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Starbucks' Transfer Pricing Leaves a Bitter Taste

. . . and Here's Why Multinationals Should Take Note

In This Update

November 2012

Hello Alexander!

This is a brief update on important transfer pricing developments that we thought would be of interest to you.

Transfer pricing hits the news again - this time in the UK where Starbucks Global Chief Financial Officer, Troy Alstead, was grilled before a House of Commons Parliamentary Committee. Starbucks, along with Google and Amazon, were called to testify on transfer pricing arrangements that resulted in minimal tax.

Companies with multinational operations need to be aware that allegations of wrongdoing in transfer pricing can have a negative impact on the business as a whole.

While most companies do not have as high a public profile as Starbucks, challenges to multinational companies for shifting profits offshore is increasingly popular with politicians, tax authorities, journalists and local competitors alike.

Key Takeaways

1. Multinational companies face both a tax and public relations dilemma when managing transfer pricing issues.

2. Politicians have become more aggressive in criticizing multinational companies for not paying their 'fair share' of tax through transfer pricing.

3. Even companies with relatively high global effective tax rates can face transfer pricing scrutiny.

4. Putting yourself in a tax inspector's "shoes" can help tax departments anticipate and manage transfer pricing risks.

Looking for assistance? Not sure where to start?

Productive Pricing has extensive audit defense experience from our 12+ years of "Big-4" U.S. and overseas experience.

With just a high-level review of readily available company information, we can offer practical insights for managing transfer pricing risk.

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Testifying before Parliament on Transfer Pricing

Starbucks' Mr. Alstead and representatives from Google and Amazon were brought before the Public Accounts Committee to testify about why they paid so little tax due to their transfer pricing arrangements.

For Starbucks, the three-hour hearing was the second round of bad transfer pricing publicity over the past two months as the company has been accused of exporting profits out of the UK to more favorable tax jurisdictions.

An archive of the hearing may be found on http://www.parliamentlive.tv/Main/Player.aspx?meetingId=11764&st=15:23:30

Members of Parliament (MPs) were particularly incensed that while Starbucks had generated $4.8 billion in revenue since entering the UK market, the company had incurred losses in 15 out of 16 years. Perhaps more troubling to the Committee were Reuters news articles that Starbucks told stock analysts that the UK business profits were funding Starbucks' expansion into new markets.

http://uk.reuters.com/article/2012/10/15/us-britain-starbucks-tax-idUKBRE89E0EX20121015

"Why Do You Manipulate Your Accounts?"

Margaret Hodge, chair of the Public Accounts Committee, repeatedly challenged Starbucks' business structure and fairness of its intercompany pricing system to the UK treasury.

The Committee was particularly critical of the 20 percent margins earned by the company's Swiss operations on sales of beans to the UK. The Committee also questioned Starbucks' payment of royalties, given that the company had not paid corporate income taxes for the past three years in the UK.

MP Hodge rejected arguments from Starbucks that the long term lack of profitability was due to high retail rents and mistakes in the early phases of its entrance into the UK market. The Committee dismissed all three companies' arguments that they already paid VAT, employment and other taxes in the UK.

Transfer Pricing Allegations Hurt Reputations

Even before the Public Accounts Committee hearing, numerous news stories on Starbucks' transfer pricing issues during October 2012 have made an impact on Starbucks' brand reputation in the UK.

YouGov's Brand Perception Index (a composite of six key image attributes) showed that the Starbucks brand fell from a +1 positive perception to a -11 negative perception in the UK during October. By comparison, Nike's brand index fell from +24 to +18 after ending the sponsorship of cyclist Lance Armstrong.

In response, Starbucks' Chief Executive Officer Howard Schultz published an open letter to UK customers denying tax evasion in an effort to manage the negative publicity from the transfer pricing charges.

Activists are still reportedly planning on holding protests in Starbucks across the UK on December 8, including turning coffee shops into homeless shelters for the day. The Prime Minister, David Cameron, and the Chief Executive Officer of UK retailer John Lewis have also called on the Government to examine how foreign multinationals pay so little income tax in the UK. http://www.guardian.co.uk/business/2012/nov/12/starbucks-tax-avoidance-controversy

News of Transfer Pricing Problems Spread Globally

Transfer pricing will likely continue to be a public relations and tax headache for Starbucks. In fact, a November 2012 Thomson Reuters report http://graphics.thomsonreuters.com/12/10/EuroStarbucks.pdf concludes that Starbucks subsidiaries in France and Germany have similar transfer pricing issues.

Local company accounts for Starbucks Germany and Starbucks France also showed losses in 2010 and 2011, with no income tax payments.

Risk Management Recommendations

Even though Starbucks CFO Troy Alstead pointed to the **company's global effective tax rate of 32.3 percent, local company operating results clearly matter**. The Committee MPs were not convinced that poor business strategies could be a reasonable explanation for the long-term losses of Starbucks' UK subsidiary.

We strongly recommend reviewing operating profitability on a country-by-country basis from the perspective of both the home and overseas tax authorities. As a starting point, we suggest reviewing the Earnings before Interest and Tax (EBIT) as a percentage of net sales over a three-year period for each individual subsidiary.

In our experience, a 'triage' approach can help Chief Financial Officers, Tax Directors and their staff spend resources on managing the more difficult transfer pricing issues. While this strategy will not identify every transfer pricing exposure, we find this approach to be a 'Best Practice' in transfer pricing.

1. Prioritize the largest intercompany transactions on a country-by-country basis.
2. For US headquartered companies, address IRS transfer pricing risks where EBIT margins for subsidiaries are highest.
3. Conversely, address foreign transfer pricing risks where subsidiaries are incurring losses or earning minimal EBIT margins.
4. Multinational companies selling into the US would review the profitability of the US subsidiary (and elsewhere).

Companies should remember that many countries require multinationals to file local subsidiary annual reports with public information on revenue and taxable income. Journalists and other interested parties have ready access to these documents.

Keep in mind that information in the public domain such as stock analyst reports, public filings and news articles all can have an impact on how a tax authority reviews transfer pricing.

How Can Productive Pricing Help?

Productive Pricing is a full-service transfer pricing consultancy that assists companies in managing transfer pricing issues on a global basis. We also complement services of accounting firms and law firms with our practical transfer pricing expertise.

Our services include transfer pricing documentation, transfer pricing benchmarking, audit defense, Advance Pricing Agreements, transfer pricing planning and tax provision services. We assist companies with intercompany pricing on goods, services, intangibles and loans.

Our company offers the experience and expertise of a Big-4 accounting firm with personalized service.

Productive Pricing is led by Alex Martin, who has over 15 years of full-time U.S. and global transfer pricing experience, including 12-plus years at PricewaterhouseCoopers where he was an economist and director. Chelsea Sander is a manager with Productive Pricing with six years of transfer pricing experience.

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