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Title: **HOW MISMATCHED TAX RULES ALLOW MULTINATIONAL ENTERPRISES TO BE ONE STEP AHEAD? – IN PARTICULAR, APPLE AND AMAZON**

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HOW MISMATCHED TAX RULES ALLOW MULTINATIONAL ENTERPRISES TO BE ONE STEP AHEAD? – IN PARTICULAR, APPLE AND AMAZON

João Ferreira

This paper deals with the applicability of International Tax Law rules to the cases of Multinational Enterprises taking advantage of distinct jurisdictions to practice tax planning and tax avoidance schemes, particularly the US, German, Irish and Luxembourg. Before getting into the comparative analysis, we will try to expose the docking tax rules of different legal systems, proceed to a preliminary approach of tax tactics commonly used by North American Multinationals and expose some basic concepts that will serve as the foundation in the analysis of the legal and commercial structure of Apple and Amazon enterprises. It will follow an analysis of its implications in the various legal systems.

1. GLOBALIZATION AND STATELESS INCOME

The role of Multinational Enterprises (MNEs) has grown over time in the context of a globalized economy. As an internal justification, capital is much more mobile than labour – investments can be made anywhere whereas immigration will find cultural and political obstacles. As for external elements, these corporations allocate capital and technology to much needed countries, and they also increase employment and Government revenue. Also, with the advantages in cost-efficiency and innovation dynamism these corporations bring more affordable and effective solutions to the world. With so much to be grasped, the international community has no alternative than to embrace it and even encourages such corporate upgrades.

In order to smoothen out commercial practices, the established International trade agreements guarantee the success of free movement of capital, goods and services and in many cases also freedom of establishment. This includes, for example, the European Union Single Market, the North American Free Trade Agreement (NAFTA), the Association of Southeast Asian Nations (ASEAN) and the World Trade Organization (WTO). In the near future we can also expect the Transatlantic Trade and Investment Partnership (TTIP) to be finalized, the Comprehensive Economic and Trade Agreement (CETA) to enter effect in 2016 and thanks to Wikileaks, we have knowledge of the Trans-Pacific Partnership (TPP) that recently came to the public attention.¹

In this sense, it is fair to say that Global Free Trade is winning over trade regulation and protectionism – following the natural course of economics, if an economy shields its domestic industry by increasing tariffs, industries may not have any encouragement to cut expenses, thus encouraging inefficiency. An efficient allocation of resources generates an increased wealth. A decrease of tariffs represents an increase in competition from abroad, consequently precluding domestic monopolies – and arguably also more economic inequity. As a rule, free trade

¹ Wikileaks, (*Wikileaks.org*. 10 June 2015) <<https://wikileaks.org/tpp/healthcare/press.html>> accessed 11 August 2015

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agreements between sovereign nations do not provide for the harmonization of direct and indirect taxation. Nevertheless, the concept of fair trade also has tax implications: *a)* National tax laws of treaty members must not discriminate against foreign businesses and investors; and *b)* Export subsidies to domestic businesses, including tax preferences, are subject to restrictions.²

With that being said, MNEs often choose locations for investment based on anticipated returns (offshoring and outsourcing), taking advantage of worldwide corporate synergies and economies of scale³. Production and trade are structured within global value chains where the different stages of the production process are located across different countries.⁴ These MNEs consist of separate legal entities that are located in different countries (parent and subsidiaries) but maneuver as a single economic entity. This combined accounting reflects the economic reality of global MNEs and this is why the International Financial Reporting Standards (IFRS) and U.S Generally Accepted Accounting Principles (GAAP) require the eradication of intra-group transactions in order to determine consolidated global income for the entire group of affiliated corporations.⁵

These chosen locations are known as tax havens. The Organization for Economic Co-operation and Development (OECD) provides no definition of this concept⁶ because by doing so it would create the risk of a restriction on the classification of a country or region as such. Thus, it decided to provide the identifying factors to aid in the framing. There are four cumulative factors: The first is the presence of a null or almost minimal taxation of income; the second is the lack of effective exchange of information; the third is the lack of transparency; and the last is the absence of substantial economic activities.⁷ Although cumulative, these factors do not prevent, and actually encourage, a case-by-case evaluation. The goals that tax havens usually aim to achieve by reducing the tax burden, or eliminating it almost completely, include an increase in profitability of investments, with high levels of confidentiality, security and flexibility for operations abroad.⁸

But, is it possible to talk about tax planning⁹ by the mere fact of setting in residence in a lower taxation country? And are economic operators entitled to exploit these differences in taxation? Keeping in mind that sovereign states, in exercising their powers of taxation, can set the tax rates that they find appropriate, and in a scenario like Europe, where there are harmonized corporate

² Patrick Love / Ralph Lattimore, 'Protectionism? Tariffs and Other Barriers to Trade' in *International Trade: Free, Fair and Open?* (2009)

³ For a more complex understanding on Economies of scale, see Paul Krugman, 'Scale Economies, Product Differentiation, and the Pattern of Trade' in *The American Economic Review* (1980).

⁴ Gary Gereffi / John Humphrey / Timothy Sturgeon, 'The governance of global value chains' In *Review of International Political Economy* (2005)

⁵ Ernst & Young, *International GAAP 2015: Generally Accepted Accounting Principles under International Financial Reporting Standards*. Wiley, 2014; and IFRS, (*International Financial Reporting Standards Website*, May 2015)

<<http://www.ifrs.org/Meetings/MeetingDocs/Interpretations%20Committee/2015/May/AP03B%20-%20%20IFRS%205%20Non-current%20assets%20held%20for%20sale%20-%20presentation%20of%20transactions%20with%20discontinued%20operations%20final.pdf>> accessed 11 August 2015

⁶ Although, André Beauchamp went the extra mile and decided to define it as such: "A country or territory that assigns to individuals or legal persons tax advantages likely to avoid taxation in their country of origin or to benefit from a more favorable tax regime than of that country." See, André Beauchamp Guide, *mondial des paradis fiscaux* (Grasset, 1992)

⁷ Organization for Economic co-operation and Development, 'Harmful Tax Competition: An Emerging Global Issue' (*oecd.org*, 1998) <<http://www.oecd.org/tax/transparency/44430243.pdf>>

⁸ Alberto Xavier, *Direito Tributário Internacional* (Lisboa: Almedina 2007)

⁹ From a permissibility point of view, tax planning is advised by governments in order to reduce an entity's tax liability; tax avoidance is not recommended because, contrary to tax planning where you make use of specific forms and legal mechanics (created for such purpose), corporations take advantage of loopholes in tax law. Although being legal, it defeats the intention of the law maker; tax evasion involves reducing an entity's tax liability, not paying one's taxes where the law clearly states that they must be paid. For a deeper understanding on tax planning, tax avoidance and tax evasion, see Paulus Merks, 'Tax Evasion, Tax Avoidance and Tax Planning' in *Intertax* (2006) 272-281.

tax rates, that possibility is undeniable. This is supported by the court ruling of the European Court of Justice (ECJ) *Cadbury Schweppes*, of 12 September 2006 (C-196/04), by ordering that “in order for a restriction of freedom of establishment to be justified on the ground of prevention of abusive practices, the specific objective of such a restriction must be to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality.”

At the present date there is no coherent international income tax system that would provide uniform rules for sourcing income and allocation of tax revenues. However, the European Commission will launch a new effort to introduce a formulary apportionment in the EU, the Common Consolidated Corporate Tax base (CCCTB) with a legal basis on article 115.⁹ TFEU, on the harmonization of national rules which directly affect the establishment or the functioning of the internal market.¹⁰ Countries pursue tax policy goals without international coordination – for example, many countries prefer Capital Import Neutrality (CIN) and exempt foreign income (e.g. Germany, Austria) while others want to achieve Capital Export Neutrality (CEN) and tax foreign income/dividends (e.g. US and UK)¹¹ or do not even want to impose any income tax at all, like tax havens abovementioned.

The current international tax system often results in the discrimination of cross-border transactions and distorts competition. Initially, MNEs used tax planning mainly to prevent double taxation (e.g. eliminate withholding taxes on dividends, interest income and royalties¹² and avoid non-creditable taxes). In a subsequent trend, MNEs shifted ‘mobile’ investment income to low-tax jurisdiction to achieve double non-taxation of some of their profits. Nowadays, many MNEs have achieved double non-taxation of large portions of their operating income, even though they are headquartered in high-tax jurisdictions and continue to sell their products into high-tax market countries. This development was facilitated by two factors: *a*) increasing importance of intangible assets such as Intellectual Propriety, which can be transferred to affiliates without having to move people or tangible assets; and *b*) increasing tax international competition, which led many (former) high-tax countries to adopt preferential tax regimes and/or to disable their anti-avoidance rules.

2. Common international tax planning strategy of MNEs in the US

Often, MNEs transfer intangible assets to a foreign subsidiary that is not subject to income tax but classified as a ‘principal/entrepreneur’ for Transfer Pricing (TP) purposes and therefore, are entitled to residual profits. Popular locations for this include: Ireland, Luxembourg, Bermuda, Cayman Islands and Singapore. They also restructure local subsidiaries into ‘low-risk distributors’ that are entitled to minimal profits under Transfer Pricing guidelines (Transactional Net Margin Method) or into ‘commissionaires’ that bear no risk at all. Other strategies used include: use base-eroding payments (interest, royalties, management fees) to reduce remaining tax liability in a market country even further (‘earnings stripping’), the avoidance of current inclusion of ‘passive’ Controlled Foreign Corporation income under US CFC rules (e.g. check-the-box regulations, same country exception, manufacturing exemption), the accumulation of

¹⁰ European Commission, ‘Common Consolidated Corporate Tax Base’ (*Europa*, 2011) <http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/common_tax_base/com_2011_121_en.pdf> accessed 11 August 2015

¹¹ More on the use of neutralities in international tax policies, see Thomas Horst, ‘A Note on the Optimal Taxation of International Investment Income’ in *The Quarterly Journal of Economics* June (1980) 793-798.

¹² We can define royalties as payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work. See more Christiana Panayi, HJI, *European Union Corporate Tax Law* (Cambridge University Press 2013). It is also defined in Article 2. ° b) of Council Directive 2003/49/EC and Article 12. ° paragraph 2 of the OECD model tax convention 2014. Although these definitions are not completely the same, they are very similar, being very broad and covering any kind of consideration for any kind of intangible assets. For a comparative view of Royalties, see Raquel Dias Pereira, ‘O conceito de royalties no Direito Fiscal Interno e Internacional’ in *FDL* (1994)

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foreign earnings at the level of the foreign principal company ('deferral'), or waiting for the next 'repatriation tax holiday' as current dividend distribution to US parent would be taxed at 35%.¹³ The result is 'stateless income' that is not taxed anywhere in the world.¹⁴

By Transfer Pricing (TP) we understand as the amount charged by a company on the sale or transfer of goods or services, tangible or intangible property, to another company related to it.¹⁵ Say that, for example, Coca Cola in the United States purchases a patent for Coca Cola in France; the parties, by establishing a price for the transaction, are using transfer prices. We can assert that in most countries, the guiding rules of transfer prices are based on the Arm's Length Standard (ALS) of Article 9 of the OECD Model Convention. Studies have shown that a strategy of transfer prices could potentially provide savings of about 15% in taxes.¹⁶ The arm's-length standard of transfer pricing states that the sum charged by one related party¹⁷ to another for a given product must be the same as if the parties were not related. An arm's-length price for a transaction is consequently what the price of that operation would be on the open market between two independent parties.

Transfer pricing is of increasing importance to corporations, as in a globalized economy their operations extend to countries with diverse taxation regimes and regulatory capacities. Experts acknowledge that transfer pricing can enable companies to avoid double taxation, but that "it is also open to abuse. It can be used to shift profits artificially from a higher-tax jurisdiction to a lower-tax one, by maximising the expenses in the former and the income in the latter".¹⁸ The MNEs often adopt aggressive strategies from tax planning which may result in tax avoidance or evasion. Manipulation of transfer pricing is one of the tax evasion arrangements enabling MNEs to transfer profits from countries with high tax rates to others where the rate is more conducive. There is illegality or abuse when this arrangement of manipulation materializes. The most common phenomenon is called 'mispricing'. We can take a look at GlaxoSmithKline, which is based in the U.K. and operates through subsidiaries worldwide. Its primary business is the creation and production of pharmaceuticals. Assuming that Glaxo-Canada develops a patent for a new drug and the patent costs €2 to be created and then sells it to its counterpart in Ireland for the same amount, €2. As the amount charged to Glaxo-Ireland is precisely the value that Glaxo-Canada

¹³ In 2004 the US Congress enacted a tax holiday for North-American MNEs allowing them to repatriate foreign profits to the United States at a 5.25% tax rate, instead of a much higher customary rate in order to inject the money in the home country that otherwise would remain in the subsidiary country. See Martin A. Sullivan, *Corporate Tax Reform: Taxing Profits in the 21st Century* (Apress 2011)

¹⁴ Edward D. Kleinbard, 'Stateless Income' in *Florida Tax Review* (2011).

¹⁵ PricewaterhouseCoopers, 'Transfer Pricing Perspectives: Fit for the Future' (2014)

¹⁶ Russ O'Haver, 'Improving Deals with Transfer Pricing' in *Interchange 4* (December 2004)

¹⁷ This concept has a different meaning from country to country – for example, Indonesia requires ownership of at least 25% or de facto control. See KPMG, 'global transfer pricing review: Indonesia' 2013. In the US, we must consider the rules in the Internal Revenue Code (IRC) Section 482 which offers the phrase "... Owned or controlled directly or indirectly by the same interests..." This broad language is subject to IRS and judicial interpretation. The IRS has taken the position that when the parties that lack common ownership cooperate to shift income and deductions, they become related parties for the purpose of transfer pricing law. See Chief Counsel Advice, 'Technical Advice Memorandum 200230001' Memorandum (2002). In other words, the related parties must be under common control. This control is based on a 'facts and circumstances' test, and not on specific ownership thresholds. In the United Kingdom, this subject falls within the spectre of Part 4 of the Taxation Act 2010. Parties are related when one party directly or indirectly participates in the management, control, or capital of the other, or when the same person or persons directly or indirectly participate in the management, control, or capital of both parties. Generally, there is a 51 percent test of control. Furthermore, in the U.K. (and even in other Common Law countries), even a brother in one company and his sister in the other would be considered as related, according to the Amendment to the Financial Reporting Council 8 'Related Party Disclosures': Legal changes 2008. See more, Deloitte, 'Global Transfer Pricing' in *Country Guide* (2014)

¹⁸ PricewaterhouseCoopers. 'Pharma 2020: taxing times ahead. Which path will you take?' <<http://www.pwc.com/gx/en/industries/pharmaceuticals-life-sciences/pharma-2020/pharma-2020-taxing-times-ahead.html>> 2009.

stated as cost of production, it results in Glaxo-Canada not being taxed. Ireland has a favorable tax regime for businesses, so it is more attractive (tax rate wise) to declare the income in this country. But if the Canadian tax authorities resort to Arm's Length Standard to determine the value of the patent traded with Glaxo-Ireland market, it might have been possible to come to the conclusion that, instead of 2 €, it could be sold at 10 €. The case that pitted GlaxoSmithKline against the North American tax administration (Internal Revenue Service) is illustrative of how MNEs manipulate transfer prices in order to reduce the payable tax and the amounts involved. The pharmaceutical giant reached an agreement accepting to pay 3.4 billion dollars to the IRS after a dispute that lasted almost two decades.¹⁹ It is estimated that such practices, to inflate or deflate the values in question, allowed in 2001 in the United States for the MNEs to raise 53 billion dollars that would otherwise be owed to the tax authorities. Examples of such cases, through examination of the US customs data and filings of import and export prices used by corporations, are a pair of tweezers from Japan at € 4896 each, a ballpoint pen from Trinidad for € 8500 and a litre of apple juice from Israel for € 2052. As exports, there were prefabricated buildings to Trinidad at € 1.20 each and missile and rocket launchers to Israel for just 52.03 €.²⁰

The International Monetary Fund (IMF) has warned of the TP abuse situations created by the MNEs in order to pay less tax and of how this undermines the tax authorities. Consequently, these situations affect the tax revenue potentially used in financing social status, on the well-being of individuals, particularly in social, education and health services.²¹ But the question remains: Are MNEs to blame? In accord with the logic of capitalism, the legal obligation of corporations is first and foremost to increase profits and dividends for the advantage of their shareholders. Such priorities are enshrined in law. For example, Section 172 of the U.K. Companies Act 2006 requires directors to promote the success of the company for the good of the shareholders as a whole and, in that process, have regard to the interests of other stakeholders (e.g. the environment, customers, suppliers, employees, and community). That means the interest of other stakeholders are subordinated to the pursuit of shareholder wealth maximization.²²

3. HOW APPLE AVOIDS TAXATION OF ITS FOREIGN EARNINGS

In the US, Corporate income tax revenue is accounted for an increasingly receding share of federal receipts and today is down to about 9% of federal revenue. That decline is due to use and abuse of loopholes that riddles the US tax code. The average US Corporation pays an effective tax rate 15% less than the statutory rate of 35%. Thirty of the largest multinationals paid nothing in federal income taxes in recent years, through the use of several loopholes that allowed them to control how much they report and pay.²³

By taking a look at the business model and financials of Apple, Inc in the fiscal year of 2013/2014, we can point that Apple manufactures and sells smartphones, desktop PCs and tablets. These products get distributed through retail outlets (Apple Stores) and Apple websites. Thus, they have a global market outreach. Apple uses proprietary Operating Systems (OS X, iOS) and Internet platforms (iTunes, AppStore) to sell digital products; this digital business represents

¹⁹ The Wall Street Journal, 'Glaxo to Settle Tax Dispute With IRS Over US Unit for \$3.4 Billion' *WSJ* (12 September 2006)

²⁰ Simon J. Pak, John S. Zdanowicz, 'US trade with the world: an estimate of 2001 lost federal income tax revenues due to over-invoiced imports and under-invoiced exports' *Executive Summary* (2002)

²¹ United Nations, 'Informal Meeting on Practical Transfer Pricing Issues for Developing Countries' *Meeting report* (New York: UN, 2011)

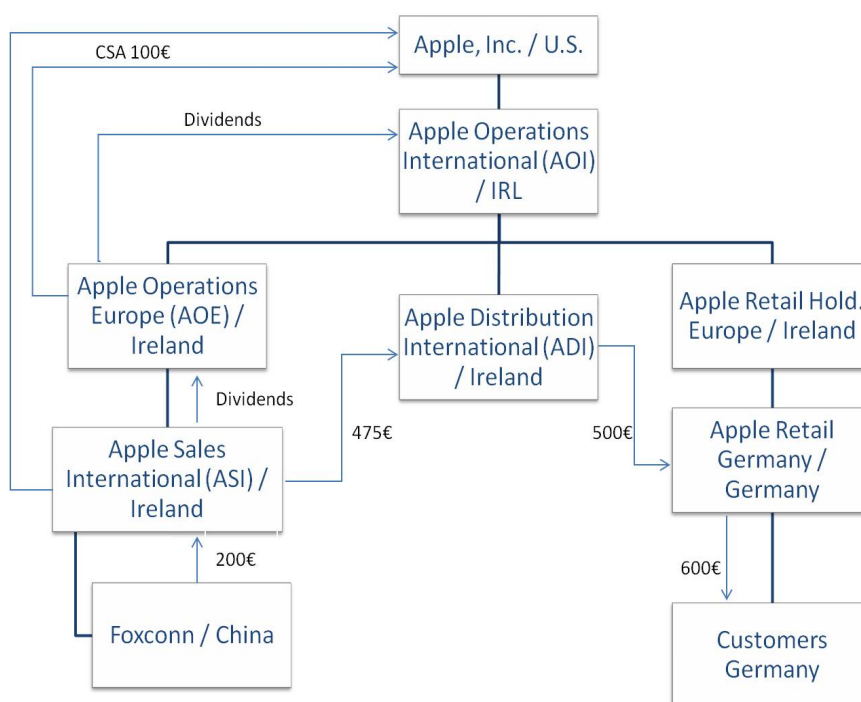
²² Allan A. Kennedy, 'The End Of Shareholder Value: Corporations At The Crossroads' in *Basic Books* (2001)

²³ Permanent Subcommittee on Investigations, 'Offshore Profit Shifting and the US Tax Code - Part 2 (Apple Inc.)' Hearing (21 May 2013)

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approximately 10% of global sales, trending upwards – the total sales of 2013/2014 amounted to 183 billion dollars.²⁴ Also, not so much of public knowledge, Apple has a highly developed tax avoidance system, through which it has amassed more than one hundred billion dollars in offshore cash in tax havens. As mentioned before, Intellectual Property (IP) is the dominant source of value in today's economy and its value can be very easily transferred around the globe. The key to offshore tax avoidance is transferring the profit generating potential of the IP offshore so that the profits are directed not to the US but to a tax haven. The first slice of this tax avoidance strategy comes in two parts, it executes a shift of the profit generating power of its IP to an offshore tax haven, thus directing the resulting income to tax havens where their accounts are setup. Subsequently, it uses a number of mechanisms to ensure once this income is offshore, it remains shielded from US taxes despite provisions in the US tax law, which are designed to target that income as taxable.²⁵

APPLE'S COMMERCIAL STRUCTURE²⁶



How does this happen? The first aspect is that Apple Inc. has created three offshore corporations – entities that receive tens of thousands of income, but have no tax residence. Apple has arranged matters in such a way so it can claim that these ghost companies for tax purposes exist nowhere. The first one is Apple Operations International (AOI). Under Irish Law (that has a corporate tax rate of 12.5% – less than half what Apple would pay in the US) only companies that are managed and controlled in Ireland are considered Irish residents for tax purposes²⁷. Apple says that although AOI is incorporated in Ireland, this company is not managed and controlled in Ireland and therefore is not a tax resident. US tax law, on the other hand, generally turns to where a

²⁴ The Irish Times, 'Can high-flying Apple become the world's first trillion-dollar company?' *The Irish Times* (9 December 2014)

²⁵ US Securities and Exchange Commission, *Form 10-k, Annual Report* (Washington, 2014)

²⁶ Reimar Pinkernell, 'Tax Challenges of the Digital Economy' in *International Taxation Course* (Münster: JurGrad, 2015)

²⁷ Irish Tax and Customs, 'Corporation Tax' Ireland.

company is incorporated. But Apple says since AOI is not incorporated in the US it is also not present in the US for tax purposes – it's neither here or there. The residence is the connecting point of excellence in the field of taxation, which serves to determine whether the obligation of an individual to contribute to public expenditure must be calculated on the basis territorial or global basis, in addition to performing a clear order of location of income. In this case, there is a mismatch of rules – the US look at the place of incorporation, which is under the Internal Revenue Code section 7701(a)(5) in Ireland, whereas Ireland only looks at the place of management²⁸, which is in the US. If we observe, for example, the United Kingdom, we quickly realize this would not be possible in this country. According to HM Revenue & Customs' Statement of Practice 1/90, a company is generally treated as resident in the United Kingdom for tax purposes if it is incorporated in the United Kingdom or, in the case that the company is not incorporated in the U.K., if its central management and control are exercised in the United Kingdom.

AOI also decided to structure itself as an unlimited company. Section 5(2)(c) of the Irish Companies Act 1963 (as amended) defines an unlimited company as “a company not having any limit on the liability of its members”, as confirmed by section 207(1) where it states that the shareholders “shall be liable to contribute to the assets of the company to an amount sufficient for the payment of its debts and liabilities, and the costs, charges and expenses of the winding up, and for the adjustment of the rights of the contributories amongst themselves”. It was structured as such for reasons of confidentiality. While an unlimited company is obliged to file an annual return, it is, in certain conditions, and according to Companies Act 2014, dismissed of the obligation to file supplementary financial records. The state of the company's financial affairs does not, consequently, grow into a matter of public record.²⁹ The second subsidiary is Apple Operations Europe (AOE) and also has no tax home. Formerly known as Apple Computer Ltd., it is a 100% subsidiary of AOI (as we have already seen an Irish-incorporated non-tax resident company with no branch in Ireland). So, AOE is an Irish incorporated non-tax resident company carrying on a trade through a branch in Ireland with a main activity of manufacturing a specialized line of personal computers. It is also a party to a cost sharing agreement³⁰ (CSA) whereby, together with Apple Sales International (ASI), it shares Research & Development costs and risks of developing Apple products. Apple Inc. holds the legal title to all Apple IP rights under that cost sharing agreement. No rights in relation to the IP concerned are attributed to the Irish branch of AOE. The third company is ASI, which is a 100% subsidiary of AOE. It holds the economic rights to Apple's IP in Europe, Asia, Africa, India, and Middle East. All strategic decisions taken by ASI, including in relation to IP, are taken outside of Ireland. As with AOE, ASI is a party to the R&D cost sharing agreement under which the total costs of the group's worldwide R&D are pooled. It is incorporated in Ireland, operated from the US, but it's a tax resident in neither

²⁸ This management and control rule emerged as a result of judicial decisions set down in case law. The most significant cases were *De Beers Consolidated Mines Ltd. v. Howe* No. 5 TC 198. *Surveyor of Taxes. 1906* and *Todd v. Egyptian Delta Land and Investment Co. Ltd* No. 14 T.C. 119. 1928. In an effort to further enhance the tax regime's transparency, the Irish Budget of 2015 announced changes to Ireland's corporate tax residence rules. In order to give certainty to companies with existing Irish operations, the Budget includes a transitional grandfathering period to the end of 2020. See PricewaterhouseCoopers 'Tax Insights from International Tax Services' 2014 in *Irish Budget 2015*. <http://www.pwc.com/en_GX/us/tax-services/publications/insights/assets/pwc-irish-budget-2015-makes-key-changes-corp-tax-residence-rules.pdf> accessed 12 August 2015. With this announcement, the Irish government is taking the same approach that the U.K. took when it changed its residence rules in 1988, with a transitional period to 1993.

²⁹ Companies Registration Office. Financial Statements Required. 2015. <<https://www.cro.ie/Annual-Return/Financial-Statements-Requirements/Filing-Exemption>> accessed 23 September 2015

³⁰ In the US the IRS issued new proposed cost-sharing regulations in 2005, which have drawn sharp criticism from many business groups. Until those proposed regulations are finalized, the current regulations, described in 26CFR 1.482-7, remain in effect.

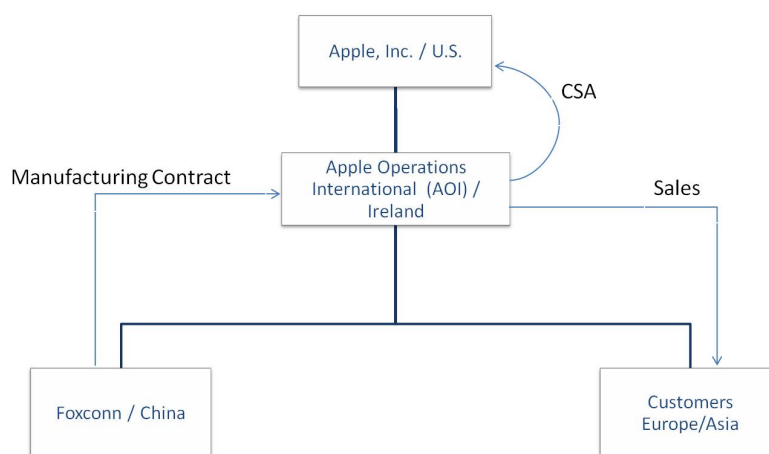
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country. ASI has paid a small amount of tax to Ireland. For example in 2011 it paid 10 million dollars from a profit of 22 billion dollars.³¹

By analyzing the commercial chain structure, we can better understand how this is done. The first element is the contract manufacturer, which is a Taiwanese manufacturer popularly known as Foxconn. Besides Foxconn, we could point out Pegatron as another manufacture for Apple. After manufacturing most of Apple's products, Foxconn sells a product, for example an iPhone, to Apple Sales International, in Ireland, for 200 €. This product is then sold within Apple's group from ASI to Apple Distribution International for a Transfer Price of 475 €. ASI by force of a cost-sharing arrangement with US parent, pays Apple, Inc. 100 € per iPhone. This agreement requires ASI to make contributions to the development work made by Apple engineers in the US. Then ASI sells on the iPhone, for instance, for 500 € to Apple Retail Germany (ARG). The final customer retail price is 600 €. The idea of this structure is to have a large profit in this overseas structure that can be accumulated at this level of AOI and the profits that come into existence at the level of ASI are distributed as dividends first to Apple Operations Europe and then on to Apple Operations International – that's the company where the deferral and the accumulation of profits is taking place. There is no profit in this picture for Germany, requiring a transfer pricing adjustment after three loss years.³²

It is relevant to address a new corporate type – the Apple Retail Holding Europe (AOI also is a Holding company).

APPLE'S STRUCTURE FROM US PERSPECTIVE



So, for US tax purposes, ASI, AOE, ADI and ARG are foreign disregarded entities. Under the IRS check-the-box³³ regulations, a US multinational can designate to have lower tier foreign subsidiaries disregarded by the IRS as distinct legal entities and instead treated as part of an upper-

³¹ Permanent Subcommittee on Investigations, 'Offshore Profit Shifting and the US Tax Code - Part 2 (Apple Inc.)' Hearing (21 May 2013). And Anna Gunn, 'Alleged State Aid to Apple' in *Highlights and Insights on European Taxation* (2014).

³² Reimar Pinkernell, 'Tax Challenges of the Digital Economy' in *International Taxation Course* (Münster: JurGrad, 2015)

³³ Treasury promulgated the check-the-box regulations in 1996 and almost immediately regretted them — US multinationals would be heavy beneficiaries by manipulating what they wanted to be considered. These elections got its name because of the action itself of 'ticking' a box in the Form 8832 of Entity Classification Election.

tier subsidiary for tax purposes. If that selection is made, transactions including the disregarded entities vanish for tax purposes, since the US tax regulations do not distinguish payments made within the boundaries of a single entity. In this case, once Apple Inc. makes its check-the-box election, the bottom three tiers of its offshore network – which include AOE, ASI, ADI, Apple Retail Holding, and the Apple Retail subsidiaries – all become disregarded subsidiaries of AOI. Those companies are then treated, for US tax purposes, as part of AOI in the first tier subsidiary. Consequently, the transactions between those disregarded entities are not acknowledged by the IRS, since the transactions are viewed as if they were conducted within the confines of the same company. The result is that the IRS only sees AOI and treats AOI as having received sales income directly from the end customers who purchased Apple products. That type of active business income is not taxable under US Code Part III, Subpart F - Controlled Foreign Corporations. Furthermore, when an offshore subsidiary of a MNE receives dividends, royalties, or other fees from a related subsidiary, that income is considered foreign personal holding company (FPHC) income. That passive income is normally subject to immediate taxation under Section 954(c) of Subpart F. Nonetheless, under check-the-box rules, if a US MNE elects to have lower-tier subsidiaries ‘disregarded’ and instead treated as part of an upper-tier subsidiary for tax purposes, any passive income paid by the lower-tier subsidiary to the higher tier parent would basically vanish.³⁴

4. AMAZON CASE

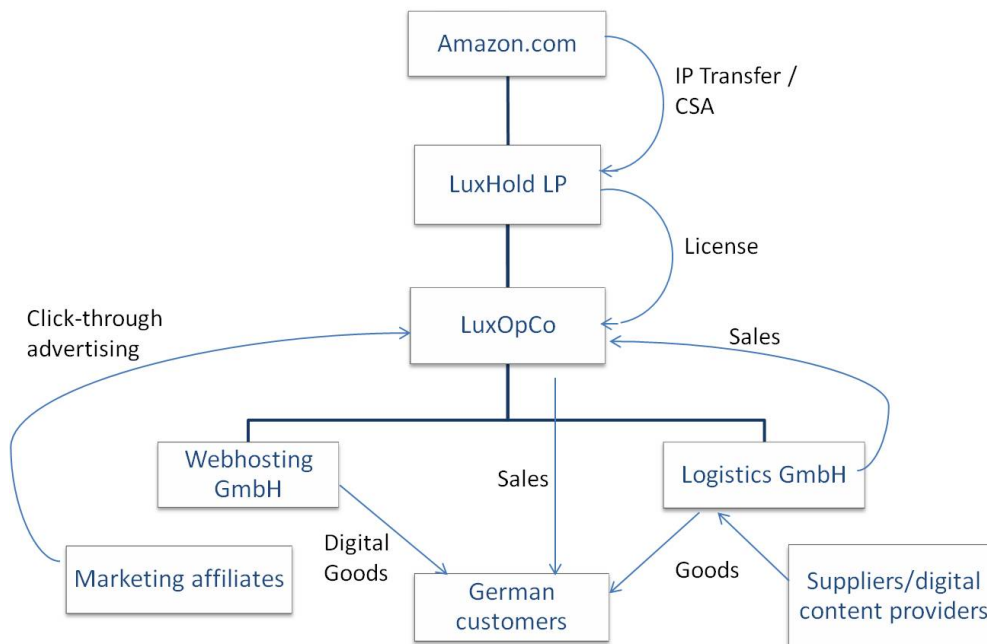
4.1. Overview

Amazon.com, Inc. was incorporated in 1994 and functions as an online retailer. It operates 13 global web sites, including amazon.com and five European websites – for this case study, we will focus on the German website. Amazon has divided its operations into two segments: North America and International. By operating retail websites in various countries, it sells consumer products and digital goods – making it a classical example of a Business to Consumer (B2C) industry - although not exclusively B2C because the company also offers an electronic marketplace for independent merchants and is a major provider of cloud computing services.

³⁴ Senator Carl Levin, Senator John McCain, ‘Memorandum - Offshore Profit Shifting and the US Tax Code - Part 2 (Apple Inc.)’ in *Memorandum* (2013)

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AMAZON COMMERCIAL STRUCTURE (SIMPLIFIED)³⁵



From 2003 to 2005, Amazon set up a tax efficient corporate structure using Luxembourg as its European headquarters: Amazon transferred tax ownership of valuable intangibles to LuxHold LP, which consequently entered into a CSA with its US parent to further develop the transferred intangibles. LuxHold LP also has a subsidiary, LuxOpCo, which holds all of its shares, and licenses the Amazon group’s IP rights to LuxOpCo to operate the European Websites in return for a tax-deductible royalty payment (license fee³⁶). This LuxOpCo functions as the head office of Amazon for Europe and is the principal operator of the retail and business services offered through Amazon’s European websites. In addition, LuxOpCo performs treasury management functions and holds (directly or indirectly) other European Amazon subsidiaries that perform merchandising, sales support and marketing functions. Furthermore, according to the information provided by Amazon to the U.K. House of Commons Committee of Public Accounts, LuxOpCo owns the inventory and bears the risk of any loss.³⁷ Additionally it has virtually no income because of royalty payments to LuxHold for use of Amazon intangibles. In Germany, for instance, LuxOpCo buys physical and digital products from various suppliers (manufacturers, digital content providers) and sells them directly to consumers in Germany. The shipping is handled by Logistics GmbH which operates twelve large ‘fulfillment centers’ (warehouses) in Germany while Webhosting GmbH hosts Amazon.de website and downloadable files for LuxOpCo. Moreover, independent ‘marketing affiliates’ place Amazon ads on their websites.

³⁵ Reimar Pinkernell, ‘Tax Challenges of the Digital Economy’ in *International Taxation Course* (Münster: JurGrad, 2015)

³⁶ More on how this License Fee is calculated in ‘European Commission, State Aid SA.38944 (2014/C) - Luxembourg; Alleged aid to Amazon by way of a tax ruling’ in *Investigation Report* (Brussels: European Commission, 2014)

³⁷ European Commission, ‘State Aid SA.38944 (2014/C) - Luxembourg; Alleged aid to Amazon by way of a tax ruling’ in *Investigation Report* (Brussels: European Commission, 2014)

4.2. Tax consequences in Germany

Logistics GmbH (*Gesellschaft mit beschränkter Haftung*, which is a limited liability company) and Webhosting GmbH supply low-value services to LuxOpCo. As fees are calculated on a cost-plus basis, both companies pay little corporate tax in Germany. Under Article 7/1 of the Double Taxation Treaty (DTT) with Luxembourg, Germany can tax business profits of LuxOpCo only if profits are attributable to a Permanent Establishment. However, servers of Webhosting GmbH do not constitute a Permanent Establishment for LuxOpCo as they are not at the disposal of LuxOpCo. We can consider Logistics GmbH as a probable 'permanent agent' under German Law (warehouse keeper), but it does not constitute a Permanent Establishment under Article 5/5 as it has no authority to conclude contracts for LuxOpCo. Furthermore, the control by parent LuxOpCo does not turn German subsidiaries into Permanent Establishment, Article 5/7. Also, local 'marketing affiliates' send traffic to Amazon.de website and may be 'permanent agents' under German Law (brokers). However, marketing affiliates also have no authority to conclude contracts in the name of LuxOpCo.³⁸ As a result, Germany cannot tax LuxOpCo's distance sales of physical goods to German customers (direct sales).

Nonetheless, under Article 12/2 of the DTT, Germany can impose a 5% withholding tax on royalties and, regarding this matter, the OECD commentary to Article 12, ¶ 17.1 is as follows: "the principles expressed above as regards software payments are also applicable as regards transactions concerning other types of digital products such as images, sounds or text".³⁹ The income from software transactions can either be characterized as business profits (Article 7) or royalties (Article 12), and the complete transfer of a copyright is considered as a capital gain (Article 13). In other words, the payments for the download of eBooks, software, MP3s and videos by end-users are characterized as business profits even if the contract explicitly grants a license. As a result, Germany also cannot tax LuxOpCo's profits from selling digital goods to German customers under Article 12.

Concerning the Value-Added Tax consequences, they are as follows: supplies of physical goods are taxable in Germany as LuxOpCo easily surpasses the threshold of distance selling (100,000€ p/year), with a tax rate of 19%. Supplies of electronic services to consumers (eBooks, software, MP3s, videos) are also taxable in Germany, with a tax rate of 19%. Prior to 1st January 2015, electronically supplied services were taxable in Luxembourg (at a 15% rate), which resulted in a competitive disadvantage for German providers. Luxembourg also applied a reduced rate to eBooks (3%) but was stopped by the European Commission (EC). (Due to an infringement procedure: Electronically Supplied Services (ESS) must be taxed at regular VAT rate, Article 98 of the COUNCIL DIRECTIVE 2006/112/EC of 28 November 2006.)⁴⁰

³⁸ Journal Officiel du Grand-Duché de Luxembourg, 'conventions fiscales et procédure en matière d'échange' (*Impots Directs Public* 23 April 2012) <http://www.impotsdirects.public.lu/archive/newsletter/2013/nl_08072013/M_morial_A_-_N_114_du_4_juillet_2013.pdf> accessed 21 September 2015; And Peter H. Dehnen, Silke Bacht, 'Recent Problems of Definition and Taxation of German Permanent Establishments' (*Tiagnet* October 2005.. <<http://www.tiagnet.com/files/Specialty%20Group%20News/German%20Permanent%20Establishm.pdf>> accessed 21 September 2015

³⁹ OECD, *Model Tax Convention on Income and on Capital: Condensed Version* (OECD 2010)

⁴⁰ Rick Minor, Claus Gärtner, *VAT on Electronically Supplied Services to EU Consumers - A Practical Compliance Guide for Cross-Border Suppliers of Digital Goods and Services* (Spitze Publishing, 2014); And Bardopoulos, Anne Michéle. *eCommerce and the Effects of Technology on Taxation: Could VAT be the eTax Solution?* Springer, 2015.

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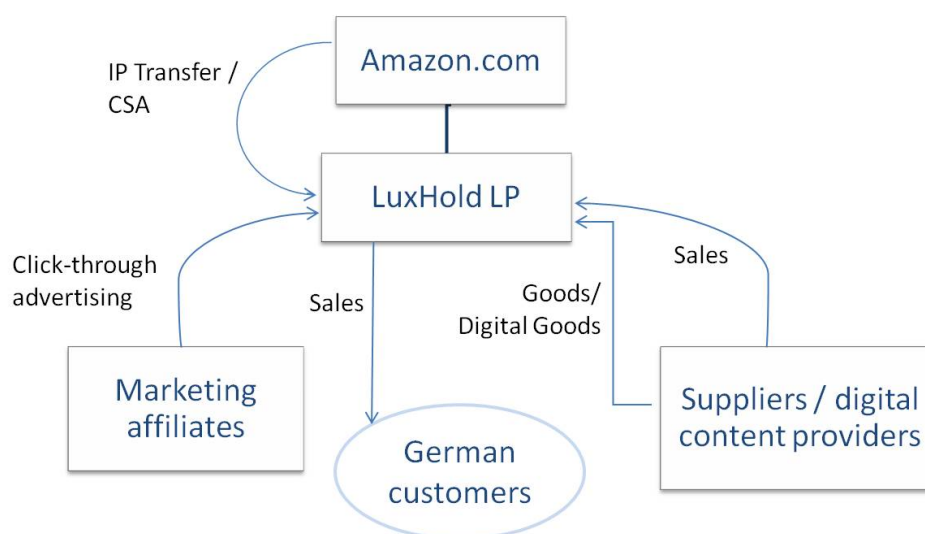
4.3. Tax consequences in Luxembourg

LuxOpCo is subject to regular taxation of 29,22 % (corporate income tax of 21% plus contribution to the employment fund of 1,47% and the Municipal Business Tax of 6,75%),⁴¹ but taxable income is minimal due to the royalties paid to LuxHold LP, while the latter is treated as a fiscally transparent limited partnership. Furthermore, the Luxembourg Tax Office granted a ruling to Amazon that LuxHold LP does not have a permanent establishment in Luxembourg. As a result, royalty income is attributed to the US parent, but Luxembourg does not impose withholding tax on royalties – this means there is no taxation at all in Luxembourg.⁴²

4.4. Tax consequences in US

LuxHold LP has ‘checked the box’ to be classified as foreign corporation, resulting in a deferral of US taxation. Controlled Foreign Corporations rules do not apply to LuxHold’s royalty income as LuxOpCo and its local subsidiaries are disregarded entities for US tax purposes (check-the-box election). From the US perspective, LuxHold LP has ‘active’ sales income, using its own IP and bearing the risks resulting from its retail business.

AMAZON’S STRUCTURE FORM US PERSPECTIVE⁴³



Nevertheless, the US has already upgraded from the previous situation with Amazon. The latter also used distance selling to circumvent sales & ‘use taxes’ of US states and state corporate

⁴¹ RSM International, ‘Tax Guide Luxembourg’ (RSM Website 2013) <http://www.rsm.lu/IMG/pdf/tax_guide_luxembourg_-_may_2013_v2-2.pdf> accessed 21 September 2015

⁴² PricewaterhouseCoopers, ‘Luxembourg Limited Partnership’ (PricewaterhouseCoopers 2014) <<https://www.pwc.lu/en/private-equity/docs/pwc-private-equity-lux-limited-partnership.pdf>> accessed 21 September 2015

⁴³ Reimar Pinkernell, ‘Tax Challenges of the Digital Economy’ in *International Taxation Course* (Münster: JurGrad, 2015)

income tax. Under prior Law, state tax jurisdiction required 'substantial nexus' such as a local shop or local agent.⁴⁴ As a distance seller, Amazon was able to avoid state taxation although it had local fulfillment centers and local 'marketing affiliates' that sent Internet traffic to Amazon's retail website. Large retail companies such as Walmart, Barnes & Noble and Sears forced state governments to act in order to eliminate Amazon's tax advantages, and the majority of US states passed Tax Law §1101(b)(8)(vi), which is popularly mentioned as 'Amazon laws', that require Amazon to pay state sales tax if it owns an in-state subsidiary ('affiliate nexus') or uses local internet marketing partners ('click-through nexus'). In addition, the majority of US states impose income tax based on in-state sales ('factor-presence test' coupled with formulary apportionment). In conclusion, it is fair to say that US states were far less tolerant than European market countries were.⁴⁵

5. WHAT TO EXPECT FROM MNEs IN EUROPE

Are MNEs tax avoidance schemes in the brink of extinction? And does the globalized economy want that? There will always exist loopholes that you can drive a truck through. Naturally, unanticipated forces can significantly impact how MNEs will maneuver over the next decade – from financial fluctuations, breakthroughs on several areas, political events and impending tax rules adjustments can all influence the degree of tax avoidance that MNEs will be allowed to practice. But the forthcoming European tax transparency measures⁴⁶ will struggle to prevent tax avoidance itself – it will, however, structure a more transparent and rigid legislative framework that will expose these MNEs - and using Margaret Hodge's terminology - as the evil tax planners which they really are. Although, even exposed as such, the backlash of this type of public perception and expected decrease in consumption won't even be enough to scratch the surface of the spared capital due to tax avoidance. In the off chance Europe elaborates a fool proof plan to end this aggressive tax avoidance it is unlikely to be adopted. This is primarily because European countries do not want to be substituted for emerging markets (although, considering recent trends, some might even do).

By 2020, the BRICS⁴⁷ are expected to account for nearly 50% of global Gross Domestic Product growth. Multinationals know they have to secure a strong base in these countries as such will be critical for corporations seeking progress.⁴⁸ And many of these markets will open their arms gratefully for the leading MNEs. So, in the current context the EU should focus on implementing international initiatives (like the Base Erosion and Profit Shifting⁴⁹) at the same pace and to the same extent as other non-EU jurisdictions. A competitive disadvantage would otherwise exist, which would be harmful for future investments in the EU. In contrast to the well-established MNEs that came to dominate global competition in recent years, the new entrants into the global economy display a combination of characteristics that give them important advantages in those markets that now harbor the largest growth potential for the future (characteristics that the EU does not have) – based in low-cost locations that are easily and rapidly catching up in terms of technology and use of economical innovation and engineering to maintain costs below those of the established global companies in Europe. These new market entries came to challenge the well-

⁴⁴ *Quill Corp. v. North Dakota* No. 504 US 298. Supreme Court of the United States. 26 May 1992.

⁴⁵ Erika K. Lunder, Carol A. Pettit, 'Amazon Laws and Taxation of Internet Sales: Constitutional Analysis' in *CRS Report Prepared for Members and Committees of the Congress* (2015)

⁴⁶ On 18 March 2015, the European Commission presented a package of tax transparency measures (the Transparency Package) as part of its ambitious agenda to tackle perceived corporate tax avoidance and harmful tax competition in the European Union (EU). See more at Ernst & Young, 'European Commission presents a package of tax transparency measures' in *Global Tax Alert* (2015)

⁴⁷ Brazil, Russia, India, China and South Africa.

⁴⁸ World Economic Journal, 'The future of Multinationals' *Future Agenda* (2014)

⁴⁹ For more on this subject, see Dhammika Dharmapala, 'What Do We Know about Base Erosion and Profit Shifting? A Review of the Empirical Literature' in *Fiscal Studies* (2014)

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established MNEs, that will have to penetrate previously ignored developing countries that are unlikely to be tax planning fool proof.

This means new MNEs won't find the need to come to Europe (or create premium sector products for that matter) and old MNEs will have to choose between re-deployment or facing new judicial (harsher tax restrictions) and economic impediments. It is expected that MNEs will try to negotiate with European Governments in order to reach a compromise. This might result in more transparency but will defraud the recent tax efforts – Europe will have to comply with a necessary evil in order to avoid the sales, purchases and operations transfers to Singapore or Hong Kong.