



The Centre for Enterprise, Markets and Ethics

An investigation into the issues surrounding the corporate tax arrangements of the Starbucks Coffee Company (UK) Limited

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1 Introduction

- 1.1 A number of multi-national corporations with significant operations in the United Kingdom have come under extensive media scrutiny for their tax affairs.
- 1.2 This report is an initial investigation into some of the detailed issues which emerge as a preliminary to further work into the wider issues of the ethics of corporate taxation.
- 1.3 Among others, Starbucks was criticised for reporting the payment of no corporate taxation in the years 2009-2011 despite significant sales, extensive operations and briefings to analysts on its profitability and success.
- 1.4 Media reporting tended to concentrate on the emotive and political aspects of the issues. The Chairman of the Conservative Party said that ‘companies in this country need to pay their way,’ the Prime Minister suggested waking up to smell the coffee, and Margaret Hodge, the Chairman of the House of Commons Public Accounts Committee said that several firms were ‘getting away with paying little or no corporation tax.’¹
- 1.5 There is no suggestion of illegal behaviour on the part of Starbucks or others.
- 1.6 The question of morality can only be discussed with a full and proper understanding of the purpose and nature of the business corporation, their place in the economy and the appropriate role of systems of taxation and the role of government.
- 1.7 The debate revealed a lack of understanding about corporate taxation but also exposed accounting and disclosure issues for the company.
- 1.8 An in-depth study was carried out by Tom Bergin of Reuters comparing analysts’ statements and the company’s accounts.²
- 1.9 This study draws upon the published accounts in the United Kingdom, the filings of the Starbucks Corporation with the Securities and Exchange Commission in the USA, statements from Starbucks and media and other publicly available statements.
- 1.10 The purpose of this investigation is to seek to place the debate onto a more solid intellectual footing, to describe carefully and accurately what the real issues are, the

¹ The Guardian, 27th January 2013; M. Hodge, 3rd December 2012, speaking on the publication of HMRC Accounts 2011-12, reported at <http://www.parliament.uk/business/committees/committees-a-z/commons-select/public-accounts-committee/news/hmrc-accounts-2011-12-report/>

² Tom Bergin, Reuters, ‘Special Report: How Starbucks avoids UK taxes.’

practices which have been adopted and their implications and to consider areas for further investigation.

- 1.11 The Centre for Enterprise, Markets and Ethics was established as an independent charity and company in 2012 with the aims of articulating a vision for an enterprise economy informed by the values and ethics of the Judeo-Christian tradition.

2 Executive Summary and recommendations

- 2.1 The announcement of a voluntary payment of corporation tax by Starbucks demonstrated a lack of appreciation of both the nature of taxation and the responsibilities of companies. It also indicated a level of corporate embarrassment which raises questions over transparency and disclosure.
- 2.2 Comment in the wider media was also characterised by a lack of understanding of the real issues.
- 2.3 The place and role of taxation is a moral as well as a legal issue but cannot be considered in isolation. The role of economic growth and investment, the consequential implications for pension fund investments, employment and the payment of employment taxes, the place of the family and the voluntary sector, as well as the role of government, the level and nature of the tax system should be considered as an integrated whole.
- 2.4 There are a number of significant issues involving multi-national organisations concerning the appropriate recognition of revenues and costs in various jurisdictions which may have differing levels of corporate taxation, their accounting and their disclosure. In addition questions arise over the role of the tax authorities in giving explicit or implicit consent to particular arrangements, the disclosure of corporate structures and the transactions which take place within those structures.
- 2.5 The payment of royalties or licence fees for the use of intellectual property within the Starbucks group of companies had a significant impact upon its tax liabilities. To establish such charges at a level which effectively prevented the long-term profitability of the company would suggest that the level of such charge was too high. The practices adopted undermined the value of the brand established in this country after several years of operation. Most importantly companies need to ensure that there is a coherent intellectual argument behind their taxation and accounting policies.
- 2.6 A second area which raised significant matters of concern involved the pricing structure for the purchase of coffee beans by the UK company. This remains an area which lacks information and could be easily corrected by appropriate disclosure.
- 2.7 A further area was the manner in which loan finance was provided by the parent company at rates significantly higher than that which the parent company obtained from the banks. The consequence of this was to further reduce UK taxation, by increasing interest charges. However, this may not have reduced the group's overall tax burden as the tax rates levied on the income in the US may well have been higher.

2.8 A significant area of concern involved issues of disclosure. The ability of the UK company to take advantage of the exemptions available under Financial Reporting Standard 8 (Related-Party Disclosures) so as not to disclose the full corporate structure of the group and the transactions between them was a major contributory factor towards the suspicion which was directed towards the company.

2.9 *We consider the following areas to warrant further investigation:*

- *There has been a shift in recent accountancy thinking in the direction of 'narrative disclosure.' In other words, companies should explain the numbers disclosed in its accounts. Consideration should be given as to whether a narrative explanation of a company's tax charge in its accounts would contribute significantly towards removing misunderstandings whilst also requiring companies to explain and justify their tax position.*
- *Further exploration should be made of the manner in which payments for intellectual property rights are accounted for and disclosed in public accounts. This should include consideration not only of how fair value is established but the relationship between where intellectual property is held and the value of such property in the specific countries of operation.*
- *The exemptions contained in FRS 8 concerning groups should be reviewed so as to consider (a) the full disclosure of the legal corporate structure of a group in the accounts of every subsidiary company (not just the identity of the ultimate holding company) and (b) the extent and manner of disclosure of related-party transactions within a group of companies*

2.10 We believe that these approaches could make a significant improvement to the quality of financial reporting and not impose any significant regulatory burden. We believe that they would enable a more carefully articulated rationale for the activities of companies and their payment of appropriate taxation. We also believe that they would enable companies to re-establish trust through transparency and ensure that the intellectual debate about taxation and business is conducted on a proper basis rather than emotive or potentially ill-informed comment. We also believe that developing these ideas could be significantly more effective in achieving the overall aim than any General Anti-Abuse Rule (GAAR).

- 2.11 We note the intention of government to introduce a GAAR.³ We welcome the recognition that any such rule should be narrowly focussed rather than a more general catch-all rule favoured by some campaigners. We welcome also the existence of an independent advisory panel. We are concerned that the GAAR could be misused in a way that compromises what has become known as the centre ground of tax planning and hence could suffer from ‘mission creep.’ We also believe that a clearance procedure whereby schemes could be submitted to HMRC for a decision as to whether they would fall within the proposed regulations would be beneficial to all concerned.
- 2.12 We also note that many of the matters discussed in this report, the payment of royalties for intellectual property and transfer pricing, both of which are conducted under the existing statutory framework, would not fall under the GAAR.
- 2.13 We believe that the tax code should be clear, certain, transparent and framed by the clear provisions of statute. We believe that wider tax policy should encourage enterprise and investment. We also believe that companies have a moral responsibility to act with transparency, integrity and honesty in the conduct of their tax affairs with appropriate policies and disclosure of all necessary information so that their accountability is clear.

³ HMRC, ‘A General Anti-Abuse Rule’ Consultation document, 12th June 2012, and Summary of Responses, 11th December 2012

3 Context: Starbucks and the voluntary payment of Corporation Tax

3.1 In December 2012, following disclosure that the UK subsidiary of the Seattle based Starbucks Corporation had not paid any corporation tax since 2009, Kris Engskov, the managing director of Starbucks Coffee Company (UK) Limited published a rather unusual open letter:

‘Today, we’re taking action to pay corporation tax in the United Kingdom – above what is currently required by tax law....Starbucks will commit to paying a significant amount of tax during 2013 and 2014 regardless of whether the company is profitable during these years.’⁴

3.2 This statement raises a significant number of questions in its own right.

3.3 Corporation tax is not a voluntary payment to Her Majesty’s Revenue and Customs (“HMRC”). Rather, it is a tax levied by law in accordance with the appropriate legal and regulatory framework. I was unaware that HMRC accepted donations.

3.4 Starbucks has an absolute moral responsibility to (a) maximise its profits in the interests of its shareholders and (b) to pay the tax that is due in the various jurisdictions that it operates.

3.5 To pay more tax than is rightfully due is a potentially immoral act because it reduces the value of the company. This has a negative impact on growth and employment and hence the payment of other taxes including income tax (by employees) and national insurance (by both employees and company). There is also a significant impact of reduced value on pension fund investments which has consequences for every individual who has a pension scheme with an investment in the Starbucks Corporation; the result is lower pensions, reduced standards of living and a potentially greater burden on the state.

3.6 The company’s decision makes a moral judgement that increased government revenue (and hence spending) is superior to wealth creation and growth in the private sector or charitable giving. This is not a judgement the company is entitled to make on behalf of its shareholders or other stakeholders.

3.7 So then, are we to conclude that Starbucks has been a victim of an ill-informed campaign, politically-motivated rhetoric and hence unfairly forced into this strange position? That may be true, but only in part.

⁴ ‘An Open Letter from Kris Engskov,’ managing director, Starbucks Coffee Company Limited

3.8 There are some specific actions of Starbucks in their corporate arrangements and accounting which have led to this situation. If we understand what it is that Starbucks has done and why, then we might be able to come to an informed conclusion how to best ensure that the appropriate tax arrangements and disclosures are in place. However, if we 'scapegoat' companies we may not only miss an opportunity but may also actually damage the economy.

4 The key issues in the payment of corporate taxation

- 4.1 There are a number of underlying reasons why Starbucks and others have so organised their affairs which have led to this situation.
- 4.2 The existence of multi-national enterprises with global operations in numerous countries means that there are a number of complexities around the recognition of revenues and costs in different jurisdictions which may have differing rates of corporate taxation. The ability to move costs or revenues from one jurisdiction to another can have significant effect upon the tax liability of a group of companies.
- 4.3 The tax laws of the UK work on the assumption of 'arms-length' transactions between independent parties. To the extent that the transactions which take place within groups are either (a) not at arms-length as between independent parties or (b) are not disclosed raises questions not only concerning the moral actions of the company but also of the tax authorities themselves and indeed of the disclosure requirements of international accounting standards.
- 4.4 Morality requires transparency. The inability to ascertain exactly what certain relationships are within corporate structures, as well as the transactions between them, contributes to the context which has led to concern being expressed.
- 4.5 A proper response to these points can also point towards solutions which encourage enterprise and morality together.

5 The accounting context

- 5.1 For the year-ended 2nd October 2011, Starbucks Coffee Company (UK) Limited⁵ reported a loss after tax of £32.9m. In the previous year this figure was a loss of £34.2m.
- 5.2 The company operated a total of 607 company owned and 128 licenced stores in the UK.
- 5.3 Sales rose 0.4% from just over £396m in 2010 to just under £398m in 2011. The gross margin rose from 19.4% to 19.7%.
- 5.4 The company had cash balances of £17.5m compared with £25.3m the previous year.
- 5.5 Accumulated profits – in fact accumulated losses – were £239m compared to £209m in 2010.
- 5.6 Amongst the more significant charges in the accounts were £59.4 for operating leases (2010, £69m) and royalty and licence fees of £25.8 compared with £25.3m).
- 5.7 The conclusions which can be drawn from the accounts are as follows:
- There are substantial sales, continued growth and reasonably high margins
 - The company does have substantial costs in operating leases
 - The company is relatively cash rich – though there is also some funding from other group companies charged interest at LIBOR +4%
 - The company owes £72m (2010: £65m) to other group companies
 - The high levels of accumulated losses seem inconsistent with the expectation of long-term profitability in any business
- 5.8 In order to assess the implications of various accounting transactions and arrangements it is necessary to have an awareness of the rates of corporation tax in various jurisdictions. The precise level of taxation paid by companies will vary according to the precise rules and allowable deductions in differing countries. However, the headline rates give an indication.
- 5.9 The main rate of corporation tax in the United Kingdom, for companies where profits exceed £1.5m, has fallen from 28% in 2010, to 26% in 2011, 24% in 2012 and to 23% in 2013.⁶

⁵ The figures in this section are extracted from the annual accounts for 2010 and 2011 filed at Companies House

- 5.10 The statutory rate of corporate tax in the US is 35%, adjusted for state taxes and various allowances and deductions. The accounts of Starbucks Corporation Inc disclosed that the corporation suffered tax at the rate of 32.8% in 2012 and 31.1% for 2011. These figures are consistent with the amounts paid in income taxes disclosed in the consolidated statements.⁷
- 5.11 The rate of corporate taxation in the Netherlands is 25% (for 2011, 2012, 2013). A small amount of profit is taxed at 20%.
- 5.12 The rate of corporate taxation in Switzerland ranges from 11.3% to 24.4% depending on locality. Lucerne is the lowest and Zurich the highest. The effective rate tends to be lower as corporate tax is deductible in computing other taxes. In some instances tax is reduced to 5%. In addition there are exemptions from canton and commune income taxes for 'holding companies' that do not trade in Switzerland. Hence in some cases, though the facts will vary with individual cases, the levels of corporate taxation in Switzerland can be very low.⁸

⁶ Rates as indicated by Her Majesty's Revenue and Customs

⁷ The accounts of Starbucks Corporation Inc, and the associated filings with the SEC are publicly available from the Corporation's website

⁸ Details of precise taxation arrangements in differing countries are complex, but these basic rates and figures are extracted from the Corporate Tax Rates Table published by KPMG.

6 How Starbucks reduced its UK corporate tax liability

- 6.1 *What have Starbucks done?* Starbucks have sought to arrange their affairs so as to ensure that more revenue and less cost is recognised in lower tax jurisdictions. They have done this primarily through *royalty payments* and *payments for coffee*. We know more about the former than the latter (due to disclosure) and we know from Kris Engskov's statement that the company would no longer claim deductions for royalties, inter-company loans, capital allowances and coffee purchases.
- 6.2 *Royalties.* Starbucks is a brand, and the use of the name constitutes intellectual property. It is perfectly reasonable for a company to pay for the use of intellectual property owned elsewhere. Perhaps this is easiest to see in the case of a licenced franchise arrangement; a franchisee pays a company for the use of its name, brand and products. However, the situation we have with Starbucks is that the company is paying another company within the same group for the right to use the Starbucks intellectual property. The Starbucks group company which 'owns' the intellectual property can thus be located in a lower tax jurisdiction and the UK company pays for its use. Hence there is a cost in the UK and revenue elsewhere. The outcome is lower tax in the UK and higher tax in the other jurisdiction. Hence if the group ensures that the receiving company is in a lower tax regime compared to the UK its overall burden is reduced.
- 6.3 The impact of this would appear to be £25.8m of payments made from Starbucks UK to another group company simply to use the brand name in the UK.⁹
- 6.4 There are a number of further issues.
- 6.5 We do not actually know from published accounts the location of the group company which receives these royalties. Kris Engskov disclosed the location as the Netherlands (Starbucks Coffee EMEA BV), however, there is at least the suggestion that they are paid on to a company located in Switzerland.
- 6.6 It is important to ask the right question. It is not as simple or straightforward as 'this is wrong.' The issues are (a) to what extent is it appropriate for intellectual property rights to be charged across companies within in a group and (b) if it is reasonable to do so, what is the appropriate level?
- 6.8 What is the intellectual property of the Starbucks brand and how should it be reflected in the company's tax arrangements?

⁹ See notes to the accounts, Starbucks Coffee Company (UK) Limited, 2011

- 6.9 One argument is that the intellectual property of the Starbucks brand originated in the USA and hence it is reasonable that a charge for the use of the brand around the world is charged back to the USA. In this case the intellectual property is in the USA, the income from it is in the USA and tax paid upon it would be in the USA. In this instance a transfer payment might be reasonable.
- 6.10 However, it is clear that this is not the argument or arrangement used by Starbucks. They appear to channel royalty payments to the Netherlands and Switzerland and there is no, or at least no disclosed, evidence that any transfers are made to the USA.
- 6.11 We have noted that the rate of corporate taxation in the Netherlands is actually higher than in the UK. Hence there is little benefit in transferring revenues to the Netherlands unless that is a staging post to further transfers, say to Switzerland where the rates of tax are substantially lower. Transfers to the USA would also incur higher taxation.
- 6.12 This argument also assumes that there is no value to the Starbucks brand in the UK say even after many years of usage.
- 6.13 Thus, an alternative argument is that a percentage charge should be made to reflect the use of the intellectual property in the UK. This is in fact what happens. However, it would appear that the level of such royalties and fees are high (6% of sales) compared to competitors (eg McDonalds at 4.5%).¹⁰ Indeed it is not at all clear how one would establish a percentage of sales as the value to be charged for the use of intellectual property.
- 6.14 Apart from the intellectual argument, tax law allows such arrangements to be deducted for tax purposes if they are conducted at 'arms-length.'
- 6.15 There are thus some questions here for the UK tax authorities which do not require any additional powers or any 'general avoidance regulation' to be adopted. Did HMRC consider these payments to be at 'arms length'? If they did, then why are Starbucks facing criticism? However, similarly, if they did, why is a royalty payment of 4.5% considered acceptable for one company but as high as 6% for another? Did Starbucks disclose to HMRC the level of the payments? As you can see there are questions here as much for HMRC as for the company.
- 6.16 However, to return to the intellectual argument, there would seem to be some reasonable principles to set out.
- 6.17 Royalty and licence fees set at a level which result in long-term unprofitable performance in the originating jurisdiction cannot be seen to be arms-length, since if

¹⁰ See Tom Bergin, Special Report

they were set at that level by independent operators, the company paying the fee would ultimately be forced out of business.

- 6.18 Royalty and licence arrangements which ignore the brand value in the country of operation could be seen as an artificial arrangement. So, for example, when Starbucks first entered the UK, payments to other group companies outside of the UK for the use of intellectual property seem entirely reasonable. However, 10, 20 or 50 years down the line for such payments to continue to be made seems to undervalue the goodwill which the brand has achieved in this country.
- 6.19 Hence, it would seem to be that there are a number of possible routes.
- 6.20 *Option 1.* A company should agree a 'fair value' for the any intellectual property for which licence fees are paid. This 'fair value' should be amortised over a period of say 20 years, on a reducing balance basis, with the amortisation allowed as a deduction for tax purposes (rather than the licence fee arrangement). This would mean a reducing deduction each year until after 20 years, there would be no deduction.
- 6.21 *Option 2.* An agreement is reached for a 'norm' for any such royalty payments. These payments should not be set at a level which prevents longer-term profitability
- 6.22 An important principle is the disclosure of the level in percentage terms of any such transactions so that there is transparency in the arrangements. Indeed there is a much wider question of disclosure and accounting standards which we will turn to subsequently.
- 6.23 *Transfer pricing.* Starbucks sells a lot of coffee in the UK. To do so they need to buy coffee beans. So far so good. Starbucks Corporation trades coffee on the world markets to ensure it obtains the necessary supply. Where do the beans come from for Starbucks UK? The answer is Starbucks. The beans for the UK are purchased from Starbucks Coffee Trading Company, based in Lausanne in Switzerland. The beans are roasted in the Netherlands and then imported into Starbucks UK warehouse in Basildon for distribution.
- 6.24 How much do Starbucks pay for these beans? Or, to be more precise, how much does Starbucks UK pay Starbucks BV for these beans and how much does Starbucks BV pay Starbucks Switzerland? If the price is 'too high' the result will be a higher cost of sales in the UK (and hence lower profits) and inflated revenues in the Netherlands or Switzerland.
- 6.25 The technique is known as transfer pricing. Again the normal tax principle of 'arms-length' transactions kicks in. However, there is no way of knowing the impact from the financial statements as there is no disclosure. We do not know whether the company

disclosed to HMRC and whether HMRC approved the level of transfer pricing. We do not know precisely where these revenues are recognised for tax purposes or the rate of effective taxation.

6.26 *Loan arrangements.* Starbucks UK receives loans from the US parent company. These are charged at the rate of LIBOR +4%. The effect of this is to transfer revenue out of the UK into the US. However, there is little gain for the US company as corporate tax is higher in the US than in the UK, but it does mean that cash can be transferred which can be used for dividend or other payments.

7 Disclosure and transparency

7.1 A number of matters come to light.

7.2 Nowhere is it possible to obtain from public documents the corporate structure of the Starbucks Corporation. There is a list of their subsidiaries published in the annual 10-K filing with the Securities and Exchange Commission but no chart showing the relationship between them. Hence it is impossible to see for certain where inter-company transactions might be taking place

7.3 The nature, level, origination and destination of royalty payments are not disclosed

7.4 There is no disclosure on transfer pricing

7.5 In assessing the disclosure there is a very important note in the Starbucks UK financial statements. Note 22 states that 'the company has taken advantage of the exemption granted by para 3 (c) of FRS 8 'Related Party Disclosures,' not to disclose related party transactions with wholly owned Starbucks group companies.'¹¹

7.6 Financial Reporting Standard 8 is designed to ensure that transactions between related parties are properly disclosed in company accounts. Paragraph 3 (c) dealing with scope, cited by Starbucks, states that disclosure is not required:

'in the financial statements of subsidiary undertakings, 90 per cent or more of whose voting rights are controlled within the group, of transactions with entities that are part of the group or investees of the group qualifying as related parties, provided that the consolidated financial statements in which that subsidiary is included are publicly available.'¹²

7.7 A significant number of the issues in relation to Starbucks would be solved or substantially mitigated by the removal or amendment of this exemption.

7.8 Among other things required by FRS 8 is the disclosure of the ultimate holding company. Starbucks UK complies with this requirement. The problem is that there is no disclosure (as none is required) of the intermediate structure.

¹¹ Starbucks Coffee Company (UK) Limited, Financial Statements for the period ended 2nd October 2011, note 22

¹² Financial Reporting Standard 8, paragraph 3 (c)

- 7.9 In paragraph 9 of FRS 8 it is stated that the reason for the exemption noted in 7.6 above is 'that the disclosure of the relationship alone will be sufficient to make users aware of the possible implications of related party transactions.'¹³
- 7.10 This provision is excessively complacent and has proved to be inadequate.
- 7.11 In paragraph 19 of FRS 8, both the purchase of goods and services ('the coffee beans') and licence agreements are listed as material related party transactions which should be disclosed. Except, of course, when companies are exempt from doing so due to being part of a group.

¹³ Financial Reporting Standard 8, paragraph 9

8 Conclusions

- 8.1 The controversy regarding Starbucks has exposed a number of issues.
- 8.2 The most important matter to emerge is the lack of a properly articulated intellectual basis for the approach to corporate taxation by the company, commentators and appropriate authorities.
- 8.3 There needs to be a serious re-articulation of the purpose of the business corporation and the respective responsibilities towards shareholders, employees, the wider economy, government and society.
- 8.4 The lack of the vision set out in paragraphs 8.2 and 8.3 above has led to serious misinformation concerning the tax affairs of Starbucks, some unfair criticism of the company, but also raised questions about some of the companies legal accounting practices as well as the role of the tax authorities.
- 8.5 The question of transparency and disclosure has been particularly significant. The appropriateness of some of the exemptions from disclosure for groups of companies in the context of multi-national enterprises has led to an unnecessary cloak of secrecy.
- 8.6 The proper disclosure of corporate structure and transactions between group companies as related party transactions would go a long way towards removing the unnecessary mystique around corporate tax affairs and protect companies from unfounded criticism.
- 8.7 What would be a 'fair' level of corporation tax for Starbucks to pay? On one level that is an impossible question, but a reasonable estimate could be made in the light of the disclosures in this report.
- 8.8 A reasonable assumption is that Starbucks intend long-term profitability.
- 8.9 In 2012 the loss reported in the accounts was £32.9m. Under normal accounting rules the reported loss of £32.9m would be adjusted by depreciation, capital allowances, disallowable expenses and so on. These items are disclosed in note 7 to the Starbucks accounts. Once these adjustments are made the loss for tax purposes reported by Starbucks would be £6.6m. We do not know whether transfer pricing has led to an excessive charge for cost of sales. However, if all royalty/licence payments were disallowed (£25.8m), the effect would be to give Starbucks taxable profits of £19.2m which would result in a corporation tax bill of £5.2m. This would be higher if inter-company interest charges etc were taken into account.

8.10 Hence, perspective needs to be maintained. There are several issues of accounting and disclosure. A careful reflection on these issues might indeed lead to changes which would be potentially beneficial to effective financial reporting and disclosure. Indeed, the outcome may well be somewhat higher tax charges in this particular situation. However, we should not conclude that Starbucks has been engaged in some widespread manipulation or that there is any large scale evasion of corporate taxation.