From: Hoon Kim
To: Glenn Cogswell (TAX)
Sent: 8/27/2003 4:46:22 PM
Subject: Puerto Rico Report
Attachments: Puerto Rico Paper - Hoon Kim.doc; Figures and Appendices.xls

Hi Glenn,

As promised, here is the Puerto Rico report. There are two files: the actual report and supporting appendices. Please take a careful look at the tax sections in the paper, checking for accuracy of data and proper delivery of information. The documents are set to be read-only, but please feel free to print out the documents and make edits there. I'll be happy to drive up to the main campus to pick up your edited draft.

Also, I am planning to schedule a conf call with you, Fred Jordan, and myself either this Friday or early next week to discuss this report. Which time is preferable for you?

Thanks,
Hoon

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Abstract

Microsoft Puerto Rico (MSPR), established in 1989, serves as the primary CD manufacturing facility for North America and Latin America. Producing high revenue FPP, Select, and Enterprise CDs, MSPR takes full advantage of IRC §936 and saves Microsoft approximately $25 million every year in net taxes.

The future of Microsoft Puerto Rico is the concern of this report. Through analysis, three most likely outcomes emerge. First, MSPR can be incorporated as a controlled foreign corporation under the United States. Its benefits include the preservation of 85 FTE positions, protection of Microsoft's local reputation, and added company asset diversity. These benefits, however, may be small compared to the high United States and Latin America tax rates. Second, MSPR can be incorporated as a CFC under a different country. While this outcome can alleviate the high U.S. tax rate of the previous possibility, it introduces the cost of having an unfavorable relationship with the U.S. government. Last, MSPR can be shut down, outsourcing all future CD production. Through this outcome, Microsoft can save approximately $5.4 million every year. But, it comes with the cost of dismissing 85 FTE employees, exposing Microsoft's reputation to bad press, and losing Microsoft's last wholly-owned CD manufacturing facility.

Determining the best outcome depends heavily on Microsoft's future business strategy and how much Microsoft values the negative consequences from closing MSPR. If the assumptions are made that Microsoft continues to service both North America and Latin America and that Microsoft puts small value to the negative consequences, the best choice of action is to shut down MSPR and outsource all future CD production.

Puerto Rico Background

Puerto Rico has been part of the United States since 1898. Not until 1952, when it passed its commonwealth constitution, did the Island officially become the Commonwealth of Puerto Rico. As a result, Puerto Rico currently governs itself and remains fiscally autonomous with the mainland United States. Puerto Ricans have been considered U.S. citizens since 1917.

Puerto Rico's highest executive position belongs to Governor Sila M. Calderon. The Legislative Assembly consists of the Senate and the House of Representatives, and Puerto Rico's highest judicial branch is the U.S. Supreme Court. Close to four million people (July 2002 estimate)[1] live on the Island, with nearly an equal number of males and females.

Puerto Rico's purchasing power parity GDP comes in at $43.9 billion (2001 estimate) with annual growth measured at 2.2%.[2] Encouraged by duty-free access to the mainland U.S. and more than 75 years of U.S. tax incentives, many U.S. firms have made substantial investments into Puerto Rico. The largest industries in Puerto Rico consist of manufacturing plants for pharmaceuticals, medical devices, biotechnology, and electronics.[3] In 2001, the total value of exported pharmaceutical products reached $28 billion. In doing so, pharmaceutical firms hired more than 26,000 local employees.[4] Tourism also ranks as a top source of income.

As a U.S. territory, Puerto Rico obeys U.S. minimum wage laws and uses the U.S. Dollar for its official currency, giving U.S.-based firms the added advantage of avoiding currency risks.

Microsoft Puerto Rico Background

Microsoft Puerto Rico (MSPR) was established in Humacao, Puerto Rico on June 1989. It serves as the primary CD production facility for the Americas Operation Center (AOC). Four rotating shifts working 24 hours, seven days a week produce:

- 65% of the high revenue full-packaged products (FPP), such as Office and Windows,
- all Select/Enterprise CDs (English SKUs only).[5]

For FY04, MSPR is budgeted to produce 14.5 million compact disks. Of these, 14.3 million CDs are targeted for North America and the rest for Latin America. The total cost of producing one CD ranges from $0.44 to $4.09, depending on the product, its target region, and volume of production. Appendix "Per Unit Matrix" provides a detailed cost/volume breakdown. The higher cost numbers come from the production of low volume CDs for Latin America.

Microsoft Puerto Rico employs 85 full-time employees and another 25 for contingent staff.[6] Total budgeted FTE headcount cost for FY04 is $5.4 million. Appendix "Line item summary." Demographically, 47% are female, 48% are between the ages 30 and 40, and 69% of MSPR employees have worked eight or more years.[7]

Microsoft Puerto Rico and IRC §936

Perhaps most importantly, MSPR was specifically located in Puerto Rico to take full advantage of the tax benefits outlined in IRC §936:

> *Section 936 possession credit is an elective alternative to the Foreign Tax Credit (FTC). The possession credit entirely replaces any FTC or deduction for taxes paid that are otherwise allowable with respect to possession sourced income.*[8]

For tax purposes, MSPR statutorily recognizes all revenue and costs associated with the SKUs going through the facility. For Microsoft, Section 936 means that the combined taxable income from MSPR is subject to a tax credit; therefore, to maximize the credit, all high revenue SKUs are routed through Puerto Rico. At the end of FY02, Microsoft's cumulative tax benefit from Section 936 reached $192 million.[9]

However, recent legislative changes have reduced the tax credit amount. When originally formed in 1954, IRC §936 allowed any income earned from possession corporations to be excluded from federal taxation. In later years, the Tax Reform Act and the Tax Equity and Fiscal Responsibility Act put severe limitations to Section 936. IRC §936(h), adopted in 1982, mandated a 50-50 split between the possession corporation and its United States affiliate on all income derived from intangible property given to the possession corporation.[10] Applying Section 936(h) to Microsoft, half of the profits from MSPR must be reported on the return of a U.S. mainland Microsoft affiliate, thereby eliminating any tax credit on this portion of income.

The next major change came with the Omnibus Budget Reconciliation Act of 1993. This legislation reduced the tax credit to just 60% of the possession corporation's U.S. tax liability (previously, tax credit has been at 100% of the possession corporation's U.S. tax liability) with further reduction to 40% in 1998.[11]

The Tax Reform Act of 1995 struck the final blow to Section 936 with two measures. First, the Act imposed a cap on the tax benefits after 1998.[12] For Microsoft Puerto Rico, the limit was set at $25 million.[13] Second, all tax benefits under Section 936 would terminate after 2005. Microsoft's tax break stops at the end of FY06.[14]

With the changes to IRC §936, it affects Microsoft and MSPR in the following ways:

- All tax credits under Section 936 will expire at the end of FY06,
- Half of MSPR's combined total income must be allocated to a U.S. mainland Microsoft affiliate, thereby exempting this portion of income from Section 936 tax benefits,
- Of MSPR's U.S. tax liability on the remaining half, only 40% will equal the tax credit,
- Net tax credit is capped at $25 million.

Using actual FY02 numbers, Figure 1 illustrates exactly how IRC §936 affects Microsoft and Microsoft Puerto Rico.

Figure 1: Example Tax Credit Calculation under IRC §936

		MSPR	U.S. Microsoft
1	Qualified 936 Net Revenue	2,567,116,679	
2	Cost of Goods Sold	(132,375,081)	
3	Gross Profit	2,434,741,598	
4	R&D Expense	(535,466,321)	
5	Other Deductions	(935,017,287)	
6	Total Deductions	(1,470,483,608)	
7	Combined Taxable Income (CTI)	964,257,990	
8	Production Cost Ratio (PCR)	87%	
9	PCR Combined Taxable Income	834,613,503	
10	Adjustment to arrive at CTI Limitation	(357,957,371)	
11	CTI Limitation	476,656,132	
12	Profit Split	50%	
13	CTI Allocation	238,328,066	238,328,066
14	Gross U.S. Tax (35%)	(83,414,823)	(83,414,823)
15	§936 Tax Credit (40% of U.S. Tax)	33,365,929	
16	Total Puerto Rico Local Tax (3.5%)	(8,341,482)	
17	Total Tax Liability	(58,390,376)	(83,414,823)
18	Net Income	179,937,690	154,913,243

Net benefit from IRC §936: 179,937,690 – 154,913,243 = **$25,024,447**

Source: Reproduced from Appendix I

In this example, the calculations to line 7 are pretty straightforward. In line 8, the Production Cost Ratio (PCR) represents the portion of "expenses, losses, or other deductions which cannot definitely be allocated to some item...."[15] Taking the PCR is permitted under Section 936(h). Multiplying the CTI and the PCR gives the PCR CTI (line 9). To this figure, an adjustment is made so that the net tax benefits do not exceed $25 million (line 10). The CTI Limitation, therefore, is the net figure from which the profit split occurs (line 11). As discussed above, half of the CTI is allocated to MSPR, and the other half to a U.S. Microsoft affiliate (line 13). At this point, both MSPR and U.S. Microsoft are taxed equally at the federal tax rate, i.e. 35% (line 14); however, the benefit of IRC §936 occurs here. For MSPR only, a tax credit is given, equal to 40% of the U.S. tax liability (line 15), thus reducing MSPR's total tax liability. MSPR must still pay any local Puerto Rican tax, which historically has been very low (line 16). Finally, after computation of net income (line 18), the total net benefits of Microsoft's operating in Puerto Rico and using IRC §936 equal $25 million.

Future of Microsoft Puerto Rico

Given that the current tax model (and the main reason for manufacturing in Puerto Rico) terminates at the end of FY06, determining what comes next for Microsoft Puerto Rico merits thorough analysis. Three most likely outcomes exist for MSPR:

- Make MSPR a Controlled Foreign Corporation under the United States,
- Make MSPR a Controlled Foreign Corporation under a country with a more favorable tax system, e.g. Ireland or Singapore,
- Shut down MSPR and outsource all CD production.[i]

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[i] Much credit is given to Glenn Cogswell for providing the direction of these outcomes.

Which one is best depends on Microsoft's future business strategy. Thus, before deciding on an outcome, it is important to understand the pros and cons of each.

Make MSPR a Controlled Foreign Corporation under the United States

A controlled foreign corporation (CFC) is defined under IRC §957 as "any foreign corporation if more than 50 percent of (1) the total combined voting power of all classes of stock of such corporation entitled to vote, or (2) the total value of the stock of such corporation, is owned…, or is considered as owned,… by United States shareholders on any day during the taxable year of such foreign corporation."[16] Except for special circumstances, income from a CFC is not taxed by the United States until the CFC repatriates a dividend.

With this definition in mind, incorporating Microsoft Puerto Rico into a controlled foreign corporation is a possibility. The benefits of continuing operations on the Island as a U.S. CFC are the preservation of jobs for the 85 full-time employees in MSPR, the protection of Microsoft's local reputation, and the assurance of wholly owning a CD manufacturing facility, providing added diversification. The dollar value of these benefits is hard to determine. But if these benefits are not critical and the only reason to keep MSPR running is to profit from a tax break, then incorporating MSPR as a U.S. CFC does not make sense for two reasons.

First, income from products sold to Latin American countries is subject to unacceptably high withholding tax rates.[ii] A withholding tax is a tax applied by country X against any distributed dividends from country X to country Y. As an example, assume that a Windows CD, which was manufactured in MSPR, is sold in Mexico for $100. Currently, Mexico's withholding

[ii] Many Section 936 corporations in Puerto Rico, primarily pharmaceuticals, have become controlled foreign corporations to extend their tax benefits. Unlike Microsoft, however, these firms are not subject to high Latin America withholding tax rates. The tax treatment for medical devices and drugs is different from the treatment for software products.

tax rate is 25%, in addition to a maximum corporate tax rate of 35%.[17] The cash flow from this sale would look like Figure 2.

Figure 2: Calculation of After-Tax Income from Mexico Sale

Mexico pre-tax earning	$100	
Local corporate tax (35%)	(35)	
Net Income	$65	
Dividends distributed from Mexico		$65
Withholding tax (25%)		(16)
Net Dividends distributed		$49

After all taxes, MSPR would receive only $49 from the $100 sale. This is an effective tax rate of 51%. The high Latin America withholding tax destroys any chance of a tax break.

Assuming that the withholding tax is not a large concern, the second reason against incorporating MSPR as a U.S. CFC is that other countries besides the United States offer better corporate tax structures. If MSPR becomes a U.S. CFC, then the U.S. corporate tax rate still applies to any funds repatriated back into the United States. Recent political pressure by the Puerto Rican government exists to amend IRC §956. Under the proposal, U.S. CFCs in Puerto Rico would be given an incentive to invest in the United States the surplus income earned from the Island;[18] however, the proposal applies only to investments, not repatriations, and it has not been favorably received by U.S. Congress.[19] Furthermore, according to Glenn Cogswell in Microsoft corporate tax, keeping Puerto Rico operations alive under the U.S. would require very aggressive tax structuring and work. Other countries offer substantially lower corporate tax rates for foreign-source income. For example, Ireland enjoys a 12.5% rate. Therefore, it may make more sense to incorporate MSPR as a CFC under a different country. However, even this outcome has its own pros and cons, which will be explored next.

Make MSPR a Controlled Foreign Corporation under a country with a more favorable tax system

Incorporating Microsoft Puerto Rico under a country, like Ireland and Singapore, offers certain advantages over the United States. In addition to the benefits discussed above such as the preservation of jobs for the 85 full-time employees in MSPR, this outcome may provide a greater overall tax break for Microsoft. For example, Ireland's corporate tax rate is 12.5% whereas the U.S.'s rate is 35%. Not only can this lower rate save Microsoft immediate cash, but it can also generate some useful foreign tax credits.

The benefits, unfortunately, come with two great costs. First, this outcome does not solve the withholding tax issue discussed previously. Second, and by far the bigger cost component, incorporating MSPR under a different country other than the U.S. will create a very unhealthy relationship between Microsoft and the U.S. government. The reason: although technically legal, a U.S. firm keeping the income earned within U.S. borders in a statutorily different country besides the U.S. is highly insulting. From the U.S. government perspective, money earned within its borders by a U.S. firm should stay in the United States. Historically, other firms that have tried this tactic faced large legal costs, bad press, and unfavorable reputation.

Incorporating MSPR in a different country may offer better tax incentives; however, this added margin comes with a potentially unaffordable cost.

Shut down MSPR and outsource all CD production

Closing MSPR and outsourcing all CD production brings measurable benefits. CD manufacturing technology is constantly becoming cheaper, and firms whose comparative advantage lies in CD production will always produce CDs the cheapest. To illustrate, Figure 3 compares the cost of producing a CD in MSPR and the cost of outsourcing the production of the same CD.

Figure 3: Comparison of CD Production Costs
(Weighted Average Cost per CD)

Production Streams	MSPR	Outsourcing Estimate	MSPR/Outsource
Edge-to-Edge Plus	$1.00	$0.71	1.4
Edge-to-Edge	$0.86	$0.44	2.0
Print	$0.61	$0.22 to $0.24	2.7

Source: Appendix

The cost to manufacture one CD in MSPR is from 1.4 to almost three times the cost of outsourcing. Over 15 million CDs a year, Microsoft can save approximately $5.4 million by outsourcing. Conversely, without any tax break, MSPR would pay $5.4 million more to produce the same CDs. Thus, the impact of the current tax break under IRC §936 becomes clear. In FY01, MSPR received a net tax break worth $24.3 million, dwarfing the extra cost incurred by not outsourcing.

The high Edge-to-Edge and Print ratios come from servicing the low volume Latin American market. While only 2% of the CDs produced in MSPR serve Latin America, these few

CDs make up 10% of MSPR's entire production costs. This emphasizes the benefits of outsourcing. Dedicated CD production firms can pool together many low volume accounts and reduce the variable cost of each CD for everyone.

Clearly, many benefits come from outsourcing; however, the costs must be analyzed as well. First, there is the cost of dismissing 85 full-time employees in MSPR, of which 69% have worked eight or more years. Second, Microsoft's local reputation in Puerto Rico may suffer from the closure, though most likely not severely. Last, Microsoft will be shutting down its last wholly-owned CD manufacturing facility. Undoubtedly, this will increase Microsoft's reliance on third-party entities and reduce the company's asset diversification. Although these costs cannot be measured easily, it is important that due diligence is given to these issues before completely deciding to shut down MSPR and outsource all CD production. Figure 4 runs through a simple cost-benefit analysis.

Figure 4: Cost-Benefit Analysis of Shutting Down MSPR and Outsourcing all CD Production

Benefit

$5.4 million cost savings

Costs

Dismissing 85 full-time employees:	$x
Loss of reputation in Puerto Rico	$y
Closure of Microsoft's only CD manufacturing facility:	$z
Total Costs	x + y + z

Possibilities	**Actions**
$5.4 million > x + y + z	Shut down MSPR
$5.4 million < x + y + z	Preserve MSPR

Figure 5 summarizes the three most likely outcomes for Microsoft Puerto Rico by listing the pros and cons associated with each possibility.

Figure 5: Summary of the Most Likely Outcomes for MSPR

Possible Outcome	Benefits	Costs
Make MSPR a U.S. CFC	Preservation of 85 FTE positions Protection of MS reputation Assurance of owning CD manufacturing facility	High Latin America withholding tax Better corporate tax rates outside U.S.
Make MSPR a Foreign CFC	Preservation of 85 FTE positions Protection of MS reputation Assurance of owning CD manufacturing facility Better corporate tax rates than U.S.	High Latin America withholding tax Damaging relationship with U.S. Government
Close MSPR & Outsource all CD Production	$5.4 million savings	Dismissal of 85 FTE positions Loss of MS reputation Loss of Microsoft's only CD manufacturing facility

In choosing the best outcome for Microsoft, two assumptions must be made. If neither of these assumptions holds, then more analysis must be done, beyond the contents of this report. The assumptions are:

- Microsoft plans to service both North America and Latin America in the foreseeable future and sell products to both regions,
- The value of the 85 FTE positions, Microsoft's reputation in Puerto Rico, and the assurance of owning a CD manufacturing facility is not significant.

If both assumptions are true, then the best outcome is to *shut down Microsoft Puerto Rico and outsource all CD production*. It is the only outcome that produces a net benefit. Of the other outcomes, preserving MSPR as a controlled foreign corporation under any country would hurt Microsoft's bottom line. The high Latin America withholding tax rates alone would swallow up any benefits received. Plus, if Microsoft even attempted to incorporate MSPR as a non-U.S. CFC, Microsoft's relationship with the U.S. government could be seriously damaged. Thus, given the assumptions above, Microsoft should not consider keeping Microsoft Puerto Rico after FY06.

Conclusion

Microsoft Puerto Rico was established to serve as the primary CD manufacturing facility for the Americas. Producing high revenue FPP, Select, and Enterprise CDs, MSPR took full advantage of IRC §936 and saved Microsoft over $192 million since 1989. Until Section 936 expires in FY06, Microsoft will save approximately $25 million every year in net taxes.

The future of Microsoft Puerto Rico is of current concern. Through analysis, three most likely outcomes emerge. First, MSPR can be incorporated as a controlled foreign corporation under the United States. Its benefits include the preservation of 85 FTE positions, Microsoft's local reputation, and added company asset diversity. These benefits, however, may be small compared to the high United States and Latin America tax rates. Second, MSPR can be incorporated as a CFC under a different country. While this outcome solves the high U.S. tax rate of the previous possibility, it introduces the cost of having a bad relationship with the U.S. government. Last, MSPR can be shut down, thus outsourcing all future CD production. Without receiving any tax benefits, Microsoft will save $5.4 million every year. But, there is the cost of dismissing 85 employees, negative exposure to Microsoft's reputation, and the loss of Microsoft's last CD manufacturing facility.

Determining the best outcome depends greatly on Microsoft's future business strategy and how much Microsoft values the negatives from closing MSPR. If the assumptions are made that Microsoft continues to service both North America and Latin America and that Microsoft puts small value to the negative consequences from MSPR's closure, the best choice of action is to shut down MSPR and outsource all CD production.

This analysis of Microsoft Puerto Rico should be followed up with a closer scrutiny as the time gets closer to 2006.

Endnotes

[1] "CIA – The World Factbook – Puerto Rico," The World Factbook, 1 Aug. 2003, http://www.cia.gov/cia/publications/factbook/geos/rq.html.

[2] "CIA – The World Factbook – Puerto Rico"

[3] "Puerto Rico's Industry Groups," PRIDCO, 18 Aug. 2003, http://www.pridco.com/english/5.0ind_groups_overview.html.

[4] "Pharmaceutical Industry Overview," PRIDCO, 18 Aug. 2003, http://www.pridco.com/english/5.10ind_groups_pharma.html.

[5] "Guidelines to Maximize Benefit," MSPR 101, 14 Oct. 2002, MSPR 101 Update for SC Project 021014.ppt, slide number 6.

[6] "Overview," MSPR Tax Benefit Update, 7 Jun. 2003, MSPR Tax Benefit 101 AOC 030607.ppt, slide number 4.

[7] "Our People Demographics," MSPR 101, 14 Oct. 2002, MSPR 101 Update for SC Project 021014.ppt, slide number 18.

[8] "Internal Revenue Manual," Internal Revenue Service, 1 Jan. 2002, http://www.irs.gov/irm/page/0,,id%3D21554,00.html.

[9] "MSPR Tax Overview," MSPR 101, 14 Oct. 2002, MSPR 101 Update for SC Project 021014.ppt, slide number 3.

[10] "Section 7.1 Possessions Corporations - The Federal Rules," Franchise Tax Board, 7 Nov. 2002, http://www.ftb.ca.gov/manuals/audit/water/WEMSec7_1a.html.

[11] "Internal Revenue Manual," Internal Revenue Service

[12] "Internal Revenue Manual," Internal Revenue Service

[13] "MSPR Tax Overview," MSPR 101

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[15] "Code Section 936(h)," The Transfer Pricing Network, 18 Aug. 2003, http://www.transferpricing.com/userguides/936_hecon.htm.

[16] "Sec. 957. Controlled Foreign Corporations; United States Persons," Asset Protection Corporation, 18 Aug. 2003, http://www.assetprotectioncorp.com/controlledforeign95.html.

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[19] Ralph J Jr Sierra, "Puerto Rico and the Anti-Inversion Challenge," International Tax Journal, Volume 29, Issue 3, 1 Jul. 2003, pp. 45-63.