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Google 2.4% Rate Shows How $60 Billion Lost to Tax Loopholes

By Jesse Drucker - Oct 21, 2010

Google Inc. cut its taxes by $3.1 billion in the last three years using a technique that moves most of its foreign profits through Ireland and the Netherlands to Bermuda.

Google's income shifting -- involving strategies known to lawyers as the "Double Irish" and the "Dutch Sandwich" -- helped reduce its overseas tax rate to 2.4 percent, the lowest of the top five U.S. technology companies by market capitalization, according to regulatory filings in six countries.

"It's remarkable that Google's effective rate is that low," said Martin A. Sullivan, a tax economist who formerly worked for the U.S. Treasury Department. "We know this company operates throughout the world mostly in high-tax countries where the average corporate rate is well over 20 percent."

The U.S. corporate income-tax rate is 35 percent. In the U.K., Google's second-biggest market by revenue, it's 28 percent.

Google, the owner of the world's most popular search engine, uses a strategy that has gained favor among such companies as Facebook Inc. and Microsoft Corp. The method takes advantage of Irish tax law to legally shuttle profits into and out of subsidiaries there, largely escaping the country's 12.5 percent income tax. (See an interactive graphic on Google's tax strategy here.)

The earnings wind up in island havens that levy no corporate income taxes at all. Companies that use the Double Irish arrangement avoid taxes at home and abroad as the U.S. government struggles to close a projected $1.4 trillion budget gap and European Union countries face a collective projected deficit of 868 billion euros.

Countless Companies

Google, the third-largest U.S. technology company by market capitalization, hasn't been accused of breaking tax laws. "Google's practices are very similar to those at countless other global companies operating across a wide range of industries," said Jane Penner, a spokeswoman for the Mountain View, California-based company. Penner declined to address the particulars of its tax strategies.

Facebook, the world's biggest social network, is preparing a structure similar to Google's that will send earnings from Ireland to the Cayman Islands, according to the company's filings in Ireland and the Caymans and to a person familiar with its plans. A spokesman for the Palo Alto, California-based company declined to comment.

Transfer Pricing

The tactics of Google and Facebook depend on "transfer pricing," paper transactions among corporate subsidiaries that allow for allocating income to tax havens while attributing expenses to higher-tax countries. Such income shifting costs the U.S. government as much as $60 billion in annual revenue, according to Kimberly A. Clausing, an economics professor at Reed College in Portland, Oregon.

U.S. Representative Dave Camp of Michigan, the ranking Republican on the House Ways and Means Committee, and other politicians say the 35 percent U.S. statutory rate is too high relative to foreign countries. International income-shifting, which helped cut Google's overall effective tax rate to 22.2 percent last year, shows one way that loopholes undermine that top U.S. rate.

Two thousand U.S. companies paid a median effective cash rate of 28.3 percent in federal, state and foreign income taxes in a 2005 study by academics at the University of Michigan and the University of North Carolina. The combined national-local statutory rate is 34.4 percent in France, 30.2 percent in Germany and 39.5 percent in Japan, according to the Paris-based Organization for Economic Cooperation and Development.

The Double Irish

As a strategy for limiting taxes, the Double Irish method is "very common at the moment, particularly with companies with intellectual property," said Richard Murphy, director of U.K.- based Tax Research LLP. Murphy, who has worked on similar transactions, estimates that hundreds of multinationals use some version of the method.

The high corporate tax rate in the U.S. motivates companies to move activities and related income to lower-tax countries, said Irving H. Plotkin, a senior managing director at PricewaterhouseCoopers LLP's national tax practice in Boston. He delivered a presentation in Washington, D.C. this year titled "Transfer Pricing is Not a Four Letter Word."

"A company's obligation to its shareholders is to try to minimize its taxes and all costs, but to do so legally," Plotkin said in an interview.

Boosting Earnings

Google's transfer pricing contributed to international tax benefits that boosted its earnings by 26 percent last year, company filings show. Based on a rough analysis, if the company paid taxes at the 35 percent rate on all its earnings, its share price might be reduced by about $100, said Clayton Moran, an analyst at Benchmark Co. in Boca Raton, Florida. He recommends buying Google stock, which closed yesterday at $607.98.

The company, which tells employees "don't be evil" in its code of conduct, has cut its effective tax rate abroad more than its peers in the technology sector: Apple Inc., the maker of the iPhone; Microsoft, the largest software company; International Business Machines Corp., the biggest computer-services provider; and Oracle Corp., the second-biggest software company. Those companies reported rates that ranged between 4.5 percent and 25.8 percent for 2007 through 2009.

Google is "flying a banner of doing no evil, and then they're perpetrating evil under our noses," said Abraham J. Briloff, a professor emeritus of accounting at Baruch College in New York who has examined Google's tax disclosures.

"Who is it that paid for the underlying concept on which they built these billions of dollars of revenues?" Briloff said. "It was paid for by the United States citizenry."

Taxpayer Funding

The U.S. National Science Foundation funded the mid-1990s research at Stanford University that helped lead to Google's creation. Taxpayers also paid for a scholarship for the company's cofounder, Sergey Brin, while he worked on that research. Google now has a stock market value of $194.2 billion.

Google's annual reports from 2007 to 2009 ascribe a cumulative $3.1 billion tax savings to the "foreign rate differential." Such entries typically describe how much tax U.S. companies save from profits earned overseas.

In February, the Obama administration proposed measures to curb shifting profits offshore, part of a package intended to raise $12 billion a year over the coming decade. While the key proposals largely haven't advanced in Congress, the IRS said in April it would devote additional agents and lawyers to focus on five large transfer pricing arrangements.

Arm's Length

Income shifting commonly begins when companies like Google sell or license the foreign rights to intellectual property developed in the U.S. to a subsidiary in a low-tax country. That means foreign profits based on the technology get attributed to the offshore unit, not the parent. Under U.S. tax rules, subsidiaries must pay "arm's length" prices for the rights -- or the amount an unrelated company would.

Because the payments contribute to taxable income, the parent company has an incentive to set them as low as possible. Cutting the foreign subsidiary's expenses effectively shifts profits overseas.

After three years of negotiations, Google received approval from the IRS in 2006 for its transfer pricing arrangement, according to filings with the Securities and Exchange Commission.

The IRS gave its consent in a secret pact known as an advanced pricing agreement. Google wouldn't discuss the price set under the arrangement, which licensed the rights to its search and advertising technology and other intangible property for Europe, the Middle East and Africa to a unit called Google Ireland Holdings, according to a person familiar with the matter.

Dublin Office

That licensee in turn owns Google Ireland Limited, which employs almost 2,000 people in a silvery glass office building in central Dublin, a block from the city's Grand Canal. The Dublin subsidiary sells advertising globally and was credited by Google with 88 percent of its $12.5 billion in non-U.S. sales in 2009.

Allocating the revenue to Ireland helps Google avoid income taxes in the U.S., where most of its technology was developed. The arrangement also reduces the company's liabilities in relatively high-tax European countries where many of its customers are located.

The profits don't stay with the Dublin subsidiary, which reported pretax income of less than 1 percent of sales in 2008, according to Irish records. That's largely because it paid $5.4 billion in royalties to Google Ireland Holdings, which has its "effective centre of management" in Bermuda, according to company filings.

Law Firm Directors

This Bermuda-managed entity is owned by a pair of Google subsidiaries that list as their directors two attorneys and a manager at Conyers Dill & Pearman, a Hamilton, Bermuda law firm.

Tax planners call such an arrangement a Double Irish because it relies on two Irish companies. One pays royalties to use intellectual property, generating expenses that reduce Irish taxable income. The second collects the royalties in a tax haven like Bermuda, avoiding Irish taxes.

To steer clear of an Irish withholding tax, payments from Google's Dublin unit don't go directly to Bermuda. A brief detour to the Netherlands avoids that liability, because Irish tax law exempts certain royalties to companies in other EU- member nations. The fees first go to a Dutch unit, Google

Netherlands Holdings B.V., which pays out about 99.8 percent of what it collects to the Bermuda entity, company filings show. The Amsterdam-based subsidiary lists no employees.

The Dutch Sandwich

Inserting the Netherlands stopover between two other units gives rise to the "Dutch Sandwich" nickname.

"The sandwich leaves no tax behind to taste," said Murphy of Tax Research LLP.

Microsoft, based in Redmond, Washington, has also used a Double Irish structure, according to company filings overseas. Forest Laboratories Inc., maker of the antidepressant Lexapro, does as well, Bloomberg News reported in May. The New York-based drug manufacturer claims that most of its profits are earned overseas even though its sales are almost entirely in the U.S. Forest later disclosed that its transfer pricing was being audited by the IRS.

Since the 1960s, Ireland has pursued a strategy of offering tax incentives to attract multinationals. A lesser-appreciated aspect of Ireland's appeal is that it allows companies to shift income out of the country with minimal tax consequences, said Jim Stewart, a senior lecturer in finance at Trinity College's school of business in Dublin.

Getting Profits Out

"You accumulate profits within Ireland, but then you get them out of the country relatively easily," Stewart said. "And you do it by using Bermuda."

Eoin Dorgan, a spokesman for the Irish Department of Finance, declined to comment on Google's strategies specifically. "Ireland always seeks to ensure that the profits charged in Ireland fully reflect the functions, assets and risks located here by multinational groups," he said.

Once Google's non-U.S. profits hit Bermuda, they become difficult to track. The subsidiary managed there changed its legal form of organization in 2006 to become a so-called unlimited liability company. Under Irish rules, that means it's not required to disclose such financial information as income statements or balance sheets.

"Sticking an unlimited company in the group structure has become more common in Ireland, largely to prevent disclosure," Stewart said.

Deferred Indefinitely

Technically, multinationals that shift profits overseas are deferring U.S. income taxes, not avoiding them permanently. The deferral lasts until companies decide to bring the earnings back to the U.S. In practice, they rarely repatriate significant portions, thus avoiding the taxes indefinitely, said Michelle Hanlon, an accounting professor at the Massachusetts Institute of Technology.

U.S. policy makers, meanwhile, have taken halting steps to address concerns about transfer pricing. In 2009, the Treasury Department proposed levying taxes on certain payments between U.S. companies' foreign subsidiaries.

Treasury officials, who estimated the policy change would raise $86.5 billion in new revenue over the next decade, dropped it after Congress and Treasury were lobbied by companies, including manufacturing and media conglomerate General Electric Co., health-product maker Johnson & Johnson and coffee giant Starbucks Corp., according to federal disclosures compiled by the non-profit Center for Responsive Politics.

Administration Concerned

While the administration "remains concerned" about potential abuses, officials decided "to defer consideration of how to reform those rules until they can be studied more broadly," said Sandra Salstrom, a Treasury spokeswoman. The White House still proposes to tax excessive profits of offshore subsidiaries as a curb on income shifting, she said.

The rules for transfer pricing should be replaced with a system that allocates profits among countries the way most U.S. states with a corporate income tax do -- based on such aspects as sales or number of employees in each jurisdiction, said Reuven S. Avi-Yonah, director of the international tax program at the University of Michigan Law School.

"The system is broken and I think it needs to be scrapped," said Avi-Yonah, also a special counsel at law firm Steptoe & Johnson LLP in Washington D.C. "Companies are getting away with murder."

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