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Doubling Down on Double Sandwich Tax Schemes

by Anup Srivastava, Hussein Warsame, and Luminita Enache

Digital multinationals are facing increased scrutiny from tax authorities worldwide.

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Alphabet **recently announced** that it will close down a tax loophole it used over the last decade to save billions of dollars of taxes, namely Double Irish Dutch Sandwich. In a parallel development, Mark Zuckerberg, whose Facebook pays hardly any taxes in Europe, despite earning billions in profits, **now appears willing** to support tax reforms in Europe, and concedes that Facebook "may have to pay more." What happened? Why did digital giants suddenly turn so philanthropic? Were they moved by recent calls for **stakeholder capitalism**, that is, companies should benefit all stakeholders in the society and not just shareholders? The answer is more practical: tax reforms in US and Europe and the growing threat from European countries to impose revenue-based taxes have left these corporations with little choice other than to pay more taxes.

Why are digital multinationals under attack from tax authorities worldwide? This question can be answered by studying the Double Irish Dutch Sandwich scheme, which Google used to move **$23 billion** of taxable income in 2017 alone. Note that key assets of digital companies are intellectual property, algorithm, formula, patent, brand, and knowhow. The location of these assets, unlike factories, land, and buildings, can be easily moved to a tax haven. For example, with a stroke of a pen, Microsoft allegedly shifted **its entire intellectual property**, the principal driver of its trillion-dollar valuation, to a small factory in Puerto Rico.

In Alphabet's case, the tax planning involved **three subsidiaries**. One located in Netherlands. The other two were Irish companies, one located in Ireland and the other in Bermuda. This Bermuda-located Irish subsidiary owns all of the Alphabet's intellectual property. Foreign income, say from Google's ad revenues in UK, was first earned by the subsidiary located in Ireland, that evaded UK's taxes. This company must normally pay the low Irish taxes, say 12.5 percent. However, it could deduct its expenses in the calculation of taxable income. So, it paid a hefty management fees to the Dutch subsidiary, leaving hardly any taxable income in Ireland. The transaction even avoided withholding taxes, because of agreements between Ireland and Netherlands. Normally, the Dutch company should pay taxes. However, even that company transferred all its profits, by paying large royalties on the intellectual property, to the Bermudan company. Dutch company did not deduct any withholding taxes either, because Bermudan company was technically an Irish company, and the payment amounted to transaction between two EU companies. So, now the profits were moved to Bermuda. But Bermuda has no corporate taxes. So, Google's profits from around the world could be transferred to a Bermudan company, nothing more than a post office in Bermuda.

The Bermudan subsidiary didn't pay any taxes to the US government either, despite the US authorities requiring all U.S. companies to pay taxes on their global income. This is because foreign subsidiaries could delay taxes on global income until the time the profits were repatriated to US. So, this sandwich scheme (a Dutch subsidiary in between two Irish ones) could help Alphabet postpone its foreign taxes for ever, while evading those taxes in foreign countries as well. Arguably, not paying fair share of taxes was not inconsistent with **"Don't be evil,"** which was Google's motto until 2015, before Google became Alphabet.

These Irish tax loopholes, which saved hundreds of billions of dollars for digital multinationals, **were finally closed** in 2015 by Ireland under the EU pressure. But multinationals were given five years to comply, a period which has now ended. So, Google's recent announcement for the closure of the sandwich scheme is simply a practical decision to comply with the rules. It would be false to implicate Google as the sole perpetrator of this sandwich scheme, because it was commonly used by digital giants such as **Apple, Microsoft, and Facebook**. If fact, Apple transferred more than hundred billion dollar profits to its **Irish subsidiaries** that were "stateless" for the purpose of paying taxes. In all, US companies accumulated **more than $2.6 trillion** of past profits in their foreign affiliates by December 2017, when tax rates were cut.

From 2010 to 2017, Facebook paid taxes at **an effective rate of about 8%**, far lower than the statutory tax rate was 35%. Sandberg, Facebook's CFO, used her past experience at Google to set up "international headquarters" in Ireland, just **large enough to justify the tax benefits**. So, what led to Mark Zuckerberg's **sudden willingness** to pay more taxes? It is a response to two major developments: US **Tax Cuts and Jobs Act** (TCJA) enacted in 2017 and the **tax reforms** proposed by Organization of Economic Development (OECD) and G20 countries.

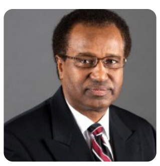
Prior to the TCJA, U.S. firms could keep their foreign income in tax havens such as Bermuda for ever. TCJA requires companies to pay a one-time tax on cash stashed abroad, which reduces the incentive to keep profits parked in tax havens. Going forward, U.S. moved to a hybrid of territorial and global tax systems, while imposing a lower **10.5 percent minimum tax on global income** from intangible assets held abroad. This **minimum tax rate**, a compromise between the normal tax rates and zero effective tax rates achievable by innovative tax-saving schemes, is designed to discourage firms from shifting income to ultra-low tax countries.

Moreover, OECD recently proposed a **two-pillar approach** to collect taxes from digital companies. One pillar would reduce the freedom with which multinationals allocate taxable income to different countries. That pillar would also allow a country to tax a company that operates in its territory even if it doesn't own physical assets there. The second pillar would reduce a company's ability to shift profits to a low-tax jurisdiction, by the imposition of a minimum tax rate and reduction of tax-rate differential across countries. While the details are being worked out, some European countries have already taken unilateral steps. As we discussed in a previous **HBR article**, France imposed a three-percent tax on revenue earned in its territory by digital giants. It recently **delayed the imposition of this tax** because U.S. government threatened retaliatory tariffs. France would, however, proceed with this tax if the OECD doesn't reach a deal by the end of 2020. Meanwhile, **UK and Italy have also decided to impose revenue-based taxes** on digital giants despite the retaliatory threats by the U.S. government.

To sum it all, digital giants could freely move around their global profits to evade taxes. Tax authorities around the world are now taking both unilateral and coordinated steps to prevent such evasion. The new willingness shown by the digital giants, to cooperate with tax authorities, is nothing more than a prudent response to those steps. Managers of digital companies must closely watch these developments and should now prepare to pay a larger portion of their profits as taxes. Their cooperation would also ensure that individual governments do not resort to blunt policy choices such as revenue-based taxes, **a move that we oppose**. Their cooperation would also be in the spirit of "**stakeholder capitalism**" because **paying fair share of taxes** is a first step towards a corporation's contribution to the society.

Anup Srivastava Follow

Anup Srivastava holds the Canada Research Chair at Haskayne School of Business, University of Calgary. He is one of the foremost experts on valuation and financial reporting of digital companies.



Hussein Warsame Follow

Hussein Warsame is a Professor of Accounting and CPA Fellow in Taxation at Haskayne School of Business, University of Calgary. His research interests are in taxation and financial accounting.

Luminita Enache Follow

Luminita Enache is an Assistant Professor at Haskayne School of Business, University of Calgary. She investigates financial disclosures of new-economy firms.