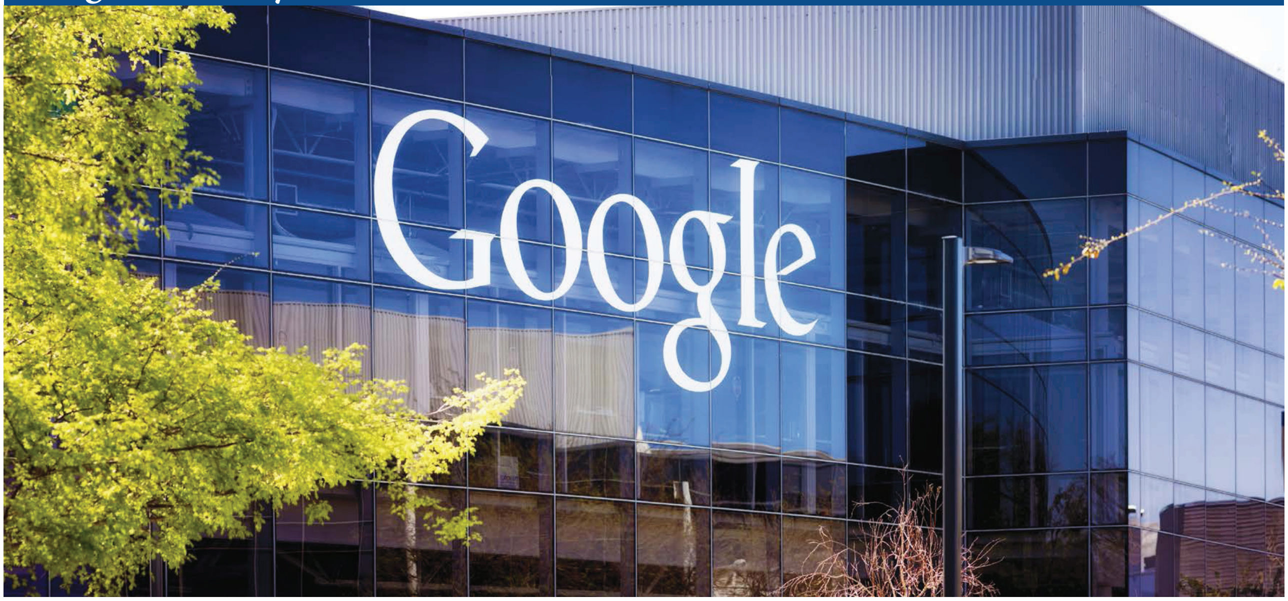

Comment

Googlegate!

Speed read

Google has reportedly agreed with HMRC to pay £130m in back taxes and bear a greater tax burden in the future. Despite the controversy, there is nothing illegal or unfair about the tax arrangements in cases such as this. They are a natural consequence of the tax landscape. If politicians are unhappy with this, they should change the law. The law is, of course, changing. The BEPS proposals, in particular, will increase the amount of domestic tax paid by the multinationals in each of the countries in which they trade, but perhaps not to the extent many would like. Until there is a legal requirement for foreign businesses to establish a local UK operating subsidiary to contract with UK customers, there will always be an argument that foreign companies aren't paying their fair share.

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Once again, it's everywhere: Google's tax affairs are in the newspapers, on the TV and radio. It certainly makes for great headlines – Google, the US technology giant, has agreed to pay HMRC £130m in back taxes and bear a greater tax burden in the future. Opinions vary from those who claim that the extra £130m is a derisory figure compared with the company's turnover, to those who see it as only right to pay what is provided by law and nothing more.

Admittedly, I side strongly with the latter view. Not because I am utterly satisfied with the current rules, but because the rules are the rules and, fundamentally, because taxation is premised neither on morality nor on a calculation of a 'fair share'. Journalists please take note.

In essence, tax laws are designed to either encourage behaviour or prevent it. In the context of Google, UK domestic law and the international tax system allows Google to trade within the UK – and to do so *without* creating a taxable presence here. Claims that Google is gaming the system (at least as far as its UK affairs are concerned) are simply ill informed ideological drivel. Let's get a few things straight: what Google has done and how it has done it is not tax avoidance; it isn't the exploitation of a loophole; it isn't immoral; and it certainly isn't evil à la Hodge.

The irony of politicians asking how Google 'gets away' with it should not be lost on anyone. If politicians don't like the law or the consequences of a law that they have passed, they alone have the power to change it. So, why don't they change the law? Well, as readers will know, the law has been changed and continues to evolve. The UK's diverted profits tax and the OECD's BEPS initiative will shape how multinationals structure their businesses in the future. That said, unless and until there is a legal requirement for foreign businesses to establish a local UK operating subsidiary to contract with UK customers, there will always be an argument that foreign companies aren't paying their fair share. That and conflating revenue with profit.

What's the alternative to the current status quo?

The US Judge Learned Hand famously said that nobody owes any public duty to pay more than the law demands: taxes are enforced extractions, not voluntary contributions. The view that Google (or any other multinational, for that matter) should pay taxes in a country on the basis of its yearly turnover is nothing short of fantasy. Taxes are levied on profits, not revenue, and therefore how much a company makes annually is mostly irrelevant. What matters is whether such profits – and if so, how much of them – can be attributed to a particular country. In tax language, the allocation of global profits between different jurisdictions on the basis of a predetermined formula (e.g. the allocation of turnover based on the location of customers/consumers) is referred to as formulary apportionment. Funnily enough, formulary apportionment, as an alternative to the arm's length principle, has been battered and continually rejected by the OECD. Current rules are instead based on the allocation of profits on a separate entity basis rather than on a single unified business, much to the dismay of certain tax campaigners.

The misuse of language

The term 'abuse', when used in a tax context, probably ranks very high on the list of misused words. This is because the term has traditionally been used, since the Romans, to refer to arrangements aimed directly at circumventing a particular rule. The difficulty with cases like Google and the headlines surrounding their tax arrangements is that there is nothing illegal, abusive, immoral or unfair about their behaviour. This might be an anathema to some (social justice warriors, campaigners and journalists), but that's the reality. The behaviour of Google is a natural consequence of the tax landscape with the 'abuse' existing only in the minds of those who don't understand the law.

The rules they are a-changin'

The challenge today is not so much about tackling the innovations of too-clever people, but rather more about rethinking whether the current rules are fit for purpose in the 21st century.

To say that nothing is being done to preserve the UK's tax base is wholly incorrect. Changes to the current principles for the allocation of taxing rights are being proposed both multilaterally and unilaterally. Two clear examples exist: the OECD's BEPS project; and the UK's diverted profits tax. Both initiatives acknowledge that the rules need to change to keep abreast of how business is being done. The BEPS project is, of course, more ambitious and perhaps more effective, because any hopes of success in tackling issues of cross-border taxation require coordinated action.

The UK structure adopted by Google isn't as complex as some would have you believe. It is, in fact, very simple. The complexity occurs once the profits are earned in Ireland and, arguably, the arrangements are in place to strip profits out of Ireland and into Bermuda. This is potentially where issues arise, but it does so as a result of US domestic law and with the blessing of Ireland. It is the US tax system that has given rise to the type of planning and structures that BEPS has in its sights. The 'check the box' election, coupled with an unsatisfactory CFC regime, has allowed US multinationals to game the system for many years and to implement abusive structures with complicit treaty partners. Unfortunately, there is no desire or political will in the US to amend their legislation, so the rest of the world is forced to accept BEPS.

Will BEPS affect Google?

The OECD BEPS project is the only realistic way of achieving change (formulary apportionment isn't the answer and would result in dire mismatches and unintended consequences).

The basic thrust of BEPS is to make a domestic tax system more adhesive through expanding the current definitions of taxable behaviour and nexus. The two actions most relevant to Google (amongst others) are on permanent establishment (Action 7) and intangibles (Action 8).

- Google's UK subsidiary provides marketing services to Google Ireland. Under current rules marketing and pre-contract negotiations are generally considered to be 'auxiliary' in nature and therefore incapable of creating a permanent establishment (PE) for the Irish parent. The new 'agency PE' rules extend the existence of a PE to situations where an individual plays the principal role leading to the conclusion of contracts that are entered by the non-resident entity (e.g. Google Ireland), regardless of where the contract is concluded. The net result of these proposals is that Google will likely pay more tax if it maintains its current operating structure.
- The second significant change in thinking is that legal ownership, in and of itself, does not confer any right to ultimately retain the income arising from the exploitation of intangibles. This is a major departure from current rules. The thrust of the new rules is on functions performed by group entities rather than legal ownership. This will be relevant to any company that exploits intangible property where the ownership of the IP is separate from associated development and marketing functions.

My expectation is that the BEPS proposals will increase the amount of domestic tax paid by the multinationals in each of the countries in which they trade, but not to the extent many would like (this would only happen when tax is levied on revenue not profit).

Conclusion

As always, I would like to see an informed and rational tax debate occurring in the UK. To date, much of the commentary is knee-jerk hysteria based on arguments around fairness and morality – little of which has anything to do with how a domestic tax system operates. We need to move on from this if we want to sensibly advance the tax debate in the UK. Let's hope we can do this. ■

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- Preventing the artificial avoidance of the permanent establishment status (Alison Lobb, 29.10.15)
- The trouble with intangibles (Mathew Oliver, 13.1.16)
- 20 questions on the diverted profits tax (Ben Jones & Cathryn Vanderspar, 25.9.15)