

**OFFSHORE PROFIT SHIFTING AND THE  
U.S TAX CODE—PART 2 (APPLE INC.)**

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**HEARING**

BEFORE THE

PERMANENT SUBCOMMITTEE ON INVESTIGATIONS  
OF THE

COMMITTEE ON  
HOMELAND SECURITY AND  
GOVERNMENTAL AFFAIRS  
UNITED STATES SENATE  
ONE HUNDRED THIRTEENTH CONGRESS

FIRST SESSION

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MAY 21, 2013  
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## **OFFSHORE PROFIT SHIFTING AND THE U.S. TAX CODE—PART 2 (APPLE INC.)**

**TUESDAY, MAY 21, 2013**

U.S. SENATE,  
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS,  
OF THE COMMITTEE ON HOMELAND SECURITY  
AND GOVERNMENTAL AFFAIRS,  
*Washington, DC.*

The Subcommittee met, pursuant to notice, at 9:33 a.m., in room SD-342, Dirksen Senate Office Building, Hon. Carl Levin, Chairman of the Subcommittee, presiding.

Present: Senators Levin, Carper, McCaskill, McCain, Johnson, Portman, Paul, and Ayotte.

Staff present: Elise J. Bean, Staff Director and Chief Counsel; Mary D. Robertson, Chief Clerk; Robert L. Roach, Counsel and Chief Investigator; David H. Katz, Senior Counsel; Daniel J. Goshorn, Counsel; Allison F. Murphy, Counsel; Adam Henderson, Professional Staff Member; Angela Messenger, Detailee (GAO); Christopher Reed, Congressional Fellow; Michael Avi-Yonah, Intern; Aaron Fanwick, Law Clerk; Alex Zerden, Law Clerk; Ty Gellash (Senator Levin); Elizabeth Herman (Senator McCaskill); Henry J. Kerner, Staff Director/Chief Counsel to the Minority; Stephanie Hall, Counsel to the Minority; Brad M. Patout, Senior Advisor to the Minority; Scott Wittman, Research Assistant to the Minority; Megan Schneider, Intern to the Minority; John Lawrence (Senator Ayotte); Ritika Rodrigues, Rachael Weaver, (Senator Johnson); and Brandon Brooker (Senator Paul).

### **OPENING STATEMENT OF SENATOR LEVIN**

Senator LEVIN. Good morning, everybody. Before we begin, I know that we are all heartbroken because of the tragedy in Oklahoma, and we want those communities and all the families and individuals who are affected to know that they are not alone. They are not going to face this alone, and American mourns with you and will help you rebuild.

The Subcommittee meets today to hold a second hearing to examine how U.S.-based multinational corporations use loopholes in the Tax Code to move profits to offshore tax havens and to avoid paying U.S. taxes. In September, we examined two case studies: a study of how Microsoft Corporation shifted profits on U.S. sales to U.S. customers from the United States to an offshore tax haven; and also a study on how Hewlett-Packard devised a “staggered foreign loan program” to effectively repatriate offshore profits to the

United States without paying the U.S. taxes that are supposed to follow repatriation.

Today the Subcommittee will focus on how Apple effectively shifts billions of dollars in profits offshore, profits that under one section of the Tax Code should nonetheless be subject to U.S. taxes, but through a complex process avoids those taxes.

Our purpose with these hearings is to shine a light on practices that have allowed U.S.-based multinational corporations to amass an estimated \$1.9 trillion in profits in offshore tax havens, shielded from U.S. taxes. One study has estimated that offshore earnings stockpiled by S&P 500 companies using these techniques have increased 400 percent in the last decade.

There is a direct relationship between this rapidly accelerating shift of corporate profits offshore, on the one hand; and on the other, a worrisome Federal deficit fed in part by a decline in the contributions corporate taxes make to Federal revenue. Corporate income tax revenue has accounted for a smaller and smaller share of Federal receipts and today is down to about 9 percent of Federal revenue. That decline is in part due to the use and abuse of loopholes that so riddle our Tax Code that the average U.S. corporation pays an effective tax rate of 15 percent, less than the statutory rate of 35 percent. A recent study found that 30 of our largest U.S. multinationals, with more than \$160 billion in profits, paid nothing in Federal income taxes over a recent 3-year period. These corporations use multiple offshore loopholes that give them significant control over how much U.S. income they will report and how much tax, if any, they will pay.

Despite the immense impact of these offshore tax practices that deepen the Federal deficit and increase the tax burden on American families, few Americans see the problem because of its complexity. The first step toward change is to acknowledge that there is a problem. Today, we again spotlight corporate offshore tax avoidance so that our colleagues, and the American people, understand the depth of our offshore tax loophole problem and the damage that it does to our fiscal and economic health.

Apple is an American success story. Its products are justifiably well known and used throughout the world. Just like millions around the world, I carry an iPhone in my pocket. The company's engineers and designers have a well-earned reputation for creativity. What may not be so well known is that Apple also has a highly developed tax avoidance system—a system through which it has amassed more than \$100 billion in offshore cash in a tax haven.

Sending valuable intellectual property rights offshore together with the profits that follow those rights is at the heart of Apple's tax avoidance strategy. More and more, intellectual property is the dominant source of value in the global economy. It is also highly mobile. Unlike more tangible, physical assets, its value can be transferred around the globe, often with just a few keystrokes. The secret to Apple's business success is not in the aluminum and steel and glass of my iPhone and other Apple products. Its profits depend on the ideas that bring those elements together in such an elegant package. That intangible genius is intellectual property that is nurtured and developed here in the United States. The key

to offshore tax avoidance is transferring the profit-generating potential of that valuable intellectual property offshore so that the profits are directed not to the United States, but to an offshore tax haven.

Apple's tax avoidance strategy comes in two parts: first, it executes a shift of the profit-generating power of its intellectual property to an offshore tax haven, thus directing the resulting income to the tax haven—and, of course, to its wholly owned corporations in that tax haven. Next, it uses a number of tactics to ensure that, once this income is offshore, it remains shielded from U.S. taxes, despite provisions of the U.S. tax law which are designed to capture that income as taxable.

Some of Apple's techniques are staples of international tax avoidance, such as its use of what is known as a "cost-sharing agreement" between the parent company and its offshore subsidiaries, and its use of so-called check-the-box regulations. We will discuss those in a moment. But others are unique. Apple has sought the Holy Grail of tax avoidance, offshore corporations that it argues are not, for tax purposes, resident anywhere in any nation. And here is how it works.

Apple Inc. has created three offshore corporations, entities that receive tens of billions of dollars in income, but which have no tax residence—not in Ireland, where they are incorporated, and not in the United States, where the Apple executives who run them are located. Apple has arranged matters so that it can claim that these ghost companies, for tax purposes, exist nowhere. One has paid no corporate income tax to any nation for the last 5 years; another pays tax to Ireland equivalent to a tiny fraction of 1 percent of its total income.

The first of these companies is Apple Operations International (AOI), and this chart,<sup>1</sup> which we will put up over here, shows Apple's offshore corporate network. AOI is at the top of the structure. Apple is its sole owner. AOI in turn directly or indirectly owns most of Apple's other offshore entities.

Under Irish law, only companies that are managed and controlled in Ireland are considered Irish residents for tax purposes. Apple says that although AOI is incorporated in Ireland, the company is not managed and controlled in Ireland and, therefore, is not a tax resident in Ireland. U.S. tax law, on the other hand, generally turns on where a company is incorporated, not on where it is managed and controlled. Apple says that since AOI is not incorporated in the United States, it is also not present in the United States for tax purposes. Magically, it is neither here nor there.

The second corporate ghost is Apple Sales International (ASI). ASI, as we will explore in a bit, holds the economic rights to Apple's valuable intellectual property in Europe, the Middle East, Africa, India, and Asia. From 2009 to 2012, its sales income amounted to \$74 billion. Apple has performed the same alchemy with ASI as with AOI. It is incorporated in Ireland, operated from the United States, but, Apple says, is a tax resident in neither country. Unlike AOI, ASI has paid a small amount of tax, to Ireland. In 2011, for example, it paid \$10 million in taxes on \$22 billion in in-

<sup>1</sup>See Exhibit No. 1b which appears in the Appendix on page 192.

come. Now, that is a tax rate of five-hundredths of 1 percent. It appears that this tiny tax payment may be related to activity unrelated to ASI's main purpose, which is to serve as a receptacle for profits generated by Apple's intellectual property in much of the world.

Apple has told the Subcommittee that a third subsidiary, Apple Operations Europe (AOE), which sits between ASI and AOI in Apple's corporate structure, also has no tax home, again using the same claims about Irish and U.S. standards on tax residency.

Now, Apple is exploiting an absurdity, one which we have not seen other companies use. The absurdity need not continue. Although the United States generally looks to where an entity is incorporated to determine its tax residency, it is possible to penetrate an entity's corporate structure for tax purposes and to collect U.S. taxes on its income, if the entity is controlled by its U.S. parent to such a degree that the shell entity is nothing more than an "instrumentality" of its parent, a sham that should be treated as the parent itself rather than as a separate legal entity. AOI, AOE, and ASI all sure seem to fit that description.

Take AOI. AOI has no owner but Apple. AOI has no physical presence at any address. In 30 years of existence, AOI has never had any employees. AOI's general ledger, its major accounting record, is maintained at Apple's U.S. shared service center in Austin, Texas. AOI's finances are managed by Braeburn Capital, an Apple Inc. subsidiary in Nevada. Its assets are held in a bank account in New York.

AOI's board minutes show that its board of directors consists of two Apple Inc. employees who live in California and one Irish employee of Apple Distribution International (ADI), an Irish company that AOI itself owns. Over the last 6 years, from May 2006 through the end of 2012, AOI held 33 board meetings, 32 of which took place in Cupertino, California. AOI's lone Irish resident director participated in just seven of those meetings, six by telephone, and in none of the 18 board meetings between September 2006 and August 2012.

ASI's circumstances are similar. Prior to 2012, ASI, like AOI, had no employees and carried out its operations through the action of a U.S.-based board of directors, most of whom were Apple Inc. employees in California. Of ASI's 33 board meetings from May 2006 to March 2012, all 33 took place in California.

In short, these companies' decisionmakers, board meetings, assets, asset managers, and key accounting records are all in the United States. Their activities are entirely controlled by Apple Inc. in the United States. Apple's tax director acknowledged to the Subcommittee staff that it was his opinion that AOI is functionally managed and controlled in the United States. The circumstances with ASI and AOE appear to be similar.

Now, our legal system has a preference to respect the corporate form. But the facts here present this issue: Are these offshore corporations so totally controlled by Apple Inc. that their identity as separate companies is a sham and a mere instrumentality of the parent, and if so, whether Apple's claim that AOI and ASI owe no U.S. taxes is a sham as well?

AOI sits at the apex of Apple's offshore tax avoidance strategy. Apple's claim that AOI and these other subsidiaries are not tax resident in any nation is a key element in its strategy to avoid taxes on its offshore income. But how did that income end up offshore to begin with? And that brings us to a second, more common arrangement for shifting income away from the United States to a low-tax jurisdiction through what is called "transfer pricing."

Many U.S. companies, including Apple, use transfer pricing to shift intellectual property rights to offshore affiliates and then direct income associated with that intellectual property—taxable income that would otherwise flow to the United States where the intellectual property was developed—to the affiliates' home jurisdiction, which is typically a tax haven. Now, there are multiple ways to transfer intellectual property rights offshore, but Apple's primary method is through a so-called cost-sharing agreement.

Generally in a cost-sharing agreement, a U.S. parent and one or more of its affiliates are assigned a designated percentage of funds and resources to be applied to the development of new products—products that in the case of Apple are developed here in the United States. Apple retains legal title to and all marketing rights to the developed property in North and South America, and its offshore affiliates get marketing rights for the rest of the world. And that is a key part of the so-called cost-sharing agreement. It is more than sharing the costs, but the offshore affiliates also gets the marketing rights and the profits for the rest of the world.

Apple set up its cost-sharing agreement with its Irish subsidiaries. Now, I use the term "cost sharing" with some skepticism since it is obviously not an arm's-length transaction, although it is called an agreement. All the money supposedly changing hands belongs to Apple, and all the signatories were Apple employees. The agreement on its face allocates the costs to be shared among the Apple companies; but since all of those costs ultimately come out of the same pocket, in reality the agreement is about shifting profits. The cost-sharing agreement enables Apple to shift profits generated by its intellectual property away from the United States where the intellectual property was developed and instead concentrate the lion's share of profits from most of the world to Apple subsidiaries in Ireland. Again, the intellectual property that generates Apple's profits was created in the United States, but most of the profits are assigned to Ireland.

Why Ireland? Another highly successful but, until now, hidden tax strategy is that Apple has quietly negotiated with the Irish Government an income tax rate of less than 2 percent, well under the Irish statutory rate of 12 percent as well as the tax rates of other European countries and the United States, well below those statutory rates. And as we have seen, in practice Apple is able to pay a rate far below even that low figure. In 2012 alone, due to the cost-sharing agreement essentially shifting profits from all Apple sales outside of the Americas to Ireland, ASI received \$36 billion in income in a nation where it pays almost no income tax.

Additional facts make it even more clear how the cost-sharing agreement functions as a conduit to shift Apple profits offshore to avoid U.S. taxes.

First, Apple's transfer of intellectual property rights through the cost-sharing agreement is not needed for Apple to conduct its commercial operations. Apple Inc. operates in numerous countries around the world without transferring intellectual property rights to each region or country. When interviewed, Apple officials could not explain why ASI needed to acquire Apple intellectual property economic rights in order to conduct business abroad. The interests of all the parties to the agreement are identical, and what is more, Apple Inc., which has renewed the agreement several times, most recently in 2009, can modify the agreement at any time, further evidence that this is not in any sense an arm's-length transaction.

Second, 95 percent of Apple's R&D, the engine behind the success of Apple products, is conducted in the United States. Yet figures provided by Apple show that, over a 4-year period from 2009 to 2012, ASI paid approximately \$5 billion to Apple Inc. as its share of the R&D costs. Over that same period, ASI received profits of \$74 billion.<sup>1</sup> The difference between ASI's costs and the profits, almost \$70 billion, is how much taxable income, in the absence of Apple Inc.'s cost-sharing agreement with its own subsidiaries and its use of other tax loopholes, would otherwise have flowed to the United States. In comparison, over the same 4 years, Apple Inc. paid \$4 billion under the cost-sharing agreement and declared profits of \$38 billion from sales in the Americas. Its subsidiary, in other words, ASI, its Irish subsidiary, received almost twice the profits from property developed by Apple Inc. in the United States.

Common sense says that Apple would never have offered such a lucrative arrangement in an arm's-length deal with an unrelated party. It is hard to imagine Apple offering such a lucrative deal to an outside party at any price. The fact that the Irish subsidiaries pay a share of the R&D costs is irrelevant to the main goal, which is concentrating profits offshore. Even if the Irish subsidiaries paid 100 percent of the R&D costs, this arrangement would still result in massive profit concentration in a tax haven and, therefore, massive tax avoidance.

The cost-sharing agreement is where profits generated by U.S. activity begin their offshore journey. Other loopholes keep these profits shielded from U.S. taxes. Apple exploits tax loopholes to protect its offshore income from being taxed under a part of the Tax Code known as Subpart F, which was designed to combat profit shifting by U.S. multinationals and to collect taxes on some of their income even when held offshore.

Subpart F was a Kennedy-era attempt to combat rampant offshore tax avoidance and evasion. It made certain types of offshore income subject to U.S. income tax, even when that income was not brought back to the United States, including, for example, funds transferred between offshore affiliates in the form of dividends, royalties, or interest.

But in the 1990s, the Treasury Department unwittingly opened a massive loophole in Subpart F. It approved a regulation known as "check the box," which allows companies to declare to the Internal Revenue Service (IRS) what type of entity they are for tax purposes, simply by checking a box on a form. Under check the box,

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<sup>1</sup>See Exhibit No. 1e, which appears in the Appendix on page 195.

multinationals began to declare offshore subsidiaries as “disregarded” for tax purposes—making it appear as if complex chains of offshore entities were one big corporation. That made the funds being transferred among those offshore entities nontaxable under Subpart F. Circumvention of Subpart F became even easier in 2006 when Congress passed what is known as the “look-through rule,” which similarly shields offshore income from taxation under Subpart F.

Apple is one among many U.S. multinationals exploiting these tax loopholes. Its strategies are complex and are outlined more fully in the memo that we have issued. But the net effect is huge. Apple argues that it is one of the biggest corporate taxpayers in America, that in 2012 alone it paid \$6 billion in taxes. What Apple does not say is that, also in 2012, it shifted \$36 billion in worldwide sales income away from the United States and paid no U.S. tax on any of it. In fact, the data provided by Apple indicates that, through its cost-sharing agreement and check the box, in 2012 alone, Apple avoided the payment of \$9 billion in U.S. taxes. That works out to avoiding \$25 million a day, more than \$1 million an hour, in taxes.

Now, Apple executives want the public to focus on the U.S. taxes the company has paid, but the real issue is the billions in taxes that it has not paid, thanks to offshore tax strategies whose purpose is tax avoidance, pure and simple.

Today we will ask Apple executives, as well as tax experts and Treasury and IRS officials, about these tax avoidance strategies. And as we listen to their testimony, we should keep in mind the context in which we meet today. The offshore tax avoidance tactics spotlighted by the Subcommittee do real harm. They disadvantage domestic U.S. companies that are not in a position to reduce their tax bills using offshore tax gimmicks. They offload Apple’s tax burden onto other taxpayers—in particular, onto working families and small businesses. The lost tax revenue feeds a budget deficit that has reached troubling proportions. It has helped lead to round after round of budget slashing and the ill-advised sequestration that now threatens our economic recovery.

Because of those cuts, children across the country are not going to get early education from Head Start. Needy seniors are going to go without meals. Fighter jets sit idle on tarmacs because our military lacks the funding to keep pilots trained. Apple and the other companies exploiting tax loopholes depend on the safety, security, and stability provided by the U.S. Government and by this Nation. Their economic existence depends on the U.S. Government’s energetic protection of their intellectual property—property which they develop here and keep under the protection of the U.S. legal system, while shifting the income that it generates overseas.

Nearly 30 years ago, Ronald Reagan faced a tax system similarly open to exploitation and loopholes. When President Reagan’s Treasury Secretary told him that dozens of America’s most profitable companies paid no income tax, President Reagan was stunned. And armed with that information, he went before the American people to decry “individuals and corporations who are not paying their fair share or, for that matter, any share.” And he said, “These abuses cannot be tolerated.” And he did not tolerate them.

The question that each of us should ask today is: Shouldn't we close unjustified tax loopholes and dedicate the revenue to educating our children, protecting our Nation, building its future, and reducing its deficit? Closing these kinds of unjustified loopholes could provide hundreds of billions of dollars to reduce the deficit and avert damaging budget cuts to our defense, to our schools, our roads, the safety of our food supply, and other important priorities. And we should close these loopholes. They are unjustified. We should dedicate the revenue that generates to these other important priorities, whether or not we reform the overall Tax Code.

Senator McCain and his staff have made an extraordinary contribution to this bipartisan effort, and I thank them for their great work and for your partnership, Senator McCain, on this Subcommittee. Thank you. Senator McCain.

#### **OPENING STATEMENT OF SENATOR McCAIN**

Senator MCCAIN. Thank you very much, Mr. Chairman. I want to thank our witnesses who are here today, our two expert witnesses, Professor Harvey and Professor Shay.

I would also like to express my appreciation to both the government witnesses and Mr. Cook and his two executives who are here to defend their position, and we will obviously listen very carefully to their testimony. And I think it is important that all of us make it very clear the admiration that we hold for Apple. The incredible changes that Apple has caused in our lives and the spread of information and the capabilities to share information and knowledge throughout the world have been phenomenal, both by Mr. Cook and his predecessor, Mr. Jobs.

However, Apple's corporate tax strategy reflects a flawed corporate tax system, and it is a system that allows large multinational corporations to shift profits offshore to low-tax jurisdictions. For years, Apple has opted to forgo fully contributing to the U.S. Treasury and to American society by shifting profits and circumventing U.S. taxes. In the last 4 years alone, Apple has avoided paying taxes on \$44 billion in income.

With over \$145 billion in cash on hand, Apple ranks as one of the wealthiest multinational corporations in the world. Given its annual intake, Apple executives enjoy reminding the public that the company is likely the largest corporate taxpayer in the United States. However, these same executives fail to mention another less attractive fact: Apple is also one of the biggest tax avoiders in America.

Today Apple has over \$100 billion, more than two-thirds of its total profits, stashed away in an offshore account. That is over \$100 billion that are not currently subject to U.S. corporate income taxes and, therefore, cannot be used to ease the deficit or help invigorate the same American economy that fostered the creation of this large corporation in the first place. As the shadow of sequestration encroaches on hard-working American families, it is unacceptable that corporations like Apple are able to exploit tax loopholes to avoid paying billions in taxes.

Apple's corporate tax strategy is fueled by the company's fixation on reducing U.S. tax payments. Apple's scheme enables the com-

pany to shift billions of dollars in global profits into overseas subsidiaries without having to pay U.S. taxes.

Although Apple is by all accounts an American company, its holding company in Ireland currently retains the bulk of its profits. The Subcommittee's investigation has uncovered a disturbing truth. Apple's three primary Irish entities hold 60 percent of the company's profits, but claim to be tax residents nowhere in the world. It is completely outrageous that Apple has not only dodged full payment of U.S. taxes, but it has managed to evade paying taxes around the world through its convoluted and pernicious strategies.

Specifically, from 2009 to 2012, Apple Operations International received roughly \$30 billion in dividends from other Apple subsidiaries around the world. That made up 30 percent of Apple's total worldwide net profits over the last few years. However, Apple Operations International did not pay corporate income taxes to any national government. Furthermore, Apple Operations International, a company with tens of billions of dollars in cash, has never had any employees and appears to be completely directed by Apple in California.

Perhaps sensing that it might need to maintain some semblance of legitimacy, Apple Sales International, another subsidiary with no tax residence and no employees through 2011, began employing 250 people in 2012. However, with \$22 billion of income in 2011, Apple Sales International, only paid one-twentieth of 1 percent in Irish taxes. As Apple funnels billions of dollars through its numerous Irish entities, even those entities that do pay taxes enjoy a negotiated tax rate of less than 2 percent. Apple contends that none of its subsidiaries in Ireland reduce its U.S. tax liability by one cent. This statement is demonstrably false.

For one thing, the very method by which Apple divides the world serves to deprive the United States of substantial revenue. By centralizing worldwide profits outside of the Americas in Ireland, Apple is able to shelter its profits from the U.S. tax authorities. Furthermore, Apple has taken its most valuable asset, its intellectual property, and divided it between its legal and economic rights. The company left 100 percent of its legal rights in the United States, but transferred a portion of these economic rights to its Irish entities, thereby shifting billions of dollars in profit to Ireland. Despite the fact that 95 percent of Apple's research and development takes place right here in the United States of America, the majority of its profits are elsewhere. Apple's Irish subsidiary has profited in an amount far in excess of its research and development contributions.

By engaging in these elusive corporate strategies aimed at deferring and reducing tax payments, Apple's tax department has given a new meaning to the company's old slogan, "Think different." In my view, loopholes like these, which multinationals like Apple aggressively employ, are harmful in that they provide large corporations huge competitive advantages over smaller domestic companies. These domestic companies pay a higher tax rate because they cannot use overseas operations to lower their effective corporate tax rate. It is problematic when small and emerging American com-

panies feel the full weight of corporate income taxes while larger corporations maneuver around full tax payment.

Given the massive budget cuts under sequestration that have impacted our Nation's most vital interests, U.S. corporations cannot continue to avoid paying their appropriate share in taxes. Our military cannot afford it, our economy cannot endure it, and the American people will not tolerate it.

America's tax system is broken and uncompetitive, and I have long supported efforts to modernize it. However, I will not allow that position to be used as an excuse to turn a blind eye to the highly questionable tax strategies used by Apple. The general American public should not have to make up the balance as corporations avoid paying billions in U.S. taxes. The egregious loopholes that exist in the Tax Code must be closed so that the nearly \$1 trillion in untaxed overseas profits can come back to the United States. It is past time for American corporations like Apple to reorganize their tax strategies to pay what they should and invest again in the American economy.

When Tim Cook, an outstanding executive, CEO of Apple, met with the Subcommittee, he said that though he has no immediate intentions of repatriating Apple's foreign cash, the company does have plans to grow manufacturing in the United States and create more American jobs. This is a step in the right direction, and we must have a tax system that encourages this objective.

Mr. Chairman, finally, as Ronald Reagan used to say, facts are stubborn things, and I would just like to repeat again the following facts: 95 percent of the research and development of Apple takes place in the United States, less than 1 percent in Ireland. Apple's Irish subsidiaries, Apple Operations in Europe, Apple Sales Incorporated, and Apple Operations International, are tax resident—I repeat, are tax resident—nowhere in the world. Apple has negotiated a tax rate in Ireland of less than 2 percent. Apple used loopholes to defer paying taxes on \$44 billion in taxable offshore income. ASI paid 0.05 percent in global taxes in 2011, \$10 million in taxes on \$22 billion in earnings. ASI from 2009 to 2012 contributed a little more than half of the cost-sharing payments to Apple Incorporated but pocketed twice the earnings of Apple Incorporated, \$74 billion compared to \$39 billion. Apple Operations International received \$30 billion in dividends from 2009 to 2012 and paid zero taxes; \$102 billion of Apple's \$145 billion in cash on hand is overseas.

I thank you, Mr. Chairman.

Senator LEVIN. Thank you very much, Senator McCain.

And we have Senator Johnson and Senator Paul. Do either of you have an opening comment? We welcome you.

#### **OPENING STATEMENT OF SENATOR PAUL**

Senator PAUL. Frankly, I am offended by the tone and tenor of this hearing. I am offended by a \$4 trillion government bullying, berating, and badgering one of America's greatest success stories.

Tell me one of these politicians up here who does not minimize their taxes. Tell me a chief financial officer that you would hire if he did not try to minimize your taxes legally. Tell me what Apple has done that is illegal.

I am offended by a government that uses the IRS to bully tea parties, but I am also offended by a government that convenes a hearing to bully one of America's greatest success stories. I am offended by the spectacle of dragging in executives from an American company that is not doing anything illegal. If anyone should be on trial here, it should be Congress.

I frankly think the Committee should apologize to Apple. I think that the Congress should be on trial here for creating a bizarre and byzantine Tax Code that runs into the tens of thousands of pages, for creating a Tax Code that simply does not compete with the rest of the world.

This Committee will admit that Apple has not broken any laws, yet we are forced to sit and Apple is forced to sit through a show trial at the whims of politicians, when, in fact, Congress should be on trial for chasing the profits of great American companies overseas.

We haul before this Committee one of America's greatest success stories, and you want applause? I say instead of Apple executives we should have brought in here today a giant mirror. OK? So we could look at the reflection of Congress, because this problem is solely and completely created by the awful Tax Code.

If you want to assign blame, the Committee needs to look in this mirror and see who created the mess, see who created this Tax Code that is chasing American companies overseas.

Our corporate Tax Code is double Canada's I never thought I would be complimenting Canada for their Tax Code. Ours is double Canada, double a lot of Europe. Instead of complaining that theirs is too low, why don't we set about to work that ours is too high?

Apple has 600,000 jobs they have created, American jobs, and we want to drag them before this Committee to chastise them? I find it abominable.

Just in my State, we have \$700 million in sales from Dow Corning. They make the Gorilla Glass, and they were virtually out of business. In the 1990s, Apple struggled. If I had to guess—unfortunately, I did not guess enough to invest in Apple, but the thing is that in the 1990s people were worried they might go out of business. They had one computer that was not doing well, and then all of a sudden, the innovation that came about. And we want to bring them forward and chastise them for their success?

A couple years ago, we did repatriation of foreign capital. We want the capital to come home. Do not double tax it. We tax it at 35 percent. Let us tax it at 5 percent. I have a bill that would repatriate profits from foreign companies at 5 percent and put it into infrastructure. Our country is woefully short of money for infrastructure. But you are not going to get it at 35 percent. You are getting zero. Let us make it 5 percent and create an infrastructure fund. There are probably 70 votes for that bill in Congress, but nobody will bring it up. Why? They say, oh, it is the sweetener for overall tax reform, which is elusive and a hill too tall to climb and never seems to get here. Why not tomorrow pass it?

Why do you think people are frustrated with Congress? Because we do not do the right thing. Everybody admits, even those who want to drag Apple before this Committee, they admit that our Tax Code is part of the problem, that if we had repatriation at 5 per-

cent that they would bring money home. Why don't we just pass it? Instead, it has to be revenue neutral, scored by the Congressional Budget Office (CBO). Just pass it if it is the right thing to do.

I would say that what we really need to do is apologize to Apple, compliment them for the job creation they are doing, and get about doing our job. Look in the mirror and let us make the Tax Code better, fairer, and more competitive worldwide. Money goes where it is welcome. Currently our Tax Code makes money not welcome in this country.

Thank you, Mr. Chairman.

Senator LEVIN. Thank you, Senator Paul. You are, of course, free to apologize if you wish. That is not what this Subcommittee is about. This Subcommittee is about investigating a Tax Code that is not working for the American people, is not working for businesses in this country, where some businesses decide how many taxes they are going to pay, how many they will not, what they are going to leave offshore in terms of profits, and cooking up all kinds of arrangements to avoid paying taxes. Apple is a great company, but no company should be able to determine how much it is going to pay in taxes, how many profits they are going to keep offshore, how they are going to bring them back home, using all kinds of gimmicks to avoid paying the taxes that should be paid to this country. They make use of this country. They use our legal system. They have the right to lobby here for whatever they want to do, and they do lobby here plenty. But they do not have a right to decide in my book how many taxes they are going to pay and to whom they are going to pay them. Avoiding paying taxes in this country to me is not right. The American people know it is not right. And if you want to hold up a mirror, you can hold up a mirror to anybody you want. You can apologize to anyone you want. This Subcommittee is not going to apologize to Apple. We did not drag them in front of this Subcommittee. They have come here willingly to explain their system. We intend to hear from them as to what this system is that they use. We are also going to hear from some experts, and those experts are now going to testify in front of us.

I now would like to call our first panel of witnesses this morning: Professor Richard Harvey of Villanova University School of Law in Villanova, Pennsylvania; and Professor Stephen Shay of Harvard Law School in Cambridge, Massachusetts. We appreciate both of you being with us this morning. We look forward to your testimony.

Professor Shay, I would like to welcome you back, having testified at our previous hearing on this matter in September of last year.

Professor Harvey, we welcome you to the Subcommittee. We appreciate both of you sharing your legal and your tax expertise today. We look forward to your testimony and your perspective on offshore profit shifting.

Pursuant to Rule VI, all witnesses who testify before the Subcommittee are required to be sworn. At this time I would ask you both to please stand, raise your right hand. Do you swear that the testimony you are about to give to this Subcommittee will be the

truth, the whole truth, and nothing but the truth, so help you, God?

Mr. HARVEY. I do.

Mr. SHAY. I do.

Senator LEVIN. We will use a timing system today. Please be aware that 1 minute before the red light comes on, you are going to see the lights change from green to yellow, giving you an opportunity to conclude your remarks. While your written testimony will be printed in the record in its entirety, we ask that you limit your oral testimony to no more than 10 minutes.

Professor Harvey, we are going to have you go first, and after we have heard your testimony, all of the testimony from both witnesses, we will then turn to questions. Professor Harvey, you may proceed.

**TESTIMONY OF J. RICHARD HARVEY,<sup>1</sup> PROFESSOR, VILLANOVA UNIVERSITY SCHOOL OF LAW, VILLANOVA, PENNSYLVANIA**

Mr. HARVEY. Thank you, Mr. Chairman. Also, thank you, Ranking Member McCain, Members of the Subcommittee. Thank you for the opportunity to speak this morning. The issues surrounding transfer pricing and the shifting of profits by multinationals offshore is a very important issue, and specifically we are going to discuss the techniques that Apple uses to accomplish that result.

My professional background is described in my written testimony, but in summary, I am currently a professor at Villanova School of Law and Graduate Tax Program. I am a retired managing partner at a Big Four accounting firm, a former senior IRS official, and was also in the Treasury Department Office of Tax Policy during the 1986 Tax Reform Act.

So, with the Chairman's permission, I want to submit my written testimony for the record, and I will summarize my major observations orally.

Senator LEVIN. It will be made part of the record, as will all the prepared testimony.

Mr. HARVEY. OK. I plan to make a few general remarks about Apple's tax planning, and then I want to discuss briefly how companies like Apple accomplish the shifting of income offshore. And then I want to close with some tax policy recommendations that hopefully the Committee will consider. So let us start with my general comments.

I guess starting off—this is obviously going to be a little bit of an Apple-bashing day, I suspect, but I would like to start off with some good news for Apple. And the first good news is after reviewing their structure, although I have not done a detailed audit—I leave that to the IRS, I suspect that what Apple has done is within the bounds of what is acceptable under current international tax law.

Now, that in its own right raises issues, though, and I will talk about them in a minute.

The second thing I want to mention is that Apple was able to allocate 64 percent of its 2011 income into Ireland, a company, as

<sup>1</sup>The prepared statement of Mr. Harvey appears in the appendix on page 81.

you folks have indicated, that basically had no employees, and had no real activity. It was basically an entity on paper.

Now, the scary thing is Apple allocated 64 percent of its global income into that shell corporation. There are other multinationals that probably would have allocated even more. So to some extent, Apple is not as aggressive as others; but, nevertheless, Apple is still shifting a substantial amount of income, 64 percent of its 2011 income, into an entity with no employees and with no real activity.

So, in my opinion, the issue today is not whether Apple's current structures are legal. It is not whether they are the most aggressive multinational company on the planet. But, rather, the real question is whether it makes sense for Apple and other companies like Apple—and I am talking about not only U.S. multinationals. This is a global issue, so it is foreign multinationals as well—whether it makes sense to have them being able to record 64 percent of their profits in an entity that has no employees and no real activity. That is the real question that I think we need to focus on. And, again, I think there is congressional action that can be taken if Congress so chooses.

Now, let us turn to how Apple was able to record so much income in an entity, Apple Sales International. And I focused mostly on 2011 during my review. So in 2011, they recorded \$22 billion of pre-tax income in Apple Sales International. And the question is: How did they do that and accomplish a 0.05 percent tax rate?

But before I go into that, I would like to directly address a statement in Apple's testimony that they made public yesterday. And, specifically, the testimony says, "Apple does not use tax gimmicks."

Now, I about fell off my chair when I read that because, when I think about tax gimmicks, certainly some of the techniques that Apple uses could, in general usage of the word, be considered "gimmicks." But I will let the Committee decide for themselves whether Apple used gimmicks that resulted in \$74 billion of income over 4 years being recorded in an Irish subsidiary with no employees for 3 of the 4 years and 250 employees in the last year and paying essentially no tax.

So I think as you listen to today's hearing, I would ask you to think about whether these are gimmicks or maybe techniques or tools, but I would also think about what we should be doing about it.

Now, quickly, some critical factors that allowed Apple to accomplish this result, and Chairman Levin and Ranking Member McCain have already discussed some of them, so I will just quickly summarize them.

The first critical factor is that the United States has this concept of arm's-length pricing. So the idea is that two affiliated entities can enter into a transaction, and as long as it is at an arm's-length price, it will be respected for international tax purposes.

Now, this is true whether the transaction is a relatively simple, say, provision of service or whether it involves the cure of cancer or the development of an iPad, an iPod, or an iPhone.

As a result, because of this arm's-length pricing, what Apple did is they entered into a cost-sharing agreement where they transferred their development rights to operations outside of the Americas to the Ireland subsidiary. Cost-sharing agreements are legal

under U.S. tax law. So I think one question for Members of the Committee and ultimately Members of Congress to consider is whether it makes sense for a company like Apple to be able to enter into an agreement that transfers its crown jewels to a foreign affiliate with no employees and very little activity. So that was the first factor.

The second factor is the United States has so-called Subpart F rules. Those Subpart F rules are designed to tax passive income, and Apple was able to avoid those. Apple avoided them mostly through check-the-box regulations and the controlled foreign corporation (CFC) look-through rule.

Now, the check-the-box regulations allow Apple to make an election to treat entities as though they do not exist, and as a result, transactions disappear.

Now, when my children were younger—I have four adult boys, but when they were younger, they were big into magic, and they might characterize the check-the-box regs as making things go, “Poof.” Now, some of us in the tax trade refer to check-the-box regulations as a tool for avoiding the Subpart F rules. However, I suspect most others may view it as a gimmick in the sense that you are able to make an election and just make transactions disappear under the U.S. tax law.

The third critical factor in Apple’s planning was they were able to avoid paying any material Irish tax. It is not clear to me whether they cut a specific deal with the Irish taxing authorities. That was what I was led to believe by some of the testimony they apparently gave to members of the staff. But at the last minute, in the last 48 hours, we became aware that Apple has entities in Ireland that are not managed and controlled—in fact, all of their major entities in Ireland are viewed as not managed and controlled and, therefore, not tax resident in Ireland. But be that as it may, the bottom line is that they had a substantial amount of income, \$74 billion over 4 years, recorded in Ireland, and they paid essentially no tax.

The fourth critical factor—and this is really important for the rest of the world—is that Apple has roughly 60 percent of its global sales outside of the United States and outside of Ireland, but they only allocate roughly 6 percent of their profits to the rest of the world. And the way they accomplish that is by having a very minimal sales commission being paid to entities that operate in those countries. I am not suggesting that that is in any way illegal, but that is the end result of their planning. They pay a sales commission to sell into those particular countries in the world, and \$74 billion of income can end up being retained in the Irish entity. Now, I suspect there will be some interesting publicity around the world surrounding the lack of Irish taxes being paid.

So let me move on because I am running out of time, but the real question here is what to do about this. And I guess the more important question is: Should anything be done? And if so, what? And I would say that except for executives of multinational companies, almost everyone I speak to would agree that something needs to be done when so much income can be allocated into an entity that has no substance of any significant effect. So it seems kind of crazy to allow that result.

Although there is general agreement that something needs to be done, there is not general agreement as to exactly what should be done, and there are different scenarios. One scenario would say we will wait for some sort of global consensus to arise. The Organization for Economic Co-Operation and Development (OECD) is studying this particular issue and is due to issue some thoughts within the next month or two. But typically my experience is the OECD does not move very quickly.

Second, another alternative is for the United States to act unilaterally, and unilateral action may be something that is needed in this particular case, if only to jump-start what is going on around the rest of the world.

So my basic recommendations are:

In the short run, Congress should consider tightening the Subpart F rules by potentially restricting check-the-box regulations for foreign entities, potentially limiting the CSC look-through rule, and potentially limiting the contract manufacturing regulations which I have not spoken about because Apple really did not take advantage of those.

In addition, I think in the short term, Congress should be thinking about increased transparency. There should be additional reporting done by U.S. multinationals that shows where they record their income for both accounting and tax purposes, as well as where they record tax expense, where they pay tax, and other factors that might be useful in allowing tax administrators around the world to audit those companies.

In the longer term, there still needs to be a solution because to the extent that there is an arm's-length pricing model, you will always have companies having the opportunity to shift income. So I would strongly suggest that in the long run the United States continue to monitor what is going on in the OECD. But assuming a global consensus cannot be reached, I would not recommend that the United States adopt a worldwide tax system unless the United States reduces its corporate rate down to 15 percent. And since I do not think that is going to happen anytime soon, we can probably reject that alternative. But if the United States does keep the arm's-length standard, I recommend imposing a minimum tax on foreign earnings, especially those from tax havens. But this tax needs to be designed so it is administrative. As a former tax adviser in the private sector as well as a government official, it needs to be administrable, and I make some specific recommendations in my written testimony.

And then one other point that I have not mentioned is the need to defer deductions with respect to activity overseas. What often-times happens is U.S. multinationals will borrow in the United States effectively on-lend that overseas, and they will deduct the interest in the United States. but they will not recognize any interest income in the United States. I think that is an issue that also needs to be addressed.

Since I am over my time here, I am going to conclude my testimony. Thank you for asking me to testify this morning, and I would be pleased to answer any questions.

Senator LEVIN. Thank you, Professor Harvey.

**TESTIMONY OF STEPHEN E. SHAY,<sup>1</sup> PROFESSOR, HARVARD  
LAW SCHOOL, CAMBRIDGE, MASSACHUSETTS**

Mr. SHAY. Chairman Levin, Ranking Member McCain, Members of the Subcommittee, thank you for the opportunity to testify on the important topic of shifting of profits offshore by U.S. multinational corporations. I am a professor of Practice at Harvard Law School. The views I am expressing are my own personal views.

I have also served in the Treasury Department and I have practiced for over two decades at a large law firm as an international tax partner.

The Subcommittee and its staff should be commended for pursuing this important investigation. Protecting the existing U.S. tax base is an important responsibility of those in Congress and the Administration responsible for the fiscal health of the country. The revenue lost to tax base erosion and profit shifting is hard to estimate, but there is compelling evidence that the amount is substantial. This revenue loss exacerbates the deficit and undermines public confidence in the tax system. Restoring revenue lost to base erosion and profit shifting would support investing in job-creating growth in the short term and reducing the deficit over the long term.

My written testimony provides background information on the taxation of foreign income of U.S. multinationals earned through a controlled foreign corporation and on transfer pricing. I will review certain of the information developed by the Subcommittee staff regarding Apple's international tax planning and consider how current elements of U.S. tax law contribute to key elements of that planning and make a limited number of observations regarding the implications for tax law changes.

Apple is a remarkable and a remarkably successful company. I will refer to the information in Apple's fiscal year ending 2011 instead of the most recently ended year because separate subsidiary information only was made available to the Subcommittee staff for fiscal year 2011.

The Apple companies in Ireland included two participants in the cost-sharing agreement that was of longstanding with Apple for the rights to sell products outside North and South America. Based on consolidating financials (without eliminations for each of these companies), in 2011 Apple's Irish companies earned approximately \$22 billion in earnings before tax (EBT), or approximately 64 percent of total global EBT. Of that \$22 billion, roughly \$18 billion was operating income. For reasons I mention in my testimony, I am going to stick with EBT for most of my numbers.

Senator LEVIN. And, again, what is EBT?

Mr. SHAY. Earnings before tax. Thank you, Mr. Chairman.

The Apple Irish companies' earnings before tax to sales margin was 46 percent compared to 23 percent for Apple in the United States.

The average effective book tax rate for the Irish companies was well below 1 percent. Although Apple listed their "location for tax purposes" as Ireland in prior disclosures to the Subcommittee, I was advised on Sunday night that the principal companies in terms

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<sup>1</sup>The prepared statement of Mr. Shay appears in the Appendix on page 107.

of earning income directly, Apple Operations Europe and Apple Sales International, are not tax resident in Ireland.

Apple Operations Europe and Apple Sales International as a result only pay Irish tax on business carried out in Ireland. Ireland does not make a claim to tax a non-resident Irish company on non-Irish income.

It is not clear where the income attributable to the cost-shared intangibles is treated as earned by Apple from the information that we have been provided. It appears to be allocated away from Ireland for tax purposes. Presumably, it is what is fondly referred to by international tax planners as “ocean income.” It would be difficult to achieve a less than 2-percent Irish effective tax rate if that income were subject to Irish tax at either its 12.5-percent rate for trading income or a 20-percent rate otherwise.

Over the 3-year period 2009–11, Apple’s Irish cost-sharing participants paid approximately \$3.3 billion in cost-sharing payments to Apple US. While that is a very large number, over the same period Apple’s Irish affiliates has earnings before tax after those payments of \$29.3 billion. So would Apple have entered into the cost-sharing arrangement if Apple’s Irish affiliates had been unrelated? To answer “yes” in my view strains credulity.

The U.S. tax that was deferred on these earnings was likely over \$10 billion. The ability to reinvest those tax savings is a valuable tax benefit.

The objective of the arm’s-length principle in transfer pricing is to achieve neutral treatment of related and unrelated party transactions. The ability of multinational businesses to take advantage of transfer pricing between related persons in different countries—or possibly in this case in no country—strongly favors structuring transactions with affiliates to be able to shift income into low-tax countries or no country. It is an advantage that is largely unavailable to purely domestic businesses including almost all small business enterprises. Yet small businesses and individuals must make up the lost taxes.

The benefit of this income shifting is enhanced when deductions are incurred in the United States to earn this low-tax income that is deferred from U.S. tax. As described in my testimony, it appears that Apple’s general and administrative and sales, marketing, and distribution expenses are incurred disproportionately in the United States. By that, it is not that they should not be incurred here, but they do not appear to be charged against this low-taxed income in Ireland.

Allowing a current deduction for whatever portion of these expenses is attributable to income booked in the Irish companies effectively is a U.S. tax subsidy for those deferred earnings. This is often referred to in exemption countries as “deduction dumping”—in other words, you put your deductions in the home country, and you try and achieve low tax exempt income outside the home country.

Our system of deferral creates, and even more if it were an exemption system, creates an irresistible incentive to shift income to where it will be low taxed or not taxed. This was understood when the Subpart F limits on deferral were first adopted in 1962. They were intended to serve as a vital backstop against transfer pricing

abuse by reducing the incentives that would arise if income could be shifted to low-or zero-tax countries. Apple's international structure takes full advantage of loopholes in existing anti-deferral rules.

Apple avoids the reach of the foreign base company sales rules by contracting for manufacture of its products with third parties and in most cases, for U.S. tax purposes, selling to third parties. By using check-the-box disregarded entities, intercompany transactions within the group of companies that are classified as disregarded simply disappear.

With respect to payments of interest and dividends, the look-through rule of 954(c)(6) accomplishes much the same result except to the extent that deductible payments offset income of the payor that would not be subject to current U.S. tax.

If all of this works, our tax rules allow Apple to allocate billions of dollars to nowhere when our rules presume that in order to achieve deferral, some country has residence jurisdiction to tax the income. That to me is the implication of what we learned on Sunday night. No country is making a claim, and yet we are allowing deferral of those earnings.

Our international tax rules are out of balance. They are too generous to foreign income and not strong enough in protecting against U.S. base erosion by foreign companies investing in and carrying on business in the United States. The losers are domestic businesses.

In the context of current law, if we are not going to go to tax reform and in my view repeal deferral, changes still may be made that would limit the scope for profit shifting. Most promising is a minimum tax imposed on the U.S. shareholder of a controlled foreign corporation in respect of low-tax foreign income. This should not be a final tax in design. It should be a deemed distribution, as under current Subpart F, but the remaining U.S. tax should be collected when the earnings are distributed or the stock is sold.

This should be accompanied by taking away the advantage of tax havens for foreign companies that invest and carry on business in the United States. The United States should protect its source tax base by measures that include imposing withholding tax on and/or restricting deductions for deductible payments of income paid to or treated as beneficially owned by related persons that are not "effectively taxed" on the income. In doing this, the United States would take away a substantial advantage that foreign-owned companies have in structuring investments in the United States.

Third, the United States should strongly support and lead efforts at the OECD to combat base erosion and profit shifting. I have described elsewhere an approach that, if taken by the United States, would provide the incentive for other countries to adopt complementary rules.

Should Congress wait for tax reform to address income shifting? The short answer is no.

I applaud the Committee for exposing—"exposing" is really the wrong word—for bringing to light international tax practices that are not easily discernible from public financial statements.

Thank you, and I would be pleased to answer any questions.

Senator LEVIN. Thank you both.

Let us have an 8-minute first round of questions for the Members of the Subcommittee.

Professor Shay, as we have all said this morning, we have learned that these three Irish subsidiaries of Apple are not tax resident anywhere in the world, and the majority of Apple's profits worldwide are not being taxed anywhere. The evidence indicates that ASI, AOI, and AOE, the Irish subsidiaries, are controlled out of the United States.

Let me start with you, Professor Shay. From a tax law perspective, does it make sense to have Apple treat this income as deferred when those entities have no tax residence? I think you just testified to that, but if you could repeat your conclusion.

Mr. SHAY. When deferral was established, its premise was that another country has asserted a tax claim or could potentially assert a claim even if it chooses not to with respect to that income. Ireland, by treating these companies as non-resident, has affirmatively said it is asserting no tax jurisdiction over the income that is not attributable to the Irish business operation. It seems to me that is inconsistent with the premise of deferral because the company has no tax residence anywhere else that is making a tax claim. So, to me that is incoherent. It is an incoherent tax system that permits that to occur.

Senator LEVIN. Now, we have also seen that ASI, which is Apple Sales International, signed a cost-sharing agreement with Apple, that they have no tax residence anywhere in the world; they had no employees at all until 2012; they currently claim to Irish tax authorities that ASI is not managed or controlled in Ireland; their board of directors is composed primarily of Apple Inc. employees; they hold their meetings in California; ASI's finances, including funds, are managed, controlled, and invested by Apple employees in a Nevada subsidiary; their business decisions are made by Apple executives in California. Now, we also know that—I will leave it at that.

Now, Professors, from a policy perspective, does it make sense for a company which is located in a foreign jurisdiction in name only, while activities are controlled in the United States, to be used as a tool to shift profits and to direct tax liabilities away from the United States? Professor Shay.

Mr. SHAY. Mr. Chairman, I do not think that makes sense. But I also meant to put it in a broader perspective, we talk about globalization. We are aware that we now have a digital economy. We have different ways of earning income that no longer have the kind of traditional physical nexus to a country that they once did. It simply is important to rethink our rules, and the premise that I would start with is that we should no longer be oblivious to what happens in the other countries. If another country is not taxing income, then, for example, we should not give a deduction with respect to payments to that country. That is subsidizing activity unnecessarily.

I think we need to rethink our rules on the cross-border context to be more aware of how other jurisdictions are taxing the income.

Senator LEVIN. Professor Shay, has Apple in their cost-sharing agreement effectively shifted profits overseas when they shifted their economic value of their intellectual property offshore?

Mr. SHAY. Yes, by entering into an agreement that had its origin long ago, although it has been renewed a couple of times—or amended a couple of times, I should say, and agreeing to pay a share of the research and development expenses, they have then taken the fruits of that and possibly the fruits of more than just those expenses—based on the numbers—and located it outside the United States. And that clearly has the result of shifting of profits.

Senator LEVIN. Overseas.

Mr. SHAY. Overseas.

Senator LEVIN. Now, they deny that they shift profits overseas, and your testimony is that they are shifting profits overseas through this mechanism. The way to test the reality of Apple's cost-sharing agreement is to ask, as you did, whether or not it would have entered into the same agreement with an independent, unrelated third party. And you, I believe, testified, Professor Shay, that to say yes to that question strains credulity.

Can you tell us why it would strain credulity to say that they would enter into this kind of a cost-sharing and profit-shifting agreement with an independent party?

Mr. SHAY. I think it is important to look at outcomes. And the law authorizes us to do that since 1986. One way of thinking about this is if you were an investor in Apple and the Apple management came to you and said, "Look, we want to partner with somebody who has few or no employees but has some money, and they are going to pay a share of our R&D, and as a result, we are going to give up the rest of the world outside of North and South America profit for that amount, is that a good deal?"

Another way of thinking of it is how would Mr. Einhorn think about that deal. Would he be pleased with that arrangement? Thinking about it that way, it does not seem credible to me.

Now, Apple correctly says in their testimony this cost-sharing agreement had its origins many years ago, and it did. And that raises the question of should that ever have been revisited, and at arm's-length would it ever have been revisited?

When you look at the numbers that were up on the chart, \$4 billion in exchange for \$74 billion of earnings before tax—or \$72 billion, whatever it was, I think in that context you would really question whether at arm's-length that deal would not have been amended sometime between 1980 and now.

Senator LEVIN. So it was amended in the last few years. Is that correct?

Mr. SHAY. It was amended. It was amended for technical reasons. I do not advise them. It appears clear that they amended it in order to stay within a grandfather clause under prior, much more relaxed, cost-sharing rules that have allowed them to perpetuate the arrangement.

Senator LEVIN. All right. And in that arrangement, you are saying that arrangement would never be entered into in the last few years at an arm's-length with an independent party. It just strains credulity, to use your word—

Mr. SHAY. Yes, there are bad deals out there. This would be a whopper. And I just doubt—

Senator LEVIN. A whopper against Apple.

Mr. SHAY. Against Apple, and would you still own the stock if somebody gave away that much of your income? That is a simple way of asking the question.

Senator LEVIN. And if Apple can create companies with no tax residence and create profits in those companies, and if that is going to be tolerated, couldn't all U.S. multinationals in effect do the same thing—eliminate the corporate tax for our multinationals and allow them not only to become tax freeloaders but also to offload their taxes on domestic competitors, small business, and working people? I mean, if they can do it, why couldn't every multinational do the same thing?

Mr. SHAY. I will point out, Apple points out in their testimony, correctly, that they only did this for their international sales. Now, their international sales are very large—

Senator LEVIN. I mean, couldn't any multinational do it for their international sales?

Mr. SHAY. Any multinational could do it for their international sales, but there is nothing preventing it from being done, as we saw with Microsoft, for domestic sales. So, again, this is not an Apple-bashing exercise to me. This is an exercise in saying: Where are we? How can we possibly be in a situation today where the law permits income to be allocated to a company resident nowhere and not be taxed anywhere and the United States just say, forget it, do not worry about it, that is fine?

Senator LEVIN. Thank you.

One last question, Mr. Harvey. You said that you almost fell off your chair when you read that Apple says that they do not use gimmicks. Why did you almost fall off your chair?

Mr. HARVEY. I think the check-the-box regulations, certainly the practical effect of those regulations is a gimmick to make transactions disappear.

Senator LEVIN. And how about creating corporations that do not exist anywhere? Did you ever hear of that before?

Mr. HARVEY. Certainly that is a goal of many tax planners. The utopian goal that tax planners try to obtain is to create an entity that is taxed nowhere. So Apple, through this particular structure, was able to substantially accomplish that result.

Senator LEVIN. Have you heard of that being done in other cases?

Mr. HARVEY. There are other situations where that situation arises, yes.

Senator LEVIN. Where it is taxed nowhere?

Mr. HARVEY. Correct.

Senator LEVIN. Okay. Thank you.

I think, Senator Johnson, probably you came in next. I am not sure who was first.

Senator JOHNSON. I was here first.

Senator LEVIN. Thank you.

Senator JOHNSON. Thank you, Mr. Chairman.

Professor Harvey, in your testimony you stated that, according to your calculations, Apple's overseas income was 64 percent of total income. Their sales were roughly 60 percent. It would strike me that seems to be a somewhat fair allocation of income to sales.

What do you think would be a more fair allocation between recognition of income?

Mr. HARVEY. First of all, just to maybe clarify the statistics, the 64 percent is the amount of income recorded in Ireland. There is another 6 percent recorded in other foreign countries. So in the aggregate, there is 70 percent of income located overseas. So the statistics that I would look at would be that there is 30 percent of the global income in the United States and there are roughly 39 percent of global sales in the United States.

Senator JOHNSON. Okay. My figures are about 39 percent global sales and about 32 percent—I mean U.S. sales about 32 percent. So there is a greater allocation of income.

How should income be allocated?

Mr. HARVEY. I think that is a question, and the key question is for technology that is developed, say, in the United States, how should that be taxed? Now, I think most economists would tell you that if you develop the technology in the United States then the United States would expect to get the lion's share or substantially all of the income with respect to that technology. But—

Senator JOHNSON. How is it handled between States in the U.S.? If you develop the technology, let us say, in New York but your manufacturing plant is in Texas, where is the income tax, the State income tax allocated on that basis?

Mr. HARVEY. Well, it depends on which State you are talking about. There are some States that are separate company States, and there are some States that are global apportionment—

Senator JOHNSON. But, generally, if you are manufacturing in Texas, even though you might have produced a product in New York, you are probably going to be taxed—well, Texas may be wrong. Let us say Wisconsin. In Wisconsin, you would be taxed in Wisconsin because you are manufacturing and selling out of Wisconsin. Isn't that correct?

Mr. HARVEY. Not necessarily. It depends on the particular State rules. It depends where the technology is located. But what I wanted to say, to finish up, which I think is important for you to hear because it may support some of where you are heading, is I think it is a legitimate question for Congress to ask how should technology income be allocated. And if Congress decides that it wants to provide some sort of incentive to have technology income not taxed in the United States then I think that is perfectly within Congress' right to do so, and they should affirmatively do it, as opposed to leaving a regime that is, in essence, a self-help regime that allows taxpayers to really decide how much they are going to pay.

Senator JOHNSON. But in the end, Apple is selling a product, and so you are really talking about where do you tax the manufacturing income. I mean, we can split this baby 16 different ways, but at some point in time you have to figure out where does the incidence of tax lie? I mean, how should income be allocated between countries, between State, between tax jurisdictions? That is a difficult question to answer, isn't it?

Mr. HARVEY. Absolutely. But what I would say is when you have 64 percent of your income in a country like Ireland with no employ-

ees and no real substance, that seems to be a serious issue, and you have to decide where should that income be taxed.

Senator JOHNSON. So let me ask, how long have we been trying to solve this problem through the U.S. Tax Code?

Mr. HARVEY. This problem has existed on and off—well, basically continuously for decades.

Senator JOHNSON. So do you really think there is a fix to it?

Mr. HARVEY. Yes, I believe there are fixes to it that Congress should take, because what has happened in the last 17 years is the passive income—or the Subpart F rules have been so significantly relaxed that it is just open season for taxpayers to go and do whatever they want.

Senator JOHNSON. If you are a business manager whose primary fiduciary responsibility is to your shareholders, and let us say the United States passed a law and said we are going to claim all of your income and tax it at our corporate tax rate of 35 percent, what would a rational business manager do with his overseas operations?

Mr. HARVEY. As I indicated in my testimony, I do not recommend that we tax worldwide income, at least at the full U.S. tax rate. I recommend that we only tax if we are going to have a minimum tax on foreign earnings, that it only be with respect to tax haven earnings, and at something less than the full rate.

Senator JOHNSON. What would that be?

Mr. HARVEY. I think the number that is thrown around by a lot of folks is 15 percent, in that range.

Senator JOHNSON. But what if a business manager felt that was too onerous and couldn't they just divest themselves of those companies and then all of a sudden you have a smaller U.S. company and you have a larger overseas company? I mean, there are unintended consequences to try and do anything there?

Mr. HARVEY. Well, you have the competitive issue, and are you going to let U.S. multinationals then effectively have free rein to move income offshore? And as Professor Shay indicated, you can, if you want to, move almost all of your income offshore. Now, Apple was not that aggressive. They were fairly aggressive, but not that aggressive. So I think you have to balance those issues and, admittedly, very difficult issues. But I think Congress needs to face up to the issue and make some tough policy calls.

Senator JOHNSON. Now, I understand the point that you might have the disadvantage of a domestic competitor that does not operate overseas when a multinational corporation's overall effective tax rate is lowered because of some of the overseas taxation issues. But, in general, who benefits from a lower tax rate on a corporate structure such as Apple? Who is the beneficiary?

Mr. HARVEY. Certainly as a result of their tax planning, their shareholders are the beneficiaries.

Senator JOHNSON. Who are the shareholders of Apple?

Mr. HARVEY. Whoever owns the shares of stock.

Senator JOHNSON. Do you have any idea what the breakdown is?

Mr. HARVEY. I do not know what it is.

Senator JOHNSON. I will probably ask Apple management that.

But, in fact, the people that benefit really are those owners, and a lot of those are probably union pension funds and just individual

shareholders, correct? In other words, there is an assumption that because Apple made a really good deal with the overseas taxing authorities that that is somehow bad for America. In fact, would we be better off if Apple were paying 12 percent to Ireland or 25 percent to Germany? Would Americans be better off?

Mr. HARVEY. I think to the extent that you get a more fair allocation of income, I think ultimately in the long term, yes, Americans would be better off.

Senator JOHNSON. So it would be better if Apple were paying more of its corporate profits to taxing authorities in Ireland and Germany? That would be better for America?

Mr. HARVEY. I think in the long run we need to come up with what is the appropriate taxation of international income. As indicated in my testimony, my written testimony, my preference would be to see a reduction in the corporate tax rate in total for both domestic and foreign companies down to 15 percent and probably replace that with some sort of alternative funds, whether it be a VAT or something else. I do not think that is going to happen anytime soon, so if that is not theoretically possible, then you have to address the very difficult issue about competition between domestic companies and U.S. multinationals and then U.S. multinationals versus foreign multinationals. And I am sensitive to that.

There is an issue as far as competitiveness between the United States and foreign multinationals, but do not forget there is also an issue between competitiveness of U.S. domestics versus U.S. multinationals.

Senator JOHNSON. If you are, let us say, a global manufacturer that wants to manufacture for the U.S. market—and, by the way, that is one of the things we have going for us. We are still the world's largest market. If I am a manufacturer, I would not dream of manufacturing for my domestic customers anywhere other than the United States. But if you are a global manufacturer, would you be more likely to site a plant, let us say, in Toronto at 15 percent or Detroit at 35 percent? What would be the rational thing to do?

Mr. HARVEY. The rational thing from a corporate perspective is to clearly locate in the lowest tax jurisdiction.

Senator JOHNSON. So we need to make sure that we are very competitive globally, and when we are competing against tax jurisdictions around the world that are willing to cut a deal, should corporations take advantage of that? I mean, isn't that the rational thing to do? And, quite honestly, when Apple is responsible for 600,000 jobs in America, that is not just Apple but all the application developers, you multiply that times about a \$50,000 median household income, that is about \$30 billion worth of payroll at about a 20-percent tax rate. That is a lot of taxes flowing into the Federal Government as well, isn't it?

Mr. HARVEY. It certainly is. But under that theory, why don't we just eliminate taxes for Apple?

Senator JOHNSON. That was my next question. So one way around this—one way of actually capturing that income—I just want to posit this idea. My business was an LLC. It was a pass-through income. Why not tax corporate income at the shareholder level? We would eliminate all these problems, wouldn't we?

Mr. HARVEY. Well, how would you propose to tax it for pension funds and foreign shareholders? Would you tax that?

Senator JOHNSON. Well, it—

Mr. HARVEY. Would the U.S. corporate tax be a withholding tax?

Senator JOHNSON. If it passed through to the actual taxpayer—if you are a tax-exempt organization, you will not pay tax on that income. But if you are a high-taxed individual, you will pay it at your high tax. You could eliminate all dividend income, and you could capture all worldwide income, and corporations would—you would eliminate the competitive disadvantage of different taxing jurisdictions.

Mr. HARVEY. Again, if that is what Congress decides to do and wants to replace the \$250 or \$300 billion a year, it is within your prerogative to do so.

Senator JOHNSON. But, again, that would eliminate the inability—and that is basically what we have had. We have had the inability for decades of trying to capture this income that shifts around the world and reacts to different, very byzantine tax structures.

Mr. HARVEY. There is no question that the U.S. tax law is extraordinarily complex. I guess one thing you did say, though, is the issue of whether the U.S. tax law puts U.S. multinationals at a competitive disadvantage, and there are pros and cons on both sides of that. My personal view is that the U.S. tax law in many cases actually favors U.S. multinationals. Maybe we can talk about that separately at some—

Senator JOHNSON. Okay. Thank you.

Thank you, Mr. Chairman.

Senator LEVIN. Thank you. Senator Carper.

#### **OPENING STATEMENT OF SENATOR CARPER**

Chairman CARPER. Thanks very much. I have another competing hearing going on over in the Finance Committee dealing with the IRS, and I apologize for missing your testimony. But thank you for joining us and welcome.

I would like to maybe put this hearing in context. Let me just thank the Chairman and the Ranking Member for holding this hearing and for all the witnesses coming. I want to put it in some context, if I could.

The Congressional Budget Office reported earlier this month that the budget deficit is coming down. About 3 or 4 years ago, it peaked out, topped out at about \$1.4 trillion. The estimate as recently as a month ago was it was—this year our deficit is going to be about \$840 billion. CBO has now said it will be probably closer to \$650 billion—only \$650 billion, and that is an improvement, but we all know it is way too much.

One of our former colleagues, Kent Conrad, who for a number of years was the Chairman of the Budget Committee, told his colleagues last year that if you added up all the tax expenditures, tax deductions, tax breaks, tax loopholes, tax credits, that it added up for the next 10 years to something like \$15 trillion. And as I recall, what our friends Erskine Bowles and Alan Simpson tried to do in leading the Deficit Commission was to propose—in order to be able to bring down the business corporate tax rate from 35 to about 25

to 28 percent, they proposed reducing significantly—not entirely but significantly—the tax expenditures and argued that if we were to do that, we would be more in line with the rest of the world. And it also called for moving to a territorial tax system.

Let me just either of you or both of you just to share with us your views of the approach laid out by the Deficit Commission, their recommendation, which a lot of people said, well, that was dead on arrival. I think it still has a heartbeat, and my hope is that it gives us a road map that will still follow as this year carries on. But let me just ask you to react to their recommendations.

Mr. SHAY. You are referring to Simpson-Bowles.

Chairman CARPER. You got it.

Mr. SHAY. I think that was a very important start to the discussion. There have been a variety of changes since, and I think the realism of eliminating all tax expenditures, as I referred to, is somewhat overstated. I do not think it is going to happen.

Chairman CARPER. I do not know of anyone suggesting we are going to get rid of all of them—they did not suggest that either—but enough to get us down to a rate between—our top rate to about 25 to 28 percent. That was what they recommended.

Mr. SHAY. Right. But I think some of the recommendations, the reason I think this hearing and this issue is important is because part of those recommendations included moving to a fairly unspecified exemption system.

I think that is a source of great concern for the reasons we have been discussing this morning. Under an exemption system, there would be even fewer restrictions; it would even be more beneficial to try and shift income abroad unless significant protections are put in place or there is some form of a minimum tax, something that is done of that nature.

Speaking more broadly, do I think the direction of tax reform should be to broaden a base? My own view is we can use more revenue, so I would not necessarily put it all into lowering rates, but some mix, some balance. I think that is a very sensible way forward.

I think we need to bring the discussion from the level of broad generalities down to specifics. One of the reasons I testified is I think that is going to take time. I actually served in the Treasury Department from 1982 to 1987 during the Reagan Administration. I served throughout tax reform. We started before the election in 1984 to prepare the Treasury proposals. They came out at the end of the year. We spent 1985 going through the House—well, before they went to the House, they first were reviewed and because the President's proposals. And that was a significant review, sort of a political screen, but pretty light, frankly. Then they went through the House. Then they went through the Senate.

That process is looked back on today with great affection and seems to be viewed as a great process. It still came out with a product that was far from perfect, even though it took 3 years. In order to do a tax reform that is going to be responsible, we need the full involvement of the Treasury Department; we need it to be done with the assistance of the Office of Tax Analysis as well as the Joint Committee on Taxation. This is difficult, complicated stuff,

and doing it in broad brush strokes or in a series of political compromises is not going to get us where we want to be.

So while I admire what the Simpson-Bowles folks have done at a high level and in the way they have contributed to the debate, we have a tremendous amount of work in front of us if we are going to have a genuinely effective tax reform.

In the meantime, we should not allow income shifting and base erosion to continue. There are things we can do that would help restore revenue that should be in the budget and that could be contributed to purposes that on a bipartisan basis probably Senator Levin and Senator McCain would agree on.

Chairman CARPER. All right. Thank you.

Mr. HARVEY. I guess what I would add just very quickly, I would concur with pretty much all of what Professor Shay says. The key is if we go to a territorial system, we need to have very clear base erosion principles to prevent that. And I think Chairman Camp from the Ways and Means Committee understands that. In the proposals he has floated, there are base erosion proposals.

Chairman CARPER. All right. The Senate Finance Committee, on which I serve, is going through a series of briefings, basically member-only briefings to look particularly at corporate tax reform and looking broadly at the exemptions that exist and trying to decide where it might make sense to make changes. I think sometimes folks in our jobs, we talk about creating jobs. Mayors, Governors, Presidents talk about creating jobs. We do not create jobs. What we do is help create a nurturing environment for job creation, and that includes a world-class workforce, access to capital, reasonably good infrastructure, some certainty on the Tax Code, and a Tax Code that incents, among other things, investment in the workforce and investment in R&D that is going to lead to products and goods and services that we can commercialize and sell around the world.

We need to provide some certainty with respect to the Tax Code, and I think we need some more revenues. I think one of you mentioned that. The idea of taking the corporate rate down to 15 percent and being able to supplement the lost revenue with a VAT or a carbon tax, actually I do not think either of those are going to happen, probably not on my watch.

And having said that, we do need to provide that certainty and that predictability. We do need the revenues. The last 4 years in the Clinton Administration we had balanced budgets, you will recall. Revenues were anywhere from 19.5 to 20.5 percent of GDP. That is when we had 4 years of balanced budgets. We need to get closer to something along those lines.

Thanks, Mr. Chairman.

Senator LEVIN. Thank you very much, Senator Carper, who is the Chairman of our full Committee. We very much appreciate your being able to get here despite these other commitments that you have. Senator McCain.

Senator MCCAIN. Thank you, Mr. Chairman.

Professor Harvey and Professor Shay, thank you for being here, and thank you for your very important and valuable knowledge and expertise.

Isn't it just a fact that these tax advantages that Apple has either taken advantage of or in some cases, in my view, invented if

you take a tax reduction in a country that you have no employees, but doesn't this put domestic companies and corporations at a distinct disadvantage?

Mr. HARVEY. Yes.

Senator MCCAIN. Professor Shay.

Mr. SHAY. Yes. I think the objective of our tax rules should be to try and achieve a balance, and in this particular case, try to create in relation to transfer pricing and cross-border activity neutrality between what would happen if you were dealing with a third party and what happens when you are dealing with an affiliate. Our rules today favor using affiliates.

Now, coming back to something Senator Johnson referred to, if I understand it correctly, most of Apple's manufacturing is not done by Apple, and that is true of many companies today. It is done, I believe, by Foxconn, or other contract manufacturers, third parties. So companies today view themselves, I believe—and I do not believe there is any problem with it—as they are allocators of capital. They are trying to allocate the capital to the highest after-tax use. And that is fine.

Our job and your job as designers of tax systems is to try and find a way that, while allowing business to do its business, we are taxing income in a way that least disturbs the pre-tax economic decisionmaking. And it seems to me very clear today that we are off balance here. We have very substantial amounts of income earned in a country where very little is done. It is not in the United States where I think most of it probably belongs, but it is also not in the market countries where the customers are.

We need to come up with rules that achieve the outcome of having it taxed fairly, our fair share in the United States wherever else, whatever their claim is their fair share, that is fine. But right now it seems to me clear we are not getting our fair share.

The R&D is done here. It is supported with our educational system. It is supported with an R&D tax credit. And that tax credit applies just as much to the R&D that is cost-shared out to the foreign location as it is here, so long as it was performed in the United States. This is not in balance.

Senator MCCAIN. Ninety-five percent of the R&D conducted by Apple, and I would imagine every other high-tech corporation, is conducted here in the United States. Thank God.

Professor Harvey, Apple has divided the world into two sections—North and South America, and the rest of the world. So if a customer in Sao Paulo, Brazil, purchases an iPhone, Apple Incorporated receives the profit and the United States the tax. However, if a similar customer purchases that same iPhone in Copenhagen, Denmark, that profit goes to Apple Ireland and no corporate tax accrues to any country.

How is it possible that no tax goes to any country?

Mr. HARVEY. I believe some tax does go to the country that the customers are located in, but it is a very small commission.

Senator MCCAIN. Like 0.005 or something like that, Ireland?

Mr. HARVEY. That was the ultimate tax rate in Ireland. I think the commission—I forget the exact commission, but it might have been 5 percent of sales, maybe 8 percent of sales. I am not sure.

Senator MCCAIN. So the moral of the story, at least in my view, is that Apple has violated the spirit of the law, if not the letter of the law, and I agree that a great deal of responsibility lies with Congress. And the last time, as you mentioned, Professor Shay, that we did any meaningful reform was way back in 1986, and it is long overdue. And perhaps this testimony today will motivate the Congress of the United States to enact a comprehensive reform and to bring him this \$1 trillion or \$1.5 trillion, I think it is, amount of money that rests overseas which is not brought back because of the 35-percent tax rate that would be imposed on it. And I guess my question to you, to both of you, is: Should there be a permanent incentive to bring that money home? Or should we have just a one-shot deal to say you can have—if you bring it home within the next year or two, you can have a 5-percent or a 10-percent tax rate imposed on it?

Mr. HARVEY. I guess I will respond first. I do not think another temporary deal makes sense. There was a temporary deal back in 2004–05. Studies done suggested that the vast majority of those funds were used to pay off debt or make dividend distributions.

So I think this really calls for a comprehensive tax reform to address this issue, but also there are some issues that can be addressed in the short term. If Congress decides it wants to tighten up Subpart F, it can do so. If Congress decides it wants to increase transparency, it can do so. So I think a one-time tax holiday of the type that existed before would not be the right policy answer.

Mr. SHAY. Senator, I am not a fan of tax holidays. The fact is quite a substantial portion of the income that is held offshore should have been in the United States in the first place if we were fully enforcing—or if we had transfer pricing rules that made sense. What we are talking about today is there is a portion of the offshore profits that should not have been offshore. In a well-designed tax system, they would not have been offshore.

When the decision was made to allocate income to the lower tax environment, it was done under a law which was crystal clear. It is deferral. It is not exemption. There are proposals to use a holiday or a low rate as an inducement to bring back money, which essentially is a windfall for the companies who earned it overseas under a law that said it was deferral.

Now, I understand that Mr. Cook has indicated to the Subcommittee that there would be no intention to bring back money at the current rates. So it is true that one contributes to pushing more income over there and keeping it there as long as you hold out the prospect of exemption, lower tax rates, and so on. That from a policy point of view does not make a lot of sense to me.

There is a sound economic argument that I am not really arguing for today but that says it is already there, if you tax it, they will bring it home. I mean, their decision to bring it home analytically should be independent of whether you tax it. If you tax it, they will bring it home. If you do not tax it, if you tax at a lower rate, maybe they will bring it home. Even under an exemption system, there is no incentive to bring money home if you are going to earn a higher after-tax return on those funds abroad. The notion that exemption is the key to having money come home, it reduces the transactional effect of having a cost at the time of repatriation. If you had taxed

it at the time it was earned, that would have gone away. That is equally an answer to repatriation, as is giving exemption. So—

Senator MCCAIN. So permanent drastic reduction of the corporate tax rate, it seems to me, following your argument, would be the answer.

Mr. SHAY. That would certainly be a windfall for the earnings that are offshore. I think we generally agree a lower corporate tax rate would be beneficial.

Senator MCCAIN. Thank you, Mr. Chairman. I thank the witnesses.

Senator LEVIN. Thank you very much, Senator McCain. Senator Paul.

Senator PAUL. I think we need to restate for the record and be very clear here that neither this panel nor anyone on the Committee has said that Apple broke any laws. So they are brought before this Committee and harangued and bullied because they tried to minimize their tax burden legally.

I would argue that it would probably be malpractice for them not to do so. If you have a publicly held company and you have shareholders and your mandate to your chief financial officer is, "Please maximize our taxes," I am guessing that that would probably be something that shareholders would not accept. I do not know of any taxpayers who really do that. I do not know of anybody on this panel who tries to maximize their tax burden.

My question for Mr. Harvey: Do you take any deductions on your taxes?

Mr. HARVEY. Obviously I do.

Senator PAUL. Do you choose to maximize your tax burden or minimize your tax burden?

Mr. HARVEY. Minimize it.

Senator PAUL. Do you think you are a bad person for doing that?

Mr. HARVEY. Absolutely not.

Senator PAUL. If you were advising as an accountant and an expert in the tax law, if you were advising a corporation and your mandate was to do what is best for their shareholders, would you advise them to count all their profit here at home at 35 percent or to try to do as much as they can legally to pay their taxes at a lower rate elsewhere?

Mr. HARVEY. Well, as I said in both my written and my oral testimony, certainly what Apple did does not appear in any way to be illegal. I think the question is a policy question as to whether they should be allowed to do it in the future.

Senator PAUL. Yes, and as a policy question, talking about taxes I think is an appropriate thing for Congress. Bringing in an individual company and vilifying them for doing something that is in every business' mandate is objectionable, and that is why I object to these entire hearings, because talking about policy is one thing. For example, \$1 trillion overseas, you want to bring it home? We have examples. We did it for 1 year at 5 percent. We brought in about \$30 billion. We actually limited how much could come in. I say make it permanent. But make it permanent and make it low enough that people would do it. If you permanently do this at 5 percent, the money will come home. But money goes where it is

welcome. If we want to have high taxes, we are going to continue along this.

Everybody talks about tax reform. Just do it. Other countries just do it. We have a 35-percent corporate income tax. We are chasing people away from us.

If the outcome of this Committee's hearing is, "Evil Apple, let us go get them, let us go get companies like this, and let us raise their taxes," guess what? Their headquarters may no longer be in Cupertino. They may be in Dublin with all their employees. They are the type of company, high-tech companies that can relocate around the world. They are not dependent on large manufacturing forces. So if you want to chase them out, bring them here and vilify them. It is exactly the wrong thing to do. We should be giving them an award today. We should be congratulating them on being a great American company and hiring people and not vilifying them for obeying the law. I mean, they are obeying the law. No one is accusing them of breaking the law. They are doing what their shareholders ask, which is to maximize profit.

We have created this byzantine and bizarre Tax Code and chased them overseas. But it has been going on a long time. But just fix it. There are 70 votes right now in the Senate for having a 5-percent repatriation tax. Those votes exist, but everybody says, oh, that is the sweetener for overall tax reform, because so many people agreed to it. Why not just pass it tomorrow? The same with the corporate income tax. We have made ourselves beholden to things like the CBO that are, like, well, the CBO will score that as a loss of revenue. Well, one, the CBO does not know a lot of times, I think, up from down in the sense that you could change the corporate tax—there is such a number that you can lower it to where you will get more revenue. I do not know what that number is, but that number does exist. We are at 35 percent. You have a couple trillion dollars overseas. There is some number you lower it to where less money goes overseas unless people set up their companies to have their taxes overseas.

So there are many ways you can do this. Repatriation would bring a lot home. But if we take it that this is a vendetta against American companies for trying to maximize profit, I think we really have missed the boat here. And really, I say one again, there should be a giant mirror sitting there. We should be looking at ourselves. We should be talking about what we do. Overall tax reform, everybody wants to do it, but they say, oh, it has to be revenue neutral. That to me is absurd as well. That means we are just going to punish some more people and punish some people less. Why don't we try to reward the economy? Why don't we try to reward shareholders? Why don't we try to reduce taxes as a stimulus to the economy? Leave it with the people who earn it.

So I am very frustrated by the whole proceeding, particularly because of all these accusations. They are simply doing what every company does. In fact, if they are not, why don't we have the next hearing of companies who come in and their chief goal, their stated goal, is to maximize their tax burden? I want to see one company come before here and tell us that their goal is different than Apple's, that their goal is to maximize their tax burden. Taxes are simply a cost, and they try to minimize them legally. I do, too. I

take a home mortgage deduction. I take my kid deductions. I take all the deductions I can legally take.

This kind of vilification has gone on before. FDR did it. The President did it in his campaign. This is something that is not good for the country. It pits one of us against another, and I think Senator Johnson really put it well when he said, "Who are these people? Is there a Mr. Apple out there?" No. It is us. If you have a mutual fund, you probably own some Apple shares. If you are a teacher with a pension fund, you own Apple shares. If you are a fireman with a pension fund, you probably own Apple. Apple is a great American company, and I do not even know if they will know the breakdown, but I think it is interesting. Probably the vast majority—I would guess 70, 80 percent of their stock may be owned by Americans. And so who are we doing when we want to punish Mr. Apple? Who are we punishing? We are punishing ourselves. And if we want to grow America, we want more companies to succeed in our country, make money welcome. Money goes where it is welcome, and as much as you want to stuff the genie back in the box and say you must do this in America, companies can and will go everywhere. So let us make it a good place to work. Let us not vilify our American companies.

And so what I would say, let us keep in mind what we are talking about today is not breaking of law. What we are talking about is a company doing what every company in America does, and that is, trying to minimize their tax burden.

Thank you.

Mr. SHAY. Could I make one comment just to be sure the record is correct? In my testimony—and I want to be crystal clear—I said I take no position on the legal correctness or strength of any tax position taken by Apple. I do not want that construed as saying what they have done is also fine. I have no idea. And that was not the point of the hearing. The Subcommittee staff did not request tax returns. They have only requested financial data, so far as I have seen.

What we are trying to do in the hearing, as I understand it, is understand what happens under current U.S. law and ask ourselves: Is this the place we want to be? We can come with different answers, but nobody is trying to vilify Apple, nobody is trying to say what they did is either wrong, but, frankly, I am also not saying that there is no adjustment to be made to their income. I simply do not know. I was not given the facts to reach that conclusion, and I do not reach that conclusion.

Senator LEVIN. Thank you. I think you have put it very clearly. There is no effort to vilify anybody. We are trying to shine a spotlight on the practices of a big company. We have done this with other companies. There is no other way to illustrate the way our current system works. It is a perfectly legitimate—not only legitimate function for Congress. We do not do enough analysis of how the current system works. We do not do enough oversight. And to attribute that to—or to characterize that in the way that it has been characterized by one Senator here as "vilification" misses totally the target of what the function of the Subcommittee is and what Congress is responsible to do and does too far little of, which is to look at how the current practices of the government work, how

they fall short, how they misfire, how they reach absurd results, which is the case here in the case of Apple paying a zero tax. Their goal is a zero tax for three corporations? Is that the goal, a zero tax? Now, it is not a matter of maximizing tax. You can set up a straw man about no one wants to maximize the tax. Of course, no one wants to maximize tax.

Senator MCCAIN. Mr. Chairman, could I also make an unnecessary comment here? I have had the honor of serving with you for more than a quarter of a century. I know of no Member of the U.S. Senate that has ever accused you of bullying or harassing a witness in the thousands of hearings that you and I have been part of over many years. And, frankly, it is offensive to hear you accused of that behavior, which has never characterized your conduct of this Committee or the Defense Committee.

Thank you, Mr. Chairman.

Senator LEVIN. Thank you very much, Senator McCain. I very much appreciate that. Senator McCaskill.

#### **OPENING STATEMENT OF SENATOR McCASKILL**

Senator McCASKILL. I have two things to say. I really do not have questions for this panel, and I am anxious to hear the testimony of the next panel.

First is I love Apple. I love Apple. I am Apple. My family—I made all my family—I harassed my husband until he converted to a MacBook. And I use it. It is a huge part of my life, from the way I consume media to the way I do my job. And I am very proud of Apple as an American company. So I will say that first.

Second, I will say that I had the opportunity coming in when I did to witness the fact—and I let the word go out—that we are capable of classy bipartisanship in the U.S. Senate, and I do not think that Senator McCain sometimes gets enough credit for being willing to go places and say things that re-establish that we are capable of classy moments of bipartisanship. And everyone just got to witness one of those, and I wanted to publicly acknowledge Senator John McCain for that moment.

And, finally, I have questions about this, not because I think Apple is the villain but, rather, Apple is utilizing the Tax Code that we have given them. And if we have any hope of changing that Tax Code to promote free enterprise and capitalism and the success of the American entrepreneur, but at the same time make sure that we are receiving enough taxes to fix our roads and bridges, to help educate our kids, to remain a country that is seen as the bright and shining light on the hill because of our infrastructure and our educated workforce, we have to make sure that we have a tax structure that supports those goals. And I think we can do both without villainizing any American companies, and I appreciate you for holding this hearing, and thank you to both witnesses for being here, and I would look forward to the next panel.

Senator LEVIN. Thank you very much, Senator McCaskill.

Professor Shay, you referred to ASI, the Irish company—I will just be a couple minutes in a second round. Why don't we have a 3-minute second round—as having “ocean income.” What do you mean by that?

Mr. SHAY. Again, we have not seen tax returns, and I tried to be very careful in my testimony, but it would appear that ASI, which has quite substantial sales but a very low tax rate in Ireland, may well be allocating income attributable to the cost-shared intangible not to its Irish business. Since ASI is not resident anywhere else, that is something that tax planners fondly refer to as “ocean income.” I have seen it occur in at least one other case, but it did not come from having no tax residence. It came from having one country view the income as earned in the other country, and that other country viewed as earned in the first country so it was not taxed anywhere. But at least at that point, there were two countries, they were parties to a treaty, they could have resolved the issue, and the income would have been located somewhere. This structure is “different,” is the most polite way I will put it.

Senator LEVIN. Thank you. Unless there is an additional question for this panel, we are going to excuse you with our thanks, and we will move now to the second panel.

Thank you. Let me now call our next panel: Timothy Cook, the Chief Executive Officer of Apple; Peter Oppenheimer, the Senior Vice President and Chief Financial Officer of Apple; and Phillip Bullock, Apple’s head of tax operations. We thank you for being with us this morning. We look forward to your testimony.

Pursuant to Rule VI, all witnesses who testify before the Subcommittee are required to be sworn, and at this time I would ask you to please stand and raise your right hand. Do you swear that the testimony you are about to give will be the truth, the whole truth, and nothing but the truth, so help you, God?

Mr. COOK. I do.

Mr. OPPENHEIMER. I do.

Mr. BULLOCK. I do.

Senator LEVIN. We will use our traditional timing system here today. About 1 minute before the red light comes on, you are going to see lights change from green to yellow, giving you an opportunity to conclude your remarks. Your written testimony will be printed in the record in its entirety. We ask that you limit your oral testimony to no more than 10 minutes.

Again, our thanks to you, Mr. Cook, and your colleagues for being here today, and you may proceed.

I am sorry. We have changed that. It is a 15-minute opportunity instead of 10 minutes.

**TESTIMONY OF TIMOTHY D. COOK,<sup>1</sup> CHIEF EXECUTIVE OFFICER, APPLE INC., CUPERTINO, CALIFORNIA; ACCOMPANIED BY PETER OPPENHEIMER, SENIOR VICE PRESIDENT AND CHIEF FINANCIAL OFFICER, APPLE INC. AND PHILLIP A. BULLOCK, HEAD OF TAX OPERATIONS, APPLE INC., CUPERTINO, CALIFORNIA**

Mr. COOK. Thank you. I appreciate that.

Good morning, Chairman Levin, Ranking Member McCain, and Members of the Subcommittee. I am proud to represent Apple before you today.

<sup>1</sup>The prepared statement of Mr. Cook appears in the Appendix on page 121.

Apple has enjoyed unprecedented success over the past 10 years. The worldwide popularity of our products has soared, and our international revenues are now twice as large as our domestic revenues. As a result, I am often asked if Apple still considers itself an American company.

My answer has always been an emphatic, “Yes.” We are proud to be an American company and equally proud of our contributions to the U.S. economy.

Apple is a bit larger today than the company created by Steve Jobs in his parents’ garage 40 years ago. But that same entrepreneurial spirit drives everything that we do.

You can tell the story of Apple’s success in just one word: “innovation.” It is what we are known for. Products like iPhone and iPad, which created entirely new markets, these give customers something so incredibly useful, they cannot imagine their lives without them.

You might be surprised to learn that much of that innovation takes place in a single U.S. Zip code—95014. That is Cupertino, California, where we have built an amazing team, the brightest, most creative people on the planet. They come to work each day with just one mission: to make the very best products on Earth. Their job is to dream up things that capture the world’s imagination.

One of those inventions is the App Store. If you have ever used an iPhone or an iPad, that mobile apps are one of the hottest things in technology today. Apps have made software development one of the fastest growing job segments in the U.S. today.

We estimate that the App Store has generated nearly 300,000 new jobs in the U.S. App developers have earned over \$9 billion from apps sold on the App Store, half in the last year alone.

None of that economic activity was there 5 years ago, but Apple took a bold step in developing the App Store, and the app economy was born. Today it is a multibillion-dollar marketplace, and it shows no sign of slowing.

We have chosen to keep the design and development of those revolutionary products right here in the United States. While job growth stagnated across the country over the last decade, Apple’s U.S. workforce grew by five-fold. Today we have 50,000 employees, and we have employees in all 50 States.

Apple has created hundreds of thousands of jobs at small and large businesses that support us, from people involved in manufacturing to people involved in delivering the products to our customers.

Components for iPhone and iPad, for example, are made in Texas, and iPhone glass comes from Kentucky. In total, Apple is responsible for creating or supporting 600,000 new jobs.

We have used our earnings growth to invest billions of dollars in the United States to create even more American jobs. We are investing \$100 million to build a line of Macs in the United States later this year. This product will be assembled in Texas, include components from Illinois and Florida, and rely on equipment produced in Kentucky and Michigan.

We have constructed one of the world’s largest data centers in North Carolina. Reflecting our commitment to the environment, the

data center is powered by the largest solar farm and fuel cell of its kind in the United States. We are building data centers in Oregon and Nevada, a new campus in Texas, and a new headquarters in Cupertino.

With all this growth and investment, to the best of our knowledge, Apple has become the largest corporate income taxpayer in America. Last year, our U.S. Federal cash effective tax rate was 30.5 percent, and we paid nearly \$6 billion in cash to the U.S. Treasury. That is more than \$16 million each day, and we expect to pay even more this year.

I would like to explain to the Subcommittee very clearly how we view our responsibility with respect to taxes. Apple has real operations in real places with Apple employees selling real products to real customers. We pay all the taxes we owe, every single dollar. We not only comply with the laws, but we comply with the spirit of the laws. We do not depend on tax gimmicks. We do not move intellectual property offshore and use it to sell our products back to the United States to avoid taxes. We do not stash money on some Caribbean island. We do not move our money from our foreign subsidiaries to fund our U.S. business in order to skirt the repatriation tax.

Our foreign subsidiaries hold 70 percent of our cash because of the very rapid growth of our international business. We use these earnings to fund our foreign operations, such as spending billions of dollars to acquire equipment to make Apple products and to finance construction of Apple retail stores around the world.

Under the current U.S. corporate tax system, it would be very expensive to bring that cash back to the United States. Unfortunately, the Tax Code has not kept up with the digital age. The tax system handicaps American corporations in relation to our foreign competitors who do not have such constraints on the free movement of capital.

Apple is a company of strong values. We believe our extraordinary success brings increased responsibilities to the communities where we live, work, and sell our products. We enthusiastically embrace the belief, as President Kennedy said, "To whom much is given, much is required."

In addition to creating hundreds of thousands of American jobs and developing products that deeply enrich the lives of millions, Apple is a champion of human rights, education, and the environment. Our belief that innovation should serve humanity's deepest values and highest aspirations is not going to change.

Apple is also a company of strong opinions. While we have never had a large presence in this town, we are deeply committed to our country's welfare. We believe great public policy can be a catalyst for a better society and a stronger America.

Apple has always believed in the simple, not the complex. You can see this in our products and in the way we conduct ourselves. It is in this spirit that we recommend a dramatic simplification of the corporate Tax Code. This reform should be revenue neutral, eliminate all corporate tax expenditures, lower corporate income tax rates, and implement a reasonable tax on foreign earnings that allows the free flow of capital back to the United States.

We make this recommendation with our eyes wide open, fully recognizing that this would likely result in an increase in Apple's U.S. taxes. But we strongly believe that such comprehensive reform would be fair to all taxpayers, would keep America globally competitive, and would promote U.S. economic growth.

My colleague Peter Oppenheimer will now make a few opening remarks, and then we will be happy to answer your questions. Thank you very much.

Senator LEVIN. Thank you very much. Mr. Oppenheimer.

**TESTIMONY OF PETER OPPENHEIMER,<sup>1</sup> SENIOR VICE PRESIDENT AND CHIEF FINANCIAL OFFICER, APPLE INC., CUPERTINO, CALIFORNIA**

Mr. OPPENHEIMER. Good morning, Chairman Levin, Ranking Member McCain, Members of this Subcommittee. My name is Peter Oppenheimer, and I am Apple's chief financial officer. I would like to discuss the structure and management of Apple's global business and financial operations.

In the United States our operational structure is quite simple: We sell to our customers through our retail stores, online stores, and channel partners. We provide our award-winning support to our customers through the Genius Bar and AppleCare. We pay taxes to Federal, State, and local governments on the full profits from these sales.

Outside the United States we seek to provide the same industry-leading products, services, and support that our U.S. customers have come to expect. We now sell the iPhone and iPad in over 100 countries.

Like all multinational companies, Apple must follow the local laws and regulations in each region where we operate. This often requires Apple to establish a physical presence not only in the region but also in the particular country where we wish to sell our products and services.

Apple's presence in these countries often takes the form of Apple-owned subsidiaries. These in-country subsidiaries acquire products to sell in their markets through Apple-owned regional operating subsidiaries, which in turn acquire products from our contract manufacturers.

In the European region, our primary operating subsidiaries are incorporated in Ireland. These subsidiaries, which were established in the early 1980s, now employ nearly 4,000 people in Ireland, and we recently broke ground on an expansion to our campus in Cork.

Since 1980, Apple has had an R&D cost-sharing agreement with our Irish subsidiaries. The agreement was first put in place when Apple was about 5 years old and wanted to sell its computers overseas. At that time, Apple's revenues were one-tenth of 1 percent of what they are today, and the invention of the iPhone was decades away.

Today the substance of the agreement is largely unchanged except for our expansion into more countries and recent updates to comply with new U.S. Treasury regulations. Our cost-sharing

<sup>1</sup>The prepared statement of Mr. Oppenheimer appears in the Appendix on page 121.

agreement, which is common in the industry, is audited by the IRS, and we are in full compliance with all laws and regulations.

The agreement enables Apple to share the costs and risks of developing new products with our Irish subsidiaries. Virtually all of this R&D, and the jobs that go with it, take place in the United States. In exchange for this funding, the Irish subsidiaries have rights to distribute in Europe and Asia products created by the R&D funded by the agreement.

We have used this method to distribute our products internationally for more than 30 years. More than half of our ongoing R&D costs are funded by Apple Ireland. When times are good, as they have been in recent years, our Irish subsidiaries benefit greatly, as we do in the United States. When Apple lost money in the mid-1990s, our Irish subsidiaries lost money as well. I mention losing money in the 1990s because it serves as a reminder of how close Apple came to going out of business.

In 1997, we were on the brink of bankruptcy and about out of cash. In just 2 years, we lost \$2 billion. I can tell you firsthand we were facing the very real possibility of a world without Apple.

A big part of the turnaround was a company-wide effort to streamline and simplify so Apple could survive. We restructured our operations and finances to make everything as simple and efficient as possible.

As part of that effort, we consolidated our European post-tax income into two existing subsidiaries: a holding company, Apple Operations International, or AOI; and an operating company, Apple Sales International, or ASI.

The consolidation eliminated enormous complexity in handling foreign bank accounts and improved our ability to manage currency risk. While AOI and ASI are both incorporated in Ireland, neither is tax resident there under the rules of Irish law. Indeed, Irish law contemplates that companies may be incorporated in Ireland without being tax resident there.

I should clarify one point here. For many years ASI has had thousands of employees in Ireland. Until 2012, the payroll for these ASI employees was run through another Apple subsidiary, AOE. The fact that AOI and ASI are not tax resident in Ireland does not reduce our U.S. taxes at all.

The profits held by AOI and ASI have already been taxed by foreign governments according to the local laws where the money is earned. The investment income on their cash holdings is taxed by the U.S. Government at the corporate tax rate of 35 percent. Apple could certainly choose to manage foreign after-tax profits in numerous foreign subsidiaries without moving the cash to AOI or ASI, but that would have absolutely no effect on the taxes we pay in the United States.

However, eliminating the central cash management function would be inefficient. Managing larger pools of cash centrally rather than many places around the world reduces complexity, better protects the asset, and helps us earn higher returns through the economies of scale.

Today Apple is in the fortunate position of having more cash from international operations than we need to run our company and pursue strategic opportunities. Some observers have ques-

tioned Apple's decision to fund part of its capital return to shareholders by issuing \$17 billion in debt rather than repatriating foreign earnings. Apple respectfully suggests that any objective analysis will conclude that this decision was in the best interest of our shareholders. If Apple had used foreign earnings to return capital, the funds would have been diminished by the very high U.S. corporate tax rate of 35 percent. By contrast, given today's historically low interest rates, the cost of issuing debt was less than 2 percent.

Mr. Cook, Mr. Bullock, and I would be happy to answer your questions. Thank you.

Senator LEVIN. Thank you very much, Mr. Oppenheimer. Mr. Bullock.

Mr. BULLOCK. Good morning.

Senator LEVIN. Good morning. Do you have any—

Mr. COOK. Our statement is concluded, Senator.

Senator LEVIN. Thank you. First let me thank Apple for the cooperation that it has extended to the Subcommittee. We very much appreciate that.

I think, Mr. Cook, you made reference to—you quoted President Kennedy. I am wondering whether you would agree with the following statement of President Kennedy that he made in his April 1961 tax message, that “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.”

Do you agree with that?

Mr. COOK. The President and his brother have been long-term heroes of mine, so I am sure if he said it, at the time it was true. Today, from at least our point of view, I do not consider deferral to be a sham or abuse in any kind of way.

Senator LEVIN. Mr. Bullock, does Apple Inc. own directly or indirectly AOI, AOE, and ASI?

Mr. BULLOCK. Yes, Apple Inc. owns directly or indirectly AOI, AOE, and ASI.

Senator LEVIN. All right. So all those companies in Ireland are owned by Apple effectively. Is that correct?

Mr. BULLOCK. They are all legally owned by Apple Inc., yes.

Senator LEVIN. And where is AOI, Mr. Bullock, functionally managed and controlled?

Mr. BULLOCK. In our view, it is functionally managed and controlled, which is an Irish legal concept, in the United States.

Senator LEVIN. In a February 11 letter to the Subcommittee, Apple wrote us that it has “not made a determination regarding the location of AOI central management and control.” Why did you tell us that?

Mr. BULLOCK. Mr. Chairman, the reason we responded in that manner is that under Irish law, the requirement for evaluating or concluding on the tax residency of Ireland looks to whether or not central management and control takes place in Ireland or not. It

does not formally require that you make a determination that it takes place somewhere else.

Senator LEVIN. But you have told us here this morning that you believe that the location of AOI's central management and control is in the United States, so Apple has concluded that. Is that correct?

Mr. BULLOCK. Yes, and I believe that in a previous meeting with your staff, they asked the same question, and I believe that I provided the same response.

Senator LEVIN. Okay. Mr. Cook, do you agree that the location of AOI's central management and control is in the United States?

Mr. COOK. Sir, I do not know what the legal definition of that is, but from a practical point of view, yes.

Senator LEVIN. All right. Now, relative to ASI, Mr. Bullock, is ASI functionally managed and controlled in the United States?

Mr. BULLOCK. As a practical matter, applying the Irish legal standard of central management and control, I believe that it is centrally managed and controlled from the United States.

Senator LEVIN. And does Apple agree that it is functionally managed and controlled in the United States?

Mr. BULLOCK. Under Irish law—

Senator LEVIN. No. Under our law, do you believe that?

Mr. BULLOCK. I do not believe that central management and control is a legal term under U.S. tax law.

Senator LEVIN. All right. Do you believe it is functionally managed and controlled in the United States?

Mr. BULLOCK. Yes.

Senator LEVIN. Mr. Cook, do you agree?

Mr. COOK. We have significant employees in Ireland. We have about 4,000. And so there is a significant amount of decisions and leadership and negotiations that go on in Ireland. But some of the most strategic ones do take place in the United States.

Senator LEVIN. Would you agree on balance that ASI is functionally managed and controlled in the United States?

Mr. COOK. From a practical matter. I do not know the legal definition of the word.

Senator LEVIN. As a practical matter, you would agree that it is functionally managed and controlled in the United States?

Mr. COOK. Yes, Senator.

Senator LEVIN. Thank you.

Now, Mr. Bullock, AOI is incorporated in Ireland. Is that correct?

Mr. BULLOCK. Yes, Mr. Chairman, it is incorporated in Ireland.

Senator LEVIN. And where is AOI a tax resident?

Mr. BULLOCK. It does not have a tax residency. That does not mean that it does not pay taxes. The interest that it earns is paid—U.S. taxes are paid in full on its interest by Apple Inc.

Senator LEVIN. And the interest you are talking about is on the tens of billions of dollars that it has in cash. Is that correct?

Mr. BULLOCK. Correct. The cash that was distributed from the operating subsidiaries underneath.

Senator LEVIN. All right. So those tens of billions of dollars of cash earn interest, and that interest is paid by Apple Inc. is that correct?

Mr. BULLOCK. The U.S. tax on that interest is paid by Apple Inc. at the U.S. statutory rate of 35 percent, yes.

Senator LEVIN. But there is no income—there is no tax paid on the money itself that has been sent to Apple—excuse me, to AOI by the distributors. Is that correct? There has been no tax paid on that either in Ireland or in the United States on those tens of billions of dollars which has been sent to AOI from the subsidiaries below that?

Mr. BULLOCK. The income of the subsidiaries has been subject to tax in the countries in which they operate.

Senator LEVIN. Right, but there has been no tax paid in Ireland on those distributions nor in the United States on those profits. Is that correct?

Mr. BULLOCK. There has been no—there is no U.S. tax on the transfer of those balances to AOI. The income earned by ASI and AOE has been subject to Irish tax in full in accordance with the agreement that we have with Ireland.

Senator LEVIN. And is that a maximum of 2 percent?

Mr. BULLOCK. Mr. Chairman, I am not precisely sure of the mechanics of the computation.

Senator LEVIN. Not the mechanics, but is that a maximum of 2 percent?

Mr. BULLOCK. Approximately, yes.

Senator LEVIN. Thank you. Has AOI filed a corporate income tax return in the last 5 years?

Mr. BULLOCK. No. Prior to that, it made filings in France for a branch operation there.

Senator LEVIN. All right. But they have paid no corporate income tax for the last 5 years, at least. Is that correct?

Mr. BULLOCK. Again, they did not pay any corporate income tax, but Apple Inc. has paid corporate income tax—

Senator LEVIN. I did not ask you about Apple Inc. I asked you about AOI.

Mr. BULLOCK. That is correct. AOI—

Senator LEVIN. That is where most of the profits go, doesn't it?

Mr. BULLOCK. They receive dividends from the operating subsidiaries underneath.

Senator LEVIN. And what is the amount of cash that went to ASI from those dividends?

Mr. BULLOCK. Over what period of time?

Senator LEVIN. The last 5 years.

Mr. BULLOCK. In the last 5 years, the company has received dividends from its operating subsidiaries approximating \$30 billion.

Senator LEVIN. That is ASI or AOI?

Mr. BULLOCK. And a number of other operating subsidiaries. AOI is a holding company. One of its roles is to own a number of Apple's international subsidiaries.

Senator LEVIN. But ASI has received about \$70 billion in cash, has it not, from those subsidiaries and about \$30 billion of that \$70 billion went to AOI? Is that about right?

Mr. BULLOCK. I do not have the precise details. There were distributions from a number of other subsidiaries as well.

Senator LEVIN. Does that sound about right?

Mr. BULLOCK. Approximately.

Senator LEVIN. Okay. Just to summarize here, AOI has received about \$30 billion over the last 5 years, but has not filed a corporate income tax return. Is that correct?

Mr. BULLOCK. That is correct. That income is not subject to U.S. tax under both statute and by regulation, and while it has not filed a tax return, Apple Inc. has paid tax on the interest earned by AOI.

Senator LEVIN. I understand that, but I am not talking about the interest earned on the \$30 billion that it has put in banks or whatever and invested and received interest. I am talking about the \$30 billion that it received in dividends, approximately. It has not filed a corporate income tax return on that money. Is that correct?

Mr. BULLOCK. That is correct. But all of the subsidiaries underneath have earned that money in their countries and paid taxes required by law.

Senator LEVIN. Whatever taxes were owed there.

Mr. BULLOCK. Right.

Senator LEVIN. Okay. Does ASI own the economic rights to Apple's intellectual property offshore other than in the Americas?

Mr. BULLOCK. Yes, it does in part. It owns that in combination with AOE, which is the subsidiary that handles some of the manufacturing that the company continues to do in Ireland.

Senator LEVIN. All right. And neither one of those companies files an income tax with the United States. Is that correct?

Mr. BULLOCK. Neither of those companies file a tax return with the United States, although Apple Inc. reports—

Senator LEVIN. We just went through that, the interest.

Mr. BULLOCK. Actually, both interest and there is a small amount of what is known as foreign-based company sales income that is subject to current U.S. tax from ASI's business activity.

Senator LEVIN. My time is up. Senator McCain.

Senator MCCAIN. Thank you, Mr. Chairman. And I thank the witnesses.

Mr. Cook, we congratulate you on all of your successes and that of Apple, and as we said earlier, you have managed to change the world, which is an incredible legacy for Apple and all of the men and women who serve it.

Also, I think you have to be a pretty smart guy to do what you do, and a pretty tough guy, too. You have that reputation, and I say that in a complimentary fashion. And I enjoyed our conversation. And so I wonder, do you feel that you have been bullied or harassed by this Committee or its Members?

Mr. COOK. I feel very good to be participating in this, and I hope to help the process. I would really like for comprehensive tax reform to be passed this year, and any way that Apple can help do that, we are ready to help.

Senator MCCAIN. So it was my understanding that you sought to testify before this Committee for that purpose, and other purposes. Is that correct?

Mr. COOK. I think it is important that we tell our story, and I would like people to hear it directly from me.

Senator MCCAIN. So you were not dragged before this Committee?

Mr. COOK. I did not get dragged here, sir.

Senator MCCAIN. You do not drag very easily, I understand.  
[Laughter.]

And I thank you. This is an issue of concern for Congress, and I guess my first question to you, Mr. Cook, is: You have obviously legally taken advantage of a number of aspects of the Tax Code, both foreign and domestic, and that has reduced the tax burden, I think we would agree, than if you were paying the 35-percent corporate tax rate that domestic companies pay. So my question is: Couldn't one draw the conclusion that you and Apple have an unfair advantage over domestic-based corporations and companies, in other words smaller companies in this country that do not have the same ability that you do to locate in Ireland or other countries overseas?

Mr. COOK. No, sir, it is not the way that I see it, and I would like to describe that. The way that I look at this is Apple pays 30.5 percent of its profits in taxes in the United States, and I do not know exactly where this stacks up relative to other companies. But I would guess it is extremely high on the list. I know with the \$6 billion that we are the top payer in the United States.

We do have a low tax rate outside the United States, but this tax rate is for products that we sell outside the United States, not within. And so the way that I look at this is there is no shifting going on that I see at all, and in addition, if you look at Apple versus other companies that do not sell in the United States I would say that the applicable comparison would be the 30.5 percent effective rate, not our foreign tax rate.

Senator MCCAIN. Well, let us get a little simpler here. Why does AOI exist? How is its income generated? How is its income taxed? Why was AOI incorporated in Ireland? Four thousand employees is impressive, but not impressive when you look at your overall workforce. So maybe you can clear that up for us.

Mr. COOK. Yes, thanks very much for the question. AOI was created in 1980, and at this period of time, Apple was—this is before the days that the iPhone, iPad, iPod, and the things that we are known for today were even invented. As a matter of fact, the Mac was not even announced until 1984. And so Apple was looking for a place to distribute its products in Europe—

Senator MCCAIN. I understand that was 1980. Is that still operative today?

Mr. COOK. The relationship between Apple and the Irish Government is still there today, and we built up a sizable population—

Senator MCCAIN. I say with respect, given the tax rate that you are paying in Ireland, I am sure you have a very close relationship.

Mr. COOK. But it is more than that, sir. It is that we have built up a significant skill base there of people that really understand deeply the European market, that serve our customers well, that provide a number of functions for that. Also I think it is important to understand that AOI is nothing more than a holding company. A holding company, as you know, is a concept that many companies use. It is not an operating company. And so the dividends that go into this holding company have already been taxed as appropriately in their local jurisdiction. And so AOI is nothing more—

Senator MCCAIN. To a great advantage to Apple, wouldn't you agree?

Mr. COOK. AOI to me, sir, is nothing more than a company that has been set up to provide an efficient way to manage Apple's cash from income that has already been taxed, and the investment income that comes out of AOI is taxed in the United States at the full 35-percent rate. And so, sir, from my point of view, AOI does not reduce our U.S. taxes at all.

Senator MCCAIN. Can you please state for the record where AOI, ASI, and AOE is a tax residence?

Mr. COOK. Yes, sir. My understanding is there is not a tax residence for either—for any of the three subsidiaries that you just named.

Senator MCCAIN. Does that sound logical?

Mr. COOK. Well, again, as I look at it, ASI and AOE are paying Irish taxes, and so I am not—I personally do not understand the difference between a tax presence and a tax residence, but I know that they fill out Irish taxes and pay those. AOI, because it is just a holding company, the interest—it only makes investment income, and all of that investment income is taxed in the United States at the full 35-percent level.

Senator MCCAIN. When you look at that avoidance or relief of a 35-percent tax burden, which I am sure that we are in agreement is way too high and now the highest in the world, I understand, but you said the purpose of AOI is to ease administrative burdens. But are there certain U.S. tax burdens—isn't it obvious that you are not bearing the same tax burden as if you were bearing in the United States, which then gives you some advantage over corporations and companies which are smaller, which are strictly located in the United States of America?

I am not saying that is wrongdoing. But I think you would agree that it gives you a significant advantage.

Mr. COOK. Again, sir, I have tremendous respect for you. I see this differently than you do, I believe. What I see is Apple is earning these profits outside the United States. By law and regulation, they are not taxable in the United States. We have set up a holding company to collect these after-tax profits from our different foreign subsidiaries into AOI. It then invests, as any treasury kind of arm would, and the interest investment—or the interest profits off of that are paid in the United States as they are required to under existing U.S. Treasury regulations.

Senator MCCAIN. Can you understand there is a perception of unfair advantage here, Mr. Cook?

Mr. COOK. Sir, I see this as a very complex topic that—I am glad that we are having the discussion, but, honestly speaking, I do not see it as being unfair. I am not an unfair person. That is not who we are as a company or who I am as an individual. And so I would not preside over that, honestly. I do not see it in that way.

Senator MCCAIN. I thank you. I am out of time. What I really wanted to ask is why the hell I have to keep updating the apps on my iPhone all the time. [Laughter.]

And why you do not fix that.

I thank you, Mr. Chairman.

Mr. COOK. Sir, we are trying to make them better all the time.

Senator LEVIN. Thank you. We have only 5 minutes left, I believe on a roll call. Have you voted already?

Senator MCCAIN. No.

Senator LEVIN. I think we better recess for about 10 minutes. Thank you.

Mr. COOK. Yes, sir. Thank you. [Recess.]

Senator LEVIN. Okay. We will come back into session. Senator McCaskill.

Senator MCCASKILL. I certainly understand that what you all have engaged in is what every good American business does, and that is, tax planning. If you do not tax-plan, then you are incompetent as an American business. But I do hope that I can understand better why the structure you have used has been embraced so that it will better inform our decisions and how to make it simpler and how we can support international growth for all of our companies that are American companies.

You borrowed \$17 billion and issued bonds to pay dividends to your shareholders fairly recently. It was in the economic news because of your large cash reserves, so clearly you made a decision that it was going to be cheaper for you to service that debt and then use the cash to pay dividends, then to bring any of this cash back.

Do you have the analysis that would help us understand how much cheaper it was for you to borrow that money?

Mr. COOK. I can describe it at a broad level, Senator. The cost of capital today is at an all-time low, as you know, and so our weighted average cost for the borrowing that we just did was less than 2 percent. And we were faced with a decision to go that route or pay 35 percent to repatriate.

So as we looked at that analysis, we felt strongly that it was in the best interest of our shareholder for us to secure the debt.

Senator MCCASKILL. Okay. Let us assume that we simplify this. Ireland gave you a 2-percent rate, which was negotiated for your company. Correct?

Mr. COOK. We went to Ireland in 1980, and they were very much recruiting, I believe, technology companies at that time, and Apple was a small, \$100 million business that had no operations in Europe. And so as a part of recruiting us, the Irish Government did give us a tax incentive agreement to enter there, and since then we have built up a sizable operation there, nearly 4,000 people. We are building a new site. We are continuing to grow. And the skills of our people there are very fundamental for understanding the European market and servicing our customers there from tech support to sales to reseller support, et cetera. And so we have quite a very strong presence there.

Senator MCCASKILL. I guess my question, Mr. Cook, is: If Ireland recruited you back when you were a \$100 million company and gave you a really good deal, how do we, if we are setting tax policy, how do we do it in a way that there is not going to be—I mean, correct me if I am wrong, but I believe that probably three-fourths of net new mobile activity growth is going to be in emerging markets in—would you disagree with that percentage, that net new growth in markets in terms of mobile activity are going to be out there in emerging markets as opposed to Europe and North America?

Mr. COOK. I think a significant amount—I am not sure of the exact number, but I think a significant amount of growth will be in emerging markets.

Senator MCCASKILL. So I guess the point I am trying to get to here is let us assume we simplify our Tax Code and let us assume that we get it down, we clear out all the underbrush, we take away some of the goodies and some sectors of our economy. We understand the reality of international moving of capital because of international economies and international trade. What keeps another country in one of the emerging markets from undercutting us once again, like Ireland did back in 1980?

Mr. COOK. I think the United States has such enormous advantages, and the barrier right now in terms of repatriating cash is that it is repatriated at the 35-percent level. And so our proposal—and I may be a bit different than my peers here—is I am not proposing zero. My proposal is that we eliminate all corporate tax expenditures, get to a very simple system, and have a reasonable tax on bringing money back from overseas. And I think if we did that, I think many companies would bring back capital to invest in the United States, and it would be great for the economy.

Senator MCCASKILL. What about the other way? What would it cost you to move out of California and go entirely to Ireland or to a country that is going to be—for example, China, if you get that deal with China Mobile soon? Which I know you are working on, right? That is a big one, hopefully, that you get done. You have been working on it awhile. What keeps you from—in terms of the relative cost analysis and the benefit analysis, what keeps you from moving out of California?

Mr. COOK. Well, we are an American company, and we are proud to be an American company. We do the vast majority of our R&D in California, and so we are there because we love it there, and this is where we can create and make things that people have not even imagined yet. And—

Senator MCCASKILL. So it is an intangible? You are saying it is an intangible? It is not something that you can reduce to—

Mr. COOK. I am saying it is who we are as people, and we are an American company. We are an American company whether we are selling in China, Egypt, or selling in Saudi Arabia. Wherever we are, we are always an American company. And so I have never thought, it has never entered my mind honestly, Senator, of moving our California headquarters to another country. It is beyond my imagination. And I have a pretty wild imagination, but it is beyond it.

Senator MCCASKILL. On the money that—the corporate bonds you issued, do you think—and I am not being judgmental about you doing that. I understand the business rationale behind it in terms of the low cost of capital. But do you think you should be able to deduct the interest on those? Would that be one of the corporate expenditures we could do away with?

Mr. COOK. It could be one of the corporate expenditures to do away with. I think, the way the Tax Code is written currently, my understanding is it would be deductible. It would be a very small percentage of the overall that we pay. We paid \$6 billion at an effective rate of 30.5 percent. But, yes, it is certainly one of the

things that I think this group should talk about in terms of doing comprehensive tax reform.

Senator MCCASKILL. Okay. And this is kind of complicated, but somewhere along the way you are deciding how to divide up sale proceeds as to where the money goes. And I know some of it depends on where the sale occurred. But some of it depends on a decision you are making internally about where you are going to allocate what you are getting for your intellectual property.

Where is that decision being made? And what do you base it on in terms of how much money comes back to the American companies that are paying taxes versus how much is attributable to the international companies?

Mr. COOK. It is a good question. Today everything that we sell in the United States is taxed in the United States. For a foreign country, generally speaking, when we sell something in a foreign country, it is taxed in the local market, and then if it is one of the countries that are being served from Ireland, those units are generally sold by an Irish subsidiary. And so that income, if you will, is taxed, to the degree it needs to be, in the local jurisdiction. And then the proceeds move to an Irish sub in most cases—or in many cases called AOI, which acts as a holding company and invests Apple's earnings. And then we pay taxes on those earnings in the United States.

Senator MCCASKILL. So does any of the proceeds of the many thousands of dollars you have taken from me over the years, do any of the proceeds of that actually get parked in Ireland or in any of the international companies under the aegis of intellectual property?

Mr. COOK. I think maybe Mr. Bullock can probably answer this better than I.

Mr. BULLOCK. Thank you, Tim. The answer to that is no. One hundred percent of the profits on any sale to a customer in the United States, whether it is through the channels or through our online stores, all of that is fully taxed in the United States.

Senator MCCASKILL. Okay.

Mr. BULLOCK. There are no outbound payments going offshore.

Senator MCCASKILL. Okay. Thank you.

Mr. COOK. Thank you.

Senator LEVIN. Thank you very much, Senator McCaskill. Senator Johnson.

Senator JOHNSON. Thank you, Mr. Chairman.

Let me kind of pick up where Senator McCaskill left off there. This is complex, and it has to do with how do you allocate income, what kind of transfer price is an appropriate price.

I did notice that your U.S. sales were about 39 percent of your total sales, international was about 61. So U.S. sales about 39, and you had income of about 35 percent in the United States; international sales, 61, and about 65 percent of income.

Can you just explain that? I mean, it is pretty close. If I were taking a look at that, you are getting pretty darn close, I would think, to proper allocation between sales and income. Can you just explain that disparity?

Mr. COOK. Sure, Senator, and I will make some comments, then pass it to Peter. He may be able to add something.

Generally, Apple's Macintosh business is a larger percentage of its sales in the United States than internationally. As we launched the iPhone, iPhone became a larger percentage of our international business than it did a part of our U.S. business, because we had this nice base of Macintosh sales in the United States.

The iPhone, generally speaking, has higher gross margins than our Macintosh business, so it is logical that the international business generally would carry higher margins than our domestic business. And Peter may be able to add something to this.

Senator JOHNSON. But basically to summarize, you have a more profitable product mix internationally than you have in the United States.

Mr. COOK. That is correct.

Senator JOHNSON. That pretty well explains that difference?

Mr. OPPENHEIMER. It does.

Senator JOHNSON. I was talking earlier about who are the beneficiaries of your very good tax rates overseas. I would point out—I think this is true—that if we ever do tax reform, if we ever do incentivize companies to start bringing some of that money back home, the way current tax law is written is you get a deduction for foreign taxes paid, correct? Mr. Bullock.

Mr. BULLOCK. That is correct. It is actually a credit, a dollar-for-dollar credit, to the extent you pay foreign taxes.

Senator JOHNSON. Okay. So as a result, now Apple has a lot more money that when you repatriate it we will be able to tax more of it. Correct? So the U.S. Government, you could argue, will be a net beneficiary if we ever get our tax house in order.

Mr. BULLOCK. To the extent of repatriation in one form or another, if it is taxable, yes, that would yield more U.S. tax.

Senator JOHNSON. Mr. Bullock, I would imagine you probably know this better than anybody. Because you are a large corporation, my guess is you have full-time IRS agents stationed in your operation basically doing a full-time audit non-stop. Is that pretty accurate?

Mr. BULLOCK. That is correct. We are under audit in a number of jurisdictions around the world, including the United States not unlike many of our multinational peers.

Senator JOHNSON. And they are looking at all this corporate structure, they are looking at all the transfer prices, and they are basically giving you the nod, saying that you are following tax law.

Mr. BULLOCK. They look at it in detail, yes.

Senator JOHNSON. Okay. Mr. Cook, again, talking about who are the beneficiaries of not only your excellent products but also just your lower tax rates and corporate profit, that would be shareholders. Can you describe your shareholders, in general?

Mr. COOK. I think Peter can probably add more to this, but generally, Apple is very widely owned because it is a part of the underlying indexes in the stock market, and a number of mutual funds own us in addition to pension funds. Peter.

Mr. OPPENHEIMER. Yes, Senator, roughly our top 50 shareholders own about half the company and these include public employee retirement systems, mutual funds such as Fidelity, Pimco, or BlackRock where people are saving for their retirements, and we also have individual retail shareholders as well.

Senator JOHNSON. So even the top 50 percent is widely dispersed, and those are large funds that also have a very diverse shareholder base in those funds.

Mr. OPPENHEIMER. Absolutely.

Senator JOHNSON. So, again, those folks benefit from the fact that Apple is able to retain more of its profit by not paying out taxes to foreign governments?

Mr. OPPENHEIMER. Yes, and they also receive our dividends.

Senator JOHNSON. In addition to U.S. and State income taxes, what other taxes in the United States does Apple basically generate? What could you almost take credit for?

Mr. OPPENHEIMER. Last year, we paid more than \$325 million in Federal employment taxes that Apple paid in addition to our employees, and we have paid over the last couple of years I think nearly \$100 million to State and local governments in property taxes and various other fees. And I believe last year we collected and remitted and paid approximately \$1.5 billion in sales taxes.

Senator JOHNSON. So that is getting close to about \$2 billion in total. Mr. Bullock.

Mr. BULLOCK. Just to clarify that a little bit, it was a little over \$1.3 billion in sales and use tax.

Senator JOHNSON. When we are talking about transfer pricing and allocation of income, you face the same dilemma between States, don't you, in terms of which State claims how much income when you are paying those State income taxes?

Mr. BULLOCK. Well, the income that the company generates in the United States the approximate 40 percent that you alluded to earlier of our total global profits, which is relatively commensurate with our U.S. customer base, that income does get apportioned around and divvied up amongst the States, under a slightly different system but it does get allocated out to the States.

Senator JOHNSON. So can you just tell me, what is the basis of that allocation? And how would that differ really from trying to allocate income between different countries?

Mr. BULLOCK. Well, that, too, varies by State. Some States apportion based on relative sales, sales to customers in that State over total sales domestically. Some States use a multifactor test. They may look to sales, property, and payroll.

Senator JOHNSON. Do you end up having to negotiate between the States in terms of who gets to claim what percentage of your income? Do you end up paying more—do you have more of your income allocated to pay State income tax than you actually—in other words, more than 100 percent?

Mr. BULLOCK. It is not over 100 percent, but it is approximately 100 percent. So in our fact pattern it is not double taxed, which would be the case if more than 100 percent of the income was apportioned. But it does approximate 100 percent.

Senator JOHNSON. But, again, that is a similar type of problem you have trying to allocate income between different countries, isn't it?

Mr. BULLOCK. If you had different States apportion in different ways, yes.

Senator JOHNSON. Can you tell me a little bit about the taxes you pay to foreign countries? Is that income taxes? Are those sales

taxes? Is it property taxes? Is it a combination of all those? And can you give me some sort of relative amount?

Mr. BULLOCK. Well, there is a combination. Last year, in fiscal year 2012, the company paid a little over \$900 million in international income taxes around the world. We are projecting that number to be larger this year. And that number is significantly larger than it was a few years ago.

In addition to that, I do not have the statistics available, but I would imagine similar to in the United States there are employer contributions for payroll tax for employees outside of the United States, and there is a considerable amount of VAT and GST that gets collected and remitted by the company to various countries around the world.

Senator JOHNSON. Of your total worldwide employment, how much is based in the United States, how much is based overseas?

Mr. OPPENHEIMER. About 50,000 of our 75,000 employees are here in the United States.

Senator JOHNSON. So even though 60 percent of your sales are overseas, what percentage is that? Almost two-thirds—

Mr. OPPENHEIMER. Yes.

Senator JOHNSON [continuing]. Of your employment is here in the States?

Mr. OPPENHEIMER. And that is also influenced by our retail stores. Of our approximately a little over 400 retail stores, about 260 of them are here, and that influences it.

Senator JOHNSON. Okay. Thank you for your testimony, and thank you, Mr. Chairman.

Senator LEVIN. Thank you very much, Senator Johnson. Senator Ayotte.

Senator AYOTTE. Thank you, Mr. Chairman. I want to thank the witnesses for being here today.

Mr. Cook, is there any dispute at this hearing that Apple has complied with our tax laws?

Mr. COOK. I have heard no dispute of that.

Senator AYOTTE. One of the issues that I heard raised when you were being asked questions by Senator McCaskill about the issue of the \$102 billion that is present overseas that you have now is this idea of repatriation. You had said that you would be willing to pay some rate on repatriation. As we look at tax reform, what do you think is the rate, thinking not only of Apple but of multinational corporations around the world, if we do tax reform and let us say we simplify the Code so deductions are eliminated and then we take that and pour that into reducing the rate? What rate do you think we have to be at if we want to be competitive in terms of making sure that we have investment here?

Mr. COOK. I think the rate on the U.S. sales in my judgment, from most of the studies I have seen, would indicate it would need to be in the mid-20s as all of the expenditures are dropped out. I think in terms of a rate on bringing back foreign earnings, I think to incent a huge number of companies to do that, it would need to be a single-digit number. And I think by doing that, you wind up in a revenue-neutral kind of situation, which means some companies may pay a bit more, and I think we would be one of those. Other companies would pay less. But I think more important than

all of the tax, it would be great for growth in this country. And so that is the reason I feel so adamant about doing this.

Senator AYOTTE. So as I understand it, let us say you are building a data center here, you are building a new facility here. Right now that money you have parked overseas, you cannot use that to invest in plant facilities here. Is that right?

Mr. COOK. That is correct. We cannot use our overseas cash to make any investments in the United States.

Senator AYOTTE. If you were in our position and thinking about tax policy and making sure that our country remains competitive, how important do you think it is that we change the Tax Code to ensure that this remains a good place for investment? I understand there are many other advantages to being here, including intellectual property advantages, et cetera, but you are not the only corporation that has significant monies overseas right now that we would like to see come back here. What do you think that would do in terms of our economy? I think you have touched on it.

Mr. COOK. I think it is vital to do. I think it is great for America to do. I think we would have a much stronger economy if we did that. I think it would create jobs and increase investment. And so I put my whole weight and force behind it.

Senator AYOTTE. And if we create more jobs and increase investment, isn't that more taxes that can be collected here as well in terms of thinking about, the fiscal State of the country?

Mr. COOK. It is, and I think that is a very excellent point, is that all ships rise with the tide.

Senator AYOTTE. Right, especially with where our unemployment rate is right now.

I wanted to ask you about the issue of thinking about—as we do tax reform, the issue of a territorial rate. How important is it that, as we go forward—hopefully we will on a bipartisan basis—to reform the Code to really create a better dynamic, simpler, lower rates for investment here that a component of that be a territorial rate? Because there has been some discussion around here about not having a territorial rate.

Mr. COOK. I think the United States is advantaged if more capital moves into the country, because I think it would really strengthen our economy significantly. And so I think there has to be—I do not propose zero. I think it has to be a reasonable tax on doing so. And some people refer to that as “territorial,” some people refer to that as “hybrid.” I have heard different terminology for it, but that is how I believe it should work.

Apple does not support a temporary tax holiday. We think that the Tax Code needs to be comprehensively reformed for a long period of time.

Senator AYOTTE. If we create a temporary tax holiday, which we have done in the past, don't we just perpetuate the situation, meaning it may have a short-term but it does not encourage long-term investment?

Mr. COOK. I think it is very important for business to be predictable, and a permanent change to me is materially better than a short-term tax holiday.

Senator AYOTTE. I actually have a question on an unrelated topic to the tax issue today. But can you tell us, when you think about—

when you were talking to Senator McCaskill, you talked about the advantages, for example, of being in this country. One of them I view very significantly is, of course, the intellectual property protections of this country, which I know are very significant to you as a technology company.

You have faced significant challenges in China, so what would be—can you tell me what those challenges are? And thinking about intellectual property protection certainly is an advantage that the United States has. How do we address this with our international partners?

Mr. COOK. We have actually faced more significant areas in other countries other than China.

Senator AYOTTE. The reason I raise China is I have heard the stories about the knock-off Apple stores, but please speak to other countries as well.

Mr. COOK. Yes, that has been an issue. That has clearly been an issue. I think that the U.S. court system is currently structured in such a way that it is very difficult to get the protection a technology company needs because our cycles are very fast. And when the cycles are very fast and the court system is very long, foreign competitors or even competitors in the United States can quickly take certain IP and use it and ship products with it, and they are on to the next product before the court system rules.

And so I actually think that we require much more work on IP in this country as well, and I would love to see conversations between countries to try to strengthen IP protection globally. I do not know how likely that is to occur in the current environment, but for us, our intellectual property is so important to our company, and I would love the system to be strengthened in order to protect it.

Senator AYOTTE. I thank all of you for being here. I appreciate it.

Mr. COOK. Thank you very much.

Senator LEVIN. Thank you, Senator Ayotte. Senator Portman.

#### **OPENING STATEMENT OF SENATOR PORTMAN**

Senator PORTMAN. Thank you, Mr. Chairman. I appreciate the opportunity, having just left the Finance Committee on the IRS, to talk about tax reform and not just tax administration.

Look, this hearing is important because it is talking about a specific provision of our international tax rules that allows U.S. companies to effectively take IP rights created here in the United States to foreign jurisdictions. Some of it is by means of cost sharing. Some of it is through other agreements.

I agree with you, Mr. Chairman, and the Ranking Member that we need to address this issue. I totally disagree that we ought to do it through picking out specific tax loopholes or tax preferences. We have to reform this Code, and if we do not do that, our companies will continue to be uncompetitive.

If you think about it, we have an uncompetitive tax system now. We are competing with one hand tied behind our back. And if we are going in and taking away certain preferences, it may make us feel better about getting more of this IP income back here, but, in

effect, it makes our companies even less competitive and hurts U.S. employment.

So that is why we have to do tax reform. We have to do it now. We are now living with an international Tax Code that is a relic of the 1960s. It was not even reformed in 1986 when the rate was lowered to 34 percent, now 35 percent. So we are looking at several decades now of tax policy that really is antiquated and does not keep up with the times.

So I have a proposal to do that. It has been scored by the Joint Committee on Taxation. It is revenue neutral. It is a 25-percent rate with a territorial system. There are other ideas out there. The President has talked about it. He has said in his February 2012 white paper he believes the rate ought to be lowered, it ought to be reinvested when you get rid of these tax preferences in lowering that rate.

So there is a lot of commonality now between where Senator Baucus is, Senator Hatch is, and where Congressman Camp is. And the Ways and Means Committee and the Finance Committee are working together on this.

So that is the way to approach it. Eighty percent of our world's purchasing power now lies beyond our borders, and so a key strategy to grow jobs here at home is by tapping into that. And that is what Apple does. That is what a lot of companies in the United States do. We want them to do that. It is also where our international Tax Code puts our workers at a disadvantage and puts our companies at a disadvantage, because when you are operating overseas you pay the tax rate of the company you are operating in plus you pay the residual U.S. tax when that income is brought home.

The other is a tax credit. In some jurisdictions, like Ireland, the tax is so low that you do not get much of a credit. But it is also incredibly complicated to go through that process. And so, in effect, it puts us, again, in a noncompetitive position.

Almost all of our industrial competitors, by the way, have shifted to a territorial type system. That includes the U.K. It includes France. It includes Germany. It includes Japan. In fact, when you look at the OECD, now 26 of our 35 fellow OECD countries have moved to this dividend exemption system, which is a specific territorial system. Congressman Camp has talked about that. I think that is the right way to go. Essentially they do not tax active business income earned beyond their borders, and their businesses are a lot more competitive internationally as a result.

So the U.S. penalty for repatriating earnings has resulted in somewhere, Mr. Chairman, between \$1.5 and \$2 trillion being locked up overseas. That means that money is starting to be deployed for R&D overseas, for putting factories overseas that otherwise could be here. So I think we have to move, and we have to move very quickly. No other nation in the world imposes such a high barrier to bringing foreign earnings home as the United States. No other one.

And, by the way, every one of our little competitors have reformed their tax code since we have back in 1986. Every one of them, their corporate tax code and their international tax codes have all been reformed. They have not just lowered their rates.

Canada just lowered theirs from 16.5 to 15 percent, and our rate, as you know, is the highest in the world. But they have reformed the code to make it more competitive for their companies.

So we have to do this. If we do not, we are going to continue to lose opportunities, and I think our guiding principle should be how do we create competitiveness so we can win customers overseas. Tightening rules related to sourcing of IP income, as again Chairman Camp has proposed and as my plan would do, is important to do. Let us just do it in the context of a comprehensive proposal.

I note, Mr. Oppenheimer and Mr. Cook, whoever wants to answer, that you all do a lot of sales overseas. I think I just heard from Senator Johnson that 65 percent of your revenue is overseas, about 60 percent of your business is overseas now. Is that accurate?

Mr. COOK. Yes, sir, that is accurate. About two-thirds last quarter were overseas.

Senator PORTMAN. And how many U.S. jobs does that represent? In other words, how many jobs in the United States of America are in the U.S. because they support your foreign sales?

Mr. COOK. In total, we have created or support 600,000 U.S. jobs. It is difficult to allocate a certain percentage of those for international business, but I would say it is significant. We are able to invest a lot more because we sell our products around the world.

Senator PORTMAN. It would be tens of thousands of jobs in the United States that are here because of your sales overseas, right?

Mr. COOK. Our earnings overseas have powered our company, yes.

Senator PORTMAN. I would suggest you come up with that number. I know it is not easy, but it is probably 40 percent of your workforce, something like that, in the United States, and it is a huge boon to us. Again, we want you to sell stuff overseas because it creates jobs in America.

Would it be fair to say that your biggest competitor globally is Samsung?

Mr. COOK. They are certainly one of them, yes.

Senator PORTMAN. So Samsung would be a major competitor?

Mr. COOK. Yes, sir.

Senator PORTMAN. And is Samsung an American company?

Mr. COOK. Korean company.

Senator PORTMAN. They are headquartered in South Korea that has as top corporate tax rate of 24 percent, which is 15 points lower than the U.S. corporate tax rate of 39.5 percent, which is our combined State and Federal. So they have a lower tax rate there.

Based on public financial statements for both the companies, my staff tells me it appears that Apple and Samsung actually pay about the same global effective tax rates. At least they did last year. And this is just looking at public documents. Apple's global tax payments were about \$7.7 billion out of \$56 billion in global pre-tax earnings. Samsung's global tax payments were about \$4 billion out of \$28 billion in global pre-tax earnings. So it comes out to a global rate of about 14 percent, the same for both companies.

Mr. Bullock, is that consistent with your estimate of Apple's rate and what you know about Samsung's rate?

Mr. BULLOCK. Senator, yes, that was Apple's global cash tax rate last year. We believe it will be actually a few points higher this year.

Senator PORTMAN. Okay. Well, let us be conservative and say that it is going to be the same. So it sounds like all the tax planning discussed at the hearing today ultimately resulted last year in nothing more than the same global tax rate as your main foreign competitor. Is that accurate?

Mr. BULLOCK. Yes, that sounds like—

Mr. OPPENHEIMER. Senator, yes, with one difference. Samsung is able to freely move its capital back—

Senator PORTMAN. I am getting to that. You are ahead of me, Mr. Oppenheimer.

So I would say the answer is it is worse for Apple because they cannot bring their money home.

Mr. OPPENHEIMER. Yes.

Senator PORTMAN. And think about that. It is partly the rate, but it is partly the fact that they cannot bring it home at 35 percent, so their investment options are a lot more limited, aren't they? Your investment options are a lot more limited.

Mr. BULLOCK. Yes.

Senator PORTMAN. How much money does Apple spend on tax compliance efforts to go through all this rigmarole we talked about earlier?

Mr. BULLOCK. I do not have the exact figure, but it is a lot.

Senator PORTMAN. Again, I would suggest you get that number. I think the American people would like to know how broken our tax system is. I mean, I am a recovering lawyer myself, but you do not need more tax lawyers. You need more engineers, you need more innovators. You need people to keep America on the cutting edge, and, your products are great already, but they could be even greater if you had fewer lawyers and more engineers, probably.

How big is your tax department?

Mr. BULLOCK. It is approximately three dozen people around the world, and we have a couple dozen additional resources through our shared service centers in Cork and Austin, Singapore, and we do have some personnel in Shanghai and Brazil.

Senator PORTMAN. And I imagine it is a lot more than three dozen plus those folks, because you hire a lot of law firms, too.

Mr. BULLOCK. Well, yes, there is a lot of outside help as well. If you could encourage Peter to help me out with more people, that would be appreciated.

Mr. OPPENHEIMER. Senator, I would add—

Senator PORTMAN. You want to have fewer people. We want to reform this Tax Code so you do not have to mess with all this stuff.

Go ahead. I am sorry.

Mr. OPPENHEIMER. I would add, if I could, that the tax return that I sign each year in the United States is 2 feet tall or greater, and we are under continuous examination, and much of the effort that Phil spoke about, both internally and particularly with our outside advisers, deals with continuous examination. So we would very much support a simplified Code that would lead to a smaller tax return.

Senator PORTMAN. So you have high tax compliance costs. You cannot bring your money home so you cannot invest it where you want to. Let me ask you this: What would it do to Apple's ability to compete successfully with Samsung if Congress effectively hiked the tax rate on your international earnings without doing anything to modernize the Tax Code so that you could move to a dividend exemption system or some other modernized system?

Mr. COOK. It would be very bad, sir.

Mr. OPPENHEIMER. It would not be helpful.

Senator PORTMAN. And that is essentially what some are advocating here today. Would you like to be able to cut your tax compliance costs and invest more of that in some productive uses?

Mr. COOK. Yes, definitely.

Senator PORTMAN. With no offense to Mr. Bullock.

Well, let me just summarize by saying, look, I appreciate the hearing today. None of us would design a Tax Code that has a company like Apple engaging in these costly, complex tax planning efforts. Not to achieve some windfall, as the Subcommittee report suggested to me, but, rather, to achieve parity and a roughly level playing field with its foreign competitors, not including, again, the costs of compliance and not including the disadvantage of not being able to bring the money home. It is an antiquated, complex—needlessly complex, in my view—tax system.

So I do not think the solution is to tinker at the margins or go backward toward a worldwide system that makes it even harder to compete. I think we should take the President up on his offer to do corporate tax reform. He says he wants to do it. The Chairman of the Ways and Means Committee and the Chairman of the Finance Committee say they want to do it. It is bipartisan. And I hope this hearing will help us to move toward that goal.

Thank you, Mr. Chairman.

Senator LEVIN. Thank you very much, Senator Portman.

Let me just, first of all, say of course you can bring the profits home. You bring the profits home from South America, don't you?

Mr. COOK. Do we bring the profits home from South America? I do not know the answer—

Senator LEVIN. Well, you have not transferred your intellectual property for that geography, have you? It is just for the rest of the world, other than the Americas. Isn't that correct?

Mr. COOK. The economic transfer for Europe is in Ireland, yes.

Senator LEVIN. I am saying that you bring the profits home from your sales in South America, don't you?

Mr. COOK. I would guess there is some cash in South America. I do not know, sir. I would—

Senator LEVIN. Well, your transfer agreement relative to the intellectual property is the rest of the world outside of the Americas. Is that correct, Mr. Bullock?

Mr. BULLOCK. Yes, that is correct.

Senator LEVIN. All right. So the other parts of the world that are not covered by that transfer of intellectual property, which is the creator of profits, that is your Golden Goose, and you have shifted that Golden Goose, except for the Americas, to Ireland. You shifted it to three companies that do not pay taxes in Ireland, Okay? They do not even exist for taxpaying purposes in terms of income tax.

You shifted your intellectual property there. That is your choice. You did that in a transfer price agreement. You did not shift the intellectual property, however, as I understand it, as far as sales in the Americas is concerned. Is that right, Mr. Bullock?

Mr. BULLOCK. The economic rights—

Senator LEVIN. Economic rights. That is the right—but shorthand, the economic rights to that intellectual property were not transferred as far as the Americas is concerned. Is that right?

Mr. BULLOCK. Mr. Chairman, the economic rights to the intellectual property for distribution in the Americas is owned by Apple Inc. The intellectual rights for distribution in Europe and Asia Pacific are owned by ASI and AOE as a result of the cost-sharing arrangement.

Senator LEVIN. All right. So to answer my question directly, they were not transferred as far as the Americas are concerned. Is that correct? They belong to the home company, Apple Inc. Is that correct?

Mr. BULLOCK. That is correct. Apple Inc.—

Senator LEVIN. All right. So the profits that result in the Americas outside of the United States, you pay income taxes on here. Is that correct? You are bringing them back here to the United States, is that correct? As far as the Americas are concerned.

Mr. BULLOCK. There is a selling profit in both Canada and in Brazil and in Mexico. And, yes, any residual profit is subject to U.S. tax in full.

Senator LEVIN. All right. So you are bringing those profits home.

Mr. BULLOCK. I would characterize it as Apple Inc. is generating those profits.

Senator LEVIN. Well, they are generating the profits through its intellectual property in Europe and Asia, too. I am just talking about the profits in those countries are brought home. Is that correct? In Canada, Mexico, the ones you just mentioned, they are brought home?

Mr. BULLOCK. I would characterize it as those profits are generated by the U.S. company. So I would not say that they are brought home. I would say that they are earned by Apple Inc.

Senator LEVIN. Apple Inc. keeps those intellectual—those economic rights, right?

Mr. BULLOCK. It has, yes.

Senator LEVIN. And it has chosen not to keep the economic rights for the rest of the world. Is that right?

Mr. BULLOCK. Via a co-funding arrangement since 1980.

Senator LEVIN. Right, which it controls. Is that right? I mean, that agreement is an Apple agreement. People who signed it all work for Apple, right?

Mr. BULLOCK. It is between two related parties.

Senator LEVIN. I understand. But they all work for Apple, don't they? Is there any doubt in your mind that Apple controls that agreement and could write that agreement the way it wants to write it, Apple Inc.?

Mr. BULLOCK. Well, I do not think that is the standard. The standard is: Would parties at arm's-length enter into that type of arrangement?

Senator LEVIN. Is that an arm's-length agreement? Are you suggesting that agreement is an arm's-length agreement when all of the signatories are Apple Inc employees?

Mr. BULLOCK. I would, yes. It is evidenced by parties at arm's-length enter into joint development arrangements all the time.

Senator LEVIN. Who signed that agreement? Three parties, right?

Mr. BULLOCK. Parties at arm's-length enter into joint development arrangements all the time. The U.S. Treasury Department on three separate occasions and even the U.S. Congress have approved cost sharing, as evidenced by arm's-length behavior.

Senator LEVIN. I am just asking you, was Apple in control—Apple Inc.'s employees in control of that agreement. It is a very simple question.

Mr. BULLOCK. Chairman, I—

Senator LEVIN. Did they all work for Apple Inc.?

Mr. BULLOCK. They all work for Apple Inc.

Senator LEVIN. Okay.

Mr. OPPENHEIMER. Senator, may I add some context to this?

Senator LEVIN. No, I think we ought to be able to try to get a straight answer on this. In terms of this so-called cost-share agreement, which shifted the economic rights to intellectual property—shifted the economic rights. These are the crown jewels of Apple Inc. They were shifted to these Irish companies in an agreement signed by three people, all of whom work for Apple. That is factually the case. If that is not, say I am wrong.

Now, you signed—

Mr. COOK. I would disagree with your characterization.

Mr. OPPENHEIMER. I disagree with your characterization.

Senator LEVIN. Well, you signed the agreement in 2008, didn't you?

Mr. OPPENHEIMER. Yes, but I think there is some very—

Senator LEVIN. Don't you work for Apple?

Mr. OPPENHEIMER. I do, but I think there is some very important context—

Senator LEVIN. Okay. Well, you can give the context in a minute, but I want to get the facts out, and then we will call on you for the context.

Mr. Cook, you signed that agreement, did you not, in 2008?

Mr. COOK. I signed the 2008 agreement, yes.

Senator LEVIN. And you were working for Apple at that time?

Mr. COOK. I have been working for Apple for 15 years, sir.

Senator LEVIN. And the other person who signed it I believe was Mr. Wipfler, is that correct, in 2008 who was the treasurer for Apple?

Mr. COOK. I am not sure. I do not have the agreement in front of me.

Senator LEVIN. Okay. Do you know, Mr. Oppenheimer?

Mr. OPPENHEIMER. Yes, he is our treasurer.

Senator LEVIN. And he was then?

Mr. OPPENHEIMER. Yes.

Senator LEVIN. Three people working for Apple signed this agreement. This agreement shifted the economic rights in your crown jewels to three Irish companies that you own and control.

Mr. OPPENHEIMER. Senator, I would respectfully disagree with that characterization.

Senator LEVIN. Well, you already said you own and control them earlier this morning. Let me just finish my question, and if you do not agree that you own and control them, you can stop me. But you agreed earlier this morning you do own and control those corporations. So I am relying on your testimony that you own and control those corporations. So now you transfer, you shift—and, by the way, when you said you shifted nothing, Mr. Cook, I could not disagree with you more. Of course you shifted something, the most valuable thing you have. The economic rights in your intellectual property you shifted to those three companies in an agreement. I am not saying it was legal or illegal. I am simply saying you shifted the economic rights to the most valuable thing you own—intellectual property. The thing that produces the profits you shifted to those three Irish corporations which you own.

Now the profits, about 70 percent of the profits worldwide now end up with those three Irish corporations. That is the fact. And now those profits are abroad. And when one of my colleagues says you cannot bring them home, of course you can bring it home—if you will pay the tax on it that would be owing on them if you brought them home. Of course you can bring them home. You bring home the profits from Mexico and Canada and South America. The only reason you are not bringing them home is because they were transferred to the companies in—these three Irish companies. That is the reason why they are there. It is your judgment, your decision. I am not saying you are making the wrong decision. It is your decision not to bring those profits home. And so \$100 billion plus is now stashed away in these three Irish companies that you control but nonetheless it is in their legal name.

And the question is: Will you bring them home? You have told us in one place, I believe, Mr. Cook, that you do not intend to bring those monies home unless our tax rates are reduced. I believe that is what you told our staff. Is that correct? You are not going to bring that money home unless we reduce our tax rates. Is that accurate as to what you told our staff?

Mr. COOK. Senator, there is a lot there. I would appreciate being able—

Senator LEVIN. You can, but I just want to ask you that one question. Is it true you told our staff you are not bringing the \$100 billion home unless we reduce our tax rates? Is that accurate?

Mr. COOK. I do not remember saying that.

Senator LEVIN. Is it true?

Mr. COOK. I said I do not remember saying it.

Senator LEVIN. No. I am saying is it true that you are not going to bring them home unless we reduce our tax rates.

Mr. COOK. I have no current plan to bring them back at the current tax rate.

Senator LEVIN. All right. Is that the same way as saying unless we reduce our tax rates you are not bringing them home? Is that the same way—

Mr. COOK. No, I do not think it is the same, sir.

Senator LEVIN. How is it different?

Mr. COOK. Your comment sounds like it is forever, and I am not projecting what I am going to do forever because I have no idea how the world may change.

Senator LEVIN. All right. It is not your intent to bring them home unless we reduce our tax rates. Is that correct?

Mr. COOK. I have no current plan to do so at the current tax rates.

Senator LEVIN. Okay. Here is where we are at, here is the situation. You have an agreement which shifts the economic rights, the most valuable thing you have, to three Irish companies that pay no taxes. That is the shift. That is the Golden Goose right there. That is your crown jewels. That is your intellectual property. You have a right to do that just the way you had a right not to shift that intellectual property for Mexico, Canada, and South America. You decided not to do it there. You are going to pay—Apple Inc. is going to pay the taxes on the income for all the parts of the world except for where two-thirds of the profits are created, roughly, and that is the rest of the world that you have transferred the economic rights to.

So, Okay, here is where we are at. You have profits going now—you have \$100 billion in profits that are sitting there and you say it is your current intent to not pay your taxes on them because you do not think you need to pay taxes on those because the profits were shifted, as we have indicated, the economic value has been shifted, and, therefore—

Mr. OPPENHEIMER. But, Senator, I must say we do not agree with the characterization.

Senator LEVIN. That the economic rights to that—to your intellectual property was shifted to those three companies? You do not agree with that?

Mr. OPPENHEIMER. We do not.

Senator LEVIN. Oh, Okay. What was shifted to them?

Mr. COOK. Senator—

Senator LEVIN. Well, what was shifted to them in that agreement that the three people signed, all of whom worked for Apple Inc.? What was shifted?

Mr. OPPENHEIMER. Well, Senator, it began in 1980.

Senator LEVIN. I know that. I am talking about 2009, the most—

Mr. OPPENHEIMER. Yes, but, Senator, it began in 1980—

Senator LEVIN. We have been through that history—

Mr. OPPENHEIMER. It fundamentally—

Senator LEVIN. We have been through the history.

Mr. OPPENHEIMER. It fundamentally did not change since 1980, and I think there is some very important context that gets to the essence of the agreement that began over 30 years ago.

Senator LEVIN. I understand, but I want to talk about the agreement signed in 2008 and 2009. There was an agreement signed in 2008 and 2009. You signed that agreement in 2008. Three Apple employees signed that agreement in 2008. That agreement did two things: it shifted the economic rights, the way they had been shifted before, 30 years ago, it continued to shift the economic rights to three Irish companies under your control that do not pay taxes in the United States.

Mr. OPPENHEIMER. Senator, I respectfully disagree with that.

Senator LEVIN. Okay. It did not shift the economic rights?

Mr. OPPENHEIMER. No, I do not—that is not the way I would characterize it.

Senator LEVIN. What did it shift?

Mr. OPPENHEIMER. What it did, beginning in 1980—

Senator LEVIN. Did it shift—

Mr. OPPENHEIMER. What it did, beginning in 1980—

Senator LEVIN. Let us start in 2008—

Mr. OPPENHEIMER [continuing]. And it continued—

Senator LEVIN. I am sorry, Mr. Oppenheimer. You have gone through the 1980. I want to talk about the 2008 and 2009 agreements. Did it shift anything? Did it give rights to those three Irish companies? Did they get any rights in those three—

Mr. OPPENHEIMER. It was a continuation of the same rights they have had for 30 years—

Senator LEVIN. Fine.

Mr. OPPENHEIMER [continuing]. That they have co-funded.

Senator LEVIN. Real good. Now, in 2008, you continued under Apple's control, totally under Apple's control—I do not think we ought to kid ourselves about that. Under Apple's control, in 2008 and 2009, there is an agreement that is reached, so-called, with a controlled corporation, which you folks have agreed this morning you control, and under that agreement, which continues an earlier arrangement—that could have been changed. You did not have to shift the profits in 2008. You did not have to shift your intellectual property, the economic benefits in 2008 and 2009. You are in control. It is your company. You are signatories. You made a decision to do it. You had a right to make a decision. But do not kid ourselves as to the implications of what this means in terms of America's revenue.

Apple makes this shift—again, I am not saying it is illegal. I am not saying it is legal. I am saying you made a decision to shift most of your crown jewels in terms of economic value and rights that creates the profits which are so massive, you made that decision to continue that arrangement in 2008 and 2009. Okay. Now, we—

Mr. OPPENHEIMER. So we did that.

Senator LEVIN. Yes.

Mr. OPPENHEIMER. Beginning in 1980, and that is the way we set up Apple. We went to Ireland when we first wanted to begin to sell computers overseas—

Senator LEVIN. I understand. But we heard that this morning. I understand that.

Mr. OPPENHEIMER. We have continued to do that for the last 30 years. We have built up a lot of skills. Our systems are set up that way. Our processes are set up that way. Our operations are, and that is why we do it today. It has been unchanged for over 30 years.

Senator LEVIN. The result of continuing that in 2008 and 2009 is most of your profits worldwide are now in three Irish companies that you control that do not pay taxes. That is the result of what you did in 2008. I know the origin—

Mr. OPPENHEIMER. Thankfully, customers around the world love the iPhone and the iPad and they are buying them.

Senator LEVIN. We love the iPhone and the iPad.

Mr. OPPENHEIMER. And so do people around the world, and they are buying them, and we are selling—

Senator LEVIN. People around the world—people in Mexico and Canada love the iPhone and the iPad. I got one right here. My granddaughter even knows how to use it. All of it.

Mr. COOK. Thank you.

Senator LEVIN. It is a terrific instrument. That is not the question. People love it in Canada, Mexico, and in South America. But the intellectual property was not transferred there.

Mr. OPPENHEIMER. And it is because it is the way we set ourselves up over 30 years ago. We have not changed.

Senator LEVIN. I understand. As a result of the continuation of that process, in 2008 and 2009, most of your profits that come from this brilliant intellectual property, which everybody that I know of applauds, the continuation of that system means that most of your profits worldwide are sitting in three Irish companies that you control that do not pay taxes. That is the result, Okay? You can defend it. But that is the result. And, folks, there is a huge drain as a result. You point out, and accurately so, Mr. Cook, that 95 percent of the creativity that goes into those products is in California. But two-thirds of the profits are in Ireland. And you have made a decision, which you have a right to do, not to bring that money home.

Mr. COOK. Senator, we are proud that all of our R&D or the vast majority of it is in the United States.

Senator LEVIN. I know, but the profits that result from it are sitting in Ireland in corporations that you control that do not pay taxes. You ought to be proud—

Mr. COOK. All of the profits from all of the products we sell in the United States—

Senator LEVIN. I know that.

Mr. COOK [continuing]. We pay taxes in the United States.

Senator LEVIN. Oh, I know that. And all the profits that you make from your products that are sold in Canada are taxed in the United States, and all of the profits that are produced from products that you sell in Mexico and Argentina and South America, all of those profits you pay taxes on in the United States. But you made a decision. You signed an agreement that continues an earlier agreement. You signed two agreements in 2008 and 2009, and in those two agreements you continued to shift most of your crown jewels in terms of economic value, you continued that arrangement, with the result that most of your profits worldwide are not taxed. You are an American company. You are proud of it. We are proud of you being an American company. We are glad you are where you are at. But the result of these arrangements that you have continued is that most of your profit is now where we have described all morning, in Ireland, in these companies that do not exist anywhere except on the water.

Now, of course we have to change it. Of course we have to change this system. But in order to change it, we have to understand it, not deny it. We have to understand what is going on. And what is going on is a huge loss of revenue to the United States because we

have these corporations—and you are the biggest one—that are able to shift profits to places where you, an American company, do not pay income tax on it. That is where we are at. And we have to better understand that if we are going to correct it. And that is our purpose here today, to shed a light on that.

And so I hope that purpose has been achieved. We cannot continue a system, and I say this from the bottom of my heart. We cannot continue a system where the company, a multinational company, as phenomenally successful as yours, and deservedly so, can make a decision, sitting down in 2008 and 2009, as to where the profits are going to flow. An American company where the R&D is 95 percent in the United States, we—you created it. I will not say “we.” You created it. You got some real benefits, by the way, in doing that. You got R&D tax credits. You have all the benefits of living in this country. You have the protection of patents.

So with all of that, you are sitting there unilaterally deciding in 2008 and 2009 whether to continue a system where profits are shifted to a place where they are not available to the American tax man. Everyone agrees apparently we have to change this system. I hope everybody agrees to that. How we do it we may not agree to. But in order for us to change this system, we have to understand what is going on, which is that you make a unilateral decision, three Apple employees in 2008 and 2009 essentially decided where these profits are going to be taxed or non-taxed.

Folks, it is not right. That is not right, to leave that decision, it seems to me, the way it is decided so unilaterally, that a company can shift its value to a place—to a tax haven, which is what Ireland is.

I hope we have—I know it is your intention here—and I applaud you for your constructive view. I do. I know it is not easy to come in front of a spotlight. We understand that. But it is important for us that have to write the laws—and you agreed, Mr. Cook, and your colleagues there, that we have to rewrite these laws. It is important for us that we know what is going on if we are going to change it in a sensible way.

And so we are going to move to our third panel, and I want to again thank you, all of you, and I want to commend your company for the great work that you produce.

With that, we are going to move to our third panel. Thank you.

Mr. COOK. Thank you.

Senator LEVIN. We are now going to move to our third panel. We call our witnesses: Mark Mazur, Assistant Secretary for Tax Policy at the Department of Treasury; Samuel Maruca, the Director of Transfer Pricing Operations of the Large Business & International Division at the Internal Revenue Service. We appreciate both of you being with us here today, and we look forward to your testimony. And I think you both know our rules, that under Rule VI all witnesses who testify before the Subcommittee are required to be sworn, so we would ask you if you would please stand and raise your right hand. Do you swear that the testimony you are about to give here today will be the truth, the whole truth, and nothing but the truth, so help you, God?

Mr. MAZUR. I do.

Mr. MARUCA. I do.

Senator LEVIN. One minute before the red light comes on, you are going to see the light change from green to yellow, which will give you an opportunity to conclude your remarks. The written testimony will be printed in the record in its entirety, and we ask that you limit your oral testimony to no more than 10 minutes.

Mr. Mazur, we will have you go first.

**TESTIMONY OF MARK J. MAZUR,<sup>1</sup> ASSISTANT SECRETARY FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY, WASHINGTON, D.C.**

Mr. MAZUR. Thank you, Chairman Levin. I appreciate the opportunity to testify on the issue of the potential shifting of profits offshore and between foreign companies and countries by U.S. multinational corporations.

Obviously this is a complex subject that has numerous tax policy issues, and it also brings up issues relating to tax accounting and tax administration. I hope to address some of the most important ones today.

The geographic allocation of profits earned by multinational enterprises historically has been challenging and has become more difficult with the rise of globalization. In my prepared testimony, I offer a stylized example of the way that this shifting could occur. The basic point, though, is if you have a multistep process that takes place over a number of jurisdictions where decisions are made to develop and market a product around the world, each of these steps is important for ensuring that the product is profitable, but the important question arises: Where is that income earned? And presumably some sliver of income goes to each of those steps in the process for a successful marketing of a product, but it is not obvious what the appropriate geographic allocation should be.

However, our Tax Code requires that the income be allocated to various subsidiaries based on an arm's-length standard, one that would exist if you have unrelated parties who charge each other for goods or services provided. But when parties are related and there is not a very well defined market, it may be very difficult to determine the arm's-length price that should prevail in those transactions.

And it is important to realize this is not just a U.S. problem. Virtually every country with a corporate income tax faces the challenge of determining what share of a global enterprise's income is part of that country's tax base.

Multinational corporations under current law are able to shift profits offshore and between subsidiaries using various organizational structures and transactions. In some cases a U.S. company transfers rights to intangible property to an offshore affiliate. These can occur through various constructs including cost-sharing arrangements. Under this type of an agreement, the foreign subsidiary is required to pay the U.S. parent an arm's-length price for any existing intangible property or other resource. And thereafter, the subsidiary contributes a portion of the costs of the shared research and development activities of the intangible. And then they share in anticipated benefits from that.

<sup>1</sup>The prepared statement of Mr. Mazur appears in the Appendix on page 139.

In theory, up front, the payment that is made for the intangible property originally contributed, combined with the reduction in the U.S. parent's tax deductions, should result in no anticipated risk-adjusted loss of tax revenue to the United States. However, there is considerable controversy whether this result is actually achieved in fact.

There are a number of ways that U.S. multinationals may shift profits, including moving intangible property through various transactions that will not result in recognized income in the United States. Some taxpayers have taken the position that certain intangible assets are not subject to the arm's-length transfer pricing rules, as one example.

What I want to do is spend a moment or two talking about the overall context. Changes in the U.S. corporate tax rates—both in absolute terms and relative to the rates of our major trading partners—have changed the economic incentives greatly over the last few decades. Before the 1986 Tax Reform Act, the United States and other developed countries had relatively high tax rates, and they were roughly similar. After the 1986 Tax Reform Act, the United States was a relatively low-tax jurisdiction. Since then, however, other countries have reduced their corporate tax rates, and now the U.S. corporate rate is among the highest in the developed world.

A higher statutory rate can encourage companies to shift income and production to lower-tax jurisdictions, especially in a global marketplace. The immediate gain from shifting a dollar is the difference in statutory tax rates, and while there may be costs to managing operations and earnings that were shifted, the multinational firm may be better off from having done so. So that is the role of tax rates.

There is also, though, the role of accounting treatment. U.S. multinationals are concerned not just about the tax treatment of their earnings but also about the financial accounting treatment of their earnings. There is a presumption under U.S. Generally Accepted Accounting Principles (GAAP) that deferred income taxes should be recognized in the financial statements for the same period in which the earnings are generated because these rules presume that the earnings will be repatriated back to the United States or remitted back to the U.S. parent at some point in time. However, this presumption can be overcome by the firm either permanently investing abroad or saying that they will permanently reinvest the earnings abroad. And then you have a situation where the deferral of earnings offshore offers not just the tax benefit, the deferral of the tax that will be due, or a lower effective tax rate paid over time, but also a higher earnings for financial statement purposes. And so financial income reporting rules may also add to the incentive to shift earnings.

Estimates of how big this issue is vary all over the lot. There are some estimates that are less than \$10 billion a year, some estimates greater than \$80 billion per year. The estimates try to account for all the possible ways of doing profit shifting between shifting intangibles, shifting risk, and using debt to shift income around. But the point of all these estimates is that you need to

have a set of assumptions about behavior, profitability and so on to generate these estimates.

Some studies assume that the rates of return are not affected by income shifting or profit margins are not affected by income shifting. Others try to estimate statistical relationships. The point here is that while there are a range of estimates, they tend to be relatively large in absolute dollar terms.

I want to change gears a little bit and look at some of the specific tax rules. Subpart F is a section of the Tax Code that is intended to limit income shifting to low-or no-tax jurisdictions. It generally focuses on passive and mobile income, and the idea is that that type of income will be taxed currently in the United States. That is, the tax on that income is not deferred.

Subpart F goes back to the 1960s. The Kennedy Administration proposed to end deferral. Subpart F was Congress' response to that. It was a more modest step toward ending deferral, and it focused on types of income that were more easily shifted.

However, Subpart F today may not be doing what it was intended to do 50 or so years ago. It is possible for taxpayers to use hybrid entities and hybrid instruments in order to avoid some of the aspects of Subpart F. Hybrid entities would be entities that are considered a corporation in one jurisdiction and a non-corporate entity in another. Hybrid instruments would be a financial instrument that is considered debt in one jurisdiction and equity or preferred stock in a different one. This type of situation effectively allows multinational firms to arbitrage tax rules by having different results in two different countries.

The Administration has several proposals to address this situation, both proposals contained in the annual budget submission and in the President's Framework for Business Tax Reform.

I want to focus a moment on the Framework. It was really intended to provide a multi-pronged approach to reduce the incentives for companies to shift income and shift investment to low-tax countries, also to put the United States on a more level playing field with our international competitors, and to help slow the global race to the bottom on corporate tax rates. The underlying principle of the President's Framework for Business Tax Reform was that the United States should become a more attractive place to create and retain high-quality jobs.

Among other things, the President's Framework would impose a minimum tax on the income earned by foreign subsidiaries of U.S. multinationals. If a U.S. multinational had a subsidiary in a low-tax country paying a low effective tax rate, the minimum tax would kick in. That income would be taxed currently at the minimum tax rate. That would provide a balance by limiting the opportunities to shift profits to low-tax jurisdictions and place U.S. multinationals on a more level playing field with their local competitors.

The President's Framework for Business Tax Reform also would incorporate many of the international tax proposals in the President's fiscal year 2014 budget that would discourage U.S. multinationals from shifting profits—and specifically profits related to intangible property offshore. One proposal that is important is the excess returns proposal. This would provide that if a U.S. firm transferred intangible property to a related foreign affiliate subject

to a low foreign effective rate and where there is excess income shifting, the U.S. firm would be taxed currently on the amount of excess shifting abroad. This would eliminate a large part of the incentive for inappropriate shifting of intangibles.

There are a number of other proposals in the President's budget that also would focus on the situation where income from intangibles is not appropriately taxed in the United States.

And the last point I want to make has to do with the work that the Treasury Department has been doing with the Organisation for Economic Co-operation and Development to analyze profit shifting. We are actively participating in the OECD's project on base erosion and profit shifting, and it is an indication where a multilateral set of steps really is necessary to address this problem in the worldwide context.

Thanks for your attention. I would be happy to answer any questions.

Senator LEVIN. Thank you very much, Mr. Mazur. Mr. Maruca.

**TESTIMONY OF SAMUEL M. MARUCA,<sup>1</sup> DIRECTOR, TRANSFER PRICING OPERATIONS, LARGE BUSINESS & INTERNATIONAL (LB&I) DIVISION, INTERNAL REVENUE SERVICE, WASHINGTON, D.C.**

Mr. MARUCA. Chairman Levin, thank you very much for the opportunity to appear and speak on tax compliance and tax administration issues related to the shifting of profits offshore by U.S. multinationals.

The IRS takes very seriously the need to ensure that U.S. multinational corporations are abiding by the U.S. tax laws and paying their fair share of tax. Over the past few years, we have been working to enhance our approach to international tax enforcement in general and to income shifting in particular. We have been refocusing our enforcement efforts to be more strategic by viewing taxpayers through the prism of their tax planning strategies and allocating our limited resources to cases presenting the highest compliance risk.

We have been aligning our resources and training our employees in key strategic areas, including income shifting, deferral planning, foreign tax credit management, and accessing profits accumulated offshore.

Further, to better manage our collective knowledge in strategic international compliance areas, we have formed 18 what we call "International Practice Networks," which are focused on integrating our training and our data management with our overall strategy in this area.

With respect to transfer pricing, the IRS is charged with ensuring that taxpayers report the results of transactions between related parties as if those transactions had occurred between unrelated parties. Under this standard, the results of the transaction as reported by the taxpayer are compared to results that would occur between unrelated taxpayers in comparable transactions under comparable circumstances.

<sup>1</sup>The prepared statement of Mr. Maruca appears in the appendix on page 146.

Now, establishing an appropriate arm's-length price by reference to comparable transactions is relatively straightforward for the vast majority of international commerce. But enforcing the arm's-length standard becomes much more difficult in situations in which a U.S. company shifts to an offshore affiliate the rights to intangible property that is at the very heart of its business—what may be referred to as the company's "core intangibles." In fact, over the past decade, applying Section 482 in these types of cases has been our most significant international enforcement challenge.

Transfers of a company's core intangibles outside of a corporate group rarely occur in the market, so comparable transactions are difficult, if not impossible, to find. In some cases the IRS has had to resort to other valuation methods not based on market benchmarks, which are often referred to as "income-based methods." Under these methods, the IRS typically has to conduct an ex ante discounted cash-flow analysis. Evaluating underlying assumptions about projects cash-flows and discount rates after the fact is a complex undertaking.

Moreover, a business' core intangible property rights are by their nature high-risk, high-reward assets, and it is often difficult to assess the extent of the risk and by whom it is borne.

The IRS has been attuned to this issue for many years and has devoted substantial resources to enforcement in this area. We are now redoubling our efforts. In 2011, a new IRS executive position, in which I am the first to serve, was created to oversee all transfer pricing-related functions, to set an overall strategy in the area, and to coordinate work on our most important cases. In building a new function devoted exclusively to tackling our transfer pricing challenges, we have recruited dozens of transfer pricing experts and economists with substantial private sector experience to help us stay on the cutting edge of enforcement and issue resolution. We are working closely with exam teams in the field to ensure the best case selection and development possible.

I would like to briefly address the issue of cost sharing. The IRS has worked with the Treasury Department over the last several years to adopt revised regulations on cost sharing. These new rules clarify a number of issues that were contentious under the prior set of cost-sharing regulations and better define the scope of intangible property contributions that are subject to taxation in connection with cross-border business restructurings. While to date the IRS has had limited experience in auditing transactions covered by these new regulations, early anecdotal information indicates that the regulations have had a positive impact.

However, concerns remain that we are considering and following very closely. Some taxpayers are taking the position that a cost-sharing arrangement, or other transaction taxable under Section 482, has, in fact, been preceded, either explicitly or implicitly, by the incorporation or reorganization transfer of core intangibles. In these cases, the taxpayers assert, among other positions, that foreign goodwill and going concern, which are exempted from tax under the regulations, are the most valuable elements in these transactions. In response, we are now training our agents to address these issues and to challenge taxpayers' positions where appropriate.

The IRS has been and continues to be vigilant and forceful in addressing compliance issues we have seen in regard to income shifting activities of United States and foreign-based multinationals. Based on a recent survey, as of May 9, 2013, we estimate that we are currently considering income shifting issues associated with approximately 250 taxpayers involving approximately \$68 billion in potential adjustments to income.

Mr. Chairman, thank you again for this opportunity to testify on the IRS' efforts to enforce the tax law as it applies to multinational companies. Although enforcing and administering international tax law will present challenges for us well into the future, the agency has made great strides in recent years, and this is a tribute to our strategic focus and to the highly dedicated and professional men and women of the IRS. I would be happy to respond to any questions you may have.

Thank you.

Senator LEVIN. Thank you very much, both of you.

Mr. Maruca and Mr. Mazur, do you agree that Subpart F of the Tax Code was designed to stop tax haven abuse, that it was supposed to stop these controlled foreign corporations from converting deferrable active income that is not easily movable into non-deferrable—i.e., taxable—passive income that is easily shifted into a tax haven for tax avoidance?

Mr. MARUCA. I would agree, Mr. Chairman, as originally conceived that was the purpose of Subpart F. But over the years, there have been numerous exceptions and exceptions within exceptions. And that circumstance, together with the check-the-box rules, as well as the interaction of our law and foreign law, create multiple different opportunities, if you will, to avoid the reach of Subpart F as it was originally conceived.

Senator LEVIN. And would you agree that the original conception, Mr. Mazur, of Subpart F was to do what I just described?

Mr. MAZUR. I think I would characterize the original characterization of Subpart F is to prevent the shifting of passive income abroad, yes.

Senator LEVIN. The shifting of passive income. I think it also, was it not, because it covered dividends that were made to corporations, for instance, that if those dividends came from a corporation and the income was active income in the first corporation, that when it shifted it in the form of a dividend or a royalty, that then became passive income, which under Subpart F was intended to be taxed.

Mr. MAZUR. I think the general idea was to focus on mobile income, passive income, sweep that up into the U.S. tax base, active income could be deferred, yes.

Senator LEVIN. Active income deferred, passive income was not supposed to be deferred. Is that correct?

Mr. MAZUR. Basic rule, yes.

Senator LEVIN. And that is the basic rule, and the passive income included dividends and royalties. Is that specified?

Mr. MAZUR. Sir, it's harder to say on that one because if you look at the role of Subpart F to prevent shifting passive income out of the U.S. tax base, then that would be correct. Over the years the

focus has mostly been on the U.S. tax base, not so much on the foreign-to-foreign tax base.

Senator LEVIN. I am talking about the original intent.

Mr. MAZUR. The 1962 intent, sir?

Senator LEVIN. Yes.

Mr. MAZUR. Hard to say, but you are probably right.

Senator LEVIN. Okay. In your written testimony, I think you make reference to regulations that were issued in March 1998 that would have modified the check-the-box regulation, restored an anti-deferral regime, but that in 1998—excuse me, that subsequent to 1998 those regulations were withdrawn. Is that correct? The 1998 regs were withdrawn?

Mr. MARUCA. I believe so, yes.

Senator LEVIN. And is it fair to say that they were withdrawn because of pressure from the Hill, Capitol Hill, and business interests? Is that what the history shows here? You are familiar with the history. You were not here at the time, I do not think.

Mr. MAZUR. I was not at Treasury at the time.

Senator LEVIN. But you are familiar with the history here. Is that a fair statement?

Mr. MAZUR. I think the fairer statement would be that the rules were proposed, they were withdrawn; there was a lot of opposition from the business community and from folks on the Hill.

Senator LEVIN. That is fine.

I believe that you indicated in your testimony that we are trying or you folks are trying at Treasury and the IRS to avoid a situation where there is shifting of revenue between the parent corporation and subsidiaries pursuant to agreements that are transfer pricing agreements, unless those subsidiaries are making payments based on, in your words, an arm's-length standard. Is that correct?

Mr. MARUCA. That is correct.

Senator LEVIN. And the arm's-length standard that you require to be followed is essentially, in your words, what unrelated parties would charge each other for the goods or services provided. Is that correct?

Mr. MAZUR. Correct.

Mr. MARUCA. That is correct.

Senator LEVIN. And I think I am actually quoting from your testimony, Mr. Mazur, so—

Mr. MAZUR. I will take the "correct."

Senator LEVIN [continuing]. You would agree it is correct. So now we have heard of—just an example, we have put the spotlight on one example of where three Apple employees sign an agreement to transfer the economic rights to intellectual property to three of their wholly owned Irish subsidiaries. That was the example that we are looking at, and you have indicated that somehow or other it is the goal of the IRS to make sure that that payment and that shift of the profits, in essence, to the subsidiary is based on an arm's-length standard. Somehow or other you have to figure out, if there were an arm's-length deal here, what would be shifted. What part of the profits would be shifted? What part of the cost would be shifted? And that is what you are trying to do. Is that correct, Mr. Maruca?

Mr. MARUCA. Yes, Mr. Chairman. I cannot comment on the particulars with respect to—

Senator LEVIN. No, I am not asking—

Mr. MARUCA [continuing]. Any taxpayer, but—

Senator LEVIN. No, I am not asking you to comment on this taxpayer. What I am asking you to comment on, your goal is to find a way to apply an arm's-length standard to a transfer pricing agreement. Is that correct?

Mr. MARUCA. Yes. So we would analyze the facts and circumstances.

Senator LEVIN. All right. Now, you also indicated, I believe, that you now have an ability to go back after the fact and to look at what the allocation of costs and profits were. Is that true?

Mr. MARUCA. Under some circumstances, yes.

Senator LEVIN. All right. So that now you have the ability to—when you have clearly a non-arm's-length transaction, I am going to—it is so obvious this is not an arm's-length that we talked about this morning, but I will not talk about this morning. I will just simply say: Where there is obviously not an arm's-length transaction, where the parties are all working for the parent corporation but are signing a transfer pricing agreement between a parent corporation and a controlled foreign corporation, wholly owned subsidiary, that you now have the ability to pierce that, to look at that, but to look at it afterwards and to see whether or not, in fact, knowing what has taken place during the life of that agreement or when that agreement is in effect, whether that is a fair allocation of benefits, risks, and profit? Are we together? Or put it in your own words.

Mr. MARUCA. Yes, I think our regulations do allow a retrospective look, but the way we apply our rules is we go back and look and see what the playing field was like when the transactions were struck. And if they are appropriately priced based on the information available at that time and the risks play out differently, we would not revisit that transaction.

Senator LEVIN. All right. And so when the—let us assume that you have a series of transfer pricing agreements signed between an American corporation and a controlled foreign corporation and there was an agreement that was signed in year one and then there was another transfer agreement, another transfer pricing agreement for the same property in year two, and then in year three, and then in year four, do you look at the most recent agreement to see if that was in effect, had the arm's-length standards met? Would you look at the most recent agreement?

Mr. MARUCA. I think we would probably have to look at the totality of the circumstances.

Senator LEVIN. Would that include—

Mr. MARUCA. That fact pattern.

Senator LEVIN. Would that include the most recent agreement?

Mr. MARUCA. It would include all the facts.

Senator LEVIN. All the agreements?

Mr. MARUCA. Yes.

Senator LEVIN. Up to date, Okay.

Do we have or do you have an obligation to stop multinational corporations from shifting income to tax haven jurisdictions? Mr. Mazur?

Mr. MAZUR. I think the obligation of the Treasury Department here is to ensure that laws that are passed are implemented in the way that Congress intended them through regulatory activity; and, second, where there are problems that arise, to propose legislative fixes to those.

Senator LEVIN. Mr. Maruca, you made reference, I believe, to Section 482 of the Code.

Mr. MARUCA. Yes, sir.

Senator LEVIN. That section reads that, "The Secretary may distribute a portion or allocate gross income, deductions, credits or allowances, between or among such organizations, trades, or businesses if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or to clearly reflect the income of any such organizations, trades, or businesses."

So under Section 482, is that still the law?

Mr. MARUCA. Yes, sir.

Senator LEVIN. And that is the one you made reference to, I believe, in your testimony.

Mr. MARUCA. Yes.

Senator LEVIN. You at the IRS and the Treasury Department can change the allocation if you find it necessary to prevent—excuse me. I will put it positively. If you find it necessary to clearly reflect the income of such organization, trade, or businesses. Right?

Mr. MARUCA. That is correct.

Senator LEVIN. Okay.

Mr. MAZUR. And one of the things that has been done, in 2009 we issued temporary regulations related to cost sharing, and those were finalized in 2011. They address a particular set of problems that we had seen in the cost-sharing area.

Senator LEVIN. All right. Now, we have been looking at U.S. multinationals, this Subcommittee has been looking at U.S. multinationals and their offshore entities for a number of years. This is the first time that we have ever come across entities that have no tax residence. Our experts have told us—except we heard slightly differently today, but at least one of our experts had told us that they had never heard about entities without a known tax jurisdiction.

In either of your experiences, have you ever heard of a controlled foreign corporation that does not have a tax residence?

Mr. MARUCA. Yes.

Senator LEVIN. Mr. Mazur.

Mr. MAZUR. No.

Senator LEVIN. So now you have heard of one that does not have a tax residence. Mr. Maruca, explain what that situation was.

Mr. MARUCA. Well, it typically arises where there is a difference between treatment under U.S. law and treatment under foreign law. So the residence rule, for example, could be different.

Senator LEVIN. They are different. That is what happens. Here the question is whether—have you ever heard of a controlled foreign corporation that has no residence?

Mr. MARUCA. A controlled foreign corporation——

Senator LEVIN. That says it has no residence.

Mr. MARUCA. Is a foreign corporation for U.S. law purposes.

Senator LEVIN. Right.

Mr. MARUCA. It is not a U.S. resident corporation. It is not a U.S. corporation. It does not have Irish or foreign law residency either because under those rules, it is not the place of organization.

Senator LEVIN. Right. We understand. That is what we went through this morning.

Mr. MARUCA. It is where it is managed and controlled.

Senator LEVIN. Right.

Mr. MARUCA. That is how it arises.

Senator LEVIN. Okay. It arises—we had an example of it here this morning. That is exactly what happened. My question is: Is it a rare event that you find a controlled foreign corporation that does not have a tax residence?

Mr. MARUCA. That I could not say.

Senator LEVIN. Well, from our perspective, from what we have seen, it is rare. And, Mr. Mazur, I guess you have never even seen one.

Now, the next question relates to a shell entity that is incorporated in a foreign tax jurisdiction. Can it be disregarded for U.S. tax purposes if the entity is controlled by its parent to such a degree that the shell entity is nothing more than an instrumentality of its parent? And here I will refer to a legal principle that was described by the IRS in a letter ruling in 2002. Did you follow the question? Mr. Mazur, let me ask you first. Did you follow the question?

Mr. MAZUR. No.

Senator LEVIN. If a shell entity is incorporated in a foreign tax jurisdiction, can it 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?

Mr. MAZUR. I believe it is possible, yes.

Mr. MARUCA. I would be happy to respond to that, Mr. Chairman.

Senator LEVIN. Okay.

Mr. MARUCA. It is possible, there are circumstances under which we have been successful in disregarding incorporations or other arrangements, contractually or otherwise, between related parties. However, those circumstances are fairly narrow under our common law. So, for example, if you have a company that is duly organized and existing, it has capital, it has assets, and it takes business risk, in those circumstances it is extremely difficult to succeed in disregarding the existence of that entity or the transactions it engages in.

Senator LEVIN. Now, is that true even if the assets are totally controlled by the parent?

Mr. MARUCA. Well, there is a difficult——

Senator LEVIN. It has no employees, for instance. It has no employees.

Mr. MARUCA. There is a difficult issue——

Senator LEVIN. AOI has no employees.

Mr. MARUCA. That is a difficult issue that we confront fairly regularly where the management and control is in one corporate entity and the funding and business risk is in another. We have rules that allow us to apply our transfer pricing valuation principles in that context, but it is typically a pricing question and not a question of whether that entity is a sham or can be disregarded.

Senator LEVIN. So if it is a sham entity, has no employees, all of its assets are controlled by the parent, its directors are the parent's directors, the meetings are held on the telephone and never held in an offshore location, there is no there there, would those be factors that you would look at to determine whether or not, in fact, the shell entity is nothing more than an instrumentality of its parent?

Mr. MARUCA. Those would definitely be factors. But there are other factors.

Senator LEVIN. Other factors as well. I understand. Cost-sharing agreements are supposed to be arm's-length or meet arm's-length standards. Is that correct?

Mr. MARUCA. They are supposed to meet the requirements of our regulations, yes.

Senator LEVIN. Is the purpose of your regulation that they meet arm's-length standards?

Mr. MARUCA. Yes.

Senator LEVIN. Mr. Mazur.

Mr. MAZUR. Roughly consistent with arm's-length standards, yes.

Senator LEVIN. Roughly consistent?

Mr. MAZUR. Consistent with arm's-length standards, yes.

Senator LEVIN. Arm's-length standards.

Mr. Mazur, if a transaction is only done for tax reasons, is it appropriate for the IRS to disallow such a transaction when it does not have a business purpose but is being done to shift profits to avoid tax?

Mr. MAZUR. There are some situations where the economic substance is the appropriate standard, but often we look at the legal standards here, and if there is risk that is shifted or some other—

Senator LEVIN. If there is what?

Mr. MAZUR. Risk that is shifted or some other attributes that are shifted, those transactions may be respected for tax purposes.

Senator LEVIN. All right. And that might be true even if a company has no employees?

Mr. MAZUR. Again, it is a facts and circumstances situation, and the question really comes down to, I think, as Mr. Maruca brought up, the pricing that is at issue here.

Senator LEVIN. And the pricing, when you look at the facts and circumstances, is it also the value of what is transferred?

Mr. MAZUR. Yes, and as pointed out, if you transfer property in year one and you are looking at a situation in year ten, you look at the totality of the facts and circumstances over the entire timeframe.

Senator LEVIN. All right. Of the entire—

Mr. MAZUR. Of the entire timeframe.

Senator LEVIN. Timeframe, all right. And you look at the fact that it is totally in the control of the parent as to what the content of that agreement is? Is that a fact that you look at?

Mr. MAZUR. I think one of the things that you are pointing out is the most difficult areas to look at transfer pricings are where you have related parties and you do not have an active market for the goods or services that are being transferred. Those are the most difficult, and that is where the tax administrator has the most difficult time trying to assess what the arm's-length standard should be.

Senator LEVIN. Now, when the company has a consolidated financial statement which it issues and consolidates all of its profit in a financial statement—it does not pay taxes on the profit, but it consolidates it for its financial statement—is there a risk that is really being transferred away from the parent when the world looks at that consolidated financial?

Mr. MAZUR. I think there is a risk of how well each of the entities will do on that transfer. You are right that if you look at the financial statements, they sweep up all the multinational firm's income from wherever it is earned and group it together. But for tax purposes, you have sometimes a different outcome.

Senator LEVIN. And if all of the money, all of the assets belong to the parent, they totally control the parent, you are still going to act as though the controlled foreign corporation has somehow or other risked its assets, even though its assets totally belong to the parent. You are still looking at that aspect.

Mr. MAZUR. We typically would respect that, yes.

Senator LEVIN. Okay. Now, there is a statutory rate in the United States of 35 percent. Is the effective rate different typically for companies than 35 percent?

Mr. MAZUR. Sure, sure—

Senator LEVIN. Do you know what the average effective rate is for corporations in the United States?

Mr. MAZUR. It would be in the mid-20 percent range, 27-ish percent range, something like that.

Senator LEVIN. Different from the statutory rate.

Mr. MAZUR. Different from the statutory rate for a number of reasons.

Senator LEVIN. And is it true that a number of corporations pay no taxes at all?

Mr. MAZUR. There is a wide range of effective tax rates in the United States from very low to very high.

Senator LEVIN. So that many corporations, including many of our most profitable corporations, pay no taxes. Is that correct?

Mr. MAZUR. I cannot answer the exact number, sir.

Senator LEVIN. I did not say exact—

Mr. MAZUR. Even—

Senator LEVIN. I said “many.”

Mr. MAZUR. There are several million corporations in the United States, many of which are very small, those pay no tax. So that is true—

Senator LEVIN. I was talking about our most profitable.

Mr. MAZUR. The larger ones—

Senator LEVIN. Have you seen the study that shows that 30 of our most profitable corporations over a period of 3 years recently paid no taxes?

Mr. MAZUR. I have seen that study, sir, yes.

Senator LEVIN. Do you—

Mr. MAZUR. I think part of what you are seeing in a study like that would be first the effect of the recession on lowering profits for a number—

Senator LEVIN. No. I said “highly profitable corporations.”

Mr. MAZUR. Lowering of profits for tax purposes—

Senator LEVIN. No. I said “highly profitable corporations.”

Mr. MAZUR. Lowering of profits for tax purposes; and, second, we had bonus expensing and—bonus depreciation and expensing for a number of years, which would have reduced the taxable income for those companies for those years. Presumably that income gets picked up in the future when they are unable to claim those depreciation deductions.

Senator LEVIN. All right. But you are familiar with that study?

Mr. MAZUR. I am familiar with the study, yes.

Senator LEVIN. And that study showed that those companies had \$160 billion in profits for those 3 years. Do you remember—

Mr. MAZUR. I do not remember that number, sir.

Senator LEVIN. All right. Mr. Mazur, is the transfer of economic rights a way to shift tax liability?

Mr. MAZUR. I think the transfer of economic rights associated with intellectual property affects a number of things, one of which is possibly shifting income and risk to other places. Another is potentially shifting some potential tax liability, yes.

Senator LEVIN. So that is one way of shifting tax liability. Is that correct?

Mr. MAZUR. Possible to do it that way, yes.

Senator LEVIN. What is the impact on U.S. tax revenue if U.S. multinationals can enter into cost-sharing agreements with offshore companies that they control and then direct most of the profits to those offshore companies, most of their worldwide profits to those offshore companies, and on top of that, if they can use offshore companies that have no tax residence anywhere, what is the effect on our revenue?

Mr. MAZUR. I do not have the number for that exact fact pattern, but as I noted in my testimony, the estimates for profit shifting that come from academic economists who know this, who have looked at it, range from somewhere below \$10 billion a year to somewhere above \$80 billion a year. There is a wide range of estimates.

Senator LEVIN. Mr. Mazur, the Treasury might be able to fix some of these problems if it would reform check-the-box, develop regs making it easier for the IRS to go after shell corporations that are used for tax avoidance, particularly those that are not tax resident anywhere. It could stop treating cost-sharing agreements that push money offshore as acceptable arm's-length agreements or arrangements.

What are the chances that the Treasury is going to take any of those actions?

Mr. MAZUR. I think, sir, in the Administration's budget proposal there are a number of legislative options that would perhaps be more effective at addressing this situation. There is an excess intangibles income proposal which really would limit some of the incentives to shift intangibles abroad. There are a number of proposals that would clarify the types of intangibles that would be subject to Section 482. And another proposal that would look at—

Senator LEVIN. Are there any regulatory proposals? I think the ones you talk about are legislative. Are you looking at any regulatory proposals?

Mr. MAZUR. We are always looking at regulatory—

Senator LEVIN. Any specific regulatory proposals to address the problems I have just described?

Mr. MAZUR. None that are in the very immediate pipeline to be popped out in the very short term.

Senator LEVIN. Okay.

Mr. MAZUR. Some longer-term projects are underway, though.

Senator LEVIN. Well, we want to thank our witnesses here. The hearing that we have had today was aimed at shining a light on how the U.S. Tax Code functions in the real world and real companies. We focused on one, but the problem exists obviously in much more than one company. We have had previous hearings which looked at two additional companies and saw how they shifted—either shifted revenue overseas and profits overseas or how they took funding and profits from overseas and brought them home without paying a tax on them when they effectively repatriated them. So we have looked at a number of ways in which taxes are avoided by some of our wealthiest companies.

The facts are mighty clear to me that loopholes in our tax laws and regulations allow many companies, including Apple, to shift enormous amounts of income from this country to other countries where they pay little or no tax. I would disagree with the Apple witness on a number of important points. I think it is clear that Apple engages in tax gimmicks. Apple tries to act as though it does not engage in tax gimmicks. Other companies engage in tax gimmicks as well, and I will insert for the record here examples of the tax gimmicks that were used by Apple.<sup>1</sup>

It is also clear that Apple used cost-sharing arrangements that it has with offshore subsidiaries to shift income from the United States to Ireland, an effective tax haven, where it pays effectively no taxes at all. And so the real question for us is not whether these actions comply with the letter of the law. Others will make that decision. The question is whether we should continue to tolerate this state of affairs, which is doing tremendous harm to our Nation's fiscal health, to our ability to protect and to serve our people, and to families and businesses that cannot or will not take advantage of these loopholes.

We had a situation this morning where three employees of Apple, a tremendously creative company, sat around a table and agreed on what share of the world's profits of Apple basically are going to come back to the United States to be taxed. They decided that they would shift a certain part of the jewels, the crown jewels of that

<sup>1</sup>See Exhibit No 1a, which appears in the Appendix on page 152.

company, to a tax haven. And that tax haven received the profits from the sales of those products in most of the world.

That decision was just made by three employees of the company unilaterally, and for our tax laws to tolerate that—it was supposed to be an arm's-length agreement to something which is just obviously not an arm's-length agreement but which has a huge effect on the revenues of this country, is unacceptable and intolerable, and we should not continue to accept it. It is unfair, needs to change, and it needs to change regardless of the broader debate about tax reform. We should close these unacceptable, these unfair corporate offshore tax loopholes, not just to simplify the Tax Code, not just as part of tax reform and, heaven knows, not just in order to keep it revenue neutral when corporations' percentage of the revenues coming into our Treasury is now down to 9 percent. Revenue neutrality, which is something that we heard from Mr. Cook today, cannot be the litmus test when we need additional revenues as part of a comprehensive deficit reduction program.

But, in any event, one way or another, whether it is closing these tax loopholes because they are so totally unjustified and because they are unfair to others who do not use them or cannot use them, or whether it is part of a larger comprehensive tax reform, one way or another these tax-shifting capabilities that these major corporations have cannot continue.

So I hope and believe that the facts that the Subcommittee has discovered will provide a catalyst for that change. We thank all of our witnesses today, and we will stand adjourned.

[Whereupon, at 2:24 p.m., the Subcommittee was adjourned.]



# A P P E N D I X

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**Testimony of J. Richard (Dick) Harvey, Jr.**  
**Before the U.S. Senate Permanent Subcommittee on Investigations**  
**May 21, 2013**

Chairman Levin, Ranking Member McCain, and members of the Subcommittee, thank you for the opportunity to testify this morning on issues surrounding the shifting of profits by MNCs to low-tax jurisdictions, and specifically the techniques used by Apple, Inc. This is a very important topic that deserves to be highlighted and discussed.

I am the Distinguished Professor of Practice at the Villanova University School of Law and Graduate Tax Program. Immediately prior to joining the Villanova faculty I was the Senior Advisor to former IRS Commissioner Doug Shulman where my focus was international tax issues and improving corporate tax transparency (e.g., Schedule UTP). I joined the IRS upon retiring from a Big 4 accounting firm as a Managing Partner and my experience also includes prior government service in the US Treasury Department Office of Tax Policy during the negotiation and implementation of the 1986 Tax Reform Act.

With the Chairman's permission, I request that my written testimony be submitted for the record and I will summarize my major observations in oral remarks.

\* \* \*

## **Executive Summary**

Apple, Inc. (Apple) is an iconic US multinational corporation (MNC) that has enjoyed extraordinary financial success. In addition to demonstrating excellence in designing, building, and selling consumer products, Apple has been very successful at minimizing its global income tax burden. For example:

- Pursuant to a long-standing cost sharing agreement, Apple recorded approximately \$22 billion of its 2011 pre-tax income in Ireland.<sup>1</sup> As a result, 64% of Apple's global pre-tax income is recorded in Ireland where only 4% of its employees and 1% of its customers are located.
- If Apple had not entered into the cost sharing agreement, 2011 US pre-tax income would have increased by approximately \$22 billion resulting in an additional federal tax liability of approximately \$22 billion x 35% = \$7.7 billion.
- Despite a published tax rate of 12.5%, Apple negotiated a special tax deal that resulted in only \$13 million of Irish tax expense being recorded with respect to the \$22 billion of Irish income.

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<sup>1</sup> During the period 2009-2012, the total pre-tax income recorded in one Irish entity, Apple Sales International (ASI), was approximately \$74 billion. There were no employees in ASI until 2012 when 250 employees appear to have been transferred from another Irish entity.

- 60% of Apple's 2011 sales were to customers in countries other than the US and Ireland, but only 6% of the consolidated pre-tax income was recorded in such countries.

Although shifting income out of the US and locating it in a tax haven like Ireland are key steps in Apple's international tax planning, Apple must also avoid the so-called "Subpart F" rules. These rules were originally designed to tax passive income earned by foreign subsidiaries of US MNCs and therefore discourage the shifting of income out of the US. However, the rules have been substantially "gutted" through adoption of (i) the check-the-box regulations, (ii) the CFC look-through rule, (iii) the contract manufacturing exemption, and to a lesser extent (iv) the same-country exception.

In order to restore the effectiveness of the Subpart F rules and discourage the shifting of income from the US, Congress should quickly adopt the following tax policy recommendations:

- **Substantially restrict the tax planning tools used to circumvent Subpart F** – The check-the-box regulations should be restricted for foreign entities, the CFC look-through rule should at most apply to only dividends, the contract manufacturing exemption should be either eliminated or substantially tightened, and the same-country exception should be modified.
- **Increase transparency** – It is often very difficult for the IRS to get a true picture of a MNC's global tax planning. Thus, US MNCs should be required to report the geographical location of income, tax, and other pertinent information.

Although adoption of these proposals would be very beneficial, additional tax policy changes will also be needed. The reason is that as long as the US (and the rest of the world) applies an arms-length pricing standard to transactions between controlled parties, there will be an opportunity for MNCs to shift income. As a result, a longer-term solution will ultimately be needed. My personal recommendations, in order of preference, are as follows:

- **Obtain global consensus on how to address corporate tax havens** – Unfortunately, this could be very difficult and the US may have to act unilaterally.
- **Substantially lower the corporate tax rate and replace the lost revenue with a VAT or other revenue source** - However, this is likely a political nonstarter.
- **If the arms-length standard is maintained, there needs to be adequate base erosion protections** - For example, a minimum tax should be imposed on earnings recorded in a tax haven, and US deductions for expenses related to foreign income should be restricted (e.g., interest). If a minimum tax is adopted, emphasis should be on making the minimum tax relatively simple to calculate and audit.
- **Consider replacing the arms-length standard with a formula apportionment approach if adequate base erosion protections are not enacted** – However there are major design issues that would need to be addressed.

### **Selected Apple Information**

Per a review of both (i) information supplied by Apple to the Permanent Subcommittee on Investigation (PSI) and (ii) publicly available information in its Form 10-K, a clearer picture emerges about the results of Apple's international tax planning. For example, the table below summarizes the geographic location of 2011 pre-tax income, employees, and customers:

Country	2011 Pre-Tax Income		Employees @ June 2011 <sup>2</sup>		2011 Customer
	\$ Billions	%	#	\$	Location <sup>3</sup>
United States	10.2	30%	67%	79%	39%
Ireland	22.0	64	4	3	1
Other countries	2.0	6	29	18	60
Consolidated	34.2	100%	100%	100%	100%

In addition, the effective tax rate on all foreign earnings was approximately \$600 million/\$24 billion = 2.5% with substantially all of the \$600 million of tax being incurred on the \$2 billion of income earned from foreign countries other than Ireland.

The information below on the profitability of US vs. non-US operations and the allocation of certain expenses between US and non-US operations is also of potential interest:

	Pre-tax Income/Sales	% of Pre-tax Income	General & Administrative Expenses		Sales, Marketing, & Distribution Expenses	
			\$ billions	%	\$ billions	%
US	24%	30%	1.7	85%	3.3	59%
Non-US	36%	70%	0.3	15%	2.3	41%
Consolidated	32%	100%	2.0	100%	5.6	100%

In addition to the above summary information, there is substantial information summarized in the PSI report prepared for today's hearing that sheds additional light on Apple's international tax planning.

<sup>2</sup> At June 2011, Apple's total employees worldwide were approximately 59,000 while total worldwide compensation was approximately \$6.9 billion.

<sup>3</sup> Customer location based upon information provided in the 2011 consolidated financial statements, except for Ireland that was assumed to be <1% based upon the relative size of Ireland's population.

### **Major Observations Surrounding Apple**

Having reviewed the Apple information several major observations can be made,<sup>4</sup> including:

- **Apple received a substantial US tax benefit from a “cost sharing agreement”** - The \$22 billion of pre-tax income recorded in Ireland results from a cost sharing agreement whereby Apple transferred to Apple Sales International (ASI), an Irish entity, its development rights to Apple products outside of the Americas.<sup>5</sup> If Apple had not transferred these rights to ASI, 2011 US pre-tax income would have been approximately \$22 billion higher.<sup>6</sup>
- **The overall effective tax rate on Apple’s foreign earnings is only 2.5%** - Apple was able to achieve this very low rate through the following:
  - **Negotiated Irish tax** - In addition to having a disproportionate amount of pre-tax income recorded in Ireland,<sup>7</sup> the effective tax rate charged on the \$22 billion of Irish income appears to be less than 1%.<sup>8</sup> Given the stated corporate tax rate in Ireland is 12.5%, it seems very clear that Apple negotiated a special deal with the Irish tax authorities.<sup>9</sup> If this special deal is not already known by finance ministers around the world, it will be interesting to see their reaction when it becomes known after this hearing.<sup>10</sup>

<sup>4</sup> These observations are not meant to conclude that Apple has done anything improper from a tax planning perspective. Such determination could only be made after a detailed audit of Apple’s facts.

<sup>5</sup> Technically the agreement is with both ASI and Apple Operations Europe (AOE). However, it appears that AOE is functioning as primarily a holding company.

<sup>6</sup> ASI’s pre-tax income in 2009, 2010, and 2011 was approximately \$36 billion, \$12 billion, and \$ 4 billion respectively. Thus, for the four-year period 2009 to 2012, Apple’s cost sharing agreement with ASI effectively resulted in a reduction in US pre-tax income of approximately \$74 billion. In addition, the cost sharing expenses incurred by Apple’s Irish entities for the period 2004 to 2011 were approximately \$5 billion. Thus, Apple’s Irish entities were able to spend \$5 billion to obtain pre-tax income before such expenses of at least \$74 billion + \$5 billion = \$79 billion.

<sup>7</sup> 64% of the consolidated pre-tax income was recorded in Ireland when (i) only 4% of the global workforce and 3% of global compensation expense is located in Ireland, and (ii) approximately 1% of customers are located in Ireland.

<sup>8</sup> The total tax expense recorded in Apple’s 2011 Consolidating Income Statement for Apple Sales International (ASI) and Apple Operations Europe (AOE) was only \$13 million (i.e., an effective tax rate of \$13 million/\$22 billion = 0.06%). Per information supplied by Apple, ASI is not taxed as an Irish resident corporation. Thus, it appears to only be taxed on certain business activity in Ireland.

<sup>9</sup> Apple reportedly confirmed this hypothesis in discussions with the PSI staff.

<sup>10</sup> During negotiations of Ireland’s bailout by the EU in 2010, there was reportedly discussion about forcing Ireland to increase its corporate tax rate and eliminate special tax deals. Nevertheless, Ireland was able to obtain its bailout without any material tax changes. Will the EU be so generous in the future?

- **Very little income recorded in countries other than the US and Ireland** - Although 60% of its 2011 sales were to customers in countries other than the US and Ireland, only 6% of the consolidated pre-tax income was recorded in such countries. This result was accomplished by recording substantially all of the pre-tax income from customers outside of the Americas in ASI. Entities in foreign countries other than Ireland received only a small commission for the sale of goods into their respective countries.
- **Irish holding company managed and controlled outside of Ireland** - Apple's foreign holding company, Apple Operations International (AOI) is incorporated in Ireland but managed and controlled elsewhere.<sup>11</sup> As a result, dividends received by AOI from both Irish and non-Irish companies escape Irish taxation. If AOI was taxed in Ireland like other Irish corporations, it would have incurred a 25% tax on dividends received from subsidiaries located in non-EU countries.<sup>12</sup>
- **Apple avoided substantial US taxation by side-stepping Subpart F income** - Subpart F of the US tax law was designed to tax passive income of the type generated by Apple's Irish operations. However, Apple avoided substantial subpart F income<sup>13</sup> through use of (i) the check-box-regulations, (ii) CFC look-through rules, and (iii) the same country exception. In the future, Apple may also attempt to argue the contract manufacturing exemption applies. See Section 1 of the Appendix accompanying this testimony for a discussion of how these techniques are used by US MNCs to avoid Subpart income.
- **US operations are less profitable than non-US operations** - The ratio of pre-tax income to net sales is 24% in the US, but 36% for non-US operations. In addition, both general and administrative (G&A) expenses and sales, marketing, and development (SM&D) expenses as shown on Apple's 2011 consolidating income statement appear to be disproportionately allocated to the US.

If G&A expenses were allocated based on pre-tax income and SM&D expenses were allocated on the basis of sales, US pre-tax income would increase by approximately \$2.2 billion and the ratios of pre-tax income to net sales would become 30% in the US and 33% outside the US. The

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<sup>11</sup> Apple apparently has not affirmatively concluded where this entity is "managed and controlled", but it is worth noting that the US would seem to be the only other possibility. For example, Board of Directors meetings are held in the US and bank accounts are in the US.

<sup>12</sup> Since very little income was recorded in other foreign countries, this tax planning does not appear to have produced a material tax benefit to Apple. In addition, the 25% tax could have been reduced in certain cases through tax treaties.

<sup>13</sup> Apple did report some subpart F income, but the amount was relatively immaterial (i.e., approximately \$100 million in 2011) and related to interest income from 3<sup>rd</sup> parties.

resulting 3% difference in profitability (as opposed to the 12% actual difference) could be easily explained by differences in product mix around the world.

Thus, even after taking into account the cost sharing arrangement, Apple's allocations of G&A and SM&D expenses between US and non-US operations are curious and could contribute to the decreased profitability of US vs. non-US operations. The impact of these allocations on the 2011 US tax liability could be as much as  $\$2.2 \text{ billion} \times 35\% = \$0.8 \text{ billion}$ .

In summary, by entering into the cost sharing agreement with its Ireland affiliates and negotiating a special tax deal with Ireland, Apple was able to shift approximately \$22 billion of its 2011 pre-tax income out of the US into Ireland and incur an immaterial amount of Irish tax. If such income had been taxable in the US, Apple would have incurred approximately  $\$22 \text{ billion} \times 35\% = \$7.7 \text{ billion}$  of additional US federal tax.<sup>14</sup> As demonstrated by many prior studies, Apple's efforts to shift income from the US to a tax haven jurisdiction are not unique. However, given Apple's overall profitability the magnitude of income shifting is startling.

### **Key Steps to Shifting Income Overseas**

Before discussing the tax policy implications of income shifting, it may be helpful to summarize the key steps US MNCs take to shift income to tax haven jurisdictions and ultimately obtain a financial statement tax benefit. It is important to note that the goal of international tax planners is to shift income with minimum disruption to the business's operations. Thus, the transfer of intangible assets (or the use of creative financing structures) is clearly preferred since it involves only minimal disruption to a MNC's normal operations.<sup>15</sup>

- **Contribute equity to a foreign subsidiary** - An equity contribution to a foreign subsidiary is usually the first step in shifting income out of the US. For example, if a US parent contributes \$1 billion of cash to a tax haven affiliate and the tax haven affiliate invests the \$1 billion at a 10% rate of return, the US parent has effectively shifted  $\$1 \text{ billion} \times 10\% = \$100 \text{ million}$  of income out of the US annually. Although annually shifting \$100 million of income can produce a significant tax benefit, US MNCs can often shift further income as described below.
- **Transfer valuable intangible asset, but minimize the compensation paid** - A transfer may be accomplished through a variety of means (e.g., a cost sharing arrangement with or without a

<sup>14</sup> There also could have been additional state and local taxes

<sup>15</sup> However, in order to provide some substance to the transactions for tax purposes, international tax planners will often move some assets or employees to improve the optics of the transfer. For example, Apple had approximately 2,500 employees in Ireland in 2011, but this was still only 4% of its 2011 global workforce with the end result that 60% of Apple's 2011 global pre-tax income was transferred to Ireland.

buy-in payment, an outright sale, a license, or a contribution to capital). More importantly, since the valuation of unique intangible assets is extraordinarily difficult, MNCs have a significant incentive to assign the lowest possible value. The use of a cost sharing arrangement allows a US MNC to shift an intangible asset before it is fully developed and therefore assign an even lower value. And in some cases (e.g., Apple), the transfer takes place before any material development in which case the tax haven affiliate only needs to share costs with its US parent and does not need to make a buy-in payment.

Continuing with the prior example, assume the tax haven affiliate uses the \$1 billion contributed from its US parent to acquire an intangible asset with an estimated value of somewhere between \$1 billion and \$5 billion. In such case, if the tax haven affiliate acquires the intangible asset for \$1 billion, but it ultimately turns out to be worth \$5 billion, the US MNC has effectively shifted another \$4 billion of income out of the US (i.e., in addition to the earnings on the original \$1 billion equity contribution).

It should be noted that even if the payment from the tax haven affiliate to the US parent is at true fair market value for the intangible assets transferred, as described above the US parent has effectively shifted income to the tax haven affiliate by virtue of the equity contribution.

- **Isolate substantial non-US income in the tax haven entity** - This can be accomplished by a variety of means. In Apple's case, substantially all of the non-US income was isolated in Ireland. This result was achieved by having ASI own the development rights outside of the Americas coupled with ASI entering into a contract manufacturing agreement with a 3<sup>rd</sup> party supplier located in China (i.e., Foxconn). ASI then sold the products manufactured by Foxconn to other Apple entities. ASI was treated as the principal in the transaction and Apple's other foreign entities appear to have only received relatively small commissions for aiding in the distribution and sale of Apple products to customers. The end result was that substantially all of the income was isolated in ASI.

In tax planning structures used by other MNCs, the valuable intangible may be held in a separate tax haven entity that charges a substantial royalty to operating entities. Regardless of the actual structure used, the goal is isolate as much non-US income as possible in tax haven entities.

- **Avoid Subpart F income for US tax purposes** - As described previously, Subpart F income was originally designed to tax passive income (e.g., interest, dividends, and income related to intangible assets) earned by foreign affiliates of US MNCs. However, as described in Section 1 of the Appendix to this testimony various techniques can be used to avoid subpart F income (e.g., check-the-box regulations, CFC look-through rule, manufacturing exemption, and to a lesser extent the same country exception).

- **Adopt “indefinite reinvestment” assumption for financial accounting purposes** – Even though a US MNC may successfully shift income to a tax haven entity, current US tax law still imposes a tax upon repatriation of the earnings from the foreign subsidiary to the US. Accounting rules generally require that a deferred US tax expense be recorded for the potential future US tax upon repatriation. However, this deferred tax expense is not recorded if the earnings of the foreign subsidiary are considered “indefinitely reinvested”. Most US MNCs assume 100% or a very high percentage of their earnings in tax haven affiliates are indefinitely reinvested. Apple is relatively conservative and only assumes approximately 50% of the earnings from their Irish affiliates are indefinitely reinvested.<sup>16</sup>

The above discussion focused primarily on the transfer of intangible assets, but US MNCs also use various creative financing structures to shift income to tax haven affiliates (for an example, see Section 1.2 of the Appendix to this testimony). In addition, as possibly demonstrated by Apple’s disproportionate allocation of G&A and SM&D costs to the US, routine cost allocations can also be a method used to shift income out of the US. Although the amount of income transferred overseas from the use of creative financing structures and routine cost allocations can be very material, the income transferred from intangible assets is usually even more material.

### **Key Tax Policy Questions**

Given this background, the question quickly becomes: What action, if any, should Congress take to address income shifting? Unfortunately, there is no silver bullet. Plus, the specific action may depend upon Congress’s view on the following questions:

- Are US policy makers only concerned about US MNCs competing against foreign MNCs, or are they also concerned about the ability of US domestic businesses to compete with US MNCs that can shift substantial income offshore?
- Does current US tax law really put US MNCs at a competitive disadvantage vs. foreign MNCs?
- Should the US act unilaterally, or wait for OECD or some other global action?
- If the US acts and cracks down too much on US MNCs, could US MNCs eventually shift even more operations overseas or expatriate their headquarters from the US?

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<sup>16</sup> This is one of the reasons why Apple’s effective tax rate disclosed on its 2011 financial statements is 24.2%. If Apple had assumed that 100% of its foreign earnings were indefinitely reinvested, the disclosed 2011 effective tax rate would have decreased to approximately 12.8% (i.e., \$8.283 billion of reported tax expense – \$3.917 billion increase in the deferred tax liability on unremitted foreign earnings = \$4.366 billion adjusted tax expense/\$34.205 billion of pre-tax income).

- Assuming global consensus is not forthcoming, is there a US policy response that could balance the competing policy goals?
- Should the US retain the arms-length standard and if so, what protections are needed to protect the corporate tax base from erosion?

These are all hard questions that could cause reasonable policy makers to disagree. Each is discussed in more detail below.

- **US MNCs vs. US domestic companies** - US MNCs have done an excellent job of framing the competitiveness issue in terms of US MNCs competing against foreign MNCs. However, that is only half of the competitive issue. If US MNCs are able to shift substantial income offshore, US domestic companies could be put at a competitive disadvantage. In addition, in order to compete, US domestic companies may decide they need to move some of their operations offshore with the resulting loss in jobs and US taxable income.

Given US domestic companies currently employ all of their workers in the US, putting them at a disadvantage may not be the best answer for a country that is struggling with persistently high unemployment. Nevertheless, by the same token, US tax policy should attempt to avoid putting US MNCs at a competitive disadvantage vs. foreign MNCs. This leads to the second key question.

- **Are US MNC's disadvantaged?** - Again, US MNCs prefer to focus on the element of US tax law that is competitively detrimental; the so-called lockout effect resulting from the taxation of dividends repatriated to the US. The lockout effect is a real problem for US MNCs, but one needs to also focus on what is causing the problem. Specifically, I believe the US MNC's lockout problem is primarily driven by the excessive amounts of income they have shifted outside the US. If such income had not been shifted, US MNCs would likely have a substantially smaller or non-existent lockout issue. Said differently, many US MNCs have been "hoisted on their own petard" by virtue of excessive income shifting out of the US.

Often forgotten in the discussion are the elements of US tax law that may give US MNCs a competitive advantage over foreign MNCs, including:

- **Subpart F rules are no longer effective** - Historically the US had the toughest rules surrounding passive income earned by foreign subsidiaries, but with the introduction of the check-the-box regulations, the CFC look-through, and the contract manufacturing exemption the US rules are no longer effective. As a practical matter US MNCs can easily avoid the rules and could be at a competitive advantage vs. MNCs from certain countries.

- **Ability to obtain a US deduction for expenses related to foreign subsidiaries** – This is especially the case for interest expense incurred in the US, but is also applicable to other expenses. For example, under current US tax law a US MNC can borrow in the US and fund its foreign operating entities through various creative tax structures.<sup>17</sup> The end result is the US MNC claims a US tax deduction for interest related to foreign operations, but can avoid the recognition of any foreign income.
- **Cross-crediting of Foreign Tax Credits (FTCs)** – If a foreign subsidiary incurs a relatively high tax rate (e.g., through tax losses not being allowed to be carried back to prior years), US tax law allows those high taxes to offset the US tax that would otherwise be incurred on low-taxed foreign earnings. This benefit is generally not available to foreign MNCs.

Overall I believe US MNCs are generally no worse off than foreign MNCs and in many cases may be better off. As a result, if Congress decides to impose restrictions on transferring income overseas, US MNCs should not be put at a competitive disadvantage vs. foreign MNCs.

- **Unilateral vs. global action** - If a global consensus is possible within a reasonable period of time and would be effective, it would be the best way forward. Given the OECD is working feverishly on its Base Erosion and Profit Splitting project<sup>18</sup> and is scheduled to disclose the results in June or July of this year, it is possible that a global consensus could emerge. Thus, Congress should clearly keep abreast of future OECD recommendations. But if history is any guide, it often takes OECD recommendations many years to come to fruition.

In addition, it often takes leadership from the US or other countries to jump-start global consensus on an issue. For example, the US adoption of FATCA addressing the reporting of offshore accounts has resulted in significant global coordination and action in the past 2 years. Thus, there may be a need for the US to take action on income shifting to spur the rest of the world into action.

- **Could the US crack down too hard on US MNCs?** - The short answer is yes. Since there will always be countries that will offer MNCs an attractive location to operate and/or relocate their headquarters operations,<sup>19</sup> US policymakers need to be concerned about the long-term impact of any proposals. For example, if the US were to unilaterally adopt full worldwide taxation without deferral of active income from foreign subsidiaries, there would be significant risk that

<sup>17</sup> See Section 1.2 of the Appendix of this testimony for a description of a specific financing structure.

<sup>18</sup> For more information see <http://www.oecd.org/tax/beps.htm>.

<sup>19</sup> In addition, countries that are not tax havens could still engage in tax competition (i.e., the UK and other countries continue to decrease their corporate tax rates).

over time US MNCs would figure out a way to eventually expatriate out of the US to take advantage of substantially lower rates in tax havens.<sup>20</sup>

- **Assuming global consensus is not forthcoming, is there a US policy response that could balance the competing policy goals?** – Possibly, but it is very unlikely to get serious political consideration. One policy response that would allow US MNCs to compete effectively with foreign MNCs and not have a competitive advantage over US domestic businesses would be to lower the US corporate income tax rate to 15% or less and replace the lost revenue with another revenue source (e.g., VAT). Although they are collected differently, a VAT and the corporate income tax have some similarities. For example, when compared with a corporate income tax, a VAT does not allow a deduction for labor costs, but does allow a 100% deduction for capital expenditures.
- **Should the US retain the arms-length standard and if so, what protections are needed to protect the corporate tax base from erosion?** – These two questions have been at the heart of much of the recent debate surrounding international tax reform and will likely be the subject of much discussion by the OECD as it develops its recommendations for its BEPS project. My views on these two questions, in reverse order, are as follows:
  - **Arms-length standard requires strong base erosion protections** - If the arms-length standard is retained and US MNCs can continue to (i) make equity contributions to foreign subsidiaries and (ii) transfer valuable intangible assets to foreign subsidiaries, it will be crucial that steps be taken to minimize base erosion (e.g., restoring the vitality of Subpart F, imposing a minimum tax on tax haven income, and limiting the deductibility of interest).
  - **Abandoning the arms-length standard requires a determination of how income should be allocated** - For example, where should the income attributable to intangible assets developed in the US be taxed? If it is the US, will it cause US MNCs over time to transfer their research activities overseas? In summary, if the arms-length standard is abandoned, there will be a need to determine what factors of production should be used to allocate income to various tax jurisdictions. A multilateral approach would be strongly preferred, but if history is any guide, multilateral action is unlikely.

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<sup>20</sup> This would likely be the case even if the US decreased its corporate tax rate to somewhere in the 20-30% range. A US tax rate of 15% or less would likely be needed to minimize the incentive for US MNCs to expatriate if deferral were eliminated.

### **Immediate Tax Policy Recommendations**

Clearly there are many potential views on the key questions discussed above, and as a result there will be significant tax policy debates surrounding the appropriate taxation of MNCs. Nevertheless, given that it is generally agreed that the Subpart F rules have recently been “guttled”, I believe Congress should seriously consider the following sooner rather than later:

- **Substantially restrict the check-the-box regulations, the CFC look-through rule, and the contract manufacturing exemption** – The Subpart F rules were designed to make it very difficult for passive income related to intangible assets and creative financing structures to be shifted out of the US. As discussed further in Section 1 of the Appendix of this testimony, the relatively recent adoption of the check-the-box regulations, the CFC look-through rule, and the contract manufacturing exemption have allowed US MNCs to effectively avoid the Subpart F rules.

Said differently, US MNCs have been able to shift income from both<sup>21</sup> the US and high-tax foreign countries and locate the income in a tax haven without much fear of triggering the US Subpart F rules. The following suggestions would help restore the original vitality of the Subpart F rules:

- **Restrict check-the-box regulations for foreign corporations** – Although there could be several options to accomplish this goal, one is to require conformity in treatment between US and foreign tax law. For example, if the foreign entity is treated as a corporation for local tax law purposes, it should be treated as a corporation for US tax purposes. Another option would be to expand the list of per-se foreign corporations (i.e., foreign corporations treated as corporations for US tax law). In summary, the goal of any change to the check-the-box regulations should be to minimize the ability of MNCs to create hybrid entities whereby the entity is respected for one country and disregarded for the other.
- **CFC look-through rule should at most apply to only dividends** - When the CFC look-through rule was enacted in 2006 I was personally stunned it was made applicable to payments other than dividends (e.g., interest and royalties). The end result has been that US MNCs can locate intangible assets and financing operations in tax havens and avoid Subpart F income. Congress should consider either totally eliminating the CFC look-through rule or alternatively only allow it to be applied to dividends.
- **Contract manufacturing exemption should be eliminated or substantially tightened** – The original Subpart F rules were designed to exclude from US taxation the income earned by a foreign corporation to the extent (i) the property was manufactured in the

<sup>21</sup> This is an important point. US MNCs prefer to discuss the use of these techniques to strip income from high-tax foreign countries, rather than the US. However, in reality they are using these techniques to aid the shifting of income from both the US and high-tax foreign countries to tax havens.

foreign country or (ii) the property was sold to customers in such country. In the good old days, “manufactured” meant that the foreign corporation had a plant in the foreign country and actually manufactured something in the plant. Not so any more.

In 2008 the IRS and Treasury issued regulations allowing supervision of contract manufacturing to qualify as manufacturing.<sup>22</sup> As a result, the manufacturing exemption to Subpart F income has been greatly expanded allowing US MNCs to avoid substantial amounts of US taxable income.<sup>23</sup>

Although there could be many potential changes to the contract manufacturing exemption, the easiest solution would be to just eliminate it. Another option might be to only allow the foreign corporation to avoid Subpart F to the extent of the labor cost of the supervisory services provided plus some reasonable profit margin.

- o **Same country exception should be modified** - See discussion in Section 1.4 of the Appendix to this testimony.

It needs to be emphasized that all of these suggestions should be adopted as a package. If only one or two are adopted, US MNCs will be able to use the remaining techniques to accomplish their tax planning goals.

- **Increased transparency** – Currently it is very difficult for the IRS and tax administrators around the world to get a true picture of a US MNC’s effort to shift income to low tax jurisdictions. As discussed in more detail in Section 2 of the Appendix to this testimony, there should be increased transparency surrounding the worldwide tax position of MNCs. Information might include a schedule summarizing where income is recorded for both financial accounting purposes and tax purposes, the amount of tax paid, and other information of potential use to tax administrators.

### **Broader Tax Reform Recommendations**

Although the above proposals would be very beneficial in turning the clock back on income shifting by restoring the vitality of the Subpart F rules, additional tax policy changes will also be needed. The reason is that as long as the US (and the rest of the world) applies an arms-length pricing standard to

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<sup>22</sup> Regulation 1.954-3(a)(4)(iv).

<sup>23</sup> Said differently, the combination of the ability of US MNCs to transfer valuable intellectual property to a foreign corporation coupled with the foreign corporation’s ability to then enter into a contract manufacturing arrangement allows for the shifting of significant income out of the US.

transactions between controlled parties, there will always be opportunity for MNCs to shift income to tax havens. The arms-length standard was developed almost 100 years ago and from a pure conceptual basis it makes some sense. The problem is getting it to work in practice, especially in today's world where:

- Production and distribution functions are no longer vertically integrated in one foreign country,
- MNCs exercise substantial or complete control over their foreign subsidiaries,
- Intangible assets being transferred are extraordinarily unique and difficult to value, and
- MNCs seek to exploit the arms-length standard by spending significant time and money developing plans to shift income to tax haven jurisdictions.

As a result, tax administrators around the world are wrestling with the issue of how to address the shifting of income by MNCs to tax haven jurisdictions. As I have stated previously, even though the IRS has greatly increased its resources for auditing transfer pricing issues, "anyone who believes the IRS can effectively enforce the arms-length standard is either eternally optimistic -- or delusional".<sup>24</sup>

For these reasons, a longer-term solution is ultimately needed. But again,<sup>25</sup> and the potential for reasonable policymakers to disagree. My personal recommendations, in order of preference, are below:

- **Obtain global consensus** - If a global consensus could be reached that little or no income should be allocated to tax havens, it would be a giant step forward. There would still need to be a determination as to how to allocate income between source and residence countries, but it would be very beneficial if tax havens could be substantially taken out of the equation.

How might this work? The scenario easiest to conceptualize would be a global agreement on some sort of formula apportionment method, but there are many others. For example, source countries could be required to impose withholding taxes on payments to a tax haven jurisdiction. In addition, a headquarters/residence country could be required to impose a tax on all income earned by foreign subsidiaries located in tax havens.<sup>26</sup>

Unfortunately, I am not optimistic about the chances of an effective global agreement occurring anytime soon, but if it does happen, it would be welcomed. Given global agreement may not

<sup>24</sup> See *Tax Notes* 121 (Jan. 2, 2012) available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1975975](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1975975)

<sup>25</sup> For example, see *International Competitiveness: Senate Finance Committee Staff Tax Reform Options for Discussion* (May 9, 2013) available at [www.finance.senate.gov/issue/?id=0587e4b4-9f98-4a70-85b0-0033c4f14883](http://www.finance.senate.gov/issue/?id=0587e4b4-9f98-4a70-85b0-0033c4f14883).

<sup>26</sup> A special rule would be needed to address MNCs headquartered or incorporated in tax havens.

occur or may not be effective, US policymakers should also consider the unilateral options discussed below.

- **Lower the corporate income tax to no more than 15%<sup>27</sup> and adopt some other revenue source (e.g., VAT, energy taxes, and/or financial transactions taxes)** – In a world where many foreign countries are competing through low corporate income tax rates, one has to wonder whether the US will ultimately have to capitulate and join the fray. A corporate income tax in the 15% range could balance the competitive issues facing both US MNCs and domestic corporations. Given the political issues faced by such a proposal, however, the chances of this policy suggestion being adopted any time soon are not very high. Therefore, I will say no more.
- **Keep the arms-length standard, but...**
  - **Overlay a minimum tax on tax haven earnings** – There are many different variations to this approach. In determining which to adopt, Congress should prefer those options that are easiest to administer. One general class of options is to identify a low-tax country (or foreign corporation) and apply a tax to some or all of the income from such country (or foreign corporation) without the benefit of a foreign tax credit.

If an approach of this type is ultimately adopted, I strongly recommend that all earnings of a tax haven should be included as opposed to trying to determine (i) excess earnings, or (ii) earnings attributable to intangible assets. This would rule out many proposals, including options “A” and “C” of the House Ways and Means October 2011 proposals.<sup>28</sup>

Again, from a simplicity perspective, it would be preferable if it is clear whether a foreign country is, or is not, a tax haven. Unfortunately, given the special deals that country’s like Ireland are willing to make with MNCs like Apple, relying on a published corporate tax rate may not work.<sup>29</sup> Thus, one may need to focus on a specific company’s fact pattern in the country.

- **Disallow US deductions for expenses attributable to foreign income** – Currently US tax law allows a MNC to take deductions (e.g., interest and G&A) in the US for expenses that may be attributable to foreign subsidiaries. This is especially a problem for those US

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<sup>27</sup> If the US corporate income tax rate is above 15% there is still will be a significant incentive for US MNCs to shift their income or operations to low-tax jurisdictions. As a result, even though discussions about lowering the US corporate income tax rate to the 25%-30% range are positive, I don’t believe they will materially alter the incentive to shift income and operations out of the US.

<sup>28</sup> See [http://waysandmeans.house.gov/uploadedfiles/discussion\\_draft.pdf](http://waysandmeans.house.gov/uploadedfiles/discussion_draft.pdf)

<sup>29</sup> One option could be to rely on the published tax law of a country, but make it clear that if any special deals are discovered the country will automatically be considered a tax haven (i.e., a death penalty).

MNCs that incur interest expense in the US and then equity fund foreign subsidiaries.<sup>30</sup>  
 US tax law should not allow these deductions until the foreign income is recognized in the US.

- **Unilaterally replace the arms-length standard with a formula apportionment approach** – This approach has been advocated by some<sup>31</sup> and in my opinion is better than current law. However, there are potential issues that would need to be addressed, including (i) whether to base the formula on sales, or sales plus other factors of production (e.g., employees and/or tangible assets), and (ii) the need for anti-abuse rules in cases where sales are made to an intermediary in a tax haven country.

It should be emphasized the above discussion is equally applicable whether Congress decides to continue with the current hybrid system of worldwide taxation, or adopts a territorial system. However, if the US wants to adopt a territorial system, it should only be adopted if there is a high degree of confidence that the risk of income shifting is minimal. The least desirable option is to keep the current US tax system for taxing MNCs without any changes. The reason for this being that the current Subpart F rules effectively allow US MNCs to shift substantial amounts of income out of the US.

\* \* \*

This concludes my testimony and I would be pleased to answer any questions.

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<sup>30</sup> Or have much higher ratios of equity to assets.

<sup>31</sup> For example, Reuven Avi-Yonah and Michael Durst.

## Appendix

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1	Techniques for Avoiding Subpart F Income
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### 1 Techniques for Avoiding Subpart F Income<sup>32</sup>

Once a US MNC has successfully shifted income into a tax haven, it must attempt to avoid the inclusion of such income in its US tax return (i.e., avoid Subpart F income). Subpart F is a very complicated area of the tax law, and the discussion below briefly discusses only two items.

- **Foreign Base Company Sales Income (FBCSI)**<sup>33</sup> – This provision is designed to tax income earned by a foreign subsidiary when the subsidiary does not materially participate in the generation of the income and the subsidiary either buys or sells personal property from or to a related party.

For example, if an Irish subsidiary of Apple (e.g., ASI) purchases personal property from a Chinese supplier (e.g. Foxconn) and sells the property to another Apple subsidiary outside of Ireland that in turns sells to a 3<sup>rd</sup> party customer, the FBSCI rules are generally intended to apply to both ASI and the related party. However, as described below, Apple is able to avoid the FBSCI rules through the use of the “check-the-box” regulations,<sup>34</sup> and possibly in the future through the so-called “contract manufacturing” exemption.<sup>35</sup>

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<sup>32</sup> IRC sections 951 to 965

<sup>33</sup> IRC 954(d)

<sup>34</sup> 301.7701-3. Apple reportedly claims they do not currently rely on the contract manufacturing exemption.

<sup>35</sup> 1.954-3(a)(4)(iv). Apple did not have any employees in ASI until 2012 and therefore was not eligible for the contract manufacturing exemption. One wonders whether in the future Apple will also argue that it avoids Subpart F by relying on the contract manufacturing exemption applies (i.e., have two arguments for avoiding Subpart F).

- **Foreign Personal Holding Company Income (FPHCI)**<sup>36</sup> – This provision is designed to tax interest, dividends, royalties, and certain other types of passive income earned by a foreign subsidiary. Thus, if a foreign subsidiary of Apple (e.g., AOI) directly or indirectly receives dividends or interest income from another Apple foreign subsidiary (e.g., AOE or ASI), the general FPHCI rules would treat such income as taxable in the US. However, as described below, Apple is able to avoid the FPHCI rules by use of (i) the check-the box regulations, (ii) the CFC look-through rule,<sup>37</sup> and/or (iii) the same country exception.<sup>38</sup>

In summary, Apple substantially avoids the application of these two subpart F provisions (i.e., FBCSI and FPHCI) through a combination of techniques referred to above (i.e., the check-the box regulations, the CFC look-through rule, the same-country exception). In addition, in the future Apple may be able to use the contract manufacturing exemption. See Sections 1.1 to 1.4 of this Appendix for more discussion of these techniques and specifically how Apple or other MNCs may use them.

### 1.1 Check-the-box regulations<sup>39</sup>

These regulations adopted by the IRS/Treasury in 1996 allow US MNCs to create so-called “hybrid entities” where the entities may be taxed as an entity in one tax jurisdiction and either a pass-through entity or a disregarded entity in the other tax jurisdiction. Although there are multiple tax planning uses for hybrid entities, one of the most common is to treat an entity for US tax purposes as disregarded and therefore also disregard transactions between the entity and its parent.

Apple appears to benefit from the check-the-box regulations by treating many entities as disregarded for US tax purposes and thus transactions between such entities are disregarded. As a result, the income that could otherwise be taxable as Foreign Base Company Sales Income (FBCSI) or Foreign Personal Holding Company Income (FPHCI) in the US disappears.

Below is a simplified illustration of Apple’s legal structure for its European sales:<sup>40</sup>

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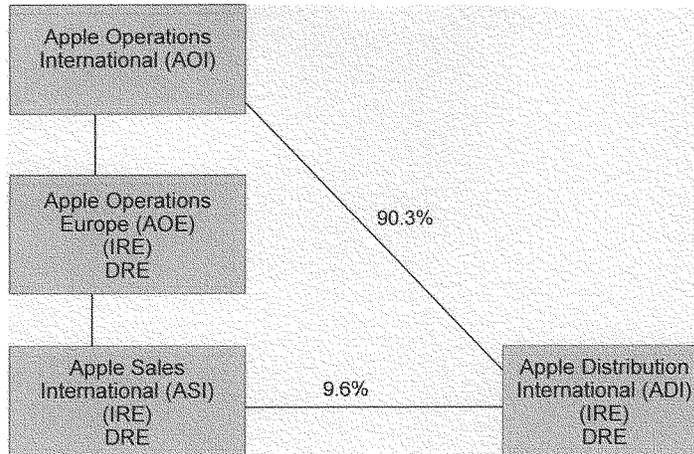
<sup>36</sup> IRC 954 (c).

<sup>37</sup> IRC 954(c)(6).

<sup>38</sup> IRC 954(c)(3).

<sup>39</sup> 301.7701-3.

<sup>40</sup> The information obtained is from a review of the information Apple supplied PSI.

**Notes:**

- 1) AOI is incorporated in Ireland, but “managed and controlled” outside of Ireland. Therefore this entity is not currently taxed in any country.
- 2) Baldwin Holdings Unlimited, a British Virgin Islands entity, owns less than 0.1% of AOI, AOE, ASI, and ADI
- 3) IRE = Incorporated in Ireland. Note that AOI is not subject to tax in Ireland and ASI is only taxed on very limited activities.
- 4) DRE = disregarded entity for US tax purposes

From an operating perspective, ASI owns the right to Apple’s development rights outside of the Americas. Thus, ASI contracts with Foxconn to manufacture Apple products and immediately sells them to ADI who in turns sells the products further down the distribution chain.<sup>41</sup> Substantial pre-tax profits (e.g., \$22 billion in fiscal 2011 and \$74 billion for the 4 years 2009 to 2012) are accumulated in ASI and relatively minor amounts of pre-tax profit are reported in ADI and other downstream affiliates.

From a legal perspective, AOI, AOE, ASI, and ADI are all incorporated in Ireland and treated as corporations under Irish law.<sup>42</sup> However, from a US tax perspective, Apple has made check-the-box elections on AOE, ASI, ADI, and other Apple affiliates further down the distribution chain. The end result

<sup>41</sup> In some cases, it appears the products may be sold to 3<sup>rd</sup> parties while in other cases they are sold to Apple affiliates who eventually sell to 3<sup>rd</sup> parties.

<sup>42</sup> AOE, ASI, and ADI are all taxed in Ireland, but AOI is not because it is managed and controlled elsewhere. In addition, ASI after 2009 ASI reportedly does not meet Irish residency requirements and therefore is only taxed on certain limited business activity in Ireland.

is that Apple appears to treat AOI, AOE, ASI, ADI, and the downstream affiliates as one big entity for US tax purposes and therefore the inter-entity transactions are ignored.<sup>43</sup>

For example, if sales from ASI to ADI were respected (i.e., not ignored), Apple could have FBCSI.<sup>44</sup> However, because Apple has checked-the-box on ADI to treat ADI as a disregarded entity, sales between ASI and ADI are totally ignored for US tax purposes and FBCSI is avoided.

In addition, ASI makes substantial annual dividends (e.g., over \$6 billion in fiscal 2011) to AOE that in turn makes dividends to its parent, AOI. Although dividends are a class of income that can cause FPHCI, Apple avoids the issue by checking-the-box on both AOE and ASI to treat them as disregarded entities. As a result the dividends from ASI to AOE and AOE to AOI are disregarded and Apple avoids FPHCI.<sup>45</sup>

## 1.2 CFC look-through rule<sup>46</sup>

The CFC look-through rule was enacted in 2006 by Congress to allow US MNCs to re-characterize what would otherwise be subpart F income (e.g., dividends, interest, and royalties) by looking-through to the character of the income earned by the entity paying the dividend, interest, royalty, etc...

For example, when AOI receives dividends from both Irish entities (e.g., AOE) and non-Irish entities, such dividends could be FPHCI subject to US tax. However, to the extent the dividends are attributable to active income from the subsidiary, the CFC look-through rule effectively re-characterizes the dividend income as active income and FPHCI can be avoided.

Apple appears to have benefited from the application of the CFC look-through rule to re-characterize dividend income as active income and therefore avoid Subpart F income. It does not appear that any substantial amount of interest or royalty income was re-characterized as operating income. Nevertheless, it is important to illustrate how the CFC look-through rule can be used to avoid US taxable income in certain cases that many may view as abusive.

- **Baseline Case** - As a baseline, assume a US Parent borrows from a 3<sup>rd</sup> party in the US and lends the borrowed funds to foreign operating subsidiaries located in a relatively high tax country. For US tax purposes the US Parent will have interest expense from the 3<sup>rd</sup> party and

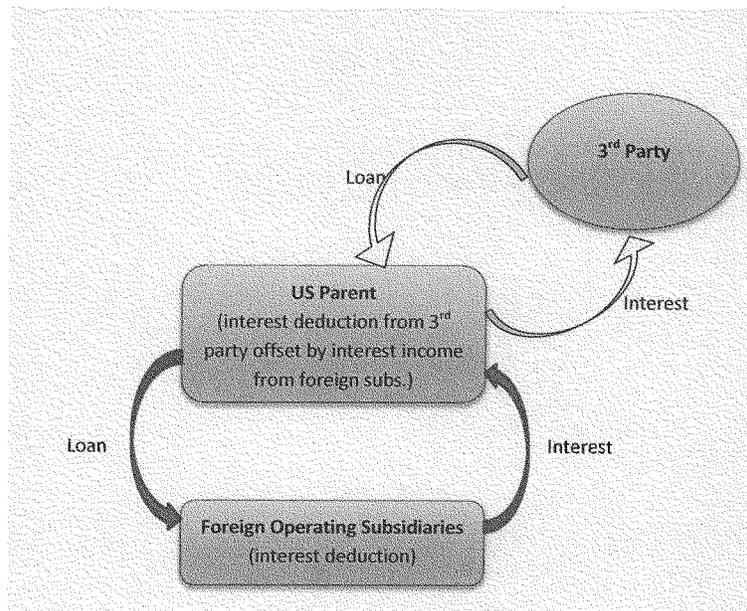
<sup>43</sup> It is not clear how Apple treats Baldwin Holdings' <0.1% ownership in the disregarded entities. If Baldwin Holdings' ownership is respected, technically one would expect ASI, AOE, and ADI to be partnerships for US tax purposes which could add complications to the US tax analysis.

<sup>44</sup> As discussed in Section 1.3 of this Appendix, FBCSI can also be avoided if ASI is a substantial participant in the manufacturing process. Thus, the contract manufacturing rules may allow Apple to avoid FBCSI but it is not clear whether they are also making this argument.

<sup>45</sup> Apple may also be able to avoid FPHCI by virtue of either the CFC look-through-rules, or the same country exception.

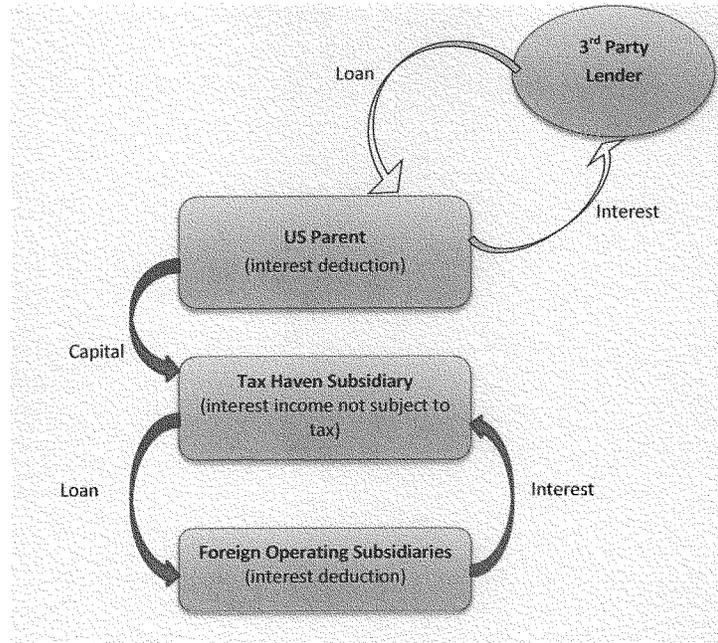
<sup>46</sup> IRC 954(c)(6).

interest income from the foreign operating subsidiaries. Presumably the two amounts will roughly offset one another and thus there is no US tax consequence from the US Parent acting as an intermediary for the loan. For foreign tax purposes, the foreign operating subsidiaries should receive a tax deduction for the interest paid to the US parent. The diagram below illustrates this simple funding scenario.



In summary, the tax results from this simple baseline case seem to be very reasonable (i.e., the interest deduction is ultimately claimed in the foreign operating subsidiaries and there is no material deduction or income in the US parent).

- **Alternative Scenario** – Assume the US Parent again borrows from a 3<sup>rd</sup> party, but instead of the US Parent directly on-lending to its foreign operating subsidiaries, the US Parent contributes the borrowed funds to the capital of a foreign subsidiary located in a country with no income tax (Tax Haven Subsidiary). Then assume the Tax Haven Subsidiary loans the funds to foreign operating subsidiaries around the world in high-tax countries. The diagram below illustrates this more complicated funding structure.



From a legal entity perspective, the consequences of this structure are (i) the US Parent will have interest expense, (ii) the Tax Haven Subsidiary will have interest income, and (iii) the Foreign Operating Subsidiaries will have interest expense. From a US tax perspective, the question is whether the interest income earned by the Tax Haven subsidiary is FPHCI and therefore included in the US Parent's US taxable income?

The answer is the Subpart F rules were originally designed to significantly discourage this sort of funding structure. However, after application of the CFC look-through rule, the interest income earned by the Tax Haven Subsidiary will likely be re-characterized as operating income because the interest is being paid from an operating entity. The end result is that the US MNC will obtain two interest deductions (i.e., one at the US Parent and one at the Foreign Operating Subsidiaries) and not pay tax on the interest income in any location. When compared with the Baseline Case, this Alternative Scenario results in income being excluded from the US tax return.

Before discussing other techniques for avoiding Subpart F income, two additional items should be noted about the above financing structure:

- **Check-the-box regulations can accomplish the same result** - If the CFC look-through rule did not exist, the US MNC in the example above could accomplish the same result by checking-the-box on foreign operating subsidiaries to treat them as disregarded entities. Since the foreign operating subsidiaries would be viewed as part of the Tax Haven Subsidiary, the interest income would be disregarded for US tax purposes (i.e., it disappears).
- **Structure is also applicable to intangible assets** - The example above assumes the Tax Haven Subsidiary was used as a finance vehicle. However, the above simple structure can also be used to avoid FPHCI on royalties from intangible assets. For example, a Tax Haven Subsidiary could use funds contributed by its US Parent to acquire rights to intangible assets that are then licensed (or sublicensed) to foreign operating subsidiaries around the world. In summary, FPHCI on the royalty income can be avoided through either (i) the application of the CFC look-through rule, or (ii) the check-the-box regulations.

### 1.3 Contract manufacturing exemption<sup>47</sup>

The original Subpart F rules were designed to exclude from US taxation the income earned by a foreign corporation to the extent (i) the property was manufactured in the foreign country or (ii) the property was sold to customers in such country. In the good old days, “manufactured” meant that the foreign corporation had a plant in the foreign country and actually manufactured something in the plant. Not so any more.

With the advent of contract manufacturing, manufacturing is now often done by a third party in a low-cost country (e.g., China, Philippines, and Bangladesh). Thus, the tax issue became whether a foreign subsidiary of a US MNC could qualify for the manufacturing exemption to Subpart F by supervising or making a “substantial contribution” to the contract manufacturing operations of the 3<sup>rd</sup> party.

In 2008 the IRS and Treasury issued regulations allowing supervision of contract manufacturing to qualify as a “substantial contribution” to the manufacturing process. As a result, foreign corporations may qualify for the contract manufacturing exemption to Subpart F and effectively avoid substantial amounts of US taxable income.<sup>48</sup>

Although there could be many potential changes to the contract manufacturing exemption, the easiest would be to just eliminate it. Another option might be to only allow the foreign corporation to avoid Subpart F to the extent of the labor cost of such supervisory services plus some reasonable profit margin.

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<sup>47</sup> Regulation 1.954-3(a)(4)(iv)

<sup>48</sup> Note that reportedly Apple does not currently rely on the contract manufacturing exemption. As Apple adds employees to ASI, it is possible that Apple could qualify in the future.

#### 1.4 Same-country exception<sup>49</sup>

Although the check-the-box regulations, the CFC look-through rule, and the contract manufacturing exemption are the primary tools US MNCs use to avoid Subpart F income, one other tool worth mentioning surrounds the same-country exception. This is especially true in Apple's case because their fact pattern would allow them to benefit from the same-country exception if for some reason the three primary tools for avoiding Subpart F were not available.

As previously described in this testimony, AOI is an entity incorporated in Ireland but considered managed and controlled elsewhere to avoid Irish tax on dividends from non-Irish companies. In 2011 there were over \$6 billion of dividends from AOE to AOI not taxed in Ireland. From a US tax perspective, the question is whether the \$6 billion of dividends from AOE to AOI should be considered FPHCI and therefore immediately taxed in the US?

Thanks to the application of the check-the-box regulations and/or the CFC look-through rules; this \$6 billion is not FPHCI. However, it should be noted that even if the check-the-box regulations and the CFC look-through rule were unavailable, it appears Apple would not have FPHCI by virtue of the same-country exception. The same-country exception provides that dividends and interest received by AOI from AOE will not be FPHCI because AOE is created or organized in the same country as AOI (i.e., Ireland). This is the case even though AOI is not taxed in Ireland because it is "managed and controlled" outside of Ireland.

Thus, one needs to question whether it is appropriate to allow the same-country exception in this type of case. Congress may want to consider modifying the same country exception to provide that it is only applicable if the two entities are subject to taxation in the same country.

## 2 Proposal for Increased Transparency

Information is money - - - Although this phrase is used commonly in the business world to refer to the ability of businesses to generate revenue from the possession of valuable information, it is also applicable to the relationship between the tax departments of many MNCs and tax officials around the world. Historically many MNCs have made it very difficult for tax officials to obtain information with the end result that either the tax officials (i) don't obtain the necessary information to propose potential audit adjustments, or (ii) spend so much time attempting to obtain information on one issue that they don't have as much time to investigate other issues.

Because of this concern, the IRS adopted Schedule UTP in 2010.<sup>50</sup> Schedule UTP now requires corporations to disclose tax issues to the IRS when the corporation has recorded a tax reserve for an

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<sup>49</sup> IRC 954(c)(3)

issue on its audited financial statement. However, the disclosure on Schedule UTP is limited to a few sentences and is only intended to identify issues for the IRS on a very general level.

When Schedule UTP was being developed there was significant concern expressed by some at the IRS that additional information surrounding transfer pricing issues was needed. A decision was made that Schedule UTP was not the correct vehicle to request such information,<sup>51</sup> but this decision did not foreclose the possibility of future additional disclosure specifically targeting transfer pricing. Since I departed the IRS almost 3 years ago, I do not know whether the IRS is currently considering any additional transfer pricing disclosure. If not, they should, especially for publicly traded MNCs. Additional transfer pricing related information could help the IRS more quickly identify the location and scope of any income shifting.

Information could be obtained on an aggregate basis (e.g., US vs. non-US), country-by-country basis, and/or on an entity by entity basis (i.e., at the controlled foreign corporation (CFC) level). At a minimum, aggregate information could include the following:

	Pre-tax income	Tax Expense		Liability per the tax return	# of Employees	Sales	Other Information
		Current	Deferred				
US				n/a			
Non-US							
Consolidated financial statements							

Note that some of this information is now included in audited financial statements, but some is not. In addition to making this available to the IRS and other tax authorities, one could also consider making it available to the public. Although MNCs would surely complain, the information disclosed is relatively aggregated and in many cases is already publicly disclosed.

Additional information could also be collected on a CFC by CFC basis<sup>52</sup>, including that requested in the following two tables:

<sup>50</sup> For information on Schedule UTP, see J. Richard (Dick) Harvey, Jr., *Schedule UTP: An Insider's Summary of the Background, Key Concepts, and Major Issues*, DePaul Business and Commerce Law Journal (Spring 2011) available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1782951](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1782951).

<sup>51</sup> As the lead architect of Schedule UTP, I personally concurred with this decision.

<sup>52</sup> Because of its potential impact on a MNC's competitive position, I would not recommend publicly disclosing CFC specific information at this time. However, I would not completely rule it out at some time in the future (e.g., if MNCs continue to shift income to low-tax jurisdictions and other efforts have failed to prevent it).

CFC name	How is the entity classified (i.e., taxable, disregarded, or flow-through)?		Financial Statement Information				
	Foreign Tax Purposes	US Tax Purposes	Pre-Tax Income	Federal tax expense		Foreign tax expense	
				Current	Deferred	Current	Deferred
A							
B							
etc...							

CFC name	US Federal tax		Foreign tax		Other Information (e.g., # of employees and/or employee compensation)
	E+P	Subpart f	Taxable income	Tax Liability	
A					
B					
etc...					

Although some of this information is currently collected on IRS Form 5471, *Information Return of US Persons With Respect to Certain Foreign Corporations*, some is not. In addition, I suspect there is additional information that IRS field agents would find useful. My bottom line suggestion is the IRS should determine what information would be useful and design a form to collect it. Whether this is a new form, or some variation of an existing form does not matter. The key is to allow IRS agents to quickly identify where income is being shifted to low-tax jurisdictions, and how such shifting is being accomplished.

**EMBARGOED UNTIL DELIVERY**

**Testimony of Stephen E. Shay**  
**Before the**  
**U.S. Senate Permanent Subcommittee on Investigations**  
**Of the Committee on Homeland Security and Governmental Affairs**  
**Hearing on Offshore Profit Shifting and the Internal Revenue Code**

**May 21, 2013**

Chairman Levin, Ranking Member McCain and members of the Subcommittee, thank you for the opportunity to testify on the important topic of shifting of profits offshore by U.S. multinational corporations.<sup>1</sup> I am a Professor of Practice at Harvard Law School.<sup>2</sup> The views I am expressing are my personal views.

The Subcommittee and its staff should be commended for pursuing this important investigation. Protecting the existing U.S. tax base is an important responsibility of those in Congress and the Administration responsible for the fiscal health of the country. The revenue lost to tax base erosion and profit shifting is hard to estimate, but there is compelling evidence the amount lost is substantial. This revenue loss exacerbates the deficit and undermines public confidence in the tax system. Restoring revenue lost to base erosion and profit shifting would support investing in job-creating growth in the short term and reducing the deficit over the long term.

My testimony provides background information on the taxation of foreign income of U.S. multinationals earned through a controlled foreign corporation and on transfer pricing.<sup>3</sup> The testimony next discusses the information developed by the Subcommittee Staff regarding Apple's international tax planning and considers how current elements of U.S. tax law contribute to key elements of that planning. I will make a limited number of observations regarding the implications of the Subcommittee's Apple case study for tax law changes and conclude.

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<sup>1</sup> My testimony is at the request of the Subcommittee, by letter dated May 1, 2013 from Chairman Carl Levin and Ranking Member John McCain. I am testifying in a personal capacity. My testimony does not represent the views of Harvard Law School or Harvard University.

<sup>2</sup> Prior to my current position, I was the Deputy Assistant Secretary for International Tax Affairs at the Department of the Treasury. Before my most recent government service, I was a tax partner at Ropes & Gray LLP for 22 years specializing in U.S. international income taxation before resigning in 2009 to serve in government. I occasionally consult for Ropes & Gray LLP on mutually agreed projects. I have provided a copy of my biography to the Subcommittee and a disclosure of my outside activities is posted on my faculty website page. Members of my family own Apple stock.

<sup>3</sup> The background portion of my testimony draws from my September 21, 2012, testimony before this Subcommittee. Readers familiar with these areas of law may wish to skip this background discussion.

With the Chairman's permission, I would like submit my written testimony for the record and summarize my principal observations in oral remarks.

**Background: Taxation of Foreign Subsidiary and Income Transfer Pricing**

**Taxation of Foreign Subsidiary Income**

Under current U.S. rules, a U.S. multinational is not taxed on active foreign income earned through a controlled foreign corporation (including, generally, a greater than 50% foreign subsidiary) until the earnings are distributed as a dividend.<sup>4</sup> This is commonly referred to as deferral.

The United States allows a domestic corporation that owns 10% or more of the voting stock of a foreign corporation a credit for foreign income taxes paid with respect to earnings received as a dividend in respect of that stock. A U.S. shareholder also may offset U.S. tax on a foreign dividend with excess foreign taxes paid in respect of other foreign income in the same foreign tax credit limitation category.<sup>5</sup> Accordingly, there is a residual U.S. tax on foreign earnings distributed as a dividend unless allowable foreign tax credits are sufficient to offset the U.S. tax. Interest expense and other deductions of a U.S. multinational, allocated to foreign income for purposes of determining the foreign tax credit limitation, are allowed as a current deduction even if the foreign income is deferred from current U.S. tax.

Through various devices, including gaps in anti-deferral provisions, many U.S. multinationals are able to reduce overall foreign taxes to burdens substantially below their effective U.S. tax rates. The combination of deferral of U.S. tax on foreign earnings, where the tax saved is reinvested at low foreign tax rates, and current deductions for expenses contributing to earning deferred income is a powerful incentive to shift income offshore. This incentive is magnified by financial accounting rules that allow undistributed foreign earnings to be taken into account in consolidated income without reserving for future U.S. tax if the earnings are considered indefinitely reinvested abroad.

<sup>4</sup> I.R.C. §§61(a)(7). The highest corporate tax rate is 35% for net income over \$10 million. I.R.C. §11(b). The recapture of lower-bracket rates causes the corporate marginal rate to exceed 35% over limited income ranges. Earnings of a controlled foreign corporation may be deemed included in a United States shareholder's income under certain anti-deferral rules discussed below. See I.R.C. §§951 - 964.

<sup>5</sup> See I.R.C. §§901, 902, 904. The credit allowed for foreign income taxes is subject to a limitation. The credit for foreign income tax may not exceed the pre-credit U.S. tax that otherwise would be paid by the taxpayer on foreign source net income in the same limitation category as the foreign tax. Today, there generally are two foreign tax credit limitation categories, one for passive income and another "general" category that includes all non-passive income. U.S. multinational taxpayers that earn high-tax foreign income, or that through planning "bunch" foreign taxes into high-tax pools of earnings used to repatriate foreign taxes for use as credits, may use excess foreign tax credits against other low-taxed foreign income in the same category. For example, excess foreign tax credits can be used to offset U.S. tax on royalty income and income from sales that pass title to customers outside the United States that is treated as foreign-source income for U.S. tax purposes (though this income generally would not be taxed by another country). See J. Clifton Fleming, Robert J. Peroni & Stephen E. Shay, *Reform and Simplification of the U.S. Foreign Tax Credit Rules*, 101 TAX NOTES 103 (2003), 31 TAX NOTES INT'L 1145 (2003).

Under the Internal Revenue Code's Subpart F anti-deferral rules, a United States shareholder in a controlled foreign corporation is subject to current income inclusion of its share of the controlled foreign corporation's "foreign personal holding company income," including interest, dividends, rents, royalties and capital gains not earned in an active business.<sup>6</sup> In addition to limiting deferral for passive income, certain other sales and services income earned through use of "base companies" may be currently included in a United States shareholder's income.<sup>7</sup> The two principal categories of active income that are subject to the anti-deferral rules are foreign base company sales income and foreign base company services income.<sup>8</sup> A United States shareholder may elect not to include currently Subpart F income that is subject to an effective rate of foreign tax greater than 90% of the highest U.S. corporate tax rate. The theory behind these base company sales and services provisions was that use of a base company in a lower-tax jurisdiction is an indicator of tax avoidance that should preclude the benefit of deferral. These provisions do not apply, however, to income earned in the country of organization of the corporation or to income from sales of property manufactured by the corporation.<sup>9</sup>

With the advent of U.S. "check-the-box" entity classification rules in 1997 and more recently the expansive acceptance of contract manufacturing by a third party for purposes of the "manufacturing" exception from foreign base company sales income, it is reasonably easy to avoid the reach of the Subpart F anti-deferral rules for a broad range of income. Statistics of Income data for 2006 show that approximately 80% of controlled foreign corporation earnings are retained and deferred from U.S. taxation, roughly 8% were distributed as dividends and 12% were currently taxed under Subpart F (and it should be recognized that Subpart F inclusions often are intentional in order to bring back earnings without triggering foreign withholding taxes).<sup>10</sup> For that year, the average effective rate of foreign tax on foreign earnings of controlled foreign corporations with positive foreign earnings was approximately 16.4%.<sup>11</sup>

<sup>6</sup> Subpart F is in Subchapter N of Chapter 1 of the Code. A controlled foreign corporation is a foreign corporation that is more than 50% owned, by vote or value, directly or indirectly under constructive ownership rules, by United States shareholders. I.R.C. § 957(b). A United States shareholder is a U.S. person that owns ten percent or more by vote, directly or indirectly under constructive ownership rules, of the foreign corporation. I.R.C. § 951(b). Passive income defined as "foreign personal holding income" in Code section 954(c) is one category of "foreign base company income" that is taxed currently.

<sup>7</sup> I.R.C. §§ 954(d) and 954(b)(4).

<sup>8</sup> I.R.C. §§ 954(d) and (e).

<sup>9</sup> Subpart F also has a de minimis exception if a controlled foreign corporation's foreign base company income is less than the lesser of 5% of gross income or \$1 million and a "full inclusion" rule if more than 70% of a foreign corporation's gross income is foreign base company income. The discussion in the text is a summary of the relevant provisions and is not intended to be comprehensive. For example, the discussion does not cover, *inter alia*, the active foreign finance or insurance exceptions to Subpart F or foreign base company oil income.

<sup>10</sup> 2006 IRS Statistic of Income (SOI) data show that 12.2% of foreign earnings and profits of controlled foreign corporations (with positive current year earnings) were taxed currently under Subpart F. Statistics of Income, Table 3. U.S. Corporations and Their Controlled Foreign Corporations: Number, Assets, Receipts, Earnings, Taxes, Distributions, and Subpart F Income, by Selected Country of Incorporation and Industrial Sector of Controlled Foreign Corporation, Tax Year 2006, at [http://www.irs.gov/taxstats/bustaxstats/article/0,,id=96282\\_00.html](http://www.irs.gov/taxstats/bustaxstats/article/0,,id=96282_00.html). An

The United States deferral system includes rules that restrict a controlled foreign corporation from making its offshore earnings available to its affiliated U.S. group other than through a taxable dividend distribution. The Section 956 “investment in U.S. property” rules, adopted in 1962 and frequently adjusted since, treat a controlled foreign corporation’s offshore earnings that are invested in a broad range of U.S. investments, including a loan to its U.S. affiliates, as though the earnings were distributed as a dividend to a U.S. affiliate.<sup>12</sup> The investment in U.S. property rules include significant exceptions that are designed to allow investment of offshore earnings in U.S. portfolio securities.<sup>13</sup> The investment in U.S. property rules defend the residual U.S. tax on distributions but do not block holdings of U.S. portfolio investments.<sup>14</sup>

The effect of the investment in U.S. property rules, when they work properly, is to protect the U.S. income tax base by preventing a U.S. multinational from using earnings not taxed by the United States in its U.S. business.<sup>15</sup> These rules also restrict the advantage a U.S. multinational

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additional 7.9% of foreign earnings were distributed in a taxable distribution. Lee Mahony and Randy Miller, *Controlled Foreign Corporations, 2006*, STATISTICS OF INCOME BULLETIN 197, 202 Figure C (Winter 2011) (taxable payout ratio of 9.7% in relation to positive current year earnings and profits net of Subpart F income) see <http://www.irs.gov/pub/irs-soi/11coforeign06winbull.pdf>. When the 9.7% is measured in relation to positive current year earnings it is 7.2% (9.7% multiplied times the ratio of positive current year earnings and profits net of Subpart F income/positive current year earnings and profits (400,854,698/491,235,961) = 7.9%).

<sup>11</sup> Statistics of Income, Table 3. U.S. Corporations and Their Controlled Foreign Corporations: Number, Assets, Receipts, Earnings, Taxes, Distributions, and Subpart F Income, by Selected Country of Incorporation and Industrial Sector of Controlled Foreign Corporation, Tax Year 2006, at

<http://www.irs.gov/taxstats/bustaxstats/article/0,,id=96282,00.html> and author’s calculations. The average effective rate disguises far lower effective rates for certain industries and companies, such as Apple. Companies in the resource industries often pay much higher levels of foreign tax.

<sup>12</sup> I.R.C. § 956. The rules were strengthened in the 1970s after a U.S. shipping magnate circumvented this restriction by using his controlled foreign corporation shares as collateral for a loan. *Ludwig v. Comm’r*, 68 T.C. 979 (1977), *nonacq.*, 1978-2 C.B. 1. In response, regulations were amended with addition of a rule known to all U.S. multinational financing lawyers (and auditors) – a pledge of stock will be deemed to be an investment in U.S. property by the controlled foreign corporation if “at least 66 2/3rds percent of the total combined voting power of all classes of stock entitled to vote is pledged and if the pledge is accompanied by one or more negative covenants or similar restrictions on the shareholder effectively limiting the corporation’s discretion with respect to the disposition of assets or the incurrence of liabilities other than in the ordinary course of business.” Treas. Reg. §1.956-2(c)(2) (T.D. 7712, 1980). See Gustafson, Peroni & Pugh, *TAXATION OF INTERNATIONAL TRANSACTIONS* [¶6200- 6220] (4<sup>th</sup> Ed. 2011).

<sup>13</sup> I.R.C. §956(c).

<sup>14</sup> Accordingly, it is commonplace for a controlled foreign corporation to hold U.S. dollar bank deposits, U.S. government and corporate debt securities of unrelated issuers, and U.S. equity securities of unrelated issuers. A 2011 survey by the U.S. Senate Permanent Investigations Subcommittee majority staff estimated that of \$538 billion of undistributed accumulated foreign earnings (of 27 surveyed multinationals as of the end of FY 2010) approximately 46% was invested in U.S. bank accounts and securities. U.S. Senate Permanent Investigations Subcommittee Majority Staff, Report Addendum to *Repatriating Offshore Funds: 2004 Tax Windfall for Select Multinationals* (Dec. 14, 2011).

<sup>15</sup> The benefit of deferral is not eliminated when the deferred earnings are reinvested in investments producing Subpart F income even when there is no U.S. interest deduction for the group. See generally, Myron S. Scholes, Mark A. Wolfson, Merle Erickson, Edward Maydew, Terry Shevlin, *TAXES AND BUSINESS STRATEGY: A PLANNING APPROACH*, 347-348 (4<sup>th</sup> Ed. 2009).

would have competing against a domestic U.S. business that will not have available low-taxed offshore earnings for use in its business. If there is leakage in the investment in U.S. property rules allowing deferred earnings to be loaned to the U.S. multinational's U.S. business without U.S. tax, the benefit of deferral on the earnings loaned would be preserved so financing from pre-U.S. tax earnings (after a foreign tax) would be available to the U.S. multinational but not its domestic competitors. The purpose of these rules is to prevent this, except in isolated cases of short-term loans.

### **Transfer Pricing**

Transfer pricing generally refers to the prices charged between affiliates under common control for intercompany transactions, including sales or leases of tangible property, the performance of services and transfers by sale or license of intangible property rights. The transfer pricing rules of Section 482 attempt to ensure that taxpayers clearly reflect income attributable to controlled transactions and to prevent the avoidance of taxes with respect to such transactions.<sup>16</sup> The rules attempt to place a controlled taxpayer on tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer.

From the first set of transfer pricing regulations in 1968, taxpayers have been permitted to share the costs of development of an intangible under a *bona fide* cost sharing arrangement as a means to determine which affiliates may earn returns attributable to the intangible. One of the substantial attractions for taxpayers of *bona fide* cost sharing is that the IRS generally will limit adjustments to the appropriate ratio for sharing costs. While the sharing ratio has been the subject of dispute, the far more substantial issue historically has been the valuation of contributions of pre-existing intangibles.<sup>17</sup>

If at the commencement of the cost sharing arrangement a participant possesses a resource, capability or right that is anticipated to contribute to development under the cost sharing arrangement, the other participants must compensate that participant for the fair market value of the contribution. The issue of pre-existing intangibles is referred to by practitioners as the "buy-in" problem, but the name is somewhat misleading. The "buy-in" concern is not limited to valuing intangible property that pre-exists the commencement of the cost sharing arrangement, but extends to the full range of contributions to development by affiliates whether or not they are participants in the arrangement. Paying for the full range and value of contributions has proved to be an Achilles heel (from the perspective of tax authorities) of cost sharing between related persons for tax purposes.

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<sup>16</sup> I.R.C. §482; Treas. Reg. §1.482-1(a).

<sup>17</sup> See *Seagate Technology, Inc. v. Comm'r*, 102 T.C. 149 (1994); *Veritas Software corp. v. Comm'r* 133 T.C. 297 (2009).

IRS and Treasury guidance regarding cost sharing has evolved through a series of developments reflecting successive problems with cost sharing in practice. The first limited guidance was given in final regulations in 1968. By the Tax Reform Act of 1986, it became clear that international transfer pricing was a substantial issue, particularly in relation to the territorial system adopted in Code Section 936 for Puerto Rico, so Section 482 was amended to permit a post-transfer review of the pricing of intangible property.<sup>18</sup> In 1988, the Treasury issued a White Paper on transfer pricing that sought to provide a sounder theoretical underpinning for the treatment of intangibles.<sup>19</sup> This was followed by 1992 proposed regulations that were heavily criticized by business and then 1995 final cost sharing regulations.

In 2007, the Treasury issued a report to Congress on transfer pricing that reported substantial evidence consistent with income shifting from non-arm's length pricing.<sup>20</sup> The 2007 Treasury Report acknowledged "that CSAs [cost sharing agreements] under the current regulations pose significant risk of income shifting from non-arm's length pricing." It reported on proposed regulations issued in 2005 that adopted a new "investor model" approach and that substantially expanded the newly-named "platform contributions" to the development of intangibles that should be compensated under new cost sharing arrangements. On the last day of 2008, the proposed regulations were largely adopted as temporary regulations, however, cost sharing agreements that were in existence on January 5, 2009 (and updated in certain respects), were subject to "grandfather" rules that insulated these agreements from the full force of the new rules. Final regulations were issued in 2011.<sup>21</sup>

The premise of the cost sharing rules is straightforward. If a participant shares all of the costs and all of the risks of developing a new intangible property, it is entitled like an entrepreneur to earn the returns from making that investment. As we were reminded in the global financial crisis of 2008, however, the application of theory and models in the messiness of the real world can lead to unintended or unanticipated results. As demonstrated by the repeated efforts to strengthen the cost sharing regulations and the continued evidence of income shifting to lower tax countries, the application of cost sharing in the context of the international taxation has proven to be highly problematic. This is in part because assumptions necessary for the theory of cost sharing to be valid, including that all contributions are fully accounted for, are nearly impossible to control in a real world setting.

The transfer pricing rules necessarily are an imprecise tool. The rules allow a taxpayer to fully comply by selecting the most advantageous price that falls within a range of allowable

<sup>18</sup> See I.R.C. §482 (second sentence).

<sup>19</sup> 1988-2 C.B. 458.

<sup>20</sup> U.S. Department of the Treasury, "Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties," (Nov. 2007).

<sup>21</sup> T.D. 9568, 76 FR 80082 (Dec. 22, 2011).

alternatives or, in respect of intangibles, by entering into a cost sharing arrangement.<sup>22</sup> The difficulties with administering transfer pricing rules in relation to a sophisticated multinational group are compounded where comparable third-party transactions are unavailable or inexact, as is the case with respect to most high-value intangible property, and by the flexibility afforded a multinational corporate group in planning and executing its global legal and pricing structure to minimize tax. The problems are exacerbated by the taxpayer's control over information and procedural advantages.<sup>23</sup>

**The Subcommittee Staff's Apple Case Study: What Does It Tell Us?**

The Apple information provided to the Subcommittee Staff offers visibility into the way one company organizes its affairs to shift very substantial amounts of income into low- or zero-tax jurisdictions. (Through its tax treatment of nonresident Irish corporations, Ireland may be considered both a low- and a zero-tax jurisdiction at the same time -- without explicitly providing a tax holiday.) The data developed by the Subcommittee staff supplements what is publicly available, but is limited to consolidating financial information (as opposed to tax return information) and written responses to Staff questions. Because of limitations on the information provided, and the circumstances under which it is made available,<sup>24</sup> the following discussion must be considered preliminary.

I take no position on the legal correctness or strength of any tax position taken by Apple. What are of interest are the techniques used to shift income to low-taxed countries and the scale of the income shifting that is possible.

Apple's business, organizational structure and international operations is described in the Staff Memorandum to the Subcommittee ("Staff Memorandum"). Apple is a remarkable and a remarkably successful company. In FY 2011, Apple had consolidated global revenues of \$112 billion and earnings before tax of \$34 billion.<sup>25</sup> Apple's FY 2011 global book tax rate was 24.2%, though Professor Harvey calculates it would be 12.8% if all of the Irish earnings are

<sup>22</sup> Treas. Reg. §§1.482-1(e), 1.482-7.

<sup>23</sup> See J. Clifton Fleming, Jr., Robert J. Peroni and Stephen E. Shay, *Worse than Exemption*, 59 Emory LAW J. 79, 119-127 (2009).

<sup>24</sup> To preserve confidentiality, information only was made available at the Subcommittee offices or in the presence of a Subcommittee staff member. In the future, I suggest that the Subcommittee employ a secure virtual data site, which is customary practice in commercial merger, acquisition and financing transactions to preserve confidential company data.

<sup>25</sup> I refer to Apple's fiscal year ending September 24, 2011 instead of the most recently ended fiscal year because separate subsidiary information only was made available to the Subcommittee staff for FY 2011. The Apple consolidated numbers are from Apple's Form 10-K for FY 2011.

considered permanently reinvested.<sup>26</sup> Apple had approximately 59,000 employees worldwide in 2011.

### Apple Transfer Pricing

The Apple companies in Ireland with respect to which information was provided (including companies organized in Ireland but reportedly tax resident nowhere) included two cost sharing participants under a longstanding cost sharing agreement with Apple for rights to sell products outside North America. In 2011, one of Apple's Irish cost sharing participants, Apple Sales International (ASI), contracted with third party manufacturers to make products and sold these products outside of North America.<sup>27</sup> Based on consolidating financials (without eliminations within those groups), in FY 2011 Apple's Irish companies earned approximately \$22 billion in earnings before tax (EBT), or approximately 64% of global EBT. The Apple Irish companies' EBT to sales margin was 46% compared to 23% for Apple US.<sup>28</sup>

The effectiveness of Apple's transfer pricing and Irish nonresident company tax strategy is evident from the breakdown of Apple's FY 2011 EBT:

	FY2011			Total
	US	Ireland	ROW	
EBT (\$ billions)	\$10.2	\$22.0	\$2.0	\$34
EBT share	30%	64%	6%	100%
Customers (approx.)	39%	1%	60%	100%

This illustrates in concrete terms for one company what has been shown in aggregate data, namely, that Apple aggressively shift earnings to a low- or zero-tax location.

To give a different measure, the Irish companies employed only 2,452 of Apple's 59,000 employees, yet they earned \$22 billion in earnings before tax or over \$9 million per employee. This actually is understated, since after the 2012 reorganization only 613 employees were assigned to the cost sharing companies (ASI and Apple Operations Europe). If 613 employees

<sup>26</sup> This seems a reasonable adjustment in light of Apple's decision to issue \$17 billion in debt to help finance a \$55 billion stock buyback rather than repatriate earnings and reportedly pay \$9.2 billion in tax. Peter Burrows, Apple Avoids \$9.2 Billion in Taxes With Debt Deal, Bloomberg.com (May 3, 2013), at <http://www.bloomberg.com/news/2013-05-02/apple-avoids-9-2-billion-in-taxes-with-debt-deal.html?cmpid=yahoo> (last visited May 19, 2013). See also, Martin Sullivan, "Economic Analysis: Apple Reports High Rate But Saves Billions On Taxes," 2012 TNT 29-2 (Feb. 9, 2012).

<sup>27</sup> In 2011, the distribution of personnel and functions among Irish companies was somewhat mixed up and was rationalized in 2012. See description in Staff Memorandum. For purposes of describing numbers of employees and earnings before tax (EBT), I will treat the entities as one entity.

<sup>28</sup> The better measure for transfer pricing analysis is operating income, however, I use EBT for comparability reasons. Use of operating income would not affect the findings.

was the correct count for 2011, the EBT/employee would be \$35.8 million per employee compared to an approximate average of \$576 thousand per employee for all Apple employees.

The average effective book foreign tax rate for the Irish companies was under 1%. Apple described its low Irish tax rate as follows: “Since the early 1990s, the Government of Ireland has calculated Apple’s taxable income in a way to produce an effective rate in low single digits ...since 2003 it has been 2% or less.” According to Apple, the principal Irish companies in terms of income, Apple Operations Europe (AOE) and ASI, are not tax resident in Ireland. Based on Apple’s disclosures so far, it is not clear that AOI, AOE and ASI are tax resident anywhere.

For U.S. tax purposes, Apple treated ASI and AOE as disregarded entities wholly-owned by Apple Operations International (AOI), an Irish-organized company with no employees or operations also considered by Apple to not be tax resident in Ireland. If the foregoing is correct, for U.S. tax purposes, all of the income earned by ASI and AOE is would be considered owned by AOI.

AOE and ASI, pay Irish tax only on their business carried on in Ireland. ASI is a party to the cost sharing agreement, but it is not clear where income attributable to the intangibles in which ASI has an interest is treated as earned; it appears to be allocated away from Ireland for Irish tax purposes, i.e., it could be what is fondly referred to by international tax planners as “ocean income.” It would be difficult to achieve a less than 2% Irish effective tax rate if that income were subject to Irish tax at a 12.5% corporate tax rate (assuming it is considered trading income) or a 20% rate (if it is not).

The facts in this case raise the question whether the income that is shifted to Ireland is shifted from the United States or from the countries where the customers are located (the source or market countries). There is no doubt that some income is shifted from the market countries, but it is reasonably clear that the largest part of the value in Apple’s products arises from its proprietary technology. Some is attributable to Apple’s marketing, for which Apple U.S. makes a small charge to affiliates. It is doubtful that the preponderance of the Irish income is properly allocable to the in-country selling activity. In sum, for its non-U.S. sales Apple’s use of cost sharing transfers the return to R&D performed in the United States to Ireland (or the ocean).

The tax motivation of Apple’s income shifting is evident. The appropriate way to test the reality of the Apple arrangement is to ask whether Apple would have entered into this cost sharing arrangement if Apple’s Irish affiliates had been unrelated. Over the three year period, 2009 – 2011 Apple’s Irish cost sharing participants paid approximately \$3.3 billion in cost sharing payments to Apple US. While that is a very large number, over the same period Apple’s Irish affiliates earned EBT (after those payments) of \$29.3 billion.<sup>29</sup> In other words, the \$3.3

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<sup>29</sup> As noted above, the better measure is operating income, but the numbers would remain enormous.

billion investment earned the right the substantial portion of \$32.6 billion, or almost a 10 times return. The U.S. tax deferred likely is over \$10 billion. The ability to reinvest those tax savings is a valuable tax benefit.

So, would Apple have entered into this cost sharing arrangement if Apple's Irish affiliates had been unrelated? To answer "yes" strains credulity.

The objective of the arm's length principle in transfer pricing is to achieve neutral treatment of related party and unrelated party transactions. The ability of multinational businesses to take advantage of transfer pricing between related persons in different countries strongly favors structuring transactions with affiliates to be able to shift income into low-taxed jurisdictions. It is an advantage that is largely unavailable to purely domestic businesses including most all small business enterprises. Yet, small businesses and individuals must make up the lost taxes.

There does not appear to be meaningful information regarding the effect of recently finalized cost sharing regulations on cost sharing. Anecdotally, it appears that companies have sought to grandfather existing agreements, as Apple has done, and are looking for other strategies for new projects.<sup>30</sup> This will bear monitoring closely. Of one point there is assurance, taxpayers will continue to focus on transfer pricing so long as there is potential to take advantage of material income tax differentials.

There are many potential steps that may and should be taken to improve the law and administration in respect of transfer pricing. I will discuss one proposal that transcends transfer pricing and bears consideration by the Subcommittee. There is a substantial need for more transparency by large public and comparable private companies. To date, companies do not routinely disclose information from consolidating financial statements with respect to the material separate legal entities of the consolidated group. Consolidating financial statements, which are unaudited separate company statements, are routinely prepared in connection with preparing an audited consolidated financial statement. These consolidating statements should be made available on a company web site with respect to each material company (with eliminations) along with information regarding the tax residency of each material company. This would provide valuable information to investors and analysts, who could monitor the group's assets and profitability by company, and more approximately by jurisdiction, and better assess the company's country and tax risks. This increased transparency would improve the monitoring of

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<sup>30</sup> It has been suggested that transferring existing intangible property in tax-free transactions so as to be subject to Section 367(d) rules avoids the reach of some of the rules of the cost sharing regulations. That certainly should not be correct in that Section 367(d) should not have a different outcome than Section 482.

multinational businesses by shareholders, civil society and tax authorities alike and put downward pressure on corporate agency costs.<sup>31</sup>

### Deduction Dumping

The benefit of income shifting is enhanced when deductions are incurred in the United States to earn low tax foreign income that is deferred from U.S. tax. Borrowing a table from Professor Harvey, below, it appears that Apple's general and administrative and sales, marketing and distribution expenses are incurred disproportionately in the United States. This helps explain the lower ratio of U.S. EBT to U.S. sales.

Allowing a current deduction for whatever portion of these expenses is attributable to income booked in the Irish companies (instead of in the United States) effectively is a U.S. tax subsidy those deferred earnings. Allowing the expense as a deduction, unreduced by the foreign earnings to which it is attributable (applying existing U.S. allocation rules), provides a tax saving benefit equal to the difference between the U.S. and foreign rate and the ability to invest that saving until the foreign earnings are distributed.

	Pre-tax Income/Sales	% of Pre-tax Income	General & Administrative Expenses		Sales, Marketing, & Distribution Expenses	
			\$ billions	%	\$ billions	%
US	24%	30%	1.7	85%	3.3	59%
Non-US	36%	<u>70%</u>	<u>0.3</u>	<u>15%</u>	<u>2.3</u>	<u>41%</u>
Consolidated	32%	<u>100%</u>	<u>2</u>	<u>100%</u>	<u>5.6</u>	<u>100%</u>

The allocation of deductions issue is a large dollar issue not only for Apple, but for the U.S. tax system more generally. In FY 2008, deductions allocable to foreign income (but not allocable to specific types of income) on Forms 1118 totaled \$201 billion, including \$99 billion of interest, \$78 billion of other deductions (such as overhead expense) and \$23 billion of R&D. The portion of these deductions properly allocable to deferred earnings should not be allowed as deductions until the deferred income is repatriated to the United States. This issue would become even more significant if the United States were to shift to a dividend exemption for active foreign income.<sup>32</sup>

<sup>31</sup> It should be possible to adopt standards that would address trade secret concerns. There is no public policy interest in basing market competition on transfer pricing and tax strategies.

<sup>32</sup> Proposals to use a 5% "haircut" in a possible U.S. dividend exemption system as a surrogate for allocating expenses materially understate the amount of deductions allocable to foreign income.

### **Sidestepping Anti-Deferral Rules**

Deferral, and even more, exemption of foreign profits, creates an irresistible incentive to shift income to where it will be low-taxed or not taxed. This was understood when the Subpart F limits on deferral were first adopted in 1962 – they were intended to serve as a vital backstop against transfer pricing abuse by reducing the incentives that could arise if income could be shifted to low- or zero-tax countries. Apple’s international structure takes full advantage of loopholes in existing anti-deferral rules. These rules have been substantially eroded, most significantly by ill-conceived application of “check-the-box” disregarded entity regulations in the international area. This problem was exacerbated by Congressional actions restricting a response to the problem. Additional exceptions that undermine the overall structure of Subpart F include an unprincipled expansion of the manufacturing exception to foreign base company sales income to cover contract manufacturing, the Section 954(c)(6) look-through rule and a “same country exception” based on place of incorporation.

Apple avoids the reach of the foreign base company sales rules by contracting for manufacture of its products by third parties and in most cases, for U.S. tax purposes, selling to third parties. By using check-the-box disregarded entities, intercompany transactions within the group of companies that are classified as disregarded entities simply disappear.<sup>33</sup> With respect to payments of interest and dividends, the look-through rule of Section 954(c)(6) accomplishes much the same result except to the extent that deductible payments offset income of the payor that would be subject to current U.S. tax.

Finally, the same country exceptions for dividends and interest apply based on place of incorporation, whether or not the corporation is tax resident in the country of incorporation. Even before check-the-box and the look-through rule, taxpayers were taking advantage of nonresident Irish companies to sidestep this rule. If changes are made to check-the-box and look-through rules, changes also should be made to this same country exception. As a general proposition, if it is retained in anything like its present form, Subpart F should operate on a branch-by-branch basis and not by reference to place of incorporation.<sup>34</sup>

### **Implications of Apple Case Study - Where to Go From Here**

Our international tax rules are out of balance. They are too generous to foreign income and not strong enough in protecting against U.S. base erosion by foreign companies investing in the United States. The losers are domestic business.

<sup>33</sup> It remains necessary to consider the application of the foreign base company sales rules for sales and manufacturing branches, but they also are fairly readily controlled.

<sup>34</sup> See American Bar Association Tax Section Task Force on International Tax Reform, “Report of the Task Force on International Tax Reform,” 59 TAX LAW. 649, 787-809 (2006).

In the context of current law, changes may be made that would limit the scope for profit shifting. Most promising is a “minimum tax” imposed on the U.S. shareholder of a controlled foreign corporation in respect of low-tax foreign income earned by the controlled foreign corporation. In design, it actually would be a deemed distribution, as under current Subpart F, but the remaining U.S. tax would be collected when the earnings are distributed or the stock is sold. This approach would effectively take away the advantage of tax havens.

This should be accompanied by taking away the advantage of tax havens for foreign companies that invest in the United States. The United States should protect its source tax base by measures that may include imposing withholding tax on and/or restricting deductions for deductible payments of income paid to or treated as beneficially owned by related persons not “effectively taxed” on the income. In doing this, the United States would take away a substantial advantage that foreign-owned companies have in structuring investments in the United States.

Adopting a balanced approach is necessary to assure a level playing field. I have described elsewhere an approach that if taken by the United States would provide an incentive for other countries to adopt complementary rules. Moreover, the United States should strongly support and lead efforts at the OECD to combat base erosion and profit shifting. I acknowledge that the ideas described above need development into specific proposals, but this may be done in a reasonable time frame and will have value in relation to the principal international tax reform proposals.

Should Congress wait for tax reform to address income shifting? The short answer is “no.” The two tax writing committees have begun work on a fundamental revision of the tax code. Many options on specific issues have been floated and a number of actual proposals put in draft legislative language. Some are good and some are bad. Like Vladimir and Estragon asking what Godot looks like, however, the players in the tax reform effort do not know what tax reform looks like. Without a coherent direction to the effort, including agreement on basic objectives and consistency in revenue estimating, the undertaking will founder or result in a messy patchwork of unstable political compromises. The political difficulty of the undertaking requires leadership from the Administration (centered in the Treasury Department, not the White House) as well as from the Hill. The technical complexity of the undertaking requires utilizing the knowledge and economic analysis skills of the Treasury Office of Tax Policy as well as the Staff of the Joint Committee on Taxation. The work on tax reform is at very early stages and will take years. Do not be lulled into “waiting for tax reform.”

### **Conclusion**

The Subcommittee is to be applauded for exposing international tax practices that are not easily discernible from public financial statements. The Apple case study adds further support to the findings from aggregate data that there is substantial shifting of profits offshore by

U.S. multinationals.<sup>35</sup> Apple's income shifting strategies, including its cost sharing transfers of valuable intellectual property rights, are not unusual as evidenced in the 2010 case studies developed by the staff of the Joint Committee on Taxation and in the testimony presented in hearings by the U.K. Public Accounts Committee.<sup>36</sup> I encourage the Subcommittee to pursue reforms in the short term to adequately protect the U.S. tax base.

Thank you and I would be pleased to answer any questions.

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<sup>35</sup> In 2010, Treasury testimony reviewed a range of studies that indicate substantial income shifting to lower tax countries, including evidence from company tax data of margin increases correlated inversely with effective tax rates. The key conclusion of that review of studies based on aggregate data was that there was evidence of substantial income shifting through transfer pricing. Testimony of Stephen E. Shay, Deputy Assistant Secretary International Tax Affairs, U.S. Department of Treasury, House Ways and Means Committee, Hearing on Transfer Pricing Issues (July 22, 2010), [http://democrats.waysandmeans.house.gov/media/pdf/111/2010Jul22\\_Shay\\_Testimony.pdf](http://democrats.waysandmeans.house.gov/media/pdf/111/2010Jul22_Shay_Testimony.pdf).

<sup>36</sup> See, Staff of Joint Committee on Taxation, Present Law And Background Related To Possible Income Shifting And Transfer Pricing, (JCX 37-10 2010); House of Commons, Committee of Public Accounts, HM Revenue & Customs: Annual Report and Accounts 2011-12, Nineteenth Report of Session 2012-13, ¶¶ 7- 12, Ev 21 – Ev 50 (HC 716, Dec. 3, 2012), at <http://www.publications.parliament.uk/pa/cm201213/cmselect/cmpubacc/716/716.pdf> (last visited March 16, 2013) (Oral Evidence Taken from Troy Alstead, Starbucks Global Chief Financial Officer, Andrew Cecil, Director, Public Policy, Amazon, and Matt Brittin, Google Vice President for Sales and Operations, Northern and Central Europe, on Monday, November 12, 2012).

**TESTIMONY OF APPLE INC.**  
**BEFORE THE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS**  
**US SENATE**

**MAY 21, 2013**

**I. INTRODUCTION**

Apple Inc. (“Apple” or the “Company”) appreciates the opportunity to testify before the Permanent Subcommittee on Investigations (“Subcommittee”) in connection with its inquiry into the tax practices of multinational companies.

Apple, a California company, employs tens of thousands of Americans, creates revolutionary products that improve the lives of tens of millions of Americans, and pays billions of dollars annually to the US Treasury in corporate income and payroll taxes. Apple’s shareholders – from individuals and institutions to pension funds and public employee retirement systems – have benefitted from the Company’s success through the appreciation of its stock price and generous dividends. Apple safeguards the capital entrusted to it by its shareholders with prudent management that reflects the Company’s extensive international operations. Apple complies fully with both the laws and spirit of the laws. And Apple pays all its required taxes, both in this country and abroad.

Apple welcomes an objective examination of the US corporate tax system, which has not kept pace with the advent of the digital age and the rapidly changing global economy. The Company supports comprehensive tax reform as a necessary step to promote growth and enable American multinational companies to remain competitive with their foreign counterparts in both domestic and international markets.

The information Apple has provided to the Subcommittee demonstrates several key points about the Company’s operations that are critical to any objective evaluation of its tax practices:

- **Apple has been a powerful engine of job creation in the US.** Apple estimates it has created or supported approximately 600,000 jobs in the US, including nearly 50,000 jobs for Apple employees and approximately 550,000 jobs at other companies in fields such as

engineering, manufacturing, logistics and software development. Approximately 290,000 of these American jobs are related to the new “App Economy” launched by Apple’s App Store. In less than five years, Apple has paid third-party app developers worldwide over \$9 billion in connection with sales of their software to Apple customers.

- **Apple pays an extraordinary amount in US taxes.** Apple is likely the largest corporate income tax payer in the US, having paid nearly \$6 billion in taxes to the US Treasury in FY2012. These payments account for \$1 in every \$40 in corporate income tax the US Treasury collected last year. The Company’s FY2012 total US federal cash effective tax rate was approximately 30.5%.<sup>1</sup> The Company expects to pay over \$7 billion in taxes to the US Treasury in its current fiscal year. In accordance with US law, Apple pays US corporate income taxes on the profits earned from its sales in the US and on the investment income of its Controlled Foreign Corporations (“CFCs”), including the investment earnings of its Irish subsidiary, Apple Operations International (“AOI”).
- **Apple does not use tax gimmicks.** Apple does not move its intellectual property into offshore tax havens and use it to sell products back into the US in order to avoid US tax; it does not use revolving loans from foreign subsidiaries to fund its domestic operations; it does not hold money on a Caribbean island; and it does not have a bank account in the Cayman Islands. Apple has substantial foreign cash because it sells the majority of its products outside the US. International operations accounted for 61% of Apple’s revenue last year and two-thirds of its revenue last quarter. These foreign earnings are taxed in the jurisdiction where they are earned (“foreign, post-tax income”).
- **Apple carefully manages its foreign cash holdings to support its overseas operations in the best interests of its shareholders.** Apple uses its foreign cash for business operations, geographic expansion, acquisitions and capital investments, and to fund other expenses required by its overseas operations, such as the capital-intensive construction of retail stores in Europe and Asia and the purchase of customized tooling equipment. If the Company repatriated these funds, they would be reduced by a 35% US corporate tax rate. Apple serves its shareholders by keeping these funds overseas where they can be deployed efficiently to fund international operations at a lower cost. As Apple’s recent bond issuance demonstrates, the Company can return capital to shareholders using debt at a far lower cost than through repatriation of foreign cash.
- **The dividends distributed among Apple’s international affiliates, including AOI, are not subject to US corporate income tax.** AOI and other Apple subsidiaries in Ireland play an important role in the Company’s international business activities. Established more than thirty years ago, Apple’s base of operations in Ireland now employs nearly 4,000 people engaged in manufacturing, customer service, sales support, supply chain and risk management operations and finance support services. For cash management purposes, these subsidiaries distribute foreign, post-tax income as dividends within

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<sup>1</sup> This calculation is a reflection of federal taxes Apple paid against US pretax earnings, not a calculation of Apple’s final tax liability for FY2012.

Apple's corporate structure. Under US tax law, these foreign intercompany payments are not taxable.

- **Apple's cost sharing agreement with two of its subsidiaries supports high-paying, tax-revenue generating jobs in the US.** Unlike companies that do a substantial share of their research and development in lower cost, foreign jurisdictions, Apple conducts virtually all its R&D in the US. Apple has an agreement with two of its Irish subsidiaries to share the costs and risks of this R&D. The agreement, first established in 1980, is authorized by US law and complies with all US tax regulations. Under the current agreement, the Irish subsidiaries have rights to distribute Apple products in territories outside the Americas in exchange for contributing to jointly-financed R&D efforts in the US. Thus, the agreement supports the funding of the Company's high-paying R&D jobs in the US, promoting domestic job growth and generating significant tax revenue for federal and state governments.
- **AOI performs important business functions that facilitate and enhance Apple's success in international markets; it is not a shell company.** AOI is a holding company that performs centralized cash and investment management of Apple's foreign, post-tax income. AOI permits Apple to mitigate legal and financial risk by providing consolidated, efficient control of its global flow of funds. AOI was incorporated in Ireland when Apple began its longstanding business presence there, and AOI is properly treated as a CFC under US law. The existence of AOI does not reduce Apple's US tax liability.
- **Apple supports comprehensive reform of the US corporate tax system.** The Company supports a dramatic simplification of the corporate tax system that is revenue neutral, eliminates all tax expenditures, lowers tax rates and implements a reasonable tax on foreign earnings that allows free movement of capital back to the US. Apple believes such comprehensive reform would stimulate economic growth. Apple supports this plan even though it would likely result in Apple paying more US corporate tax.

## II. APPLE'S STORY

Apple is an American success story. Founded by Steve Jobs and Steve Wozniak nearly four decades ago in a residential garage, Apple has become the world's most valuable high tech company. Its success results from a simple priority: Apple strives to make the best products on Earth through a singular focus on its customers. Apple has introduced new products, new categories – even new markets – that have profoundly improved people's lives around the world. True to its California roots, Apple remains headquartered in Cupertino, and it is now building a

large new campus in that community to accommodate its substantial growth over the past decade.

Apple designs, manufactures and markets a range of personal computers, mobile communication and media devices, and portable digital music players. The Company also provides consumers a variety of related software and services, including access to third-party digital content and applications. Apple sells its products worldwide through retail stores, online stores, its direct sales force, third-party cellular network carriers, wholesalers, retailers and value-added resellers. The hallmarks for which Apple is best known – creativity, innovation and design – drive its development activities, almost all of which take place on Apple’s main campus in Cupertino.

Apple launched the personal computer revolution in 1976 with the Apple I, followed by the highly successful Apple II. In 1984, Apple reignited that revolution when it introduced its first category-defining product, the Macintosh. With innovations such as the graphical user interface and mouse, the Macintosh made computing accessible to consumers and set the standard for all personal computers that followed.

The mid-1990s proved to be difficult years for the Company. Apple struggled to manage declining sales and market share in an increasingly competitive personal computing market. In 1996 and 1997, Apple lost nearly \$2 billion. Many observers predicted Apple would not survive.

Mr. Jobs, who had left Apple in 1985, returned in 1997 with the task of saving the Company. Under his direction, Apple was entirely restructured and focused on innovation. The results are legendary. In 1998, Apple introduced the iMac, a groundbreaking new computer for the consumer market. In 2001, the Company introduced the iPod, another category-defining product that marked Apple’s expansion beyond personal computing into the digital marketplace.

Two years later, Apple launched the iTunes on-line music store, changing forever the way consumers legally acquired digital content. The innovative design and customer-focused engineering evident in these products laid the foundation for the Company's explosive growth over the next decade.

In 2007, Apple introduced the iPhone, which quickly set the standard for smartphones. In 2010, Apple introduced the iPad, which established a new market for tablet computers. The iPhone and the iPad illustrate Apple's emphasis on delivering an unmatched user experience and superior technical performance. These products generated unprecedented commercial success and growth for the Company, and created extraordinary value for its shareholders.

In 2008, following the introduction of the iPhone, Apple launched the App Store, which has fundamentally transformed how customers acquire and use software. Today, Apple customers can choose from among 850,000 applications in the App Store. Customers currently download approximately 800 apps per second. Just days ago, the fifty billionth app was downloaded – about seven downloaded apps for every person on Earth.

Apple's growth has created hundreds of thousands of highly-skilled, high-paying jobs for Americans during one of the most difficult economic periods in US history. While the overall size of the domestic workforce has stagnated during the last ten years, Apple has increased its US workforce more than five-fold, from fewer than 10,000 in 2002 to approximately 50,000 today. The Company has also built and opened 250 retail stores in the US. Apple's R&D budget, almost all of which is spent in the US, has also grown dramatically.

Apple is committed to increasing its foundation and operations in the US. The Company is building a new three million square-foot campus in Cupertino that will house 12,000 Apple employees. The Company has broken ground on a new one million square-foot campus in

Austin, Texas. In 2010, Apple built one of the country's largest data centers in North Carolina, and it is in the process of constructing two additional data centers in Oregon and Nevada. Reflecting Apple's strong commitment to the environment, these new facilities incorporate green architecture and an emphasis on renewable energy. The North Carolina data center, for example, is powered entirely by renewable energy sources and contains a solar farm and fuel cells on-site, both of which are the largest non-utility owned installations of their kind. The Company will also begin manufacturing one of its Mac lines in the US this year, creating high-quality American manufacturing jobs for a product previously assembled primarily overseas.

Apple's investments over the past decade have resulted in the creation of entirely new products, product categories and industries. The Company estimates that it has created or supported approximately 600,000 jobs for American workers. These US jobs are found in both small and large businesses, and include people who create components for Apple products, deliver those products to Apple's customers and develop apps for sale on the App Store. Apple estimates that approximately 290,000 jobs are related to the "App Economy" created by the App Store.<sup>2</sup>

Apple's commercial success and effective management of cash reserves have yielded significant returns to the Company's shareholders, including individual investors, widely-held mutual funds, US pension funds and public employee retirement systems. Based on the latest available public filings, at least twelve public and private pension funds in the US held Apple stock as their top equity investment, including funds for public employees in Michigan, Ohio and

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<sup>2</sup> Apple Inc., *Apple - Job Creation*, available at <http://www.apple.com/about/job-creation/>.

Kentucky.<sup>3</sup> At least twenty-nine such funds identified Apple as a top five holding. All told, these entities own approximately \$14.6 billion worth of Apple stock, which entitles them to annual dividend payouts totaling approximately \$396 million.<sup>4</sup> At approximately 3% of the S&P 500, Apple is one of the most-widely held equities in the mutual fund industry.

### **III. APPLE'S CORPORATE STRUCTURE AND TAX PRACTICES**

As a result of its success over the past decade, Apple has likely become the country's largest corporate income taxpayer. In FY2012, Apple made income tax payments to the US Treasury totaling nearly \$6 billion – or \$16 million per day – and had a US federal cash effective tax rate of approximately 30.5%. Expressed differently, Apple paid \$1 out of every \$40 of corporate income taxes collected by the US Treasury last year. The Company expects its US income tax bill to increase to more than \$7 billion this year.

Income taxes do not represent Apple's entire contribution to the federal and state treasuries. In FY2012, the Company paid approximately \$327 million in the employer's share of payroll taxes for its US-based employees and \$830 million in income taxes to state governments. Apple also pays a host of other state and local taxes arising from its property holdings and operations in the US. In addition, Apple paid or collected and remitted over \$1.3 billion of US state sales and use taxes.

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<sup>3</sup> These pension funds include the Michigan Department of Treasury, the State Teachers' Retirement System of Ohio and the Kentucky Teachers' Retirement System. The State of Wisconsin Investment Board, the Ohio Public Employees Retirement System and the Arizona State Retirement System each identifies Apple stock as its second largest holding. At a share price of \$450 and annual dividend of \$12.20 per share, these six funds' combined holdings amount to more than \$2.3 billion and entitle them to annual dividend payouts of approximately \$62 million.

<sup>4</sup> Assuming a share price of \$450 and an annual dividend of \$12.20 per share.

While Apple's success in the US market has continued, the global popularity of its products has soared. The Company's international revenue has outpaced US sales in recent years and substantially contributed to its rapid growth. Last year, approximately 61% of Apple's revenue was derived from its international operations. International revenue accounted for about two-thirds of Apple's revenue last quarter. Revenues from international operations are taxed in accordance with the laws of the countries where they are earned.

As a result of its international success, Apple has accumulated significant amounts of cash outside the US. As described in greater detail below, Apple carefully manages this foreign, post-tax income to support its foreign operations through a corporate structure that protects and promotes the interests of its shareholders. Current US corporate income tax law severely discourages the use of these funds in the US by imposing a 35% tax on repatriation.

To support its global business, Apple relies on a network of foreign subsidiaries incorporated in countries around the world to perform a variety of functions, from manufacturing to sales and support. Several subsidiaries are incorporated in Ireland, where Apple began operations in 1980. The Irish subsidiaries, which are involved in manufacturing, distribution, technical support, sales support and finance support services, include the following: Apple Operations International ("AOI"), Apple Operations ("AO"), Apple Operations Europe ("AOE"), Apple Sales International ("ASI") and Apple Distribution International ("ADI"). Apple's Irish subsidiaries employ nearly 4,000 people<sup>5</sup> and pay taxes there as required by Ireland. Apple recently broke ground on an expansion of its campus in Cork.

To meet the needs of Apple's expanding overseas operations, the Company's Irish subsidiaries have distributed active foreign, post-tax income as dividend payments within

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<sup>5</sup> The number of employees fluctuates with seasonal demands and new product launches.

Apple's foreign corporate structure. These dividends represent profit that was previously taxed in accordance with the laws of the local jurisdiction in which it was earned. Under US tax law, these dividends are not taxable. However, in accordance with US Subpart F income rules, Apple Inc. pays taxes to the US Treasury on investment income generated by the assets held by the Irish subsidiaries, including interest earned on their cash.

Apple wants to make clear to the Subcommittee that the Company does not use its Irish subsidiaries or any other entities to engage in the following tax practices that were the focus of the Subcommittee's September 20, 2012 hearing, entitled Offshore Profit Shifting and the US Tax Code. Specifically, Apple does not move its intellectual property into offshore tax havens and use it to sell products back into the US to avoid US tax, nor does it use revolving loans from CFCs to fund its domestic operations. Apple does not hold money on a Caribbean island, does not have a bank account in the Cayman Islands, and does not move any taxable revenue from sales to US customers to other jurisdictions in order to avoid US taxation. Nonetheless, Apple realizes the Subcommittee staff has expressed an interest in its corporate structure and some of its tax-related practices. The Company appreciates the opportunity to address each of the Subcommittee staff's apparent concerns below.

A. Cost Sharing Agreement Among Apple Inc., ASI and AOE

Pursuant to US Treasury regulations, Apple Inc. properly uses a cost sharing agreement with two of its Irish subsidiaries to share the R&D costs of co-developing its innovative products for a global market. Cost sharing agreements allow parties to combine financial resources, and therefore jointly bear risk, to invest in R&D in exchange for a share of the rights to any resulting intellectual property for their respective markets. Apple's cost sharing agreement was first put in

place in 1980, when Apple had revenue of \$117 million and the invention of the iPhone was decades into the future.

Companies commonly use cost sharing agreements for non-tax business purposes. These agreements were sanctioned by the US Congress in 1986 and are expressly authorized by US Treasury regulations.<sup>6</sup> Those rules acknowledge that R&D cost sharing agreements are common between unrelated parties. Accordingly, the regulations explicitly permit related parties, such as wholly-owned subsidiaries, to make use of such arrangements to grant licenses to share the rights to intellectual property that is co-developed under those agreements. By sharing the costs and benefits of R&D activities among domestic and international companies, these agreements allow US multinational companies like Apple to fund high-paying R&D jobs in this country.

Apple's cost sharing agreement is regularly audited by the IRS and complies fully with all applicable Treasury regulations. This agreement allows the Company to co-develop and share the risk of developing new products with its foreign subsidiaries. Under the agreement's terms, ASI and AOE, which are two of Apple's Irish operating companies, partially fund R&D costs incurred by Apple Inc. The share of R&D costs funded by the Irish subsidiaries is based on the relative share of revenue they earn outside the Americas from the intellectual property covered by the agreement. For example, in FY2012, approximately 61% of Apple's revenue was earned internationally, and ASI and AOE funded more than half of Apple's

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<sup>6</sup> H.R. Rep. 99-841, II-638 (1986); Treas. Reg. sec. 1.482-7. Final regulations addressing cost sharing arrangements were first issued in 1968. See 1968 Treas. Reg. sec. 1.482-2(d)(4), 33 Fed. Reg. 5848 (4/16/68). The US Treasury and IRS revised the cost sharing agreement provisions in final regulations in 1995 and 2011. See TD 8632, 60 Fed. Reg. 65553 (12/20/95); T.D. 95568 (12/16/2011, amend T.D. 9569 (12/19/2011)).

R&D costs. Apple Inc. does not deduct on its US tax return the R&D costs funded by ASI and AOE.

Apple's initial cost sharing agreement was executed in December 1980, when the Company selected Ireland as its principal base of operations for distributing products and servicing customers in western Europe. The cost sharing agreement afforded Apple the means to share the costs and risks of that market expansion with its Irish subsidiaries. In return, the Irish subsidiaries received a license to Apple Inc.'s intellectual property and the right to share in any profits that might result.

When Apple struggled financially and lost market share in the 1990s despite investments in new products and services, the Irish subsidiaries also lost money. The Irish subsidiaries had to fund a portion of Apple's R&D efforts, yet they were not realizing offsetting gains from the sale of Apple products in their markets. The Company almost ran out of cash and was on the verge of bankruptcy.

Eventually, Apple's R&D investments paid off. The R&D funded by Apple Inc., ASI and AOE fueled worldwide commercial success and growth. After paying their share of R&D expenses and bearing losses during some very lean years in the 1990s, Apple's Irish subsidiaries are now profiting from the cost sharing arrangement established three decades ago. This balance of risk and reward is precisely what was contemplated by the US Treasury regulations governing cost sharing agreements.

From a tax policy standpoint, cost sharing agreements play an important role in encouraging companies like Apple to keep R&D efforts – and the high-paying, income tax generating jobs associated with them – in the US. As an American multinational company, Apple is proud of its efforts to create American jobs. Its cost sharing arrangement enables the

Company to use revenues earned overseas to fund R&D in the US. Some commentators have urged eliminating these types of cost sharing agreements, but doing so would harm American workers and the broader US economy. If cost sharing agreements were no longer available, many US multinational companies would likely move high-paying American R&D jobs overseas.

B. Apple Operations International

AOI is a holding company that directly or indirectly holds shares in certain Apple foreign operating subsidiaries, including ASI and AOE. A holding company is a widely recognized corporate form under the laws of the US and foreign countries. Some of America's most successful companies, such as Procter & Gamble and Johnson & Johnson, operate as holding companies. AOI functions, as holding companies do, to exercise control over foreign operating subsidiaries on behalf of, and under the direction of, AOI's parent company, Apple Inc. AOI's proper observance of corporate formalities is consistent with this status, as is the appointment of US-based directors who are Apple Inc. employees. These employees act both as AOI directors and stewards for Apple Inc.'s ultimate 100% ownership interest in AOI.

AOI consolidates and manages a substantial portion of Apple's foreign, post-tax income through intercompany dividends. This consolidation creates economies of scale that allow AOI to obtain better rates of return with money management firms. The consolidation of funds into as few bank accounts as possible improves operational controls over cash held within and among other foreign subsidiaries. AOI allows Apple to efficiently redeploy funds to meet the needs of Apple's international operations. Using this structure, Apple's Irish subsidiaries have invested billions of dollars to fund customized tooling equipment used to manufacture Apple products.

The Irish subsidiary structure has also allowed the Company to transfer funds efficiently to construct retail stores in Europe and elsewhere.

AOI uses US-based investment advisors and banks to manage its financial assets. This reflects a prudent business decision regarding the benefits AOI can derive from these service providers. AOI's cash and investments are held in US banks and centrally managed to promote efficiency and offer the opportunity to earn higher returns, which are subject to US income tax. These assets are held in US dollars to mitigate the economic and accounting effects of foreign currency fluctuations. There are severe limitations, however, on Apple's use of these non-repatriated earnings. For example, Apple cannot use these funds to pay US employees, make capital investments in the US, repurchase shares or pay dividends.

AOI invests in US securities for many of the same reasons as other foreign companies: AOI deems these investments most suitable to accomplish its cash management goals of capital preservation and protection against currency fluctuations. US tax law does not interpret these investment-related activities as an indication of deemed repatriation or national corporate residency. Such an interpretation could have a negative impact on US advisors and banks. Foreign companies, for example, might decline to use US-based financial services firms out of concern that such activities would expose them to US taxation. For the same reason, foreign companies might decline to purchase US Government debt, raising the government's borrowing costs.

As Congress affirmed when it codified the economic substance doctrine in the Patient Protection and Affordable Care Act, taxpayers are free to use a domestic or foreign entity for purposes of conducting their foreign affairs.<sup>7</sup> AOI is incorporated in Ireland; thus, under US law,

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<sup>7</sup> See General Explanation of Tax Legislation Enacted in the 111th Congress, JCS-2-11, 379 (March 2011).

it is not tax resident in the US. AOI is also not tax resident in Ireland because it does not meet the fact-specific residency requirements of Irish law. This does not mean that AOI's income has not been subject to tax. AOI's dividend receipts consist of foreign, post-tax income, i.e., funds that have already been subject to tax in accordance with the laws of the countries where they were earned. AOI's investment income earned on its cash holdings is taxable to Apple Inc., because AOI is a CFC that is wholly owned by Apple Inc.<sup>8</sup>

It should be emphasized that AOI does not reduce Apple's tax bill in the US. If AOI did not exist, the funds it receives from other foreign subsidiaries through dividends would simply remain in the custody of those subsidiaries and would not be subject to US corporate income tax. However, without AOI, Apple would lose the considerable risk management and administrative benefits it provides for the Company's international operations.

C. Deferred Tax Liability

Some observers have suggested that Apple's recording of a US deferred tax liability for portions of its foreign, post-tax income reflects the Company's current plan for cash repatriation. This is incorrect. Apple reports this liability in accordance with a US accounting standard

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<sup>8</sup> Like AOI, ASI is incorporated in Ireland, is not tax resident in the US, and does not meet the requirements for tax residency in Ireland. ASI is an operating company with employees who manage the procurement and supply chain for Apple products sold abroad by ADI. Accordingly, ASI files an Irish corporate tax return and pays taxes in Ireland. ASI's investment income is taxed in the US on Apple Inc.'s tax return as Subpart F income. The fact that ASI is not tax resident in Ireland does not reduce Apple Inc.'s US tax liability.

known as APB 23. This recording of a US deferred tax liability provides no indication of the Company's intentions to repatriate foreign, post-tax income. Indeed, Apple has no current plans to repatriate these funds.

#### **IV. APPLE'S CAPITAL RETURN PROGRAM**

On April 23, 2013, Apple announced it would substantially increase the return of capital to shareholders. Under this program, Apple expects to return \$100 billion to its shareholders in less than three years through a combination of share repurchases and dividends. Apple will expend \$60 billion in the share repurchase program, making it the largest single share repurchase authorization in history. Apple's increased quarterly dividend of \$3.05 per share makes the Company among the largest dividend payers in the world, with annual payments to shareholders of about \$11 billion. Apple expects to fund the capital return program from existing US cash, future cash generated in the US and domestic borrowing.

Some observers have questioned Apple's decision to fund part of its return of capital by issuing \$17 billion in debt rather than repatriating some offshore funds. Apple respectfully suggests that any objective analysis will conclude that the Company's choice to issue debt, rather than repatriate foreign earnings, was in its shareholders' best interests. Indeed, the Company's largest investors and financial analysts urged Apple to engage in borrowing to add leverage to its capital structure.

If Apple had used its overseas cash to fund this return of capital, the funds would have been diminished by the very high corporate US tax rate of 35% (less applicable foreign credits). By contrast, given today's historically low interest rates, issuing debt at a cost of less than 2% is much more advantageous for the Company's shareholders. Because Apple was able to borrow at a cost lower than the cost of its equity, issuing debt lowered Apple's overall cost of capital.

Additionally, issuing debt served the interests of Apple's shareholders because the debt's interest rate is lower than the dividend yield on the Company's equity. Thus, for every debt-financed repurchase of a share of stock, the Company pays less in debt interest than it would have paid in a dividend to the holder of that share. The prudence of this decision has been ratified by the very positive response to Apple's announcement from the investors in its bond offering.

V. **APPLE SUPPORTS COMPREHENSIVE CORPORATE TAX REFORM**

Apple agrees with those in Congress who believe the current US corporate tax system must be reformed to reflect both the digital age and the globalization of commerce. The Company believes the current system, which applies industrial era concepts to a digital economy, actually undermines US competitiveness.

Apple has always believed in the simple, not the complex. This is evident in the Company's products and the way it conducts itself. In this spirit, Apple has recommended to the Obama Administration and several members of Congress – and suggests to the Subcommittee today – to pass legislation that dramatically simplifies the US corporate tax system. This comprehensive reform should:

- Be revenue neutral;
- Eliminate all corporate tax expenditures;
- Lower corporate income tax rates; and
- Implement a reasonable tax on foreign earnings that allows free movement of capital back to the US.

Apple recognizes these and other improvements in the US corporate tax system may increase the Company's taxes. Apple is not opposed to such a result if it occurs in the context of an overall improvement in efficiency, flexibility and competitiveness. Apple believes the changes it

proposes will stimulate the creation of American jobs, increase domestic investment and promote economic growth.

While some Subcommittee members may have differing views on these tax policy matters, Apple hopes the Subcommittee will see that these recommendations aim to create meaningful change and go well beyond what most US companies propose. As both a pioneer and participant in the American innovation economy, Apple looks forward to working with the Subcommittee on its efforts to encourage comprehensive reform of the US corporate tax system. Apple appreciates the opportunity to appear before the Subcommittee to contribute constructively to this important debate.

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**Written Testimony of Mark J. Mazur, Assistant Secretary for Tax Policy,  
U.S. Department of the Treasury  
Before the U.S. Senate Homeland Security and Government Affairs Permanent Subcommittee on  
Investigations  
Hearing on “The Shifting of Profits Offshore by U.S. Multinational Corporations”  
May 21, 2013**

Chairman Levin, Ranking Member McCain, and members of the Subcommittee, I appreciate the opportunity to testify on the issue of the potential shifting of profits offshore and between foreign countries by U.S. multinational corporations.

This is a multifaceted, complex subject that raises numerous tax policy issues as well as issues relating to tax administration and tax accounting. My testimony, however, will be limited to tax policy considerations.

**Potential Shifting of Profits Offshore by U.S. Multinational Corporations**

The geographic allocation of profits earned by multinational enterprises historically has been challenging and has become more difficult with the rise of globalization. To see the complexity, consider a stylized example:

- Employees at a U.S.-based firm come up with an idea for a new software application;
- They collaborate with a team of software engineers at a subsidiary in Country A to elaborate on the concept and develop the initial prototype;
- Employees at a subsidiary in Country B develop and test the Beta version and pilot it to a limited audience;
- Employees at a subsidiary in Country C modify the Beta version for commercial use;
- Software is distributed in the U.S., Europe, and Asia through company-owned cloud computing centers; while
- Employees at a subsidiary in Country D oversee all the contractual arrangements between the parties and also account for all the transactions between related and unrelated parties.

The question that arises is where the income from this product is earned. Presumably, some sliver of income should be attributed to each of the subsidiaries, but because all the steps were required to successfully market the product, the appropriate geographic allocation between the U.S. parent and each of the subsidiaries is not obvious.

However, the Internal Revenue Code (“Code”) requires that income be allocated to the various subsidiaries based on the “arm’s length” standard, which is essentially what unrelated parties would charge each other for the goods or services provided. But, when parties are related and where there is not a well-defined market, it may be problematic to determine the arm’s length prices that should prevail on these transactions. And with more cross-border transactions taking place between related parties, this issue has become bigger over the last few decades. It is important to realize that this is not just a U.S. problem. Virtually every country with a corporate income tax faces the challenge of determining what share of a global enterprise’s income is part of that country’s tax base. Pushing in the other direction are trends in tax planning and accounting where multinational enterprises are creating what some commentators have called “stateless income,” not subject to tax in the jurisdictions where the company is located and where it does business.<sup>1</sup>

<sup>1</sup> See, e.g., Edward D. Kleinbard, *The Lessons of Stateless Income*, 65 TAX L. REV. 99 (2011); Edward D. Kleinbard, *Throw Territorial Taxation from the Train*, 114 TAX NOTES 547 (Feb. 5, 2007).

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Multinational corporations are able under current law to shift profits offshore and between subsidiaries located in different countries using various organizational structures and transactions. In some cases, a U.S. company transfers rights to intangible property to an offshore affiliate. Such cross-border transfers of intangible property rights could occur in various contexts, including cost-sharing arrangements. Under a cost-sharing agreement, a U.S. multinational corporation enters into an agreement with one of its controlled foreign corporations (“CFCs”), typically in a low-tax jurisdiction, in which both companies agree to share the costs and benefits of the development of intangible property. The CFC is required to pay the U.S. parent an arm’s length amount for any existing intangible property or other resources it makes available for use in the shared research and development activities. Thereafter, the CFC contributes a percentage of the costs corresponding to its anticipated benefits from the intangible property to be developed (e.g., from the rights to exploit the intangible property in the CFC’s territory). Under established transfer pricing principles, because the CFC bears its share of development costs, the CFC is entitled to the returns from exploiting the intangible property in its territory, which, in some instances, may be significant. This may be the case even if the CFC employs few people and otherwise performs few functions beyond the cost contribution and acting as owner of the intangible property.

In theory, the upfront arm’s length payment for the intangible property originally contributed by the parent (reflecting the value of the property transferred), combined with the reduction in the parent’s U.S. tax deductions, should result in no anticipated risk-adjusted loss of tax revenue to the U.S. as compared to the case in which no cost-sharing agreement is entered into. However, there has been considerable controversy about whether this result is achieved in fact.

Further, some other U.S. tax rules (e.g., the “check-the-box” rules and the Subpart F CFC look-through rule) allow U.S.-based multinationals to redeploy profits earned by the CFC from exploiting the intangible property to related CFCs (or other customers/licensees) without incurring a U.S. level of income tax. Under U.S. tax rules, the profits of foreign corporations are not subject to U.S. income tax until the profits are repatriated to U.S. persons, unless the profits constitute Subpart F income (discussed below). The postponement of taxation until repatriation is commonly referred to as deferral.

In other transactions, profits of foreign subsidiaries may be shifted by assigning certain risks to a minimal-activity foreign affiliate in a lower-tax jurisdiction. Such an affiliate may be treated as a “principal” earning profit (in the form of a risk premium) with respect to ongoing activities that continue to be conducted by the “de-risked” transferor.

Additional ways that U.S. multinationals may shift profits include moving intangible property (and related profits) offshore through various transactions that may not result in recognized income for U.S. tax purposes. In general, transfers of intangible property by a U.S. person to a non-U.S. corporation would result in a deemed royalty to the U.S. transferor under Code Section 367(d) over the useful life of the property that is commensurate with the transferee’s income from the property. However, taxpayers sometimes take the position that this outcome does not apply to certain intangibles (such as workforce in place). In addition, taxpayers sometimes take the position that a disproportionate amount of intangible value represents foreign goodwill and going concern value (i.e., the value of a corporation to potential buyers as a continuing operation), which are explicitly carved out of the Section 367(d) regulations. Similarly, taxpayers sometimes take the position that foreign goodwill, going concern value, and workforce in place are not covered by the current definition of intangible property in the Code, so that their transfer is not subject to the arm’s length transfer pricing rules of Code Section 482.

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#### **Changes in U.S. Corporate Income Tax Rates**

Changes in U.S. corporate income rates – both in absolute terms and relative to the rates of our major trading partners – have changed the economic incentive for the shifting of profits. Before 1987, the U.S. maximum statutory corporate income tax rate was relatively high (between 46 percent and 53 percent from the 1950s through 1986) and roughly similar to those of other industrialized countries. The 1986 Tax Reform Act reduced U.S. income tax rates and broadened tax bases significantly and the maximum statutory corporate rate has remained at 34 percent or 35 percent since. Through the late 1990s, the U.S. corporate tax rate tended to be below the average for developed countries but since then, due to reductions in foreign corporate income tax rates, it has been above average and is now among the highest in the developed world.

A higher statutory rate can encourage companies to shift income and production to a lower-tax jurisdiction, especially in today's global marketplace. The immediate financial gain from shifting a dollar of income from one jurisdiction to another equals the difference in statutory income tax rates between the two locations. And while there may be costs to managing operations and earnings that have been shifted between jurisdictions, the multinational firm may still be better off from having done so. In addition, the statutory corporate income tax rate may also affect the decision to invest in one country rather than another, especially where the investments are independent and highly profitable.

#### **Accounting Treatment of Deferred Earnings**

U.S. multinationals are concerned not just about the tax treatment of their earnings but also about the financial accounting treatment. There is a presumption under U.S. Generally Accepted Accounting Principles (GAAP) that deferred income taxes should be recognized in the financial statements for the same period in which the earnings are generated because U.S. GAAP presumes that the foreign earnings will be remitted to the U.S.-based parent company at some point in time in order to distribute the earnings to shareholders. This presumption may be overcome if the firm develops sufficient evidence that the foreign entity has permanently invested or will permanently invest the earnings in the foreign jurisdiction. Accordingly, the deferral of earnings offshore not only offers a tax benefit (lower effective tax rate paid in the current accounting period) but may result in higher earnings for financial statement purposes (by presuming that the U.S. corporate income tax will never be paid on these "permanently" reinvested earnings). Thus, financial income reporting rules may add to the incentive to shift earnings.

#### **Revenue Loss from Profit Shifting**

Estimates of the potential revenue loss to the U.S. government from profit shifting cover a wide range, from \$10 - \$20 billion to well over \$80 billion per year. These estimates attempt to consider profit shifting from all sources, including non-arm's length transfer pricing on intercompany trade with affiliates, strategic location of debt, and transfers and location decisions involving intangibles. One prominent estimate showed a revenue loss to the Federal government of \$87 billion for 2002. This estimate included shifting by both U.S.-based multinationals and foreign-based multinationals operating in the United States.<sup>[2]</sup> Other estimates are lower, for example, one indicated a revenue loss of \$17.4

<sup>[2]</sup> Clausing, Kimberly A., "Multinational Firm Tax Avoidance and Tax Policy," *National Tax Journal*, Vol LXII, No. 4, December 2009, pp. 703-724. This estimate attributes the difference in profitability between U.S. multinational firms and their affiliates abroad to differences in the U.S. and host country tax rates and allocates the profit difference to the United States based on the share of affiliate transactions that occur with the United States relative to the share that occurs with affiliates in other countries. This approach does not take into account the myriad other factors that may affect differences in profitability.

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billion for U.S.-based companies in 2004, though this only attempted to measure the additional shifting that occurred in 2004 relative to that which occurred in 1999 and not total shifting.<sup>[3]</sup>

Author	Annual Tax Shift	Year of Estimate
Clausing (2009)	\$87 b	2002
Christian and Shultz (2005)	\$30 b	2001
Sullivan (2008)	\$17.4 b	2004

A different way to develop estimates of the magnitude of profit shifting involves estimating the potential revenue gain from adopting specific policies intended to restrict income-shifting opportunities. In this regard, the Joint Committee of Taxation estimated that the revenue gain from completely repealing deferral would be around \$11 billion in 2010.

One study of sales-based formulary apportionment approaches to allocating income to geographic locales estimates that its adoption would have raised \$50 billion in 2004.<sup>[4]</sup> However, that estimate does not incorporate all the behavioral responses by companies if formulary apportionment were implemented. A different analysis that attempts to simulate various behavioral responses concludes that formulary apportionment would raise no more revenue than the current system.<sup>[5]</sup>

All these estimates are necessarily based on a set of assumptions about behavior and profitability. For example, some studies assume that rates of return or profit margins in the United States and foreign locations would be the same if there were no income shifting. Others try to estimate statistical relationships between profitability in a country and tax differentials. And most of these studies are based on financial data published by the Commerce Department, not tax data. That said, these studies provide some insight into the potential magnitudes of profit shifting and the effect on Federal revenues.

#### Overview and History of the Subpart F Rules

The Subpart F rules attempt to prevent the shifting of income, either from the United States or from the foreign country in which it was earned, into a low- or no-tax jurisdiction. Thus, Subpart F generally targets both passive and mobile income. The Subpart F rules discourage the shifting of these types of income by disallowing deferral of U.S. taxation for such income and requiring current taxation. (In related party transactions, the shifting of income may be achieved more easily because a commonly controlled group of corporations can direct the flow of income between entities in different jurisdictions.)

The Subpart F rules are set forth in Code Sections 951-964 and apply to certain income of CFCs. The Code defines a CFC as a foreign corporation more than 50 percent of which, by vote or value, is owned by U.S. persons, each of whom owns a 10 percent or greater interest in the corporation by vote (each a "U.S. shareholder"). The term "U.S. persons" includes U.S. citizens or residents, domestic corporations, domestic partnerships, and domestic trusts and estates. If a CFC has Subpart F income, each U.S. shareholder must include its pro-rata share of that income in its gross income as a deemed dividend in the year the income was earned. Thus, this income is taxed at the U.S. tax rate in the year earned (that is, the tax on this income is not "deferred").

<sup>[3]</sup> Sullivan, Martin A., "U.S. Multinationals Shifting Profits Out of the United States," *Tax Notes*, March 10, 2008, pp. 1078-1082.

<sup>[4]</sup> Clausing, Kimberly A. and Reuven Avi-Yonah, *Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment*, Brookings Institution: The Hamilton Project, Discussion paper 2007-2008, June 2007.

<sup>[5]</sup> Altshuler, Rosanne and Harry Grubert, "Formula Apportionment: Is it Better Than the Current System and Are There Better Alternatives," *National Tax Journal*, forthcoming.

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Subpart F was enacted in 1962 during the Kennedy Administration. Key rationales for its enactment included preventing tax abuse, taxing passive income currently, promoting equity, promoting economic efficiency, and avoiding undue harm to the competitiveness of U.S. multinationals. While the Kennedy Administration proposal would have ended deferral for all income earned by foreign subsidiaries of U.S. taxpayers, Congress was concerned that ending deferral completely would place U.S. companies at a competitive disadvantage in their foreign operations. The enactment of Subpart F was a more modest step toward ending deferral, focused on the types of income that were viewed as more easily shifted.

The Subpart F rules have been modified since 1962. For example, in 1976, a new foreign base company shipping income category was added.<sup>161</sup> In 1982, a new category of foreign oil-related income was added. In 1986, many changes were made to the Subpart F rules, including the expansion of the foreign personal holding company income category to include income from commodities (unless derived in the active conduct of a qualifying commodities business), gains from the disposition of many types of property and certain foreign currency gains. In 1997, the foreign personal holding company income category was expanded to include income from notional principal contracts and substitute dividend payments. Additionally, a temporary exception for income derived from the active conduct of a banking, financing or insurance business was added after being removed 11 years earlier (and this exception has been extended multiple times, most recently in the American Taxpayer Relief Act of 2012). A look-through rule providing an exception to foreign personal holding company income for payment of dividends, interest, rents and royalties out of active earnings was added in 2006.<sup>171</sup>

Subpart F may, in some cases, not be doing what it was intended to do. It is possible for taxpayers to avoid some important provisions of Subpart F, due in part to the proliferation of hybrid entities and hybrid instruments. Hybrid entities are entities that are classified as flow-through entities in one jurisdiction (for example, the United States) and as corporations in another jurisdiction. Hybrid instruments are financial instruments that are treated as debt in one jurisdiction and as equity in another jurisdiction. Therefore, it is now possible in some cases to shift income to low- or no-tax jurisdictions and earn passive income in such jurisdictions without triggering Subpart F and having this income taxed in the U.S. as it is earned.

#### **The Check-the-Box Rules**

Several observers have noted that the proliferation of techniques involving hybrid entities has lessened the effectiveness of the current Subpart F regime. Although not the exclusive source of these planning techniques, the “check-the-box” entity classification regulations, which became effective January 1, 1997, have resulted in significantly increased use of hybrid entities. And while initially not aimed at foreign affiliates, these rules have been substantially used by multinational firms.

The availability of tax avoidance techniques involving hybrid entities did not originate with the check-the-box regulations. However, the check-the-box regulations exacerbated the problem in three significant ways. First, they eliminated the uncertainty associated with applying the existing test for entity classification. This reduced the costs and risks associated with hybrid arrangements and thus greatly facilitated their use. Second, they focused attention on the use of hybrid arrangements. The result was a considerable increase in design and marketing efforts among tax planners that introduced hybrid planning techniques to mainstream taxpayers. Finally, and perhaps most importantly, the check-the-box regulations facilitated the formation of a new type of entity (or non-entity): an entity “disregarded as an entity separate from its owner” (often referred to as a “disregarded entity”). The disregarded entity features prominently in a number of Subpart F tax planning techniques.

<sup>161</sup> The foreign base company shipping income category was repealed in 2004.

<sup>171</sup> For more information about the development of the Subpart F rules, see Treasury’s Policy Study: “The Deferral of Income Earned through U.S. Controlled Foreign Corporations” (December 2000).

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The Administration is concerned about the misuse of various income-shifting devices, including misuse of the check-the-box rules, to inappropriately avoid the Subpart F rules, and thus has proposed legislative changes to tighten rules and reduce incentives that encourage the shifting of investment and income overseas.

#### **Section 954(c)(6) Look-through Rule**

Congress enacted the so-called “look-through rules” under Section 954(c)(6) as part of the Tax Increase Prevention and Reconciliation Act of 2005. Section 954(c)(6) allows one CFC to make payments of dividends, interest, rents, and/or royalties to a related CFC without resulting in Subpart F income to the recipient CFC so long as the amounts are attributable to income of the payor CFC that is neither non-Subpart F income nor income effectively connected with the conduct of a U.S. trade or business. Section 954(c)(6) was intended to allow U.S. multinational corporations to redeploy their active foreign earnings without incurring a level of U.S. tax.

Section 954(c)(6) was enacted as a temporary provision effective for taxable years beginning after December 31, 2005, and before January 1, 2009. Since then, Section 954(c)(6) has been extended three times (most recently in the American Taxpayer Relief Act of 2012) and is currently in effect through taxable years beginning before January 1, 2014.

#### **Impact of the Check-the-Box Rules and Section 954(c)(6)**

The check-the-box rules and Section 954(c)(6) both result in a higher amount of earnings being eligible for deferral. Deferral encourages U.S. multinationals to keep earnings offshore.

The Treasury Department estimates that the U.S. revenue impact of these provisions is on the order of a few billion dollars per year, mainly because the provisions reduce the after-tax cost of foreign activity and therefore encourage such activity. The provisions also reduce repatriation of profits to the parent company, albeit with a higher U.S. residual tax rate for the funds that are repatriated. Absent these provisions, the shifting of profits from high- to low-tax foreign countries would occur less frequently and would incur greater costs. The United States generally would not directly receive significant additional revenue as a result of the profits not being shifted, but U.S. multinationals would pay higher foreign taxes through their foreign subsidiaries (and thus to the extent these earnings were repatriated, there would be a lower residual U.S. tax, after foreign tax credits).

#### **Administration Initiatives to Reduce the Shifting of Profits Offshore**

The President’s Framework for Business Tax Reform is intended to strengthen the international tax system. The proposals for reform take a multi-pronged approach that reduces incentives for companies to shift profits and investment to low-tax countries, puts the United States on a more level playing field with our international competitors, and helps slow (or perhaps end) the global race to the bottom on corporate tax rates. There is considerable debate as to how to reform the international tax system, but there appears to be common ground on this subject, including a shared concern about preserving the U.S. tax base by reducing incentives for the shifting of investment and income overseas and about making the United States a more attractive place to create and retain high-quality jobs.

The President’s Framework would impose a minimum rate of tax on the income earned by the foreign subsidiaries of U.S. multinationals. This would discourage companies from moving profits offshore. Foreign income otherwise subject to deferral in a low-tax jurisdiction would be subject to immediate taxation up to the minimum tax rate with a foreign tax credit allowed for income taxes on the income paid to the host jurisdiction. This minimum tax would be designed to provide a balance by limiting the

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opportunities to shift profits to lower-tax jurisdictions while also placing U.S. multinationals on a more level playing field with local competitors.

The President's Framework for Business Tax Reform also would incorporate many of the international tax proposals included in the President's FY 2014 Budget that would discourage U.S. multinationals from shifting profits (and specifically profits related to intangible property) offshore. Under one such proposal, a new category of Subpart F income would be added for excess profit returns from intangibles that have been transferred by a U.S. person to a related CFC. Specifically, this proposal provides that if a person transfers intangible property from the U.S. to a related foreign affiliate that is subject to a low foreign effective tax rate in circumstances evidencing excess income shifting, then the U.S. person must include in income currently the amount equal to the excessive return.

A second proposal would clarify the scope of intangible property that is subject to the deemed-royalty rules of Section 367(d) and the transfer pricing rules of Section 482 to include workforce in place, goodwill and going concern value. Another proposal addresses the concern that, under current law, a U.S. business can borrow money and invest overseas and take a current deduction for the interest related to overseas investment, even though the U.S. business may pay little or no U.S. taxes on the income from the overseas investment. The Administration's proposal would eliminate this tax advantage by requiring that the deduction for interest expense attributable to the overseas investment be matched with the income it is supporting (that is the deduction for interest expense would be delayed until the related income is taxed in the U.S.).

Furthermore, the Treasury Department and the Internal Revenue Service (IRS) have issued regulations and other guidance to discourage the shifting of profits offshore. In 2008, the Treasury Department and the IRS issued comprehensive temporary regulations under Section 482 pertaining to cost-sharing arrangements. These temporary regulations, which became effective on January 5, 2009, and were finalized in 2011, clarified a number of contentious issues and better defined the scope of intangible property transfers and contributions that require compensation. Early anecdotal information indicates that the regulations have had a positive impact on taxpayers' reporting positions. As an important complement to the cost sharing regulations, in 2009, the Treasury Department and the IRS also finalized regulations covering service transactions, including services performed using high value intangibles.

Additionally, the Treasury Department and the IRS have recently issued regulations under Section 909 that limit the use of foreign tax credits in situations in which foreign taxes are inappropriately separated from (and taken into account in advance of) the underlying foreign income with respect to which the foreign taxes were paid. The regulations defer the ability to claim a foreign tax credit for foreign taxes until the related income is taxed in the United States. The Treasury Department and the IRS have also issued regulations under Section 367(a)(5) that make it more difficult to move earnings offshore in tax-free reorganization transactions, and Notice 2012-39 reduced incentives to move intangible property offshore as part of a tax-free repatriation strategy.

Finally, the Treasury Department supports the efforts of the Organisation for Economic Co-Operation and Development (OECD) to analyze these profit-shifting issues and is actively participating in the OECD's projects to address these issues, including the project analyzing Base Erosion and Profit Shifting. This important multilateral effort is evidence that governments around the world are wrestling with these difficult issues and trying to find ways to address inappropriate profit-shifting.

Thank you, and I look forward to answering your questions.

**WRITTEN TESTIMONY  
OF  
SAMUEL M. MARUCA  
DIRECTOR, TRANSFER PRICING OPERATIONS  
INTERNAL REVENUE SERVICE  
BEFORE THE  
SENATE COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL  
AFFAIRS  
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS  
HEARING ON  
THE SHIFTING OF PROFITS OFFSHORE BY U.S. MULTINATIONAL  
CORPORATIONS  
MAY 21, 2013**

**INTRODUCTION**

Chairman Levin, Ranking Member McCain, and members of the Subcommittee, thank you for the opportunity to testify on tax compliance and administration issues related to the shifting of profits offshore by U.S. multinational corporations.

The IRS takes very seriously the need to ensure that U.S. multinational corporations are abiding by U.S. tax laws and paying their fair share of tax. Over the last few years, we have been working to enhance our approach to international tax enforcement in general and to offshore profit shifting in particular. We have been refocusing our enforcement efforts to be more strategic by viewing taxpayers through the prism of their tax planning strategies and allocating our limited resources to cases presenting the highest compliance risk.

In implementing this new approach, we began from the premise that we need to determine where companies are using legitimate strategies to manage global tax exposure and where they may be pushing the envelope too far. Thus, we have been aligning our resources and training our employees in key strategic areas such as income shifting, deferral planning, foreign tax credit management, and accessing profits accumulated offshore through repatriation transactions.

To better manage our collective knowledge in strategic international compliance areas, we have formed 18 International Practice Networks, which are focused on integrating our training and data management with our strategy. We have also established a new International Practice Service, which will serve as a central repository for the knowledge and expertise of our international staff. For example, in the income shifting area, an international practice network is in the process of developing 25 different training and job aid tools, and over 400 international staff members have been participating in regular network calls devoted to income shifting topics.

As the IRS works to address tax avoidance issues involving multinationals, it is also important that we continue to work with other countries. At the multilateral level, the IRS

and the Treasury Department are active participants in the Organisation for Economic Co-Operation and Development, where we are currently participating in several major guidance projects. The goal is to develop a coordinated and comprehensive action plan to update international tax rules to reflect modern business practices while preventing inappropriate cross-border profit-shifting.

## CURRENT ISSUES IN TAXATION OF U.S. MULTINATIONALS

The IRS' enforcement authority in regard to profit shifting by U.S. multinational corporations arises primarily from section 482 of the Internal Revenue Code, under which the IRS is charged with ensuring that taxpayers report the results of transactions between related parties as if those transactions had occurred between unrelated parties. Under the section 482 regulations, as well as under multinational transfer pricing guidelines, the determination of whether the pricing of a transaction reflects an arm's length result is generally evaluated under the so-called "comparability standard." Under this standard, the results of the transaction as reported by the taxpayer are compared to results that would occur between by unrelated taxpayers in comparable transactions under comparable circumstances.

Establishing an appropriate arm's length price by reference to comparable transactions is relatively straightforward for the vast majority of cross-border transactions involving transfers of goods or services. But enforcing the arm's length standard becomes much more difficult in situations in which a U.S. company shifts to an offshore affiliate the rights to intangible property that is at the very heart of its business – what may be referred to as the company's "core intangibles." In fact, over the past decade, applying section 482 in these types of cases has been the IRS' most significant international enforcement challenge.

When the rights to the core intangibles of a business are shifted offshore, enforcement of the arm's length standard is challenging for two reasons:

- First, transfers of a company's core intangibles outside of a corporate group rarely occur in the market, so comparable transactions are difficult, if not impossible, to find. In some cases the IRS has had to resort to other valuation methods, which are often referred to as "income-based methods." Under these types of methods, the IRS typically has to conduct an *ex ante* discounted cash flow analysis. This means that we are required to evaluate the projections of anticipated cash flows that the taxpayer used in setting its intercompany price; then we must further evaluate how the taxpayer discounted those projected cash flows to compensate for the risk associated with earning them. The challenge here is that evaluating the underlying assumptions made by the taxpayer, without benefit of hindsight, is not an exact science.
- Second, a business's core intangible property rights are by their nature very "risky" assets. So projecting cash flows from these assets and the appropriate

discount rate requires an inherently challenging assessment of the underlying risk and how, and by which party, that risk is borne. These can be difficult assessments to make, at least in some cases.

Outbound international tax planning involves not only shifting profits to low-tax jurisdictions, but also managing exposure to the Code's anti-deferral provisions under subpart F. Subpart F requires U.S. shareholders of controlled foreign corporations (CFCs) to include currently in income for U.S. tax purposes their pro rata share of certain of the CFC's income – including dividends, interest, rents, royalties, and income from certain sales and services transactions. However, because subpart F contains many exceptions, careful planning allows companies to avoid subpart F inclusions and even to enhance income shifting to low-tax jurisdictions.

Commonly, a company's strategy involves the making of deductible payments from foreign affiliates operating in high-tax jurisdictions to affiliates organized in low-tax jurisdictions. For example, if a low-tax affiliate lends to a high-tax affiliate, the interest expense related to that loan offsets the higher taxes imposed on the affiliate paying the interest, and the interest income received by the recipient affiliate is subject to a low, or zero, rate of tax. Under the original framework of the subpart F regime, the interest or royalty income received by the low-tax affiliate would constitute subpart F income and therefore would be taxable to the U.S. parent of the multinational group. Taxpayers, however, have long been able currently to avoid subpart F through various techniques.

For example, avoidance of subpart F on foreign-to-foreign deductible payments was facilitated with the issuance of the check-the-box regulations in 1997. Under these regulations, an eligible business entity can elect its classification for federal tax purposes. Of particular note, the check-the-box regulations provide that an eligible foreign entity with a single owner can be treated as "disregarded" as a separate entity and therefore taxed as a branch for U.S. purposes. As a result, deductible payments – such as interest and royalties – paid between the disregarded entity and its owner (or between two disregarded entities with the same owner) are ignored for U.S. tax purposes and avoid subpart F treatment. Importantly, these payments continue to be regarded for foreign tax purposes and thus reduce taxable income in the high-tax foreign jurisdiction.

Today, taxpayers can also rely on the so-called "CFC look-through rule" under section 954(c)(6) to avoid subpart F treatment on deductible payments without resorting to the check-the-box regulations. This rule excludes from subpart F income dividends, interest, rents, and royalties paid by one foreign affiliate to another affiliate, to the extent the payment is out of non-subpart F earnings of the payor.

Once profit is shifted to a low-tax foreign affiliate, and subpart F is avoided, U.S. multinationals will seek to repatriate offshore cash to the United States with minimal tax consequences. Simply dividending the cash to a U.S. affiliate will result in U.S. taxation at a 35-percent rate, reduced by a credit for any foreign tax imposed on the earnings. So U.S. multinationals seek ways to repatriate cash through sophisticated structures they assert do not result in dividend treatment. This is another area in which we are dedicating enforcement resources to ensure that these transactions are treated appropriately.

**IRS ACTIONS TO IMPROVE TAX COMPLIANCE BY MULTINATIONALS*****Transfer Pricing***

The IRS' approach to the income shifting challenge is evolving. In the early 2000s, the IRS formed teams of experts known as issue management teams, or IMTs, to focus on transfer pricing and related business practices. These teams were made up of IRS transfer pricing specialists and Chief Counsel attorneys, led by IRS industry executives, and centrally managed the "inventory" of examinations involving transactions in these respective areas. The teams ensured that IRS resources were appropriately dedicated to these examinations, that best practices and processes were shared, and that the IRS position on the underlying issues was applied uniformly to cases under similar facts and circumstances.

In 2011, a new IRS executive position was created to oversee all transfer pricing-related functions, to set an overall strategy in the area, and to coordinate work on our most important cases. Further, in building a new function devoted exclusively to tackling our transfer pricing challenges, we recruited dozens of transfer pricing experts and economists with substantial private sector experience to help us stay on the cutting edge of enforcement and issue resolution.

Transfer Pricing Operations is divided into two parts. First is the Transfer Pricing Practice, which collaborates with other international personnel and industry groups to identify strategic work in the transfer pricing area and ensure appropriate development and presentation of cases with strategic merit. Second is the Advanced Pricing and Mutual Agreement program (APMA), which was created a year ago through the merger of our Mutual Agreement and Advanced Pricing Agreement programs. These new functions operate as a unified team with a global focus, a unified strategy, and a robust knowledge base.

***Cost Sharing***

The IRS has worked with the Treasury Department over the last several years to adopt revised regulations on cost sharing. In 2008, new section 482 regulations pertaining to cost sharing transactions were issued. These temporary regulations were effective on January 5, 2009, and were finalized in 2011. They clarify a number of issues that had been contentious under the previous set of cost sharing regulations and better define the scope of intangible property contributions that are subject to taxation in connection with cross-border business restructurings. While to date the IRS has had limited experience in auditing transactions covered by the new cost sharing regulations, early anecdotal information indicates that the regulations have had a positive impact on taxpayers' reporting positions in the area.

However, concerns remain that we are considering and following closely. Some taxpayers are taking the position that a cost sharing arrangement, or other transaction

taxable under section 482, has been preceded, either explicitly or implicitly, by an incorporation or reorganization transfer of core intangibles. In these cases, the taxpayers assert, among other positions, that foreign goodwill and going concern value are the most valuable elements in these transfers. In response, we are now training our agents to address these issues and to challenge taxpayers' positions where appropriate.

### ***Repatriation of Earnings***

Focusing on the repatriation area, Treasury and the IRS over the past six years have issued several anti-abuse notices – one as recently as July 2012 – making clear that a variety of transaction types give rise to inappropriate repatriation results. In several of these cases, Treasury and the IRS have already followed up with regulatory changes necessary to make clear what the appropriate results should be.

In general, these transactions were designed to take advantage of mechanical rules which are scattered through the Code and regulations, and which pertain to determinations of either tax basis or earnings and profits. These rules were not written with repatriation in mind, and the transactions in which the rules have been used may not look like repatriation transactions at first blush – so they can be difficult to find. But we are finding them and where we have, we have acted quickly.

As to specific repatriation strategies being challenged by the IRS, these often involve foreign affiliates entering into various transactions with their U.S. parent that result in the parent receiving cash, notes or other property from the affiliates. Taxpayers assert that these transactions do not result in a dividend or gain to the U.S. parent corporation under various corporate non-recognition provisions. Examples of these transactions include so-called “Killer B” transactions, “Deadly D” transactions, zero-basis structures, and outbound F reorganizations. While these types of transactions have been addressed by new regulations, for pre-effective date periods the IRS has challenged many of them under common law doctrines and will continue to do so.

Taxpayers have also attempted to avoid dividend treatment by manipulating the amount and timing of a foreign subsidiary's earnings and profits. The IRS has challenged these types of transactions under existing law and has had some success. For example, in *Falkoff v. Commissioner*, the Seventh Circuit Court of Appeals reversed a Tax Court holding that a corporation's distribution in advance of recognizing earnings had economic substance.

Moreover, taxpayers may be able to offset residual U.S. tax on foreign earnings by using foreign tax credits. For example, taxpayers have implemented so-called “splitter” transactions to free up foreign tax credits for use to offset U.S. tax on repatriated low-taxed earnings. The IRS has challenged such transactions, under both the applicable provisions of the Code and underlying regulations and various judicial doctrines. Further, legislation enacted in 2010, *i.e.*, section 909, and the regulations published thereunder in 2012, should put a stop to many of these transactions.

Foreign corporations also enter into various repatriation transactions that are disguised loans to their U.S. parent corporation. Taxpayers assert that these transactions are not subject to section 956 and therefore do not result in income inclusion to the U.S. parent. The IRS has challenged, and will continue to challenge, these types of transactions under the applicable provisions of the Code and regulations, and under various judicial doctrines such as the doctrine of substance over form. For example, in *Merck & Co. Inc.* the Third Circuit Court of Appeals held that interest rate swaps entered into with foreign subsidiaries constituted a disguised loan subject to section 956.

Further, to address abusive short-term loan transactions like the one highlighted by this Subcommittee in the past, we developed and delivered specialized training for our employees on these issues. In April 2013, we conducted a three-hour online training session focusing on section 956, which was attended by more than 250 international examiners. This training session, which remains available online to all international employees, covers the general anti-deferral rules under section 956, as well as the exception for short-term loans, avoidance planning techniques, and audit techniques. We are also developing detailed job aid tools related to the section 956 short-term loan exception and the techniques being used to exploit it.

#### ***Casework: Examinations and Litigation***

The IRS has been, and continues to be, vigilant and forceful in addressing compliance issues we have seen in regard to U.S. multinationals. Based on a recent survey, as of May 9, 2013, we estimate that we are currently considering income shifting issues associated with approximately 250 taxpayers involving approximately \$68 billion in potential adjustments to income.

As for litigation in the income shifting area, the IRS has challenged approximately 34 transfer pricing issues involving 15 taxpayers in 22 U.S. Tax Court cases over the past three years. Of those 22 cases, the IRS litigated and lost two: *Xilinx v. Commissioner*, 125 T.C. 37 (2005), *aff'd*, 598 F.3d 1191 (9th Cir. 2010), and *Veritas v. Commissioner*, 133 T.C. No. 14 (2009). In *Xilinx*, the IRS included stock-based compensation as a cost to be shared in a cost sharing arrangement. Unfortunately, the court did not sustain the government's position. In *Veritas*, the IRS challenged the taxpayer's buy-in amount under the cost-sharing arrangement by applying an income method. In this case as well, the court rejected the government's approach and sustained the taxpayer's buy-in amount with some adjustments.

#### **CONCLUSION**

Mr. Chairman, Ranking Member McCain, thank you again for this opportunity to testify on the IRS' efforts to enforce the tax law as it applies to U.S. multinational corporations. Although enforcing and administering this section of the tax law will present challenges for the IRS into the future, the agency has made great strides in recent years, and this is a tribute to strategic focus and to the highly dedicated and professional men and women of the IRS. I would be happy to answer any questions you have.

**MEMORANDUM**

TO: Members of the Permanent Subcommittee on Investigations

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

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

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/asp/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. Urquidí, 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.asaecenter.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.

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<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(e).

### 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. On January 1, 1997, without any statutory basis, Treasury issued the check-the-box regulations. 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 December 31, 2012.

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:

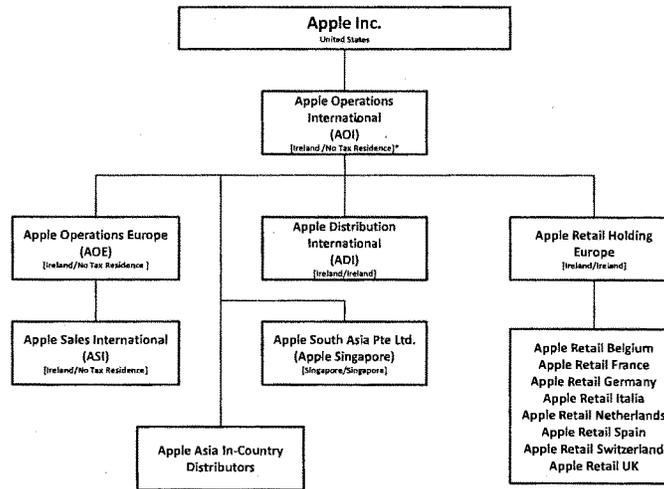
<sup>69</sup> 4/23/2013 Apple Second Quarter Earnings Call, Fiscal Year 2013, <http://www.nasdaq.com/aspx/call-transcript.aspx?StoryId=1364041&Title=apple-s-ceo-discusses-f2q13-results-earnings-call-transcript>.

<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-hundreds of one percent (0.05%):

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

	2011	2010	2009	Total
<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.

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<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).

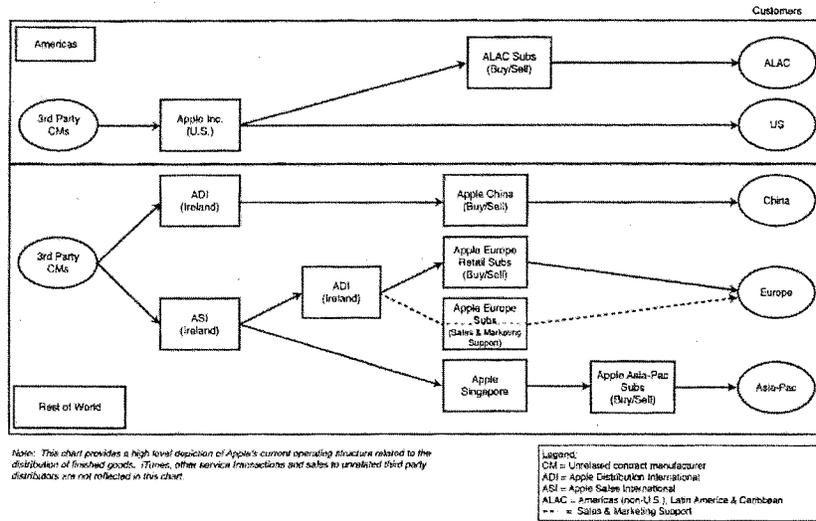
<sup>109</sup> Information supplied to Subcommittee by Apple, APL-PSI-000129.

<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.

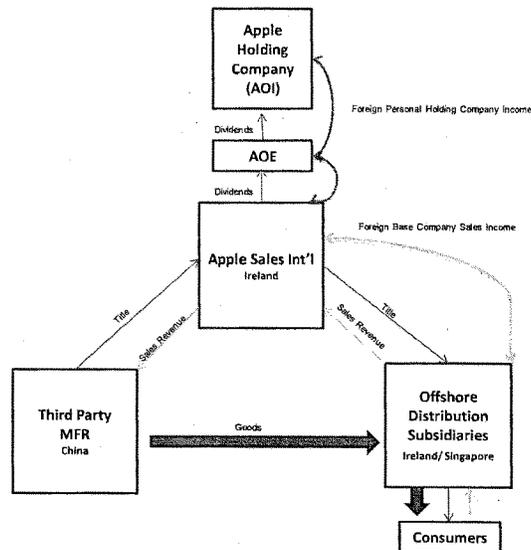
In 2009, Apple Inc, ASI and AOE entered into another Cost Sharing agreement which replaced the one signed in 2008. Mr. Oppenheimer, the CFO of Apple Inc. and a director of both ASI and AOE, was the signatory on behalf of Apple Inc. Two other Apple Inc employees signed as directors of ASI and AOE. See 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(e).

### 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

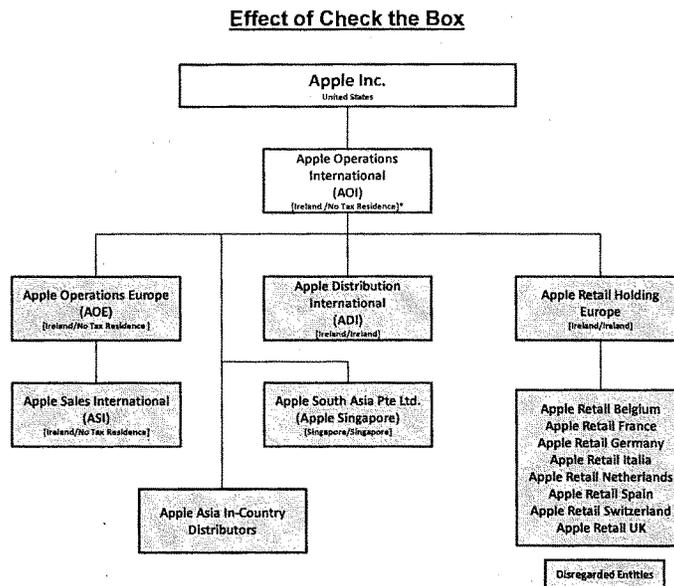
These figures indicate that, in two years alone, from 2011 to 2012, Apple Inc. used the check-the-box loophole to avoid paying \$12.5 billion in U.S. taxes or about \$17 million per day.

<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 apply, 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 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 (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**

Form (in millions of dollars)	FY2009	FY2010	FY2011
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>	<b>\$ 1.4 billion</b>	<b>\$ 2.6 billion</b>	<b>\$ 4.4 billion</b>

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.

# # #

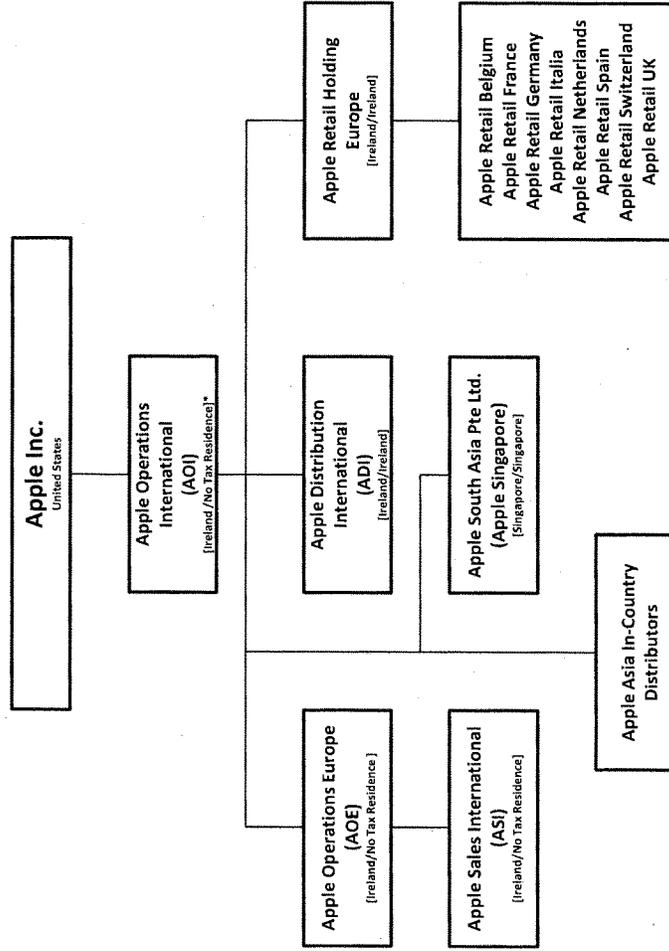
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<sup>150</sup> Information supplied to Subcommittee by Apple, PSI-Apple-02-0004.

<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).

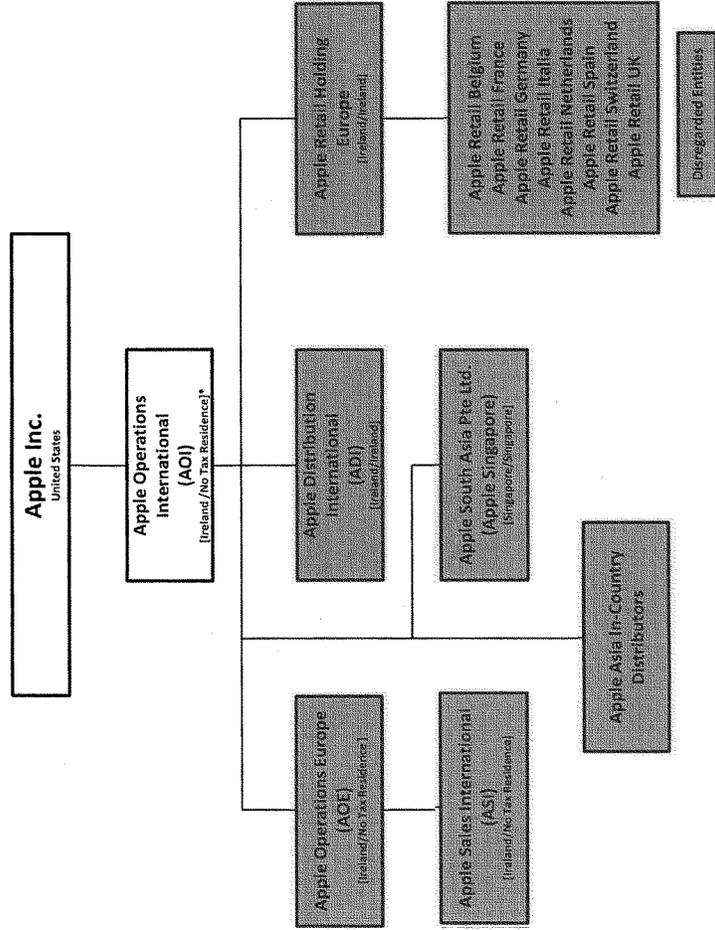
**Apple's Offshore Organizational Structure**



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

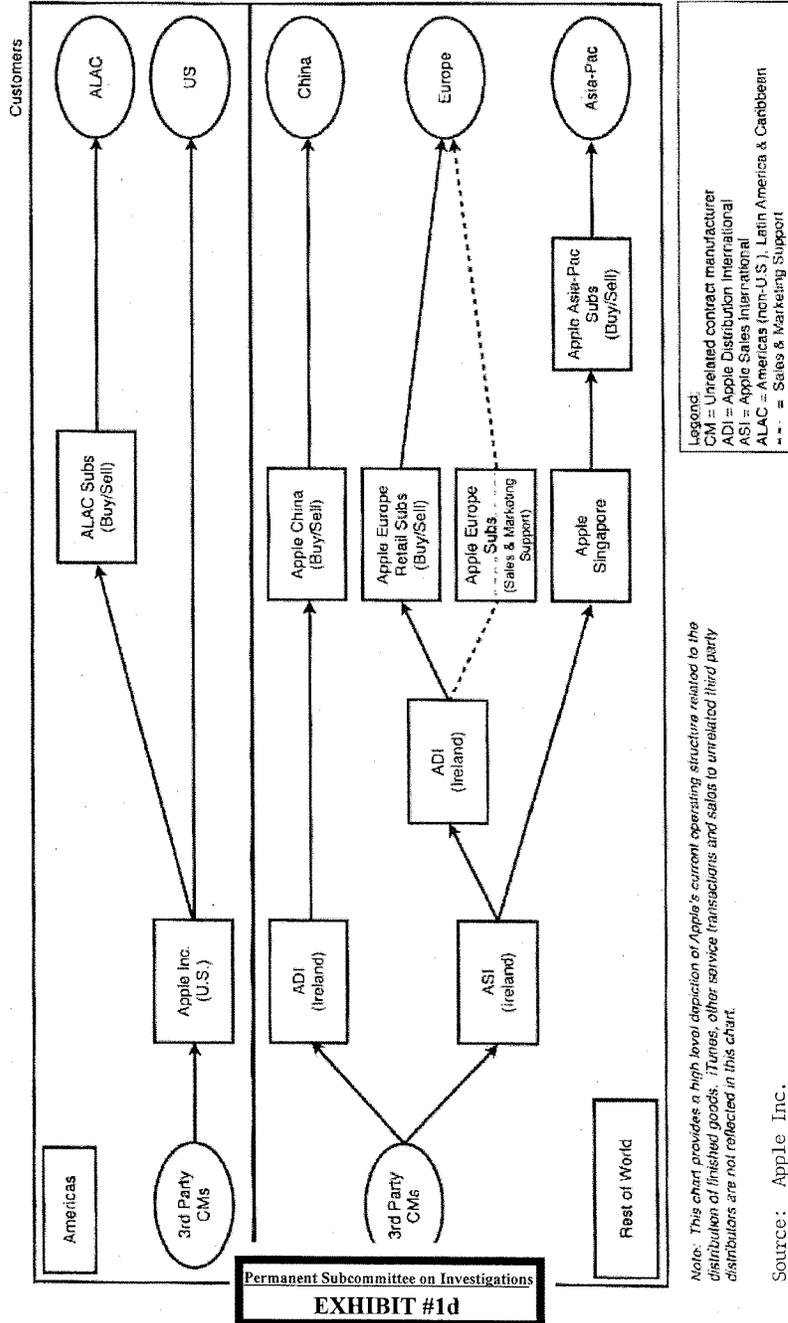
Prepared by the Permanent Subcommittee on Investigations, May 2013. Source: Materials received from Apple Inc.

**Effect of Check the Box**



\* 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.

**APPLE'S CURRENT OPERATING STRUCTURE**



Permanent Subcommittee on Investigations  
**EXHIBIT #1d**

**Cost Sharing Payments and Earnings of Apple Sales International (Ireland)**

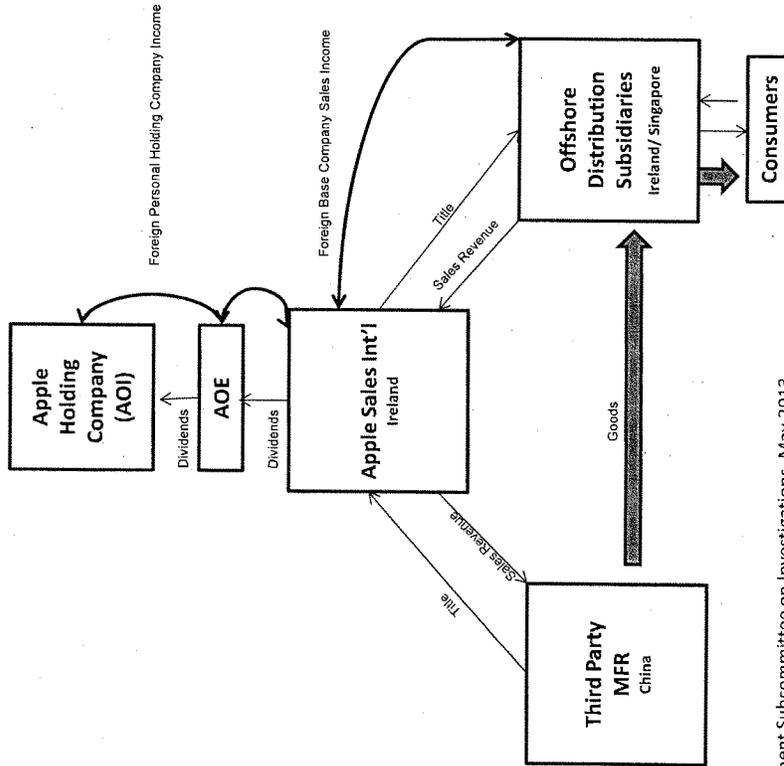
	<b>Cost Sharing Payments By ASI</b>	<b>Earnings of ASI</b>
2009	\$ 600 million	\$ 4 billion
2010	\$ 900 million	\$ 12 billion
2011	\$ 1.4 billion	\$ 22 billion
2012	\$ 2.0 billion	\$ 36 billion
<b>TOTAL</b>	<b>\$ 4.9 billion</b>	<b>\$ 74 billion</b>

**Cost Sharing Payments and Earnings of Apple Inc. (United States)**

	<b>Cost Sharing Payments By Apple Inc.</b>	<b>Earnings of Apple Inc.</b>
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>

Prepared by the Permanent Subcommittee on Investigations, May 2013.  
 Source: Information supplied to the Subcommittee by Apple, APL-PSI-000129, 000381-384.

### Apple's Offshore Distribution Structure



Permanent Subcommittee on Investigations  
**EXHIBIT #1f**

Prepared by the Permanent Subcommittee on Investigations, May 2013.

## Global Distribution of Apple's Earnings

Country	2011 Pre-Tax Income		2010 Pre-Tax Income		2009 Pre-Tax Income	
	\$ billions	%	\$ billions	%	\$ billions	%
Apple Inc.	\$ 10.7	31	\$ 5.3	29	\$ 3.4	43
Apple Sales International	\$ 22.0	64	\$ 12.1	65	\$ 4	50
Other	\$ 1.5	5*	\$ 1.1	6	\$ 0.6	7*
Total	\$ 34.2	100	\$ 18.5	100	\$ 8	100

Source: Consolidating Financial Information supplied by Apple to the Subcommittee.

\* Figure calculated based on Apple Inc. & ASI rounded results.

Prepared by the Permanent Subcommittee on Investigations, May 2013.

## Apple Operations International's Profits as a Share of Worldwide Profits

	Apple Operations International	Worldwide
2012	\$ 15.4 billion	\$ 42 billion
2011	\$ 6.3 billion	\$ 26 billion
2010	\$ 8.1 billion	\$ 14 billion
2009	\$ 110 million	\$ 6 billion
<b>Total</b>	<b>\$ 29.9 billion</b>	<b>\$ 88 billion</b>
<b>AOI's share of Worldwide Income:</b>		<b>34%</b>

Source: Information provided to the Subcommittee by Apple, APL-PSI-000386.

Prepared by the Permanent Subcommittee on Investigations, May 2013.

## Global Taxes Paid by Apple Sales International 2009-2011

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

Source: Information provided to the Subcommittee by Apple.

Permanent Subcommittee on Investigations

**EXHIBIT #1i**

Prepared by the Permanent Subcommittee on Investigations, May 2013.

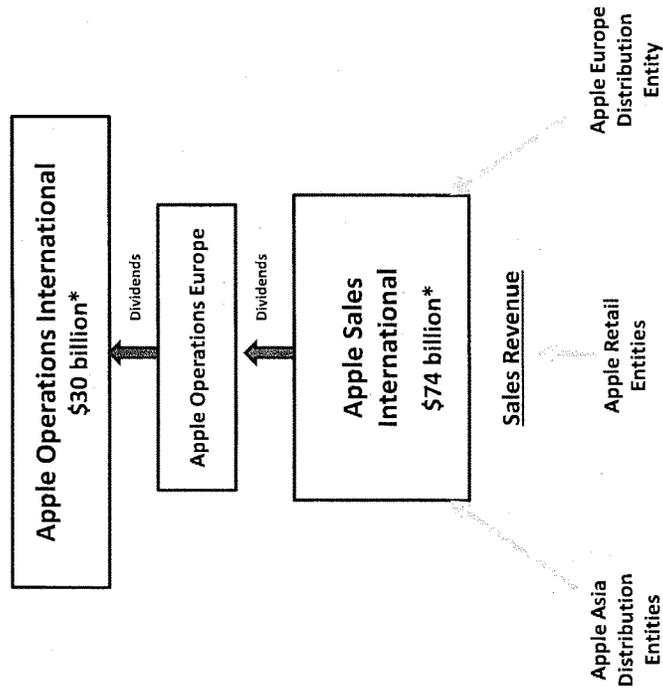
## Taxes Avoided by Apple Using Check The Box

	Foreign Base Company Sales Income	Total Tax Avoided	Tax Avoided Per Day
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 provided to the Subcommittee by Apple, APL-PSI-000386.

Permanent Subcommittee on Investigations  
**EXHIBIT #1j**

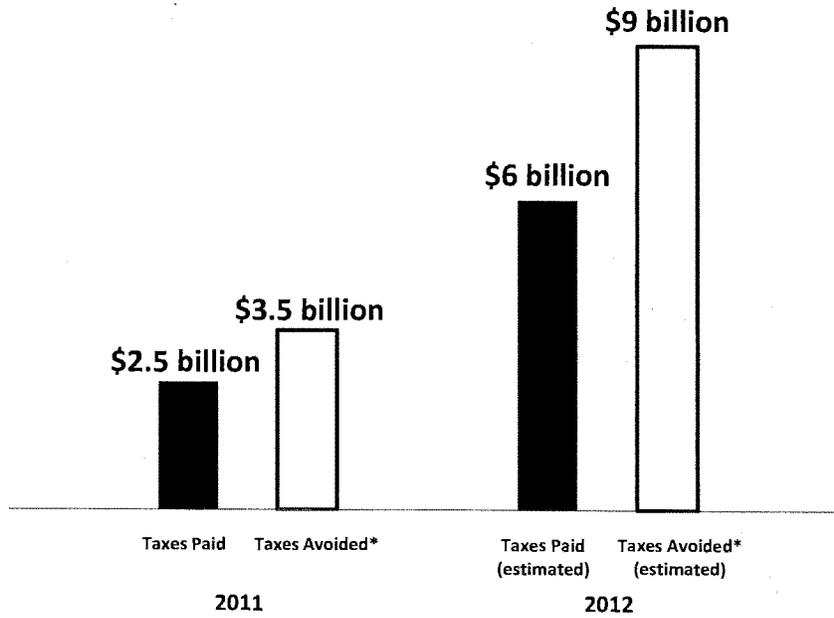
# Apple's Non-Tax Resident Entities



Permanent Subcommittee on Investigations  
**EXHIBIT #1k**

\* Income reported from 2009 to 2012  
Prepared by the Permanent Subcommittee on Investigations, May 2013. Source: Materials received from Apple Inc.

### Apple: Avoiding Billions in U.S. Taxes



\* U.S. taxes were avoided using the Check the Box Loophole  
Prepared by the Permanent Subcommittee on Investigations, May 2013. Source: Materials received from Apple Inc.

203

AMENDED & RESTATED

COST SHARING AGREEMENT

Between

APPLE INC.

APPLE OPERATIONS EUROPE

&

APPLE SALES INTERNATIONAL

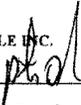
Confidential Proprietary Business Information  
Produced Pursuant to Senate Rule XX

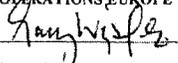
Permanent Subcommittee on Investigations

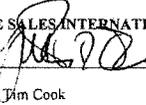
EXHIBIT #2

APL-PSI-000020

PSI-Apple-02-0028

APPLE INC.  
By:   
Name: Peter Oppenheimer  
Title: Senior Vice President & Chief  
Financial Officer  
Date: MAY 22, 2008

APPLE OPERATIONS EUROPE  
By:   
Name: Gary Wipfler  
Title: Director  
Date: May 22, 2008

APPLE SALES INTERNATIONAL  
By:   
Name: Jim Cook  
Title: Director  
Date: MAY 23, 2008

**AMENDED AND RESTATED AGREEMENT TO SHARE COSTS AND RISKS  
OF INTANGIBLES DEVELOPMENT  
(GRANDFATHERED COST SHARING ARRANGEMENT)**

This AMENDED AND RESTATED AGREEMENT TO SHARE COSTS AND RISKS OF INTANGIBLES DEVELOPMENT ("Agreement") is entered into effective as of January 5, 2009 ("Effective Date") by and between:

**Apple Inc.**, a company organized and existing under the laws of California, U.S.A., with its principal place of business located at 1 Infinite Loop, Cupertino, California 95014, U.S.A. ("Apple"),

and

**Apple Operations Europe ("AOE")**, a company organized under the Irish Companies Act with a branch registered under the Singapore Companies Act, Cap. 50, to do business in Singapore and having a place of business at 7 Ang Mo Kio Street 64, Singapore 2056, and a branch doing business in Ireland at Hollyhill Industrial Estate, Hollyhill Cork, Ireland; and

**Apple Sales International ("ASI")**, a company organized under the Irish Companies Act doing business in Ireland at Hollyhill Industrial Estate, Hollyhill Cork, Ireland.

(Apple, AOE, and ASI are collectively referred to as the "Parties" and individually referred to as "Party")

**RECITALS**

- A. Apple is the parent company of the Apple corporate group. Apple indirectly owns all of the shares of Apple Operations International ("AOI"), a company organized in Ireland. AOI in turn wholly owns AOE, which in turn wholly owns ASI.
- B. Each of AOE and ASI has, respectively, elected to be classified as a disregarded entity of AOI for U.S. federal income tax purposes under United States Treasury Regulation (hereinafter referred to as "Treas. Reg.") § 301.7701-3(a).
- C. Apple, AOE and ASI are engaged in the business of developing, manufacturing, or having manufactured, marketing and distributing the "Products" listed in Section 1.14.
- D. The Parties have previously entered into a qualified cost sharing arrangement in accordance with former Treas. Reg. § 1.482-7, effective as of September 30, 2007 (the "FY 2008 Cost Sharing Agreement"). The FY 2008 Cost Sharing Agreement amended and restated a qualified cost sharing arrangement in accordance with former Treas. Reg. § 1.482-7 that the Parties entered into, effective as of September 26, 1999, as amended effective as of September 28, 2003 (the "FY 2000 Cost Sharing Agreement (as amended)").

1

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Permanent Subcommittee on Investigations

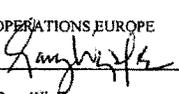
**EXHIBIT #3**

APL-PSI-000035

PSI-Apple-02-0043

IN WITNESS WHEREOF, the Parties have caused this Agreement to be executed by their duly authorized representatives effective as of the Effective Date.

APPLE INC.  
By:   
Name: Peter Oppenheimer  
Title: Senior Vice President & Chief Financial Officer  
Date: June 25, 2009

APPLE OPERATIONS EUROPE  
By:   
Name: Gary Wipfler  
Title: Director  
Date: June 25, 2009

APPLE SALES INTERNATIONAL  
By:   
Name: Joe Allen  
Title: Director  
Date: 25 JUNE 2009



■ Business Advisors  
Stapleton House  
89 South Mall  
Cork  
Ireland

■ Telephone: (021) 4277116  
Fax: (021) 4272465  
www.ey.com/ireland

September 15, 2004

Inspector of Taxes  
Large Cases Division  
Healthcare, ICT and Manufacturing  
Government Offices  
Sullivans Quay  
Cork

Attn: Tom Connor

**Re: Apple Computer Inc Ltd**

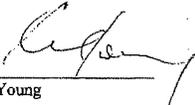
*Our ref: GM/A64/03*

Dear Sir,

We refer to your letter of September 13. The company is a non-resident holding company and is non-trading. In the circumstances there is nothing to return from the corporation tax standpoint.

If you require any further information, please let us know.

Yours truly,

  
Ernst & Young

joc

■ J Bellard, N Byrne, S Cassidy, D Clarke, J Hefczman, P Hendhan,  
E Kelly, K Keany, F Kerr, M O'Connor, E O'Doherty, J O'Leary,  
D O'Neill, D O'Sullivan, J Ryan, PC Smith, D Smyth, J Somers.

The Irish firm Ernst & Young is a Member Practice of Ernst & Young Global. It is authorized by the Institute of Chartered Accountants in Ireland to carry on investment business in the Republic of Ireland.



**Revenue** 

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Office of the Revenue Commissioners  
Large Cases Division  
Healthcare, ICT and Manufacturing  
Government Offices  
Sullivans Quay  
Cork, Ireland

Oifig na gCoimisiúnairí Ioncaim  
Rannán na gCásanna Móra  
Cúram Sláinte, TCE agus Diántaisíocht  
Oifigí an Rialtais  
Port Uí Shúilleabháin  
Corcaigh, Éire

**M/s Ernst & Young  
Stapleton House  
89 South Mall  
Cork**

13 September 2004

*Re: Apple Computer Inc Ltd*

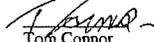
*Your Ref: GM/A 64/03*

Dear Sir/Madam

I note from my records the above company has not submitted any Corporation Tax returns.  
Could you let me know if the company is trading and if you intend to submit tax returns.

If you wish to contact me please telephone (021) 4325323.

Yours faithfully

  
Tom Connor  
For District Manager

Tel 021 4966077 Ext 72323 Fax 021 4325485 Direct Line 021 4325323

Apple Confidential - Need to Know  
 Appendix A: Apple Operations International - 2008-2012 Shareholder Meetings

Meeting Date	Meeting Location	Attendees* (Entity represented)	County of Residence	Employer/Title
<b>FY 2005</b>				
10-Jan-08	Cupertino, CA	Peter Oppenheimer (Apple Inc.) Gene Levart (Bladown)	United States	Apple Inc., SVP, CFO Apple Inc., Director, Corporate Law
16-Jul-08	Cupertino, CA	Peter Oppenheimer (Apple Inc.) Gene Levart (Bladown)	United States	Apple Inc., SVP, CFO Apple Inc., Director, Corporate Law
<b>FY 2009</b>				
3-Aug-09	Cupertino, CA	Peter Oppenheimer (Apple Inc.) Gene Levart (Bladown)	United States	Apple Inc., SVP, CFO Apple Inc., Director, Corporate Law
<b>FY 2010</b>				
23-Jul-10	Cupertino, CA	Peter Oppenheimer (Apple Inc.) Gene Levart (Bladown)	United States	Apple Inc., SVP, CFO Apple Inc., Director, Corporate Law
<b>FY 2011</b>				
27-Jun-11	Cupertino, CA	Audrey Fernandez-Ellson (Apple Inc.) Gene Levart (Bladown)	United States	Apple Inc., Senior Corporate Counsel Apple Inc., Director, Corporate Law
<b>FY 2012</b>				
17-Jul-12	Cupertino, CA	Gene Levart (Apple Inc.) Tim Sheahan (Apple (UK) Limited)	United States	Apple Inc., Director, Corporate Law Apple Inc., Senior Corporate Counsel

\* Meeting attendance was in person, unless otherwise noted.

APL-PSI-000340

Confidential Proprietary Business Information  
 Produced Pursuant to Senate Rules XXVI(5)(b)(5)

Excerpt from June 22, 2012 information supplied by Apple to the Permanent Subcommittee on Investigations.

Questions from PSI May 14th Tax Call

**1. What percent of Apple's overall revenues are booked in each of its Irish entities and what is the total revenue for each entity?**

Of the \$108.25 billion of Net Sales reported on Apple Inc.'s Form 10-K for Period Ending September 24, 2011, approximately \$26.06 billion of worldwide Net Sales was recorded by Apple Sales International.

Apple Sales International was the only Irish entity with third party sales.

**2. What is the breakdown of employees for each Irish entity, by headcount, total compensation, percent of worldwide headcount, and percent of worldwide compensation?**

Apple's Irish headcount is provided in the table below. The table provides the Apple Irish headcount as a percentage of Apple's worldwide headcount. Additionally, we have provided Apple's Irish headcount as a percentage of Apple's worldwide headcount excluding Apple retail store employees as a meaningful comparison of functional headcount since Apple currently has no Apple retail stores in Ireland.

	Headcount (as of May 19, 2012)		
	Headcount	% of WW Headcount	
		Total	Excluding Retail Store Employees
Apple Distribution International	2,091	2.7%	6.7%
Apple Operations Europe	363	0.5%	1.2%
Apple Sales International	250	0.3%	0.8%
Apple Sales Ireland	5	0.0%	0.0%
Apple Operations	5	0.0%	0.0%
Apple Operations International <sup>†</sup>	0	0.0%	0.0%
Apple Retail Europe Holding <sup>†</sup>	0	0.0%	0.0%
<b>Total Irish Headcount</b>	<b>2,714</b>	<b>3.5%</b>	<b>8.7%</b>

<sup>†</sup> Note: Apple Operations International and Apple Retail Europe Holding are holding companies

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Permanent Subcommittee on Investigations

**EXHIBIT #6**

1  
PSI-Apple-02-0002

— = Redacted by the Permanent Subcommittee on Investigations

Total Compensation* (Est. Through FY2012)		
	Amount (in millions)	% of WW Total
Total Irish Compensation	██████████	2.1%

\* Note: Apple does not forecast compensation at an entity level and therefore a breakdown of the total compensation by Irish entity is not readily available.

**3. Please identify the board members, corporate officers, and shareholders for each Irish entity, as well as Baldwin Holdings, including any corporations that may hold these positions.**

The following table identifies the Board Members and Corporate Officers of Apple's Irish entities as well as Baldwin Holdings Unlimited as of May 19, 2012:

Entity	Board Members	Corporate Officers
Apple Sales International	Cathy Kearney (Director) Gene Levoff (Director, Secretary) Elizabeth Rafael (Director) Mark Stevens (Director)	Gene Levoff (Secretary)
Apple Operations Europe	Cathy Kearney (Director) Gene Levoff (Director, Secretary) Gary Wipfler (Director)	Gene Levoff (Secretary)
Apple Distribution International	Cathy Kearney (Director) Gene Levoff (Director, Secretary) Michael O'Sullivan (Director)	Gene Levoff (Secretary)
Apple Sales Ireland	Cathy Kearney (Director) Gene Levoff (Secretary) Michael O'Sullivan (Director)	Gene Levoff (Secretary)
Apple Operations	Cathy Kearney (Director) Gene Levoff (Director, Secretary) Michael O'Sullivan (Director)	Gene Levoff (Secretary)
Apple Operations International	Cathy Kearney (Director) Gene Levoff (Director, Secretary) Gary Wipfler (Director)	Gene Levoff (Secretary)
Apple Retail Europe Holding	Cathy Kearney (Director) Jerome Maume (Secretary) Michael O'Sullivan (Director)	Jerome Maume (Secretary)
Baldwin Holdings Unlimited	Peter Oppenheimer (Director)	N/A

The following table identifies the shareholders for each of Apple's Irish entities as well as Baldwin Holdings Unlimited as of May 19, 2012:

Entity	Shareholders
Apple Sales International	Apple Operations Europe Apple Operations International Baldwin Holdings Unlimited
Apple Operations Europe	Apple Operations International Baldwin Holdings Unlimited
Apple Distribution International	Apple Operations International Apple Sales International Baldwin Holdings Unlimited
Apple Sales Ireland	Apple Operations Europe Apple Operations International Baldwin Holdings Unlimited
Apple Operations	Apple Operations International Baldwin Holdings Unlimited
Apple Operations International	Apple Inc. Apple (UK) Limited Baldwin Holdings Unlimited
Apple Retail Europe Holding	Apple Operations International Baldwin Holdings Unlimited
Baldwin Holdings Unlimited	Apple Inc.

#### 4. What factors contribute to Apple's 4% effective tax rate in Ireland?

Due to Ireland's overall attractive business environment, Apple has operated in Cork, Ireland since the 1980's and continues to use Ireland as its principal base of operations in Europe, including for some manufacturing and logistics; sales, accounting and finance; after sales support; and other functions. Apple has grown its operations in Ireland to include approximately 2,700 employees and recently announced Apple's intention to add 500 new jobs to the Cork facility and expand Apple's campus with an additional owned building.

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, and this is the primary factor that contributes to Apple's rate. The rate has varied from year to year, but since 2003 has been 2% or less. This result is similar to incentives made available by many U.S. states and other countries to entice investment in their jurisdictions.

**5. Since 2003, what is the total amount of dividends paid to Apple Operations International by other entities, by year?**

<u>Fiscal Year</u>	<u>Amount of Dividends</u>
2004	\$ 8,444,194
2005	\$ 0
2006	\$ 1,269,328,781
2007	\$ 57,033,000
2008	\$ 0
2009	\$ 101,477,000
2010	\$ 8,082,328,428
2011	\$ 6,381,029,926
Total	\$ 15,899,641,329

**6. Since 2003, what is Apple's total amount of interest earnings subject to Subpart F taxation, by year?**

The Subpart F income reported on Apple's federal income tax return included the following amounts:

<u>Fiscal Year</u>	<u>Interest Earnings</u>	<u>Other Earnings<sup>#</sup></u>	<u>Total</u>
2004			
2005			
2006			
2007			
2008			
2009			
2010			
2011			
Total	\$1,532,279,622	\$ 58,979,835	\$1,591,259,457

<sup>#</sup>Note: The Other Earnings reported on Apple's federal income tax return as Subpart F Income consisted of other Foreign Personal Holding Company Income derived from Apple's foreign currency management, bank fees and other miscellaneous income and expense.

**7. Since 2003, please list any other earnings subject to Subpart F taxation, by year.**

See the response to question 6 above.

**— = Redacted by the Permanent Subcommittee on Investigations**

Excerpt from July 6, 2012 information supplied by Apple to the Permanent Subcommittee on Investigations.

US Senate Permanent Subcommittee on Investigations

June 1, 2012 Questionnaire

1. Please provide your corporate legal name and address and the name, address, telephone number and e-mail address of the individual who will serve as our primary contact and who can answer questions about your questionnaire responses.

**Apple Legal Name/Address:** Apple Inc.  
1 Infinite Loop  
Cupertino, CA 95014

**Apple Primary Contact:** Catherine A. Novelli  
Vice President, Worldwide Government Affairs  
901 15<sup>th</sup> Street, NW Suite 1000  
Washington, DC 20005  
Phone: (202) 772-9505  
Email: cnovelli@apple.com

2. Please provide an organizational chart depicting your company's worldwide legal and operational structure, including related offshore entities. In addition, please identify all of your company's offshore headquarters.

Please find attached in Appendix A, an organizational chart which depicts Apple's worldwide legal ownership structure, and a high level operational structure chart for the distribution of finished goods. Apple does not have offshore headquarters companies, but its principal offshore trading activities take place in Ireland through Apple Distribution International and in Singapore through Apple South Asia Pte. Ltd.

For responses to the questions below, to the extent that the request calls for financial information, please provide information for each of your fiscal years 2009, 2010, and 2011. Please submit information only for the years for which the requested information has not already been provided to the Subcommittee.

For purposes of Apple's responses hereafter, references to fiscal years 2009, 2010, and 2011 shall mean years ending September 26, 2009, September 25, 2010, and September 24, 2011, respectively.

3. What percentage amount of your company's world-wide revenues were:  
a. booked or recorded in the U.S.?

<u>FY2009</u>	<u>FY2010</u>	<u>FY2011</u>
52%	44%	39%

- b. booked or recorded outside the U.S.?

<u>FY2009</u>	<u>FY2010</u>	<u>FY2011</u>
48%	56%	61%

- c. from sales to customers located in the U.S.?

<u>FY2009</u>	<u>FY2010</u>	<u>FY2011</u>
52%	44%	39%

Permanent Subcommittee on Investigations  
**EXHIBIT #7**

Appendix C  
Apple Non-US Subsidiaries  
as of Sept 24, 2011 (FY11)

Subsidiary's Name	CFC	IF CFC, Controlling entity	Incorporation Date	Incorporating Jurisdiction	Subsidiary's Headquarters	Location for Tax Purposes
Apple Distribution International	No		5/11/09	Ireland	Hollyhill Industrial Estate, Hollyhill, Cork, Ireland	Ireland

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Appendix C  
APL-PSI-000088

**Appendix C**  
**Apple Non-US Subsidiaries**  
as of Sept 24, 2011 (FY11)

Subsidiary's Name	CFC	If CFC Controlling entity	Incorporation Date	Incorporating Jurisdiction	Subsidiary's Headquarters	Location for Tax Purposes
Apple Operations	No		12/8/10	Ireland	Hollyhill Industrial Estate, Hollyhill, Cork, Ireland	Ireland
Apple Operations Europe	No		8/5/80	Ireland	Hollyhill Industrial Estate, Hollyhill, Cork, Ireland	Ireland

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Appendix C  
Apple Non-US Subsidiaries  
as of Sept 24, 2011 (FY11)

Subsidiary's Name	CFC	If CFC Controlling entity	Incorporation Date	Incorporating Jurisdiction	Subsidiary's Headquarters	Location for Tax Purposes
Apple Operations International	Yes	Apple Inc. (U.S.)	8/6/80	Ireland	Hollyhill Industrial Estate, Hollyhill, Cork, Ireland	

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**Appendix C**  
**Apple Non-US Subsidiaries**  
as of Sept 24, 2011 (FY11)

Subsidiary's Name	CFC	IF CFC, Controlling entity	Incorporation Date	Incorporating Jurisdiction	Subsidiary's Headquarters	Location for Tax Purposes
Apple Sales International	No		4/4/90	Ireland	Hollyhill Industrial Estate, Hollyhill, Cork, Ireland	Ireland
Apple Sales Ireland	No		12/17/81	Ireland	Hollyhill Industrial Estate, Hollyhill, Cork, Ireland	Ireland
Baldwin Holdings Unlimited	Yes	Apple Inc. (U.S.)	9/27/06	Virgin Islands, British	Tricar Services (BV) Limited, Box 3340, Road Town, Tortola, Virgin Islands, British	Virgin Islands, British

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**Apple Non-US Subsidiaries**  
As of FY2009, 2010 and 2011  
Appendix D

Subsidiary Name	Number of Employees			(in \$ millions) Compensation	
	FY2009	FY2010	FY2011	FY2009	FY2010
Apple (UK) Limited	263	285	309		
	87	105	160		
	115	113	410		
	78	94	117		
	1,036	1,575	2,283		
	0	0	0		
	29	37	38		
	465	200	294		
	0	0	0		
	0	4	8		
	0	0	0		
Apple Distribution International	91	229	491		
	296	352	384		
	155	167	180		
	14	18	20		
	206	233	252		
	0	0	0		
	0	4	10		
	39	71	92		
	69	94	105		
	2	2	2		
	792	869	1,060		
	32	34	46		
	7	9	6		
	74	91	110		
	28	38	46		
	n/a	2	11		
	34	15	8		
	n/a	n/a	0		
Apple Operations Europe	1,572	2,326	2,452		

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**Apple Non-US Subsidiaries**  
As of FY2009, 2010 and 2011  
Appendix D

Subsidiary's Name	Number of Employees			(In \$ millions) Compensation		
	FY2009	FY2010	FY2011	FY2009	FY2010	FY2011

Apple Operations International

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Apple Sales International	0	0	0	0	0	0
Apple Sales Ireland	7	6	6	1	1	2

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Baldwin Holdings Unlimited	0	0	0	0	0	0
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APL-FSI-000104



**Appendix E**  
**Apple Non-US Subsidiaries**  
as of Sept 24, 2011 (FY11)

Subsidiary's Name	US Tax Classification	Foreign Tax Classification	"Check-the-Box" or "Look-Through Rule" relied upon to reduce FPHI
Apple (UK) Limited	Disregarded Entity	Corporation	N/A
Apple Asia Limited	Disregarded Entity	Corporation	N/A
<b>Redacted by the Permanent Subcommittee on Investigations</b>			
Apple Computer Trading (Shanghai) Co. Ltd.	Disregarded Entity	Corporation	N/A
Apple Computer UK Partners	Disregarded Entity	Corporation	N/A
<b>Redacted by the Permanent Subcommittee on Investigations</b>			
Apple Holding B.V.	Disregarded Entity	Corporation	N/A
Apple Japan G.K.	Disregarded Entity	Corporation	N/A
Apple Japan, Inc.	Disregarded Entity	Corporation	N/A
<b>Redacted by the Permanent Subcommittee on Investigations</b>			

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Appendix E  
APL-PSI-000106

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**Appendix E**  
**Apple Non-US Subsidiaries**  
as of Sept 24, 2011 (FY11)

Subsidiary's Name	US Tax Classification	Foreign Tax Classification	"Check-the-Box" or "Look-Through Rule" relied upon to reduce FPHCI
Apple Netherlands BV	Disregarded Entity	Corporation	N/A
Apple Operations Europe	Disregarded Entity	Corporation	N/A
Apple Operations International	Corporation	Corporation	Yes
[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Apple Pty Limited	Disregarded Entity	Corporation	Yes
Apple Retail Belgium BVBA	Disregarded Entity	Corporation	N/A
Apple Retail Europe Holding	Disregarded Entity	Corporation	N/A
Apple Retail France E.U.R.L.	Disregarded Entity	Corporation	N/A
Apple Retail Germany GmbH	Disregarded Entity	Corporation	N/A
Apple Retail Italia S.R.L.	Disregarded Entity	Corporation	N/A
Apple Retail Netherlands B.V.	Disregarded Entity	Corporation	N/A
Apple Retail Spain, S.L.	Disregarded Entity	Corporation	N/A
Apple Retail Switzerland GmbH	Disregarded Entity	Corporation	N/A
Apple Retail UK Limited	Disregarded Entity	Corporation	N/A
Apple Sales International	Disregarded Entity	Corporation	N/A
Apple Sales Ireland	Disregarded Entity	Corporation	N/A
Apple Sales New Zealand	Disregarded Entity	Corporation	N/A

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Appendix E  
Apple Non-US Subsidiaries  
as of Sept 24, 2011 (FY11)

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Subsidiary's Name	US Tax Classification	Foreign Tax Classification	"Check-the-Box" or "Look-Through Rule" relied upon to reduce FPHCI
Apple South Asia Pte. Ltd.	Disregarded Entity	Corporation	N/A
Baldwin Holdings Unlimited	Corporation	Corporation	N/A

**Appendix J**  
**Cash Reserves and Amounts Paid to Top 5 non-U.S. Subsidiaries**  
*(in millions of US\$)*

Top 5 non-U.S. Subsidiaries	Reasons funds paid to the Top 5 non-U.S. Subsidiaries	Amount excluded due to check-the-box/look-through #
<b>FY2009</b>		
Apple Sales International	Intercompany sales, services, and loans	\$ 1,281
Apple Operations Europe	Intercompany sales and services	\$ 135
Apple Operations International	Intercompany dividends	\$ 78
Apple Asia Limited	Intercompany services	\$ 10
Apple South Asia Pte Ltd	Intercompany sales and services	\$ 41
<b>FY2010</b>		
Apple Sales International	Intercompany sales, services and loans	\$ 5,552
Apple Operations International	Intercompany dividends	\$ 8,082
Apple Asia Limited	Intercompany services	\$ 8
Apple South Asia Pte Ltd.	Intercompany sales and services	\$ 134
FileMaker International	Intercompany sales	\$ -
<b>FY2011</b>		
Apple Sales International	Intercompany sales, services and loans	\$ 11,092
Apple Operations International	Intercompany dividends	\$ 6,381
Apple Distribution International	Intercompany sales	\$ 2,356
Apple Asia Limited	Intercompany services	\$ 10
Apple South Asia Pte Ltd.	Intercompany sales and services	\$ 240

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\* The amounts received represent approximate balances as the payments and receipts of funds may have been netted for administrative convenience.  
 # The amount identified as excluded due to check-the-box or look-through represents the gross sales margin or other intercompany amounts received. Such amounts have not been adjusted for certain allocable expenses. As such, these amounts do not represent the subpart F income that might have been associated with the identified intercompany transactions.

Excerpt from September 10, 2012 & January 11, 2013 information supplied by Apple to the Permanent Subcommittee on Investigations.

**U.S. Senate Permanent Subcommittee on Investigations**

**Follow Up Question Dated September 03, 2012**

1. For the fiscal years 2009, 2010, and 2011, please provide a breakdown of any research and development expenses attributed to any entity participating in such activity.

Apple Inc., Apple Sales International ("ASI"), and Apple Operations Europe ("AOE") participate in a long-standing R&D cost sharing arrangement pursuant to which each participant bears expenses based on their respective geographic territories. Pursuant to your request for additional information, we provide the following supplemental information:

*(in millions of US\$)*

	<b>FY2009</b>	<b>FY2010</b>	<b>FY2011</b>
Apple Inc./Filemaker (US)	737	867	1,031
ASI/AOE (Ireland)	596	915	1,397
Total Worldwide R&D Expense*	1,333	1,782	2,428

*Notes:*

- \* R&D expense under U.S. Generally Accepted Accounting Principles ("GAAP").

Apple

	Legal Name	FY09	FY10	FY11
US	Apple Inc. (includes Apple Value Services, LLC)	1,248,754	1,696,046	2,302,764
US		5,738	5,575	8,312
US		0	-86	-118
US		17,489	17,825	18,627
US		2,517	2,331	2,707
	Apple Operations Europe	18,832	12,064	17,164
	Apple Sales International	0	0	13,707

**Subcommittee Note:**  
 This table provides a break out of aggregate numbers listed on page APL-PSI-000129

Total GAAP R&D	1,332,662	1,781,893	2,428,374
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APL-PSI-000133

Excerpt from September 12, 2012 information supplied by Apple to the Permanent Subcommittee on Investigations.

Apple Operations International - 2009-2011 Minutes

Meeting Date	Description	Meeting Location	Attendees	Title	Employer
2009 21-Sep-09	Minutes of a Meeting of the Board of Directors	Cupertino, CA	Peter Oppenheimer Gary Wipfler	SVP, CFO VP & Treasurer	Apple Inc.
2010 23-Jul-10	Minutes of a Meeting of the Board of Directors	Cupertino, CA	Peter Oppenheimer Gary Wipfler	SVP, CFO VP & Treasurer	Apple Inc.
15-Sep-10	Minutes of a Meeting of the Board of Directors	Cupertino, CA	Peter Oppenheimer Gary Wipfler	SVP, CFO VP & Treasurer	Apple Inc.
23-Sep-10	Minutes of a Meeting of the Board of Directors	Cupertino, CA	Peter Oppenheimer Gary Wipfler	SVP, CFO VP & Treasurer	Apple Inc.
26-Oct-10	Minutes of a Meeting of the Board of Directors	Cupertino, CA	Peter Oppenheimer Gary Wipfler	SVP, CFO VP & Treasurer	Apple Inc.
2011 7-Sep-11	Minutes of a Meeting of the Board of Directors	Cupertino, CA	Gene Lavoff Gary Wipfler	Director, Corporate Law VP & Treasurer	Apple Inc.

Permanent Subcommittee on Investigations  
EXHIBIT #9

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App. 4  
APL-PSI-000323

Excerpt from January 11 & 18, 2013 information supplied by Apple to the Permanent Subcommittee on Investigations.

Entity	Shareholders	Percentage Ownership
Apple Sales International	Apple Operations Europe Apple Operations International Baldwin Holdings Unlimited	> 99.99% <.001% <.001%
Apple Operations Europe	Apple Operations International Baldwin Holdings Unlimited	>99.99% <.001%
Apple Distribution International	Apple Operations International Apple Sales International Baldwin Holdings Unlimited	90.253% 9.657% 0.09%
Apple Sales Ireland	Apple Operations Europe Apple Operations International Baldwin Holdings Unlimited	>99.99% <.001% <.001%
Apple Operations	Apple Operations International Baldwin Holdings Unlimited	99.9% 0.1%
Apple Operations International	Apple Inc. Apple (UK) Limited Baldwin Holdings Unlimited	96.418% 3.581% .001%
Apple Retail Europe Holding	Apple Operations International Baldwin Holdings Unlimited	>99.99% <.001%

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8. Please confirm whether Irish corporation rules require second nominee shareholders such as Baldwin to be located in a foreign jurisdiction.

Certain Irish Corporation principles require companies to have a second shareholder that is located outside of the European Union.

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- d. **If not, what were the factors and reasons cited as being the basis for that determination?**
- e. **Did Apple make a request or make any initial inquiries about granting AOI such a status before Ireland made its decision?**
- f. **If so, please describe the circumstances surrounding Apple's actions regarding this matter.**
- g. **Please identify the reasons why Apple believes that AOI should not be designated as a tax resident and why that determination was reached?**

Apple Operations International is an Irish incorporated holding company whose primary purpose is to hold shares of Apple international subsidiaries. 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. Although we are not aware whether the Irish government has made a specific determination regarding the tax residency of AOI, it has not challenged Apple's determination.

12. **Has any jurisdiction determined or declared that AOI is tax resident in its or any other jurisdiction?**

Not to the best of our knowledge. However, AOI had a taxable presence in France from Tax Years 1987 to 2007. See response to Question 14.

- a. **If so please identify the jurisdictions which have made such a determination, where Apple has been determined to be tax resident and the reason for the determination(s).**

N/A

13. **If Apple has not declared AOI to be tax resident in any jurisdiction, please explain why.**

As described above, it was determined that AOI is not a tax resident of Ireland notwithstanding that Ireland is its country of incorporation. The determination of tax residency is to be conducted on a country by country basis, applying the residency tests and requirements as determined under applicable local laws. Apple does not believe that AOI qualifies as a tax resident of any other country under the applicable local laws.

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14. Has AOI ever filed a corporate income tax return with the national government of any jurisdiction? If so, please identify the jurisdiction, the year the return was filed, and the amount of income reported on the return.

AOI filed corporate income tax returns in France for Tax Years 1987-2007. During those years, AOI owned a building in France from which it earned rental income. AOI sold the building in Tax Year 2007. Taxable income for Tax Years 1994-2007 is provided below. Data relating to Tax Years 1987-1993 is not readily available.

Year Return Filed	Taxable Income (FF to TY01) (EUR from TY02)
FY94	2,444,298
FY95	2,490,621
FY96	18,005,739
FY97	1,809,054
FY98	350,806
FY99	258,984
FY00	1,107,191
FY01	760,778
FY02	105,360
FY03	128,753
FY04	200,891
FY05	115,339
FY06	187,185
FY07	5,402,440

15. For its past three fiscal years please identify by year the amount of income tax AOI has paid to any national government, the amount paid to each government and the government to which it was paid.

For the past three fiscal years, AOI has not filed any corporate income taxes with any national government. However, please note that interest income generated by AOI has been included in Apple Inc.'s US tax return as subpart F income.

Excerpt from March 11, 2013 information  
 supplied by Apple to the Permanent  
 Subcommittee on Investigations.

US Senate Permanent Subcommittee on Investigations  
 Follow Up Questions Dated February 11 2013

1. **Please describe the central management and control tests under Irish law. What criteria were applied by Apple and what were the facts and reasoning applied that led to its determination that AOI was not managed and controlled in Ireland?**

Under Irish law, factors that would demonstrate management and control in Ireland include:

1. All directors' meetings should be physically held in Ireland.
2. The majority of directors should live in Ireland.
3. All major decisions should be made at directors'/shareholders' meetings. Directors must be able to make decisions of substance as to investment, marketing, purchasing, etc. The Articles of Association of the Company should provide that all directors' meetings are held in Ireland.
4. The quorum for directors meetings should be such that a majority of Irish resident directors is required to conduct a valid board meeting.
5. Major contracts should be negotiated in Ireland.
6. All important policy questions should be decided in Ireland.
7. All shareholders' meetings, if possible, including EGM's, should take place in Ireland.
8. The company's main accounting records should be kept in Ireland.
9. The accounts should, in the main, be written up in Ireland.
10. Minute books of company meetings should be kept in Ireland.
11. The company seal (if any) should be kept in Ireland.
12. The share register should be kept in Ireland.
13. Dividends should be declared in Ireland.
14. The company should have bank accounts in Ireland.

To the best of our knowledge, AOI does not meet any of the Irish central management and control factors stated above.

2. **According to data provided to the Subcommittee, AOI has three shareholders: Apple Inc. which owns 96.4 percent; Apple (UK) Limited which owns 3.6 percent; and Baldwin Holdings Unlimited which owns .001%. Has**

Permanent Subcommittee on Investigations

EXHIBIT #11

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APL-PSI-000241

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**Apple determined that the location of any of these entities is the location of central management and control of AOI? If so, which entity and why? If not, why not?**

No. Location of shareholders is not relevant to the application of the central management and control test under Irish law.

3. **According to data provided to the Subcommittee, the board of directors of AOI consists of Cathy Kearney of Ireland, Gene Levoff of the United States, and Gary Wipfler of the United States. Has Apple determined that the location of any of these directors is the location of central management and control of AOI? If so, which jurisdiction and why? If not, why not?**

No. As noted in response to question 1, the location of the majority of directors is one of the fourteen factors that are applied in determining whether AOI's central management and control is in Ireland (Factor 2). That factor is not satisfied because only one of AOI's three directors is located in Ireland.

4. **For Irish tax law purposes, is it Apple's determination that AOI is not managed and controlled in any jurisdiction?**
- a. **If so, please identify the criteria applied by Apple and the facts and reasoning that led Apple to reach that conclusion and, if so, how management is management and control exercised?**
  - b. **If not, please identify where Apple determined the location of AOI's central management and control to be situated and identify the criteria applied by Apple and the facts and reasoning that led Apple to reach that conclusion.**

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.

5. **Functionally (i.e. for organizational and daily operational purposes), where does Apple Inc. consider AOI to be managed and controlled?**

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a. **What facts and reasoning led Apple to that conclusion?**

Apple has not determined the location of AOI's central management and control for organizational and daily operational purposes. Apple has concluded that AOI is not managed and controlled in Ireland based on the application of the central management and control test under Irish law, as discussed in the response to Question 1.

i. **In its January 18, 2013 response to the Subcommittee, Apple wrote that following about the tax residence of AOI:**

*Since its initial formation, Apple Operations International has not had a tax residence in Ireland and is not believed to be a tax resident of any other jurisdiction, although it had a taxable presence in France from 1987 until 2007.*

a. **Please identify the criteria applied by Apple and the facts and reasoning applied that led Apple to conclude that AOI is not tax resident in Ireland.**

Apple Operations International ("AOI") is an Irish incorporated holding company whose primary purpose is to hold shares of certain other Apple subsidiaries incorporated outside the United States.

Under Section 23A, of Ireland's Taxes Consolidation Act 1997 ("TCA") a company that is incorporated in Ireland will be regarded as a tax resident in Ireland. However, a company will not be so regarded if it is a relevant company and it either carries on a trade in Ireland or it is related to a company which carries on a trade in Ireland. A relevant company is a company:

1. which is under the control, directly or indirectly, of a person or persons who is or are-
  - (I) by virtue of the law of any relevant territory, resident for the purposes of tax in a relevant territory or territories, and
  - (II) not under the control, directly or indirectly, of a person who is, or persons who are, not so resident, or
2. which is, or is related to, a company the principal class of shares of which is substantially and regularly traded on one or more recognized stock exchanges in a relevant territory or territories.

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A relevant territory is another Member State in the European Union or a territory with which Ireland has a tax treaty. AOI is considered a relevant company and therefore is not deemed to be Irish tax resident as a result of being incorporated in Ireland. A company which is not tax resident in Ireland under the "place of incorporation" test above will be tax resident in Ireland if its central management and control is located there. As described in response to question one, AOI's central management and control is not located in Ireland.

- b. **In its January 18, 2013 response to the Subcommittee, Apple wrote the following about its determination that AOI is not a tax resident of any country:**

*As described above, it was determined that AOI is not a tax resident of Ireland notwithstanding that Ireland is its country of incorporation. The determination of tax residency is to be conducted on a country by country basis, applying the residency tests and requirements as determined under applicable local laws. Apple does not believe that AOI qualifies as a tax resident of any other country under the applicable local laws.*

**Please identify the criteria applied by Apple and the facts and reasoning applied that led Apple to conclude that AOI is not tax resident in the jurisdiction that is the location of AOI's central management and control.**

Apple has not made a determination regarding the location of AOI's central management and control. Rather, Apple has applied the central management and control test under Irish law and determined that AOI is not a tax resident of Ireland notwithstanding the fact that AOI is incorporated in Ireland. Apple has not concluded that AOI is not tax resident in the jurisdiction that is the location of AOI's central management and control.

- c. **Under Irish law, if the jurisdiction where Apple determined AOI to be managed and controlled and an income tax structure that resulted in AOI having to pay income tax, would Apple consider AOI to be tax resident in that jurisdiction?**

The determination of tax residency depends on the corporate residency rules of

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individual jurisdictions. Irish law is not controlling for determining tax residency anywhere other than Ireland.

- d. **If the jurisdiction where Apple determined AOI to be managed and controlled did not have an income tax, would Apple consider AOI to be tax resident of that jurisdiction?**

Tax residency is a jurisdiction-specific inquiry. If the corporate tax residency laws of a jurisdiction led Apple to conclude that AOI was a tax resident of that jurisdiction, Apple would apply that jurisdiction's tax laws with respect to AOI, without regard to whether that jurisdiction had an income tax.

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7. **According to data provided to the Subcommittee, AOI reported interest income of \$100.4 million, \$46.7 million, and \$3.5 million in FY 2011, 2010, and 2009 respectively.**
  - a. **Of this interest income, how much was included as Subpart F income on Apple's US tax return? How much in taxes was paid on the reported amount?**

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AOI's reported interest income for FY2009, 2010, and 2011 was included in full in the calculation of subpart F income in Apple Inc.'s US tax returns for each of the relevant years, subject to application of the provisions of IRC Sections 951-954. The subpart F inclusion for AOI as finally determined for each year was included in Apple Inc.'s US federal income tax return for the relevant year and subject to US taxation.

- b. If a portion of this interest income was excluded, or if the tax liability was reduced or eliminated, please provide the amount and reason for any exclusion, reduction or elimination.**

N/A

- c. Please explain any tax provision that was primarily relied upon to reduce taxes paid in the U.S. (e.g. check-the-box or the earnings and profits limitation).**

See response to 7a, above.

- d. According to data provided to the Subcommittee, it appears that interest income and intercompany dividends are AOI's primary source of income. Did AOI have any other sources of income in FY 2009, FY 2010, and FY 2011? If so, what were the sources and amount of income?**

AOI did not have any material source of income other than interest income and intercompany dividends.

- 3. According to Apple's September 12, 2012 response to the Subcommittee, AOI paid taxes of \$14,546 in FY 2011 and had a deferred tax liability of \$117,077 in FY 2009.**

- a. To what local or national governments did AOI pay taxes or are taxes owed? Please identify the government, the amount paid to each, and a description of the reason for such payments.**

In FY2011, Apple France paid a dividend to its shareholders, including AOI, which owns 0.25% of Apple France. The dividend was subject to a 25% French withholding tax. The gross dividend to AOI was Euro 41,250, with withholding tax

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deducted of EUR 10,312.50 (approximately US \$14,546). The withholding tax was paid to the French government.

- b. According to Apple's August 15, 2012 response to the Subcommittee, AOI had an effective tax rate of 6.9%, 0.2%, and 0.7% and a deferred tax rate of 11.2%, 17.8%, and 17.3% in FY 2009, 2010, and 2011 respectively. What portion of this tax is attributable to AOI and what portion is attributable to Apple Inc.? To which governments were these taxes paid or deferred, and in what portions?

		2009	2010	2011
Current - French	AOI	--	--	0.1%
Deferred - French	AOI	0.1%	--	--
Current - US	Apple Inc.	6.9%	0.2%	0.6%
Deferred - US	Apple Inc.	11.1%	17.8%	17.3%
Total		18.1%	18%	18%

- c. Please explain the reason for the deferred tax liability.

The foreign deferred tax expense recognized in FY 2009 relates to the accounting for the tax effects of the disposition of French real estate in FY 2007.

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- c. **What percentage of AOI's earnings were characterized as indefinitely reinvested in each of FY 2009, FY 2010, and FY 2011?**

Approximately 50% of the non-subpart F earnings of AOI (representing intercompany dividends received from international subsidiaries) were characterized as indefinitely reinvested during this time period.

10. **According to Apple's August 15, 2012 response to the Subcommittee, dividends account for 100% of AOI's intercompany funds.**

- a. **What individuals at Apple are involved in the determination or recommendation of whether dividends should be paid to AOI? For each individual, please list the country of residence, job title, and the Apple entity for which he/she is employed. Please provide a copy of any written analysis or recommendation.**

Apple's corporate treasury and corporate legal departments make recommendations regarding intercompany dividend distributions to be made by subsidiaries of AOI. Gary Wipfler is Vice President and Corporate Treasurer of Apple Inc and Gene Levoff is Director of Corporate Law of Apple Inc. The other key decision makers with respect to dividend distributions are the Directors of the AOI subsidiaries that paid the dividends. Please see App. 2 for a list of these individuals.

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Permanent Subcommittee on Investigations**

Excerpt from March 11, 2013 information  
supplied by Apple to the Permanent  
Subcommittee on Investigations.

MINUTES OF A MEETING OF THE BOARD OF DIRECTORS OF  
APPLE OPERATIONS EUROPE  
(the "Company")

DULY CONVENED, CONSTITUTED AND HELD AT  
One Infinite Loop, Cupertino, California, 95014 USA  
on 17 November 2010

PRESENT: Peter Oppenheimer, Director  
Gary Wipfler, Director  
APOLOGIES: Cathy Kearney, Director

1. CHAIRMAN

It was agreed that Gary Wipfler would chair the meeting.

2. QUORUM

The Chairman noted that a quorum of two directors was present and that the meeting had been properly convened and constituted. The directors had no personal interests in the matter to be discussed. The interests of Peter Oppenheimer as a director of Apple Operations International and of Baldwin Holdings Unlimited had already been noted in the records of the Company.

3. RECEIPT OF INTERIM ORDINARY DIVIDEND

IT WAS NOTED that the Company was to receive on 18th November 2010 a dividend in the amount of US\$1,750,000,000 from Apple Sales International. A review of the Company's financial statements to 26th September 2009 also indicated substantial retained profits of [REDACTED] available for distribution. Interim Dividends had been received subsequent to the 26<sup>th</sup> September 2009 in the total amount of US\$6,574,972,906.56 and interim dividends had been paid in the total amount of US\$7,909,796,428 which left [REDACTED]

4. PAYMENT OF INTERIM ORDINARY DIVIDEND

IT WAS RESOLVED that subject to the receipt of an interim dividend in the amount of US\$1,750,000,000 from Apple Sales International, an interim dividend in respect of the year ending 25<sup>th</sup> September 2010, as justified by the profits of the Company and by the dividend to be received, be paid in the total amount of US\$1,750,000,000 on the 18<sup>th</sup> of November 2010, to Apple Operations International as shareholder of the Company (Baldwin Holdings Unlimited) having mandated payment of its dividend to Apple Operations International).

— = Redacted by the Permanent  
Subcommittee on Investigations

Permanent Subcommittee on Investigations

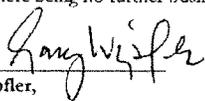
EXHIBIT #12

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5. CLOSE

There being no further business the Chairman declared the meeting closed.

  
\_\_\_\_\_  
Gary Wipfler,  
Chairman

Excerpt from April 26, 2013 information supplied by Apple to the Permanent Subcommittee on Investigations.

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Apple Operations International - Board of Directors Meetings During Tim Cook Directorship\*

Meeting Date	Meeting Location	Attendees**	Apologies	Summary
8-May-06	N/A	N/A	N/A	Tim Cook appointed a director of the company effective this date.
13-May-06	Cupertino, CA	Peter Oppenheimer, Gary Wulfer	None listed	
18-May-06	Cupertino, CA	Peter Oppenheimer, Gary Wulfer, Tim Cook	None listed	Resolving to seek shareholder resolution to renew Director's authority to allot shares to Baldwin Holdings Unlimited.
18-May-06	Cupertino, CA	Peter Oppenheimer, Gary Wulfer, Cathy Kearney	None listed	
18-May-06	Cupertino, CA	Peter Oppenheimer, Gary Wulfer, Cathy Kearney	None listed	
19-May-06	Cupertino, CA	Peter Oppenheimer, Gary Wulfer, Tim Cook	None listed	
19-May-06	Cupertino, CA	Peter Oppenheimer, Gary Wulfer, Cathy Kearney	None listed	Resolving to allot 1 ordinary share of AIO and Apple Computer Limited, Apple Computer Europe Holding Limited and Apple Computer (Baltic) to Baldwin Holdings Unlimited.
22-May-06	Cupertino, CA	Peter Oppenheimer, Gary Wulfer, Tim Cook	None listed	Resolving to re-register as an unlimited company.
25-May-06	Cupertino, CA	Peter Oppenheimer, Gary Wulfer, Tim Cook	None listed	Resolving to change company's name to "Apple Operation International."
30-May-06	Cupertino, CA	Peter Oppenheimer, Gary Wulfer, Tim Cook	None listed	
8-Jun-06	Cupertino, CA	Peter Oppenheimer, Gary Wulfer, Tim Cook	None listed	Payment of dividends to Apple Computer, Inc., in the amount of \$1,277,018,905 and to Apple Computer UK Limited in the amount of \$42,980,097 on June 23, 2006.
13-Jun-06	Cupertino, CA	Peter Oppenheimer, Gary Wulfer, Tim Cook	None listed	
12-Jul-06	Cupertino, CA	Peter Oppenheimer, Gary Wulfer, Tim Cook, Cathy Kearney by phone	N/A	Resolving to approve a Letter of Intent relating to the lease back of premises in France.
28-Jul-06	Cupertino, CA	Peter Oppenheimer, Gary Wulfer, Tim Cook	None listed	Resolving to empower certain individuals to manage AIO's banking, investment, brokerage, and other accounts.
28-Jul-06	Cupertino, CA	Peter Oppenheimer, Gary Wulfer, Tim Cook, Cathy Kearney by phone	N/A	Resolving to approve the sale of premises in France owned by AIO.
12-Sep-06	Cupertino, CA	Peter Oppenheimer, Gary Wulfer, Tim Cook	None listed	Payment of dividends to Apple Computer, Inc., in the amount of \$300,737,725 and to Apple Computer UK Limited in the amount of \$11,282,076 on September 21, 2006.
12-Sep-06	Cupertino, CA	Peter Oppenheimer, Gary Wulfer, Tim Cook	None listed	
11-Oct-06	Cupertino, CA	Peter Oppenheimer, Tim Cook, Gary Wulfer	None listed	
19-Oct-06	Cupertino, CA	Peter Oppenheimer, Gary Wulfer, Tim Cook	None listed	
15-Nov-06	Cupertino, CA	Peter Oppenheimer, Gary Wulfer	None listed	
5-Jan-07	Cupertino, CA	Peter Oppenheimer, Gary Wulfer, Tim Cook	None listed	
19-Apr-07	Cupertino, CA	Peter Oppenheimer, Gary Wulfer, Tim Cook	None listed	
22-May-07	Cupertino, CA	Peter Oppenheimer, Gary Wulfer	None listed	
27-Jun-07	Cupertino, CA	Peter Oppenheimer, Gary Wulfer, Tim Cook	None listed	Resolving to approve the draft Director Report and financial statements for FY 2007; setting date of Annual General Meeting; noting that interim dividends of \$1,515,000,000 were paid during the year; appointing Peter Oppenheimer as representative for AIO and ASI ASMs.
10-Jan-08	Cupertino, CA	Peter Oppenheimer, Gary Wulfer	None listed	Noting AGM previously convened for July 20, 2007 was not held; resolving to date of Annual General Meeting (AGM) for Jan. 20, 2008; noting that interim dividends of \$1,515,000,000 were paid during the year; appointing Gary Wulfer as representative for AIO and ASI ASMs.
10-Jan-08	Cupertino, CA	Peter Oppenheimer, Gary Wulfer	None listed	
11-Sep-09	Cupertino, CA	Peter Oppenheimer, Gary Wulfer	Tim Cook, Cathy Kearney	
28-Oct-09	N/A	Peter Oppenheimer, Gary Wulfer, Cathy Kearney	N/A	Written Resolution and Request of the Directors resolving that Tim Cook shall vacate his office as a Director of AIO effective this date.

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EXHIBIT #13

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Apple Operations Europe - Board of Directors Meetings During Tim Cook Directorship*				
Meeting Date	Meeting Location	Attendees**	Apologies	Summary
8-May-06	Cupertino, CA	Gary Wigfler, Peter Oppenheimer, Cathy Kearney	None listed	Resolving to appoint Tim Cook as an additional director of the company effective this date.
15-May-06	Cupertino, CA	Peter Oppenheimer, Gary Wigfler	None listed	
18-May-06	Cupertino, CA	Gary Wigfler, Peter Oppenheimer, Tim Cook	None listed	Resolving to distribute a written resolution soliciting one ordinary share in the company to Baldwin Holdings Unlimited.
18-May-06	Cupertino, CA	Peter Oppenheimer, Gary Wigfler, Cathy Kearney	None listed	
19-May-06	Cupertino, CA	Peter Oppenheimer, Gary Wigfler, Tim Cook	None listed	
19-May-06	Cupertino, CA	Peter Oppenheimer, Gary Wigfler, Cathy Kearney	None listed	Resolving to allot one ordinary share to Baldwin Holdings Unlimited.
27-May-06	Cupertino, CA	Peter Oppenheimer, Gary Wigfler, Tim Cook	None listed	Resolving to re-register as an unlimited company.
25-May-06	Cupertino, CA	Peter Oppenheimer, Gary Wigfler, Tim Cook	None listed	Resolving to distribute a written resolution to change the name of "Apple Computer Limited" to "Apple Operations Europe" to avoid confusion with its parent companies.
12-Jun-06	Cupertino, CA	Peter Oppenheimer, Gary Wigfler, Tim Cook	None listed	
13-Jun-06	Cupertino, CA	Peter Oppenheimer, Gary Wigfler, Tim Cook	None listed	
24-Jul-06	Cupertino, CA	Peter Oppenheimer, Gary Wigfler, Tim Cook	None listed	Resolving to retain Braeburn Capital Inc. to assist ADE in managing its cash reserves.
28-Jul-06	Cupertino, CA	Peter Oppenheimer, Gary Wigfler, Tim Cook	None listed	Resolving to allow the opening, maintenance, closure of banking, investment, brokerage, and other accounts in the name of ADE.
11-Sep-06	Cupertino, CA	Peter Oppenheimer, Gary Wigfler, Tim Cook	None listed	
11-Oct-06	Cupertino, CA	Peter Oppenheimer, Gary Wigfler, Tim Cook	None listed	
5-Jan-07	Cupertino, CA	Peter Oppenheimer, Gary Wigfler, Tim Cook	None listed	
26-Jun-07	Cupertino, CA	Peter Oppenheimer, Gary Wigfler, Tim Cook	None listed	Resolving to approve the draft Directors Report and financial statements for FY 2007; noting that interim dividends of \$1,249,875,000 were paid during the year.
10-Jan-08	Cupertino, CA	Peter Oppenheimer, Gary Wigfler	None listed	
10-Jan-08	Cupertino, CA	Peter Oppenheimer, Gary Wigfler	None listed	Resolving to consent to short notice for the Annual General Meeting for January 10, 2008; noting that interim dividends of \$1,249,875,000 were paid during the year.
10-Jan-08	Cupertino, CA	Peter Oppenheimer, Gary Wigfler	None listed	
17-Dec-08	Cupertino, CA	Gary Wigfler, Peter Oppenheimer, Genie Levoff (listed as "in attendance")	None listed	
14-Jan-09	Cupertino, CA	Peter Oppenheimer, Gary Wigfler	None listed	
22-Jul-09	Cupertino, CA	Peter Oppenheimer (by phone), Gary Wigfler (by phone)	Tim Cook, Cathy Kearney	Resolving to execute a Business Transfer Agreement to transfer the business of the ADE Singapore Branch to Apple South Asia Pte. Ltd.
23-Oct-09	Cupertino, CA	Peter Oppenheimer, Gary Wigfler	Tim Cook, Cathy Kearney	Noting the upcoming receipt of a dividend of \$5,482,850,783.21 from ADI on October 23, 2009, and resolving to pay ADI a dividend of \$4,607,274,646.29 on October 27, 2009.
21-Dec-09	N/A	Peter Oppenheimer, Gary Wigfler, Cathy Kearney	N/A	

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Apple Sales International - Board of Directors Meetings During Tim Cook Directorship*				
Meeting Date	Meeting Location	Attendees**	Highlights	Summary
8-May-06	Cupertino, CA	Gary W. Aitken, Peter Oppenheimer, Joe Allen	None listed	
15-May-06	Cupertino, CA	Gary W. Aitken, Peter Oppenheimer, Joe Allen	None listed	
24-May-06	Cupertino, CA	Gary W. Aitken, Peter Oppenheimer, Joe Allen	None listed	Resolving to distribute within a resolution to the shareholders recommending that \$101,142,784.33 of ASU's income be capitalized and appropriated as capital. The \$60,000 share of EURL288738 such in the capital of ASI constituted 50% paid and accrued.
18-May-06	Cupertino, CA	Gary W. Aitken, Peter Oppenheimer, Joe Allen	None listed	Resolving to distribute within a resolution to the shareholders recommending that EURL142,784.33 of ASU's income be capitalized and appropriated as capital. The \$60,000 share of EURL288738 such in the capital of ASI constituted 50% paid and accrued to Apple Computer Ireland.
24-May-06	Cupertino, CA	Tim Cook, Gary W. Aitken, Peter Oppenheimer	None listed	
24-Jun-06	Cupertino, CA	Tim Cook, Gary W. Aitken, Peter Oppenheimer, Joe Allen	None listed	Resolving to retain Ericsson Capital, Inc. to assist ASI in managing its cash resources.
28-Jul-06	Cupertino, CA	Gary W. Aitken, Peter Oppenheimer, Joe Allen	None listed	
13-Sep-06	Cupertino, CA	Tim Cook, Gary W. Aitken, Peter Oppenheimer	None listed	
12-Oct-06	Cupertino, CA	Peter Oppenheimer, Gary W. Aitken, Tim Cook	None listed	
5-Nov-06	Cupertino, CA	Tim Cook, Gary W. Aitken, Peter Oppenheimer	None listed	
9-May-07	Cupertino, CA	Tim Cook, Peter Oppenheimer	None listed	
28-Jun-07	Cupertino, CA	Tim Cook, Peter Oppenheimer	None listed	
16-Jun-07	Cupertino, CA	Tim Cook, Gary W. Aitken, Peter Oppenheimer	None listed	Resolving to approve the draft Directors Report and financial statements for the year ending September 30, 2006, noting that \$1,250,000,000 of income dividends were paid during the year.
23-Jul-07	Cupertino, CA	Tim Cook, Gary W. Aitken, Peter Oppenheimer	None listed	
10-Oct-08	Cupertino, CA	Peter Oppenheimer, Gary W. Aitken	None listed	NOTE: 50% income dividends in the amount of \$1,250,000,000 were paid during the financial year.
23-Oct-09	Cupertino, CA	Peter Oppenheimer, Joe Allen, Cathy Kamey, Tim Cook	Cathy Kamey, Tim Cook	Resolving to pay AISE an interim dividend of \$1,442,492,781.22 on October 27, 2009.
10-Dec-09	N/A	Peter Oppenheimer, Joe Allen, Cathy Kamey (opponents)	N/A	
1-Mar-10	N/A	Peter Oppenheimer, Cathy Kamey, Joe Allen, Elizabeth Ruffalo (opponents)	N/A	
13-Mar-10	Cupertino, CA	Elizabeth Ruffalo, Joe Allen	Peter Oppenheimer, Cathy Kamey, Tim Cook	Resolving to pay an interim dividend of \$1,000,000,000 to AISE on March 20, 2010.
16-Mar-10	Cupertino, CA	Peter Oppenheimer, Elizabeth Ruffalo	Joe Allen, Tim Cook, Cathy Kamey	Resolving to pay an interim dividend of \$200,000,000 to AISE on June 7, 2010.
22-Jun-10	Cupertino, CA	Peter Oppenheimer, Elizabeth Ruffalo	Joe Allen, Tim Cook, Cathy Kamey	
23-Jul-10	Cupertino, CA	Peter Oppenheimer, Elizabeth Ruffalo	Joe Allen, Tim Cook, Cathy Kamey	
25-Sep-10	Cupertino, CA	Peter Oppenheimer, Joe Allen	Elizabeth Ruffalo, Cathy Kamey, Tim Cook	Resolving to pay an interim dividend of \$390,000,000 to AISE on September 22, 2010.
17-Nov-10	Cupertino, CA	Peter Oppenheimer, Elizabeth Ruffalo	Joe Allen, Tim Cook, Cathy Kamey	Resolving to pay AISE an interim dividend of \$1,750,000,000 on Nov. 18, 2010.
23-Dec-10	Cupertino, CA	Peter Oppenheimer, Elizabeth Ruffalo	Joe Allen, Tim Cook, Cathy Kamey	
4-Mar-11	Cupertino, CA	Peter Oppenheimer, Elizabeth Ruffalo	None listed	Resolving to pay an interim dividend of \$1,000,000,000 to AISE on March 25, 2011.
22-Mar-11	Cupertino, CA	Peter Oppenheimer, Elizabeth Ruffalo	None listed	
21-Apr-11	Cupertino, CA	Elizabeth Ruffalo, Mark Stevens	None listed	
11-May-11	Cupertino, CA	Peter Oppenheimer, Elizabeth Ruffalo	Tim Cook, Cathy Kamey, Mark Stevens	Resolving to pay AISE an interim dividend of \$1,000,000,000 on May 16, 2011.
29-Jun-11	Cupertino, CA	Mark Stevens, Elizabeth Ruffalo	Peter Oppenheimer, Cathy Kamey, Tim Cook	Noting the resignation of Peter Oppenheimer as Director and secretary in his stead, resolving that the Directors Report and Financial Statements for the period ending September 30, 2010 be approved, noting that income dividends of \$1,000,000,000 were declared and paid to AISE.
27-Jul-11	Cupertino, CA	Gina Lewis, Elizabeth Ruffalo	Tim Cook, Cathy Kamey, Mark Stevens	
7-Sep-11	Cupertino, CA	Gina Lewis, Elizabeth Ruffalo	Cathy Kamey, Mark Stevens	Resolving to pay an interim dividend of \$1,502,296,137 to AISE on September 8, 2011.
23-Sep-11	Cupertino, CA	Gina Lewis, Elizabeth Ruffalo	Tim Cook, Cathy Kamey, Mark Stevens	Noting that interim dividends totaling \$4,750,000,000 in cash and \$1,500,000,000 in stock had been paid since September 25, 2010, resolving to pay an interim dividend of \$1.5 billion to AISE.
30-Nov-11	Cupertino, CA	Gina Lewis, Elizabeth Ruffalo	Tim Cook, Cathy Kamey, Mark Stevens	
18-Jan-12	Cupertino, CA	Gina Lewis, Elizabeth Ruffalo	Tim Cook, Cathy Kamey, Mark Stevens, Peter Oppenheimer	Resolving to pay an interim dividend of \$1.1 billion to AISE immediately.
7-Mar-12	Cupertino, CA	Gina Lewis, Elizabeth Ruffalo	Tim Cook, Cathy Kamey, Mark Stevens	Resolving to pay an interim dividend of \$4,000,000,000 to AISE immediately.
2-May-12	N/A	Tim Cook (opponents)	N/A	Letter from Tim Cook resigning as a director of ASI effective this date.

Excerpt from May 3, 2013 information supplied by Apple to the Permanent Subcommittee on Investigations.

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Appendix C

PSI Question B

Apple Operations International - FY08 and FY 12 Board of Directors Meeting Information

FY 2008

Meeting Date	Meeting Location	Attendees*	Employer/Title
10-Jan-08	Cupertino, CA	Peter Oppenheimer Gary Wipfler	Apple Inc., SVP, CFO Apple Inc., VP & Treasurer

FY 2012

Meeting Date	Meeting Location	Attendees	Employer/Title
17-Jul-12	Cupertino, CA	Gene Levoff Gary Wipfler	Apple Inc., Director, Corporate Law Apple Inc., VP & Treasurer
7-Aug-12	Cork, Ireland	Gene Levoff (by telephone) Cathy Kearney	Apple Inc., Director, Corporate Law Apple Distribution International, VP European Operations

\* Attendance in person unless otherwise noted

Permanent Subcommittee on Investigations  
EXHIBIT #14

Excerpt from May 12, 2013 information supplied by Apple to the Permanent Subcommittee on Investigations.

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6. Please describe the relationship between AOE and ASI with respect to their ownership of the economic rights to the intellectual property that they have obtained from Apple Inc.

AOE and ASI are participants in a Cost Sharing Arrangement with Apple Inc. whereby AOE, ASI and Apple Inc. have agreed to pool their resources for purposes of undertaking intellectual property co-development activities that are incorporated into Apple products and to share the benefits and rewards of such development in their respective territories. Apple Inc. has the rights, among others, to manufacture or have manufactured, sell and distribute Apple products in North America, South America, Central America and the Caribbean (the "Americas") and AOE and ASI have the rights, among others, to manufacture or have manufactured, sell and distribute Apple products in the worldwide territory excluding the Americas.

7. Please state Apple's business purpose for the formation of (1) AOI and (2) Baldwin Holdings. In addition, what functions are performed by each and where are those functions performed?

We have not located historical records about the business purpose for the formation of AOI in 1980. However, as previously noted, AOI is a holding company whose primary purpose is to hold shares of Apple international subsidiaries and to centralize treasury management of international cash.

The business purpose of Baldwin Holdings is to act as nominee shareholder of AOI and other Irish entities. Certain Irish Corporation principles require companies to have a second shareholder that is located outside of the European Union. As a separate subsidiary, it also provides limited liability protection to Apple. As a nominee shareholder, Baldwin Holdings does not have any operational function.

8. What is the purpose, business or otherwise, for locating AOI in Ireland?

We have not located historical records that document the original purpose for locating AOI in Ireland in 1980, but it was incorporated there at the same time that Apple commenced its longstanding business presence in Ireland. AOI

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EXHIBIT #15

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continues to serve its primary purpose as holding company and to centralize treasury management of international cash. Apple is not aware of a business reason today to change AOI's location today and to do so would be needlessly complex, time-consuming, and expensive.

10. **For US tax purposes, is Baldwin Holdings considered an owner of the companies for which it is a shareholder? If not, who are the owners and what is Baldwin's status considered to be? Please provide any documents maintained by Apple to support these answers.**

Baldwin Holdings Unlimited holds bare legal title to the single share it holds in the relevant entities and acts as a nominee for the shareholder that has the benefits and burdens of the shares to which Baldwin Holdings Unlimited holds bare legal title. For US tax purposes, Baldwin Holdings Unlimited's nominal ownership interest in these entities is disregarded.

<u>Entity</u>	<u>Owner for US tax purposes</u>
Apple Operations International	Apple Inc.
Apple Operations Europe	Apple Operations International
Apple Distribution International	Apple Operations International
Apple Sales International	Apple Operations International
Apple Sales Ireland	Apple Operations International
Apple Operations	Apple Operations International
Apple Retail Europe Holding	Apple Operations International

See Appendix C for copies of relevant Nominee Agreements with Baldwin Holdings Unlimited.

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Permanent Subcommittee on Investigations**

18. Did Apple Inc. use foreign earnings to finance its recent dividend payments to shareholders, whether through repatriation, short-term loan, or some other method? If so, please describe the method employed and the amount involved. Does Apple plan to do so for future dividend payments or stock buy-backs?

Apple Inc. did not use foreign earnings to finance its recent dividend payments to shareholders, whether through repatriation, short-term loan or another method. Apple does not have any current plan to use foreign earnings for future dividend payments or stock buy-backs.

We said in April that we would fund our return of capital program through calendar year 2015 from current domestic cash, future cash generated in the US, and domestic borrowings.

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Permanent Subcommittee on Investigations**

Excerpt from May 16, 2013 information supplied by Apple to the Permanent Subcommittee on Investigations.

US Senate Permanent Subcommittee on Investigations  
Follow Up Questions Dated April 15, 2013

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**11. Why did Apple make the determination to transfer the economic rights to its intellectual property to a foreign jurisdiction?**

We have not located historical information regarding why Apple made the determination to enter into a cost sharing agreement in 1980. However, we note that the formation of the cost sharing arrangement was contemporaneous with Apple's decision to establish a European base of operations in Ireland, including a manufacturing facility. Through the cost sharing arrangement, ASI/AOE (or their predecessors) partially funded and shared the risks and benefits of the co-developed intellectual property and obtained the right to manufacture and distribute product in their territory.

**12. In addition to the information already provided by Apple, please provide the amounts of any other buy-in or cost sharing payments made to Apple Inc. in conjunction with the execution or amendment of Apple's cost sharing agreements with its foreign subsidiaries or affiliates. Please identify any entity that made any payments and the dates of the payments.**

We have not located historical information regarding any buy-in payments associated with the original cost sharing agreement dating back to 1980. To the best of our knowledge, there were no other buy-in or cost sharing payments made to Apple Inc. specifically in conjunction with the execution or amendment of Apple's cost sharing agreements with its foreign subsidiaries or affiliates.

However, ASI and AOE made payments for cost sharing or buy-ins that were not in conjunction with the execution or amendment of Apple's cost sharing agreements.

Appendix H to the July 6 PSI submission, APL-PSI-000113, reflects these payments from FY2009-FY2011. One additional payment in the amount of \$472 million for FY2011 was inadvertently omitted from Appendix H, though Apple separately disclosed it to the Subcommittee on June 22, 2012, in the Company's Response to Question 10.

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**EXHIBIT #16**

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During FY2012, Apple Inc. charged ASI/AOE the following amounts relating to cost sharing, buy-ins or platform contribution transactions (PCT), or transfer of intangible property:

- cost sharing of \$1,657,558,523
- platform contribution transactions of \$215,843,121
- other Treas. Reg. § 1.482-4 transfer of intangible property: \$371,504,618

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- 15. For the years 2006 to present, please provide the annual gross income, total sales, operating income and pre-tax income for each of the entities that, for the purposes of Apple's cost sharing agreement, was determined to receive economic benefit from Apple's intellectual property, both in the Americas and the rest of the world. Please indicate whether each entity is considered part of the Americas or the rest of the world.**

AOE and ASI are parties to the cost sharing agreement with Apple Inc. Apple Inc's territory is defined in the cost sharing agreement as North America, South America, Central America and the Caribbean (the "Americas") while AOE and ASI's territory is defined as the worldwide territory excluding the Americas. See Appendix C for the annual gross income (margin), total sales, operating income and pre-tax income for fiscal years 2006 to 2012 for ASI, AOE and Apple Inc. These are the only entities that, for purposes of Apple's cost sharing agreement, receive economic benefit from Apple's intellectual property.

- 16. Given that ASI, an Irish entity, regularly purchases personal property from a third party manufacturer outside of Ireland, and sells the personal property to related parties for use, consumption, or disposition outside of Ireland, please describe whether IRC 954(d)(related for Foreign Base Company Sales Income) applied or currently applies to income received by ASI, or any of Apple's other Irish entities, during the period 2008 to present and if so, the amount of income it applied or applies to. Please indicate whether any analysis was conducted on this issue. If so, please indicate who performed the analysis, the conclusion reached and the amount of any income determined to be subject to 954(d). In addition, please provide the analysis.**

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IRC section 954(d) generally does not apply to income received by ASI or any of Apple's other Irish entities during the period 2008 to present because sales made to third parties are generally made through disregarded entities.

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**Apple's ten largest entities by exclusion amount.**

Apple does not routinely perform this calculation since IRC Section 954(d) does not apply to these transactions due to check the box or look through rules. However, as requested, we have estimated the hypothetical foreign base company sales and foreign personal holding company income as follows for FY2009-2012. (This analysis assumes that the "same country" dividend exception under IRC Section 954(c)(3) and the substantial contribution test of the contract manufacturing exception would not otherwise apply.)

	(Amounts in millions of dollars)			
	<u>FY2009</u>	<u>FY2010</u>	<u>FY2011</u>	<u>FY2012</u>
Apple Sales International	1,191	4,698	9,823	24,614
Apple Distribution International	-	21	155	350
Apple South Asia Pte Ltd	4	7	16	180
Hypothetical FBCSI income	<u>1,195</u>	<u>4,726</u>	<u>9,994</u>	<u>25,144</u>
Apple Operations Europe				
Dividends	-	6,575	6,253	14,900
Less: PTI	-	(5,889)	(6,253)	(14,900)
	<u>-</u>	<u>686</u>	<u>-</u>	<u>-</u>
Apple Operations International				
Dividends	101	8,082	6,381	15,457
Less: PTI	-	(6,575)	(6,253)	(14,900)
	<u>101</u>	<u>1,507</u>	<u>128</u>	<u>557</u>
Hypothetical FPHCI income	<u>101</u>	<u>2,193</u>	<u>128</u>	<u>557</u>
Total hypothetical subpart F	<u>1,296</u>	<u>6,919</u>	<u>10,122</u>	<u>25,701</u>

**Redacted by the  
Permanent Subcommittee on Investigations**

Excerpt from May 17, 2013 information supplied by Apple to the Permanent Subcommittee on Investigations.

US Senate Permanent Subcommittee on Investigations  
Follow Up Questions Dated April 15, 2013

4. Which individuals at Apple are responsible for negotiating or signing master servicing agreements with third-party manufacturers on behalf of Apple Inc, AOE, and ASI? Please identify the title, position, employer, and country of residence of each individual.

As discussed during our May 14, 2013 telephone call with PSI staff, we are answering this question and Question 5 concerning individuals responsible for negotiating or signing agreements with Foxconn and the makers of the A5 chip.

Foxconn is a trade name for Hon Hai Precision Industry Co., Ltd. ("Hon Hai"). The individuals with primary responsibility for negotiating agreements with Hon Hai for products containing the A5 chip were U.S.-based Apple Inc. employees working in Operations. Their titles and positions include Vice President, Operations; Vice President, Procurement; Senior Director, Procurement; Director, Procurement; and Business Operations Manager. In exceptional cases, Apple's Senior Vice President, Operations, was involved. An Apple Shanghai employee with the title of Manager, APO Business Operations was also involved in negotiations. Individuals signing the relevant agreements for Apple Inc. were U.S.-based Apple Inc. employees with the title VP, Procurement. The individual who signed the relevant agreements for Apple Sales International was a U.S.-based Apple Inc. employee who signed the agreement in his capacity as Director of Apple Sales International.

The individuals with primary responsibility for negotiating relevant agreements with Samsung, the manufacturer of the A5 chip, were Apple Inc. employees working in the U.S. with the title of Senior Director, Operations, and Director, Procurement. The individuals who signed the relevant agreements for Apple Inc. were U.S.-based Apple Inc. employees with titles/positions of: Sr. Director, Operations, and Director, GSM. The individual who signed the relevant agreements for Apple Sales International was a U.S.-based employee of Apple Inc. who signed the agreements in his capacity as Director of Apple Sales International.

AOE is not a party to the agreements with Hon Hai or Samsung referred to herein.

Redacted by the  
Permanent Subcommittee on Investigations

Permanent Subcommittee on Investigations  
EXHIBIT #17

**Redacted by the  
Permanent Subcommittee on Investigations**

**Email Question from D. Goshorn dated May 16, 2013: Could you please confirm for us whether Apple considered ASI to not be a tax resident of Ireland at any point from 2009 to present?**

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.

Apple Inc. 10-K Select Figures 2009-2012

Year	Effective Tax Rate	Income before provision for income tax	"Provision for income" tax each year		"Provision for income" tax each year		"Provision for income" tax each year		Total "Net Sales"	Gross profit ("gross margin")	Operating profit ("operating income")	Total cash	Cash offshore ("held by foreign subsidiaries")
			Federal Current	Federal Deferred	Foreign Current	Foreign Deferred	Federal Current	Federal Deferred					
2012*	23.20%	\$55,763 bil	\$7,240 bil	\$5,018 bil	\$1,203 bil	\$(490) mil	\$156,598 bil	\$68,662 bil	\$121,251 bil	\$55,241 bil	\$121,251 bil	\$82.6 bil	
2011**	24.20%	\$34,205 bil	\$3,884 bil	\$2,988 bil	\$769 mil	\$(677) mil	\$108,249 bil	\$43,818 bil	\$81,770 bil	\$33,790 bil	\$81,770 bil	\$54.3 bil	
2010***	24.46%	\$18,540 bil	\$2,150 bil	\$1,676 bil	\$282 mil	\$(121) mil	\$65,225 bil	\$22,684 bil	\$51,011 bil	\$18,385 bil	\$51,011 bil	\$30.8 bil	
2009****	31.80%	\$12,056 bil	\$1,322 bil	\$1,077 bil	\$345 mil	\$(335) mil	\$42,905 bil	\$17,222 bil	\$11,740 bil	\$11,740 bil	\$11,740 bil	\$17.4 bil	

KEY

Page number of the applicable Form 10-K in ( )  
 \*Form 10-K (for fiscal year ended 9/29/2012), <http://files.shareholder.com/downloads/AAPL/252524318186063119312512-446660/920193/filing.pdf>  
 \*\*Form 10-K (for fiscal year ended 9/24/2011), <http://files.shareholder.com/downloads/AAPL/252524318186063119312512-446660/920193/filing.pdf>  
 \*\*\*Form 10-K (for fiscal year ended 9/26/2010), <http://files.shareholder.com/downloads/AAPL/252524318186063119312512-446660/920193/filing.pdf>  
 \*\*\*\*Form 10-K/A (amended 1/28/2010, for fiscal year ended 9/27/2009), <http://files.shareholder.com/downloads/AAPL/252524318186063119312512-446660/920193/filing.pdf>

Permanent Subcommittee on Investigations  
**EXHIBIT #18**

**APPLE INC****FORM 10-K/A**  
(Amended Annual Report)

Filed 01/25/10 for the Period Ending 09/26/09

Address	ONE INFINITE LOOP CUPERTINO, CA 95014
Telephone	(408) 996-1010
CIK	0000320193
Symbol	AAPL
SIC Code	3571 - Electronic Computers
Industry	Computer Hardware
Sector	Technology
Fiscal Year	09/30

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## PART II

## Item 6. Selected Financial Data

The Consolidated Balance Sheets as of September 26, 2009 and September 27, 2008, and the Consolidated Statements of Operations for the years ended September 26, 2009, September 27, 2008, and September 29, 2007 have been amended to reflect the impact of the retrospective adoption of the new accounting principles, which has been reflected in the following table. There was no impact from the retrospective adoption of the new accounting principles for the years ended September 30, 2006 and September 24, 2005. Those years predated the Company's introduction of iPhone and Apple TV.

The information set forth below for the five years ended September 26, 2009, is not necessarily indicative of results of future operations, and should be read in conjunction with Part II, Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the consolidated financial statements and related notes thereto included in Part II, Item 8 of this Form 10-K to fully understand factors that may affect the comparability of the information presented below (in millions, except share amounts which are reflected in thousands and per share amounts).

	2009	2008	2007	2006	2005
Net sales	\$ 42,905	\$ 37,491	\$ 24,578	\$ 19,315	\$ 13,931
Net income	\$ 8,235	\$ 6,119	\$ 3,495	\$ 1,989	\$ 1,328
Earnings per common share:					
Basic	\$ 9.22	\$ 6.94	\$ 4.04	\$ 2.36	\$ 1.64
Diluted	\$ 9.08	\$ 6.78	\$ 3.93	\$ 2.27	\$ 1.55
Cash dividends declared per common share	\$ —	\$ —	\$ —	\$ —	\$ —
Shares used in computing earnings per share:					
Basic	893,016	881,592	864,595	844,058	808,439
Diluted	907,005	902,139	889,292	877,526	856,878
Cash, cash equivalents and marketable securities	\$ 33,992	\$ 24,490	\$ 15,386	\$ 10,110	\$ 8,261
Total assets	\$ 47,501	\$ 36,171	\$ 24,878	\$ 17,205	\$ 11,516
Long-term debt	\$ —	\$ —	\$ —	\$ —	\$ —
Total liabilities	\$ 15,861	\$ 13,874	\$ 10,347	\$ 7,221	\$ 4,088
Shareholders' equity	\$ 31,640	\$ 22,297	\$ 14,531	\$ 9,984	\$ 7,428

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The Company's Other Segments experienced an increase in net sales of \$1.0 billion, or 59% during 2008 as compared to 2007. These increases are related primarily to strong growth in sales of iPhone, Mac portable systems, iPods and iMac in the Company's Asia Pacific region. Sales from the iTunes Store in the Company's Asia Pacific region grew 109% compared to 2007.

**Gross Margin**

Gross margin for the three years ended September 26, 2009, are as follows (in millions, except gross margin percentages):

	<u>2009</u>	<u>2008</u>	<u>2007</u>
Net sales	\$42,905	\$37,491	\$24,578
Cost of sales	<u>25,683</u>	<u>24,294</u>	<u>16,426</u>
Gross margin	<u>\$17,222</u>	<u>\$13,197</u>	<u>\$ 8,152</u>
Gross margin percentage	40.1%	35.2%	33.2%

The gross margin percentage in 2009 was 40.1% compared to 35.2% in 2008. The primary contributors of the increase in 2009 as compared to 2008 were a favorable sales mix toward products with higher gross margins and lower commodity and other product costs, which were partially offset by product price reductions.

The gross margin percentage in 2008 was 35.2% compared to 33.2% in 2007. The primary contributors of the increase in 2008 as compared to 2007 were a favorable sales mix toward products with higher gross margins and lower commodity costs, which were partially offset by higher other product costs. In 2007, gross margin was impacted by higher than expected costs associated with the initial iPhone product launch.

**Operating Expenses**

Operating expenses for the three years ended September 26, 2009, are as follows (in millions, except for percentages):

	<u>2009</u>	<u>2008</u>	<u>2007</u>
Research and development	\$ 1,333	\$ 1,109	\$ 782
Percentage of net sales	3.1%	3.0%	3.2%
Selling, general and administrative	\$ 4,149	\$ 3,761	\$ 2,963
Percentage of net sales	9.7%	10.0%	12.1%

**Research and Development ("R&D")**

R&D expenditures increased 20% or \$224 million to \$1.3 billion in 2009 compared to 2008. These increases were due primarily to an increase in headcount in the current year to support expanded R&D activities and higher stock-based compensation expenses. In addition, \$71 million of software development costs were capitalized related to Mac OS X Snow Leopard and excluded from R&D expense during 2009, compared to \$11 million of software development costs capitalized during 2008. Although total R&D expense increased 20% during 2009, it remained relatively flat as a percentage of net sales given the 14% increase in revenue in 2009. The Company continues to believe that focused investments in R&D are critical to its future growth and competitive position in the marketplace and are directly related to timely development of new and enhanced products that are central to the Company's core business strategy. As such, the Company expects to make further investments in R&D to remain competitive.

Expenditures for R&D increased 42% or \$327 million to \$1.1 billion in 2008 compared to 2007. These increases were due primarily to an increase in headcount in 2008 and higher stock-based compensation expenses. In 2008, \$11 million of software development costs were capitalized related to Mac OS X Snow Leopard and excluded

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from R&D expense, while R&D expense for 2007 excluded \$75 million of capitalized software development costs related to Mac OS X Leopard and iPhone software. Although total R&D expense increased 42% during 2008, it remained relatively flat as a percentage of net sales given the 53% increase in revenue during 2008.

*Selling, General and Administrative Expense ("SG&A")*

SG&A expenditures increased \$388 million or 10% to \$4.1 billion in 2009 compared to 2008. These increases are due primarily to the Company's continued expansion of its Retail segment in both domestic and international markets, higher stock-based compensation expenses and higher spending on marketing and advertising.

Expenditures for SG&A increased \$798 million or 27% to \$3.8 billion in 2008 compared to 2007. These increases are due primarily to higher stock-based compensation expenses, higher variable selling expenses resulting from the significant year-over-year increase in total net sales and the Company's continued expansion of its Retail segment in both domestic and international markets. In addition, the Company incurred higher spending on marketing and advertising during 2008 compared to 2007.

**Other Income and Expense**

Other income and expense for the three years ended September 26, 2009, are as follows (in millions):

	<u>2009</u>	<u>2008</u>	<u>2007</u>
Interest income	\$407	\$653	\$647
Other income (expense), net	(81)	(33)	(48)
Total other income and expense	<u>\$326</u>	<u>\$620</u>	<u>\$599</u>

Total other income and expense decreased \$294 million or 47% to \$326 million during 2009 compared to \$620 million and \$599 million in 2008 and 2007, respectively. The overall decrease in other income and expense is attributable to the significant decline in interest rates during 2009 compared to 2008 and 2007, partially offset by the Company's higher cash, cash equivalents and marketable securities balances. The weighted average interest rate earned by the Company on its cash, cash equivalents and marketable securities was 1.43%, 3.44% and 5.27% during 2009, 2008 and 2007, respectively. During 2009, 2008 and 2007, the Company had no debt outstanding and accordingly did not incur any related interest expense.

The Company's investment portfolio had gross unrealized losses of \$16 million and \$121 million as of September 26, 2009 and September 27, 2008, respectively, which were offset by gross unrealized gains of \$73 million and \$4 million as of September 26, 2009 and September 27, 2008, respectively. The net unrealized gains as of September 26, 2009 and the net unrealized losses as of September 27, 2008 related primarily to long-term marketable securities. The Company considers the declines in market value of its marketable securities investment portfolio to be temporary in nature. The unrealized losses on the Company's marketable securities were caused primarily by changes in market interest rates, specifically widening credit spreads. The Company does not have the intent to sell, nor is it more likely than not the Company will be required to sell, any investment before recovery of its amortized cost basis. Accordingly, no material declines in fair value were recognized in the Company's Consolidated Statements of Operations during 2009, 2008 and 2007. The Company may sell certain of its marketable securities prior to their stated maturities for strategic purposes, in anticipation of credit deterioration, or for duration management. The Company recognized no material net gains or losses during 2009, 2008 and 2007 related to such sales.

**Provision for Income Taxes**

The Company's effective tax rates were 32%, 32% and 30% for 2009, 2008 and 2007, respectively. The Company's effective rates for these periods differ from the statutory federal income tax rate of 35% due primarily to certain undistributed foreign earnings for which no U.S. taxes are provided because such earnings are intended to be indefinitely reinvested outside the U.S.

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**Liquidity and Capital Resources**

The following table presents selected financial information and statistics as of and for the three years ended September 26, 2009 (in millions):

	2009	2008	2007
Cash, cash equivalents and marketable securities	\$33,992	\$24,490	\$15,386
Accounts receivable, net	\$ 3,361	\$ 2,422	\$ 1,637
Inventories	\$ 455	\$ 509	\$ 346
Working capital	\$20,049	\$18,645	\$12,595
Annual operating cash flow	\$10,159	\$ 9,596	\$ 5,470

As of September 26, 2009, the Company had \$34.0 billion in cash, cash equivalents and marketable securities, an increase of \$9.5 billion from September 27, 2008. The principal component of this net increase was the cash generated by operating activities of \$10.2 billion, which was partially offset by payments for acquisitions of property, plant and equipment of \$1.1 billion.

The Company's marketable securities investment portfolio is invested primarily in highly rated securities, generally with a minimum rating of single-A or equivalent. As of September 26, 2009 and September 27, 2008, \$17.4 billion and \$11.3 billion, respectively, of the Company's cash, cash equivalents and marketable securities were held by foreign subsidiaries and are generally based in U.S. dollar-denominated holdings. The Company believes its existing balances of cash, cash equivalents and marketable securities will be sufficient to satisfy its working capital needs, capital asset purchases, outstanding commitments and other liquidity requirements associated with its existing operations over the next 12 months.

**Capital Assets**

The Company's cash payments for capital asset purchases were \$1.1 billion during 2009, consisting of \$369 million for retail store facilities and \$775 million for real estate acquisitions and corporate infrastructure including information systems enhancements. The Company anticipates utilizing approximately \$1.9 billion for capital asset purchases during 2010, including approximately \$400 million for Retail facilities and approximately \$1.5 billion for corporate facilities, infrastructure, and product tooling and manufacturing process equipment.

Historically the Company has opened between 25 and 50 new retail stores per year. During 2010, the Company expects to open a number of new stores near the upper end of this range, over half of which are expected to be located outside of the U.S.

**Off-Balance Sheet Arrangements and Contractual Obligations**

The Company has not entered into any transactions with unconsolidated entities whereby the Company has financial guarantees, subordinated retained interests, derivative instruments, or other contingent arrangements that expose the Company to material continuing risks, contingent liabilities, or any other obligation under a variable interest in an unconsolidated entity that provides financing, liquidity, market risk, or credit risk support to the Company.

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## CONSOLIDATED STATEMENTS OF OPERATIONS

(in millions, except share amounts which are reflected in thousands and per share amounts)

Three years ended September 26, 2009	2009	2008	2007
Net sales	\$ 42,905	\$ 37,491	\$ 24,578
Cost of sales	25,683	24,294	16,426
Gross margin	17,222	13,197	8,152
Operating expenses:			
Research and development	1,333	1,109	782
Selling, general and administrative	4,149	3,761	2,963
Total operating expenses	5,482	4,870	3,745
Operating income	11,740	8,327	4,407
Other income and expense	326	620	599
Income before provision for income taxes	12,066	8,947	5,006
Provision for income taxes	3,831	2,828	1,511
Net income	\$ 8,235	\$ 6,119	\$ 3,495
Earnings per common share:			
Basic	\$ 9.22	\$ 6.94	\$ 4.04
Diluted	\$ 9.08	\$ 6.78	\$ 3.93
Shares used in computing earnings per share:			
Basic	893,016	881,592	864,595
Diluted	907,005	902,139	889,292

See accompanying Notes to Consolidated Financial Statements.

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## Note 7 – Income Taxes

The provision for income taxes for the three years ended September 26, 2009, consisted of the following (in millions):

	<u>2009</u>	<u>2008</u>	<u>2007</u>
Federal:			
Current	\$2,166	\$1,945	\$1,223
Deferred	<u>1,077</u>	<u>498</u>	<u>80</u>
	<u>3,243</u>	<u>2,443</u>	<u>1,303</u>
State:			
Current	280	210	112
Deferred	<u>(2)</u>	<u>(25)</u>	<u>9</u>
	<u>278</u>	<u>185</u>	<u>121</u>
Foreign:			
Current	345	275	103
Deferred	<u>(35)</u>	<u>(75)</u>	<u>(16)</u>
	<u>310</u>	<u>200</u>	<u>87</u>
Provision for income taxes	<u>\$3,831</u>	<u>\$2,828</u>	<u>\$1,511</u>

The foreign provision for income taxes is based on foreign pretax earnings of \$6.6 billion, \$4.6 billion and \$2.2 billion in 2009, 2008 and 2007, respectively. As of September 26, 2009 and September 27, 2008, \$17.4 billion and \$11.3 billion, respectively, of the Company's cash, cash equivalents and marketable securities were held by foreign subsidiaries and are generally based in U.S. dollar-denominated holdings. Amounts held by foreign subsidiaries are generally subject to U.S. income taxation on repatriation to the U.S. The Company's consolidated financial statements provide for any related tax liability on amounts that may be repatriated, aside from undistributed earnings of certain of the Company's foreign subsidiaries that are intended to be indefinitely reinvested in operations outside the U.S. U.S. income taxes have not been provided on a cumulative total of \$5.1 billion of such earnings. It is not practicable to determine the income tax liability that might be incurred if these earnings were to be distributed.

Deferred tax assets and liabilities reflect the effects of tax losses, credits, and the future income tax effects of temporary differences between the consolidated financial statement carrying amounts of existing assets and liabilities and their respective tax bases and are measured using enacted tax rates that apply to taxable income in the years in which those temporary differences are expected to be recovered or settled.

As of September 26, 2009 and September 27, 2008, the significant components of the Company's deferred tax assets and liabilities were (in millions):

	<u>2009</u>	<u>2008</u>
Deferred tax assets:		
Accrued liabilities and other reserves	\$1,030	\$1,003
Basis of capital assets and investments	180	173
Accounts receivable and inventory reserves	172	126
Other	<u>470</u>	<u>415</u>
Total deferred tax assets	1,852	1,717
Less valuation allowance	<u>---</u>	<u>---</u>
Deferred tax assets, net of valuation allowance	<u>1,852</u>	<u>1,717</u>
Deferred tax liabilities - Unremitted earnings of foreign subsidiaries	<u>2,774</u>	<u>1,569</u>
Net deferred tax (liabilities)/assets	<u>\$ (922)</u>	<u>\$ 148</u>

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- (a) The Americas asset figures do not include fixed assets held in the U.S. Such fixed assets are not allocated specifically to the Americas segment and are included in the corporate assets figures below.  
 (b) Retail segment depreciation and asset figures reflect the cost and related depreciation of its retail stores and related infrastructure.  
 (c) Other Segments include Asia-Pacific and FileMaker.

A reconciliation of the Company's segment operating income and assets to the consolidated financial statements for the three years ended September 26, 2009 is as follows (in millions):

	<u>2009</u>	<u>2008</u>	<u>2007</u>
Segment operating income	\$14,692	\$10,881	\$ 5,846
Other corporate expenses, net (a)	(2,242)	(2,038)	(1,197)
Stock-based compensation expense	(710)	(516)	(242)
Total operating income	<u>\$11,740</u>	<u>\$ 8,327</u>	<u>\$ 4,407</u>
Segment assets	\$ 5,604	\$ 4,563	\$ 3,151
Corporate assets	41,897	31,608	21,727
Consolidated assets	<u>\$47,501</u>	<u>\$36,171</u>	<u>\$24,878</u>
Segment depreciation, amortization and accretion	\$ 170	\$ 129	\$ 109
Corporate depreciation, amortization and accretion	564	367	218
Consolidated depreciation, amortization and accretion	<u>\$ 734</u>	<u>\$ 496</u>	<u>\$ 327</u>

- (a) Other corporate expenses include research and development, corporate marketing expenses, manufacturing costs and variances not included in standard costs, and other separately managed general and administrative expenses, including certain corporate expenses associated with support of the Retail segment.

No single country outside of the U.S. accounted for more than 10% of net sales in 2009, 2008 or 2007. One of the Company's customers accounted for 11% of net sales in 2009; there was no single customer that accounted for more than 10% of net sales in 2008 or 2007. Net sales and long-lived assets related to the U.S. and international operations for the three years ended September 26, 2009, are as follows (in millions):

	<u>2009</u>	<u>2008</u>	<u>2007</u>
Net sales:			
U.S.	\$22,325	\$20,893	\$14,683
International	20,580	16,598	9,895
Total net sales	<u>\$42,905</u>	<u>\$37,491</u>	<u>\$24,578</u>
Long-lived assets:			
U.S.	\$ 2,698	\$ 2,269	\$ 1,752
International	495	410	260
Total long-lived assets	<u>\$ 3,193</u>	<u>\$ 2,679</u>	<u>\$ 2,012</u>

**APPLE INC****FORM 10-K**  
(Annual Report)

Filed 10/27/10 for the Period Ending 09/25/10

Address	ONE INFINITE LOOP CUPERTINO, CA 95014
Telephone	(408) 996-1010
CIK	0000320193
Symbol	AAPL
SIC Code	3571 - Electronic Computers
Industry	Computer Hardware
Sector	Technology
Fiscal Year	09/30

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**Item 6. Selected Financial Data**

The information set forth below for the five years ended September 25, 2010, is not necessarily indicative of results of future operations, and should be read in conjunction with Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the consolidated financial statements and related notes thereto included in Item 8 of this Form 10-K to fully understand factors that may affect the comparability of the information presented below (in millions, except share amounts which are reflected in thousands and per share amounts).

	2010	2009	2008	2007	2006
Net sales	\$ 65,225	\$ 42,905	\$ 37,491	\$ 24,578	\$ 19,315
Net income	\$ 14,013	\$ 8,235	\$ 6,119	\$ 3,495	\$ 1,989
Earnings per common share:					
Basic	\$ 15.41	\$ 9.22	\$ 6.94	\$ 4.04	\$ 2.36
Diluted	\$ 15.15	\$ 9.08	\$ 6.78	\$ 3.93	\$ 2.27
Cash dividends declared per common share	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0
Shares used in computing earnings per share:					
Basic	909,461	893,016	881,592	864,595	844,058
Diluted	924,712	907,005	902,139	889,292	877,526
Total cash, cash equivalents and marketable securities	\$ 51,011	\$ 33,992	\$ 24,490	\$ 15,386	\$ 10,110
Total assets	\$ 75,183	\$ 47,501	\$ 36,171	\$ 24,878	\$ 17,205
Total long-term obligations (a)	\$ 5,531	\$ 3,502	\$ 1,745	\$ 687	\$ 395
Total liabilities	\$ 27,392	\$ 15,861	\$ 13,874	\$ 10,347	\$ 7,221
Total shareholders' equity	\$ 47,791	\$ 31,640	\$ 22,297	\$ 14,531	\$ 9,984

(a) The Company did not have any long-term debt during the five years ended September 25, 2010. Long-term obligations excludes non-current deferred revenue.

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**Gross Margin**

Gross margin for the three years ended September 25, 2010, are as follows (in millions, except gross margin percentages):

	<u>2010</u>	<u>2009</u>	<u>2008</u>
Net sales	\$65,225	\$42,905	\$37,491
Cost of sales	<u>39,541</u>	<u>25,683</u>	<u>24,294</u>
Gross margin	<u>\$25,684</u>	<u>\$17,222</u>	<u>\$13,197</u>
Gross margin percentage	39.4%	40.1%	35.2%

The gross margin percentage in 2010 was 39.4% compared to 40.1% in 2009. This decline in gross margin is primarily attributable to new products that have higher cost structures, including iPad, partially offset by a more favorable sales mix of iPhone, which has a higher gross margin than the Company average.

The gross margin percentage in 2009 was 40.1% compared to 35.2% in 2008. The primary contributors to the increase in 2009 as compared to 2008 were a favorable sales mix toward products with higher gross margins and lower commodity and other product costs, which were partially offset by product price reductions.

The Company expects its gross margin percentage to decrease in future periods compared to levels achieved during 2010 and anticipates gross margin levels of about 36% in the first quarter of 2011. This expected decline is largely due to a higher mix of new and innovative products that have higher cost structures and deliver greater value to customers, and expected and potential future component cost and other cost increases.

The foregoing statements regarding the Company's expected gross margin percentage are forward-looking and could differ from anticipated levels because of several factors, including but not limited to certain of those set forth below in Part I, Item 1A, "Risk Factors" under the subheading "*Future operating results depend upon the Company's ability to obtain key components including but not limited to microprocessors, NAND flash memory, DRAM and LCDs at favorable prices and in sufficient quantities.*" which is incorporated herein by reference. There can be no assurance that targeted gross margin percentage levels will be achieved. In general, gross margins and margins on individual products will remain under downward pressure due to a variety of factors, including continued industry wide global product pricing pressures, increased competition, compressed product life cycles, product transitions and expected and potential increases in the cost of key components including but not limited to microprocessors, NAND flash memory, DRAM and LCDs, as well as potential increases in the costs of outside manufacturing services and a potential shift in the Company's sales mix towards products with lower gross margins. In response to these competitive pressures, the Company expects it will continue to take product pricing actions, which would adversely affect gross margins. Gross margins could also be affected by the Company's ability to manage product quality and warranty costs effectively and to stimulate demand for certain of its products. Due to the Company's significant international operations, financial results can be significantly affected in the short-term by fluctuations in exchange rates.

**Operating Expenses**

Operating expenses for the three years ended September 25, 2010, are as follows (in millions, except for percentages):

	<u>2010</u>	<u>2009</u>	<u>2008</u>
Research and development	\$ 1,782	\$ 1,333	\$ 1,109
Percentage of net sales	2.7%	3.1%	3.0%
Selling, general and administrative	\$ 5,517	\$ 4,149	\$ 3,761
Percentage of net sales	8.5%	9.7%	10.0%

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**Research and Development Expense ("R&D")**

R&D expense increased 34% or \$449 million to \$1.8 billion in 2010 compared to 2009. This increase was due primarily to an increase in headcount and related expenses in the current year to support expanded R&D activities. Also contributing to this increase in R&D expense in 2010 was the capitalization in 2009 of software development costs of \$71 million related to Mac OS X Snow Leopard. Although total R&D expense increased 34% during 2010, it declined as a percentage of net sales given the 52% year-over-year increase in net sales in 2010. The Company continues to believe that focused investments in R&D are critical to its future growth and competitive position in the marketplace and are directly related to timely development of new and enhanced products that are central to the Company's core business strategy. As such, the Company expects to make further investments in R&D to remain competitive.

R&D expense increased 20% or \$224 million to \$1.3 billion in 2009 compared to 2008. This increase was due primarily to an increase in headcount in 2009 to support expanded R&D activities and higher stock-based compensation expenses. Additionally, \$71 million of software development costs were capitalized related to Mac OS X Snow Leopard and excluded from R&D expense during 2009, compared to \$11 million of software development costs capitalized during 2008. Although total R&D expense increased 20% during 2009, it remained relatively flat as a percentage of net sales given the 14% increase in revenue in 2009.

**Selling, General and Administrative Expense ("SG&A")**

SG&A expense increased \$1.4 billion or 33% to \$5.5 billion in 2010 compared to 2009. This increase was due primarily to the Company's continued expansion of its Retail segment, higher spending on marketing and advertising programs, increased stock-based compensation expenses and variable costs associated with the overall growth of the Company's net sales.

SG&A expenses increased \$388 million or 10% to \$4.1 billion in 2009 compared to 2008. This increase was due primarily to the Company's continued expansion of its Retail segment in both domestic and international markets, higher stock-based compensation expense and higher spending on marketing and advertising.

**Other Income and Expense**

Other income and expense for the three years ended September 25, 2010, are as follows (in millions):

	<u>2010</u>	<u>2009</u>	<u>2008</u>
Interest income	\$ 311	\$ 407	\$ 653
Other income (expense), net	(156)	(81)	(33)
Total other income and expense	<u>\$ 155</u>	<u>\$ 326</u>	<u>\$ 620</u>

Total other income and expense decreased \$171 million or 52% to \$155 million during 2010 compared to \$326 million and \$620 million in 2009 and 2008, respectively. The overall decrease in other income and expense is attributable to the significant declines in interest rates on a year-over-year basis, partially offset by the Company's higher cash, cash equivalents and marketable securities balances. The weighted average interest rate earned by the Company on its cash, cash equivalents and marketable securities was 0.75%, 1.43% and 3.44% during 2010, 2009 and 2008, respectively. Additionally the Company incurred higher premium expenses on its foreign exchange option contracts, which further reduced the total other income and expense. During 2010, 2009 and 2008, the Company had no debt outstanding and accordingly did not incur any related interest expense.

**Provision for Income Taxes**

The Company's effective tax rates were 24%, 32% and 32% for 2010, 2009 and 2008, respectively. The Company's effective rates for these periods differ from the statutory federal income tax rate of 35% due

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## CONSOLIDATED STATEMENTS OF OPERATIONS

(In millions, except share amounts which are reflected in thousands and per share amounts)

Three years ended September 25, 2010	2010	2009	2008
Net sales	\$ 65,225	\$ 42,905	\$ 37,491
Cost of sales	39,541	25,683	24,294
Gross margin	25,684	17,222	13,197
Operating expenses:			
Research and development	1,782	1,333	1,109
Selling, general and administrative	5,517	4,149	3,761
Total operating expenses	7,299	5,482	4,870
Operating income	18,385	11,740	8,327
Other income and expense	155	326	620
Income before provision for income taxes	18,540	12,066	8,947
Provision for income taxes	4,527	3,831	2,828
Net income	\$ 14,013	\$ 8,235	\$ 6,119
Earnings per common share:			
Basic	\$ 15.41	\$ 9.22	\$ 6.94
Diluted	\$ 15.15	\$ 9.08	\$ 6.78
Shares used in computing earnings per share:			
Basic	909,461	893,016	881,592
Diluted	924,712	907,005	902,139

See accompanying Notes to Consolidated Financial Statements.

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## Note 6 – Income Taxes

The provision for income taxes for the three years ended September 25, 2010, consisted of the following (in millions):

	<u>2010</u>	<u>2009</u>	<u>2008</u>
Federal:			
Current	\$2,150	\$1,922	\$1,796
Deferred	<u>1,676</u>	<u>1,077</u>	<u>498</u>
	<u>3,826</u>	<u>2,999</u>	<u>2,294</u>
State:			
Current	655	524	359
Deferred	<u>(115)</u>	<u>(2)</u>	<u>(25)</u>
	<u>540</u>	<u>522</u>	<u>334</u>
Foreign:			
Current	282	345	275
Deferred	<u>(121)</u>	<u>(35)</u>	<u>(75)</u>
	<u>161</u>	<u>310</u>	<u>200</u>
Provision for income taxes	<u>\$4,527</u>	<u>\$3,831</u>	<u>\$2,828</u>

The foreign provision for income taxes is based on foreign pretax earnings of \$13.0 billion, \$6.6 billion and \$4.6 billion in 2010, 2009 and 2008, respectively. The Company's consolidated financial statements provide for any related tax liability on amounts that may be repatriated, aside from undistributed earnings of certain of the Company's foreign subsidiaries that are intended to be indefinitely reinvested in operations outside the U.S. As of September 25, 2010, U.S. income taxes have not been provided on a cumulative total of \$12.3 billion of such earnings. The amount of unrecognized deferred tax liability related to these temporary differences is estimated to be approximately \$4.0 billion.

As of September 25, 2010 and September 26, 2009, \$30.8 billion and \$17.4 billion, respectively, of the Company's cash, cash equivalents and marketable securities were held by foreign subsidiaries and are generally based in U.S. dollar-denominated holdings. Amounts held by foreign subsidiaries are generally subject to U.S. income taxation on repatriation to the U.S.

Deferred tax assets and liabilities reflect the effects of tax losses, credits, and the future income tax effects of temporary differences between the consolidated financial statement carrying amounts of existing assets and liabilities and their respective tax bases and are measured using enacted tax rates that apply to taxable income in the years in which those temporary differences are expected to be recovered or settled.

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(a) Other corporate expenses include research and development, corporate marketing expenses, manufacturing costs and variances not included in standard costs, and other separately managed general and administrative expenses, including certain corporate expenses associated with support of the Retail segment.

No single country outside of the U.S. accounted for more than 10% of net sales in 2010, 2009 or 2008. One of the Company's customers accounted for 11% of net sales in 2009; there was no single customer that accounted for more than 10% of net sales in 2010 or 2008. Net sales and long-lived assets related to the U.S. and international operations for the three years ended September 25, 2010, are as follows (in millions):

	<u>2010</u>	<u>2009</u>	<u>2008</u>
Net sales:			
U.S.	\$28,633	\$22,325	\$20,893
International	36,592	20,580	16,598
Total net sales	<u>\$65,225</u>	<u>\$42,905</u>	<u>\$37,491</u>
Long-lived assets:			
U.S.	\$ 4,292	\$ 2,698	\$ 2,269
International	710	495	410
Total long-lived assets	<u>\$ 5,002</u>	<u>\$ 3,193</u>	<u>\$ 2,679</u>

Information regarding net sales by product for the three years ended September 25, 2010, is as follows (in millions):

	<u>2010</u>	<u>2009</u>	<u>2008</u>
Desktops (a)	\$ 6,201	\$ 4,324	\$ 5,622
Portables (b)	11,278	9,535	8,732
Total Mac net sales	17,479	13,859	14,354
iPod	8,274	8,091	9,153
Other music related products and services (c)	4,948	4,036	3,340
iPhone and related products and services (d)	25,179	13,033	6,742
iPad and related products and services (e)	4,958	0	0
Peripherals and other hardware (f)	1,814	1,475	1,694
Software, service and other net sales (g)	2,573	2,411	2,208
Total net sales	<u>\$65,225</u>	<u>\$42,905</u>	<u>\$37,491</u>

(a) Includes iMac, Mac mini, Mac Pro and Xserve product lines.

(b) Includes MacBook, MacBook Air and MacBook Pro product lines.

(c) Includes iTunes Store sales, iPod services, and Apple-branded and third-party iPod accessories.

(d) Includes revenue recognized from iPhone sales, carrier agreements, services, and Apple-branded and third-party iPhone accessories.

(e) Includes revenue recognized from iPad sales, services and Apple-branded and third-party iPad accessories.

(f) Includes sales of displays, wireless connectivity and networking solutions, and other hardware accessories.

(g) Includes sales of Apple-branded operating system and application software, third-party software, Mac and Internet services.

**Note 10 – Related Party Transactions and Certain Other Transactions**

The Company entered into a Reimbursement Agreement with its CEO, Steve Jobs, for the reimbursement of expenses incurred by Mr. Jobs in the operation of his private plane when used for Apple business. The Company recognized a total of approximately \$248,000, \$4,000 and \$871,000 in expenses pursuant to the Reimbursement

EXCERPT

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**Form 10-K**

(Mark One)

 ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended September 24, 2011

Or

 TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 000-10030

**APPLE INC.**

(Exact name of registrant as specified in its charter)

California (State or other jurisdiction of incorporation or organization) 94-2404110 (I.R.S. Employer Identification No.)

1 Infinite Loop (Address of principal executive offices) 95014 (Zip Code)

Registrant's telephone number, including area code: (408) 996-1010

Securities registered pursuant to Section 12(b) of the Act:

Common Stock, no par value (Title of class) The NASDAQ Global Select Market (Name of exchange on which registered)

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes  No 

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

Yes  No 

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No 

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (section 229.405 of this chapter) is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. 

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer   
Non-accelerated filer  (Do not check if smaller reporting company) Smaller Reporting Company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act).

Yes  No 

The aggregate market value of the voting and non-voting stock held by non-affiliates of the registrant, as of March 25, 2011, the last business day of the Company's most recently completed second fiscal quarter, was approximately \$322,921,000,000 based upon the closing price reported for such date on the NASDAQ Global Select Market. For purposes of this disclosure, shares of common stock held by persons who hold more than 5% of the outstanding shares of common stock and shares held by executive officers and directors of the registrant have been excluded because such persons may be deemed to be affiliates. This determination of executive officer or affiliate status is not necessarily a conclusive determination for other purposes.

929,409,000 shares of Common Stock Issued and Outstanding as of October 14, 2011

## DOCUMENTS INCORPORATED BY REFERENCE

(1) Portions of the registrant's definitive Proxy Statement relating to its 2012 Annual Meeting of Shareholders are incorporated by reference into Part III of this Annual Report on Form 10-K where indicated. Such Proxy Statement will be filed with the U.S. Securities and Exchange Commission within 120 days after the end of the fiscal year to which this report relates.

**Gross Margin**

Gross margin for the three years ended September 24, 2011, are as follows (in millions, except gross margin percentages):

	<u>2011</u>	<u>2010</u>	<u>2009</u>
Net sales .....	\$108,249	\$ 65,225	\$ 42,905
Cost of sales .....	64,431	39,541	25,683
Gross margin .....	<u>\$ 43,818</u>	<u>\$ 25,684</u>	<u>\$ 17,222</u>
Gross margin percentage .....	40.5%	39.4%	40.1%

The gross margin percentage in 2011 was 40.5%, compared to 39.4% in 2010. This year-over-year increase in gross margin was largely driven by lower commodity and other product costs.

The gross margin percentage in 2010 was 39.4% compared to 40.1% in 2009. This year-over-year decline in gross margin was primarily attributable to new products that had higher cost structures, including iPad, partially offset by a more favorable sales mix of iPhone, which had a higher gross margin than the Company average.

The Company expects to experience decreases in its gross margin percentage in future periods, as compared to levels achieved during 2011, largely due to a higher mix of new and innovative products with flat or reduced pricing that have higher cost structures and deliver greater value to customers, and potential future component cost and other cost increases.

The foregoing statements regarding the Company's expected gross margin percentage are forward-looking and could differ from anticipated levels because of several factors including, but not limited to certain of those set forth below in Part I, Item 1A, "Risk Factors" under the subheading "*Future operating results depend upon the Company's ability to obtain components in sufficient quantities,*" which is incorporated herein by reference. In general, gross margins and margins on individual products will remain under downward pressure due to a variety of factors, including continued industry wide global product pricing pressures, increased competition, compressed product life cycles, product transitions and potential increases in the cost of components, as well as potential increases in the costs of outside manufacturing services and a potential shift in the Company's sales mix towards products with lower gross margins. In response to these competitive pressures, the Company expects it will continue to take product pricing actions, which would adversely affect gross margins. Gross margins could also be affected by the Company's ability to manage product quality and warranty costs effectively and to stimulate demand for certain of its products. Due to the Company's significant international operations, financial results can be significantly affected in the short-term by fluctuations in exchange rates.

**Operating Expenses**

Operating expenses for the three years ended September 24, 2011, are as follows (in millions, except for percentages):

	<u>2011</u>	<u>2010</u>	<u>2009</u>
Research and development .....	\$ 2,429	\$ 1,782	\$ 1,333
Percentage of net sales .....	2%	3%	3%
Selling, general and administrative .....	\$ 7,599	\$ 5,517	\$ 4,149
Percentage of net sales .....	7%	8%	10%

*Research and Development Expense ("R&D")*

R&D expense increased \$647 million or 36% to \$2.4 billion in 2011 compared to 2010. This increase was due primarily to an increase in headcount and related expenses to support expanded R&D activities. Although total

R&D expense increased 36% during 2011 compared to 2010, it declined slightly as a percentage of net sales, due to the 66% year-over-year growth in the Company's net sales during 2011.

R&D expense increased 34% or \$449 million to \$1.8 billion in 2010 compared to 2009. This increase was due primarily to an increase in headcount and related expenses in the current year to support expanded R&D activities. Also contributing to this increase in R&D expense in 2010 was the capitalization in 2009 of software development costs of \$71 million related to Mac OS X Snow Leopard. Although total R&D expense increased 34% during 2010, it declined as a percentage of net sales given the 52% year-over-year increase in net sales in 2010.

The Company continues to believe that focused investments in R&D are critical to its future growth and competitive position in the marketplace and are directly related to timely development of new and enhanced products that are central to the Company's core business strategy. As such, the Company expects to make further investments in R&D to remain competitive.

*Selling, General and Administrative Expense ("SG&A")*

SG&A expense increased \$2.1 billion or 38% to \$7.6 billion during 2011 compared to 2010. This increase was due primarily to the Company's continued expansion of its Retail segment, increased headcount and related costs, higher spending on professional services and marketing and advertising programs, and increased variable costs associated with the overall growth of the Company's net sales.

SG&A expense increased \$1.4 billion or 33% to \$5.5 billion in 2010 compared to 2009. This increase was due primarily to the Company's continued expansion of its Retail segment, higher spending on marketing and advertising programs, increased share-based compensation expenses and variable costs associated with the overall growth of the Company's net sales.

**Other Income and Expense**

Other income and expense for the three years ended September 24, 2011, are as follows (in millions):

	2011	2010	2009
Interest and dividend income .....	\$ 519	\$ 311	\$ 407
Other expense, net .....	(104)	(156)	(81)
Total other income and expense .....	<u>\$ 415</u>	<u>\$ 155</u>	<u>\$ 326</u>

Total other income and expense increased \$260 million or 168% to \$415 million during 2011 compared to \$155 million and \$326 million in 2010 and 2009, respectively. The year-over-year increase in other income and expense during 2011 was due primarily to higher interest income and net realized gains on sales of marketable securities. The overall decrease in other income and expense in 2010 compared to 2009 was attributable to the significant declines in interest rates on a year-over-year basis, partially offset by the Company's higher cash, cash equivalents and marketable securities balances. Additionally the Company incurred higher premium expenses on its foreign exchange option contracts, which further reduced the total other income and expense. The weighted average interest rate earned by the Company on its cash, cash equivalents and marketable securities was 0.77%, 0.75% and 1.43% during 2011, 2010 and 2009, respectively. During 2011, 2010 and 2009, the Company had no debt outstanding and accordingly did not incur any related interest expense.

**Provision for Income Taxes**

The Company's effective tax rates were approximately 24.2%, 24.4% and 31.8% for 2011, 2010 and 2009, respectively. The Company's effective rates for these periods differ from the statutory federal income tax rate of

35% due primarily to certain undistributed foreign earnings for which no U.S. taxes are provided because such earnings are intended to be indefinitely reinvested outside the U.S.

As of September 24, 2011, the Company had deferred tax assets arising from deductible temporary differences, tax losses, and tax credits of \$3.2 billion, and deferred tax liabilities of \$9.2 billion. Management believes it is more likely than not that forecasted income, including income that may be generated as a result of certain tax planning strategies, together with future reversals of existing taxable temporary differences, will be sufficient to fully recover the deferred tax assets. The Company will continue to evaluate the realizability of deferred tax assets quarterly by assessing the need for and amount of a valuation allowance.

The Internal Revenue Service (the "IRS") has completed its field audit of the Company's federal income tax returns for the years 2004 through 2006 and proposed certain adjustments. The Company has contested certain of these adjustments through the IRS Appeals Office. The IRS is currently examining the years 2007 through 2009. All IRS audit issues for years prior to 2004 have been resolved. In addition, the Company is subject to audits by state, local, and foreign tax authorities. Management believes that adequate provisions have been made for any adjustments that may result from tax examinations. However, the outcome of tax audits cannot be predicted with certainty. If any issues addressed in the Company's tax audits are resolved in a manner not consistent with management's expectations, the Company could be required to adjust its provision for income taxes in the period such resolution occurs.

#### Liquidity and Capital Resources

The following table presents selected financial information and statistics as of and for the three years ended September 24, 2011 (in millions):

	<u>2011</u>	<u>2010</u>	<u>2009</u>
Cash, cash equivalents and marketable securities	\$81,570	\$51,011	\$33,992
Accounts receivable, net	\$ 5,369	\$ 5,510	\$ 3,361
Inventories	\$ 776	\$ 1,051	\$ 455
Working capital	\$17,018	\$20,956	\$20,049
Annual operating cash flow	\$37,529	\$18,595	\$10,159

Cash, cash equivalents and marketable securities increased \$30.6 billion or 60% during 2011. The principal components of this net increase was the cash generated by operating activities of \$37.5 billion, which was partially offset by payments for acquisition of property, plant and equipment of \$4.3 billion, payments for acquisition of intangible assets of \$3.2 billion and payments made in connection with business acquisitions, net of cash acquired, of \$244 million. The Company believes its existing balances of cash, cash equivalents and marketable securities will be sufficient to satisfy its working capital needs, capital asset purchases, outstanding commitments and other liquidity requirements associated with its existing operations over the next 12 months.

The Company's marketable securities investment portfolio is invested primarily in highly rated securities and its policy generally limits the amount of credit exposure to any one issuer. The Company's investment policy requires investments to generally be investment grade with the objective of minimizing the potential risk of principal loss. As of September 24, 2011 and September 25, 2010, \$54.3 billion and \$30.8 billion, respectively, of the Company's cash, cash equivalents and marketable securities were held by foreign subsidiaries and are generally based in U.S. dollar-denominated holdings. Amounts held by foreign subsidiaries are generally subject to U.S. income taxation on repatriation to the U.S.

#### Capital Assets

The Company's capital expenditures were \$4.6 billion during 2011, consisting of approximately \$614 million for retail store facilities and \$4.0 billion for other capital expenditures, including product tooling and manufacturing

**CONSOLIDATED STATEMENTS OF OPERATIONS**

(In millions, except number of shares which are reflected in thousands and per share amounts)

<u>Three years ended September 24, 2011</u>	<u>2011</u>	<u>2010</u>	<u>2009</u>
Net sales .....	\$108,249	\$ 65,225	\$ 42,905
Cost of sales .....	64,431	39,541	25,683
Gross margin .....	<u>43,818</u>	<u>25,684</u>	<u>17,222</u>
Operating expenses:			
Research and development .....	2,429	1,782	1,333
Selling, general and administrative .....	7,599	5,517	4,149
Total operating expenses .....	<u>10,028</u>	<u>7,299</u>	<u>5,482</u>
Operating income .....	33,790	18,385	11,740
Other income and expense .....	415	155	326
Income before provision for income taxes .....	<u>34,205</u>	<u>18,540</u>	<u>12,066</u>
Provision for income taxes .....	8,283	4,527	3,831
Net income .....	<u>\$ 25,922</u>	<u>\$ 14,013</u>	<u>\$ 8,235</u>
Earnings per common share:			
Basic .....	\$ 28.05	\$ 15.41	\$ 9.22
Diluted .....	\$ 27.68	\$ 15.15	\$ 9.08
Shares used in computing earnings per share:			
Basic .....	924,258	909,461	893,016
Diluted .....	936,645	924,712	907,005

See accompanying Notes to Consolidated Financial Statements.

**Note 5 – Income Taxes**

The provision for income taxes for the three years ended September 24, 2011, consisted of the following (in millions):

	<u>2011</u>	<u>2010</u>	<u>2009</u>
Federal:			
Current .....	\$3,884	\$2,150	\$1,922
Deferred .....	<u>2,998</u>	<u>1,676</u>	<u>1,077</u>
	6,882	3,826	2,999
State:			
Current .....	762	655	524
Deferred .....	<u>37</u>	<u>(115)</u>	<u>(2)</u>
	799	540	522
Foreign:			
Current .....	769	282	345
Deferred .....	<u>(167)</u>	<u>(121)</u>	<u>(35)</u>
	602	161	310
Provision for income taxes .....	<u>\$8,283</u>	<u>\$4,527</u>	<u>\$3,831</u>

The foreign provision for income taxes is based on foreign pretax earnings of \$24.0 billion, \$13.0 billion and \$6.6 billion in 2011, 2010 and 2009, respectively. The Company's consolidated financial statements provide for any related tax liability on amounts that may be repatriated, aside from undistributed earnings of certain of the Company's foreign subsidiaries that are intended to be indefinitely reinvested in operations outside the U.S. As of September 24, 2011, U.S. income taxes have not been provided on a cumulative total of \$23.4 billion of such earnings. The amount of unrecognized deferred tax liability related to these temporary differences is estimated to be approximately \$8.0 billion.

As of September 24, 2011 and September 25, 2010, \$54.3 billion and \$30.8 billion, respectively, of the Company's cash, cash equivalents and marketable securities were held by foreign subsidiaries and are generally based in U.S. dollar-denominated holdings. Amounts held by foreign subsidiaries are generally subject to U.S. income taxation on repatriation to the U.S.

Deferred tax assets and liabilities reflect the effects of tax losses, credits, and the future income tax effects of temporary differences between the consolidated financial statement carrying amounts of existing assets and liabilities and their respective tax bases and are measured using enacted tax rates that apply to taxable income in the years in which those temporary differences are expected to be recovered or settled.

- (a) Other corporate expenses include research and development, corporate marketing expenses, manufacturing costs and variances not included in standard costs, and other separately managed general and administrative expenses, including certain corporate expenses associated with support of the Retail segment.

The U.S. and China were the only countries that accounted for more than 10% of Company's net sales in 2011. No single country other than the U.S. accounted for more than 10% of net sales in 2010 or 2009. There was no single customer that accounted for more than 10% of net sales in 2011 or 2010. One of the Company's customers accounted for 11% of net sales in 2009. Net sales for the three years ended September 24, 2011 and long-lived assets as of September 24, 2011, September 25, 2010 and September 26, 2009 are as follows (in millions):

	<u>2011</u>	<u>2010</u>	<u>2009</u>
Net sales:			
U.S. ....	\$ 41,812	\$ 28,633	\$ 22,325
China (a) .....	12,472	2,764	769
Other countries .....	53,965	33,828	19,811
Total net sales .....	<u>\$108,249</u>	<u>\$ 65,225</u>	<u>\$ 42,905</u>
Long-lived assets:			
U.S. ....	\$ 4,375	\$ 3,096	\$ 2,348
China (a) .....	2,613	1,245	365
Other countries .....	1,090	661	480
Total long-lived assets .....	<u>\$ 8,078</u>	<u>\$ 5,002</u>	<u>\$ 3,193</u>

- (a) China includes Hong Kong. Long-lived assets located in China consist primarily of product tooling and manufacturing process equipment and assets related to retail stores and related infrastructure.

Information regarding net sales by product for the three years ended September 24, 2011, is as follows (in millions):

	<u>2011</u>	<u>2010</u>	<u>2009</u>
Desktops (a) .....	\$ 6,439	\$ 6,201	\$ 4,324
Portables (b) .....	15,344	11,278	9,535
Total Mac net sales .....	21,783	17,479	13,859
iPod .....	7,453	8,274	8,091
Other music related products and services (c) .....	6,314	4,948	4,036
iPhone and related products and services (d) .....	47,057	25,179	13,033
iPad and related products and services (e) .....	20,358	4,958	0
Peripherals and other hardware (f) .....	2,330	1,814	1,475
Software, service and other net sales (g) .....	2,954	2,573	2,411
Total net sales .....	<u>\$108,249</u>	<u>\$ 65,225</u>	<u>\$ 42,905</u>

- (a) Includes iMac, Mac mini, Mac Pro and Xserve product lines.  
(b) Includes MacBook, MacBook Air and MacBook Pro product lines.  
(c) Includes sales from the iTunes Store, App Store, and iBookstore in addition to sales of iPod services and Apple-branded and third-party iPod accessories.  
(d) Includes revenue recognized from iPhone sales, carrier agreements, services, and Apple-branded and third-party iPhone accessories.  
(e) Includes revenue recognized from iPad sales, services and Apple-branded and third-party iPad accessories.  
(f) Includes sales of displays, wireless connectivity and networking solutions, and other hardware accessories.  
(g) Includes sales from the Mac App Store in addition to sales of other Apple-branded and third-party Mac software and Mac and Internet services.

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**EXCERPT**


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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**Form 10-K**

(Mark One)

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the fiscal year ended September 29, 2012

or  
 **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 000-10030

**APPLE INC.**

(Exact name of registrant as specified in its charter)

California (State or other jurisdiction of incorporation or organization)	94-2404110 (I.R.S. Employer Identification No.)
1 Infinite Loop Cupertino, California (Address of principal executive offices)	95014 (Zip Code)
Registrant's telephone number, including area code: (408) 996-1010	

Common Stock, no par value (Title of class)	The NASDAQ Stock Market LLC (Name of exchange on which registered)
Securities registered pursuant to Section 12(g) of the Act: None	

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes  No 

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

Yes  No 

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No 

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (section 229.405 of this chapter) is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. 

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer <input checked="" type="checkbox"/>	Accelerated filer <input type="checkbox"/>
Non-accelerated filer <input type="checkbox"/> (Do not check if a smaller reporting company)	Smaller reporting company <input type="checkbox"/>

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act).

Yes  No 

The aggregate market value of the voting and non-voting stock held by non-affiliates of the registrant, as of March 30, 2012, the last business day of the registrant's most recently completed second fiscal quarter, was approximately \$560,356,000,000 based upon the closing price reported for such date on the NASDAQ Stock Market LLC. Solely for purposes of this disclosure, shares of common stock held by executive officers and directors of the registrant as of such date have been excluded because such persons may be deemed to be affiliates. This determination of executive officers and directors as affiliates is not necessarily a conclusive determination for any other purposes.

940,692,000 shares of common stock were issued and outstanding as of October 19, 2012.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the registrant's definitive proxy statement relating to its 2013 annual meeting of shareholders (the "2013 Proxy Statement") are incorporated by reference into Part III of this Annual Report on Form 10-K where indicated. The 2013 Proxy Statement will be filed with the U.S. Securities and Exchange Commission within 120 days after the end of the fiscal year to which this report relates.

**Operating Expenses**

Operating expenses for 2012, 2011, and 2010 are as follows (in millions, except for percentages):

	<u>2012</u>	<u>2011</u>	<u>2010</u>
Research and development .....	\$ 3,381	\$2,429	\$1,782
Percentage of net sales .....	2%	2%	3%
Selling, general and administrative .....	\$10,040	\$7,599	\$5,517
Percentage of net sales .....	6%	7%	8%

*Research and Development ("R&D") Expense*

R&D expense increased \$952 million or 39% in 2012 compared to 2011 and \$647 million or 36% in 2011 compared to 2010. The growth in R&D expense was driven by an increase in headcount and related expenses to support expanded R&D activities. Although total R&D expense increased 39% and 36% in 2012 and 2011, respectively, it remained fairly consistent as a percentage of net sales.

The Company continues to believe that focused investments in R&D are critical to its future growth and competitive position in the marketplace and are directly related to timely development of new and enhanced products that are central to the Company's core business strategy. As such, the Company expects to make further investments in R&D to remain competitive.

*Selling, General and Administrative ("SG&A") Expense*

SG&A expense increased \$2.4 billion or 32% during 2012 compared to 2011 and \$2.1 billion or 38% during 2011 compared to 2010. These increases were primarily due to the Company's continued expansion of its Retail segment, increased headcount and related expenses, higher spending on professional services, marketing and advertising programs, and increased variable costs associated with the overall growth of the Company's net sales.

**Other Income and Expense**

Other income and expense for 2012, 2011, and 2010 are as follows (in millions):

	<u>2012</u>	<u>2011</u>	<u>2010</u>
Interest and dividend income .....	\$ 1,088	\$ 519	\$ 311
Other expense, net .....	(566)	(104)	(156)
Total other income/(expense), net .....	<u>\$ 522</u>	<u>\$ 415</u>	<u>\$ 155</u>

Total other income and expense increased \$107 million or 26% to \$522 million during 2012 compared to \$415 million and \$155 million in 2011 and 2010, respectively. The year-over-year increase in other income and expense during 2012 was due primarily to higher interest and dividend income on the Company's higher cash, cash equivalents and marketable securities balances, partially offset by higher premium expenses on foreign exchange contracts. The overall increase in other income and expense in 2011 compared to 2010 was attributable to higher interest income and net realized gains on sales of marketable securities. The weighted average interest rate earned by the Company on its cash, cash equivalents and marketable securities was 1.03%, 0.77%, and 0.75% during 2012, 2011, and 2010, respectively. During 2012, 2011, and 2010, the Company had no debt outstanding and accordingly did not incur any related interest expense.

**Provision for Income Taxes**

The Company's effective tax rates were approximately 25.2%, 24.2%, and 24.4% for 2012, 2011, and 2010, respectively. The Company's effective rates for these periods differ from the statutory federal income tax rate of

35% due primarily to certain undistributed foreign earnings for which no U.S. taxes are provided because such earnings are intended to be indefinitely reinvested outside the U.S.

As of September 29, 2012, the Company had deferred tax assets arising from deductible temporary differences, tax losses, and tax credits of \$4.0 billion, and deferred tax liabilities of \$14.9 billion. Management believes it is more likely than not that forecasted income, including income that may be generated as a result of certain tax planning strategies, together with future reversals of existing taxable temporary differences, will be sufficient to fully recover the deferred tax assets. The Company will continue to evaluate the realizability of deferred tax assets quarterly by assessing the need for and amount of a valuation allowance.

The Internal Revenue Service (the "IRS") has completed its field audit of the Company's federal income tax returns for the years 2004 through 2006 and proposed certain adjustments. The Company has contested certain of these adjustments through the IRS Appeals Office. The IRS is currently examining the years 2007 through 2009. All IRS audit issues for years prior to 2004 have been resolved. In addition, the Company is subject to audits by state, local, and foreign tax authorities. Management believes that adequate provisions have been made for any adjustments that may result from tax examinations. However, the outcome of tax audits cannot be predicted with certainty. If any issues addressed in the Company's tax audits are resolved in a manner not consistent with management's expectations, the Company could be required to adjust its provision for income taxes in the period such resolution occurs.

#### Liquidity and Capital Resources

The following table presents selected financial information and statistics as of and for the years ended September 29, 2012, September 24, 2011, and September 25, 2010 (in millions):

	2012	2011	2010
Cash, cash equivalents and marketable securities	\$121,251	\$81,570	\$51,011
Accounts receivable, net	\$ 10,930	\$ 5,369	\$ 5,510
Inventories	\$ 791	\$ 776	\$ 1,051
Working capital	\$ 19,111	\$17,018	\$20,956
Annual operating cash flow	\$ 50,856	\$37,529	\$18,595

As of September 29, 2012, the Company had \$121.3 billion in cash, cash equivalents and marketable securities, an increase of \$39.7 billion or 49% from September 24, 2011. The principal components of this net increase was the cash generated by operating activities of \$50.9 billion, which was partially offset by payments for acquisition of property, plant and equipment of \$8.3 billion, payments for acquisition of intangible assets of \$1.1 billion and payments of dividends and dividend equivalent rights of \$2.5 billion.

The Company's marketable securities investment portfolio is invested primarily in highly-rated securities and its investment policy generally limits the amount of credit exposure to any one issuer. The policy requires investments generally to be investment grade with the objective of minimizing the potential risk of principal loss. As of September 29, 2012 and September 24, 2011, \$82.6 billion and \$54.3 billion, respectively, of the Company's cash, cash equivalents and marketable securities were held by foreign subsidiaries and are generally based in U.S. dollar-denominated holdings. Amounts held by foreign subsidiaries are generally subject to U.S. income taxation on repatriation to the U.S. The Company believes its existing balances of cash, cash equivalents and marketable securities will be sufficient to satisfy its working capital needs, capital asset purchases, outstanding commitments, common stock repurchases, dividends on its common stock, and other liquidity requirements associated with its existing operations over the next 12 months.

#### Capital Assets

The Company's capital expenditures were \$10.3 billion during 2012, consisting of \$865 million for retail store facilities and \$9.5 billion for other capital expenditures, including product tooling and manufacturing process

**CONSOLIDATED STATEMENTS OF OPERATIONS**

(In millions, except number of shares which are reflected in thousands and per share amounts)

	Years ended		
	September 29, 2012	September 24, 2011	September 25, 2010
Net sales .....	\$156,508	\$108,249	\$ 65,225
Cost of sales .....	87,846	64,431	39,541
Gross margin .....	<u>68,662</u>	<u>43,818</u>	<u>25,684</u>
Operating expenses:			
Research and development .....	3,381	2,429	1,782
Selling, general and administrative .....	10,040	7,599	5,517
Total operating expenses .....	<u>13,421</u>	<u>10,028</u>	<u>7,299</u>
Operating income .....	55,241	33,790	18,385
Other income/(expense), net .....	522	415	155
Income before provision for income taxes .....	55,763	34,205	18,540
Provision for income taxes .....	14,030	8,283	4,527
Net income .....	<u>\$ 41,733</u>	<u>\$ 25,922</u>	<u>\$ 14,013</u>
Earnings per share:			
Basic .....	\$ 44.64	\$ 28.05	\$ 15.41
Diluted .....	\$ 44.15	\$ 27.68	\$ 15.15
Shares used in computing earnings per share:			
Basic .....	934,818	924,258	909,461
Diluted .....	945,355	936,645	924,712
Cash dividends declared per common share .....	\$ 2.65	\$ 0.00	\$ 0.00

See accompanying Notes to Consolidated Financial Statements.

**Note 5 – Income Taxes**

The provision for income taxes for 2012, 2011, and 2010, consisted of the following (in millions):

	<u>2012</u>	<u>2011</u>	<u>2010</u>
Federal:			
Current .....	\$ 7,240	\$ 3,884	\$ 2,150
Deferred .....	5,018	2,998	1,676
	<u>12,258</u>	<u>6,882</u>	<u>3,826</u>
State:			
Current .....	1,182	762	655
Deferred .....	(123)	37	(115)
	<u>1,059</u>	<u>799</u>	<u>540</u>
Foreign:			
Current .....	1,203	769	282
Deferred .....	(490)	(167)	(121)
	<u>713</u>	<u>602</u>	<u>161</u>
Provision for income taxes .....	<u>\$14,030</u>	<u>\$ 8,283</u>	<u>\$ 4,527</u>

The foreign provision for income taxes is based on foreign pretax earnings of \$36.8 billion, \$24.0 billion and \$13.0 billion in 2012, 2011 and 2010, respectively. The Company's consolidated financial statements provide for any related tax liability on amounts that may be repatriated, aside from undistributed earnings of certain of the Company's foreign subsidiaries that are intended to be indefinitely reinvested in operations outside the U.S. As of September 29, 2012, U.S. income taxes have not been provided on a cumulative total of \$40.4 billion of such earnings. The amount of unrecognized deferred tax liability related to these temporary differences is estimated to be approximately \$13.8 billion.

As of September 29, 2012 and September 24, 2011, \$82.6 billion and \$54.3 billion, respectively, of the Company's cash, cash equivalents and marketable securities were held by foreign subsidiaries and are generally based in U.S. dollar-denominated holdings. Amounts held by foreign subsidiaries are generally subject to U.S. income taxation on repatriation to the U.S.

A reconciliation of the provision for income taxes, with the amount computed by applying the statutory federal income tax rate (35% in 2012, 2011 and 2010) to income before provision for income taxes for 2012, 2011, and 2010, is as follows (in millions):

	<u>2012</u>	<u>2011</u>	<u>2010</u>
Computed expected tax .....	\$19,517	\$11,973	\$ 6,489
State taxes, net of federal effect .....	677	552	351
Indefinitely invested earnings of foreign subsidiaries .....	(5,895)	(3,898)	(2,125)
Research and development credit, net .....	(103)	(167)	(23)
Domestic production activities deduction .....	(328)	(168)	(48)
Other .....	162	(9)	(117)
Provision for income taxes .....	<u>\$14,030</u>	<u>\$ 8,283</u>	<u>\$ 4,527</u>
Effective tax rate .....	25.2%	24.2%	24.4%

The Company's income taxes payable have been reduced by the tax benefits from employee stock plan awards. For stock options, the Company receives an income tax benefit calculated as the tax effect of the difference

2011, and 2010 and long-lived assets as of September 29, 2012 and September 24, 2011 are as follows (in millions):

	<u>2012</u>	<u>2011</u>	<u>2010</u>
Net sales:			
U.S. ....	\$ 60,949	\$ 41,812	\$28,633
China (a) .....	22,797	12,472	2,764
Other countries .....	<u>72,762</u>	<u>53,965</u>	<u>33,828</u>
Total net sales .....	<u>\$156,508</u>	<u>\$108,249</u>	<u>\$65,225</u>
		<u>2012</u>	<u>2011</u>
Long-lived assets:			
U.S. ....		\$ 6,012	\$ 4,375
China (a) .....		7,314	2,613
Other countries .....		<u>2,560</u>	<u>1,090</u>
Total long-lived assets .....		<u>\$15,886</u>	<u>\$ 8,078</u>

(a) China includes Hong Kong. Long-lived assets located in China consist primarily of product tooling and manufacturing process equipment and assets related to retail stores and related infrastructure.

Information regarding net sales by product for 2012, 2011, and 2010, is as follows (in millions):

	<u>2012</u>	<u>2011</u>	<u>2010</u>
Mac desktops (a)(i) .....	\$ 6,040	\$ 6,439	\$ 6,201
Mac portables (b)(i) .....	<u>17,181</u>	<u>15,344</u>	<u>11,278</u>
Total Mac net sales .....	23,221	21,783	17,479
iPod(c)(i) .....	5,615	7,453	8,274
Other music related products and services (d) .....	8,534	6,314	4,948
iPhone and related products and services (e)(i) .....	80,477	47,057	25,179
iPad and related products and services (f)(i) .....	32,424	20,358	4,958
Peripherals and other hardware (g) .....	2,778	2,330	1,814
Software, service and other net sales (h) .....	<u>3,459</u>	<u>2,954</u>	<u>2,573</u>
Total net sales .....	<u>\$156,508</u>	<u>\$108,249</u>	<u>\$ 65,225</u>

(a) Includes revenue from iMac, Mac mini and Mac Pro sales.

(b) Includes revenue from MacBook, MacBook Air and MacBook Pro sales.

(c) Includes revenue from iPod sales.

(d) Includes revenue from sales from the iTunes Store, App Store, and iBookstore in addition to sales of iPod services and Apple-branded and third-party iPod accessories.

(e) Includes revenue from sales of iPhone, iPhone services, and Apple-branded and third-party iPhone accessories.

(f) Includes revenue from sales of iPad, iPad services, and Apple-branded and third-party iPad accessories.

(g) Includes revenue from sales of displays, networking products, and other hardware.

(h) Includes revenue from sales of Apple-branded and third-party Mac software, and services.

(i) Includes amortization of related revenue deferred for non-software services and embedded software upgrade rights.

AUDIT ANALYTICS

MAY

FOREIGN INDEFINITELY REINVESTED EARNINGS:  
BALANCES HELD BY THE RUSSELL 3000  
A 5-YEAR SNAPSHOT

Don Whalen, Esq.  
Director of Research  
dwhalen@ivesinc.com  
508.476.7007 x222

Mark Cheffers,  
CPA, CFM, CFP

Permanent Subcommittee on Investigations  
**EXHIBIT #19**

Chris McCoy,  
Research Analyst  
cmccoy@ivesinc.com  
508.476.7007 x256

## Foreign Indefinitely Reinvested Earnings: Balances Held by the Russell 3000: A 5-Year Snapshot

### Apple's Record Breaking Bond Sale

Apple, Inc. (AAPL) recently announced that it intends to use \$100 billion for dividends and share buybacks. As part of this program, during the first week in May 2013, Apple raised \$17 billion in a well-received, record-breaking bond sale. With record low interest rates available, Apple chose to borrow the money inexpensively instead of using its available cash. Apple's most recent Form 10-Q reports \$144.7 billion in cash, cash equivalents & marketable securities held at March 30, 2013. As indicated in the 10-Q, a large portion of the \$144.7 billion, a total of \$102.3 billion at quarter-end, is retained foreign earnings. The decision to sell the bonds signaled that Apple would rather issue debt securities instead of repatriating earnings held offshore. This move mimics Microsoft's and Hewlett-Packard's decisions to incur corporate debt in recent years while having cash available overseas.

### The Tax Code and Permanently Reinvested Foreign Earnings

In general, the tax code applicable to the transactions noted above is Subpart F, Section 956. In addition, further treatment is given by Accounting Principles Board Opinion No. 23 (APB 23), codified in Accounting Standards Codification ASC 740-30-05 (see also, ASC 740-30-25-17). The objective of FASB ASC Topic 740 is to recognize current and deferred income tax liability. In short, offshore passive earnings, such as royalties, are reportable under Subpart F whether or not repatriated, but under APB 23 such earnings are not reportable if a company asserts that the foreign earnings are permanently and indefinitely reinvested offshore. Therefore, for example, subsidiaries that own intellectual property licenses can maintain the cash offshore tax-free as long as the earnings are permanently reinvested overseas.

### Foreign Indefinitely Reinvested Earnings Balances of the Russell 3000

Since many companies maintain Foreign Indefinitely Reinvested Earnings (IRE) balances, Audit Analytics analyzed the amount of Foreign IRE balances held by the Russell 3000 since 2008. As shown in the table below, the total untaxed indefinitely reinvested earnings reported in 10-K filings for firms comprising the Russell 3000 for the years 2008-2012 increased by 70.3% over this period. In addition, the number of firms reporting indefinitely reinvested earnings increased by 11.4% from 2008 to 2012.

Year	# of Firms with an Accumulated IRE Balance	Total Foreign Indefinitely Reinvested Earnings (in \$ billions)	Total Assets (in \$ billions) with an IRE Balance (in \$ billions)	Total % of Assets of Total Assets
2008	1003	\$1,684	\$22,137	7.6%
2012	1120	\$1,475	\$19,311	7.6%

Notes: 1) The 2008 to 2011 research is based on an Audit Analytics database download of 10/3/12, supplemented with 2012 research based on a download of 4/25/13.

With interest rates near record lows, other firms holding substantial sums abroad may follow the lead of Apple and other intellectual property-intensive firms. A table listing the Top-20 companies for 2012 with Foreign IRE balances is provided below.

Top 20 Companies for 2012 With Foreign Indefinitely Reversed Earnings							
Company	C.S. Code	Ticker	Period Ended Date	Effective Foreign Tax Rate	Foreign Indefinitely Reversed Earnings (Millions)	Parent Type	Total Assets (Millions)
Walmart Inc.	590000	WMT	12/31/12	31.00%	\$71,000	100%	\$180,700
Walgreens	280000	WAG	12/31/12	30.00%	\$22,800	100%	\$28,000
United Therapeutics	280000	UTH	12/31/12	30.00%	\$23,400	100%	\$26,000
International Business Machines Corp.	360000	IBM	12/31/12	34.00%	\$44,400	100%	\$70,000
Johnson & Johnson	280000	JNJ	12/31/12	32.00%	\$43,000	100%	\$100,000
GlaxoSmithKline	280000	GSK	12/31/12	32.00%	\$42,000	100%	\$144,000
Apple Inc.	360000	APPL	9/30/12	35.00%	\$41,400	100%	\$150,000
Procter & Gamble Co.	300000	PG	6/30/12	32.00%	\$39,000	100%	\$110,000
Novartis Inc.	280000	NVS	12/31/12	35.00%	\$38,000	100%	\$50,000
Chick-fil-A Inc.	550000	CHCA	12/31/12	28.00%	\$26,000	100%	\$60,000
Abbott Laboratories	280000	ABB	12/31/12	30.00%	\$26,000	100%	\$51,000,000
United Therapeutics Corp.	280000	UTH	12/31/12	30.00%	\$25,000	100%	\$26,000

Notes: 1) The research is based on an Audit Analytic database download of 4/25/13.

**FOREIGN INDEFINITELY REINVESTED EARNINGS  
BALANCES HELD BY THE RUSSELL 3000**

Growth in Foreign Indefinitely Reinvested Earnings (IRE) Balances				
Year	# of Firms with an Accumulated IRE Balance	Total Foreign Indefinitely Reinvested Earnings (IRE) (\$mm)	Total Assets for Firms With an IRE Balance (\$Billion)	Total IRE As a % of Total Assets
2007	1002	\$1,682	\$2,275	74.2%
2008	1008	\$1,684	\$2,217	75.9%
2009	993	\$1,678	\$2,121	79.1%
2010	993	\$1,678	\$2,121	79.1%
2011	993	\$1,678	\$2,121	79.1%
2012	993	\$1,678	\$2,121	79.1%

**Notes:**

1) The 2008 to 2011 research is based on an Audit Analytics database download of 10/3/12, supplemented with 2012 research based on a download of 4/25/13.

TOP 20 COMPANIES FOR 2012 WITH FOREIGN INDEFINITELY REINVESTED EARNINGS

Company	CIN Code	Ticker	Fiscal End Date	Effective Income Tax Rate	Foreign Indefinitely Reinvested Earnings (Millions)	Peer Type	Total Assets (Millions)
Philo Inc.	PHLO	PHE	12/31/12	21.00%	\$1,000	EQ	\$100,000
Alcoa Corp.	ALCO	AA	12/31/12	20.00%	\$1,000	EQ	\$100,000
Alcoa & Co. Inc.	ALCOA	AA	12/31/12	20.00%	\$1,000	EQ	\$100,000
International Business Machines Corp.	IBMC	IBM	12/31/12	20.00%	\$1,000	EQ	\$100,000
Johnson & Johnson	JNJ	JNJ	12/31/12	20.00%	\$1,000	EQ	\$100,000
Altria Inc.	ALTR	MO	12/31/12	20.00%	\$1,000	EQ	\$100,000
Procter & Gamble Co.	PG	PG	12/31/12	20.00%	\$1,000	EQ	\$100,000
Boeing Co.	BOE	BA	12/31/12	20.00%	\$1,000	EQ	\$100,000
United Technologies Corp.	UTX	UTX	12/31/12	20.00%	\$1,000	EQ	\$100,000

Notes: 1) The research is based on an Audit Analytic database download of 4/25/13.

## AUDIT, REGULATORY AND DISCLOSURE INTELLIGENCE

**Audit Analytics** delivers comprehensive intelligence on public companies, broker dealers, Registered Investment Advisors, Single Audit Non Profits and over 1,500 accounting firms. Our data includes detailed categorizations of audit and compliance issues and is considered by many professionals to be the best primary data source for tracking and analysis of the following public company disclosures:

### Sarbanes-Oxley Disclosures

- Track Section 404 internal control disclosures and Section 302 disclosure controls.

### Auditor Information

- Know who is auditing whom, their fees, auditor changes, auditor opinions and more.

### Financial Restatements

- Identify company restatements by type, auditor and peer group. Analyze by date, period and specific issue.

### Legal Disclosures

- Search all federal litigation by auditor, company and litigation type. Know who is representing whom.

### Corporate Governance

- Track director & officer changes, audit committee members, C-level executives and their biographies.

### SEC Comment Letters

- An extensive collection of analyzed SEC Comment Letters back to 2004 and indexed according to a taxonomy of over 2,800 issues, rules, and regulations.

**Detailed reports** are easily created by issue, company, industry, auditor, fees and more. These reports are downloadable into Excel. Daily notifications via email are available for auditor changes, financial restatements, adverse Internal controls & disclosure controls, late filings, going concerns and director & officer changes.

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O'MELVENY & MYERS LLP

BEIJING  
BRUSSELS  
CENTURY CITY  
HONG KONG  
JAKARTA†  
LONDON  
LOS ANGELES  
NEWPORT BEACH

1625 Eye Street, NW  
Washington, D.C. 20006-4001  
TELEPHONE (202) 383-5300  
FACSIMILE (202) 383-5414  
www.omm.com

NEW YORK  
SAN FRANCISCO  
SEOUL  
SHANGHAI  
SILICON VALLEY  
SINGAPORE  
TOKYO

WRITER'S DIRECT DIAL  
(202) 383-5282

WRITER'S E-MAIL ADDRESS  
dleviss@omm.com

July 19, 2013

VIA HAND DELIVERY

Daniel J. Goshorn, Esq.  
Counsel  
Permanent Subcommittee on Investigations  
United States Senate  
199 Russell Senate Office Building  
Washington, D.C. 20510

Re: *PSI Hearing on Offshore Profit Shifting and the US Tax Code - Part 2 (Apple Inc.)*

Dear Dan:

Please accept this letter in response to Questions for the Record dated June 13, 2013 ("Questions for the Record"), concerning submissions by Apple Inc. ("Apple") to the U.S. Senate's Permanent Subcommittee on Investigations. Apple is today voluntarily producing information responsive to Questions for the Record.

In response to Questions for the Record Nos. 1 through 10, enclosed please find documents bearing control numbers APL-PSI-000403 to APL-PSI-000410. These documents consist of Apple's narrative response to Questions 1 through 4 and 6 through 10, and an Appendix containing the information responsive to Question 5.

\* \* \*

As you may know, the information that you have requested includes confidential and proprietary business information that Apple does not make available to the general public. Public disclosure of this information would cause significant competitive harm to Apple. Please be advised that Apple formally requests that these materials be afforded the full confidentiality protection provided by the Rules of the United States Senate, including but not limited to Rule XXVI. Should you wish to publicly release any of this information, Apple respectfully requests reasonable notice of your intent to do so and the opportunity to object to such disclosure.

In association with Tumbuan & Partners

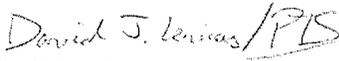
Permanent Subcommittee on Investigations

EXHIBIT #20

Daniel J. Goshorn, Esq., July 19, 2013 - Page 2

Should you have any questions regarding this information or this matter generally, please do not hesitate to contact me.

Sincerely,

  
David J. Levis  
of O'MELVENY & MYERS LLP

Enclosures

cc: David Katz, Esq.  
Counsel, Permanent Subcommittee on Investigations  
Robert L. Roach, Esq.  
Counsel/Chief Investigator, Permanent Subcommittee on Investigations  
Henry J. Kerner, Esq.  
Chief Counsel, Minority Staff, Permanent Subcommittee on Investigations  
K. Lee Blalack, II, Esq.  
O'Melveny & Myers LLP

Apple Confidential - Need to Know

**Questions for the Record dated June 13, 2013**

1. For each Apple entity incorporated in Ireland, for each of the years 2009, 2010, 2011, and 2012, please list: (a) the entity's total amount of pretax income, (b) the total amount of taxable income reported to Ireland, (c) the amount of tax actually paid to Ireland, (d) the total amount of taxable income reported to any other country, and (e) the amount of tax actually paid to any other country.

**Apple Distribution International**

Year	(a) Pre Tax Income (US GAAP) \$k	(b) Taxable Income Reported to Ireland <sup>1</sup> €k	(c) Irish tax paid €k
2009	(7)	0	0
2010	20,893	0	0
2011	155,284	0	0
2012	143,505	186,176	23,764

(e) Withholding taxes of \$204k were reported and paid to the Israeli tax authorities on behalf of ADI by another group company during 2012.

**Apple Operations**

Year	(a) Pre Tax Income (US GAAP) \$k	(b) Taxable Income Reported to Ireland €k	(c) Irish tax paid €k
2011 <sup>2</sup>	0	0	0
2012	260	0	0

<sup>1</sup> "Taxable Income Reported to Ireland" comprises taxable trading profits and taxable investment income.

<sup>2</sup> Apple Operations was incorporated December 8, 2010 and had no income prior to 2012.

## Apple Confidential - Need to Know

## Apple Operations Europe

Year	(a) Pre Tax Income (US GAAP) \$k	(b) Taxable Income Reported to Ireland €k	(c) Irish tax paid €k
2009	71,670	12,265	1,227
2010	6,665,917	12,738	1,274
2011	6,295,964	17,706	2,095
2012	14,980,057	15,267	1,908

## Apple Operations International

Year	(a) Pre Tax Income (US GAAP) \$k	(b) Taxable Income Reported to Ireland €k	(c) Irish tax paid €k
2009	111,955	0	0
2010	8,079,038	0	0
2011	6,318,480	0	0
2012	15,437,261	0	0

## Apple Retail Europe Holding

Year	(a) Pre Tax Income (US GAAP) \$k	(b) Taxable Income Reported to Ireland €k	(c) Irish tax paid €k
2009	(5,146)	1,216	227
2010	2,412	899	132
2011	1,709	185	47
2012	(510)	366	75

## Apple Confidential - Need to Know

## Apple Sales International

Year	(a) Pre Tax Income (US GAAP) \$k	(b) Taxable Income Reported to Ireland €k	(c) Irish tax paid €k
2009	4,024,376	34,338	4,781
2010	12,095,431	37,879	4,795
2011	21,855,410	54,971	7,136
2012	35,877,241	40,497	5,357

## Apple Sales Ireland

Year	(a) Pre Tax Income (US GAAP) \$k	(b) Taxable Income Reported to Ireland €k	(c) Irish tax paid €k
2009	813	652	84
2010	2,177	1,647	206
2011	1,123	876	110
2012	2,971	2,344	293

(d-e) For each Apple entity incorporated in Ireland, other than amounts identified above, there was no income tax paid by these entities to any country other than Ireland during this period. Note that Apple Inc. included on its US federal income tax returns as Subpart F income the Investment income attributable to AOI and its subsidiaries, of which more than 90% was attributable to the Irish entities in each of these years. Apple Inc. paid US federal income tax on such income at the US statutory rate of 35%.

## Subpart F income attributable to AOI:

FY2009: \$461,838,668

FY2010: \$65,130,091

FY2011: \$238,742,473

FY2012: \$880,711,789

## Apple Confidential - Need to Know

**2. What types and amounts of the pretax income of Apple Operations International (AOI), Apple Operations Europe (AOE), and Apple Sales International (ASI), did you determine were not taxable in Ireland for each of the years 2009, 2010, 2011 and 2012? How was this determination made? Who made this determination?**

AOI is a corporation that is nonresident for Irish corporate tax purposes and has no Irish based activities. As a result, none of its income is taxable under Irish law, specifically, section 25 of the Taxes Consolidation Act of 1997.

ASI and AOE are also corporations that are nonresident for Irish corporate tax purposes, but both have activities and a physical presence in Ireland that give rise to a taxable presence (also referred to as their Irish branches). The activities of ASI's Irish branch primarily include procurement, sales, operations and distribution. The activities of AOE's Irish branch primarily include manufacturing and distribution. The trading profits and investment income of these Irish branches are subject to taxation in Ireland (referred to herein as "taxable trading profits" and "taxable investment income").

For the years relevant to this response, the taxable trading profits of ASI and AOE were determined using a methodology confirmed by Irish taxation authorities. This methodology was based primarily on the operating costs of ASI and AOE and includes a return on sales of products manufactured by AOE. Under this methodology, unlike AOE, the amount of ASI's sales income is not used in determining its Irish tax liability.

The taxable trading profits and taxable investment income of ASI and AOE are subject to tax in Ireland at the applicable statutory rates.<sup>3</sup> As Apple CEO Tim Cook noted during a recent interview, Apple has "no special deal with the Irish government that gives [the Company] a 2% flat tax rate."<sup>4</sup> Rather, the Irish taxation authorities have confirmed a methodology for calculating the taxable trading profits of ASI and AOE that, since 2003, has resulted in an effective tax rate of 2 percent or less.<sup>5</sup> As Apple informed the Subcommittee in its June 22, 2012 written submission, this methodology "is the primary factor that . . . produce[s] an effective rate in the low single digits."<sup>6</sup>

<sup>3</sup> Under current Irish tax law, the statutory rate of tax on trading profit is 12.5%. Up to December 31, 2010, AOE's taxable trading profits were subject to the 10% statutory rate of tax applicable to manufacturing activities under prior Irish law. Investment income is subject to a 25% statutory rate of tax under Irish law.

<sup>4</sup> All Things D Conference, May 28, 2013, <http://allthingsd.com/20130528/tim-cook-talks-taxes/>.

<sup>5</sup> See Response to Question 4 for the June 22, 2012 Follow-Up Questions.

<sup>6</sup> *Id.*

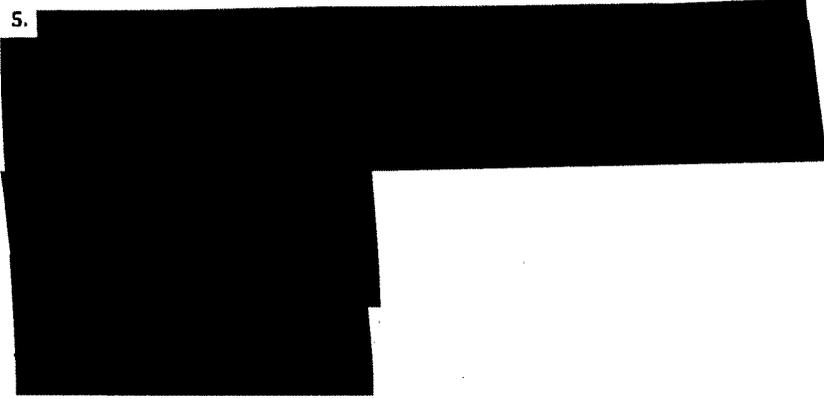
Apple Confidential - Need to Know

**3. Please describe what activities of ASI and AOE you decided were taxable in Ireland in each of the years 2009, 2010, 2011 and 2012. How was this determination made? Who made this determination?**

See Response to Question 2.

**4. Apple informed the Subcommittee that ASI's sales revenues for fiscal years 2009, 2010, 2011, and 2012, were \$12.4 billion, \$28.8 billion, \$47.5 billion, and \$63.9 billion respectively. For each of these years, what amount of ASI's sales revenue has Apple determined to be subject to Irish tax?**

As noted in response to Question 2, ASI's taxable trading profits were determined using a methodology confirmed by Irish taxation authorities. Under this methodology, the amount of ASI's sales income is not used in determining its Irish tax liability.

5. 

## Apple Confidential - Need to Know

6. Please identify for the period, 2009 through 2012, the legal entities that purchased finished A5 chips from Samsung. If any of those finished chips were purchased by Apple entities, please indicate the following: (a) the number of individuals who are authorized to make those purchases on behalf of one or more Apple entities, (b) the employer and country of residence of each such individual, and (c) the specific Apple entities on behalf of which the purchases were made.

During the relevant period, Apple Inc. was the only Apple entity that purchased finished A5 chips from Samsung.

(a) Three individual buyers are authorized to make A5 purchases on behalf of Apple Inc.

(b) Two of the individual buyers referred to in 6(a) were employed by Apple Procurement and Operations Management (Shanghai) Company Limited (China) and the other was employed by Apple Inc. (United States).

(c) The purchases were made on behalf of Apple Inc.

7. If the finished A5 chips are purchased by Apple entities prior to being integrated into Apple devices, which legal entity or entities hold title to the chips and in what country or countries are the chips stored prior to being shipped to manufacturers for integration into Apple devices?

Generally, Apple Inc. receives title from Samsung and transfers title to the A5 chip to contract manufacturers or other third parties in a nearly simultaneous transaction (transitory title). In certain situations, Apple Inc. would hold title to the A5 chips for a period of time in China or Hong Kong before the A5 chips are sold to the contract manufacturers.

## Apple Confidential - Need to Know

**8. Was any legal analysis conducted in connection with the determination that Apple Sales International and AOE are not tax residents of Ireland? If so, please provide the name of the party that conducted that analysis and identify when the analysis was conducted. Please provide a copy of any such analysis.**

We have completed a diligent search for legal analyses regarding the determination that ASI and AOE are not tax resident in Ireland, and we have been unable to find any documents responsive to this request. Any original analyses of the tax residency of ASI and AOE would likely have been completed decades ago contemporaneous with the two subsidiaries' incorporation. As a result, such records may no longer exist. Nonetheless, Apple's conclusion remains that ASI and AOE are not tax resident in Ireland under the relevant test.

**9. Please describe how the fact that ASI and AOE are not tax residents of Ireland affects their tax liability on income from sales to related parties. Please identify which provisions of the Irish tax code Apple relied on to make this determination.**

The relevant applicable provision of the Irish tax code regarding taxation of nonresident entities is section 25 of the Taxes Consolidation Act 1997. Under Irish tax law, ASI and AOE as nonresident entities pay taxes in Ireland based on their taxable trading profits and taxable investment income. As noted in response to Question No. 2, their taxable trading profits were determined using a methodology confirmed by Irish taxation authorities. Under this methodology, related party sales of products manufactured by AOE are included in the computation of taxable trading profits but related party sales are not used in determining ASI's Irish tax liability.

**10. For 2012, please provide the total income and taxable income reported on Apple's U.S. tax return and the amount of actual U.S. tax paid.**

From Apple Inc. and Subsidiaries FY 2012 Form 1120:

Total Income before Deductions	\$ 35,642,145,068
Taxable Income	\$ 16,521,322,762
Total Tax	\$ 5,390,027,310
Total Tax Payments	\$ 6,075,586,981
Overpayment to be applied to next year	\$685,559,671