Funding the Future

# The economics of Google's tax

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The row over Google's tax settlement of just £130 million to cover the last ten years has become political.

John McDonnell raised an urgent question on the issue yesterday, making the point that tax experts (including Prof Prem Sikka, Labour tax barrister Jolyn Maugham and me) all think that the likely tax rate paid by Google on its likely UK profits may, even after this settlement, not exceed 5%. Jolyon comes up with data identical to mine and he assures me wrote before reading what I had suggested.

The logic is simple. Google made sales of about £4.5bn into the UK in 2014 according to its global accounts. Those same accounts show an average profit rate worldwide of a little over 25%. There is no reason to think the UK is an abnormal Google market so profits in the UK would, on this basis, be at least £1 billion. It would be entirely reasonable to expect a corporate  tax rate of 20% in that year so I have said at least £200 million should have been due in that year. We think that at most less than £50 million will be paid after the latest tax settlement.

John McDonnell has accepted these estimates.

David Gauke, uncomfortably understudying for George Osborne at the Dispatch Box, decided to deny there was any credibility to such estimates, claiming that tax is paid in the UK on economic activity. The line was repeated by him so often during his nervous appearance that it must have been what he was briefed to say, by HMRC, I presume. But what does it mean?

Gauke used an example of cars made in the UK and sold abroad. Where, he asked, should the total profit on sale be taxed? Where the car is sold, or where it was made? The answer, of course, is neither. The whole point of the international tax system that has been in place since the 1930s has been to try to find a fair way to split the profits between the two places since it is obvious that economic activity takes place in both countries.

The trouble for Davod Gauke is that this was a very poor argument to use in the case of Google. In their case a technology, undoubtedly developed in the USA in the first instance, that is beyond doubt used by UK customers is not recorded as being sold in this country but is instead recorded for that purpose in Ireland with the benefit of the sales transaction not going back to the USA, to where under Gauke's logic it should flow, but does instead arrive (untaxed) in Bermuda, where, all parties agree, no economic activity giving rise to it took place.

To put it another way, when it is very obvious that the eocnomic activity that Google creates in the UK is advertising for UK businesses on a website that is explicitly UK focussed (as it is) then to pretend that the only actual economic activity that Google undertakes here is the sale of those adverts, but not their actual display or use, is absurd.

This is exacerbated by a particular factor in Google's cause, which is that in practice most of the revenue they earn here is entirely dependent upon people living in the UK clicking on those ads: that is how the revenue structure works for most of the Google ads sold. So, in fact, the revenue is wholy dependent upon UK activity and without it Google would have no income in this country. It could put those ads up on the web if it wished but unless it quite specifically made sure they were available in the UK for the use of UK based web readers wishing to buy from UK based companies then their presence would be near enough worthless to Google. The economic substance is, then, that it is only the presence of those adverts for UK based businesses on the web browsers of UK based people that creates value for Google. The economic substance of Google's UK sales does in that, therefore, arise wholly in the UK because it is almost worthless anywhere else. That is why when you ask about a local restaurant if you live in Boston, UK you are not offered one in Boston, Massachusetts. That US one if worthless to you and Google know it.

In that case for Google, David Gauke and HMRC to agree that Google need only be taxed on a bit of profit relating to the cost of selling those adverts in the UK is wrong: that is very obviously not subjecting the economic activity that Google undertakes in the UK to the right amount of tax.

The OECD BEPS process has recognised this and is designed to permit countries to force companies like Google to take up tax residence in the countries in which they make their sales, like the UK, and pay tax on the revenues earned in those countries as a result. John McDonnell referred to that yesterday. He was right to do so. David Gauke ducked the issue.

But there is a technical argument to be had in that case about what costs should be offset against the UK sales revenue that, for reasons already noted, is obviously taxable here. It can be quite logically economically argued that the only costs to be offset are the direct selling costs, which we know happen in this country, and any additional marginal costs that Google incurs for servicing the UK market. I suspect this is little more than the additional server cost, which may well arise outside the UK, and some regulatory fees. After all, all the algorithms and technical development costs of Google are incurred solely to ensure it can operate in its prime market - which is the USA. They would, it can quite reasonably be argued, incur all those costs wholly to service that market so there is almost literally no additional cost incurred to use that technology in this country. Using the quite appropriate, in this case, economic logic of profit being determined by local marginal revenue (which is everything earned in the UK) less local marginal costs (selling costs plus the costs of the servers and and admin costs relating to them to meet UK legal requirements) it could, I think, be wholly appropriately argued that Google's UK profit margins have to be a lot higher than its US margins, where the costs of establishing its technology has to be incurred to ensure it can make any sale at all in its home market. On this logic using economic substance Google should have a much higher tax rate in the UK than the US.

Now I have to say that does not instinctively feel fair from a tax point of view. For the UK to argue that because Google has relatively few direct costs of sale in the UK it should pay tax on a very high profit margin here, even though David Gauke's logic would suggest that would be the right technical outcome, would instinctively be wrong, and be penal on the USA and its tax base. So a compromise has to be sought. Clearly it is fair that in the case of a integrated global company selling an almost identical product into many markets the costs of product creation should be shared, even if they are not incurred in the location where the economic substance of the sale takes place. That reflects the economic reality of the business, which is that it is really one global entity which happens to adapt, slightly, and with ease in the case of Google, to local situations.

So what would be the fair charge that the UK should suffer for the global costs Google incurs for product development in all its forms, including designing the sales processes used in the UK? Should it be, and this is the appropriate question I suggest, a proportion less than, equal to, or greater than the equivalent costs that will end up being offset against the equivalent economic activity (advertising sales) in the USA, which is Google's home market?

I can see the argument that it should not be less than: that seems fair.

But the argument some are making (including commentators on Jolyon's blog) is that it should be more. But why does that make sense? Remember that economically speaking Google is in reality making much more profit in the UK than it is in the US for all the reasons I have already given. Why then should it be taxed on a figure that is less than the equivalent US rate? I have to say that no economic logic I can find can come close to suggesting a reaosn for that.

Legally, of course, I can make them up. And I can argue prejudicially that because the US staff were so much more clever than the UK people for thinking this idea up in the first place the reward should go there, but that's not an argument about economic substance. That is just an argument for profit reallocation without foundation in economic logic when the economic logic of the UK operation is that it creates a massive pile of cash for Google at relatively little real cost. That, I suggest, should be reward enough for the US team.

So the only obvious conclusion in a company like Google (and I am not suggesting that this applies in the same way in all companies) is that costs should be shared out equally across the worldwide operations. And then you come back to the logic Prem Sikka, Jolyon Maugham and I have all used, which has to be right in that case.

And which means David Gauke and HMRC are both wrong.

So what does this mean politically?

First, because this conclusion can be reached instinctively without having to torture yourself as I have just done, it means that HMRC, and in turn the government, now have a credibility problem on this issue. Their logic is very obviously wrong, and David Gauke just made it a lot worse yesterday.

Second, if it is really true that they have accepted the new Google settlement as a mechanism that both avoids a Diverted Profits Tax charge and is BEPS compliant then UK tax strategy on these issues has made not an iota of progress over the last few years, despite what David Gauke claimed. For all the huff and puff, time expended at international summits and supposed commitment to the OECD process of renegotiating international tax literally nothing of substance will have changed. Google was paying very little tax before this deal on the economic substance of what it earned in the UK and is still paying very little afterwards. That is a disastrous precedent for UK taxation, and it has happened on David Gauke's and George Osborne's watch.

Third, John McDonnell was right in that case to raise the questions he did yesterday. And was right to say that this set a dangerous precedent, was right argue that the deal should be on the record, was right to say HMRC should explain how it reached this conclusion, was right to argue that country-by-country reporting is required on public record so we can see where such abuses are happening and was right to argue that HMRC need more resources to tackle such issues.

And David Gauke was wrong to ignore all those demands.

In which case, and quite extraordinarily, Google has once again created the necessary conditions for tax reform. But this time that reform has to happen and what is, beyond doubt, clear is that so far that reform has neither happened and is without support in HMRC, which is why John McDonnell was also right to demand its reform.

Tax is back centre stage in UK politics. I can't see it going away again for a while yet.