

Summary of the decision from the European Commission concerning the Starbucks tax ruling

1. Introduction

In the decision dated 21 October 2015 (the decision), the European Commission determined that the advance pricing agreement (APA) entered into between the Dutch Tax Authorities and Starbucks Manufacturing EMEA B.V. (SMBV) on 28 April 2008, relating to the period 1 October 2007 to 31 October 2017, includes prohibited State aid (State aid number SA.38374).

An APA is an agreement between tax authorities and a taxpayer concerning the application of the tax legislation in relation to (future) transactions. Set out in such an agreement are the criteria suitable for determining the corporate transfer prices for intragroup transactions during a specific period. Calculations are made based on that to determine how much profit from a taxpayer's activities will be taken into consideration in that fiscal jurisdiction and how much corporation tax is payable annually thereby. An APA is initiated through an application from a taxpayer.

2. Assessment by the European Commission of the APA with SMBV

2.1. Conditions for the existence of State aid

According to Article 107, paragraph 1, of the Treaty on the Functioning of the European Union (TFEU), State aid measures are (i) from a Member State or funded by state means in whatever manner, which (ii) could have an unfavourable influence on the trade between Member States (iii) by giving advantages to certain companies or certain productions and (iv) thus distort the competition, or threaten to do so, which is incompatible with the internal market.

The first condition is fulfilled. The APA was entered into by the Tax Authorities, which are part of the Dutch government. The APA can therefore be attributed to the Netherlands. In addition, the APA leads to a loss of tax income, which the Netherlands would otherwise have at its disposal. This means that the APA is considered to lead to a loss of state means.

The second condition is also fulfilled. SMBV is part of the Starbucks Group, which is active worldwide and in all the Member States of the European Union, which means that aid could affect trade within the Union.

Furthermore, the third condition is fulfilled. The APA allows Starbucks a selective advantage, insofar as that measure leads to a reduction in the tax payable by SMBV in the Netherlands. The greater part of the decision is dedicated to this condition in the Commission's assessment.

Finally, the fourth condition is also fulfilled. Since the APA discharges SMBV from payable taxes, which it would otherwise have been required to pay, this measure strengthens the financial position of Starbucks in respect of other competing companies, whereby the competition is distorted or threatens to be distorted.

Since all the conditions are fulfilled, the APA amounts to State aid within the meaning of Article 107, paragraph 1, of the TFEU.

2.2. Existence of a selective advantage

2.2.1. Fiscal State aid test

In order to determine whether a specific tax measure contains a selective advantage, a fiscal State aid test has been developed in the European case law, comprising three steps. The first step entails determining which general or normal tax regulations are applicable in the Member State: "the reference system". The second step entails determining whether the tax measure involved forms a deviation from that reference system. If the measure does form a deviation from the reference system, then it is determined during the third step of the analysis whether that measure is justified by the nature and general scheme of the reference system.

2.2.2. Reference system

The reference system is formed by the general Dutch system of corporation tax, which is targeted at the tax on profits of all taxpaying companies in the Netherlands, irrespective of whether that concerns a group of companies or an independent company. That the taxable profits for integrated and non-integrated companies are calculated in a different manner out of necessity is not important for determining the reference system.

Contrary to the argument put forward by the Netherlands, the reference system is not formed through Section 8b of the Corporation Tax Act and the Transfer Pricing Decree, which contain specific rules for group companies. By assuming, in the manner used by the Netherlands, that the reference system only concerns group companies, then an artificial distinction is made between companies on the basis of their company structure. That is all the more true, since the Transfer Pricing Decree is intended to ensure that group companies and independent companies are handled in a similar manner on grounds of the Dutch system of corporation tax. If the Transfer Pricing Decree is however intended to establish special rules for integrated companies, which deviate from the general Dutch rules concerning corporation tax, then its implementation is selective in itself, which means that all advantages given on grounds of those regulations are selective.

2.2.3. Arm's length principle

Since it has now been established that the general Dutch system of corporation tax is the reference system against which the APA should be tested, then it must be ascertained whether that APA forms a deviation from that system, whereby companies that are in a comparable situation, actually and legally, are handled unequally. This is on the basis of the arm's-length principle. The system applied by the Commission in the state aid assessment does not follow from the non-binding OECD Model Tax Convention relating to taxes, but concerns a general principle under European law of equal fiscal treatment.

The methodological choices in the transfer pricing report provided by the tax adviser for Starbucks, which were accepted by the Tax Authorities in the APA, do not lead to a reliable approach to a market result and thereby do not fulfil the arm's length principle. More specifically, this concerns:

- the choice to apply the transactional net margin method (TNMM) in order to forecast a taxable profit, while the OECD guidelines and the Transfer Pricing Decree show a preference for the Comparable Uncontrolled Price Method (CUP);
- if the CUP was applied, then the taxable profit of SMBV would be substantially higher, because:
 - i) the royalties paid by SMBV to Alki LP for knowhow in the area of coffee roasting are too high;
 - ii) the purchase price paid by SMBV for green beans to a company established in Switzerland and belonging to the Starbucks Group, Starbucks Coffee Trading Company SARL (SCTC), is too high.

Alternatively, the Commission is of the opinion that the TNMM is applied incorrectly:

- i) it was incorrectly assumed that SMBV (in comparison with a company established in the United Kingdom and belonging to the Starbucks Group: Alki LP) should be designated as "least complex function" and therefore applies for the application of the TNMM as the "tested party"; and
- ii) in connection with the comparability of SMBV with other market participants in the coffee trade sector, two corrections in the cost base were wrongly carried out.

These choices resulted in SMBV's taxable basis being too limited, whereby SMBV enjoys a tax advantage in the Netherlands.

2.2.4. Royalties

The payment of royalties by SMBV to Alki LP does not provide a correct representation of the value of the intellectual property rights and therefore cannot be deemed to be arm's length.

The royalties comprise an adjustment variable, the level of which is determined by the accounting profits of SMBV combined with the compensation agreed in the APA in the form of a fixed mark-up on the operational costs of SMBV. This means that the APA contains no method of being able to assess the arm's length nature of the level of the royalties. In addition, on the basis of a CUP test, the actual price that SMBV would have been willing to pay for the royalties – in an arm's length transaction – would have amounted to nil. This can be deduced from a few comparable agreements for roasting coffee, which Starbucks had entered into with other coffee roasters worldwide. Alki LP should not have been paid any royalties. Those royalties, which were paid for years, therefore cannot be arm's length, even more so because SMBV does not appear to gain any business advantage itself from the use of the intellectual property in the area of roasting coffee. An independent company would not have been prepared to pay for licences if it was unable to earn back the royalties paid.

In addition, the payment for royalties does not represent a payment for taking over the company risks. The argument from the Tax Authorities that Alki LP (and not SMBV) carried the economic risk of loss of stock is not accepted by the Commission.

By accepting this reasoning, the application of the arm's-length principle for the pricing policy for intragroup transactions would be pointless since the economic reality could in fact be reasoned away or

contracted out of as an alternative. Moreover, Alki LP's capacity is too limited for actually being able to carry such risks. This can be illustrated by the fact that the latter company has no employees itself. The level of the royalty payments also cannot be justified by the amounts Alki LP pays to Starbucks US for technology.

2.2.5. Purchase of green beans

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.

In the first place, there was a failure to investigate the extent to which the transactions between SCTC and SMBV – the purchase and delivery of green coffee beans – actually take place arm's length. Starbucks has also not provided any grounds for justification of the significant increase as from 2011 of the mark-up in the costs for the coffee beans supplied by SCTC. The Tax Authorities should also not have accepted this deduction from the accounting profits. That SCTC's activities became increasingly important, partly due to the evolving "C.A.F.E. Practices" programme, does not form grounds for justification. Taking similar fair-trade programmes into account (and the costs of those), the figures provided by Starbucks in connection with that are problematic both in terms of consistency as well as the arm's length nature. Moreover, the losses incurred through SMBV's coffee roasting activities since 2010 can be connected directly to the increased mark-up. This also highlights the non arm's length of this mark-up. SMBV's profits are reduced artificially by purchasing green coffee beans at a non- arm's length price, due to its high level.

2.2.6. Least complex function

SMBV was wrongly designated as the "least complex function" for the application of the TNMM.

Determining the least complex function takes place prior to the application of the TNMM as transfer price method. In order to determine the entity with the least complex function, a function comparison must be made. The outcome of the function comparison indicates an entity, to which the transfer price method can be applied in the most reliable manner and for which the most reliable comparison points can be found.

In its coffee roasting function, SMBV does not only carry out routine activities. SMBV conducts market research (outgoings were paid for market research) and it holds significant intellectual property (there is amortisation of intangible assets). Moreover, SMBV performs an important resale function. A routine producer is not involved in such activities.

Alki LP's activities are very limited in comparison with that. Besides the fact that Alki LP has no employees as well as a limited operational capacity, the financial capacity of Alki LP cannot be equated with the total financial capacity of the worldwide Starbucks Group.

2.2.7 Alternative standpoint of the Commission

Even if Section 8 of the Corporation Tax Act and the Transfer Pricing Decree are used as the reference system, a selective advantage is given by means of the APA agreed with SMBV. Also in that case the APA

cannot be deemed to provide a reliable approach to a market result in accordance with the arm's-length principle and the payable tax is reduced in comparison with other group companies that are required to pay tax in the Netherlands.

3. Conclusion

The APA amounts to State aid within the meaning of Article 107, paragraph 1, of the TFEU and is incompatible with the internal market. Since the Netherlands has not notified to the Commission any intention to grant the contested aid measure, there is a case of illegal aid being provided to SMBV and the Starbucks Group, which is carried out contrary to Article 108, paragraph 3, of the TFEU.

This illegal aid, including interest from the date on which it became available until the date of repayment in full, must be claimed back immediately and effectively from SMBV (or otherwise from the Starbucks Group). The decision must be implemented by the Netherlands within four months of the date of notification.