

Money moves: Tax planning in multinational companies - A case of Microsoft

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Multinational companies utilise various strategies in order to minimize their payments. This behaviour is controversially debated and it has a strong impact on the well-being of nations. Therefore, it is important to understand tax-avoidance strategies better. In order to do so, the thesis analyses the case of Microsoft. Microsoft Corp pays lower effective tax rate than the U.S federal statutory rate. Due to its advanced company structure and international operation, the company avoids the U.S withholding taxes by using deferral; avoids tax payment for transaction between CFC entities by using CFC disregard and check-the-box; and manages to bring back the profits to the U.S. untaxed. Using buy-in and cost sharing agreement, Microsoft transfers its IP rights to its foreign operating centres in low-tax jurisdictions. Double Irish Dutch Sandwich and tax havens enable the company to transfer its profit to tax havens, i.e. Bermuda. For Microsoft operation in Norway, the booked revenue is only six percent of the total sales in the Norwegian market because the sales is directly from Ireland.

Multinational companies, in particular U.S. technological companies, utilise various strategies such as deferral, transfer pricing, check-the-box, thin capitalisation, advanced company structure and tax havens to minimise and avoid taxes. From a legal point of view, this practise is debateable. Some people consider that the advanced tax planning is tax evasion, which is illegal; while some others argue that it is still in accordance with the tax regulations in the countries concerned. In any case, tax avoidance in multinationals will have a strong impact on countries' welfare. Many countries, in particular developing countries with weak institutions, depend on corporate tax revenue paid by international companies operating in these countries. Tax avoidance implies a loss in revenue or a shift to other tax bases, such as labour income or domestic firms and will challenge a fair balance of the tax burden. Therefore, many institutions, including the OECD, have voiced the need to review the international tax regulations in recent years.

In order to understand tax-avoidance strategies and to provide a first feeling for the magnitude of revenue losses, it is helpful to focus on case studies of large multinationals that are active in international tax planning. A point in case is Microsoft which effective tax rate, 20.65 percent in 2014 and 19.18 percent in 2013, is significantly lower than the U.S. federal statutory rate (35 percent). This is due to earnings from producing and distributing activities through foreign regional operation centres in Ireland, Singapore and Puerto Rico that are taxed in foreign jurisdictions. In addition, Microsoft exploits the loopholes in the U.S and international tax regulations to avoid the U.S.

withholding tax and taxes on passive income. Their international operations and geographic locations are structured and managed for the purpose of tax minimisation. Three vehicles in international tax avoidance are present in the case of Microsoft: deferral, transfer pricing and check-the-box.

Deferral allows Microsoft to avoid U.S. withholding taxes on foreign income until the foreign earnings is repatriated to the United States. From 2007-2013, the company increased the money held offshore from \$6.1 billion to \$76.4 billion. The estimated U.S. tax bill on this offshore cash is \$24.4 billion, implying a tax rate of 3.1 percent to foreign governments. In practice, from 2011 – 2014, Microsoft kept around 90 percent of the foreign cash indefinitely in the operations centres in tax havens. In 2014, the total cash held offshore was \$79.7 billion, 93 percent of the total cash \$85.7 billion. However, this cash is, in reality, brought back to the United States untaxed in the form of investment done by the foreign subsidiaries in the U.S financial market.

By using cost sharing agreements and “buy-in” payments, Microsoft manages to transfer its intellectual property (IP) rights from the United States to the IP-Holding entities: Flat Island Company and Microsoft Ireland Research (MIR) in Ireland, Microsoft Island Asia Ltd. (MAIL) in Bermuda and Microsoft Operation Puerto Rico (MOPR) in Puerto Rico. This transfer takes place in the early stage of the development of the intangible, allowing low transfer price. The IP-Holdings then relicense the rights to the operating entities. In this way, Microsoft keeps the profits received from licensing the IP rights in the IP-Holding entities and paying low taxes (14.4 percent in Ireland, 0.3 percent in Bermuda and 2 percent in Puerto Rico).

Using disregarded CFC entities and check-the-box, combined with the complex and advanced company structure and low organisational and financial report transparency, Microsoft avoids tax payments for the transaction between the disregarded CFCs, allowing Microsoft to move the IP to low-tax jurisdictions untaxed. The company, then, reduces its tax liabilities further by using a double Irish Dutch sandwich involving Microsoft Financing International B.V. in the Netherlands, Round Island One in Ireland and RI Holdings in Bermuda.

Microsoft as a whole operates as a complex network of interconnected entities including the subsidiaries registered in tax havens. The company is reluctant to disclose the company structure, resulting in the difficulty to identify and to understand how each subsidiary relates to each other. Microsoft reduced the number of reported subsidiaries in tax havens from 10 in 2007 to only five in 2013 - three in Ireland, one in Luxembourg and one in Singapore. The Wall Street Journal calls the phenomenon as “incredible vanishing subsidiary”, i.e. eliminating subsidiaries that are considered significant or “material”. In addition, out of 942 subsidiaries, only 112 disclose key financial reports and 431 provide information about Microsoft ownership. In 2014, The Transparency International

reported that Microsoft scored 3.4 (0 is the least transparent and 10 is the most transparent) in the corporate reporting transparency.

Looking at Microsoft operations in Norway, Microsoft Norge AS mentions that it has a function to support the partners in Norway. Even though some of these partners are developing software using Microsoft platform, the firm claims that there are no added-value activities in Norway. As a result, there is no sales revenue booked in Norway as the goods are directly sold from Ireland (MIOL). Microsoft Norge AS' revenue is the commission received from MIOL, which is six percent of total sales in Norwegian market. During 2009-2014, the booked revenue from this commission was NOK 3.471 billion. It implies NOK 57.865 billion of total sales in the Norwegian market. For the same period, the subsidiary paid NOK 310.5 million in tax to the Norwegian tax authority (31.85 percent of taxable income from the commission). If the total sales in Norwegian market had been booked in Norway, the tax payment would have been NOK 15.4 billion. Using the total sales in Norwegian market as the tax base would imply that the effective tax rate paid by Microsoft Norge AS is only 0.56 percent.

Further, the sales revenue in the Norwegian market is booked in Ireland via Luxembourg (Microsoft Luxembourg S.A.R.L) to avoid Irish tax income. Microsoft books the cost (with average of 79 percent of the revenue for year 2009-2014) for activities done for MIOL by Microsoft Norge AS in Norway, and finances this subsidiary by debt (debt-to-asset ratio in 2014 is 19.80). This reduces the tax burden in Norway.

Analysis of the other three subsidiaries in Norway shows that Microsoft uses MDCN AS to shift the revenue from North America to Norway in order to avoid high taxes in the United States. The acquisition itself was a way in using the foreign cash held by MACS Holdings Limited in Bermuda. Despite the revenue and interest income received, MDCN AS run in deficit in 2010-2013. Microsoft Holdings Norge AS and Microsoft Domains Norge AS book only costs and do not have any revenue; it results in zero tax.

Some existing tax regulations are able to curb the tax avoidance. However, there is a need to increase tax transparency in the international and country level, and to review the tax regulations due to the advanced development of the business models. A system called Common Consolidated Corporate Tax Base (CCCTB) proposed by the European Commission proposed in 2011 is one of the focus. CCCTB is used to calculate taxable profits for companies operating within the EU. It is calculated using apportion mechanism with a three-factor formula: labour, assets and sales. Sales are mentioned to be measured by destination, using an argument that "demand" is an income-generating factor because companies make profit only when they sell their output. The role of sales factor is then

to represent the demand side that generates income. For this reason, it has to be measured at destination. The location is determined by the place where the sales to the third parties occur, i.e. final place of delivery. In this way, companies have less possibilities to do tax planning as they cannot control the location of consumers. Norway is not an EU member and CCCTB limits the Member States within EU (“CCCTB water’s edge”). Hence, the CCCTB will not affect companies operating in Norway, unless special measures are taken, such as an agreement between the EU and Norway. If such an agreement takes place, the sales revenue in Norwegian market will be taxed in Norway, following the “sales by destination” factor.

Key numbers:

Microsoft Corp:

- Effective tax rate: 20.65% (2014) and 19.18% (2013)
- Microsoft keeps 90% of its cash outside the U.S. The total offshore cash in 2014 was \$79.7 billion. Tax rate to foreign government on the offshore cash from 2007-2013 was 3.1%. Microsoft brings back the offshore cash to the U.S. untaxed.
- Earnings from production and distribution in foreign operation centers is taxed in: Ireland (14.4%), Bermuda (0.3%) and Puerto Rico (2%).
- “Incredible vanishing subsidiary”: Microsoft reduces the number of reported subsidiaries in tax havens from 10 (in 2007) to 5: three in Ireland, one in Luxembourg and one in Singapore (in 2013).
- Out of 942 subsidiaries, only 112 with disclosed key financial reports and 431 with information about Microsoft ownership.
- Microsoft scored 3.4 in the corporate reporting transparency in the Transparency International report 2014.

Microsoft in Norway

- Microsoft has 16 subsidiaries, but only 12 that are active and only 4 with financial information
 - Microsoft Norge AS, Microsoft Development Center Norway AS, Microsoft Holdings Norge AS, and Microsoft Domains AS.
- Microsoft Norge AS’ revenue is 6% commission from MIOL (Ireland), which is based on sales in Norwegian market.
- From 2011-2014:
 - Booked revenue: NOK 3.471 billion;
 - Total sales in Norwegian market: NOK 57.865 billion

- Tax paid: NOK 310.5 million (implies 0.56% effective tax rate based on if the total sales has been book in Norway)
- The sales revenue is booked in Ireland via Luxembourg.

If Norway enters an agreement with the UE and applies the CCCTB using “sales by destination” factor, it will be possible to book the sales in the Norwegian market in Norway and use it as a tax base. The tax payment for 2011-2014 would have been NOK 15.4 billion and not NOK 310.5 million