THE EU APPLE CASE

WHO HAS A DOG IN THE FIGHT?

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INTRODUCTION Under the present U.S. Internal Revenue Code, a U.S. corporation that owns a foreign subsidiary corporation generally pays no U.S. tax on the active business income of the foreign subsidiary until the foreign subsidiary pays dividends to the U.S. corporation. Thus, foreign business income that Apple packs into an Irish subsidiary bears no U.S. tax except to the extent that the subsidiary pays dividends to Apple. Such dividends rarely occur.

ILLUSTRATIONS BY THOMAS FLUHARTY

THE BASIC FACTS

The diagram on the next page is a significantly simplified version of Apple's multinational structure. For example, the Irish Sub box represents three separate Apple subsidiaries rather than one.[1] The simplifications allow for a considerably more understandable presentation without obscuring any significant concerns of either EU law or U.S. income tax law.

As indicated in the diagram, Irish Sub owned economic rights to all intellectual property relevant to the sale of Apple products outside the Americas. Those products were manufactured to Apple's specifications by Foxconn, an independent contract manufacturer in the People's Republic of China.[2] Irish Sub purchased those products from Foxconn and sold them to Foreign Reseller Subs, which resold them to end customers outside the Americas.

The prices that Irish Sub charged were toward the high end of what is permissible under transfer pricing law and generated large profits.[3] Because the sales were structured to occur in Ireland for tax purposes, those profits were income of Irish Sub.[4] Also, Foreign Reseller Subs paid dividends to Irish Sub as well as royalties for the use of IP related to the Apple products being sold. The sales transactions, dividends, and royalties effectively moved much of Foreign Reseller Subs' income to Irish Sub,[5] even though Foreign Reseller Subs did the real marketing work.[6]

This arrangement concentrated Apple's non-American foreign income in Irish Sub, which appeared to be the beneficiary of Ireland's 12.5 percent corporate income tax rate. However, the actual result was much better. This was because Apple had negotiated generous rulings from the Irish revenue authority. Those rulings seem to take the view that since Irish Sub did little in Ireland to produce the income it received,[7] only a small portion of that income should be allocated to Ireland for Irish tax purposes, with the remainder being apportioned to Irish Sub's non-Irish headquarters.[8] Because Ireland taxes resident corporations on their worldwide income, that income division would have been irrelevant had Irish Sub been a resident of Ireland for Irish tax purposes. However, the fact that Irish Sub was managed from Apple's headquarters in California made it a foreign corporation for Irish tax purposes even though it was incorporated under Irish law.[9] (This oddity will be fully repealed after 2020.[10]) Thus, Irish income tax did not apply to the income allocated away from Ireland. Still, for U.S. tax purposes, the Irish rulings were ignored, and incorporation in Ireland made Irish Sub a nonresident[11] in the United States. As a result, U.S. tax did not apply to Irish Sub's foreign sales profits, and the only income tax imposed on Irish Sub's sales profits was the Irish corporate tax that applied to the portion of its income allocated to Ireland under the generous Irish tax rulings. That portion was so small that the 12.5 percent Irish tax thereon was less than 2 percent of Irish Sub's total income.[12] In other words, the tax rulings reduced Irish Sub's effective tax rate from an attractive 12.5 percent to a super-attractive rate of less than 2 percent.

On August 30, 2016, the European Commission ruled that because Irish Sub's non-Irish headquarters did less to produce Irish Sub's income than did Irish Sub's Irish operations, the income allocation endorsed by the Irish tax rulings "depart[s] from a market-based outcome in line with the arm's-length principle."[13] The commission therefore concluded that Ireland's favorable treatment of Apple violated EU law and that more than €100 billion of income must be reallocated from Irish Sub's non-Irish headquarters to Ireland.[14] Thus, Ireland must collect about €13 billion of tax (at 12.5 percent) on that amount, plus interest.[15]

The legal basis of the commission's ruling is controversial. The EU treaties do not give the EU government a general power to enact income tax legislation.[16] EU income tax legislation requires the unanimous consent of all 28 member countries,[17] and that consent has never been given. Stated differently, there is no EU income tax legislation that imposes any restrictions on the multinational structure that resulted in profits from the sales of Apple products outside the Americas being allocated away from Irish Sub. Any possible tax law restrictions would have to arise from the national laws of member countries, and Apple contends that its multinational structure fully complied with those laws. That contention has not been seriously challenged.

Thus, the European Commission needed a basis other than tax law to allocate income away from Irish Sub's non-Irish headquarters and into Ireland. The commission asserted that the necessary basis was provided by article 107.1 of the Treaty on the Functioning of the European Union, which states:

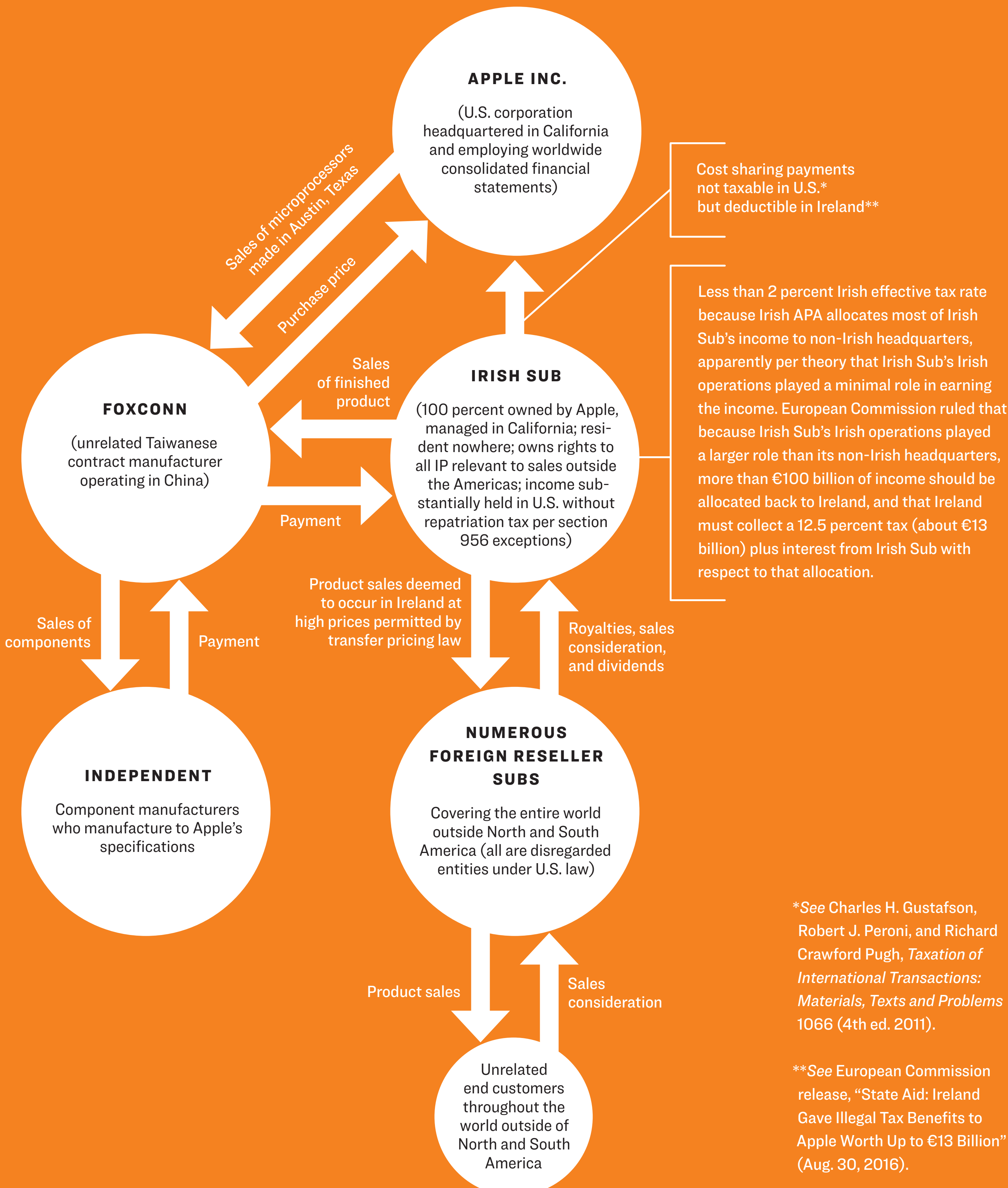
Save as otherwise provided in the Treaties, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market.

The commission ruled that by effectively applying a corporate tax rate of less than 2 percent instead of 12.5 percent to Irish Sub's income, Ireland violated article 107.1 by providing state aid to Apple that gave the company a significant advantage over businesses subject to the regular 12.5 percent Irish rate.[18] In article 107.1 violation cases, the offending member government can be required to recover 10 years' worth of illegal state aid plus interest.[19] Consequently, the commission directed Ireland to recover from Apple the income tax that would have been due for 2003 to 2014 if the misallocated profits had borne the 12.5 percent Irish tax plus interest thereon. The commission calculated that the tax portion of the recovery could be as much as €13 billion.

Apple is furious and has appealed to the EU judiciary;[20] Ireland has also appealed.[21] Moreover, the U.S. Treasury is engaged in a very public dispute with the European Commission in which the agency vigorously supports the Irish and Apple positions.[22] This article is an attempt to understand the uproar by examining the stakes of the parties—that is, who has dogs in the fight, and what are their natures?

THE REDUCTIONIST DIAGRAM

The figure shows a highly simplified diagram of the multinational structure involved in the European Commission's case against Apple Inc.



*See Charles H. Gustafson, Robert J. Peroni, and Richard Crawford Pugh, *Taxation of International Transactions: Materials, Texts and Problems* 1066 (4th ed. 2011).

**See European Commission release, "State Aid: Ireland Gave Illegal Tax Benefits to Apple Worth Up to €13 Billion" (Aug. 30, 2016).

At the end of the day, the Irish dog seems to be named "Tax Competition," but its size is uncertain.

THE UNCERTAIN IRISH DOG

Initially, it would seem that Ireland has no interest in challenging a commission decision that awards it a windfall of up to €13 billion plus interest. Yet, Ireland has indeed decided to appeal. The Irish government's officially stated reasons for doing so are to (1) defend the integrity of the Irish tax system, (2) provide tax certainty to businesses, and (3) challenge the use of state aid rules to curtail national sovereignty over income tax matters.[23] The first and third reasons seem mostly symbolic, and the second reason seems like a concern of multinational corporations rather than the Irish government. Are the preceding reasons truly adequate explanations for Ireland's refusal to accept a huge windfall? An Irish parliamentary leader as well as Ireland's finance minister have suggested that Ireland is actually motivated by a different consideration: a concern that if the commission's decision is allowed to stand, it will greatly impair Ireland's ability to attract foreign multinationals.[24] But because Ireland will continue to have the lowest corporate income tax rate of any major developed country[25]—plus sound infrastructure and security, a healthy and educated labor force, and ready access to the EU market—this fear seems exaggerated. At the end of the day, the Irish dog seems to be named "Tax Competition," but its size is uncertain.

THE IGNORED SOURCE-COUNTRY DOGS

The biggest European dogs belong to the comparatively high-tax source countries, such as Germany and France, where the end sales of Apple's products occur. This is because the transfer prices that Irish Sub charges Foreign Reseller Subs, plus the deductible royalties that Foreign Reseller Subs pay to Irish Sub, effectively move most of the profit inherent in Apple products out of the tax bases of the countries where the end sales occur and into the hands of Irish Sub.[26] The commission's decision does nothing to address this matter. It leaves Apple's profits concentrated in low-tax Ireland,[27] although Ireland is required to apply its 12.5 percent tax rate instead of an effective rate of less than 2 percent.

THE UNCERTAIN U.S. DOG

Is there a U.S. dog in the fight? A superficial examination yields a negative answer. Because Irish Sub is incorporated under Irish law, it is a foreign corporation for U.S. tax purposes even though its U.S. headquarters makes it a U.S. corporation for Irish tax purposes. Thus, as long as the foreign income that is concentrated in Irish Sub by means of the diagrammed structure is not repatriated to the United States, it is not subject to U.S. taxation, unless it is subpart F income.

Apple's tax planners skillfully avoided the subpart F problem, however. The profits that Irish Sub earns from selling Apple products at high prices to Foreign Reseller Subs are not subpart F income because Foreign Reseller Subs are disregarded entities under the check-the-box rules.[28] Thus, Irish Sub is viewed as making the sales of Apple products directly to the unrelated end customers and as having bought those products from an unrelated manufacturer (Foxconn). This means that the sales profits are not subpart F income.[29] Moreover, because the Foreign Reseller Subs are disregarded, they are treated as part of Irish Sub, and the royalties and dividends they pay to it are treated as internal transfers within Irish Sub instead of "real" dividends and royalties. Therefore, those payments are not subpart F income either.[30] Consequently, all the income concentrated in Irish Sub is covered by the default rule that no U.S. tax applies until that income is repatriated to the United States.

The foregoing suggests that the United States should be indifferent to how much of Irish Sub's income is allocated to the Irish tax base over Apple's objections. Stated differently, the United States does not appear to have a dog in that fight. This is an oversimplification, however.

Because Irish Sub was incorporated under Irish law, the United States regards it as a foreign corporation[31] that pays U.S. tax only on U.S.-source income.[32] Although the Irish tax ruling allocated most of Irish Sub's income away from Ireland, that allocation did not give the income a U.S. source for U.S. tax purposes. Thus, U.S. tax did not apply to the income allocated to Irish Sub's non-Irish headquarters by the Irish tax ruling, and subpart F does not reverse that conclusion. Moreover, as previously noted, Irish tax did not apply, either. Therefore, most of Irish Sub's income was not taxed anywhere—that is, it bore a zero rate.[33] This means that when the European Commission reallocated more than €100 billion of that income from the non-Irish headquarters to Ireland over Apple's objections, that income swung from a zero tax rate to a 12.5 percent rate. But should the United States care?

There is a somewhat exaggerated argument that the United States has a significant revenue interest that is prejudiced by the Apple decision. The argument goes this way: When Apple repatriates zero-foreign-taxed income from Irish Sub to the United States, it will bear a 35 percent U.S. residual tax. However, because the commission's decision results in more than €100 billion of Irish Sub's income moving from a zero foreign tax to a 12.5 percent Irish tax, which is creditable against U.S. income tax when the income is repatriated to the United States, the U.S. residual tax will drop to 22.5 percent (35 percent minus 12.5 percent). Thus, the approach taken in the Apple decision shifts 12.5 percentage points of tax revenue from the United States to Ireland. To protect against that loss, Treasury should, so the argument goes, use its "soft" powers to oppose the decision.

As previously suggested, this view seems exaggerated for several reasons. First, a significant amount of Irish Sub's foreign income (as well as the foreign income of other U.S. multinationals' foreign subsidiaries) is likely to already be in the United States[34] in the form of investments that are freed from U.S. repatriation tax by loopholes in section 956.35. In the future, some of that income may be moved to uses not covered by the section 956 loopholes, and a U.S. repatriation tax (net of foreign tax credits) would then be triggered. But if Apple is pleased with the results of its U.S. "loophole" investments, there will be no repatriation tax and therefore no U.S. revenue lost on account of FTCs.

More important, much of Apple's unrepatriated foreign income (and the unrepatriated foreign income of other U.S. multinationals) has been designated as indefinitely reinvested abroad for financial accounting purposes.[36] Thus, taxable repatriation of that income, and the loss of U.S. revenue because of FTCs, is unlikely to occur in the foreseeable future, if ever. Moreover, if taxable repatriation does occur, the liberal cross-crediting of non-Irish foreign taxes that is permitted under the U.S. FTC limitations means that U.S. tax on repatriations of Apple's Irish income would suffer a substantial reduction even if the Irish tax on that income was zero.[37] Finally, Apple and other U.S. multinationals eventually may be able to repatriate foreign income at a low U.S. rate as occurred with the 2004 U.S. tax holiday.[38] For these reasons, the amount of U.S. revenue jeopardized by the increased Irish tax resulting from the Apple decision is subject to meaningful limitations, and from this standpoint, the U.S. dog in the fight is smaller than initially thought.

Nevertheless, if the United States international income tax system did not include the deferral privilege, the United States would benefit if the EU judiciary reversed the commission's Apple decision. This is because the United States would collect an immediate 35 percent tax on Apple's profits

instead of the 22.5 percent tax (35 percent U.S. tax minus 12.5 percent Irish tax) that results from the commission's approach. The reality, however, is that both U.S. tax amounts are deferred until repatriation. This means that although the deferred U.S. tax collection is potentially greater if the commission's ruling is reversed, the deferral benefit and its distortive impact on the business location decisions of Apple and similarly situated U.S. multinationals is also greater if the commission's decision is overturned. Thus, when assessing the impact of the commission's Apple decision on the United States, Treasury must balance the greater deferred tax that it might collect[39] if the decision is overturned against the efficiency loss to the U.S. economy if the decision is not upheld on appeal. The efficiency loss would seem to be small if the taxpayer expects a short deferral period and would seem to increase as the anticipated deferral period lengthens. Treasury's assessment of the U.S. interest will therefore be affected by data regarding the average time that U.S. multinationals in Apple's position defer repatriation of the foreign income of foreign subsidiaries.

The balancing does not end there, however. Treasury must also recognize that if the commission's decision is reversed, Apple and similarly situated U.S. multinationals will be free to continue the Apple-type tax planning that strips income out of the tax bases of the source countries. This undermines the social welfare systems of those countries when, particularly in Europe, they are under stress. If those countries become less stable, they will be less effective allies of the United States at a time when cooperative allies are needed. All of the foregoing suggests that the U.S. dog should be named "Uncertain."

Without mentioning the preceding revenue and efficiency issues, Treasury has joined in other criticisms of the commission's Apple approach. To this extent, Treasury may be moving beyond the uncertain U.S. dog in the fight and onto arguments of pure principle. Some of its criticisms involve arguments based on interpretations of EU law—that is, that the Apple decision is wrong as a matter of state aid law and that even if it is correct, it is a novel interpretation that should be applied prospectively only. The EU judiciary will sort out these points when it adjudicates Ireland's and Apple's appeals, and Americans should feel reticent to express an opinion with any degree of confidence.

Treasury has also joined in a policy-based criticism of the commission approach reflected in the Apple decision. It is that Apple and Ireland followed the orthodox arm's-length principle of transfer pricing law in allocating most of Irish Sub's income to nontaxable, non-Irish headquarters and that the commission invented a new arm's-length principle for purposes of state aid law that seems to differ from the familiar tax law arm's-length principle. Thus, so the argument goes, this new approach to the arm's-length concept, which is innovative and lacks clearly delineated content, will make the international tax planning of multinational groups highly uncertain. The European Commission rejects that criticism and insists that it applied the traditional arm's-length approach. The critics are not persuaded, however. Resolving this dispute will require adjudication of more Apple-type cases.

THE STRAIGHTFORWARD APPLE DOG

As noted earlier, if Apple has to substitute a 12.5 percent Irish tax for a zero tax on income allocated to Ireland by the commission's decision, a U.S. FTC for the Irish tax will arise and reduce U.S. tax *protant* when the affected income is repatriated to the United States. Conversely, if Apple does not pay the 12.5 percent Irish tax, its 35 percent U.S. tax will not be reduced by a U.S. FTC. Regardless, Apple faces a potential 35 percent tax that is either paid entirely to the United States or paid 12.5 percent to Ireland and 22.5 percent to the United States. If so, why does Apple object to paying the 12.5 percent portion to Ireland instead of to the United States? Patriotism? Hardly.

Apple understands the time value of money and therefore appreciates that it is better off deferring tax until income is repatriated to the United States instead of currently paying tax to Ireland. In other words, Apple's dog is named "Deferral," and Apple's objection to the commission's decision is all about the resulting loss of the opportunity to defer 12.5 percentage points of tax, or to avoid that amount of tax to the extent there is no income repatriation to the United States or there is another U.S. tax holiday. Obviously, Apple's dog exists because of the deferral feature of the U.S. international income tax regime, and that pooch would vanish if deferral were repealed. It hangs around only because the United States cannot achieve real international tax reform.

CONCLUSION

The objective of this article is to assess the stakes of the interested parties in the brouhaha over the European Commission's Apple decision. Ireland seems to be primarily concerned about its position as a tax competitor, but the seriousness of its concern is speculative. As to the market countries where Apple's products are put to end use, Apple's tax planning inflicts earnings stripping losses, but that earnings stripping is unaffected by the commission's decision. Thus, it is not surprising that those countries seem to have mostly ignored the Apple ruling. The motivation behind the United States' disapproval of the Apple decision is unclear. Any revenue concern seems small and would be eliminated by the repeal of deferral. For Apple, however, preserving deferral is clearly the essence of the fight.[40] CM

J. Clifton Fleming Jr. is the Ernest L. Wilkinson Chair and Professor of Law at the J. Reuben Clark Law School. In this article, Fleming provides a simplified diagram and explanation of Apple's foreign tax planning and assesses the stakes of the interest parties in the controversy over the European Commission's Apple decision. Fleming also explains that the Apple case would not have happened but for the deferral feature of U.S. international income tax law.

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NOTES

1 *See* Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations, "Offshore Profit Shifting and the U.S. Tax Code—Part 2 (Apple Inc.)," at 170–171 (May 21, 2013) (Apple hearing).

2 *See id.* at 177.

3 *See id.* at 176–177.

4 *See* European Commission Decision of 30.8.2016 on State Aid Implemented by Ireland to Apple 87 (Commission Decision), European Commission release on Apple decision 2 (Aug. 30, 2016) (release).

5 *See* Apple hearing, *supra* note 1, at 191.

6 *See id.* at 177–178.

7 *See* Explanatory Memorandum for the Information of Members of the Oireachtas Dail Debate of the Government Motion on the Apple State Aid Case 8 (Sept. 7, 2016) (Irish memo); Amanda Athanasiou, "Apple Decision Seen as Highlighting Failures of Many," *Tax Notes*, Oct. 31, 2016, p. 631 (Failing).

8 *See* release, *supra* note 4, at 2. The rulings referred to the non-Irish headquarters as a "head office." *See id.* Although the management of Irish Sub occurred primarily at Apple's California headquarters, the Irish rulings did not ascribe any physical location to Irish Sub's head office other than to indicate that the location was outside Ireland. Nevertheless, California is the only realistic candidate for the location of Irish Sub's headquarters or head office. *See* Commission Decision, *supra* note 4, at 30–31.

9 *See* Apple hearing, *supra* note 1, at 174.

10 *See* Commission Decision, *supra* note 4, at 9 n. 12.

11 *See* section 7701(a)(4) and (5).

12 *See* Apple hearing, *supra* note 1, at 191.

13 *See* Commission Decision, *supra* note 4, at 118; *see also* Ryan Finley, "Apple Subs Taxable in Ireland by Default, EU Official Says," *Tax Notes Int'l,* Sept. 19, 2016, p. 1681, at 1686 n. 30.

14 Release, *supra* note 4, at 2.

15 *See id.* at 1; and Shaviro, *supra* note 13, at 1686 n. 30.

16 *See* Paul Craig and Grainne De Burca, *EU Law: Text, Cases and Materials* 631 (5th ed. 2011); and Frans Vanistendael, "Are the EU and U.S. Headed for a Tax War?" *Tax Notes Int'l*, Sept. 19, 2016, p. 1057.

17 *See* Treaty on the Functioning of the European Union, articles 114 and 352.

18 *See* Commission Decision, *supra* note 4, at 118; release, *supra* note 4, at 1.

19 *See id.* at 3.

20 *See* Sam Schechner, "Apple, EU Trade Jabs in Tax Case," *The Wall Street Journal*, Dec. 20, 2016, at B1; Tim Cook, "A Message to the Apple Community in Europe" (Aug. 30, 2016).

21 *See* Irish memo, *supra* note 7, at 13.

22 *See* William Hoke, "State Aid Decisions Defy Transfer Pricing Analysis, Treasury Says," *Tax Notes*, Oct. 10, 2016, p. 220.

23 *See* Irish memo, *supra* note 7, at 13.

24 *See* J. P. Finet, "Ireland to Appeal Apple Ruling, Review Corporation Tax Code," *Tax Notes*, Sept. 12, 2016, p. 1493, at 1494; Irish Parliament Backs Apple Tax Appeal After Angry Debate, EurActiv.com, Sept. 8, 2016.

25 The commission's decision did not affect Ireland's 12.5 percent corporate income tax rate. *See* release, *supra* note 4, at 2.

26 *See* Apple hearing, *supra* note 1, at 191.

27 *See* Lee A. Sheppard, "EU Pulls the Curtain on Apple's Tax Magic," *Tax Notes*, Sept. 5, 2016, p. 1321, at 1324.

28 *See* reg. section 301.7701-2(a).

29 *See* section 954(d)(1); Apple hearing, *supra* note 1, at 184–187.

30 *See* Apple hearing, *supra* note 1, at 187.

31 *See* section 7701(a)(4) and (5).

32 *See* sections 881(a) and 882(a).

33 *See* Apple hearing, *supra* note 1, at 174. For an argument by David Rosenbloom asserting that this is incorrect and that taxable income should be attributed to the United States, see Athanasiou, Failing, *supra* note 7, at 632.

34 *See id.* at 170 ("As of 2011, Apple held between 75 and 100 percent of those offshore cash assets in accounts at U.S. financial institutions."); and Stephen E. Shay, "The Truthiness of 'Lock-out': A Review of What We Know," *Tax Notes*, Mar. 16, 2015, p. 1393, at 1395.

35 *See* section 956(c)(2); and Andrea Wong, "Americans Are Paying Apple Millions to Shelter Overseas Profits," Bloomberg Technology, Dec. 7, 2016.

36 *See* Sheppard, "Debunking the Overseas Cash Meme," *Tax Notes*, May 25, 2015, p. 847.

37 For an explanation of cross-crediting, see J. Clifton Fleming Jr., Robert J. Peroni, and Shay, "Worse Than Exemption," 59 *Emory L.J.* 79, 132–137 (2009).

38 *See* Fleming and Peroni, "Eviscerating the Foreign Tax Credit Limitations and Cutting the Repatriation Tax—What's ETI Repeal Got to Do with It?" *Tax Notes*, Sept. 20, 2004, p. 1393, at 1406–1415.

39 Collection of deferred tax is subject to the uncertainties of permanent reinvestment and cross-crediting.

40 *See generally* Romero J. S. Tavares, Brett N. Bogenschneider, and Marta Ponkiv, "The Intersection of EU State Aid and U.S. Tax Deferral: A Spectacle of Fireworks, Smoke, and Mirrors," 19 *Fla. Tax Rev.* 121, 185–188 (2016).