The New York Times

NEW YORK, SUNDAY, APRIL 29, 2012

How Apple Sidesteps Billions in Taxes

Funneling Earnings to Low-Tax Regions

By CHARLES DUHIGG and DAVID KOCIENIEWSKI

RENO, Nev.

APPLE, the world's most profitable technology company, doesn't design iPhones here. It doesn't run AppleCare customer service from this city. And it doesn't manufacture MacBooks or iPads anywhere nearby.

THE iECONOMY
Protecting Profits

Yet, with a handful of employees in a small office here in Reno, Apple has done something central to its corporate strategy: it has avoided millions of dollars in taxes in California and 20 other states.

Apple's headquarters are in Cupertino, Calif. By putting an office in Reno, just 200 miles away, to collect and invest the company's profits, Apple sidesteps state income taxes on some of those gains.

California's corporate tax rate is 8.84 percent. Nevada's? Zero.

Setting up an office in Reno is just one of many legal methods Apple uses to reduce its worldwide tax bill by billions of dollars each year. As it has in Nevada, Apple has created subsidiaries in low-tax places like Ireland, the Netherlands, Luxembourg and the British Virgin Islands — some little more than a letterbox or an anonymous office — that help cut the taxes it pays around the world.

Almost every major corporation tries to minimize its taxes, of course. For Apple, the savings are especially alluring because the company's profits are so high. Wall Street analysts predict Apple could earn up to $45.6 billion in its current fiscal year — which would be a record for any American business.

Apple serves as a window on how technology giants have taken advantage of tax codes written for an industrial age and ill suited to today's digital economy. Some profits at companies like Apple, Google, Amazon, Hewlett-Packard and Microsoft derive not from physical goods but from royalties on intellectual property, like the patents on software that makes devices work. Other times, the products themselves are digital, like downloaded songs. It is much easier for businesses with royalties and digital products to move profits to low-tax countries than it is, say, for grocery stores or automakers. A downloaded application, unlike a car, can be sold from anywhere.

The growing digital economy presents a conundrum for lawmakers overseeing corporate taxation: although technology is now one of the nation's largest and most valued industries, many tech companies are among the least taxed, according to government and corporate data. Over the last two years, the 71 technology companies in the Standard & Poor's 500-stock index — including Apple, Google, Yahoo and Dell — reported paying worldwide cash taxes at a rate that, on average, was a third less than other S.& P. companies'. (Cash taxes may include payments for multiple years.)

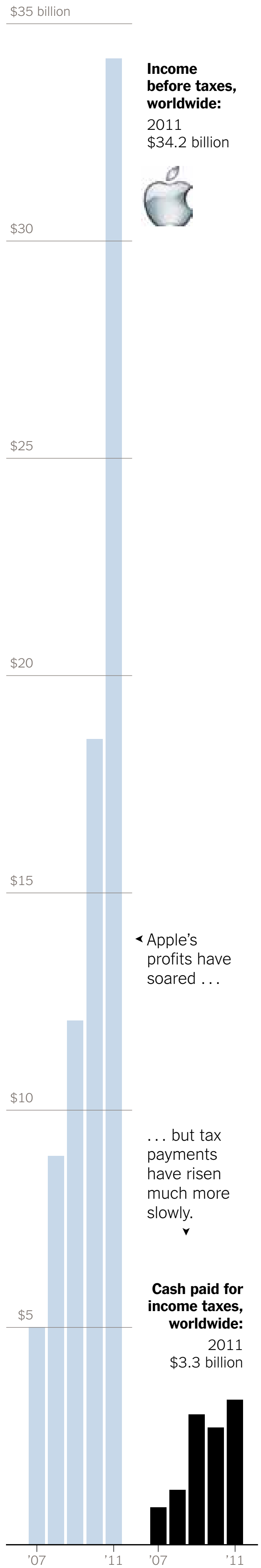
Even among tech companies, Apple's rates are low. And while the company has remade industries, ignited economic growth and delighted customers, it has also devised corporate strategies that take advantage of gaps in the tax code, according to former executives who helped create those strategies.

Apple, for instance, was among the first tech companies to designate overseas salespeople in high-tax countries in a manner that allowed them to sell on behalf of low-tax subsidiaries on other continents, sidestepping income taxes, according to former executives. Apple was a pioneer of an accounting technique known as the "Double Irish With a Dutch Sandwich," which reduces taxes by routing profits through Irish subsidiaries and the Netherlands and then to the Caribbean. Today, that tactic is used by hundreds of other corporations — some of which directly imitated Apple's methods, say accountants at those companies.

Without such tactics, Apple's federal tax bill in the United States most likely would have been $2.4 billion higher last year, according to a recent study by a former Treasury Department economist, Martin A. Sullivan. As it stands, the company paid cash taxes of $3.3 billion around the world on its reported profits of $34.2 billion last year, a tax rate of 9.8 percent. (Apple does not disclose what portion of those payments was in the United States, or what portion is assigned to previous or future years.)

By comparison, Wal-Mart last year paid worldwide cash taxes of $5.9 billion on its booked profits of $24.4 billion, a tax rate of 24 percent, which is about average for non-tech companies.

Apple's domestic tax bill has piqued particular curiosity among corporate tax experts because although the company is based in the United States, its profits — on paper, at least — are largely foreign. While Apple contracts out much of the manufacturing and assembly of its products to other companies overseas, the majority of Apple's executives, product designers, marketers, employees, research and development, and retail stores are in the United States. Tax experts say it is therefore reasonable to expect that most of Apple's profits would be American as well. The nation's tax code is based on the concept that a company "earns" income where value is created, rather than where products are sold.



Source: company filings THE NEW YORK TIMES

However, Apple's accountants have found legal ways to allocate about 70 percent of its profits overseas, where tax rates are often much lower, according to corporate filings.

Neither the government nor corporations make tax returns public, and a company's taxable income often differs from the profits disclosed in annual reports. Companies report their cash outlays for income taxes in their annual Form 10-K, but it is impossible from those numbers to determine precisely how much, in total, corporations pay to governments. In Apple's last annual disclosure, the company listed its worldwide taxes — which includes cash taxes paid as well as deferred taxes and other charges — at $8.3 billion, an effective tax rate of almost a quarter of profits.

However, tax analysts and scholars said that figure most likely overstated how much the company would hand to governments because it included sums that might never be paid. "The information on 10-Ks is fiction for most companies," said Kimberly Clausing, an economist at Reed College who specializes in multinational taxation. "But for tech companies it goes from fiction to farcical."

Apple, in a statement, said it "has conducted all of its business with the highest of ethical standards, complying with applicable laws and accounting rules." It added, "We are incredibly proud of all of Apple's contributions."

Apple "pays an enormous amount of taxes, which help our local, state and federal governments," the statement also said. "In the first half of fiscal year 2012, our U.S. operations have generated almost $5 billion in federal and state income taxes, including income taxes withheld on employee stock gains, making us among the top payers of U.S. income tax."

The statement did not specify how it arrived at $5 billion, nor did

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Braeburn Capital, an Apple subsidiary in Reno, Nev., manages and invests the company's cash. Nevada has a corporate tax rate of zero, as opposed to the 8.84 percent levied in California, where Apple has its headquarters.

it address the issue of deferred taxes, which the company may pay in future years or decide to defer indefinitely. The $5 billion figure appears to include taxes ultimately owed by Apple employees.

The sums paid by Apple and other tech corporations is a point of contention in the company's backyard.

A mile and a half from Apple's Cupertino headquarters is De Anza College, a community college that Steve Wozniak, one of Apple's founders, attended from 1969 to 1974. Because of California's state budget crisis, De Anza has cut more than a thousand courses and 8 percent of its faculty since 2008.

Now, De Anza faces a budget gap so large that it is confronting a "death spiral," the school's president, Brian Murphy, wrote to the faculty in January. Apple, of course, is not responsible for the state's financial shortfall, which has numerous causes. But the company's tax policies are seen by officials like Mr. Murphy as symptomatic of why the crisis exists.

"I just don't understand it," he said in an interview. "I'll bet every person at Apple has a connection to De Anza. Their kids swim in our pool. Their cousins take classes here. They drive past it every day, for Pete's sake.

"But then they do everything they can to pay as few taxes as possible."

Escaping State Taxes

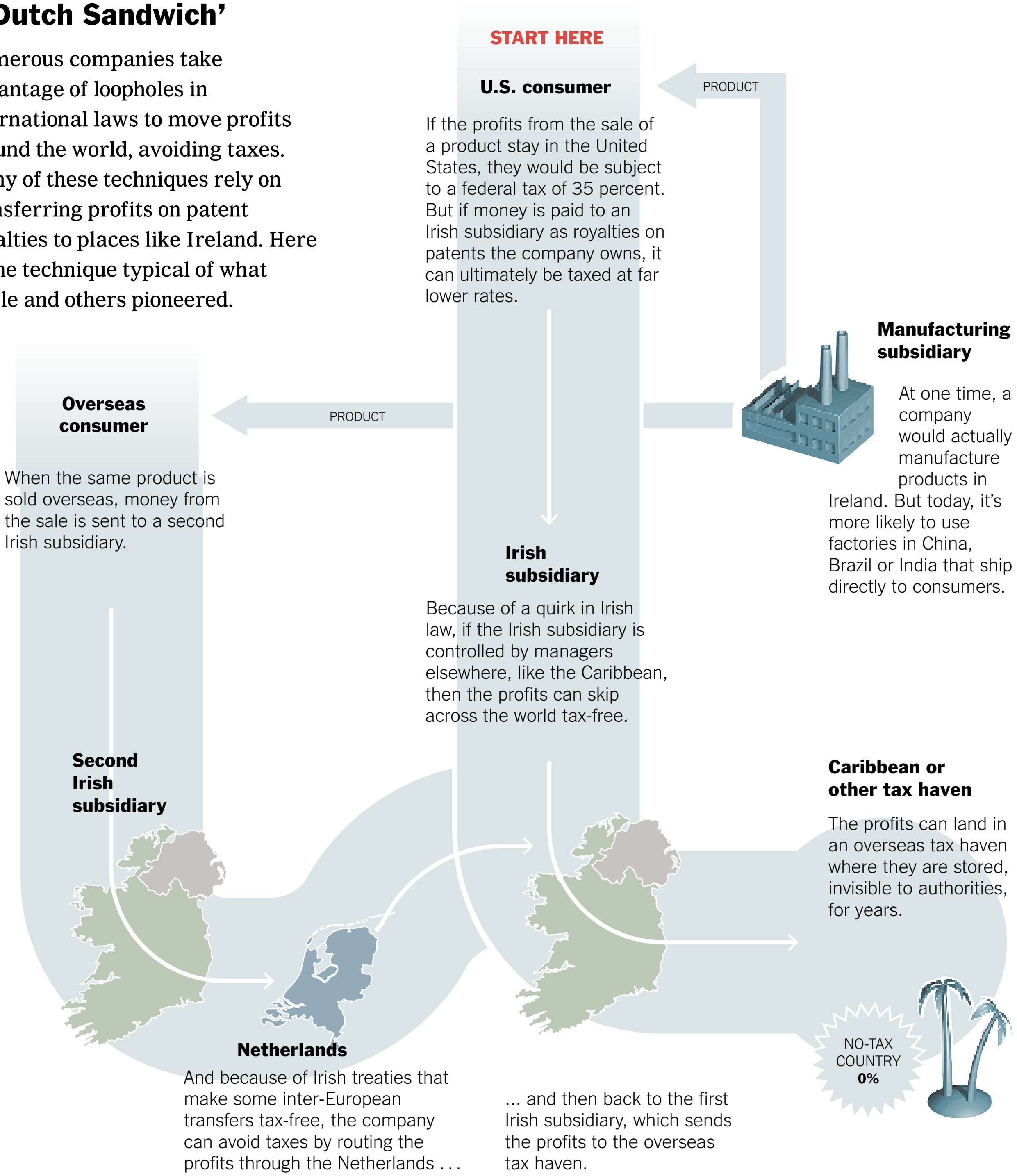
In 2006, as Apple's bank accounts and stock price were rising, company executives came here to Reno and established a subsidiary named Braeburn Capital to manage and invest the company's cash. Braeburn is a variety of apple that is simultaneously sweet and tart.

Today, Braeburn's offices are down a narrow hallway inside a bland building that sits across from an abandoned restaurant. Inside, there are posters of candy-colored iPods and a large Apple insignia, as well as a handful of desks and computer terminals.

When someone in the United States buys an iPhone, iPad or other Apple product, a portion of the profits from that sale is often deposited into accounts controlled by Braeburn, and then invested in stocks, bonds or other financial instruments, say company executives. Then,

‘Double Irish With A Dutch Sandwich’

Numerous companies take advantage of loopholes in international laws to move profits around the world, avoiding taxes. Many of these techniques rely on transferring profits on patent royalties to places like Ireland. Here is one technique typical of what Apple and others pioneered.



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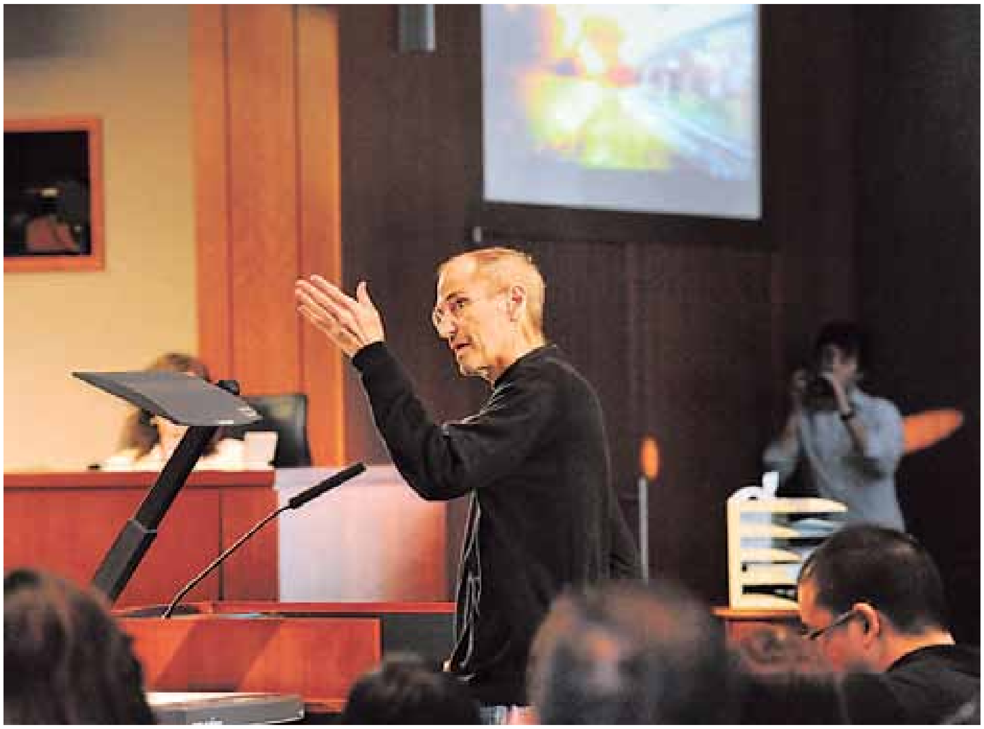
when those investments turn a profit, some of it is shielded from tax authorities in California by virtue of Braeburn’s Nevada address.

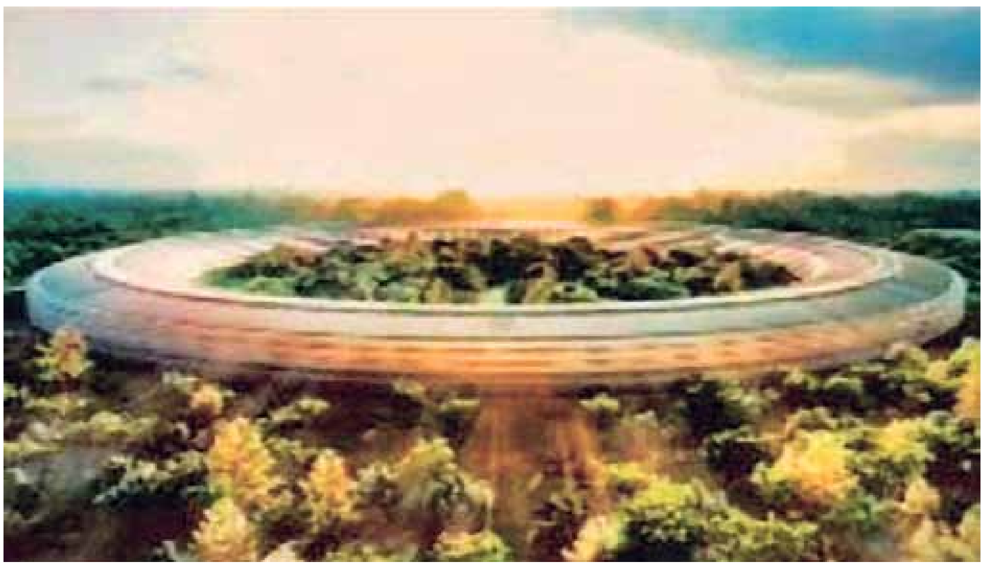
Since founding Braeburn, Apple has earned more than $2.5 billion in interest and dividend income on its cash reserves and investments around the globe. If Braeburn were located in Cupertino, where Apple’s top executives work, a portion of the domestic income would be taxed at California’s 8.84 percent corporate income tax rate.

But in Nevada there is no state corporate income tax and no capital gains tax.

What’s more, Braeburn allows Apple to lower its taxes in other states — including Florida, New Jersey and New Mexico — because many of those jurisdictions use formulas that reduce what is owed when a company’s financial management occurs elsewhere. Apple does not disclose what portion of cash taxes is paid to states, but the company reported that it owed $762 million in state income taxes nationwide last year. That effective state tax rate is higher



CITY OF CUPERTINO, VIA ASSOCIATED PRESS



APPLE, VIA ASSOCIATED PRESS

Last June, Steven P. Jobs, then the chief of Apple, top, introduced plans for a new corporate campus, above, to the City Council of Cupertino, Calif. Residents disagree on whether the company pays its fair share.

than the rate of many other tech companies, but as Ms. Clausing and other tax analysts have noted, such figures are often not reliable guides to what is actually paid.

Dozens of other companies, including Cisco, Harley-Davidson and Microsoft, have also set up Nevada subsidiaries that bypass taxes in other states. Hundreds of other corporations reap similar savings by locating offices in Delaware.

But some in California are unhappy that Apple and other California-based companies have moved financial operations to tax-free states — particularly since lawmakers have offered them tax breaks to keep them in the state.

In 1996, 1999 and 2000, for instance, the California Legislature increased the state's research and development tax credit, permitting hundreds of companies, including Apple, to avoid billions in state taxes, according to legislative analysts. Apple has reported tax savings of $412 million from research and development credits of all sorts since 1996.

Then, in 2009, after an intense lobbying campaign led by Apple, Cisco, Oracle, Intel and other companies, the California Legislature reduced taxes for corporations based in California but operating in other states or nations. Legislative analysts say the change will eventually cost the state government about $1.5 billion a year.

Such lost revenue is one reason California now faces a budget crisis, with a shortfall of more than $9.2 billion in the coming fiscal year alone. The state has cut some health care programs, significantly raised tuition at state universities, cut services to the disabled and proposed a $4.8 billion reduction in spending on kindergarten and other grades.

Apple declined to comment on its Nevada operations. Privately, some executives said it was unfair to criticize the company for reducing its tax bill when thousands of other companies acted similarly. If Apple volunteered to pay more in taxes, it would put itself at a competitive disadvantage, they argued, and do a disservice to its shareholders.

Indeed, Apple's decisions have yielded benefits. After announcing one of the best quarters in its history last week, the company said it had net profits of $24.7 billion on revenues of $85.5 billion in the first half of the fiscal year, and more than $110 billion in the bank, according to company filings.

A Global Tax Strategy

Every second of every hour, millions of times each day, in living rooms and at cash registers, consumers click the "Buy" button on iTunes or hand over payment for an Apple product.

And with that, an international financial engine kicks into gear, moving money across continents in the blink of an eye. While Apple's Reno office helps the company avoid state taxes, its international subsidiaries — particularly the company's assignment of sales and patent royalties to other nations — help reduce taxes owed to the American and other governments.

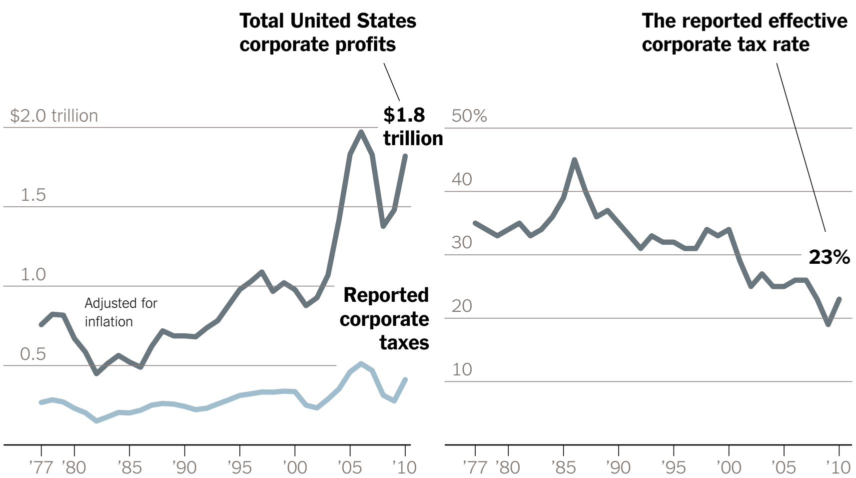
For instance, one of Apple's subsidiaries in Luxembourg, named iTunes S.à r.l., has just a few dozen employees, according to corporate documents filed in that nation and a current executive. The only indication of the subsidiary's presence outside is a letterbox with a lopsided slip of paper reading "ITUNES SARL."

Luxembourg has just half a million residents. But when customers across Europe, Africa or the Middle East — and potentially elsewhere — download a song, television show or app, the sale is recorded in this small country, according to current and former executives. In 2011, iTunes S.à r.l.'s revenue exceeded $1 billion, according to an Apple executive, representing roughly 20 percent of iTunes's worldwide sales.

The advantages of Luxembourg

Shrinking Corporate Tax Rates

Corporate profits are far bigger now than they were in 1977, the year Apple was incorporated ... ... and corporate tax rates have fallen.



Some tax experts say that Apple moves more profits offshore than appears justified by its operations, which are largely in the United States. And overseas, technology companies pay particularly low taxes.

2011	Apple domestic	Apple foreign
Share of employees	72%	28%
Number of retail stores	68%	32%
Long-term assets	54%	46%
Sales	39%	61%
Apple's allocation of profits	30%	70%

What American industries pay in taxes abroad

	2006
Mining	32.0%
Textiles	24.4
Food manufacturing	23.4
Retail trade	22.5
Construction	21.5
Printing and related	18.4
Utilities	17.2
Real estate	16.8
Wood products	16.7
Overall	15.6
Apparel	14.6
Chemical mfg.	13.1
Agriculture	12.2
Services	11.7
Finance	11.3
Computer and electronic product manufacturing	**8.7**

Sources: Bureau of Economic Analysis; company reports; American Tax Policy Institute

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are simple, say Apple executives. The country has promised to tax the payments collected by Apple and numerous other tech corporations at low rates if they route transactions through Luxembourg. Taxes that would have otherwise gone to the governments of Britain, France, the United States and dozens of other nations go to Luxembourg instead, at discounted rates.

"We set up in Luxembourg because of the favorable taxes," said Robert Hatta, who helped oversee Apple's iTunes retail marketing and sales for European markets until 2007. "Downloads are different from tractors or steel because there's nothing you can touch, so it doesn't matter if your computer is in France or England. If you're buying from Luxembourg, it's a relationship with Luxembourg."

An Apple spokesman declined to comment on the Luxembourg operations.

Downloadable goods illustrate how modern tax systems have become increasingly ill equipped for an economy dominated by electronic commerce. Apple, say former executives, has been particularly talented at identifying legal tax loopholes and hiring accountants who, as much as iPhone designers, are known for their innovation. In the 1980s, for instance, Apple was among the first major corporations to designate overseas distributors as "commissionaires," rather than retailers, said Michael Rashkin, Apple's first director of tax policy, who helped set up the system before leaving in 1999.

To customers the designation was virtually unnoticeable. But because commissionaires never technically take possession of inventory — which would require them to recognize taxes — the structure allowed a salesman in high-tax Germany, for example, to sell computers on behalf of a subsidiary in low-tax Singapore. Hence, most of those profits would be taxed at Singaporean, rather than German, rates.

The Double Irish

In the late 1980s, Apple was among the pioneers in creating a tax structure — known as the Double Irish — that allowed the company to move profits into tax havens around the world, said Tim Jenkins, who helped set up the system as an Apple European finance manager until 1994.

Apple created two Irish subsidiaries — today named Apple Operations International and Apple Sales International — and built a glass-encased factory amid the green fields of Cork. The Irish government offered Apple tax breaks in exchange for jobs, according to former executives with knowledge of the relationship.

But the bigger advantage was that the arrangement allowed Apple to send royalties on patents developed in California to Ireland. The transfer was internal, and simply moved funds from one part of the company to a subsidiary overseas. But as a result, some profits were taxed at the Irish rate of approximately 12.5 percent, rather than at the American statutory rate of 35 percent. In 2004, Ireland, a nation of less than 5 million, was home to more than one-third of Apple's worldwide revenues, according to company filings. (Apple has not released more recent estimates.)

Moreover, the second Irish subsidiary — the "Double" — allowed other profits to flow to tax-free companies in the Caribbean. Apple has assigned partial ownership of its Irish subsidiaries to Baldwin Holdings Unlimited in the British Virgin Islands, a tax haven, according to documents filed there and in Ireland. Baldwin Holdings has no listed offices or telephone number, and its only listed director is Peter Oppenheimer, Apple's chief financial officer, who lives and works in Cupertino. Baldwin apples are known for their hardiness while traveling.

Finally, because of Ireland's treaties with European nations, some of Apple's profits could travel virtually tax-free through the Netherlands — the Dutch Sandwich — which made them essentially invisible to outside observers and tax authorities.

Robert Promm, Apple's controller in the mid-1990s, called the strategy "the worst-kept secret in Europe."

It is unclear precisely how Apple's overseas finances now function. In 2006, the company reorganized its Irish divisions as unlimited corporations, which have few requirements to disclose financial information.

However, tax experts say that strategies like the Double Irish help explain how Apple has managed to keep its international taxes to 3.2 percent of foreign profits last year, to 2.2 percent in 2010, and in the single digits for the last half-decade, according to the company's corporate filings.

Apple declined to comment on its operations in Ireland, the Netherlands and the British Virgin Islands.

PETER DaSILVA FOR THE NEW YORK TIMES

Brian Murphy, center, head of De Anza College in Cupertino, Calif., says the big tech firms are "philosophically antitax, and it's decimating the state."

Apple reported in its last annual disclosures that $24 billion — or 70 percent — of its total $34.2 billion in pretax profits were earned abroad, and 30 percent were earned in the United States. But Mr. Sullivan, the former Treasury Department economist who today writes for the trade publication Tax Analysts, said that "given that all of the marketing and products are designed here, and the patents were created in California, that number should probably be at least 50 percent."

If profits were evenly divided between the United States and foreign countries, Apple's federal tax bill would have increased by about $2.4 billion last year, he said, because a larger amount of its profits would have been subject to the United States' higher corporate income tax rate.

"Apple, like many other multinationals, is using perfectly legal methods to keep a significant portion of their profits out of the hands of the I.R.S.," Mr. Sullivan said. "And when America's most profitable companies pay less, the general public has to pay more."

Other tax experts, like Edward D. Kleinbard, former chief of staff of the Congressional Joint Committee on Taxation, have reached similar conclusions.

"This tax avoidance strategy used by Apple and other multinationals doesn't just minimize the companies' U.S. taxes," said Mr. Kleinbard, now a professor of tax law at the University of Southern California. "It's German tax and French tax and tax in the U.K. and elsewhere."

One downside for companies using such strategies is that when money is sent overseas, it cannot be returned to the United States without incurring a new tax bill.

However, that might change. Apple, which holds $74 billion offshore, last year aligned itself with more than four dozen companies and organizations urging Congress for a "repatriation holiday" that would permit American businesses to bring money home without owing large taxes. The coalition, which includes Google, Microsoft and Pfizer, has hired dozens of lobbyists to push for the measure, which has not yet come up for vote. The tax break would cost the federal government $79 billion over the next decade, according to a Congressional report.

Fallout in California

In one of his last public appearances before his death, Steven P. Jobs, Apple's chief executive, addressed Cupertino's City Council last June, seeking approval to build a new headquarters.

Most of the Council was effusive in its praise of the proposal. But one councilwoman, Kris Wang, had questions.

How will residents benefit? she asked. Perhaps Apple could provide free wireless Internet to Cupertino, she suggested, something Google had done in neighboring Mountain View.

"See, I'm a simpleton; I've always had this view that we pay taxes, and the city should do those things," Mr. Jobs replied, according to a video of the meeting. "That's why we pay taxes. Now, if we can get out of paying taxes, I'll be glad to put up Wi-Fi."

He suggested that, if the City Council were unhappy, perhaps Apple could move. The company is Cupertino's largest taxpayer, with more than $8 million in property taxes assessed by local officials last year.

Ms. Wang dropped her suggestion.

Cupertino, Ms. Wang said in an interview, has real financial problems. "We're proud to have Apple here," said Ms. Wang, who has since left the Council. "But how do you get them to feel more connected?"

Other residents argue that Apple does enough as Cupertino's largest employer and that tech companies, in general, have buoyed California's economy. Apple's workers eat in local restaurants, serve on local boards and donate to local causes. Silicon Valley's many millionaires pay personal state income taxes. In its statement, Apple said its "international growth is creating jobs domestically, since we oversee most of our operations from California."

"The vast majority of our global work force remains in the U.S.," the statement continued, "with more than 47,000 full-time employees in all 50 states."

Moreover, Apple has given nearby Stanford University more than $50 million in the last two years. The company has also donated $50 million to an African aid organization. In its statement, Apple said: "We have contributed to many charitable causes but have never sought publicity for doing so. Our focus has been on doing the right thing, not getting credit for it. In 2011, we dramatically expanded the number of deserving organizations we support by initiating a matching gift program for our employees."

Still, some, including De Anza College's president, Mr. Murphy, say the philanthropy and job creation do not offset Apple's and other companies' decisions to circumvent taxes. Within 20 minutes of the financially ailing school are the global headquarters of Google, Facebook, Intel, Hewlett-Packard and Cisco.

"When it comes time for all these companies — Google and Apple and Facebook and the rest — to pay their fair share, there's a knee-jerk resistance," Mr. Murphy said. "They're philosophically antitax, and it's decimating the state."

"But I'm not complaining," he added. "We can't afford to upset these guys. We need every dollar we can get." ■

Additional reporting was contributed by Keith Bradsher in Hong Kong, Siem Eikelenboom in Amsterdam, Dean Greenaway in the British Virgin Islands, Scott Sayare in Luxembourg and Jason Woodard in Singapore.