

12/11/19

Tax Policy and Statistics Division,
Centre for Tax Policy and Administration
OECD
Paris, France

Dear Tax Policy and Statistics Division,

In 2016 Google made almost exactly 50% of its pre-tax profits in the United States and 50% in the rest of the world (\$12bn and 12.1bn).¹ On that profit, it paid \$3.8bn in US federal and state taxes, and \$966m was divided between every other government in the world where Google operates.

The reason for this extreme inequality is that in that year Google Ireland Holdings Unlimited, a company with an address in Dublin but tax resident in Bermuda, declared a profit of \$8.9bn which was subject to a 0% corporation tax rate.² As stated in the Google 10-K form, this was most of the profit that the company made outside of the United States (although the 10-K uses the term “substantially all”. Google Ireland Holdings Unlimited appears to have no employees, and all of its income derives from the ownership of intellectual property rights.

As has been accepted by the OECD, the BEPS reforms proposed and implemented so far have not grasped the issue presented by these kinds of structures. This is confirmed by our own research, which found that the effective tax rates in the UK of five of the largest tech corporations in the UK had barely changed following the last round of BEPS reforms.³

I believe that the test for any reform of the international corporate tax system has to be judged by how much of the profit declared by companies like Google Ireland Holdings Unlimited will be reallocated and subject to tax in the jurisdictions where real economic activity takes place.

The current consultation paper published by the OECD suggests that the answer to that question may be very little.

Scope of the new taxing right

The OECD proposes the creation of a new taxing right which sits on top of the existing tax structure. This new taxing right will be targeted at the residual profits of consumer facing businesses.

1 Google’s 10-K form states pre-tax earnings in the US and International divisions, the 2016 results are used as 2017 was an anomolous year due to one-off charges associated with the the US tax reforms.

2 The annual report of Google Ireland Holdings Unlimited Company for 2017 is available from the Irish Corporate Records Office

3 <https://www.taxwatchuk.org/corporate-tax-and-tech-companies-in-the-uk-2/>

Excluding the extractives industry from sales based apportionment methodologies makes sense, as it would allocate profits away from capital and labour intensive productions centres. However, further restricting this right to consumer facing businesses risks creating unnecessary complexity.

A test which only included purely consumer facing businesses would exclude companies like Google and Facebook, who derive the majority of their revenues from advertising. Overwhelmingly the purchasers of advertising are other businesses and not consumers.

The OECD accepts this and talks about consumer facing elements, which would encompass online advertising businesses. To stretch the definition of consumer facing in this way could end up creating significant grey areas which could be open to exploitation. The private equity industry has demonstrated very well that the profits of almost any industry can be easily converted to finance income for example.

It would be better to broaden the unitary principle to a wider set of companies rather than simply seeking to place companies into an artificial consumer facing category. As was set out long ago by Lord Carnwath LJ, tax statutes “draw their life-blood from real world transactions with real world economic effects”. In the real world, multinational groups are single businesses rather than a set of loosely affiliated, separate entities and so as far as possible should be taxed as such.

Residual profits and the Arm’s-Length Approach

The consultation paper states that the arm’s-length approach remains a good foundation for the division of taxing rights with regard to most transactions, and that the apportionment methodology will only be applied to residual profits.

We see little evidence that the arm’s-length principle is working. The evidence we have seen demonstrates that currently businesses are able to eliminate most if not all of their profit in market jurisdictions using the arms length approach.

This is despite the fact that in a jurisdiction like the UK, almost all of the digital businesses which are the subject of the current OECD work will have some sort of permanent establishment or associated enterprise in the country.

As demonstrated by the Google example given above, despite substantial marketing and research operations in the UK, the outcome of the arm’s-length approach is not the transfer of a residual profit to tax havens, but by Google’s own admission, substantially all of their non-US profit.

TaxWatch has also studied the video games industry in the UK. Our work discovered that the makers of Grand Theft Auto have not declared any profit in the UK over the last ten years, despite producing the most popular entertainment product in history.⁴

This perverse outcome was achieved because Take-Two Interactive, which publishes Grand Theft Auto, reimburses the UK based developer of the game at a rate which means that it does not declare a taxable profit in the UK.

As far as we are aware, this outcome has not been challenged under any existing transfer pricing rules, despite the fact that the low level of reimbursement does not correspond to the economic facts as is evidenced in the pay agreements made between the company and staff.

4 <https://www.taxwatchuk.org/reports/gaming-the-tax-system/>

The video games industry is an industry which has made the transition from a physical to a digital distribution model. The industry previously distributed physical goods, in the form of CDs and DVDs sold in shops, and now distributes its software through digital downloads. Our report on Activision Blizzard, the makers of World of WarCraft, demonstrated how this shift has allowed companies to locate their revenues offshore. However, it also demonstrated that even when the company was still selling large amounts of physical products, the limited risk distribution model meant that the company did not declare much profit in the UK.⁵

In February 2019 the UK government announced a new Diverted Profits Tax Compliance Facility.⁶

The background note published alongside the facility noted:

“HMRC has found that some Multinational Enterprises (MNEs) have adopted cross border pricing arrangements which are based on an incorrect fact pattern and/or are not consistent with the Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines (TPG)”

The fact that the UK government created a new compliance facility to deal with such MNEs suggests that the problem was significant, and not isolated to a few companies. The introduction of a compliance facility also suggests that even in cases where companies can be challenged under the existing rules, tax authorities are struggling to deal with the issue.

All of this indicates significant problems with the arm’s-length approach which are downplayed in the OECD consultation document. The OECD should be congratulated for thinking outside the current orthodoxy, however, I do not see how adopting a hybrid between the arm’s length approach and an apportionment system will solve the clear problems that exist with the current system.

Thank you for taking the time to consider my response. I hope that the research of TaxWatch will prove useful in the OECD’s deliberations. If you would like any further information on our work we would be very happy to assist.

Yours faithfully,

George Turner

Director

TaxWatch

5 HMRC are currently in a dispute with Activision Blizzard over its international business model, however HMRC are only looking at tax years post 2013 when the digital transition was well underway as evidenced by falling turnover at Activision Blizzard UK Limited.

6 <https://www.gov.uk/government/publications/hmrc-profit-diversion-compliance-facility/profit-diversion-compliance-facility>