ECONOMIC ANALYSIS

Apple Reports High Rate But Saves Billions on Taxes

By Martin A. Sullivan — martysullivan@comcast.net

By taking advantage of lax U.S. transfer pricing rules, Apple Inc., the world's most valuable company, cut its federal tax bill by billions of dollars in 2011. Moreover, by taking advantage of flexible accounting rules, the company masked its tax avoidance by reporting a relatively high effective tax rate.

Apple does most of its research in the United States. Most of its key employees are in the United States. Fifty-four percent of its long-lived assets, 69 percent of its retail stores, and 39 percent of its sales are in the United States. A recent study funded by the Sloan Foundation and the National Science Foundation concluded: ''Apple continues to keep most of its product design, software development, product management, marketing and other high-wage functions in the U.S.'' (See Kenneth Kraemer, Greg Linden, and Jason Dedrick, ''Capturing Value in Global Networks: Apple's iPad and iPhone,'' July 2011.)

Yet the company reports only 30 percent of its profits as being from the United States. By shifting large amounts of profits out of the United States, Apple is doing nothing illegal or out of line with the tax practices of other companies with lots of high-value intangibles. U.S. transfer pricing rules are a sieve. (For prior analysis of Apple, see *Tax Notes*, Aug. 1, 2011, p. 459, *Doc 2011-16455*, or *2011 TNT 147-3*.)

There will never be a precise answer as to where profits are created. But if the corporate tax is a tax on income, it is reasonable to place profits where value is created. In Apple's case, can there be any doubt that most of its value is created inside the United States? If we assume, conservatively, that 50 percent of profits should be U.S. sourced, then Apple's federal taxes would have been $2.4 billion

Apple's Financial Information
(For fiscal year ending September 2011, unless otherwise indicated; dollar amounts in billions.)

Market value (Feb. 8, 2012)	$444.4	Reported effective tax rate*	24.2%
Before-tax profits*	$34.2	Foreign effective tax rate	4.7%
Before-tax foreign profits*	$24	Accumulated foreign earnings*	$54.3
U.S. share of before-tax profits	29.8%	Permanently invested foreign earnings*	$23.4
U.S. share of sales	38.6%	Accumulated foreign earnings not permanently invested	$30.9
U.S. share of long-lived assets	54.2%	Deferred tax liability of not permanently invested foreign earnings, end of 2011*	$8.9
U.S. share of retail stores	68.6%	Deferred tax liability of not permanently invested foreign earnings, end of 2010*	$5
U.S. sales margin	24.4%	Estimated book U.S. tax expense on foreign profit	$3.9
Foreign sales margin	36.1%	Estimated foreign profit with booked U.S. tax expense	$12.4
Additional U.S. tax if 50% profits in U.S.	$2.4	Estimated U.S. tax rate on repatriated foreign earnings	28.8%
Additional U.S. tax if 70% profits in U.S.	$4.8	Adjusted effective tax rate	12.8%

Notes:
Asterisk (*) means information is directly from 2011 annual report.
Market value. From Yahoo Finance. Second in market capitalization is Exxon Mobil at $403.9 billion.
U.S. share of before-tax profits. Calculated from 2011 reported total before-tax profits ($34.2 billion) and 2011 reported before-tax foreign profits ($24 billion).
Additional U.S. tax if 50% profits in U.S. The difference between 50 percent and 29.8 percent multiplied by $34.2 billion (before-tax profits) and 35 percent (the marginal U.S. federal corporate tax rate).
Foreign effective tax rate. Total foreign tax liability ($602 million) divided by total before-tax foreign profits ($24.0 billion).
Accumulated foreign earnings not permanently invested. The difference between accumulated foreign earnings at the end of 2011 ($54.3 billion) and permanently invested foreign earnings at the end of 2011 ($23.4 billion).
Estimated foreign profit with booked U.S. tax expense. Increase from 2010 to 2011 (from $18.5 to $30.9 billion) in accumulated foreign profit not permanently reinvested.
Estimated book U.S. tax expense on foreign profit. Increase from 2010 to 2011 (from $5 to $8.9 billion) in deferred tax liability related to foreign earnings not permanently invested.
Estimated U.S. tax rate on repatriated foreign earnings. Booked U.S. tax expense on foreign profits as a percentage of estimated booked foreign profit with U.S. tax expense.
Adjusted effective tax rate. The difference between booked tax expense ($8.238 billion) and estimated book tax expense on foreign profits ($3.9 billion) divided by before-tax profits ($34.2 billion).

more in 2011. Given the pivotal importance to Apple's success of product design and other functions performed in the United States, one could reasonably expect U.S. profits to be 70 percent of the worldwide total. In this case, payments to the U.S. government would have been $4.8 billion more in 2011.

> ***If we assume, conservatively, that 50 percent of profits should be U.S. sourced, then Apple's federal taxes would have been $2.4 billion more in 2011.***

Apple reports a worldwide effective tax rate of 24.2 percent. A lower effective tax rate increases a company's reported book profits. Apple would have a lower reported effective tax rate and higher profits if it recorded its tax expense the way most other companies do. Under generally accepted accounting principles, U.S. companies do not have to book tax expense on foreign profits if the company deems them to be permanently invested overseas. To lower their reported effective tax rates and boost their reported after-tax profits, most companies assume all of their unrepatriated foreign profits are permanently reinvested offshore. If Apple asserted that all of its foreign earnings were permanently invested outside the United States, it would have booked an estimated $3.6 billion less in tax expense, and its effective tax rate would be 12.8 percent. (See the table.) When assessing Apple's tax situation relative to that of most other companies, this adjusted rate is probably more relevant than the reported 24.2 percent rate.

Why doesn't Apple maximize reported profit like most other companies? We can only speculate. Perhaps because it is breaking all records for profitability now, it is saving some profits for less fortunate times in the future. As the Joint Committee on Taxation recently wrote: ''If the company accrues the tax expense in the year the profits are earned, it may later decide that those funds will not be repatriated after all. At that later time it may then reverse the tax expense and shift financial statement income from the prior period into the current period.'' (See ''Present Law and Background Relating to the Interaction of Federal Income Tax Rules and Financial Accounting Rules,'' JCX-13-12, Feb. 7, 2012, *Doc 2012-2443* or *2012 TNT 26-15*.)

An alternative explanation is that perhaps Apple — with its young, socioeconomically elite customer base — does not want the negative publicity that a low effective tax rate could generate with groups like Citizens for Tax Justice and US Uncut. ■

NEWS ANALYSIS

Vodafone and the Reach Of Capital Gains Taxation

By Lee A. Sheppard — lees@tax.org

Members and representatives of the world's 1 percent recently took over the Swiss spa town of Davos for the World Economic Forum, their annual gabfest about making the world better. Much of the world has figured out that these guys — attendees are mostly male — are acting largely to make the world better for themselves.

Elites feathering their own nests at the expense of workers has come to be the meaning of, uh, globalization. For the past two decades, Western establishment newspapers have spoken respectfully of globalization as though it were inevitable, like climate change. Even *Time* magazine openly wondered whether multinational companies have become more powerful than national governments (*Time*, Jan. 27, 2012).

Globalization was not inevitable. It was the result of a series of decisions about trade, taxation, labor rights, and currency movements by the Davos crowd. This tiny cabal, who have more in common with each other than with their less wealthy countrymen, used free trade and unfettered currency movements to enrich themselves at the expense of labor.

Globalization was not purely the result of technological change. Indeed, there's nothing particularly high-tech about shipping labor-intensive manufactured goods across the Pacific on Liberian-flagged cargo ships running on cheap Arab oil.

Free trade allowed the elites to offshore jobs and incomes to escape the cost of the social contract in their home countries — whose governments they still rely on to protect their investments. Whom do they whine to when some guy in a doorman's outfit wants to expropriate their assets? Or when some country will not import their products? Or when they want to complain about piracy?

In *Foreign Policy*, Clyde Prestowitz of the Economic Strategy Institute put it bluntly: Even though Apple, which manufactures its popular gadgets in Asia, feels no obligation to the United States, it still depends on the 7th Fleet to protect Pacific shipping lanes. He noted that most of Apple's technology had some sort of government subsidy (*Foreign Policy*, Jan. 23, 2012).

''The theory of globalization underlying the Davos concept is false,'' Prestowitz wrote. ''That theory holds that globalization is a win-win economic movement that will enrich the whole world and thereby lead the nations to democracy and