iTax—Apple's International Tax Structure and the Double Non-Taxation Issue

Antony Ting*

Abstract

Apple, famous for its innovative products, has proved to be equally creative in its tax structure. From 2009 to 2012, it successfully sheltered US $44 billion from taxation anywhere in the world. An unusual feature of its tax structure is the relative simplicity: it does not rely on the Double Irish Dutch Sandwich structure that has been commonly used by other US multinationals. A recent parliamentary hearing in the US revealed detailed information about Apple's tax structure, which is difficult, if not impossible, to discern from its financial statements. At the same time, interesting information and issues of tax avoidance by multinational enterprises from the perspective of source countries were also revealed in parliamentary committee hearings in the UK. The aim of this article is twofold. First, it analyses the international tax structure of Apple and investigates how it achieved the double non-taxation of US $44 billion. The analysis reveals that the US Government has knowingly facilitated the avoidance of foreign income tax by its multinational enterprises (MNEs), thus creating double non-taxation. It also highlights the structural issues of domestic and international tax rules that enable the creation of double non-taxed income. Secondly, the article reviews the possible responses of both the residence and source countries to Apple's tax avoidance structure, and argues that two issues are important in the design of effective solutions to the problem. First, the application of the enterprise doctrine—under which a corporate group under the common control of a parent company is treated as one single entity—is more likely to produce effective measures to tackle MNEs' tax avoidance transactions. Secondly, the increase in transparency, in particular a properly designed country-by-country reporting regime, would be a much needed weapon for tax authorities which at present suffer from information asymmetry in the tax avoidance battle with MNEs.

Introduction

Apple is famous for its innovative products. From the iMac in 1998 and the iPod in 2001 to the more recent iPhone in 2007 and iPad in 2010, they often set the standard for the product category.[1] In the tax world, Apple has also proved to be equally creative and bold. An unusual feature of its tax structure is its relative simplicity: it does not rely on the Double Irish Dutch Sandwich structure that has been commonly used by other US multinationals. Nevertheless, it is highly effective in achieving the goal of tax avoidance. A recent parliamentary hearing in the US reveals that from 2009 to 2012 Apple's international tax structure successfully sheltered US $44 billion from taxation anywhere in the world.[2] While there may be good grounds for Apple's CEO to

* Senior Lecturer, University of Sydney.

[1] For a brief summary of the success story of Apple, see T. Cook, "Testimony of Apple Inc. Before the Permanent Subcommittee on Investigations US Senate" delivered on May 21, 2013, 4–5, available at: *http://www.apple.com/pr/pdf/Apple_Testimony_to_PSI.pdf* [Accessed January 20, 2014].

[2] Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations, *Offshore Profit Shifting and the U.S. Tax Code—Part 2 (Apple Inc.)* (2013) (US Hearing Report), 17, available at: *http://www.hsgac.senate.gov/subcommittees/investigations/hearings/offshore-profit-shifting-and-the-us-tax-code_-part-2* [Accessed January

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claim in the hearing that his company "complies fully with both the laws and spirit of the laws. And Apple pays all its required taxes, both in [the US] and abroad",[3] the double non-taxation of the US $44 billion has caused uproar in both the US and the source countries where Apple makes substantial profits but pays relatively small amounts of tax. The hearing revealed detailed information about the tax structure of Apple that is difficult, if not impossible, to discern from its financial statements. At the same time, interesting information and issues of tax avoidance by MNEs from the perspective of source countries were also revealed in parliamentary committee hearings conducted in the UK.[4]

A fundamental principle of international taxation is that "all incomes would be taxed once and only once."[5] In other words, the international tax norms should not only avoid double taxation, but also prevent double non-taxation. However, it is observed that

> "for tax competition reasons some countries were happy to see structures that reduced the tax burden *on their multinational enterprises in their activities abroad*, and facilitating double non-taxation was part of that effort" (emphasis added).[6]

Though the statement was made in the context of the OECD's harmful tax competition project, the analysis of Apple's tax structure in this article suggests that it still holds much truth today.

The aim of this article is twofold. First, it analyses the international tax structure of Apple and investigates how it achieved the double non-taxation of US $44 billion. By highlighting some tax planning tools commonly used by MNEs, it identifies the structural issues of domestic and international tax rules that facilitate the creation of double non-taxed income. Secondly, the article reviews the possible responses of both the residence and source countries to Apple's tax avoidance structure and argues that two issues are important in the design of effective solutions

20, 2014]. Of course, Apple is only one of the many multinational enterprises that are engaged in international tax planning. For instance, the same Subcommittee held a similar hearing in September 2012 to investigate the international tax planning of Microsoft and Hewlett-Packard. Source countries such as the UK had also held hearings on the issue with regard to several US multinationals including Google, Amazon and Starbucks: see for example the numerous documents available at the House of Commons Public Accounts Committee website: *http://www.parliament.uk/business/committees/committees-a-z/commons-select/public-accounts-committee/* [Accessed January 20, 2014]; and the House of Lords Select Committee on Economic Affairs, *Tackling corporate tax avoidance in a global economy: is a new approach needed?* (2013). However, Apple is a particularly interesting case partly due to the relative simplicity of its tax structure as compared to other US multinationals, as well as the quantum involved: Apple's worldwide gross income is equivalent to the California state budget: L.A. Sheppard, "Apple's Tax Magic" (May 26, 2013) *Tax Notes Worldwide Tax Daily* 967, 967.

[3] Cook, above fn.1, 1.

[4] For example, see UK Public Accounts Committee, *Ninth Report—Tax Avoidance-Google* (June 10, 2013), available at: *http://www.publications.parliament.uk/pa/cm201314/cmselect/cmpubacc/112/11202.htm* [Accessed January 20, 2014].

While other countries may not conduct similar hearings, many countries are concerned about base erosion and profit shifting (BEPS) and have released reports on the issues: see for example Treasury of Australia, *Risks to the Sustainability of Australia's Corporate Tax Base—Scoping Paper* (2013). Australian Government, The Treasury, *Scoping Paper on Risks to the Sustainability of Australia's Corporate Tax Base* (July 2013), available at: *http://www.treasury.gov.au/PublicationsAndMedia/Publications/2013/Aus-Corporate-Tax-Base-Sustainability* [Accessed January 20, 2014].

[5] League of Nations, *Double Taxation and Tax Evasion—Report presented by the Committee of Technical Experts on Double Taxation and Tax Evasion* (C.216.M.85 1927 11 (1927)), 23.

[6] H.J. Ault, "Some Reflections on the OECD and the Sources of International Tax Principles" (2013) 70(12) *Tax Notes International* 1195, 1195.

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to the problem. First, an application of the enterprise doctrine—under which a corporate group under the common control of a parent company is treated as one single entity—is more likely to produce effective measures to tackle MNEs' base erosion and profit shifting (BEPS) transactions. Secondly, increasing transparency, in particular a properly designed country-by-country reporting regime, would be a much needed weapon for tax authorities who at present suffer from information asymmetry in the tax avoidance battle with MNEs.

This article begins with a review of Apple's international tax structure with the aim of identifying the tax regimes that facilitate the creation of double non-taxation. It then explores the possible responses of the US as the residence country. This is followed by a discussion of the two issues that source countries should consider in the BEPS battle with MNEs. The article then argues why the enterprise doctrine should be a more appropriate underlying principle in the design of effective anti-BEPS rules. It concludes with a discussion of the importance of country-by-country information being provided to tax authorities as an essential tool in identifying audit targets as well as an effective deterrent measure in relation to double non-taxation.

The word iTax used in the title of this article has double meanings. It refers primarily to the international tax structure of Apple, as the names of its products often start with an "i". It also infers the need for new thinking about some of the fundamental concepts and principles of international taxation rules in response to the double non-taxation issue, as the prefix "i" nowadays often suggests a new product or modern approach.

Before proceeding, some caveat is in order. The international tax issues involved in BEPS are immensely complex. This article does not intend to provide a comprehensive discussion and technical analysis of all the issues and potential solutions. Instead, it focuses on the issues arising from the double non-taxation created in the iTax structure. For the same reason, detailed analysis of the BEPS project of the OECD is beyond the scope of this article.[7]

iTax—Apple's international tax structure

The iTax structure is relatively simple when compared to the more common Double Irish Dutch Sandwich structure commonly used by other US MNEs.[8] Shortly before its listing on the New York Stock Exchange, Apple Inc established the following wholly owned subsidiaries in Ireland in 1980: Apple Operations International (AOI), Apple Operations Europe (AOE) and Apple Sales International (ASI). The corporate structure is depicted in the diagram below[9]:

[7] The growing international concerns about international tax avoidance by MNEs have prompted the OECD to embark on the project. It released an initial report in February 2013 identifying the key pressure areas with respect to the issue: OECD, *Addressing Base Erosion and Profit Shifting* (OECD Publishing, 2013) (BEPS Report), available at: *http://dx.doi.org/10.1787/9789264192744-en* [Accessed January 20, 2014] and an action plan to deal with the key pressure areas in July 2013: OECD, *Action Plan on Base Erosion and Profit Shifting* (OECD Publishing, 2013) (BEPS Action Plan), available at: *http://dx.doi.org/10.1787/9789264202719-en* [Accessed January 20, 2014].

[8] This appears to be consistent with the philosophy of Apple Inc: "Apple has always believed in the simple, not the complex. This is evident in the Company's products and the way it conducts itself": Cook, above fn.1, 16.

[9] The diagram is prepared based on information in the US Hearing Report, above fn.2, in particular the chart at 20.

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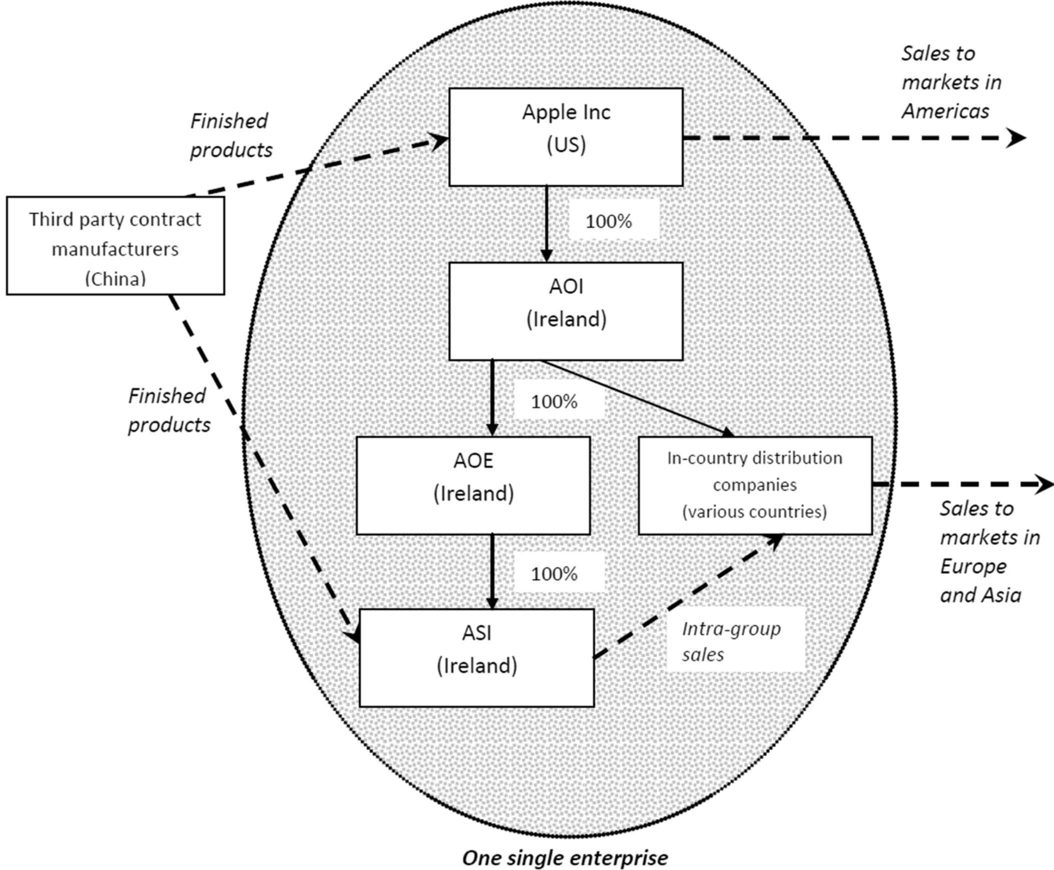

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AOI and ASI serve vital roles in the iTax structure as described below.

AOI

AOI is incorporated in Ireland, but has its central management and control in the US.[10] It is a shell company with no employees.[11] The definition of corporate tax residence in Ireland appears to be the "perfect partner" for that in the US. AOI is not a resident of Ireland, as the Irish definition of corporate tax residence is determined solely by the location of a company's central management and control. Nor is it a resident of the US, as the US tax law defines the residence of a company solely in terms of the place of incorporation.

AOI is the intermediate holding companies for many group companies involved in the overseas operations of the group. Its subsidiaries include ASI and group distribution companies in the respective countries in Europe and Asia.[12] The company received substantial dividends from its subsidiaries (for example, it received US $30 billion dividends between 2009 and 2011), but has not paid any corporate income tax in any country for many years.[13] Besides its subsidiaries, its only major asset is cash, which is held in bank accounts in New York.[14]

ASI

ASI is also incorporated in Ireland. Similar to AOI, it enjoys the perfectly complementary definitions of corporate tax residence in Ireland and the US, and is not a tax resident of any country. The company had no employees until 2012 when 250 employees were assigned to it from its parent company AOE.[15]

ASI engages unrelated contract manufacturers in China to assemble the products, and sells the finished products to distribution subsidiaries in Europe and Asia.[16] In most cases, the products never physically transit through Ireland.[17] The company has entered into a cost sharing agreement with its ultimate parent company Apple Inc, under which it has the *economic* rights to Apple's intellectual property outside the Americas while the legal ownership of the intellectual property always rests with Apple Inc in the US.[18] For instance, in 2011, as approximately 60 per cent of Apple's worldwide sales occurred outside the Americas, ASI was obliged to pay 60 per cent of the group's research and development (R&D) costs of US $2.4 billion, or US $1.4 billion, to Apple Inc under the cost sharing arrangement.[19]

[10] AOI has three directors. Two are employees of Apple Inc and reside in California. The third is an employee of another Irish group company and resides in Ireland. AOI's board meetings have almost always taken place in the US: US Hearing Report, above fn.2, 22.
[11] US Hearing Report, above fn.2, 21.
[12] US Hearing Report, above fn.2, 35.
[13] US Hearing Report, above fn.2, 23.
[14] US Hearing Report, above fn.2, 22.
[15] US Hearing Report, above fn.2, 24.
[16] US Hearing Report, above fn.2, 27. An exception is the sales to China, which do not pass through ASI. Instead, the sales are made through another Irish subsidiary, Apple Distributions International, US Hearing Report, above fn.2.
[17] US Hearing Report, above fn.2.
[18] US Hearing Report, above fn.2, 25–26. Under the agreement, ASI is responsible for a portion of group's R&D expenses corresponding to the proportion of the group's sales in markets outside the Americas.
[19] US Hearing Report, above fn.2, 26.

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A review of the amounts of cost shared under the cost sharing arrangement and the corresponding income earned by ASI suggests that the arrangement is not commercially justifiable. ASI derived disproportionally significant amounts of income in return for its cost sharing payments. In particular, the profits to cost ratios under the cost sharing agreement were 7:1 for Apple Inc and 15:1 for ASI.[20] Pursuant to the intra-group sales structure, ASI derived sales income of US $74 billion from 2009 to 2012.[21] It is highly doubtful if Apple Inc would have entered into the cost sharing arrangement with a third party. However, it appears that there was no dispute about Apple's claim in the hearing that "Apple's cost sharing agreement is regularly audited by the IRS and complies fully with all applicable Treasury regulations."[22]

ASI has filed corporate tax returns in Ireland, presumably reporting income sourced in the country. The tax liabilities were trivial compared to its income. For instance, it paid US $10 million while its income was US $22 billion in 2010, and paid US $7 million in 2011 while its income was US $12 billion in 2011.[23] Apple successfully avoided paying any tax on US $44 billion from 2009 to 2012.[24]

In the US hearing, there is no dispute that Apple's tax planning structure is in full compliance with the tax laws of the countries involved. However, the outcome defies common sense. The locations of real economic activities—such as R&D and sales—are detached from the locations of profits. A disproportional amount of income was booked in the Irish subsidiaries that have relatively few employees and activities, and the effective tax rate on the income was very low. The disproportionate allocation of income to Ireland is depicted in the following table[25]:

Factors	**Groupwide**	**Ireland subsidiaries**
Earnings before tax	100% (US $34 billion)	64% (US $22 billion)
Customers	100%	1%
Employee numbers	100%	4%

The success of the iTax structure stems primarily from two "non-taxation" outcomes. First, the profits booked in the Irish companies were not taxable in the US, which is the residence country of Apple Inc. One may wonder why the profits were not captured by the US controlled foreign corporation (CFC) regime which is supposedly designed to capture this kind of base company income. Secondly, the profits booked in the Irish companies were not taxable in the

[20] US Hearing Report, above fn.2, 29.
[21] US Hearing Report, above fn.2, 4.
[22] Cook, above fn.1, 10.
[23] US Hearing Report, above fn.2, 24–25.
[24] US Hearing Report, above fn.2, 17. Another way to look at the issue is the effective tax rate of ASI. For the three years from 2009 to 2011, its effective tax rates were 0.1%, 0.06% and 0.05% respectively: US Hearing Report, above fn.2, 21.
[25] S.E. Shay, "Testimony before the US Senate Permanent Subcommittee on Investigations—Hearing on Offshore Profit Shifting and the Internal Revenue Code" (May 21, 2013), 8. A similar pattern of disproportional allocation of income was observed in Microsoft: S.E. Shay, Hearing before the Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs United States Senate One Hundred Twelfth Congress Second Session, "Testimony before the US Senate Permanent Subcommittee on Investigations—Hearing on Offshore Profit Shifting and the Internal Revenue Code" (September 20, 2012), 6–7, available at: *http://www.gpo.gov/fdsys/pkg/CHRG-112shrg76071/pdf/CHRG-112shrg76071.pdf* [Accessed February 28, 2014].

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source countries where the Apple products were sold to end customers.[26] These issues, and the tax laws in the US and Ireland that facilitate the double non-taxation, are discussed in the next section of this article. The discussion highlights the major weaknesses of the domestic and international tax laws that are often exploited by MNEs.

How did the iTax structure achieve double non-taxation?

The double non-taxation of the profits booked in AOI and ASI was achieved primarily by the combined effect of the following:

1. Definitions of corporate residence in Ireland and the US;
2. Transfer pricing rules on intangibles;
3. Controlled foreign corporation (CFC) regime in the US;
4. Check-the-box regime in the US; and
5. Low-tax jurisdiction.

These issues are analysed in detail in the following paragraphs.

Arbitrage between corporate residence definitions

Ireland appears to be the perfect partner for the US to create a company that is not a tax resident in any country. Both countries define corporate tax residence in terms of a single factor: place of incorporation for the US, and central management and control for Ireland.[27] A company incorporated in Ireland with central management and control in the US is therefore not a resident of either country. It follows that under the source principle, the Irish company would be subject to tax in Ireland only on its income sourced in the country (if any). The important implication of the non resident status of ASI in Ireland is that its foreign source income is tax free in the country.

The iTax structure takes advantage of the complementary definitions of corporate tax residence in the two countries, as well as the source principle, to facilitate the creation of the double non-taxation outcome. This arbitrage opportunity is too tempting for US MNEs to ignore. Apple is not alone in benefiting from this arbitrage.[28]

[26] Similar concerns were raised in the UK with respect to a number of MNEs, including Google: see for example, J. Martin, "UK Grills Google, Ernst & Young on Tax Avoidance" (2013) 70(9) *Tax Notes International* 823.

[27] Ireland's Finance Minister announced in his budget address on October 15, 2013 that the corporate residence definition would be amended as a response to the creation of "stateless" companies. This was followed by the release of Finance Bill (No.2) 2013 on October 22, 2013, which stipulates that if a company is incorporated in Ireland but is managed and controlled in another country that determines corporate residence based on the place of incorporation, the company is deemed to be a resident of Ireland. It is not certain at the time of writing this article whether the Bill will be enacted in its current form. However, many have already cast doubt on its effectiveness as an anti-BEPS measure: D.D. Stewart, "Ireland Targets 'Stateless' Companies in 2014 Budget" (2013) 72(3) *Tax Notes International* 212, 213; and D.D. Stewart, "Ireland Acts Against Apple's Tax Arrangement but Leaves Google's Untouched" (October 31, 2013) *Worldwide Tax Daily*.

[28] M. Sapirie, "News Analysis: As American as Apple" (June 3, 2013) *Tax Analysts—Worldwide Tax Daily*. Microsoft also takes advantage of the tax arbitrage opportunity: its subsidiaries incorporated in Ireland are tax resident of Bermuda: Shay (2012), above fn.25, 6.

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Transfer pricing rules on intangibles

A key component of the iTax structure is the transfer of the economic rights of Apple's intellectual property to ASI under the cost sharing agreement.[29] Pursuant to the intra-group contract, ASI owns the production and marketing rights of Apple's products for Europe and Asia. ASI does not have to pay any royalties to Apple Inc due to the split economic ownership of the intangible assets.[30] Having those rights located in Ireland detaches from the reality that the R&D activities are virtually all carried out in the US, and possibly more importantly, the *legal ownership* of the intellectual property always rests with Apple Inc in the US. It is common for US MNEs to keep the legal ownership of an intangible asset in the US "because of the protections offered by the US legal system and the importance of protecting such rights in such a large market."[31]

The tax planning technique of transferring intangible assets to a low-tax country is neither new nor uncommon.[32] For instance, US MNEs have been successfully employing the technique to shift profits to low-tax countries since the 1970s.[33] Since the cost sharing regime was introduced by the US Treasury in the early 1990s, the transfer pricing regime in the US has been ineffective to enforce the arm's length principle on the transfer.[34] Under a cost sharing agreement, a US parent company may agree to share with its foreign subsidiary the R&D costs on a, say, 40:60 basis. By contributing 60 per cent of the development costs, the subsidiary is entitled to 60 per cent of the profits from the intangible. This is so even if the R&D activities take place wholly in the US. Besides being an intra-group contract, the cost contributions of the subsidiary are often funded by a round robin: the parent company makes a contribution to the subsidiary which in turn pays it back as the cost sharing payments.[35]

[29] The statutory authority for the US transfer pricing rules is found in s.482 of the Inland Revenue Code (IRC) and the specific rules governing cost sharing arrangements are provided in Temporary Treasury Regulations s.1.482-7T. Alternative ways to transfer intangible assets to an offshore subsidiary include an outright sale of the asset and a licensing agreement under which the subsidiary pays royalties to the parent company: US Hearing Report, above fn.2, 7. The US hearings suggest that the cost sharing agreement is the commonly preferred mechanism for MNEs. For a discussion of the alternative structure of a cost sharing arrangement, see US Joint Committee on Taxation, *Present Law and Background Related to Possible Income Shifting and Transfer Pricing* (2010), 21.

[30] US Joint Committee on Taxation, above fn.29.

[31] US Hearing Report, above fn.2, 8. It is common for US MNEs to exploit their intangible property rights for tax purposes: US Joint Committee on Taxation, above fn.29, 103.

[32] For example, another US Senate hearing revealed that Microsoft employed this technique to shift substantial profits to Ireland, Singapore and Puerto Rico: R. Avi-Yonah, *Testimony for Hearing on Profit Shifting—US Senate Permanent Subcommittee on Investigations* (Washington DC: US Senate Committee Homeland Security and Government Affairs, September 20, 2012), 2.

[33] For a good summary of the historical development of the issue in the US, see Avi-Yonah, above fn.32, 1–3.

[34] See Avi-Yonah, above fn.32, 3.

[35] See Avi-Yonah, above fn.32, A related issue of the cost sharing arrangement is the amount of payment (known as the "buy in" payment) that the subsidiary should pay the parent company for the prevailing market value of the rights over the intangible that the parent company will transfer to the subsidiary. For a summary of the development of the cost sharing issue, see US Joint Committee on Taxation, above fn.29, 111–115. The "buy in" payment can be a lump sum or in the form of royalties: BEPS Report, above fn.7, 74. In theory, the properly priced "buy in" payment should equal the net present value of the intangible asset transferred to the foreign subsidiary: US Joint Committee on Taxation, above fn.29, 17. However, the tax authorities do not appear to have much luck with the "buy in" payment issue, as valuation is an art, not a science: Shay (2013), above fn.25, 5 and 7. The valuation of intangible assets is complex and difficult, as the asset is often unique and has no comparables: US Hearing Report, above fn.2, 8. The Internal Revenue Service confirmed that the issue has been its "most significant international enforcement challenge over the past decade": Sapirie, above fn.28. The rules in the US with respect to the "buy in" payment have been tightened in

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The rationale behind the cost sharing regime is worth analysing, as it highlights a fundamental issue of the taxation of multinational corporate groups. The regime was originally designed based on the belief that a MNE would not know in advance whether the R&D activities would be successful or not. That belief implies that if the research turns out to be unsuccessful, the MNE would lose the deduction of the R&D costs borne by the subsidiary. Therefore, it was assumed that MNEs would not be too aggressive in entering into a cost sharing agreement predominantly for tax avoidance purposes.

This assumption has proven to be far from the truth. It ignores the "information asymmetry" between MNEs and tax authorities.[36] A MNE is in the best position to assess the risk of its research project while the tax authority is virtually clueless. In practice, a MNE will enter into a cost sharing arrangement only if the project is likely to be successful.[37] In other words, the cost sharing regime provides a legal mechanism for a MNE to shift offshore profits from intangibles to low-tax countries. In fact, it is possible that in most cases, MNEs have no good reason to use cost sharing arrangements other than for tax avoidance purposes.[38]

It is unclear why the US Government has not closed the loophole for so many years.[39] A couple of explanations are possible. First, the removal of a tax regime so beneficial to businesses is politically difficult. Secondly, the US Government may be aware of the loophole, but is willing to "support" its MNEs by allowing them to book income in low-tax countries—especially when the income is sourced from overseas markets—and thus improve the competitiveness of US businesses.[40]

A small episode in the history of transfer pricing is telling in the context of the current discussion.[41] The arm's length principle was originally developed in the 1930s with a focus on

2011; however, MNCs with pre-existing cost sharing arrangements can enjoy grandfathered status: US Hearing Report, fn.2, 9.

[36] US Joint Committee on Taxation, above fn.29, 110. The information asymmetry issue also helps to explain why MNEs often have the upper hand over tax authorities in disputes about transfer pricing valuations: US Joint Committee on Taxation, above fn.29, 116.

[37] Avi-Yonah, above fn.32, 3. In the Apple hearing, a senior US Treasury official admitted that "there has been considerable controversy about whether [the anticipated anti-avoidance effect of the fear-of-loss-of-deduction] is achieved in fact": M.J. Mazur, *Written Testimony of Mark J Mazur, Assistant Secretary for Tax Policy, US Department of the Treasury, before the US Senate Homeland Security and Government Affairs Permanent Subcommittee on Investigations—Hearing on The Shifting of Profits Offshore by US Multinational Corporations* (May 21, 2013), 2.

[38] M.A. Sullivan, "The Other Problem with Cost Sharing" (May 27, 2013) *Worldwide Tax Daily* 975. It is interesting to see that the CEO of Apple claimed in the hearing that if "cost sharing agreements were no longer available, many US multinational companies would likely move high-paying American R&D jobs overseas": Cook, above fn.1, 12. One would suspect that if it is commercially beneficial to move R&D activities to, say, India, Apple does not need encouragement from the tax law to do so.

[39] It appears that cost sharing arrangements have been subject to more serious challenges by the tax authority in recent years: US Joint Committee on Taxation, above fn.29, 111. The US Treasury issued regulations in December 2011 designed to strengthen the rules on cost sharing arrangements: Treasury Regulations §1.482-7; for a brief summary of the rules, see US Hearing Report, above fn.2, 9. However, US MNEs have been able to grandfather their pre-existing arrangements: above fn.2.

[40] A commentator from the US observed that "some countries like the US have been complicit in structuring their own CFC rules to keep the domestic tax base but in effect encouraging base erosion by US companies operating in other jurisdictions, thus lowering the US companies' overall effective tax rate and strengthening their competitive position in foreign markets": Ault, above fn.6, 1198.

[41] The following discussion is drawn from a well-written summary of the historical development of the transfer pricing rules with respect to corporate groups in: R. Vann, "Reflections on Business Profits and the Arm's-Length Principle"

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branches, not subsidiaries. That position had remained for 30 years until the US issued its transfer pricing regulations with a new focus on transactions between group companies in 1968. The US regulations ultimately shaped to a large extent the modern transfer pricing regime under which the rules in general are applied to a corporate group on an entity-by-entity basis.[42] The default position of the separate entity treatment and respecting the transactions between group companies has this undesirable effect[43]:

> "The practical result is a tax planning free-for-all, which allowed MNEs to subvert the arm's-length principle by using transactions to allocate functions, assets, and risks rather than looking at … the underlying economic substance. Tax administrations have to deal with transfer pricing based on an economic analysis with one hand tied behind their back because of the transactional requirement."

Though this article does not intend to discuss the application of transfer pricing rules to corporate groups in detail,[44] the iTax story highlights the need to review the fundamental issue of how tax law should treat intra-group transactions, especially in the context of tax avoidance. Transfer of rights under a cost sharing arrangement between group companies does not involve bona fide shifting of economic risk. While the contract may assign risks among group members from a legal perspective, the reality is that the risks never leave the group.[45]

The OECD has been working on the transfer pricing issues relating to intangibles and the working party has expressed the view that

> "transfer pricing outcomes in cases involving intangibles should reflect the functions performed, assets used, and risks assumed by the parties. This suggests that neither legal ownership, nor the bearing of costs related to intangible development … entitles an entity within an MNE group to retain the benefits or returns with respect to intangible without more."[46]

It seems to suggest that a group company should not be entitled to receive income from intangible assets solely due to a cost sharing agreement.[47] This issue is discussed in more detail below in the section "The enterprise doctrine—a generic solution?"

in B.J. Arnold, J. Sasseville and E.M. Zolt (eds), *The Taxation of Business Profits under Tax Treaties* (2003), 133, at 135–139.

[42] The OECD recognises that this is one of the key issues with respect to its BEPS project: BEPS Report, above fn.7, 42.

[43] Vann, above fn.41, 142. The separate entity approach has also been criticised as the "arm's-length principle … tries to hypothesize its way around the economic integration of the firm while taking its legal and financial structure at face value": R. Couzin, "The End of Transfer Pricing?" (2013) 61(1) *Canadian Tax Journal* 159, 171.

[44] There is huge literature on the issue. For a recent article on the topic, see Couzin, above fn.43.

[45] US Joint Committee on Taxation, above fn.29, 110.

[46] OECD, *Discussion Draft—Revision of the Special considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions* (2012) (the Discussion Draft), 12. The Discussion Draft was prepared by Working Party No.6 of the OECD Committee on Fiscal Affairs and released on June 6, 2012 inviting public comments on proposed revisions of the relevant sections in the OECD Transfer Pricing Guidelines. The document was an interim draft prepared at the request of the business community, and importantly has not yet addressed "any necessary modifications to … the Transfer Pricing Guidelines related to cost contribution arrangements …": the Discussion Draft, above, 3. The Action Plan for the BEPS project also aims to address the abuse with respect to intangibles (namely, Actions 8, 9 and 10): BEPS Action Plan, above fn.7, 20–21.

[47] Sullivan, above fn.38.

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The US CFC regime

The US introduced its CFC regime in 1962 and was the first country to do so.[48] It is designed to limit tax deferral of certain passive or highly mobile income, including intra-group dividend, interest and royalty payments, and intra-group sales income.[49] Given the general impression that the US is aggressive in attacking tax avoidance, one may be inclined to believe that its CFC regime should be rigorous and effective. The Apple hearing, together with hearings on other US MNEs, reveals that this is not the case at all.

The US CFC regime has proved ineffective in dealing with the iTax structure primarily for two reasons. First, the regime contains a number of exceptions which deny the application of the regime to iTax. Secondly, and more importantly, the check-the-box regime in the US often effectively disables the CFC regime. The first reason is discussed in the following paragraphs, and the second reason is discussed in detail in the next section.

A CFC regime is an anti-avoidance measure designed to prevent deferral or denial of taxation by shifting profits to a CFC. It imposes immediate taxation on certain income of the CFC. In designing the regime, a difficult balance has to be maintained between the policy objectives of anti-avoidance and competitiveness.[50] The latter refers to the goal of ensuring that the tax system promotes economic growth instead of hindering normal business operations. It is therefore common for CFC regimes to ring-fence the scope of application to specific types of income or to provide specific exclusions.

The US CFC regime has an exclusion known as the "manufacturing exception", which was originally designed to exempt income of a CFC from immediate taxation if the CFC itself was a manufacturer that added substantial value to the goods.[51] The original exception may be well justified as the CFC regime should not discourage a MNE from expanding its manufacturing operations to a foreign country. However, the requirements for the exception were relaxed in 2008 and a CFC could qualify for the exception if it makes a "substantial contribution" to the goods, even though the company itself is not a manufacturer.[52] As a result, ASI could, potentially,

[48] IRC ss.951–965.

[49] For a summary of the US CFC rules, see US Joint Committee on Taxation, above fn.29, 36–46.

[50] For instance, the original proposal to introduce a CFC regime in the US would have eliminated deferral of all income earned by foreign subsidiaries of US MNEs. However, after "a lengthy and complex legislative process, the general elimination of deferral was rejected": P.R. McDaniel, H.J. Ault and J.R. Repetti, *Introduction to United States International Taxation*, 5th edn (The Hague: Kluwer Law International, 2005), 113. Instead, the scope of the final regime was more limited as "Congress was concerned that ending deferral completely would place US companies at a competitive disadvantage in their foreign operations": Mazur, above fn.37, 5. As a result of the tension between anti-deferral and competitiveness, "the lines drawn in reaching a compromise between those who favoured complete elimination of deferral and those urging its retention or extension are extremely detailed and complex": McDaniel, Ault and Repetti, above.

[51] US Hearing Report, above fn.2, 16. The other exception in the CFC regime that the US Senate Committee regarded as a loophole is the same country exception, under which payments between CFCs incorporated in the same foreign country are excluded from the regime: US Hearing Report, above fn.2. Apple did not need to rely on the exception to achieve double non-taxation, as the CFC regime is effectively gutted by the check-the-box regime, as discussed in the next section.

[52] US Hearing Report, above fn.2, 16. For a summary of the relevant rules and provisions, see US Joint Committee on Taxation, above fn.29, 40–43. In particular, a CFC may satisfy the substantial contribution test if its employees are engaged in "oversight and direction of manufacturing activities … material selection … management of manufacturing costs … control of manufacturing related logistics … quality control": US Joint Committee on Taxation, above fn.29, 43. In fact, many countries "have intentionally weakened their CFC rules to improve the alleged

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qualify for the manufacturing exception, due to its contract manufacturing activities. However, as discussed below with regard to the check-the-box regime, ASI in fact did not have to rely on this exception to escape from the CFC net. This illustrates, ironically, that the US tax law provides multiple shields to "protect" ASI's income from US taxation.[53]

The US CFC regime may be on the radar of the OECD BEPS project. One of the actions to be taken under the project is to "strengthen CFC rules", as the OECD observes that "the CFC rules of many countries do not always counter BEPS in a comprehensive manner."[54] An effective CFC regime is important in the fight against BEPS, as it not only protects the tax base of the residence country, but also has

> "positive spillover effects in *source countries* because taxpayers have no (or much less of an) incentive to shift profits into a third, low-tax jurisdiction."[55]

A study of the Apple story suggests that if the US CFC regime were more robust and could capture the income booked in the Irish subsidiaries, Apple would most likely decide not to implement the iTax structure at all.[56] It is unclear whether the OECD will achieve the objective of this action, as the US has traditionally been influential in the direction of international tax rules.[57]

The US check-the-box regime

Though with a relatively short history, the check-the-box regime represents a fascinating example of the significant influence of politics on the US tax system. The regime was introduced in 1997.[58] It allows taxpayers to elect the classification of an eligible entity as either a corporation or a pass-through entity.[59] The regime was intended to

> "relieve both taxpayers and the IRS from the need to expend considerable resources in determining the proper classification of … entities, when classification was effectively elective for well-advised taxpayers."[60]

competitiveness of their MNEs in foreign markets or to attract companies' headquarters to their jurisdictions …": Ault, above fn.6, 1198.

[53] US Hearing Report, above fn.2, 16. Similarly, the same country exception (as discussed in fn.51 above) would have "protected" the dividend income of AOI from the CFC regime even if the check-the-box regime does not apply: US Hearing Report, above fn.2, 15. The Apple story with respect to the US CFC regime is not an isolated incident. Empirical evidence suggests that in general the CFC regime has not been very effective in limiting deferral of taxation. For instance, in 2006, approximately 80% of the income of CFCs was deferred from US taxation, while the average effective tax rate on foreign income of the CFCs was approximately 16.4%: Shay (2013), above fn.25, 3. It should be noted that the average effective tax rate of 16.4% is likely to be more than the rate applicable to most MNCs, as companies in the resource industries are often subject to much higher tax rates: Shay (2013), above fn.25, 4.

[54] BEPS Action Plan, above fn.7, 16.

[55] BEPS Action Plan, above fn.7, 16.

[56] Of course, it is possible that Apple, with its army of tax advisors, may devise other ways to shift profits from the source countries.

[57] It is not clear if this is the reason why the description of this action in the OECD report is the shortest (merely two lines) among the 15 actions listed in the report: BEPS Action Plan, above fn.7, 16.

[58] Treasury Regulations s.301.7701-2.

[59] For a summary of the check-the-box rules, see US Joint Committee on Taxation, above fn.29, 47–49.

[60] US Joint Committee on Taxation, above fn.29, 48.

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The US Government basically gave up the fight with MNEs in the battle of entity classification. Just one year after the introduction of the regime, the Treasury and the IRS recognised that the flexibility allowed by the regime was excessive, creating significant tax avoidance opportunities to circumvent the CFC regime by using hybrid entities (that is, entities treated as a separate entity under foreign tax law but elected to be a pass-through entity in the US).[61] In essence, the CFC regime is effectively "gutted" by the check-the-box regime. The CFC regime is designed to capture profits shifted to a subsidiary incorporated in a low-tax country through, say, intra-group sales, and is premised on the separate entity doctrine under which each group company is treated as a separate taxpayer. Going back to the iTax structure, ASI sells products to other group distribution companies which in turn sell the products to end customers in Europe and Asia. In this way, a substantial portion of the profits on the sale of the products in those markets is shifted to ASI and that amount, in the absence of the check-the-box regime, would have been subject to the CFC regime.[62] However, by simply "checking the box" for all the subsidiaries (including ASI) of AOI, those companies are deemed to have disappeared and become part of AOI for US tax purposes.[63] Through the magic of checking the box, AOI was regarded as having derived sales income directly from the end customers under US tax law and the income was exempted from the CFC regime under the active business exception.[64] The intra-group sales between ASI and the distribution companies were effectively ignored and the CFC regime became irrelevant. In other words, the check-the-box regime effectively disables the CFC regime to a large extent by deeming intra-group transactions as non-existent.

The quantum of income and tax liability involved is significant. For instance, Apple's group income before tax was US $34 billion in 2011, with only US $150 million recorded for its Japanese subsidiaries, even though Japan is one of its largest foreign markets. In the same year, ASI reported US $22 billion net income. At the request of the US Senate Committee, Apple estimated that a total income of US $35 billion escaped from the application of the CFC regime by "checking the box" for 2011 and 2012 alone. The US tax avoided successfully for the two years was US $12.5 billion.[65]

In 1998, one year after the check-the-box regime was introduced, the US Treasury and the IRS attempted to close the loophole by issuing Notice 98-11 and corresponding temporary and proposed regulations which would basically treat various hybrid entities as subject to the CFC regime.[66] Those documents "provoked controversy among taxpayers and *members of Congress*"

[61] Hybrid entities have been identified by the OECD as one of the key tax avoidance tools in its BEPS project: BEPS Report, above fn.7, 40.
[62] This is the typical target of the "foreign base company sales income" provisions in the US CFC regime: IRC s.954(d)(1). For a summary of the relevant rules, see for example McDaniel, Ault and Repetti, above fn.50, 117–119.
[63] US Hearing Report, above fn.2, 35. The effect is very similar to the single entity rule in Australia's tax consolidation regime. For a discussion of the rule, see A. Ting, *The Taxation of Corporate Groups under Consolidation: An International Comparison* (Cambridge Tax Law Series, 2013), 73–75.
[64] US Hearing Report, above fn.2, 35–36.
[65] US Hearing Report, above fn.2, 34. By checking the box, the intra-group dividend payments between the Irish companies are deemed to have disappeared for income tax purposes: US Hearing Report, above fn.2, 36. The amount of dividend income that was excluded from the CFC regime in this way was US $29.9 billion from 2009–2012: US Hearing Report, above fn.2, 15.
[66] For a discussion of the notice and the regulations, see US Joint Committee on Taxation, above fn.29, 48–49.

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(emphasis added).[67] It did not take long before the IRS issued another notice in the same year to redraw Notice 98-11 and the regulations.[68] It appears that business lobbying and political influence won a swift battle against the tax administration.

Proponents of the check-the-box regime have put forward basically two arguments.[69] First, the regime helps to reduce foreign income tax of an US MNE and thus eventually will increase the profits repatriated to the US. Secondly, many MNEs operate on a regional basis, the typical example being the EU. They argue that the check-the-box regime allows MNEs to "operate from a tax perspective in a manner that reflects these business realities …"[70] However, both arguments are problematic. With respect to the first argument, avoiding foreign income tax implies a lower effective foreign tax rate, which in turn encourages MNEs further to shift profits overseas. Furthermore, empirical evidence shows that most US MNEs keep their foreign profits permanently overseas.[71] The second argument does not sit comfortably with the MNEs' insistence that the international tax rules should respect the legal contracts between group members, even though the "economic reality" is that the group as a whole operates as one single enterprise. In any case, a tax rule that facilitates tax avoidance is not a good rule. Matching tax law with business reality is no excuse for double non-taxation.

Nevertheless, the proponents of the check-the-box regime not only successfully blocked the introduction of the specific anti-avoidance measures to deal with the hybrid entity issue in 1998, but even managed to convince Congress to enact the "CFC look-through rule" in 2006.[72] The rule specifically excludes from the CFC regime certain payments of passive income between two CFCs. In other words, the look-through rule effectively enacted the effect of the check-the-box regime—which was introduced through Treasury regulations that can be revoked or revised at any time[73]—with respect to passive income.

It is unclear whether the hearings on Apple and other US MNCs will have any impact on changing the prevalence of the check-the-box regime in the US. However, the tide may be changing due to the pressure from abroad. The OECD BEPS project has identified hybrid entities as one of the key issues to address.[74] In the Action Plan, the OECD aims to develop "model treaty

[67] US Joint Committee on Taxation, above fn.29, 49. The business reaction to those documents was described as "a firestorm [as] multinationals went to Congress to complain about the notice and the proposed rules": Sheppard, above fn.2, 969. It was observed that the issues of the check-the-box regime were "exacerbated by Congressional actions restricting a response to the problem": Shay (2013), above fn.25, 12.
[68] US Joint Committee on Taxation, above fn.29, 49. The Joint Committee report did not explain explicitly why the IRS decided to withdraw the documents. The episode reminded the author of a scene in the Oscar-winning documentary "Inside Job" in which after the US Commodity Futures Trading Commission proposed to strengthen the regulations on derivatives, the head of the Commission received a phone call from the then US Treasury Secretary—with 13 bankers in his office—demanding immediate abortion of the proposal. A witness described how he saw the "blood had drained from the face" of the Commission's head.
[69] US Joint Committee on Taxation, above fn.29, 123.
[70] US Joint Committee on Taxation, above fn.29, 123.
[71] One of the main reasons is to avoid the US tax on profit repatriation.
[72] IRC s.954(c)(6). For the interesting history of the "quiet and surprising" passage of this provision, see US Hearing Report, above fn.2, 14–15.
[73] US Hearing Report, above fn.2, 14.
[74] BEPS Report, above fn.7, 40.

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provisions and recommendations regarding the design of domestic rules to neutralise the effect (e.g. double non-taxation …) of hybrid … entities."[75]

Low tax jurisdictions

Shifting profits to low tax jurisdictions has been a tax avoidance technique used by MNEs for decades. Empirical data suggests that the tax arbitrage opportunity to exploit tax rate differentials between a low tax country and the residence/source country is too tempting to resist.[76] For instance, in 2010, Barbados, Bermuda and the British Virgin Islands together received more foreign direct investment (FDI) (namely, 5.11 per cent of global FDI) than Germany (4.77 per cent) while these three jurisdictions made more outbound investments (4.54 per cent in total) than Germany (4.28 per cent).[77] Focusing on the US, a study in 2008 found that out of the 100 largest listed US corporations in terms of revenue, only 14 had no foreign subsidiaries. Among the 86 corporations that had foreign subsidiaries, 83 had subsidiaries in tax havens or financial privacy jurisdictions.[78] The presence of a subsidiary in a tax haven does not necessarily imply tax avoidance schemes. However, tax avoidance is possibly a key consideration for having a subsidiary in those jurisdictions.

It is not surprising that US MNEs seem to be more aggressive in shifting profits to low tax countries, as the US maximum statutory corporate income tax rate of 35 per cent is among the highest in developed countries.[79] This is the result of the US keeping its corporate tax rate steady since 1986, while most other developed countries have reduced their corporate tax rates repeatedly in recent decades.[80]

Ireland is an increasingly popular jurisdiction for international tax structures for three main reasons. First, it is a low tax country with a corporate tax rate of 12.5 per cent. Secondly, it is an EU Member State, which means that subsidiaries established in Ireland can take advantage of the EU laws which allow them to avoid corporate tax as well as value added tax in high tax Member States where they do business.[81] Thirdly, Ireland seems to have a particularly "accommodating" tax system for MNEs, especially those from the US. In particular, as discussed

[75] BEPS Action Plan, above fn.7, 15. The mission is expected to be accomplished by September 2014, slightly more than one year after the release of the report in July 2013: BEPS Action Plan, above fn.7, 30. The time frame is short for international tax projects of this kind, but the OECD seems to be determined that the "pace of the project must be rapid so that concrete actions can be delivered quickly": BEPS Action Plan, above fn.7, 24. It remains to be seen whether the deadline can be met, as the work involved appears to be quite substantial, especially when the action on hybrid instruments and entities "will be co-ordinated with the work on interest expense deduction limitations, the work on CFC rules, and the work on treaty shopping": BEPS Action Plan, above fn.7, 16.

[76] The tax rate arbitrage issue has been nicely described by Couzin: "Taxable income, like water, tend to flow downhill, from high- to low-tax jurisdictions": Couzin, above fn.43, 165.

[77] BEPS Report, above fn.7, 17.

[78] US Government Accountability Office, *Large US Corporations and Federal Contractors with Subsidiaries in Jurisdictions Listed as Tax Havens or Financial Privacy Jurisdictions* (2008), 4, available at: *http://www.gao.gov/products/GAO-09-157* [Accessed January 20, 2014].

[79] For a brief history of the US corporate tax rate, see Mazur, above fn.37, 3.

[80] Mazur, above fn.37. Some commentators have suggested that the US should lower its corporate tax rate to reduce the incentive to arbitrage. However, the lost revenue would have to be replaced with a value added tax which most agree is likely to be "a political nonstarter": J.R. Harvey Jr, *Testimony before the US Senate Permanent Subcommittee on Investigations* (May 21, 2013), 2.

[81] R. Mitchell, "France Urges OECD, G-20 Action to Boost Taxation of Global Internet Giants" (January 25, 2013) *Bloomberg BNA Daily Tax Report*.

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above, the Irish definition of corporate tax residence complements perfectly that of the US thereby facilitating international tax avoidance.[82]

What can or should countries do in response to the issue of double non-taxation? The next two sections explore the possible responses of residence countries and source countries respectively.

Possible responses to iTax from residence countries

It is common for US MNEs to allocate profits to low-tax countries disproportionately.[83] Apple Inc is no exception. The following table summarises the information disclosed in the US hearing on the group:

Factors	US portion	Foreign portion
Effective tax rates		
Revenue[84]	39%	61%
2011 tax provision[85]	US $6.9 billion	US $0.6 billion
Effective tax rate[86]	20.1%	1.8%
Profit shifting		
Employee number[87]	52,000 (65%)	28,000 (35%)
R&D activities[88]	95%	5%
Profits to cost ratio under the cost sharing arrangement[89]	7:1 (for Apple Inc)	15:1 (for ASI)

A couple of observations can be made after considering the table. First, Apple derives over 60 per cent of its revenue from foreign jurisdictions. This is not necessarily a bad outcome from the US perspective, as it may simply reflect Apple's highly successful global business. However, the foreign revenue has been subject to an effective tax rate of merely 1.8 per cent, which is much lower than that for the US revenue, and also much lower than the corporate tax rates in the source countries where its markets are located. This suggests that the foreign income has not been subject to the normal levels of taxation in the source countries. Those countries are entitled to be more dismayed to learn that the income has not been taxed in the residence country either.[90]

[82] See discussion of the issue and the resulting "no residence" status in the section "Arbitrage between corporate residence definitions" above at page 46.
[83] The US Government Accountability Office reported in 2008 that low-tax countries often had a larger share of a MNC's income than they had of the MNC's physical assets and employment, and vice versa: US Joint Committee on Taxation, above fn.29, 6.
[84] Cook, above fn.1, 2.
[85] US Hearing Report, above fn.2, 38.
[86] US Hearing Report, above fn.2.
[87] US Hearing Report, above fn.2, 17.
[88] US Hearing Report, above fn.2, 28.
[89] US Hearing Report, above fn.2, 29.
[90] A commentator stated that the governments of the source countries were dismayed to learn that "companies like Apple are paying tax nowhere, and … they have told the US government that they would be happier if … US multinationals were paying some tax to the United States": Sheppard, above fn.2, 970.

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Secondly, while 65 per cent of Apple's employees and 95 per cent of its R&D activities are located in the US, the profits to cost ratio of ASI is double that of Apple Inc itself. This suggests that the cost sharing arrangement allocates a disproportionally low level of costs to ASI. It begs the question of whether Apple's iTax structure, with the intra-group contracts which do not transfer any functions, assets or risks outside the group, has inappropriately shifted profits out from the US and booked in a low-tax country.

The question of international allocation of profits of MNEs has no theoretically correct answer. There is no clear guiding economic principle to determine the allocation of taxing rights between residence and source countries. In the end, it is a political compromise between jurisdictions. The international consensus achieved so far is remarkable, given the inherently conflicting policy objective of competitiveness that is high on the agenda of most governments. The difficulty of reaching international consensus in the context of the OECD's BEPS project has been nicely summarised as follows[91]:

> "… the OECD had a mandate from G-20, whose members include the BRICS countries (Brazil, Russia, India, China, and South Africa), which often disagree with OECD tax policies; the United States, which often goes its own way; and from European finance ministers … who generally don't agree on anything but agree on the need for change and giving a timetable to the OECD to produce this work."

It appears that the US Government has been turning a blind eye to the fact that US MNEs are avoiding paying foreign income taxes. In fact, some have argued that the US should cheer about the success of its US MNEs in this regard.[92] However, the US Government seems to have underestimated the desire of MNEs to minimise their tax bills. They have proceeded, with the help of the US tax law that has been blessed by the US Government, to implement tax structures to avoid not only foreign income tax, but also US income tax. There is no good reason for a MNE to stop short of maximising tax benefits from its tax structure, as long as the tax laws in both the residence and source countries allow it to do so. Apple's double non-taxed income is a piece of clear evidence of that desire.

Through the recent congressional committee hearings, the US as the residence country may have woken up and realised that its indulgence of its MNEs to avoid foreign income taxes has backfired on two fronts. First, US MNEs have shifted profits out from not only source countries, but also the US. This is obviously not a desirable outcome for the Government.[93] Secondly, the reactions of the source countries may intensify the BEPS of US MNEs, as

> "promoting [US MNEs] to avoid the tax systems of other countries leads to the mirror image response from them, and a beggar-thy-neighbor race to the bottom, where multinational firms are the winners and every taxing jurisdiction the loser."[94]

[91] Ault, above fn.6, 1196.
[92] For the counter-arguments, see E.D. Kleinbard, *Testimony of Prof. Edward D. Kleinbard—Hearing Titled 'Tax Reform: Tax Havens, Base Erosion and Profit-Shifting' of US House of Representatives Committee on Ways and Means* (June 13, 2013), 2.
[93] For a discussion of the related problems in the US, see Kleinbard, above fn.92, 10–12.
[94] Kleinbard, above fn.92, 3.

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Should the US respond by a fundamental reform of the taxation of MNEs or by fine tuning the existing rules with respect to corporate groups? Some have argued for a long time that the existing international tax norms, especially the transfer pricing regime, are so fundamentally flawed that a radical reform is required to address the problems.[95] Formulary apportionment has been proposed for several decades and the Common Consolidated Corporate Tax Base (CCCTB) project in the EU is the most ambitious attempt so far. However, the political resistance and conflicts of interest between the EU Member States renders the future of the project uncertain, and it is unlikely to make significant progress in the near future.[96] A worldwide adoption of a formulary apportionment regime would require global consensus and appears utopian.[97] The significant transitional costs of replacing the existing international tax norms—that are embedded in over 3,000 tax treaties around the world—represent another formidable obstacle to a radical reform.[98] The formulary apportionment concept is therefore not discussed in detail in this article.[99]

Some commentators have suggested another radical reform in the US to deal with the BEPS issue: worldwide tax consolidation of MNEs.[100] The proposal is to tax an US MNE on its worldwide net income, and allow for foreign tax credits. However, the fact that such a regime is rarely accepted in other countries suggests that it may be as utopian as the formulary apportionment model.[101] Therefore, it is not discussed further in this article.

[95] There is huge literature on the issue. For a recent article suggesting applying formulary apportionment within the framework of the transfer pricing rules, see R.S. Avi-Yonah, "Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation" (2010) 2(1) *World Tax Journal* 3. Another possible way to reduce the incentive for US MNEs to shift profits out from the country is to lower its corporate tax rate and replace the lost revenue with a value added tax. However, this option is widely regarded as politically unacceptable: see for example Harvey Jr, above fn.80, 2.

[96] For a discussion of the problems of the CCCTB proposal, see for example A. Ting, "Multilateral formulary apportionment model—A reality check" (2010) 25(1) *Australian Tax Forum* 95. There appears to be a general consensus that a cross border application of the formulary apportionment model is not feasible: see for example UK House of Lords Select Committee on Economic Affairs, *Tackling corporate tax avoidance in a global economy: is a new approach needed?* (July 31, 2013) (1st Report of Session 2013–14), paras 100–102. It is also doubtful if a formulary apportionment regime would raise more revenue than the current system, after taking into account the behavioural responses of taxpayers: Mazur, above fn.37, 4.

[97] P. Saint-Amans, Director of the Centre for Tax Policy and Administration in OECD, described the issue in this way in a parliamentary committee hearing in the UK on June 11, 2013: "global formulary apportionment … would require all jurisdictions around the world—… there are more than 200 tax sovereignties—to agree on criteria and to trust each other enough to rely on the information, the consolidated accounts, which will be held in the headquarters of the group. I do not see this happening any time soon": Answer to Question 107 in UK House of Lords, *Unrevised transcript of evidence taken before the Select Committee on Economic Affairs—Inquiry on Taxing Corporations in a Global Economy: Is a New Approach Needed?* (June 11, 2013).

[98] The OECD recognises that with respect to the BEPS project, "the main challenge is not only to identify appropriate responses, but also the mechanisms to implement them in a streamlined manner, in spite of the well-known existing legal constraints, such as the existence of more than 3000 bilateral tax treaties": BEPS Report, above fn.7, 8.

[99] Radical changes to the international tax norms, in particular the formulary apportionment concept, have been rejected by the OECD as a viable option in its BEPS project: BEPS Action Plan, above fn.7, 11 and 14. Another radical proposal is the "destination-based tax on corporate cash flows" model which is similar to VAT, and is one that the UK House of Lords believed to be worthy of further study: UK House of Lords, above fn.96, paras 103–111.

[100] Kleinbard, above fn.92, 16–17.

[101] France is possibly the only country in the world that currently implements a worldwide group pooling system (which is different from a full consolidation, as it does not allow tax free intra-group asset transfers). For a discussion of the worldwide group pooling model, see Ting, above fn.63, 45–46.

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Compared to a fundamental reform of the international tax regime that requires international consensus, it is relatively more feasible to fine tune the US tax law to deal with Apple's double non-taxation issue. The key pressure areas are apparent and the solutions obvious, as listed below:

1. Check-the-box regime: this regime, together with the statutory look through rule in the CFC regime, is a structural flaw in the US tax system. It effectively disables to a large extent the CFC regime and facilitates tax avoidance structures using hybrid entities.[102] Many commentators have proposed an outright repeal of the regime.[103] The US Senate Committee that conducted the Apple hearing recommended reforming the regime so that it does not "undermine the intent" of the CFC regime.[104]
2. CFC regime: even without the check-the-box regime, the CFC regime contains problematic provisions that facilitate the creation of double non-taxation. Exceptions within the regime—such as the manufacturing exception—should be tightened to enable the CFC regime to effectively prevent profit shifting to low tax countries.[105]
3. Transfer pricing rules with respect to intangibles: it appears that the US has recently strengthened the transfer pricing rules for cost sharing arrangements, although it remains to be determined whether this will be effective in preventing similar abuse, as in Apple's case, in the future.

It is doubtful if the US Government has the political will to close the loopholes. The indulgent attitude of the US Government is forcefully summarised in the testimony of a US tax lawyer before a US hearing (emphasis added)[106]:

> "Returning to the examples of Starbucks, Amazon, and Google—the companies that were the focus of the enquiries in the UK—all of them were earning income from their UK sales … if that income is not the Unites States' to tax, *why should we—rather than the UK tax authorities—worry if those companies are employing strategies to minimize their UK taxes?*
>
> Indeed, that was the position taken in the past when, for example, Congress put the brakes on Treasury and the IRS's efforts to write regulations that would limit the use of the check-the-box rules to achieve foreign tax minimization. When the IRS announced its intent

[102] A more general solution to the hybrid entity issue may be to "develop further some of the ideas in the OECD partnership report dealing with qualification conflicts": Ault, above fn.6, 1196. A detailed discussion of this issue is beyond the scope of this article.
[103] For example, see Avi-Yonah, above fn.32, 2.
[104] US Hearing Report, above fn.2, 6.
[105] The US Senate Committee recommended that the manufacturing exception should be restricted to cases where "substantial manufacturing activities [take] place in the jurisdiction where the intermediary CFC is located": US Hearing Report, above fn.2, 6.
[106] P.W. Oosterhuis, *Statement of Paul W Oosterhuis, Partner, Skadden, Arps, Slate, Meagher & Flom LLP—Testimony before the House Committee on Ways and Means* (June 13, 2013), 5–6. The accommodating attitude of the US Government to the "avoiding-foreign-tax" practice of its MNEs has been described in less blatant terms by others: see for example Avi-Yonah, above fn.32, 4–5. The US attitude is not a secret to many source countries. For example, that attitude was described by a UK tax lawyer in a House of Lords hearing in the UK: Answer by Steve Edge to Question 79 in UK House of Lords, above fn.97, (June 4, 2013). In the same hearing, the UK tax lawyer attempted to defend the double non-taxation outcome by putting forward the argument that "if we change our rules so as to … collect the tax foreign jurisdictions are not collecting, actually we discourage inward investment into the UK": answer to Question 84.

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> … the negative reaction was widespread and the effort was abandoned in the face of congressional scrutiny. And thereafter *Congress effectively codified the permissibility of foreign-tax minimization* through its enactment of the look-through rules of section 965(c)(6), *whose primary purpose is to allow multinational corporations to achieve foreign tax minimization without triggering an immediate resulting US tax liability*.
>
> Ultimately, in considering the appropriate reaction to profit shifting and base erosion whose primary impact is *foreign* tax minimization, *we must consider carefully whether the Unites States has an interest in imposing and enforcing rules whose primary beneficiaries are foreign fiscs, rather than the US treasury*."

If one believes that the best prediction of future behaviour is past behaviour, it is unlikely that the US will take any effective action to address the double non-taxation issue.[107] The history of the check-the-box regime suggests that political lobby from MNEs seems to have such a significant influence on the Government that it may surprise observers from abroad. If the US political environment dictates that the US will be likely continue to facilitate the creation of double non-taxation, what can source countries do to tackle the issue? The following section explores the possible reactions of source countries.

Possible responses to iTax from source countries

If the US continues to promote the competitiveness of its MNEs through its tax law as illustrated in the iTax structure, what can source countries do to counteract this?[108] This is a complex and difficult question to answer.[109] The OECD is at present pursuing these issues in its BEPS project.

[107] It is observed that US MNEs "have done an excellent job of framing the competitiveness issue in terms of US [MNEs] competing against foreign [MNEs]": Harvey Jr, above fn.80, 9. Another commentator predicted that the hearing on Apple "provided little hope that Congress will find the motivation to do anything about [the problematic tax provisions]": M. Sapirie, "As American as Apple" (June 3, 2013) *Worldwide Tax Daily*.

[108] To be fair, the US is not the only country that has introduced specific regimes to promote the competitiveness of its businesses. For example, the UK has introduced the generous patent box regime which appears to be successful in attracting investments: Answer by H. Jones (Senior Vice President, Global Tax, GSK) to Question 23 in UK House of Lords, above fn.97, (May 14, 2013). However, it is unclear how long the "benefit" to the UK will last, as many countries have proposed to introduce a similar regime, including the Netherlands, Ireland, France, Spain and the US: Ault, above fn.6, 1201. Another recent "competitiveness" move in the UK was to relax its CFC rules "so that interest received in subsidiaries in low taxed countries from lending outside the UK will only be taxed at 5.75%": UK House of Lords, above fn.96, para.18. The CFC reform has been described in this way: "the United Kingdom is in the process of watering down its CFC rules to meaninglessness": L.A. Sheppard, "Picking Apart the OECD BEPS Action Plan" (2013) 71(10) *Tax Notes International* 861, 861. The UK seems to have achieved much success in the pursuit of a competitive tax system in recent years. For example, over the last decade, the UK tax system has reportedly become one of the most competitive systems in the world: The Confederation of British Industry, *Tax in a global economy—The way forward* (2013), citing a KPMG survey on tax competitiveness, at 13. The OECD has decided to revamp the work on harmful tax practices in its BEPS project, as it realises that "a 'race to the bottom' would ultimately drive applicable tax rates on certain … income to zero for all countries, whether or not this was the tax policy a country wished to pursue": Action 5 in BEPS Action Plan, above fn.7, 17–18. Patent box regimes appear to be on the radar of the OECD: Answer by P. Saint-Amans to Question 113 in UK House of Lords, above fn.97.

[109] The OECD has raised a similar issue with respect to the definition of permanent establishment (emphasis added): "In an era where non-resident taxpayers can derive substantial profits from transactions with customers located in another country, questions are being raised as to whether the current rules ensure a fair allocation of taxing rights on business profits, *especially where the profits from such transactions go untaxed anywhere*": BEPS Report, above fn.7, 36. The Report contains other examples of double non-taxation achieved through the check-the-box regime. For example, see the case study where the regime is used to "erode the [source country] tax base with deductible royalty

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The complexity of the issues is reflected in the time frame of the project: in general it is expected to take at least a couple of years to come up with proposed solutions.[110] Detailed analysis of the possible solutions to the double non-taxation issue is beyond the scope of this article. Instead, in this part the following two issues that may be critical to the success of the design and implementation of anti-BEPS rules are discussed:

1. the application of enterprise doctrine as an effective principle for the purposes of tackling BEPS by MNEs; and
2. the power of information in the battle between tax authorities and MNEs.

The enterprise doctrine as an anti-BEPS principle

The corporate structure of a MNC has changed significantly over the last 60 years. In the past, a MNC typically established a foreign subsidiary in its market that

> "functioned as its own self-contained unit, with a local equivalent of a chief executive officer, chief financial officer … Manufacturing, distribution, and marketing decisions were typically made locally, but were often based on financial targets imposed by the home office".[111]

However, the modern corporate structure of a MNC is "more apt to be characterised by specialisation, by function, of entities and operations, with less duplication country to country."[112] In other words, modern MNCs are more integrated as one single enterprise both economically and operationally. The Apple hearing in the US substantiates that

> "Apple executives interviewed by the Subcommittee said they viewed the 'priorities and interest' of Apple's closely held entities to align with those of Apple Inc. Apple's offshore affiliates operate as one worldwide enterprise, following a coordinated global business plan directed by Apple Inc."[113]

The legal corporate structure of a MNE is at the discretion of the management. A tax director confirms in an UK parliamentary committee hearing that MNEs

> "have *a great deal of choice* about where they locate activities, and the exercise of that choice can give rise to consequences of where tax is payable" (emphasis added).[114]

payments and simultaneously side-step application of the [residence country] CFC provisions": BEPS Report, above fn.7, 76–79.

[110] BEPS Action Plan, above fn.7. It is uncertain at this stage whether the project will eventually produce effective solutions to prevent profit shifting from source countries. Again, if history is of any guide, one may be reluctant to predict a complete success. The harmful tax competition project of the OECD—which commenced in 1998—depicts a history "full of political intrigue, broken promises, and the like": Ault, above fn.6, 1195.

[111] US Hearing Report, above fn.2, 12.

[112] US Hearing Report, above fn.2. The OECD has made similar observations that corporate structures of MNEs have shifted "from country-specific operating models to global models based on matrix management organisations and integrated supply chain that centralise several functions at a regional or global level": BEPS Action Plan, above fn.7, 7.

[113] US Hearing Report, above fn.2, 30.

[114] Answer by P. Morton, Head of Group Tax, Reed Elsevier Group, to Question 18, in UK House of Lords, above fn.97, (May 14, 2013). The mismatch between the reality that a MNE operates as a single global enterprise and the jurisdictional boundaries was also identified as the cause of the difficulty to allocate taxing rights among countries

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The OECD also recognises that[115]

> "[Corporate group members] are able to make a much greater variety of contracts and arrangements than can independent enterprises because the normal conflict of interest which would exist between independent parties is often absent … Moreover, contracts within an MNE could be quite easily altered, suspended, extended, or terminated according to the overall strategies of the MNE as a whole, and such alternations may even be made retroactively."

These remarks have at least two important implications. First, it challenges the traditional separate entity doctrine with respect to corporate groups that are far more integrated than those which existed at the time when the doctrine was developed. Secondly, at present tax authorities are fighting the BEPS battle with one hand tied behind their backs, as MNEs are free to manipulate the group structure and intra-group contracts which dictate and restrict to a large extent what the tax authorities can do to counter the tax avoidance.

The issue of double non-taxation often arises when in broad terms a MNE converts a bilateral transaction to a trilateral (or even multilateral) scenario under which profits booked in an interposed subsidiary are subject to low or even no tax.[116] Going back to the iTax structure, instead of a bilateral transaction under which Apple Inc sells its products directly to its distribution subsidiary in, say, the UK, Apple has created a trilateral scenario in which the Irish subsidiaries were inserted between the two companies and booked a substantial portion of the profits arising from the transaction. The issue can be conceptually depicted in the following diagram:

on a MNE's profits: Answer by M. Gammie to Question 6 in UK House of Lords, *Unrevised transcript of evidence taken before the Select Committee on Economic Affairs—Inquiry on Taxing Corporations in a Global Economy: Is a New Approach Needed?* (April 23, 2013).

[115] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010), para.1.67.

[116] The OECD acknowledges that the current international tax rules "need to be adapted to prevent BEPS that results from the interactions among more than two countries …": BEPS Action Plan, above fn.7, 18. The items in the Action Plan that are particularly relevant in the context of the iTax structure include: Action 7 "Prevent the artificial avoidance of PE status", Action 8 "Intangibles", Action 9 "Risks and capital" and Action 10 "Other high-risk transactions."

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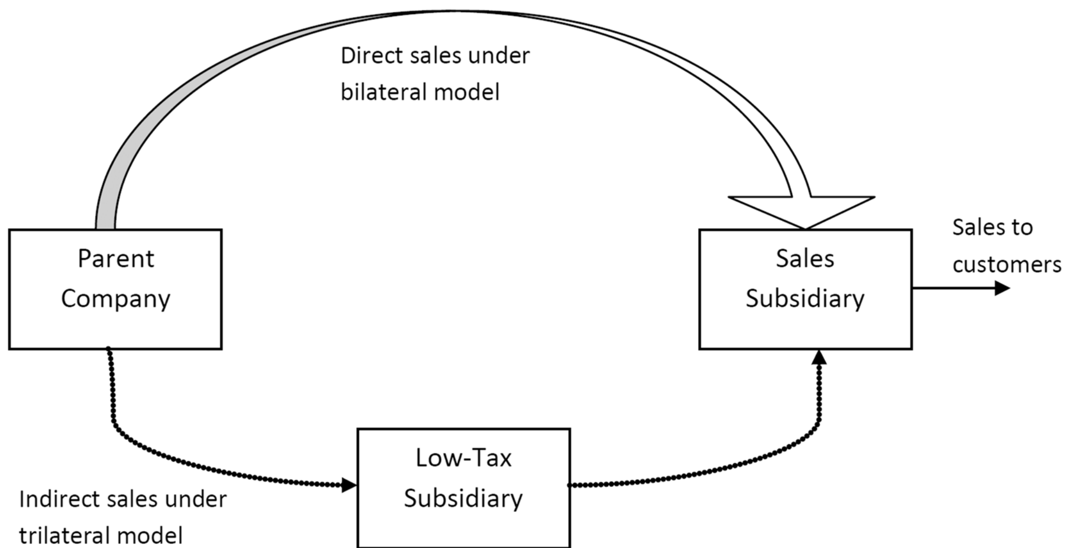

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The challenge is to determine how the existing international tax norms—which are designed primarily to deal with bilateral transactions—can be applied effectively to address the trilateral structures.

The discussion of the iTax structure so far suggests that a generic solution may lie in the application of the enterprise doctrine, under which a corporate group under the common control of the parent company should be treated as one single enterprise.[117] In contrast to the separate entity doctrine, the enterprise doctrine respects the economic reality that a corporate group operates as one single entity.[118] An application of the enterprise doctrine may effectively revert a trilateral scenario to a bilateral one which the international tax norms are more capable of dealing with. It should therefore be more likely to be effective as the underlying principle for anti-BEPS measures. In many cases, intra-group transactions are created artificially for tax avoidance purposes. The enterprise doctrine is effective to see through the form and applies the appropriate tax treatments according to the economic substance. For instance, the double non-taxation issue may not be difficult to resolve if the residence country determines to enforce an effective CFC regime, which is essentially an application of the enterprise doctrine to a corporate group.[119] Similarly, the source countries may switch over from the application of the default separate entity doctrine to the enterprise doctrine with respect to the income shifted to ASI. For instance, it may design an anti-BEPS rule that ignores the intra-group transaction and denies deduction of sales payments to ASI, as they are not subject to any tax at all.

In fact, the application of the enterprise doctrine as an anti-avoidance measure has a long history. It was described in the 1933 League of Nations report which addressed the international taxation issues of enterprises (emphasis added)[120]:

> "If [a subsidiary's] income is diverted to other units of the enterprise in any manner, the tax authorities, *as a general rule, have only to examine the inter-company transactions, appraise their terms and results in the light of sound legal and business principles* … and recapture any profit that may be shown to have been diverted."

It is interesting to note from the quote that at that time, the examination of intra-group transactions as a tool to combat profit shifting was regarded as a *general rule*. The approach was described as if it was trivial. In contrast, the current international tax norms appear to have been to a large extent captured by the separate entity doctrine and have lost the flexibility that is necessary to address the BEPS issue effectively.

[117] For a detailed discussion of the enterprise doctrine in the context of corporation law, see P.I. Blumberg, *The Multinational Challenge to Corporation Law: The Search for a New Corporate Personality* (Oxford: OUP, 1993).

[118] The application of the single enterprise doctrine is consistent with the economic concept of a firm, which in general defines the boundary of a firm in terms of independence. In other words, as group companies are under the common control of the parent company, they are not independent and thus should be treated as part of the same firm. For a brief discussion of the concept and how it may assist in the taxation of MNEs, see Vann, above fn.41, 360 and 381; and Ting, above fn.63, 16–18.

[119] For a discussion of the constraints imposed by the international tax norms on the application of the enterprise doctrine, see Ting, above fn.63, 28–32. The allocation of primary taxing right to the residence country seems to be consistent with the original concept proposed by M. Carroll, as discussed and cited in R.J. Vann, "Tax Treaties: The Secret Agent's Secret" [2006] BTR 345, 364–366.

[120] M.B. Carroll, *Taxation of Foreign and National Enterprises: Volume 4: Methods of Allocating Taxable Income* (League of Nations, 1933), 627.

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The enterprise doctrine should be an effective principle to deal with the manipulations of MNEs. However, the actual policy option adopted by a source country will depend on the extent to which the doctrine is applied, as well as other constraints such as the existing tax regimes of the country. Careful consideration of the domestic circumstances is necessary when designing an effective anti-BEPS rule for a country.

The OECD position on the enterprise doctrine

The OECD has always recognised the dominance of the separate entity doctrine in international tax norms:

> "Jurisdiction to tax is exercised on an entity by entity basis, not on a group-wide basis, subject to the exception of the availability of domestic group consolidation regimes".[121]

At present, the OECD in general respects the legal construct of intra-group transactions and allows re-characterisation of the transactions only in two limited circumstances:

1. the economic substance of a transaction differs from its form[122]; and
2. a transaction is non-commercial in the sense that independent parties would not enter into it.[123]

The influence of the separate entity doctrine is apparent in these exceptional circumstances. For instance, the OECD's recommended action with respect to the second circumstance of non-commercial transaction is "to adjust the conditions of the agreement in a commercially rational manner as a continuing … agreement".[124] It does not allow for the agreement to be ignored at all. If an intra-group contract is so non-commercial that independent parties would not enter into such an agreement, one may suspect that a possible action, or even an appropriate action, of the tax authority would be to ignore it. Of course, this option represents a stronger application of the enterprise doctrine, which may be a bridge too far for the OECD at the time of drafting the provisions.

It appears that the OECD may now be willing to take a bolder stand with regard to the application of the enterprise doctrine for anti-BEPS purposes.[125] One of the main purposes of the BEPS project is to "provide countries with instruments, domestic and international, aiming at better aligning rights to tax with real economic activity."[126] After analysing some common BEPS structures, the OECD observed that the:

[121] BEPS Report, above fn.7, 33. For instance, the dominance of the separate entity doctrine is apparent throughout the OECD Commentary of Art.5, para.7 with respect to the PE exposure of a subsidiary.
[122] The example given in the Transfer Pricing Guidelines is the re-characterisation of an intra-group debt to equity: OECD, above fn.115, para.1.65.
[123] The example given is a sale of an intangible asset that is not properly priced to take into account future research for the term of the contract: OECD, above fn.115.
[124] OECD, above fn.115.
[125] In the 2013 International Fiscal Association annual congress, Marlies de Ruiter, head of the tax treaty, transfer pricing and financial transaction division of the OECD's Centre for Tax Policy and Administration, was reported to confirm that the OECD was considering more circumstance in which intra-group contracts might be ignored as special measures: L.A. Sheppard, "The OECD's Special Measures" (2013) 71(10) *Tax Notes International* 863, 863.
[126] BEPS Report, above fn.7, 51.

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"overall effect is … to associate more profit *with legal constructs* and intangible rights and obligations, and to legally shift risk intra-group, with the result of reducing the share of profits associated with substantive operations".[127]

This issue is not new, as Vann commented in 2003[128]

"there is a basic issue across the whole transfer-pricing area in relation to the disregard of transactions. If this is not tackled, then it is possible … to take a substantial operation in a source country and effectively dismantle and reconstruct it in such a way that virtually no profits are left there. US MNEs have been actively pursuing this strategy in ways detrimental to US and foreign taxing jurisdiction in recent time."

The mismatch between the economic substance of a corporate group as one single enterprise and the separate legal entity treatment of each group member lies at the heart of the double non-taxation issue. A general non-discriminating respect of intra-group contracts inevitably creates ample tax avoidance opportunities for MNEs.

Recent parliamentary committee hearings in the UK reiterate that the OECD may be more willing to accept the application of the enterprise doctrine. For instance, the Director of the Centre for Tax Policy and Administration of the OECD stated that (emphasis added)[129]:

"The weakness of the arm's-length principle … is it may *rely too much on the contractual arrangements* … That is where you have this divorce between the location of the real activity … and the location of the profit. But you can certainly twist the principle … to ensure that you can *disregard the contractual arrangements* where the outcome is not satisfactory because of this gap between the real activity and the location of the profit. That is something that we certainly can do."

This statement is formally expressed in the OECD's Action Plan on BEPS, in which one of the "new consensus-based approaches" is that a "realignment of taxation and relevant *substance* is needed to restore the intended effects and benefits of international standards" (emphasis added).[130] In particular, Action 9 aims to develop anti-BEPS rules against "transferring risks among … group members … to ensure that inappropriate returns will not accrue to an entity solely because it has *contractually* assumed risks …" (emphasis added).[131] Similarly, Action 10 aims to develop

"rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties [including rules to] clarify the circumstances in which transactions can be recharacterised …"[132]

[127] BEPS Report, above fn.7, 45.
[128] Vann, above fn.41, 156.
[129] Answer by P. Saint-Amans to Question 107 in UK House of Lords, above fn.97.
[130] BEPS Action Plan, above fn.7, 13.
[131] BEPS Report, above fn.7, 20.
[132] BEPS Report, above fn.7, 20–21. The increasing willingness of the OECD to respect more the economic reality of a corporate group and to ignore intra-group contracts in certain circumstance was also confirmed at the 2013 International Fiscal Association Annual Congress: Sheppard, above fn.125.

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The power of information—transparency

Tax authorities often struggle in the BEPS war with MNEs for a number of reasons. First, MNEs have ready access to substantial resources and an army of highly intelligent tax advisors while most tax authorities have tight constraint on resources. For instance, HMRC in the UK has 65 transfer pricing specialists while the big four accountancy firms alone have around 250.[133] Secondly, tax authorities suffer from "information asymmetry".[134] While MNEs operate as one single enterprise with full information about their tax affairs, it is often a challenge for the tax authorities to obtain relevant information necessary to make informed decisions on the tax positions of the taxpayers. The difficulty lies not only in asking MNEs the right questions, but also the possible delay between asking for the information and actually receiving it from the MNEs. The information gathering process may be further frustrated by MNEs which may deliberately "drip feed" information piecemeal to the tax authorities.

Transparency is an important and effective way of tilting the balance to some extent in favour of tax authorities. Tax authorities need essential information about the tax affairs of MNEs in order to identify targets for further investigations and audits. This view is apparently shared by tax officials in the UK, as the Association of Revenue and Customs stated that "*any* additional transparency is welcome, such as more public information on key business data *like the group structure*" (emphasis added).[135] One cannot help but have sympathy for the tax authorities who see a challenge in obtaining even the most basic of information such as that concerning group structures of MNEs. The move to automatic information exchange in the international tax arena is in the right direction, but may not be sufficient.[136] The following section analyses the proposed country-by-country reporting requirement which should be an effective weapon for tax authorities in the BEPS battle. Of course, even a properly designed country-by-country reporting system is not by itself the magic potion to cure BEPS. However, it is a critical ingredient in assisting tax authorities to focus their limited resources on the right targets.

Country-by-country reporting

Country-by-country reporting is frequently proposed as a measure to strengthen the armoury of tax authorities in the battle against BEPS by MNEs. Under the proposal, a MNE has to disclose, at least to the tax authorities, certain information about its tax affairs.[137] Information that has to

[133] UK House of Commons Committee of Public Accounts, *Tax avoidance: the role of large accountancy firms* (2013), 6. In a parliamentary committee hearing about BEPS, a member of the UK House of the Lords made an interesting analogy: "in general in warfare it is a rather bad idea to send a small, lightly armed battalion against the massed ranks of a huge army, which would be fielded by the big four on behalf of the companies concerned": Comment made by Lord Lipsey in Question 103 in UK House of Lords, above fn.97.

[134] The OECD recognises that, in the context of transfer pricing, a "key issue in the administration of [the] rules is the asymmetry of information between taxpayers and tax administrations": BEPS Action Plan, above fn.7, 22.

[135] UK House of Lords Select Committee on Economic Affairs, *Taxing Corporations in a Global Economy: Is a New Approach Needed?—Oral and Written Evidence* (2013), 16.

[136] G-8 countries endorsed the automatic information exchange system between tax authorities in June 2013: S.S. Johnston and D.D. Stewart, "G-8 Leaders Endorse Global Information Exchange Standard" (2013) 70(13) *Tax Notes International* 1243, 1243.

[137] The OECD released a Memorandum on October 3, 2013 discussing the issues and options with respect to the development of a country-by-country reporting template: OECD, *Memorandum on Transfer Pricing Documentation and Country by Country Reporting* (2013).

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be disclosed may include the amount of accounting profits, taxable profits and tax payments in each of the countries that it has operations. Additional information about the number of employees and the value of assets in each country would be useful for tax authorities to assess the substance of the MNE's presence in a particular country. Going back to the iTax structure of Apple Inc, if such a disclosure requirement was in place, tax authorities in the US as well as in the source countries would have been alerted to the questionable low effective tax rate in Ireland much earlier and may have taken appropriate action promptly.

Another benefit of the country-by-country reporting may be more important than the "identify-the-target" function. Prevention is always better than cure. If a MNE knows that it will have to disclose the detailed country-by-country information to the tax authorities, it may have less incentive to undertake aggressive BEPS transactions. The potential tax benefit may be outweighed by the increased risk of tax investigations and audits.

The deterrent effect is likely to be more powerful if the country-by-country tax information is disclosed in the public financial statements of the MNE.[138] The reputational issue is now a boardroom concern and can be a deal breaker when a MNE contemplates a BEPS structure. In the OECD BEPS Report, it is observed that[139]

> "… news stories such as Bloomberg's 'The Great Corporate Tax Dodge', the New York Times' 'But Nobody Pays That', The Times' 'Secrets of Tax Avoiders' and the Guardian's 'Tax Gap' are only some examples of the increased attention mainstream media has been paying to corporate tax affairs … [MNEs] are being accused of dodging taxes worldwide, and in particular in developing countries, where tax revenue is critical to foster long-term development."

The reputational concern has proved to be effective in dampening the appetite of MNEs for BEPS schemes. The power of information is well illustrated by the recent experience of the public anger over tax avoidance by MNEs in the UK, and especially the dramatic reaction of Starbucks. In an attempt to calm down public outcry about its tax avoidance, Starbucks, the world's largest coffee chain, decided to "voluntarily" make a £20 million total payment to the tax authority in 2013 and 2014.[140] It was reported that, despite making substantial profits in the UK, the payments would be the first corporate tax payments Starbucks would make in the UK since 2009, and would be only the second time it had paid corporate tax since commencing its business in the UK in 1998.[141] Starbucks would make those tax payments by forgoing available deductions.[142]

This saga provides two interesting observations. First, MNEs are genuinely concerned about the reputational issue. This is particularly true for companies like Starbucks that deal directly

[138] The possible disclosure of the country-by-country information to the public has to be weighed against the potential risk of simplistic reporting in the general media. The OECD has pointed out that civil society and non-government organisations "have also been vocal in this respect, sometimes addressing very complex tax issues *in a simplistic manner* …" (emphasis added): BEPS Report, above fn.7, 13.
[139] BEPS Report, above fn.7, 13.
[140] The payment was described in a UK parliamentary hearing in this way: "In the notorious Starbucks case, it essentially found an extra £20 million to try to buy peace": Comment by Lord Lipsey to Question 22 in UK House of Lords, above fn.97.
[141] R. Jackson, "Starbucks Pays First UK Corporate Tax Since 2009" (June 25, 2013) *Worldwide Tax Daily*.
[142] Jackson, above fn.141.

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with customers who are "mobile" in the sense that it is relatively easy for such customers to switch from buying coffee from Starbucks to buying from another coffee shop down the street. Secondly, the "voluntary" tax payments may raise even more concerns about the corporate tax system in the eyes of the public. Unlike charitable donation, taxation should not be discretionary. It is an insult to the tax system when taxpayers can decide if they want to pay some tax, and if so, when and how much to pay.

The move towards country-by-country reporting appears to be gaining momentum. The European Parliament adopted a resolution in May 2013, calling the Commission to, among other things[143]

> "… introduce … country-by country reporting for cross-border companies in all sectors … by requiring disclosure of information such as the nature of the company's activities and its geographical location, turn-over, number of employees on a full-time equivalent basis, profit or loss before tax, tax on profit or loss …"

The G-8 countries asked the OECD to develop a template for country-by-country reporting in June 2013.[144] The OECD BEPS project has set the goal to

> "streamline the information that is needed so that the tax administrations … have the big picture [which] will provide them with a good understanding of the transactions within the group".[145]

In the BEPS Action Plan released in July 2013, transparency is one of the three key guiding principles for its 15 actions[146]:

> "The actions implemented to counter BEPS cannot succeed without further transparency … The availability of timely, targeted and comprehensive information is essential to enable governments to quickly identify risk areas."

The call for the development of a country-by-country reporting template has been specifically answered by the OECD in Action 13 of its BEPS project, which aims to[147]:

> "Develop rules regarding transfer pricing documentation to enhance transparency for tax administrations … The rules to be developed will include a requirement that MNE's provide all relevant governments with needed information on their global allocation of the income, economic activities and taxes paid among countries according to a common template."

It is apparent that the OECD believes this task is in the "relatively easy to achieve" basket among the 15 items in the Action Plan. The work on this transparency task is expected to be

[143] European Parliament Resolution of May 21, 2013 (2013/2020(INI)), para.48. The resolution basically adopted a report prepared by the Committee on Economic and Monetary Affairs: *Report on Fight against Tax Fraud, Tax Evasion and Tax Havens* (A7-0162/2013). The European Parliament has also approved country-by-country reporting requirements for certain EU financial institutions in April 2013, and for certain EU extractive and logging companies in June 2013: KPMG, "Tax transparency and information exchange within the EU—recent developments" (June 13, 2013) (215) *Euro Tax Flash*.
[144] Johnston and Stewart, above fn.136, 1243.
[145] Answer by P. Saint-Amans to Question 115 in UK House of Lords, above fn.97.
[146] BEPS Action Plan, above fn.7, 14.
[147] BEPS Action Plan, above fn.7, 23.

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completed by September 2014, being one of the only four Actions with this relatively short deadline.[148]

The fierce opposition from MNEs and tax advisors to the general adoption of the country-by-country reporting proposal suggests that it may be an effective weapon against BEPS activities. For instance, the American Chamber of Commerce to the European Union claimed that the proposals "would [make] financial statements even more complex; increasing the risk of information overload; and [impose] significant costs on business …".[149] Its arguments are weak on several fronts. First, it may have underestimated the ability of the users of financial statements—including tax authorities—to understand the country-by-country information, which should be relatively straightforward and easy to comprehend provided there is no hiding of essential information. Secondly, the country-by-country information may be reserved for the eyes of tax authorities and not disclosed to the public in financial statements. This also seems likely to be the OECD position, as the Director of the Centre for Tax Policy and Administration of OECD explained in a UK parliamentary committee hearing (emphasis added)[150]:

> "A number of observers, the NGOs in particular, say it should be transparent to the whole world. What we can achieve is getting the information to the tax administrations. *There is nothing stricter than secrecy for tax administrations* … As long as the information would remain within the tax administrations, *I am confident that we can reach consensus* to streamline the information … which could be provided to tax administrations for them to do the right risk assessments."

Thirdly, MNEs have been willing to spend a substantial amount of money, time and effort to implement BEPS structures. It is likely that the cost of compiling the country-by-country information—which is readily available to the group—would be a small fraction of the tax planning costs. Of course, even if the OECD eventually achieves consensus on country-by-country reporting, the devil may be in the detail and it is unclear how much additional useful information will become available to tax authorities. One can never underestimate the determination and political influence of the MNEs.[151]

[148] BEPS Action Plan, above fn.7, 34. There are three other Actions with multiple deadlines including September 2014. Most Actions have deadlines in September 2015 and three in December 2015. The OECD appears to be optimistic about the push for country-by-country reporting, as it indicated that the reporting requirement, "which has been endorsed by the G-8, is likely to be endorsed by the G-20": Sheppard, above fn.108, 863. With the purpose of setting the stage for a public consultation on the issue, the OECD released a Memorandum on October 3, 2013 outlining among other things some questions relevant to the development of a country-by-country reporting template: see above fn.137.

[149] American Chamber of Commerce to the European Union, "AmCham EU expresses deep concern over the possible extension of tax reporting" (media release, June 20, 2013). Businesses in the UK are singing in the same tune: The Confederation of British Industry, *Tax in a global economy—The way forward* (2013), 23. The Big Four accountancy firms take a similar stand opposing the country-by-country proposal, based on "concerns about the costs and complexity of gathering [the] data and commercial confidentiality": UK House of Commons Committee of Public Accounts, above fn.133, para.19.

[150] Answer by P. Saint-Amans to Question 115 in UK House of Lords, above fn.97.

[151] For instance, the concerns of MNEs seem to have made inroads in the OECD consultation with respect to the development of the country-by-country reporting template: OECD, above fn.137, s.1. The business comments in the OECD public consultation held on November 12, 2013 were reportedly to "have echoed some general themes … The information to be provided should be based on readily available data … should be brief and simple …": Ernst &

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Insights provided by Vodafone's disclosure

The recent voluntary "country-by-country" reporting by the UK-based Vodafone is an interesting episode with respect to the transparency issue and provides some useful insights into the design of the country-by-country reporting regime.[152] The additional disclosure of Vodafone appears to be a reaction to the criticism that it had not paid any UK corporate taxes for a number of years.[153] It also highlights that while MNEs may be willing to disclose more tax information in response to the public demand, they may attempt to hide as much information as possible at the same time. Ironically, while Vodafone appears to be desperately trying to hide critical information about its BEPS structure, it has in fact provided much food for thought for policy makers who may be responsible for the design of a robust and effective country-by-country reporting regime.

Two features stand out in Vodafone's disclosure. First, the amount of corporate tax payment is buried among over 60 other taxes and charges—including not only customs duty and social security tax, but also garbage tax, municipal waste tax, numbering tax—with the total shown as "direct revenue contribution: taxation."[154] Secondly, the data about Vodafone's key vehicle for BEPS—a subsidiary established in Luxembourg which is responsible for the group's "global procurement, financing and roaming operations"[155]—is hidden among other group companies that act as the holding companies for an investment in the US, with the aggregate numbers for those entities shown under the caption "Non-OpCo."[156] A couple of lessons can be learnt from the Vodafone disclosure. First, an effective country-by-country reporting regime should insist on separate disclosure of the amount of corporate tax payment in each country. Secondly, aggregating country data should not be allowed.

A detailed discussion of the proposed country-by-country reporting is beyond the scope of this article. Nevertheless, increased transparency of tax information from MNEs is a critical, and possibly in the short term the most feasible, anti-BEPS weapon that can be forged for the tax authorities.

Conclusion

The OECD admits that there "is no magic recipe to address BEPS issues."[157] The BEPS project is likely to be a long and winding road. What is certain is that MNEs and their tax advisors will not stop pursuing tax avoidance so long as tax arbitrage opportunities exist. In the real world,

Young, "OECD holds public consultation on BEPS-related reporting and transfer pricing issues" (November 14, 2013) *Global Tax Alert* 2.

[152] Vodafone Group plc, *Sustainability Report 2012/13* (2013), 66–76, available at: *http://www.vodafone.com/content/sustainability.html* [Accessed January 20, 2014].

[153] It was reported that though Vodafone made substantial profits in the UK in the years ended March 31, 2012 and 2013, it did not pay any corporate tax in the UK in those two years: S.S. Johnston, "Vodafone and Thames Water on Defensive Over Nonpayment of UK Corporate Tax" (June 13, 2013) *Worldwide Tax Daily*.

[154] Vodafone Group plc, above fn.152, 71 and 74.

[155] Vodafone Group plc, above fn.152, Note 2 at 72. It was reported that the Luxembourg subsidiary was used to shift profits from countries by intra-group loans: Answer by R. Brooks to Question 74 in UK House of Lords, above fn.97, (May 21, 2013).

[156] Vodafone Group plc, above fn.152, 72.

[157] BEPS Report, above fn.7, 48. We have also been warned not to "underestimate the inertia effect resulting from the existing domestic tax rules and treaties": Ault, above fn.6, 1201.

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most governments are keen to promote the competitiveness of their tax systems. The desire to do so is vividly illustrated in this iTax story. The analysis of the iTax structure reveals that the US Government has knowingly and willingly facilitated its MNEs in avoiding foreign income tax, thus creating double non-taxation. If history is a guide, this "accommodating" attitude is unlikely to change in the near future. It is therefore important for source countries to take effective measures to counter the BEPS transactions.

The separate entity doctrine embedded in the current international tax norms ignores the reality that in substance a MNE operates as a single enterprise under the common control of its parent company, and thus facilitates manipulations by MNEs to achieve BEPS and double non-taxation. The rigid application of the separate entity doctrine gives significant power to MNEs to create legal corporate structures that produce favourable tax outcomes without real economic implications. Intra-group transactions do not shift risk or economic value outside the corporate group; however, they often dictate the tax burden of the group. The application of the enterprise doctrine should therefore be a more appropriate and effective principle in the design of anti-BEPS rules.

The analysis of the iTax structure also highlights that the double non-taxation issue is exacerbated by the "unfair" battle between tax authorities and MNEs. The battle is unfair in two ways. First, resources are relatively limited for tax authorities, especially in times of fiscal stress experienced in many developed countries. In contrast, MNEs often have ready access to an army of highly intelligent tax advisors. Secondly, it is a serious challenge to tax authorities to obtain full information about the tax structure of a MNE. The challenge lies not only in asking the right questions, but also in the time lag between asking the questions and receiving answers from the MNE. The information asymmetry affects severely the ability and timeliness of tax authorities' actions. The country-by-country reporting regime should be an effective weapon for the tax authorities in combating BEPS with respect to risk assessment as well as providing a deterrent effect. The disclosure requirement should be carefully designed to ensure that essential information is not hidden, as illustrated vividly by the Vodafone example.

There is no doubt that the BEPS project will keep all interested parties very busy for at least the next two years. Given the powerful political influence of MNEs, it is doubtful that the project will be a complete success in combating the BEPS issues. As a US tax professor reminded us recently, the OECD faces a real challenge of

> "the bad habits of policymakers worldwide to try to steal a match on other countries by arguing that others should be bound to more rigorous standards, while they continue to subsidize the international exploits of their national champions."[158]

It is apparent that the BEPS project promises interesting times ahead.

[158] Kleinbard, above fn.92, 12.

International tax planning; Multinational companies; Profit-sharing schemes; Tax avoidance; Transfer pricing

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