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Apple Hearing: Observations From an Expert Witness

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Harvey was an expert witness at the May 21 Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations hearing on Apple Inc.'s international tax planning. In this article, Harvey describes one of the arguments used by Apple and Sen. Ron Johnson, R-Wis., to justify the amount of income Apple recorded in the United States. Although Harvey disagrees with Apple's argument, he believes that if it is accepted, it should result in Apple recording substantially more income in foreign countries other than Ireland. Harvey also questions the 30.5 percent effective tax rate advocated by Apple during the hearing and instead suggests a rate between 7 and 15 percent.

Harvey can be reached at rharvey@law.villanova.edu. He would like to thank his research assistant, Cuyler Lovett, for his helpful comments on short notice. All views expressed and any mistakes are solely the author's.

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The Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations held a hearing May 21 to discuss Apple Inc.'s international tax planning. As an expert witness called to testify at the hearing, I had a ringside seat. Like many congressional hearings, the May 21

panel resulted in good theater, but the real question is whether lawmakers will ultimately take any action.

One purpose of this article is to identify two key tax policy issues that need to be addressed both in the United States and internationally:

- Should the United States and the rest of the world allow Apple to record approximately two-thirds of its global income in an Irish entity that has few or no employees and little or no real activity?¹
- Assuming the answer is no, where should the income be recorded? Should it be in the United States, other countries, or some combination?

Both topics were touched on during the hearing, but the discussion was mostly U.S.-centric and therefore they might not have been clearly articulated. Further, Apple and Sen. Ron Johnson, R-Wis., made arguments supporting Apple's allocating income to the United States that were not fully explored and warrant additional discussion.

The final purpose of this article is to expand on several items mentioned during the hearing that could benefit from additional explanation:

- total income Apple shifted to Ireland and potential U.S. tax savings;
- Apple's effective tax rate; and
- Apple's use of tax gimmicks.

Should 2/3 of Apple's Income Be in Ireland?

The Senate hearing was partly intended to highlight that policy question. Stated more broadly, is it appropriate for multinational corporations (MNCs) to record a disproportionate amount of their global income in tax havens, based on paper transactions? It was clear the result of Apple's international tax planning troubled several senators, including subcommittee Chair Carl Levin, D-Mich., and ranking minority member John McCain, R-Ariz.

It was less clear where Sens. Rand Paul, R-Ky., and Johnson stood on the question. One could interpret their statements and questions as supporting Apple's allocation of income to Ireland, but like

¹Even if all the activity of Apple's Irish operations is aggregated, Ireland accounts for only 4 percent of Apple's global employees, 3 percent of its global compensation, and 1 percent of its customers.

many lawmakers, they are good at sidestepping difficult topics. Paul's primary complaint was that the hearing was taking place. And as demonstrated by some of the questions he asked me, he also wanted to emphasize that Apple had the right to minimize its tax liability.

Johnson's comments were more nuanced. He seemed to say it was appropriate for Apple to record 70 percent of its 2011 global income outside the United States when 60 percent of its sales were outside the United States.² Apple itself seemed to make a similar argument by stating that (1) the income recorded in Ireland related to sales to customers outside the Americas; and (2) the income related to U.S. sales was recorded in the United States.

Even if one accepts Johnson's and Apple's argument that from a tax policy and economic perspective the United States was allocated the correct amount of income, there still is a question whether Ireland should have been allocated more than 90 percent of Apple's non-U.S. income.³ Unfortunately, that point was glossed over during the hearing.

Johnson and Apple appear to have argued that Apple allocated the correct amount of income to the United States because the ratio of U.S. to global pretax income is approximately equal to the ratio of U.S. sales to global sales.⁴ But if that theory is used, Ireland should have been allocated less than 1 percent of global pretax income as opposed to approximately two-thirds. As a result, foreign countries that were allocated approximately 6 percent of 2011 global pretax income should instead be allocated approximately 70 percent. Because many of those source countries have relatively high corpo-

rate tax rates, that allocation would greatly increase Apple's worldwide income taxes.⁵

As the Bible says, "Live by the sword, die by the sword." In other words, Apple should not have it both ways. It should not be able to support its income allocation to the United States by using the ratio of U.S. sales to global sales as an indicator of the proper U.S. income allocation, but then argue that the income of substantially all foreign sales should be recorded in Ireland. One suspects Apple's real position is that the arm's-length standard should continue to be respected among related parties so that it can allocate technology income for U.S. sales to the United States and technology income for foreign sales to Ireland.

In summary, the allocation of two-thirds of Apple's global pretax income to Ireland, a country that accounts for only 4 percent of its workforce and less than 1 percent of its customers, does not make economic sense when the technology was developed in the United States and the bulk of the manufacturing is done by third parties in China. As discussed below, there could be reasonable disagreement as to where the income currently recorded in Ireland should be reported (that is, the U.S. or foreign-source countries), but the important point should be that Ireland is not the proper location.

Where Should Tax Haven Income Be Recorded?

Assuming most tax policymakers around the world reach the conclusion that tax havens should not be allocated a disproportionate amount of global income, attention then turns to the second key issue: how to reallocate income currently recorded in tax havens. A detailed discussion is beyond the scope of this article, but it will be interesting to see whether a global consensus can be reached.⁶ There should be spirited discussion between residence and source countries, but one would hope the proverbial increase in the overall size of the non-tax-haven pie should be sufficient to satisfy their collective hunger for tax revenues.

As I mentioned in my testimony, global consensus would be beneficial — but if history is any guide, that could take a while. Thus, the United States will likely need to consider unilateral action and therefore address some or all of the following:

- Should cost-sharing agreements and other transfers of valuable intangible property between related parties be respected?

²Johnson also appeared to advocate for the elimination of the corporate income tax, or at least to treat corporations as flow-through entities.

³U.S. tax law attempts to allocate income to the geographical location where income is economically earned, so I disagree that Apple should record only 30 percent of its pretax income in the United States. Apple acknowledges that substantially all its technology is developed in the United States and that in 2011 67 percent of its employees were in the United States, 79 percent of its employee compensation was in the United States, and 39 percent of its customers were in the United States. Thus, the recording of only 30 percent of Apple's pretax income in the United States seems inconsistent with where the income was economically earned. However, a cost-sharing agreement allows Apple to allocate only 30 percent of its income to the United States.

⁴In 2011 the ratio of U.S. to global pretax income was approximately 30 percent, while the ratio of U.S. sales to global sales was approximately 40 percent. Thus, applying the rationale advocated by Johnson, the pretax income allocated to the United States could still be understated.

⁵Given that the Senate hearing was U.S.-centric, that observation was never really made.

⁶For example, through the OECD's base erosion and profit shifting project.

- Should anti-base-erosion provisions be strengthened? For example, tightening the subpart F rules, imposing a minimum tax on income recorded in tax havens, and restricting the deductibility of expenses attributable to foreign operations (for example, interest).
- Should there be increased transparency regarding the geographical location of income, tax, and other pertinent information?⁷
- Should formulary apportionment be adopted? It could replace the arm's-length standard or serve as a backstop.⁸

If MNCs can continue to shift valuable intangible assets overseas, it is imperative the United States adopt strong anti-base-erosion rules. Otherwise, we will continue to observe MNCs like Apple allocating a disproportionate amount of their income to tax havens.

Income Shifted to Ireland and U.S. Tax Savings

There have been conflicting press reports regarding how much pretax income Apple shifted from the United States to Ireland by virtue of its cost-sharing agreement. For example, for the four-year period from 2009 to 2012, various reports stated that \$30 billion, \$44 billion, and \$74 billion of aggregate pretax income was shifted to Ireland.⁹ As a result, there also have been varying estimates of Apple's U.S. tax savings.

Based on my review, the amount of pretax income recorded by Apple Sales International (ASI) during the four-year period was \$74 billion.¹⁰ The amount of Irish tax expense recorded appears to have been less than 1 percent.¹¹ Thus, it is reasonable to conclude that if Apple had not entered into the cost-sharing agreement, there would have been approximately \$74 billion of additional pretax in-

come recorded in the United States, resulting in approximately \$26 billion (approximately \$74 billion x 35 percent) of additional U.S. federal tax.¹²

Apple's Effective Tax Rate

Apple's testimony refers to its 2012 U.S. federal cash effective tax rate (ETR) of 30.5 percent.¹³ Apple also likes to tout its overall ETR for financial accounting purposes (approximately 24.5 percent for 2010 to 2012). ETR is not a defined concept, except for financial statement purposes, so there are many alternative calculations. Thus, those analyzing Apple's ETR may want to also consider the following alternative ETRs:

- *Adjusted global ETR according to financial statements* — Apple's total financial statement tax expense assumes that approximately 50 percent of the company's Irish earnings are not indefinitely reinvested. That is an unusual assumption for a U.S. MNC, especially one that says it has "no current plans to repatriate these funds."¹⁴ If Apple assumed that 100 percent of the Irish earnings are indefinitely reinvested, its global ETR according to its financial statements would decrease from approximately 24.5 percent to somewhere between 12.4 and 14.7 percent between 2010 and 2012.
- *Global cash tax paid ETR* — ETR can be calculated by taking the cash paid for income taxes in the consolidated statement of cash flows and dividing by the global pretax income.¹⁵ In Apple's case, that results in an ETR ranging from 9.6 to 14.6 percent for the period from 2010 to 2012.
- *Adjusted U.S. ETR to reflect income shifted out of the United States* — Apple prefers to calculate a U.S. ETR based on a denominator that already reflects a massive shifting of income from the United States to Ireland. One could calculate the U.S. ETR by taking the amount of tax liability shown on Apple's Form 1120, divided by U.S. pretax income reported in financial

⁷EU leaders announced May 22 that the union would pursue a proposal to require MNCs to disclose profits and taxes on a country-by-country basis.

⁸One option would be to use formulary apportionment as a backstop to arm's-length pricing. For example, if a business has \$1 billion of global income and on an arm's-length basis records 80 percent of that income as outside the United States and 20 percent as inside the United States, formulary apportionment could be used to check the result of the arm's-length allocations. Thus, if formulary apportionment suggested the ratio should be 30 percent foreign and 70 percent U.S., some compromise between formulary apportionment and arm's-length pricing could be used for U.S. tax purposes.

⁹\$30 billion relates to the dividends received by AOI; \$44 billion relates to the use of the check-the-box regulations; and \$74 billion relates to the pretax income in ASI.

¹⁰\$36 billion + \$22 billion + \$12 billion + \$4 billion = \$74 billion for 2012, 2011, 2010, and 2009.

¹¹I was not given ASI's Irish tax information for 2012. However, as summarized on p. 21 of a memorandum by Levin and McCain, the Irish effective tax rate for 2009 to 2011 averaged 0.06 percent.

¹²There also could have been additional state and local tax.

¹³Apple CEO Tim Cook admits in footnote 1 of his testimony that the \$6 billion paid in fiscal 2012 is not a calculation of the company's final tax liability for the year. Thus, it could include taxes paid from prior years (for example, either audit adjustments or amounts related to the fiscal 2011 return that were not due until fiscal 2012).

¹⁴*Id.* at 15. When asked a question by Sen. Levin, Cook was careful to repeat that he had "no current plans to repatriate the funds." If he had said he had no plans to repatriate those funds, Apple's financial statement assumption that only 50 percent of its Irish earnings are indefinitely reinvested could have come under serious questioning by the SEC.

¹⁵The cash taxes paid may not equal the tax liability for the year, but if the calculation is averaged over a few years, the impact of timing differences is usually mitigated.

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statements increased for the income shifted to Ireland through the cost-sharing agreement. That calculation results in a U.S. ETR ranging from 6.9 to 10.9 percent for the period from 2010 to 2012.¹⁶

In summary, although Apple would like policy-makers to focus on a relatively high ETR, a more appropriate ETR may be in the 7 to 15 percent range.

Apple's Use of Tax Gimmicks

Those who watched the hearing or read press reports likely noted my statement that "I about fell off my chair" when I read in Apple's testimony that it claimed not to have used tax gimmicks.¹⁷ I will leave it to the readers of *Tax Notes* to form their own judgment, but I believe that at least two of the tax planning tools used by Apple rise to the level of a tax gimmick.¹⁸

- *Check-the-box regulations* — Given these regulations allow entities and transactions that otherwise exist for legal and economic purposes to be totally disregarded for U.S. tax purposes, I believe the use of check-the-box regulations rises to the level of a tax gimmick. However, I also admit they are a strong tax planning tool.
- *Irish entities that are tax resident nowhere* — Apple incorporated at least three entities in Ireland (AOI, AOE, and ASI) that it claims have substantial business operations in Ireland but are managed and controlled in the United States. By arbitraging the U.S. and Irish tax residency rules, Apple was able to avoid both U.S. and Irish tax residency.

In summary, I believe Apple has used tax gimmicks to substantially reduce its worldwide income tax burden. Those tax gimmicks are legal, but maybe they shouldn't be.

Conclusion

Through the use of various tax planning techniques, Apple is able to record approximately two-

thirds of its global pretax income in Ireland even though (1) Ireland accounts for only 1 percent of its customers and 4 percent of its employees, and (2) substantially all of Apple's technology is developed in the United States. Apple was able to accomplish that through a combination of factors, including:

- a cost-sharing agreement to transfer the development rights to Apple products outside the Americas to Ireland;
- the check-the-box regulations to avoid subpart F¹⁹;
- Irish entities that are considered managed and controlled in the United States, but are not considered resident in either Ireland or the United States; and
- sales commission arrangements to limit the amount of income recorded in foreign-source countries.

As a result, Apple was able to record approximately \$74 billion of pretax income in Ireland from 2009 to 2012 and potentially avoid approximately \$26 billion of U.S. income tax.

During the hearing, Sen. Johnson and Apple seemed to believe that Apple's allocation of global pretax income was reasonable because its ratio of U.S. pretax income to global pretax income is approximately 30 percent while the ratio of U.S. sales to global sales is approximately 40 percent.²⁰ One major point of this article is that if Apple wants to make that argument to defend its income allocation to the United States, it should be required to use the same analysis to conclude that the income allocated to foreign countries other than Ireland is grossly understated. Said differently, Apple should not be able to argue one thing to support its U.S. income allocation and then argue something different for foreign tax purposes.

Finally, Apple would like policymakers to focus on its relatively high ETR (approximately 30 percent), but more appropriate calculations of that ETR may range from 7 to 15 percent.

¹⁶In billions of dollars, 2012 = 6/(19 + 36); 2011 = 2.5/(10.2 + 22); and 2010 = 1.2/(5.5 + 12).

¹⁷Defined in one legal dictionary as artifice, contrivance, deception, design, device, flimflam, gadget, invention, maneuver, method, plan, ploy, ruse, scheme, secret device, snag, stratagem, strategy, subterfuge, trap, or trick.

¹⁸I could also add Apple's cost-sharing agreement to the list, but it does not seem as gimmicky to me. Rather, it is the result of U.S. tax law respecting transactions between related parties that are purportedly entered into on an arm's-length basis.

¹⁹Apple also relied on the look-through rule in section 954(c)(6) to avoid subpart F income.

²⁰Apple argued that the difference in profitability between U.S. and foreign sales was attributable to a more profitable product mix overseas. That may be the case, but as I discussed in my testimony, there were some curious expense allocations that may also have contributed to a lower profit margin being recorded on U.S. sales.