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THE VALUE OF INTANGIBLE ASSETS IN THE STARBUCKS CASE

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TABLE OF CONTENTS:

ABSTRACT

The purpose of this thesis is to analyze the theme of intangible assets in the context of transfer pricing through the use of the Starbucks case. The difficult evaluation of intangible assets allows multinationals like Starbucks to exploit the different and incomplete regulations between the countries to obtain tax advantages. The Organization for Economic Cooperation and Development (OECD) has been trying in recent years to stem these problems by introducing new guidelines such as the "base erosion and profit shifting" (BEPS) project. The thesis is divided into four chapters. The first chapter presents an overview of intangible assets regarding: the context in which they are found; their definition and classification; how to calculate their value in the most correct manner and finally what are the criteria for maximizing the profit of them in the seat of the country chosen by the multinational that holds the rights for their legal ownership. In the second chapter the Starbucks case is introduced explaining how Starbucks is present in countries with favorable taxation and how it uses intangible assets. In-depth studies are carried out on its structure in Europe and in particular in the countries involved in the case dealt by the European Commission and brought to the attention of the media. In the third chapter the Starbucks case is explained in details starting from the context, proceeding with the investigation of the European Commission and arriving at the sentence with the reactions of the various parties involved. Furthermore, an explanation is given on the payment of royalties between the various Starbucks

companies. The fourth and final chapter contains personal thoughts about the case and the general context. Finally, in-depth studies on the case are also proposed relying on the actions of the BEPS project to allow understanding and dealing with similar situations in the future in the most correct and transparent way possible.

INTRODUZIONE

Lo scopo di questa tesi è analizzare il tema dei beni intangibili nel contesto del transfer pricing attraverso l'utilizzo del caso Starbucks. La difficile valutazione dei beni intangibili permette a multinazionali come Starbucks di sfruttare le differenti e lacunose normative tra i vari paesi per ottenere un vantaggio fiscale. L'Organizzazione per la cooperazione e lo sviluppo economico (OCSE) sta cercando negli ultimi anni di arginare queste problematiche introducendo nuove linee guida come il progetto "base erosion and profit shifting" (BEPS). La tesi è articolata in quattro capitoli. Il primo capitolo presenta una panoramica sui beni intangibili riguardo: il contesto in cui si trovano; una loro definizione e classificazione; come calcolare il loro valore nella maniera più corretta e in ultimo quali sono i criteri per massimizzarne il profitto nella sede del paese scelto dalla multinazionale che detiene i diritti della loro proprietà legale. Nel secondo capitolo viene introdotto il caso Starbucks spiegando come è presente in paesi con tassazione favorevole e come utilizza i beni intangibili. Vengono fatti approfondimenti sulla sua struttura in Europa e in particolar modo nei paesi coinvolti nel caso affrontato dalla Commissione Europea e arrivato all'attenzione dei media. Nel terzo capitolo viene spiegato nei dettagli il caso Starbucks partendo dal contesto, procedendo con l'investigazione della Commissione Europea e arrivando alla sentenza con le reazioni delle varie parti coinvolte. Inoltre viene proposta una delucidazione sul pagamento delle royalties tra le varie sedi Starbucks. Il quarto e conclusivo capitolo

contiene delle riflessioni personali sul caso e sul contesto generale. Infine, vengono anche proposti degli approfondimenti sul caso basandosi sulle azioni del progetto BEPS per permettere di comprendere e affrontare situazioni simili in futuro nella maniera più corretta e trasparente possibile.

CHAPTER 1:

AN OVERVIEW ABOUT INTANGIBLES

1.1 THE CONTEXT

Transfer pricing is one of the most important issues in international taxation. Transfer pricing happens whenever two companies that are part of the same multinational group trade with each other. Transfer pricing is not, in itself, illegal or necessarily abusive. What it is illegal or abusive is transfer mispricing, also known as transfer pricing manipulation or abusive transfer pricing. It is estimated that about 60 percent of international trade happens within, rather than between, multinationals: that is, across national boundaries but within the same corporate group. The conventional international approach to deal with transfer mispricing is through the "arm's length" principle: a transfer price should be the same as if the two companies involved were indeed two unrelated parties negotiating in a normal market, and not part of the same corporate structure. If two unrelated companies trade with each other, a market price for the transaction will generally result. This is known as "arms-length" trading, because it is the product of genuine negotiation in a market. This arm's length price is usually considered to be acceptable for tax purposes. The Organization for Economic Cooperation and Development (OECD) have endorsed the "arm's length" principle, and it is widely

used as the basis for bilateral treaties between governments. The Article 9 of the OECD Model Tax Convention is dedicated to the Arm's Length Principle (ALP). But when two related companies trade with each other, they may wish to artificially distort the price at which the trade is recorded, to minimize the overall tax bill. Many companies strive to use the arm's length principle faithfully but many others companies move in exactly the opposite direction. Aggressive intragroup pricing (especially for debt and intangibles) has played a major role in corporate tax avoidance, and it was one of the issues identified when the OECD released its base erosion and profit shifting (BEPS) action plan in 2013. The OECD's 2015 final BEPS reports called for country-by-country reporting and stricter rules for transfers of risk and intangibles but recommended continued adherence to the arm's-length principle.

1.2 DEFINITION

In its simplest form, an 'intangible' is something that belongs to a company but it is not a physical or financial asset (e.g. intellectual property or organizational know-how). Whenever a company's intangible assets are used for commercial purposes by another party, a royalty rate has to be paid (a fixed value or a percentage, depending on the license agreement) of the revenue gained through their use. For such transactions, companies need to carry out a transfer pricing analysis for the estimation of royalty rates or valuation of intangibles, ensuring that their pricing for

related-party transactions is comparable to what it would be if the same transaction were to be made by two or more unrelated parties. Understanding the exact definition of 'intangibles' is important for being able to conduct an effective transfer pricing benchmarking study or ensure a reliable valuation of intangibles. The Organization for Economic Co-operation and Development (OECD) has provided a clear definition of the term. On October 5th 2015, it published "Aligning Transfer Pricing Outcomes with Value Creation", the final report on Action 8-10 of the BEPS project. The report says that the term 'intangible' "is intended to address something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated as if it had occurred in a transaction between independent parties in comparable circumstances" (Paragraph 6.6 of Section A). Even though intangible assets do not add any physical value to companies compared to equipment or factories, they are very valuable to the long-term success of companies. According to OECD research, there has been an immense increase in investment in intangible assets by companies in Europe, Japan and the US, with significant impact on their productivity. This trend is also being seen in the rest of the world. In fact, it has been noted that intangible assets increase the total value of companies.

1.3 CLASSIFICATION

OECD Transfer Pricing Guidelines in chapter VI indicates a number of different items that can be characterized as intangibles for transfer pricing. These include:

- Patents: a legal instrument that grants an exclusive right to its owner to use a given invention for a limited period of time within a specific geography;
- know-how and trade secrets: proprietary information or knowledge that assist or improve a commercial activity;
- trademarks, trade names and brands: a trademark is a unique name, symbol, logo or picture that the owner may use to distinguish its products and services; a trade name may have the same force of market penetration as a trademark;
- rights under contracts and government licenses;
- goodwill and ongoing concern value.

OECD also specifies items that cannot be called intangibles when it comes to transfer pricing, such as market-specific qualities (like local purchasing power), group synergies and assembled workforces. Intangible assets can also be classified into definite and indefinite assets. A great example of an indefinite asset is a company's brand name. It stays with the company for as long as the company continues its operations. A definite asset, on the other hand, would be any asset acquired through a license agreement (for example, a license to operate under another company's name for a set period of time without any plans of extending the

licensing term). The OECD highlights the importance of being specific when it comes to identify intangibles for transfer pricing. It also says analyses should consider things like the way intangibles add value to transactions and interact with other intangible and tangible assets helping to ensure accurate valuation.

1.4 HOW TO EVALUATE INTANGIBLES

OECD has established five Transfer Pricing methods, which are unified under two separate groups: "traditional transaction methods" and "transactional profit methods". Comparable uncontrolled price method ("CUP" method), resale price method and cost plus method belong to the traditional transaction methods; transactional net margin method ("TNMM") and transactional profit split method belong to transactional profit methods. The comparable uncontrolled price method compares the price charged for transferred assets and services in a controlled transaction to the price set up for the same assets and services transferred in an uncontrolled transaction within comparable circumstances. Generally, this method is applicable for almost every type of operation. The second traditional transaction method is the resale price method. This method begins with the price of a product purchased from an associated enterprise which is then resold to an independent enterprise. This price is then decreased by the resale price margin (gross margin) and the received amount is considered as transfer price for the examined transaction. The cost plus method begins with the costs incurred by the supplier of

property (or services) in a controlled transaction for property transferred or services provided to a related purchaser. A cost plus mark up is then added to this cost. As comparable transactions can be used uncontrolled transactions of the examined supplier, as well as uncontrolled transactions between independent parties. The transactional profit methods, by contrast, do not approximate the arm's length price of a specific transaction, but are based on comparisons of net profit indicators. TNMM method examines the net profit relative to a particular base such as assets, costs, sales, etc that a taxpayer realizes from a controlled intra-group transaction. This means in particular that the net profit indicator of the taxpayer from the controlled transaction should ideally be established by reference to the net profit indicator that the same taxpayer earns in comparable uncontrolled transactions. For arm's length test it is preferable to make a comparison of net profit indicator between inspected entity and independent one. The last method is the transactional profit split method which makes a division of profits (or losses) between enterprises involved in the transaction, aiming to eliminate the impact of factors which exists between associated companies and which would not affect independent enterprises. Profits are to be allocated at the same level as they would have been between independent enterprises engaged in the transaction. The tax commission starts its transfer pricing investigation from the perspective of the method used by the taxpayer at the time of the transaction. The taxpayer is in principle free to choose a transfer pricing method, provided that the chosen method leads to an arm's length

result for the specific transaction. The selection of the most appropriate transfer pricing method should be based on a functional analysis that provides a clear understanding of the multinational enterprise's (MNE) global business processes and how the transferred intangibles interact with other functions, assets and risks that comprise the global business. The functional analysis should identify all factors that contribute to value creation, which may include risks borne, specific market characteristics, location, business strategies, and MNE group synergies and take these factors into account in determining the material contribution of each party to the creation of intangible's value, instead of purely split only in intangibles and routine functions. OECD agrees that transfer pricing methods most likely to be useful in matters involving transfers of one or more intangibles are the CUP method and the transactional profit split method but also valuation techniques (including income-based methods such as the discounted cash flow method) can be useful tools; while the resale price method and the TNMM, are generally not reliable methods for directly valuing intangibles as they usually allocate all residual profit, after a limited return to those providing the relevant functions, to the owner of intangibles. Regarding the application of the valuation techniques, OECD points out that the following factors should be appropriately considered:

- Accuracy of financial projections;
- Assumptions regarding growth rates;

- Discount rates;
- Useful life of intangibles and terminal values;
- Assumptions regarding taxes
- Form of payment

OECD further stresses that a price for a transaction involving intangibles can often be identified as consistent with the realistically available options of each of the parties considering that MNE groups seek to optimize resource allocations.

1.5 HARD TO VALUE INTANGIBLES (HTVI)

OECD states that tax authorities should recognize the mechanism which independent taxpayers might also adopt for evaluating intangibles of highly uncertainty at the time of the transaction, which include:

- Adopt shorter-term agreements;
- Include price adjustment clauses in the terms of the agreement;
- Adopt a payment structure involving contingent payments to protect against subsequent developments that might not be sufficiently predictable
- Re-negotiation of the pricing arrangements when there is changes on fundamental assumptions for the pricing.

OECD defines “hard to value intangibles” as those intangibles: for which no reliable comparable exist and at the time the transactions was entered into, the projections of future cash flows or income expected to be derived from the transferred intangible, or the assumptions used in valuing the intangible were highly uncertain, making it difficult to predict the level of ultimate success of the intangible at the time of the transfer. OECD agrees that in these circumstances, the tax administration can consider ex post outcomes as presumptive evidence about the appropriateness of the ex ante pricing arrangements. However, in circumstances where the taxpayer can satisfactorily demonstrate what was foreseeable at the time of the transaction and reflected in the pricing assumptions and that the developments leading to the difference between projections and outcomes arose from unforeseeable events, tax administrations will not be entitled to make adjustments to the ex ante pricing arrangements based on ex post outcomes.

1.6 LEGAL OWNERSHIP OF INTANGIBLES

Many multinational groups employ a strategy whereby any intellectual property developed within the group is transferred into a ‘title holding’ entity or a centralized IP holding company, which is responsible to ensure the legal ownership of the IP is maintained in one centralized entity within the group. Under this structure, the legal owner of the IP charges royalties or licensing fees to other group members for the use of the IP. This is regardless of the fact that the legal owner of the IP may have

had limited involvement in the development of the IP. Under the new OECD Guidelines, where an entity within a multinational group is involved in the development of IP, and that IP is transferred or assigned to a centralized IP holding company, the economic rights associated with the IP do not automatically follow legal ownership. In accordance with the new OECD Guidelines, unless the centralized IP holding entity (the legal owner of the IP) has been economically responsible and exercised control over the development, enhancement, maintenance, protection and exploitation of the IP, the centralized IP holding entity is not the economic owner of the IP. This is despite the fact that it may be the legal owner. In such circumstances, the OECD Guidelines sets out a scenario whereby the legal owner of the IP may have no rights to income associated with the exploitation of the IP (despite owning the IP), which is a significant divergence from how many multinational groups have currently structured their IP dealings. According to Chapter VI of the OECD's revised transfer pricing guidelines, if the legal owner of intangibles or intellectual property has an expectation to retain all profits derived from the exploitation of the intangible, the legal owner must:

- perform all functions;
- contribute all assets;
- assume all risks

related to the development, enhancement, maintenance, protection and exploitation of the IP. If the legal owner of the intangible is economically responsible for all functions, assets and risks with respect to the five above mentioned areas of the intangible lifecycle, the OECD Guidelines indicate the legal owner of the intangible is likely to have the right to expect full rights to any profits derived from the use of that intangible. According to the revised OECD Guidelines on intangibles, where a related party other than the legal owner of the intangible performs activities that could contribute to the value of the intangible, either:

- the legal owner of the intangible needs to fully compensate the related party, on an arm's length basis, for the functions performed, assets contributes and risks assumed in order for the legal owner of the intangible to retain all rights to the profits associated with the exploitation of the intangible; or
- if the legal owner does not compensate the related party for its contribution to the value of the intangible, the related party who contributed that value (i.e. not the legal owner of the intangible) would have rights to some of the profits associated with the exploitation of the intangible. This is by virtue of the fact that, despite not being the legal owner of the intangible, the related party that has contributed to the value of the intangible has become an economic owner of the intangible, with rights to some of the profits generated from its use.

It is clear that one of the objectives of the OECD Guidelines is to match returns generated via the use of intangibles with the functions/assets/risks (and therefore entities) involved in the development of the value within the intangible. In this regard, the OECD encourages multinational groups to look at the economic substance associated with the development, enhancement, maintenance, protection and exploitation of the intangible, rather than the legal structures/ownership associated with the intangible. The OECD cautions against the use of structures that involve the location of a few key personnel in a low/no tax jurisdiction to evidence economic substance, noting that such structures are unlikely to be able to evidence the required decision making, control or assumption of risk to prove economic substance. Nor are they likely to have the development, enhancement, maintenance, protection and enhancement functions/assets/risks associated with the intangible to prove economic substance. In order for a legal entity to assert all rights over the profits associated with the use of an intangible, the OECD notes it should be able to evidence it has assumed all the risks and that it has a financial capacity to cover them.

1.7 DEMPE

Actions 8–10 of the BEPS project by the OECD, released in October 2015, states that the arm's length principle requires that all members of the group receive

appropriate compensation for any functions they perform, assets they use, and risks they assume in connection with the development, enhancement, maintenance, protection, and exploitation (DEMPE) of intangibles. This new guidance material has been developed because most tax authorities and the OECD believe that the transfer pricing of intangibles has long been used as a mechanism for multinational groups to move profits (and therefore tax) from high tax jurisdictions to low/no tax jurisdictions. In its new guidance material, the OECD is seeking to establish a transfer pricing framework for intangibles that will ensure profits associated with the transfer or use of intangibles are appropriately allocated in accordance with value creation. DEMPE is designed to help both taxpayers (including MNEs) and tax authorities achieve an accurate assessment of transactions to help with the determination of appropriate transfer pricing. By identifying the entities that perform DEMPE functions in a transaction, MNEs and taxpayers in general can ensure that they are complying with the OECD's BEPS guidelines. Before the DEMPE concept was introduced, the legal owner of an intangible was entitled to essentially all the returns generated by that particular intangible. Now, however, any income that is generated as a result of that intangible is owned by all the parties that perform the DEMPE functions. Section 6.34 of the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017 outlines six steps for multinational enterprises to follow when analyzing transactions involving intangibles. They help to determine appropriate arm's length prices for transactions

made between associated enterprises. Conducting this analysis is important for accurately determining whether any entities within an MNE are entitled to a portion of the returns gained from the exploitation of a particular intangible. They may have performed functions, used assets or assumed risks in relation to DEMPE of the intangibles. If the DEMPE functions contributed value to the intangible, then the MNE entities will need to be compensated accordingly before a transfer price is delineated. The OECD's six steps for analyzing transactions involving intangibles are as follows:

1. Identify the intangibles and risks within a particular transaction
2. Identify the contractual agreements relating to the transaction in question
3. Identify which parties performed DEMPE functions, by means of a functional analysis
4. Determine whether the conduct of the parties was consistent with the contractual assumption of risk
5. Delineate the actual controlled transactions relating to DEMPE
6. Determine arm's length prices for the transactions.

In the following chapter, I will analyze the Starbucks case which I think it is one of the most interesting and relevant about intangibles.

CHAPTER 2:

THE STARBUCKS CASE

2.1 PILLS OF HISTORY

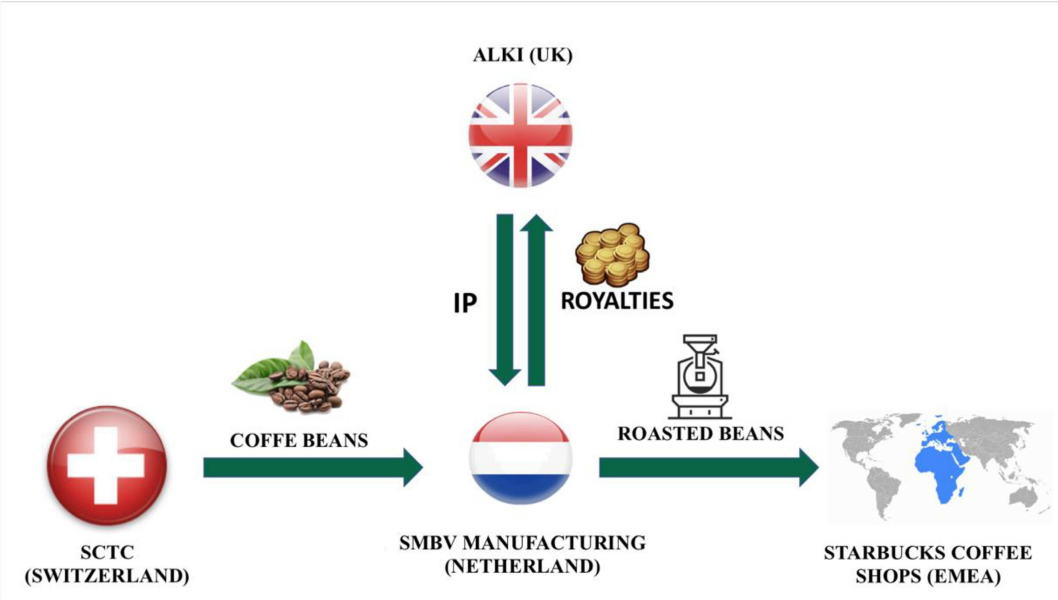
Starbucks is an American coffee chain founded in 1971. It is the largest chain of its kind in the world, with 28720 stores in 78 countries, of which 12000 in the United States. Starbucks stores sell only their own brand of coffee (ground or grain), tea, drinks, pastries, utensils and coffee machines, the company's main goal is to "provide the consumer with an experience", to offer its customers a unique service that will not find in the cafes of another brand. Since March 2012, Starbucks has also arrived in Europe. The last countries Starbucks has arrived in 2018 are Italy and Uruguay. Starbucks is listed on the US NASDAQ stock exchange.

2.2 STARBUCKS STRUCTURE IN EUROPE

Starbucks Manufacturing SMBV based in Amsterdam, is the only roasting company of the Starbucks group present in Europe. It sells, packages and distributes the roasted coffee and the products that are processed by them to all the stores under Starbucks or Starbucks brand in Europe, the Middle East and Africa. The UK-based company, the so-called Alki, is the owner of the IP or the so-called "know how" for the universal roasting process for all Starbucks companies. The last company is

SCTC based in Switzerland that has the task of buying coffee beans from the international market and then selling it within the Starbucks group and to all those who have a Starbucks license. The SMBV company buys green beans from SCTC at a price almost tripled, according to the Commission as we will see later completely unjustified, since profits related to international trade in raw materials such as coffee are taxed at 5 percent in Switzerland, while if this had happened in the Netherlands it would have been taxed at 25%. At the same time, SMBV pays very high royalties to Alki for the use of its intellectual property shifting profits to the United Kingdom where the tax rate is about 24%. But analyzing the profits ended in the UK, they do not stay here long. Indeed, in the period 2013-2015, Starbucks has not registered any kind of profit in the United Kingdom and has therefore paid no income tax and this affects a figure of more than 1.2 billion pounds. Still analyzing the situation in the UK, the average loss of the company in the fiscal years 2008-2010 was on average 37 million pounds despite the sales continued to grow. This is not all, the Dutch authorities impose the payment of taxes for the activity carried out in their territory by Starbucks, however, again here on an average annual turnover of 154 million euro, the average profit of the Dutch tax authorities was about 1.6 millions of euros, close to 1% of the total. This was possible thanks to a price agreement (APA) signed in 2008 between SMBV and the Dutch tax authority. An advanced pricing agreement (APA) is an early agreement between a tax payer and a tax authority on an appropriate transfer pricing method

(TPM) for certain series of transactions in question over a given period of time (calls "Covered transactions"). The APA in question regards the determination of the arm's length remuneration for SMBV for its functions performed of roasting and distribution, and thanks to that, the determination of the royalty payment to Alki for the use of intangibles such as process and distribution know how. The Dutch tax system has a law which states that profits are taxed wherever value is created. Starbucks has exploited this law to its own advantage because intellectual property rights are not found in the Netherlands, therefore fees for the use of these cannot be taxed in the Netherlands. The scheme below will help to understand better the links between these companies:



2.3 UK SITUATION

In Britain, Starbucks has been telling to investors that the business was profitable, even as it consistently reported losses. Accounts filed by its UK subsidiary show that since it opened in the UK in 1998 the company has racked up over 3 billion pounds in coffee sales, and opened 735 outlets but paid only 8.6 million pounds in income taxes. In the period 2012-2015, Starbucks has reported no profit, and paid no income tax, on sales of 1.2 billion pounds in the UK. Presented with the contradiction between Starbucks UK accounts and its comments to investors, Starbucks CFO Alstead identified two factors at play, both related to payments between companies within the group. The first is royalties. Starbucks, like other consumer goods businesses, has taken a leaf out of the book of tech companies such as Google and Microsoft. The fees from Starbucks European units are paid to Amsterdam-based Starbucks Coffee EMEA BV, described by the company as its European headquarters. It's unclear where the money paid to Starbucks Coffee EMEA BV ends up, or what tax is paid on it. The firm had revenues of 73 million euros in 2011 but declared a profit of only 507,000 euros. The UK tax authority, Her Majesty's Revenue & Customs (HMRC), allows companies to deduct intellectual property fees if firms can show the charges were made at "arm's length", that is if companies can show they would have agreed on the terms even if they were not connected. The second factor for the contradiction between Starbucks local accounts and its comments to investors is a requirement to allocate some funds

generated in the UK to other subsidiaries in its supply chain. Starbucks buys coffee beans for the UK through a Lausanne, Switzerland-based firm (SCTC). Before the beans reach the UK, they are roasted at a subsidiary (SMBV) which is based in Amsterdam but separate from the European HQ. It's not clear how Starbucks allocates such costs. What is clear is that Alki is making a loss. Starbucks UK accounts show a third way it cuts its tax: inter-company loans. These are a common tactic for shifting profits to low-tax jurisdictions. Such loans bring a double tax benefit to multinationals: the borrower can set any interest paid against taxable income, and the creditor can be based in a place that doesn't tax interest. Starbucks' UK unit is entirely funded by debt, and paid group companies 2 million pounds in interest last year.

2.4 THE NETHERLANDS SITUATION

The U.K. press and government inquiry led the EU Commission to request on July 30, 2013 to the Netherlands tax authority to provide information on the tax ruling practice in the Netherlands as well as all rulings related to Starbucks Coffee BV and SMBV. On April 12, 2001 SMBV and the Netherlands tax authority entered into an advance pricing agreement (APA) which was adjusted and clarified in 2002 and 2004. That agreement formed the basis of the next APA entered into force on April 28, 2008 to cover a ten year period of October 1, 2007 until December 31, 2017. The APA consists of two elements. The primary element regards the determination

of the arm's length remuneration for SMBV for its functions performed of roasting and logistics/distribution (the "services" element). The secondary element regards a royalty payment to a Starbucks group partnership, Alki, for intangibles such as process and distribution know how and for Starbucks branding. For the roasting and logistics/distribution services element of the APA, Starbucks tax advisor's transfer pricing report describes SMBV as primarily a processor of green coffee that sells roasted coffee to affiliated and non-affiliated parties. SMBV also performs associated supply chain operations ("SCOs"). SCOs consist of green coffee requirements planning, sourcing and buying; coffee roasting and the distribution of roast coffee; the sourcing and supply of other products and supplies. Starbucks and the Netherlands tax administration agreed to treat SMBV like a contract manufacturer, which is known as a "co-packer" within the food industry. The green beans are purchased from Starbucks Coffee Trading Company ("SCTC") in Switzerland which buys those beans for the benefit of the entire Starbucks corporate group worldwide and its independent licensees. More than seventy-five percent of the world's coffee, as a commodity, is sourced and traded via Switzerland intermediaries. Thus, while Switzerland offers the advantage of a low effective corporate income tax rate, it is also the hub of coffee commodities. Starbuck's tax advisor, for the Starbucks transfer pricing report prepared to negotiate the APA, chose to use the transactional net margin method ("TNMM") as the preferred transfer pricing method to benchmark the operating performance of SMBV.

Starbucks and the Netherlands tax administration agreed a remuneration for SMBV, apparently as a co-packer, of a mark-up within a range of nine to twelve percent of SMBV's costs. Starbucks' tax advisor proposed that the underlying costs only for which SMBV performs a value added role should form the basis of the pool for which the markup would be applied. The pool consisted of:

- costs of personnel employed for manufacturing,
- costs associated with its supply chain activities,
- costs of production equipment such as depreciation,
- costs of plant overheads.

SMBV excluded from its cost pool, for purposes of applying the remuneration mark-up, the Starbucks cups, paper napkins, etc., the costs of green coffee beans (cost of raw materials), the logistics and distribution cost for services provided by third parties, the remuneration for activities provided by third parties under so-called "consignment manufacturing contracts", and the royalty payments to Alki. For the royalty element of the APA, Starbucks and the Netherlands tax administration agreed that the "residual profit" remaining after the application of the mark-up would determine the annual license fee due at Alki. After the roasting, Starbucks sold the finished, packaged product to the Starbucks controlled shops and affiliates at a price higher than it paid to purchase. Thus, SMBV's accounting profit each year exceeded its APA remuneration. Consequently, SMBV paid a changing

license fee each year of the residual that depends on the amount of its finished product bought by the group. All these ambiguous facts brought the European Commission to in-depth investigations which will be analyzed in the following chapter.

CHAPTER 3:

THE EUROPEAN COMMISSION'S DECISION ABOUT STARBUCKS

3.1 THE AMBIGUOS CONTEXT

In 2012, the United Kingdom press reported that Starbucks in the previous 14 years had only paid £8.6m of tax. In 2013, a Starbucks tax advisor from Deloitte dismissed the allegation that transfer pricing played a significant role in the reduction of the tax base because he claimed the intra-group charges were relatively small compared to the revenue. He instead put forward that the UK government's Business Secretary, Sir Vince Cable, examined the Starbucks tax situation and discovered that Starbucks was "losing money in the UK because their rents are much higher than some of their competitors and their staff costs are high." Troy Alstead, Starbucks Global Chief Financial Officer, testified to a UK Parliamentary Committee that Starbucks had lost money 13 of the previous 14 years because its occupancy costs in the UK are two and a half times higher than in its US business. He stated that Starbucks UK paid a 20 percent markup on the cost of roasted beans to Starbucks Switzerland's sourcing operation. He also stated that the UK paid a six percent royalty for Starbucks intangibles to a Starbucks licensing company in

Netherlands, of which half was forwarded to the US. He justified the six percent royalty as compensation for the half billion dollar investment of development costs borne primarily in the US and based on Starbucks arms' length agreements with third parties. The U.K. press and government inquiry led the EU Commission to request on July 30, 2013 to the Netherlands tax authority to provide information on the tax ruling practice in the Netherlands as well as all rulings related to Starbucks Coffee BV and SMBV.

3.2 THE INVESTIGATION

The EC has been investigating tax rulings from a state aid perspective since 2013. Following in-depth investigations, the Commission has concluded that the Netherlands has granted selective tax advantages to Starbucks coffee roasting company. A tax ruling issued by the respective national tax authority artificially lowered the tax paid by the company. Tax rulings as such are perfectly legal. They are comfort letters issued by tax authorities to give a company clarity on how its corporate tax will be calculated or on the use of special tax provisions. However, the tax ruling under investigation endorsed artificial and complex methods to establish taxable profits for the companies because it doesn't reflect economic reality**.** As a result, most of the profits of Starbucks coffee roasting company are shifted abroad, where they are also not taxed. This is illegal under EU state aid

rules: tax rulings cannot use methodologies, no matter how complex, to establish transfer prices with no economic justification and which unduly shift profits to reduce the taxes paid by the company. It would give to that company an unfair competitive advantage over other companies (typically SMEs) that are taxed on their actual profits because they pay market prices for the goods and services they use. Therefore, the Commission has ordered the Netherlands to recover the unpaid tax from Starbucks in order to remove the unfair competitive advantage they have enjoyed and to restore equal treatment with other companies in similar situations.

3.3 THE DECISION OF THE EC AND THE DEFENSE BY THE NTA

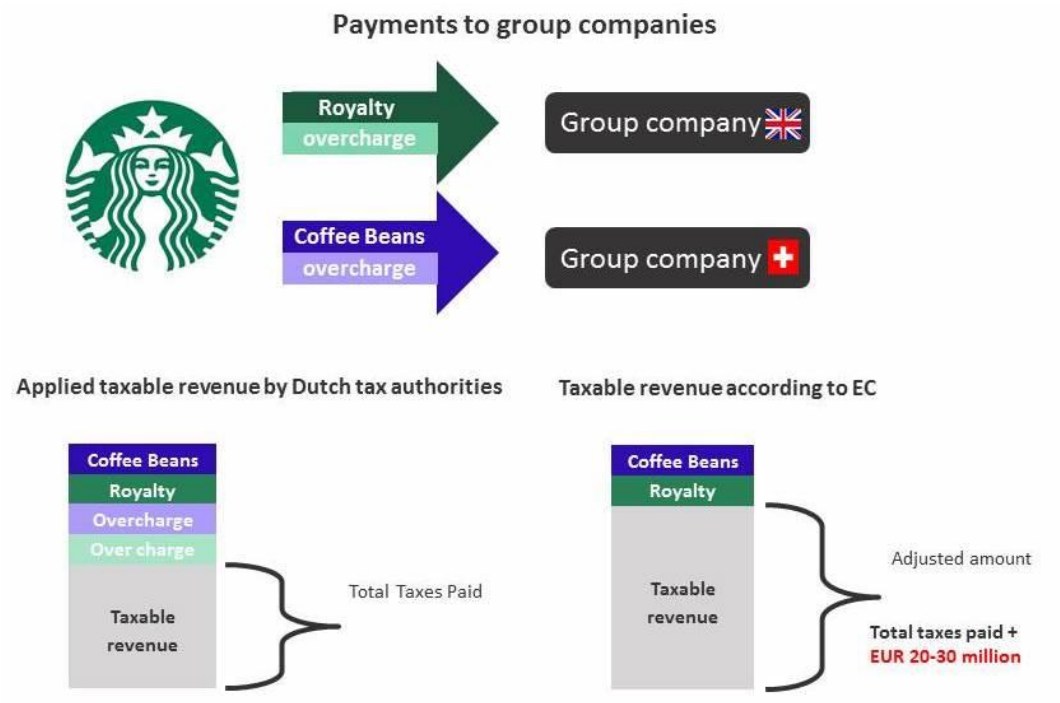
The EU Commission's decision challenges the outcome of the advanced pricing agreement (APA) between the Netherlands Tax Authority (NTA) and SMBV. The Tax Authority responded that within the Dutch tax system profit is taxed where value is created. The Tax Authority concluded an advance pricing agreement (APA) with SMBV which includes an arm's length business remuneration for the roasting of coffee beans. The Tax Authority collects taxes on profit made by SMBV for roasting coffee beans. Because the intellectual property rights of Starbucks are not located in The Netherlands, the royalties for the use of these cannot be taxed in The Netherlands. The Tax Authority, acting in accordance with the international OECD framework for transfer pricing, agreed with Starbucks that it may apply the Transactional Net Margin Method (TNMM) to determine an arm's length result

to attach to its Netherlands based activities. The TNMM requires that members of multinational enterprises be treated as independently operating national enterprises: profits are taxed wherever value is created. The Commission's alleges that Starbucks should have applied the Comparable Uncontrolled Price (CUP) method to each activity of each enterprise instead of the TNMM. However, the Netherlands Tax Authority does not agree that the CUP method should have been applied in the Starbucks case because of the absence of suitably similar, comparable data to the situation of Starbucks operations and value creating activities and assets. The Commission alleges that the methodological choices in the transfer pricing report provided by the tax advisor for Starbucks to the Netherlands Tax Authority, and agreed to in the APA between Starbucks and the Tax Authority, are not a reliable approach to a market result and thereby do not fulfill the arm's length principle. The Commission alleges also that the transactional net margin method (TNMM) is not the most appropriate method to forecast a taxable profit because the OECD guidelines and the Transfer Pricing Decree show a preference for the Comparable Uncontrolled Price Method (CUP). The Commission determined that if the CUP had been applied to Starbucks coffee roasting of SMBV, the taxable profit would be substantially higher. According with the Commission, on the basis of its application of an arm's length transaction price via a CUP test, SMBV would not have been willing to pay any royalty for the know-how to Alki. The Commission's allegation is based upon a comparison of Starbucks agreements for roasting coffee

with other coffee roasters worldwide. Moreover, the Commission contends that the royalties, paid over for many years, cannot be arm's length because SMBV does not appear to gain any business advantage from the use of the intellectual property in the area of roasting coffee. An independent company, argues the Commission, will not pay for a license if it is unable to earn back the royalties paid. Additionally, the Commission contends that payment for royalties does not represent a payment for Alki taking upon itself the risks of SMBV. The Commission dismissed the tax authority argument that Alki bore the economic risk of SMBV's loss of stock. The Commission points to Alki's lack of employees as justification that Alki's capacity is too limited to actually bear such risk. Finally, the Commission dismissed Alki's payment for technology to Starbucks US as a justification of its royalty payment from SMBV. Moreover, the Commission contests that SMBV overpays Starbucks coffee sourcing operation in Switzerland (SCTC) for the acquisition of 'green beans', which are then roasted by SMBV and distributed to Starbucks various national operations. The purchase price of green beans paid by SMBV to SCTC is abnormally high and therefore does not comply with the arm's-length principle. The Commission alleges that Starbucks did not use an arm's length relationship for the transactions between SCTC and SMBV. Secondly, the Commission did not accept Starbucks underlying grounds for the justification of the significant increase from 2011 of the mark-up in the costs for the green beans supplied by SCTC. Starbucks contends that SCTC's activities became increasingly important

from 2011 partly due to the evolving "C.A.F.E. Practices" program. The Coffee and Farmer Equity (C.A.F.E.) Practices is based on developing standard to ensure that Starbucks is sourcing sustainably growth and processed coffee. Starbucks defines sustainability as an economically viable model that addresses the social and environmental needs of all the participants in the supply chain from farmer to consumer. Comparing the costs of similar fair-trade programs, the figures provided by Starbucks in connection with its C.A.F.E. Practices program, argues the Commission, are problematic both in terms of consistency as well as the arm's length nature. The Commission contends that the tax authority should have rejected the additional deduction from the accounting profits. Moreover, the increased mark-up can be connected directly to the losses incurred by SMBV's coffee roasting activities since 2010, which highlights the non arm's length relationship of this mark-up. In its coffee roasting function, the Commission contends that SMBV does not only carry out routine activities but it conducts market research. Also, SMBV holds significant intellectual property reflected by the amortization of intangible assets in its accounts. Moreover, SMBV performs an important resale function. A contract manufacturer (as Starbucks and the national tax authority decided to consider SMBV) is not involved in such activities. In the end, the European Commission has decided that the Netherlands provided state aid to Starbucks Manufacturing. The EU Commission ordered to the NTA to recapture for the previous ten years the profit difference between what the Commission determined

is an arm's length arrangement and the APA arrangement and to levy the appropriate Netherlands corporate tax rate. The NTA has appealed to the European Court of Justice that its APA with Starbucks is arm's length. The EC has ordered the Dutch State to recover the aid granted to the Dutch Starbucks group company (Starbucks Manufacturing EMEA BV), which is estimated to be between € 20 – 30 million. The Starbucks decision has been widely reported in the national and international press. The case may become an important reference point in future discussions on the tax treatment of cross-border transactions by companies in EU member states. This decision will be very important in the future, in fact, although the amount requested by Starbucks barely reaches 0.1% of profit in the fiscal year 2015, it has introduced a new principle that will be used for the next years: "Tax rulings cannot use methodologies, no matter how complex, to set transfer prices without economic justification and unduly shift profits to reduce taxes paid by companies". This decision shows, and in a certain way enforce, the legal uncertainty that surrounds the transfer pricing discipline putting into question the interpretation of the OECD transfer pricing guidelines of the Member States tax authorities. The Commission introduced with the Starbucks case, principle as: "artificial and extremely complex", "economically unjustifiable" and "not reflecting market reality". The following scheme is useful to understand the situation more easily:



SOURCE: http://www.stibbeblog.nl/all-blog-posts/public-law/the-european-commission-orders-the-recovery-of-at-least-e-20-million-from-starbucks-due-to-alleged-state-aid/

3.4 AN INSIGHTS ON THE PAYMENT OF ROYALTIES

The most interesting and useful part of the European Commission's decision for my analysis, it is the one about the payment of royalties from SMBV to Alki. That royalty is calculated as a residual in the profit and loss account. When constructing the profit and loss account of SMBV, all the input figures other than the royalty are either observed or assumed to be priced at arm's length. Based on the pricing agreed in the SMBV APA, a taxable profit (the position "Result before taxation" in Figure below) is calculated at approximately [9-12] % of SMBV's operating expenses (the

position "General and administrative expenses" in Figure). However, as the position "Sales" in Figure minus all the accounting costs before the royalty payment do not sum up to this taxable profit calculated based on the SMBV APA, the excess profit beyond that [9-12] % mark-up is paid by SMBV in the form of a tax deductible royalty to Alki for the coffee roasting related IP (the position "Other expenses" in Figure). Based on SMBV's accounts, the royalty payment thus takes place as determined by the SMBV APA issued by the Dutch tax administration. The figure below is taken from the Commission's analysis and it is about the profit and loss account of Starbucks for one of the years took in consideration and it is important to clarify better the situation.

Starbucks Manufacturing EMEA B.V.
Amsterdam

Profit and loss account for the year ended October 2, 2011

	2010/2011 EUR		2009/2010 EUR
Sales	184.159.097		142.627.243
Direct Cost of sales	(153.275.834)		(120.020.824)
Gross margin	30.883.263		22.606.419
General and administrative expenses	(14.303.059)	Operating Expense	(16.835.153)
Foreign currency exchange	(2.089.448)		(2.266.492)
Operating result	14.490.756		3.504.774
Other expenses = Royalty	(12.352.838)		(1.079.817)
Interest income			
Interest expense	(707.298)		(771.639)
Result before taxation	1.430.620	Taxable profit	1.653.318
Corporate income tax	(337.599)		(428.611)
Net result for the year	1.093.021		1.224.707

[9 – 12%] mark-up

SOURCE: http://ec.europa.eu/competition/state_aid/cases/253201/253201_1762441_575_2.pdf

In response to the Commission's doubts on the arm's length nature of the royalty payment, the Netherlands and Starbucks claimed that that payment does not only reflect a remuneration for the use of the IP, but also a payment for the taking over of entrepreneurial risk by Alki. The Netherlands invokes the fact that SMBV would not carry the economic risk of loss of inventory because those costs are ultimately borne by Alki. In the present case the determination of SMBV tax base in the Netherlands influences the royalty payments to Alki as the royalty corresponds to any profit recorded by SMBV above [9-12] % of operating expense as agreed by the SMBV APA. Starbucks sets out the role of Alki against the role of SMBV. Starbucks argues that since SMBV is only engaged in routine execution activities in the areas of roasting, packaging and supporting logistic and administrative services, while Alki licenses the valuable intellectual property and bears the entrepreneurial risk, SMBV is the least complex entity. Therefore, using the TNMM method, SMBV is the "tested party" (the party to the transaction for which a financial indicator is tested and the one with the less complex function). In one-sided transfer pricing methods such as the TNMM, only the remuneration of the "tested party" is analyzed for transfer pricing purposes, regardless of the resulting remuneration of the other parties to the transaction. On the assumption that SMBV is the "least complex function" in the relationship between SMBV and Alki, Starbucks tax advisor took SMBV as the "tested party" and did not consider whether the residual profit allocated to Alki is in proportion to Alki's functions,

risks and assets. Starbucks justifies that choice on the grounds that SMBV does not own valuable IP and does not incur meaningful business risks in performing routine activities; SMBV would therefore be the least complex entity in that relationship. So according to Starbucks, since there are no comparable transactions similar to the arrangement between Alki and SMBV, the CUP method would not have been suitable for transfer pricing purposes. Finally, the Commission contests that the tax advisor thus inappropriately used operating expenses instead of sales as profit level indicator in the application of the TNMM. A functional analysis based on SMBV's reselling function and a remuneration based on margin of sales would have led to a higher level of remuneration. In the case of SMBV, the royalty paid to Alki is classified as an operating expense, but it is excluded from the operating expenses used to calculate the taxable income according to the SMBV APA. After having analyzed the situation from the point of view of the Commission, the tax authority and Starbucks, I will present in the next and final chapter my conclusions about the case and some suggestions to deal with similar cases in the future in a better way.

CHAPTER 4:

CONCLUSION

In the Starbucks case, the EU Commission has decided that they have the authority, under a State Aid premise, to step into the shoes of the national tax authority and re-allocate profits of an enterprise according to their interpretation and analysis of the arm's length concept. The EU Commission's finding of a range of two – three Euro million annual difference from its own assessment of the scenario versus the assessment of the Dutch tax authority reflects its trepidation (for an MNE like Starbucks, 20-30 million is a very modest amount) and it will cause confusion and uncertainty among tax authority of member states, among trade partners and the underlying enterprises subject to their audit authority. The EU Commission have also chosen to apply this new approach retroactively rather than only prospectively. But it is important to highlight that the Commission doesn't have an easy life fighting against tax evasion because in this sector there is a "race to the bottom" war. It means that many countries compete to provide certain tax breaks in their tax policies. The purpose is to fight over the investment of the multinational companies to invest in their country. Multinational used this chance to choose which country offers the best benefit for them to lower their global effective tax rate. Aggressive tax planning and race to the bottom competition led to an unfair BEPS. The tax

ruling offered by Netherlands tax policies gives the chance to Starbucks to minimize the tax bill. As a result, Starbucks make decision to place its Europe Middle East and Africa (EMEA) headquarters in Netherlands. To prevent harmful tax practices, each country should be transparent each other about their tax ruling and domestic taxed rules. Special tax ruling offered by Dutch tax authority to Starbucks could give them the chance to generate double non-taxation. Since advance pricing agreement (APA) is recommended for certainties in tax between tax payer and tax administration, there is nothing wrong about tax ruling with Starbucks when the ruling is consistent with arm's length principle. But special tax ruling also needs to be made in international basis. Make deals with multinational companies is not only a business of one company to one country, but it will affect other countries through its special relationship between related parties placed in other countries. For example the Dutch government offer a very low tax ruling to Starbucks and other multinational companies to attract them to invest in the country. In the end, there is a reduction of the global tax bill by all parties involved which harms competition, efficiency, transparency and fairness. Since the transacting companies are part of the same multinational company, transfer prices and the allocation of profits across subsidiaries have no effect on the total gross profit reported in the consolidated financial statements for the entire corporation. However, transfer prices and the allocation of profit across subsidiaries in multiple tax jurisdictions can substantially affect the total income tax paid by a multinational

company, and thus its consolidated net income. It can also affect the amount of income tax that a multinational company pays in individual countries. All this situation generates the notion of "stateless income": income derived for tax purposes by a multinational group from business activities in a different country than the domicile of the group's ultimate parent company, which is subject to tax only in a jurisdiction that isn't the source of the factors of production through which the income was derived. The problem is that a subsidiary can "own" intangibles developed originally by the parent and use them to commercial purposes without subjecting the income thereby generated to tax where the business and customers actually are located and, in this way, the base erosion cannot be addressed unless the OECD member states dismantle their traditional conducts to such non-commercial modes of business organization. If Europe wants to fight these harmful tax practices, each country should start to ensure transparency, particularly with regard to their tax rulings. OECD and G20 countries have taken joint action to address the weaknesses within the international tax system that create opportunities for base erosion and profit shifting (BEPS). They have developed a comprehensive package of measures to tackle BEPS: the BEPS package, as said in the introduction of this thesis. The BEPS report has been delivered in 2015, it consists on 15 actions and I have found out that some of these (action 2,3,4,8) are strictly related with the Starbuck case, so it is interesting to analyze them in order to understand how to avoid similar situation in the future. Action 2 develops model treaty provisions and

recommendations regarding the design of domestic rules to neutralize the effects of hybrid instruments and entities. Indeed, as in the Starbucks case, rules that allow taxpayers to choose the tax treatment of certain domestic and foreign entities could facilitate hybrid mismatches. In the case of Starbucks, the situation was that: UK domestic law requires companies making payments of patent, copyright, and design royalties that arise in the United Kingdom to deduct withholding taxes at 20%. But, for an international tax treaty between UK and the Netherlands the withholding taxes on royalties are zero. Which means UK Her Majesty's Revenue and Customs (HMRC) will not charge withholding taxes on the royalty paid to the Netherlands's Starbucks EMEA Headquarter. On the other hand, there is a special tax ruling between Starbucks EMEA BV with the Dutch tax authority on royalties, which provide Starbucks a very low tax rate. The final result is a reduction of the global tax bill as a consequence of this hybrid mismatch arrangements. Action 3 sets out recommendations to strengthen the rules for the taxation of controlled foreign corporations (CFC). Indeed, taxpayers could have no incentive to shift profits into a third, low-tax jurisdiction. In this regard, the Starbucks subsidiary in Switzerland was created to be a coffee beans distributor, buying and sell coffee beans to all Starbucks manufacturing. The small activity made by Switzerland subsidiary cannot be compared to the activities in UK. Yet, Switzerland subsidiary earns much more and pays more tax than UK subsidiary. It is not surprising that corporate income tax rates were similar in the UK and the Netherlands (24 and 25 percent,

respectively), but in Switzerland, profits from international commodity trades were taxed at 5 percent. Even though the mark-up price charged by Switzerland subsidiary has been consistent with the arm's length principle, the fact that it caused a loss in another subsidiary was not fair and that is the reason why I think that the implementation of this action is very relevant. Second, Starbucks Corporation charged 6% royalty (use of Starbucks brand and trademark, rights to "the highest quality and ethically sourced Arabica coffee," expertise in store operations, use of the Starbucks proprietary business model and store design concepts) on its sales for each subsidiary and licensed stores which was the highest royalty rate compared to the competitors. In EMEA cases, half of royalty goes to EMEA headquarter placed in Netherlands, and half goes to US parent company through Netherlands. Action 4 outlines a common approach based on best practices for preventing base erosion through the use of interest expense. Even in this field the connection with the Starbucks case is immediate. Starbucks company in UK had reported losses for more than 15 years but had survived thanks to debt, it means thanks to inter-company loans (loan from US parent company). The unusual thing is that Starbucks US charge its UK unit at Libor +4% (London Interbank Offered Rate, serves as a globally accepted key benchmark interest rate that indicates borrowing costs between banks) while KFC charges its subsidiary at Libor +2% and McDonald charges its subsidiary at below of Libor rate. Based on this, I think that limitation regarding deductible interest from the taxable income should be more effective.

The final action that I considered is the number 8 which contains transfer pricing guidance to assure that transfer pricing outcomes are in line with value creation in relation to intangibles. The problem in valuing intangibles is that you can't clearly evaluate the future economic benefits that it can bring from the sale of products or services. Since there are no certain rules regarding how to value intangible assets, the development of some fix standards in valuing them could be helpful to avoid future disputes like the one between the Commission and Starbucks.

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