

Statement of William J. Sample, Corporate Vice President, Worldwide Tax, Microsoft Corporation

Before the Permanent Subcommittee on Investigations

of the U.S. Senate Committee on Homeland Security and Governmental Affairs

September 20, 2012

Chairman Levin, Ranking Member Coburn, and Members of the Subcommittee:

Good afternoon. My name is Bill Sample, and I am the Corporate Vice President for Worldwide Tax at Microsoft Corporation. I am here today at the request of Chairman Levin and Ranking Member Coburn to testify on specific aspects of Microsoft's business, corporate tax structure, and domestic and international tax issues.

As you know, Microsoft has voluntarily provided extensive information on a confidential basis to the Subcommittee Staff and voluntarily met with Staff several times to assist the Subcommittee in its inquiry. As discussed with Staff, the information provided by Microsoft to the Subcommittee contains highly confidential tax return information, trade secrets, and other proprietary information protected from public disclosure pursuant to Internal Revenue Code Section 6103 or other law. It is therefore my hope and expectation that we can address the important issues before the Subcommittee today in a manner that does not disclose Microsoft's confidential taxpayer information, trade secrets, or other proprietary information.

I. Corporate Structure and Organization

Microsoft Corporation is a U.S. corporation incorporated and headquartered in Washington State. Microsoft was founded in 1975. Our mission is to enable people and businesses throughout the world to realize their full potential by creating technology that transforms the way people work, play, and communicate. We develop and market software, services, and hardware that deliver new opportunities, greater convenience, and enhanced value to people's lives. We do business worldwide and have offices in more than 100 countries.

We operate our business in five segments: Windows & Windows Live Division, Server and Tools, Online Services Division, Microsoft Business Division, and Entertainment and Devices Division. Approximately 75% of total Windows & Windows Live Division revenue comes from Windows operating system software acquired by original equipment manufacturers, which they pre-install on hardware equipment they sell.

II. Economic Footprint in the United States and in Washington State

Microsoft from 2007 to 2009 increased its employment in the United States by 13.2 percent, to 53,892 employees. According to a recent study of Microsoft's economic impact on the United States, through its employment, compensation, and purchases of U.S. goods and services, Microsoft's operations supported roughly 462,000 U.S. jobs.

Microsoft also purchased \$7.7 billion in goods and services from other U.S. businesses in 2009 and provided \$10.8 billion in total direct compensation (wages, non-wage compensation, and stock compensation) to its U.S. employees in that year. The direct impact of Microsoft on the U.S. economy

was \$18.5 billion, representing the sum of wage compensation and U.S. goods and services purchases. According to the study, the indirect impact of Microsoft's operations in 2009 totaled \$91 billion in U.S. industry output, \$53 billion in value added, and \$30 billion in labor income.

The study also discussed Microsoft's economic impact on Washington State. In 2009, Microsoft directly employed 41,241 employees in the state, representing an increase of 13,004 employees since 2004. From 2008 to 2009, Microsoft was directly responsible for 1,930 new jobs in King County, at a time when King County experienced a net loss of 21,250 jobs. Through its employment, compensation, and in-state purchases, Microsoft's operations in Washington State supported 252,863 jobs, with \$6.96 billion in gross wage compensation and \$8.15 billion in total compensation. Per employee, Microsoft gross wage compensation was \$168,665, compared to an average of \$113,412 in aerospace employee gross wage compensation.

Since 1990, Microsoft has been the single largest contributor to economic growth in Washington; its impact on the state accounted for 32.4 percent of the total gain in state employment.

III. Worldwide Business Operations and Regional Operating Centers

One of the business imperatives faced by Microsoft today is that we must operate in foreign markets in order to compete and succeed as a company. Although over 52% of our total FY 2012 revenue was classified as U.S., our foreign revenues continue to grow faster than our U.S. revenues, increasing from 42% in FY 2010 to 48% in FY 2012.

Foreign revenue growth helps support the growth of our U.S. operations, creating additional U.S. jobs. In addition to our 55,000 U.S. employees, Microsoft today employs approximately 39,000 employees internationally. Of the total, 36,000 are in product R&D, 25,000 in sales and marketing, 18,000 in product support and consulting services, 6,000 in manufacturing and distribution, and 9,000 in general and administration. The substantial majority of our R&D employees and R&D spending are in the United States.

Our worldwide business operations are divided into regions, with significant investment and employees in each region to enable us to successfully compete in markets throughout the world. To serve the needs of customers around the world and to improve the quality and usability of products in international markets, we localize many of our products to reflect local languages and conventions. Localizing a product, for example, may require modifying the user interface, altering dialog boxes, and translating text.

We have a number of regional operating centers ("**ROCs**") that support all operations in their respective geographic regions, including software production and distribution, customer contract and order processing, credit and collections, information processing, and vendor management and logistics. The ROC in Ireland supports the European, Middle Eastern, and African (EMEA) region; the ROC in Singapore supports the Japan, India, Greater China, and Asia-Pacific (APAC) region; and the ROC in Fargo, North Dakota, Fort Lauderdale, Florida, Puerto Rico, Redmond, Washington, and Reno, Nevada supports Latin America and North America (Americas). Regionalizing production and distribution enables us to be more responsive to customer demands and improves the efficiency of our operations. While the primary

objective of our regional structure is to improve our competitiveness and efficiency in each of the three regions, we evaluated available tax incentives when deciding where to locate the ROCs.

Our worldwide OEM business, consisting primarily of the licensing of the Windows operating system to computer manufacturers for pre-installation on PCs, is primarily operated and supplied from our ROC in Reno, Nevada and the resulting income is reported on our consolidated U.S. income tax return as taxable in the U.S.

Our non-OEM (Retail) business is generally operated and supplied by our ROCs located in the following three regions:

- Our Irish ROC group near Dublin, Ireland supplies software to EMEA;
- Our Singapore ROC group supplies software to APAC; and
- Our Humacao, Puerto Rico ROC, supplies software to our Reno Nevada ROC, for further distribution to the Americas.

Each of these ROCs represents a significant investment in infrastructure and headcount.

The Dublin, Ireland ROC group, created in 1986, supplies and supports our EMEA business, representing billions in customer revenue earned and operating expenses incurred serving over 100 countries. EMEA group operating costs are funded by the Dublin ROC. Our EMEA group employs thousands of people, including several thousand in R&D. The Dublin ROC group employs over 1,000 people, including hundreds of R&D employees. The Dublin ROC owns and operates the datacenter facilities required to distribute software to EMEA customers. Regional production, marketing and G&A functions are performed by the EMEA group. The profits earned from the EMEA software business, after appropriate taxable payments to the U.S. group for technology rights and other support, are earned primarily by the Ireland ROC group.

The Singapore ROC group, organized in 1998, supplies and supports our APAC business, also representing billions in customer revenue earned and operating expenses incurred serving 18 countries. The APAC group operating costs are funded by the Singapore ROC. The APAC group employs thousands of people, including hundreds in R&D. The Singapore ROC group employs hundreds of people and owns and operates the datacenter facilities required to distribute software to APAC customers. Regional production, marketing and G&A functions are performed by the APAC group. The profits earned from the APAC software business, after appropriate taxable payments to the U.S. group for technology rights and other support, are earned primarily by the Singapore ROC group.

The Americas ROC group supplies and supports our Americas business representing billions in customer revenue serving over 25 countries. The Americas business includes Microsoft's U.S. operations and employs thousands of people, including thousands in R&D. Regional production, marketing and G&A functions are performed by the Americas group. The U.S. entities in the Americas group are responsible for substantially all aspects of our OEM business and for the marketing and distribution aspects of the Americas Retail business. The profits from these activities are taxable in the U.S. The Puerto Rico ROC is

responsible for the Americas Retail business and has made substantial taxable payments to the U.S. group for technology rights relating to that business, as described below.

Puerto Rico is a self-governing unincorporated territory of the United States, and its residents are U.S. citizens. Puerto Rico-based businesses have a long history of producing for the U.S. market, and Puerto Rico has a long history of offering tax incentives to attract export businesses to operate development, production, and distribution facilities there. The Puerto Rico ROC performs the software production and initial distribution operations for the Americas group. It owns and operates the primary release lab for the creation of Microsoft software masters for our worldwide business operations as well as the datacenter initiating software product distribution for the Americas market. The Puerto Rico ROC also owns and operates Microsoft's only media production facility. The Puerto Rico ROC employs hundreds of people to produce masters in the release lab, manufacture media, and distribute digital software copies from the datacenter. The Puerto Rico ROC delivers software products to our Reno Nevada ROC for final distribution to Americas customers. The Puerto Rico ROC also funds the costs of development for the technology used in its business. These costs are based on pooling Microsoft's worldwide R&D expenditures, and include the salary and expenses associated with R&D conducted in the U.S. by U.S. employees.

IV. Current Tax Environment

Microsoft complies with the tax rules in each jurisdiction in which it operates and pays billions of dollars each year in total taxes, including U.S. federal, state, and local taxes and foreign taxes. The tax rules that we follow in the U.S. generally provide for the deferral of U.S. tax on the earnings of foreign subsidiaries until those earnings are repatriated in the form of dividends. Anti-deferral rules in the Internal Revenue Code, such as Subpart F, also can operate to eliminate deferral and impose current U.S. tax on certain types of income earned by those foreign subsidiaries. Exceptions to Subpart F, such as the "controlled foreign corporation" (CFC) "look through" rule in Internal Revenue Code Section 954(c)(6), in certain cases permit continued deferral on transfers of foreign earnings between foreign subsidiaries. Microsoft has made very limited use of this exception. Similarly, Internal Revenue Code Section 956 generally ends deferral and imposes U.S. tax on foreign earnings when they are loaned by Microsoft's foreign subsidiaries back to Microsoft, but those rules permit U.S. companies to preserve deferral on certain short-term loans from foreign subsidiaries to their U.S. affiliates. Microsoft has made very limited use of this exception.

Our foreign ROCs pay tax locally in the jurisdiction in which they operate, and Microsoft pays U.S. tax on the earnings of the foreign ROCs when those earnings are repatriated back to the U.S. in the form of dividends or included in income under Subpart F. Microsoft also pays U.S. tax on royalties and cost sharing payments that are received from the foreign ROCs. Our worldwide OEM business, consisting primarily of licensing PC operating systems to computer manufacturers for pre-installation on PCs, departs from this regional model and is, with very limited exceptions, operated and supplied from our operations center in Reno, Nevada. The resulting income is reported on our consolidated U.S. income tax return as taxable in the U.S. without regard to the location of the customer.

V. Research & Development and Rights to Use Technology

Microsoft develops most of its software products and services internally. Internal development allows us to maintain competitive advantages that come from closer technical control over our products and services. It also gives us the freedom to decide which modifications and enhancements are most important and when they should be implemented. We strive to obtain information as early as possible about changing usage patterns and hardware advances that may affect software design. Before releasing new software platforms, we provide application vendors with a range of resources and guidelines for development, training, and testing. Generally, we also create product documentation internally.

While our main research and development facilities are located in Redmond, Washington, we also operate research and development facilities in other parts of the U.S. and around the world, including Canada, China, Denmark, Estonia, Germany, India, Ireland, Israel, and the United Kingdom. This global approach helps us remain competitive in local markets and enables us to continue to attract top talent from across the world. In addition to our main research and development operations, we also operate Microsoft Research. Microsoft Research is one of the world's largest computer science research organizations, and works in close collaboration with top universities around the world to advance the state-of-the-art in computer science, providing us a unique perspective on future technology trends.

The legal ownership of intellectual property developed as a result of our research and development activities generally resides with Microsoft Corporation in the U.S. In accordance with Internal Revenue Code Section 482 and applicable Treasury Regulations, our three foreign ROC groups, Ireland, Singapore and Puerto Rico, license the rights to use the relevant intellectual property to produce and sell Microsoft software products in their respective regions.

The foreign ROC groups make multi-billion dollar initial and annual compensation payments back to the U.S. group for these license rights. One component of these payments requires the three foreign ROC groups to fund the majority of Microsoft's annual worldwide R&D expenditures. These payments increase the income taxable in the U.S. The foreign ROC compensation payments are computed in compliance with the applicable Treasury Regulations under Internal Revenue Code Section 482. Microsoft complies with the requirements of the Treasury cost sharing regulations contained in Treas. Reg. section 1.482-7.

The original cost sharing regulations date back to 1968 and have been revised several times, with the last major revision effective in 2009. The cost sharing regulations generally require two separate categories of compensation payments:

- A buy-in payment to the developer of any pre-existing technology which is contributed to the cost sharing agreement ("**CSA**"); and
- Payments for ongoing intangible development costs ("**IDC**") related to the intangibles developed pursuant to the CSA.

The primary buy-in payments are generally determined at the beginning of the CSA, although subsequent external technology acquisitions (e.g., from an acquisition of a target company) also require buy-in payments from the CSA participants. In our case, because the pre-existing Microsoft software technology contributed to our CSAs was developed by the U.S. group, multi-billion dollar buy-in payments have been made from the foreign ROC participants to Microsoft's U.S. group. These payments have been taxable in the U.S.

The second major component of compensation requires the CSA participants to pay a share of the annual IDCs incurred to develop the technology made available to the cost-sharing participants to conduct their businesses. We determine each participant's share in compliance with the applicable Treasury regulations, which generally require each participant to share in the IDCs in proportion to their "reasonably anticipated benefits," or "RAB," from the intangibles developed pursuant to the CSA.

Two other aspects of cost sharing bear mentioning. First, the location of the R&D activities generally does not impact the tax results for the participants. Thus, cost sharing creates no disincentive to performing the R&D in the U.S. and creates no incentive to export U.S. jobs. Microsoft incurs the large majority of its R&D spending, and employs the large majority of its R&D workforce, in the U.S. Second, cost-sharing payments under U.S. tax rules are sourced to the location where the R&D is performed, so payments to Microsoft's U.S. group for U.S. R&D do not generate foreign source income, creating no opportunity to offset the U.S. tax on these payments with foreign tax credits.

VI. Check-the-box ("CTB") Regulations and the CFC Look-Through Rule

The Ireland and Singapore ROC groups have 5 CTB entities and rely on the CTB rules to effectively form the foreign equivalent of U.S. consolidated return groups to permit the transfer of income between group members without adverse U.S. tax consequences from losing tax deferral by creating Subpart F income subject to immediate U.S. taxation. All of the income transferred between group members is earned by the ROC group's business operations within their respective regions, and all of the income remains within the ROC group. These groups include IP holding companies that make annual cost sharing payments to the U.S. that are fully subject to U.S. tax. The Puerto Rico ROC group does not include any CTB entities. Microsoft has made very limited use of the CFC "look-through" rule in Internal Revenue Code Section 954(c)(6) to prevent the application of Subpart F.

VII. Managing Cash Flow to Ensure Liquidity

As noted above, Subpart F income taxable in the U.S. includes income related to "Investments of Earnings in United States property" as defined by Internal Revenue Code Section 956. CFC loans to related U.S. entities may be considered investments in "United States property," but the Treasury regulations and other guidance have historically provided an exception from Internal Revenue Code Section 956 for certain short-term loans. During the 2008-2009 liquidity crisis, the U.S. Treasury issued guidance that both re-affirmed the existence of this exception and extended the time limit that the CFC loans could be outstanding and still qualify for the exception. Microsoft's U.S. operations generate substantial positive cash flow on an annual basis, so Microsoft has made very limited use of this exception. We have made other, relatively small CFC loans to U.S. related parties but these loans were reported as fully taxable in the U.S. under Internal Revenue Code Section 956.

VIII. Conclusion

Microsoft's tax results follow from its business, which is fundamentally a global business that requires us to operate in foreign markets in order to compete and grow. In conducting our business at home and abroad, we abide by U.S. and foreign tax laws as written. That is not to say that the rules cannot be improved--to the contrary, we believe they can and should be.

In our view, the U.S. international tax rules are outdated and are not competitive with the tax systems of our major trading partners. These rules all too often provide a disincentive for U.S. investment. The U.S. now has the highest corporate tax rate among OECD countries and, unlike our major trading partners, taxes the worldwide income of its domestic corporations. The U.S. also requires worldwide American businesses to pay residual U.S. tax when foreign subsidiary earnings are repatriated back to the U.S., which creates a significant tax burden for U.S. companies, a disincentive for U.S. investment, and compares unfavorably with 26 of the 34 OECD member countries (including recent converts Japan and the U.K.) that offer a permanent tax exemption for the repatriation of foreign subsidiary profits. We believe the U.S. should reform its tax rules to support the ability of worldwide American businesses to compete in global markets and invest in the U.S.