Irish tax cocktail gets German twist

BY TOM BERGIN
In July 2012, then-U.S. Treasury Secretary Tim Geithner travelled to an island off the German coast to meet Wolfgang Schaeuble, Germany’s finance minister. Schaeuble was on vacation, but Geithner visited to discuss the euro zone crisis. Talk also turned to a long-running bugbear of Schaeuble’s: corporate tax avoidance.

According to a letter Schaeuble later wrote to Geithner, the Treasury Secretary had explained in their conversation that the most aggressive forms of avoidance often involved technology companies parking valuable know-how in low-tax countries and making other parts of the company pay high rates to use it. In Schaeuble’s letter he sought Geithner’s support for international action against legal tax dodging. Profit shifting, the finance minister said, was largely a problem involving U.S. companies. Tax rules in Germany made it more difficult there. This “could explain why we do not know of German companies with comparable tax arrangements to the U.S. companies,” the letter, seen by Reuters, said.

But an examination of the accounts of one of Germany’s largest firms shows it uses similar techniques. Without them, it would pay more than 100 million euros ($133.53 million) in additional tax each year, some of it to the United States.

SAP AG provides software for businesses to process and analyse transactions, counts 80 percent of the Fortune 500 as customers and has a market capitalisation of $90 billion, making it the fourth biggest firm in Germany. Its accounts show that it – like U.S. tech firms such as Google and Microsoft – channels profit to subsidiaries in Ireland, where the corporate tax rate is 12.5 percent. The comparable rate in Germany is 30 percent and in the United States, SAP’s largest market, 39 percent, according to the Organisation for Economic Cooperation and Development (OECD), an international think tank.

SAP, which is headquartered in Walldorf, Germany, has paid a global annual tax rate in the last three years averaging 26 percent. That’s nearly 20 percentage points less than the company paid a decade earlier.

Like other German companies, SAP has benefited from significant German tax cuts over that time, but it is only taxed on part of its profits in Germany. The company is structured so that Ireland, which accounts for less than 1 percent of its sales and employees, is the home base for 20 percent of its profits. SAP uses Dublin as a base for know-how and other intellectual property generated by staff around the world, and has an Irish subsidiary lend billions of dollars to a U.S. affiliate for much higher interest rates than the group pays on the open market.

There is nothing illegal about this; the company said profits reported in Ireland reflect genuine economic activity and risks borne by Irish subsidiaries, and the structure was driven by operational rather than tax motives. “SAP didn’t come to Ireland for taxes,” Liam Ryan, who heads SAP’s Irish operation, told Reuters at the group’s campus in the leafy Citywest office park on the outskirts of Dublin. “The reason SAP invests here is because we deliver.”

Tax authorities in Germany and the United States declined comment, citing rules on taxpayer confidentiality. A spokesman for Finance Minister Schaeuble said he would not comment on specific companies.

Sven Giegold, a German member of the European Parliament and spokesman on economic affairs with the Green Party, said, “This shows U.S. companies are not alone in engaging in clever tax planning.” He said the arrangements were clearly “contrived... It is obvious that these arrangements are tax motivated. It is not convincing to say otherwise.”

Sahra Wagenknecht, a member of the German parliament and a spokeswoman on economic and tax matters for Die Linke, a left-wing party which calls for higher taxation, said SAP’s case highlighted inadequacies in current tax rules that the government should address.
Corporate tax is an increasingly touchy topic as indebted governments cut budgets. Last year, Schaeuble worked with colleagues from France and Britain to launch a major review of international tax rules aimed at ensuring multinationals pay their fair share and at reducing what has become known as “base erosion and profit shifting” (BEPS). Governments aim to agree new rules in a couple of years.

Edward Kleinbard, Professor of Law at the University of Southern California, says U.S. business lobbyists have depicted these efforts at tax reform as anti-competitive, a bid to weaken U.S. firms by having them pay more tax to overseas governments.

“U.S. firms have designed a good deal of their domestic lobbying on BEPS along the lines that BEPS is all about bashing American success,” said Kleinbard, who was formerly Chief of Staff of the U.S. Congress’s Joint Committee on Taxation.

But he said the case of SAP shows the United States is also a victim of tax avoidance by foreign companies; the U.S. treasury, too, could benefit from tax reform.

Like all companies, SAP has a responsibility to investors to maximise returns by minimising costs, including taxes. “Clearly, if I was an investor looking at two identical companies, I would choose the one with the lower tax rate,” said Robert Jakobsen, senior equity analyst at Jyske Bank in Denmark, who covers SAP.

**ACQUIRED TAX EFFICIENCY**

In January 2012, a fund manager at a presentation for investors in Frankfurt asked SAP’s chief financial officer, Werner Brandt, how the company had managed to reduce its effective tax rate so much “in the last few years”, given “an environment where countries need more taxes and have stretched budgets.”

The question prompted laughter from the room and from Brandt himself, a video of the event on SAP’s website shows.

“I hope you understand that I do not ** Tax efficient**

Profits climb in Ireland, tax rate in Germany doesn’t

### BUSINESS OBJECTS ADVANCES...

Before tax profits at Business Objects Software Ltd, Ireland

### SAP’S TAX RATE DECLINES

Effective rate for SAP AG (percent, IFRS*)

### IRELAND’S PROFITABLE WORKERS

Profits per head in Irish units compared with other countries (’000 euros)

<table>
<thead>
<tr>
<th>Company</th>
<th>Profits (’000 euros)</th>
</tr>
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<tbody>
<tr>
<td>SAP Ireland US-Financial Services Ltd</td>
<td>106,910</td>
</tr>
<tr>
<td>Business Objects Software Limited</td>
<td>1,594</td>
</tr>
<tr>
<td>SAP Deutschland AG &amp; Co. KG</td>
<td>111</td>
</tr>
<tr>
<td>Walldorf, Germany</td>
<td>106</td>
</tr>
<tr>
<td>SAP France</td>
<td>47</td>
</tr>
<tr>
<td>Paris, France</td>
<td>33</td>
</tr>
<tr>
<td>SAP JAPAN Co., Ltd.</td>
<td>20</td>
</tr>
<tr>
<td>Tokyo, Japan</td>
<td>11</td>
</tr>
<tr>
<td>SAP (UK) Limited</td>
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<tr>
<td>Feltham, U.K.</td>
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<td>SAP Canada Inc.</td>
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<td>SAP America, Inc.</td>
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<td>Pennsylvania, USA</td>
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Source: SAP

* IFRS: International Financial Reporting Standards
want to go into too much detail here,” he responded. “But if you think of acquisitions and the way how you finance and structure acquisitions, this could help you, in order to reduce your tax rate.”

SAP spokesman Jim Dever said Brandt’s comment referred to U.S. acquisitions made by SAP in recent years. He declined to name the acquisitions, though he said Brandt’s answer did not refer to SAP’s biggest pre-2012 deal, the $7 billion takeover of French software company Business Objects in 2008.

Even so, SAP’s accounts show the Business Objects deal did contribute to a significant reduction in taxes by allowing it to report large profits in Ireland. In fact, Business Objects’ Irish operation gave SAP a low-tax home for its intellectual property which could then charge other parts of the group for the right to use the software, thereby shifting profits to Dublin.

Profitability at Business Objects’ Irish subsidiary, Business Objects Software Ltd., has risen tenfold since the deal. Last year, the Dublin-registered unit reported profits of 381 million euros, making it the second most profitable arm of the group after the main German operation.

SAP says this high profitability is due to the fact that Dublin owns the intellectual property underpinning Business Objects’ branded software. The firm charges affiliates royalties for licensing this, and the affiliates then sell the software to clients.

Dublin did not develop the original software and did not even have a research department before 2008, said Andrey Grigoriev, Senior Director at Business Objects. It accumulated the know-how by buying rights to software that had been developed by affiliates in the United States, the UK, Canada and France.

Since SAP took over, Business Objects has established a research unit in Dublin. The centre, known as “App Haus”, sits on the third floor of one of SAP’s glass-and-stone clad buildings at Citywest. Its look is deliberately unfinished: part-plastered walls, exposed wooden supports, uncarpeted steel floors, furniture on wheels and floor-to-ceiling whiteboards which hang from rails. Mark Brennan, Vice President Development, Ireland, said the “garage” look aims to foster the energy of a start-up.

In 2011, the last year for which full accounts for Business Objects Software are available, it spent 180 million euros on research. Less than 10 percent of that was spent in Ireland.

Business Objects Software is markedly more profitable than the company’s other units that develop or sell software. At the group’s main North American “development, research, and innovation” centre, SAP LABS, LLC, in Palo Alto, California, where more than 2,000 staff work, profit margins were 4 percent in 2011, accounts show. SAP (UK) Ltd., which sells a range of SAP software in Britain, had margins of just 7 percent, a similar level to other SAP distribution subsidiaries. Dublin’s profit margins were 37 percent in 2011. It made that by charging other group companies more than 700 million euros for its intellectual property, while paying less than 180 million euros to subsidiaries that develop the software.

SAP’s customers and programmers are largely based in the United States, Canada, France, Japan, the UK and Germany. If its profit were allocated more closely in line with sales and research this would boost its tax bill, potentially by more than 60 million euros based on headline tax rates. SAP said it follows international rules on transfer pricing – the common practice of pricing inter-company transactions. It said the high profits in Ireland were the unintentional result of its application of international tax rules.

Kleinbard, the California law professor, said the structure of the Irish unit was lawful but defied economic logic: “It’s just not credible to say that a company which has such a low percentage of sales in a country can generate so much profit there.”

**LOAN TO SELF**

Two floors beneath the “App Haus” sits the other key to SAP’s tax efficiency.

Visitors might easily miss the small plaque on the wall, and the slightly darker hue in the carpet tiles that designate the shift from the realm of Business Objects Software to that of its subsidiary, SAP Ireland US-Financial Services Ltd. But the three staff who work here are far and away the most productive in the group, SAP accounts show. On average, each one of them generated profits of 107 million euros in 2012.

The company said SAP Ireland US-Financial Services was established in 2010 to help manage foreign currency risk and finance U.S. acquisitions. The unit also helps reduce taxes by creating large interest costs in Germany and the United States and large interest income in Ireland.

How does it do this? Take an
example from 2010. SAP AG – the German-registered group parent – raised 2.2 billion euros by issuing Eurobonds, and injected the money as equity into SAP Ireland US-Financial Services. The bonds generated annual interest payments of 57 million euros which were not offset by interest received from Ireland, so SAP’s taxable income was reduced by a similar amount, the accounts show.

The Irish financing unit then borrowed additional funds from U.S. lenders at an interest rate of less than 3 percent, which it lent on to SAP America Inc., to which it charged a higher interest rate. By the end of 2011, the Dublin subsidiary had extended loans of $4.25 billion to its U.S. affiliate, and generated interest income of $300 million that year – equivalent to an interest rate of 8 percent.

If SAP America had borrowed on the public markets at 3 percent, the lower interest charge would also have boosted its profit – and its taxes.

SAP’s Dever said the corporate structure was not motivated by tax. He said the financing arm was established in Ireland because not all countries allow firms to report their accounts in foreign currencies – SAP Ireland US-Financial Services uses dollars.

The interest rates charged to SAP America were reasonable, SAP said, because they reflect the rates that such a company would have to pay in the open market if it did not have a guarantee from a cash-rich parent.

Professor Michael Graetz, at the Columbia University law school, said the arrangement was a well established tax-reduction strategy.

“They’re stripping the income out of the U.S. into Ireland, using debt,” he said. “Income is flocking to a low-tax country and the deductions are flocking to high-tax countries.”

**ACTION PLAN**

Much of the debate around corporate tax over the past year has focused on U.S. companies. The SAP example shows firms from other countries use the same techniques.

Reimar Pinkernell, tax partner at law firm Flick Gocke Schaumburg in Bonn, said tough international competition in businesses like software meant Europeans had to take advantage of tax optimisation opportunities.

The OECD, which advises its mainly rich nation members on taxation, has recommended countries seek to end many contrived tax avoidance practices. In July it published an Action Plan that highlighted firms’ use of inter-company debt and the way they locate intellectual property in low tax areas as problems to address.

The governments of all the Group of 20 leading nations, including Germany, have backed that plan.

Business groups on both sides of the Atlantic have pushed back, saying the drive fosters an anti-business environment that could hamper growth.

“U.S. companies are concerned about the impact of the Action Plan,” said Carol Doran Klein, International Tax Counsel with the United States Council for International Business (USCIB), which counts over 300 of the biggest U.S. multinationals among its members. “There is a sense that U.S. companies are targets.”

($1 = 0.7489 euros)

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