ECONOMIC ANALYSIS

Microsoft Moving Profits, Not Jobs, Out of the U.S.

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The tax practices of the world's largest software maker made front-page news in 2005. *The Wall Street Journal* reported that profit shifting into a "virtually unknown" Microsoft Irish holding company "shielded billions of dollars from U.S. taxation" and at the same time allowed the company to "radically reduce its corporate taxes in much of Europe" (Glenn Simpson, "Irish Subsidiary Lets Microsoft Slash Taxes in U.S. and Europe," Nov. 7, 2005).

Between 2000 and 2007, Microsoft's reported worldwide effective tax rate fell from 34 percent to 31 percent. Since 2007 the decline has accelerated. For fiscal 2010 the effective rate was 25 percent.

Well, that was then. It's nothing compared with now. Back in fiscal 2005, the company's non-U.S. operations allowed it to reduce its effective tax rate by 3.1 percentage points. As shown in Figure 1, the impact of lower foreign tax rates on the company's overall effective tax rate has steadily increased, and it now stands at 12.1 percentage points. With profits of a little more than $25 billion in 2010, that 9 percentage point change results in an *additional* tax savings of $2.3 billion because of low foreign tax rates. Between 2000 and 2007, the company's reported worldwide effective tax rate fell from 34 percent to 31 percent. Since 2007 the decline has accelerated. For fiscal 2010 the effective rate was 25 percent.

Consistent with its declining tax rates, the share of Microsoft's worldwide profits generated outside the United States has increased sharply — from 38 percent over the 2005-2007 period to 60 percent over the 2008-2010 period. This clear trend can be seen in the dark solid line in Figure 2. Putting the information from figures 1 and 2 together tells us that Microsoft's profit growth is primarily in countries with tax rates that are considerably lower than the United States' 35 percent rate.

In general, the United States does not tax foreign profits of subsidiaries of U.S. companies until they are repatriated back to the United States. As a result, the rise in foreign profits has resulted in a rapid accumulation of profits "locked out" of the country. Figure 3 shows a striking increase for Microsoft. The rise was temporarily abated in 2006 when Microsoft took advantage of the "one-time" partial exclusion of repatriated profits under the American Jobs Creation Act of 2004. Since then, unrepatriated foreign profits have skyrocketed from less than $1 billion to $29.5 billion in 2010.

Microsoft reports that if it repatriated those foreign earnings, it would incur an additional tax expense of $9.2 billion. That means U.S. tax (federal and state) net of foreign tax credits would equal about 31 percent of the earnings. Assuming a combined state and federal tax rate of 39 percent, that implies a foreign tax rate of only 8 percent.

The huge tax advantage of low-taxed foreign profits has created a cash management problem for Microsoft. Investors are not confident that Microsoft can invest its enormous cash reserves profitably, so they are demanding dividends. But foreign-booked income cannot be used to pay dividends without paying U.S. taxes and taking a large hit on reported profits. Microsoft's board of directors solved the problem by approving a plan that would allow the company to borrow up to $6 billion at today's rock-bottom interest rates. The company later issued $4.25 billion of bonds at record-low interest rates for a private company. (Its three-year bonds had a coupon yield of 0.875 percent!) This is a low point in the history of high finance. Because of tax rules, a company absolutely saturated in excess cash must borrow, while small businesses that actually need the money to create jobs cannot access bank credit.

Out of Proportion

With globalization, it is only natural to expect any multinational to get an increasing share of its profits from activities outside the country where it started. So what's wrong with Microsoft's increasing share of foreign profits? As can be seen from Figure 2, the rise in foreign profits is way out of

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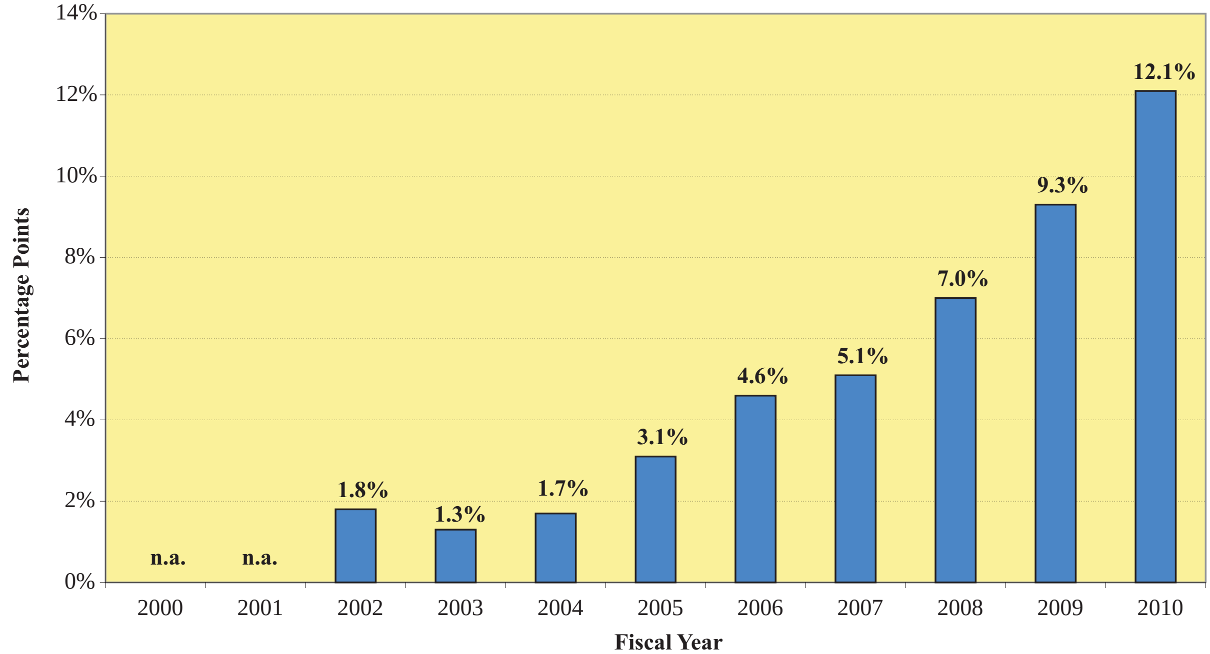
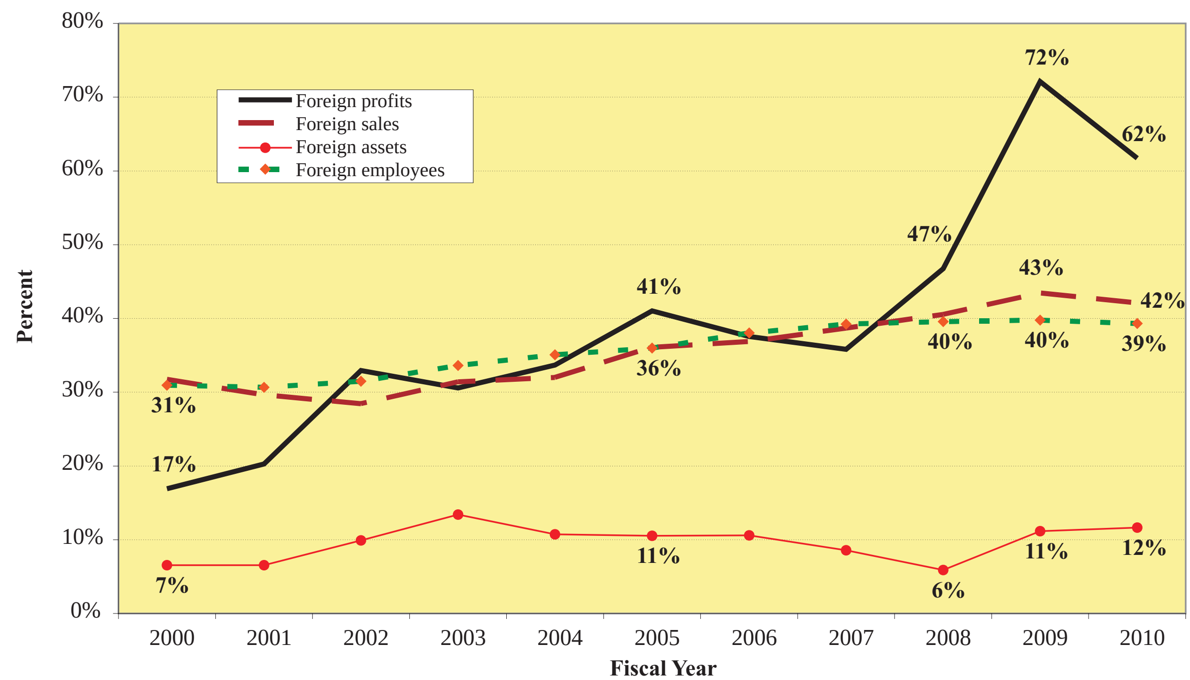
Figure 1. Microsoft's Reduction in Effective Tax Rate Due to Low Foreign Tax Rates



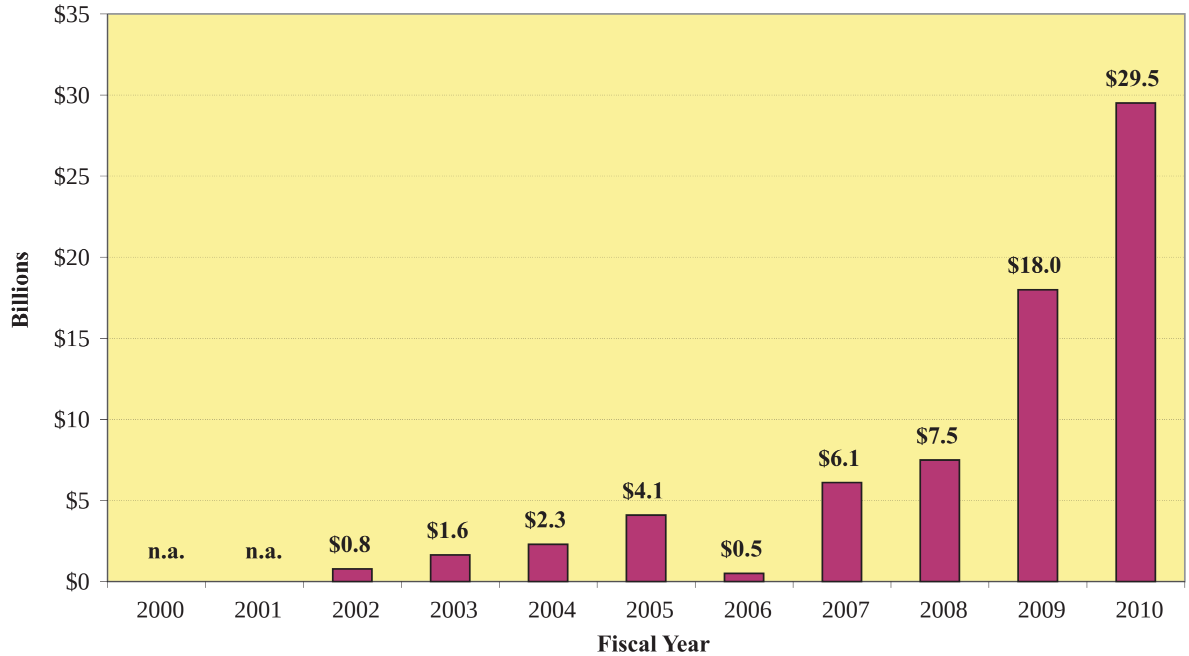
Source: Microsoft annual 10-K reports; "n.a." means not available.

Figure 2. Microsoft Foreign Activity as Share of Worldwide Total



Source: Microsoft annual 10-K reports.

Figure 3. Microsoft's Accumulated Foreign Earnings



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proportion with growth in measurable foreign activities. Between 2000 and 2010, the foreign shares of both Microsoft sales and employment grew from about 30 percent to about 40 percent. But over the same period, foreign profits grew from less than 20 percent to more than 60 percent.

For a company like Microsoft, tangible assets are not an important source of profits, but they can serve as an indicator of where business activity is taking place. Between 2000 and 2010, the foreign share of tangible assets has remained in the neighborhood of 10 percent of worldwide assets.

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There are reasons why foreign profitability can exceed domestic profitability. There may be favorable currency fluctuations. There may be less competition in foreign markets. For manufacturing companies, low foreign wages can increase foreign profit margins. But as we are continually reminded, the value of companies is increasingly based on intangible assets. Microsoft conducts basic research and development around the world. But the bulk is still done in the United States. And is there any doubt that U.S.-developed Microsoft Windows software is responsible for the lion's share of Microsoft's success? So it is hard to understand why profitability — measured as a percentage of sales — is so much greater outside the United States.

Another reason to expect a larger share of profits to be attributable to the United States is that "headquarters services" are performed here.

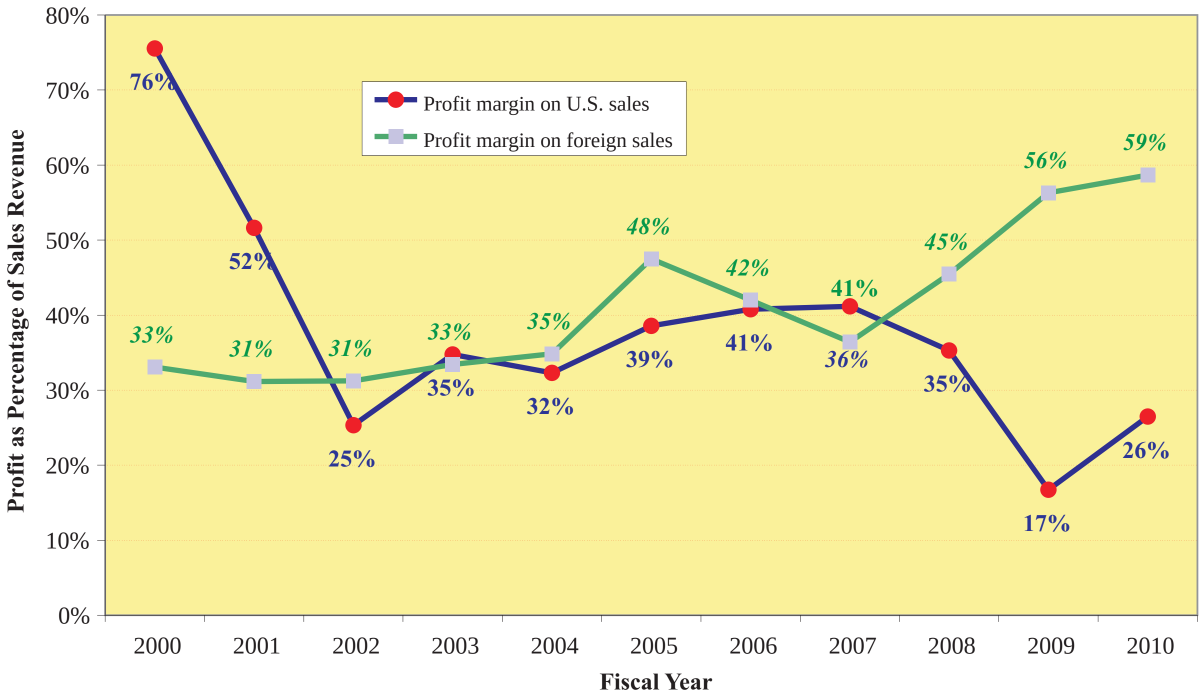
Figure 4 shows that from 2002 through 2007, the profitability (measured as a percentage of sales) of foreign and U.S. operations was about equal. Given the greater value added in the United States, this is not easy to explain. Even more puzzling are the last three years, when the rate of domestic profit dropped sharply while foreign profit rose — leaving the rate of foreign profitability higher than the domestic rate.

Without more detailed information it is impossible to reach absolute conclusions, but the publicly available information from Microsoft strongly suggests that during the last three years, the company has dramatically stepped up its efforts to take advantage of lax U.S. transfer pricing rules. It is hard to pin down an exact number, but we are talking lost revenue to the treasury of billions of dollars each year.

Jobs, Jobs, Jobs

In 2009 Microsoft CEO Steve Ballmer said that President Obama's proposals to tighten U.S. tax rules on foreign investment by U.S. companies would cause companies like his to shift jobs out of

Figure 4. Microsoft's Domestic and Foreign Return on Sales



Source: Microsoft annual 10-K reports.

the United States to foreign locations ("Ballmer Says Tax Would Move Microsoft Jobs Offshore," Bloomberg, June 3, 2009). A recent editorial in *The Wall Street Journal* cites Ballmer's claim: "CEO Steve Ballmer has warned that if the President's plan is enacted, Microsoft would move facilities and jobs out of the U.S." (Sept. 28, 2010).

> ***To the extent that there is any effect on jobs at all, the Obama proposals will encourage multinationals to shift jobs into the United States.***

Unfortunately, Ballmer's analysis doesn't make sense. You can claim a lot of things about the Obama foreign tax agenda. For example, it might encourage U.S. companies to move their headquarters offshore (if they can merge into a foreign company or find a way to circumvent expatriation prevention rules). Or it might shrink U.S. employment because fewer foreign subsidiaries might reduce export demand for U.S. products. Alternatively, Ballmer might want to claim that the inordinately high U.S. statutory tax rate encourages job creation out of the United States. But to the extent that there is any effect on jobs at all, the Obama proposals — which raise the cost of doing business abroad relative to the cost of doing it at home — will encourage multinationals to shift jobs into the United States — the exact opposite effect predicted by Ballmer.

Until 2009 Microsoft had never experienced companywide layoffs. Comparing the company's 2009 and 2010 annual reports, the net reduction in the number of employees was about 2,000 inside and 2,000 outside the United States. In percentage terms, the U.S. decline was about 2 percent compared with about 4 percent for foreign employees. At least for now it does not appear Microsoft is creating foreign jobs at the expense of its U.S. workers. ■