whereby a deduction is granted in one jurisdiction and at the same time no, or exempt income is recognized in the other state.[113]

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[110] C. Levin & J. McCain, *Report on Offshore Profit Shifting and the U.S. Tax Code – Part 2 (Apple Inc.)*, May 21, 2013, pp. 25-26

[111] J. Carr, J. Hoerner, V. Sorokina and S.Y. Wu, *BEPS Action Plan: A Case Study of The Potential Implications for a U.S.-Based Multinational*, Tax Notes International, March 17, 2014, pp. 1032-1033

[112] OECD (2014), *Guidance on Transfer Pricing Aspects of Intangibles*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris

[113] OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing, Action Point 2, pp. 15-16

The nonresident Irish structure most probably falls under the scope of this Action Point, due to the fact that the resident Irish companies, (in the Apple structure: Apple Retail Holding and Apple Distribution International) can request a deduction for royalty payments made to nonresident Irish companies, (In Apple's case: Apple Operations International, Apple Operations Europe and Apple Sales International). The nonresident Irish company's royalty income will possibly not be taxed at all as a result of Ireland's domestic tax law which does not subject royalty income of nonresident corporations to taxation.[114]

When the proposition under Action Point 2 is enforced, these consequences could be changed. In October 2014, Michael Noonan, the Irish Minister of Finance announced a Finance Bill that encompasses a provision in order to guarantee that an Irish incorporated company cannot be regarded as "stateless" in terms of its place of tax residence as a result of a "mismatch" between the Irish regulations on company residence and those of a treaty partner.[115]

It however seems that the provision is of restricted applicability and it would not include Irish incorporated companies, which are considered tax residents of another jurisdiction in the situation where this jurisdiction has chosen not to tax corporate profits.

3.2.5 Deliverables to date on Action Point 2

Work has been done to introduce broad and precise proposals for domestic hybrid mismatch rules and model treaty provisions in order to stop multiple deductions for a sole expense in one jurisdiction without analogous taxation in another. The next step will be the provision of a commentary to the rules with the intent to improve guidance.

An ordering rule has also been introduced to restrain multiple countries from implementing their domestic hybrid mismatch rules to the same provision.

This rule has the aim to prevent the risk of double taxation and at the same time to secure that national rules in various jurisdictions do not overlap.

Furthermore, a defensive rule has been incorporated which a country can administer to offset a hybrid mismatch that emerges within its jurisdiction in the case when a counterparty jurisdiction does not have its own hybrid mismatch rule in place.

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[114] J. Carr, J. Hoerner, V. Sorokina and S.Y. Wu, *BEPS Action Plan: A Case Study of The Potential Implications for a U.S.-Based Multinational,* Tax Notes International, March 17, 2014, pp. 1033-1034

[115] Finance (No. 2) Bill 2013, paragraph 38, Section 38 amends section 23A of the Taxes Consolidation Act 1997

The rules are drafted to neutralize the impact of hybrid entities. At the moment these rules are enforced by a country, they will offset the hybrid mismatch outcomes of “check the box” planning in these jurisdictions.[116]

3.2.6 Action Point 3 on CFC rules

BEPS Action Point 3 is concerned with the reinforcement of the CFC rules and pursues to improve recommendations about the composition of CFC regulations. Together with Action Point 2, Point 3 might contribute to recommendations to tackle hybrid mismatch arrangements by means of adjusting domestic CFC policies.

Until this moment, the OECD has not given any suggestion of what changes to the current CFC rules might be undertaken. There is likelihood that the United States comes up with a regulatory framework, which would end the “check-the-box” appointments on the resident Irish companies. This might lead to inclusion of royalty payments to Subpart F. The check-the-box election that brought about “hybrid mismatches” is not an undisputed subject, it endured threats of withdrawal by means of legislative and regulatory initiatives many times in the past. There have been several initiatives by the U.S. government in the recent past to tackle hybrid mismatch arrangements.

Even though it remains to be seen which actions will be translated into law, it appears to be probable that royalty income of the non-resident Irish companies (in the situation of Apple: ASI, AOE and AOI) will be brought under the scope of current U.S. taxation.[117]

3.2.7 Action Point 1 on the “tax challenges of the digital economy”

Under this action item a report has been presented which analyzes issues caused by the digital economy and comes forward with potential actions to handle these problems.
The consequence of this Action Point might be that permanent establishments, PEs,[118] are identified in the region where customers are located instead of the profits being concentrated at the location of the nonresident Irish companies.[119]

[116] OECD (2014), *Neutralizing the Effects of Hybrid Mismatch Arrangements,* OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris & OECD/G-20 Base Erosion and Profit Shifting Project, *Frequently Asked Questions,* 2014, pp. 1-19
[117] J. Carr, J. Hoerner, V. Sorokina and S.Y. Wu, *BEPS Action Plan: A Case Study of The Potential Implications for a U.S.-Based Multinational,* Tax Notes International, March 17, 2014, pp. 1034-1035 & OECD (2013), *Action Plan on Base Erosion and Profit Shifting,* OECD Publishing, Action Point 3, pp. 16-17
[118] Permanent Establishment, hereafter: PE

As Apple Inc. works with so called "cloud computing" and "Software as a Service" (SaaS), the work on Action Point 1 might be of considerable relevance. It is however expected that this action item will not lead to elementary transformations in the way U.S.-based multinationals are taxed abroad. As the U.S. has some deeply rooted domestic fundamentals, the virtual permanent establishment approach will encounter confrontations. The U.S. will remain to fight against the constitution of PE rules for the digital economy that would diverge from the general PE rules.[120]

3.2.8 Deliverables to date on Action Point 1

The report noted that modifications caused by the digital economy led to the augmentation of challenges respecting the capability of the current international tax framework to make sure that profits are taxed at the location where the economic activities take place and where value is generated.

The report does not endorse the enactment of a virtual permanent establishment principle. Because the process of efforts to address BEPS is still continuing, it is hard to judge the intensity of these specific challenges as well as the significance of the possible alternatives to address them.

It thus brings forward different alternatives to address the tax challenges of the digital economy but acknowledges that more works needs to be executed to investigate these different options.[121]

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[119] OECD (2013), *Action Plan on Base Erosion and Profit Shifting, OECD Publishing,* Action Point 1, pp. 14-15

[120] J. Carr, J. Hoerner, V. Sorokina and S.Y. Wu, *BEPS Action Plan: A Case Study of The Potential Implications for a U.S.-Based Multinational,* Tax Notes International, March 17, 2014, pp. 1035-1036

[121] OECD (2014), *Addressing the Tax Challenges of the Digital Economy,* OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris & OECD/G-20 Base Erosion and Profit Shifting Project, *Frequently Asked Questions,* 2014, pp. 1-19

Chapter 4

This part of the thesis is committed to the international tax reform proposal of former chairman Baucus as presented in mid-November 2013. With this draft, the same international tax matters, which the OECD BEPS report dealt with, are addressed from an entire U.S. perspective.

Further, the consequences for the specific case of Apple Inc. are presented to clarify the potential impact of the Baucus proposal on U.S.-based multinationals with similar planning structures as Apple Inc.

The Baucus plan consists of two main points. The first point is about the elimination of parts of the "check-the-box" rule. The second point deals with minimum tax proposals in order to repeal the system of deferral on earnings of foreign subsidiaries of U.S. companies with the aim to replace it with a system under which all that income is either taxed at a current basis or is permanently exempt from U.S. taxation.[122]

To conclude the chapter in a complete fashion, the different viewpoints on the Baucus plan are provided.

4.1 Baucus Discussion Draft on International Tax Reform

On November 19, 2013, Max Baucus, Chairman of the U.S. Senate Finance Committee, has issued a Discussion Draft ("the draft") that was completely dedicated to the objective of reforming the international tax system. The draft encompasses provisions that might significantly modify the tax treatment of income realized by CFCs.[123]

Even though no assessment of revenues is included in the draft, Chairman Baucus underlined that the overall tax reform should substantially enhance the revenues in order to cut the deficits.[124]

The proposition package is also aimed to realize a considerable decline in the corporate tax rate, which will be funded by means of the expansion of the corporate tax base, however, no new specific corporate tax rate was introduced in the draft.[125]

[122] J. Carr, J. Hoerner, V. Sorokina & S.Y. Wu, *BEPS Action Plan: A Case Study of The Potential Implications for a U.S.-Based Multinational*, Tax Notes International, March 17, 2014, pp. 1034-1035
[123] M. Gilleard, *Baucus releases US tax reform discussion draft,* International Tax Review (ITR), November 26, 2013, pp. 1-4
[124] BakerHostetler, *Senate Finance Committee Chairman Releases Tax Reform Staff Discussion Drafts- More Expected*, December 5, 2013

The draft approaches a hybrid territorial/worldwide system, whereby it establishes a minimum tax on foreign income that currently often remains untaxed or nearly untaxed until the moment of repatriation to the United States. The new draft has the effect of companies paying their taxes when the income is realized, thus ending the deferral on U.S. income. Supplementary taxes are also no longer owed at the moment when the income is repatriated to the U.S.[126] Also certain parts of the "check-the-box" regulations are eliminated under the plan.

With the draft, an important attempt has been made to address the same international tax matters as the OECD BEPS report focused on, with the important difference that the Baucus draft is concentrated exclusively on the U.S. perspective. Action Point 2, (hybrid mismatch arrangements), Action Point 3, (enhancement of CFC Rules), Action Point 4 (The Limitation of Base Erosion via Interest Deductions and Other Financial Transactions), and Action Points 8,9 and 10 (Transfer Pricing) are dealt with in the outline presented by Baucus.[127]

These Action Points (except for Action Point 4) were already examined in great detail in the previous chapter, as these points were connected with the profit shifting framework of Apple Inc. It is of great importance to get an understanding of the efforts undertaken to date to transform these BEPS Action Points into U.S. legislation.

4.1.1 Elimination of parts of the "check-the-box" rule

Parts of the "check-the-box" rule under which U.S. multinationals as Apple Inc. could disregard certain foreign subsidiaries for U.S. tax purposes are eliminated under this proposal. A disregarded entity is recharacterized as a corporation in one of two situations:

- If the entity has a single owner, and this owner is a CFC or
- The entity is directly owned by two or more members of an expanded affiliated group and at least one of these owners is a CFC.[128]

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[125] Summary of Staff Discussion Draft: *International Business Tax Reform*, Chairman Max Baucus U.S. Senate Committee on Finance, November 19, 2013

[126] The Committee for a Responsible Federal Budget (CRFB), *Baucus Releases International Tax Reform Draft*, November 19, 2013

[127] M. Cadesky, R. Rinninsland & K. Lobo, *The U.S. View On BEPS*, Presented to Asia-Oceania Tax Consultants' Association (AOTCA) 2014 Conference, October 2014, pp. 1-29, (available at: http://publications.ruchelaw.com/pdfs/2014-10/US_View_On_BEPS_AOTCA.pdf) & OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, Action Points 2,3,4,8,9 and 10, OECD Publishing

[128] U.S. Senate Committee on Finance, *Baucus Unveils Proposals for International Tax Reform*, Press Release, November 19, 2013

In the case of Apple Inc. as demonstrated in the previous chapter, Apple Operations International (AOI) acts as an intermediate holding between Apple Inc. in the U.S. and the offshore activities of the company. AOI was incorporated in Ireland when Apple began its longstanding business presence there, and it is treated as a CFC under US law.[129]

Apple Inc. owns 100 percent of AOI in a direct-, or indirect manner through other CFCs. AOI owns the greater part of Apple's offshore entities, for instance, Apple Operations Europe (AOE), Apple Distribution International (ADI), and Apple Retail Holding Europe. Apple Sales International (ASI) is a subsidiary of AOE, which is in turn a subsidiary of AOI.
As a result of the Baucus proposal, AOE, ASI, ADI and Apple Retail Holding Europe might be reclassified as corporations. The box can no longer be checked for these entities, because these entities are owned by one or more CFCs. This means that all subsidiaries of AOI are not regarded as divisions of AOI anymore for taxation purposes and the transactions between these entities no longer go unnoticed by the IRS as the transactions are not considered any longer as taking place within one single company.

Because the elimination of parts of the check-the-box rule, sales income is in this case no longer assumed to be received directly by AOI from the end-consumers. This has the consequence that parts of the income are not regarded as "active business income" anymore and becomes taxable under Subpart F.

4.1.2 Minimum tax proposal

As proposed in this draft, passive and highly mobile income of the foreign subsidiaries of Apple Inc. will be taxed at an annual basis, whereby the applicable U.S. rates are enforced in full.

The shifting of IP-rights to avoid U.S. taxes, whereby no risks or benefits are transferred away from Apple Inc., only alters the place of the tax liability on the profits of this company. By means of Cost Sharing Agreements between Apple Inc., AOE and ASI, the place of the tax liability on the profits of Apple's Inc. was changed.[130] Because of this CSA between these entities, the AOE and ASI facilitated Apple Inc. to keep a great part of the worldwide sales income outside U.S. When this kind of highly mobile income (IP-rights) of the foreign subsidiaries is taxed at full rates at an annual basis, as proposed under the Baucus reform plans, the incentive to participate in these types of agreements will disappear.

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[129] *TESTIMONY OF APPLE INC. BEFORE THE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS US SENATE*, MAY 21, 2013, p.3

[130] Cost Sharing Agreement, (hereafter: CSA)

When an offshore subsidiary of Apple Inc. earns passive income such as dividends, interests, royalties and other related payments from an affiliated subsidiary, this income is normally treated as Foreign Personal Holding Company income.[131]

Usually, this kind of income is subject to immediate taxation under Subpart F, however, because of the existence of the “check-the-box” regulations these payments between related parties were regarded as taking place within one single entity. The proposal of Chairman Baucus might bring the situation of disregarded payments to an end by means of eliminating parts of the “check-the-box” regulations. As a consequence, the FPHC-income will become subject to Subpart F taxation.

A clear distinction has been made between sales income from U.S. customers and that of non-U.S. customers. Income from sales of goods and services by these foreign subsidiaries to U.S. customers falls under the scope of immediate and full taxation.

With respect to the income of foreign subsidiaries from sales of goods and services to markets outside the U.S., the draft introduces two "minimum-tax" alternatives, “Option Y” and “Option Z”.

4.1.3 Foreign Base Company Sales income and the “check-the-box” regulations

Foreign Base Company Sales income consists of the part of the sales income of Apple Inc. that was designated to Ireland with the aim to accumulate the profits in this jurisdiction.[132] The FBCS-rules are enacted to coordinate the taxation of products sold through an entity in one jurisdiction, to an affiliate entity for the final consumption in another country. To impede multinational companies from organizing intermediary entities in low tax jurisdictions with the intention to buy the finished goods and to sell them onwards to affiliates for use in another country where they concentrate the sales revenues in low-tax jurisdictions (as Apple Inc. did), the FBCS-section of Subpart F has been enacted.

In the circumstance of Apple Inc., ASI was the buyer of the finished Apple products that had been assembled in China. It sells the products onwards to the distributors, Apple Distribution International and Apple Singapore, which consecutively sold the products to countries around the world.

As mentioned earlier, ASI did not contribute to the manufacturing of these products and it also did not take the physical ownership of the products. Everything that happened was the transfer of the title at the moment of transportation of the goods to the country of sale.

131 Personal Holding Company income, (hereafter: FPHC-income)
132 Foreign Base Company Sales income, (hereafter: FBCS-income)

This gave Apple Inc. the opportunity to maintain the greatest part of its profits in Ireland and at the same time, to reduce the income disclosed in the non-tax haven jurisdictions where Apple carries out the greater part of its business. Because of the possibility of "checking the box", Apple Inc. is in the position to avoid all U.S. taxation on the FBCS-income.

Ordinarily, this income would be taxed under Subpart F in the year it is earned, By means of "checking the box", the sales transactions become invisible for U.S. tax-purposes and therefore no FBCS-income is generated. When certain parts of the check-the-box are eliminated this might bring this current situation to an end.

To make sure that a minimum amount of tax is paid on this kind of income, Baucus brought forward two minimum tax options, (Option Y and Option Z), regarding the taxation of income of foreign subsidiaries from sales of goods and services to markets outside the U.S.

4.1.4 Option Y: proposes a minimum tax that instantly taxes all of the aforementioned income of Apple Inc. at 80 percent of the U.S. corporate tax rate. At the moment these foreign revenues are repatriated to the U.S., full foreign tax credits connected with a full dividend received deduction for the foreign-source portion of the dividend are granted. The full dividend exemption is only allotted on the condition that the domestic corporation that obtains the share of the foreign source dividends from the CFC meets a one-year holding period.

The dividend exemption only covers foreign business income and no income that has its source within the United States. There are however CFCs that also own U.S.-source income, (such as ASI in the case of Apple Inc.), in this circumstance a deduction is only granted for the foreign-source portion of a dividend.[133]

A 10-percent U.S. shareholder continues to be taxable in the U.S. on an ongoing basis on its pro-rata share of specific elements of passive, low-tax or U.S.-related income of the CFC. The adjusted Subpart F rules are designed to make sure that the dividend exemption is only applicable to income from the conduct of an active foreign business and to restrict the transfer of income from the U.S. to low-tax jurisdictions.

Two new classes of Subpart F income are included, U.S. related income and low-taxed income. U.S.-related income consists of the aggregate amount of the CFC's imported property income and its United States related income.

[133] Joint Committee on Taxation, *Technical Explanation of the Senate Committee on Finance Chairman's Staff Discussion Draft of Provisions to Reform International Business Taxation (hereafter: JCX-15-13),* November 19, 2013, pp. 25-27 & Joint Committee on Taxation, *Present Law and Background Related to Proposals to Reform the Taxation of Income of Multinational Enterprises (hereafter: JCX-90-14),* July 21, 2014, pp. 71-72

Imported property income comprises income obtained from manufacturing, producing, growing, extracting, the sale, exchange or other disposition, or the lease, rental or licensing of imported property by the CFC or a related person.[134]

The second category consists of U.S.-services income, income derived from services provided (including insurance, reinsurance, annuity contracts, banking, financing or a similar business), where these services corresponds to persons or property located in the U.S. This section does not include imported property income.[135]

Low-taxed income covers any item of income, apart from specific other Subpart F categories of income, on the condition that the effective rate of the income tax on this particular element of income is less than 80 percent of the maximum U.S. corporate tax rate. This kind of income does not cover any dividend received or accrued from another CFC, which is equally part of the same extended associated organization.

Also the characterization of Foreign Personal Holding Company income is changed,[136] whereby it does not reinvigorate and prolongs the CFC look-through rules. It does however retain the same-country exception for dividends, interest, rents and royalties.[137]

Furthermore, active financing and active insurance income exceptions are secured. Adjustments are made in order to easier define the activities that are entitled to the separate exceptions.[138]

Eventually, the proposal changes the foreign tax credit limitation, whereby it assigns the limitations for six distinct classes of income.[139]

4.1.5 Option Z: includes a minimum tax that directly taxes all income of foreign subsidiaries from sales of goods and services to markets outside the U.S., at 60 percent of the U.S. corporate tax rate on the condition that this income is obtained in connection with active business operations. If this is not the case, the total income is taxed at the full applicable U.S. rates. Also, under this option the income would be subject to foreign tax credits and at the point of repatriation no additional U.S. taxes are owed.

Subpart F income is redefined as the total of "modified active" income, which contains the 60 percent of a CFC's active foreign market income and the remainder that consists of "modified non-active" income.

[134] Related person in this context means a person defined in Section 954(b) of the Internal Revenue Code
[135] (JCX-15-13), pp. 30-31 & (JCX-90-14), pp. 73-75
[136] (JCX-15-13), pp. 33-34
[137] Ibid, pp. 31-33
[138] Ibid, pp. 34-35
[139] (JCX-15-13) pp. 48-49 & (JCX-90-14) pp. 77-78

Unlike the methods administered under Option Y, this proposal applies a so called "full inclusion" scheme where the U.S. shareholder of the CFC is obliged to include its proportion of all CFC earnings, in the income. All reported income is considered as previously taxed income although only 60 percent was subject to tax.[140]

This definition of Subpart F income eliminates the deferral of income by a CFC and permits an exclusion of 40 percent of the "active foreign market income" of the CFC. Active foreign market income encompasses income connected with "economically significant" contributions of a qualified trade or business obtained with respect to property sold or exchanged for purposes outside the U.S. or services performed outside the U.S. with regard to persons or property situated outside the U.S.

These economic significant contributions have the precondition that they have to be executed outside the U.S. by officers or employees of the CFC and that a substantial contribution to the production of income has been made.

In the situation of Apple Inc., as mentioned earlier, ASI approaches third party contract manufacturers in China to assemble the Apple products and arranges contracts with these entities. When the products are assembled in China, ASI takes the title of the finished products and then sells them to the distribution entities in Europe, Apple Distribution International (ADI) and to Apple Singapore for sales in Asia.

The greater part of these products does not enter Ireland after the title transfer between the Chinese manufacturer and ASI but are directly shipped from China to the country of ultimate sale. ASI asks its related parties a price that is higher than it initially paid for the products, hereby ASI is able to receive a significant amount of income.

The structuring of Apple’s distribution operations actually proves that the location of the Irish associates does not form a fundamental part in the sales and distribution activities that they execute. It seems that the location in Ireland is merely chosen with the objective of consolidating the profits in a low tax jurisdiction.

Under the Baucus proposals, the income that has been concentrated in Ireland is not regarded as “active foreign market income”, as the officers or employees of the CFC do not produce the items and it therefore seems that ASI has made no “substantial” contribution to the production of income. As a consequence, the total income is taxed at the full applicable U.S. rates.

However, the term “substantial contribution” remains unclear and leaves open an opportunity for interpretation and for potential manipulation.

[140] (JCX-15-13), pp. 39-40 & (JCX-90-14), p. 72

Eliminated from active foreign market income is any type of income if it is legitimate to expect that the property in question would be used, consumed or disposed of in the U.S., or is integrated in another item that would. Also passive income does not fall under the scope of active foreign income.

However, there are kinds of typical passive income that can be considered as active foreign market income, and are thus qualified for the exclusion, on the condition that the item of income complies with the exceptions for active banking, finance, insurance income or is specified rent and royalty income.[141]

Ultimately, under this option, the types of foreign tax credit limitations are adjusted. The foreign tax credit limitations are assigned individually for three distinct categories ("baskets") of income.[142]

4.1.6 Common provisions and a transition rule

The draft will exclude the 30-day holding requirement under both Options. This means that the sphere of Subpart F is expanded. Further the determination of a "U.S. shareholder" under Subpart F is broadened, any U.S. person owning 10 percent or more of the entire value of shares of every class of stock of a foreign corporation is included.[143]

The indirect credit of foreign taxes that has been "deemed" paid is abolished. No credits are granted for taxes attributable to formerly deferred income that has been deducted from the aggregate income. Also deductions for any foreign taxes for which a credit is refused are denied.[144] Finally, a transition rule for formerly deferred foreign income is incorporated whereby taxes are due on the U.S.-shareholder pro-rata share of accumulated income which will be payable in portions over eight years.[145]

Both Options support the abolition of "check-the box" regulations as mentioned extensively earlier in this chapter, which facilitates specific entities owned by CFCs to elect their own entity classification.[146] Finally, Option Y and Z both further exclude deductions for interest expenses attributable to exempt income of a CFC.[147]

[141] (JCX-15-13), pp. 39-40 & (JCX-90-14), pp. 75-76
[142] Ibid, pp. 51-52 & Ibid, p. 78
[143] Ibid, p. 61 & Ibid, p. 73
[144] Ibid, pp. 62-63 & Ibid, p. 77
[145] Ibid, pp. 58-60 & Ibid, pp. 78-79
[146] Ibid, pp. 64-65 & Ibid, p. 76
[147] Ibid, pp. 54-57 & Ibid, p. 77

4.2 Opinions on the Baucus Discussion Draft

Several business groups have responded to the proposals of Chairman Baucus, whereby most parties applauded the actual efforts of international tax reform but nevertheless continue to be skeptical about the substance of the draft.

One of these critics is John Engler, president of the American Business Round Table.[148] He underlined that the chief executive officers consider the actual comprehensive tax reform as one of the most important themes to guarantee the progress of the U.S. economy.[149] Engler agrees with Baucus' aim of boosting the capacity of U.S. businesses to rival abroad with other companies, because this competition is regarded as crucial for doing business in other jurisdictions. However, Engler is skeptical at the same time whether the draft has the same intentions, as it actually has the undesirable effect of U.S. firms being less competitive in comparison to their non-U.S. contestants.

Cathy Schultz, the vice president of tax policy at the National Foreign Trade Council,[150] also embraced the ongoing discussion on tax reform. She nevertheless claims that the draft is unsatisfactory and it actually leads to the undesirable situation in which multinational enterprises are punished and it becomes more complicated for these companies to compete on a worldwide level.

Dorothy Coleman, vice president for tax and domestic economic policy of the National Association of Manufacturers expressed the disappointment on behalf of the manufacturers.[151] According to Coleman, the focus of the new international tax system should be on the reinforcement of the competitiveness of the U.S., instead of boosting the earnings of the treasury.

Finally, Manal Corwin,[152] domestic director of KPMG's international tax practice emphasizes that Baucus' draft shows resemblance with prior propositions, for instance with the plans of the Obama Administration with respect to tax reform.

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[148] Business Roundtable (BRT) is an association of chief executive officers of leading U.S. companies working to promote sound public policy and a thriving U.S. economy

[149] Chief Executive Officer, hereafter: CEO

[150] The National Foreign Trade Council (NFTC) is the leading business organization supporting a rules-based world economy. Founded in 1914 by a group of American companies that supported an open world trading system, the NFTC and its affiliates now serve more than 300 member companies through offices in Washington and New York

[151] National Association of Manufacturers (NAM) The National Association of Manufacturers (NAM) is the largest manufacturing association in the United States, representing small and large manufacturers in every industrial sector and in all 50 states

[152] A domestic director of KPMG's international tax practice and a previous deputy assistant secretary for tax policy, international tax affairs at the U.S. Treasury Department

Obama also proposed the approach of introducing a minimum tax on foreign income. She nevertheless applauds the efforts of Baucus on the phasing out of the "lock-out" effect and the connected issues with deferral.[153]

All in all, it can be concluded that the draft faces critics that can actually hinder its enactment but the proposals are a significant step forward on the path of international corporate tax reform. As it remains unclear whether the Baucus initiative will be enforced into law, it does however appear to be likely that royalty income of the non-resident Irish affiliates of Apple Inc. will become subject to current U.S. taxation at a certain point in time.

[153] M. Gilleard, *Baucus releases US tax reform discussion draft,* International Tax Review (ITR), November 26, 2013

Chapter 5

This chapter is dedicated to the most important initiatives taken by the U.S. government with the objective of reforming the U.S. system of international taxation. Also the structuring alternatives for companies as Apple Inc. in order to alleviate the possible consequences of these proposals are dealt with. Finally the various viewpoints of different stakeholders on these reform proposals and on the BEPS Action Plan are presented.

5.1 Obama's "Green Book" 2015/2016

The Obama Administration also undertook efforts to reform the international taxation system. In this part, attention is given to the reform proposals for the fiscal year of 2015, presented in March 2014, and the recent outline for the fiscal year of 2016.

Furthermore, their corresponding viewpoints are introduced. Obama's plans can be considered as a strategic answer from the U.S. Treasury to the BEPS Action Plan and are therefore examined in further detail. As it is out of the sphere of this thesis to cover all the proposals that Obama introduced, only those propositions in relation with the BEPS Action Points that might seem of significance to the case of Apple Inc. are dealt with.[154]

In order to better address the digital economy, as a reaction to BEPS Action Point 1, a new type of Subpart F income has been added. This "foreign base company digital income" (FBCDI), is connected with the sale or lease of a digital copyrighted item or the supply of a service, whereby the CFC uses the intellectual property that has been developed by an affiliate. The CFC in question does furthermore not provide a "substantial contribution" to the development of the article or service in question.[155]

In the case of Apple Inc., the Irish affiliates of the company sell digital copyrighted items or supply such a service, whereby it became clear earlier in the thesis that these affiliates do not make a substantial contribution to the development of the article or service. By means of a Cost Sharing Agreement economic rights to Apple's intellectual property where partly shifted outside the U.S. Nevertheless, almost all the research that Apple undertakes was still carried out by Apple Inc. employees in California, and an excessive amount of the resulting profits were kept outside the U.S.

[154] OECD (2013), *Action Plan on Base Erosion and Profit Shifting,* OECD Publishing, BEPS Action Points 1,2,3,8,9 and 10
[155] *General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals,* Department of the Treasury, March 2014, pp. 58-59

The Obama Proposal tries to bring these deferral practices to an end, and this type of income will be taxed in full on a current basis.

Action item 2 deals with the development of model treaty provisions and recommendations concerning the design of domestic rules in order to neutralize the consequences of “hybrid mismatch arrangements”. Because of the existence of a hybrid, an instrument that also has been used by Apple Inc., the income is not included at the level of the beneficiary. These types of instruments are further constrained by Obama as deductions for interest paid to related persons are refused.

In the case of a “reverse hybrid”, an entity is considered as a corporation for U.S. tax principles but as fiscally transparent or a branch under the legislation of a foreign country. As a result of this difference in classification, income realized by the reverse hybrid will not be subject to U.S. taxation. In the situation where such an entity is regarded as a CFC, interest and royalty income derived by the reverse hybrid from qualifying foreign affiliated persons may furthermore not be subject to present U.S. taxation by reason of the “same country exception” or the “CFC look through rules”. Because of these circumstances, Obama requested the denial of relief under the “same country exception” and the “CFC look through” rules.

Action Point 3 is involved with the enhancement of CFC rules to tackle BEPS practices in a more exhaustive manner. Due to the fact that transactions of intangible property between affiliates, such as between Apple in the U.S. and its associates in Ireland, can lead to possibilities whereby less taxes are payable, a proposal is introduced to tax the surplus of revenues connected with the transfers of intangibles abroad by means of expanding Subpart F for these kind of transactions.[156]

As the estimation of the value of an intangible often comes with difficulties, Action Points 8, 9, and 10 are dealing with assuring that transfer pricing outcomes are in line with value creation. When such property is relocated or as in the situation of Apple Inc., partly sublicensed to offshore affiliates, valuation problems can emerge. These complications may lead to the avoidance of U.S. taxes and the exploitation of the rules connected with the transfer of intangibles to related persons in other jurisdictions. Therefore, a new rule should broaden the current definition of “intangible property” and more guidance on the actual valuation of the intangibles should be provided.[157]

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[156] *General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals,* Department of the Treasury, March 2014, pp. 45-46

[157] Ibid, p. 47

The proposals as a whole, as brought forward by the Obama Administration can phase out the deferral of U.S. taxation on revenues derived by U.S. multinationals abroad, and can in this matter, increase their effective tax rate. However, at the moment of introducing these plans, the Congress was already divided, it was therefore not considered as a reasonable and feasible option.[158] Because of the midterm elections of last November, the congressional expectations were very ambiguous and considerable tax legislations stayed out.

On February 2nd of this year, the Obama Administration announced its annual budget for the fiscal year of 2016. In this budget the plans for international tax reform are included. The presentation of a 19 percent minimum tax on foreign earnings was among the most significant propositions.[159] Further, a 14 percent one-time tax is levied on previously untaxed foreign income.[160]

The majority of the Republicans however, want to refrain as a whole from taxing the future foreign revenues because of the fact that nearly all developed countries decided to do so. With these proposals Obama desires to move to a worldwide system of taxing multinational enterprises.[161]

The plans can be considered as an attempt to overhaul the U.S. system of business taxation and are drafted with the objective to reduce the advantages of moving profits and income out of the U.S. and into low tax jurisdictions.[162] Because the greatest part of the Republicans does not support any type of new taxes, Obama offered to reduce the corporate tax rate on domestic income to 28 percent.[163] This lower corporate income tax rate will diminish the tax receipts but the budget indicates that this cut in revenues can be compensated by means of closing the "loopholes" in the current corporate tax system.[164]

The proposal of the Obama Administration can be considered as a first offer to break the impasse and to raise billions, which the government can employ for different purposes. As the annual budget needs to be authorized by Congress, it is given the ongoing political conflicts implausible that the proposals will be enacted into law.

[158] A.M. Parker, *Dueling International Tax Proposals Reflect BEPS Debate, Showing Common Ground in Efforts to Combat Tax Avoidance,* Transfer Pricing Report, March 6, 2014, pp. 1-4

[159] *General Explanations of the Administrations Fiscal Year 2016 Revenue Proposals,* Department of the Treasury, February 2015, pp. 19-22

[160] Ibid, p. 23

[161] J.D. McKinnon, *Obama Aims to Change Tax System Many Call Worst of All Worlds,* The Wall Street Journal, February 1, 2015

[162] J. Scott, *Obama's Foreign Earnings Tax: 19% Minimum DOA But Deemed Repatriations Key,* Forbes

[163] *Corporate-tax reform in America, An offer they could refuse,* The Economist, February 7, 2015, p. 62

[164] *General Explanations of the Administrations Fiscal Year 2016 Revenue Proposals,* Department of the Treasury, February 2015, pp. 32-34

Due to the midterm elections of last November, the Republicans are currently dominating the Senate and expanded their House majority. The Republicans are advocates of tax reform by means of clarifying the tax code and reducing the tax rates, they are however not willing to cooperate with the president in the situation where he wants to burden U.S. based companies with increases in taxes and when he further complicates the tax code.[165]

Furthermore, the budget proposals of Obama will lead to a government deficit of approximately 474 billion U.S. Dollars for the fiscal year commencing at October 1st 2015. The Congress, which is currently dominated by Republicans, will oppose this deficit. Treasury Secretary Jacob Lew forecasts that the chairman and the committee members will scrutinize the plans in order to examine whether U.S.-based corporations are harmed by these proposals with respect to their competitiveness. It should be avoided that the plans make the U.S. less attractive to concentrate business activities and investments and that U.S. based companies are taken over by foreign companies on a more regular basis.[166]
It further needs to be investigated to what extent U.S. based corporations with principally domestic operations are affected by Obama's plans. It is likely that these companies consider the implementation of the new tax system as a rationale to relocate their operations abroad as this would reduce the effective tax rate on the activities that have been moved outside the U.S. In the new system there are no longer hindrances to repatriate the profits to the United States.[167]

The proposal of a transition tax of 14 percent grants monumental tax reduction for a large number of corporations that are presently retaining their profits in low-tax jurisdictions. Companies such as Apple Inc., which are perceived as "tax dodgers" would receive a considerable tax break, and it could be conceived as these companies are being rewarded for their avoidance of the U.S. statutory tax rate of 35 percent on their profits.[168]
Ultimately, stakeholders from the industry have responded on the plans of the Obama Administration.

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[165] J. Mason & K. Drawbaugh, *Obama targets foreign profits with tax proposal, Republicans skeptical,* Reuters, February 1, 2015
[166] R. Rubin & J. Allen, *Obama Wants a New Tax on U.S. Companies' Overseas Profits,* Bloomberg Business Review, February 1, 2015
[167] *Corporate-tax reform in America, An offer they could refuse,* The Economist, February 7, 2015, p. 62
[168] *Press Statement: Obama's Corporate Tax Proposals Would Benefit the Worst Corporate Tax Dodgers,* Citizens for Tax Justice (CTJ), February 2, 2015 & *Ten Corporations Would Save $82 Billion in Taxes Under Obama's Proposed 14% Transition Tax,* Citizens for Tax Justice (CTJ), February 3, 2015

Marty Regalia, a chief economist for the U.S. Chamber of Commerce,[169] declared that multinationals are against the fact that they are being held accountable for the augmentation of contributions to among others, the country's infrastructure.

Also John Engler of the Business Roundtable,[170] argued that U.S. companies are punished with the introduction of the proposed 19 percent minimum tax on all prospective offshore profits as companies wrongly assumed for a great period of time, that they weren't obliged to pay taxes as long as they kept their foreign income outside the United States.

5.2 Camp 2014 Discussion Draft

The idea of a minimum tax coupled with a transition tax as presented by president Obama is not entirely new. After Chairman Baucus,[171] also Chairman Dave Camp introduced minimum- and transition taxes in his Discussion Draft of February 2014.[172] What can be inferred from these proposals is that there is a bipartisan support for corporate foreign tax reform.

Chairman Camp proposed a more or less territorial tax system by means of a 95 percent dividend received deduction. He further suggested the enactment of a one-off tax of 8.75 percent on accrued foreign earnings kept in cash and a tax rate of 3.5 percent on other income. In the case of Apple Inc., the sales income that has been concentrated in Ireland will be taxed under this proposal. Baucus also introduced these one-off taxes but Camp proposed lower rates.

Camps' Draft also advocates the current taxation on intangible income held abroad at a rate of 15 percent accompanied with foreign tax credits, in the situation of Apple Inc., the company sublicensed intangible property from the U.S. to its associates in Ireland, this income will become subject to taxation under the Camp proposal. Subpart F income would be extended with a section of Foreign Base Company Intangible Income just like the Baucus tax reform proposed. Under this plan, in the situation where a U.S. person (Apple Inc.) relocates an intangible from the U.S. to a related CFC (Apple affiliates in Ireland) which is subject to a low effective tax rate, whereby "excessive income shifting" takes place, the "excessive" amount of income will fall under the scope of Subpart F, and is taxed accordingly.

[169] The U.S. Chamber of Commerce is the world's largest business organization representing the interests of more than 3 million businesses of all sizes, sectors, and regions
[170] Business Roundtable (BRT) is an association of chief executive officers of leading U.S. companies working to promote sound public policy and a thriving U.S. economy
[171] Max Baucus, former chairman of the U.S. Senate Committee on Finance (Democrats)
[172] Dave Camp, former chairman of the House Ways and Means Committee (Republican)

In addition, the corporate income tax rate would be reduced to 25 percent, in contrast to the plans of Chairman Baucus who did not propose any decrease in the corporate income tax rates.

Finally, Camp devoted efforts to deal with the apprehension of critics. These critics feared that because of the system of the participation exemption the U.S. tax base would be eroded as a result of corporations establishing their debts in the U.S. to create deductible interest expenses, and relocating their income to foreign jurisdictions. These expenses could be employed to finance non-U.S. exempt income. Camp therefore supported tighter interest deduction limitations by means of the introduction of a "thin capitalization rule", which would exclude a share of the net interest expense under certain circumstances.[173]

5.3 Structuring alternatives for companies as Apple Inc.

Companies as Apple Inc. could also consider alleviating the potential consequences of the possible tax reform plans on their tax burden in advance. The nonresident Irish company, in the case of Apple: ASI and AOE could contemplate appointing extra personnel and to carry out more functions connected with the control of the R&D or the protection and management of intellectual property in order to preserve more residual IP-profits in Ireland.

However, this proposal would demand the allocation of profits between the nonresident Irish company and other related parties that carries out considerable functions. Allocation can lead to administrative concerns, ambiguities, and disputes. Furthermore, it is still uncertain which degree of activities might appease the new transfer pricing regulations. Also the fact that IP owners are in most cases managed from low-tax jurisdictions can impede the hiring of extra employees and the performance of complex functions at this location.
As it seems probable that new rules would give a favorable treatment to active income, companies might wish to increase the level of employees and the activities to IP owners in particular. It is possible when the IP owner carries out adequate activities it can defer a portion or all of its income, or it can lead to the application of lower rates of current taxation.

[173] Committee On Ways And Means, Chairman Dave Camp, *Summary of Ways and Means Discussion Draft: Participation Exemption (Territorial) System*, February 2014, (available at: http://waysandmeans.house.gov/uploadedfiles/summary_of_ways_and_means_draft_option.pdf)

The U.S. multinational (Apple Inc.,) could also migrate to a "single-tier" structure. It can achieve this framework by means of converting the nonresident Irish company and the resident Irish company into one resident Irish company, whereby the R&D functions are controlled in this entity. The single entity could then reach the standard of executing sufficient activities in order to be able to retain a considerable amount of intangible-related profits.

These profits are subject to allocation between other entities that execute significant functions. As the resident Irish company will, under this construction, no longer pay royalties to a non-resident Irish company, CFC rules that would lead to current taxation of this passive royalty income, are no longer applicable.

However, as a result of this structure, all the income of the company probably becomes subject to the national tax rate of currently 12.5 percent, but the Irish government has reassured that Ireland will remain dedicated to low tax rates in the future.

Finally, U.S.-based multinationals (Apple Inc.) might migrate the IP ownership to other jurisdictions instead of Ireland. For example the United Kingdom might be an attractive jurisdiction to concentrate the ownership of IP. This advantage must however be weighed against the possible costs of such a transfer and the uncertainty that could arise from it.[174]

It is considered highly unlikely that there will be a significant U.S. initiated international tax reform in the near future. Around the middle of this year the Presidential election season will commence. By the time there will be a new President in 2017 it is improbable he or she will make the international tax reform a priority in the first term. It therefore depends on the probability of the enactment of the OECD Action Plan whether companies should take preventive measures in order to offset the problems caused by the proposals to reform the international system of corporate taxation.

5.4 U.S. views on specific BEPS Action Points

In this part the U.S. viewpoints on the particular BEPS Action Points addressed in previous chapters are dealt with. Action Point 1 is involved with addressing tax challenges of the digital economy. The Tax Executive Institute responded to this BEPS Action Item.[175]

[174] J. Carr, J. Hoerner, V. Sorokina & S.Y. Wu, *BEPS Action Plan: A Case Study of The Potential Implications for a U.S.-Based Multinational*, Tax Notes International, March 17, 2014, pp. 1036-1037

[175] Tax Executive Institute (T.E.I.), hereafter: T.E.I., Tax Executives Institute is the preeminent association of in-house tax professionals worldwide. Its members are business executives who are responsible for taxation matters on an administrative or policy-making level, or whose work is otherwise primarily concerned with the challenges of business taxation

T.E.I. disputes the adjustments to the permanent establishment exemptions, the introduction of a new nexus principle depending on a “significant digital presence”, the launch of a “virtual permanent establishment”, and the formation of a withholding tax system on digital transactions. The reasoning behind this criticism is that the Action Point is not in agreement with the testimony of the G20 that argues that profits are ought to be taxed where they are situated.

Further, the proposals of the Action Point are also not in line with other Action Points of the BEPS Action Plan. T.E.I. argues that inaccurate initiatives in the sphere of taxation of digital organizations could simply lead to the situation where these companies are taxed more than one time with respect to the same transaction.

T.E.I. further claims that other proposals mentioned in Action Point 1 are drafted to focus on circumstances, which have been the consequence of intentional tax policy of the OECD Member States. Therefore almost every problem diagnosed by the OECD regarding the digital economy could be dealt with by means of correctly operating the current international tax standards.

Action item 2 is concerned with neutralizing the impacts of hybrid mismatch arrangements. The principle consideration regarding the hybrid mismatch arrangements is whether the OECD will support a so-called “top-down approach” to impede certain kinds of these arrangements or a “bottom-up approach”. A “top-down approach” could be applicable to all debt instruments that are possessed abroad, a “bottom-up approach” only includes instruments that are owned by affiliates. The Internal Revenue Service opposes the “top-down approach” as this would be impractical and needs further analysis for irregularities in all circumstances and it also fears that the administrative pressure on companies might be too overwhelming.

Action Point 3 deals with the reinforcement of CFC rules. As these efforts on this Action Point are thoroughly discussed in the discussion Drafts of Senator Baucus, the budget proposals of the Obama Administration and the tax reform plans of Chairman Camp there will be no further elaboration on this action item.

Action Points 8, 9 and 10 are developed with the aim to ensure that transfer pricing outcomes are in agreement with value creation. The U.S. has the opinion that standards to evaluate intangibles that are “difficult to value” could be codified in the Internal Revenue Code or in special legislation.

The IRS favors a “commensurate-with-income” principle, which means that in cases where the U.S. parent transfers an intangible out of the U.S. at an exceptionally low price the tax authorities have the power to adjust the valuation of the intangible retroactively if the value increases significantly after the transfer.

In relation with risks and capital, the IRS argues that the party owning the capital is authorized to receive an “arm’s length” compensation for the use of this capital. Regarding debt that has been obtained between affiliates the IRS holds the opinion that this matter should not be directed by means of the efforts proposed in the BEPS report.

With respect to the efforts made to impede transactions that are unlikely to take place between third parties, the opinion of the U.S. is that the “arm’s length” principle is the best instrument at hand to handle the matter of transfer pricing between related parties of a multinational group.

However, the U.S. tries to refrain from the possibility that existing standards become ambiguous theories that can be simply shaped by jurisdictions in order to support their own revenue requirements. The U.S. assumes that the OECD might move into the direction of transfer pricing principles that are no longer consistent with the arm’s length standard. According to the U.S., a departure from an established and approved principle might lead to a greater chance of double taxation.[176]

5.5 U.S. opinions on the OECD BEPS efforts and the future expectations

While the United States procrastinated the international tax reforms, many advanced economies have a certain degree of a territorial tax system in place. These jurisdictions therefore are in a favored position in comparison to the U.S. with its worldwide system of taxation.

These jurisdictions are also in a more favorable position because of their application of lower tax rates and the fact that they offer attractive tax incentives. Because of the worldwide system of taxation of their country, U.S.-based multinationals are under higher scrutiny than their competitors abroad as regards to disclosing their revenues to taxation and their complicated structures which often leads to base erosion and profit shifting as a result of their limited abilities to freely move their capital.

[176] M. Cadesky, R. Rinninsland & K. Lobo, *U.S. Based Pushback On B.E.P.S.*, October 2014, pp. 10-29, (available at: http://publications.ruchelaw.com/pdfs/2014-10/US_View_On_BEPS_AOTCA.pdf)

As mentioned earlier in the thesis, a number of high-profile U.S.-based multinationals including Apple Inc. have been subject to “tax shaming” whereby their operations were labeled as tax avoidance. Because of this attitude towards U.S.-based multinationals, a significant sense of suspicion prevails that the OECD is prejudiced against these U.S. multinational corporations.[177]

Also former Chairman of the House Ways and Means Committee Dave Camp and Senate Finance Ranking Member Orrin Hatch expressed their concerns about the BEPS project as the probability exists that the plan is enforced with the aim of raising the tax burden on U.S. taxpayers. They argue that the BEPS issue should be addressed by means of an extensive U.S. tax reform whereby the corporate tax rate will be lowered and the antiquated tax regime is updated.

Such amendments will lead to a greater level playing field for U.S. companies with their competitors abroad and the need to participate in tax planning structures will be less urgent.[178] Robert Stack,[179] a U.S. Treasury Official, expresses that the U.S. should await the evolvements of the BEPS process over time before it decides if it should remain dedicated to the project.[180]

There are however critics which argue that the U.S.-based multinationals cannot afford to wait. This has been argued as the OECD BEPS project allegedly has a great effect on those entities with foreign activities and these foreign affiliates are expected to meet the requirements of the amended laws of a specific jurisdiction.[181]

The U.S. has in essence three different options, it could put the entire OECD Action Plan to Congressional vote, it could adopt BEPS “by bits”, or it could enforce BEPS “by default”. The immediate endorsement of the OECD proposals is considered too ambitious, as it is expected the U.S. Congress would like to make amendments to a number of the recommendations. Also as the business community is not entirely positive about the plans of the OECD, it is therefore considered highly unlikely that the package is put up to a vote in the near future.

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[177] FTI Consulting, *Snapshot, OECD Tax Reform Recommendations*, September 24, 2014, available at http://www.fticonsulting.com/global2/media/collateral/united-states/oecd-tax-reform-recommendations.pdf
FTI Consulting LLP, is a global business advisory firm dedicated to helping organisations to protect and enhance enterprise value in an increasingly complex legal, regulatory and economic environment

[178] B. Dodwell, *Who are the BEPS supporters?* Tax Adviser Magazine, July 2014, pp. 26-27 & Committee on Ways and Means, *Camp, Hatch Statement on 2014 OECD Tax Conference,* June 2, 2014

[179] U.S. Treasury Deputy Assistant Secretary on International Tax Affairs

[180] D.D. Stewart, *BEPS Failure is an Option, Says U.S. Treasury Official,* Tax Analysts, June 20, 2014

[181] C. Chandler, S. Blough & M. Plowgian, *Why U.S. Multinationals Need to Care About BEPS Even if the U.S. Doesn’t Change Anything,* Daily Tax Report, Bloomberg BNA, September 15, 2014

Another option is the enactment of specified provisions, also referred to as BEPS “by bits”. This enactment will depend on the political agenda of the U.S. government, and Congress might decide to put up specific proposals to the vote in order to deal with a particular pressing matter. When the current division of the U.S. government is taken into account, and the upcoming presidential elections at the end of this year, it seems implausible that the enactment of specified provisions will lead to significant changes.

Finally, the U.S. government can enact the BEPS plan at the moment when most countries already adopted the entire package or the majority of the plans advocated by the OECD. Under this condition it might be less burdensome and even essential that Congress legislates BEPS as for instance multinational corporations are faced with the legislation abroad. These companies could even prefer the enactment by Congress in order to contribute to the coherence of these kind regulations, therefore this last option seems the most feasible considering the current political situation in the U.S.[182]

[182] J. Gimigliano, *The U.S. government's options for implementing the OECD's Base Erosion and Profit Shifting (BEPS) proposals, and the likelihood of these various pathways*, August 14, 2014, (available at: http://www.kpmg-institutes.com/institutes/taxwatch/articles/2014/08/beps-us-govt-options-video.html)
J. Gimigliano is principal in charge of the Washington National Federal Legislative and Regulatory Services group for KPMG LLP

Chapter 6 Conclusion

The research paper investigated to what extent the OECD BEPS Action Plan and the recent proposals to reform the U.S. international corporate tax system are feasible to end the current artificial income shifting practices of U.S. multinationals. Special attention was given to the practices of Apple Inc.

The thesis firstly looked at the U.S. planning structures and how U.S.-based multinationals are currently being taxed. This led to the to the research question which policy concerns U.S. policymakers have in connection with the current fashion of international taxation of U.S. based multinationals

In an answer to this question, various U.S. policymakers are concerned about the capacity of U.S. corporations to postpone U.S. taxation on foreign earnings as this may impede investment in the United States. As deferral may influence companies in their investment decisions, this may lead to less productive investments than in a situation without deferral.

Deferral stimulates multinational corporations to retain foreign-sourced active income offshore, because corporate taxes are not payable until the moment of repatriation. As a result of the existence of deferral there is an impetus to move income to low tax jurisdictions and to keep it there, this is also known as the "lock-out effect".

Furthermore, policymakers fear that U.S. companies are not capable to compete effectively in foreign local markets with foreign companies who are on a limited basis, -or not at all-, subject to residual home-country taxation on their foreign income and investments. As various countries have enacted some kind of territorial tax system, the competitive disadvantage that might challenge U.S. corporations may be critical.

With the introduction of the BEPS report by the OECD, a number of crucial principles for the taxation of cross-border activities have been highlighted. It also connects these principles with the possibilities for BEPS practices. The Report formed the basis for further inquiry to establish the expected consequences of the BEPS Action Plan on the base eroding and profit shifting methods of U.S.-based multinationals. As it is out of the scope of this thesis to investigate in detail every planning structure of each U.S.-based multinational corporation, it was chosen to focus on the practices of Apple Inc.

The thesis further dedicated attention to the proposals that have been made by the U.S. government to deal with the planning structures of U.S.-based multinationals in connection with the deferral of taxation on the income earned by their CFCs and other base eroding and profit shifting practices.

In mid-November 2013, former Chairman Baucus presented a discussion draft which has been completely dedicated to the subject of the reform of the U.S. system of international corporate taxation. With this draft, the same international tax matters that were addressed in the OECD BEPS report were dealt with from an entire U.S. perspective.

The consequences for the specific case of Apple Inc. were presented in order to clarify the potential impact of the Baucus proposal on U.S.-based multinationals with similar planning structures as this company.

Several business groups have responded to the proposals of Chairman Baucus, whereby most parties applauded the actual efforts of international tax reform but nevertheless remained skeptical about the substance of the draft. The Baucus draft faces critics that can actually impede its enactment but the proposals are viewed as a significant step forward on the path of international corporate tax reform.

The Obama Administration also undertook efforts to reform the U.S. system of international corporate taxation. Obama's plans can be considered as a strategic answer from the U.S. Treasury to the BEPS Action Plan. The proposals as a whole can terminate the deferral of U.S. taxation on revenues derived by U.S. multinationals abroad, and can in this matter, increase their effective tax rate. The plans can be considered as an attempt to modernize the U.S. system of business taxation and are drafted with the objective to reduce the advantages of moving profits and income out of the U.S. and into low tax jurisdictions.

However, at the moment of introducing these plans, the Congress was already divided, the proposals were therefore not considered as a reasonable and feasible option for the near future. As a result of the midterm elections of last November, the congressional expectations were doubtful and considerable tax legislations did not take place.

The proposal of the Obama Administration can be viewed as a first offer to break the impasse and to raise billions, which the government, in times of economic crisis, can employ for different purposes. As the annual budget needs to be authorized by Congress, which is currently dominated by Republicans, it is unlikely that the proposals of Obama will be enacted into law.

The idea of a minimum tax coupled with a transition tax as presented by president Obama is not completely new. After Chairman Baucus, also Chairman Dave Camp introduced minimum- and transition taxes in his Discussion Draft of February 2014. Hereby it can be concluded that there is a bipartisan support for corporate foreign tax reform.

It is considered highly unlikely that there will be a significant U.S. initiated international tax reform in the near future. Around the middle of this year the Presidential election season will start. By the time there will be a new President in 2017 it is implausible he or she will make the international tax reform a priority in the first term.

A number of high-profile U.S.-based multinationals including Apple Inc. has been subject to "tax shaming" whereby their operations were labeled as tax avoidance. Because of this attitude towards U.S.-based multinationals, a significant sense of suspicion exists in the U.S. where it is believed that the OECD is prejudiced against these U.S. multinational corporations.

Also former Chairman of the House Ways and Means Committee Dave Camp and Senate Finance Ranking Member Orrin Hatch are concerned about the BEPS project, as the probability exists that the plan is enforced with the aim of raising the tax burden on U.S. taxpayers. Robert Stack, a U.S. Treasury Official, underlined that the U.S. should await the evolvements of the BEPS process over time before it decides if it should remain committed to the project.

There are however critics which argue that the U.S.-based multinationals cannot afford to wait. This has been argued as the OECD BEPS project allegedly has a great effect on entities with foreign activities and these foreign affiliates are expected to meet the requirements of the amended laws of a specific jurisdiction.

The U.S. has in essence three different options, it could put the entire OECD Action Plan to Congressional vote, it could adopt BEPS "by bits", or it could enforce BEPS "by default".

BEPS "by default" means that the U.S. government can enact the BEPS plan at the moment when most countries already adopted the entire package or the majority of the plans advocated by the OECD. Under this condition it might be less difficult and even crucial that Congress legislates the BEPS proposals as for instance multinational corporations are faced with the legislation abroad. These companies could even prefer the enactment by Congress in order to contribute to the coherence of these kind regulations. Therefore this option seems the most feasible considering the current political situation in the U.S.

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ANNEX: 26 U.S. Code § 952 - Subpart F income defined

(a) In general
For purposes of this subpart, the term “subpart F income” means, in the case of any controlled foreign corporation, the sum of—
(1) insurance income (as defined under section 953),
(2) the foreign base company income (as determined under section 954),
(3) an amount equal to the product of—
(A) the income of such corporation other than income which—
(i) is attributable to earnings and profits of the foreign corporation included in the gross income of a United States person under section 951 (other than by reason of this paragraph), or
(ii) is described in subsection (b),
multiplied by
(B) the international boycott factor (as determined under section 999),
(4) the sum of the amounts of any illegal bribes, kickbacks, or other payments (within the meaning of section 162 (c)) paid by or on behalf of the corporation during the taxable year of the corporation directly or indirectly to an official, employee, or agent in fact of a government, and
(5) the income of such corporation derived from any foreign country during any period during which section 901 (j) applies to such foreign country.
The payments referred to in paragraph (4) are payments which would be unlawful under the Foreign Corrupt Practices Act of 1977 if the payor were a United States person. For purposes of paragraph (5), the income described therein shall be reduced, under regulations prescribed by the Secretary, so as to take into account deductions (including taxes) properly allocable to such income.

(b) Exclusion of United States income
In the case of a controlled foreign corporation, subpart F income does not include any item of income from sources within the United States which is effectively connected with the conduct by such corporation of a trade or business within the United States unless such item is exempt from taxation (or is subject to a reduced rate of tax) pursuant to a treaty obligation of the United States. For purposes of this subsection, any exemption (or reduction) with respect to the tax imposed by section 884 shall not be taken into account.

(c) Limitation
(1) In general
(A) Subpart F income limited to current earnings and profits
For purposes of subsection (a), the subpart F income of any controlled foreign corporation for any taxable year shall not exceed the earnings and profits of such corporation for such taxable year.
(B) Certain prior year deficits may be taken into account
(i) In general The amount included in the gross income of any United States shareholder under section 951 (a)(1)(A)(i) for any taxable year and attributable to a qualified activity shall be reduced by the amount of such shareholder’s pro rata share of any qualified deficit.
(ii) Qualified deficit The term “qualified deficit” means any deficit in earnings and profits of the controlled foreign corporation for any prior taxable year which began after December 31, 1986, and for which the controlled foreign corporation was a controlled foreign corporation; but only to the extent such deficit—
(I) is attributable to the same qualified activity as the activity giving rise to the income being offset, and
(II) has not previously been taken into account under this subparagraph.
In determining the deficit attributable to qualified activities described in subclause (II) or (III) of clause (iii), deficits in earnings and profits (to the extent not previously taken into account under this section) for taxable years beginning after 1962 and before 1987 also shall be taken into account. In the case of the qualified activity described in clause (iii)(I), the rule of the preceding sentence shall apply, except that “1982” shall be substituted for “1962”.

(iii) Qualified activity For purposes of this paragraph, the term “qualified activity” means any activity giving rise to—
(I) foreign base company oil related income,
(II) foreign base company sales income,
(III) foreign base company services income,
(IV) in the case of a qualified insurance company, insurance income or foreign personal holding company income, or
(V) in the case of a qualified financial institution, foreign personal holding company income.
(iv) Pro rata share For purposes of this paragraph, the shareholder’s pro rata share of any deficit for any prior taxable year shall be determined under rules similar to rules under section 951 (a)(2) for whichever of the following yields the smaller share:
(I) the close of the taxable year, or
(II) the close of the taxable year in which the deficit arose.
(v) Qualified insurance company For purposes of this subparagraph, the term “qualified insurance company” means any controlled foreign corporation predominantly engaged in the active conduct of an insurance business in the taxable year and in the prior taxable years in which the deficit arose.
(vi) Qualified financial institution For purposes of this paragraph, the term “qualified financial institution” means any controlled foreign corporation predominantly engaged in the active conduct of a banking, financing, or similar business in the taxable year and in the prior taxable year in which the deficit arose.
(vii) Special rules for insurance income
(I) In general An election may be made under this clause to have section 953 (a) applied for purposes of this title without regard to the same country exception under paragraph (1)(A) thereof. Such election, once made, may be revoked only with the consent of the Secretary.
(II) Special rules for affiliated groups In the case of an affiliated group of corporations (within the meaning of section 1504 but without regard to section 1504 (b)(3) and by substituting “more than 50 percent” for “at least 80 percent” each place it appears), no election may be made under subclause (I) for any controlled foreign corporation unless such election is made for all other controlled foreign corporations who are members of such group and who were created or organized under the laws of the same country as such controlled foreign corporation. For purposes of clause (v), in determining whether any controlled corporation described in the preceding sentence is a qualified insurance company, all such corporations shall be treated as 1 corporation.
(C) Certain deficits of member of the same chain of corporations may be taken into account
(i) In general A controlled foreign corporation may elect to reduce the amount of its subpart F income for any taxable year which is attributable to any qualified activity by the amount of any deficit in earnings and profits of a qualified chain member for a taxable year ending with (or within) the taxable year of such controlled foreign corporation to the extent such deficit is attributable to such activity. To the extent any deficit reduces subpart F income under the preceding sentence, such deficit shall not be taken into account under subparagraph (B).
(ii) Qualified chain member For purposes of this subparagraph, the term “qualified chain member” means, with respect to any controlled foreign corporation, any other corporation which is created or organized under the laws of the same foreign country as the controlled foreign corporation but only if—
(I) all the stock of such other corporation (other than directors’ qualifying shares) is owned at all times during the taxable year in which the deficit arose (directly or through 1 or more corporations other than the common parent) by such controlled foreign corporation, or
(II) all the stock of such controlled foreign corporation (other than directors’ qualifying shares) is owned at all times during the taxable year in which the deficit arose (directly or through 1 or more corporations other than the common parent) by such other corporation.
(iii) Coordination This subparagraph shall be applied after subparagraphs (A) and (B).

(2) Recharacterization in subsequent taxable years
If the subpart F income of any controlled foreign corporation for any taxable year was reduced by reason of paragraph (1)(A), any excess of the earnings and profits of such corporation for any subsequent taxable year over the subpart F income of such foreign corporation for such taxable year shall be recharacterized as subpart F income under rules similar to the rules applicable under section 904 (f)(5).
(3) Special rule for determining earnings and profits
For purposes of this subsection, earnings and profits of any controlled foreign corporation shall be determined without regard to paragraphs (4), (5), and (6) of section 312 (n). Under regulations, the preceding sentence shall not apply to the extent it would increase earnings and profits by an amount which was previously distributed by the controlled foreign corporation.

(d) Income derived from foreign country
The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of subsection (a)(5), including regulations which treat income paid through 1 or more entities as derived from a foreign country to which section 901 (j) applies if such income was, without regard to such entities, derived from such country.