STATEMENT OF SENATOR CARL LEVIN (D-MICH)
BEFORE
U.S. SENATE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
ON
OFFSHORE PROFIT SHIFTING AND THE U.S. TAX CODE – PART 2 (APPLE INC.)

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Today the Subcommittee holds 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 avoid paying U.S. taxes. In September, we examined two case studies: (1) 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 (2) a study of how Hewlett-Packard devised a "staggered foreign loan program" to effectively repatriate offshore profits to the United States without paying 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 large 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 half the statutory rate of 35 percent. A recent study found that 30 of the largest U.S. multinationals, with more than $160 billion in profits, paid nothing in federal income taxes over a recent three year period. Zero. 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 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 isn't 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. 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 U.S. tax law 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 in any nation. Here's 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 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 five years; another pays tax to Ireland equivalent to a fraction of one percent of its total income.

The first of these ghost companies is Apple Operations International, or AOI. This chart 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 not 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 since AOI isn't incorporated in the United States, it is also not present in the U.S. for tax purposes. Magically, it's neither here nor there.

The second corporate ghost is Apple Sales International, or ASI. ASI, as we'll 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's incorporated in Ireland, operated from the United States, but, Apple says, is 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 income. That's a tax rate of five-hundreds of one percent. It appears that this tiny tax payment may be related to activity unrelated to ASI's main purpose, which is to serve as the 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, 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.

Apple is exploiting an absurdity, one that 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 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 thirty 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, an Irish company that AOI itself owns. Over the last six 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 7 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 Cupertino.

In short, these companies' decision makers, 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.

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? That brings us to a second, more common arrangement for shifting income away from the United States to a low tax jurisdiction through what's 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.
While there are multiple ways to transfer intellectual property rights offshore, Apple's primary method today 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.

Apple set up its cost-sharing agreement with its Irish subsidiaries. I use the term "cost-sharing agreement" with some skepticism, since it is obviously not an arm's-length transaction. 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: 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. And as we've 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's more, Apple Inc., which has renewed the agreement several times, most recently in 2009, can modify it 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 four-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 time period, ASI received profits of $74 billion. 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 four years, Apple Inc. paid $4 billion under the cost-sharing agreement and declared profits of $38 billion from sales in the Americas. Its subsidiary, ASI, received almost twice the profits from property developed by Apple Inc. in the United States.

Common sense says Apple would never have offered such a lucrative arrangement in an arm's-length deal with an unrelated party. Indeed, it's 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 R&D costs is irrelevant to the main goal: concentrating profits offshore. Even if the Irish subsidiaries paid 100 percent of 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 those 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 evasion. It made certain types of offshore income subject to U.S. income tax – even when that income wasn't 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 IRS what type of entity they are for tax purposes, simply by checking a box on a form. Under "check the box," 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 tax strategies are complex, and are outlined more fully in the memo 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 doesn't say is that, also in 2012 alone, 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, which works out to avoiding $25 million a day, more than $1 million an hour, in taxes.

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 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. 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 aren't 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, and has helped lead to round after round of budget slashing and the ill-advised sequestration now threatening our economic recovery.

Because of those cuts, children across the country won't get early education from Head Start. Needy seniors will 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. 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 it generates overseas.

Nearly thirty years ago, Ronald Reagan faced a tax system similarly open to exploitation and loopholes. When his Treasury Secretary told him that dozens of America's most profitable companies paid no income tax, he was stunned. 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." He said: "These abuses cannot be tolerated."

The question each of us should ask today is this: Shouldn't we close unjustified tax loopholes, and dedicate the revenue to educating our children, protecting our nation and building its future? 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, our schools, our roads, the safety of our food supply and other important priorities. We should close them and dedicate the revenue that generates to these important priorities, whether or not we reform the overall tax code.

Senator McCain, you and your staff have made a phenomenal contribution to this bipartisan effort. Thank you for their great work and for your partnership on this subcommittee.