Out of the Patent Box:
Apple’s Manipulation of Intellectual Property for Tax Avoidance

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In recent years the topic of multinational corporations avoiding taxes has gained increased interest. Technology companies such as Apple Inc. have benefitted greatly from dealing with intellectual property (IP). The use of IP over physical assets allows these companies to easily move their assets from one country to another to avoid paying millions and sometimes billions of dollars in taxes each year. As a result several countries have started to implement patent boxes, also known as innovation boxes or IP boxes, into their tax systems. A patent box is a special tax regime in which income attributable to IP is taxed at a lower, preferential rate. The purpose of this paper is to explore the patent box issue with a focus on Apple and their manipulation IP revenue and review the current legislative proposals before Congress and make policy recommendations. We will begin by analyzing Apple’s operations, specifically their use of foreign and domestic subsidiaries. The use of these subsidiaries and IP have helped Apple avoid paying billions of dollars in United States (U.S.) taxes. As a result of this tax avoidance many countries have started implementing patent box regimes in order to attract companies and their profits. We will first take a look at some of the patent box regimes already in place around the world and then examine the proposals before Congress advocating for a U.S. patent box regime. Finally, I will conclude with my own thoughts on the matter.

First, we must take a look at Apple and how they conduct their business, specifically the allocation of IP revenue and avoidance of income taxes. Our

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investigation begins by delving into the company’s annual and 10-K reports. One piece of relative information that is constantly referenced is Apple’s use of subsidiaries. As of their 2015 annual report Apple has reported the use of four subsidiaries—three of which are incorporated in Ireland. Keep in mind that Apple is headquartered in the U.S. Under the company’s note for income taxes in their annual report it is stated, “Substantially all of the Company’s undistributed international earnings intended to be indefinitely reinvested in operations outside the U.S. were generated by subsidiaries organized in Ireland, which has a statutory tax rate of 12.5%.”2 The key words in this sentence are “indefinitely reinvested.” As long as Apple doesn’t bring the cash back to the U.S. and plans to reinvest it somewhere abroad then they are not obligated to pay U.S. taxes on those earnings. In their latest annual report Apple disclosed that it had $91.5 billion in indefinitely reinvested earnings abroad—31% more than in 2014.3 By doing so Apple is able to reduce their effective tax rate and the large increase from year to year is evidence to the effectiveness of this method. Apple is able to save billions in taxes by simply labeling earnings as “indefinitely reinvested.” The approach may seem simple but it is extremely effective.

In addition, Apple’s use of Irish subsidiaries has long been documented. In the late 1980s Apple helped pioneer the tax structure known as the double Irish arrangement. In the double Irish arrangement companies like Apple are able to funnel


royalty payments for intellectual property, such as patents and trademarks, from one Irish-registered subsidiary to another with the latter usually residing in a country with no corporate income taxes.\(^4\) This arrangement allowed Apple to “transfer patent-related income created in the the U.S. to its Irish subsidiaries.”\(^5\) In doing so these companies are able to lower their effective tax rates even more. However, this arrangement is no longer available as of January 2015 for newly incorporated companies. Companies with existing operations in Ireland, such as Apple, may keep this tax structure in place through the year 2020.\(^6\)

Not only does Apple avoid paying taxes through the use of foreign subsidiaries they are also able to avoid paying millions in state income taxes with the help of Braeburn Capital, Inc.\(^7\) Although this company doesn’t design or manufacture Apple products and doesn’t assist in customer service, this small office in Reno, Nevada with a handful of employs is a subsidiary of Apple which collects and invests the company’s profits. By locating this office only 200 miles away from Apple’s headquarters in


Cupertino, California, Apple is able to go from paying California’s corporate tax rate of 8.84% to Nevada’s 0%. With this clever move Apple has avoided paying millions of dollars in taxes to California and 20 other states.  

Furthermore, one should note that the United States and China are the only countries that comprise more than 10% of Apple’s net sales. With this information in mind it only seems logical that they should be paying a significant amount more in U.S. taxes. However, the IP profits being earned are not being taxed by the U.S. and instead Apple is able to pay taxes in countries offering lower taxes, such as Ireland.

Additionally, Apple may continue to face more problems in regard to their Irish subsidiaries other than the countermeasure used to eliminate the double Irish arrangement. The company states in their 10-K report:

On June 11, 2014, the European Commission issued an opening decision initiating a formal investigation against Ireland for alleged state aid to the Company. The opening decision concerns the allocation of profits for taxation purposes of the Irish branches of two subsidiaries of the Company. The Company believes the European Commission’s assertions are without merit. If the European Commission were to conclude against Ireland, the European Commission could require Ireland to recover from the Company past taxes covering a period of up to 10 years reflective of the disallowed state aid. While such amount could be

Ibid.

material, as of September 26, 2015 the Company is unable to estimate the impact.⁠¹⁰

Paying ten years of taxes would indeed be material, especially for a company that earns as much as Apple. No matter what the cost, Apple will definitely feel the impact from this ruling and it could significantly affect their operations. Although the company seems confident that they won’t be affected, this investigation must have shareholders worried about the future impact these potential taxes could have on the company. It is no joking matter and Apple has long been a target and seen as one of the elite companies at avoiding taxes. They may be skating on thin ice as of now and I’m sure much of the business world is watching to see if the ice will break and force Apple to pay millions in taxes, or if it will hold and let the company continue their creative ways.

Bear in mind that Apple isn’t the only company to use these practices to avoid paying taxes. A recent study done by Citizens for Tax Justice and the U.S. Public Interest Research Group Education Fund found that America’s 500 largest companies hold more than $2.1 trillion in accumulated profits offshore. These companies would collectively owe $620 billion in U.S. taxes; companies including General Electric, Microsoft, and Pfizer. For example, General Electric has booked $119 billion offshore in 18 tax havens, Microsoft is holding $108.3 billion in five tax haven subsidiaries, and Pfizer is holding $74 billion in 151 subsidiaries.⁠¹¹ Clearly Apple is not alone in their

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⁠¹⁰ Ibid.

quest to lower their taxes; most if not all companies attempt to reduce the amount of
taxes they must pay. However technology companies such as Apple, Hewlett-Packard,
and Microsoft have the added benefit of their vast intellectual property. Since
intellectual property can be moved around easier than a physical asset these
companies are better able to manipulate the tax system into their favor and reduce their
effective tax rate as much as possible.

In May of 2013 Apple went in front of a Senate committee and their CEO, Tim
Cook, declared, “We pay all the taxes we owe, every single dollar.” However, the
Senate’s investigation claims that Apple has shifted millions of dollars in profits from the
U.S. to Ireland where they have negotiated a special corporate tax rate of 2% or less. While it may seem difficult to believe, what Tim Cook is saying may actually be the truth
behind the situation. Apple may indeed pay all of the taxes they owe, but it is due to the
company’s manipulation of the tax system. Apple has used all of these loopholes to
lower and avoid paying billions of dollars in taxes on $44 billion in offshore income over
a span of four years according to the Senate’s report. While the company’s tax
strategy may be legal, that doesn’t necessarily mean it is ethical. One could argue that
they are helping their shareholders more by reducing their tax expenses. Furthermore,

sites/connieguglielmo/2013/05/21/apple-called-a-tax-dodger-by-senate-committee-
apple-says-system-needs-to-be-dramatically-simplified/#35903e7d47d9>.

13 Ibid.

Offshore Income, Senate Committee Claims." Business Source Complete
2013/05/20/apple-used-loopholes-to-skip-paying-44-billion-in-u-s-taxes-senate-
committee-claims/#56e592442971>.
those in Apple have claimed the company already pays some of the most in taxes to the U.S.\textsuperscript{15} Although this may be true due to the remarkable earnings Apple obtains, they are still withholding millions of dollars in federal and state taxes which could benefit the U.S. The company’s methods may be legal, but the ethics around their tax structure leaves room for individual interpretation.

Moving on, the idea behind a patent box has several goals in mind. For one, it is meant to increase domestic investment in research and development. Additionally, a patent box’s goal is to encourage companies to locate intellectual property in their countries.\textsuperscript{16} Currently, several nations have already implemented patent box regimes. These nations include Belgium, China, France, Luxembourg, the Netherlands, and the U.K.\textsuperscript{17} Although these countries all have a patent box regime, each one is constructed differently.

Belgium first introduced their patent box regime in 2007 offering an effective corporate income tax rate of 6.8%. This is the result of only 20\% of a individual company’s gross income attributable to qualified IP being subjected to Belgium’s corporate tax rate of 33.99\%.\textsuperscript{18} This lower tax rate applies to ordinary patent income.

\textsuperscript{15} Ibid.


\textsuperscript{18} Ibid.
from licenses and royalties, as well as to patent income embedded in the sales price of patented products. However, development costs and other patent-related expenses remain deductible at the regular corporate tax rate, 33.99%. Additionally, the lower tax rate does not apply to: “(i) income attributable to know-how, trademarks, designs, models, secret recipes and processes, (ii) information concerning experience with respect to trade or science, or (iii) a capital gain attributable to the sale of the IP.”\textsuperscript{19} An important note is that a company does not have to develop or manufacture the product in Belgium to take advantage of the lower tax rate offered by the patent box regime. The rate only applies to Belgian corporations and subsidiaries of foreign corporations that are subject to Belgium’s corporate income tax and have income that is attributable to qualified IP.\textsuperscript{20}

Then in 2008 China implemented a patent box regime that has a 0% tax rate on revenue attributable to qualified IP up to five million renminbi (about $800,000) and a 12.5% tax rate, half of China’s standard corporate income tax rate of 25%, for revenue above five million renminbi. This lower tax rate applies to income attributable to registered patents and know-how. Furthermore, “China’s patent box also offers lower income tax rates to companies that spend at least 3% to 6% of gross revenue on R&D, derive 60% of revenue from core IP, or have more than 30% of their workforce with a college degree or more than 10% employed in technical positions.”\textsuperscript{21}

\textsuperscript{19} Ibid.

\textsuperscript{20} Ibid.

\textsuperscript{21} Ibid.
One of the first countries to implement a patent box regime was France back in 2001. This patent box regime helps reduce the corporate income tax from the standard rate of 33.33% to 15% for the revenue derived from the license, sublicense, sale, or transfer or qualified IP. This lower tax rate not only applies to IP developed by a company, but also any IP acquired by a company after it is held for two years. Additionally, France’s patent box is similar to Belgium’s in that a company is not required to develop or produce the products in France.\(^\text{22}\)

Moving along, Luxembourg’s patent box regime applies an effective rate of 5.76% to net royalty income attributable to qualified IP. This low rate applies to the income attributable to many different types of intellectual property such as: “patents, protection certificates, trademarks, brands, designs, domain names, models, software copyrights, and even products that are based on the name or image of sports celebrities.”\(^\text{23}\) Luxembourg joins Belgium and France as countries with patent box regimes that do not require products to be developed or produced on domestic soil in order to obtain these lower rates.

The Netherlands original patent box regime implemented in 2007 was revised in 2010, lowering the effective tax rate to 5% on all net income derived from qualifying IP. This rate applies to “qualifying self-developed or acquired IP (that the company further develops) once the income attributable to that IP has exceeded its development or acquisition costs.”\(^\text{24}\) Furthermore, the lowered rate applies to income derived from

\(^{22}\text{Ibid.}\)
\(^{23}\text{Ibid.}\)
\(^{24}\text{Ibid.}\)
patents and to all innovations and activities granted an R&D declaration. An agency of the Dutch Ministry of Economic Affairs grants R&D declarations to “all technological innovations that are deemed to be sufficiently innovative, but cannot be patented, or in which the developing company deems a patent to be undesirable.” In addition, the taxpayer must either coordinate, supervise, and manage the outsourced R&D activities or perform at least 50% of the R&D in the Netherlands when an R&D declaration is sought.

Recently the United Kingdom (U.K.) has begun implementing a patent box regime that applies a 10% effective tax rate, as opposed to the standard corporate tax rate of 25%. The U.K. patent box does not apply to trademarks and copyrights because the government did not think that these types of IP have a “strong enough link to the high-tech activities that the lower tax is meant to attract.” However, it does apply to patents, supplementary protection certificates, royalty and licensing fees, and embedded income in the sale of patented goods, as well several other types of income. Any business subject to the U.K.’s corporate income tax can use the reduced rate, but they must use a formulaic approach outlined by the patent box in order to determine which profits can be subjected to the lower rate.

With all of these countries implementing patent box regimes in recent years to attract businesses and their profits, the U.S. has been considering implementing a patent box regime of their own with several possibilities already proposed to Congress.

25 Ibid.
26 Ibid.
27 Ibid.
28 Ibid.
One of the proposals before Congress advocating for a patent box regime in the U.S. is known as the Innovation Promotion Act of 2015. “The draft bill,” proposed by Charles Boustany Jr. (R., La.) and Richard Neal (D., Mass.), “introduces the concept of an innovation box system that, through a complex formula, would lower the effective tax rate on innovation box profits to around 10 percent by allowing a large deduction on profits derived from qualifying intellectual property.” The hope is to attract American IP and profits back to the U.S. It is designed not only to benefit manufacturers, but also tech and pharmaceutical companies. However, there are some concerns regarding the cost this proposal would have on the government.

Another proposal for Congress is to amend the Internal Revenue Code of 1986 by adding the following section:

(a) Allowance of Deduction—If the taxpayer elects the application of this section, there shall be allowed as a deduction an amount equal to 71 percent of the lesser of—

(1) the patent box profit of the taxpayer for the taxable year, or

(2) taxable income (determined without regard to this section) for the taxable year.

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Additionally, “Senator Feinstein has outlined a plan for a 15% tax rate on corporate income that is generated by a product that is: (1) ‘significantly improved by or comprised of patented technology developed in the United States’ and (2) manufactured in the United States.” While all of these proposals may differ slightly they all have the same purpose—to bring money to the U.S. from the IP of American companies. Time will tell whether the U.S. ever adopts a patent box regime; however, they may want to hurry as more countries begin implementing patent box regimes of their own.

Next, I would like to give my opinion on the situation. In regards to Apple I believe they are making clever, creative choices as a business. Their current tax structure abides by the law and is able to save them billions of dollars each year. With this money they can reinvest it into the company and continue improving and being a leader in the industry. If I were in charge at Apple I would most likely be doing the same exact thing. It is their job to positively impact their bottom line and create a profitable business that benefits their shareholders. With this tax structure they are able to do exactly that, while remaining within the confines of the law. Although it may be legal, it is not the most ethical course of action. It may frustrate many people, but until the laws are changed, Apple may continue on with their tax system. They have a job to do and the tax structure they use helps them compete with the best in the world.

In regards to the U.S. adopting a patent box, I believe it is a good idea; it will help them compete with other countries vying for these corporation’s business. Currently the

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U.S. has one of the highest corporate tax rates in the world with a 35% federal rate. If the U.S. were to lower this rate or have a patent box to reduce the rate, then the country may be able to draw more business and therefore more money into the U.S. In order to do so I would recommend a patent box that would bring the tax rate between 5 and 15 percent in order to be competitive with other countries that are currently using a patent box regime. Furthermore, after concluding my research I believe that any product intending to use the patent box must be manufactured in the U.S. While this differs from some of the current foreign patent boxes it would help create jobs. However, the products do not have to be a result of domestic R&D. As Senator Feinstein points out, doing so may incentivize foreign companies to set up factories on American soil. These factories could manufacture products based on foreign R&D. Additionally, this would likely lead companies to set up R&D facilities in the U.S. Ultimately, a patent box could help create jobs and benefit the economy.

In conclusion, multinational corporations such as Apple have manipulated the tax system with the use of their intellectual property. The use of subsidiaries and allocation of income derived from intellectual property has cost countries such as the U.S. billions of dollars in tax revenue. Therefore, several countries have begun implementing patent box regimes in an effort to stop corporations’ manipulation of the current tax laws. The U.S. has begun the discussion of implementing a patent box of their own but have yet to put one in place. I believe a patent box of any kind would benefit the U.S. It is now time

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for legislators to come together and propose a patent box regime that will make America competitive with other countries around the world and bring money made off of American IP back to the U.S.