

**International Tax Planning
Issues in a Large
Multinational Company -
Tax Planning in Today's
Environment**

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Topics

- **Changes in the non-tax environment**
 - **Sarbox**
 - **Auditing standards**
 - **GAAP**
 - **WTO**
 - **Publicity**

Topics (cont'd)

- **Changes in the tax environment**
 - **IRS enforcement**
 - **Legislative**
 - **Treaty**
- **Lack of changes in the tax environment for software**
 - **Revenue characterization**
 - **Withholding taxes**
 - **Anti-deferral regime**

Sarbox

- **CEO certification**

- **From MSFT's 10-K**

- **Other Potential Tax Liabilities.** We are subject to income taxes in both the United States and numerous foreign jurisdictions. Significant judgment is required in determining our worldwide provision for income taxes. In the ordinary course of our business, there are many transactions and calculations where the ultimate tax determination is uncertain. We are regularly under audit by tax authorities. Although we believe our tax estimates are reasonable, the final determination of tax audits and any related litigation could be materially different than that which is reflected in historical income tax provisions and accruals. Should additional taxes be assessed as a result of an audit or litigation, a material effect on our income tax provision and net income in the period or periods for which that determination is made could result.

Sarbox (cont'd)

- **CEO certification**

- From MSFT's 10-K

- **Taxation of Extraterritorial Income.** In August 2001, a World Trade Organization ("WTO") dispute panel determined that the tax provisions of the FSC Repeal and Extraterritorial Income Exclusion Act of 2000 ("ETI") constitute an export subsidy prohibited by the WTO Agreement on Subsidies and Countervailing Measures. The U.S. government appealed the panel's decision and lost its appeal. On March 1, 2004, the European Union began imposing retaliatory tariffs on a specified list of U.S.-source goods. In May, the U.S. Senate passed the Jumpstart our Business Strength (JOBS) Act that would repeal ETI, provide a three-year phase-out of current ETI benefits, and would replace ETI with a phased-in 9% domestic production activity deduction that would not be fully effective until 2012. The U.S. House of Representatives passed similar legislation in June that would repeal ETI effective December 31, 2004, provide a two-year phase-out of ETI benefits, and replace ETI with a 3% tax rate reduction for income from domestic production activities that would be full phased in by 2006. Neither bill will fully replace our current ETI tax benefits. Both bills must still be reconciled in conference, and significant changes could be made to the final legislation, so we remain unable to assess the ultimate form and financial impact of this legislation, if enacted. If the ETI provisions are repealed and financially comparable replacement tax legislation is not enacted, the loss of the ETI tax benefit to us could be significant.

Sarbox (cont'd)

- **CEO certification (cont'd)**
 - **Quarterly CEO "302" certification**
 - **Tax sub-certification**
 - **Taxes are always featured in "issues and uncertainties"**

Sarbox (cont'd)

- **404 controls certification**
 - The "2nd Friday of the month" rule
 - 50 controls to be tested and certified
- **Auditor independence**
 - Disrupted "trusted advisor" relationships

Sarbox (cont'd)

- **Auditor independence (cont'd)**
 - **From MSFT's policy:**
 - **For example, permitted tax services do not include...services in which the auditor recommends transactions the sole business purpose of which may be tax avoidance and the tax treatment of which may not be supported by the Internal Revenue Code and related regulations.**

Sarbox (cont'd)

- **Auditor independence (cont'd)**
 - **Increases potential for Board-level tax issues**
 - **More difficult for auditors to “opine” on tax issues they don’t “work”**
 - **Audit Committee “pre-approval” workload**
 - **34 service “buckets” approved and tracked**
 - **How to approve “general tax services”?**

Auditing standards

- **PCAOB wrests control from the AICPA???**
 - **Validity of existing audit standards**
 - **March 2003 tax accrual documentation standard**
- **PCAOB peer review of the Big 4**
 - **Auditors are not used to being audited**
- **PCAOB documentation “standards”**
 - **Impact on FAS 5 contingencies**
 - **Attorney/client privilege**
 - **Impact on third-party opinions**

GAAP/SEC

- **International convergence**
- **APB 23 project**
 - GAAP equivalent of repealing U.S. deferral rules
- **FAS 5/FAS 109 project**
 - Uncertain tax positions – “on/off” switch
 - **Scope**
 - Administrative convenience
 - **Disclosure**
 - SEC comment letters

GAAP/SEC (cont'd)

■ SEC Chief Accountant:

- "Sunlight is said to be the best of disinfectants and the area of income tax accounting could use more sunlight."
- "...it may be good practice to keep the audit committee apprised of the vendors you most frequently use for income tax planning strategies, income tax opinions..."
- "...the external auditor has to comply with the standards for auditor documentation. Anything less is a scope limitation."

WTO

- **Impact of trade rules on domestic law tax incentives**
- **FSC/ETI**
 - Transition
 - Grandfathering
- **State business incentives**
 - Boeing 7E7 final assembly plant in Everett
- **WTO accession**
 - IBFD China project
 - Tax incentives, transparency rules

Publicity

- **Corporate governance is a hot topic**
- **IRS campaign against corporate tax shelters**
 - **Commissioner Everson on the soapbox**
- **Legislative activity**
 - **Mandatory disclosure of tax penalties in SEC filings**
 - **Define “economic substance”**
 - **CEO certification**
- **Litigation is public**
- **Need corporate PR expertise**

IRS enforcement

- **Aggressive penalty assertion**
 - Long-term Capital Holdings
 - Transfer pricing documentation
 - 5471 “non-compliance”
 - Third party opinions
- **Case law uncertainty**
 - Black & Decker, Coltec Industries, Castle Harbor
- **Reporting (disclosures, M-3, Announcement 2002-2, disregarded entities, foreign subsidiary tax shelter disclosures)**

IRS enforcement (cont'd)

- **Strategy shifts = uncertainty**
 - **Check-the-box/entity classification**
 - **New IRS regs treat dual-chartered entities as domestic corporations**
 - **Cost sharing equity compensation**
 - **Buy-in valuation**
 - **ETI benefits**
 - **Services**
 - **R&D Credit "discovery test"**

Legislative change

- **FSC/ETI replacement legislation**
 - **7 year process & uncertainty**
 - **Production activity deduction**
 - **Repatriation incentive**
 - **International tax reform**

Treaty changes

- **The e-commerce “distraction”**
 - **Admirable attempt by tax authorities to get “ahead of the wave”**
 - **E-commerce business models in constant flux**
 - **20-20 hindsight – too much work for too long on too little (1996 to ????)**
 - **PE, attribution of profit, transfer pricing, revenue characterization, and VAT work provided springboard for current initiatives**

Treaty changes (cont'd)

- **Permanent establishment**

- **Article 5**

- **Business wants clear guidance on the threshold**
 - **Article 7 guidance is no substitute**
 - **“Physical presence” standard in new economy**
 - **Which “new economy” are we waiting for?**
 - **Uncertainty about outsourcing decisions**

Treaty changes (cont'd)

- **PE**

- **Article 5 (cont'd)**

- **Philip Morris**

- **Group PE, mgt services, agent participation**

- **12 month bright line rule?**

- **Contract manufacturing**

- **Commissionnaire arrangements**

- **Preparatory and auxiliary exception**

- **Link to Article 15(2)**

- **Employee or service?**

Treaty changes (cont'd)

- **Article 7**
 - **Hypothetical separate entity construct**
 - **No arms-length standard applied**
 - **Apply the transfer pricing guidelines “by analogy”**
 - **“Arms-length” required or optional???**
 - **KERT**
 - **Marketing intangibles**
 - **Deference to host-country determinations**
 - **“Two tax return” approach to dependent agent PE’s**
 - **Complexity underscores need for clear Article 5 guidance**

Treaty changes (cont'd)

- **Transfer pricing guidelines**
 - **Equity compensation**
 - **Cost contribution arrangements**
 - **Subsidiary employee compensation charge**
 - **Thin capitalization**
 - **Use of profits-based methods**
 - **Application to "typical" e-commerce issues**
 - **Questionnaire on comparability issues**

Treaty changes (cont'd)

■ MAP

- Taxpayers' reluctant to use MAP
 - OECD wants to discourage unilateral solutions
- Joint working group recommendations
 - Increase transparency of domestic process
 - Publish target time frame for completion of MAP cases
 - Increase communication to affected taxpayers
 - Develop time frame for full implementation of the MAP agreement

Revenue characterization

- **Most significant question affecting planning for software companies**
 - **Product sale, rental, service, license, IP sale**
 - **Sourcing**
 - **Taxation rights**
 - **Base and rate**
 - **Creditability**
 - **MAP disputes**

Revenue characterization (cont'd)

- **OECD “business or personal use”**
 - **Article 12 commentary**
 - **Inconsistent application to different sales models (shrink-wrap, enterprise licenses)**
- **U.S. “transfer of copyright right”**
 - **861-18 regulations**

Withholding taxes

- **Primary impact growth markets in developing economies**
- **Dramatic impact on vendor economics**
- **Uncertainty increases potential for:**
 - **Inadvertent non-compliance**
 - **Penalties**
 - **Controversy**
 - **Double taxation**

Anti-deferral regime

- **Software revenue classified as passive income**
 - **Scope includes third party revenue**
 - **Software developers must prove that they are in an active business**
 - **Manufactured, produced, grown or extracted**