Spending Well
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Moving profits offshore

How Microsoft cuts its tax bill

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Microsoft product adviser Stephanie Le (right) answers questions about a laptop for Windows 10 Insider Eddie Tan of Fremont, California, at the Microsoft store at Westfield Valley Fair mall in Santa Clara, California, in July.

SEATTLE — When someone in Seattle buys a copy of Office at a Microsoft Store, that cash doesn't take the short route to the company's area headquarters.

Instead, after accounting for state taxes, the profit goes to a Microsoft sales subsidiary in Nevada.

From there, much of that money begins a complicated global trek that ultimately leads across the Atlantic, with two stops on the island tax haven of Bermuda.

Microsoft in the past 20 years built that network of subsidiaries in part to minimize the taxes it pays to governments worldwide.

The company is hardly alone. Many multinational corporations have set up similar structures, in some cases reducing their tax burden to near zero.

But a court fight this year between Microsoft and the Internal Revenue Service brought to light new documents outlining the deals that set up the company's structure. Additional court papers, corporate filings and tax records from four continents offer a rare, detailed look at the business of avoiding taxes.

In the case of the Seattle Office purchase, after paying state taxes, the company sends the money to the subsidiary in Reno, Nevada. After landing in Nevada, more than half the cash from the sale goes to a Puerto Rican entity.

The Puerto Rican company, after paying a 2 percent local tax and accounting for a share of Microsoft's research costs, passes a portion of the remaining cash to an Irish company.

The final stop is an entity called RI Holdings. Its headquarters is a law firm in Hamilton, Bermuda, a United Kingdom territory that charges no corporate tax.

Similar structures cover Microsoft's operations across the globe.

From 2001 to 2006, Microsoft completed a series of intracompany deals that, in exchange for upfront payments, shifted the rights to software code and other assets developed largely in the U.S. to subsidiaries in Bermuda, Ireland, Singapore and Puerto Rico.

Those deals reduced Microsoft's cumulative tax bill in future years by tens of billions of dollars, according to court documents and an analysis of the company's filings.

Microsoft has $108 billion in income held offshore. That's evidence of the company's success avoiding not only the relatively high U.S. tax rate, but income-tax payments in the U.K., Germany and other countries where it sells products.

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The type of structures Microsoft has created are legal, and company representatives say Microsoft pays the appropriate amount of taxes in the countries in which it operates.

"We serve customers in hundreds of countries all over the world and our tax structure reflects that global footprint," the company said in a statement. A spokesman noted the company paid $4.4 billion in taxes in its most recent fiscal year, and said Microsoft's tax rate was in the middle third of companies in the S&P 500.

During the past decade, Microsoft's cash tax payments have averaged an effective rate of 21.7 percent, according to S&P Capital IQ.

That measure strips out taxes deferred to future years and some one-time items, and includes taxes paid to both the U.S. and other governments. Microsoft's rate puts the company in the middle of the pack among U.S. technology firms.

The top U.S. federal corporate income tax rate is 35 percent.

REUTERS FILE

President Barack Obama and Microsoft co-founder Bill Gates leave a meeting to launch the "Mission Innovation: Accelerating the Clean Energy Revolution" at the World Climate Change Conference 2015 in Le Bourget, near Paris, France, in November.

Looking only at Microsoft's operations outside the U.S., however, the company's tax rate is as low as 4.5 percent, according to Microsoft financial disclosures. That rate is lower than the tax rate in any of the countries in which the company does business.

Governments worldwide have started to take notice of companies that shift profits for tax reasons. Microsoft's tax arrangements in recent years have drawn scrutiny from regulators in the U.S., the European Union, China and Australia.

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Microsoft's tax practices are a contradiction for a company that bills itself as a model corporate citizen, some tax experts and business-ethics scholars say.

Microsoft gives away software to nonprofits, encourages employees to donate time and money to charitable causes, and sponsors educational programs. Those efforts, along with commitments to a diverse workplace and environmental stewardship, earn the company high marks in rankings that measure corporate citizenship.

In Washington state, the company has used its platform to encourage policymakers to boost funding for education and infrastructure.

But when it comes to another inherent component of citizenship — paying the taxes that support those programs — Microsoft behaves as do many of its peers in corporate America: The company has worked to limit what it pays to governments.

"One of the things we think of when we hear the word 'citizenship' is meeting certain basic obligations," said Jeffery Smith, who teaches business ethics at Seattle University's Albers School of Business and Economics. "You could make a pretty tight case that if you're going to consider yourself a good citizen, you make sure you contribute your due to the system."

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Other Washington state corporate giants also have trimmed their tax bills well below the U.S. rate.

During the past decade, Boeing's cash tax payments averaged an effective rate of 2.8 percent, according to S&P Capital IQ data. A spokesman attributed that to deductions and deferrals that account for big spending on development projects such as the 787 Dreamliner, among other items.

Over the same period, Amazon.com's effective rate averaged 10.7 percent, while Starbucks paid 30.5 percent.

Both companies are among the targets of a European Union crackdown on what regulators say are potentially unfair tax deals struck with local authorities in Luxembourg and the Netherlands. A Starbucks spokesman said the company disagreed with the EU assessment, adding that the company pays more taxes than the typical large U.S. company.

Corporations and business-funded interest groups say the U.S. rate is too high, giving companies an incentive to move property and jobs overseas. Companies, which have a fiduciary duty to their shareholders, and individuals shouldn't be blamed for taking advantage of legal maneuvers, they say.

"For decades, most countries' tax systems were very inward-looking because there were so few meaningful global operations," said Matt Lerner, a lawyer with Sidley Austin who advises companies on tax issues. As companies grew global, he said, people have started to realize that a lot of money ends up, legally, subject to less tax.

For policymakers, that means less cash in their coffers. That's led to a movement to crack down on corporate tax avoidance and reform the loophole-rich global tax system.

"If something clearly 'works,' you can't really be surprised (companies) take advantage of it," said Daniel Shaviro, a tax scholar at New York University School of Law. "It's a bad rule, and a bad system. I don't think the people doing this should be proud of themselves."

Profit shifting by multinational companies cost the U.S. government between $77 billion and $111 billion in 2012, according to Kimberly Clausing, an economics professor at Reed College in Portland. Corporate use of global tax havens probably reduced government revenue that year, the most recent for which data is available, by more than $280 billion, her research shows.

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Microsoft has spent decades creating tax-reducing barriers between its headquarters, based outside Seattle in Redmond, and the cash it generates from the sales of software largely developed there.

That effort started in September 1994, when three of Bill Gates' top tax and finance executives signed their names to papers founding GraceMac Corp. in Nevada, according to corporate filings.

Unlike the sales offices Microsoft opened around the world at that time, GraceMac didn't make products or undertake business ventures.

Its purpose, according to a tax court case that later involved the entity, was to serve as a kind of corporate sandbox Microsoft could fill with the royalty rights to software made in Washington state. GraceMac was managed by Monte Miller, whose Las Vegas firm operates holding companies in Nevada and Delaware on behalf of out-of-state clients.

Miller confirmed his association with GraceMac but otherwise declined to comment.

In the decade that followed, Microsoft founded at least 55 other subsidiaries in Nevada, a state that doesn't tax businesses income. That included a Reno office that would serve as the legal home of Microsoft's Windows sales. The Nevada footprint helped Microsoft avoid what would have been among its biggest Washington state tax bills: the software royalty tax. According to an analysis of company filings, the savings over more than a decade on sales to out-of-state customers may have amounted to hundreds of millions of dollars.

It hasn't been a one-way street, though. Microsoft didn't object this year when the state ended a sales-tax break for high-tech spending. The state expects to raise $128 million over four years from Microsoft by ending the break.

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When Microsoft's international business was growing rapidly in the early 2000s, the Nevada structure seemed to serve as a model for its global operations.

Microsoft established a series of sales hubs that, in exchange for an initial payment to the parent company and ongoing payment of research costs, would own the rights to profit from the company's software in their area.

The first was established in 2001 in Ireland, a country with one of the lowest tax rates in Western Europe. A hub in the business-friendly city-state of Singapore followed in 2004. A year later, Microsoft converted its Puerto Rico unit, a CD-making facility built to take advantage of a tax credit, into an on-paper sales hub for the Americas.

By officially conducting its sales from places with low taxes and small populations, Microsoft avoids paying the going income-tax rate on sales in countries where most of its customers live. Local tax agencies typically ignore sales by foreign companies with no "permanent establishment" locally.

And each of Microsoft's three regional sales hubs was structured to book some profit in Bermuda, meaning a slice of the cash from sales to customers from Australia to Germany is taxed at the territory's zero percent rate.

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Here's how Microsoft's structure works in practice in the U.K.

When someone buys a copy of Office in London, the vast majority of the sale's proceeds leave the country before triggering corporate income tax. That's because the company that owns the rights to sell Microsoft products there is an Irish entity.

Microsoft sold about $3.3 billion in products to U.K. customers in its 2014 fiscal year. The company's local subsidiary paid $33 million in income tax, an approximate effective rate of about 3 percent if that structure didn't exist.

The Organization for Economic Co-operation and Development, a group that helps coordinate economic policy among developed nations, in October proposed the biggest overhaul to the global tax system in decades, an effort to compel tax regulators to ensure that corporate taxable income more closely aligns with the company's actual economic activity in that country.

Another recommendation is that companies proactively disclose to governments where they pay their taxes and generate income.

Microsoft declined to detail the geographic breakdown of the company's revenue and tax bills.

"Firms will argue that it's confidential information," said Clausing, the Reed College economist. "But maybe where you're paying your taxes shouldn't be a vital part of your business strategy. If you're shoving a bunch of money in Bermuda and you're embarrassed about it, that's something you have to fix."

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Microsoft has been at the center of the debate about corporate tax avoidance over the years.

The Wall Street Journal in 2005 investigated Microsoft's use of Irish subsidiaries, highlighting the growing number of American technology companies establishing outposts there to take advantage of generous tax breaks.

A U.S. Senate hearing in 2012 outlined maneuvers that helped Microsoft save $6.5 billion in taxes over three years.

In December 2014, the IRS sued Microsoft, seeking testimony and documents as part of a long-running audit. Ultimately, a court ordered Microsoft to cooperate with the latest IRS requests. The audit continues.

The company isn't alone in drawing scrutiny for its tax practices. Boeing has paid federal income tax in just three of the past 12 years, in part because of tax deductions the company took to account for development programs like the 787 Dreamliner. Amazon's tax maneuvers have been criticized by the U.K. and European Union.

EU regulators have also targeted a tax deal Starbucks struck with the Netherlands. After a public outcry over low tax payments to the U.K., in 2013 Starbucks said it would not claim some tax deductions.

Reports have also focused on use of tax haven by other U.S. corporate stalwarts, from Wal-Mart to Google, Apple and General Electric.