Funding the Future

Starbucks: brewing up more than coffee when it comes to…

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Last week's big tax story was Facebook. It's a new week, it's time for a new story, and a new US company that's willing to play the world's tax systems off against each other for its own benefit.

Reuters has investigated Starbucks accounts and found:

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.

I should mention straight away that I played a role in tuis investigation: Reuters have shown me the evidence and the claims they make are supported by it. As they say:

The Seattle-based group, with a market capitalization 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.

In fact:

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 capitalization, 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.

How come, because this seems no chance. Reuters have analysed both the accounts and shareholder presentations to come to the conclusion that this paradox exists. The shareholders are told the UK is profitable. HMRC are told something different. As Reuters note:

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

So it's important to share Reuters point that:

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.

And that puts Starbucks in with the IT companies in appearing to be almost totally tax compliant in the US and mysteriously a little more difficult to pint down when it comes to what happens when they're operating away from home.

As Reuters note, having reviewed 46 shareholder announcements:

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."

But as they go on to note, despite that:

In 2009, accounts filed in London claimed a record loss of 52 million pounds for the financial year to September 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.

And guess what:

Starbucks UK unit's accounts for the year to September 2011 showed a 33 million 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."

All of which is odd as Reuters note:

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.

Others have a differen view:

Michael 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.

So, how do they do it. Reuters suggest two things account for the alchemy of turning operating profits into tax losses, both related to payments between companies within the group. The first is royalties on intellectual property. As Reuters note:

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.

What happens to that money?:

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.

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.

That's its right, of course.

Now, none of this is illegal: if Starbucks can convince H M Revenue & Customs why they have to pay a royalty they can deduct it for tax. But it's weird that the result is almost always a loss. That makes no commercial sense, at all.

Then there's the other factor that might have a role to play:

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.

As Reusters note:

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 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.

No one outside Starbucks knows what the Swiss operation makes. But if, as is possible, it like the Dutch company is profitable there is again an odd anomaly when the UK company is not.

Which brings us to method number three to reduce profit used by Starbucks UK:

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.

Of course none of this is illegal. But it just means Starbucks can on the one hand sing the praises of its profitable IUk operation and yet manage to pay no tax. Yet again the credibility of the tax system is undermined as a result.

And that's why we need worry about this, because as the credibility of our tax system unwinds so with it does the structure and coherence of our society. And that's what really worries me.