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## Through a Latte, Darkly: Starbucks's Stateless Income Planning

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## Through a Latte Darkly: Starbucks's Stateless Income Planning

By Edward D. Kleinbard



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In this report, Kleinbard reviews the recent Starbucks Corp. U.K. tax controversy (including a parliamentary inquiry), which revolved around the intersection of the company's consistent unprofitability in the United Kingdom with large deductible intragroup payments to Dutch, Swiss, and U.S. affiliates. He also examines the company's more recent submission to the House Ways and Means Committee. From those, Kleinbard draws two lessons.

First, if Starbucks can organize itself as a successful stateless income generator, any multinational company can. Starbucks follows a classic brick-and-mortar retail business model, with direct customer interactions in thousands of "high street" locations in high-tax countries around the world. Nonetheless, it

appears that Starbucks is subject to a much lower effective tax rate on its non-U.S. income than would be predicted by looking at a weighted average of the tax rates in the countries where it does business.

Second, the Starbucks story demonstrates the fundamental opacity of international tax planning, in which neither investors in a public company nor the tax authorities in any particular jurisdiction have a clear picture of what the company is up to. It is inappropriate to expect source country tax authorities to engage in elaborate games of 20 Tax Questions, requiring detailed knowledge of the tax laws and financial accounting rules of many other jurisdictions, to evaluate the probative value of a taxpayer's claim that its intragroup dealings necessarily are at arm's length. U.S.-based multinational companies owe a similar duty of candor and transparency when dealing with Congress.

The remedy begins with transparency toward tax authorities and policymakers, through which those institutions have a clear and complete picture of the global tax planning structures of multinational companies, and the implications of those structures for generating stateless income. National governments should recognize their common interest in that regard and promptly require their tax and securities agencies to promulgate rules providing a uniform, worldwide disclosure matrix for actual tax burdens by jurisdiction. As a first step, the United States should enforce the rule requiring U.S. companies to quantify the U.S. tax cost of repatriating their offshore permanently reinvested earnings.

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## I. Introduction

### A. Overview

Fresh from its U.K. tax public relations disaster,<sup>1</sup> Starbucks Corp. is lobbying the House Ways and Means Committee for special rules that would permanently allow its strategies for generating “stateless income” — income that through internal tax planning, first becomes unmoored from the host country where it is earned and then sets sail for the tax haven of choice.<sup>2</sup> This report uses Starbucks’s tax planning in the United Kingdom and its April 15 letter to the Ways and Means Committee to examine the problems confronting tax authorities in addressing base erosion and profit shifting (BEPS).<sup>3</sup>

This report makes two fundamental points. First, if Starbucks can organize itself as a successful stateless income generator, any multinational company can. Starbucks follows a classic brick-and-mortar retail business model, with direct customer interactions in thousands of “high street” locations in high-tax countries around the world. Moreover, without deprecating the company’s corporate pride in the “Starbucks experience” afforded by its retail outlets, or in its proprietary coffee roasting formulae, Starbucks is not driven by hugely valuable identifiable intangibles.<sup>4</sup> The Starbucks experience is a business model by another name, and all successful companies have business models. Despite those facts, it appears that Starbucks enjoys a much lower effective tax rate on its non-U.S. income than would be predicted by looking at a weighted average of the tax rates in the countries in which it does business.

Second, the tangled trail of news reports, financial statements, and Starbucks’s claims during a U.K. House of Commons parliamentary inquiry and to the Ways and Means Committee cloud any examination with uncertain facts and incomplete claims. The Starbucks story — in particular, its U.K. experience — demonstrates the fundamental opacity of international tax planning, in which neither investors in a public company nor the tax authorities in any particular jurisdiction have a clear picture of what the company is up to. That murkiness is in contrast to the frequent calls by multinationals

for tax transparency — and certainty in their dealings with tax authorities around the world — by which they generally mean that tax rules should be clear in how they apply to a company’s particular situation, that authorities as well as taxpayers should follow those rules, and that audits should be resolved promptly.<sup>5</sup>

The tension was visible in Starbucks’s CFO Troy Alstead’s testimony before the Public Accounts Committee of the U.K. House of Commons: “We believe very strongly in transparency — with the Committee, with tax authorities around the world, and with consumers — recognizing that one of the challenges that we often face is that the global tax structure is very complex. It is very difficult to explain it, and that is without having anything to do with avoidance. It is just a difficult challenge.”<sup>6</sup>

The Starbucks U.K. story demonstrates just how great a challenge it is for taxing authorities to have a transparent view of the consequences of the stateless income planning of multinational companies or, phrased conversely, what a poor job multinational companies have done explaining it. Source country tax authorities in particular have a legitimate interest in a complete and transparent presentation of a multinational company’s global tax planning relevant to that company’s source country base erosion strategies. Without that understanding, a source country’s authorities are not able to evaluate, for example, claims made by a multinational company that there is a natural tax tension between deductions claimed in that jurisdiction and income inclusions elsewhere. That claim cannot be assessed without considering the totality of a multinational group’s tax planning for the income side of the equation.

<sup>5</sup>See, e.g., Allison Bennett, “Multinational Companies Seeking Transparency, Certainty as Audits Increase, Panelists Say,” 85 *DTR G-6* (May 2, 2013).

<sup>6</sup>House of Commons Public Accounts Committee, Minutes of Hearing HC716, Q601 (Nov. 12, 2012). The hearing continued:

Ian Swales: But that is partly because you make it so. I do have experience in this area so I am not being entirely simplistic, but if you run a business in this country, that country, and another country, it is clear what your profit is. If you transfer money between them, you can make it clear what the basis is. It does not need to be that complicated.

Troy Alstead: The reason it is difficult to explain at times is that if we did not buy those services for the UK business, we would have to build an R and D centre in the UK.

Swales: Just be transparent. You buy the services. Just tell people what you buy and what it costs. That is transparency. I am not saying that everything has to be in one country, but there should be transparency in why you do certain things. That is probably enough from me, but it is one of the themes that has come out today.

<sup>1</sup>See, e.g., Peter Campbell, “Starbucks Facing Boycott Over Tax,” *The Daily Mail*, Oct. 12, 2012.

<sup>2</sup>James Politi and Barney Jopson, “Starbucks Seeks Fresh U.S. Tax Breaks,” *The Financial Times*, Apr. 24, 2013.

For analyses of the tax policy issues surrounding stateless income, see Edward D. Kleinbard, “Stateless Income,” 11 *Fla. Tax Rev.* 699 (2011).

<sup>3</sup>OECD, “Addressing Base Erosion and Profit Shifting” (2013), available at <http://www.oecd.org/tax/beeps.htm>.

<sup>4</sup>See Starbucks Corp. 2012 Form 10-K, shareholders’ letter, and letter to the House Ways and Means Committee.

Similarly, without understanding the global tax structure of a company, it is difficult for source countries to evaluate the economic efficiency consequences of double dips, or to consider the competitiveness burdens faced by local companies that are unable to rely on international stateless income tax planning. Source countries typically are in much weaker positions than are tax authorities and policymakers in the parent company's domicile to obtain a clear, holistic picture of a company's global tax planning. And of course when it comes to U.S. multinational companies, source countries are doubly nonplussed by check-the-box entities, whose U.S. tax status as disregarded entities stands at complete odds to their apparent status as companies for all other purposes.

It is not appropriate to expect source country tax authorities to engage in elaborate games of 20 Questions, which requires detailed knowledge of the tax laws and financial accounting rules of many other jurisdictions, in order to determine the value of a taxpayer's claim that its intragroup dealings are at arm's length by virtue of alleged symmetries in tax treatment for expense and income across the group's affiliates.

By the same token, Starbucks's submission to the Ways and Means Committee is an unexceptional example of the substantive tax law shamelessness that marks much corporate tax lobbying. The observation has a "dog bites man" quality about it, and Starbucks runs with a large crowd in that respect. Because most corporate legislative tax lobbying is not public, it is useful to review just how large a gap there is between Starbucks's request and sensible international tax policy.<sup>7</sup> Lawmakers and their staff are busy and harried individuals, not always able to parse constituent requests to find a kernel of sensible tax policy lurking among standard demands for competitiveness or a level playing field. U.S.-based multinational companies owe a duty of candor and transparency, not only to source country tax authorities, but also to Congress.

The OECD has recently focused on the transparency problem in the context of its BEPS project and has called for greater transparency in the effective tax rates of multinational enterprises.<sup>8</sup> Similarly, the most recent annual report of the U.K. House of Commons Public Accounts Committee, drawing on the lessons of the inquiry described below, concluded that there is a complete lack of transparency in the amount of tax paid by multinational companies. The committee has called for the development

<sup>7</sup>The Freedom of Information Act does not apply to legislative lobbying.

<sup>8</sup>*Supra* note 3, at 6 and 47.

of best practices standards governing the information companies should publicly release about their tax practices.<sup>9</sup>

Governments should respond to those calls by recognizing their common interest and requiring their tax and financial accounting and securities agencies to promulgate rules for a uniform, worldwide disclosure matrix for actual tax burdens by jurisdiction. A complete and transparent presentation of companies' global tax structures would greatly assist tax authorities in designing international tax regimes that avoid double taxation and stateless income tax planning.

The United States, as the home country for more multinational enterprises than any other and a jurisdiction with very lax practices in implementing those requirements, must take the lead. It can begin by enforcing the rule that nominally requires U.S.-based multinational companies to disclose in the tax footnotes to their financial statements the cost of repatriating their offshore permanently reinvested earnings (earnings of foreign subsidiaries for which a U.S. tax cost has not been provided on the parent company's U.S. generally accepted accounting principles financial statements). That rule is overwhelmingly honored in the breach rather than in practice, as the vast majority of companies claim it is not practicable (by which they mean inconvenient) to do so.

This report uses Starbucks as an example of a widespread problem, but Starbucks is not an outlier in its stateless income generating strategies (to the extent they are visible) or its legislative wish list. This report does not suggest that any of Starbucks's tax planning runs afoul of the laws of any jurisdiction. The issues identified are not unique to U.S.-based multinational companies (with the exception of the occlusion attributable to check-the-box entities): Multinational companies wherever domiciled generally follow similar strategies. This report's call for structural tax transparency for source country tax authorities is one intended to apply regardless of a parent company's place of domicile.

## B. Stateless Income

**1. Summary of prior work.**<sup>10</sup> Stateless income<sup>11</sup> is income derived for tax purposes by a multinational

<sup>9</sup>House of Commons Public Accounts Committee, "HM Revenue & Customs: Annual Report and Accounts 2011-12," 3-5 (Nov. 28, 2012).

<sup>10</sup>This subsection quickly summarizes some themes more fully developed in the articles cited in note 2.

<sup>11</sup>The term has been adopted by at least some tax policymakers around the world. See David Bradbury, Australia's assistant treasurer and minister for deregulation, "Stateless Income: A Threat to National Sovereignty," Address to the Tax Institute of Australia (Mar. 15, 2013); Lee A. Sheppard, "Is

(Footnote continued on next page.)

group from business activities in a country other than the domicile of the group's ultimate parent company, but which is subject to tax only in a jurisdiction that is neither the source of the factors of production through which the income was derived, nor the domicile of the group's parent company. Google Inc.'s "Double Irish Dutch Sandwich" structure is one well-known example of stateless income tax planning in operation.

The pervasiveness of stateless income tax planning upends standard characterizations of how U.S. tax law operates, as well as the case for the United States to move to a territorial tax system, unless accompanied by strong antiabuse rules. U.S. tax rules do not operate as a worldwide system, but rather as an ersatz variant on territorial systems, with hidden benefits and costs when compared with standard territorial regimes. That claim holds whether one analyzes the rules as a cash tax matter, or through the lens of financial accounting standards. Effective foreign tax rates do not disadvantage U.S. multinational companies when compared with their territorial-based competitors.

Stateless income "prefers" U.S.-based multinational companies over domestic ones by allowing the former to capture tax rents, or low-risk inframarginal returns derived by moving income from high-tax foreign countries to low-tax ones. Other important features of stateless income include the dissolution of any coherence to the concept of geographic source (in turn the exclusive basis for the allocation of taxing authority in territorial tax systems); the systematic bias toward offshore rather than domestic investment; the bias in favor of investment in high-tax foreign countries to provide the raw feedstock for the generation of low-tax foreign income in other countries; the erosion of the U.S. domestic tax base through debt-financed tax arbitrage; many instances of deadweight loss; and, unique to the United States, the exacerbation of the lockout phenomenon, under which the price that U.S. companies pay to enjoy the benefits of dramatically low foreign tax rates is the accumulation of extraordinary amounts of earnings (\$1.95 trillion, by the most recent estimates<sup>12</sup>) and cash outside the United States.

U.S. policymakers and observers sometimes think the United States should not object if U.S.-based multinational companies successfully game

the tax laws of foreign jurisdictions in which they do business, but the preceding paragraph demonstrates why the United States would lose if it were to follow that strategy. By generating tax rents by moving income from high-tax foreign countries in which they actually do business to low-tax jurisdictions, U.S. multinational companies have an incentive to locate investment in high-tax foreign countries. And by leaving their global interest expenses in particular in the United States without significant tax constraints, U.S.-based multinationals in turn can erode the U.S. tax payable on their domestic operations.<sup>13</sup>

Stateless income tax planning as applied to our ersatz territorial tax system means the lockout effect actually operates as a kind of lock-in effect: Companies retain more overseas earnings than they profitably can redeploy to the great frustration of their shareholders, who would prefer the cash be distributed to them. The tension between shareholders and management likely lies at the heart of current demands by U.S.-based multinational companies that the United States adopt a territorial tax system. The companies themselves are not greatly disadvantaged by the U.S. tax system, but shareholders are. The ultimate reward of successful stateless income tax planning from that perspective should be massive stock repurchases, but instead shareholders are tantalized by glimpses of enormous cash hoards just beyond their reach.

Stateless income tax planning also undercuts the policy utility of some standard efficiency benchmarks relating to foreign direct investment. Logical conclusions in a world without stateless income do not follow once that type of tax planning is considered. More specifically, implicit taxation is an underappreciated assumption in the capital ownership neutrality model that has been advanced as a reason why the United States should adopt a territorial tax system, but stateless income tax planning vitiates that critical assumption.

I have concluded that policymakers face a Hobson's choice between the highly implausible (a territorial tax system with teeth) and the manifestly imperfect (worldwide tax consolidation). Because the former is so unrealistic, and because the imperfections of the latter can be mitigated through the

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Multinational Tax Planning Over?" *Tax Notes*, Apr. 15, 2013, p. 231 (quoting Edwin Visser, deputy director-general of taxation of the Dutch Ministry of Finance: "Stateless income is the big problem now" and distorts investment decisions and undermines voluntary compliance).

<sup>12</sup>CFO Journal, "Indefinitely Reinvested Foreign Earnings on the Rise," *The Wall Street Journal*, May 7, 2013.

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<sup>13</sup>The foreign tax credit interest allocation rules of section 864(e) have almost no bite when companies are able to drive down their foreign effective tax rates to single digits, because even after interest expenses are allocated companies still have capacity to claim whatever foreign taxes they do pay as credits in the United States.

choice of tax rate (and ultimately, by a more sophisticated approach to the taxation of capital income), I ultimately recommended a worldwide tax consolidation solution.

**2. Recent developments.** Other recent academic work is consistent with the themes above.<sup>14</sup> The OECD's BEPS project and the G-8's commitment to address those sorts of issues point in the same direction.

Factual developments and quantitative analysis confirm the magnitude of the problem. Two years ago, the stockpile of U.S. companies' permanently reinvested earnings stood at a little more than \$1 trillion; it now hovers at almost \$2 trillion.<sup>15</sup>

Harry Grubert and Rosanne Altshuler, working with company-by-company IRS data for 2006, recently calculated the effective foreign tax rates of profitable foreign subsidiaries of U.S. companies whose foreign operations in the aggregate had net positive earnings.<sup>16</sup> Fifty-four percent of all income earned by those subsidiaries was taxed at effective foreign tax rates of 15 percent or less. Only 24 percent of the income was taxed at rates of 30 percent or greater. And perhaps more remarkably, almost 37 percent of the total income earned by those companies was taxed at rates below 5 percent. In light of those data, drawn directly from companies' tax returns, those who advocate that U.S. companies suffer abroad from an anti-competitive U.S. tax system should have to explain why that might be so.

## II. The U.K. Story

### A. Overview

Starbucks has operated in the United Kingdom since 1998. In October 2012 Reuters reported that Starbucks had claimed losses in 14 of the first 15 years of its existence in the United Kingdom and as a result paid virtually no U.K. company tax, despite a 31 percent market share and shareholder reports indicating solid profitability for the Starbucks group attributable to its U.K. operations.<sup>17</sup> The story

unleashed a political firestorm, including threats of boycotts of U.K. Starbucks stores. Less than a month after the story's publication, the House of Commons Committee of Public Accounts convened a hearing to review the U.K. corporate tax planning of Starbucks, Amazon, and Google. It published a report two weeks later, finding it "difficult to believe that a commercial company with a 31 percent market share by turnover, with a responsibility to its shareholders and investors to make a decent return, was trading with apparent losses for nearly every year of its operation in the U.K."<sup>18</sup>

During the hearing and in its written submissions, Starbucks denied that it had underpaid its U.K. tax obligations. Later blogs in the *Financial Times*<sup>19</sup> generally were sympathetic to Starbucks's interpretation of the facts and took issue with some inferences in the Reuters article. Despite the friendlier tone of the *Financial Times* blogs, less than two months later, Starbucks "caved in to public pressure and pledged to pay £10m in U.K. corporate tax in each of the next two years even if it makes a loss following calls to boycott the coffee chain over its 'immoral' tax practices."<sup>20</sup> The announcement evoked a range of reactions within the British government and among observers<sup>21</sup>; Starbucks itself described the settlement as unprecedented.

In its fiscal year ended October 2, 2011 (the most recent year available), Starbucks Coffee Co. (UK) Ltd. (Starbucks UK), the principal Starbucks operating company in the United Kingdom, reported under U.K. financial accounting principles turnover of nearly £400 million, gross profit of £78.4 million, an operating loss after administrative expenses of

<sup>14</sup>E.g., J. Clifton Fleming Jr. et al., "Designing a U.S. Exemption System for Foreign Income When the Treasury Is Empty," 13 *Fla. Tax Rev.* 397 (2012).

<sup>15</sup>See *supra* note 12.

<sup>16</sup>Harry Grubert and Rosanne Altshuler, "Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax," Table 3 (Apr. 1, 2013), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2245128](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2245128).

<sup>17</sup>Tom Bergin, "How Starbucks Avoids U.K. Taxes," Reuters, Oct. 15, 2012.

At the parliamentary inquiry, the members of Parliament questioning Starbucks consistently contrasted its U.K. losses to the significant corporate taxes paid by its largest competitor, Costa. E.g., *supra* note 6, at Q235 and Q281.

(Footnote continued in next column.)

For the market share figure and "solid profitability" claim, see House of Commons Public Accounts Committee — 19th Report (Nov. 28, 2012), Item 1, para. 8, available at <http://www.publications.parliament.uk/pa/cm201213/cmselect/cmpubacc/716/71602.htm>. That report includes oral and written testimony (Starbucks UK supplementary statement, 19th Report).

<sup>18</sup>*Id.* at Item 1, para. 8.

<sup>19</sup>Lisa Pollack, "Bitching About Starbucks," *Financial Times* Alphaville Blog.

<sup>20</sup>Vanessa Houlder et al., "Starbucks to Pay £20m UK Corporate Tax," *Financial Times*, Dec. 6, 2012. Pollack describes the terms of the settlement in "The Marketing Smackdown and That Very Odd Voluntary Tax 'Payment,'" *Financial Times* Alphaville Blog, Dec. 13, 2012.

As of mid-May the payments had not been made. Tim Wigmore, "So Starbucks Haven't Paid the Taxes They Promised? Blame the Government," *The Telegraph*, May 16, 2013.

<sup>21</sup>E.g., Jim Pickard et al., "Tory MPs Fear Starbucks Tax 'Precedent,'" *Financial Times*, Dec. 7, 2012.

£28.8 million, and a net pretax loss on ordinary activities of £32.9 million<sup>22</sup> (fiscal 2010 had similar results).

Starbucks UK has paid £8.6 million of U.K. corporate tax during its 15-year existence on revenue of more than £3.4 billion; of that amount, all but £600,000 was attributable to an audit settlement with the U.K. tax authorities.<sup>23</sup> In 14 out of 15 years, Starbucks UK recorded losses.

Starbucks UK finished fiscal 2011 with a negative shareholder's equity of £1.3 million. For the 15 years of its existence (through its 2011 fiscal year), Starbucks UK has reported for U.K. financial accounting purposes a cumulative loss of £239 million.

Starbucks UK also almost certainly has a cumulative loss for U.K. tax purposes.<sup>24</sup> Its financial statements do not provide a cumulative tax loss carryover figure, but its £40.5 million deferred tax asset at the end of fiscal 2011 would imply cumulative tax losses of approximately £150 million (roughly \$240 million).<sup>25</sup> Starbucks Corp.'s U.S. consolidated financial statements note that at the end of fiscal 2012, the group had foreign net operating losses of \$318 million, with the predominant amount having no expiration date (which is true in the United Kingdom).<sup>26</sup>

The Reuters report and subsequent House of Commons hearing focused on three intragroup charges through which Starbucks UK paid substantial amounts to other group companies: (1) royalties and license fees paid to a Dutch affiliate, (2) mark-ups on coffee purchased via another Dutch affiliate and a Swiss affiliate, and (3) interest paid on a loan from the U.S. parent company. The Reuters report argued that those charges explain Starbucks UK's

near-continuous losses for corporation tax purposes. At the same time, the Reuters article argued, Starbucks reported a much rosier picture of its U.K. subsidiary's performance to analysts and shareholders. Finally, the Reuters article and testimony at the hearing suggested that the royalties and coffee markups in particular were taxable at very low rates.

Throughout the controversy, Starbucks maintained that it had difficulty making a U.K. profit "under any measure," despite 13 consecutive quarters of store-on-store sales growth.<sup>27</sup> It ascribed that difficulty to the cost of leasing property on high streets in the United Kingdom and to the fact that the country is a very competitive market in which to sell coffee.<sup>28</sup> To an outsider (and to the House of Commons Public Accounts Committee), those arguments ring hollow: Starbucks's competitors also face high rental costs for desirable space (which in an efficient rental market should be reflected in the ultimate price of the products sold to consumers).<sup>29</sup> Starbucks is the second-largest restaurant or café chain in the world<sup>30</sup> and it certainly is one of the largest specialty coffee vendors in the United Kingdom, with a 31 percent market share, which suggests some market power.

The *Financial Times* reviewed transcripts of Starbucks securities analyst conference calls. There is no doubt that Starbucks believed its U.K. operations to be profitable. For example, in 2009 Starbucks told analysts:

Canada, the U.K., China, and Japan are our largest international markets and drive the majority of the segment's revenue and operating profits. Each of these markets is profitable to Starbucks. Each is a priority for future investment, and each is a key component of future growth.<sup>31</sup>

And in its 2012 annual report, Starbucks stated that "in particular, our Japan, UK, and China [marketing business units] account for a significant

<sup>22</sup>Audited financial statements of U.K. companies are available at <http://www.companieshouse.gov.uk/>. Starbucks UK's company identification number is 02959325. Its immediate parent is Starbucks Coffee Holdings (UK) Ltd., identification number 03346087.

<sup>23</sup>Starbucks UK supplementary statement, 19th Report, *supra* note 17, at para. 10.

Alstead testified before the Committee that about £8 million of that sum was attributable to an audit settlement with the U.K. tax authorities, whereby Starbucks agreed to forgo deducting 22 percent of the intercompany royalties charged by its Dutch affiliate, as described below. *Supra* note 6, at Q264.

<sup>24</sup>Starbucks UK's tax position seems to be one of smaller losses than are recorded for U.K. accounting purposes. In particular, it deducts royalties to its Dutch affiliate at 6 percent for the latter purpose, and a 4.7 percent rate for the former. Also, it appears to have a permanent book-tax difference in depreciation charges. That might be attributable to the consequences of purchase accounting when Starbucks acquired the predecessor of Starbucks UK in 1998, or to its treatment of some impairment charges, or both.

<sup>25</sup>Starbucks UK 2011 Financial Statements, n.8. £40.5 million deferred tax asset/0.27 tax rate in 2011. See also Section II.D *infra*.

<sup>26</sup>Starbucks 2012 Form 10-K, *supra* note 4, at 83.

<sup>27</sup>Starbucks UK supplementary statement, 19th Report, *supra* note 17, at para. 10.

<sup>28</sup>*Id.* at para. 11.

<sup>29</sup>Starbucks coffee products sell on average for about 20 percent more in the U.K. market than in the United States. *Supra* note 6, at Q320.

Starbucks's European and Middle Eastern (EMEA) market business unit has higher costs of sales (which includes occupancy costs) as a percentage of revenues than does its Americas unit — but in fact EMEA's costs are closely comparable to those in the China/Asia Pacific (CAP) unit. Starbucks 2012 Form 10-K, *supra* note 4, at 31-32 and 36-38.

<sup>30</sup>Bergin, *supra* note 17.

<sup>31</sup>Pollack, "Media Said, Starbucks Said," *Financial Times* Alphaville blog.

portion of the net revenue and earnings of our EMEA and CAP segments.”<sup>32</sup>

Starbucks UK argued strenuously to the House of Commons that in substance Starbucks had not told securities analysts and shareholders that its U.K. operations were profitable and denied that it had ever claimed (as Reuters had reported) that operating margins in the United Kingdom approached 15 percent; rather, the facially different statements could be explained by the fact that U.S. GAAP rules required Starbucks to add back the intercompany royalties and interest paid to affiliates, while U.K. rules required Starbucks to include them.<sup>33</sup> But the questions in the U.K. tax controversy were the overall Starbucks group’s profitability from dealing with U.K. customers and whether the division of those profits among different group entities reflected economic reality. For those purposes, Starbucks’s own holistic picture of its U.K. operations is directly relevant. By contrast, Starbucks UK’s argument that only its own accounts were relevant essentially assumed the conclusion by treating as bona fide deductions from the U.K. tax base items whose appropriateness were at the heart of the controversy.

Consider, for example, 2007 (apparently Starbucks UK’s second best year). Starbucks UK reported a pretax loss of £1.4 million. If one reverses royalties and interest expense paid to affiliates, Starbucks UK’s income would have been about £21 million. That translates into a positive operating margin of about 6 percent (as Starbucks UK itself suggested in its statements to the parliamentary inquiry). But that figure ignores the intragroup markup on coffee sold to Starbucks UK, which might have been substantial.<sup>34</sup> The *Financial Times*

<sup>32</sup>Starbucks 2012 Form 10-K, *supra* note 4, at 12. To be fair, later in its annual report, Starbucks management described the “macro-economic headwinds” the company faces in Europe, summarizes the EMEA unit’s barely profitable 2012, and pledges to work toward “improving the profitability of the existing store base.” *Id.* at 26.

<sup>33</sup>*Id.* at para. 13. See also *supra* note 6, at Q195.

Starbucks’s written statement is difficult to parse. It first refers to the different requirements imposed by U.K. and U.S. tax authorities. It continues, specifically, U.S. GAAP requires “us to exclude intra-company royalty payments and loans interest for tax filing purposes.” But GAAP has no bearing on actual tax filing requirements. The statement concludes, “Starbucks UK, as a subsidiary of a US multi-national company, is obliged to follow US GAAP principles,” by which Starbucks might have meant that the consolidated U.S. GAAP financials would ignore those intercompany payments. That of course is not the same thing as claiming that a U.K. subsidiary is obliged to follow U.S. GAAP.

<sup>34</sup>The *Financial Times* blog, *supra* note 31, suggests that the cost of coffee might be in the range of 6 percent of sales, or £20 million in 2007. That figure appears much too low (see Section

(Footnote continued in next column.)

has speculated that Starbucks UK may pay intra-group markups on fixtures and equipment.<sup>35</sup>

## B. Internal Structure and Cash Flows

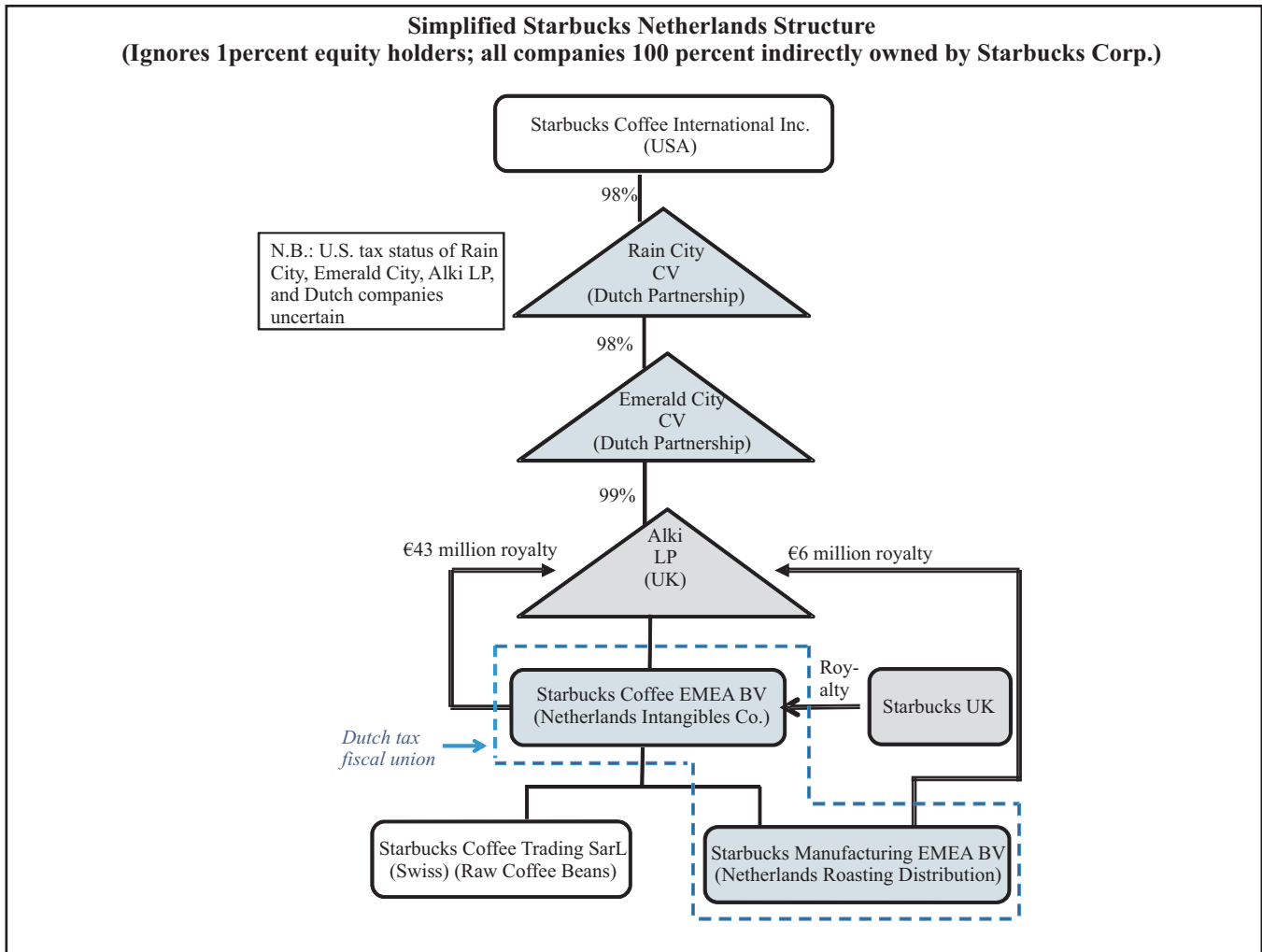
The internal structure of Starbucks’s U.K. operations and cash flows, including the flow of royalties from Starbucks UK to their ultimate resting place, is complex and opaque. An examination of the available financial statements for Starbucks’s Dutch affiliates, as well as those for the U.K. companies, suggests the following:

- Starbucks holds Starbucks UK through an intermediate U.K. holding company (Starbucks Coffee Holdings (UK) Ltd.).
- Through another chain, and ignoring *de minimis* interests owned by other affiliates within the Starbucks group, Starbucks owns two tiers of Dutch partnerships (Rain City CV and Emerald City CV). Emerald City owns a third-tier entity, Alki LP, a U.K. limited partnership. Alki LP owns Starbucks Coffee BV EMEA, a Dutch company (Starbucks Holdings EMEA). Alki LP also appears to own key intangible assets for which it receives royalties.
- Starbucks Holdings EMEA holds the intangible assets for which Starbucks UK pays royalties and acts as a holding company for Starbucks’s operations in the Netherlands, Switzerland, and other countries. It has a first-tier subsidiary, Starbucks Manufacturing EMEA BV, another Dutch company (Starbucks Mfg.), that handles coffee roasting and distribution for all Starbucks operations in Europe and the Middle East. Starbucks Holdings EMEA is described in its financials as having 123 employees (97 in 2011), although it is not clear what the employees do. Starbucks Mfg. has about 90 employees.
- Both Starbucks Holdings EMEA and Starbucks Mfg. pay royalties to Alki LP for intangible rights owned by Alki LP, but since that company is not required to file financial statements in the United Kingdom, there is no detail about the arrangement. Royalties paid by the Dutch companies to Alki LP totaled about €50 million in 2012. It is not apparent whether Alki LP retains the cash royalties it receives or passes the cash up the chain; in any event, neither Rain City nor Emerald City holds significant cash or third-party financial assets.

II.C.2 *infra*). Despite that, if it were correct, and if the sum of Swiss and Dutch markups were around 30 percent (20 percent for the Swiss green bean purchasing function, and an assumed additional 10 percent for the Dutch roasting operation), the total markups would be approximately £6 million.

<sup>35</sup>*Id.*





- Starbucks Holdings EMEA and Starbucks Mfg. file the equivalent of a consolidated tax return in the Netherlands (that is, fiscal unity). Their separate financial statements show tax receivables rather than liabilities in each of the last two years and a combined loss. Starbucks Mfg. on a stand-alone basis had a small pretax profit.
- Starbucks Holdings EMEA also owns Starbucks Coffee Trading SarL, a Swiss company (Starbucks Trading). Starbucks purchases all its raw or green coffee for its worldwide use through that Swiss subsidiary. Starbucks Trading is said to charge a 20 percent markup on coffee sales to Starbucks roasters around the world.

It is not possible to determine from the outside whether Starbucks foreign entities described as companies are treated for U.S. tax purposes as hybrid fiscal transparencies by virtue of the check-the-box regulations, or whether entities described as foreign law partnerships are reverse hybrid corporations for U.S. tax purposes.

**C. The Three Intragroup Charges**

**1. Royalties.** Starbucks UK pays a 6 percent royalty to what it describes as an “Amsterdam structure,”<sup>36</sup> but as a result of an agreement with the U.K. tax authorities, reduced the deduction it claimed for tax years 2003-2009 to 4.7 percent (years 2010 forward were under examination as of the time of the parliamentary inquiry). The royalty payment covers rights to the Starbucks brand and trademark, rights to “the highest quality and ethically sourced Arabica coffee,” expertise in store operations, use of the Starbucks proprietary business model, and store design concepts.<sup>37</sup>

Starbucks UK’s intragroup royalty payments are in the neighborhood of £20 million to £25 million annually. In 2011 Starbucks UK accounted for roughly 40 percent of the royalty income received by Starbucks Holdings EMEA.

<sup>36</sup>Starbucks UK supplementary statement, 19th Report, *supra* note 17, at Q246.  
<sup>37</sup>*Id.*

Had no royalty been charged over the last 10 years, Starbucks UK said it would have paid £2 million more in aggregate corporation tax.<sup>38</sup> That figure is difficult to understand, because it implies that Starbucks UK had aggregate tax losses (including the royalty payments) of perhaps £200 million or more, but Starbucks's statement offers no further explanation.

Starbucks claimed that the 6 percent royalty paid to the Amsterdam structure was an arm's-length rate, because the same rate was charged to more than 20 unrelated third parties around the globe.<sup>39</sup> Without more information, it is difficult to evaluate the comparability of those other arrangements. For example, some appear to be ventures in which Starbucks itself has a substantial stake. While there are almost as many licensed stores as there are Starbucks-owned stores around the world, Starbucks derives only about 9 percent of its revenues from licensees.<sup>40</sup>

In the United Kingdom, there are roughly three times as many company-owned stores as there are licensees. One such licensee, for example, is Euro Garages, an enterprise that runs convenience stores alongside gas stations in the United Kingdom. It is possible to imagine that such an operator benefits enormously from Starbucks UK's investment in developing the brand at Starbucks-owned full service stores, but that the reverse is not the case, and that the economics of running a Starbucks station (along with other branded foods) in a highway "forecourt" is not the same as the economics of running a high street store. And the fact that Starbucks UK agreed to reduce its tax deduction for its royalties from 6 to 4.7 percent from 2003 through at least 2009 might be viewed as an admission that the 6 percent charge was not justifiable in this particular case.

Starbucks UK is part of a fully integrated global enterprise. The fundamental tax policy question is not what royalties should be charged to third-party licensees who take on the risks and benefits of developing local markets, but rather, given that the Starbucks group was responsible for developing the U.K. market from a standing start in 1998, and that it was Starbucks that took on those risks and benefits, is the resulting income fairly taxed in the United Kingdom? That is, what substance is there to the ownership of the marketing intangibles required to operate the Starbucks business in the United Kingdom neither in the United States nor in the United Kingdom?

<sup>38</sup>*Id.* at Q214-Q229.

<sup>39</sup>*Id.*

<sup>40</sup>Starbucks 2012 Form 10-K, *supra* note 4, at 3 and 5.

In its written submission to the Public Accounts Committee, Starbucks UK said, "We pay both Dutch and U.S. taxes on the royalties. . . . The overall effective tax rate we have paid on the royalties received by our Amsterdam regional structure has averaged 16 percent over the past five years."<sup>41</sup>

The consistent reference to an Amsterdam structure is odd. Reuters concluded:

It's unclear where the money paid to [Starbucks Holdings EMEA] ends up, or what tax is paid on it. The company 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, [Starbucks] pointed to staff costs and rent. The HQ has 97 employees.<sup>42</sup>

Starbucks's explanation lacked important details, and the Reuters summary was not completely accurate. Starbucks Holdings EMEA's 2011 revenues were €73 million (essentially all from royalties and licensing revenues), but its total employment costs were only about €16 million, and its total third-party expenses amounted to only €27 million.<sup>43</sup> One therefore would expect Starbucks Holdings EMEA to show a pretax profit of more than €40 million; instead, it recorded a pretax loss for the year ending September 30, 2011, of €12.4 million, and a tax receivable of €530,000.

What is the explanation for that? Starbucks Holdings EMEA's pretax result reflects a €40 million valuation reserve for the assumed permanent diminution in value of some lower-tier subsidiaries, as determined by a formula, and Starbucks Holding EMEA's royalty payment to Alki LP of €46 million.<sup>44</sup> Starbucks Holdings EMEA has an advance pricing agreement with the Dutch tax authorities, which Starbucks argued is secret. It therefore is impossible to determine whether the valuation reserve is respected for Dutch tax purposes.

In fiscal 2011 about 60 percent of Starbucks Holdings EMEA's royalty income was paid over to Alki LP, and in 2012 about 50 percent was paid over. What tax ultimately was imposed on the royalties, both those remaining as income of Starbucks Holdings EMEA and those passed up the chain to Alki LP?

Alstead acknowledged that the tax rate paid by Starbucks on the royalty income coming to rest in

<sup>41</sup>*Supra* note 6, at Q246.

<sup>42</sup>Bergin, *supra* note 17.

<sup>43</sup>Starbucks Coffee EMEA annual accounts for the year ending September 30, 2012.

<sup>44</sup>*Id.* The valuation reserve formula assumes a growth rate in perpetuity of 2 percent per year and a weighted average cost of capital of 15.18 percent. It is therefore not surprising that in both 2011 and 2012 the Dutch companies recorded significant additions to their valuation reserves.

the Netherlands was “very low.”<sup>45</sup> Based on the Dutch financial statements of Starbucks Holdings EMEA and its subsidiary Starbucks Mfg., “very low” seems to be practically indistinguishable from zero.

The House of Commons might have had a better idea of Starbucks’s stateless income tax planning for its intragroup royalties had the company complied with the Public Accounts Committee’s request for a copy of its Dutch tax ruling, but Starbucks refused to disgorge or describe it, on the grounds that to do so would have violated its understanding of mutual confidentiality with its Dutch tax inspector.<sup>46</sup> In a disturbing development, however, at the end of March the *Financial Times* reported that the Dutch deputy finance minister told fellow lawmakers that Starbucks’s statement was untrue and that “the Netherlands never asked companies to keep their tax arrangements secret.”<sup>47</sup>

It would be odd if all the royalties paid by Starbucks UK did come to rest in the Netherlands, in light of the stateless income strategies routinely pursued by other U.S. multinational companies — for example, Google, in its well-known “Double Irish Dutch Sandwich” structure.<sup>48</sup> One plausible structure that taxpayers might use in this sort of situation is an open-faced variant on that sandwich, in which the Dutch affiliate is a check-the-box entity that pays almost all the royalty income it receives to a Bermuda or other tax haven affiliate. But in his testimony to the House of Commons Public Accounts Committee, Starbucks’s CFO was emphatic that Starbucks did not use tax haven affiliates for its royalty stream or any other purpose — although that might have been an overstatement.<sup>49</sup> Beyond

that, he did not elaborate on the operation of its Amsterdam structure or the foreign tax burden imposed on royalties not retained by Starbucks Holdings EMEA.

How then to interpret Starbucks’s assertion that the overall effective tax rate it paid on the royalties received by its Amsterdam regional structure averaged more than 16 percent? If no significant tax was paid to the Netherlands, the effective rate must be attributable to U.S. taxes. Alstead testified that about half the royalties paid to the Amsterdam structure in turn were paid to the United States for a buy-in for the value of the intangibles provided by the U.S. parent.<sup>50</sup> That is consistent with the idea that Alki LP and the two Dutch partnerships above it are taxed as partnerships for U.S. tax purposes, so that Alki LP’s income would pass all the way up to the U.S. consolidated income tax return (although it does not explain the purpose behind that triple-decker sandwich of holding companies). And because Starbucks described the relevant tax as “paid,” we can presumably put aside the thought that the tax in question was provided for on the company’s financial statements, but not actually paid to a tax authority — or the idea that Starbucks was referring to a theoretical tax cost on ultimate repatriation from a foreign corporate subsidiary.

The explanation almost certainly is not that the royalty income gives rise to subpart F income (and thereby to immediate U.S. tax liability). Foreign personal holding company income (one of the components of subpart F income) generally includes royalty income earned by a controlled foreign corporation.<sup>51</sup> There is an exception for royalty income paid by an unrelated person to a CFC in the course of the latter’s active conduct of a trade or business.<sup>52</sup> Assuming that Starbucks’s operations in the Netherlands satisfy the active business test, then royalties received from third-party licensees would be protected from inclusion as subpart F income, but royalties paid by Starbucks UK to its affiliate in the Netherlands would not. Despite that, the foreign personal holding company subpart F inclusion rules have almost been read out of the code by section 954(c)(6), which characterizes intragroup royalties and other deductible payments (as well as dividends) as active income as long as the amounts are not paid out of the payer’s own subpart F income, and by the check-the-box regulations, under which payments to a foreign jurisdiction that appear to be cross-border intercompany payments are for U.S. tax purposes nullities, because the payer

<sup>45</sup>*Supra* note 6, at Q243.

<sup>46</sup>*Id.* at Q246, Q284-Q286, and Q288. *See also* Matt Steinglass, “Dutch Deny Starbucks Tax Deal Is Secret,” *Financial Times*, Mar. 27, 2013 (reporting that Alstead refused to answer the Committee’s questions concerning the agreement because he was bound by confidentiality to the Dutch government).

<sup>47</sup>*Id.*

<sup>48</sup>Kleinbard, “Stateless Income,” *supra* note 2.

<sup>49</sup>*Supra* note 6, at Q213. Schedule 21 of Starbucks 2012 Form 10-K, *supra* note 4, lists one Cayman Islands subsidiary (President Coffee (Cayman) Holdings Ltd.), as well as subsidiaries in Hong Kong (five), Singapore (two), Cyprus, and Switzerland (two).

Under SEC rules, Schedule 21 lists only “significant” subsidiaries, a term that is subject to a range of interpretations across companies. *See* Michael P. Donohoe et al., “Through a Glass Darkly: What Can We Learn About a U.S. Multinational Corporation’s International Operations From Its Financial Statement Disclosures?” 65 *Nat’l Tax J.* 961, 962-963 (2012).

The overlap in the titles of their work and this report was unintentional. On the other hand, neither of us can claim great originality: The database at SSRN lists 51 titles that are plays on “through a looking glass” or “through a glass darkly.”

<sup>50</sup>*Supra* note 6, at Q213 and Q237.

<sup>51</sup>Section 954(c)(1)(A).

<sup>52</sup>*Id.*

and the recipient are collapsed into a single entity. Again and again we see how U.S. tax rules both aid and abet stateless income planning, and perhaps less intentionally, help U.S. companies obfuscate the actual global tax consequences of their intragroup tax structures.

To an unsympathetic U.S. reader, at least two possible (albeit speculative) explanations come to mind for why Starbucks would argue that the royalties paid to the Amsterdam structure attract U.S. tax. First, as described above, about half the royalties received by the Amsterdam structure from Starbucks UK apparently were paid over to either the U.S. parent company or to a lower-tier subsidiary organized as a partnership by way of a buy-in. But (as discussed later), the question then follows whether U.S. federal income tax was “paid” on any such buy-in royalties only by using excess FTCs, which are visible in the tax footnote of Starbucks’s annual reports in the form of FTC carryovers. For reasons described in Section II.C.3 below, in the context of interest payments to the United States, those credits should have been available to shelter Starbucks’s royalty income received from the Amsterdam structure. Starbucks finally used up its excess FTCs in 2012.

Second, as described in Section III below, Starbucks today has large stores of unrepatriated foreign earnings and of cash. Royalty income received by one foreign subsidiary from another can avoid subpart F income if the requirements of the look-through rule in section 954(c)(6) are satisfied (or if the affiliates are check-the-box entities that for U.S. purposes collapse into one company), but the investment of the resulting cash generally gives rise to subpart F income. So it is possible that some portion of the tax to which Starbucks refers is simply U.S. tax on the interest income arising from reinvesting a foreign entity’s cash hoard.

The second reading can be extended to explain the triple-decker partnership structure that Starbucks uses to hold its Dutch operations, if one hypothesizes that the top-tier partnership (Rain City) in fact is a reverse hybrid: an entity that is a partnership for foreign tax purposes but that for U.S. purposes is taxed as a corporation. In that case, the royalties paid to Alki LP presumably would roll up (without subpart F consequences) as an income matter to Rain City CV (although the cash might remain at Alki LP), and that income would not be taxed in the United States (or presumptively anywhere else). Instead, only interest income from the investment of the cash would be taxed currently in the United States.

The above observations are speculative, but that makes my basic point. Why should the presumption be that the basic international tax structure of a

multinational company — particularly one that chooses to divide its integrated business into watertight compartments located in different jurisdictions, with the apparent purpose of minimizing U.K. tax — not be transparent to the U.K. House of Commons, HMRC, the IRS, or any other tax authority with an interest in the matter? The game of 20 tax questions is tedious and frustrating; tax authorities have limited time and resources, and the real consequences of those elaborate structures often require analyzing the tax and financial accounting rules of multiple jurisdictions. (The stealth role of the U.S. check-the-box regulations is one obvious example whereby a foreign tax authority might easily be misled as to the tax consequences of intragroup payments.) Yet multinational companies continue to make tax authorities play the game to shield their stateless income planning from direct scrutiny, while asking for more tax transparency in how those tax authorities deal with companies.

There is a fundamental and substantive tax policy question lurking here. As its comment letter to the Ways and Means Committee emphasizes, Starbucks’s fundamental corporate strategy is to deliver the Starbucks Experience to each customer, store by store. Starbucks basically argues that some third-party franchisees pay royalties, which in turn are treated favorably under U.S. tax law, but that the tightly integrated Starbucks Experience strategy contemplates that Starbucks generally relies on company-owned stores, so intragroup royalties also should be privileged for tax purposes — and that any other conclusion is an attack on “the core of Starbucks’ business model.” But the simple response is that Starbucks is free to pursue its core business model — providing the same Starbucks Experience to every high street, mall, and airport in the world — without any commercial exigency requiring it to hold the abstract experience in a low-tax country, where it is made available to actual customers only through the payment of intragroup royalties that strip income away from the host country where those customers actually sip their lattes.

In an unintended admission against interest, Starbucks wrote in its letter that the brain center of the Starbucks Experience is its support center in Seattle; foreign operations appear to be reduced to the localization of that centrally conceived experience. So why does Starbucks UK pay any significant royalties for the rights to the Starbucks Experience playbook to a low-taxed Netherlands affiliates rather than the United States? What is Amsterdam adding for the half of U.K. royalties that stick there? Neither the brains of the operation nor the location-specific tweaks to reflect British tastes logically should be located there.

Starbucks offers no explanation other than the standard refrain that it must have a level playing field. Alstead added in his testimony before the House of Commons Public Accounts Committee that Starbucks's foreign tax rate was 21 percent — “much higher than most multinationals' global rate,”<sup>53</sup> which in his view demonstrated that Starbucks is “an extremely high taxpayer.” But the simple fact is that a 21 percent effective rate (which for reasons described below might more plausibly be described as an effective rate in the low teens) is itself far below the tax rates in the principal foreign jurisdictions in which Starbucks does business (Japan, Canada, and the United Kingdom).

Here we see the central role of intangibles — more specifically, the central role of intangible ownership divorced from the actual business or customers that the intangibles serve — in stateless income tax planning. (We also see the ease with which multinational companies can turn a simple business model into intangible assets for which royalties must be paid.) The idea that a subsidiary can own intangibles developed by the parent and harness them to commercial use without subjecting the income they generate to tax where the business and customers actually are located is the core reason that base erosion cannot be addressed unless the OECD member states dismantle their traditional institutional acquiescence to conspicuously non-commercial modes of business organization.<sup>54</sup>

**2. Coffee bean markups.** Starbucks purchases all its green coffee for its worldwide use (including the United States) through Swiss subsidiary Starbucks Trading, which resells the coffee to other Starbucks affiliates at what Starbucks says is a 20 percent markup.<sup>55</sup> In Europe, Starbucks Mfg. buys green beans from Starbucks Trading, roasts them, and distributes them to Starbucks UK and other Starbucks retailers. That means that there are two levels of intercompany buy-sells (the green beans and the roasted beans) where transfer pricing is relevant.

**a. Starbucks Trading.** The U.S. foreign base company sales income rules (section 954(d)) generally subject to subpart F income derived from buying personal property from unrelated persons and reselling it to related persons (or buying from unrelated persons on behalf of related ones). That describes what Starbucks Trading does. Those rules do not, however, apply to sales of agricultural commodities not grown in the United States in

commercially marketable quantities,<sup>56</sup> and coffee falls into that exception.<sup>57</sup>

The Swiss subsidiary presumably functions as a dealer in commodities to avoid its income being characterized as foreign personal holding company income for subpart F purposes.<sup>58</sup> The subsidiary would be expected to perform the business functions required by relevant Treasury regulations to avail itself of that exception.<sup>59</sup> Those rules do not require the Swiss subsidiary to take physical possession of the coffee in Switzerland but do require that it incur substantial expenses for “the physical movement, handling and storage of the commodities, including the preparation of contracts and invoices, arranging freight, insurance and credit, arranging for . . . shipping documents, arranging storage or warehousing, and dealing with quality claims.”<sup>60</sup>

<sup>56</sup>Section 954(d)(1), last sentence.

<sup>57</sup>Reg. section 1.954-3(a)(1)(ii)(a). The proposed regulations took the opposite view; Treasury reversed itself in the final regulations for coffee and bananas because “information was submitted by interested persons indicating that the amount of coffee and bananas produced in the United States is insignificant by comparison to the total world production of the two commodities.” T.D. 7555.

The agricultural commodities exception in the last sentence of section 954(d)(1) was added to the code by section 602(b) of the Tax Reduction Act of 1975. (That legislation should not be confused with the Tax Reform Act of 1976; the House version of that act would have further modified the exception, but it was not adopted.)

The legislative history of the agricultural commodities exception is sparse, even by the standards of the time. The provision did not appear in the House bill, which contained no amendments to subpart F at all. The Senate bill would have expanded subpart F dramatically, by requiring that U.S. persons holding at least a 1 percent in a foreign corporation be taxed currently on their proportionate share of the income from that corporation if more than 50 percent of the corporation's stock was controlled by U.S. persons. (That proposed amendment was adopted by a floor vote, and therefore has no associated Senate Finance Committee report analysis.) The conference committee scaled back the Senate's ambitions, but in general expanded the scope of subpart F. The conference committee adopted the agricultural commodities exception. The conference report in one sentence simply repeats the language of the statutory exception without explanation. S. Conf. Rpt. No. 94-120, at 33. See also Robert J. Peroni et al., “Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income,” 52 *SMU L. Rev.* 455, 482-483 (1999).

The agricultural commodities exception has not been a hotbed of interpretation or guidance since the promulgation of reg. section 1.954-3. One scholar, in the course of an extensive analysis of the foreign base company sales income rules, wryly observed that “the justification for the exclusion is not apparent.” He went on to propose the repeal of the exclusion. Eric T. Laity, “The Foreign Base Company Sales Income of Controlled Foreign Corporations,” 31 *Cornell Int'l. L. J.* 93, 142-143 (1998).

<sup>58</sup>Section 954(c)(1)(B) and (c)(1)(C)(ii).

<sup>59</sup>Reg. section 1.954-2(f).

<sup>60</sup>Reg. section 1.954-2(f)(2)(iii)(B).

<sup>53</sup>*Supra* note 6, at Q230.

<sup>54</sup>Kleinbard, “Stateless Income,” *supra* note 2, at 710.

<sup>55</sup>*Supra* note 6, at Q274 and Q292-Q315; Pollack, “Losing for Tax Purposes: A Diagram,” *Financial Times* Alphaville blog.

The two exceptions from subpart F are available even for sales of green coffee to Starbucks's U.S. operations, which buy their coffee through the Swiss trading center.<sup>61</sup>

Starbucks testified before the House of Commons Public Accounts Committee that its Swiss tax rate "has been approximately 12 percent over history."<sup>62</sup> Starbucks has retail operations in Switzerland, and it is not clear from the testimony whether the 12 percent rate relates to the entirety of its Swiss operations or only to the coffee trading business.<sup>63</sup> If the latter, then Starbucks's coffee trading operations appear to be taxed more highly than most Swiss commodities trading companies.<sup>64</sup>

Alstead testified that Starbucks's profitability in Switzerland was in the "single digit range — 7 percent or 8 percent, throughout all our history there," but as brought out by questioning, that figure is a percentage of sales, not cost or investment, in Switzerland, and as such is largely meaningless.<sup>65</sup> In its submission to the U.K. committee, Starbucks stated that the total income tax liability for fiscal 2011 for the Swiss coffee procurement company was CHF 11.6 million (about \$10 million), but it provided no information about the entity's income.<sup>66</sup>

Starbucks Trading is doing well enough that according to the financial statements of its immediate parent company, Starbucks Holdings EMEA, it was able to pay its parent a €35 million dividend in 2012. The *Financial Times* has speculated that the cost of coffee should account for perhaps 6 percent of the cost of sales for a company like Starbucks, but in the absence of any public-company-specific information, it is impossible to reach any conclusions about the actual contribution of the 20 percent markup on green coffee to Starbucks UK's tax losses.<sup>67</sup> Nor is it possible to say whether that markup is an arm's-length charge, because this is a fact-intensive transfer pricing question. The price

for Arabica beans (the kind used by Starbucks and other high-end coffee vendors) has trended dramatically upward over the last 12 years (although displaying great volatility along that trend line), which would lead to sharply higher profits for any organization enjoying a "cost plus" structure.<sup>68</sup>

Any market power that Starbucks's Swiss affiliate is able to exercise by virtue of the volume of Arabica coffee it purchases for the worldwide Starbucks group economically is attributable to the combined demands of the various group operating companies, and the resulting volume discounts logically should be passed on to those entities. Starbucks noted in its submission to the Public Accounts Committee that its trading represents less than 5 percent of the world's coffee trade.<sup>69</sup> But the bulk of the trade is in lower-quality Robusta coffee; the top-drawer Arabica beans that Starbucks exclusively serves (and within that subset, ethically sourced Arabica beans) is a far smaller market.<sup>70</sup>

Starbucks roasts its coffee destined for U.K. customers in the Netherlands; that function earns a markup, but details do not appear to be publicly available. The oral testimony on that point is confusing. It could suggest that the roasting markup is another 20 percent, or that 20 percent is the entire markup on coffee (which would leave unanswered how the roasting operation is compensated).<sup>71</sup>

**b. Starbucks Mfg.** Starbucks Mfg. buys green beans from Starbucks Trading and roasts in the Netherlands the coffee destined for U.K. customers, a function that earns a markup.<sup>72</sup> Because coffee roasting is a well-defined commercial function for which comparables should be readily obtainable, and because Starbucks's Amsterdam structure already receives its royalty partly for Starbucks's proprietary roasting style, that markup logically should be closely comparable to what a third-party roaster would charge, a point Starbucks emphasized in its submissions to the Public Accounts

<sup>61</sup>*Supra* note 6, at Q271.

<sup>62</sup>See Pollack, *supra* note 55.

<sup>63</sup>Starbucks 2012 Form 10-K, *supra* note 4, at 4 (50 retail stores in Switzerland at year-end 2012). Starbucks's Swiss retail stores apparently were held through a joint venture until 2011, when Starbucks bought out its partner.

<sup>64</sup>Two recent articles offer useful insights into the Swiss commodities trading industry. Emiko Terazono and Javier Blas, "Swiss Ties to Trading Houses Under Strain," *Financial Times*, Mar. 26, 2013 ("Commodities traders in Geneva and Zug face an effective tax rate of about 8-11 per cent"); Javier Blas, "Commodities: Tougher Times for Trading Titans," *Financial Times*, Apr. 14, 2013 ("Low tax has proved to be a strong tailwind for the commodities trader").

<sup>65</sup>*Supra* note 6, at Q259 and Q298-Q299.

<sup>66</sup>Starbucks UK supplementary statement, 19th Report, *supra* note 17, at Q276.

<sup>67</sup>Pollack, *supra* note 55.

<sup>68</sup>Blas, "Coffee Still Full of Beans Amid 34-Year High," *Financial Times*, Feb. 22, 2011 (historical chart). Coffee futures prices on the ICE futures exchange trended up from late 2001 (\$42) to early 2011 (briefly touching \$300), before reverting to roughly \$140 today.

<sup>69</sup>Starbucks UK supplementary statement, 19th Report, *supra* note 17.

<sup>70</sup>"The coffee we buy is actually the top 1% or 2% of the most expensive coffee in the world." *Supra* note 6, at Q238. For a description of Starbucks's coffee bean purchases, see Starbucks 2012 10-K, *supra* note 4, at 6-7. At the end of fiscal 2012 Starbucks had \$854 million in negotiated open coffee purchase commitments.

<sup>71</sup>*Supra* note 6, at Q301-Q307.

<sup>72</sup>*Id.*

Committee.<sup>73</sup> Yet that could be the largest source of the tax leakage from the United Kingdom.

Alstead's oral testimony on that point is confusing and could suggest that the roasting markup is another 20 percent, or that 20 percent is the entire markup on coffee (which would leave unanswered how the roasting operation is compensated).<sup>74</sup> Regardless, the financial statements of Starbucks Mfg. tell a more dramatic story.<sup>75</sup> In fiscal 2012 it paid €65 million for green coffee purchased from Starbucks Trading.<sup>76</sup> Yet those beans in the hands of Starbucks Mfg. translated into €286 million in total sales, of which €233 million were to group companies and related parties — more than four times the cost of the raw products. The numbers for fiscal 2011 were smaller but not much different in broad outline.

What explains that extraordinary transmutation of €70 million of raw coffee into €286 million of coffee packaged for retail sales? Not salaries, depreciation, or general and administrative expenses: all those combined amounted to just more than €17 million.<sup>77</sup> Yet somehow, Starbucks Mfg.'s books show its direct cost of sales (which do not include the €17 million just summarized) amounts to €253 million. There is nothing to explain the €180 million in Starbucks Mfg.'s direct cost of sales beyond its green coffee purchases. Surely bags to hold the coffee and shipping to other European countries in the single market cannot be that expensive?

Starbucks Mfg. pays essentially zero income tax in the Netherlands as a result of its tax consolidation (fiscal unity) with Starbucks Holdings EMEA and apparently, from the large non-third-party costs that each of the two firms incurs: the royalties paid to Alki LP and the completely noncash charges incurred both in 2011 and in 2012 to reflect revaluations of the carrying value of their lower-tier subsidiaries, by reference to a discounted cash flow model of their own devising.

**3. Intercompany loan.** The third intragroup charge that Reuters identified as eroding Starbucks UK's tax base is the interest paid by Starbucks UK to the ultimate U.S. parent company (Starbucks Corp.). The loan is a demand loan paying interest at LIBOR plus 400 British pounds.<sup>78</sup> Interest paid on the loan has varied from year to year, both because LIBOR has fluctuated and because substantial amounts of the loan have been capitalized into equity over the

years. In fiscal 2011 intercompany interest payments were around £2 million; in 2010 they were £4.3 million.

Starbucks UK's annual report reveals that the company "is funded by, and meets its day to day working capital requirements through a loan from the ultimate parent company."<sup>79</sup> The company relies on a "commitment of continuing financial support from the ultimate parent company to provide sufficient funding to enable the company to meet its liabilities as they fall due for at least the next 12 months," and it is only the existence of this commitment that enables the company to prepare its U.K. financial statements on a going concern basis.<sup>80</sup>

To a U.S. reader, that suggests that Starbucks UK is overleveraged; indeed, it finished its 2011 fiscal year with negative shareholder's equity and a £72 million obligation to Starbucks Corp. Consistent with that observation, in 2010 Starbucks capitalized £50 million of its intercompany loan into equity.<sup>81</sup> Also, Starbucks UK has on several occasions sold new equity to its parent companies to fund its annual operating losses (for example, £4.5 million in 2011, £33 million in 2010, and £14 million in 2009).

All of that suggests that the intercompany demand loan between Starbucks Corp. and Starbucks UK has much of the flavor of a quasi-equity arrangement, at least under U.S. tax norms.<sup>82</sup> And the intercompany interest charge (LIBOR + 400) on its face seems quite high.<sup>83</sup> Yet Starbucks UK has relied on that arrangement to strip several million pounds from its U.K. tax base annually.

When that issue came up during the parliamentary inquiry, Starbucks dismissed the idea that tax avoidance could have played any role in the large intercompany loan, saying, "There is absolutely nothing about the loan that could actually produce tax savings for us, because it is a much higher tax regime in the U.S. than it is in the U.K."<sup>84</sup>

That claim is facially plausible, particularly to a U.K. audience, but is it the entire story? Here again we see the importance of looking at the entirety of the global picture when considering the claims of any multinational company. In fact, Starbucks for many years had substantial FTC carryovers for U.S.

<sup>73</sup>Starbucks UK supplementary statement, 19th Report, *supra* note 17, at Q239.

<sup>74</sup>*Supra* note 6, at Q301-Q307.

<sup>75</sup>Starbucks Mfg. annual accounts for the year ended September 30, 2012.

<sup>76</sup>*Id.* at 9.

<sup>77</sup>*Id.* at n.8.

<sup>78</sup>*See, e.g.*, Starbucks UK fiscal 2011 annual report.

<sup>79</sup>*Id.* at 7.

<sup>80</sup>*Id.*

<sup>81</sup>Starbucks UK fiscal 2010 annual report, financial statements, n.18.

<sup>82</sup>*Cf. Laidlaw Transportation Inc. v. Commissioner*, T.C. Memo. 1998-232.

<sup>83</sup>It would be circular to argue that the rate must be so high because the company is so overleveraged — that would simply rely on one non-arm's-length fact to justify another.

<sup>84</sup>*See* Pollack, *supra* note 55 (quoting Alstead's testimony).

tax purposes; the last of those carryovers was absorbed in fiscal 2012.<sup>85</sup> Assuming that Starbucks UK was treated as a corporation for U.S. tax purposes, the interest income received by Starbucks Corp. presumptively would fall into the “active basket” of section 904(d)(1)(B), by virtue of the look-through rules of section 904(d)(3), and therefore could be sheltered from tax by Starbucks Corp.’s FTC general limitation carryovers.

The hypothesis that more might have been afoot than a simple payment of interest from a foreign jurisdiction to the United States — where it would be subject to tax at higher U.S. marginal corporate tax rates — finds further circumstantial support in the observation that the United States has made it trivially easy for U.S.-based multinational companies to create stateless income through intragroup interest stripping, albeit at the cost of keeping the resulting interest income offshore.<sup>86</sup> The reasons are the emergence of the check-the-box regulations and the look-through rule of section 954(c)(6). Because U.S. tax law (whether wittingly or not) now aids and abets easy stateless income generation through internal group leverage, at the singular cost of leaving the resulting income in a foreign subsidiary, one might think twice before concluding that a sophisticated U.S. multinational group would structure its affairs to use intragroup leverage so as to increase its global effective tax rate.

The same reasoning would apply to the U.S. component of the 16 percent tax rate that Starbucks testified it paid on the royalties its Amsterdam structure received from the United Kingdom, half of which were paid to the U.S. parent. Again, that royalty income should have been sheltered by Starbucks Corp.’s FTCs. It is not easy for an outsider to explain why that result would not be the case.

Regardless of that hypothesis, Alstead might be said to have given an incomplete answer when asked how much tax Starbucks UK pays on the money that is remitted to the United States (in context, a question about the portion of royalties paid on to the U.S. parent); he said approximately 38 percent.<sup>87</sup> That is Starbucks’s financial accounting effective rate for its U.S. domestic income, including state income taxes, which in general do not apply to foreign-source income. It also is phrased in such a way that it does not directly answer the question.

<sup>85</sup>Starbucks 2012 Form 10-K, financial statements n.13, *supra* note 4, at 83; Starbucks Corp. 2011 Form 10-K, financial statements n.13, at 71.

<sup>86</sup>Kleinbard, “Stateless Income,” *supra* note 2, at 728-733.

<sup>87</sup>*Supra* note 6, at Q316.

If Starbucks did shelter either its U.K. interest income or half of the U.K. royalty income paid on to the U.S. parent through the use of unrelated excess FTCs — and again, the fundamental point here is that no tax authority has a complete picture of what the relevant facts are regarding the stateless income planning of a multinational company — then the arguments that the United States is a higher tax regime or that Starbucks paid significant U.S. tax on the royalty stream attributable to its U.K. operations are not as relevant to the situation as the company’s statements during the parliamentary inquiry might have implied. One can argue that the use of FTC carryovers to shelter royalty and interest income from Starbucks UK is not costless, because those carryovers are now not available to shelter other income, but the reasonableness of that claim in turn requires a detailed and holistic understanding of Starbucks’s global stateless income planning.<sup>88</sup>

Starbucks appears to be an enthusiastic compiler of offshore permanently reinvested earnings. It therefore is conceivable that Starbucks had little use for its FTC carryovers, and so capitalized Starbucks UK, for example, with a view toward generating zero-cost stateless income through U.K. deductions that led to no tax liability and no economic burden in the United States.

The ultimate point is not that this must be what happened, but rather that the U.K. parliamentary inquiry did not necessarily have a complete picture, just as source country tax authorities in general also do not have a complete picture of the pressure points that should be of interest to them when trying to piece together why multinational companies organize their internal structures as they do. Transnational transparency must be radically rethought, and critically important components of a company’s global stateless income tax planning must be made automatically transparent to each affected jurisdiction. The game of 20 Tax Questions has grown tiresome and is fundamentally unfair to source country citizens, who are asked to make up the revenue shortfalls that stateless income planning creates.

#### D. Useless Losses?

The Starbucks group engaged in classic intragroup earnings stripping transactions, little different from those employed by many other U.S.-based multinational companies, to erode its U.K. tax base.

<sup>88</sup>In 2010, for example, Starbucks’s FTC carryovers were scheduled to expire starting in 2014. Starbucks Corp. 2010 Form 10-K, financial statements, n.15, at 66. That is relevant to the question whether it would have been economically burdensome for Starbucks to use its FTCs to shelter its interest income on its loan to Starbucks UK.



The royalties paid to the Amsterdam structure, the markup on coffee sold via the Starbucks trading operation in Switzerland, and the interest paid to the U.S. parent all served to reduce taxable income in the United Kingdom, presumably at little tax cost to the recipient group members.

And yet, there is something unusual in the Starbucks accounts, which is that it has structured its U.K. operation in such a way that it consistently operates at a loss — to the point that it appears to have U.K. tax loss carryovers in the range of about \$240 million.<sup>89</sup> That means that any tax (even a small one) incurred by recipient group members is a net cash cost to the group. Ordinarily, the goal is to zero out high-tax jurisdiction liabilities, not to drive one's subsidiary into a perpetual loss-making situation.

Now consider this fact pattern from the perspective of financial accounting, rather than cash taxes. In the ordinary course, under both U.S. and U.K. accounting principles, when a company has a loss year, it books a deferred tax benefit (the mirror image of a tax liability) to reflect that the current loss has created a valuable asset (the ability to avoid tax in future years through applying the old losses against current income). U.K. NOLs do not have expiration dates. Starbucks UK carried a deferred tax asset on its financial statements until 2008, when it was reversed, on the basis that there was insufficient evidence that Starbucks UK would have income in the foreseeable future against which to use its tax losses. At the end of fiscal 2011 the unclaimed deferred tax asset amounted to £40.5 million.<sup>90</sup>

Similarly, Starbucks Corp.'s U.S. consolidated annual reports have established a \$154 million valuation allowance at year-end 2012 as an effective deduction against its deferred tax asset; that allowance "is primarily related to net operating losses and other deferred tax assets of consolidated foreign subsidiaries."<sup>91</sup> What the Starbucks financial statements are saying is that based on all the relevant facts and circumstances, it is less likely than not that Starbucks will ever get a cash tax benefit from its large U.K. tax loss carryovers, even though they are of perpetual duration.

Why has Starbucks created what appears to be a long-term tax-costly structure, in which useless losses pile up in one jurisdiction, while low-taxed profits — but nonetheless profits that bear at least some tax — pile up in others? One plausible answer

is that U.K. business vicissitudes have outstripped Starbucks's tax planning — the light at the end of the tunnel recedes a bit each year, rather than drawing closer. That is consistent with Alstead's testimony, in which he emphasized that Starbucks had committed itself too quickly to too many unaffordable leases in central London. Another is that Starbucks believes itself locked into the terms of its royalty and markup arrangements, because it is important for Starbucks's global tax or commercial dealings to maintain that it applies the same terms consistently around the world. (However, Starbucks UK has for many years deducted royalties paid to the Amsterdam structure for U.K. tax purposes at a 4.7 percent rate, not the 6 percent cash charge.) No doubt there are others.<sup>92</sup>

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<sup>92</sup>It is worth speculating on one other point, because it illustrates my basic point about the difficulties jurisdictions face in reaching appropriate policy outcomes when a company's global stateless income planning is occluded. That is the possibility that Starbucks has used Starbucks UK's losses on a current basis, but just not in the United Kingdom. The hypothesis is that Starbucks has checked the box on Starbucks UK (and on its passive U.K. holding company parent), so that from a U.S. tax point of view Starbucks UK is a branch of Starbucks in the United States. In those circumstances, the U.K. losses could be used to offset U.S. domestic operating income.

It might be thought that the U.S. dual consolidated loss rules would prevent Starbucks from using the losses of Starbucks UK against the domestic income of the U.S. consolidated group, but that is not the case. Basically those rules would not bar the Starbucks U.S. consolidated group from using Starbucks UK's tax losses to reduce the U.S. group's domestic income, as long as Starbucks U.S. promised that the losses would not be made available to a U.K. company treated for U.S. tax purposes as a corporation at any point in the five years following their use in the United States. Reg. section 1.1503(d)-6(d).

I discount that explanation, because as described, Starbucks Corp.'s consolidated U.S. financial statements show a substantial deferred tax asset (albeit with a 100 percent valuation adjustment associated with it) attributable to foreign NOLs, and presumptively a large portion of those NOLs are attributable to Starbucks UK. My understanding of financial accounting for taxes is that if Starbucks were using Starbucks UK's losses on a current basis in the United States, Starbucks would not establish a deferred tax asset for those losses. But financial accounting for taxes is an arcane discipline, my understanding thereof is incomplete, and a company's individual facts are known in detail only to it and its auditors.

Imagine, for a minute, that this hypothesis were correct, if not for Starbucks, then say for Acme Widgets UK. Would it be relevant to U.K. (or U.S.) policymakers that Acme Widgets UK was simultaneously deducting losses in the United States and the United Kingdom, getting an immediate cash tax benefit in the United States from those losses, and booking the other side of various intercompany transactions that in part give rise to those losses in low-taxed foreign jurisdictions, where the earnings would remain outside the U.S. tax net as long as the earnings were not repatriated? The question answers itself.

But how are we to expect U.K. policymakers even to know to ask the question when confronted with the next Acme Widgets case? That is a knock-on effect of the check-the-box regulations; whether intentionally or not, the United States has created a

(Footnote continued on next page.)

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<sup>89</sup>See *supra* Section II.A.

<sup>90</sup>Starbucks UK fiscal 2011 financial statements, n.8, *supra* note 25.

<sup>91</sup>Starbucks 2012 Form 10-K, *supra* note 4, financial statement n.13, at 82. In 2010 the deferred tax asset was described as relating entirely to foreign items.

For example, Starbucks Corp. might have in its conceptual back pocket the idea of a so-called *Granite Trust* transaction, in which through a carefully structured check-the-box transaction it liquidates Starbucks UK in a taxable section 331 liquidation for the purpose of triggering the large capital losses presumably inherent in its investment in its U.K. operations.<sup>93</sup> In the presence of unrelated capital gains in the United States, that would create a 35 percent cash tax benefit from the realization of the diminution in value of its investment through so many years of operating losses.

### III. The U.S. Perspective

#### A. The Fruits of Stateless Income

In both its submission to the Ways and Means Committee and its written submissions to the Public Accounts Committee, Starbucks emphasized that its global effective tax rate exceeds 32 percent. How can a company be both a successful stateless income opportunist and have such a high effective tax rate? The answer lies in the murky intersection of tax laws and financial accounting for taxes.<sup>94</sup>

Starbucks's statement is true, but only in the way that a Hollywood biopic "based on a true story" is true. In 2012 Starbucks's global GAAP tax provision indeed showed a tax rate exceeding 32 percent. But GAAP tax provisions are not the same as taxes actually paid, and a U.S. company's global effective tax rate is not the same as the rate it enjoys on its non-U.S. income, which is the real issue when lobbying to privilege the stateless income strategies of multinational companies.

That last point is particularly important when looking at Starbucks, which is still overwhelmingly a U.S. business. In fiscal 2012, for example, Starbucks derived about 82 percent of its global pretax income from U.S. operations.<sup>95</sup> Given that the United States has a 35 percent tax rate (putting aside the domestic production deduction) with state income taxes applicable to domestic income, that heavy weighting toward domestic income cannot help but increase Starbucks's global effective tax

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world in which the implications of a group's internal tax structures for any particular jurisdiction are even more obscure than formerly was the case.

<sup>93</sup>Mark W. Boyer et al., "*Granite Trust* Planning: Properly Adopting a Plan of Liquidation," *Tax Notes*, Mar. 18, 2013, p. 1331.

<sup>94</sup>One helpful paper on the difficulty of extracting useful information on the international operations of multinational companies through studying their tax footnotes is Donohoe et al., *supra* note 49.

<sup>95</sup>Starbucks 2012 Form 10-K, *supra* note 4, financial statement n.13, at 80.

rate, relative to other companies with a larger international component to their business mix.

Consider the public data that are consistent with stateless income tax planning. Starbucks had an \$8.2 billion balance sheet at the end of its fiscal 2012, but more than \$2 billion of that comprised cash (about \$1.2 billion) and short-term investments (predominantly U.S. Treasury securities). At year-end, Starbucks held \$703 million in cash in foreign subsidiaries, of which \$343 million was U.S. dollar-denominated.<sup>96</sup> Large quantities of cash and short-term investments held offshore are certainly consistent with stateless income tax planning.

At year-end 2012, Starbucks reported that it held about \$1.5 billion in offshore permanently reinvested earnings — more than double its after-tax foreign earnings for the last three years combined. Those earnings of course are low-taxed foreign earnings for which a company does not provide a financial accounting tax expense, on the grounds that the earnings are indefinitely invested outside the United States.<sup>97</sup> In 2012 Starbucks added \$513 million to its permanently reinvested earnings — which greatly exceeded its total net foreign after-tax income for the year (about \$300 million).<sup>98</sup>

How can a company set aside 170 percent of its annual after-tax foreign income as permanently reinvested earnings? One possibility is that the company reclassified prior year earnings for which tax had formerly been provided. In this case, given that Starbucks's foreign tax benefits in the tax rate reconciliation tables to its financial statement tax footnotes didn't fluctuate much from year to year and its U.K. tax experience, another explanation seems more likely: Starbucks had significant losses in some jurisdictions and higher profits in others, which for financial statement purposes consolidated down to the roughly \$300 million in net foreign after-tax profits. The implied losses suggest that profitable foreign subsidiaries whose after-tax income was classified as permanently reinvested earnings (so-called Accounting Principles Board Opinion No. 23 entities) must have earned \$513 million after tax on about \$590 million of pretax

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<sup>96</sup>*Id.* at 41.

<sup>97</sup>Kleinbard, "*Stateless Income*," *supra* note 2, at 744-745.

<sup>98</sup>Starbucks 2012 Form 10-K, *supra* note 4, financial statements, n.13, at 80 (\$380 pretax income, \$80 million in total foreign taxes, of which \$77 million were current liabilities). The \$513 million addition to permanently reinvested earnings comes from a comparison of the year-end balance (\$1.5 billion) with the balance at the end of the prior year (\$987 million).

foreign income.<sup>99</sup> That becomes relevant when analyzing Starbucks's effective tax rate on its foreign income.

Those data are consistent with the intuition that Starbucks, like many other U.S. multinational companies, is an enthusiastic stateless income tax planner, but what would be most relevant is a clear picture of Starbucks's actual effective foreign tax rate. Under the relevant financial accounting guidance, Starbucks is supposed to include in the tax footnote to its audited financial statements the approximate U.S. tax cost of repatriating its \$1.5 billion in low-taxed permanently reinvested foreign earnings, from which it would be a trivial exercise to calculate the company's true foreign effective tax rate. But Starbucks, following the shameful example of most other U.S. companies with significant permanently reinvested earnings, pleads its financial accounting inadequacy and avers that the task is simply too difficult to perform, what with the complexity of all the rules.<sup>100</sup> Why the SEC permits companies to hide their true foreign effective tax burden in that manner is a mystery worth solving.

GAAP financial statements do break out a company's cash flow used to pay tax bills, but they do not distinguish which country's bills those are. On that basis, Starbucks's average global effective tax rate between 2010 and 2012 was about 24 percent.<sup>101</sup> But that number must be used with caution, as even when averaged across a few years, the cash tax bills paid in a period match up only roughly with current years' tax liabilities. And that figure says nothing about a company's foreign effective tax rate, which is the only relevant question in judging the magnitude of stateless income tax planning afoot.

<sup>99</sup>Starbucks's consolidated current foreign tax provision for 2012 was \$77 million. The text makes conservative assumptions, in that it treats 100 percent of Starbucks's foreign tax liabilities as associated with APB 23 subsidiaries and ignores the possibility that there are significant non-APB 23 entities with positive tax liabilities, which in turn would imply still larger losses in other subsidiaries — and lower effective tax rates in the APB 23 entities.

<sup>100</sup>Starbucks 2012 Form 10-K, *supra* note 4, financial statements n.13, at 81. To their credit, Microsoft Corp. and Apple Inc., both companies orders of magnitude larger and more complex than Starbucks, are able to do so. Donohoe et al., *supra* note 49, at 972-973, summarize the history of that requirement and current practice; they report that 55 out of 66 companies with permanently reinvested earnings exceeding \$5 billion declined to calculate the tax cost of repatriating those earnings. They further conclude that companies' reluctance to provide the required estimate is driven by "political cost reasons." *Id.* at 981.

<sup>101</sup>\$1,294 tax cash flow for three-year period (2012 Form 10-K, *supra* note 4, at 52)/\$5,307 three-year pretax income (at 80).

In the absence of cash tax data from the permanently reinvested earnings footnote or elsewhere, one must work with GAAP financial accounting data. The fair starting point for measuring a company's tax burden in any given year from GAAP financial data is the company's current tax expense — that is, ignoring deferred tax items — because deferred items do not necessarily lead to future tax expense for a growing company. On that basis, Starbucks had a foreign effective tax rate of about 20 percent in fiscal 2012 and 13 percent in 2011. But following the logic of the earlier discussion of Starbucks's implied foreign losses, the 2012 figure appears to overstate the tax burden the company actually incurred on profit-making foreign subsidiaries. If the pretax income of profit-making subsidiaries whose income is classified as permanently reinvested (the APB 23 entities) in fact was \$590 million, then its 2012 effective current foreign tax rate on profit-making subsidiaries drops to around 13 percent.<sup>102</sup>

Tax rates in the low- to mid-teens are far below the statutory rates in the countries in which Starbucks does significant customer business. Starbucks's success in reducing its foreign effective tax rate to those levels should be alarming to tax policymakers around the world because Starbucks is a classic brick-and-mortar business, with fixed customer locations in high-tax jurisdiction high streets around the world. Further, and without disrespect to Starbucks's claims of proprietary coffee bean roasting recipes, it would be difficult to imagine a successful young business that has a smaller component of intellectual property driving its profitability. In short, if Starbucks can achieve stateless income tax planning success at this level (more than twice as much in permanently reinvested earnings as its last three years of after-tax foreign profits combined, an apparent effective foreign tax rate in the mid-teens, etc.), then any company can.

The remedy begins with transparency — genuine transparency, in which tax authorities and policymakers have a clear and complete picture of the global tax planning structures of multinational

<sup>102</sup>From another vantage point, Starbucks's global pretax income in 2012 was \$2.059 billion. The company recorded a 3.3 percent permanent tax savings from "benefits and taxes related to foreign operations." That 3.3 percent difference  $\times$  \$2.059 billion pretax income = \$68 million. The company reported \$379.5 million in net pretax foreign income, on which tax at 35 percent would have been \$133 million. \$133 - \$68 in permanent savings implies a foreign tax cost of \$65 million; \$65/\$379.5 implies a 17 percent effective foreign tax rate. That is an approximate computation, intended as a reality check, not an estimate of actual effective foreign tax rates.

companies and the implications of those structures for generating stateless income. National governments should recognize their common interest and require their tax and securities agencies to promulgate rules providing a uniform worldwide disclosure matrix for actual tax burdens by jurisdiction.

Anticipating the argument that a worldwide tax disclosure matrix would reveal proprietary information about a company's real business operations, the matrix could contemplate some aggregation of data. For example, it might divide companies' tax burdens into buckets by effective tax rates in 5 percentage point increments and then lump all income taxed at effective rates more than 25 percent into one bucket. Within each lower-taxed bucket, a company would show the income attributable to each country and its tax liability for that income, unless the income attributable to a particular country was less than 2 percent of the company's worldwide income, in which case it would be lumped into a category of "other." Income would be presented by reference to the accounting principles followed in preparing the company's consolidated worldwide financial statements.

The OECD made some proposals in a 2011 report,<sup>103</sup> but much of the organization's earlier work on transparency was aimed at tax shelter promoter disclosure or secret financial accounts. As the OECD's recent BEPS report stresses, it is time to emphasize transparency of the effective tax rates of multinational enterprises.<sup>104</sup>

In early May the European Union took important steps in that direction when its Committee on Economic and Monetary Affairs passed a motion to bring to the European Parliament a resolution that "welcomes the progress made on country-by-country reporting under the Accounting and Transparency Directives; calls on the Commission to introduce, as the next step, country-by-country reporting for cross-border companies in all sectors, enhancing the transparency of payments transactions — by requiring disclosure of information such as the nature of the company's activities and its geographical location, turn-over, number of employees on a full-time equivalent basis, profit or loss before tax, tax on profit or loss, and public subsidies received on a country-by-country basis on the trading of a group as a whole — in order to monitor respect for proper transfer pricing rules."<sup>105</sup>

<sup>103</sup>OECD, "Tackling Aggressive Tax Planning Through Improved Transparency and Disclosure" (2011).

<sup>104</sup>*Supra* note 3, at 6 and 47.

<sup>105</sup>European Union Committee on Economic and Monetary Affairs, "Report on Fight Against Tax Fraud, Tax Evasion and Tax Havens" (2013/2060(INI)), para. 48 (May 2, 2013).

At a May 22 meeting, the European Council agreed to press forward with EU-level legislation in that area, with enactment possible as early as this summer.<sup>106</sup>

It would be a tangible and significant achievement if the European Union were to continue that effort and if as a result the G-8 or OECD were to help implement a matrix along the lines suggested above or other corporate effective tax rate transparency measures in the course of their current anti-base-erosion initiatives. At a minimum, and as an important and easily implementable first step, the United States should promptly eliminate the "not practicable" exception to the requirement that publicly held U.S. companies disclose the tax costs of repatriating their offshore permanently reinvested earnings.

Tax transparency rules along those lines are not a substitute for substantive reform of the international tax regimes of the United States and other jurisdictions. But tax transparency would let tax authorities identify possible patterns of inappropriate income shifting, thereby making better use of limited resources. A transparency principle would alert the public to the levels of international tax avoidance known only to specialists. Without an engaged public, policymakers will have a difficult time resisting the blandishments and veiled threats of corporate lobbyists.

## B. U.S. Tax Policy Implications

As noted at the outset, corporate shamelessness in tax lobbying is a dog-bites-man story, and so one should not be surprised that Starbucks hopes that the Ways and Means Committee will permanently sanction its stateless income tax planning as part of U.S. tax reform. To avoid doubt, however, Starbucks's arguments are patently inconsistent with any well-ordered international tax system, including a well-designed territorial tax (the structure that the United Kingdom employs).

In its submission to the Ways and Means Committee International Working Group, Starbucks makes several substantive tax points. First, and as

<sup>106</sup>European Council, Conclusions of 22 May 2013, EUCO 75/1/13 REV 1 (May 23, 2013). The new requirements could be attached either to existing proposals requiring disclosures related to social and environmental issues or to new accounting rules that are expected to be passed in June. Randall Jackson, "EU Looks to Expand Country-By-Country Reporting," *Tax Notes Int'l*, June 3, 2013, p. 948. The recent interest in transparency initiatives was prefigured by a 2011 group study produced under the aegis of the Oxford Centre for Business Taxation, and chaired by Michael Devereux: *Transparency in Reporting Financial Data by Multinational Corporations* (July 2011), available at [http://www.sbs.ox.ac.uk/centres/tax/Documents/reports/Transparency\\_reporting\\_multinationals\\_july2011.pdf](http://www.sbs.ox.ac.uk/centres/tax/Documents/reports/Transparency_reporting_multinationals_july2011.pdf).

discussed above in Section III.A, it reminds the reader that in 2012 its financial accounting global effective tax rate was more than 32 percent. But as demonstrated above, the relevant question in the context of an inquiry into the shape of our international tax rules is not Starbucks's global rate (given that it derives more than 80 percent of its pretax income from the United States), but rather what its effective tax rate is on its foreign income.

That should be a straightforward inquiry, but it is made difficult by the failure of Starbucks (as well as most other companies) to quantify the cost of repatriating its permanently reinvested earnings. The idea that this calculation is beyond the ability of the Starbucks tax department is simply not credible, and it is fair to draw the inference that Starbucks has not done so not because it would inconvenience some tax accountants, but because doing so would reveal the full extent of its success at stateless income tax planning. Many other companies offer the same weak excuse of tax accounting incompetence, and it rings hollow in every case.<sup>107</sup>

Unsurprisingly, Starbucks argues for a territorial tax system, but it does not seem to fully grasp what a well-ordered territorial tax system would entail. Starbucks argues that its business is local in its focus (which is a sensible business story) and that it must provide proximal support to those local operators (which also is logical). Starbucks also avers that current law enables it to earn active income from licensing its intangibles (trade name, Starbucks Experience signifiers, proprietary roasting methods, operating manuals, etc.) to third parties, but in doing so favors royalties received from unrelated franchisees over royalties received from related ones. It seems to forget the helpful roles played by the look-through rules of section 954(c)(6) and check-the-box strategies in avoiding the practical reach of the foreign personal holding company provisions of subpart F.

Starbucks claims that the foreign personal holding company component of subpart F income discourages it "from employing its core business model, which is to own and operate its stores." It thinks the remedy is to extend territorial tax principles — in particular, the patent box proposal known as option C in the Ways and Means Committee's discussion draft for international tax reform — to related party royalties used to strip income from high-tax foreign jurisdictions to low-

tax ones. Starbucks's hope is that the Ways and Means Committee will not restore subpart F's former reach, by subjecting related party royalties to subpart F income (which category will remain in place in a future territorial system).

Starbucks does not make the same argument for protecting from the reach of subpart F income the 20 percent markup charged by its Swiss trading operation on coffee bean purchases for the simple reason that today that income clearly falls outside subpart F, even when the coffee is resold to the U.S. parent. But as described earlier, the exception in section 954(d)(1) for sales to affiliates of some agricultural products was hardly the result of careful consideration by Congress. The two taxwriting committees never considered that provision, which simply appeared at the end of a legislative process in a House-Senate conference agreement without any explanation. A major tax reform initiative is precisely the time to revisit just that unexamined hoary political accommodations.

Both for royalties paid to affiliates and markups on coffee sold to affiliates, Starbucks confuses activities that might reasonably be inferred as falling outside the scope of subpart F, because those royalties or markups arise from independent real businesses done with third parties (for example, a franchise business model, or entering business as a coffee trading operation with third-party counterparties), with activities that represent largely arbitrary internal divisions of a different, integrated business model — selling coffee to customers. The United States does not discourage Starbucks from owning and operating stores in the United Kingdom — it discourages Starbucks, in a weak and ineffectual way, from deriving economic income from the United Kingdom but paying tax on that income essentially nowhere, by purporting not to bring into the United Kingdom all the goodwill and know-how that it puts to work with every *macchiato* that it serves. To the contrary, future policy, consistent with the OECD's goals in its recent BEPS report, should be to make such discouragement more effective.

Starbucks's core argument rests on the shaky foundations of competitiveness, without the slightest evidence that it is in fact disadvantaged by current tax law. As described earlier, its current effective foreign tax rate on its foreign income appears to be in the neighborhood of 13 percent — taking into account the tax that it does pay in many high-tax jurisdictions on the profits it recognizes from its thousands of high street retail locations. That effective rate is far below the statutory rates prevailing in its three largest foreign markets (Canada, Japan, and the United Kingdom). It also is likely to be far below the effective tax rates suffered

<sup>107</sup>See Donohoe et al., *supra* note 49, at 981-982 (labeling the reluctance to estimate the tax cost of repatriation as motivated by "political" considerations and urging the elimination of the "not practicable" exception to the rule requiring that disclosure).

by the host of smaller domestic competitors in every market, including the United Kingdom, that do not have the advantage of complex international stateless income structures to rely on to drive down their tax bills.

Starbucks argues that in a future territorial tax system the United States owes Starbucks a preferential tax rate on a large slice of its international income, at the expense of not only U.S. taxpayers, but also of taxpayers in the source countries where its customers are located and its beverages are served. The United States has strong national policy reasons to object to Starbucks's preferred outcome, without regard to any appeals to worldwide welfare concerns.<sup>108</sup>

Starbucks essentially has demanded that tax source be divorced from economic source. It makes a persuasive case that its business model contemplates direct ownership of its stores — and thereby direct responsibility for engagement with its customers — and further emphasizes the importance of proximity and localization. But it then claims that

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<sup>108</sup>It is a mistake of logic to think that U.K. tax avoidance is of no concern to the United States and a mistake of fact to think that U.S. companies today face an “uncompetitive” international tax system. Kleinbard, “Stateless Income,” *supra* note 2, at 752-770.

what follows as a tax matter is a completely different model, in which proximity and localization are abandoned, and instead the intangibles and capital required to make its own local customer-focused business model work should be found to reside far over the horizon.

The Achilles' heel of all territorial tax systems is that they rely entirely on underdeveloped ideas of the geographic source of income to apportion tax liability. When that underdeveloped concept is combined with the artificial idea of the separate juridical status of wholly owned subsidiaries within multinational groups, the result is smooth sailing for stateless income.<sup>109</sup> If one wants to implement a thoughtful and economically sensible territorial tax system — as I believe that the Ways and Means Committee does — then the geographic source of income must be well defined and protected at every turn from tax slicing and dicing through arbitrary intragroup structures for the siting of group intangibles or capital. From that policy perspective, Starbucks's comment letter is a blueprint for precisely the sort of source-avoidance techniques that the Ways and Means Committee's bill must forcefully foreclose.

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<sup>109</sup>Kleinbard, “The Lessons of Stateless Income,” 65 *Tax L. Rev.* 99, 136-140 (2011).

#### SUBMISSIONS TO TAX NOTES

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