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Maximizing Returns or Unethical Tax Avoidance?

Companies that take advantage of the varied tax laws of different countries to limit their tax payments claim they're maximizing shareholder returns. The result is that U.S. companies hold huge cash reserves in countries with low tax rates.

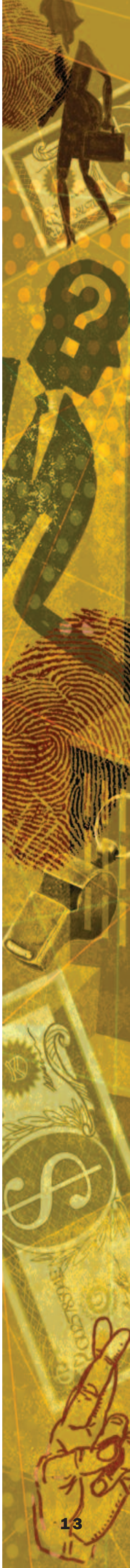
The furor over the extensive tax-avoidance measures used by technology companies such as Google and Apple has reached new heights in both the United Kingdom and the United States. Government members from both countries recently accused the two tech giants of scheming to avoid paying taxes. When this kind of news breaks, most companies respond by saying they must do everything possible to maximize net profits for shareowners, but the countries that miss out on the tax revenue based on profits they believe were generated within their borders argue that these companies are being unethical and possibly skirting the law. Critics maintain that high taxes on repatriating profits to the U.S. exacerbate the problem and encourage overseas investment to the detriment of employment at home.

During a Parliament committee hearing in the U.K., Margaret Hodge, chair of the Public Accounts Committee (PAC), accused Google of "devious, calculating, and unethical" behavior. Hodge alleged that the company marketed its product in the U.K. but used "smoke and mirrors to avoid paying tax" there. "You are a company that says you do no evil, and I think that you do do evil," Hodge told Matt Brittin, Google's vice president for sales and operations in northern Europe.

Google vigorously denied it avoided taxes by disguising the real nature of its business in the U.K. The company asserted that it did pay tax on profits from its services provided to affiliated entities but that the profits on the bulk of its business—sales to U.K. retail customers—were actually transacted in Ireland and that it didn't sell product from London. The head tax partner at Ernst & Young, however, told the hearing that an Irish resident company could be deemed to be trading in Britain if U.K.-based employees had habitually concluded deals on behalf of an Irish company. Hodge replied that "if sales activity is taking place in the U.K.…you are misleading both Parliament and the tax authorities in suggesting that is not happening."

In the U.S., the Senate Permanent Subcommittee on Investigations held hearings at which Apple CEO Tim Cook defended the company's practice of paying no U.S. income tax on Apple operations outside the country. Cook strenuously asserted that the company paid its tax bill in full for all of its domestic operations. In the case of foreign operations, however, Apple utilizes avoidance provisions in the Irish tax law to the full extent, as do many other companies. As hard as it is to believe, Apple has been able to create corporations that pay no income tax to any taxing nation. This is possible because Ireland doesn't assess income tax on entities that are managed from outside the country, and the U.S. assesses taxes based on the country of subsidiary incorporation only.

These issues have become more prominent as the technological advances of recent years enable "remote control" management of a corporation. Directors meetings and other legally determined functions for Apple's Irish holding company subsidiary, Apple Operations International (AOI), were held in California. AOI has no employees and no physical presence in Ireland, being entirely managed and operated from the United States. Apple's U.S. service center



in Austin, Texas, does the entity's accounting, and another Apple subsidiary in Nevada manages finances. The assets are held in a bank account in New York.

The importance of intellectual property to the profitability of tech companies has made them the focus of governments looking into the alleged shifting of profits to low-tax countries. According to Senator Carl Levin (D.-Mich.), chair of the Investigating subcommittee, those "profits depend on the ideas that bring [physical] elements together in such an elegant package. That intangible genius is intellectual property that is nurtured and developed here in the United States." He continued, "[Intellectual property] is also highly mobile—unlike more tangible, physical assets, its value can be transferred around the globe, often with just a few keystrokes."

Apple's statement to the subcommittee explained the company's belief in no uncertain terms that it wasn't a tax evader: "Apple does not use tax gimmicks. Apple does not move its intellectual property into offshore tax havens and use it to sell products back into the U.S. in order to avoid U.S. tax; it does not use revolving loans from foreign subsidiaries to fund its domestic operations; it does not hold money on a Caribbean island; and it does not have a bank account in the Cayman Islands. Apple has substantial foreign cash because it sells the majority of its products outside the U.S."

The subcommittee's description of Apple's strategies was quite different: "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 appears to have negotiated a special corporate tax arrangement of less than 2%. Despite reporting net income of $30 billion over the four-year period 2009 to 2012, AOI paid no corporate income taxes to any national government during that period. Similarly, Apple Sales International [ASI], 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."

ASI purchases finished products from Chinese manufacturing corporations and then resells them to other Apple marketing affiliates around the world at a substantial markup. Ireland allows Apple to record virtually all of its profits from these transactions in that country based on a cost-sharing arrangement set up when the economic benefits of intellectual properties were transferred there years ago. It appears that only products destined for countries outside the U.S. market use this procedure.

The subcommittee's statement concluded that "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."

Subpart F of the Internal Revenue Code was enacted some 50 years ago to forestall the increased use of tax-haven subsidiaries by U.S. corporations. Regulations designed to require "market-based" transfer prices between affiliates are now less effective because of the unique qualities of technology-based products and less frequent transfers of physical goods. According to the Internal Revenue Service's (IRS) testimony at the subcommittee hearing, "the check-the-box regulations provide that an eligible foreign entity with a single owner can be treated as 'disregarded' as a separate entity." The result is that many U.S. companies prefer to hold cash overseas rather than repatriate it back to the U.S. and incur income tax at what they perceive to be a very high rate. According to Joe Rosenberg, U.S. corporations hold more than $1 trillion in subsidiaries incorporated in countries with lower tax rates ("Let Apple and Microsoft

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Bail Out Uncle Sam," *The Wall Street Journal*, May 16, 2013).

Unfortunately, there's no international organization with the ability to harmonize tax laws on a global basis. Each sovereign nation structures its tax laws to accomplish the objectives of raising revenue while protecting its own particular economic interests. As a consequence, countries compete against each other for tax revenue, and companies take advantage of it. One country's pain from not collecting taxes it believes result from economic activity within its borders is another country's success in using its own unique strategies to be an economic attraction. A study by the Organisation for Economic Co-operation and Development (OECD), commissioned by the G20 nations, finds that these tax avoidance strategies, "though technically legal, erode the tax base of many countries and threaten the stability of the international tax system," according to OECD Secretary-General Angel Gurría.

The tech companies aren't alone in sheltering income from U.S. taxation. Presently, most corporations feel no obligation to help solve the fiscal problems of any country they do business in. They believe their only responsibility is to maximize return to their shareowners, and the compensation of most CEOs and senior executives is based primarily on short-term financial performance. A solution to this problem involves motivating the investment community to place more emphasis on a company's nonfinancial obligations to all of its stakeholders. Fortunately, the reporting of sustainability information by corporations is increasing. **SF**

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