Tax Analysis and Profit Shifting Starbucks Corporation

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Abstract: This research is an analysis of tax avoidance case and profit shifting Starbucks Corporation. The selected case analyzed its tax avoidance structure and analyzed whether current tax measures in Indonesia could prevent tax avoidance structure such as that of Starbucks Corporation. This research aims to analyze the structure of tax avoidance and transfer pricing conducted by Starbucks Corporation and analyze what regulations can be applied by Indonesian tax authorities if such cases occur in Indonesia. This research is a qualitative research with literature study approach. The results of the study found that Starbucks Corporation made profit shifting by marking up the price of coffee, thin capitalization through high lending rates between group companies, royalty fees and from this research resulted the conclusion that the existing tax policies and policies in Indonesia enough to overcome the structure of tax evasion with a scheme like the one done by Starbucks Corporation but it is necessary to add rules governing rate valuation royalty.

1 INTRODUCTION

This research is important to conduct because it can provide knowledge about profit shifting schemes especially with transfer pricing and thin capitalization scheme as do by multinational company Starbucks Corporation. This research refers to the previous research which analyze “Tax Regulation of Thin Capitalization Transactions in Indonesian Tax Law”. Previous research has only conducted an analysis of the thin capitalization regulations in Indonesia and in some countries while the current research, the analysis focuses on profit shifting with transfer pricing, thin capitalization schemes and Indonesian tax rules that can be applied to prevent the occurrence.

In the current era of globalization, trade relations between countries with one another are increasingly open and no longer recognize national borders. In some countries, this international trade plays an important role in increasing Gross Domestic Product. Within the scope of taxation, this international transaction raises its own problems. This relates to the country of source of income, the subject of income tax, and which country obtains the right to taxation on that income.

Each country may tax the income from the transaction. The source country (the country in which the income is earned) may impose a tax because there is a close relationship between countries and transactions that provide income. This is in line with the logic that the country in which the tax subject transacts has provided a place, the resources so that the tax subject can earn income. So this is the reason why the source country can impose a tax on that income, which is known as the benefit theory of taxation. (Darussalam, 2010)

On the other hand, the country in which the tax subject is established or domiciled, resident may also impose a tax on income derived from abroad by the domestic tax subject. State where the tax subject is established or domiciled, domiciled or resident is referred to as a domicile country. The relationship of taxation rights to a country resulting from the related tax subject matter is named as a personal attachment.

In addition to revenue from international trade, the state also gets tax revenue from global investment. Countries compete to get global investment because the competition between countries is very tight. For this reason, to win the competition, there are certain countries that are willing to provide excessive tax incentives by providing tax free or tax facilities at a very low rate (low tax rate), the guarantee of confidentiality of information (secrecy of information), and the availability of a highly sophisticated financial infrastructure. This group of countries is known as tax haven countries.

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Due to the varied tax treaty facilities between countries, investors are encouraged/ interested in doing treaty shopping to get the most profitable incentives for their business. Investors actions can be categorized as "against the law" because they are conducted solely to enjoy the benefits of tax facilities and are contrary to the purpose of providing such incentives.

In addition to tax treaty, vacancy tax regulations can also be used by companies to avoid taxes to be paid. The company takes advantage of this empty gap by creating sophisticated financial transaction schemes in the context of tax avoidance.

In international taxation, there are various schemes commonly used by multinational companies in order to make tax savings (Anang Mury, 2015, p. 4): (1) transfer pricing; (2) thin capitalization; (3) treaty shopping; (4) controlled foreign corporation; and (5) special purpose company.

Many multinational corporations do tax avoidance by using transfer pricing schemes. Transfer pricing is usually done with the aim of minimizing the tax burden of the company, usually multinational companies apply it by way of determining the subsidiary in the country where the cost center or profit center. Usually a subsidiary in a country whose tax rate is lower that will be profit center and vice versa. In this way, the company can adjust the tax burden that will be paid.

Multinational companies do transfer pricing by conducting transactions between groups of companies, such as royalty payments, goods/services sales transactions, debt lending, and so on. The price of transactions applied to these transactions sometimes costs below the market price.

The object of research is tax avoidance and profit shifting conducted by Starbucks with transfer pricing. For three consecutive years (2008-2010) Starbucks UK claimed a big loss but different things delivered to investors in the United States. For 14 years Starbucks has been doing business in the UK, Starbucks only paying a total tax of £ 8.6 million. (Reuters, 2012).

Because of this, Starbucks UK is suspected doing unaccepted tax avoidance by paying a royalty to Starbucks Holland called Starbucks Coffee EMEA BV while Starbucks Coffee EMEA BV's headquarters is based in the UK, besides that British Starbucks buys coffee beans from Swiss-based Starbucks unit which is then roasted and distributed to Starbucks UK at a price already marked 20%, and Starbucks UK said to finance all its efforts with debt loans from other Starbucks subsidiaries, it causing Starbucks UK to pay substantial interest expense to the subsidiary. Therefore, Starbucks UK was showered with criticism and judged to have committed an immoral act. Tax authorities in the UK require Starbucks to pay its taxes.

In accordance with the background that has been described above, then the issues to be raised are as follows: (1) What is the tax avoidance and profit shifting structure undertaken by Starbucks Corporation? (2) How can Indonesia avoid the possibility of tax avoidance when a case like Starbucks Corporation happens in Indonesia?

2 LITERATURE REVIEW

The purpose of the company is to get profit as much as possible so that tax is considered as a burden for the company. Therefore, many companies, both domestic and multinational companies will always try to minimize the tax burden either legal or illegal. Efforts to minimize this tax can also be called tax avoidance. Although tax rules have been established, a regulation usually selects a loop hole that is ultimately used by tax subjects (multinational companies) in the interest of its economy.

According to Brian J. Arnold (2015), "Tax avoidance is a transaction or arrangement by a taxpayer to minimize the amount of tax to be paid but in a manner consistent with the legal corridor.

Meanwhile, according to Mohammad Zain (2008), citing the opinion of Ernest R. Mortenson, tax avoidance with regards to the arrangement of a transaction or condition to minimize the tax burden to be paid by the company with regard to or take into account the consequences. So tax avoidance is a false act because it is done in a way that is not contrary to the law.

Meanwhile, according to Roy Rohatgi in his book Basic International Taxation (2005, p. 332), tax avoidance is defined as follows:

> "Tax avoidance implies that a tax payer has arranged his affairs in such a way that his tax burden is less than it would otherwise have been, or that no tax is payable because of such arrangement.

In many countries, tax avoidance schemes can be divided into 2 (Darussalam, 2010, p. 197): (1) acceptable tax avoidance or commonly called defensive tax planning; and (2) unacceptable tax avoidance or commonly also called aggressive tax planning.

There are several factors that influence/encourage the occurrence of profit shifting as quoted from

Bawono Kristiaji (2015) is the differences of tax rate and the emergence of tax haven countries.

2.1 Differences of Tax Rate

In this era of globalization, every company competing for each other's market. This is not just happening to multinational companies alone, countries also compete to get capital investment in their respective countries. Each country needs investment for development and progress country. In order to achieve these objectives, every country is trying to earn its income through tax income. Each country must have its own taxation provisions with different tax rates.In order to get an investment, eventually each country mutually offer low tax rates to attract foreign investors.In the end this is beneficial for foreign investors.

Because of this varied tax rate offer, multinational companies are encouraged to make profit shifting to countries that offer low tax rates and profitable for the company so that tax avoidance happens.

2.2 Tax Haven Country (THC)

Another factor that affects the occurrence of profit shifting is the emergence of tax haven country. The OECD says that the THC is "a country which imposes a low or no tax, and is used by corporations to avoid taxes that otherwise would be payable in high tax country. According to Barry Larking, the definition of Tax Haven Country is "a place where tax is levied at low tax rate or not at all, or where it is hard for foreign jurisdictions to access information about citizens taxable income.

According to the OECD, some tax haven country characteristics are: (1) low-cost or no-tax-only taxes (no or only nominal taxes); (2) lack of exchange of information (lack of effective exchange of information); (3) lack of transparency; (4) no meaningful economic activity (no substantial activities). There are several popular ways that multinational companies can shift their profits by:

2.2.1 Manipulating transfer pricing

Transfer pricing is one of the international tax issues facing multinational companies today (paragraph 11 OECD Transfer of TP Guidelines, 2017). According to the OECD, transfer pricing is the price at which a company transfers/delivers tangible or intangible goods or services to its affiliated companies.

According to Gunadi (2007), transfer pricing is the amount of price on the delivery of goods/services agreed by both parties in a business transaction in which case both parties have a special relationship.

According to Carmine Rotorando (2000, p. 2), a special relationship is a major point for the tax authorities to be able to distinguish whether a sale transaction is likely to manipulate transfer rates or not. A country's tax authority has the authority to make corrections to transactions that do not reflect fair prices during which the transactions are related parties.

2.2.2 Shifting their debts

According to Prof. Dr. Gunadi, 2007, p. 279, thin capitalization is an act of financing larger subsidiaries using interest-bearing debt from related companies rather than funding with share capital.

Thin capitalization is done through a tendency to finance its subsidiary by granting loans by a parent company to a subsidiary domiciled in another country compared to a capital payment on the grounds that the interest expense on the loan may be deducted from the taxable income of the subsidiary receiving the loan. (Hutagaol, 2007)

3 RESEARCH METHODS

The research approach is a case study approach because it intends to analyze what phenomenon experienced by the research subject. The unit of analysis used is single case in single unit. Based on the purpose, this research is qualitative and descriptive research which aims to give an analysis about a problem as clear as possible and provide an overview of a problem solving or solution to an existing problem. Based on the benefits, this research includes pure research oriented to science and is expected to contribute to education. Methods of data collection in the form of literature study by reading books or literature, journals and papers related to the subject of research problems.

The selection of research with case study approach is also based on the consideration that the researcher wants to give an idea how the issue of transfer pricing for transactions between subsidiaries in multinational companies and how the solution is solve if such problems occur in Indonesia.

Data collection methods used by the researcher is qualitative data with secondary data types derived from reading books or literatures, journals and papers related to the subject matter of research that is about

transfer pricing, tax avoidance, and thin capitalization.
According to Miles and Huberman, there are 3 techniques in analyzing data, namely:

1. Data reduction
   Data reduction is the process of selecting and classifying / categorizing data.
2. Presentation of data
   Presentation of data is a way of presenting data, for example in the form of narration, images, graphics, charts, and others.
3. Conclusion
   The conclusion is the process of concluding from the analysis that can be used as the solution of the problem.

4 ANALYSIS AND DISCUSSION

Starbucks has opened its business in the UK since 1998 and has opened 800 outlets, but Starbucks pays only £ 8.6 million in taxes. The amount is very small, considering Starbucks is the second largest restaurant after McDonald's in UK which was followed by KFC who finished third. The tax paid by McDonald's UK is £ 80 million, 10 times larger than Starbucks and, by comparison, KFC pays taxes in the UK £ 36 million. This is one of the background of the Starbucks tax case in the UK revealed. (Bergin, 2012). For 3 consecutive years (2008-2010), Starbucks UK admitted suffered considerable losses. This loss is caused by enormous operating costs. Starbucks's operating expenses consist of royalty fees, interest payments on loans.

In 2008, Starbucks posted a gross profit of £ 77.8 million and net pretax loss on ordinary activities of £ 26.3 million, but CEO Schultz told investors in the United States that units in the UK had profits to fund Starbucks expansion at other overseas markets. In 2009, Starbucks posted a gross profit of £ 69.7 million and net pretax loss on ordinary activities of £ 52.2 million, but CFO Alstead told investors in the United States that a UK unit was "profitable".In 2010, Starbucks posted a gross profit of £ 76.7 million and also recognized profit loss after administrative expenses of £ 25.7 million and net pretax loss on ordinary activities of £ 34.2 million, but Starbucks told investors that sales continue to increase. In 2011, Starbucks still claimed losses, but John Culver (head of the Starbucks International division) told analysts that "we are very pleased with the performance of business units in UK." These statements are in stark contrast to the financial reports reported by Starbucks UK.

When the media tried to confirm the statement, Starbucks issued a statement very different from the previous statement, the Starbucks stated that the unit in UK is very disappointing and is trying to improve the condition of business units in UK.

Table 1. Fact versus Starbucks UK Reports to the UK Tax Authority

Fact on NASDAQ	**Version of Starbucks UK**
Reuters interviewed 46 Starbucks investors in the US as well as stocks analysis, it turned out that Starbucks UK is big profits. For 3 years Starbucks reported sales of up to £ 1.2 billion. Peter Bocian as Starbucks CFO at the time, it was revealed that the profits from business units in the UK so massive, so the funds can be used to finance the expansion of Starbucks in other countries	Report to UK taxpayer, Starbucks claimed their business in Britain was losing frenzy. In 2008, they claimed a loss of up to £ 26 million and in 2009 again lost £ 52 million, and in 2010 suffered another loss up to £ 34 million. The total loss reported by Starbucks for three years was £ 112 million.

According to a report from Reuters and the House of Common, there are 3 focus points on allegations against Starbucks UK which stressed that Starbucks UK has made a substantial payment to the group of companies to deliberately make losses in the UK that is (Kleinbard 2013): (1) royalties and license fees paid to a Dutch affiliate; (2) mark-ups of coffee beans purchased through other Dutch affiliates and Swiss affiliates; (3) interest paid on a loan from Starbucks Group.

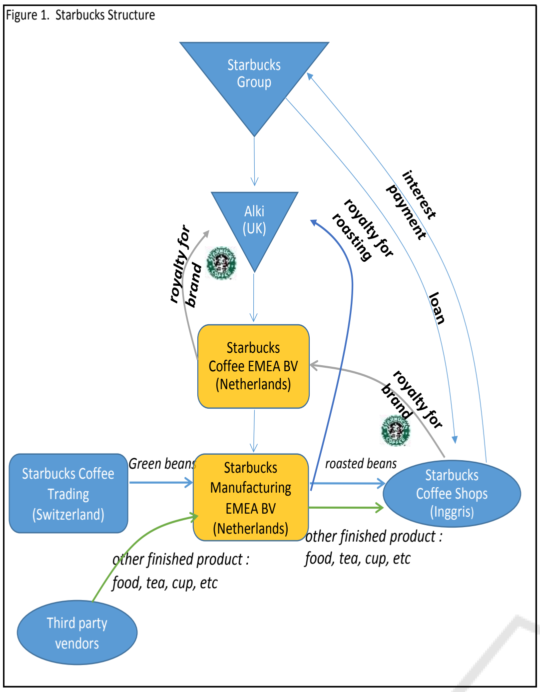

Figure 1: Starbuck Structure

4.1 Starbucks UK's Tax Avoidance and Profit Shifting Scheme:

One of the factors that cause Starbucks UK losses is the payment of royalty fees. During running its business, Starbucks UK has to pay a royalty fee to Starbucks Coffee BV (Amsterdam) based on a percentage of total sales. This is one element that enlarges the nominal loss of Starbucks. The royalty fee Starbucks UK pays to Starbucks Coffee BV (Amsterdam) is 6% of total sales, this percentage is quite high when compared to similar businesses. The royalty fee paid by McDonald's UK is only 4%.

In addition to royalty fees, there are other factors that cause losses on Starbucks UK. Starbucks UK pays other operational costs of buying roasted coffee beans, coffee beans purchased from SMBV. To analyze whether the price of coffee beans purchased by Starbucks UK is reasonable or not, it is necessary to do value chain analysis as follows:

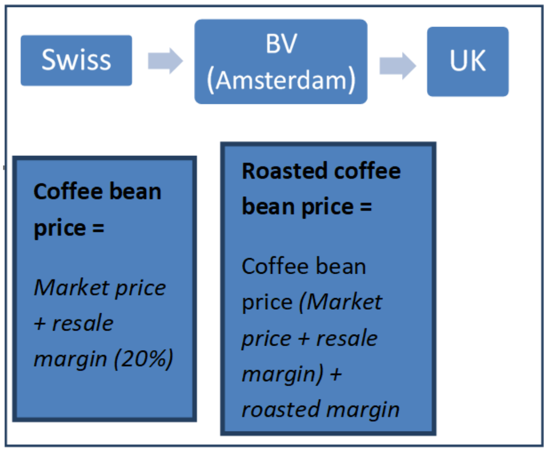

Figure 2: Value Chain Anlysis

From the above value chain analysis, it can be seen that the coffee beans used by Starbucks UK are purchased from Starbucks affiliated companies in Switzerland that have been mark up 20%, then the coffee beans are roasted by SMBV that located in Amsterdam which price has been added with the roasting service fee then distributed to Starbucks UK. This is the way to make the cost of buying coffee beans paid by Starbucks UK to be very high and allegedly there is manipulation of the transfer price of coffee beans.

Starbucks said the transfer price is in accordance with the principle of fair price (arm's length). To test whether the added margin resale at the price of the beans is reasonable, it is necessary to benchmark some coffee trader companies. In addition to testing the margin resale, benchmarking of some similar companies that provide coffee roasting services is necessary to see if the mark up is added to normal roasting services. From benchmarking results can only be determined whether the price of coffee beans purchased by Starbucks UK reasonable or not.

The last factor that causes losses to Starbucks UK is interest payments on loans provided by Starbucks Group. Starbucks UK further confirmed its loss by stating that its business operations have been almost entirely funded by the debt of the Starbucks Group. The interest charged to Starbucks UK is + 4% from LIBOR, the interest rate is quite high when compared to the 2% interest rate of McDonald's.

STARBUCKS COFFEE COMPANY (UK) LIMITED

NOTES TO THE FINANCIAL STATEMENTS
FOR THE PERIOD ENDED 28 SEPTEMBER 2008 (continued)
6. INTEREST

	Period ended 28 September 2008 £	Period ended 30 September 2007 £
Bank interest receivable	419.553	319.937
Bank interest payable	(92.278)	(43.511)
Interest payable to group companies	(3.900.372)	(1.321.916)
Interest payable	(3.992.650)	(1.365.427)

Interest on borrowings from group companies is calculated at LIBOR (one year rate) plus 4% as adjusted for changes in LIBOR each fiscal quarter

Figure 3: Details of Interest Expenses paid by Starbucks UK 2007 - 2008

STARBUCKS COFFEE COMPANY (UK) LIMITED

NOTES TO THE FINANCIAL STATEMENTS
FOR THE PERIOD ENDED 03 OCTOBER 2010 (continued)
6. INTEREST

	Period ended 03 October 2010 £	*Period ended 27 September 2009* £
Bank interest receivable	18.130	192.644
Interest receivable from third parties	15.463	-
	33.593	192.644
Third party interest payable	(31.364)	-
Interest payable to group companies	(4.630.489)	(6.266.908)
Interest payable	(4.661.853)	(6.266.908)

Figure 4: Details of Interest Expenses paid by Starbucks UK 2009 - 2010

4.2 The Tax Policy on Starbucks Decided by the European Commissions to Obtain State Revenue Optimally

In examining the case of Starbucks Corporation, the European Commissions (EU) has made several comparison of Starbucks transactions with similar companies (Starbucks Co. competitors). The EU compares the royalty fees paid by SMBV to Alki LP for a coffee roasting license with several Starbucks competitors namely Company Y and Alois Dallmayr Kaffee oHG. Company Y that does the same roasting activity as Starbucks says it does not pay any royalties to its group to find out how to process roasting. Likewise Dallmayr says that royalty payments by companies that roast coffee beans are unusual (odd), because usually buyers of roasted coffee beans will pay to a coffee grill company instead of the other way around.

Therefore the EU through Article 16 (1) of Regulation no. 2015/1589 establishes the obligation of the Commission to order the restoration of unlawful and inappropriate aid. The provision also provides that the Member State concerned shall take all necessary measures to recover any unlawful assistance which is found to be inappropriate. Article 16 (2) of Regulation No. 2015/1589 provides that such assistance should be recovered, including interest from the date of the unauthorized removal to the effective date of its recovery.

The recovery methods applied to Starbucks are as follows:

1. The transaction comparison method used to check whether it is in accordance with the principle of fairness is the CUP method.
2. According to the comparison of transactions with the CUP method with several independent independent companies, it is found that SMBV does not need to pay the royalty fee to Alki LP for the coffee roasting license.
3. Upon the above decision, the tax authorities in the Netherlands shall impose a tax on SMBV profits without deducting royalty fees (formerly the Netherlands withholds the SMBV tax after deducting the royalty fee paid to Alki LP).

Based on the above decision, the Dutch tax authorities finally made a recovery/refund of € 25.7 million from Starbucks Co which was obtained from the ruling with the Dutch Government.

4.3 Anti Tax Avoidance Terms in UK and Netherland

4.3.1 UK

UK has a focus on issues of tax reduction through debt from shareholders, royalty payments on intangible assets that can reduce taxes in the UK. For transfer pricing rule, all transfer pricing methods in OECD are accepted but the most effective method according to the UK is the comparable uncontrolled price (CUP) method.

The UK does not have a financing ratio between debt and capital so there are no restrictions on interest reduction. Reduction of interest is limited in terms of debt and interest rate that has met the fairness/arm's length (Andrew Casley, 2007 quoted from Fajar Budiman). This provision regulates loans and debt payments to affiliated companies. In 2004, the Government terminated the special provisions of thin capitalization arrangements and improved the provision of transfer pricing in order to accommodate the provision of thin capitalization.

4.3.2 Netherlands

The Netherlands has a General Anti-Avoidance Rule (GAAR) which is about transfer pricing rules only. In 2002, a provision was applied in the Dutch tax rules to facilitate the tax authorities to check the transfer price, whose contents are as follows: "Where an entity participates, directly or indirectly, in the management, control or capital of another entity and conditions are made or imposed between these entities in their commercial and financial relations (transfer prices) which differ from conditions which would be made between independent parties , the profit of these entities will be done as if the last mentioned conditions were made. "

The Netherlands uses the 5 methods of transfer pricing. But the best method of transfer pricing according to the Netherlands is CUP method, the resale price method, the cost plus method.

4.4 Anti Tax Avoidance Terms in Indonesia

Some of the existing anti-profit shifting rules in Indonesia that can be used to prevent tax avoidance schemes such as those committed by Starbucks Corporation are as follows:

4.4.1 Prevention of Thin Capitalization Transactions

To prevent tax avoidance by multinational corporations with funding from very large debts, countries make rules on DER (Debt to Equity Ratio). In Indonesia, its domestic tax rules set the ratio of capital and debt ratio of 4:1.

Based on the PMK No. 169/PMK.010/2015 Article 2 paragraph 1 states the ratio between capital and debt is set at the maximum of 4: 1. This rule can be regarded as a powerful enough rule to prevent tax avoidance by thin capitalization scheme. Given a fixed ratio that can prevent the tax payer from getting excessive deductions on his taxable income. In the case of Starbucks, with this rule, Starbucks can not avoid taxes with this scheme in Indonesia.

4.4.2 Rules to Prevent Manipulation of Transfer Price of Coffee Beans and Mark up roasted coffee bean price for roasting service

Transfer pricing can be prevented by PER-32 / PJ / 2011 through:

1. In article 11, there are already established methods of pricing transfer which may be used together with appropriate conditions for applying such methods
2. The most important articles which may prevent the transfer price manipulation are article 20 and 21. This article emphasizes that: "Directorate General of Taxation is authorized to re-determine the amount of income and deductions to calculate the amount of taxable income on transactions conducted between related parties."

Article 11 describes what methods can be used for fair pricing, when analyzed from several countries, in this case the UK, the Netherlands, these two countries choose to apply the CUP method.

In Indonesia, if a case like Starbucks UK happen in Indonesia, the tax authorities may use the CUP method to test the fairness of the purchase price of its coffee beans. CUP method is commonly used for testing the reasonableness of the prices of industrial goods or commodity goods. To test it, the tax authorities can compare product transactions similar to independent parties.

For the coffee roasting service provided, SMBV charges the price of coffee beans already in mark-up by 20%. To test whether the price is reasonable or not we need to do comparison intra-group service transactions. Testing steps for intra-group service transactions are set up in SE-50 / PJ / 2013 and PER-22 / PJ / 2013 by: (1) Check if the service is properly provided; (2) Recalculate the fairness of the service payments

In the case of Starbucks, proper coffee roasting services have been done, but to recalculate the fairness of service payments, it must be done by benchmarking on similar service companies (roasted services).

4.4.3 Rules to Prevent Transfer Price Manipulation of Royalty

The fairness of royalty fees can be tested with Comparable Uncontrolled transactions (CUT) and the TNMM method. Royalty fees can be compared to CUT by comparing the percentage of royalty fees of similar companies whose transactions are conducted by independent parties. These methods are set out in PER 32 PJ / 2011.

In addition to comparing the above method, the transfer price manipulation of royalties can be tested using Transactional Net Margin Method (TNMM method) by comparing percentage of operating profit to sales. A further concern is whether the royalty payments provide a corresponding rate of return (SE-50/PJ/2013).

5 CONCLUSIONS

Based on the results of the analysis it can be concluded that tax avoidance and profit shifting structures undertaken by Starbucks corporation are: Starbucks UK manipulates transfer pricing for royalty payments at a much higher percentage than similar industries at comparable market levels, performing thin capitalization schemes with considerable interest expense. Starbucks recognizes interest expense of + 4% of LIBOR when other similar companies only charge 2% interest, and manipulates transfer pricing by marking up the price of coffee beans and roasted coffee beans at very high price. Mark up on resale margin and roasting services should be benchmarked against similar companies to be able to assess whether the mark up is reasonable.

Rules that can be applied by Indonesian tax authorities if such cases as Starbucks UK occur in Indonesia are:

a. The current Thin Capitalization Rule is sufficient after the issuance of PMK No. 169/ PMK.010/2015 because in this rule the amount of ratio of capital and debt (DER) is 4:1.
b. To prevent the transfer price manipulation in royalty payments, the fairness of royalty fees can be tested with CUT and the TNMM method. This method is set in PER 32 PJ/2011
c. To prevent impropriety on the sale of coffee beans, the tax authorities can test it using the CUP and TNMM methods. To test it, the tax authorities can compare product transactions similar to independent parties and compare net margin of transactions similar to independent parties. Steps to perform the tests have been made in SE-50/PJ/2013
d. The current rules on transfer pricing are getting better and more stringent with the issuance of new rules on the transfer pricing document prerequisite of PMK No. 213/PMK03/2016. With this rule, the tax authorities can see where the company's largest profit from the report per country.

The tax rules of transfer pricing and thin capitalization in Indonesia are sufficient, but a rule that regulates the rate valuation of royalties and the clear provisions of what factors should be considered and compared to be able to get a fair percentage rate for certain companies royalty.

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