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Wearing of the Green

Irish Subsidiary Lets Microsoft Slash Taxes in U.S. and Europe

Tech and Drug Firms Move Key Intellectual Property To Low-Levy Island Haven Center of Windows Licensing

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DUBLIN -- A law firm's office on a quiet downtown street here houses an obscure subsidiary of Microsoft Corp. that helps the computer giant shave at least $500 million from its annual tax bill.

The four-year-old subsidiary, Round Island One Ltd., has a thin roster of employees but controls more than $16 billion in Microsoft assets. Virtually unknown in Ireland, on paper it has quickly become one of the country's biggest companies, with gross profits of nearly $9 billion in 2004.

Ireland's citizens may not have heard of Round Island One, but they benefit greatly from its presence. Last year the unit handed the government of this small country of four million citizens more than $300 million in taxes.

The citizens of other nations where Microsoft sells its products are less fortunate. Round Island One provides a structure for Microsoft to radically reduce its corporate taxes in much of Europe, and similarly shields billions of dollars from U.S. taxation.

Giant U.S. companies whose products are heavily based on their innovations, such as technology and pharmaceutical firms, increasingly are setting up units in Ireland that route intellectual property and its financial fruits to the low-tax haven -- at the expense of the U.S. Treasury.

Much of Round Island's income is licensing fees from copyrighted software code that originates in the U.S. Some of the rights to these lucrative assets end up in Ireland via complex accounting rules on intellectual property that the Treasury is now seeking to overhaul. The Internal Revenue Service said it is also looking closely at how companies account for such transactions.

In a statement, Microsoft said its European units "report and pay significant amounts of taxes" and that Microsoft "is fully compliant with the tax laws of the United States and all other countries."

Through a key holding, dubbed Flat Island Co., Round Island licenses rights to Microsoft software throughout Europe, the Middle East and Africa. Thus, Microsoft routes the license sales through Ireland and Round Island pays a total of just under $17 million in taxes to about 20 other governments that represent more than 300 million people.

Microsoft's effective world-wide tax rate plunged to 26% in its last fiscal year from 33% the year before. Nearly half of the drop was due to "foreign earnings taxed at lower rates," Microsoft told the Securities and Exchange Commission in an August filing. Microsoft leaves much of its profit in Ireland, including $4.1 billion in cash, avoiding U.S. corporate income taxes. But it still can count this profit in its earnings.

Round Island One is a key component in a drive by Microsoft to place its intellectual property and other assets into tax havens. In the past three years, Round Island has swallowed up other Microsoft units, from Israel to India, moving much of their tax liability to Ireland. Within the U.S., the rights to many of Microsoft's products and copyrights are managed by a subsidiary in Nevada, which, unlike the company's headquarters state of Washington, doesn't tax royalty income on intellectual property. The Nevada unit, Round Island LLC, is the corporate parent of Ireland's Round Island One.

Microsoft's Irish venture is part of a historic emigration of U.S. intellectual capital, a cornerstone of the modern American economy, to an island that once sent millions of famine-wracked migrants to America. Companies built on knowledge and innovations are an ever-larger portion of the U.S. corporate tax base, displacing the old industrial concerns. But the newer firms' principal assets -- ideas, codes and formulas -- are intangible, and thus easily exported to places where the huge royalties they produce can be shielded from American taxation.

Accountants and lawyers now avidly market such relocations. Round Island's legal address is in the headquarters of a Dublin law firm, Matheson Ormsby Prentice, that advertises its expertise in helping multinational companies use Ireland to shelter income from taxes. It represents other U.S. technology companies including Google Inc., which recently set up an Irish operations center that the firm credits in its SEC filings with reducing its tax rate. A Google spokesman said the company set up in Ireland to be close to its European customers. "Because that business is done outside of the U.S. it is taxed according to international law," he said.

Microsoft's other neighbors in Ireland include Oracle Corp., which also recently set up a network of Irish subsidiaries that helped drive its taxes down sharply. "The decrease in our effective tax rate...is attributable to higher earnings in low tax rate jurisdictions," Oracle said in its July annual report to the SEC. An Oracle spokesman declined to comment.

Ireland, through a blend of deft marketing, potent financial incentives and advantageous geography, has largely beaten out its many tax-haven rivals in the heated competition for offshore investment by technology companies. The flow of U.S. know-how has helped make Ireland an economic powerhouse, dubbed the Celtic Tiger, now one of the richest countries in Europe.

In the past four years, Ireland has stepped up its effort to woo U.S. high-tech firms by piling on new tax breaks for technology transfers, leading a string of major U.S. companies to announce research facilities here. The trend poses a quandary for U.S. regulators and policy makers in the face of a skyrocketing federal deficit and widespread tax shelters.

Irish officials say U.S. companies aren't exporting their intellectual wealth to Ireland, just sharing it. "This isn't about sucking knowledge out of the U.S. This is about building up capability elsewhere," says Enda Connolly, a manager at the Industrial Development Agency of Ireland.

The IRS is fighting intellectual-property migration in court, and the Treasury Department has issued a draft of new rules to limit it. Their efforts have done little to slow the trend. A Washington panel advising the White House on tax policy is now floating a possible new strategy: Simply eliminate the taxes on overseas corporate income that motivate firms to move their intellectual property and other assets offshore. Most major U.S. trading partners have already taken this step, giving their firms a competitive edge against American companies.

Licensing fees make up about three-fourths of Microsoft's nearly $40 billion in annual revenue. Computer makers pay such a fee for every copy of Windows they pre-install in a PC. Companies pay licensing fees for using programs like Microsoft Office and to license programs that run on corporate networks.

Microsoft has just over 1,000 full-time employees in three suburban Dublin buildings, each with its own Starbucks outlet. About half of the Irish employees work on software "localization," translating and modifying for local markets the programs produced by some 29,000 employees of Microsoft in the Puget Sound region of Washington state.

"We have a very real business" in Ireland, said Michael Doyle, a Microsoft tax lawyer at its headquarters in Redmond, Wash. He said the company is using a well-accepted, widely used practice to share its intellectual property with offshore subsidiaries. "The IRS is keenly aware of this and they audit it regularly," he said.

A spokesman for the IRS said the agency doesn't comment on individual taxpayers. But he said the agency is "concerned" about how U.S. companies structure such arrangements and sometimes challenges them.

Ireland's emergence as the top overseas destination for U.S. intellectual capital culminates a long effort to attract foreign investment. For decades after Ireland gained independence in 1921, its economy was largely agricultural. In 1969 John A. Mulcahy, a wealthy American from Ireland, used his one-third holding in Pfizer Inc. to persuade the U.S. drug company to set up a citric acid plant in Cork, according to a Harvard Business School case study.

Other U.S. manufacturers followed, attracted by tax benefits, a low-wage, English-speaking work force, and Ireland's 1973 induction into the European Economic Community. Ireland grew adept at wooing U.S. businesses, dispatching teams of lobbyists to America. Young tech firms such as Apple Computer Inc. began flocking to the island in the 1980s.

Despite criticism from its neighbors, Ireland continued introducing incentives, including in 1983 a 10% tax rate on profits from software exports. The incentives spurred Microsoft in 1985 to set up its first plant in Ireland to help supply Europe. But most foreign operations remained small, and through the mid-1980s "Ireland was a basket case economically," says Mr. Connolly.

That changed with the 1990s technology boom, beginning with the 1990 arrival of an Intel Corp. microchip assembly plant in exchange for $157 million in incentives. Soon to follow were Dell Inc., Gateway Inc., Hewlett-Packard Co. and International Business Machines Corp. Pfizer's drug-industry rivals also followed its path to the green hills of County Cork. The European Union's free-trade rules let them build products in Ireland and sell them cheaply in Europe's many higher-tax countries. Spokesmen for Intel and Dell said tax incentives, the skilled work force and Ireland's location were all reasons for moving operations there.

Microsoft and others now are going further. Microsoft delivers its Windows products to European customers straight from Ireland, and the profits go straight back to Ireland. Since most of the profits from Microsoft programs are in the form of copyright licensing fees, "it is likely that low or nil taxes are payable in the other EU states," says John Ward, a tax professor at the University of Ulster in Belfast, Northern Ireland. Microsoft said it has separate units in every major jurisdiction in the region "that report and pay significant amounts of taxes," but declined to provide an example.

One critic of tax havens contends that the arrangement amounts to an accounting fiction. "You would expect there would be some profits earned in these other countries," says Richard Murphy, an Irish accountant and visiting fellow at the Centre for Global Political Economy at the University of Sussex who is affiliated with a European group called the Tax Justice Network, a coalition of left-leaning nonprofits. Microsoft's ability to avoid reporting large profits in the United Kingdom relies on its position that its U.K. sales -- $1.8 billion in fiscal 2004 -- are actually conducted from Ireland.

To avoid U.K. corporate-profits tax, a company must show it has no "permanent establishment" in Britain through which it makes sales. Microsoft has a large U.K. operation (owned by Round Island) that it calls marketing and a tiny Ireland-based sales staff. Mr. Murphy says Microsoft "is walking a fine tightrope." The software company's Mr. Doyle says its practices have been extensively vetted by tax authorities in the relevant countries.

Round Island -- the name is just a placeholder that never got changed, Microsoft says -- filed its annual report in Ireland on Oct. 27, some seven months late. When asked, Microsoft attributed the delay to the need to finish routine audits of subsidiaries. In the U.S., such a late filing would require an explanation to regulators and possibly large penalties. In Ireland, regulators don't even ask. The penalty for late filing: $3.60 a day.

Taxes paid to Ireland, though modest to giant Microsoft, are a big deal to the Irish treasury, amounting to $77 for each Irish citizen. Last year Microsoft also helped cover Ireland's costs in its six-month turn in the EU presidency, donating software and forgiving some $60,000 in royalties. Bertie Ahern, the Irish taoiseach, a title similar to prime minister, spoke at Microsoft events twice this year. "The growth and success of Microsoft Ireland has coincided with, and played an important role in, a dramatic transformation in the Irish economy," he said at an event at Dublin Castle last month.

Ireland sees intellectual property as the key to its future. Irish labor is now growing scarce, and costs higher. The development authority adopted a new strategy in 2000 of becoming "the foremost knowledge-based society in Europe." Last year, Ireland enacted a new R&D tax credit and abolished a 9% tax on sale or transfer of intellectual property.

Lucent Technologies Inc. now is building a new research center here, attracted by "access to high-caliber engineering talent and scientists," according to spokeswoman Mary Lou Ambrus. IBM is developing Lotus Workplace in Ireland, Hewlett-Packard is designing new inkjet printers here. In March, Microsoft announced it is creating a new R&D center in Ireland to help work on the flagship products currently designed primarily in Redmond, including the planned new release of Windows, called Vista. Pharmaceutical companies are also doing more research in Ireland.

"We're transitioning the nation from being a supplier and producer of other people's ideas to a place where you actually do that development," says Mr. Connolly. The development officer calls offshoring of research a natural part of globalization, and "a good thing. Is that being done at the expense of the American taxpayer? I don't think so."

The research facilities are necessary to satisfy IRS rules on moving intellectual property abroad. To do so -- and thus have profits from it be taxed abroad -- a company must be able to argue plausibly that its offshore unit is at least partly responsible for the innovations.

A common device is to take successful, patented American ideas and then develop new generations of them -- with help from an offshore research division. The ownership of the new version (and profits on licensing it) can then legally be shared between the U.S. parent company and the offshore unit.

Suppose a U.S. company develops a new, easy-to-use computerized day planner, and it's a global hit. All the royalties must go to the U.S., where it was invented, and be taxed at the U.S. corporate income tax rate of 35%. But if the company builds a new and improved version, adding features created partly by its offshore R&D team, the intellectual property rights of day planner 2.0 can be shared between the U.S. and the foreign unit -- as can the profits. Day planner 1.0, of course, disappears.

U.S. law explicitly permits this practice. The controversy comes in valuing the contribution made by the offshore unit. Did it pay a fair share of the development cost? And did it pony up a reasonable price to the parent company to be able to share the rights to the original invention, a price an arm's-length party would pay?

U.S. companies seek to meet the test by creating "cost sharing arrangements" between them and the foreign unit. "R&D cost-sharing agreements within corporate structures can minimize the tax payable in the parent country," notes Ireland's government in a development paper.

Flat Island, according to its filings, has cost-sharing agreements with a Microsoft unit in the U.S. called MELLC, which is the ultimate party controlling offshore patent licensing rights. Microsoft filings give no additional information about MELLC, nor will the company disclose details.

The IRS and Treasury say they are worried that some firms set artificially low prices for their offshore units to buy into such deals. "IRS regulations require that sales or other transfers between subsidiaries of multinational corporations meet the arm's-length standard," said Eric Smith, an IRS spokesman. "Intellectual property is a special case that may be difficult to value. The IRS is concerned that intellectual property is valued according to the arm's-length standard, and actively audits and contests transfers that do not meet this standard." The U.S. government has not questioned the legality of Microsoft's Round Island structure, which appears to be carefully constructed to meet federal regulations.

"Cost sharing is a concept in the U.S. income tax regulations that was developed many years ago to determine the amount of compensation attributable to R&D that is considered "arm's length," Microsoft noted in its statement. "Many large companies use this concept as it was originally created to help minimize disputes..."

The underlying concern is that American companies rely on the U.S. education system and other tax-supported infrastructure to produce a highly creative work force, then move the fruits of that labor abroad without due compensation to American society.

In August, the Treasury issued 188 pages of proposed new regulations on cost-sharing. The new rules are meant to prevent foreign subsidiaries from taking control of U.S. intellectual property without paying a reasonable price to the parent U.S. company for the innovation developed in America. The IRS has been trying to invalidate some cost-sharing deals through litigation, with little success to date.

The Matheson Ormsby law firm in Ireland promotes its expertise in setting up tax-sheltered structures, in a glossy booklet available at its Dublin office. As the global economy changes and technology develops, the firm notes, it is getting easier for multinationals "to unbundle the traditional value chain and locate appropriate profit generating functions in Ireland," including "ownership and exploitation of intellectual property." The law firm has an office in the heart of Silicon Valley, in Palo Alto, Calif.

The booklet sheds light on how Ireland has beat out smaller locales like Bermuda and the Cayman Islands in the competition for U.S. firms' intellectual property. The answer involves the IRS. As Matheson notes, small, sparsely populated and largely undeveloped havens like Cayman lack "the necessary economic infrastructure to which value and ultimately profits can justifiably be attributed." But Ireland has the people and physical infrastructure to permit "construction of profit-generating centres defensible by reference to functions, risks and tangible assets of the Irish operation."

Donald McAleese, the Matheson partner who set up the Microsoft and Google operations, didn't respond to requests for comment by email, telephone or a visit to his office.

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