

## MEMORANDUM

TO: Members of the Permanent Subcommittee on Investigations

FROM: Senator Carl Levin, Chairman  
Senator John McCain, Ranking Minority Member  
Permanent Subcommittee on Investigations

DATE: May 21, 2013

RE: **Offshore Profit Shifting and the U.S. Tax Code - Part 2 (Apple Inc.)**

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|      |   |    |
|------|---|----|
| I.   | EXECUTIVE SUMMARY .....   | 2  |
| A.   | Subcommittee Investigation .....  | 2  |
| B.   | Findings and Recommendations .....  | 5  |
|      | Findings:   |    |
| 1.   | Shifting Profits Offshore .....   | 5  |
| 2.   | Offshore Entities With No Declared Tax Jurisdiction .....                             | 5  |
| 3.   | Cost Sharing Agreement.....   | 5  |
| 4.   | Circumventing Subpart F.....  | 5  |
|      | Recommendations:  |    |
| 1.   | Strengthen Section 482.....   | 6  |
| 2.   | Reform Check-the-Box and Look Through Rules.....                                      | 6  |
| 3.   | Tax CFCs Under U.S. Management and Control .....                                      | 6  |
| 4.   | Properly Enforce Same Country Exception.....  | 6  |
| 5.   | Properly Enforce the Manufacturing Exception .....                                    | 6  |
| II.  | OVERVIEW OF TAX PRINCIPLES AND LAW.....   | 7  |
| A.   | U.S. Worldwide Tax and Deferral.....  | 7  |
| B.   | Transfer Pricing .....  | 7  |
| C.   | Transfer Pricing and the Use of Shell Corporations .....                              | 9  |
| D.   | Piercing the Veil – Instrumentality of the Parent.....                                | 10 |
| E.   | Subpart F To Prevent Tax Haven Abuse .....  | 11 |
| F.   | Subpart F To Tax Current Income .....   | 12 |
| G.   | Check-the-Box Regulations and Look Through Rule.....                                  | 13 |
| H.   | Foreign Personal Holding Company Income – Same Country Exception.....                 | 15 |
| I.   | Foreign Base Company Sales Income – Manufacturing Exception.....                      | 15 |
| III. | APPLE CASE STUDY.....   | 17 |
| A.   | Overview .....  | 17 |
| B.   | Apple Background.....   | 17 |
| 1.   | General Information .....   | 17 |
| 2.   | Apple History .....   | 18 |
| C.   | Using Offshore Affiliates to Avoid U.S. Taxes.....                                    | 19 |
| 1.   | Benefiting From a Minimal Tax Rate.....   | 20 |
| 2.   | Avoiding Taxes By Not Declaring A Tax Residency.....                                  | 21 |
| 3.   | Helping Apple Inc. Avoid U.S. Taxes Via A Cost Sharing Agreement .....                | 25 |
| D.   | Using U.S. Tax Loopholes to Avoid U.S. Taxes on Offshore Income.....                  | 31 |
| 1.   | Foreign Base Company Sales Income: Avoiding Taxation Of Taxable Offshore Income ..... | 33 |
| 2.   | Using Check-the-Box to Make Transactions Disappear.....                               | 35 |
| 3.   | Using Check-the-Box to Convert Passive Income to Active Income .....                  | 36 |
| 4.   | Other Tax Loopholes .....   | 36 |
| E.   | Apple’s Effective Tax Rate .....  | 37 |

## I. EXECUTIVE SUMMARY

On May 21, 2013, the Permanent Subcommittee on Investigations (PSI) of the U.S. Senate Homeland Security and Government Affairs Committee will hold a hearing that is a continuation of a series of reviews conducted by the Subcommittee on how individual and corporate taxpayers are shifting billions of dollars offshore to avoid U.S. taxes. The hearing will examine how Apple Inc., a U.S. multinational corporation, has used a variety of offshore structures, arrangements, and transactions to shift billions of dollars in profits away from the United States and into Ireland, where Apple has negotiated a special corporate tax rate of less than two percent. One of Apple's more unusual tactics has been to establish and direct substantial funds to offshore entities in Ireland, while claiming they are not tax residents of any jurisdiction. For example, Apple Inc. established an offshore subsidiary, Apple Operations International, which from 2009 to 2012 reported 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. A second Irish affiliate, Apple Sales International, received \$74 billion in sales income over four years, but due in part to its alleged status as a non-tax resident, paid taxes on only a tiny fraction of that income.

In addition, the hearing will examine how Apple Inc. transferred the economic rights to its intellectual property through a cost sharing agreement with its own offshore affiliates, and was thereby able to shift tens of billions of dollars offshore to a low tax jurisdiction and avoid U.S. tax. Apple Inc. then utilized U.S. tax loopholes, including the so-called "check-the-box" rules, to avoid U.S. taxes on \$44 billion in taxable offshore income over the past four years, or about \$10 billion in tax avoidance per year. The hearing will also examine some of the weaknesses and loopholes in certain U.S. tax code provisions, including transfer pricing, Subpart F, and related regulations, that enable multinational corporations to avoid U.S. taxes.

### A. Subcommittee Investigation

For a number of years, the Subcommittee has reviewed how U.S. citizens and multinational corporations have exploited and, at times, abused or violated U.S. tax statutes, regulations and accounting rules to shift profits and valuable assets offshore to avoid U.S. taxes. The Subcommittee inquiries have resulted in a series of hearings and reports.<sup>1</sup> The Subcommittee's recent reviews have focused on how multinational corporations have employed various complex structures and transactions to exploit taxloopholes to shift large portions of their profits offshore and dodge U.S. taxes.

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<sup>1</sup> See, e.g., U.S. Senate Permanent Subcommittee on Investigations, "Fishtail, Bacchus, Sundance, and Slapshot: Four Enron Transactions Funded and Facilitated by U.S. Financial Institutions," S.Prt. 107-82 (Jan. 2, 2003); "U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals," S.Hrg. 108-473 (No. 18 and 20, 2003); "Tax Haven Abuses: The Enablers, The Tools and Secrecy," S.Hrg. 109-797 (Aug. 1, 2006); "Tax Haven Banks and U.S. Tax Compliance," S.Hrg. 110-614 (July 17 and 25, 2008); "Tax Haven Banks and U.S. Tax Compliance: Obtaining the Names of U.S. Clients with Swiss Accounts," S.Hrg. 111-30 (Mar. 4, 2009); "Repatriating Offshore Funds: 2004 Tax Windfall for Select Multinationals," S.Prt. 112-27 (Oct. 11, 2011); and "Offshore Profit Shifting and the U.S. Tax Code – Part 1 (Microsoft and Hewlett-Packard)," S.Hrg. 112-\*\*\* (Sept. 20, 2012).

At the same time as the U.S. federal debt has continued to grow – now surpassing \$16 trillion – the U.S. corporate tax base has continued to decline, placing a greater burden on individual taxpayers and future generations. According to a report prepared for Congress:

“At its post-WWII peak in 1952, the corporate tax generated 32.1% of all federal tax revenue. In that same year the individual tax accounted for 42.2% of federal revenue, and the payroll tax accounted for 9.7% of revenue. Today, the corporate tax accounts for 8.9% of federal tax revenue, whereas the individual and payroll taxes generate 41.5% and 40.0%, respectively, of federal revenue.”<sup>2</sup>

Over the past several years, the amount of permanently reinvested foreign earnings reported by U.S. multinationals on their financial statements has increased dramatically. One study has calculated that undistributed foreign earnings for companies in the S&P 500 have increased by more than 400%.<sup>3</sup> According to recent analysis by Audit Analytics, over a five year period from 2008 to 2012, total untaxed indefinitely reinvested earnings reported in 10-K filings for firms comprising the Russell 3000 increased by 70.3%.<sup>4</sup> During the same period, the number of firms reporting indefinitely reinvested earnings increased by 11.4%.

The increase in multinational corporate claims regarding permanently reinvested foreign earnings and the decline in corporate tax revenue are due in part to the shifting of mobile income offshore into tax havens. A number of studies show that multinational corporations are moving “mobile” income out of the United States into low or no tax jurisdictions, including tax havens such as Ireland, Bermuda, and the Cayman Islands.<sup>5</sup> In one 2012 study, a leading expert in the Office of Tax Analysis of the U.S. Department of Treasury found that foreign profit margins, not foreign sales, are the cause for significant increases in profits abroad. He wrote:

“The foreign share of the worldwide income of U.S. multinational corporations (MNCs) has risen sharply in recent years. Data from a panel of 754 large MNCs indicate that the MNC foreign income share increased by 14 percentage points from 1996 to 2004. The differential between a company’s U.S. and foreign effective tax rates exerts a significant effect on the share of its income abroad, largely through changes in foreign and domestic profit margins rather than a shift in sales. U.S.-foreign tax differentials are estimated to have raised the foreign share of MNC worldwide income by about 12 percentage points by 2004. Lower foreign effective tax rates had no significant effect on a company’s domestic sales or on the growth of its worldwide pre-tax profits. Lower taxes on foreign income do not seem to promote ‘competitiveness.’”<sup>6</sup>

<sup>2</sup> 12/8/2011 “Reasons for the Decline in the Corporate Tax Revenues” Congressional Research Service, Mark P. Keightley, at 1. See also 4/2011 “Tax Havens and Treasure Hunts,” *Today’s Economist*, Nancy Folbre.

<sup>3</sup> 4/26/2011 “Parking Earnings Overseas,” Zion, Varsheny, Burnap: Credit Suisse, at 3.

<sup>4</sup> 5/1/2013 Audit Analytics, “Foreign Indefinitely Reinvested Earnings: Balances Held by the Russell 3000.”

<sup>5</sup> See, e.g., 6/5/2010 “Tax Havens: International Tax Avoidance and Evasion,” Congressional Research Service, Jane Gravelle, at 15 (citing multiple studies).

<sup>6</sup> 2/2012 “Foreign Taxes and the Growing Share of U.S. Multinational Company Income Abroad: Profits, Not Sales, are Being Globalized,” Office of Tax Analysis Working Paper 103, U.S. Department of Treasury, Harry Grubert, at 1.

One study showed that foreign profits of controlled foreign corporations (CFCs) of U.S. multinationals significantly outpace the total GDP of some tax havens.”<sup>7</sup> For example, profits of CFCs in Bermuda were 645% and in the Cayman Islands were 546% as a percentage of GDP, respectively. In a recent research report, JPMorgan expressed the opinion that the transfer pricing of intellectual property “explains some of the phenomenon as to why the balances of foreign cash and foreign earnings at multinational companies continue to grow at such impressive rates.”<sup>8</sup>

On September 20, 2012, the Subcommittee held a hearing and examined some of the weaknesses and loopholes in certain tax and accounting rules that facilitated profit shifting by multinational corporations. Specifically, it reviewed transfer pricing, deferral, and Subpart F of the Internal Revenue Code, with related regulations, and accounting standards governing offshore profits and the reporting of tax liabilities. The Subcommittee presented two case studies: (1) a study of structures and practices employed by Microsoft Corporation to shift and keep profits offshore; and (2) a study of Hewlett-Packard’s “staggered foreign loan program,” which was devised to *de facto* repatriate offshore profits to the United States to help run its U.S. operations, without paying U.S. taxes.

The case study for the Subcommittee’s May 2013 hearing involves Apple Inc. Building upon information collected in previous inquiries, the Subcommittee reviewed Apple responses to several Subcommittee surveys, reviewed Apple SEC filings and other documents, requested information from Apple, and interviewed a number of corporate representatives from Apple. The Subcommittee also consulted with a number of tax experts and the IRS.

This memorandum first provides an overview of certain tax provisions related to offshore income, such as transfer pricing, Subpart F, and the so-called check-the-box regulations and look-through rule. It then presents a case study of Apple’s organizational structure and the provisions of the tax code and regulations it uses to shift and keep billions in profits offshore in two controlled foreign corporations formed in Ireland. The first is Apple Sales International (ASI), an entity that has acquired certain economic rights to Apple’s intellectual property. Apple Inc. has used those rights of ASI to shift billions in profits away from the United States to Ireland, where it pays a corporate tax rate of 2% or less. The second is Apple Operations International (AOI), a 30-year old corporation that has no employees or physical presence, and whose operations are managed and controlled out of the United States. Despite receiving \$30 billion in earnings and profits during the period 2009 through 2011 as the key holding company for Apple’s extensive offshore corporate structure, Apple Operations International has no declared tax residency anywhere in the world and, as a consequence, has not paid corporate income tax to any national government for the past 5 years. Apple has recently disclosed that ASI also claims to have no tax residency in any jurisdiction, despite receiving over a four year period from 2009 to 2012, sales income from Apple affiliates totaling \$74 billion.

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<sup>7</sup> 6/5/2010 “Tax Havens: International Tax Avoidance and Evasion,” Congressional Research Service, Jane Gravelle, at 14.

<sup>8</sup> 5/16/2012 “Global Tax Rate Makers,” JPMorgan Chase, at 2 (based on research of SEC filings of over 1,000 reporting issuers).

Apple is an American success story. Today, Apple Inc. maintains more than \$102 billion in offshore cash, cash equivalents and marketable securities (cash).<sup>9</sup> Apple executives told the Subcommittee that the company has no intention of returning those funds to the United States unless and until there is a more favorable environment, emphasizing a lower corporate tax rate and a simplified tax code.<sup>10</sup> Recently, Apple issued \$17 billion in debt instruments to provide funds for its U.S. operations rather than bring its offshore cash home, pay the tax owed, and use those funds to invest in its operations or return dividends to its stockholders. The Subcommittee's investigation shows that Apple has structured organizations and business operations to avoid U.S. taxes and reduce the contribution it makes to the U.S. treasury. Its actions disadvantage Apple's domestic competitors, force other taxpayers to shoulder the tax burden Apple has cast off, and undermine the fairness of the U.S. tax code. The purpose of the Subcommittee's investigation is to describe Apple's offshore tax activities and offer recommendations to close the offshore tax loopholes that enable some U.S. multinational corporations to avoid paying their share of taxes.

## **B. Findings and Recommendations**

**Findings.** The Subcommittee's investigation has produced the following findings of fact.

1. **Shifting Profits Offshore.** Apple has \$145 billion in cash, cash equivalents and marketable securities, of which \$102 billion is "offshore." Apple has used offshore entities, arrangements, and transactions to transfer its assets and profits offshore and minimize its corporate tax liabilities.
2. **Offshore Entities With No Declared Tax Jurisdiction.** Apple has established and directed tens of billions of dollars to at least two Irish affiliates, while claiming neither is a tax resident of any jurisdiction, including its primary offshore holding company, Apple Operations International (AOI), and its primary intellectual property rights recipient, Apple Sales International (ASI). AOI, which has no employees, has no physical presence, is managed and controlled in the United States, and received \$30 billion of income between 2009 and 2012, has paid no corporate income tax to any national government for the past five years.
3. **Cost Sharing Agreement.** Apple's cost sharing agreement (CSA) with its offshore affiliates in Ireland is primarily a conduit for shifting billions of dollars in income from the United States to a low tax jurisdiction. From 2009 to 2012, the CSA facilitated the shift of \$74 billion in worldwide sales income away from the United States to Ireland where Apple has negotiated a tax rate of less than 2%.
4. **Circumventing Subpart F.** The intent of Subpart F of the U.S. tax code is to prevent multinational corporations from shifting profits to tax havens to avoid U.S. tax. Apple has exploited weaknesses and loopholes in U.S. tax laws and regulations, particularly the "check-the-box" and "look-through" rules, to circumvent Subpart F

<sup>9</sup> 4/23/2013 Apple Second Quarter Earnings Call, Fiscal Year 2013, <http://www.nasdaq.com/aspx/call-transcript.aspx?StoryId=1364041&Title=apple-s-ceo-discusses-f2q13-results-earnings-call-transcript>.

<sup>10</sup> Subcommittee interview of Apple Chief Executive Officer Tim Cook (4/29/2013).

taxation and, from 2009 to 2012, avoid \$44 billion in taxes on otherwise taxable offshore income.

**Recommendations.** Based upon the Subcommittee's investigation, the Memorandum makes the following recommendations.

1. **Strengthen Section 482.** Strengthen Section 482 of the tax code governing transfer pricing to eliminate incentives for U.S. multinational corporations to transfer intellectual property to shell entities that perform minimal operations in tax haven or low tax jurisdictions by implementing more restrictive transfer pricing rules concerning intellectual property.
2. **Reform Check-the-Box and Look Through Rules.** Reform the "check-the-box" and "look-through" rules so that they do not undermine the intent of Subpart F of the Internal Revenue Code to currently tax certain offshore income.
3. **Tax CFCs Under U.S. Management and Control.** Use the current authority of the IRS to disregard sham entities and impose current U.S. tax on income earned by any controlled foreign corporation that is managed and controlled in the United States.
4. **Properly Enforce Same Country Exception.** Use the current authority of the IRS to restrict the "same country exception" so that the exception to Subpart F cannot be used to shield from taxation passive income shifted between two related entities which are incorporated in the same country, but claim to be in different tax residences without a legitimate business reason.
5. **Properly Enforce the Manufacturing Exception.** Use the current authority of the IRS to restrict the "manufacturing exception" so that the exception to Subpart F cannot be used to shield offshore income from taxation unless substantial manufacturing activities are taking place in the jurisdiction where the intermediary CFC is located.

## II. OVERVIEW OF TAX PRINCIPLES AND LAW

### A. U.S. Worldwide Tax and Deferral

U.S. corporations are subject to a statutory tax rate of up to a 35% on all their income, including worldwide income, which on its face is a rate among the highest in the world. This statutory tax rate can be reduced, however, through a variety of mechanisms, including tax provisions that permit multinational corporations to defer U.S. tax on active business earnings of their CFCs until those earnings are brought back to the United States, *i.e.*, repatriated as a dividend. The ability of a U.S. firm to earn foreign income through a CFC without US tax until the CFC's earnings are paid as a dividend is known as "deferral." Deferral creates incentives for U.S. firms to shift U.S. earnings offshore to low tax or no tax jurisdictions to avoid U.S. taxes and increase their after tax profits. In other words, tax haven deferral is done for tax avoidance purposes.<sup>11</sup> U.S. multinational corporations shift large amounts of income to low-tax foreign jurisdictions, according to a 2010 report by the Joint Committee on Taxation.<sup>12</sup> Current estimates indicate that U.S. multinationals have more than \$1.7 trillion in undistributed foreign earnings and keep at least 60% of their cash overseas.<sup>13</sup> In many instances, the shifted income is deposited in the names of CFCs in accounts in U.S. banks.<sup>14</sup> In 2012, President Barack Obama reiterated concerns about such profit shifting by U.S. multinationals and called for this problem to be addressed through tax reform.<sup>15</sup>

### B. Transfer Pricing

A major method used by multinationals to shift profits from high-tax to low-tax jurisdictions is through the pricing of certain intellectual property rights, goods and services sold between affiliates. This concept is known as "transfer pricing." Principles regarding transfer pricing are codified under Section 482 of the Internal Revenue Code and largely build upon the principle of arms length dealings. IRS regulations provide various economic methods that can be used to test the arm's length nature of transfers between related parties. There are several ways in which assets or services are transferred between a U.S. parent and an offshore affiliate entity: an outright sale of the asset; a licensing agreement where the economic rights are transferred to the affiliate in exchange for a licensing fee or royalty stream; a sale of services; or a cost sharing agreement, which is an agreement between related entities to share the cost of developing an intangible asset and a proportional share of the rights to the intellectual property

<sup>11</sup> See 12/2000 "The Deferral of Income Earned through U.S. Controlled Foreign Corporations," Office of Tax Policy, U.S. Department of Treasury, at 12.

<sup>12</sup> 7/20/2010 "Present Law and Background Related to Possible Income Shifting and Transfer Pricing," Joint Committee on Taxation, (JCX-37-10), at 7.

<sup>13</sup> 5/16/2012 "Global Tax Rate Makers," JP Morgan Chase, at 1; see also 4/26/11 "Parking Earnings Overseas," Credit Suisse.

<sup>14</sup> See, e.g., U.S. Senate Permanent Subcommittee on Investigations, "Repatriating Offshore Funds: 2004 Tax Windfall for Select Multinationals," S.Rpt. 112-27 (Oct. 11, 2011)(showing that of \$538 billion in undistributed accumulated foreign earnings at the end of FY2010 at 20 U.S. multinational corporations, nearly half (46%) of the funds that the corporations had identified as offshore and for which U.S. taxes had been deferred, were actually in the United States at U.S. financial institutions).

<sup>15</sup> See 2/22/2012 "The President's Framework for Business Tax Reform," <http://www.treasury.gov/resource-center/tax-policy/Documents/The-Presidents-Framework-for-Business-Tax-Reform-02-22-2012.pdf>.

that results. A cost sharing agreement typically includes a “buy-in” payment from the affiliate, which supposedly compensates the parent for transferring intangible assets to the affiliate and for incurring the initial costs and risks undertaken in initially developing or acquiring the intangible assets.

The Joint Committee on Taxation has stated that a “principal tax policy concern is that profits may be artificially inflated in low-tax countries and depressed in high-tax countries through aggressive transfer pricing that does not reflect an arms-length result from a related-party transaction.”<sup>16</sup> A study by the Congressional Research Service raises the same issue. “In the case of U.S. multinationals, one study suggested that about half the difference between profitability in low-tax and high-tax countries, which could arise from artificial income shifting, was due to transfers of intellectual property (or intangibles) and most of the rest through the allocation of debt.”<sup>17</sup> A Treasury Department study conducted in 2007 found the potential for improper income shifting was “most acute with respect to cost sharing arrangements involving intangible assets.”<sup>18</sup>

Valuing intangible assets at the time they are transferred is complex, often because of the unique nature of the asset, which is frequently a new invention without comparable prices, making it hard to know what an unrelated third party would pay for a license. According to one recent study by JPMorgan Chase:

“Many multinationals appear to be centralizing many of their valuable IP [intellectual property] assets in low-tax jurisdictions. The reality is that IP rights are easily transferred from jurisdiction to jurisdiction, and they are often inherently difficult to value.”<sup>19</sup>

The inherent difficulty in valuing such assets enables multinationals to artificially increase profits in low tax jurisdictions using aggressive transfer pricing practices. The Economist has described these aggressive transfer pricing tax strategies as a “big stick in the corporate treasurer’s tax-avoidance armoury.”<sup>20</sup> Certain tax experts, who had previously served in senior government tax positions, have described the valuation problems as insurmountable.<sup>21</sup>

Of various transfer pricing approaches, “licensing and cost-sharing are among the most popular and controversial.”<sup>22</sup> The legal ownership is most often not transferred outside the United States, because of the protections offered by the U.S. legal system and the importance of protecting such rights in such a large market; instead, only the economic ownership of certain

<sup>16</sup> 7/20/2010 “Present Law and Background Related to Possible Income Shifting and Transfer Pricing,” Joint Committee on Taxation, (JCX-37-10), at 5.

<sup>17</sup> 6/5/2010 “Tax Havens: International Tax Avoidance and Evasion,” Congressional Research Service, Jane Gravelle, at 8 (citing 3/2003 “Intangible Income, Intercompany Transactions, Income Shifting and the Choice of Locations,” National Tax Journal, vol. 56.2, Harry Grubert, at 221-42).

<sup>18</sup> 7/20/2010 “Present Law and Background Related to Possible Income Shifting and Transfer Pricing,” Joint Committee on Taxation, (JCX-37-10), at 7 (citing November 2007 “Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties,” U.S. Treasury Department).

<sup>19</sup> 5/16/2012 “Global Tax Rate Makers,” JPMorgan Chase, at 1.

<sup>20</sup> 2008 “An Introduction to Transfer Pricing,” New School Economic Review, vol. 3.1, Alfredo J. Urquidi, at 28 (citing “Moving Pieces,” The Economist, 2/22/2007).

<sup>21</sup> 3/20/2012 “IRS Forms ‘SWAT Team’ for Tax Dodge Crackdown,” Reuters, Patrick Temple-West.

<sup>22</sup> 5/16/2012 “Global Tax Rate Makers,” JPMorgan Chase, at 20.

specified rights to the property is transferred. Generally in a cost sharing agreement, a U.S. parent and one or more of its CFCs contribute funds and resources toward the joint development of a new product.<sup>23</sup> The Joint Committee on Taxation has explained:

“The arrangement provides that the U.S. company owns legal title to, and all U.S. marketing and production rights in, the developed property, and that the other party (or parties) owns rights to all marketing and production for the rest of the world. Reflecting the split economic ownership of the newly developed asset, no royalties are shared between cost sharing participants when the product is ultimately marketed and sold to customers.”<sup>24</sup>

The tax rules governing cost sharing agreements are provided in Treasury Regulations that were issued in December 2011.<sup>25</sup> These regulations were previously issued as temporary and proposed regulations in December 2008. The Treasury Department explained that cost sharing arrangements “have come under intense scrutiny by the IRS as a potential vehicle for improper transfer of taxable income associated with intangible assets.”<sup>26</sup> The regulations provide detailed rules for evaluating the compensation received by each participant for its contribution to the agreement<sup>27</sup> and tighten the rules to “ensure that the participant making the contribution of platform intangibles will be entitled to the lion’s share of the expected returns from the arrangement, as well as the actual returns from the arrangement to the extent they materially exceed the expected returns.”<sup>28</sup> Under these rules, related parties may enter into an arrangement under which the parties share the costs of developing one or more intangibles in proportion to each party’s share of reasonably anticipated benefits from the cost shared intellectual asset.<sup>29</sup> The regulations also provided for transitional grandfathering rules for cost sharing entered into prior to the 2008 temporary regulations. As a result of the changes in the regulations, multinational taxpayers have worked to preserve the grandfathered status of their cost sharing arrangements

### **C. Transfer Pricing and the Use of Shell Corporations**

The Subcommittee’s investigations, as well as government and academic studies, have shown that U.S. multinationals use transfer pricing to move the economic rights of intangible assets to CFCs in tax havens or low tax jurisdictions, while they attribute expenses to their U.S. operations, lowering their taxable income at home.<sup>30</sup> Their ability to artificially shift income to a

<sup>23</sup> 7/20/2010 “Present Law and Background Related to Possible Income Shifting and Transfer Pricing,” Joint Committee on Taxation, (JCX-37-10), at 21.

<sup>24</sup> *Id.*

<sup>25</sup> Treas. Reg. §1.482-7.

<sup>26</sup> 1/25/2012 “U.S. Department of Treasury issues final cost sharing regulations,” International Tax News, Paul Flignor.

<sup>27</sup> 7/20/2010 “Present Law and Background Related to Possible Income Shifting and Transfer Pricing,” Joint Committee on Taxation, (JCX-37-10), at 25.

<sup>28</sup> 1/14/2009 “IRS Issues Temporary Cost Sharing Regulations Effective Immediately” International Alert, Miller Chevalier.

<sup>29</sup> 12/12/2012 “Final Section 482 Cost Sharing Regulations: A Renewed Commitment to the Income Method,” Bloomberg BNA, Andrew P. Solomon.

<sup>30</sup> U.S. Senate Permanent Subcommittee on Investigations, “Offshore Profit Shifting and the U.S. Tax Code – Part 1 (Microsoft and Hewlett-Packard),” S.Hrg.112-\*\*\* (Sept. 20, 2012).

tax haven provides multinationals with an unfair advantage over U.S. domestic corporations; it amounts to a subsidy for those multinationals. The recipient CFC in many cases is a shell entity that is created for the purpose of holding the rights. Shell companies are legal entities without any substantive existence - they have no employees, no physical presence, and produce no goods or services. Such shell companies are “ubiquitous in U.S international tax planning.”<sup>31</sup> Typically, multinationals set up a shell corporation to enable it to artificially shift income to shell subsidiaries in low tax or tax haven jurisdictions.

According to a 2008 GAO study, “eighty-three of the 100 largest publicly traded U.S. corporations in terms of revenue reported having subsidiaries in jurisdictions list as tax havens or financial privacy jurisdictions....”<sup>32</sup> Many of the largest U.S. multinationals use shell corporations to hold the economic rights to intellectual property and the profits generated from those rights in tax haven jurisdictions to avoid U.S. taxation.<sup>33</sup> By doing this, multinational companies are shifting taxable U.S. income on paper to affiliated offshore shells. These strategies are causing the United States to lose billions of tax dollars annually.

Moreover, from a broader prospective, multinationals are able to benefit from the tax rules which assume that different entities of a multinational, including shell corporations, act independently from one another. The reality today is that the entities of a parent multinational typically operate as one global enterprise following a global business plan directed by the U.S. parent. If that reality were recognized, rather than viewing the various affiliated entities as independent companies, they would not be able to benefit from creating fictitious entities in tax havens and shifting income to those entities. In fact, when Congress enacted Subpart F, discussed in detail below, more than fifty years ago in 1962, an express purpose of that law was to stop the deflection of multinational income to tax havens, an activity which is so prevalent today.

#### **D. Piercing the Veil – Instrumentality of the Parent**

It has long been understood that a shell corporation could be at risk of being disregarded for U.S. tax purposes “if one entity so controls the affairs of a subsidiary that it ‘is merely an instrumentality of the parent.’”<sup>34</sup> Courts have applied the “piercing the corporate veil” doctrine, a common law concept, when determining whether to disregard the separateness of two related

<sup>31</sup> Testimony of Professor Reuven S. Avi-Yonah, hearing before the U.S. Senate Committee on Finance, International Tax Issues, S.Hrg. 112-645 (9/8/2011).

<sup>32</sup> 12/4/2008 “Large U.S. Corporations and Federal Contractors with Subsidiaries in Jurisdictions Listed as Tax Havens or Financial Privacy Jurisdictions,” U.S. Government Accountability Office, No. GAO-09-157, at 4.

<sup>33</sup> See, e.g., 2/16/2013 “The price isn’t right: Corporate profit-shifting has become big business,” The Economist, Special Report.

<sup>34</sup> 2/2011 “Recent IRS determination Highlights Importance of Separation Among Affiliates,” by George E. Constantine, at 1, <http://www.venable.com/recent-irs-determination-highlights-importance-of-separation-among-affiliates-02-24-2011/> (originally published in February 2011 edition of Association Law and Policy, <https://www.asacenter.org/Resources/EnewsletterArticleDetail.cfm?ItemNumber=57654>, (citing IRS Priv. Ltr. Rul. 2002-25-046 (Mar. 28, 2002), which cites Moline Properties v. Commissioner of Internal Revenue, 319 U.S. 436, 438 (1943); Britt v. United States, 431 F. 2d 227, 234 (5th Cir. 1970); and Krivo Indus. Supply Co. v. National Distillers and Chem. Corp., 483 F.2d 1098, 1106 (5th Cir. 1973)).

entities for corporate and tax liabilities.<sup>35</sup> It is a fact-specific analysis to determine whether the veil of a shell entity should be pierced for tax purposes. The courts over time have looked at such factors as: the financial support of the subsidiary's operations by the parent; the lack of substantial business contacts with anyone except the parent; and whether the property of the entity is used by each as if jointly owned.<sup>36</sup> Despite the availability of this tool to "sham" a corporation and pierce the corporate veil for tax purposes, the IRS and the courts have been hesitant to take action against shell foreign corporations or attribute the activities or income of a CFC to its U.S. parent.<sup>37</sup>

### **E. Subpart F To Prevent Tax Haven Abuse**

As early as the 1960s, "administration policymakers became concerned that U.S. multinationals were shifting their operations and excess earnings offshore in response to the tax incentive provided by deferral."<sup>38</sup> At that time, circumstances were somewhat similar to the situation in the United States today. "The country faced a large deficit and the Administration was worried that U.S. economic growth was slowing relative to other industrialized countries."<sup>39</sup> To help reduce the deficit, the Kennedy Administration proposed to tax the current foreign earnings of subsidiaries of multinationals and offered tax incentives to encourage investments at home.<sup>40</sup>

In the debates leading up to the passage of Subpart F, President Kennedy stated in an April 1961 tax message:

"The undesirability of continuing deferral is underscored where deferral has served as a shelter for tax escape through the unjustifiable use of tax havens such as Switzerland. Recently more and more enterprises organized abroad by American firms have arranged their corporate structures aided by artificial arrangements between parent and subsidiary regarding intercompany pricing, the transfer of patent licensing rights, the shifting of management fees, and similar practices which maximize the accumulation of profits in the tax haven as to exploit the multiplicity of foreign tax systems and international

<sup>35</sup> Id. See also, e.g., *Moline Properties v. Commissioner of Internal Revenue*, 319 U.S. 436, 439 (1943) (holding that, for income tax purposes, a taxpayer cannot ignore the form of the corporation that he creates for a valid business purpose or that subsequently carries on business, unless the corporation is a sham or acts as a mere agent).

<sup>36</sup> Id.

<sup>37</sup> Id. See also *Perry Bass v. Commissioner*, 50 T.C. 595, 600 (1968) ("[A] taxpayer may adopt any form he desires for the conduct of his business, and ... the chosen form cannot be ignored merely because it results in a tax saving." However, the form the taxpayer chooses for conducting business that results in tax-avoidance "must be a viable business entity, that is, it must have been formed for a substantial business purpose or actually engage in substantive business activity.")

<sup>38</sup> 5/4/2006 "The Evolution of International Tax Policy- What Would Larry Say?" The Laurence Neal Woodworth Memorial Lecture in Federal Tax Law and Policy, Paul Oosterhuis, at 2, <http://www.taxanalysts.com/www/features.nsf/articles/3193a0ff95f96d378525726b006f4ad2?opendocument>.

<sup>39</sup> Id.

<sup>40</sup> Id. (citing 1/11/1962 "Annual Message to Congress on the State of the Union," President Kennedy 1 Pub. Papers, at 13-14).

agreements in order to reduce sharply or eliminate completely their tax liabilities both at home and abroad.”<sup>41</sup>

Although the Kennedy Administration initially proposed to end deferral of foreign source income altogether, a compromise was struck instead, which became known as Subpart F.<sup>42</sup> Subpart F was enacted by Congress in 1962, and was designed in substantial part to address the tax avoidance techniques being utilized today by U.S. multinationals in tax havens. In fact, to curb tax haven abuses, Congress enacted anti-tax haven provisions, despite extensive opposition by the business community.<sup>43</sup>

## F. Subpart F To Tax Current Income

Subpart F explicitly restricts the types of income whose taxation may be deferred, and it is often referred to as an “anti-deferral” regime. The Subpart F rules are codified in tax code Sections 951 to 965, which apply to certain income of CFCs.<sup>44</sup> When a CFC earns Subpart F income, the U.S. parent as shareholder is treated as having received the current income. Subpart F was enacted to deter U.S. taxpayers from using CFCs located in tax havens to accumulate earnings that could have been accumulated in the United States.<sup>45</sup> “[S]ubpart F generally targets passive income and income that is split off from the activities that produced the value in the goods or services generating the income,” according to the Treasury Department’s Office of Tax Policy.<sup>46</sup> In contrast, income that is generated by active, foreign business operations of a CFC continues to warrant deferral. But, again, deferral is not permitted for passive, inherently mobile income such as royalty, interest, or dividend income, as well as income resulting from certain other activities identified in Subpart F.<sup>47</sup> Income reportable under Subpart F is currently subject to U.S. tax, regardless of whether the earnings have been repatriated. However, regulations, temporary statutory changes, and certain statutory exceptions have nearly completely undercut the intended application of Subpart F.

<sup>41</sup> 1961 “President’s Recommendations on Tax Revision: Hearings Before the House Ways and Means Committee,” reprinted in Richard A. Gordon, *Tax Havens and Their Use by United States Taxpayers – An Overview*, (2002), at 44.

<sup>42</sup> 5/4/2006 “The Evolution of International Tax Policy- What Would Larry Say?” The Laurence Neal Woodworth Memorial Lecture in Federal Tax Law and Policy, Paul Oosterhuis, at 3, <http://www.taxanalysts.com/www/features.nsf/articles/3193a0ff95f96d378525726b006f4ad2?opendocument>.

<sup>43</sup> See, e.g., 12/2000 “The Deferral of Income Earned through U.S. Controlled Foreign Corporations,” Office of Tax Policy, U.S. Department of Treasury, at 21.

<sup>44</sup> A CFC is a foreign corporation more than 50% of which, by vote or value, is owned by U.S. persons owning a 10% or greater interest in the corporation by vote (“U.S. shareholders”). “U.S. persons” include U.S. citizens, residents, corporations, partnerships, trusts and estates. IRC Section 957.

<sup>45</sup> See *Koehring Company v. United States of America*, 583 F.2d 313 (7th Cir. 1978). See also 12/2000 “The Deferral of Income Earned through U.S. Controlled Foreign Corporations,” Office of Tax Policy, U.S. Department of Treasury, at xii.

<sup>46</sup> 12/2000 “The Deferral of Income Earned through U.S. Controlled Foreign Corporations,” Office of Tax Policy, U.S. Department of Treasury, at xii.

<sup>47</sup> IRC Section 954(c).

## G. Check-the-Box Regulations and Look Through Rule

“Check-the-box” tax regulations issued by the Treasury Department in 1997, and the CFC “look-through rule” first enacted by Congress as a temporary measure in 2006, have significantly reduced the effectiveness of the anti-deferral rules of Subpart F and have further facilitated the increase in offshore profit shifting, which has gained significant momentum over the last 15 years. Treasury issued the check-the-box regulations which became effective on January 1, 1997. Treasury stated at the time that the regulations were designed to simplify tax rules for determining whether an entity is a corporation, a partnership, a sole proprietorship, branch or disregarded entity (DRE) for federal tax purposes.<sup>48</sup> The regulations eliminated a multi-factor test in determining the proper classification of an entity in favor of a simple, elective “check-the-box” regime. Treasury explained that the rules were intended to solve two problems that had developed for the IRS. First, the rise of limited liability companies (LLCs) domestically had placed stress on the multi-factor test, which determined different state and federal tax treatment for them. Second, international entity classification was dependent upon foreign law, making IRS classification difficult and complex. Check-the-box was intended to eliminate the complexity and uncertainty inherent in the test, allowing entities to simply select their tax treatment.

The regulations, however, had significant unintended consequences and opened the door to a host of tax avoidance schemes. Under Subpart F, passive income paid from one separate legal entity to another separate legal entity – even if they were both within the same corporate structure – was immediately taxable. However, with the implementation of the check-the-box regulations, a U.S. multinational could set up a CFC subsidiary in a tax haven and direct it to receive passive income such as interest, dividend, or royalty payments from a lower tiered related CFC without it being classified as Subpart F income. The check-the-box rule permitted this development, because it enabled the multinational to choose to have the lower tiered CFC disregarded or ignored for federal tax purposes. In other words, the lower tiered CFC, although it was legally still a separate entity, would be viewed as part of the higher tiered CFC and not as a separate entity for tax purposes. Therefore, for tax purposes, any passive income paid by the lower tiered entity to the higher tiered CFC subsidiary would not be considered as a payment between two legally separate entities and, thus, would not constitute taxable Subpart F income. The result was that the check-the-box regulations enabled multinationals for tax purposes to ignore the facts reported in their books – which is that they received passive income. Similarly, check-the-box can be used to exclude other forms of Subpart F income, including Foreign Base Company Sales Income, discussed below.

Recognizing this inadvertent problem, the IRS and Treasury issued Notice 98-11 on February 9, 1998, reflecting concerns that the check-the-box regulations were facilitating the use of what the agencies refer to as “hybrid branches” to circumvent Subpart F. “The notice defined a hybrid branch as an entity with a single owner that is treated as a separate entity under the relevant tax laws of a foreign country and as a branch (i.e., DRE) of a CFC that is its sole owner for U.S. tax purposes.”<sup>49</sup> The Notice stated: “Treasury and the Service have concluded that the

<sup>48</sup> IRC Sections 301.7701-1 through 301.7701-3 (1997).

<sup>49</sup> 7/20/2010 “Present Law and Background Related to Possible Income Shifting and Transfer Pricing,” Joint Committee on Taxation, (JCX-37-10), at 48.

use of certain hybrid branch arrangements [described in Examples 1 and 2 of the Notice] is contrary to the policies and rules of subpart F. This notice (98-11) announces that Treasury and the Service will issue regulations to address such arrangements.”<sup>50</sup>

On March 26, 1998, Treasury and the IRS proposed regulations to close the loophole opened by the check-the-box rule to prevent the unintended impact to Subpart F. Recognizing that neither had the authority to change the tax law, the IRS and Treasury stated in the proposed rule “the administrative provision [check-the-box] was not intended to change substantive law. Particularly in the international area, the ability to more easily achieve fiscal transparency can lead to inappropriate results under certain provisions [of subpart F] of the Code.”<sup>51</sup>

As noted by the Joint Committee on Taxation, “The issuance of Notice 98-11 and the temporary and proposed regulations provoked controversy among taxpayers and members of Congress.”<sup>52</sup> On July 6, 1998, Treasury and the IRS reversed course in Notice 98-35, withdrawing Notice 98-11 and the proposed regulations issued on March 26, 1998. The agencies reversed course despite their expressed concern that the check-the-box rules had changed substantive tax law as set out in Subpart F. The result left the check-the-box loophole open, providing U.S. multinationals with the ability to shift income offshore without the threat of incurring Subpart F taxation on passive foreign income.

Because the check-the-box rule was a product of Treasury regulations and could be revoked or revised at any time, proponents of the rule urged Congress to enact supporting legislation. In 2006, Congress eliminated related party passive income generally from subpart F when it enacted Section 954(c)(6) on a temporary basis. This Section was enacted into law without significant debate as part of a larger tax bill.<sup>53</sup> It provided “look-through” treatment for certain payments between related CFCs, and became known as the CFC look-through rule. It granted an exclusion from Subpart F income for certain dividends, interest, rents and royalties received or accrued by one CFC from a related CFC. As one analyst has explained:

“*Section 954(c)(6)* came into the law somewhat quietly, through an oddly named piece of legislation (the Tax Increase Prevention and Reconciliation Act of 2005, or TIPRA, which was enacted in May 2006). *Section 954(c)(6)* had earlier passed the Senate and the House as part of the American Jobs Creation Act of 2004, but was then dropped without explanation in conference. When it reemerged one-and-a-half years later in TIPRA it did not attract huge pre-enactment attention, and when finally enacted, its retroactive effective date surprised some taxpayers.”<sup>54</sup>

The 2006 statutory look-through provision expired on December 31, 2009, but was retroactively reinstated for 2010, and extended through 2011, by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, enacted on December 17, 2010. It was

<sup>50</sup> 1/16/1998, IRS Notice 98-11, at 2.

<sup>51</sup> 3/26/1998 “Guidance Under Subpart F Relating to Partnerships and Branches,” 26 CFR Parts 1 and 301 [TD 8767], at 2.

<sup>52</sup> 7/20/2010 “Present Law and Background Related to Possible Income Shifting and Transfer Pricing,” Joint Committee on Taxation, (JCX-37-10), at 49.

<sup>53</sup> Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, § 103(b)(1) (2006).

<sup>54</sup> 4/23/2007 “The New Look-Through [R]ule: W[h]ither Subpart F?” Tax Notes, David Sicular, at 359.

then retroactively reinstated again for 2012, and extended through December 31, 2013 by the American Taxpayer Relief Act, enacted on January 2, 2013.

In addition to the regulations and temporary statutory provisions that have undercut Subpart F's effort to tax offshore passive income, certain statutory exceptions have also weakened important provisions of the law. Two of those exceptions relevant to the Subcommittee's review of Apple are the "same country exception" and "manufacturing exception."

## **H. Foreign Personal Holding Company Income – Same Country Exception**

A major type of taxable Subpart F offshore income is referred to in the tax code as Foreign Personal Holding Company Income (FPHC).<sup>55</sup> It consists of passive income such as dividends, royalties, rents and interest.<sup>56</sup> One example of FPHC income that is taxable under Subpart F is a dividend payment made from a lower tiered to a higher tiered CFC. Another example would be a royalty payment made from one CFC to another. Under Subpart F, both types of passive income received by the CFCs are treated as taxable income in the year received for the U.S. parent.

There are several exceptions, however, to current taxation of FPHC income under Subpart F.<sup>57</sup> One significant exclusion exists for certain dividends, interest and royalties where the payor CFC is organized and operating in the same foreign country as the related CFC recipient. This exclusion is often referred to as the "same country exception." The purpose of this exception is to shield from taxation a payment from one related CFC to another in the same country, on the theory that since both CFCs are subject to the same tax regime, they would have little incentive to engage in tax transactions to dodge U.S. taxes.

## **I. Foreign Base Company Sales Income – Manufacturing Exception**

A second key type of taxable Subpart F offshore income is referred to in the tax code as Foreign Base Company Sales (FBCS) income. FBCS income generally involves a CFC which is organized in one jurisdiction, used to buy goods, typically from a manufacturer in another jurisdiction, and then sells the goods to a related CFC for use in a third jurisdiction, while retaining the income resulting from those transactions. It is meant to tax the retained profits of an intermediary CFC which typically sits in a tax haven. More specifically, FBCS income is income attributable to related-party sales of personal property made through a CFC, if the country of the CFC's incorporation is neither the origin nor the destination of the goods and the CFC itself has not "manufactured" the goods.<sup>58</sup> In other words, for the income to be considered foreign base company sales income, the personal property must be both produced outside the CFC's country of organization and distributed or sold for use outside that same country.<sup>59</sup> The

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<sup>55</sup> IRC Section 954(c).

<sup>56</sup> IRC Section 954(c).

<sup>57</sup> 7/20/2010 "Present Law and Background Related to Possible Income Shifting and Transfer Pricing," Joint Committee on Taxation, (JCX-37-10), at 36.

<sup>58</sup> IRC Section 954(a)(2).

<sup>59</sup> IRC Section 954(d)(1).

purpose of taxing FBCS income under Subpart F was to discourage multinationals from splitting the manufacturing function from the sales function to deflect sales income to a tax haven jurisdiction.

An exclusion known as the “manufacturing exception” was created, however, for certain FBCS income. Under this exception, the income retained by the intermediary CFC would not be taxed if the CFC itself were a manufacturer and added substantive value to the goods. In 2008, the regulations governing the manufacturing exception were liberalized to make it very easy for a company to claim the exception, further undermining Subpart F. The 2008 regulations provided that “[a] CFC can qualify for the manufacturing exception if it meets one of three tests. The first two [are] physical manufacturing tests: the substantial transformation test and the substantial activity test. The third test [is] the substantial contribution test.”<sup>60</sup> Moving from a requirement that the CFC demonstrate that it performed a manufacturing activity to demonstrating that it made a “substantial contribution” to the goods being sold has transformed this exception into another possible loophole to shield offshore income from Subpart F taxation.

These exceptions and loopholes, as well as other tax provisions, often form overlapping layers of protection against offshore income being taxed under Subpart F. In many instances, a multinational corporation may have multiple exceptions or loopholes available to it to dodge U.S. taxes. For example, as noted above, certain types of passive income may be excluded from Subpart F inclusion through the use of the check-the-box regulations, the look-through rule, or the same country exception. Similarly, FBCS income may be excluded through the use of the check-the-box regulations or the manufacturing exception. If one is not available or taken away, other provisions may be relied on to circumvent the original intent of Subpart F. Through the benefits of deferral and various regulatory and statutory exceptions, the tax code has created multiple incentives for multinational corporations to move income offshore to low or no tax jurisdictions and provided multiple methods to avoid current tax on those offshore transfers. The purpose of the Subcommittee’s investigation is to examine those tax loopholes and find an effective way of closing them.

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<sup>60</sup> 7/20/2010 “Present Law and Background Related to Possible Income Shifting and Transfer Pricing,” Joint Committee on Taxation, (JCX-37-10), at 38.

### **III. APPLE CASE STUDY**

#### **A. Overview**

The Apple case study examines how Apple Inc., a U.S. corporation, has used a variety of offshore structures, arrangements, and transactions to shift billions of dollars in profits away from the United States and into Ireland, where Apple has negotiated a special corporate tax rate of less than 2%. One of Apple's more unusual tactics has been to establish and direct substantial funds to offshore entities that are not declared tax residents of any jurisdiction. In 1980, Apple created Apple Operations International, which acts as its primary offshore holding company but has not declared tax residency in any jurisdiction. Despite reporting net income of \$30 billion over the four-year period 2009 to 2012, Apple Operations International paid no corporate income taxes to any national government during that period. Similarly, Apple Sales International, a second Irish affiliate, is the repository for Apple's offshore intellectual property rights and the recipient of substantial income related to Apple worldwide sales, yet claims to be a tax resident nowhere and may be causing that income to go untaxed.

In addition, this case study examines how Apple Inc. transferred the economic rights to its intellectual property through a cost sharing agreement to two offshore affiliates in Ireland. One of those affiliates, Apple Sales International, buys Apple's finished products from a manufacturer in China, re-sells them at a substantial markup to other Apple affiliates, and retains the resulting profits. Over a four-year period, from 2009 to 2012, this arrangement facilitated the shift of about \$74 billion in worldwide profits away from the United States to an offshore entity with allegedly no tax residency and which may have paid little or no income taxes to any national government on the vast bulk of those funds. Additionally, the case study shows how Apple makes use of multiple U.S. tax loopholes, including the check-the-box rules, to shield offshore income otherwise taxable under Subpart F. Those loopholes have enabled Apple, over a four year period from 2009 to 2012, to defer paying U.S. taxes on \$44 billion of offshore income, or more than \$10 billion of offshore income per year. As a result, Apple has continued to build up its offshore cash holdings which now exceed \$102 billion.

#### **B. Apple Background**

##### **1. General Information**

Apple Inc. is headquartered in Cupertino, California. It was formed as a California corporation on January 3, 1977, and has been publicly traded for more than 30 years. The current Chairman of the Board is Arthur D. Levinson, Ph.D., and the Chief Executive Officer (CEO) is Tim Cook. Apple is a personal computer and technology company specializing in the design and sale of computers, mobile telephones, and other high-technology personal goods. The sales of personal computers, mobile telephones, and related devices accounts for 95% of Apple's business, while the remaining 5% comes from the sale of related software and digital media.

The company has approximately 80,000 employees worldwide, with 52,000 of those in the United States. The U.S. jobs include 10,000 Apple advisors and 26,000 retail employees. In

2012, Apple reported in its public filings with the Securities and Exchange Commission (SEC) net income of \$41.7 billion, based upon revenues of \$156.5 billion.<sup>61</sup> These figures translate into earnings per share of \$44.15.<sup>62</sup>

Apple conducts its business geographically, with operations for North and South America, including the United States, headquartered in California, and operations for the rest of the world, including Europe, the Middle East, India, Africa, Asia, and the Pacific, headquartered in Ireland.<sup>63</sup> Apple develops its products through research and development conducted primarily in the United States; the materials and components for Apple products are sourced globally.<sup>64</sup> The finished products are typically assembled by a third party manufacturer in China and distributed throughout the world via distribution centers headquartered in the United States and Ireland.<sup>65</sup>

## 2. Apple History

Apple was founded in 1976 by Steve Jobs, Steve Wozniak, and Ronald Wayne, to design and sell personal computers.<sup>66</sup> In the late 1970s, Apple decided to expand its presence in Europe and, in the summer of 1980, established several Irish affiliates. Apple entered into a cost-sharing agreement with two of them, Apple Operations Europe (AOE) and its subsidiary, Apple Sales International (ASI).<sup>67</sup> Under the terms of the cost-sharing agreement, Apple's Irish affiliates shared Apple's research and development costs, and in exchange, were granted the economic rights to use the resulting intellectual property. At the time in 1980, Apple's Irish affiliate manufactured the products for sale in Europe.

In December 1980, Apple had its initial public offering of stock and began trading on the New York Stock Exchange.<sup>68</sup> During the 1980s and 1990s, Apple expanded its product lines. While the majority of Apple's research and development continued to be conducted in the United States, its products were manufactured in both California and Cork, Ireland.

By the late 1990s, Apple was experiencing severe financial difficulties and, in 1996 and 1997, incurred two consecutive years of billion-dollar losses. In response, Apple significantly restructured its operations, eliminating many of its product lines and streamlining its offshore operations. In addition, Apple began to outsource much of its manufacturing, using third-party manufacturers to produce the components for the products developed in its California facilities.

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<sup>61</sup> Apple Inc. Annual Report (Form-10K), at 24 (10/21/2012).

<sup>62</sup> *Id.*

<sup>63</sup> Subcommittee interviews of Cathy Kearney, Apple Distribution International, Vice President of European Operations (4/19/2013) and Tim Cook, Apple Inc.'s former Chief Operating Officer and current Chief Executive Officer (4/29/2013). See also Information supplied to Subcommittee by Apple, APL-PSI-000351.

<sup>64</sup> Subcommittee interviews of Cathy Kearney (4/19/2013) and Tim Cook (4/29/2013).

<sup>65</sup> *Id.*

<sup>66</sup> See "30 Pivotal Moments In Apple's History," *Macworld*, Owen W. Linzmayer, (3/30/2006),

<http://www.macworld.com/article/1050112/30moments.html>.

<sup>67</sup> Apple's first cost-sharing agreement was executed on December 1, 1980. See information supplied to Subcommittee by Apple, APL-PSI-000003. AOE was then named Apple Computer Ltd., and ASI was then named Apple Computer International, Inc. *Id.*

<sup>68</sup> Apple Inc – Frequently Asked Questions, <http://investor.apple.com/faq>.

Apple also outsourced the assembly of nearly all of its finished products to a third party manufacturer in China. Apple subsequently consolidated its financial management in five shared service centers, with the service center for the Europe region located in Cork, Ireland. It also eliminated over 150 bank accounts in foreign affiliates and established a policy of consolidating excess offshore cash in bank accounts held by its Irish affiliates.

According to Apple, it currently has about \$145 billion in cash, cash equivalents and marketable securities, of which \$102 billion is “offshore.”<sup>69</sup> As of 2011, Apple held between 75 and 100% of those offshore cash assets in accounts at U.S. financial institutions.<sup>70</sup>

### **C. Using Offshore Affiliates to Avoid U.S. Taxes**

Apple continues to organize its sales by dividing them between two regions as it has since 1980. Apple Inc. in the United States is responsible for coordinating sales for the Americas, and Apple’s Irish affiliate - Apple Sales International (ASI) is responsible for selling Apple products to Europe, the Middle East, Africa, India, Asia and the Pacific.<sup>71</sup> Apple bifurcates its economic intellectual property rights along these same lines. Apple Inc. is the sole owner of the legal rights to Apple intellectual property. Through a cost-sharing arrangement, Apple Inc. owns the economic rights to Apple’s intellectual property for goods sold in the Americas, while Apple’s Irish affiliates, Apple Sales International (ASI) and its parent, Apple Operations Europe Inc. (AOE), own the economic rights to intellectual property for goods sold in Europe, the Middle East, Africa, India, and Asia (“offshore”).<sup>72</sup> According to Apple, this cost sharing-arrangement enables Apple to produce and distribute products around the world.

Apple Inc. conducts its offshore operations through a network of offshore affiliates. The key affiliates at the top of the offshore network are companies that are incorporated in Ireland and located at the same address in Cork, Ireland. Apple’s current offshore organizational structure in Ireland is depicted in the following chart:

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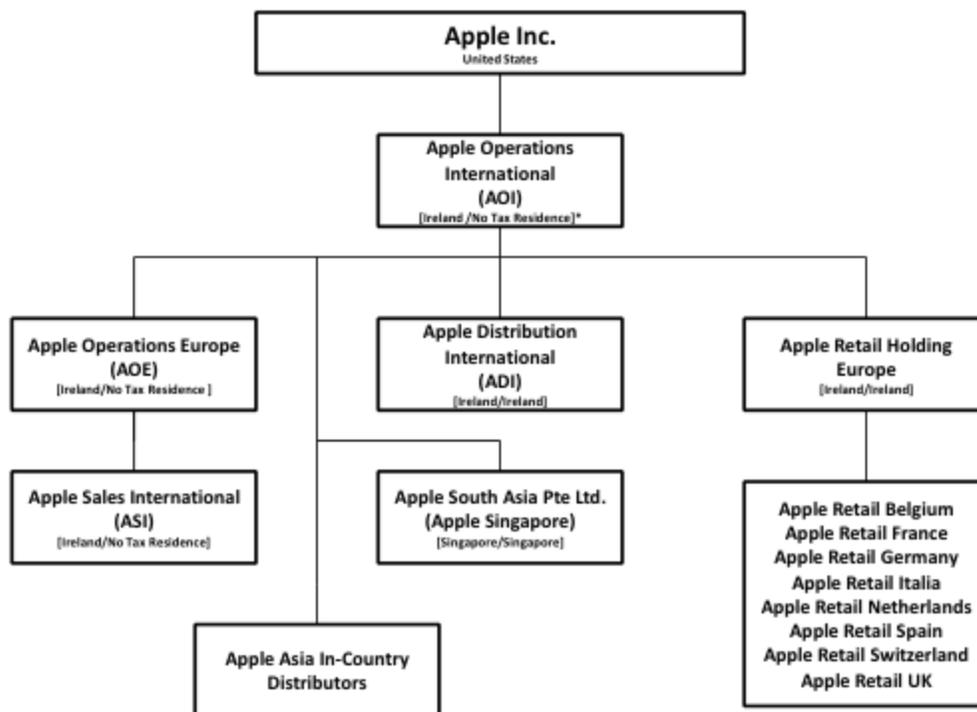
<sup>69</sup> 4/23/2013 Apple Second Quarter Earnings Call, Fiscal Year 2013, <http://www.nasdaq.com/aspx/call-transcript.aspx?StoryId=1364041&Title=apple-s-ceo-discusses-f2q13-results-earnings-call-transcript>.

<sup>70</sup> U.S. Senate Permanent Subcommittee on Investigations, “Offshore Funds Located Onshore,” (12/14/2011), at 5 (an addendum to “Repatriating Offshore Funds: 2004 Tax Windfall for Select Multinationals,” S.Rpt. 112-27 (Oct. 11, 2011)).

<sup>71</sup> Information supplied to Subcommittee by Apple, APL-PSI-000351.

<sup>72</sup> Id. See also Amended & Restated Cost Sharing Agreement between Apple Inc., Apple Operations Europe, & Apple Sales International, APL-PSI-000020 [Sealed Exhibit].

## Apple's Offshore Organizational Structure



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

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

### 1. Benefiting from A Minimal Tax Rate

A number of Apple's key offshore subsidiaries are incorporated in Ireland. A primary reason may be the unusually low corporate income tax rate provided by the Irish government. Apple told the Subcommittee that, for many years, Ireland has provided Apple affiliates with a special tax rate that is substantially below its already relatively low statutory rate of 12 percent. Apple told the Subcommittee that it had obtained this special rate through negotiations with the Irish government.<sup>73</sup> According to Apple, for the last ten years, this special corporate income tax rate has been 2 percent or less:

“Since the early 1990’s, the Government of Ireland has calculated Apple’s taxable income in such a way as to produce an effective rate in the low single digits .... The rate has varied from year to year, but since 2003 has been 2% or less.”<sup>74</sup>

Other information provided by Apple indicates that the Irish tax rate assessed on Apple affiliates has recently been substantially below 2%. For example, Apple told the Subcommittee that, for the three year period from 2009 to 2011, ASI paid an Irish corporate income tax rate that

<sup>73</sup> Subcommittee interview of Phillip Bullock, Apple Inc. Tax Operations Head (5/15/2013).

<sup>74</sup> Information supplied to Subcommittee by Apple, PSI-Apple-02-0004.

was consistently below far below 1% and, in 2011, was as low as five-hundredths of one percent (0.05%):

**Global Taxes Paid by ASI, 2009-2011**

|                         | <b>2011</b>   | <b>2010</b>   | <b>2009</b>  | <b>Total</b>  |
|-------------------------|---------------|---------------|--------------|---------------|
| <b>Pre-Tax Earnings</b> | \$ 22 billion | \$ 12 billion | \$ 4 billion | \$ 38 billion |
| <b>Global Tax</b>       | \$ 10 million | \$ 7 million  | \$ 4 million | \$ 21 million |
| <b>Tax Rate</b>         | 0.05%         | 0.06%         | 0.1%         | 0.06%         |

Source: Apple Consolidating Financial Statements, APL-PSI-000130-232 [Sealed Exhibit]

These figures demonstrate that Ireland has essentially functioned as a tax haven for Apple, providing it with minimal income tax rates approaching zero.

## 2. Avoiding Taxes By Not Declaring A Tax Residency

### (a) Apple Operations International (AOI)

Apple's first tier offshore affiliate, as indicated in the earlier chart, is Apple Operations International (AOI). Apple Inc. owns 100% of AOI, either directly or indirectly through other controlled foreign corporations.<sup>75</sup> AOI is a holding company that is the ultimate owner of most of Apple's offshore entities. AOI holds, for example, the shares of key entities at the second tier of the Apple offshore network, including Apple Operations Europe (AOE), Apple Distribution International (ADI), Apple South Asia Pte Ltd. (Apple Singapore), and Apple Retail Europe Holdings, which owns entities that operate Apple's retail stores throughout Europe. In addition to holding their shares, AOI serves a cash consolidation function for the second-tier entities as well as for most of the rest of Apple's offshore affiliates, receiving dividends from and making contributions to those affiliates as needed.<sup>76</sup>

AOI was incorporated in Ireland in 1980.<sup>77</sup> Apple told the Subcommittee that it is unable to locate the historical records regarding the business purpose for AOI's formation, or the purpose for its incorporating in Ireland.<sup>78</sup> While AOI shares the same mailing address as several other Apple affiliates in Cork, Ireland, AOI has no physical presence at that or any other address.<sup>79</sup> Since its inception more than thirty years earlier, AOI has not had any employees.<sup>80</sup> Instead, three individuals serve as AOI's directors and sole officer, while working for other Apple companies. Those individuals currently consist of two Apple Inc. employees, Gene Levoff and Gary Wipfler, who reside in California and serve as directors on numerous other

<sup>75</sup> Apple Inc. directly owns 97% of AOI and holds the remaining shares through two affiliates, Apple UK which owns 3% of AOI shares, and Baldwin Holdings Unlimited, a nominee shareholder formed in the British Virgin Islands, which holds a fractional share of AOI, on behalf of Apple Inc. Information supplied to Subcommittee by Apple, APL-PSI-000236, and APL-PSI-000352.

<sup>76</sup> Subcommittee interview of Gary Wipfler, Apple Inc. Corporate Treasurer (4/22/2013).

<sup>77</sup> Information supplied to Subcommittee by Apple, APL-PSI-000100.

<sup>78</sup> Information supplied to Subcommittee by Apple, APL-PSI-000351.

<sup>79</sup> Subcommittee interview of Cathy Kearney (4/19/2013).

<sup>80</sup> Id.

boards of Apple offshore affiliates, and one ADI employee, Cathy Kearney, who resides in Ireland. Mr. Levoff also serves as AOI's sole officer, as indicated in the following chart:<sup>81</sup>

### Apple Operations International Officers and Directors

| AOI Directors and Officer        | Residence | Employer / Job Title                  |
|----------------------------------|-----------|---------------------------------------|
| Gene Levoff (Director/Secretary) | USA       | Apple Inc./Director of Corporate Law  |
| Gary Wipfler (Director)          | USA       | Apple Inc./VP and Corporate Treasurer |
| Cathy Kearney (Director)         | Ireland   | ADI/VP of European Operations         |

Source: Apple Response to Subcommittee Questionnaire, APL-PSI-00235

AOI's board meetings have almost always taken place in the United States where the two California board members reside. According to minutes from those board meetings, from May of 2006 through the end of 2012, AOI held 33 board of directors meetings, 32 of which took place in Cupertino, California.<sup>82</sup> AOI's lone Irish-resident director, Ms. Kearney, participated in just 7 of those meetings, 6 by telephone. For a six-year period lasting from September 2006 to August 2012, Ms. Kearney did not participate in any of the 18 AOI board meetings. AOI board meeting notes are taken by Mr. Levoff, who works in California, and sent to the law offices of AOI's outside counsel in Ireland, which prepares the formal minutes.<sup>83</sup>

Apple told the Subcommittee that AOI's assets are managed by employees at an Apple Inc. subsidiary, Braeburn Capital, which is located in Nevada.<sup>84</sup> Apple indicated that the assets themselves are held in bank accounts in New York.<sup>85</sup> Apple also indicated that AOI's general ledger – its primary accounting record – is maintained at Apple's U.S. shared service center in Austin, Texas.<sup>86</sup> Apple indicated that no AOI bank accounts or management personnel are located in Ireland.

Because AOI was set up and continues to operate without any employees, the evidence indicates that its activities are almost entirely controlled by Apple Inc. in the United States. In fact, Apple's tax director, Phillip Bullock, told the Subcommittee that it was his opinion that AOI's functions were managed and controlled in the United States.<sup>87</sup>

In response to questions, Apple told the Subcommittee that over a four-year period, from 2009 to 2012, AOI received \$29.9 billion in dividends from lower-tiered offshore Apple

<sup>81</sup> Mr. Levoff told the Subcommittee that he serves on about 70 different boards of Apple subsidiaries. Subcommittee interview of Gene Levoff, Apple Inc. Director of Corporate Law (5/2/2013). Mr. Levoff also stated that he rarely traveled internationally to carry out his duties as a director on the boards of Apple's subsidiaries, instead carrying out his duties from the United States. *Id.*

<sup>82</sup> Summary tables of the Board of Directors meetings of AOI prepared by Apple for the Subcommittee, APL-PSI-000323, APL-PSI-000341, and APL-PSI-000349.

<sup>83</sup> Subcommittee interview of Gene Levoff (5/2/2013).

<sup>84</sup> Subcommittee interview of Gary Wipfler (4/22/2013).

<sup>85</sup> *Id.*

<sup>86</sup> Subcommittee interview of Phillip Bullock (11/28/2012).

<sup>87</sup> *Id.*

affiliates.<sup>88</sup> According to Apple, AOI's net income made up 30% of Apple's total worldwide net profits from 2009-2011,<sup>89</sup> yet Apple also disclosed to the Subcommittee that AOI did not pay any corporate income tax to any national government during that period.<sup>90</sup>

Apple explained that, although AOI has been incorporated in Ireland since 1980, it has not declared a tax residency in Ireland or any other country and so has not paid any corporate income tax to any national government in the past 5 years.<sup>91</sup> Apple has exploited a difference between Irish and U.S. tax residency rules. Ireland uses a management and control test to determine tax residency, while the United States determines tax residency based upon the entity's place of formation. Apple explained that, although AOI is incorporated in Ireland, it is not tax resident in Ireland, because AOI is neither managed nor controlled in Ireland.<sup>92</sup> Apple also maintained that, because AOI was not incorporated in the United States, AOI is not a U.S. tax resident under U.S. tax law either.

When asked whether AOI was instead managed and controlled in the United States, where the majority of its directors, assets, and records are located, Apple responded that it had not determined the answer to that question.<sup>93</sup> Apple noted in a submission to the Subcommittee: "Since its inception, Apple determined that AOI was not a tax resident of Ireland. Apple made this determination based on the application of the central management and control tests under Irish law." Further, Apple informed the Subcommittee that it does not believe that "AOI qualifies as a tax resident of any other country under the applicable local laws."<sup>94</sup>

For more than thirty years, Apple has taken the position that AOI has no tax residency, and AOI has not filed a corporate tax return in the past 5 years. Although the United States generally determines tax residency based upon the place of incorporation, a shell entity incorporated in a foreign tax jurisdiction could be disregarded for U.S. tax purposes if that entity is controlled by its parent to such a degree that the shell entity is nothing more than an instrumentality of its parent. While the IRS and the courts have shown reluctance to apply that test, disregard the corporate form, and attribute the income of one corporation to another, the facts here warrant examination.

<sup>88</sup> Information supplied to Subcommittee by Apple, APL-PSI-000347, APL-PSI-000219, APL-PSI-000181 and APL-PSI-000149.

<sup>89</sup> Apple Consolidating Financial Statements, APL-PSI-000130-232 [Sealed Exhibit].

<sup>90</sup> Information supplied to Subcommittee by Apple, APL-PSI-000240.

<sup>91</sup> Id. Apple reported that, in 2007, AOI paid just under \$21,000 in tax in France, related to the sale of a building owned by AOI, and paid a withholding tax on a dividend that same year. Information supplied to Subcommittee by Apple, APL-PSI-000246-247. Apple explained that AOI had a taxable presence in France from 1987-2007, due to its ownership of the building from which it earned rental income until the 2007 sale. Apple has not been able to identify to the Subcommittee any other tax payment by AOI to any national government since 2007.

<sup>92</sup> Information supplied to Subcommittee by Apple, APL-PSI-000241.

<sup>93</sup> "Apple has not made a determination regarding the location of AOI's central management and control. Rather, Apple has determined that AOI is not managed and controlled in Ireland based on the application of the central management and control test under Irish law. The conclusion that AOI is not managed and controlled in Ireland does not require a determination where AOI is managed and controlled." Information supplied to Subcommittee by Apple, APL-PSI-000242.

<sup>94</sup> Information supplied to Subcommittee by Apple, APL-PSI-000239.

AOI is a thirty-year old company that has operated since its inception without a physical presence or its own employees. The evidence shows that AOI is active in just two countries, Ireland and the United States. Since Apple has determined that AOI is not managed or controlled in Ireland, functionally that leaves only the United States as the locus of its management and control. In addition, its management decisions and financial activities appear to be performed almost exclusively by Apple Inc. employees located in the United States for the benefit of Apple Inc. Under those circumstances, an IRS analysis would be appropriate to determine whether AOI functions as an instrumentality of its parent and whether its income should be attributed to that U.S. parent, Apple Inc.

### **(b) Apple Sales International (ASI)**

AOI is not the only Apple offshore entity that has operated without a tax residency. Apple recently disclosed to the Subcommittee that another key Apple Irish affiliate, Apple Sales International (ASI), is also not a tax resident anywhere. Apple wrote: “Like AOI, ASI is incorporated in Ireland, is not a tax resident in the US, and does not meet the requirements for tax residency in Ireland.”<sup>95</sup> ASI is exploiting the same difference between Irish and U.S. tax residency rules as AOI.

ASI is a subsidiary of Apple Operations Europe (AOE) which is, in turn, a subsidiary of AOI.<sup>96</sup> Prior to 2012, like AOI, ASI operated without any employees and carried out its activities through a U.S.-based Board of Directors.<sup>97</sup> Also like AOI, the majority of ASI’s directors were Apple Inc. employees residing in California.<sup>98</sup> Of 33 ASI board meetings from May 2006 to March 2012, all 33 took place in Cupertino, California.<sup>99</sup> In 2012, as a result of Apple’s restructuring of its Irish subsidiaries, ASI was assigned 250 employees who used to work for its parent, AOE.<sup>100</sup> Despite acquiring those new employees, ASI maintains that its management and control is located outside of Ireland and continues to claim it has no tax residency in either Ireland or the United States.

Despite its position that it is not a tax resident of Ireland, ASI has filed a corporate tax return related to its operating presence in that country.<sup>101</sup> As shown in an earlier chart, ASI has paid minimal taxes on its income. In 2011, for example, ASI paid \$10 million in global taxes on

<sup>95</sup> Prepared statement of Apple CEO Tim Cook before U.S. Senate Permanent Subcommittee on Investigations, (5/21/2013), at page 14, footnote 8. See also Apple Consolidating Financial Statements, APL-PSI-000130-232 [Sealed Exhibit].

<sup>96</sup> AOI owns 99.99% of AOE and .001% share of ASI; AOE owns 99.99% of ASI. Baldwin Holdings Unlimited, a British Virgin Islands nominee shareholder, holds the remaining fractional share of both AOE and ASI, on behalf of Apple Inc. Information supplied to Subcommittee by Apple, APL-PSI-000236, and APL-PSI-000352.

<sup>97</sup> Subcommittee interview of Tim Cook (4/29/2013); information supplied to the Subcommittee by Apple, APL-PSI-000104.

<sup>98</sup> Information supplied to the Subcommittee by Apple, APL-PSI-000343.

<sup>99</sup> Id.

<sup>100</sup> Subcommittee interview of Cathy Kearney (4/19/2013).

<sup>101</sup> See information supplied to Subcommittee by Apple, 5/19/2013 electronic communication (“From 2009 to present, ASI has not met the tax residency requirements in Ireland. However, ASI is an operating company that files an Irish corporate tax return and pays Irish corporate income tax as required by Ireland. As we indicated in our response to Question 8(c) of our July 6, 2012 submission, ASI’s location for tax purposes is Ireland because ASI files a corporate tax return in Ireland.”)

\$22 billion in income; in 2010, ASI paid \$7 million in taxes on \$12 billion in income. Those Irish tax payments are so low relative to ASI's income, they raise questions about whether ASI is declaring on its Irish tax returns the full amount of income it has received from other Apple affiliates or whether, due to its non-tax resident status in Ireland, ASI has declared only the income related to its sales to Irish customers. Over the four year period, 2009 to 2012, ASI's income, as explained below, totaled about \$74 billion, a portion of which ASI transferred via dividends to its parent, Apple Operations Europe. ASI, which claims to have no tax residence anywhere, has paid little or no taxes to any national government on that income of \$74 billion.

### 3. Helping Apple Inc. Avoid U.S. Taxes Via A Cost-Sharing Agreement

In addition to shielding income from taxation by declining to declare a tax residency in any country, Apple Inc.'s Irish affiliates have also helped Apple avoid U.S. taxes in another way, through utilization of a cost-sharing agreement and related transfer pricing practices. Three key offshore affiliates in this effort are ASI, its parent AOE, and Apple Distributions International (ADI), each of which holds a second or third tier position in Apple's offshore structure in Ireland. All three companies are incorporated and located in Ireland, and share the same mailing address. Another key second-tier player is Apple South Asia Pte. Ltd., a company incorporated and located in Singapore (Apple Singapore). These offshore affiliates enable Apple Inc. to keep the lion's share of its worldwide sales revenues out of the United States and instead shift that sales income to Ireland, where Apple enjoys an unusually low tax rate and affiliates allegedly with no tax residency.

The key roles played by ASI and AOE stem from the fact they are parties to a research and development cost-sharing agreement with Apple Inc., which also gives them joint ownership of the economic rights to Apple's intellectual property offshore.<sup>102</sup> As of 2012, AOE had about 400 employees and conducted a small amount of manufacturing in Cork, Ireland involving a line of specialty computers for sale in Europe.<sup>103</sup> Also as of 2012, ASI moved from zero to about 250 employees who manage Apple's other manufacturing activities as well as its product-line sales.<sup>104</sup> As part of its duties, ASI contracted with Apple's third-party manufacturer in China to assemble Apple products and acted as the initial buyer of those finished goods. ASI then re-sold the finished products to ADI for sales in Europe, the Middle East, Africa, and India; and to Apple Singapore for sales in Asia and the Pacific region.<sup>105</sup> When it re-sold the finished

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<sup>102</sup> Although AOE and ASI jointly participate in the cost-sharing agreement with Apple Inc., the bulk of Apple's offshore earnings flow to ASI. Information supplied to Subcommittee by Apple, APL-PSI-000384. For simplicity, the Subcommittee will refer to the cost-sharing agreement as between Apple Inc. and ASI, even though the true contractual relationship is between Apple Inc. and both ASI and AOE jointly.

<sup>103</sup> Prior to Apple's restructuring of its Irish affiliates in 2012, all of Apple's 2,452 Irish employees were employed by Apple Operations Europe. In 2012, Apple re-distributed those employees across 5 different Irish affiliates, with the majority now employed by ADI. Information supplied to Subcommittee by Apple, APL-PSI-000103 and PSI-Apple-02-0002.

<sup>104</sup> Subcommittee interview of Cathy Kearney (4/19/2013).

<sup>105</sup> This description reflects Apple's current distribution arrangements, following its 2012 restructuring of its Irish operations. Prior to the restructuring, ASI contracted with the third party manufacturer, bought the finished Apple products, and then sold those finished products to several Apple retail affiliates and directly to third-party retailers and internet customers. In 2012, Apple split the manufacturing and sales functions so that ASI now arranges for the manufacturing of Apple goods, sells the goods to ADI or Apple Singapore, and ADI or Apple Singapore then

products, ASI charged the Apple affiliates a higher price than it paid for the goods and, as a result, became the recipient of substantial income, a portion of which ASI then distributed up the chain in the form of dividends to its parent, AOE. AOE, in turn, sent dividends to AOI.<sup>106</sup>

**Cost Sharing Agreement.** The cost-sharing agreement is structured as follows.<sup>107</sup> In the agreement, Apple Inc. and ASI agree to share in the development of Apple's products and to divide the resulting intellectual property economic rights. To calculate their respective costs, Apple Inc. first pools the costs of Apple's worldwide research and development efforts. Apple Inc. and ASI then each pay a portion of the pooled costs based upon the portion of product sales that occur in their respective regions. For instance, in 2011, roughly 40 percent of Apple's worldwide sales occurred in the Americas, with the remaining 60 percent occurring offshore.<sup>108</sup> That same year, Apple's worldwide research and development costs totaled \$2.4 billion.<sup>109</sup> Apple Inc. and ASI contributed to these shared expenses based on each entity's percentage of worldwide sales. Apple Inc. paid 40 percent or \$1.0 billion, while ASI paid the remaining 60 percent or \$1.4 billion.<sup>110</sup>

**Distribution Structure.** For the majority of Apple products, as mentioned earlier, ASI contracted with a third-party manufacturer in China to assemble the finished goods. The persons who actually negotiated and signed those contracts on behalf of ASI were Apple Inc. employees based in the United States, including an Apple Inc. employee serving as an ASI director.<sup>111</sup> The third-party manufacturer manufactured the goods to fill purchase orders placed by ASI.<sup>112</sup> ASI was the initial purchaser of all goods intended to be sold throughout Europe, the Middle East, Africa, India, Asia, and the Pacific region. The chart below illustrates ASI's distribution structure as of 2012.

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manage all sales. As part of this restructuring, Apple moved employees from AOE to ASI and ADI. Information supplied to Subcommittee by Apple, APL-PSI-000103 and PSI-Apple-02-0002??

<sup>106</sup> See, e.g., 11/17/2010 Minutes of a Meeting of the Board of Directors of Apple Operations Europe, APL-PSI-000288.

<sup>107</sup> See, e.g., the most recent version of the cost-sharing agreement, 6/25/2009 Amended and Restated Agreement to Share Costs and Risks of Intangibles Development (Grandfathered Cost Sharing Arrangement), APL-PSI-000035 [Sealed Exhibit].

<sup>108</sup> Subcommittee interview of Phillip Bullock (11/28/2012).

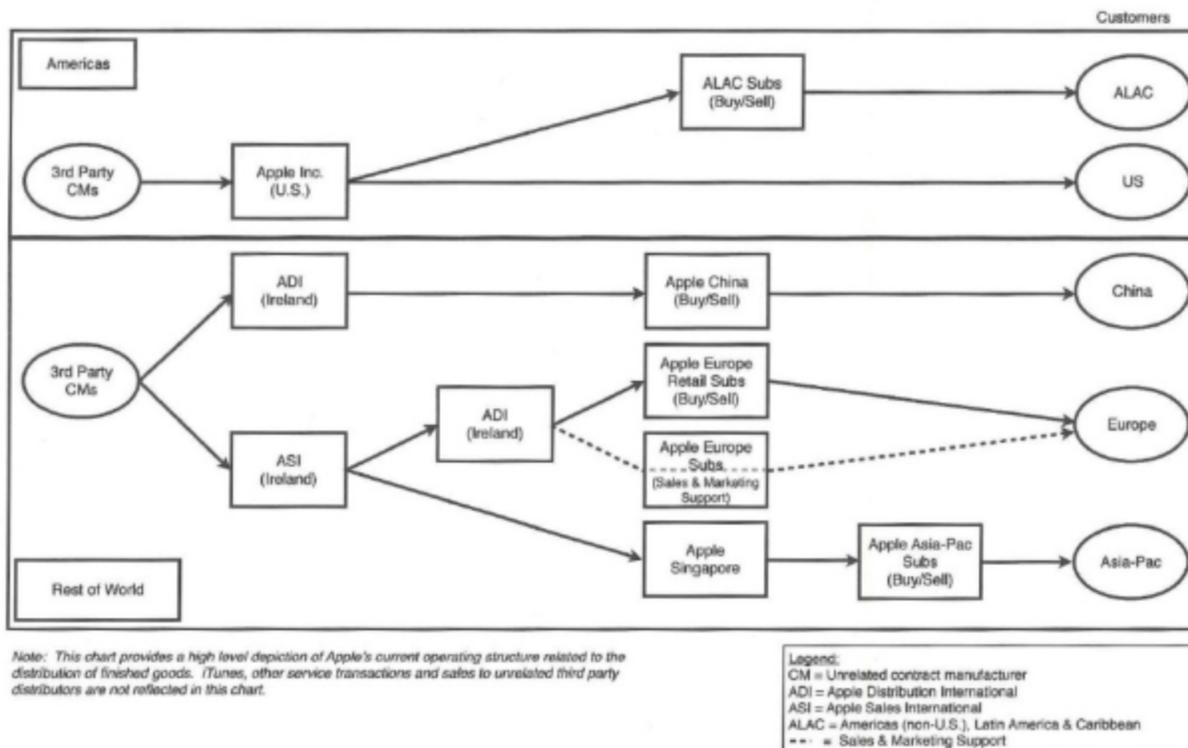
<sup>109</sup> Information supplied to Subcommittee by Apple, APL-PSI-000129.

<sup>110</sup> Information supplied to Subcommittee by Apple, APL-PSI-000129.

<sup>111</sup> Information supplied to Subcommittee by Apple, APL-PSI-000392.

<sup>112</sup> Subcommittee interview of Phillip Bullock (11/28/2012).

### APPLE'S CURRENT OPERATING STRUCTURE



Source: Apple chart, prepared by Apple at the Subcommittee's request

Once ASI took initial title of the finished goods, it resold the goods to the appropriate distribution entity, in most cases without taking physical possession of the goods in Ireland.<sup>113</sup> For sales in Europe, for example, ASI purchased the finished products from the third party manufacturer and sold them to ADI. ADI then resold the products to Apple retail subsidiaries located in various countries around Europe, to third-party resellers, or directly to internet customers. For sales in Asia and the Pacific region, ASI sold the finished goods to Apple Singapore, which then re-sold them to Apple retail subsidiaries in Hong Kong, Japan, and Australia, third party resellers, or directly to internet customers.<sup>114</sup>

Although ASI is an Irish incorporated entity and the purchaser of the goods, only a small percentage of Apple's manufactured products ever entered Ireland. Rather, title was transferred between the third party manufacturer and ASI, while the products were being directly shipped to the eventual country of sale. Upon arrival, the products were resold by ASI to the Apple distribution affiliate that took ownership of the goods. The Apple distribution affiliate then sold

<sup>113</sup> Prior to 2012, ASI also sold Apple goods directly to end customers or Apple retail entities. Subcommittee interview of Phillip Bullock (11/28/2012).

<sup>114</sup> For sales to China, the third party contract manufacturer sells the finished products to ADI, which then sells to retailers in China. To facilitate this distribution arrangement, ADI sublicenses the rights to distribute Apple products in China for a substantial sum. In FY 2012, for example, ADI paid ASI \$5.9 billion for the right to distribute in China. Information supplied to the Subcommittee by Apple, APL-PSI-000234.

the goods to either end customers or Apple retail subsidiaries.<sup>115</sup> Apple's distribution process suggests that the location of its affiliates in Ireland was not integral to the sales or distribution functions they performed. Rather, locating the entities in Ireland seemed primarily designed to facilitate the concentration of offshore profits in a low tax jurisdiction.

**Shifting Profits Offshore.** By structuring its intellectual property rights and distribution operations in the manner it did, Apple Inc. was able to avoid having worldwide Apple sales revenue related to its intellectual property attributed to itself in the United States where it would be subject to taxation in the year received. Instead, Apple Inc. arranged for a large portion of its worldwide sales revenue to be attributed to ASI in Ireland. As explained earlier, according to Apple, Ireland has provided Apple affiliates with an income tax rate of less than 2% and as low as 0.05%. In addition, given ASI's status as a non-tax resident of Ireland, it may be that ASI paid no income tax at all to any national government on the tens of billions of dollars of Apple sales income that ASI received from Apple affiliates outside of Ireland. If that is the case, Apple has been shifting its profits to its Irish subsidiary that has a tax residence nowhere, not to benefit from Ireland's minimal tax rate, but to take advantage of the disparity between Irish and U.S. tax residency rules and thereby avoid paying income taxes to any national government.

The cost-sharing agreement that Apple has signed with ASI and AOE is a key component of Apple's ability to lower its U.S. taxes. Several aspects of the cost-share agreement and Apple's research and development (R&D) and sales practices suggest that the agreement functions primarily as a conduit to shift profits offshore to avoid U.S. taxes. First, the bulk of Apple's R&D efforts, the source of the intangible value of its products, is conducted in the United States, yet under the cost sharing agreement a disproportionate amount of the resulting profits remain outside of the United States. Second, the transfer of intellectual property rights to Ireland via the cost-sharing agreement appears to play no role in the way Apple conducts its commercial operations. Finally, the cost-sharing agreement does not in reality shift any risks or benefits away from Apple, the multinational corporation; it only shifts the location of the tax liability for Apple's profits.

Almost all of Apple's research activity is conducted by Apple Inc. employees in California. The vast majority of Apple's engineers, product design specialists, and technical experts are physically located in California.<sup>116</sup> ASI and AOE employees conduct less than 1% of Apple's R&D and build only a small number of specialty computers.<sup>117</sup> In 2011, 95% of Apple's research and development was conducted in the United States,<sup>118</sup> making Apple's arrangement with ASI closer to a cost reimbursement than a co-development relationship, where both parties contribute to the intrinsic value of the intellectual property being developed.

However, despite the fact that ASI conducts only de minimis research and development activity, the cost sharing agreement gives ASI the rights to the "entrepreneurial investment"

<sup>115</sup> Subcommittee interview of Phillip Bullock (11/28/2012). Prior to 2012, ASI sold to Apple retail subsidiaries and directly to internet customers. Since the company reorganized, ASI now sells to ADI and Apple Singapore, and those entities sell to Apple retail subsidiaries, third party resellers, or internet customers. Several Asian subsidiaries also have their own distribution entities that buy from Apple Singapore and resell in country. *Id.*

<sup>116</sup> Subcommittee interview of Phillip Bullock (5/15/2013).

<sup>117</sup> Information supplied to Subcommittee by Apple, APL-PSI-000233.

<sup>118</sup> *Id.*

profits that result from owning the intellectual property.<sup>119</sup> According to Apple, over the four year period, 2009 to 2012, ASI made cost-sharing payments to Apple Inc. of approximately \$5 billion.<sup>120</sup> ASI's resulting income over those same 3 years was \$74 billion, a ratio of more than 15 to one, when comparing its income to its costs.<sup>121</sup> In short, ASI profited in amounts far in excess of its R&D contributions.

#### Cost Sharing Payments and Pre-Tax Earnings of Apple Sales International (Ireland)

|              | Cost Sharing Payments By ASI | Pre-Tax Earnings of ASI |
|--------------|------------------------------|-------------------------|
| 2009         | \$ 600 million               | \$ 4 billion            |
| 2010         | \$ 900 million               | \$ 12 billion           |
| 2011         | \$ 1.4 billion               | \$ 22 billion           |
| 2012         | \$ 2.0 billion               | \$ 36 billion           |
| <b>TOTAL</b> | <b>\$ 4.9 billion</b>        | <b>\$ 74 billion</b>    |

#### Cost Sharing Payments and Pre-Tax Earnings of Apple Inc. (United States)

|              | Cost Sharing Payments By Apple Inc. | Pre-Tax Earnings of Apple Inc. |
|--------------|-------------------------------------|--------------------------------|
| 2009         | \$ 700 million                      | \$ 3.4 billion                 |
| 2010         | \$ 900 million                      | \$ 5.3 billion                 |
| 2011         | \$ 1.0 billion                      | \$ 11 billion                  |
| 2012         | \$ 1.4 billion                      | \$ 19 billion                  |
| <b>TOTAL</b> | <b>\$ 4.0 billion</b>               | <b>\$ 38.7 billion</b>         |

Source: Information supplied to the Subcommittee by Apple, APL-PSI-000129, 000381-384

In comparison, over the same four years, Apple Inc. paid \$4 billion under the cost-sharing agreement and reported profits of \$29 billion.<sup>122</sup> Its cost to profits ratio was closer to 7 to one, substantially less advantageous than that of ASI. The figures disclose that Apple's Irish subsidiary, ASI, profited more than twice as much as Apple Inc. itself from the intellectual property that was largely developed in the United States by Apple Inc. personnel. That relative imbalance suggests that the cost-sharing arrangement for Apple Inc. makes little economic sense without the tax effects of directing \$74 billion in worldwide sales revenue away from the United States to Ireland, where it undergoes minimal – or perhaps – no taxation due to ASI's alleged non-tax resident status.

Second, Apple's transfer of the economic rights to its intellectual property to Ireland has no apparent commercial benefit apart from its tax effects. The company operates in numerous countries around the world, but it does not transfer intellectual property rights to each region or country where it conducts business. Instead, the transfer of economic rights is confined to Ireland alone, where the company enjoys an extremely low tax rate. When interviewed, Apple

<sup>119</sup> Subcommittee interview of Phillip Bullock (11/28/2012).

<sup>120</sup> Information supplied to Subcommittee by Apple, APL-PSI-000129 and 000382.

<sup>121</sup> Information supplied to Subcommittee by Apple APL-PSI-000384. It is important to note that the cost sharing payments made by ASI have been ongoing for nearly 30 years, and that the costs and resulting profits have fluctuated over that time.

<sup>122</sup> Information supplied to Subcommittee by Apple, APL-PSI-000129 and APL-PSI-000382.

officials could not adequately explain why ASI needed to acquire the economic rights to Apple's intellectual property in order for each to conduct its business. In fact, prior to Apple's reorganization in 2012, ASI had no employees. All business decisions were made by ASI's board of directors, which was composed primarily of Apple Inc. employees and held its meetings in Cupertino, California. Apple's CEO, Tim Cook, told the Subcommittee staff that, during his time as Chief Operating Officer of Apple, he was unable to recall any instance where the ownership of intellectual property rights affected Apple's business operations.<sup>123</sup>

Components used in Apple's finished goods are also produced in multiple countries around the world, without regard to where the economic rights to the underlying intellectual property are located, physically or legally. Many of the component elements of Apple's new products are designed by Apple Inc. in the United States and then manufactured by third parties from different geographic areas, including the United States. The vast majority of Apple's finished products are assembled by a third-party manufacturer in China. The Apple components are sourced globally, and the master servicing agreement governing Apple's relationship with the third-party manufacturer in China that assembles Apple's finished products is negotiated by Apple executives in California. Where this manufacturing work is performed and what entities are selected to perform that work do not appear to be driven by or restricted by which Apple entity holds the economic rights or by where those rights are located.

For example, Apple has noted that the "engine," or central processing unit (CPU), for Apple's iPhones and iPads, is the A5 series of microprocessors built in Austin, Texas. Technically, as a result of Apple's cost-sharing agreement, Apple Inc. owns all of the intellectual property rights (both legal and economic rights) embedded in the CPUs used in the Americas, and ASI owns the intellectual property economic rights for the CPUs used in rest of the world.<sup>124</sup> However, a single facility in Texas produces all of the microprocessors used in all Apple products sold around the world. No business distinction is made between microprocessors manufactured for eventual use in U.S. products, where Apple Inc. owns the intellectual property economic rights, versus use in offshore products, where ASI owns the intellectual property economic rights. In an interview with the Subcommittee, Mr. Cook noted that based on his experience as Chief Operating Officer he considered the costs of Apple components to be borne by the worldwide company rather than the economic rights holders.<sup>125</sup>

Finally, the cost-sharing agreement does not assign any costs, risks, or rewards to any third party independent of Apple. To the contrary, Apple and its offshore affiliates collectively share the risks and rewards of the corporation's research and sales activities. Although Apple Inc. and ASI are distinct legal entities, Apple executives interviewed by the Subcommittee said they viewed the "priorities and interests" of Apple's closely held entities to align with those of Apple Inc.<sup>126</sup> Apple's offshore affiliates operate as one worldwide enterprise, following a coordinated global business plan directed by Apple Inc. In fact, the last two versions of Apple's

<sup>123</sup> Subcommittee interview of Tim Cook (4/29/2013).

<sup>124</sup> Apple retains the legal rights for the rest of the world. See 6/25/2009 Amended & Restated Agreement to Share Costs and Risks of Intangibles Development (Grandfathered Cost Sharing Arrangement), APL-PSI-000020 [Sealed Exhibit].

<sup>125</sup> Subcommittee interview of Tim Cook, (4/29/2013).

<sup>126</sup> Subcommittee interview of Peter Oppenheimer, Apple Inc. Chief Financial Officer (5/10/2013); Subcommittee interview of Gene Levoff (5/2/2013).

cost-sharing agreement were signed by Apple Inc. U.S.-based employees, each of whom worked for multiple Apple entities, including Apple Inc., ASI, and AOE.<sup>127</sup> Regardless of where the costs associated with the cost sharing agreement were assigned within the Apple network, or which Apple entities purchased or sold the resulting Apple products, all of the profits and losses from Apple sales were ultimately consolidated in the financial statements of Apple, Inc. The cost sharing agreement did not alter any of those arrangements in any meaningful way. The agreement primarily affects how Apple's R&D costs and sales revenues will be attributed among the affiliates of the international company and in what proportions. Apple, in every case, entered into an agreement with its own entities. In other words, the true function of the cost-sharing agreement has been, not to divide R&D costs with an outside party, but instead to afford Apple the opportunity to direct its costs and profits to affiliates in a low-tax jurisdiction.

These facts raise questions as to whether Apple's intellectual property transfers to related parties perform any function other than to shift profits and tax liability out of the United States to a low-tax jurisdiction.

#### **D. Using U.S. Tax Loopholes to Avoid U.S. Taxes on Offshore Income**

Apple's cost-sharing agreement enabled Apple Inc. to direct the lion's share of its worldwide sales income from various Apple affiliates away from the United States to its Irish affiliate, ASI, and its primary offshore holding company, AOI. Because under the U.S. tax code, that offshore income could, under certain circumstances, become subject to U.S. tax in the year received and lose its ability for those taxes to be deferred, Apple took additional steps to shield that income from U.S. taxation.

As noted above, although the United States taxes domestic corporations on their worldwide income, the U.S. tax code allows companies to defer taxes on active business income until that income is returned to the United States. To curb abuse of this foreign income deferral regime, however, Subpart F of the tax code requires that U.S. companies pay tax immediately on certain types of sales revenue transferred between CFCs and on passive foreign income such as dividends, royalties, fees, or interest payments. As explained earlier, the purpose of Subpart F is to prevent U.S. companies from shifting income to tax havens to lower their tax rate without engaging in substantive economic activity. At the same time, the effectiveness of Subpart F has

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<sup>127</sup>In 2008, Apple Inc, Apple Sales International (ASI), and Apple Operations Europe (AOE) signed an "Amended and Restated Cost Sharing Agreement." The signatory on behalf of AOE, an Irish company, was Gary Wipfler. At the time he was a Board member of both AOE and ASI and was the Treasurer of Apple Inc., in California. The signatory for Apple Inc was Peter Oppenheimer. At the time, he was a board member ASI and AOE, as well as the Chief Financial Officer of Apple Inc. The signatory for ASI, an Irish company, was Tim Cook. At the time, he was a board member of ASI and AOE and the Chief Operating Officer of Apple Inc., in California. In other words, all three signatories to the agreement were directors or officers of all three parties involved in the contract. See Amended & Restated Cost Sharing Agreement Between Apple Inc., Apple Operations Europe & Apple Sales International, May 2008, at 15.

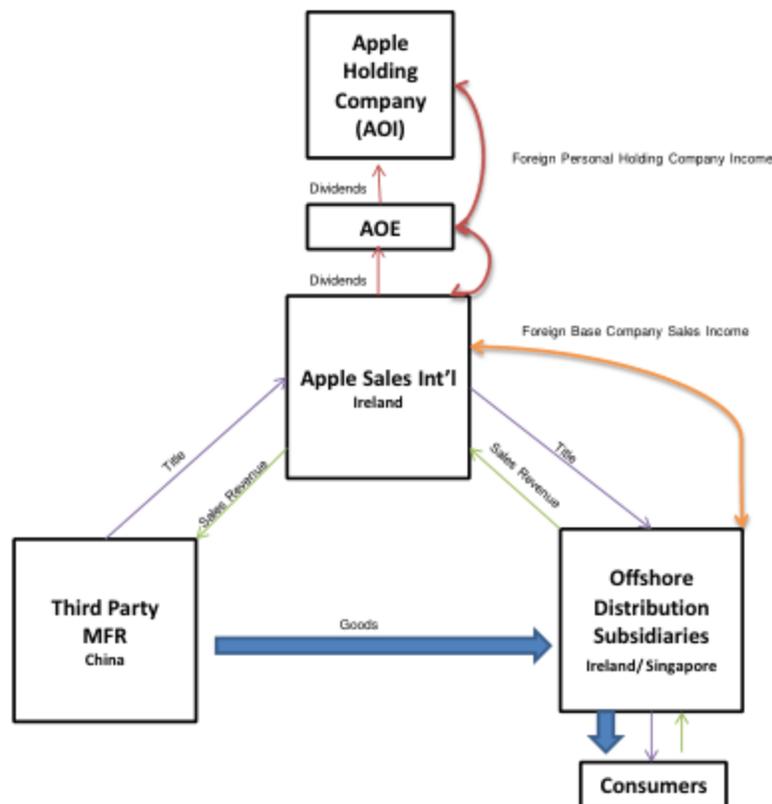
In 2009, Apple Inc, ASI and AOE entered into another Cost Sharing agreement which replaced the one signed in 2008. Mr. Oppenheimer, the CFO of Apple Inc. and a director of both ASI and AOE, was the signatory on behalf of Apple Inc. Two other Apple Inc employees signed as directors of ASI and AOE. See Amended and Restated Agreement To Share costs and Risks of Intangibles Development (Grandfathered Cost Sharing Arrangement), June 2009, at 19.

been severely weakened by certain regulations, temporary statutory changes, and statutory exemptions.

According to figures supplied by Apple, over a four year period from 2009 to 2012, as explained further below, Apple used a number of those tax loopholes to avoid Subpart F taxation of offshore income totaling \$44 billion.<sup>128</sup> During that time period, Apple generated two types of offshore income that should have been immediately taxed under Subpart F: (1) foreign base company sales (FBCS) income,<sup>129</sup> which involves the sales income Apple directed to Ireland for no reason other than to concentrate profits there, and (2) foreign personal holding company (FPHC) income,<sup>130</sup> which involves passive foreign income such as dividends, royalties, fees, and interest. Apple avoided U.S. taxation for the entire \$44 billion through a combination of regulatory and statutory tax loopholes known as the check-the-box and look-through rules.

The following chart depicts both types of income and how Apple structured its offshore operations to avoid U.S. taxes on both.

### Apple's Offshore Distribution Structure



Source: Prepared by Subcommittee based on interviews with Apple employees

<sup>128</sup> Information supplied to Subcommittee by Apple, APL-PSI-000386.

<sup>129</sup> IRC Section 954(d).

<sup>130</sup> IRC Section 954(c).

## 1. Foreign Base Company Sales Income: Avoiding Taxation Of Taxable Offshore Income

As explained earlier, foreign base company sales (FBCS) income rules regulate the taxation of goods sold by an entity in one country to a related entity for ultimate use in a different country. The rules were designed to prevent multinational corporations from setting up intermediary entities in tax havens for no purpose except to buy finished goods and sell them to related entities for use in another country in order to concentrate profits from the sales revenue in the tax havens. The distribution structure used by Apple's Irish entities generated significant taxable FBCS income, leading Apple to employ a web of disregarded entities to avoid those U.S. taxes.

The FBCS income designation applies to: (1) purchases of personal property manufactured (by a person other than the CFC) in a jurisdiction other than the country in which the CFC is located, and (2) sold to a related party for use outside of the jurisdiction in which the CFC is located. In the case of Apple, ASI purchased finished Apple goods manufactured in China and immediately resold them to ADI or Apple Singapore which, in turn, sold the goods around the world. ASI did not conduct any of the manufacturing – and added nothing – in Ireland to the finished Apple products it bought, yet booked a substantial profit in Ireland when it resold those products to related parties such as ADI or Apple Singapore.

In fact, ASI never took physical possession of the products it ordered from the third party manufacturer. Transfer was made in title only while the products were being shipped to the country of sale.<sup>131</sup> For example, Apple products sold in Asia were not shipped to Ireland from the third-party manufacturer and then shipped back to Asia for sale. Rather, ASI took title to the manufactured products while they were being shipped to Apple's Asian distribution centers.<sup>132</sup> When they arrived, ASI sold the products to Apple Singapore at a substantial profit.<sup>133</sup> Apple Singapore then resold the products, in turn, to Apple retail entities or end customers.<sup>134</sup> In other instances, the Apple products were shipped directly from the third-party manufacturer to end customers without any Apple intermediary taking prior physical possession.<sup>135</sup>

Transferring title in this manner allowed Apple to retain most of its profits in Ireland, where it has negotiated a favorable tax rate and maintains entities claiming to have no tax residence in any country, and limit the income it reported in the non-tax haven countries where

<sup>131</sup> Subcommittee interview of Cathy Kearney (4/19/13).

<sup>132</sup> Subcommittee interview of Phillip Bullock (11/28/12).

<sup>133</sup> The goods were not necessarily shipped to Singapore either, but may have been shipped to a wide variety of Apple retail entities or end customers across Asia and the Pacific region. Subcommittee interview of Cathy Kearney (4/19/13).

<sup>134</sup> This example is accurate under Apple's current organizational structure. However, Apple Singapore only became an active participant in Apple's distribution channel after Apple's 2012 reorganization. Prior to that reorganization, the same basic structure applied to Apple's distribution channels. At that time, ASI purchased products from the third-party manufacturer and then sold them to Apple affiliates that owned Apple retail stores around the globe. For example, ASI purchase the finished goods from the manufacturer in China and then resold them to an Apple retail store in Australia, with ASI taking ownership of the products while in transit to Australia, then reselling them at a substantial profit to the Apple retail entity upon arrival.

<sup>135</sup> Subcommittee interview of Cathy Kearney (4/19/13).

the company did most of its business. For example, in 2011, Apple reported \$34 billion in income before taxes; however, just \$150 million of those profits, a fraction of one percent, were recorded for Apple's Japanese subsidiaries, even though Japan is one of Apple's strongest foreign markets.<sup>136</sup> ASI, meanwhile, reported \$22 billion in 2011 net income.<sup>137</sup> Those figures indicate that Apple's Japanese profits were being shifted away from the United States to Ireland, where Apple had negotiated a minimal tax rate and maintained two non-tax resident corporations.

It is this type of transfer of worldwide sales income to a tax haven subsidiary that the FBCS income provisions were designed to tax, because they do not contribute to the manufacturing or sales processes, but serve only to concentrate profits in a low tax jurisdiction. Under Subpart F, ASI's income should have been treated as FBCS income subject to U.S. taxation in the year received. Rather than declare that income, however, Apple used the check-the-box loophole to avoid all U.S. taxation of that FBCS income. When asked to calculate the total amount of U.S. taxes on FBCS income that Apple Inc. was able to avoid by using the check-the-box loophole, Apple provided the following estimates:

**Estimated U.S. Taxes Avoided by Apple Inc. Using Check-The Box  
2001-2012**

|              | <b>Foreign Base Company Sales Income</b> | <b>Tax Avoided</b>     | <b>Tax Avoided Per Day</b> |
|--------------|--|------------------------|----------------------------|
| 2011         | \$ 10 billion                            | \$ 3.5 billion         | \$ 10 million              |
| 2012         | \$ 25 billion                            | \$ 9.0 billion         | \$ 25 million              |
| <b>Total</b> | <b>\$ 35 billion</b>                     | <b>\$ 12.5 billion</b> | <b>\$ 17 million</b>       |

Source: Information supplied to Subcommittee by Apple, APL-PSI-000386

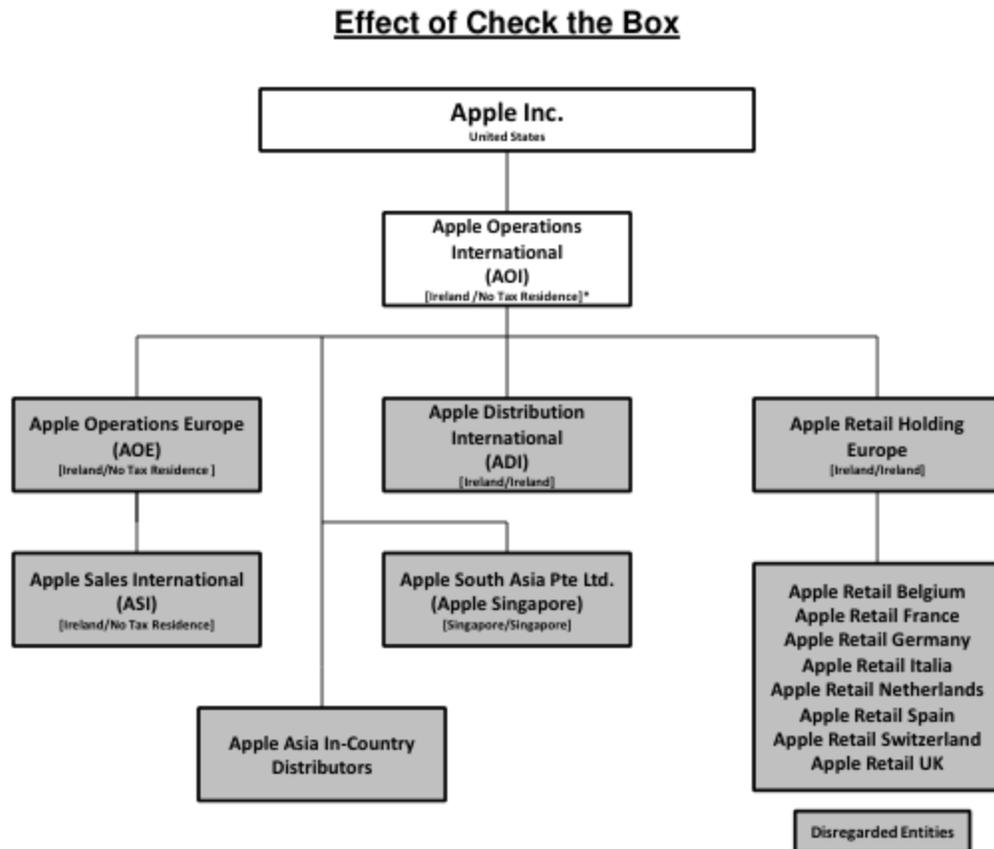
These figures indicate that, in two years alone, from 2011 to 2012, Apple Inc. used the check-the-box loophole to avoid paying \$12.5 billion in U.S. taxes or about \$17 million per day.

<sup>136</sup> Apple Consolidating Financial Statements, APL-PSI-000130-232 [Sealed Exhibit].

<sup>137</sup> Id. at APL-PSI-000219.

## 2. Using Check-the-Box to Make Transactions Disappear

To understand how Apple used the check-the-box loophole to avoid those billions of dollars in U.S. tax liability for ASI income, it helps to review Apple's offshore structure as indicated in this chart:



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

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

Under the IRS check-the-box regulations, a U.S. multinational can elect to have lower-tier foreign subsidiaries “disregarded” by the IRS as separate legal entities and instead treated as part of an upper-tier subsidiary for tax purposes. If that election is made, transactions involving the disregarded entities disappear for tax purposes, because U.S. tax regulations do not recognize payments made within the confines of a single entity.

In the Apple case, after Apple Inc. makes its check-the-box election, the bottom three tiers of its offshore network – which include AOE, ASI, ADI, Apple Singapore, Apple Retail Holding, and the Apple Retail subsidiaries – all become disregarded subsidiaries of AOI. Those companies are then treated, for U.S. tax purposes, as part of, or merged into, AOI the first tier subsidiary. As a result, the transactions between those disregarded entities are not recognized by the IRS, because the transactions are viewed as if they were conducted within the confines of the same company. The result is that the IRS sees only 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 Subpart F. The sales income produced when ASI sold Apple products to ADI, Apple Singapore, or Apple's Retail Entities at a substantial markup is no longer considered sales income for tax purposes – it is as if no intercompany sales happened at all. Since no intercompany sales occurred, Subpart F's FBSC income rules no longer applies, which allowed Apple to avoid paying taxes on nearly \$44 billion in income from 2009-2012.<sup>138</sup>

### 3. Using Check-the-Box to Convert Passive Income to Active Income

Apple also uses the check-the-box regulations to avoid U.S. taxation of a second type of offshore income. When an offshore subsidiary of a multinational corporation receives dividends, royalties or other fees from a related subsidiary, that income is considered foreign personal holding company (FPHC) income. That passive income, as it is commonly known, is normally subject to immediate taxation under Section 954(c) of Subpart F. However, once again, under check-the-box rules, if a U.S. multinational elects to have lower-tier subsidiaries "disregarded" – i.e., no longer considered as separate entities – 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 essentially disappear. Because those dividends, royalties and fee payments would be treated as occurring within a single entity, the IRS would not treat them as payments between two legally separate entities or as taxable income under Subpart F.

In Apple's case, in 2011 alone, AOI in Ireland received \$6.4 billion in dividends from lower-tier offshore affiliates. Over a four year period, from 2009 to 2012, Apple reported that AOI received a total of \$29.9 billion in income, almost exclusively from dividends issued to it by lower-tier CFCs.<sup>139</sup> That dividend income is exactly the type of passive income that Subpart F intended to be immediately taxable. However, by invoking the check-the-box regulations, Apple Inc. was able to designate the lower-tier CFCs as "disregarded entities," requiring the IRS to view them for tax purposes as part of AOI. Once they became part of AOI, their dividend payments became payments internal to AOI and were no longer taxable passive income.

The check-the-box regulations were never intended to be used to convert taxable, offshore, passive income into nontaxable income. Nevertheless, they do, and the resulting loopholes are utilized by Apple and other U.S. multinationals. As explained earlier, the look-through rule provides a similar statutory basis for U.S. multinationals to shield passive offshore income from U.S. taxes. Despite the billions of dollars in offshore income that is escaping U.S. taxation, neither Congress nor the IRS has yet taken any effective action to close these loopholes.

### 4. Other Tax Loopholes

Even though Apple relies primarily on the check-the-box rules to shield its offshore income from U.S. taxes, if that regulation as well as the look-through rule were eliminated, two other tax loopholes may be available to Apple to continue to avoid Subpart F taxation. They are known as the same country exception and the manufacturing exception.

<sup>138</sup> Information supplied to Subcommittee by Apple, APL-PSI-000386.

<sup>139</sup> Information supplied to Subcommittee by Apple, APL-PSI-000347, APL-PSI-000219, APL-PSI-000181 and APL-PSI-000149.

**Same Country Exception.** The first loophole is the same country exception.<sup>140</sup> This exception to Subpart F allows payments made between related parties organized and operating within the same country to escape taxation. This exception was created to address the situation in which related entities are located in the same jurisdiction, are theoretically subject to the same tax rate, and supposedly have less incentive to engage in tax-motivated transactions.

Many of the dividends paid to AOI originate from other Apple affiliates incorporated and operating within Ireland, such as AOE and ASI. Under the same country exception, even if the check-the-box and the look-through rules were abolished, the dividend payments made by AOE and ASI to AOI would escape taxation under Subpart F, since the companies are all organized and operating within Ireland. Ironically, because the rule is drafted in terms of the country under whose laws a company is organized, Apple could take advantage of this exception even though it claims AOI, an Irish organized company, is not tax resident in Ireland or anywhere else in the world. Under the explicit terms of the exception, Apple may be able to avail itself of the exception and eliminate all tax liability for intra-country transfers, despite the fact that, according to Apple, AOI and ASI are not tax resident in the same jurisdiction.

**Manufacturing Exception.** The second loophole is the manufacturing exception to FBCS income.<sup>141</sup> FBCS income is income attributable to related-party sales of personal property made through a CFC if the country of the CFC's incorporation is neither the origin nor the destination of the goods and the CFC itself has not "manufactured" the goods. Under Subpart F, FBCS income is currently taxable. However, under the manufacturing exception, the income from related party purchases and sales will not be characterized as FBCS income if the goods are sold to a related party that transforms or adds substantive value to the goods. In 2008, the regulations governing the manufacturing exception were liberalized to make it very easy for a company to claim such an exception.

Apple told the Subcommittee that it has made no determination about whether the company's supervision of third-party manufacturers qualifies it for the manufacturing exception to FBCS income taxation, since the company relies on the check-the-box rules. However, according to experts consulted by the Subcommittee, the low threshold of the new manufacturing exception rules makes it easy to meet the exception requirements and could be used to avoid taxation.

## **E. Apple's Effective Tax Rate**

When confronted with evidence of actions taken by the company to shield billions of dollars in offshore income from U.S. taxation – including by claiming its offshore Irish subsidiaries, AOI and ASI, have no tax residence in any country and by using the check-the-box and look-through rules to shield its offshore income to from taxation – one of Apple's responses has been to claim that it already pays substantial U.S. tax.<sup>142</sup> Apple's public filings to investors cite an effective tax rate of between 24 and 32 percent. The Subcommittee's

<sup>140</sup> IRC Section 954(d)(1)(A); Reg. § 1.954-3(a)(2).

<sup>141</sup> IRC Section 954(d)(1)(A).

<sup>142</sup> See, e.g., Anna Palmer, *Apple Target of Senate Hearing on Offshore Taxes*, Politico, May, 15, 2013, <http://www.politico.com/story/2013/05/apple-hearing-offshore-tax-91425.html>.

investigation has determined, however, that Apple has actually paid billions less to the government than the tax liability reported to investors.

From 2009 to 2012, in its annual report to investors, Apple claimed effective tax rates of between 24% and 32%.<sup>143</sup> In 2011, for example, Apple's annual report (Form 10-K) stated that its net income before taxes was \$34.2 billion and that its provision for the payment of corporate income taxes – the company's tax liability – was \$8.2 billion, resulting in an effective tax of 24.2%.<sup>144</sup> Apple's calculation, however, included not just its U.S. income taxes, but state and foreign taxes as well. A breakdown of its figures shows that, by its own admission, its effective tax rate for U.S. corporate income taxes was 20.1%, a third lower than the federal statutory rate of 35 percent.

The table below shows Apple's stated provision for income taxes in 2011, broken out by its U.S. federal tax liability, U.S. state-level tax liability, and foreign tax liability<sup>145</sup> as follows:

### Apple's Provision for Income Tax in its 2011 Annual Report

|                                   | 2011 Tax Provision<br>(in millions of dollars) | Effective Tax Rate |
|-----------------------------------|--|--------------------|
| <b>Federal tax liability:</b>     |  |                    |
| Current                           | \$ 3,884                                       |                    |
| Deferred                          | \$ 2,998                                       |                    |
|                                   | <b>\$ 6,882</b>                                | <b>20.1%</b>       |
| <b>State tax liability:</b>       |  |                    |
| Current                           | \$ 762   |                    |
| Deferred                          | \$ 37  |                    |
|                                   | <b>\$ 799</b>                                  | <b>2.3%</b>        |
| <b>Foreign tax liability:</b>     |  |                    |
| Current                           | \$ 769   |                    |
| Deferred                          | (\$ 167)                                       |                    |
|                                   | <b>\$ 602</b>                                  | <b>1.8%</b>        |
| <b>Provision for Income Taxes</b> | <b>\$ 8,283</b>                                | <b>24.2%</b>       |

Source: Apple Inc. Annual Report (Form 10-K), at 62 (10/26/2011)

Apple calculates its effective tax rate in accordance with GAAP using information in its publicly available annual reports. If the focus, however, were to turn to Apple's federal tax returns and the taxes Apple actually paid to the U.S. treasury each year, its tax payments fall substantially. As part of its investigation, the Subcommittee asked Apple to report the corporate

<sup>143</sup> Apple Inc. Annual Report (Form-10K), at 61 (10/21/2012).

<sup>144</sup> Apple Inc. Annual Report (Form 10-K), at 62 (10/26/2011).

<sup>145</sup> Apple reported an overall tax rate of 24.2%, which is larger than its three component tax rates of 20%, 2.3%, and 1.8%. The larger total is due to U.S. Generally Accepted Accounting Principles (GAAP) which require Apple to include in its "Provision for Income Taxes" all funds it has set aside to pay future taxes, even though Apple continues to retain those funds and has not actually paid those amounts to any tax authority.

income taxes it actually paid to the U.S. treasury over a three-year period, from 2009 to 2011. According to Apple, the company actually paid just \$2.4 billion in federal taxes in 2011, which is \$1.4 billion or 30 percent less than the current federal tax provision and \$4.4 billion less than the total tax provision included in the company's 2011 annual statement.<sup>146</sup>

While legitimate reasons may exist for differences between a corporation's financial statements and its tax returns, the Subcommittee found large and growing differences in each of the three years it examined with respect to Apple. In all three years, Apple reported much higher provisions for tax on its annual report than it did on its federal tax return for the same year. Moreover, the differences widened substantially over the three-year period, expanding from a 2009 difference of \$1.4 billion to a 2011 difference of \$4.4 billion. The following chart summarizes that information:

**U.S. Tax Liability Reported by Apple Inc. in its Annual Report  
versus Federal Tax Return, 2009-2011**

| <b>Form (in millions of dollars)</b>  | <b>FY2009</b>  | <b>FY2010</b>  | <b>FY2011</b>  |
|---|----------------|----------------|----------------|
| Total Federal Tax Provision (current plus deferred) reported on 10-K annual report filed with SEC | \$ 3.0 billion | \$ 3.8 billion | \$ 6.9 billion |
| U.S. tax reported paid on Form 1120 tax return filed with the IRS                                 | \$ 1.6 billion | \$ 1.2 billion | \$ 2.5 billion |
| <b>Difference:</b>  | \$ 1.4 billion | \$ 2.6 billion | \$ 4.4 billion |

Source: Information supplied to the Subcommittee by Apple, APL-PSI-000082; Apple Inc. Form 10-K for the fiscal year ended September 29, 2011, at 63

Tax payments of \$1.6 billion, \$1.2 billion, or even \$2.5 billion produce effective tax rates well below the statutory tax rate. In that, Apple is far from alone. Recent studies indicate that, over a three-year period, from 2008 to 2010, U.S. corporations paid effective tax rates ranging from 12 to 18 percent.<sup>147</sup> One recent study found that 30 large corporations paid no tax at all during a three year period, 2008 to 2010.<sup>148</sup> U.S. records indicate that, in 2011, U.S. corporations collectively paid about \$181 billion in federal taxes, compared to the \$819 billion in payroll taxes and \$1.1 trillion in individual income taxes.<sup>149</sup> Closing offshore tax loopholes such as those created by the check-the-box and look-through rules, the same country exception, and

<sup>146</sup> Information supplied to Subcommittee by Apple, APL-PSI-000082, referencing data taken from Apple's Form 1120 U.S. Corporation Income Tax Return. According to Apple's 2011 10-K, the company had net excess tax benefits from stock based compensation which is the main reason for the difference between Apple's current tax liability on its financial statement and the liability reported on Apple's tax return. See Apple Inc. Form 10-K for the fiscal year ended September 29, 2011, at 63; Subcommittee interview of Phillip Bullock (5/15/2013).

<sup>147</sup> See, e.g., 2/2012 study by Congressional Budget Office (finding total corporate federal taxes paid fell to 12.1% of profits earned from activities within the United States in FY2011); "Corporate Taxpayers and Corporate Tax Dodgers, 2008-2010," Citizens for Tax Justice and the Institute on Taxation and Economic Policy (11/3/2011), <http://www.ctj.org/corporatetaxdodgers/CorporateTaxDodgersReport.pdf>.

<sup>148</sup> "Corporate Taxpayers and Corporate Tax Dodgers, 2008-2010," Citizens for Tax Justice and the Institute on Taxation and Economic Policy (11/3/2011), <http://www.ctj.org/corporatetaxdodgers/CorporateTaxDodgersReport.pdf>.

<sup>149</sup> OMB, Historical Tables, Budget of the U.S. Government. FY2001 (April 2012).

the manufacturing exception, as well as putting a stop to corporations that deny tax residence in any jurisdiction, would help ensure that U.S. multinational corporations begin to pay their share.

The benefits of offshore tax deferral are enhanced by the fact that Apple is able to direct its offshore earnings to jurisdictions with low tax rates. As explained earlier, Apple consolidates as much of its offshore earnings as possible in Ireland, where Apple has an Irish tax rate of less than 2%.<sup>150</sup> Furthermore, Apple's ability to avoid Subpart F taxation through vehicles like check-the-box enables the company to not only shift profits out of the United States, but to shift profits out of other developed countries as well. In 2011, for example, Apple's ability to pass title to the goods it sells around the world through Ireland resulted in 84% of Apple's non-U.S. operating income being booked in ASI.<sup>151</sup> This left very small earnings, and correspondingly small tax liabilities, in countries around the world. In 2011, for example, only \$155 million in earnings before taxes were recorded in Apple's UK affiliates. Apple also had no tax liability in its French and German retail affiliates that same year. Through this foreign profit shifting, Apple is able to reduce its foreign tax rate to below 2%.<sup>152</sup> The ability to pay taxes of less than 2% on all of Apple's offshore income gives the company a powerful financial incentive to engage in convoluted tax planning to avoid paying U.S. taxes. Congress can change those incentives by closing offshore tax loopholes and strengthening U.S. tax law.

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<sup>150</sup> Information supplied to Subcommittee by Apple, PSI-Apple-02-0004.

<sup>151</sup> ASI's operating income was \$18 billion in 2011. Apple Consolidating Financial Statements, APL-PSI-000219 [Sealed Exhibit].

<sup>152</sup> According to Apple, in FY2011, its foreign tax rate was 1.8%. See Apple Inc. Annual Report (Form 10-K), at 62 (Oct. 26, 2011).