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Insight: Vodafone in new 1 billion pounds tax "scandal"

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By [Tom Bergin](#)

LONDON (Reuters) - The world's largest mobile phone company, Vodafone Group, has shaved 1 billion pounds, and possibly more, off the taxes its UK operating unit might have paid in the past decade, thanks to accounting factors not seen at other European units.

A Reuters examination of statutory filings made by Vodafone across Europe over the past 16 years shows the UK taxman has often gone empty handed, while tax authorities in Germany, Spain and elsewhere have raked in billions of euros.

Indeed, rather than incurring UK tax in recent years, Vodafone has racked up tax credits such that it may not have to pay any tax on its UK operations for the foreseeable future.

Vodafone's low UK tax bill is in spite of soaring revenues here and the fact that Chief Executive Vittorio Colao has repeatedly told investors that Britain was one of the group's stronger performing markets.

"This is yet another tax scandal," said Member of Parliament Margaret Hodge, chair of the parliamentary Public Accounts Committee, which scrutinises public expenditure and revenue-raising.

"It may be legal, but it's completely immoral. They make money out of Britain, and they should put money back into Britain."

Vodafone declined to answer most questions about its accounts, citing commercial sensitivity. It said it was committed to acting with integrity and transparency in all tax matters, while also having a responsibility to shareholders to control tax costs.

There is no suggestion the company has behaved unlawfully, and arranging its affairs in a tax-efficient manner within the law is standard business practice.

"Paying more than was required would be a dereliction of duty to shareholders," said Robin Bienenstock, research analyst at Sanford C Bernstein in London.

The British tax authorities, which MPs last year accused of being "too cosy" with big business, the Treasury and Vodafone Limited's auditor Deloitte said they could not comment on individual companies' tax affairs.

Tax avoidance is already at the top of the political agenda in the UK; last week Prime Minister David Cameron said popular comedian Jimmy Carr was "morally wrong" to shelter 3.3 million pounds of income from tax by using an apparently legal tax avoidance scheme.

Tax campaigners say the tough approach to individuals avoiding tax contrasts with a lax approach toward corporations doing the same.

HOW DO THEY DO IT?

Between 1998 and 2003, Vodafone's UK unit, Vodafone Ltd, made annual profits of around 530 million pounds and paid taxes of around 170 million each year, its accounts show.

While revenues have soared since 2003, reported profits have plunged. In the past three years, the UK unit has racked up losses in excess of 100 million pounds each year.

The profit collapse is tied to two factors, the accounts show.

In 2001, Vodafone limited began making large interest payments on money it borrowed from companies within the Vodafone group.

In the 10 most recent years for which accounts have been published, Vodafone Ltd paid associated companies 3.3 billion pounds in interest.

This reduced the UK unit's taxable profits by a commensurate amount because interest payments are tax deductible.



Using the prevailing corporation tax rates at the time, this translated to savings worth 961 million pounds to Vodafone Ltd, either in reduced taxes, or by generating tax credits that could be used to offset future profits.

Tax experts say there have been cases where UK companies have established units in Luxembourg, which then lend the money back to UK units, as a tax avoidance mechanism.

This reduces profit in the UK, where corporate profits are taxed at 24 percent - down from 30 percent a few years ago - while generating profits in Luxembourg, where financial profits can be taxed at rates under 1 percent.

Vodafone has a Luxembourg-based unit, Vodafone Investments Luxembourg S.a.r.l., which it says on its website was "established as the main financing company for our many operations around the world".

A spokesman said Vodafone Limited's interest payments were to other UK-based units of Vodafone but declined to say whether these units had in turn borrowed the money from Vodafone Investments Luxembourg.

The dramatic rise in inter-company interest payments seen at the UK unit is not reflected at other Vodafone units in Europe.

Vodafone D2 GmbH, the phone giant's Duesseldorf-based German unit, paid less than 2 million euros in interest to affiliated companies in the year to March 2011, the most recent year for which accounts are available. Vodafone Espana paid 43 million euros in interest to group companies in that year.

Accounts for the holding company for the Italian operations do not break down interest payments between affiliated and non-affiliated companies but do not show any significant rise in overall interest payments since 2007.

SOARING COSTS OF GOODS

The other main reason behind Vodafone Limited's swing to reported losses was an increase in the price its UK unit pays for the mobile phones and connection services it sells on to consumers. In 2002-2004, the 'costs of goods sold' represented around 55 percent of turnover.

In the past three years, reported costs of goods sold have averaged 76 percent of turnover, squeezing Vodafone's income.

Vodafone said in an emailed statement that the "extremely competitive commercial environment in the UK" had affected margins.

A narrowing gap between revenues and cost of goods sold can reflect increased competition, whereby companies struggle to pass on cost increases to consumers via higher prices.

However, transcripts of conference calls with analysts, that CEO Colao or Chief Financial Officer Andy Halford host each quarter on the release of earnings results shows the company has warned for several years that its margins across all European markets were under constant pressure.

The UK was not singled out as a market that suffered an exceptional increase in margin pressure.

In Germany, where Vodafone says call costs are at the European average or below, the cost of goods sold has not risen dramatically as a percentage of turnover, and averaged 57 percent in the two most recent years for which accounts are available.

"This suggests there is some very odd pricing going on into Vodafone UK," tax campaigner Richard Murphy said.

At Spanish group Telefonica's UK division, O2, cost of goods sold has remained constant at around 58 percent in financial statements for 2007 to 2010, the last four years for which accounts are available.

This allowed O2 to generate profits of 788 million pounds in 2010, on which it paid tax of 189 million pounds.

Had Vodafone's cost of goods sold in the UK since 2003 averaged the same level as the German unit experienced in recent years, the unit's profits could have been 4.7 billion pounds higher, and it could have incurred an additional 1.4 billion pounds in tax, according to Reuters calculations based on the company accounts.

By massaging the prices group companies charge each other for goods and services, multinationals can shift profits from high-tax to low-tax jurisdictions.

This technique, known as "transfer pricing", typically involves a group company in a low-tax regime selling goods above market price to an affiliate in a higher tax regime.

Tax authorities around the world keep a sharp eye out for transfer pricing abuses, but it can be hard to spot.

Vodafone declined to say why costs of goods sold as a percentage of UK turnover rose so sharply.

It said the absence of a UK income tax charge for Vodafone Group in the year to March 2012, was due to high capital allowances and high external interest charges rather than transfer pricing adjustments.

It also cited the high cost of purchasing a UK 3G phone licence in 2000. UK profits were indeed hit by a depreciation charge on licences of 333 million pounds last year. However, in the profitable German unit, the charge was 519 million pounds.

At Vodafone Germany and Spain, the lower cost of goods sold and absence of big inter-company interest payments explain their high profitability - and the high taxes paid in those countries.

Vodafone's German unit incurred corporate taxes of 3.14 billion euros from 2007 to 2011. Between 2008 and 2010, the Spanish unit paid almost 900 million euros. In 2011 alone, corporate income taxes payable by the holding company for the

Italian unit were 721 million euros.

A VIBRANT LOSS-MAKER

Vodafone Limited has racked up so many losses in recent years and its reported profitability has declined so much that it has even written off previously accrued tax losses, as it no longer expects to have enough future profits to absorb them.

Yet the ostensibly parlous state of the UK unit's finances is in sharp contrast to comments from the company to investors and analysts over the past few years.

The company's most recent annual report said the UK "performed well" last year.

"(Group) Service revenue declined by 0.4%, reflecting reductions in most markets offset by growth in Germany, the UK, the Netherlands and Turkey," the report said.

In every quarterly analyst call bar one since May 2010, Colao and Halford have praised the UK as one of the group's stronger markets.

Another factor of which they regularly boast in these calls is Vodafone's proactive approach to managing its tax affairs.

In 2002 and 2003 the company paid an effective tax rate of 36 percent. It said it brought this down to 25 percent last year, a level it has told analysts it expects to maintain in the coming years.

This drop came about even before the UK began cutting corporate taxes, and rather reflects diligent planning.

"Without further tax planning ... over the next few years, the underlying adjusted effective tax rate will be in the mid-30s," then-Finance Director Ken Hydon told analysts in 2005.

Vodafone boosted its tax team in 2007 by hiring the head of the HMRC unit that dealt with large corporations, John Connors. Connors is now Vodafone's head of tax, according to its website.

Connors, Colao and Halford declined requests for interviews.

Around 2008, Vodafone even changed its top management bonus scheme to ensure that bosses would have a strong incentive for aggressive tax planning.

Payouts under the group's Global Long Term Incentive Plan (GLTI) are tied to the company's cash flow. However, large one-off payments to settle tax disputes are excluded from the cashflow measure used to compute the bonus.

This means that if the company doesn't pay taxes for years, cashflow is higher than it should be, facilitating a higher payout under the bonus scheme. But if the tax authority comes back and forces the company to pay back taxes, the payment doesn't diminish cashflow for bonus purposes.

HMRC has challenged Vodafone's tax planning in the courts. In 2010, the company agreed to pay the authority 1.25 billion pounds to settle a claim related to its 2000 takeover of Germany's Mannesmann, which later became Vodafone Deutschland.

The taxman viewed Vodafone's decision to structure the acquisition via Vodafone Investments Luxembourg S.a.r.l. (VIL) as a tax avoidance tactic, and sought to tax interest payments to VIL that were payable out of the profits of the German unit.

The settlement - which was criticised by the Public Accounts Committee last year for potentially costing the taxpayer millions of pounds - allowed Vodafone to continue to channel interest payments into Luxembourg.

Though this fact received little press attention at the time, Vodafone considered it a major coup.

"This agreement preserves the very significant benefits of our efficient Group tax structure, which we have benefited from for many years," CFO Halford said on a conference call to analysts at the time.

UK A SOFT TOUCH ON TAX?

Multinational corporations pay most of their taxes in the individual countries where they have a bricks and mortar presence, tax experts say.

Hence, Vodafone's base in Berkshire, to the west of London, means Britain should enjoy a double dip into the company's earnings - on income from its UK phone business and from some overseas income not taxed at the local level.

But tax lawyers said the UK can suffer financially because of a willingness to allow structures that might be challenged as tax avoidance by overseas tax collectors.

"The German system is very rigid and constrained. There seems less appetite for tax planning and tax-efficient structuring in Germany than in the UK," said Ben Jones, tax lawyer at Eversheds. "In France there is currently a greater capacity for the authorities to clamp down on structures they don't like," he added.

The system may be about to become even more conducive to tax avoidance.

Chancellor of the Exchequer George Osborne, who has said aggressive tax avoidance schemes are "morally repugnant", has published planned changes to the tax treatment of overseas subsidiaries that campaigners say will make it easier for big companies to shield profits from the tax man.

As part of a drive to attract more international businesses to set up headquarters in the UK, Osborne has broadened the definition of what could be construed as legitimate use of controlled foreign subsidiaries.

Campaigners including Murphy say this will make it harder for HMRC to challenge movements of cash to low tax jurisdictions.

The Treasury has estimated the measures could cost the Exchequer 805 million pounds a year by 2016, according to documents on the HMRC website.

Osborne hopes any direct revenue hit will be outweighed by increased job creation.

But Vodafone's experience challenges the link between tax rates and jobs.

Despite the UK's low headline corporate tax rate and the absence of actual tax charges on Vodafone's activities here, the mobile phone giant has cut jobs here by 23 percent since 2007, while increasing employment by 21 percent in Germany, where corporate taxes are over 30 percent.

Also Vodafone's investment in Germany has risen 34 percent since 2007, against 11 percent in the UK.

The UK's relaxing of tax rules is at odds with moves overseas, and Vodafone is feeling the heat. It faces a major tax challenge from the Indian government and believes rising fiscal deficits internationally could spell trouble.

"The temptation of taxation that some governments, if not all governments, are feeling these days - this is really what I would put under the number one cloud (Vodafone faces)," CEO Colao said last month.

(Editing by Will Waterman)

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TAX-FREE LATTE

The U.S. coffee giant has sung the praises of its British business for years, but reported big losses

Starbucks slips the UK tax hook

BY TOM BERGIN
LONDON, OCTOBER 15, 2012

REUTERS/ANDREW WINNING

Starbucks' coffee menu famously baffles some people. In Britain, it's their accounts that are confusing. Starbucks has been telling investors the business was profitable, even as it consistently reported losses.

This apparent contradiction arises from tax avoidance, and sheds light on perfectly legal tactics used by multinationals the world over. Starbucks stands out because it has told investors one thing and the taxman another.

The Seattle-based group, with a market capitalisation of \$40 billion, is the second-largest restaurant or cafe chain globally after McDonald's. Accounts filed by its UK subsidiary show that since it opened in the UK in 1998 the company has racked up over 3 billion pounds (\$4.8 billion) in coffee sales, and opened 735 outlets but paid only 8.6 million pounds in income taxes, largely due because the taxman disallowed some deductions.

Over the past three years, Starbucks has reported no profit, and paid no income tax, on sales of 1.2 billion pounds in the UK. McDonald's, by comparison, had a tax bill of over 80 million pounds on 3.6 billion pounds of UK sales. Kentucky Fried Chicken, part of Yum Brands Inc., the no. 3 global restaurant or cafe chain by market capitalisation, incurred taxes of 36 million pounds on 1.1 billion pounds in UK sales, according to the accounts of their UK units.

Yet transcripts of investor and analyst calls over 12 years show Starbucks officials regularly talked about the UK business as "profitable", said they were very pleased with it, or even cited it as an example to follow for operations back home in the United States.

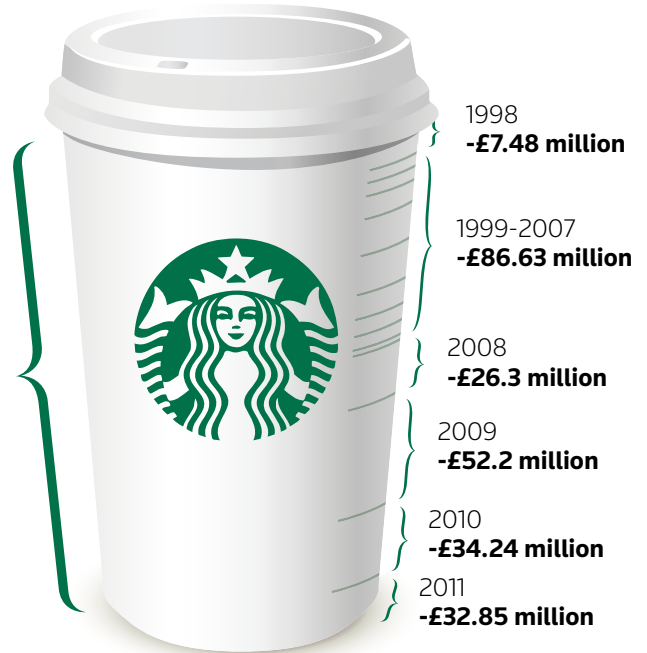
Troy Alstead, Starbucks' Chief Financial Officer and one of the company officials quoted in the transcripts of calls Reuters reviewed, defended his past comments, saying the company strictly follows international accounting rules and pays the appropriate level of tax in all the countries where it operates. A spokeswoman said by email that: "We seek to be good taxpayers and to

Starbucks' tax reduction techniques

A CUPFUL OF LOSSES

STARBUCKS' UK LOSSES, BY YEAR

TOTAL
£239.7 million
loss over 14 years



In 2007, Starbucks' UK unit's accounts showed its tenth consecutive annual loss. Its Chief Financial Officer said the unit had margins of almost 15 percent that year – equivalent to a profit of almost £50 million.

“They are trying to play the taxman, game him. It is disgraceful.”

Michael Meacher

Labour MP and tax campaigner

pay our fair share of taxes ... We don't write this tax code; we are obligated to comply with it. And we do.”

When presented with Reuters' findings, Michael Meacher, a member of parliament for the Labour Party who is campaigning against tax avoidance, said Starbucks' practice “is certainly profoundly against the interests of the countries where they operate and is extremely unfair ... they are trying to play the taxman, game him. It is disgraceful.”

There is no suggestion Starbucks has

broken any laws. Indeed, the group's overall tax rate – including deferred taxes which may or may not be paid in the future – was 31 percent last year, much higher than the 18.5 percent average rate that campaign group Citizens for Tax Justice says large U.S. corporations paid in recent years.

But on overseas income, Starbucks paid an average tax rate of 13 percent, one of the lowest in the consumer goods sector.

The UK tax authorities and the U.S. Internal Revenue Service (IRS) said confidentiality rules prevented them from commenting.

A LOSSMAKER WITH FAT MARGINS

You could think of Starbucks' differing versions of its experience in the UK as two different coffees. To its investors, it sells an espresso – strong and vibrant. The UK tax-

man gets a watered-down Americano.

The contradiction between the two stories becomes evident from scrutiny of its group reports and the transcripts of 46 conference calls with investors and analysts.

Like most big corporations, Starbucks' group earnings statements do not break down its profits and tax payments by country, although on calls it occasionally shares details about larger markets such as the UK. But companies operating in the UK are obliged to lodge accounts at the company register, Companies House, to give a picture of the unit's financial performance.

In the 2007 financial year to end-September, Starbucks' UK unit's accounts showed its tenth consecutive annual loss. Yet that November, Chief Operating Officer Martin Coles told analysts on the fourth-quarter earnings call that the UK unit's profits were funding Starbucks' expansion in other overseas markets. Then-Chief Financial Officer Peter Bocian said the unit had enjoyed operating profit margins of almost 15 percent that year – equivalent to a profit of almost 50 million pounds.

For 2008, Starbucks filed a 26 million pounds loss in the UK. Yet CEO Schultz told an analysts' call that the UK business had been so successful he planned to take the lessons he had learnt there and apply them to the company's largest market – the United States. He also promoted Cliff Burrows, former head of the UK and Europe, to head the U.S. business.

Schultz said he looked forward to Burrows "now applying that same drive and business acumen to leading our U.S. business."

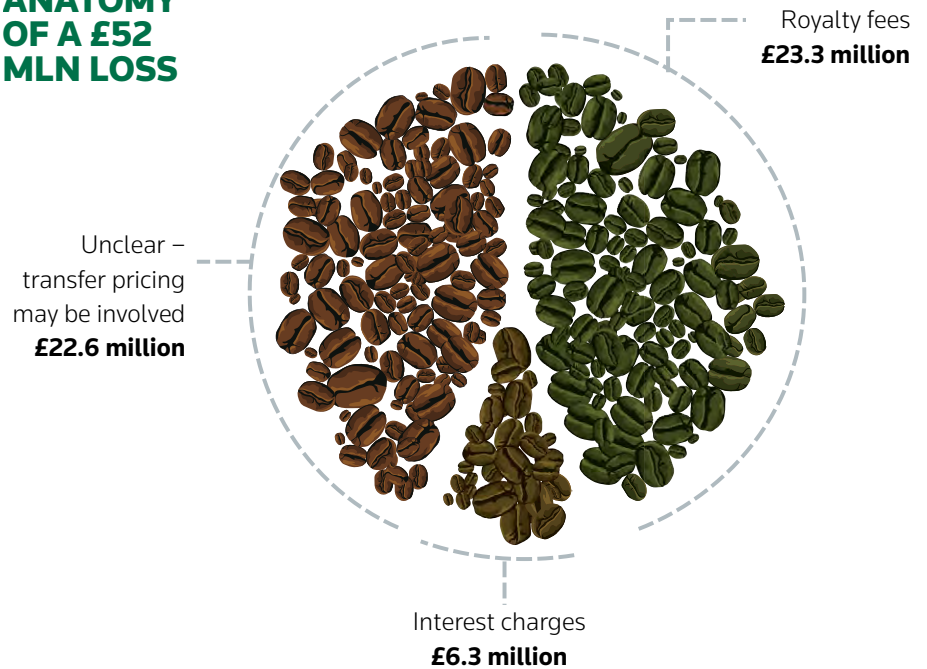
In 2009, accounts filed in London claimed a record loss of 52 million pounds for the financial year to Sept. 27, while CFO Alstead told investors on a call that the UK unit was "profitable."

For 2010, the UK unit reported a 34 million pounds loss, and Starbucks told investors that sales continued to grow.

Starbucks UK unit's accounts for the year to September 2011 showed a 33 mil-

Starbucks' tax reduction techniques

ANATOMY OF A £52 MLN LOSS



In 2009, Starbucks UK told investors it was profitable but reported a record £52 million loss.

What caused that?

lion pounds loss. Yet John Culver, President of Starbucks' International division, told analysts on a call earlier that year that "we are very pleased with the performance in the UK."

When Reuters asked Starbucks' CFO Alstead which version was accurate – Starbucks'

accounts for the UK taxman, or its comments to investors, he said: "The UK is very troubled, unfortunately. Historically it has performed a little bit better than it does now."

He did not explain why the UK business was so disappointing, but said Starbucks was "taking very aggressive actions" to improve its performance, including changing its cost structure.

Meacher, the politician, said Starbucks' experience reflects broader problems in the UK system, which allows companies to pay less tax than they morally should. Tax campaigners say that failure is partly policy: successive governments have urged the tax authority to take a pro-business stance. The UK is one of the few rich countries not to have general anti-avoidance legislation, which the government is preparing now.

15%

The profit margin Starbucks' CFO told investors the UK had made in 2007. That year it reported its ninth annual loss

Source: Starbucks

Presented with the contradiction between Starbucks' UK accounts and its comments to investors, Starbucks' CFO Alstead identified two factors at play, both related to payments between companies within the group.

The first is royalties on intellectual property. Starbucks, like other consumer goods businesses, has taken a leaf out of the book of tech companies such as Google and Microsoft. Such firms were identified by Senator Carl Levin, chairman of the U.S. Senate Permanent Subcommittee on Investigations, in a September hearing on how U.S. companies shield billions from tax authorities. He said they were engaged in "gimmickry" by housing intellectual property units in tax havens, and then charging their subsidiaries fat royalties for using it.

Like those tech firms, Starbucks makes its UK unit and other overseas operations pay a royalty fee - at Starbucks, of six percent of total sales - for the use of its 'intellectual property' such as its brand and business processes. These payments reduce taxable income in the UK.

McDonald's also charges its UK subsidiary a royalty for 'intellectual property', although at a lower rate of 4-5 percent.

The fees from Starbucks' European units are paid to Amsterdam-based Starbucks Coffee EMEA BV, described by the company as its European headquarters, although Michelle Gass, the firm's president in Europe, is actually based in London.

It's unclear where the money paid to Starbucks Coffee EMEA BV ends up, or what tax is paid on it. The firm had revenues of 73 million euros in 2011 but declared a profit of only 507,000 euros. When asked how it burnt up all its revenue, Alstead pointed to staff costs and rent. The HQ has 97 employees.

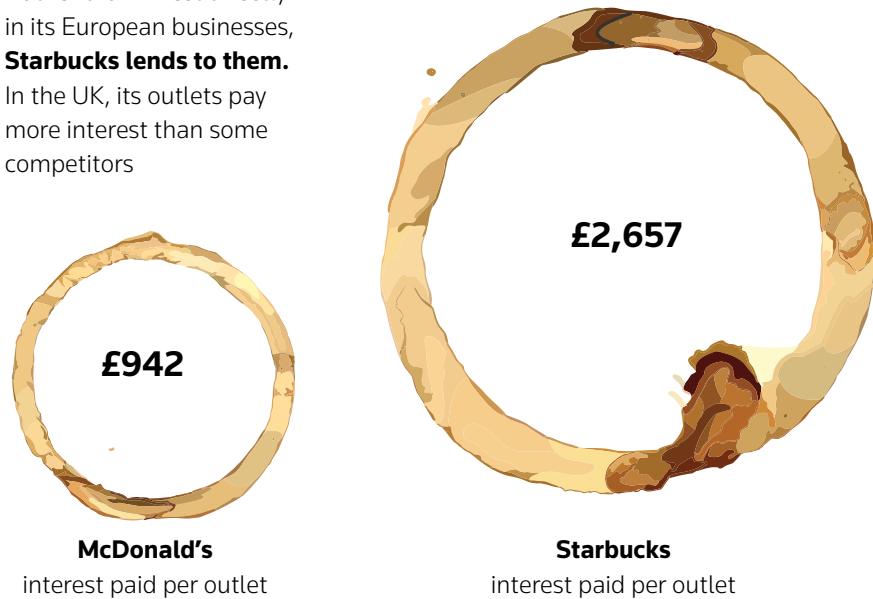
Alstead said some of the unit's revenue was also paid to other Starbucks units, including one in Switzerland. He declined to say if fees paid for the use of the brand, which originated in the United States, are sent back to be taxed.

Starbucks' tax reduction techniques

INTER-COMPANY LOAN

Rather than invest directly in its European businesses, **Starbucks lends to them.**

In the UK, its outlets pay more interest than some competitors



Starbucks' UK unit pays roughly £2 million in **interest that is tax deductible** a year, lowering its tax bill. For McDonald's UK units, that bill is around £1 million.

Professor Michael McIntyre at the Wayne State University Law School said it was rare for such fees to be repatriated to the United States, where corporate profits are taxed at up to 39 percent. In contrast in Switzerland, lawyers say, earnings from royalties can be taxed at rates as low as 2 percent.

Starbucks declined to comment when asked if it used offshore jurisdictions in this way.

ARM'S LENGTH

The UK tax authority, Her Majesty's Revenue & Customs (HMRC), allows companies to deduct intellectual property fees if firms can show the charges were made at "arm's length" - that is, if companies can show they would have agreed on the terms even if they were not connected.

One way to prove this is to show that a licence for which a royalty is paid is key to the subsidiary's profitability, said Stella Amiss, international tax partner with accountancy firm PwC. After all, if you are paying for an asset that never generates a profit, you are probably paying too much. "You would need to show a track record of profitability," she said.

Starbucks says it abides by the 'arm's length' principle, even if the company has not been profitable in the UK.

Accounts for McDonald's UK unit show it also pays trademark fees to associated companies, but these have generated profit. A spokeswoman for KFC said its UK unit did not pay such fees.

Accounting firm Deloitte, which audits both Starbucks' group accounts and those

of the UK unit, declined to comment.

The second factor for the contradiction between Starbucks' local accounts and its comments to investors is a requirement to allocate some funds generated in the UK to other subsidiaries in its supply chain. "The profit sits where the value is created. That is a principle we subscribe to," Starbucks CFO Alstead said.

Starbucks buys coffee beans for the UK through a Lausanne, Switzerland-based firm, Starbucks Coffee Trading Co. Before the beans reach the UK they are roasted at a subsidiary which is based in Amsterdam but separate from the European HQ.

Alstead said that tax authorities in the Netherlands and Switzerland require Starbucks to allocate some profits from its UK sales to its Dutch roasting and Swiss trading units. This is a common requirement, which multinationals meet by setting prices, known as a "transfer prices", for goods that pass between different group entities. Experts say transfer prices are also a way for a company to minimize its tax bill.

It's not clear how Starbucks allocates such costs. What is clear is that while its UK subsidiary is making a loss, its Dutch roasting operation has only a small profit. In the past three years, the Amsterdam unit

REUTERS TV



See the video:

<http://link.reuters.com/nur33t>

has had an average annual turnover of 154 million euros but recorded average profit of 1.6 million euros, or 1 percent of that, according to its accounts.

On average, 84 percent of the Amsterdam unit's annual revenue has gone on buying goods such as raw coffee beans, the electricity to roast them, and packaging.

Starbucks declined to give details, or comment on what the charges indicate about the price its roaster paid its Swiss unit

Fast food, tax lite

When does a hamburger become intellectual property? For fast food giants, the transformation happens at the tax office.

Restaurant chains such as McDonald's, Burger King and Subway, and coffee chain Starbucks, save millions in taxes each year by claiming that part of what they're selling is the parent companies' know-how.

There's nothing illegal about this, but tax campaigners such as Richard Murphy say the tactic "undermines the whole tax system."

Take Florida-based Burger King. It has units in more than a dozen European countries which operate stores and support franchisees, who pay to operate independent stores.

Local units in places such as the UK and Germany are liable for taxes on any profit they make, levied at around 25 percent. To reduce that profit – and the tax – the units pay a fee for the right to use the brand. At Burger King this is around 5 percent of sales.

Such fees are common in tech firms and other multinationals.

In Burger King's case, the IP was created in the United States, home of the Whopper. But the fee the European units pay to use it goes to Burger King's main European office in Zug, Switzerland. There the effective tax rate could range from 2 percent to 12 percent, according to Thierry Boitelle, tax partner with law firm Bonnard Lawson in Geneva.

Zug-based Burger King Europe GmbH retains the payments, a Burger King spokesman said. Had the fee been remitted to the United States it would have faced a tax rate of 35 percent to 39 percent.

Around a third of the company's total revenues of \$2.3 billion are generated outside the United States, Securities and Exchange Commission filings show. Burger King declined to comment on its royalty structures outside Europe.

BIG MAC, SUBWAY

It's hard to know how widespread this practice is. Tax experts say the use of intellectual property or royalty fees has existed for decades but spread after a U.S. loophole opened up in the 1990s. The fees first appeared in McDonald's UK accounts in 2007. The UK unit in 2011 paid 62 million pounds (\$99 million), 4-5 percent of its turnover, in such fees. McDonald's European headquarters is also in Switzerland.

McDonald's overseas subsidiaries generate over \$17 billion a year in revenues. "McDonald's believes that a local, decentralised approach is the best way to run our global business and drive long-term value," a UK spokesman said. He declined to say whether all overseas units pay royalties to group companies, or answer detailed questions. U.S. tax is paid on any royalties that flow to the United States, he added.

Sandwich chain Subway, with around 37,000 stores in 100 countries, has even more outlets than McDonald's. The chain, jointly owned by billionaires Fred DeLuca and Peter Buck, licenses restaurants across Europe directly from its European HQ in Amsterdam.

Subway International B.V. reaps around \$150 million each year in royalty payments from franchisees in Europe. However, accounts show almost all the income flows to its parent, a partnership registered in the Caribbean island of Curacao which offers tax exemptions on overseas income, according to accountants Deloitte. Subway declined to answer questions about its tax affairs.

The average corporate income tax rate among members of the Organisation of Economic Cooperation and Development (OECD) was 25.5 percent last year, according to Deloitte. Burger King and Starbucks had a 13 percent tax rate on overseas income last year, while McDonald's paid 20 percent, regulatory filings show. Subway does not publish such data.



JOB CREATOR: London Mayor Boris Johnson and Starbucks CEO Howard Schultz launch Starbucks' apprenticeships, a youth employment scheme, at the company's Mayfair branch. **REUTERS/ANDREW WINNING**

for coffee beans. It also declined to say what profit the Swiss coffee-buying unit makes, although Alstead said it was “moderately” profitable. Swiss law does not require the unit to publish accounts.

Corporate profits are taxed at 24 percent in the UK and 25 percent in the Netherlands, whereas profits tied to international trade in commodities like coffee are taxed at rates as low as 5 percent in Switzerland, lawyers there say.

Starbucks was the subject of a UK customs inquiry in 2009 and 2010 into the company's transfer pricing practices. This was “resolved without recourse to any further action or penalty”, a Starbucks spokesman said. HMRC declined to comment on the probe.

Starbucks' UK accounts show a third way it cuts its tax: inter-company loans. These are a common tactic for shifting

profits to low-tax jurisdictions, according to a guidance manual used by the UK tax authorities, who try to limit the technique.

Such loans bring a double tax benefit to multinationals: the borrower can set any interest paid against taxable income, and the creditor can be based in a place that doesn't tax interest.

An examination of its accounts shows that Starbucks' UK unit is entirely funded by debt, and paid group companies 2 million pounds in interest last year. For comparison, McDonald's UK – which has 465 more branches than Starbucks – paid only 1 million pounds in interest to its group companies last year.

Starbucks hardly cuts its UK subsidiary a good deal. Its group bonds carry a coupon of Libor plus 1.3 percent. Libor, the London Inter-Bank Offered Rate, is an international interest rate benchmark frequently

used in commercial lending. Starbucks charges its UK unit interest at Libor plus 4 percentage points. For comparison, KFC charges its subsidiaries around Libor plus 2 percentage points and the UK units of McDonald's pay affiliates interest at or below the Libor rate.

Additional reporting by Cezary Podkul, New York; Editing by Sara Ledwith, Richard Woods and Simon Robinson

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JAVA SIREN: Starbucks is a major presence in European countries such as France, Germany and the UK.

REUTERS/LUKE MACGREGOR

Like its UK operation, Starbucks's units in France and Germany use transfer pricing to keep taxes low

Starbucks's continental de-tax cafe culture

BY TOM BERGIN

LONDON, NOVEMBER 1, 2012

Starbucks told investors its European businesses made a \$40 million profit in 2011, but accounts filed for its UK, German, and French units, which make up 90 percent of European revenues, showed a loss of \$60 million.

Did the coffee giant lose \$100 million in the year between advising investors and filing its returns to European tax men?

Far from it. An examination of Starbucks's compa-

ny accounts in Germany and France shows the firm employed the same tactics there that Reuters recently showed it has used in the UK: reporting losses to the taxman while boasting healthy cashflows to investors.

Starbucks Chief Financial Officer Troy Alstead said the company simply used a different measure of profit when reporting its performance to investors and when filing its tax returns.

If the chain had reported its Europe, Middle East

TAXES STARBUCKS IN FRANCE AND GERMANY

and Africa (EMEA) region profit of \$40 million in the UK, France, Germany or the Netherlands, where its EMEA headquarters is based, it would have faced a tax liability of around \$11 million, according to Reuters calculations.

Instead, accounts for its European units show it paid around \$1.2 million in Dutch taxes and racked up millions of dollars worth of accounting losses it can use to reduce future German, French or British tax bills.

There is no evidence the firm has broken tax rules in any of the countries where it operates, and investors naturally expect companies to manage their tax bills.

“If you’re not finding ways to mitigate your tax responsibilities to the best of your ability, that’s something that will impact shareholders,” said RJ Hottovy, an analyst who covers Starbucks for Morningstar.

Alstead said that while Starbucks tried to optimise its tax bill, the company followed the rules and was not an aggressive tax avoider.

“Our intent is to be absolutely fair taxpayers everywhere,” he said.

But muscular tax planning also brings risks. A YouGov survey conducted days after Reuters reported earlier this month that Starbucks had paid just 8.6 million pounds (\$13.9 million) in British corporation tax on 3.1 billion pounds of sales over the past 13 years, showed that Britons now take a much more negative view of the firm.

The story prompted a wave of media criticism and British members of parliament called for an inquiry by the tax department. Prime Minister David Cameron, asked in parliament about the tax paid by Starbucks and other companies, said: “I am not happy with the current situation. I think the HMRC (UK tax authority) needs to look at it very carefully. We do need to make sure we are encouraging these businesses to invest in our country, as they are, but they should be paying fair taxes as well.”

In France and Germany, where Starbucks has not paid income tax in a decade



COFFEE MAN: Howard Schultz, president of Starbucks Coffee Company, opens the chain’s first outlet in France in 2004.

REUTERS/CHARLES PLATIAU

of operations, some politicians now say their tax men should also investigate the coffee chain’s affairs. Tax structures that allow corporations to shift money around to minimise taxes “is a form of corporate welfare”, said Sven Giegold, Member of the European Parliament for the German Green Party. He said he would raise the issue of Starbucks tax record with tax authorities in Bavaria, where Starbucks’s German unit is based.

A spokesman for Germany’s left-of-centre Die Linke party said it would ask the finance ministry to investigate whether Starbucks had complied with German tax rules.

The finance ministry said it did not comment on individual taxpayers. French and German tax authorities also declined to comment, citing taxpayer confidentiality.

Starbucks said in a statement it was “totally committed” to the UK, France and Germany. The company said that though it paid no corporation tax in what it called “three

of our largest and most important markets” in 2011, it had paid value added taxes, social security costs and business rates.

Alstead said the primary reason the French and German units didn’t pay corporation tax was because high rental rates and labour costs made it hard to turn a profit. The CFO said German tax authorities had expressed concern about the large accumulated tax losses Starbucks Coffee Deutschland had built up and was pressing the firm to agree not to use them to offset any future taxable income.

Starbucks said its overall tax rate, which includes deferred taxes that may or may not be payable in the future, was 31 percent in 2011. This compares with an average U.S. corporate income tax rate of 26 percent from 1987 to 2008, according to the Congressional Budget Office.

CAFE SOCIETY

Starbucks’s Europe, Middle East and Africa division has boasted sales of \$1 billion in each of the past three years. The UK contributed most of that – in 2011, for instance, its turnover was \$636 million.

The company operates in the UK, France and Germany via wholly owned subsidiaries that manage coffee stores and license the brand to other retailers. It also has smaller, wholly owned subsidiaries in Switzerland, Austria and the Netherlands.

Most of the rest of the income generated by the firm’s EMEA division comes from licensing fees paid by partners operating under the Starbucks brand in countries such as Spain, Greece and Russia.

Starbucks entered Germany with a cafe near Berlin’s Brandenburg Gate in 2002 and now operates 150 stores in the country. It opened its first French store, near Paris’s Opera House, in 2004 and now has over 60 branches in France.

Starbucks executives like to recall how critics predicted their failure in France and Germany, which had long-established café cultures that shared little with Starbucks’s

TAXES STARBUCKS IN FRANCE AND GERMANY

uniform interiors, paper cups and whipped-cream-topped concoctions such as Cinnamon Dolce Lattes and Mocha Frappuccinos.

“A lot of people asked if Starbucks would have any relevance in Germany,” Chief Executive Howard Schultz told Germany’s *Frankfurter Allgemeine Zeitung* in 2008. “I think we’ve proven that we’ve been accepted in Germany.”

In December 2010, John Culver, president of Starbucks’s international division, told an investor conference that the German unit “showed a profit on the bottom line” in the year to October. He also said France had turned “cash flow positive”.

Yet the accounts Starbucks Coffee Deutschland GmbH and Starbucks Coffee France SAS filed to local company registers showed losses in 2010 and 2011, as in every previous year.

Starbucks had sales of 117 million euros in Germany last year, accounts for the local unit show. It reported a loss of 5.3 million euros and paid no income tax.

The group had sales of 73 million euros in France, but reported a loss of 2.5 million euros and paid no income tax.

By contrast, the German unit of Mc-

“A lot of people asked if Starbucks would have any relevance in Germany. I think we’ve proven that we’ve been accepted in Germany.”

Howard Schultz
Chief Executive

Donald’s had turnover of 196 million euros in 2010, the most recent year for which accounts are available, and paid tax of 12.6 million euros. McDonald’s France paid tax of 49 million euros last year on 812 million of revenue.

A ROYAL LOSER

Alstead said the accounts its French and German units file could vary from the picture given to investors because of inter-company payments that can be deducted when calculating the units’ taxable income.

Like the UK division, the French and German units use inter-company transfers to shift profit.

In France and Germany, the main deduction is a royalty the two units pay to their immediate parent, Netherlands-based Starbucks Coffee EMEA BV, for “use of the trademark and Starbucks business processes”, according to a spokeswoman.

The fees are equivalent to 6 percent of turnover, and additional charges of \$25,000 are also due when the local units open a new store, accounts for the units show.

Royalty payments helped Starbucks achieve an average tax rate of 13 percent on overseas income in 2011, lower than consumer companies such as Nike, Wal-Mart, Gap, Burger King, Yum Brands and Tiffany.

Other U.S. companies also charge their European units fees to use trademarks or business processes, though not as much as that charged by Starbucks.

McDonald’s and Burger King charge their European units a fee of 4-5 percent of turnover. Supermarket chain Wal-Mart charges its UK subsidiary Asda 0.6 percent

for various services including royalties. A spokesman for Kentucky Fried Chicken, owned by Yum Brands, said it did not charge associated companies money to rent the KFC brand.

Starbucks is unusual among these chains in that the royalty fee it charges European units has consistently eaten up most or all of the profits they would otherwise have earned. Other retailers would not comment on why they don’t charge higher fees.

International tax rules allow companies to deduct royalty payments to associated entities, provided they are at “arms length”. In other words, a Starbucks unit has to establish it would have agreed to pay an unrelated company 6 percent of turnover to rent a comparable brand and business processes.

Starbucks said it followed industry practice and that it abides by the “arms length” rule at all times.

In 2009, though, after a decade of losses, the British taxman challenged Starbucks’s deduction of a 6 percent royalty and told the company it could deduct just 4.7 percent from taxable income in future, Alstead said. HMRC would not say what prompted the examination.

DUTCH WINNER

Though the Starbucks brand was developed in the United States, the brand fees the French and German units pay do not go back there, where they might face tax at 35-39 percent, but to the Netherlands.

Dutch corporation tax is 25 percent, but tax experts say few of the many multinationals that transfer royalties from European units to a related company in the Netherlands pay tax there at that rate.

Dutch tax officials declined to comment on Starbucks, citing taxpayer confidentiality.

European Union rules allow the transfer of such fees within the bloc without tax deductions, but require withholding taxes to be levied when the fees are moved outside the bloc. But Dutch tax law allows companies to send royalty fees earned in other countries



HOT BREW: A customer in the chain’s Mayfair Vigo branch in central London.

REUTERS/ANDREW WINNING

TAXES STARBUCKS IN FRANCE AND GERMANY

on to tax havens without incurring taxes.

In September, the European Parliament voted to close this loophole. But its views on tax matters are only advisory, and rule changes require unanimity among member states.

Despite the royalties it receives, Starbucks Coffee EMEA doesn't make much profit either. On revenues of 73 million euros in 2011 it managed a profit of just 507,000 euros.

When asked how the unit burnt up its revenue, Alstead cited staff costs – the HQ has 97 employees – and rent. Average gross earnings are 44,800 euros per head in the Netherlands, according to Eurostat, while rent on an Amsterdam office to house 100 employees would typically cost about 300,000 euros a year, said Michael Hesp of real estate firm Jones Lang LaSalle Netherlands.

Even if Starbucks Coffee EMEA BV paid twice those average wages and rents, that would account for only 13 percent

of revenues.

Alstead said the unit also paid other group companies for unspecified services, including a Swiss-based associate he declined to identify.

The French and German units also run up big losses thanks to their large debts.

Rather than investing cash in these units, Starbucks Coffee EMEA lends them money to fund growth. The interest on those loans – charged at a higher rate than the group pays to borrow – reduces the taxable income of the national units, according to tax rules in both jurisdictions.

Starbucks itself has a conservative debt-to-equity ratio of 12.5 percent, meaning its business is mostly financed by shareholders' capital and retained profits. Its French and German units, however, are overwhelmingly financed by debt, with ratios of 156 percent and 764 percent, respectively.

Alstead said the high debt levels were a

function of the French and German units' weak profitability, which required the parent to extend loans to help them cover their bills.

The Dutch unit has also taken on loans, but the company declined to identify the lender.

Without royalty fees and interest payments, Starbucks's French and German units would have generated a profit of over 10 million euros in the past two years and faced a tax liability of 3.4 million euros, the units' accounts show.

Instead, Starbucks Coffee EMEA BV and the group's Amsterdam-based roasting unit, Starbucks Manufacturing EMEA, declared profits of 2 million euros in 2011 and paid taxes of 870,000 euros.

Starbucks declined to say where the rest of its 2011 EMEA profit ended up or how much tax was paid on it.

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GERMAN APPEAL:

A branch in Germany's financial centre

Frankfurt. **REUTERS/**

RALPH ORLOWSKI

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Insight - eBay's double tax base prompts calls for investigation

Sat, Dec 1 2012

By [Tom Bergin](#)

LONDON (Reuters) - Britain and Germany may have missed out on a combined \$1 billion (623 million pounds) in sales tax since online marketplace eBay picked a tiny Luxembourg office as its base for EU sales, a shift that lawmakers say should now be investigated.

eBay's nomination of Luxembourg unit eBay Europe Sarl - with a staff of nine - as its provider of services to EU clients allows it to charge customers in Europe a low rate of sales tax, often known as Value Added Tax, helping it to compete against rivals.

However, the unit doesn't actually receive the money from sales. Instead, eBay said it continues to channel revenues through a Berne-based unit, allowing the company also to benefit from what Swiss tax lawyers say is the most competitive corporate income tax regime in Europe.

EU rules allow companies to establish subsidiaries in Luxembourg and levy VAT at Luxembourg's low VAT rate on sales to customers across the bloc.

However, the rules also allow individual EU taxmen to challenge any claim to Luxembourg residence, and the right to charge Luxembourg VAT, in their domestic courts, if the taxman feels a Luxembourg-based subsidiary does not have sufficient staff or assets to support its claim to be the true supplier of goods or services.

Tax experts say eBay's arrangement, which appears to give eBay the best of both income and sales tax worlds, could be open to challenge, and lawmakers in the UK and Germany want their taxmen to investigate.

"I hope that HMRC (UK tax authority Her Majesty's Revenue and Customs) takes note ... and takes prompt action," said Margaret Hodge, member of parliament and chairman of the Public Accounts Committee (PAC), which monitors government finances.

"I will be seeking assurance that they are, next time we take evidence from HMRC," she added. Officials from HMRC are due to testify to the PAC in early December as part of the committee's investigation into tax matters.

Sven Giegold, member of the European Parliament for Germany's Green Party, said he wanted the German tax authorities to "have a very critical look at this".

It is common for companies to seek to reduce their tax bills, and a number of multinationals have established bases in Luxembourg so they can charge customers lower levels of VAT.

eBay said HMRC was aware of all its tax arrangements and that it was confident it met all its tax liabilities in the UK and elsewhere.

"In all countries and at all times, eBay is fully compliant with national, EU and international tax rules (including the OECD) including the remittance of VAT to the appropriate authorities," an eBay spokesman said in an emailed statement.

The UK, German, French and Luxembourg tax authorities declined to comment on eBay, citing rules on taxpayer confidentiality.

LOWER THRESHOLD

Big companies' tax practices have risen to the top of the political agenda in Europe in the past year, with lawmakers growing increasingly frustrated with the way in which companies such as search engine company Google pay almost no income tax in countries where they have billions of dollars in sales.

The companies escape liability for income taxes in countries like the UK by arguing the value created by their business, and therefore the location where the profit should be realised, is not the place where the customer resides, but rather in the location where the intellectual property underpinning the product or service is based.

Chas Roy-Chowdhury, head of taxation at the Association of Chartered Certified Accountants, said this was a valid



economic argument and that if, for example, HMRC wants to claim more income tax from Google, it has to prove the company is generating more value in the UK than it is declaring.

This would require a thorough deconstruction of its business model and supply chain.

However, it is easier to establish liability to VAT, since this tax hinges simply on the location of the buyer and seller.

"The threshold is lower," said Simon Newark, head of VAT at accountants UHY Hacker.

"There are a lot more aspects for HMRC to challenge in VAT than in direct (income) tax."

For tax purposes, the EU deems eBay's online platform an "electronically supplied service", a category that also covers e-Books and music downloads.

Under EU rules, suppliers of such services based within the bloc are supposed to charge EU customers VAT at the rate prevailing in the country where the supplier is based.

A number of suppliers of electronic services, including Amazon.Com Inc and Apple Inc's iTunes have established European headquarters in Luxembourg to enable them to charge customers lower VAT rates than prevail in their customers' countries.

Luxembourg has traditionally charged the lowest standard VAT rates in the European Union. Its 15 percent rate compares with rates of 19-25 percent in most other EU members.

By charging customers VAT at Luxembourg's rate eBay is better able to compete with rivals based elsewhere in the EU, such as Britain's eBid, which must charge customers VAT at the standard UK rate of 20 percent.

However, to be entitled to charge Luxembourg rates, a company has to be able to prove in British, German or EU courts that it is genuinely based in the Grand Duchy.

Companies selling to EU customers from outside the EU - as eBay was until the 2007 nomination of eBay Europe Sarl as supplier to EU clients - must charge European customers VAT at the rate prevailing in the country where the customer resides, and to pay that VAT to the taxman in the customer's country.

There is no definitive checklist that determines the true base of a company and any decision by a national court can be challenged in the European Court of Justice. In the UK, HMRC said it approached the matter on a case-by-case basis, and disputes are often resolved in court.

"HMRC will challenge any arrangements where it is claimed that supplies are made from a particular country but the business does not have the necessary resources to make those supplies," a spokesman said.

EUROPE EXPANSION

eBay, which is headquartered in San Jose, California, moved into Europe in 1999 when it established eBay International in Berne. Switzerland's low income tax regime for foreign companies was highly beneficial for the auction site. "We do have a very favourable international tax structure," then-Chief Financial Officer Rajiv Dutta told analysts in 2002 when asked how the company managed to pay such low taxes on its non-U.S. income.

The Swiss base also meant, initially, that the company didn't have to charge EU customers VAT. But in 2003, Brussels changed the rules, which forced eBay to charge EU sellers on its platform VAT based on their residence. The VAT gathered was remitted to the tax authority in the customer's country.

Not all customers are charged VAT. Most medium-sized and big businesses are legitimately exempted from paying VAT on some purchases, such as eBay seller fees.

eBay's Swiss-based European public relations head declined to say what portion of its EU customers were liable to be charged VAT. James Cordwell, equities analyst at Atlantic Equities, estimated that such customers accounted for 40-50 percent of sales in Europe.

Since the 2007 creation of its Luxembourg operation, eBay has had German fee revenues of \$6.1 billion and UK revenues of \$5 billion, its annual accounts show.

If the services were supplied from Switzerland or another non-EU country, and assuming only half of customers should have been charged VAT, EU rules would have obliged eBay to collect \$580 million in VAT for the German taxman and \$500 million in VAT for HMRC since 2007.

eBay's entitlement to charge Luxembourg VAT on sales and to pay this to the Luxembourg taxman rests on being able to prove in court that eBay Europe Sarl is the provider of services to EU clients.

But despite German and UK fee income of \$3.1 billion last year, eBay Europe Sarl recorded turnover of only 5 million euros in 2011.

John Hemming, an MP with the Liberal Democrats, the junior partner in the British coalition government, said the fact eBay's sales revenues did not go through the Luxembourg unit undermined the claim that it was the true provider of services to EU clients.

"If it's a real transaction, you would expect the money to pass with it, and not pass someplace else," he said.

Rather than going to Luxembourg, the money generated from customers continues to go to Berne-based eBay International

AG, a spokeswoman said.

When Reuters visited in mid November, staff at the Luxembourg office, just opposite the central post office, declined to discuss what operations the unit conducted for eBay.

A spokesman later said the office conducted activities including billing, data privacy, contracting, regulatory, management and some customer services operations.

By contrast, Amazon and iTunes do report their sales of ebooks and music downloads to EU customers through their Luxembourg units.

Prem Sikka, professor of accounting at Essex University, along with Newark and Roy-Chowdhury said a cash trail through a unit was one of the key factors used as evidence that the unit was the true supplier of a service.

UK and German tax authorities could argue that the shift in eBay's supply base to Luxembourg from Berne was therefore not genuine. If successful, they could claim back the VAT lost.

EBay declined to say why it channelled sales through Switzerland. Tax advisors say the country can still offer some companies lower tax rates than other European low-tax jurisdictions such as Ireland and Luxembourg.

Indeed, eBay's closest rival Amazon, which channels about half its non-U.S. earnings through Luxembourg, reported average income tax on overseas earnings of 6 percent in the past four years. eBay paid just 3 percent over the same period.

(Additional reporting by Brenda Goh; Editing by Will Waterman)

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DUSKY VALLEY: The Grand Duchy of Luxembourg is a haven for firms that want to minimise their corporation tax. REUTERS/FRANCOIS LENOIR

How the online retailer's Luxembourg operation built a \$2 billion cash pile out of reach of U.S. tax authorities

Amazon's billion-dollar tax shield

BY TOM BERGIN
LUXEMBOURG, DECEMBER 6, 2012

In 2005, Amazon rented a historic five-storey building in Luxembourg's Grund quarter, right at the bottom of a steep rock-walled valley below the old town.

By setting up in Luxembourg, and channelling sales through its units there, the world's biggest online retailer could minimise corporate taxes.

It was a move with big financial consequences.

Amazon's Luxembourg arrangements have deprived European governments of hundreds of millions of dollars in tax that it might otherwise have owed, as reported in European newspapers. But a Reuters examination of accounts filed by 25 Amazon units in six countries shows how they also allowed the company to avoid paying more tax in the United States, where the company is based.

In effect, Amazon used inter-company payments to form a tax shield for the group, behind which it has accumulated \$2 billion to help finance its expansion.

Amazon revealed last year that the U.S. Internal Revenue Service (IRS) wants \$1.5 billion in back taxes. The claim, which Amazon said it would "vigorously contest", is linked to its foreign subsidiaries and payments made between them.

The issue highlights the way multinationals reduce their taxes by parking intellectual property in tax havens and charging affiliates big fees for using it. Politicians in rich countries are beginning to target such practices, which have been used by other multinationals including Google and Microsoft.

U.S. Senator Carl Levin has called the tactics "gimmickry." Michael McIntyre, a tax expert at Wayne State University in Michigan, said that while Amazon's arrangement, and others like it, looked like commercial transactions, they actually only served to reduce taxes.

"The IRS shouldn't be happy about this," he said. "It sounds like they're not."

Amazon declined to answer questions about its tax affairs for this story, the latest



FROM A TO Z: Amazon's Luxembourg operation employs 300 people. Amazon says it is the nerve-centre of the European business. **REUTERS/FRANCOIS LENOIR**

in a Reuters series on corporate tax avoidance. In an emailed statement a spokesman said that "Amazon pays all applicable taxes in every jurisdiction that it operates within."

The group has come under scrutiny from tax departments in at least six countries over the past six years. Tax authorities in the United States, UK, Germany, France and Luxembourg declined to comment, citing rules on taxpayer confidentiality.

The Luxembourg structure, outlined by media including the Guardian newspaper in April, fulfils a corporate obligation to shareholders to maximise returns. There is no suggestion the company has broken any laws; Amazon, which started out selling books and now offers everything from tools to toys, paid an average 44 percent tax on its

“All the strategic functions for our business in Europe are based in Luxembourg.”

Andrew Cecil

Amazon's head of public policy

U.S. earnings in the last five years.

This is an examination of how Amazon set up its tax shield, and how it works.

MARKET SHARE

Amazon's first foray abroad came in 1998, when it bought online retailers in Britain and Germany and rebranded them Amazon.co.uk and Amazon.de. In 2000, it launched a French website, Amazon.fr.

At first it did little to integrate these foreign units, former senior executives say. Even product purchasing – where Amazon would later squeeze huge savings by negotiating hard with suppliers – was handled independently in different markets.

"There were no real operational synergies in our early years. The units operated largely independently," said Todd Edebohls, current CEO of recruitment website Inside Jobs, and Amazon's Director of Business Development and Sales between 1999 and 2007.

But in late 1999, accounts for the UK business show, the UK unit's principal activity changed from "marketing and selling

How Amazon parks profits in Luxembourg

EUROPE



European customers pay Amazon EU SARL in Luxembourg. Orders filled by country units



Amazon EU SARL pays up to **€583 million a year** to its parent



Money builds up, earning tax-free interest

Amazon Europe Holding Technologies makes payments back to Nevada of up to **€230 million per year**

AMERICA



Parent company Amazon.com Inc has minimal tax liability

of books via the Internet” to “the provision of services to other group undertakings.”

People shopping on Amazon.co.uk would now do business with a U.S. unit registered in Delaware. There were similar changes at the German business: in effect, the fast-growing European units had become fulfilment operations just to distribute packages and offer customer support. Amazon's accounts show the bulk of its overseas revenues were now attributed to the U.S. parent.

That shift helped with a problem it faced at home.

Founded in 1995 and listed two years later, the company lost money every year until 2003. This was standard practice for a dotcom startup: Amazon focused on market share rather than profit.

But by the end of 1999 Amazon's accumulated losses were so large - more than \$1 billion - that its own accountants would not

let the firm recognise them as a tax asset, because it was unclear it could ever make enough profit to use them up. Bringing foreign profits home allowed Amazon to set them against U.S. losses, so the company did not have to pay tax on overseas profits, according to Stephen Shay, a professor of tax law at Harvard University.

SERVICES, NOT BOOKS

That changed in 2003, when Amazon started making a lot more profit in the United States. There was a chance the foreign earnings would now increase its global tax bill, according to Shay, because U.S. corporate tax rates were higher than in other markets such as Britain.

Amazon turned to the tiny country of Luxembourg. The Grand Duchy has a population of 500,000 - half the size of Rhode Island - and offers a variety of advantages. It's a member of the European Union, so businesses

based there can sell across EU borders with less red tape. Then there's the tax rate.

Luxembourg has a headline charge on corporate income of 29 percent, but under certain circumstances it will exempt income a company earns through intellectual property by up to 80 percent, a government spokesperson said. This cuts the effective tax rate to below 6 percent. Tax advisers and academics say rates close to zero can be achieved using other methods.

In June 2003, Amazon registered Amazon Services Europe SARL in Luxembourg, establishing an office in a drab grey concrete building overlooking the central bus depot. The initials stand for Societe a Responsabilite Limitee - a limited company, liable for tax.

A month later, it told clients in the UK its terms were changing. Contracts with third-party retailers who used Amazon to sell their products would no longer be

handled in the United States but with the Luxembourg unit.

In June 2004, Amazon established another Luxembourg entity - Amazon Europe Holding Technologies - whose purpose was to hold shares in Amazon group companies and "to acquire ... any intellectual property rights, patents, and trademarks licences and generally to hold, to license the right to use it solely to one of its direct or indirect wholly owned subsidiaries."

This group was set up as a "Societe en Commandite Simple" or SCS, a type of limited partnership that a Luxembourg government spokesman said is exempt from income taxes. It has not had any operational staff or premises, its registered address being the offices of a trust services company in an upmarket residential area west of Luxembourg's old town.

A month later, this company established a third Luxembourg company, Amazon EU SARL, whose principal purpose was to "sell, auction, rent or otherwise distribute products or services of all types" via Amazon websites.

This taxable unit was to become, on paper at least, the supplier of all goods and services to Amazon's European customers.

FROM NEVADA TO LUXEMBOURG

To be tax efficient, though, Amazon needed to shift the profit this unit would make into its untaxed parent. The easiest way to do this was for Amazon EU SARL to pay Amazon Europe Holding Technologies a fee to license the Amazon technology it would use to sell things.

There was just one problem: Amazon Europe Holding Technologies had no technology to license. Amazon's patents - including the Amazon brand and its '1-click' ordering software - were held by Amazon Technologies Inc, a unit registered in Nevada, Patent and Trademark Office records show.

In early 2005, Amazon did an inter-company deal that solved this problem.



LESS THAN MEETS THE EYE: Luxembourg's headline tax rate is 29 percent, but exemptions make it is possible to bring that near to zero.

REUTERS/FRANCOIS LENOIR

Exact details of the arrangement have never been made public and Amazon declined to clarify them. Chief Financial Officer Tom Szkutak told analysts on a conference call a few weeks afterwards that the deal to create the Luxembourg operation involved shifting "certain operating assets" offshore and that it would boost the group's 2005 tax bill by \$58 million but "beneficially impact our effective tax rate over time."

Amazon's Luxembourg arrangements have helped it pay an average tax rate of 5.3 percent on overseas income over the past five years, less than a quarter of the average rate across its major foreign markets.

Company accounts show that since 2005, Amazon Europe Holding Technologies started to make payments to Amazon Technologies Inc in Nevada of up to 230 million euros (\$300 million) each year. At the same time it received up to 583 million euros each year from its European affiliates.

The difference stayed in Luxembourg.

Had Amazon remitted all that to the United States and then paid the headline U.S. corporate income tax rate on it, the

firm would have incurred taxes of more than \$700 million. But it has not and the deal has allowed Amazon's Luxembourg unit to accrue tax-free cash worth more than \$2 billion.

Historically, such inter-company payments might have been treated as a taxable dividend under U.S. tax law, but a provision introduced in 1997 known as 'check-the-box' allowed companies to have them disregarded by the IRS. Senator Levin, a Democrat, is among many U.S. politicians who want this loophole rescinded.

"HEADQUARTERS OF NIGHT LIFE"

For Amazon's tax-free money-making machine to work, it had to show it had more than a nameplate in Luxembourg.

To benefit from favourable taxation, the Grand Duchy says firms "must ensure that they give adequate substance to their presence in the country in terms of both logistics and staff." At the end of 2005, Amazon had just a dozen staff there. If tax departments around the continent were to recognise the arrangement, Amazon needed a meaningful corporate presence.

In February 2006, it transferred ownership of its UK, German and French businesses to Amazon EU SARL, and ownership of its UK and French web domains to Amazon Europe Holding Technologies. It also moved some U.S. executives to Luxembourg, hired more locals and began to call Amazon EU its European headquarters.

Filings show that in December 2006, the group relocated its Luxembourg operating units into the rented building on Plaetis Steet, a stone's throw from the English and Irish bars that lead the city-state's tourist office to describe the Grund and neighbouring Clausen as the "Headquarters of Luxembourg's night life."

As the cash built up in Amazon Europe Holding Technologies, the firm started to lend to Amazon EU SARL. Besides funding international expansion, this has generated up to 45 million euros a year in interest

since 2005 – all untaxed.

Today, Amazon calls its 300-person Luxembourg operation the nerve-centre of an operation which employs tens of thousands of people across the continent. It expanded into a new building, opened by Luxembourg's Finance Minister, Luc Frieden, in October.

"All the strategic functions for our business in Europe are based in Luxembourg," Amazon's head of public policy, Andrew Cecil, told UK parliamentarians in November.

At home in the United States, though, the Internal Revenue Service seems unconvinced.

Amazon disclosed in October 2011 that the IRS wanted \$1.5 billion in unpaid taxes. It has declined to say exactly what transactions the charge relates to but said it was linked to "transfer pricing with our foreign subsidiaries" over a seven-year period from 2005.

"We disagree with the proposed adjustments and intend to vigorously contest them," Amazon said at the time. "If we are not able to resolve these proposed adjustments ... we plan to pursue all available administrative and, if necessary, judicial remedies."

Shay, the Harvard professor who contributed to a recent Congressional committee investigating tax avoidance, said the fact the Luxembourg unit charged a much higher price than it paid for the right to license Amazon intellectual property could open the company to an investigation into whether it is engaging in abusive transfer pricing.

"The price originally paid to the U.S. for the rights is something the IRS should want to look at," he said.

Transfer pricing is the way corporations trade goods or services between their units. Many multinationals use it.

The Organisation for Economic

Co-operation and Development, which lays down the rules on transfer pricing, stipulates that it should not be used to shift profits from high tax jurisdictions to low tax jurisdictions.

The IRS declined to comment.

Additional reporting by Alistair Barr in San Francisco; Edited by Sara Ledwith and Simon Robinson

FOR MORE INFORMATION

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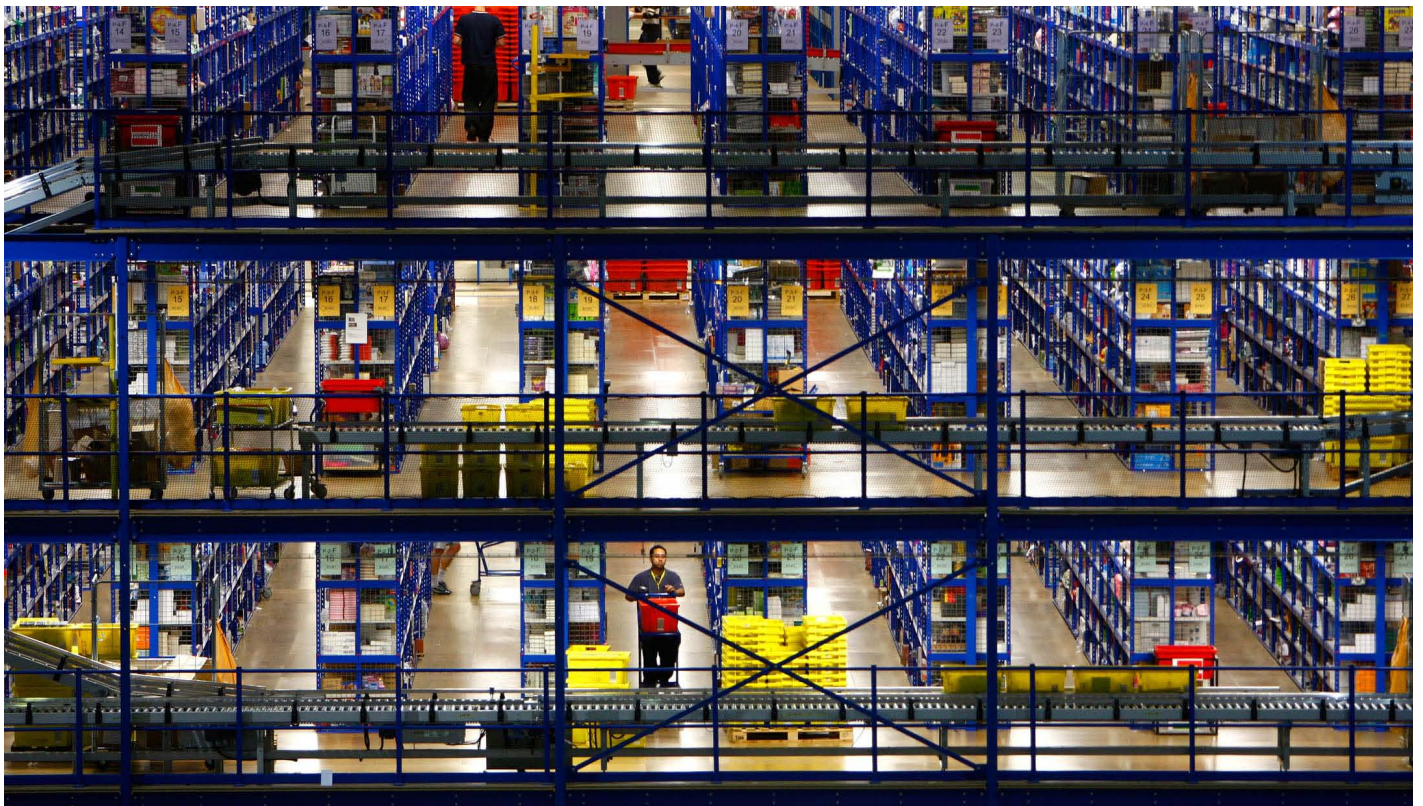
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THE PICKING TOWER: Amazon's warehouse in Milton Keynes, UK, in 2007. REUTERS/KIERAN DOHERTY