Death of the "Double Irish Dutch Sandwich"? Not so Fast.

By Jeffrey L. Rubinger and Summer Ayers LePree on October 23, 2014
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On October 14, 2014, the Irish Minister for Finance released proposals as part of the 2015 Irish Budget that would cause Irish incorporated non-resident ("INR") companies to be treated as tax resident in Ireland beginning January 1, 2015. The goal is to shut down the use of so-called "Double Irish" and "Double Irish Dutch Sandwich" structures commonly used by U.S. multinationals, such as Google, Microsoft, and Facebook, among others, to significantly reduce their worldwide effective tax rate on royalties derived from the exploitation of intellectual property .

Although the rules are proposed to take effect January 1, 2015, so that any new Irish incorporated company will be regarded as an Irish tax resident after that date, the proposal contains a grandfathering rule for existing INR companies that will allow such companies to continue to be regarded as non-residents of Ireland until December 31, 2020.

The proposal clearly demonstrates Ireland's desire to comply with the G20-endorsed new international tax initiatives (such as the "Base Erosion and Profits Shifting" initiative). The question, however, is whether this proposal actually will have any impact on U.S. multinational companies that utilize INR companies in their global structures, given that Ireland's vast treaty network presumably will continue to allow Irish incorporated companies that are effectively managed outside of Ireland to be regarded as a non-residents of Ireland for Irish tax purposes.

U.S. Tax System, in General

The U.S. federal income tax treatment of a corporation depends on whether the corporation is domestic or foreign. For U.S. federal income tax purposes, a corporation is treated as domestic if it is incorporated under the law of the U.S. or of any state. All other corporations (i.e., those incorporated under the laws of foreign countries) are treated as foreign. The U.S. employs a "worldwide" tax system, under which domestic corporations generally are taxed on all income, whether derived in the U.S. or abroad. To mitigate the potential double taxation that may result from such a system, a foreign tax credit (FTC) is allowed for income taxes paid to foreign countries to reduce or eliminate the U.S. tax liability imposed on foreign-source income, subject to certain limitations.

In addition to the direct taxation of a domestic corporation, income earned by a domestic parent corporation through foreign corporate subsidiaries generally is not subject to U.S. federal income tax until the profits are repatriated to the U.S. in the form of a dividend. Certain anti-deferral regimes, however, may cause the domestic parent corporation to be taxed currently with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries, regardless of whether any distributions are made. The main anti-deferral regime in this context is the controlled foreign corporation ("CFC") rules of Subpart F.

One of the primary categories of Subpart F income consists of foreign personal holding company income ("FPHCI"). FPHCI includes most forms of passive income, including royalties. Excluded from FPHCI, however, are royalties received by a CFC from a related corporation for the use of, or the privilege of using, property within the country under the laws of which the CFC is created or organized (the "same country" exception). It should be noted that under the same country exception, it is irrelevant whether the CFC is actually considered a tax resident under local laws in its country of incorporation.

Double Irish Structures

Under a typical "Double Irish" structure, a U.S. parent company (USCo) forms two Irish subsidiaries, IrishCo1 and IrishCo2. IrishCo1 is a first-tier Irish subsidiary organized under Irish law but managed and controlled in a low-tax jurisdiction (e.g., Bermuda or the British Virgin Islands). While U.S. rules determine tax residency of a corporation based on its place of incorporation, Irish law often determines tax residency based on the country where the company is managed and controlled. Accordingly, IrishCo1 will be treated for U.S. tax purposes as an Irish corporation, but for Irish tax purposes generally will be structured so as to be treated as a nonresident of Ireland resident in, for example, Bermuda. USCo will retain all US rights in the relevant IP and will license to IrishCo1 the rights to develop and exploit the IP outside the US. IrishCo1 will then sublicense these IP rights to IrishCo2, which in turn will use the IP to manufacture/produce IP products and then sell those products to customers outside the U.S.

IrishCo2 is wholly-owned by IrishCo1 and is organized, managed and controlled in Ireland. For Irish tax purposes, IrishCo1 and IrishCo2 will be treated as two separate corporations – a Bermuda resident corporation and its Irish subsidiary, respectively. Ireland will thus treat payments from IrishCo2 to IrishCo1 as royalties paid by an Irish corporation to a Bermuda corporation for the use of the Bermuda corporation's IP in Ireland. Accordingly, IrishCo2 should be able to deduct the royalty payments made to IrishCo1 as a trade expense against its Irish taxable income, thereby minimizing its Irish tax burden. The remaining income of IrishCo2 will be subject to tax at the standard 12.5% Irish corporate tax rate applicable to active business income. Bermuda does not generally impose an income tax, so the royalty payments to IrishCo1 will not be taxed in Bermuda (or other no-tax countries in which IrishCo1 may be tax resident for Irish purposes, such as BVI or Cayman Islands).

In contrast, IrishCo2 will file a check-the-box election in the U.S. to be treated as a disregarded entity for U.S. tax purposes. As a result, for U.S. tax purposes, IrishCo1 and IrishCo2 will be treated as a single Irish corporation and therefore the U.S. will ignore transactions that take place between IrishCo1 and IrishCo2, viewing these as strictly internal transactions. The income and activities of IrishCo1 and IrishCo2 also will be combined in determining whether sales made by either company result in foreign base company sales income to IrishCo1 (which is a CFC). The non-U.S. sales of IrishCo1 and IrishCo2 should not be characterized as generating foreign base company sales income because the IrishCo1/IrishCo2 combined entity will not have purchased any property from a related person. In addition, royalty payments from IrishCo2 to IrishCo1 should be disregarded for U.S. tax purposes, since the two companies are viewed for U.S. purposes as a single entity.

This structure takes advantage of the U.S. check-the-box rules, the Irish management and control standard, and the generally favorable tax and economic environment in Ireland. The structure ultimately allows the companies to avoid generating Subpart F income for US purposes, obtain deferral from the US perspective until dividends are repatriated to the US parent, and minimize global tax rates by making deductible payments from IrishCo2 to IrishCo1 (sometimes through a Dutch company that is included to eliminate withholding taxes on such royalty payments, as discussed below) that typically will not be taxable in either Ireland or IrishCo1's country of tax residence (e.g., Bermuda).

Double Irish Structures with Dutch Sandwich

In this variation of the Double Irish structure laid out above, further global tax efficiencies are obtained, because the royalty payments made from IrishCo2 to IrishCo1 in the basic Double Irish structures may be subjected to withholding tax in Ireland in some cases. This withholding tax can easily be avoided simply by inserting a Dutch (or other EU) company between IrishCo1 and IrishCo2, and having IrishCo1 license the IP to DutchCo, which in turn sublicenses the IP to IrishCo2. This DutchCo also checks the box for U.S. purposes to be treated as a disregarded entity. Royalty payments from IrishCo2 to DutchCo are not subject to Irish withholding tax, because pursuant to EU directives, such withholding taxes are not permitted when such payment are made between EU resident companies. There also is minimal Dutch tax imposed because the outbound royalty payment largely offsets this royalty income. Outbound dividends from DutchCo to IrishCo1 also should not be subject to withholding tax, pursuant to Dutch law.

Real Life Example

Google is one of the many large multinational tech companies that has been prominently featured in the press for having utilized the Double Irish with Dutch Sandwich structure. When customers buy Google advertising, Google's Dublin-based subsidiary, Google Ireland Ltd., bills the customers and collects the revenue. This entity (which is like IrishCo2 in the above discussion) is disregarded for U.S. tax purposes and is wholly-owned by Google Ireland Holdings, an Irish company whose center of management and control is located in Bermuda (like IrishCo1 in the above discussions). Google Ireland Holdings owns the rights to Google's search and advertising technology and other intangible property for Africa, Europe, and the Middle East. Google Ireland Holdings licenses those rights to Google Netherlands Holdings B.V., Google's subsidiary in the Netherlands (which may either be inserted between Google Ireland Ltd. and Google Ireland Holdings, or be a sister subsidiary to Google Ireland Ltd.), which then sublicenses them to Google Ireland Ltd. Google Ireland Ltd. pays royalties to Google Netherlands Holdings B.V., and these royalties are exempt from withholding tax under EU law because they are made to a resident of an EU member state. Google Netherlands Holdings B.V. then makes further royalty payments to Google Ireland Holdings, which payments also are exempt from withholding tax because the Netherlands does not have an outbound royalty withholding tax. Ireland does not tax the receipts, because Google Ireland Holdings is considered a Bermuda tax resident for Irish tax purposes. Neither does Bermuda impose any tax on these earnings. When Google wants to bring the money back to the U.S., it will pay U.S. corporate tax on the dividends it repatriates.

Does the New Proposal Really Change Anything?

The question raised by the recent Irish finance proposals is, do they really put an end to the Double Irish structures (with or without the Dutch sandwich) or to the use of Ireland in general as an attractive jurisdiction for companies with IP that is used outside the U.S.? Upon a closer examination, the answer would seem to be no. The same benefits can be achieved by only slightly modifying the existing structures to avoid triggering the new proposed rules.

The Double Dutch structures were useful for a few reasons. First, Ireland has a 12.5 percent corporate income tax rate for active "trading" income, is English speaking, and is highly educated. These facts are not likely to change any time soon and thus will remain valid going forward even if and when the proposals become final. Second, because Ireland uses a management and control standard for residency, it is possible to prevent Ireland from taxing income earned by the top-tier subsidiary by placing management in another country. Third, thanks to the U.S. check-the-box rules, Subpart F can be entirely avoided from the U.S. perspective by causing the lower-tier subsidiaries to be disregarded for U.S. tax purposes, since all of the non-U.S. activities are thus considered to be conducted by a single entity. The only factor that has been altered by the Irish proposals is the second. Under the proposals, moving management and control of an Irish company to a Caribbean nation with which Ireland does not have a tax treaty will no longer achieve the desired objective. But this does not mean the objective cannot still be achieved in other ways. Ireland has an extensive treaty network. At least two of these treaties contain management and control residency standards and are with countries that have similarly low tax rates. Specifically, it is possible to form an INR, as under existing structures, with its management and control in Malta. Pursuant to the treaty between Malta and Ireland (which should not be overridden by the new proposal), that company should be treated as a resident of Malta, and not Ireland (See Article 4(3) of the treaty). Malta does not impose any tax on royalties derived from patents, trademarks, or copyrights (resident non-domiciled companies also are exempt from Malta tax on foreign source income that is not remitted to Malta.) And since Malta is an EU member state, royalties paid from an Irish company to a Malta company should not be subject to Irish withholding tax. Thus, this Malta company should provide essentially the same benefits as the Bermuda company in the above Google example. Alternatively, the treaty between the United Arab Emirates (UAE) and Ireland likewise has a management and control standard, and the UAE does not impose corporate income tax. The Ireland-UAE treaty also exempts royalty payments from withholding tax.

Thus, notwithstanding the Irish proposal, it should still be possible to achieve the same results using a company managed and controlled in Malta or the UAE, rather than in a Caribbean nation. The practical wrinkle is that in order to satisfy the management and control standard, it generally will be necessary to hold board meetings, etc., in the relevant country, e.g. Malta. While many executives would no doubt prefer to travel to Bermuda or the Cayman Islands for such meetings, travel to Malta should not be so burdensome or undesirable as to eliminate this structure from consideration.

Another issue worth mentioning is the role of the same-country exception to certain categories of Subpart F income. This is one frequently cited reason for using two Irish companies (only one of which is considered to be Irish for Irish tax purposes), rather than simply forming one company in Malta from the start, for example, so that moving management and control is not necessary. As long as we have the U.S. check-the-box rules and can simply cause all lower-tier entities to be disregarded, the same country exception is not technically needed because the U.S. law sees only one foreign entity. However, it is possible that at some point in time these check-the-box rules could go away. If that were to occur, having both of the “Double Irish” companies (IrishCo1 And IrishCo2) incorporated in Ireland would provide a “belts and suspenders” fallback in that taxpayers could instead rely, from the U.S. perspective, on the same country exception to prevent Subpart F income from arising from these licensing arrangements between related parties.

In any case, all of the press declaring the Double Dutch a thing of the past seems to be a bit overstated. As we have explained above, the only thing that has truly changed is the scope of permissible jurisdictions to which management and control may be moved to achieve the desired benefits. The number of such permissible jurisdictions certainly has been diminished. But the viability of the structure going forward has by no means been eliminated entirely.