ANALYSIS METHOD OF TRANSFER PRICING USED BY MULTINATIONAL COMPANIES RELATED TO TAX AVOIDANCE AND ITS CONSISTENCIES TO THE ARM'S LENGTH PRINCIPLE (CASE STUDY: STARBUCKS CORPORATION)

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ABSTRACT

The purpose of this study is to evaluate about how Starbucks Corporation uses transfer pricing to minimize the tax bill. In addition, the study also will evaluate how Indonesia's domestic rules can overcome the case if Starbucks UK case happened in Indonesia. There are three steps conducted in this study. First, using information provided by UK HMRC and other related articles, find methods used by Starbucks UK to minimize the tax bill. Second, find OECD view point regarding Starbucks Corporation cases. Third, analyze how Indonesia's transfer pricing rules will work if Starbucks UK's cases happened in Indonesia. The results showed that there were three inter-company transactions that helped Starbucks UK to minimize the tax bill, such as coffee costs, royalty on intangible property, and interest on inter-company loans. Through a study of OECD's BEPS action plans, the authors recommends to improve the OECD Model Tax Convention including Indonesia's domestic tax rules in order to produce a fair and transparent judgment on transfer pricing. This study concluded that by using current tax rules, although UK HMRC has been disadvantaged because transfer pricing practices done by most of multinational companies, UK HMRC still cannot prove the

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transfer pricing practices are not consistent with arm's length principle. Therefore, current international tax rules need to be improved.

Keywords: transfer pricing, multinational companies, tax avoidance, arm's length principle

ABSTRAK

Tujuan dari penelitian ini adalah untuk mengevaluasi tentang bagaimana Starbucks Corporation menggunakan harga transfer untuk meminimalkan tagihan pajak. Selain itu, penelitian ini juga akan mengevaluasi bagaimana peraturan di Indonesia dapat mengatasi permasalahan yang sama dengan kasus Starbucks Inggris terjadi di Indonesia. Ada tiga langkah yang dilakukan dalam penelitian ini. Pertama, menggunakan informasi yang diberikan oleh Inggris HMRC dan artikel terkait lain untuk menemukan metode yang digunakan oleh Starbucks Inggris dalam meminimalkan tagihan pajak. Kedua, menemukan sudut padang dalam OECD mengenai kasus Starbucks Corporation. Ketiga, menganalisis bagaimana aturan harga transfer di Indonesia dapat mengatasi jika kasus Starbucks Inggris terjadi di Indonesia. Hasil penelitian menunjukkan bahwa ada tiga transaksi antar-perusahaan yang membuat Starbucks Inggris dapat meminimalkan tagihan pajak, seperti biaya kopi, royalti di aset tidak berwujud, dan bunga pinjaman antar perusahaan. Melalui studi OECD dalan pembuatan rencana BEPS, penulis menyarankan untuk meningkatkan OECD Model Tax Convention termasuk peraturan pajak dalam negeri di Indonesia untuk menghasilkan keputusan yang adil dan transparan pada harga transfer. Penelitian ini menyimpulkan bahwa dengan menggunakan peraturan pajak saat ini, meskipun HMRC Inggris telah dirugikan karena praktek harga transfer yang dilakukan oleh sebagian besar perusahaan multinasional, HMRC Inggris masih belum bisa membuktikan praktek harga transfer tidak konsisten dengan prinsip kelaziman usaha. Oleh karena itu, peraturan pajak internasional saat ini perlu ditingkatkan.

Kata kunci: harga transfer, perusahaan multinasional, penghindaran pajak, prinsip kelaziman usaha

INTRODUCTION

The development of a country is a continuous activity that is done by the government in order to improve the prosperity of the people inside the country. In developing a country, there are various ways to acquire the source of state revenue, such as taxes revenue, oil and gas sector revenue and non-tax revenue. Taxes have the most contribution to the state revenue and are used for public interest. In term of people awareness, not all the people will be willingly give contribution to pay the tax. Most of people will try to avoid or minimize the tax by various ways. For example: in international taxation, most of multinational companies use transfer pricing as their tools to avoid paying taxes.

Managerial accounting defined transfer pricing as a part of company charges on products or services transferred among associated enterprises. It could be among divisions within one company, or among subsidiaries within one multinational company. Inter-company transactions within multinational company usually cause taxation problems. Global economy now became more globally integrated. The free movement of capital and labour, the shift of manufacturing bases from high-cost to low-cost locations, the gradual removal of trade barriers, technological and telecommunication developments, and the ever-increasing importance of managing risks of developing, protecting and exploiting intellectual property, have had an important impact on the way cross-border activities take place. Globalisation has boosted trade and increased foreign direct investments in many countries.

Usually multinational company uses Transfer Pricing, in the purpose of tax avoidance. Transfer pricing is not, in itself, illegal or necessarily abusive. There are several methods of Transfer Pricing that is accepted by the OECD (Organisation for Economic Co-Operation and Development) and use the methods consistent with the arm’s length principles. The multinational company need to meet criteria and conditions required in the arm’s length principles that regulated by the OECD in selecting the appropriate transfer pricing method. What is illegal or abusive is transfer mispricing, also known as transfer pricing manipulation or abusive transfer pricing. In other word, the method used by the multinational company is not consistent to the arm's length principle. This is not a new issue but this issue still a problem for most of multinational companies.

Starbucks Coffee (Starbucks Corporation) is the premier roaster, marketer and retailer of speciality coffee in the world, operating around 18,000 retail stores in 60 countries. It was started from a roaster and retailer of whole bean and ground coffee, tea and spices with a single store in Seattle's Pike Place Market in 1971. Starbucks was incorporated under the laws of the State of Washington, in Olympia, Washington, on November 4, 1985 and went public on June 26, 1992 at a price of $17 per share (or $0,53 per share, adjusted for subsequent stock splits) and closed trading that first day at $21,50 per share. Starbucks Corporation's common stock is listed on NASDAQ, under the trading symbol SBUX.

Recently, Starbucks is accused of tax avoidance activities in the UK, having paid just £8,6m in corporation tax over 15 years for their existence in UK. According to a Reuters Investigation in October 2012, Starbucks has told investors that the UK business is profitable, while reporting losses to tax authorities. There is no suggestion that any laws have been broken, but campaigners suggest that this is a clear case of tax avoidance made possible due to current UK tax system rules. Payments between companies, for example intellectual property fees, have been identified as a factor in reducing Starbucks' taxable income, in addition to the allocation of funds generated in the UK to other subsidiaries in its supply chain. But in their initial response, Starbucks strongly denies any wrongdoing in relation to tax avoidance.

In United States, research conducted by Kleinbard (2013) to analyze Starbucks Transfer Pricing cases according to stateless income planning theory. The results of the research that Starbucks like many other U.S. multinational companies is an enthusiastic stateless income tax planner. Starbucks had significant losses in some jurisdictions and higher profits in others. The remedy begins with transparency toward tax authorities and policymakers, through which those institutions have a clear and complete picture of the global tax planning structures of multinational companies, and the implications of those structures for generating stateless income. National governments should recognize their common interest in that regard and promptly require their tax and securities agencies to promulgate rules providing a uniform, worldwide disclosure matrix for actual tax burdens by jurisdiction. As a first step, the United States should enforce the rule requiring U.S. companies to quantify the U.S. tax cost of repatriating their offshore permanently reinvested earnings.

Research by Nurhayati (2013) evaluated the effectiveness of Indonesia's tax policies against transfer pricing practice by multinational companies in Indonesia. The results of the research are Indonesia's tax policies effective enough but DJP still need to establish new policies and improve current policies along with business practice that advanced very fast. Beside, Indonesia's tax administrator also need to give training to the tax examiners, form a team of transfer pricing that fully concentrate to solve transfer pricing problem, and also improve cooperation with the other countries.

Based on the background discussed above, these are several issues that will be discussed in this article: (1) What methods of transfer pricing that are used by Starbucks Corporation related to tax avoidance? (2) Are methods of transfer pricing used by Starbucks Corporation accepted by OECD and consistent to the arm's length principles? (3) How will Indonesia's transfer pricing rules overcome the cases if Starbucks Coffee Company (UK) Limited's cases happened in Indonesia?

The purpose of this study is to know whether the method used by Starbucks Corporation is acceptable or not and to know whether the method is consistent to the arm's length principles or not. Based on the purpose, there are several benefits of this study are: (1) For the writer, this research will improve the knowledge about method used by most of multinational companies in tax avoidance and the knowledge about the arm's length principle criteria in transfer pricing. (2) For multinational company, this research will give more experience regarding the effective and efficient tax planning, and how to deal with the tax administrator. (3) For Indonesia's tax administrator, this research will give more experience regarding the effectiveness of Indonesia's tax law to deal with certain transfer pricing problem.

METHOD

The research methodologies for this study are as follows: (1) Type of the research is Exploratory study (Qualitative Research). (2) The time horizon of the research is Cross Sectional. (3) Data collection method of the research is secondary data. In this study, data are obtained from Oral and Written Evidence of Public Hearing in United Kingdom conducted by Committee of Public Accounts on 12 November 2012, special report by a reporter from Reuters titled as *How Starbucks avoid UK taxes*, other article related to the topic, such as the secondary data used in this research are the annual report of Apple, Inc and Starbucks Coffee FY2011 and FY 2012, press release of Apple, Inc and Starbucks Coffee, and other article which are related to the international tax and transfer pricing issues. (4) Supporting analysis data from vertical, and horizontal analysis. Horizontally integrated multinational corporations means the company produce the same or similar products or services which located in many different countries. For example: McDonalds'. Vertically integrated multinational corporations means the company produce products or services that serve as input or materials to its production in the other countries. For example: Starbucks Netherlands.

In this study, authors analyze the data from some findings stated in Oral and Written Evidence of Public Hearing in United Kingdom conducted by Committee of Public Accounts on 12 November 2012 and report from Reuters titled as *How Starbucks avoid UK taxes*. Then authors compare the data with the arm's length principal, tax treaties and international tax law or OECD Model to prove that all three inter-company transactions on Starbucks are consistent with arm's length principle, then their method in applying all three inter-company transactions are in line with the regulations. If one of the three intercompany transactions failed to prove that it was based on the regulation or principle, then it can be stated that the transaction was related to tax avoidance. The current Indonesian tax law is also compared and analyzed with OECD to determine whether the Indonesian Tax Law is appropriate and cover the existing regulations in OECD.

RESULTS AND DISCUSSION

Case Summary

Making losses for more than 15 years, Starbucks Coffee Company (UK) Limited can survive from bankruptcy due to intercompany loans from US parent company. Described in below picture how intercompany transaction is going and how Starbucks UK can survive from the bankruptcy.

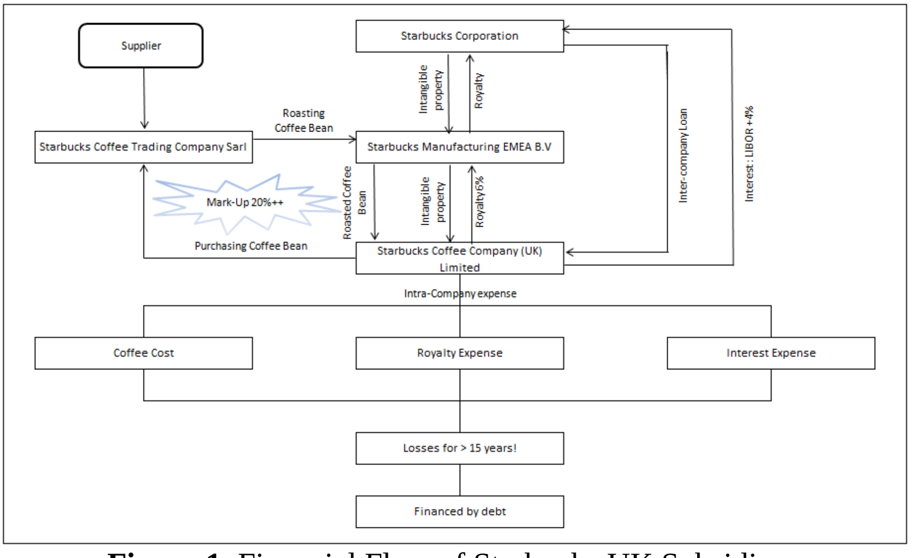

Figure 1. Financial Flow of Starbucks UK Subsidiary

It is considered a good practice for a taxpayer that uses comparables to support its transfer pricing, or a tax administration that uses comparables to support a transfer pricing adjustment, to provide appropriate supporting information for the other interested party (i.e tax auditor, tax payer or foreign competent authorities) to be able to assess the reliability of the comparables used.

If Starbucks could prove that all three inter-company transactions are consistent with arm's length principle, then their method in applying all three inter-company transactions are accepted. The strong point that could support Starbucks is consistent with Arm's Length Principle is they charge the same amount of royalty and coffee cost mark-up to the over 20 unrelated licensed parties. And the over 20 unrelated licensed parties are willingly to pay that much amount considering high quality and differentiation of coffee and trademark value Starbucks has.

BEPS (Base Erosion and Profit Shifting)
The purpose of tax treaties and international tax law or OECD Model (2008) is provide a means of settling on a uniform basis the most common problems that arise in the field of international juridical double taxation which means the imposition of comparable taxes in two (or more) States on the same taxpayer in respect of the same subject matter and for identical periods. Countries around the world agree on the need to eliminate double taxation and the need to achieve this on the basis of agreed international rules that are clear and predictable, giving certainty to both governments and businesses. International tax law is therefore a key pillar in supporting the growth of the global economy.

Overtime, the current rules have also revealed weaknesses that create opportunities for BEPS. BEPS relates chiefly to instances where the interaction of different tax rules leads to double non-taxation or less than single taxation. It also relates to arrangement that achieves no or low taxation by shifting profits away from the jurisdictions where the activities creating those profits take place.

Starbucks Corporation, even though all three inter-company transactions are consistent with arm's length principle, inter-company transactions treated as same as more than 20 unrelated licensed parties, but one country has been harmed. More than 50% stores of EMEA opened in UK and it has generated more than 50% revenue in EMEA region. Yet, Starbucks has only paid £8.6million (about US$12million) corporate tax for more than 15 years their existence in the UK. If we compare it with the Switzerland subsidiary, Starbucks paid CHF 11.6million (about US$10million) for only in 2011. By using the current tax law, and OECD model, the tax administration could not tell if Starbucks is consistent or not to the arm's length principle and Starbucks might have done nothing wrong regarding the current OECD model tax convention.

Beside Starbucks, a lot of multinational enterprises would do the same practice that caused a country or more lose tax revenue. Therefore, there are 15 action plans proposed by OECD to address the concern of BEPS (2013) that are supposed to be done by September 2014 until December 2015. Authors use the action plans sets by OECD to analyze how current international tax law cannot overcome Starbucks aggressive tax planning.

- **Action 1 - Address the tax challenges of the digital economy**

Identify the main difficulties that the digital economy poses for the application of existing international tax rules and develop detailed options to address these difficulties, taking a holistic approach and considering both direct and indirect taxation. Issues to be examined include, but are not limited to, the ability of a company to have a significant digital presence in the economy of another country without being liable to taxation due to the lack of nexus under current international rules, the attribution of value created from the generation of marketable location-relevant data through the use of digital products and services, the characterisation of income derived from new business models, the application of related source rules and how to ensure the effective collection of VAT/GST with respect to the cross-border supply of digital goods and services. Such work will require a thorough analysis of the various business models in this sector.

As OECD Transfer Pricing Guidelines for Multinational Enterprises (2010) stated in paragraph 1.13, both tax administrations and taxpayers often have difficulty in obtaining adequate information to apply arm’s length principle. Because the arm’s length principle usually requires taxpayers and tax administrations to evaluate uncontrolled transactions and the business activities of independent activities of independent enterprises, and to compare these with the transactions and activities of associated enterprises, it can demand a substantial amount of data. The information that is accessible may be incomplete and difficult to interpret; if exists, may be difficult to obtain for reasons of its geographical location or that of the parties from whom it may have to be acquired.

For Starbucks cases, the main difficulty to test arm’s length principle of the inter-company transactions is to evaluate uncontrolled transaction that is comparable to the controlled transaction being tested. Starbucks has certain coffee standard as the source, high quality green Arabica coffee bean. Different quality and type of coffee used must have different cost for it. Starbucks coffee specializations roast and process the coffee by their own subsidiary. Differentiation business strategy drives Starbucks to be a well known coffee roaster and coffee house. Yet, Starbucks UK through two intra-company transactions to buy coffee bean that would make mark-up from the original cost. The coffee bean purchased through Starbucks Coffee Trading Company Sarl, Switzerland which is said by Troy Alstead in the oral examination that the coffee bean bought in Switzerland and then shipped to the roasting facilities around the world (In Starbuck UK cases, it shipped to Netherland and roasted there). The coffee bean never physically goes to Switzerland yet they add a 20% mark-up in Switzerland to support the activities there (Q260-Q262).

From analysis above, the mark up from Switzerland and Netherland subsidiary on UK subsidiary's coffee cost has significant impact to the corporate tax bill of Starbucks UK. In addition, the corporate tax rate in Switzerland is very low around 12% compared to UK corporate tax rate around 28% (2010), 26% (2011), 24% (2012). Buying coffee through Switzerland trading subsidiary will reduce the global tax bill than buying coffee directly from the supplier.

The arm's length principle requires that transaction with a related party be entered into under comparable conditions and circumstances as a transaction with an independent party. The fact that Starbucks charge the same mark-up to the related party and more than 20 unrelated licensed parties, make it simply consistent to the arm's length principle. But, with the difficulties to search for comparable uncontrolled transaction data, make it difficult to perform a comparability analysis. Development of a more specific meaning of arm's length principle and also requirement that prove the controlled transaction is comparable to the uncontrolled transaction in OECD rules is important, in order to make certain the inter-company transaction is fair, effective, and transparent.

- **Action 2 - Neutralise the effects of hybrid mismatch arrangements**

Develop model treaty provisions and recommendations regarding the design of domestic rules to neutralise the effect (e.g. double non-taxation, double deduction, long-term deferral) of hybrid instruments *and entities. This may include: (i) changes to the OECD Model Tax Convention to ensure that hybrid instruments and entities (as well as dual resident entities) are not used to obtain the benefits of treaties unduly; (ii) domestic law provisions that prevent exemption or non-recognition for payments that are deductible by the payor; (iii) domestic law provisions that deny a deduction for a payment that is not includible in income by the recipient (and is not subject to taxation under controlled foreign company (CFC) or similar rules); (iv) domestic law provisions that deny a deduction for a payment that is also deductible in another jurisdiction; and (v) where necessary, guidance on co-ordination or tie-breaker rules if more than one country seeks to apply such rules to a transaction or structure. Special attention should be given to the interaction between possible changes to domestic law and the provisions of the OECD Model Tax Convention. This work will be co-ordinated with the work on interest expense deduction limitations, the work on CFC rules, and the work on treaty shopping.*

Hybrid mismatch arrangements can be used to achieve unintended double non-taxation or long-term tax deferral by, for instance, creating two deductions for one borrowing, generating deductions without corresponding income inclusions, or misusing foreign tax credit and participation exemption regimes. Rules that allow taxpayers to choose the tax treatment of certain domestic and foreign entities could facilitate hybrid mismatches. As Starbucks cases, Troy Alstead mentioned there was a confidential tax ruling between Netherlands government with Starbucks that made the tax become very low tax rates for royalties. It may cause one or some other country loses their tax revenue, because the law of each country has been followed. As for the tax treaty between UK and Netherland, UK government does not charge withholding tax on royalties that company gave to Netherland subsidiary. Yet, under UK accounting rules, royalty could be expensed and deduct the taxable amount. In the end, there is a reduction of the global tax bill by all parties involved as a whole, which harms competition, economic, efficiency, transparency and fairness.

- **Action 3 - Strengthen CFC (Controlled Foreign Company) rules**

Develop recommendations regarding the design of controlled foreign company rules. This work will be co-ordinated with other work as necessary.

One of the sources of BEPS concerns is the possibility of creating affiliated non-resident taxpayers and routing income of a resident enterprise through the non-resident affiliate. CFC and other anti-deferral rules have been introduced in many countries to address this issue. However, the CFC rules of many countries do not always counter BEPS in a comprehensive manner. While CFC rules in principle lead to inclusions in the residence country of the ultimate parent, they also have positive spill-over effects in source countries because taxpayers have no (or much less of an) incentive to shift profits into a third, low-tax jurisdiction.

Starbucks creates affiliate or subsidiary in Switzerland called as Starbucks Coffee Trading Company Sarl. This subsidiary is created to be a coffee bean distributor or trader for all Starbucks manufacturing geographies around the world. Essentially, the key activity of this subsidiary is to buy and sell coffee bean to all Starbucks manufacturing, yet, the coffee bean never physically goes to Switzerland. Transfer pricing method used by this subsidiary is cost plus, mark-up for 20%. The price will go up or down following the green coffee cost at that time, and the gross profit margin stays the same overtime. Thus with the gross profit margin for 20% and having employee just about 30 people, this subsidiary makes a stable net profit 7% or 8%. The tax rate in the Switzerland approximately 12% and Starbucks paid 11.6million CHF (US$10million).

Small activities performed by Switzerland subsidiary could not be compared to the activities performed in the UK subsidiary. Yet, Switzerland subsidiary earned much more earnings and pay more tax than UK subsidiary. 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 efficient. To develop some rules to strengthen CFC (Controlled Foreign Company) rules in limiting BEPS is important.

- **Action 4 - Limit base erosion via interest deduction and other financial payments**

Develop recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense, for example through the use of related-party and third-party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income, and other financial payments that are economically equivalent to interest payments. The work will evaluate the effectiveness of different types of limitations. In connection with and in support of the foregoing work, transfer pricing guidance will also be developed regarding the pricing of related party financial transactions, including financial and performance guarantees, derivatives (including internal derivatives used in intra-bank dealings), and captive and other insurance arrangements. The work will be co-ordinated with the work on hybrids and CFC rules.

Reporting losses for more than 15 years, has driven Starbucks Company UK to be financed by inter-company loan. When a multinational enterprise enters inter-company loans, most of the problem comes from the interest expense of the inter-company loan. How interest expense charged by the lender, often bring problems to the tax administration. For charging too high interest expense for inter-company loan to the US parent company, Starbucks Company UK is suspected to use it as a tool to avoid paying tax. Bergin in (2012) on Reuter's Special Report, Starbucks charge its UK unit at Libor+4%, while KFC charges its subsidiary at Libor+2%, and McDonald charges its subsidiary at below of Libor rate. The rules should strengthen the rules to make the more effective limitation regarding deductible interest income to the taxable income.

- **Action 5 - Counter harmful tax practices more effectively, taking into account transparency and substance**

Revamp the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and on requiring substantial activity for any preferential regime. It will take a holistic approach to evaluate preferential tax regimes in the BEPS context. It will engage with non-OECD members on the basis of the existing framework and consider revisions or additions to the existing framework.

In international taxes, there is “race to the bottom” word. It means 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 that offer the most benefit for them to lower their global effective tax rate. Aggressive tax planning and race to the bottom competition will result an unfair BEPS.

The tax ruling offered by Netherlands tax policies gives the chance to Starbucks to minimize the tax bill. As the result, Starbucks make decision to place its EMEA headquarter in Netherlands, while most of activities and most of sales derived in UK. To prevent harmful tax practices, each country should be transparent each other about their tax ruling and domestic taxed rules.

- **Action 6 - Prevent treaty abuse**

Develop model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances. Work will also be done to clarify that tax treaties are not intended to be used to generate double non-taxation and to identify the tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country. The work will be co-ordinated with the work on hybrids.

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 international tax treaty between UK and Netherland on Royalty is zero. Which means UK HMRC will not charge withholding taxes to 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.

Special tax ruling offered by Dutch tax authority to Starbucks could give chance Starbucks to generate double non-taxation. Since APA (Advance Pricing Agreement) 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 need to be made in international basis. Make deal 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, for Dutch government, they offer a very low tax ruling to Starbucks and other multinational companies to attract them to invest in the country. As the result, Starbucks placed headquarter of EMEA in Netherlands while the most of activities happened in UK. It transfers a high royalty to EMEA headquarter in Netherlands and taxed in there in a very low tax rate. In the end, there is a reduction of the global tax bill by all parties involved as a whole, which harms competition, economic, efficiency, transparency and fairness.

- **Action 8 - Assure that transfer pricing outcomes are in line with value creation: intangibles**

Develop rules to prevent BEPS by moving intangibles among group members. This will involve: (i) adopting a broad and clearly delineated definition of intangibles; (ii) ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with (rather than divorced from) value creation; (iii) developing transfer pricing rules or special measures for transfers of hard-to-value intangibles; and (iv) updating the guidance on cost contribution arrangements.

One of the problems in Starbucks cases is the royalty charges to the related parties. It charges too high royalty to the related parties, especially Starbucks UK who has faced loss for more than 15 years. This problem could be driven by there is no certain rules regarding how to value its intangible assets based on standard. In this case, development of some standard in valuing the intangibles should be helpful.

- **Action 11 - Establish methodologies to collect and analyse data on BEPS and the actions to address it**

This action is to develop recommendations regarding indicators of the scale and economic impact of BEPS and ensure that tools are available to monitor and evaluate the effectiveness and economic impact of the actions taken to address BEPS on an ongoing basis. This will involve developing an economic analysis of the scale and *impact of BEPS (including spill-over effects across countries) and actions to address it. The work also involve assessing a range of existing data sources, identifying new types of data that should be collected, and developing methodologies based on both aggregate (e.g. FDI and balance of payments data) and micro-level data (e.g. from financial statements and tax returns), taking into consideration the need to respect taxpayer confidentiality and the administrative costs for tax administrations and businesses.*

OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration (2010) stated documentation would be most helpful tool to show that the controlled transactions satisfy the arm's length principle and hence in resolving transfer pricing issues and facilitating tax examinations. By looking for Starbucks cases, there are not enough data obtained to prove the genuine arm's length principle in the inter-company transaction. One solution is to require the taxpayer to document all steps and supporting document in their activity in comparability analysis to prove their genuine arm's length transaction, and also identifying new types of data that should be helpful in tax examinations.

- **Action 13 - Re-examine transfer pricing documentation**

Develop rules regarding transfer pricing documentation to enhance transparency for tax administration, taking into consideration the compliance costs for business. The rules to be developed will include a requirement that MNE's provide all relevant governments with needed information on their global allocation of the income, economic activity and taxes paid among countries according to a common template.

Transparency also relates to transfer pricing and value-chain analyses. Transfer pricing documentation often unavailable to tax administrators and this kind of limitation potentially undermines the administration of the arm's length principle and enhances opportunities for BEPS. Starbucks cases, because of the document limitation, the tax administrator do not know how to give the transparent and reliable solutions. In order to obtain reliable and transparent solutions, tax administrator must require the tax payer to document the supporting evidence regarding their transfer pricing.

Indonesia's Transfer Pricing Rules

Most of multinational enterprises use transfer pricing practices to minimize their tax bill. With a really complex method, multinational enterprises look for the lack of the rules or laws and search for a country with low-tax jurisdiction, to minimize their tax bill. Well, their methods applied in inter-company transactions are consistent with arm's length principle, but these methods are not fair, transparent, effective, economic and efficient.

By applying such immoral tactics, a country can lose large amount of tax revenue, considering the role of multinational enterprises in the world wide economic. UK experience on Starbucks describes structured tax avoidance. As explained above, Starbucks tries to shift the revenue generated in UK to the low tax jurisdiction like Switzerland and Netherlands (which has special low tax ruling with Starbucks) by intercompany-transaction as coffee cost, royalty expense and interest expense.

Problem driven by cost and revenue contribution by multinational enterprises should be well regulated in every country involved in the international or usually called as cross-border transaction. For Indonesia there are certain acts that regulate transfer pricing problem that is believed could prevent tax abusive or tax avoidance driven by cross-border transactions. Some regulations are UU PPh Article 18, PER-43/PJ/2010 and later revised as PER-32/PJ/2011 discussing about arm's length implementation in related parties' transactions, S-153/PJ.04/2010 discussing about guidance in examining transfer pricing practice in Indonesia.

As what stated in Article 18 (1) UU PPh that authorizes the Minister of Finance to give decisions about the magnitude of the ratio between debt and corporate capital can be justified for tax purposes. In the business world there is a certain level of reasonable comparison of the magnitude of the ratio between debt and capital (debt to equity ratio). If the ratio between debt and huge capital exceeded the limits of reasonableness, in general, the company is in an unhealthy state. In such case, for the calculation of taxable income, this law determines the existence of disguised capital. The term capital here refers to the definition of the term or equity in accordance with accounting standards, while the definition of "reasonableness or the predominance of business" is a custom or practice engaged in business or a healthy activity in the business world.

Reporting losses for more than 15 years, Starbucks UK ends up to be financed by debt. If this case happened in Indonesia, Minister of Finance has the authorities to decide the magnitude of the debt to equity ratio for tax purposes. Based on PER-43/PJ/2010 and later revised as PER-32/PJ/2011 Article 4 paragraph 2, Taxpayers are required to document the steps, study, and a review of the conduct and determination of comparability analysis, the use of Comparative Data Internal and/or External Comparative data and storing books, basic notes, or documents in accordance with applicable regulations.

Based on Indonesia's tax regulation, Starbucks required to provide the document regarding the steps, study and a review of comparability analysis, including the use of the internal and external comparable data, and other document that support their statement about the consistencies of their inter-company transactions to the arm's length principle. If Starbucks cannot provide the supportive document and the reported income is understated or reported expense is overstated, Direktur Jenderal Pajak (DJP) has the authority to recalculate the taxable income according to the state if there is no special relationship or it was a transaction between independent enterprises.

Coffee Cost

In the guidance for examining transfer pricing practice in Indonesia which is regulated in S-153/PJ.04/2010, there are several conditions that are must be tested whether the inter-company transactions are met with arm's length principle or not, such as:

> Arm's length principle are implemented by comparing condition and the results (price/gross profit/operating profit) from an inter-company transaction with comparable independent transactions, and then tie up the difference of the conditions and the difference of the result obtained. After transfer prices are determined, tax administrator should examine if the taxable income is realistic and economist enough compared to the industry.

Arm's length principle are implemented by comparing condition and the result from an inter-company transaction with the result derived by transactions of other company in the same industry, and then tie up the difference of the conditions and the difference of the result obtained.

Transfer price is fair if the inter-company transaction conditions are similar or the same to the comparable independent transaction and the result is the same between inter-company transaction and the comparable independent transaction.

The fact that conditions of inter-company transaction compared to independent transaction are not always the same, this is the formula to determine if the inter-company transaction prices are consistent with arm's length principle:

Fair price (inter-company) = price (independent) +/- condition difference that give impact to the price

If transfer prices comparison cannot be performed, the examiner could perform gross profit comparison. And if gross profit comparison cannot be performed, the examiner could perform net profit comparison. So, the net profit comparison formula with difference condition that is consistent with arm's length principle can be:

Fair Net Profit = Net Profit (independent) +/- condition difference that give impact to the net profit

As a conclusion, to acknowledge if the inter-company transactions have a fair price, examiner should compare with other independent company that is in the same industry with taxpayer. The questions could be: In the industry, does business practice done by the taxpayer is a general business practice that is also done by the other independent company?

Going through these 5 processes in determining the fair transfer prices, there are several conclusions for Starbucks cases, which are: (1) The same price charged by Starbucks Trading Switzerland to all manufacturing subsidiaries does not prove if the price is in arm's length principle. There are several difference condition, should be considered. For example: Starbucks Trading charged the same mark-up price to the US and to the UK. But in the US, coffee bean directly goes to US, and for UK, coffee bean must be roasted in the Netherlands before goes to UK. By looking at this condition, the price is not genuinely consistent with arm's length principle. (2) Assumed the conditions of the global and the UK subsidiary except the nation, are similar. Analyzed above, the gross profit margin and operating profit margin from UK subsidiary is far below the global (consolidated income statement). Most of it affected by cost of sales including occupancy cost, the difference nearly 30-40%. The fact that the global or consolidated income statement exclude all inter-company transactions drive researcher to the conclusion that most of the difference 30-40% comes from inter-company transactions. By looking at the result, the mark-up price did not generate a realistic and economist result.

The provisions in Chapter III KEP-01/PJ.7/1993 indicate that price or other profit indicators do not always have to be made to the price and profit indicators of the parties under investigation, but may also be made to the price and profit indicators of affiliate parties transactions, as such research can be conducted on the parties and the transaction is examined or to parties and transactions from affiliate parties.

In Starbucks cases, the role of Starbucks Switzerland subsidiary is distributor of coffee beans to the all Starbucks manufacturers in the world. The method used by Starbucks Switzerland subsidiary is cost plus method which adds 20% to the cost of beans.

Regulated in PER-32/PJ/2011, to determine a reasonable price or reasonable profit, taxpayer required to examine which method that is the most appropriate method based on the right conditions for each method. As for cost plus method, the right conditions are: (1) Semi-finished goods sold to related parties. (2) There is contract/agreement for joint facility agreement or long term buying and supply agreement between related parties. (3) Form of the transaction is service provisions.

By looking at the right conditions, cost plus method is not the most appropriate method that matched the conditions for Starbucks Switzerland. The role that is appropriate for cost plus method is manufacturing company. Filtering the conditions of the Starbucks Switzerland, which its role is distributor and it do not give additional value to the goods sold to affiliate, the most appropriate method is Resale Price Method. As regulated in PER-32/PJ/2011, the rights conditions for resale price method are: (1) High comparability between the controlled transaction and uncontrolled transaction between unrelated parties, especially comparability in functional analysis result, although the goods or services traded are different. (2) The reseller does not give significant additional value to the traded goods or services.

As the result, the most appropriate method for Starbucks Switzerland is resale price method. Resale price method is transfer pricing method that is done by comparing controlled sales price to the resale price of the product deducting the reasonable gross profit margin, which reflects the functions, assets, and risks of reasonable resale price of the product to the unrelated parties or customers.

Royalty and Interest

In guidance for examining the transfer pricing S-153/PJ.4/2010, these are several considerations in examining special transactions like royalty and interest. (1) Reasonable Royalty. For the inter-company transactions for the use of intangible assets and royalty, the arm's length principle examination should check the availability of the intangible assets. The examiner should make sure if the taxpayer has the ownership of these assets, and value the intangible assets in the right amounts. The existence of transfer of rights to use intangible asset. An intangible asset has transferred the rights if the intangible assets give benefits to the tax payer and the fairness of royalty reward for the use of intangible assets. (2) Reasonable Interest. For the inter-company transaction of loans and interests, the arm's length principle examination should check the availability of the loans. The examiner should make sure if the borrowed money is already transferred into the taxpayer's bank accounts, and the loans give benefits to the taxpayer. The fairness of the loans. The examiner should concern to the debt equity ratio when he/she analyze the fairness of the loans and the fairness of the interest rate of the loans.

In PER-32/PJ/2011, transactions of intangible property carried out between related parties are considered to be arm's length principle when: (1) The use of intangible property transactions actually occur. (2) There are economic or commercial benefits. (3) Transactions between the related parties have the same value with the transactions conducted between unrelated parties that have comparable conditions by applying comparability analysis and applying the transfer pricing method that is appropriate to the transaction.

Based on Indonesia's provision, Starbucks UK does have the economic benefits from the intangible assets. Using the trademarks, know-how and other intangible assets of Starbucks Corp, Starbucks UK could generate sales around US$1.9million in 2010-2012. But, Starbucks UK paid 6% royalty to the EMEA region and US parent company, after suffering loss for more than 15 years. In fact, the benefits carried by intangible assets do not suitable with the 6% royalty they paid for EMEA region and US parent company. By looking the fact, Starbucks UK actually did not earn profits from the intangible property yet they paid 6% royalty for them.

Looking to the case, Indonesia should give more specific criteria how to value the intangible assets and how to calculate the reasonable royalty besides compare it to the competitor or industry.

On the other hands, the tax treaty between Indonesia and US allows both countries to charge taxes on royalty and interest expense or income derived from one of the country. The tax rate of royalty and interest in Indonesia for US is 10%. Different from UK HMRC, Indonesia's DJP still got tax benefit 10% from the 6% royalty and LIBOR+4% interest charged by the US based parent company.

CONCLUSIONS

Starbucks Coffee Company (UK) Limited used three inter-company transactions to minimize its global tax bill. First is coffee cost.

Starbucks UK moved its profits to Switzerland which charged 12% for corporate tax rate, through purchasing of coffee bean. The purchase of coffee bean was through Starbucks Trading Company which is placed in Switzerland and charged mark-up for 20% and then more mark-up for roasting the coffee bean in Netherlands. However, there was a possibility if the coffee bean never physically gone to that Switzerland subsidiary. Second is royalty on intangible property.

Starbucks Corporation charged 6% royalty 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 paid to EMEA headquarter placed in Netherlands, and half goes to US parent company through Netherlands. Both have taxed the royalty, but in Netherlands there is a confidential tax ruling that give a very low tax rate to Starbucks. Third, Interest on Inter-company loans. Facing losses for more than 15 years, has drive Starbucks UK into inter-company loans to the US parent. Interest charged by US parent is LIBOR+4%, which believed as the highest interest rate compared to the competitors. Using these three inter-company transactions, Starbucks UK moved its profit to the low tax jurisdiction countries and it generated a minus taxable income.

The same price charged by Starbucks to the associated companies and to more than 20 unrelated parties leads authors to the conclusion that the transfer prices have been consistent with arm's length principle. However, strangely the result is not fair to the countries involved to the transaction. In fact, more than 50% sales of EMEA region derived by UK subsidiary and more than 50% stores of EMEA are operated in UK but paid only £8,6 millions during more than 15 years of their existence in UK.

The fact that inter-company transactions done by Starbucks Corporation have been consistent with arm's length principle unfairly, following OECD's BEPS action plans, author recommended several rules to be improved and changed in every country in the world.

Based on the discussion, Indonesia's transfer pricing rules are effective enough to deal with Starbucks UK cases if the cases happened in Indonesia. It gives authority to the tax administration to recalculate the taxable income if the taxpayer cannot prove and give the supportive evidence that their prices are consistent with arm's length principle. Indonesia's transfer pricing rules also gives detailed conditions that are suitable in applying the most appropriate method. However, Indonesia's transfer pricing rules are still lacking in regulating special transaction like royalty and interest. By using current rules, tax administrators cannot prove that the royalty and interest charged by Starbucks Corporation are too high for a loss subsidiary like UK Subsidiary. On the other hands, Indonesia's tax administrator more benefited compared to the UK HMRC, because the tax treaty between Indonesia and US allows both country to charge tax on royalty and interest. Indonesia could charge 10% withholding tax of the royalty and interest paid to the US parent company. But still, Indonesia's tax administrator loss its 15% tax revenue from the royalty and interest.

Arm's length principle cannot fully depend on comparables uncontrolled transaction. Based on the discussions, it is not easy to find comparable uncontrolled transaction with similar conditions with the controlled transaction. In the authors' opinion, OECD should develop a more specific meaning of arm's length principle that will obtain more fair, effective and transparent result of inter-company transaction.

The fairness of inter-company transactions also depends on domestic rules regulated in each country involved. In attracting multinational companies to invest in their country, a tax ruling is not bad or illegal. It could be Advance Pricing Arrangement (APA) as an agreement between tax administrator and the taxpayer, to make a certain rules regarding transfer pricing. However, a tax ruling also should consider the other countries that could be affected by the tax ruling. The tax ruling and other domestic rules should be improved, transparent to the other countries and be accepted world-widely. In the authors' opinion, OECD should require each country be transparent about their agreements with taxpayer especially multinational companies that would affect other countries that will obtain more fair, effective and transparent result in international taxation.

The major problem is the establishment of special purposes entities that somehow will help multinational enterprises to minimize their tax bills legally or illegally. OECD should develop requirement to strengthen Controlled Foreign Company (CFC) rules that limit the chance for multinational companies to establish special proposes entities. It will require cooperative of domestic rules in each country to strengthen the rules regarding special purposes entities.

According to Suandy (2011), there are at least three points that should be followed in tax planning. Beside it does not violate the tax policy, the tax planning also should make sense in the business. Maintaining to do business that faces losses for more than 15 years is not suitable for profit organization. At least, Starbucks should comply with its global goals and global financial conditions, because tax planning is an integral part of the company's global strategy, in both long term and short term. Therefore, tax planning that does not make sense will weaken the planning itself.

It becomes a sensitive issue if we discussed about transfer pricing. To prove the transfer prices obtained is consistent with arm’s length principle, Starbucks should provide supporting evidence. Before entering transfer pricing practice, it is better for Starbucks to document the steps, study, and a review of the conduct and determination of comparability analysis, the use of Internal and/or External Comparative Data and storing books, basic notes, or documents in accordance with applicable regulations.

Considering most of multinational companies’ attitude that usually uses intangible assets as one of the tools to minimize their tax bills. Transactions like royalties, interest on inter-company loans, dividend etc. Indonesia’s transfer pricing tax rules should be more concerned about how they value their intangible assets and the royalty tax rate. There should be certain requirement to value intangible assets and to determine a fair royalty tax rate. One of the requirements can be considered is to include the profitability of the subsidiary in the intangible assets valuation.

As what happened in UK, HMRC loses so much tax revenue from transfer pricing practice done by most of multinational companies, probably due to the limited experts available to face transfer pricing cases. There is no certain decision regarding Starbucks cases. Therefore, Indonesia’s tax administrator (DJP) also should maintain its human resource quality by training, comparative study to the developed countries, and workshop, especially international tax issues or cross-border transactions issues.

UK HMRC is doing well with the transparency problems to the public. The fact that Starbucks UK issue is brought to the public by a special report from Reuters's reporter, it helps UK HMRC to prevent illegal practices and it will restrict the taxpayer's action. Sometimes, public opinion regarding a certain problem is required to make a fair decision and adjustment. Furthermore, public will know better how the company is doing in the real life. Therefore, Indonesia's tax administrator (DJP) also should maintain and to improve its transparency to the public.

This study is just discussing part of the subsidiary of Starbucks and using secondary data. For a more reliable and accurate result, the authors give recommendation for the next research to analyze transfer pricing globally, not only subsidiary in one country because transfer pricing issue will be related from one to another country, and to use a primary data like the agreement, sales invoice, etc that will be more reliable in analyzing transfer pricing issues in that companies.

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