Starbucks Corporation (A)
Tax Avoidance Controversies in the United Kingdom

“Starbucks’ coffee menu famously baffles some people. In Britain, it’s their accounts that are confusing. Starbucks has been telling investors the business was profitable, even as it consistently reported losses.”

Introduction

On October 15, 2012, Reuters released a special report titled “How Starbucks avoids UK Taxes.” The investigative reporters at Reuters compared legal filings in the English company register, Companies House, with Starbucks’ own group reports and 46 transcripts of conference calls with investors and analysts over a 12 year period. What they turned up were stark differences in how Starbucks viewed its UK subsidiary internally and how it was portrayed to the UK government, specifically the tax authority, Her Majesty’s Revenue and Customs.

Starbucks officials internally gushed praise on their UK business unit. On multiple occasions it was referred to as “profitable” and a model for other regions to follow. In November 2007, the Chief Operating Officer Martin Coles told analysts that the UK unit’s profits were funding Starbucks’ expansion in other overseas markets. However, the unit’s accounts showed a tenth consecutive annual loss. The Reuters report went on to cite multiple instances when Starbucks provided positive news to analysts yet showed operating losses to the UK government:

“For 2008, Starbucks filed a 26 million pounds loss in the UK. Yet CEO Schultz told an analysts’ call that the UK business had been so successful he planned to take the lessons he had learnt there and apply them to the company’s largest market – the United States. He also promoted Cliff Burrows, former head of the UK and Europe, to head the U.S. business.”

As soon as the newspaper hits newstands and the Reuters website, there was an immediate public and political outcry. UK Uncut, an activist organization, planned boycotts and sit-ins. Several Members of Parliament (MPs) voiced outrage and quickly summoned Starbucks Chief Financial Officer Troy Alstead to testify before committee.

Starbucks History and Image

Starbucks Corporation
In 1971, Starbucks was founded in Seattle as a coffee bean roaster and retailer. The location sold high-quality coffee beans and equipment. The company started serving espresso coffee, the first drink that Starbucks sold, in 1986. The next year, the original owners sold the fledgling chain to former employee and current CEO Howard Schultz, who began an aggressive expansion campaign. Since 1986, the company has opened, on average, two stores per day.

Starbucks performed its Initial Public Offering in June 1992. At the time the company owned or licensed 140 outlets and booked annual revenue of $75 million. In 2012, the total number of stores in operation numbered more than 18,000 and were spread over 60 countries.
For the fiscal year, Starbucks’ consolidated revenues reached a record $13.3 billion. Company-operated stores accounted for 79 percent of total net revenues during the 2012 fiscal year.3

Coffee is no longer the only item sold through Starbucks locations. This excerpt from the 2012 10-K filing with the United States Securities and Exchange Commission summarizes the extent of their offerings:

“Starbucks stores offer a choice of coffee and tea beverages, distinctively packaged roasted whole bean and ground coffees, a variety of premium single serve products, juices and bottled water. Starbucks stores also offer an assortment of fresh food offerings, including selections focusing on high-quality ingredients, nutritional value and great flavor. A focused selection of beverage-making equipment and accessories are also sold in our stores.” 4

Starbucks has also spun off a unique tea bar concept called Teavana Fine Teas and Tea Bar. They are expanding their juice line, Evolution Fresh, with an aggressive growth strategy with the goal of further increasing their market share in the super-premium juice category. The company has also begun exploring handcrafted carbonated beverages to offer for sale in its existing locations.

Howard Schultz
Howard Schultz is the Chairman, President, and Chief Executive Officer of Starbucks. Before joining the company he was the general manager for a Swedish drip coffee maker manufacturer called Hammarplast.5 Starbucks was a client of Hammarplast and Schultz was impressed by the company’s knowledge of coffee and the amount of business that they were conducting, even as a small outfit. A couple of years after his first encounter with Starbucks, Schultz joined the company in 1983 as the Director of Marketing.

While visiting Milan on a buying trip, Schultz was struck by the presence of a coffee bar on virtually every street corner. Not only were they serving countless espresso drinks, they also acted as meeting places or public squares, providing a sense of community and belongingness. He took this newfound knowledge back with him and tried to convince the owners to start offering hot brewed beverages in addition to the coffee beans and leaf teas that they already offered. The owners resisted and, after a brief stint trying to start his own coffee company, Schultz bought the retail unit of Starbucks for $3.8 million.6

Social Responsibility
Howard Schultz is considered the “soul” of the company. His passion and business savvy have made the company into what it is today. He also brought to the company “a distinctive set of values that has and continually shapes how the company engages their customers, their employees, and the communities where they do business.” 7 The company continually monitors with social responsibility and has . . .
“...been building a company with a conscience for more than four decades, intent on the fair and humane treatment of our people as well as the communities where we do business, and the global environment we all share.”

Starbucks provides full benefits for all of its employees, which it refers to as “partners.” They also have a goal: All of their coffee will be “ethically sourced” by 2015. The cornerstone of this approach is Coffee and Farmer Equity (C.A.F.E.) Practices, “a comprehensive coffee buying program that ensures coffee quality while promoting social, economic and environmental standards.” Through 2012, the company purchased 93 percent of its coffee in this manner.

**International Taxation**

**Typical International Tax Methods**
Most governments tax individuals and/or corporations on income or profits, respectively. These taxes are used to pay for everything from national defense and transportation infrastructure to food stamps and farm subsidies. These taxation systems vary widely by government and there are few broad, general rules. However, it is possible to understand the general corporate tax environment by understanding a few choices that each government must make when it comes to its corporate tax policy.

Nations usually choose between two systems: territorial or residential. In a territorial system, only the income from a source inside the country is taxed. For example, an American company with locations in Canada would only have to pay Canadian taxes on the portion of sales that are within Canadian borders. In a residential system, the residents of a country are taxed on their worldwide income, not just local income. The residential system is geared more toward personal income tax and does not affect corporations.

Corporate tax rates also vary widely by country. Every country has different funding needs based on their size, the extent to which the government operates social welfare programs, and numerous other factors. Those looking to increase investment within their borders may offer lower tax rates and those with large infrastructures to maintain may have higher tax rates. These varied tax rates provide an unintended incentive for companies to attempt to transfer revenues and profits from countries with higher tax rates to those with lower tax rates, thereby retaining more net income for shareholders and managers.

Several tax avoidance strategies exist to achieve such goals. Some companies charge subsidiaries for the use of “intellectual property” such as the brand name and their business practices. These types of arrangements typically charge 4% of revenue. Other companies that are vertically integrated upstream and downstream charge units in high tax jurisdictions higher prices in order to move money to lower-taxed countries. Transfer-pricing regulations allow this practice and companies can then allocate profits to high-charging subsidiaries in low tax rate areas.
Starbucks Money Trail
Starbucks employs various legal methods in order to minimize their tax liability within the UK. The corporate tax rate in the UK in 2011 was 26%. Each step along the money trail is designed so that in the end, the Starbucks subsidiary in the UK shows no profits on paper. This effectively reduces their tax bill in that jurisdiction to zero even though that market may be very profitable for them.

The Starbucks subsidiary in the UK is heavily debt-financed. Even for a company with positive net cash flows, the UK subsidiary still has large amounts of debt and large interest bills. All of these loans are from the Starbucks headquarters in Seattle. The interest on these loans is higher than the interest rate on the average Starbucks bond, at the LIBOR rate plus 4% versus the LIBOR rate plus 1.3%. While this moves profits to the United States where there is a relatively high tax rate, the interest stays within the company instead of being paid out to banks or investors who purchase their bonds.

Starbucks also charges the UK unit a royalty and licensing fee of 6%. This is higher than the 4% that a typical arrangement of this sort would charge. Starbucks claims that it has some independent licensees who also pay 6%, so they are within their legal right to charge their own subsidiary the higher rate, as well.

The final method that Starbucks employs is how it pays for its main product and largest source of revenue: coffee. A Starbucks entity is set up in Switzerland which is responsible for all coffee bean purchases. The Switzerland location then has those beans sent to roasters throughout Europe, which turn the raw beans into product suitable for making coffee products. The beans are then sold to the UK Starbucks with a 20% markup. The beans never physically enter Switzerland. Switzerland has an approximate 5% corporate tax rate on profits tied to international trade in commodities, a category under which coffee falls.

Coffee Shop Market
Starbucks’ growth plan and business model have been widely successful, allowing it to become the second largest restaurant chain globally after McDonald’s with a market capitalization of $40 billion. Starbucks’ 2012 SEC annual filings reports revenues of $13.3 billion, with revenues in the EMEA region, including the United Kingdom, of $1.14 billion. The EMEA revenues represent a 9% growth over the previous fiscal year. Within the United Kingdom specifically, the coffee shop market has remained strong despite a recession. A 2009 study from Allegra Strategies shows that the coffee shop market in the UK has seen 15 consecutive years of either flat sales or growth, with the market reaching £2 billion in consumer spending in 2012.

Within the United Kingdom, Starbucks faces a fierce competitor in Costa Coffee. Founded in London in 1971, Costa Coffee has grown from a wholesale roasted coffee supplier to become the UK’s largest coffee chain, supplanting Starbucks in 2010. In 2012, Costa saw an increase in profits of nearly 30%, reaching £90.1 million. In contrast to Starbucks, Costa paid a
tax bill of £15 million during the 2011-12 reporting period. While the UK coffee shop market appears strong and close competitor Costa Coffee reports growing profits, Starbucks claims that it is not generating profits within the UK. Global CFO Troy Alstead reports that Starbucks has recorded profits in only three years since they entered the UK in 1998 and that 25% of their UK stores run at a loss.\textsuperscript{15} High rents and space costs within UK cities were proposed as reasons for Starbucks’ failure to generate profits; however, Costa Coffee has been able to achieve an operating margin of 14.3% with a similar retail footprint and comparable labor costs.\textsuperscript{16} Chief executive of Costa Coffee, Andy Harrison, appeared to enjoy Starbucks’ tax avoidance controversy, commenting “Costa has been the UK’s favourite coffee shop for quite some time and we remain the taxman’s favourite coffee shop, too.”\textsuperscript{17}

**HMRC, Parliament & Public Opinion**

The taxman within the United Kingdom is Her Majesty’s Revenue and Customs (HMRC), which is responsible for the collection of both personal and corporate income taxes, among other duties. Formed in 2005 as a merger of two previous tax entities, the HMRC outlined its purpose and vision by stating “We make sure that the money is available to fund the UK’s public services” and “We will close the tax gap, our customers will feel that the tax system is simple for them and even-handed, and we will be seen as a highly professional organisation.”\textsuperscript{18} In the HMRC charter, it is further laid out that the public can expect the HMRC to “tackle people who deliberately break the rules and challenge those who bend the rules.”\textsuperscript{19}

The HMRC received help in their mission from Reuters in publishing their special report on Starbucks, as well as from several other media investigations in 2012. A *Guardian* report on Amazon showed the online retail giant paid no corporation tax on more than £3 billion in sales within the United Kingdom,\textsuperscript{20} while the *Telegraph* reported that Google paid just £6 million in tax on £395 million of UK turnover.\textsuperscript{21} Following these reports, representatives from all of the firms were summoned to Parliament to speak to the Public Accounts Committee. Corporate tax avoidance had become a hot button issue for both the media and government, with Michael Meacher, an MP for the Labour Party, stating specifically that Starbucks’ tax behaviour “is certainly profoundly against the interests of the countries where they operate and is extremely unfair . . . . they are trying to play the taxman, game him. It is disgraceful.”\textsuperscript{22}

While several corporations were the subject of media tax avoidance investigations and summoned to Parliament, Starbucks faced the brunt of the public uproar. According to the YouGov BrandIndex, which measures the strength of a company’s brand perception, Starbucks dropped to a record low score of -28.6 following the release of the Reuters special report. In the month leading up to the Parliament summons, Starbucks’ score remained around -16.7, which is in sharp contrast to its score from 2011 of +3.1.\textsuperscript{23} In contrast, the BrandIndex scores for Google and Amazon barely dropped due to their media reports and Parliament summons. The UK director for BrandIndex, Sarah Murphy commented:
“A brand’s buzz score typically recovers following a spate of bad press, but we aren’t seeing that with Starbucks, which is quite unusual. Its scores started to level out around the end of last month, but whatever modest recovery Starbucks has made could well be in jeopardy if this story flares up again in the media.”  

**UK Uncut**

The continued negative public backlash against Starbucks could have something to do with the actions of the organization UK Uncut. While it started as a simple hashtag, UK Uncut grew during the recession into an organized movement with protests and boycotts in over fifty UK cities.  

UK Uncut campaigned against the government’s austerity plans to cut public services and reduce the deficit, claiming the deficit could be reduced and welfare services maintained if the government collected all the tax revenue it was due. A UK Uncut FAQ says, “It is estimated that £25bn a year is lost through tax avoidance – money that could fund the refuges, rape crisis centres, sure start centres and child benefit payments that are currently being axed by the government.”

One of the first UK Uncut targets, Vodafone, was forced to close nearly thirty stores around the country due to protests and sit-ins. Since 2010, banks such as Barclays, RBS and HSBC, and retailers like Boots and Tesco have come under fire from UK Uncut.

Following the release of the Reuters report in October 2012, UK Uncut began to target Starbucks with protests and boycotts. On November 11, 2012, the date that Starbucks CFO Troy Alstead was scheduled to meet with Parliament, UK Uncut announced a new campaign against Starbucks, titled “Refuge from the Cuts.” The intent of the campaign was to turn dozens of Starbucks locations on a Saturday in December 2012 into services that were being cut by the government, such as refuges, homeless shelters and crèches. A UK Uncut activist was quoted as saying “Starbucks is a really great target because it is on every high street across the country and that’s what UK Uncut finds really important: people can take action in their local areas.”

**What Next?**

In November 2012, Starbucks finds itself in an untenable situation with the British government summoning CFO Troy Alstead to hearings in Parliament, and public protests and demonstrations against the company escalating. Starbucks has not been accused of illegal activities, but has followed common international tax procedures to minimize payments within the United Kingdom.
**Discussion Questions**

1. How should CFO Troy Alstead testify at the Parliament hearings? Should he continue Starbucks’ claims of an unprofitable UK market, or admit to tax avoidance practices?

2. What actions, if any, should Starbucks take in order to minimize the impact of the public outcry and actions planned by UK Uncut?

3. Does Starbucks have a responsibility to the community to obey the spirit of corporate tax laws, or an obligation to shareholders to legally minimize tax expenses?

4. How can Starbucks, or other companies, avoid such situations in the future?

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Starbucks Response

Starbucks Chief Financial Officer Troy Alstead was called to testify before Parliament on November 15, 2012. Mr. Alstead, despite being asked multiple direct and pointed questions, repeatedly stood by his assertion that Starbucks does nothing illegal and pays every cent of taxes that it owes. As the questioning continued, Mr. Alstead denied funneling money into tax havens in order to reduce the company’s tax liability. The interrogation concluded with Mr. Alstead proclaiming:

“We sincerely believe that we are doing everything to an ethical standard – not just the legal standard, but exactly what we should be doing. We will continue to do our best to communicate that both here and with our customers.”

Public outcry persisted and UK Uncut planned an even larger number of sit-ins and boycotts. On December 6th, Starbucks posted an open letter on its website (Attachment 1) discussing how they plan to remedy the tax avoidance claims. The letter was signed by the Managing Director of Starbucks Coffee Company UK, Kris Engskov. At the same time, they published a “Starbucks commitment to the UK” section on their UK corporate website. The new page not only has a Tax FAQ section but links to a video showing Mr. Engskov delivering a speech to the London Chamber of Commerce and Industry.

The open letter and new web page indicated that while Starbucks did nothing illegal, it wished to be in good standing with its customers:

“In 2013 and 2014 Starbucks will not claim the tax deductions for royalties or payments related to our intercompany charges for interest and mark-up on the coffee we buy . . . . In addition, we have committed to paying a significant amount of corporation tax during 2013 and 2014 regardless of whether our company is profitable during these years. We are still working through some of the calculations, but we believe we could pay or prepay somewhere in the range of £10 million in each of the next two years in addition to the variety of taxes we already pay.”

An Open Letter from Kris Engskov

06 December 2012
Posted by Kris Engskov, Managing Director, Starbucks Coffee Company UK

Today, we’re taking action to pay corporation tax in the United Kingdom—above what is currently required by tax law. Since Starbucks was founded in 1971, we’ve learned it is vital to listen closely to our customers – and that acting responsibly makes good business sense.

Over the more than 14 years we’ve been in business here in the UK, the most important asset we have built is trust. Trust with our partners (employees), our customers and the wider society in which we operate.

The fact remains that Starbucks has found making a profit in the UK to be difficult. This is a hugely competitive market and we have not performed to our expectations over the many years we’ve been in business here.
It has always been our plan to become sustainably profitable in the UK. We annually inject nearly £300 million into the UK economy and are exploring additional initiatives to expand our growth and speed our way to profitability in future.

And while Starbucks has complied with all UK tax laws, today we are announcing changes that will result in the company paying higher corporation tax in the UK. Specifically, Starbucks will not claim tax deductions for royalties and standard intercompany charges. Furthermore, Starbucks will commit to paying a significant amount of tax during 2013 and 2014 regardless of whether the company is profitable during these years.

Starbucks will continue to open our books to HM Treasury and HM Revenue and Customs on an ongoing basis to ensure our financial performance and tax structure is transparent and appropriate.

The commitments Starbucks is making today are intended to begin a process of enhancing trust with customers and the communities that we have been honoured to serve for the past 14 years. And we will do even more. Our contribution will increase as we train over 1,000 apprentices over the next two years and pursue a series of initiatives that will increase employment and investment.

We know we are not perfect. But we have listened over the past few months and are committed to the UK for the long term. We hope that over time, through our actions and our contribution, you will give us an opportunity to build on your trust and custom.

Yours sincerely,

Kris Engskov, managing director, Starbucks Coffee Company UK

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