# Double Irish and Dutch Sandwich Tax Strategy

## Executive Summary

Prepared by
Lori Brewster
Corporate Controller

Assignment for GEB5212
September 17, 2012

Prepared for
Jeffery Laborde, Chief Financial Officer
SumTotal Systems, Inc.

# Executive Summary

Businesses struggle to remain solvent in today's increasingly global marketplace. Conduits to increase corporate profits are needed now more than ever. With the multitude of regulations to be navigated in the complex U.S. tax code, tax and legal teams must be consulted to receive accurate tax deductions available to U.S. businesses. The following report studies a tax strategy called the Double Irish and Dutch Sandwich method, successfully helping many major U.S. companies minimize corporate income taxes. Beneficiaries of the Double Irish and Dutch Sandwich tax strategy include software manufacturers and intellectual property rights holders such as Google, Apple, Oracle, Pfizer, Facebook, and Microsoft.

Jeffery Laborde, Chief Financial Officer, has requested a report on the feasibility, legality, ethical concerns, and potential tax savings of adopting the Double Irish and Dutch Sandwich strategy to lower SumTotal's taxable income. The goal is to provide maximum value for SumTotal's shareholders while maintaining its public sentiment as an ethical business leader.

**Research Methodologies**

Research on how to incorporate the Double Irish and Dutch Sandwich tax strategy was conducted using two sources: (1) Consultations with two different tax and legal teams. The first was SumTotal's current tax and legal professionals since they have a good understanding of its business model. The second was the tax and legal team who have helped Google enact the Double Irish and Dutch Sandwich approach because of their experience regarding the specifics of the plan. (2) Business literature and articles that give details on how the Double Irish and Dutch Sandwich method is implemented. Additionally, articles were examined to assess diverging opinions on the ethical significance and ramifications of shifting income into overseas subsidiaries to reduce tax expense.

**Questions Concerning Overseas Tax Planning**

In this report, the following questions were addressed regarding the Double Irish and Dutch Sandwich tax strategy:

- How is intellectual property transferred overseas to avoid paying U.S corporate income tax?
- What are the U.S. tax rules on deferrals of income and transfer-pricing?
- Which countries are the best to open subsidiaries within to minimize tax liability?
- What steps should the foreign subsidiaries take to minimize overseas income taxes?
- How much tax money can be saved by instituting the Double Irish and Dutch Sandwich method?
- What are the ethical, legal, and business implications for establishing overseas tax havens?

## Report Findings

The findings from this study confirm the Double Irish and Dutch Sandwich is a viable tax strategy for SumTotal to reduce its overall corporate tax rate. Several options exist for foreign subsidiary locations. To maximize tax benefits, this report specifically looks at launching one subsidiary in Bermuda, a second in Dublin, and a third in the Netherlands.

The total tax savings for SumTotal is estimated to be 10 to 20 percent per year. This is a conservative figure compiled by studying the effective tax rate paid by other companies who have adopted the Double Irish and Dutch Sandwich tax system. However, attaining an even lower effective tax rate is possible, such as Google's 2.4 percent.

## U.S. Tax Rules and Initial Set-Up of Foreign Subsidiaries

The Bermuda subsidiary will enter into a cost-sharing agreement with the U.S. parent company for the property rights to co-develop the software. The rights to the underlying software code is retained by the U.S. parent company and transferred over time to the Bermuda subsidiary though buy-in payments. U.S. Code Section 482 regulates property transfers to related entities by U.S. citizens. The transfer must be at a price equal to the fair market value of the product. To avoid IRS challenges, the royalty fee paid by the subsidiary for the software property license from the U.S. parent company must not be artificially high or low. Since the U.S. corporate tax rate is a world-high 35 percent, reducing income in the U.S. is best; accordingly, the royalty fee should be set at the low end of market value.

Subpart F of the U.S. Tax Code deals with anti-deferral regulations and requires companies to recognize all income received from a controlled foreign corporation at the time earned. An exception to Subpart F income exists for a controlled foreign corporation who manufactures the product. In the next step, Bermuda will enter into its own license agreement with the Dublin subsidiary for the rights to the underlying software code; in effect, a sub-license. Dublin will manufacture a new software version to be sold in Europe; thus, creating an exception to U.S. Subpart F income.

Another U.S. tax code to consider is Code Section 367 stating that payments made (e.g. the royalty fee) must be commensurate with the income attributed to the intangible property, regardless of consideration. Consequently, foreign income is taxable in the U.S. despite Subpart F income exceptions. The transfer of the intangible property embedded within the software program applies to this regulation. However, because software becomes largely obsolete when a new version is developed, Code Section 367 will not apply to the income from sales of the newly manufactured software version in Dublin.

Finally, the Dublin subsidiary needs to file a U.S. Form 8882 election to be disregarded as a separate entity from the Bermuda subsidiary. This election will consider the Dublin and Bermuda subsidiaries as a single entity for U.S tax purposes. Income and transactions from both subsidiaries will be combined; subsequently, the license transfer between the Irish entities will not generate a related-party property purchase, and the transactions between the Irish subsidiaries will simply be disregarded by the IRS.

**Irish and Dutch Subsidiary Arrangements**

Ireland has a double taxation treaty between its countries; so, the Bermuda subsidiary can be treated as a non-resident as long as its management and control activities occur in Bermuda. The royalty fee paid by Dublin for the use of Bermuda's intellectual property is a deductible expense. All the royalty income is taxable in Bermuda at a zero percent income tax rate. Ireland does not aggressively apply its transfer-pricing rules; hence, the license fee can be set optimally high to lower Dublin's taxable income from its European sales. Dublin's tax rate is only 12.5 percent, much lower than the U.S. tax rate.

Ireland does, however, impose a withholding tax on annual payments made by an Irish company to a non-resident. Under this rule, the royalty fee transferred to Bermuda is subject to a 20 percent Irish withholding tax. Ireland does not tax money being moved between European countries; therefore, running the license and royalty transaction through the Netherlands (the Dutch Sandwich) bypasses the Irish withholding tax to further lower SumTotal's effective tax rate. Instead of licensing the intellectual property directly, the license goes through the Netherland subsidiary before being passed to Dublin. Conversely, the royalty fee and company profits are passed from Dublin - to the Netherlands - to Bermuda. The Netherlands does not charge a withholding tax and charges only a small fee to use its tax system. By using the Netherlands for the licensing transaction between Dublin and Bermuda, the royalty and sales income is passed to Bermuda essentially tax free.

**Ethical and Legal Considerations**

Substantial debate exists regarding the ethics of using offshore tax planning strategies to avoid paying U.S. corporate income taxes. Ethical viewpoints may strictly depend on an individual's economic position in the argument. As a corporation, we have a duty to increase shareholder value as long as legal and ethical precepts are maintained. Legally, the door is open to use offshore tax planning to increase shareholder value. Furthermore, SumTotal must stay competitive in the global marketplace to remain sustainable. The U.S. government also must start thinking of ways to stay competitive to attract and maintain U.S. companies. The health of the U.S. tax base and job prospects demand a more efficient government. Both sides of the ethical argument need to consider the options best suited for building a strong economy for all U.S. citizens.

**Conclusion**

Overseas tax planning is a great tool available for SumTotal to increase shareholder value by lowering its effective tax rate. Exercising the Double Irish and Dutch Sandwich strategy will help create the lowest possible tax rate, and is a feasible opportunity for software companies to capitalize on. The U.S. will charge income tax if the income is brought back into the country, so, this strategy will only work if the money earned by the foreign subsidiaries stays overseas to be used for expansion into European markets. However, keeping the income overseas will increase shareholder value twofold – by reducing taxable income, and by growth into overseas markets. Diagram 1 on the next page walks you through the flow of licenses, royalty fees, and profits using the Double Irish and Dutch Sandwich tax strategy.

# *Double Irish with Dutch Sandwich*

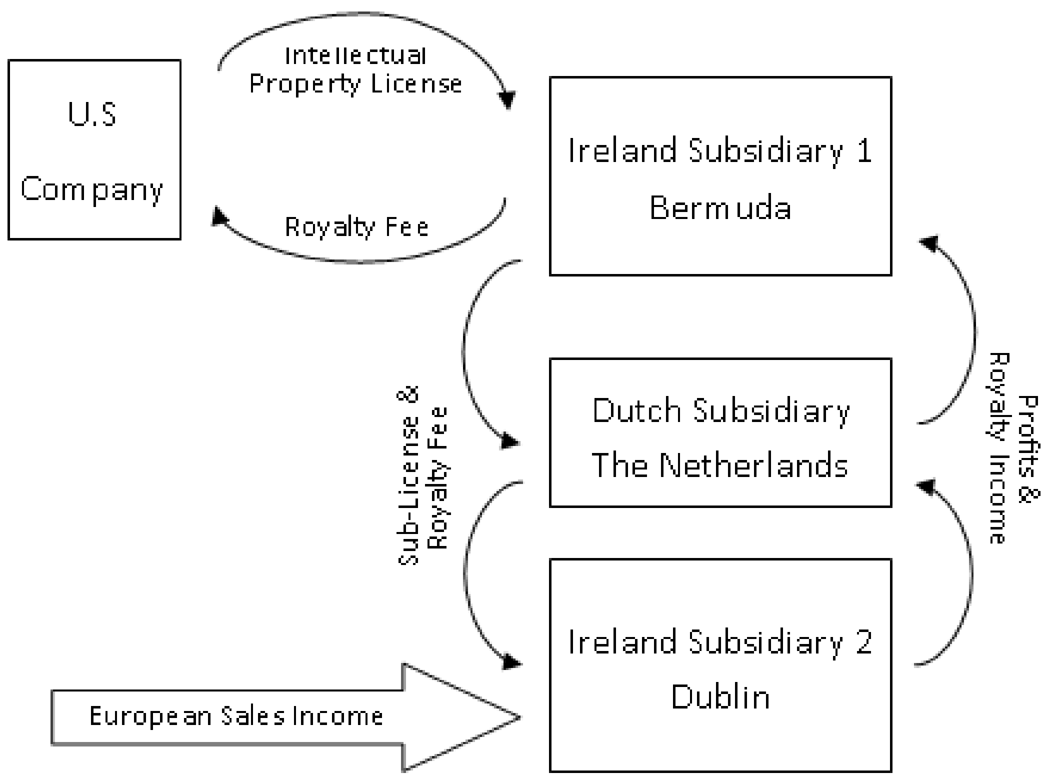


Diagram 1