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.[61] These figures translate into earnings per share of $44.15.[62]

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.[63] Apple develops its products through research and development conducted primarily in the United States; the materials and components for Apple products are sourced globally.[64] 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.[65]

2. Apple History

Apple was founded in 1976 by Steve Jobs, Steve Wozniak, and Ronald Wayne, to design and sell personal computers.[66] 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).[67] 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.[68] 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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[61] Apple Inc. Annual Report (Form-10K), at 24 (10/21/2012).
[62] Id.
[63] 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 the Subcommittee by Apple, APL-PSI-000351.
[64] Subcommittee interviews of Cathy Kearney (4/19/2013) and Tim Cook (4/29/2013).
[65] Id.
[66] See "30 Pivotal Moments In Apple's History," Macworld, Owen W. Linzmayer, (3/30/2006), http://www.macworld.com/article/1050112/30moments.html.
[67] Apple's first cost-sharing agreement was executed on December 1, 1980. See Information supplied to the Subcommittee by Apple, APL-PSI-000003. AOE was then named Apple Computer Ltd., and ASI was then named Apple Computer International, Inc. Id.
[68] 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."[69] As of 2011, Apple held between 75 and 100% of those offshore cash assets in accounts at U.S. financial institutions.[70]

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.[71] 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").[72] According to Apple, this cost sharing-arrangement enables Apple to produce and distribute products around the world.

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

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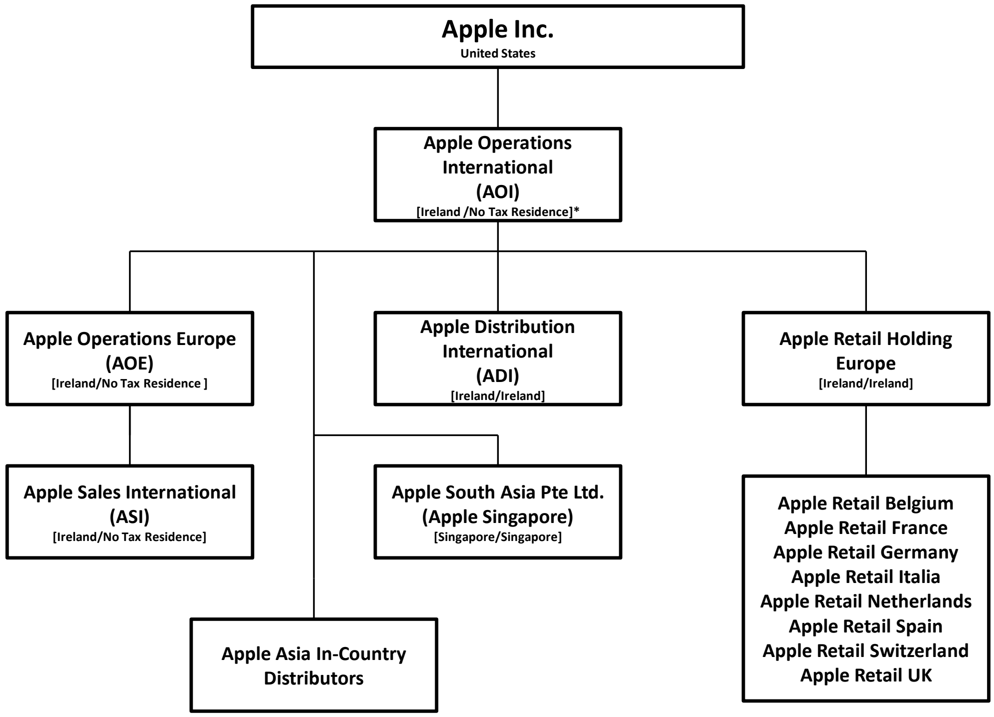
[69] 4/23/2013 Apple Second Quarter Earnings Call, Fiscal Year 2013, http://www.nasdaq.com/aspx/call-transcript.aspx?StoryId=1364041&Title=apple-s-ceo-discusses-f2q13-results-earnings-call-transcript.

[70] 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)).

[71] Information supplied to the Subcommittee by Apple, APL-PSI-000351.

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

<u>Apple's Offshore Organizational Structure</u>



*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.[73] 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." [74]

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

[73] Subcommittee interview of Phillip Bullock, Apple Inc. Tax Operations Head (5/15/2013).
[74] Information supplied to the 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
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: 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.[75] 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.[76]

AOI was incorporated in Ireland in 1980.[77] 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.[78] 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.[79] Since its inception more than thirty years earlier, AOI has not had any employees.[80] 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

[75] 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 the Subcommittee by Apple, APL-PSI-000236, and APL-PSI-000352.
[76] Subcommittee interview of Gary Wipfler, Apple Inc. Corporate Treasurer (4/22/2013).
[77] Information supplied to the Subcommittee by Apple, APL-PSI-000100.
[78] Information supplied to the Subcommittee by Apple, APL-PSI-000351.
[79] Subcommittee interview of Cathy Kearney (4/19/2013).
[80] 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:[81]

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.[82] 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.[83]

Apple told the Subcommittee that AOI's assets are managed by employees at an Apple Inc. subsidiary, Braeburn Capital, which is located in Nevada.[84] Apple indicated that the assets themselves are held in bank accounts in New York.[85] 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.[86] 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.[87]

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

[81] 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.

[82] 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.

[83] Subcommittee interview of Gene Levoff (5/2/2013).

[84] Subcommittee interview of Gary Wipfler (4/22/2013).

[85] Id.

[86] Subcommittee interview of Phillip Bullock (11/28/2012).

[87] Id.

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

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.[91] 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.[92] 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.[93] 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."[94]

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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[88] Information supplied to the Subcommittee by Apple, APL-PSI-000347, APL-PSI-000219, APL-PSI-000181 and APL-PSI-000149.
[89] Apple Consolidating Financial Statements, APL-PSI-000130-232 [Sealed Exhibit].
[90] Information supplied to the Subcommittee by Apple, APL-PSI-000240.
[91] 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 the 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.
[92] Information supplied to the Subcommittee by Apple, APL-PSI-000241.
[93] "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 the Subcommittee by Apple, APL-PSI-000242.
[94] Information supplied to the 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."[95] 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.[96] Prior to 2012, like AOI, ASI operated without any employees and carried out its activities through a U.S.-based Board of Directors.[97] Also like AOI, the majority of ASI's directors were Apple Inc. employees residing in California.[98] Of 33 ASI board meetings from May 2006 to March 2012, all 33 took place in Cupertino, California.[99] 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.[100] 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.[101] 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

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[95] 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].

[96] 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 the Subcommittee by Apple, APL-PSI-000236 and APL-PSI-000352.

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

[98] Information supplied to the Subcommittee by Apple, APL-PSI-000343.

[99] Id.

[100] Subcommittee interview of Cathy Kearney (4/19/2013).

[101] See Information supplied to the 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.[102] 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.[103] 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.[104] 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.[105] When it re-sold the finished

[102] 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 the 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.

[103] 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 the Subcommittee by Apple, APL-PSI-000103 and PSI-Apple-02-0002.

[104] Subcommittee interview of Cathy Kearney (4/19/2013).

[105] 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.[106]

Cost Sharing Agreement. The cost-sharing agreement is structured as follows.[107] 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.[108] That same year, Apple's worldwide research and development costs totaled $2.4 billion.[109] 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.[110]

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.[111] The third-party manufacturer manufactured the goods to fill purchase orders placed by ASI.[112] 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 the Subcommittee by Apple, APL-PSI-000103 and PSI-Apple-02-0002.

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

[107] 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].

[108] Subcommittee interview of Phillip Bullock (11/28/2012).

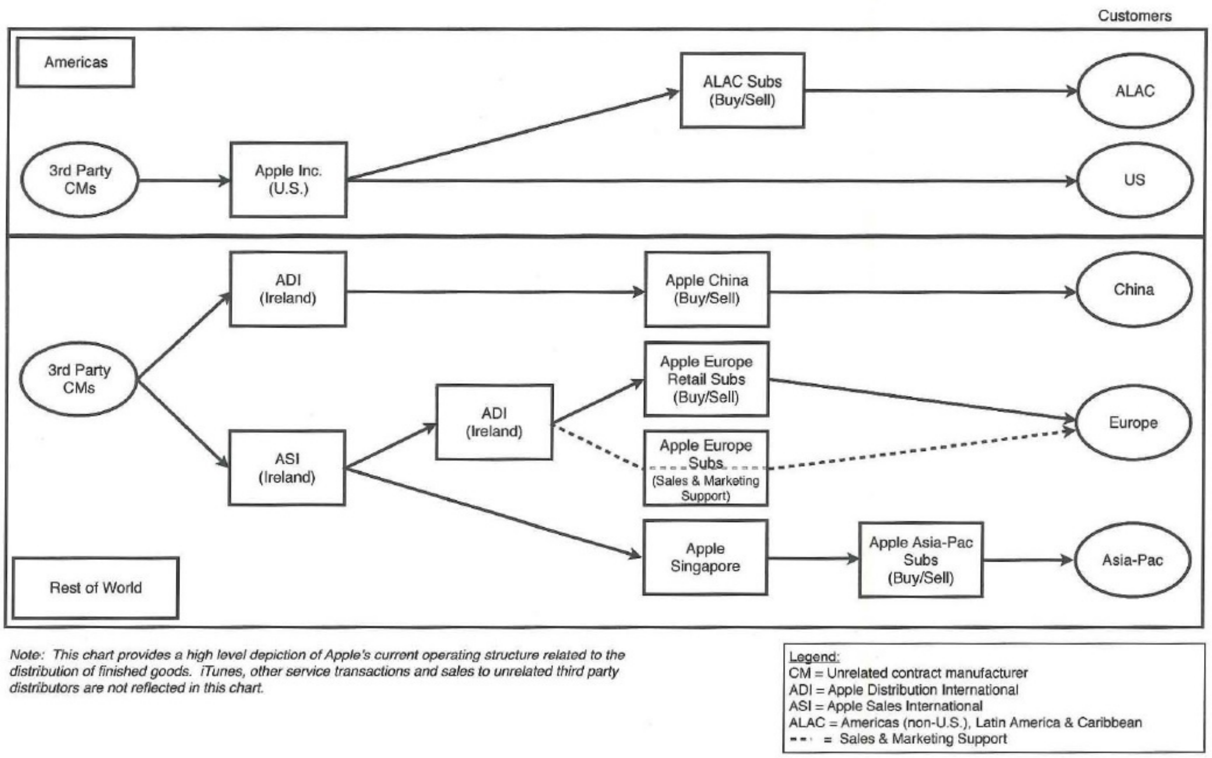
[109] Information supplied to the Subcommittee by Apple, APL-PSI-000129.

[110] Information supplied to the Subcommittee by Apple, APL-PSI-000129.

[111] Information supplied to the Subcommittee by Apple, APL-PSI-000392.

[112] 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.[113] 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.[114]

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

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

[114] 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.[115] 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.[116] ASI and AOE employees conduct less than 1% of Apple's R&D and build only a small number of specialty computers.[117] In 2011, 95% of Apple's research and development was conducted in the United States, [118] 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"

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[115] 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.
[116] Subcommittee interview of Phillip Bullock (5/15/2013).
[117] Information supplied to the Subcommittee by Apple, APL-PSI-000233.
[118] Id.

profits that result from owning the intellectual property.[119] According to Apple, over the four year period, 2009 to 2012, ASI made cost-sharing payments to Apple Inc. of approximately $5 billion.[120] 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.[121] 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
TOTAL	**$ 4.9 billion**	**$ 74 billion**

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
TOTAL	**$ 4.0 billion**	**$ 38.7 billion**

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.[122] 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

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[119] Subcommittee interview of Phillip Bullock (11/28/2012).
[120] Information supplied to the Subcommittee by Apple, APL-PSI-000129 and 000382.
[121] Information supplied to the 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.
[122] Information supplied to the Subcommittee by Apple, APL-PSI-000129 and 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.[123]

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.[124] 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.[125]

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.[126] 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

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[123] Subcommittee interview of Tim Cook (4/29/2013).
[124] 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].
[125] Subcommittee interview of Tim Cook (4/29/2013).
[126] 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.[127] 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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[127]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.

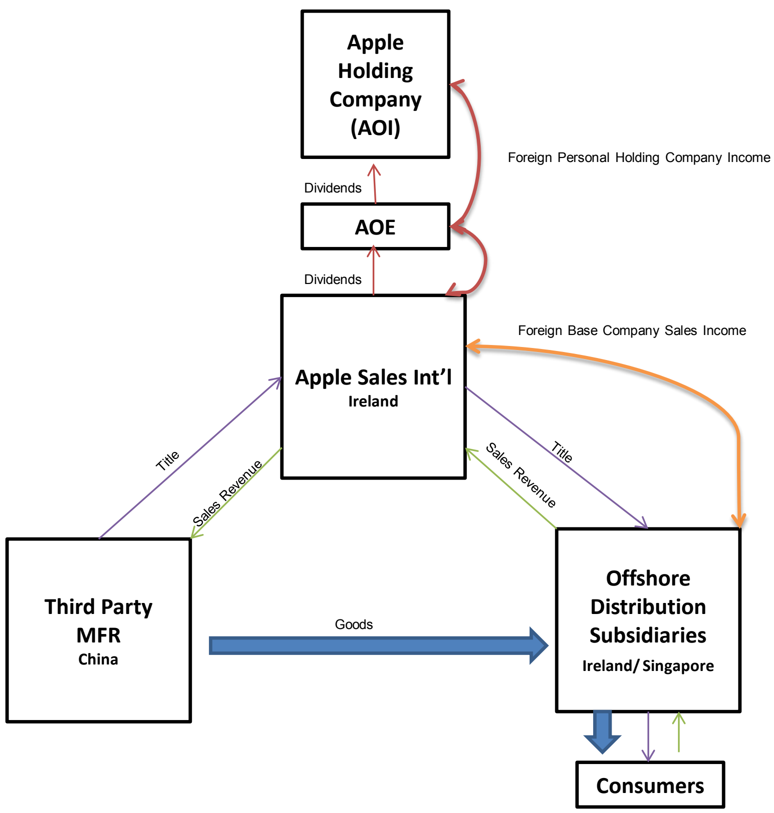
In 2009, Apple Inc., ASI and AOE entered into another Cost Sharing agreement which replaced the one signed in 2008. Mr. Oppenheimer, the CFO of Apple Inc. and a director of both ASI and AOE, was the signatory on behalf of Apple Inc. Two other Apple Inc employees signed as directors of ASI and AOE. See 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.[128] 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,[129] 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,[130] 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.

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128 Information supplied to the Subcommittee by Apple, APL-PSI-000386.
129 IRC Section 954(d).
130 IRC Section 954(c).

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

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

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

In fact, ASI never took physical possession of the products it ordered from the third party manufacturer. Transfer was made in title only while the products were being shipped to the country of sale.[131] 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.[132] When they arrived, ASI sold the products to Apple Singapore at a substantial profit.[133] Apple Singapore then resold the products, in turn, to Apple retail entities or end customers.[134] 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.[135]

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

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[131] Subcommittee interview of Cathy Kearney (4/19/13).
[132] Subcommittee interview of Phillip Bullock (11/28/12).
[133] 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).
[134] 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.
[135] 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.[136] ASI, meanwhile, reported $22 billion in 2011 net income.[137] 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

	Foreign Base Company Sales Income	**Tax Avoided**	**Tax Avoided Per Day**
2011	$ 10 billion	$ 3.5 billion	$ 10 million
2012	$ 25 billion	$ 9.0 billion	$ 25 million
Total	**$ 35 billion**	**$ 12.5 billion**	**$ 17 million**

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

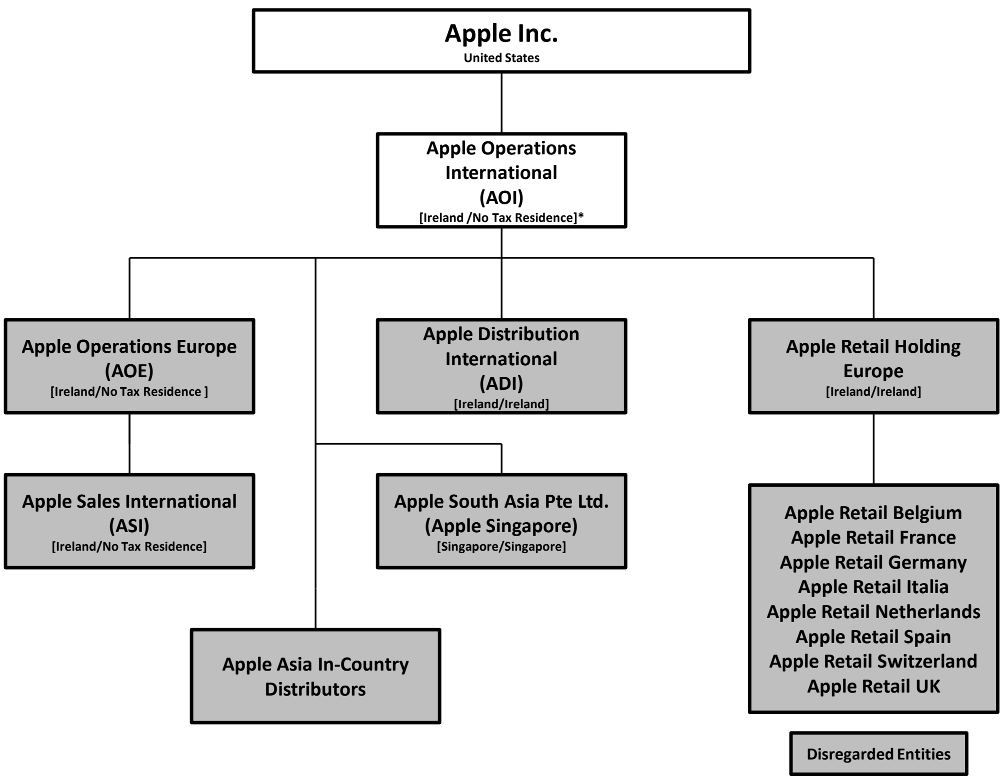
These figures indicate that, in two years alone, from 2011 to 2012, Apple Inc. used the check-the-box loophole to avoid paying $12.5 billion in U.S. taxes or about $17 million per day.

[136] Apple Consolidating Financial Statements, APL-PSI-000130-232 [Sealed Exhibit].
[137] 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:

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.

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

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

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.[139] 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.

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[138] Information supplied to the Subcommittee by Apple, APL-PSI-000386.
[139] Information supplied to the 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.[140] 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.[141] FBCS income is income attributable to related-party sales of personal property made through a CFC if the country of the CFC's incorporation is neither the origin nor the destination of the goods and the CFC itself has not "manufactured" the goods. Under Subpart F, FBCS income is currently taxable. However, under the manufacturing exception, the income from related party purchases and sales will not be characterized as FBCS income if the goods are sold to a related party that transforms or adds substantive value to the goods. In 2008, the regulations governing the manufacturing exception were liberalized to make it very easy for a company to claim such an exception.

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

E. Apple's Effective Tax Rate

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

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[140] IRC Section 954(d)(1)(A); Reg. §1.954-3(a)(2).
[141] IRC Section 954(d)(1)(A).
[142] 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%.[143] 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%.[144] 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[145] as follows:

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

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

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

[143] Apple Inc. Annual Report (Form-10K), at 61 (10/21/2012).
[144] Apple Inc. Annual Report (Form 10-K), at 62 (10/26/2011).
[145] 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.[146]

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
Difference:	$ 1.4 billion	$ 2.6 billion	$ 4.4 billion

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

Tax payments of $1.6 billion, $1.2 billion, or even $2.5 billion produce effective tax rates well below the statutory tax rate. In that, Apple is far from alone. Recent studies indicate that, over a three-year period, from 2008 to 2010, U.S. corporations paid effective tax rates ranging from 12 to 18 percent.[147] One recent study found that 30 large corporations paid no tax at all during a three year period, 2008 to 2010.[148] U.S. records indicate that, in 2011, U.S. corporations collectively paid about $181 billion in federal taxes, compared to the $819 billion in

[146] Information supplied to the Subcommittee by Apple referencing data taken from Apple's Form 1120 U.S. Corporation Income Tax Return, APL-PSI-000082. 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).

[147] See, e.g., 1/31/2012 "The Budget and Economic Outlook, Fiscal Years: 2012 to 2022," Congressional Budget Office, at 89, http://www.cbo.gov/sites/default/files/cbofiles/attachments/01-31-2012_Outlook.pdf (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/CorporateTaxDodgers Report.pdf.

[148] "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/CorporateTaxDodgers Report.pdf.

payroll taxes and $1.1 trillion in individual income taxes.[149] Closing offshore tax loopholes such as those created by the check-the-box and look-through rules, the same country exception, and 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%.[150] 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.[151] 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%.[152] 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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[149] OMB, Historical Tables, Budget of the U.S. Government, FY2001 (April 2012).
[150] Information supplied to the Subcommittee by Apple, PSI-Apple-02-0004.
[151] ASI's operating income was $18 billion in 2011. Apple Consolidating Financial Statements, APL-PSI-000219 [Sealed Exhibit].
[152] 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).