From the Double Irish to the Bermuda Triangle

by Joseph P. Brothers

Joseph P. Brothers is an associate with Caplin & Drysdale in Washington.

The ''double Irish'' tax planning strategy employed by Apple and other multinational companies has been in the mainstream press of late, as has the challenge brought by the European Union. This article explains how the strategy works, the gist of the EU position, and the reaction of the Irish government.

Recently, the EU's antitrust and competition regulators have criticized aspects of the so-called double Irish arrangement, suggesting that some details of this scheme constitute unlawful state aid from the Republic of Ireland to Apple in contravention of article 107(1) of the Treaty on the Functioning of the European Union (TFEU). The investigation relates specifically to Apple, but similar complaints could be lodged against many other firms who employ the scheme (or parts of it).

This article is divided into four parts. Section I describes the mechanics, beginning with a generalized ''double Irish Dutch sandwich'' avoidance structure. At each stage, the ways in which Apple's use of the double Irish structure differs from the typical arrangement are identified. Section II articulates the basic elements of the state aid doctrine under EU competition law and how it is relevant to the current controversy. It also describes and analyzes the EU's investigation of Apple. Section III describes measures recently undertaken by Ireland's Finance Ministry in response to the criticism. Section IV is devoted to commentary.

In brief, the Irish Finance Department's decision to toughen Ireland's idiosyncratic corporate residency determination rules is unlikely to significantly impede the basic mechanics of the strategy or to allay the EU's concerns. The double Irish structure depends most crucially on the U.S. check-the-box entity classification rules to create a hybrid entity mismatch arrangement, as well as the cost-sharing provisions of Treas. reg. section 1.482-7.

At its most basic level, the point of the structure is simply to shift income from an Irish operating subsidiary into a holding company located in a zero-tax jurisdiction, while also avoiding inclusions to the U.S. parent that might result from outbound intellectual property transfers. From the U.S. perspective, the operating subsidiary is disregarded under the check-the-box regime so that the cash flowing into the holding company does not trigger subpart F inclusions to the U.S. parent. At the same time, the separate status of the holding company is recognized for Irish tax purposes so that these payments can be deducted against the taxable income of the Irish subsidiary. The structure depends in large part on the cost-sharing rules of Treas. reg. section 1.482-7 to avoid the possibility of deemed royalty inclusions under section 367(d) or other transfer pricing adjustments between the U.S. parent and the foreign subsidiaries.

By contrast, Ireland's current management and control test for corporate residency (the rule behind the double Irish neologism) plays a much smaller role in the structure compared with the other elements. It also has attracted outsized media and regulatory attention compared with the more important factors. It appears that the EU is attacking the wrong target. It is focusing on Irish domestic tax law, when the real culprits, if any exist, are:

- the U.S. check-the-box rules;
- the U.S. cost-sharing safe harbor under Treas. reg. section 1.482-7; and

- the general international tax principle that wholly owned shell entities located in tax havens (regardless of whether the term ''located'' means incorporated, managed, or something else) should be respected as economically independent entities rather than mere instrumentalities of their parent companies or overall corporate groups.

Accordingly, the Irish Finance Department's response (changing Ireland's corporate residency rules so that the double Irish may give way to the Irish-Bermuda) will likely prove unsatisfactory to the EU.

I. Mechanics of the Strategy

This section describes in broad terms a generalized or prepackaged double Irish or double Irish Dutch sandwich structure, and at each stage describes whether and how Apple's specific structure differs from this generalized model.

A. A Generalized Structure

A typical version of the double Irish or the double Irish Dutch sandwich structure involves at least three or four business entities. The group's top level parent is usually tax resident in the United States. In Step 1, the parent entity forms a wholly owned entity organized under the laws of Ireland but managed and controlled in a tax haven such as Bermuda (hereinafter ''Ireland HoldCo''). In Step 2, Ireland HoldCo forms another wholly owned entity at a level one tier below, which is organized, managed, and controlled in Ireland (hereinafter ''Ireland OpCo''). The lowest level operating entities are sometimes (as in Apple's case) branches or permanent establishments of Ireland HoldCo rather than separately incorporated subsidiaries (that is, ''Ireland Operating PE'' or ''Ireland Operating Branch'' rather than Ireland OpCo). But in most cases the operating entities are separately incorporated, wholly owned, Irish-registered, and Irish-controlled companies. Apple is also unique in that its version of Ireland HoldCo (the intermediate level, tax haven resident entity) is not resident in Bermuda but rather is resident ''nowhere.'' This article explains below how this subsidiary, Apple Operations International (AOI), avoids filing a residence-based tax return in any jurisdiction, in addition to skirting inbound tax obligations in any jurisdiction.

Many businesses have recently added another step to the structure. Ireland HoldCo, rather than directly forming Ireland OpCo, forms a Dutch holding entity (Netherlands HoldCo). Netherlands HoldCo, in turn, forms Ireland OpCo.

Regarding actual business operations, Ireland OpCo typically sells products to consumers in Europe and the Middle East and collects the corresponding gross receipts. Operating subsidiaries in other countries typically perform customer service and marketing functions (for example, ''France ServiceCo''); these entities are usually reimbursed on a cost or cost-plus basis by Ireland OpCo.

U.S. parent company and Ireland HoldCo jointly develop the IP embedded in the business's products. These entities typically enter into a cost-sharing arrangement in order to jointly fund and develop new IP (such as new software code). Under this arrangement, the U.S. parent typically retains the domestic IP rights as well as legal ownership of the IP, with Ireland HoldCo making a buy-in payment in exchange for the right to co-develop and exploit the software in the foreign marketplace. Ireland HoldCo sublicenses the foreign IP rights to Ireland OpCo in exchange for a royalty payment (in a Dutch sandwich scenario, there is an additional layer of sublicensing, this time from Ireland HoldCo to Netherlands HoldCo, and then from Netherlands HoldCo to Ireland OpCo). Ireland OpCo is responsible for manufacturing and selling digital products to customers in Europe and elsewhere.

Ireland OpCo is taxed on income from sales to European customers at the Irish ''trading income'' rate of 12.5 percent. However, the entity's taxable income base is reduced via the deductible royalty payments flowing up the corporate structure to Netherlands HoldCo or Ireland HoldCo. In Apple's case, the company's equivalent of Ireland OpCo does not actually sublicense the IP from further up the corporate chain; instead, it may simply sell its digital products with the IP embedded in its product inventory.

On the U.S. side, the parent minimizes potential subpart F inclusions by checking the box and electing to treat Ireland OpCo as a disregarded entity (along with Netherlands HoldCo, if it exists). This has the effect of:

- combining the foreign operations into a single entity so that the combined entity's manufacturing activities are substantial enough to prevent base company sales income; and
- causing the intra-entity royalty payments to be ignored, in order to avoid any foreign personal holding company income (FPHCI).

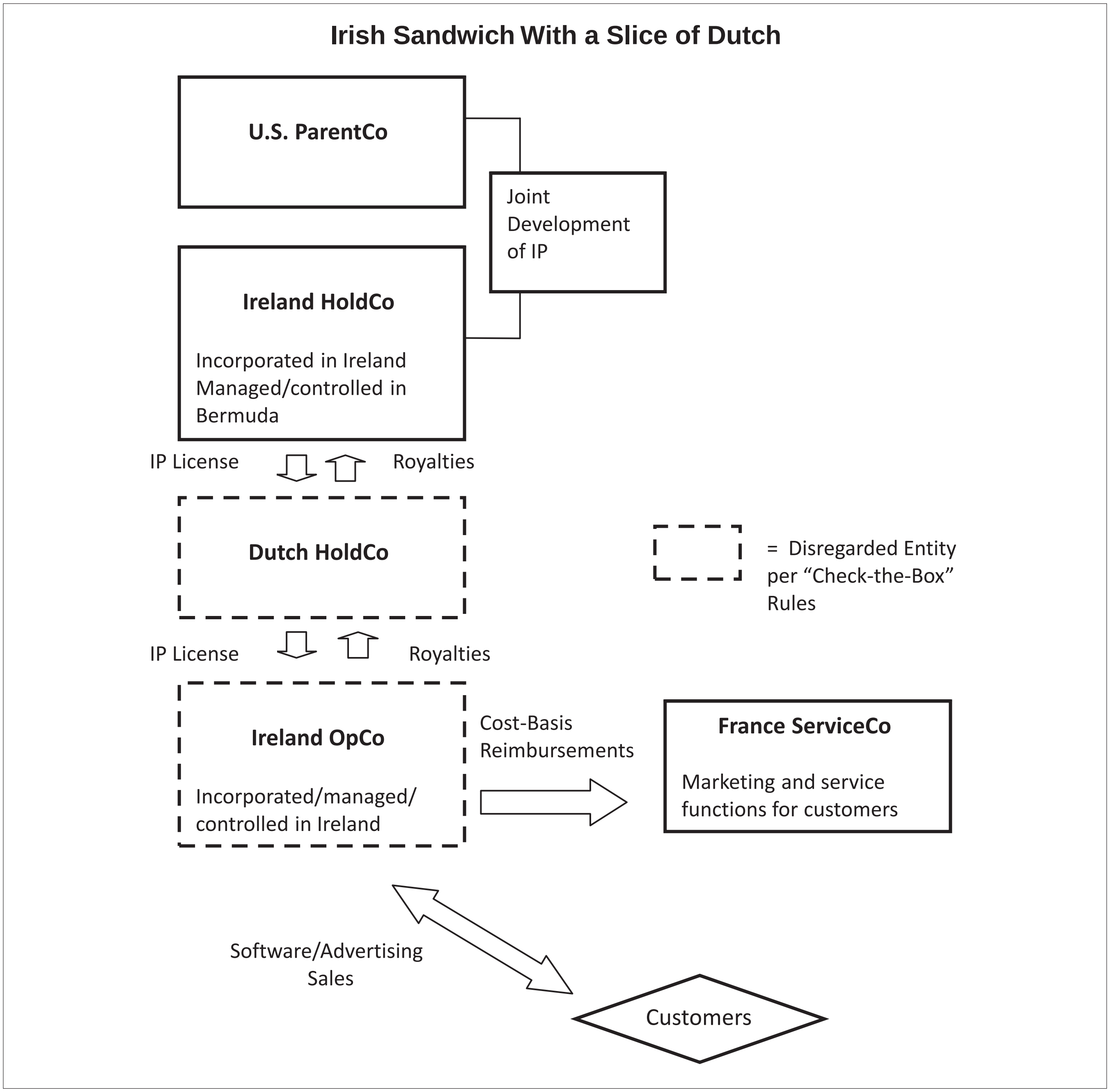
Graphically, the structure is shown in Figure 1.

B. U.S. Tax Treatment

1. Subpart F

Ireland HoldCo is typically a wholly owned subsidiary of the U.S. parent company. It therefore qualifies as a controlled foreign corporation under subpart F of the Internal Revenue Code.[1] Cognizant of Ireland HoldCo's controlled foreign corporation status, tax planners carefully craft the structure to ensure that little or none of the income flow taking place within it gives rise to foreign base company sales income (FBCSI) under IRC section 954(d) or FPHCI under IRC section 954(c).

[1] *See generally* IRC section 957.



The parent company achieves both of these objectives by electing to disregard the wholly owned Ireland OpCo (and Netherlands HoldCo conduit entity, if it exists) as separate entities for U.S. tax purposes, while retaining separate entity treatment of Ireland HoldCo.[2]

a. 'Manufacturing' activities of combined subsidiaries sufficient to avoid FBCSI. At all times during the double Irish scheme, Ireland OpCo conducts real business activity and has a tangible, physical presence in Ireland. The entity is managed and controlled in Ireland[3] and typically employs at least a handful of software engineers or other highly educated, value-adding employees. In Apple's case (and many others), Irish activities also

[2]*See generally* Treas. reg. section 301.7701-1.

[3]But not in Apple's case (Ireland Operating PE); Apple's software engineering and sales activities take place in Ireland, but the entity is managed and controlled in a tax haven jurisdiction.

include distribution and sales functions by purchasing inventory from controlled entities or third-party manufacturers and reselling them to European customers. Irish subsidiaries or branches usually participate in the joint development of new IP alongside their U.S.-based counterparts.[4]

The Ireland-based IP development activity is crucially helpful from a U.S. tax perspective, since it allows the company to credibly rely on the manufacturing exception to the FBCSI rules.[5] According to this exception, a CFC that ''substantially transforms'' the input materials into a final product or otherwise engages in activities that are ''substantial in nature'' and that are ''generally considered to constitute the manufacture, production or construction of property'' does not suffer FBCSI on the resulting sales (which would trigger income inclusions to the U.S. parent).

Treasury regulations relating to FBCSI apparently provide little guidance regarding sales of software-embedded products whose constituent components are predominantly intangible in nature. The IRS has been similarly reluctant to issue guidance on its view regarding application of the manufacturing exception in these contexts.[6] Nonetheless, firms employing the double Irish have relied on the exception in taking the position that they are not subject to the current inclusion requirements established by section 954(d).

Ireland OpCo is usually disregarded as a separately taxable entity. As such, the manufacturing activities are imputed to Ireland HoldCo, which is credited with all of the IP and software design functions that would have been limited to Ireland OpCo absent such an election.

b. Royalty payments flowing up the corporate chain are ignored, and therefore do not give rise to FPHCI. Without the election to disregard Ireland OpCo and Netherlands HoldCo as separately taxable entities, the FPHCI rules might be implicated. FPHCI might arise from Ireland HoldCo's passive receipt of royalty income from its wholly owned subsidiary Ireland OpCo or Netherlands HoldCo.[7]

However, the royalty payments are ignored for U.S. tax purposes[8] as a result of the election to disregard the lower level subsidiaries. The structure therefore gives rise to no FPHCI and thus no subpart F inclusions to the U.S. parent.

c. Same-country exception for some items of passive income (but only absent the Dutch sandwich component). FPHCI includes most forms of passive income, including royalties. However, some categories of passive income flowing to a CFC that qualify under the same country exception of section 954(c)(3) do not trigger subpart F inclusions to the U.S. parent. Interest and dividends are excluded from FPHCI if they are received from a related entity incorporated in the same country as the recipient CFC and substantially engaged in business in such country.[9] Also, rents and royalties are excluded from FPHCI if they are received from a related entity for the use of, or the privilege of using, property within the CFC's country of incorporation.[10]

Since both Ireland HoldCo and Ireland OpCo are incorporated in Ireland, and Ireland OpCo uses sublicensed IP rights (that is, ''property'') within Ireland to carry out its operations in Ireland, interest, dividend, and royalty payments from Ireland OpCo moving into Ireland HoldCo might not generally trigger subpart F inclusions even absent the check-the-box election. This rule would only matter, of course, if Ireland HoldCo were receiving payments directly from the operating subsidiary rather than through Netherlands HoldCo.

2. Avoiding Section 367(d) Deemed Royalties

A U.S. company that transfers specific items of intangible property to a foreign transferee is deemed to have sold the property in exchange for payments that are contingent upon the income generated by the property.[11] For the double Irish or the double Irish Dutch sandwich, this means that software rights transferred to Ireland HoldCo might give rise to deemed income to the U.S. parent ''commensurate with [the] income'' generated by that software.[12]

From the perspective of section 367(d), software represents an especially taxpayer-friendly form of IP in that it usually becomes obsolete not long after its initial creation. In the scheme at issue, the U.S. parent may exploit this taxpayer-friendly characteristic of software by transferring a nearly obsolete form of the code to Ireland HoldCo, then jointly developing subsequent versions alongside the Ireland HoldCo-disregarded entities group.

The U.S. parent may be required to recognize some de minimis section 367(d) income inclusions on the initial transfer, but these inclusions are usually minor because of the limited income-generating potential of that barely marketable version of the software code.

---

[4] *See* Treas. reg. section 1.482-7 (discussed in more detail below).

[5] *See generally* Treas. reg. section 1.954-3(a)(4).

[6] *See generally* IRS Memorandum, Vaughan #8083 (Apr. 1, 1991) (stating that the manufacturing exception would *not* be satisfied merely by imprinting completed software code onto floppy disks, but providing little guidance regarding when it *would* be satisfied).

[7] *See generally* IRC section 954(c)(2)(A), (c)(1)(A).

[8] But (fortunately) not for Irish tax purposes, as explained below.

[9] *See* IRC section 954(c)(3)(A)(i).

[10] *See* IRC section 954(c)(3)(A)(ii).

[11] *See generally* IRC section 367(d)(2)(A), (C).

[12] *Id.*

Software updates are developed under a qualified cost-sharing arrangement between the U.S. parent and Ireland HoldCo.[13] The group's U.S. parent usually retains the legal ownership and domestic exploitation rights, while Ireland HoldCo makes a buy-in payment in exchange for the right to exploit the underlying property overseas. As long as the cost-sharing agreement remains in effect, the U.S. parent should have no additional section 367(d) income regarding the jointly developed software once the initial transfer of code (which is not particularly marketable in light of its imminent obsolescence) has occurred.

C. Foreign Tax Treatment

1. Ireland OpCo

Irish domestic corporations are generally taxed at 12.5 percent on net ''trading income'' but at a higher 25 percent rate for ''passive income.''[14]

Irish tax law does not provide a succinct or precise definition of the term ''trading income,'' but the Irish Revenue authorities have published guidance about when business activity qualifies for the taxpayer-friendly ''trading'' rate.[15] According to this guidance, key factors determining whether income from corporate operations qualifies as ''trading income'' include:

- whether value-adding activities take place in Ireland;
- whether skilled employees are located in Ireland; and
- the nature of the activities performed and the commercial rationale for locating the business in Ireland.

Ireland OpCo's net income from its European sales transactions should be taxed at the (lower) trading rate because of the IP development activities and distribution functions physically based in Ireland.

Importantly, Ireland OpCo employs a variety of techniques to minimize the taxable income base upon which this 12.5 percent rate is assessed. One of these may involve exploiting Ireland's relatively permissive transfer pricing regime. Until 2010, Ireland had an informal and loosely structured statutory scheme regarding transfer pricing. The country promulgated its first detailed transfer pricing legislation in 2010.[16] Generally, this legislation codified the arm's-length principle into Irish statutory law.

Before 2010, Ireland OpCo would exploit Ireland's lack of formal transfer pricing rules by paying an aggressively overpriced royalty in exchange for the IP sublicense (or a high price for inventory purchases) from Ireland HoldCo. Moreover, as explained below, Ireland negotiated advance pricing agreements with Apple and other firms in which the Irish transfer pricing authorities may have allowed some firms to operate at below arm's-length profit levels. The EU's current antitrust investigation is focused primarily on these taxpayer-favorable APAs. The gravamen of the EU's claim is that Ireland's *selective* acquiescence to these below arm's-length prices amounted[17] to illegal state aid to Apple (and possibly others) in violation of EU competition law.

In some circumstances, Ireland OpCo may be required to withhold taxes on the royalty payments flowing up the corporate chain to Ireland HoldCo (whether via the intermediary of Netherlands HoldCo or not). According to Irish domestic law, companies must withhold taxes on ''annual payments'' of royalties. An ''annual payment'' clearly includes payments made regarding patents, but does not necessarily include other types of royalties, such as copyright or trade secret royalties.[18] Apparently, Irish IP law is ambiguous on whether a license to use software code should be placed into the former or the latter category. Ireland OpCo typically construes this ambiguity in its favor, taking the position that its royalty payments are not captured by the ''annual payments'' provision and therefore not subject to withholding tax. As a caveat, note that these provisions of Irish law draw no distinction between resident and nonresident recipients of royalty payments. The withholding tax would apply whether the royalty payments coming out of an Irish entity are bound for another Irish entity or, for example, a Bermuda entity.[19]

The uncertainty regarding the annual payment rules may be responsible for the increasing popularity of the Dutch sandwich step. This provides additional protection to Ireland OpCo regarding its position that it is not required to withhold tax on outgoing royalty payments.

2. Ireland HoldCo

From the perspective of Irish tax law, Ireland HoldCo is not an Irish corporation but rather a resident of Bermuda (or, in Apple's case, a California resident corporation; see below). Generally, Ireland's domestic tax law follows the U.S.-style place-of-incorporation rule for determining corporate tax

[13] *See generally* Treas. reg. section 1.482-7.

[14] *See* TCA 1997, section 21 and 21A.

[15] *See* ''Guidance on Revenue Opinions on Classification of Activities as Trading,'' Irish Revenue Guidance Document, *available at* http://www.revenue.ie/en/practitioner/tech-guide.

[16] *See* 2010 Finance Act, section 42, *codified at* TCA section 835A-835H.

[17] And continue to ''amount,'' since the APAs are apparently still in force.

[18] *See In Re Hanbury,* 38 TC 588 (defining the term ''annual payment'' as a ''pure income profit''), TCA 1997, section 237.

[19] As explained below, Irish tax law considers an Irish-incorporated company managed in Bermuda to be a tax resident of Bermuda, not Ireland, so even if Irish domestic law *did* distinguish between foreign and domestic royalty recipients, the Irish incorporation of the holding entity would be without consequence on the Irish side.

residency. However, there is an important exception. A company incorporated in Ireland may claim residency in its country of ''management and control,'' but only if two prerequisites are satisfied:

- the company must be ''in control'' of a resident Irish corporation; and
- the company must be ''controlled'' by a company that is resident in a state with which Ireland has an income tax treaty.[20]

Ireland HoldCo satisfies both of these criteria. It ''controls'' Ireland OpCo, which is fully tax resident in Ireland, and it is ''controlled'' by its U.S. parent company, which is entitled to the benefits of the Ireland-U.S. tax treaty.

Consequently, Ireland HoldCo is ordinarily not taxed by Ireland. The royalties flowing into the company's coffers from lower-tier subsidiaries therefore escape Irish income taxation that would have resulted if Ireland followed the U.S. place of incorporation rule.[21]

Also, Apple's corporate structure does not involve any entities located in tax havens such as Bermuda. In Apple's structure, the analogue to the generalized Ireland HoldCo (that is, the tax haven entity collecting the company's non-U.S. profits) is a company known as AOI. AOI is a shell entity incorporated in Ireland and whose directors mostly reside in California. It is not liable for any U.S. tax. In fact, AOI files no residency-based corporate income tax returns in any jurisdiction. From a U.S. perspective, it is resident in Ireland,[22] but from an Irish perspective, it is resident in California.[23] As a result, it has been described as being tax resident ''nowhere.''[24]

How AOI manages to avoid triggering U.S. inbound taxation is not entirely clear, but it may be on the basis of the higher inbound threshold afforded by the Ireland-U.S. tax treaty.[25]

Despite these differences, AOI fulfills a role that is substantially similar to that of an entity filing tax returns in the Cayman Islands or Bermuda (that is, declaring a tax residency, and remitting a tax of zero dollars on the basis of that residency status).

It may matter at the margin whether the generalized Ireland HoldCo is resident ''nowhere'' or resident in Bermuda, but the overall functioning of the generalized double Irish structure would seem to be minimally affected by this difference.

3. Netherlands HoldCo

Some firms,[26] especially in recent years, have elected to ''sandwich'' a Netherlands conduit entity between Ireland OpCo and Ireland HoldCo. This company acts as a tax treaty conduit entity, allowing Ireland OpCo to avoid withholding taxes that *may* be owed (but are not *necessarily* owed, as explained above) on its royalty payments to Ireland HoldCo.

According to the Ireland-Netherlands tax treaty, royalty payments may only be taxed in the country of residence (assuming the receiving entity does not have a PE in the source country).[27] Thus, Ireland OpCo is relieved of the uncertainty described above about whether it must withhold tax on the royalties under the ''annual payments'' provision of Irish domestic law. Moreover, there is no limitation on benefits clause in the Ireland-Netherlands treaty, so there is no requirement[28] that Netherlands HoldCo be anything more than a shell entity. Little or no taxable profits remain in the Netherlands, since Netherlands HoldCo pays virtually the same royalty to Ireland HoldCo as it receives from Ireland OpCo. The arrangement relies on the same bilateral treaty in mirror-image fashion to avoid Dutch withholding taxes on this second transfer. Importantly, according to Dutch domestic law, Ireland HoldCo is an Irish tax resident entitled to the benefits of the Ireland-Netherlands treaty (even though Irish domestic law regards it as a Bermuda tax resident).

The entities involved in the scheme may take additional comfort regarding their (lack of) withholding obligations from a number of EU-wide laws that seek to eliminate withholding taxes within the Union. For example, the interest and royalty directive eliminates tax on cross-border interest and royalty payments made between associated companies of different EU member states. For the purpose of the directive, two companies are ''associated'' if, in relevant part, one owns at least

[20] *See generally* TCA 1997, section 23A (defining ''control'' as 50 percent ''commonality of shareholding'').

[21] A substantially identical result would occur if the holding company had simply been incorporated in Bermuda.

[22] Perhaps because its California directors perform activity sufficient to qualify under the ''management and control'' test in Irish tax law.

[23] Those same directors *avoid* carrying out sufficient activity to trigger inbound U.S. taxation obligations.

[24] *See, e.g.,* Carl Levin and John McCain, ''Offshore Profit Shifting and the U.S. Tax Code — Part 2 (Apple Inc.),'' Memorandum — Permanent Subcommittee on Investigations (Senate Committee on Homeland Security & Governmental Affairs), 2 (May 21, 2013) (hereinafter ''Senate memorandum'') (stating that from 2009 to 2012, AOI ''reported a net income of $30 billion, but declined to declare any tax residence, filed no corporate income tax return, and paid no corporate income taxes to any national government for five years'').

[25] *See* Ireland-U.S. treaty article 4(1)(a) (defining ''resident of a Contracting state'' as a person liable to taxation on a residency

(Footnote continued in next column.)

basis under the domestic laws of either country). It is not clear how Ireland's unique tests of residency mesh with the ''liable to tax'' requirements.

[26] But not Apple, apparently.

[27] *See* Ireland-Netherlands tax treaty, articles 10(1) and 10(4).

[28] For treaty purposes, at least.

25 percent of the other.[29] In the double Irish Dutch sandwich scheme, this requirement is easily satisfied because each subsidiary is usually wholly owned by the one above it. The interest and royalty directive attempts to ferret out abusive schemes by incorporating a general antiabuse provision in its text, but this is rarely enforced.

Finally, Dutch domestic law does not levy any withholding tax on royalty payments to nonresident companies lacking a Dutch PE.[30] Thus, even under ordinary Dutch domestic law, Netherlands HoldCo would probably not be required to withhold tax on the royalties it pays to Ireland HoldCo.

In sum, the scheme provides at least four layers of insurance regarding withholding tax obligations. If tax enforcers try to claim that the companies involved in the scheme have neglected their withholding tax obligations on royalties passing up the chain, the company under scrutiny may rely on one or more of:

- Irish domestic law;
- the Ireland-Netherlands tax treaty;
- the EU directive on interest and royalties; and
- Dutch domestic law.

II. The EU Crackdown

The EU has begun to pressure the Irish government into curbing some taxpayer-favorable rules. The crackdown has been spearheaded by the European Commission's Directorate General for Competition, State Aid Registry office.

In general, the European Commission acts as the EU's executive branch and is responsible for implementing and enforcing EU treaty law. The commission derives its jurisdiction from article 17 of the Treaty of the European Union (TEU), as well as articles 244-250 of the TFEU. These treaties, which have gradually evolved from the original legal instruments establishing the European Coal and Steel Community (ESOC), were recently ratified again by the 2007 Treaty of Lisbon.

The TEU and TFEU are directly binding on all EU member states. Article 107(1) of the TFEU forbids any EU member state from selectively providing aid to businesses in a manner that distorts competition or is otherwise ''incompatible with the common market'' among EU member states. Article 108(2) of the same treaty gives the European Commission broad authority to investigate potential violations of this prohibition, while other articles allow the commission to order a ''suspension'' of the offending aid.[31]

The commission's State Aid Registry Office is investigating whether some of Ireland's APAs, which it negotiated with Apple in 1991 and 2007 and which are still in force, amount to illegal state aid in violation of Ireland's obligations under the treaty provisions described above.

In a letter dated June 11, 2014, and published on September 30, 2014 (referred to below as ''EC letter''), European Commission Vice President Joaquín Almunia informed Ireland's Foreign Minister Eamon Gilmore that the commission was initiating a formal investigation into whether Irish transfer pricing practices regarding Apple amount to prohibited state aid in violation of the TFEU's competition rules.

According to the letter, two APAs, originally negotiated in 1991 and amended in 2007, have allowed Apple to operate several unincorporated Irish branches in the country at below arm's-length profit levels.[32] These APAs relate to two of Apple's Irish incorporated but non-tax-resident Irish branches — Apple Operations Europe (AOE) and Apple Sales International (ASI). AOE is a 100 percent owned subsidiary of AOI, which is an Irish incorporated, nonresident company lacking any branch or otherwise taxable presence in Ireland.[33] ASI is a 100 percent owned subsidiary of AOE, and is subject to Irish taxation in the same general manner as its parent company, that is, as an Irish branch or PE, but not as an Irish tax resident (ASI's management and control activities, like those of AOE, occur outside Ireland). ASI's primary function is described as:

> procurement of Apple finished goods from third-party manufacturers . . . onward sale of those products to Apple-affiliated companies and other customers, and logistics operations involved in supplying Apple products from the third-party manufacturers to Apple-affiliated companies and other companies.[34]

The EC letter argues that by allowing ASI and AOE to operate at below arm's-length profit levels, the Irish government unlawfully and selectively provided and

[29] *See* TCA 1997, sections 267G-267L (Irish domestic legislation promulgated under the EU directive).

[30] *See generally* KPMG Country Profile — Netherlands, at 2, *available at* http://www.kpmg.com/Global/en/services/Tax/regional-tax-centers/european-union-tax-centre/Documents/eu-country-profiles/2013-netherlands.pdf.

[31] *See generally* BNA Tax Management Portfolio, ''Business Operations in the European Union,'' 999-2nd, A46(8)-(9) (2013).

[32] *See* EC letter, at 16-19.

[33] AOI also lacks any taxable presence anywhere (even in a tax haven). By analogy to the more generalized ''double Irish'' scheme described above, AOE resembles Ireland OpCo and AOI resembles Ireland HoldCo. One potentially important distinction is that AOE's Irish tax liability is imposed on the basis of its branch/PE in Ireland rather than its residency status — even though AOE maintains an office in Ireland, its management and control is situated elsewhere (perhaps in a tax haven).

[34] EC letter, at 8. AOE's Irish branch apparently ''manufactur[es] a specialized line of personal computers.'' EC letter, at 8.

continues to provide indirect state aid to Apple that threatens the fairness of the EU's common market. In crafting its argument, the EC letter cites case law promulgated by the Court of Justice of the European Union, which has held that article 107(1)'s ban on state aid captures not only direct state subsidies but also ''measures which in various forms mitigate the charges which are normally included in the budget of a [commercial] undertaking.''[35] On the basis of this principle, the letter contends that granting Apple selectively favorable transfer pricing treatment violates the relevant article of the TFEU.

The bulk of the EC letter consists of complaints that Ireland incorrectly employed the cost-plus method in order to calculate appropriate profit levels for ASI and AOE's branch activities. The implication is that Ireland selectively permitted Apple to operate in Ireland at below arm's-length profit levels, allowing the company to misallocate what should have been ASI and AOE's profits either to other subsidiaries in the corporate group or to other taxable branches.

It is difficult to assess whether the agreed-upon cost-plus markups for ASI and AOE are appropriate or whether they are below what would be acceptable or sustainable for a company (or branch) operating at arm's length. Some experts believe the profit levels are not inappropriately low; indeed, according to knowledgeable observers, these profit levels probably are at the high end of what a similarly situated company would expect to collect. The European Commission apparently thinks otherwise.

The EC letter concludes by conveying the commission's decision to open a formal investigation into Ireland's putative violation of the state aid prohibition according to its procedural powers under article 108(2), and warns both Apple and the Irish state that ''all unlawful aid may be recovered from the recipient [Apple, in this case].''[36]

III. Irish Legislative Response

On October 14, 2014, Irish Finance Minister Michael Noonan announced that the country would be strengthening some of its domestic tax rules, a decision undertaken partly in reaction to the negative attention wrought by the current EU investigation.[37]

These measures include eliminating (though not necessarily with immediate effect) the ''management and control'' exception to the tax residency rules, so that any Irish-incorporated business entity would also and without exception be an Irish tax resident liable for tax on its worldwide income.[38] However, Noonan also defended other taxpayer-friendly aspects of Irish tax policy, particularly the country's 12.5 percent tax rate on trading income. The EC letter does not criticize that 12.5 percent tax rate. Indeed, the EU's state aid doctrine is supposedly *not* intended to affect ''legitimate'' tax competition among or between member states.

IV. Comment

In light of the heavy media and legislative attention focused on the idiosyncratic ''management and control'' test for Irish corporate residency, it is odd that the substance of the EU's state aid investigation of Ireland essentially amounts to an allegation that Irish APA negotiators *might* have committed errors in their cost-plus analysis regarding the profitability of Apple's Irish branches. As noted, the EC letter does not focus on or criticize the residency rule.

It may be that the transfer pricing complaint is just a subterfuge for venting frustration at the residency rule. After all, the state aid doctrine under EU law requires that Ireland has provided a *selective* advantage to a firm or groups of firms.[39] Ireland's management and control exception is (or was) available to any company with Irish corporate charters, so it would not provide a sufficient legal basis for a European Commission competition complaint. This may explain why the profit levels discussed in the EC letter do not seem, at first glance, to be inappropriately low; in reality, there may have been little wrong with the APAs under scrutiny. It may also shed light on why Ireland's legislative response (eliminating the double Irish possibility) is often characterized as a response to the EU's aid investigation, even though the two are not directly linked.[40]

There is, however, another possibility, which is that Ireland's residency rules may not actually play an especially important role in allowing this avoidance arrangement to work. Rather than a subterfuge for attacking Ireland's domestic tax law, the EU investigation may reflect a generalized set of grievances regarding the U.S. check-the-box rules, the cost-sharing regime, and legal fictions shared by most domestic tax laws

[35]EC letter, at 15 (*citing Adria-Wien Pipeline* (C-143/00) [2001] ECR, I-8365, para. 38).

[36]*See* EC letter, at 21 (*citing* article 14, Council Regulation (EC) No. 659/1999).

[37]*See generally* John Campbell, ''Irish budget: Michael Noonan is to abolish 'Double Irish' tax structure,'' BBC News (Oct. 14, 2014), *available at* http://www.bbc.com/news/world-europe-29613065.

[38]*See id.*

[39]*See* EC letter, at 19.

[40]*See, e.g.,* Casey Egan, ''Ireland ends 'double Irish' tax loophole favored by Apple, Google, Facebook,'' Irish Central (Oct. 15, 2014), *available at* http://www.irishcentral.com/news/Ireland-ends-double-Irish-tax-loophole-favored-by-Apple-Google-Facebook.html (''The 'double Irish' has permitted corporations registered in Ireland to be tax resident in other countries. . . . However, Ireland's allowance of the double Irish has come under heavy fire in recent months, *with European Union . . . officials calling for an end to the loophole*'' (emphasis added)).

that allow U.S. and European value creation to be redirected to Bermuda, the Cayman Islands, or, in the case of Apple's AOI subsidiary, ''nowhere.'' The double Irish may at bottom represent a colorfully named yet fairly standard hybrid entity mismatch arrangement, one that would not necessarily be damaged by Ireland's elimination of its management and control exception.

It is probably best to explore this possibility via a counterfactual. The counterfactual assumes that in the general avoidance structure described in Section I, Ireland HoldCo has been transformed into Bermuda HoldCo (in Apple's case, assume that AOI, rather than claiming residency ''nowhere,'' asserts that it is a Bermuda resident, is run (minimally) by some Bermuda resident directors, and timely files whatever documents are required by the Bermuda authorities reflecting a residency-based Bermuda tax of nil — since Bermuda has no income tax).

On the U.S. side, most of the crucial details would function more or less identically. The check-the-box election does not require any same country showing, so the activities of the Irish operating subsidiary would still be imputed to Bermuda HoldCo, thus avoiding FBCSI. By the same token, any royalties paid from Ireland OpCo to Bermuda HoldCo would still be ignored from the U.S. perspective so that no FPHCI income would result. At the same time, these royalties would still be deductible against the trading income of the Irish operating subsidiary. The cost-sharing arrangement would not be affected.

Admittedly, Bermuda HoldCo would no longer be able to take advantage of the Irish tax treaty network, but the consequences here are not especially severe. Even if the royalties went directly to Bermuda from Ireland, Irish domestic law would likely not require a withholding tax, as noted above (and any uncertainty would relate to the eligibility of the royalty payments, not the identity of the destination country). If the royalties were indeed paid as a result of a *patent* license, thus triggering Irish withholding, this could be eliminated by routing the payments through Netherlands HoldCo and triggering available tax treaty entitlements. Dutch domestic law does not impose withholding even on patent royalties, so there would be no need to use a tax treaty on the back end of this conduit arrangement, when the royalties would be transferred from Netherlands HoldCo to Bermuda HoldCo. Bermuda HoldCo would no longer be entitled to benefits under the Ireland-U.S. tax treaty, but this never seemed to matter in the first place because Ireland HoldCo may never have been in danger of triggering inbound U.S. tax obligations (and almost surely would not be in danger of U.S. inbound taxation if the directors lived in Hamilton, Bermuda rather than Cupertino, California).

One potentially significant drawback to using Bermuda HoldCo rather than Ireland HoldCo would be that the ''same country exception'' for some passive income under subpart F would no longer be available (because the name on the corporate charter would have changed from ''Ireland'' to ''Bermuda''). However, the protection from inclusions to the U.S. parent afforded by this rule is redundant in light of the check-the-box rules. If check-the-box is eliminated, the change from Ireland HoldCo to Bermuda HoldCo may represent a more significant change. Under current law, the situation would be little different than before.

This counterfactual is intended to illustrate that the Irish ''management and control'' residency rule is not doing heavy lifting in this avoidance arrangement. The double Irish works mainly because of the hybrid entity mismatch possibilities available because of the check-the-box and the cost-sharing regime under U.S. domestic rules.[41] The elimination of the residency rule may entail significant tax costs for companies already employing the structure in terms of reorganizations or recognition events, but these costs would relate to the costs of corporate restructuring rather than any unique avoidance opportunity afforded by the residency rule itself.

In sum, whatever flaws are being exploited in structuring the double Irish, they are not related to flaws or lack of coherence in the Irish domestic tax system. As a result of Ireland's residency rule change, the double Irish may soon become the ''Bermuda Triangle''; indeed, AOI, which is tax resident ''nowhere,'' seems to have already disappeared into it. This may excite headline writers but will likely cause few problems for tax planners (at least as long as check-the-box remains in place). Accordingly, the EU is likely to be left unsatisfied. ◆

[41]In his testimony to the U.S. Senate hearings on Apple's tax structuring, Harvard Law School professor Stephen Shay said that ''In sum, for its non-U.S. sales Apple's use of cost sharing transfers the return to R&D performed in the United States to Ireland (or the ocean).'' Testimony of Stephen Shay, Permanent Subcommittee on Investigations (Senate Committee on Homeland Security & Governmental Affairs) (May 21, 2013).