USC Gould
School of Law

Through a Latte, Darkly: Starbucks' Window into Stateless Income Tax Planning

Edward D. Kleinbard
USC Gould School of Law

Center in Law, Economics and Organization
Research Papers Series No. C13-9

Legal Studies Research Paper Series No. 13-10

May 13, 2013

Electronic copy available at: http://ssrn.com/abstract=2264384

May 10, 2013

THROUGH A LATTE, DARKLY: STARBUCKS' WINDOW INTO STATELESS INCOME TAX PLANNING

By:

Edward D. Kleinbard
University of Southern California Gould School of Law
Fellow, The Century Foundation
ekleinbard@law.usc.edu

WORKING PAPER: Comments welcomed. Please do not cite or quote without checking for updated drafts.

This paper has benefitted enormously from the advice and comments of several anonymous reviewers.

Electronic copy available at: http://ssrn.com/abstract=2264384

ABSTRACT

This paper uses Starbucks Corporation, the premier roaster, marketer and retailer of specialty coffee in the world, as an example of stateless income tax planning in action. "Stateless income" comprises income derived for tax purposes by a multinational 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.

The paper reviews both Starbucks' recent U.K. tax controversy (including a parliamentary inquiry), which revolved around the intersection of its consistent unprofitability in the United Kingdom with large deductible intragroup payments to Dutch, Swiss and U.S. affiliates, and its more recent submission to the U.S. House Ways and Means Committee. The paper draws from this review two lessons.

First, if Starbucks can organize itself as a successful stateless income generator, any multinational firm can. Starbucks follows a classic bricks and mortar retail business model, with direct customer interactions in thousands of "high street" locations in high-tax countries around the world. Moreover, Starbucks is not a firm driven by hugely valuable identifiable intangibles that are separate from its business model, which it employs whenever it deals with those retail customers. Nonetheless, 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 Starbucks story – in particular, its U.K. experience – demonstrates the fundamental opacity of international tax planning, in which neither investors in a public firm nor the tax authorities in any particular jurisdiction have a clear picture of what the firm is up to. It is not appropriate to expect source country tax authorities to engage in elaborate games of Twenty Tax Questions, in turn requiring detailed knowledge of the tax laws and financial accounting rules of many other jurisdictions, in order simply to evaluate the probative value of a taxpayer's claim that its intragroup dealings necessarily are at arm's-length by virtue of alleged symmetries in tax treatment for expense and income across the group's affiliates. U.S.-based multinational firms owe a similar duty of candor and transparency when dealing with the Congress of the United States.

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

Electronic copy available at: http://ssrn.com/abstract=2264384

May 10, 2013

THROUGH A LATTE, DARKLY: STARBUCKS' WINDOW INTO STATELESS INCOME TAX PLANNING

Edward D. Kleinbard[1]
University of Southern California Gould School of Law
Fellow, The Century Foundation

I. INTRODUCTION.

A. Overview.

Fresh from its recent U.K. tax public relations disaster,[2] Starbucks Corporation now is lobbying the U.S. House of Representatives' Ways and Means Committee for special rules that would permanently privilege its strategies for generating "stateless income" – income that, through internal tax planning, first becomes unmoored from the host country where it originally is earned, and then sets sail for the welcoming harbor of the tax haven of choice.[3] This paper uses Starbucks' tax planning in the United Kingdom and its submission to the House Ways and Means Committee as windows into the problems confronting tax authorities in addressing this

[1] ekleinbard@law.usc.edu

[2] See, e.g., http://www.dailymail.co.uk/news/article-2218819/Starbucks-facing-boycott-tax.html.

[3] James Polity and Barney Jopson, *Starbucks Seeks Fresh U.S. Tax Breaks*, Financial Times, Apr. 24, 2013. The Starbucks paper is available at http://waysandmeans.house.gov/uploadedfiles/starbucks_wg_comments.pdf (hereinafter, "Starbucks Ways and Means Submission").

For analyses of the tax policy issues surrounding stateless income, see Edward Kleinbard, *Stateless Income,* 11 Florida Tax Rev. 699 (2011); Edward Kleinbard, *The Lessons of Stateless Income,* 65 Tax Law Rev. 99 (2011). Condensed versions of these articles were published in Tax Notes: *Stateless Income's Challenge to Tax Policy*, 132 Tax Notes 1021 (Sept. 5, 2011), and *Stateless Income's Challenge to Tax Policy*, Part 2, 136 Tax Notes 1431 (Sept. 17, 2012).

"base erosion and profit shifting," to use the term employed by the Organization for Economic Cooperation and Development.[4]

The paper makes two fundamental points. First, to put matters bluntly, if Starbucks can organize itself as a successful stateless income generator, any multinational firm can. Starbucks follows a classic bricks and mortar retail business model, with direct customer interactions in thousands of "high street" locations in high-tax countries around the world. Moreover, without meaning to deprecate Starbucks' corporate pride in the "Starbucks experience" afforded by its retail outlets, or in its proprietary coffee roasting formulae, Starbucks is not a firm driven by hugely valuable identifiable intangibles.[5] The "Starbucks experience" is a business model by another name, and all successful firms have business models. Despite these facts, it appears that Starbucks indeed 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' claims made to a U.K. House of Commons parliamentary inquiry and to the U.S. House Ways and Means Committee are another window of sorts, but this time a window occluded by 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 firm nor the tax authorities in any particular jurisdiction have a clear picture of what the firm is up to. This murkiness stands in contrast to the frequent calls by multinational firms for tax "transparency" and certainty in their dealings with tax authorities around the world, by which they mean in general that tax rules should be clear in how they apply to a firm's particular situation, authorities as well as taxpayers should follow those rules, and audits should be resolved promptly.[6]

---

[4] OECD, *Addressing Base Erosion and Profit Shifting*, http://www.oecd.org/tax/beps.htmm (2013).

[5] See, e.g., Starbucks Corporation 2012 Form 10-K, Shareholders' Letter, and Starbucks Ways and Means Submission, supra n. 3.

[6] See, e.g., Allison Bennett, *Multinational Firms Seeking Transparency, Certainty as Audits Increase, Panelists Say*, 85 BNA Daily Tax Report G-6 (May 2, 2013).

The tension is visible in the record of the testimony of Troy Alstead, Chief Financial Officer of Starbucks Corporation, at the inquiry held by the Public Accounts Committee of the U.K. House of Commons, when he stated "We believe very strongly in transparency-with the Committee, with tax authorities around the world and with consumers – recognising 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."[7]

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 firms – or, phrased conversely, what a poor job multinational firms have done in "explaining it." Source country tax authorities in particular have a legitimate interest in a complete and transparent presentation of a multinational firm's *global* tax planning relevant to that firm's source country base erosion strategies. Without such an understanding, a source country's authorities are not able to evaluate, for example, claims made by a multinational firm 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 surrounding the income side of the equation.

---

[7] Public Accounts Committee, House of Commons, Minutes of Hearing HC716, Nov. 12, 2012, Q 601 (available at http://www.publications.parliament.uk/pa/cm201213/cmselect/cmpubacc/716/121112.htm)

The questioning continued:

Q602 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.

Ian 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.

Similarly, without understanding the global tax structure of a firm, 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 not able 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 firm's global tax planning. And of course when it comes to U.S. multinational firms, 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 Twenty Tax Questions, in turn requiring detailed knowledge of the tax laws and financial accounting rules of many other jurisdictions, in order simply to evaluate the probative value of a taxpayer's claim that its intragroup dealings necessarily 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' submission to the Ways and Means Committee is an unexceptional example of the substantive tax law shamelessness that marks much corporate tax lobbying. This observation has a dog bites man quality about it, and Starbucks runs with a large crowd in this respect. Nonetheless, since most corporate legislative tax lobbying is not conducted in public forums, it is useful to review just how large a gap there is between Starbucks' "ask" and any sensible international tax policy.[8] It frequently is overlooked that Members of Congress and their staff are busy and harried individuals, not always able to parse constituent "asks" to find whether a kernel of sensible tax policy lurks among the standard demands for "competitiveness" or "a level playing field." U.S.-based multinational firms owe a duty of candor and transparency, not only to source country tax authorities, but also to the Congress of the United States.

The Organization for Economic Cooperation and Development (OECD) has recently focused on this problem in the context of its base erosion and profit shifting project, and it has

[8] The Freedom of Information Act does not apply to legislative lobbying.

called for greater transparency in the effective tax rates of multinational enterprises.[9] 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 was "a complete lack of transparency" concerning the amount of tax paid by multinational firms, and called for the development of best practice standards governing the information that such firms should publicly release about their tax practices.[10]

National governments should respond to these calls by recognizing their common interest and requiring their tax, financial accounting and securities agencies to promulgate consistent rules providing a uniform world-wide disclosure matrix for actual tax burdens by jurisdiction. A complete and transparent presentation of firms' global tax structures would greatly assist tax authorities everywhere in designing international tax regimes that avoid double taxation while remaining robust to stateless income tax planning.

The United States, as the home country for more multinational enterprises than any other, and a jurisdiction that today has very lax practices in implementing such requirements, must take a leadership role. It can begin by enforcing the current rule that nominally requires U.S.-based multinational firms to disclose in the tax footnotes to their financial statements the cost of repatriating their stores of offshore "permanently reinvested earnings." Today, this rule is overwhelmingly honored in the breach rather than in practice, as the vast majority of firms claim that it is not practicable (by which they mean, not convenient to their interests) to do so.

This paper 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. Nor does this paper suggest that any of Starbucks' tax planning runs afoul of the laws of any jurisdiction. And finally, the issues identified herein are not unique to U.S.-based multinational firms (with the exception of the occlusion attributable to check-the-box entities): multinational firms wherever domiciled in general follow broadly similar strategies. This paper's

[9] OECD, *Base Erosion and Profit Shifting*, at 6 and 47 (OECD 2013).

[10] House of Commons Committee of Public Accounts, *HM Revenue & Customs: Annual Report and Accounts2011–12*, http://www.publications.parliament.uk/pa/cm201213/cmselect/cmpubacc/716/716.pdf, (Nov. 28, 2012) at 3-5.

call for structural tax transparency towards 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.[11] "Stateless income" comprises income derived for tax purposes by a multinational 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 term has been adopted by at least some tax policymakers around the world.[12]

The pervasive presence of stateless income tax planning upends standard characterizations of how current U.S. tax law operates, as well as the case for the United States to move to a territorial tax system, unless accompanied by extremely robust antiabuse rules. In practice current U.S. tax rules do not operate as a "worldwide" system of taxation, but rather as an ersatz variant on territorial systems, with hidden benefits and costs when compared to standard territorial regimes. This claim holds whether one analyzes these rules as a cash tax matter, or through the lens of financial accounting standards. In practical application, current law does not disadvantage U.S. multinational firms in respect of the effective foreign tax rates they suffer, when compared with their territorial-based competitors.

Stateless income privileges U.S.-based multinational firms over domestic ones by offering the former the prospect of capturing "tax rents" – low-risk inframarginal returns derived by moving income from high-tax foreign countries to low-tax ones. Other important implications of stateless income include the dissolution of any coherence to the concept of geographic source

[11] This subsection quickly summarizes some of the themes of the papers cited in note 3. Interested readers can find these arguments more completely developed therein.

[12] David Bradbury, Assistant Treasurer of Australia and Minister for Deregulation, *Stateless Income: A Threat to National Sovereignty*, Address to the Tax Institute of Australia, March 15, 2013, http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=speeches/2013/003.htm&pageID=005&min=djba&Year=&DocType= ; Lee A. Sheppard, Is Multinational Tax Planning Over?, 139 Tax Notes 231 (Apr. 15, 2013) (quoting Edwin Visser, deputy director-general of taxation of the Dutch Ministry of Finance: "Stateless income is the big problem now," Visser, who is involved in the OECD project, echoed. Stateless income distorts investment decisions and undermines voluntary compliance, he added.")

(in turn the exclusive basis for the allocation of taxing authority in territorial tax systems), the systematic bias towards offshore rather than domestic investment, the more surprising 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 – essentially uniquely to the United States – the exacerbation of the lock-out phenomenon, under which the price that U.S. firms 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[13]) and cash outside the United States.

U.S. policymakers and observers sometimes understandably articulate the intuition that the United States should not object if U.S.-based multinational firms successfully game the tax laws of foreign jurisdictions in which they do business, but the points summarized in the preceding paragraph demonstrate why the United States would be the loser if it were to follow that strategy. By generating "tax rents" – low-risk supersized returns – through moving income from high-tax foreign countries in which they actually do business to low-tax jurisdictions, U.S. multinational firms 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 U.S. domestic operations.[14]

Stateless income tax planning as applied in practice to current U.S. law's ersatz territorial tax system means that the lock-out effect now operates in fact as a kind of lock-in effect: firms retain more overseas earnings than they profitably can redeploy, to the great frustration of their shareholders, who would prefer that the cash be distributed to them. This tension between shareholders and management likely lies at the heart of current demands by U.S.-based multinational firms that the United States adopt a territorial tax system. The firms themselves are not greatly disadvantaged by the current U.S. tax system, but shareholders are. The ultimate

[13] Wall St. J., CFO Journal, *Indefinitely Reinvested Foreign Earnings on the Rise*, May 7, 2013.

[14] The foreign tax credit interest allocation rules of section 864(e) have almost no bite when firms are able to drive down their foreign effective tax rates to single digit levels, because even after interest expenses are allocated firms still have capacity to claim whatever foreign taxes they do pay as credits in the United States.

reward of successful stateless income tax planning from this perspective should be massive stock repurchases, but instead shareholders are tantalized by glimpses of enormous cash hoards just out of their reach.

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

My papers 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, while the imperfections of the latter can be mitigated through the 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 summarized above.[15] And of course the OECD's "base erosion and profit shifting" project, and the commitment of the G-8 group of countries to address these sorts of issues, point in the same direction.

Tellingly, factual developments and quantitative analysis confirm the magnitude of the problem. Two years ago the stockpile of U.S. firms' "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. GAAP financial statements) stood at a little over $1 trillion; now that stockpile hovers at just about $2 trillion.[16]

And in a recent paper, Harry Grubert and Rosanne Altshuler, working with firm-by-firm IRS data for 2006, calculated the effective foreign tax rates of profitable foreign subsidiaries of

---

[15] E.g., J. Clifton Fleming, Jr. Robert J. Peroni, and Stephen E. Shay, *Designing a U.S. Exemption System For Foreign Income When the Treasury is Empty*, 13 Fla. Tax. Rev. 397 (2012).

[16] Note 13, supra.

U.S. firms whose foreign operations in the aggregate had net positive earnings.[17] 54 percent of all income earned by such subsidiaries was taxed at effective foreign tax rates of 15 percent or less. Only 24 percent of all such income was taxed at rates of 30 percent or greater. And perhaps more remarkably, almost 37 percent of the total income earned by such firms was taxed at rates lower than 5 percent. In light of these data drawn directly from firms' tax returns, advocates of the view that U.S. firms suffer abroad from an anti-competitive U.S. tax system should be assigned the burden of proof to explain why this might be so.

II. THE U.K. STORY.

A. Overview.

Starbucks has operated in the United Kingdom since 1998. In October 2012, Reuters published a news story describing the fact that Starbucks had reported losses in 14 of the first 15 years of its existence there, and of course 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.[18] In reactions that would surprise American observers, where such reports typically have few direct repercussions, this story unleashed a political firestorm in the United Kingdom, including threats of boycotts of Starbucks stores.[19] Less than a month after the story's publication, the Committee of Public Accounts of the House of Commons

---

[17] Harry Grubert and Rosanne Altshuler, *Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax*, working paper draft of April 1, 2013, Table 3 (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2245128)

[18] Tom Bergin, *How Starbucks Avoids U.K. Taxes*, Oct. 15, 2012, available at http://www.reuters.com/article/2012/10/15/us-britain-starbucks-tax-idUSBRE89E0EX20121015.

At the parliamentary inquiry described below, the M.P.s questioning Starbucks consistently contrasted Starbucks' losses in the United Kingdom to the significant company taxes paid by its largest competitor, Costa. E.g., Public Accounts Committee, House of Commons, Minutes of Hearing HC716, supra n.7, Q235, Q281.

For the market share figure and "solid profitability" claim, see House of Commons, Public Accounts Committee Report (Nov. 2012) , Item 1, Par. 8 (http://www.publications.parliament.uk/pa/cm201213/cmselect/cmpubacc/716/71602.htm) The latter claim is discussed in more detail below.

[19] See note 2, supra.

convened a hearing to review the U.K. corporate tax planning of Starbucks, Amazon and Google. Its report was published two weeks later; it concluded "We found it difficult to believe that a commercial company with a 31% 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 UK." [20]

In the course of that hearing and in its written submissions,[21] Starbucks vigorously rejected any suggestion that it had underpaid its U.K. tax obligations. The *Financial Times* subsequently published an online series of blog posts (collectively titled, *Bitching About Starbucks*[22]) that generally were sympathetic to Starbucks' interpretation of the facts and that took issue with some of the inferences reached in the original Reuters article. Notwithstanding the friendlier tone of the *Financial Times* (which in any event came a week too late), less than two months after the original Reuters article, Starbucks "caved in to public pressure and pledged to pay £10m in UK 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."[23] Starbucks itself described the settlement as "unprecedented," and the announcement immediately precipitated a range of reactions within the British government and among observers.[24]

In its fiscal year ended October 2, 2011 (the most recent year available), Starbucks Coffee Company (UK) Limited ("Starbucks UK"), the principal Starbucks operating company in

---

[20] http://www.publications.parliament.uk/pa/cm201213/cmselect/cmpubacc/716/71602.htm Item 1, Par. 8.

[21] The written submissions are available at http://www.publications.parliament.uk/pa/cm201213/cmselect/cmpubacc/716/716we01.htm.

[22] Lisa Pollack, *Bitching About St*arbucks, Financial Times Alphaville Blog, http://ftalphaville.ft.com/tag/bitching-about-starbucks/ .

[23] Vanessa Houlder, Jim Pickard and Louise Lucas and Barney Jopson, *Starbucks to Pay £20m UK Corporate Tax*, Financial Times, Dec. 6, 2012, available at http://www.ft.com/intl/cms/s/0/ac97bb1e-3fa5-11e2-b0ce-00144feabdc0.html#axzz2SAnSG5iI. The terms of the settlement are described in Lisa Pollack, *The marketing smackdown and that very odd voluntary tax 'payment', http://ftalphaville.ft.com/2012/12/13/1307552/the-marketing-smackdown-and-that-very-odd-voluntary-tax-payment/*.

[24] E.g., Jim Pickard, Vanessa Houlder and Kiran Stacey, *Tory MPs fear Starbucks tax 'precedent*,' Financial Times, Dec. 7, 2012, available at: http://www.ft.com/intl/cms/s/0/a9f3baf0-408d-11e2-8f90-00144feabdc0.html#axzz2SAnSG5iI.

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 £28.8 million, and a net pretax loss on ordinary activities of £32.9 million.[25] (Fiscal year 2010 was broadly similar in results.)

Starbucks UK has paid £8.6 million of U.K. corporation tax during its 15-year existence, on revenue of more than £3.4 billion; of that amount of tax, all but £600,000 was attributable to an audit settlement with the U.K. tax authorities.[26] In 14 out of 15 years Starbucks U.K. recorded losses.

Starbucks UK finished FY 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.[27] 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 year 2011 would imply cumulative tax losses in the range of £150 million (roughly $240 million).[28] Starbucks Corporation's U.S. consolidated financial statements note that, at the end of fiscal year 2012, the group had foreign net operating losses for

---

[25] Audited financial statements of U.K. companies are available through the website of Companies House, http://www.companieshouse.gov.uk/. Starbucks UK's company identification number is 02959325. Its immediate parent is Starbucks Coffee Holdings (UK) Limited; that company's identification number is 03346087.

[26] Starbucks UK statement to House of Commons Public Accounts Committee, supra n. 21, at Par. 10. The Chief Financial Officer of Starbucks testified before that 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. Public Accounts Committee, House of Commons, Minutes of Hearing HC716, supra n.7, Q264.

[27] 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 rate for the latter purpose, and a 4.7 percent rate for the former. See text at note 39, below. In addition, it appears to have a permanent book-tax difference in depreciation charges. This might be attributable to the consequences of purchase accounting when Starbucks acquired the predecessor of Starbucks UK in 1998, or to its treatment of certain impairment charges, or both.

[28] Starbucks UK 2011 Financial Statements, note 8, £40.5 million deferred tax asset ÷ 0.27 tax rate in 2011. See also Section II.C., below.

tax purposes of $318 million, with the predominant amount having no expiration date (which is true of the United Kingdom).[29]

The Reuters news report and subsequent House of Commons hearing focused on three intragroup charges through which Starbucks UK paid substantial amounts to other group companies: (i) royalties and license fees paid to a Dutch affiliate, (ii) markups on coffee purchased via another Dutch affiliate and a Swiss affiliate, and (iii) interest paid on a loan from the U.S. parent company. It was argued that these charges explain Starbucks UK's near-continuous losses for corporation tax purposes. At the same time, it was argued, Starbucks reported a much rosier picture of its U.K. subsidiary's performance to analysts and shareholders. Finally, the argument went, the royalties and coffee markups in particular were subject to tax at very low rates.

During the course of its recent U.K. tax controversy Starbucks consistently maintained that "it has been difficult for us to make a profit in the UK under any measure," notwithstanding 13 consecutive quarters of store-on-store sales growth.[30] It ascribed this great 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.[31] To an outsider (and to the House of Commons Public Accounts Committee), these arguments ring hollow: Starbucks' competitors also face high rental costs for desirable space (which in an efficient market should be reflected in the ultimate price of the products sold to consumers).[32] Starbucks is the second-largest restaurant or café chain in the world,[33] and Starbucks certainly is one of the largest specialty

[29] Starbucks Corporation 2012 Form 10-K, at 83.

[30] Starbucks UK statement to House of Commons Public Accounts Committee, supra n. 21, at Par. 10.

[31] Id at Par. 11.

[32] Starbucks coffee products sell on average for about 20 percent more in the U.K. market than in the United States. Public Accounts Committee, House of Commons, Minutes of Hearing HC716, supra n. 7, at Q 320.

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

[33] Bergin, supra n. 7.

coffee vendors in the United Kingdom, with a 31 percent market share, which suggests a certain amount of market power.

The *Financial Times* reviewed the transcripts of Starbucks' securities analyst conference calls. There is no doubt that, when viewed from the perspective of the group as a whole, Starbucks believed its U.K. operations to be profitable. For example, in 2009, Starbucks told analysts: "Canada, the UK, 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."[34] And in its 2012 Annual Report, Starbucks stated that "in particular, our Japan, UK, and China MBUs [marketing business units] account for a significant portion of the net revenue and earnings of our EMEA and CAP segments . . . ."[35]

Starbucks UK argued strenuously to the House of Commons that in substance Starbucks had not claimed to securities analysts and shareholders that its U.K. operations were profitable, and in particular denied that it had ever claimed (as the Reuters story had stated) that operating margins in the United Kingdom approached 15 percent; rather, the facially different statements could be explained by the fact that US GAAP rules "require" Starbucks to add back the intercompany royalties and interest paid to affiliates, while U.K. rules "require" Starbucks to include them.[36] But of course, the questions at issue in the U.K. tax controversy were, first, the

---

[34] Lisa Pollack, *Media Said, Starbucks Said*, Financial Times Alphaville blog, http://ftalphaville.ft.com/2012/12/12/1304442/media-said-starbucks-said/.

[35] Starbucks Corporation 2012 Form 10-K, at 12. To be fair, later in the Annual Report, Starbucks' management describes the "macro-economic headwinds" the firm faces in Europe, summarizes the EMEA unit's barely-profitable 2012 year, and pledges to work towards "improving the profitability of the existing store base." Id. at 26.

[36] Id at Par. 13. See also Public Accounts Committee, House of Commons, Minutes of Hearing HC716, at Q. 195.

Starbucks' written statement is difficult to parse. It first refers to the different requirements imposed by UK and US tax authorities. It then continues, "Specifically, US [AAP] require[s] us to exclude intra-company royalty payments and loans interest for tax filing purposes . . . ." But GAAP in fact 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

overall Starbucks group's profitability from dealing with U.K. customers, and second whether the division of those profits among different group entities reflected economic reality. For these purposes Starbucks' 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). In that 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. This would translate into a positive operating margin of about 6 percent (as Starbucks UK itself suggested in its statements to the parliamentary inquiry). That figure ignores the intragroup markup on coffee sold to Starbucks UK, for which there is no hard data, but which in 2007 might have added something in the neighborhood of £6 million in overall profits.[37] The *Financial Times* further has speculated that Starbucks UK may pay intragroup markups on fixtures and equipment.[38]

B. The Three Intragroup Charges.

1. Royalties. Starbucks UK pays a 6 percent royalty to an "Amsterdam structure,"[39] but as a result of an agreement with the U.K. tax authorities reduced the deduction it claimed for tax years 2003-09 to a 4.7 percent rate. (Years from 2010 forward were under examination as of the time of the parliamentary inquiry.) The royalty payment covers rights to the Starbucks brand and

---

meant that the consolidated US GAAP financials would ignore these intercompany payments. This of course is not the same thing as claiming that a U.K. subsidiary is obliged to follow U.S. GAAP.

[37] The *Financial Times* blog, supra n. 34, suggests that the cost of coffee might be in the range of 6 percent of sales, or £20 million in 2007. In turn, 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 very approximately £6 million.

[38] *Financial Times* blog, supra n. 34.

[39] Starbucks UK supplementary statement to House of Commons Public Accounts Committee, supra n. 21, at Q 246.

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.[40]

Starbuck UK's intragroup royalty payments are in the neighborhood of £20 to £25 million/year. Had no royalty been charged over the last 10 years, Starbucks UK stated that it would have paid £2 million more in aggregate corporation tax.[41] This figure is difficult to understand, in that it would imply that Starbucks UK had aggregate tax losses (including the royalty payments) of perhaps £200 million or more, but Starbucks' statement offers no further explanation.

Starbucks argued strenuously that the 6 percent royalty paid to the "Amsterdam structure" was an arm's-length rate, because the same rate was charged to over 20 unrelated third parties around the globe.[42] 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 almost as many licensed stores as there are Starbucks-owned stores around the world, Starbucks derives only about 9 percent of its revenues from those licensees.[43]

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 of course, the fact that Starbucks UK agreed to reduce its tax deduction for its royalties from 6 percent to 4.7 percent, from 2003 at least through 2009, might be viewed as an admission that the 6 percent charge was not irrefutably justifiable in this particular case.

---

[40] Id.

[41] Id., Q 214-229.

[42] Id.

[43] Starbucks Corporation 2012 Form 10-K, at 3 and 5.

More generally, 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?

Starbucks UK's written submission to the House of Commons Public Accounts Committee stated that "We pay both Dutch and US taxes on the royalties," and that "The overall effective tax rate we have paid on the royalties received by our Amsterdam regional structure has averaged 16% over the past five years."[44]

This consistent reference to an "Amsterdam structure" is an odd phrase, and can reasonably be read to imply that the royalty income does not come to rest in the Netherlands. The Reuters news report concluded that: "It's unclear where the money paid to Starbucks Coffee EMEA BV ends up, or what tax is paid on it. The firm had revenues of 73 million euros in 2011 but declared a profit of only 507,000 euros. When asked how it burnt up all its revenue, [Starbucks] pointed to staff costs and rent. The HQ has 97 employees."[45]

Indeed, it would be odd that the income did come to rest in the Netherlands, in light of the stateless income strategies routinely pursued by other U.S. multinational firms – for example, Google, in its well-known "Double Irish Dutch Sandwich" structure.[46] One plausible "structure" that taxpayers in general might use in this sort of situation is a sort of 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' CFO was emphatic that Starbucks did not employ tax haven affiliates in respect of this royalty stream, or for any other purpose – although

[44] Id, Q 246.

[45] Bergin, supra n. 7.

[46] Kleinbard, *Stateless Income*, supra n.3, at 707-13.

this might have been somewhat of an overstatement.[47] Beyond that, he did not elaborate on the precise composition of its "Amsterdam structure." He did, however, acknowledge that the tax rate paid by Starbucks on the royalty income coming to rest in the Netherlands was "very low."[48]

The House of Commons might have had a better idea of Starbucks' stateless income tax planning with respect to its intragroup royalties had Starbucks 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.[49] In a disturbing recent development, however, at the end of March 2013 the *Financial Times* reported that the Dutch deputy finance minister "told fellow lawmakers . . . that [Starbucks'] statement was not true," and that "the Netherlands never asked companies to keep their tax arrangements secret."[50]

How then to interpret Starbucks' assertion that "the overall effective tax rate we have paid on the royalties received by our Amsterdam regional structure has averaged over 16%"? If no significant tax was paid to the Netherlands, the effective rate must be attributable to U.S. taxes. In this connection, the Chief Financial Officer of Starbucks testified that about one-half of 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.[51]And since Starbucks described

[47] Public Accounts Committee, House of Commons, Minutes of Hearing HC716, supra n.7, Q 213. Starbucks Corporation's 2012 Form 10-K, Schedule 21, lists one Cayman Islands subsidiary (President Coffee (Cayman) Holdings Ltd.), as well as subsidiaries in Hong Kong (five), Singapore (two), Cyprus, and, as discussed below, Switzerland (two). Under SEC rules, schedule 21 to Form 10-K lists only significant subsidiaries, and that term in turn is subject to a range of interpretations across companies. Michael P. Donohoe, Gary A. McGill, and Edmund Outslay, *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, 962-63 (2012).

[48] Id. Q 243.

[49] Id, Q 246, 285 and Q 288; Starbucks UK supplementary statement to House of Commons Public Accounts Committee, supra n. 19, at Q 284-86; Matt Steinglass, *Dutch Deny Starbucks Tax Deal is Secret*, Financial Times, March 27, 2013 (reporting that Troy Alstead, Starbucks' CFO, had refused to answer the Committee's questions concerning the agreement, because "I am bound by confidentiality to the Dutch government on that.").

[50] Steinglass, supra n. 34.

[51] Public Accounts Committee, House of Commons, Minutes of Hearing HC716, supra n.7, Q 213, 237.

the relevant tax as "paid," we can presumably put to one side in this instance the thought that the tax in question was one provided for on the firm's financial statements, but not actually paid to a tax authority.

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) in general does include royalty income earned by a controlled foreign corporation.[52] There is an exception for royalty income paid by an unrelated person to a controlled foreign corporation in the course of the latter's active conduct of a trade or business.[53] Assuming that Starbucks' operations in the Netherlands satisfy the active business test (as developed in Treasury regulations), then royalties received from third party licensees would be protected from inclusion as subpart F income, but on its face this exception would not protect royalties paid by Starbucks UK to its affiliate in the Netherlands. Nonetheless, the foreign personal holding company subpart F inclusion rules have almost entirely been read out of the Code by the look-through rules of section 954(c)(6), which characterizes intragroup royalties and other deductible payments (as well as dividends) as 'active' income, so long as the amounts are not paid out of the payor's own subpart F income, and by the check-the-box regulations, under which payments that to a foreign jurisdiction appear to be cross-border intercompany payments are for U.S. tax purposes nullities, because the payor 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. firms to obfuscate the actual global tax consequences of their intragroup tax structures.

To a jaundiced and unsympathetic American reader, at least two alternative 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 one-half of the royalties received by the "Amsterdam structure" from Starbucks UK apparently were been paid on to the U.S. parent company, by way of a buy-in. But as discussed later in this paper, there then would follow a separate question whether U.S. federal income tax was "paid" on any such buy-in royalties only by way of the utilization of excess foreign tax credits, which are

---

[52] Section 954(c)(1)(A).

[53] Section 954(c)(2)(A).

visible in the tax footnote of Starbucks' annual reports in the form of foreign tax credit carryovers. For the reasons described in Section II.B.3 in the context of interest payments to the United States, those credits should have been available to shelter Starbucks Corporation's royalty income received from the "Amsterdam structure." Starbucks finally used up its excess foreign tax credits in 2012.

Second, as described in Section III, below, Starbucks today has very large stores of unrepatriated foreign earnings and of cash. Royalty income received by one foreign subsidiary from another one can avoid subpart F income if the requirements of section 954(c)(6)'s look-through rule 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 does give 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.

It can fairly be said that the above hypotheses are speculative, but that observation really makes my basic point. Why should the presumption be that the basic international tax structure of a multinational firm – 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 – should not be transparent to the U.K. House of Commons or HMRC, or the IRS, or any other tax authority with an interest in the matter? The game of Twenty Tax Questions is tedious and frustrating, tax authorities have limited time and resources, and the real consequences of these 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 firms continue to rely on requiring tax authorities to play the game in order to shield their stateless income planning from the harsh glare of direct scrutiny – all the while asking for more tax transparency in how those tax authorities deal with the firms.

There is a fundamental substantive tax policy question lurking here as well. As its comment letter to the House Ways and Means Committee emphasizes, Starbucks' fundamental corporate strategy it to deliver the "'Starbucks Experience' to each customer[,] store by store." Starbucks basically argues that some third party franchisees pay it 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 ought also to 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 – pushing out 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, whence 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' submission to the House Ways and Means Committee explains that the brain center of the Starbucks Experience is its Support Center in Seattle; as presented in that letter, foreign operations appear to be reduced to the "localization" of this centrally-conceived "experience." Then why does Starbucks U.K. 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 one-half of U.K. royalties that stick there? Neither the brains of the operation nor the location-specific tweaks (more umbrella stands?) to reflect British tastes logically should be located there.

We are given no explanation in the Ways and Means submission, other than the standard refrain that Starbucks must have "a level playing field." To this, the Chief Financial Officer of Starbucks added in his testimony before the House of Commons Public Accounts Committee that Starbucks' foreign tax rate was 21 percent – "much higher than most multinationals' global rate,"[54] which in his view demonstrated that "we are an extremely high taxpayer." But the simple fact is that a 21 percent effective rate (which for the reasons described below might more plausibly be described as an effective rate in the low teens) is itself far below the tax rates applicable in the principal foreign jurisdictions in which Starbucks does business (in particular, its three largest presences: 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

[54] Public Accounts Committee, House of Commons, Minutes of Hearing HC716, supra n.7, Q 230.

– in stateless income tax planning. (We also see the ease with which multinational firms can turn a simple business model into intangible assets for which royalties must be paid.) This idea – the conceit that a subsidiary can "own" intangibles developed originally by the parent and harness them to commercial use without subjecting the income thereby generated 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 such conspicuously non-commercial modes of business organization.[55]

2. Coffee Bean Markups. Starbucks purchases all of its raw (green) coffee for its worldwide use through a Swiss subsidiary, which resells the green coffee to other Starbucks affiliates at a 20 percent markup.[56] The U.S. foreign base company sales income rules (section 954(d)) generally treat as subpart F income derived from just such patterns – buying personal property from unrelated persons and reselling the property to related persons (or buying such property from unrelated persons on behalf of related ones). Those rules do not, however, apply to sales of agricultural commodities not grown in the United States in commercially marketable quantities;[57] coffee falls into this exception (if one overlooks the coffees grown in Hawaii and Puerto Rico, as do the relevant regulations).[58]

---

[55] Kleinbard, *Stateless Income*, supra n. 3, at 710.

[56] Public Accounts Committee, House of Commons, Minutes of Hearing HC716, supra n.7, Q 274, 292-315; Lisa Pollack, *Losing for Tax Purposes: A Diagram*, FT Alphaville blog, http://ftalphaville.ft.com/2012/12/11/1304382/losing-for-tax-purposes-a-diagram/

[57] Section 954(d)(1), last sentence.

[58] Treas. Reg. 1.954-3(a)(1)(ii)(*a*). Interestingly, the proposed regulations took the opposite view; Treasury reversed itself in the final regulations in respect of 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, 1978-2 C.B. 199.

The agricultural commodities exception found 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, P.L. 94-12. (This legislation should not be confused with the Tax Reform Act of 1976, P.L. 94-455; the House version of that Act would have further modified the exception, but this proposal 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 a

The Swiss subsidiary further presumably functions as a dealer in commodities, so as to avoid its income being characterized as "foreign personal holding company income" for subpart F purposes.[59] In that connection, the subsidiary would be expected to perform the business functions required by relevant Treasury regulations to avail itself of this exception.[60] Those rules do not require the Swiss subsidiary ever to take physical possession of the coffee in Switzerland, but do require that the subsidiary incur "substantial expenses" relating to "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."[61]

The two exceptions from subpart F income are available even for sales of green coffee to Starbucks' U.S. operations. Those operations in fact buy their coffee through the Swiss trading center.[62]

Starbucks testified before the House of Commons Public Accounts Committee that its Swiss tax rate "has been approximately 12% over history."[63] Starbucks has retail operations in

---

one percent or greater interest in a foreign corporation be taxed currently on their proportionate share of the income from that corporation if more than 50 percent of the stock of the corporation was controlled by U.S. persons. (This 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. As the single exception to this expansion, the Conference Committee adopted the agricultural commodities exception. The Conference Report in one sentence simply repeats the language of the statutory exception without explanation. Conf. Rpt. No. 94-120, 94th Cong., 1st Sess., at 33 (reprinted at 1975-1 C.B. 624, 631). See also, Robert J. Peroni, J. Clifton Fleming and Stephen E. Shay, *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. Rev. 455, 482-83 (1999).

The agricultural commodities exception has not been a hotbed of interpretation or guidance since the promulgation of Treas. Reg. 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, 142-43 (1998).

[59] Section 954(c)(1)(B) and (c)(1)(C)(ii).

[60] Treas. Reg. section 1.954-2(f).

[61] Treas. Reg. section 1.954-2(f)(2)(iii)(B).

[62] Public Accounts Committee, House of Commons, Minutes of Hearing HC716, supra n.7, Q 271.

Switzerland, and it is not clear from the testimony whether the 12% rate relates to the entirety of Starbucks' Swiss operations, or only to the coffee trading business.[64] If the latter, then Starbucks' coffee trading operations would appear to be somewhat higher-taxed than is the norm for Swiss commodities trading firms.[65]

The Chief Financial Officer of Starbucks testified before the House of Commons Public Accounts Committee that Starbucks' profitability in Switzerland was in the "single digit range – 7% or 8%, throughout all our history there," but as brought out in the inquiry through patient questioning, that figure is a percentage of sales, not cost or investment in Switzerland, and as such is largely meaningless.[66] In its submission to that committee, Starbucks stated that "The total income tax liability for FY2011 for our coffee procurement company in Switzerland was 11.6 million CHF" (about $10 million), but provided no information about the entity's income.[67]

Starbucks roasts its coffee destined for U.K. customers in the Netherlands; that function also earns a markup, but details do not appear to be publicly available. The minutes of the oral testimony on this point are confusing. They can be read to 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). [68] Since coffee roasting is a well-

---

[63] Lisa Pollack, *Losing for Tax Purposes: A Diagram*, FT Alphaville blog, http://ftalphaville.ft.com/2012/12/11/1304382/losing-for-tax-purposes-a-diagram/

[64] Starbucks 2012 Form 10-K, at 4 (50 retail stores in Switzerland at year-end 2012). Starbucks' Swiss retail stores apparently were held through a joint venture until 2011, when Starbucks bought out its partner.

[65] Two recent articles in the Financial Times 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 traders.").

[66] Public Accounts Committee, House of Commons, Minutes of Hearing HC716, supra n.7, Q 259, 298-99.

[67] Starbucks UK supplementary statement to House of Commons Public Accounts Committee, supra n. 19, at Q 276.

[68] Public Accounts Committee, House of Commons, Minutes of Hearing HC716, supra n.7, Q 301-07.

defined commercial function for which comparables should be readily obtainable, and since Starbucks' "Amsterdam structure" already receives its royalty in part in respect of Starbucks' "proprietary" roasting style, this markup logically should be closely comparable to what a third party roaster would charge, a point emphasized by Starbucks in its submissions to the House of Commons Public Accounts Committee.[69]

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 firm-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.[70] Nor is it possible to say anything useful about whether that markup is an arm's-length charge, as this is a classic factually-intensive transfer pricing question. It is relevant, however, to note that the price for Arabica beans (the kind used by Starbucks and other high-end coffee vendors) has generally trended dramatically upwards over the last 12 years (although nonetheless displaying great volatility along that trend line), which would lead to sharply higher profits for any organization enjoying a "cost plus" structure.[71]

It also is the case that any market power that Starbucks' 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. In this regard, Starbucks noted in its submission to the House of Commons Public Accounts that its trading represents less than 5% of the world's coffee trade.[72] But the bulk of the world coffee trade is in

[69] Starbucks UK supplementary statement to House of Commons Public Accounts Committee, supra n. 19, at Q 239.

[70] Lisa Pollack, *Losing for Tax Purposes: A Diagram*, FT Alphaville blog, http://ftalphaville.ft.com/2012/12/11/1304382/losing-for-tax-purposes-a-diagram/

[71] Javier Blas, Coffee Still Full of Beans Amid 34-Year High, Financial Times, Feb. 22, 2011 (historical chart), available at http://www.ft.com/intl/cms/s/0/26725f62-3ea8-11e0-834e-00144feabdc0.html#axzz2SRFClYOz. Coffee futures prices on the ICE futures exchange generally trended up from late 2001 ($42) to early 2011 (briefly touching $300), before reverting to roughly $140 today.

[72] Starbucks UK statement to House of Commons Public Accounts Committee, supra n. 21, at Par. 6.

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.[73]

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 Corporation). The loan is a demand loan paying interest at LIBOR plus 400bp.[74] Interest paid on the loan has varied from year to year, both because LIBOR has fluctuated and because (as described below) very substantial amounts of the loan have been capitalized into equity over the years. In fiscal year 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."[75] 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 firm to prepare its U.K. financial statements on a going concern basis.[76]

To a U.S. reader, at least, this suggests that Starbucks UK is overleveraged, and indeed it finished its 2011 fiscal year with negative shareholder's equity and a £72 million obligation to Starbucks Corporation. Consistent with this observation, in 2010 Starbucks capitalized £50 million of its intercompany loan into equity.[77] In addition, Starbucks UK has on several occasions sold new equity to its parent companies to fund its annual operating losses (e.g., £4.5 million in 2011, £33 million in 2010, and £14 million in 2009).

---

[73] "The coffee we buy is actually the top 1% or 2% of the most expensive coffee in the world." Public Accounts Committee, House of Commons, Minutes of Hearing HC716, supra n.7, Q 238. For a description of Starbucks' coffee bean purchases, see its 2012 Form 10-K at 6-7. At the end of fiscal year 2012 Starbucks had $854 million in negotiated open coffee purchase commitments.

[74] See e.g. Starbucks UK FY 2011 Annual Report.

[75] Id. at 7.

[76] Id.

[77] Starbucks UK FY 2010 Annual Report, Financial Statements, note 18.

All of this suggests that the intercompany demand loan between Starbucks Corporation and Starbucks UK has much of the flavor of a quasi-equity arrangement, at least under U.S. tax norms.[78] And of course the intercompany interest charge (LIBOR + 400) on its face seems quite high.[79] Yet Starbucks UK has relied on this arrangement to strip several million pounds per year from its U.K. tax base.

When this issue came up before the parliamentary inquiry, Starbucks dismissed the idea that tax avoidance could have played any role in the large intercompany loan: "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 US than it is in the UK."[80]

This 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 firm. In fact, Starbucks for many years had substantial foreign tax credit carryovers for U.S. tax purposes; the last of those carryovers was absorbed in fiscal year 2012.[81] Assuming that Starbucks UK was treated as a corporation for U.S. tax purposes, the interest income received by Starbucks Corporation 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 Corporation's foreign tax credit 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 firms to create stateless

[78] Cf. *Laidlaw Transportation v. C.I.R.*, 75 T.C.M. (CCH) 2598 (1998).

[79] For this purpose it would be circular to argue that the rate must be so high because the firm is so overleveraged: that would simply rely on one non-arm's-length fact to justify another.

[80] Lisa Pollack, *Losing for Tax Purposes: A Diagram*, FT Alphaville blog, http://ftalphaville.ft.com/2012/12/11/1304382/losing-for-tax-purposes-a-diagram/, quoting testimony of Troy Alstead, chief financial officer of Starbucks.

[81] Starbucks Corporation 2012 Form 10-K, financial statements n. 13 (p. 83); 2011 Form 10-K, financial statements n. 13 (p. 71).

income through intragroup interest stripping, albeit at the cost keeping the resulting interest income offshore.[82] The reasons are the emergence of the "check-the-box" regulations, on the one hand, and the look-through rule of section 954(c)(6), on the other. Since U.S. tax law (whether wittingly or not) now aids and abets easy stateless income generation through internal group leverage, at the cost only 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.

Exactly the same reasoning would apply to the U.S. component of the16 percent tax rate that Starbucks testified it "paid" in respect of the royalties received by its "Amsterdam structure" from the United Kingdom, half of which were paid on to the U.S. parent. Again, that royalty income should have been sheltered by Starbucks Corporation's foreign tax credits. It is not easy for an outsider to explain why this result would *not* have been the case.

Regardless of this hypothesis, the Chief Financial Officer of Starbucks in his testimony to the House of Commons Public Accounts Committee might be said to have given an incomplete answer when, in response to the question "How much do you pay in tax on the money that is remitted to the US?" (in context, a question about the portion of royalties paid on to the U.S. parent), he responded "Our average US tax rate is approximately 38%."[83] That is Starbucks' 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 a phrasing that does not directly engage with the particular question being asked.

If it were to be the case that Starbucks sheltered either its U.K. interest income or the one-half of the U.K. royalty income paid on to the U.S. parent through the use of unrelated excess foreign tax credits – and again, the fundamental point here is that no tax authority has a complete picture of what the relevant facts are in respect of the stateless income planning of a multinational firm – then the facts that the United States is a "higher tax regime" or that it "paid" significant U.S. tax on the royalty stream attributable to its U.K. operations are not as relevant to the Starbucks situation as its statements in the parliamentary inquiry might have implied. To be

[82] Kleinbard, *Stateless Income*, supra n. 4, at 728-33.

[83] Public Accounts Committee, House of Commons, Minutes of Hearing HC716, supra n.7, Q 316.

sure, one can argue that the use of foreign tax credit 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' global stateless income planning.[84]

As it happens, Starbucks appears to be a very enthusiastic compiler of offshore "permanently reinvested earnings" (to use the U.S. GAAP phrase). It therefore is conceivable that Starbucks had little use for its foreign tax credit carryovers, and so capitalized Starbucks UK, for example, with a view to 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 necessarily 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 firms organize their internal structures as they do. Transnational transparency must be radically rethought, and critically important components of a firm's global stateless income tax planning must be made automatically transparent to each affected jurisdiction. The game of Twenty Tax Questions has grown tiresome. At the same time, the game is fundamentally unfair to source country citizens, who are asked to make up the revenue shortfalls that stateless income planning creates.

C. Useless Losses?

The Starbucks group engaged in classic intragroup earnings stripping transactions, little different from those employed by many other U.S.-based multinational firms, to erode its U.K. tax base. 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, presumptively at little tax cost to the recipient group members.

[84] In 2010, for example, Starbucks' foreign tax credit carryovers were scheduled to expire starting in 2014. Starbucks Corporation 2010 Form 10-K, financial statements n. 15, at 66. This is relevant to the question whether it in fact would have been economically burdensome for Starbucks to utilize its foreign tax credits to shelter its interest income on its loan to Starbucks UK.

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 where it appears to have U.K. tax loss carryovers in the range of $240 million or thereabouts.[85] This means that any tax (even if 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 firm has a loss year, it books a deferred tax *benefit* (the mirror image of a tax liability), to reflect the fact 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. net operating losses 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 year 2011 the unclaimed deferred tax asset amounted to £40.5 million.[86]

Similarly, Starbucks Corporation's U.S. consolidated annual reports have established a $154 million valuation allowance at year-end 2012 as an effective deduction against their deferred tax asset; this allowance "is primarily related to net operating losses and other deferred tax assets of consolidated foreign subsidiaries."[87] 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 – notwithstanding that 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

[85] See Section II.A., above.

[86] Starbucks UK 2011 Financial Statements, note 8.

[87] Starbucks Corporation 2012 Form 10-K, financial statement n. 13, p. 82. In 2010 the deferred tax asset was described as relating entirely to foreign items.

have outstripped Starbucks' tax planning: the light at the end of the tunnel recedes a bit each year, rather than drawing closer. This is consistent with the testimony of Starbucks' Chief Financial Officer before the House of Commons Public Accounts Committee, where 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' global tax or commercial dealings to maintain that it applies the same terms consistently around the world. (Note, however, in this regard that 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.[88]

[88] It is worth mentioning one other speculative hypothesis, because it illustrates my basic point about the difficulties that jurisdictions face in reaching appropriate policy outcomes in situations where a firm's global stateless income planning is occluded from view. That is the possibility (and again, based on external information it is only a possibility) that Starbucks in fact has used Starbucks UK's losses on a current basis, but just not in the United Kingdom. The hypothesis would be 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 U.K. is a branch of Starbucks in the United States. In such circumstances, the United Kingdom 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 U.K. 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, so 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. Treas. Reg. section 1.1503(d)-6(d).

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

Imagine, for a minute, that this speculative 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 deducting losses in the United States and the United Kingdom simultaneously, 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 so long as the earnings were not repatriated? The question answers itself.

For example, Starbucks Corporation 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.[89] In the presence of unrelated capital gains in the United States, this would have the effect of creating 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. <u>THE U.S. PERSPECTIVE</u>.

A. <u>The Fruits of Stateless Income.</u>

The previous section has argued that Starbucks, like many other firms, relies on intragroup stateless income tax planning to reduce substantially its tax burdens. In both its submission to the House Ways and Means Committee and its written submissions to the House of Commons Public Accounts Committee, Starbucks emphasized that its global effective tax rate exceeds 32 percent. How can a firm 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.[90]

Starbucks' statement is true, but only in the way that a Hollywood biopic "based on a true story" is true. In 2012, Starbucks' global GAAP tax provision indeed showed a tax rate over 32 percent. But GAAP tax provisions are not the same as taxes actually paid, and a U.S. firm's

---

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

[89] Mark W. Boyer, Ciara M. Foley, and Benjamin M. Willis, *Granite Trust Planning: Properly Adopting a Plan of Liquidation*, 138 Tax Notes 1331 (Mar. 18, 2013).

[90] One helpful recent paper on the difficulty of extracting useful information on the international operations of multinational firms through studying their tax footnotes is Donohoe, McGill and Outslay, supra n. 47. The overlap in the titles of their work and the present paper was unintentional. On the other hand, neither of us can claim great originality: the database at Social Sciences Research Network lists 51 titles that are plays on "through a looking glass" or "through a glass darkly."

global effective tax rate is not the same as the rate it enjoys on its non-U.S. income, which after all is the real matter at issue when lobbying to privilege the stateless income strategies of multinational firms.

This last point is particularly important when looking at Starbucks, which is still overwhelmingly a U.S. business. In fiscal year 2012, for example, Starbucks derived about 82 percent of its global pretax income from U.S. operations.[91] Given that the United States has a 35 percent tax rate (putting to one side the domestic production deduction), and that state income taxes sit on top of this in respect of domestic income, this heavy weighting towards domestic income cannot help but increase Starbucks' global effective tax rate, relative to other companies with a larger international component to their business mix.

Let us now 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 2012 fiscal year, but over $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.[92] Large quantities of cash and short-term investments held offshore are certainly consistent with stateless income tax planning in operation.

At year-end 2012, Starbucks reported that it held about $1.5 billion in offshore "permanently reinvested earnings" (to use the financial accounting slang term) – more than double its after-tax foreign earnings for the last three years, combined. These of course are low-taxed foreign earnings for which a firm does not provide a financial accounting tax expense, on the grounds that the earnings are indefinitely invested outside the United States.[93] In 2012, Starbucks added $513 million to its permanently reinvested earnings: this number greatly exceeded its *total* net foreign after-tax income for the year (about $300 million).[94]

---

[91] Starbucks Corporation 2012 Form 10-K, financial statements, n. 13, at p. 80.

[92] Starbucks Corporation 2012 Form 10-K, p.41.

[93] Kleinbard, *Stateless Income*, supra n.4, at 744-45.

[94] Starbucks Corporation 2012 Form 10-K, financial statements, n. 13, at p. 80 ($380 pre-tax 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).

How can a firm set aside 170 percent of its annual after-tax foreign income as permanently reinvested earnings? One possibility is that the firm reclassified prior year earnings for which tax had formerly been provided. In this case, given that Starbucks' foreign tax benefits in the tax rate reconciliation tables to its financial statement tax footnotes have not fluctuated greatly from year to year, and given its U.K. tax experience, the other explanation seems more likely: that 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 APB 23 entities) must have earned $513 million after tax, on about $590 million of pretax foreign income.[95] This observation becomes relevant when analyzing Starbucks' effective tax rate on its foreign income.

These data all are consistent with the intuition that Starbucks, like many other U.S. multinational firms, is an enthusiastic stateless income tax planner, but what would be most relevant in this regard is a clear picture of Starbucks' actual effective foreign tax rate. Under the relevant financial accounting guidance, Starbucks is supposed to furnish investors 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 firm's true foreign effective tax rate. But Starbucks, following the shameful example of most other U.S. companies with significant permanently reinvested earnings, here pleads its financial accounting inadequacy, and avers that the task is simply too difficult to perform, what with the complexity of all the rules.[96] Why the SEC permits firms to hide their true foreign effective tax burden in this manner is a mystery well worth solving.

---

[95] Starbucks' consolidated current foreign tax provision for 2012 was $77 million. The text in fact is making conservative assumptions, in that it treats 100 percent of Starbucks' 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.

[96] Starbucks Corporation 2012 10-K, financial statements note 13, at p. 81. To their credit, Microsoft and Apple, both firms orders of magnitude larger and more complex than Starbucks, are able to do so. Donohoe, McGill and Outslay, supra n. 47, at 972-73 summarize the history of this requirement and current practice; they report that 55 out of 66 firms with permanently reinvested earnings exceeding $5 billion declined to calculate the tax cost of repatriating those earnings. They further conclude that firms' reluctance to provide the required estimate are driven by "political cost reasons." Id at 981.

GAAP financial statements do break out a firm's cash flow used to pay tax bills, but do not distinguish which country's bills those are. On this basis Starbucks' average global effective tax rate for the 2010-2012 period was about 24 percent.[97] But this 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 in any event this figure tells one nothing about a firm's foreign effective tax rate, which is the only relevant question in judging the magnitude of stateless income tax planning afoot.

In the absence of cash tax data from the permanently reinvested earnings footnote or elsewhere, one must working with GAAP financial accounting data. The fair starting point for measuring a firm's tax burden in any given year from GAAP financial data is the firm's *current* tax expense (that is, ignoring deferred tax items), because deferred items do not necessarily lead to future tax expense for a growing firm. On that basis, Starbucks had a foreign effective tax rate of about 20 percent in fiscal year 2012, and 13 percent in 2011. But following the logic of the earlier discussion of Starbuck's implied foreign losses, the 2012 figure appears to overstate the tax burden Starbucks actually incurred on profit-making foreign subsidiaries. If the pre-tax 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.[98]

Tax rates in the low to mid-teens are far below the statutory rates in the countries in which Starbucks does significant customer business. (Canada, Japan and the United Kingdom are its three largest international markets). Starbucks' success in reducing its foreign effective tax rate to these levels should be particularly alarming to tax policymakers around the world, because it is a classic bricks-and-mortar business, with fixed customer locations in high-tax jurisdiction high streets around the world. Further, and without disrespect to Starbucks' claims of

---

[97] $1294 tax cash flow for 3-year period (2012 10-K p. 52) ÷ $5307 3-year pretax income (p.80).

[98] From another vantage point, Starbucks' global pre-tax income in 2012 was $2059 million. The firm recorded a 3.3 percent permanent tax savings from "benefits and taxes related to foreign operations." That 3.3 percent difference x $2059 million pre-tax income amounts to $68 million. The firm 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. This is a very approximate computation, intended as a reality check, not an estimate of actual effective foreign tax rates.

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 firm can.

The remedy here 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 firms, 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 world-wide disclosure matrix for actual tax burdens by jurisdiction.

The OECD made some proposals in its 2011 report, *Tackling Aggressive Tax Planning through Improved Transparency and Disclosure*,[99] but much of the OECD's earlier work on transparency was aimed at tax shelter promoter disclosure or secret financial accounts. As the OECD's current *Base Erosion and Profit Shifting* report stresses, it is now time to emphasize transparency with regard to the effective tax rates of multinational enterprises.[100]

It would be a tangible and significant achievement if 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. firms disclose the tax costs of repatriating their offshore "permanently reinvested" earnings.

B. U.S. Tax Policy Implications Going Forward.

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 in the context of U.S. tax reform. For

[99] OECD 2011.

[100] OECD, *Base Erosion and Profit Shifting*, at 6 and 47 (OECD 2013).

the avoidance of doubt, however, Starbucks' 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 House Ways and Means Committee International Working Group, Starbucks makes several substantive tax points. First, and as discussed above in Section III.A., it reminds the reader that in 2012 its financial accounting global effective tax rate was over 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' global rate (given that Starbucks 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.

This is an inquiry that should be straightforward, but is made more difficult by the failure of Starbucks (as well as most other firms), to quantify the cost of repatriating their permanently reinvested earnings. In 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 firms offer the same weak excuse of tax accounting incompetence, and it rings hollow in every case.[101]

Unsurprisingly, Starbucks argues for a "territorial" tax system, but 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 (tradename, 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. In this 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.

[101] See Donohoe, McGill and Outslay, supra n. 47, at 981-82 (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 such disclosure).

From this Starbucks claims that the foreign personal holding company component of subpart F income "discourages Starbucks from employing its core business model, which is to own and operate its stores." In Starbucks' mind, the remedy, of course, is to extend territorial tax principles – in particular the "patent box" proposal known as Option C in the House 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 foreign ones. Starbucks' 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, section 954(d)(1)'s exception for sales to affiliates of certain agricultural products was hardly the result of careful consideration by the U.S. Congress: that provision was never considered by the two tax-writing committees, and instead 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 such unexamined hoary political accommodations.

Both in respect of 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 (e.g., 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 today "discourage" Starbucks from owning and operating stores in the United Kingdom – it discourages, in a weak and ineffectual way, Starbucks 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 in fact puts to work with every macchiato that it serves. To the contrary, future policy, consistent with the OECD's goals in its recent study on base erosion and profit shifting, should be to make such discouragement more effective.

Starbucks' 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 in respect of the profits it recognizes from its thousands of high street retail locations. This 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 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.

From this premise, Starbucks argues that in a future territorial tax system the United States of America owes Starbucks a preferential tax rate on a large slice of its international income, at the expense not only of American taxpayers, but also of taxpayers in the source countries where its customers actually are located, and its beverages actually are served. The United States has strong national policy reasons to object to Starbucks' preferred outcome, without regard to any appeals to worldwide welfare concerns.[102]

Starbucks' demands essentially are that tax source should 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 what follows from this 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 this 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

[102] 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. firms today face an "uncompetitive" international tax system. Kleinbard, *Stateless Income*, supra n. 4, at 752 -770.

income.[103] If one wants in fact to implement a thoughtful and economically sensible territorial tax system – as I believe that the House 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 this policy perspective, Starbucks' comment letter is a blueprint for precisely the sort of source-avoidance techniques that the Ways and Means Committee's bill must forcefully foreclose.

[103] Kleinbard, *The Lessons of Stateless Incom*e, supra n. 4, at 136-40.