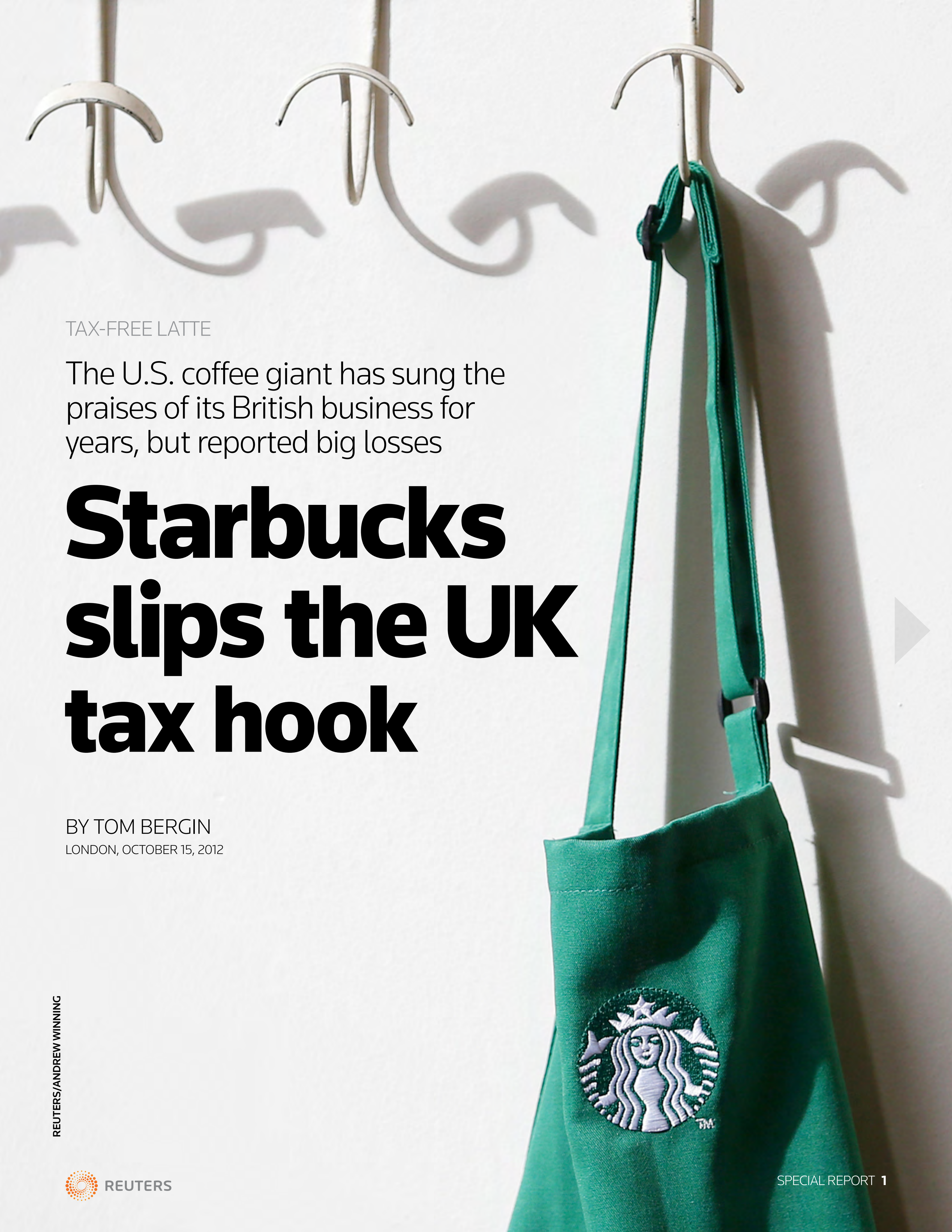


REUTERS/ANDREW WINNING

TAX-FREE LATTE

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

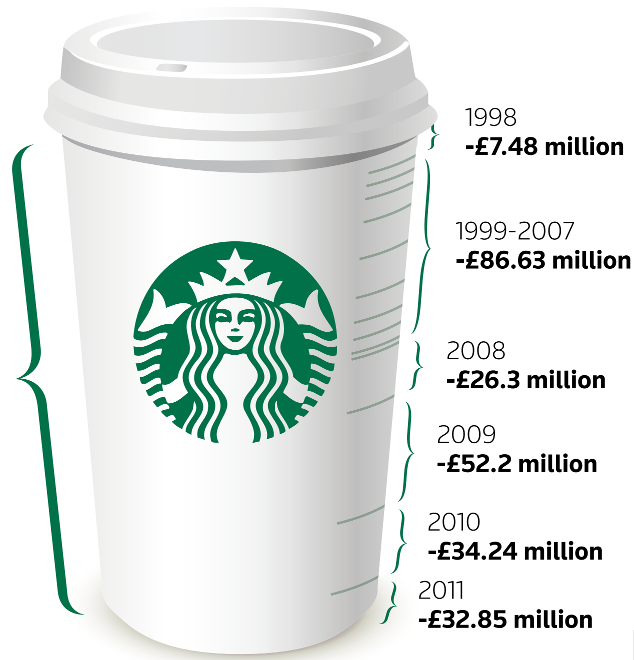
Starbucks slips the UK tax hook

BY TOM BERGIN
LONDON, OCTOBER 15, 2012

Starbucks' tax reduction techniques

A CUPFUL OF LOSSES

STARBUCKS' UK LOSSES, BY YEAR



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

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 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 taxman 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 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."

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.

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?

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

McDonald's
interest paid per outlet

Starbucks
interest paid per outlet

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 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

REUTERS TV

See the video:
http://link.reuters.com/nur33t

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.

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