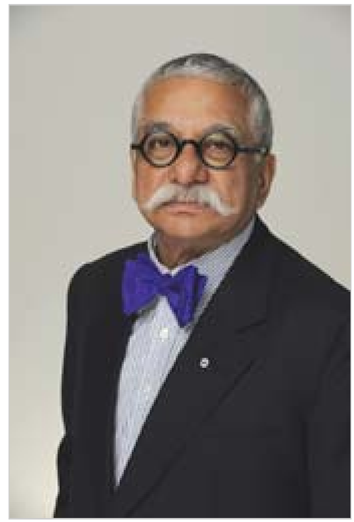
Tax tension within the Tim Hortons takeover

By Jeff Buckstein



Vern Krishna, of counsel, TaxChambers LLP

Burger King’s purchase of Tim Hortons in a recent $12.6 billion US cash-stock deal represents more than a takeover of an iconic Canadian brand. The fast-food restaurant giant’s decision to create a new corporation headquartered in Canada through an increasingly popular transaction known as a corporate inversion will, say experts, carry significant tax implications.

Although this particular deal is not likely to be affected, some American lawmakers are looking for ways to curtail this type of transaction in the future. However, there are serious doubts that goal can be achieved and even disagreement about how to address the U.S. tax code in order to attempt doing so.

"The sudden impetus for doing more [of these transactions] this year is because [participants] are nervous that U.S. authorities are looking at this entire situation, and may well try and close [what some view as] a loophole. So it’s a stampede towards the gate. Somebody has shouted ‘fire’ and everybody is rushing for the exits," said Vern Krishna, counsel for TaxChambers LLP in Toronto.

The motivation for a U.S. company to participate in such a deal is because the combined U.S. federal and state tax rate is roughly between 35 per cent and 40 per cent, compared to Canada’s federal and provincial rate of about 26 per cent, depending on which jurisdiction one resides in.

"A 10 percentage-point benefit in taxes is a huge amount when it comes to calculating return on equity," Krishna said.

Most corporate inversion transactions involve a U.S. parent and a multinational firm with a significant amount of offshore operations. That is important because these companies have often been able to build up untaxed profits outside the U.S. and an inversion provides them with an opportunity to repatriate that money in a tax-efficient way, said Susan Morse, an assistant professor at the University of Texas’ Faculty of Law in Austin.

This also explains why companies in certain industries, such as pharmaceuticals, have been major participants in such transactions in the past, she added.

Each transaction is structured differently depending on where the inversion takes place and that jurisdiction’s corporate and securities laws.

The U.S., for example, has certain technical rules for corporate inversions covering factors such as the involvement of legacy shareholders in the new corporation. In order to qualify as a corporate inversion for Internal Revenue Service purposes, shareholders of the acquired company must receive at least 20 per cent of the total stock of the resulting entity, Krishna said.

But "you have to be careful not to look at a tax inversion in isolation," he cautioned.

"Many inversions also involve other business considerations and economic substance considerations that the U.S. looks at. Corporate/business reorganizations are driven by many factors, one of which, very importantly, is tax. Another very important factor for exporting a corporation is labour costs. Then [there is] the legal structure," he said.

Morse said the prospect of a tax savings via a corporate inversion may be a key incentive for companies to proceed with a mergers and acquisition transaction. But companies typically have varied reasons for participating.

"I resist the idea that these mergers are happening primarily for tax reasons. I think it's true that people take the opportunity when they have a merger moment to think about what structure is appropriate, or which one is going to be the most efficient from a financial perspective and a tax perspective," she said.

"They have to think about things like 'what's the parent company going to look like? How are we going to put together these two strands of presumably lots of subsidiaries underneath each of the merger partners to make things rational going forward?' " Morse said.

Burger King's U.S. transactions will continue to be taxed at U.S. rates, and the company has said they will maintain their U.S. operations base in Miami. Furthermore, the company has publicly denied that tax considerations were the primary motivation behind this particular deal with Tim Hortons, based in Oakville, Ont.

There are political efforts afoot in the U.S., particularly among members of the Democratic Party, to curtail corporate inversions and prevent further erosion of the U.S. tax base. This isn't the first time such efforts have been launched. Previous initiatives a decade ago resulted in Section 7874 of the *Internal Revenue Code* — rules relating to expatriated entities and their foreign parents.

Section 7874 says that some corporations that would be treated as a foreign corporation under the usual U.S. rules are treated as domestic if an inversion transaction has taken place. An earlier exception for substantial business activities in a foreign jurisdiction was carved back, said Morse.

She noted that one proposed means for strengthening section 7874 is to add on a managed and controlled rule. But "that's a little tricky because that's not the way that U.S. law typically has looked at it. Usually U.S. law treats a corporation as domestic if it's incorporated in the United States. So this would be a significant change, and I'm not sure that would be well advised," said Morse.

It is possible that a beefed-up managed and controlled rule could be broad enough to catch companies that are not really managed and controlled in the U.S. But there are questions about how that is going to be impacted by globalization. Another potential disadvantage associated with basically imposing a tax on a manager's location is that this could discourage companies from locating in the U.S., she elaborated.

Various other suggestions have been made by experts. They include addressing section 163(j) of the *Code* [Interest] to lower the ceiling on U.S. corporate tax base erosion that will be tolerated with respect to U.S. domestic earnings. Amendments have also been proposed to expand section 956 of the *Code* [Investment of earnings in United States property] to prevent so-called "hopscotch loans" or "hopscotch trades" and seek to identify who the real beneficiaries of low-taxed offshore earnings of a controlled foreign corporation are, including where they reside.

But there are also political realities to deal with, including an extremely divided Congress in general, and on this particular issue where Democrats tend to favour reforms and Republicans are opposed. Republicans will likely argue that efforts to curtail tax inversions will amount to an effective corporate tax increase, and so it is extremely improbable that they will agree with it, said Krishna.

Furthermore, the U.S. process is much more complicated than in Canada, where under the parliamentary system the ruling party with a majority government can unilaterally enact the legislation it wants, said Krishna.

Krishna said it is difficult to predict the possible fallout or reaction in other jurisdictions if legislation to curtail corporate inversions is enacted in the United States.

"[Other countries] will not be particularly pleased with it. [But] there is a certain amount of disharmony in the international community anyway as to tax rates. Everyone, for example, is upset that Ireland has a low rate [12.5 per cent], or that Barbados has a 2.5 per cent rate. It's a very competitive world, and everyone is trying to attract capital into their country. That is why there is all this international disharmony, because no one can agree really on what the perfect system is," said Krishna.

While tax inversions are currently generating a lot of publicity it is worthwhile to note that a form of tax inversion has always existed domestically and internationally, since taxes were introduced, said Krishna.

In Canada, "we have our own tax rules which also induce a different form of corporate behaviour which no one pays much attention to. Under our rules, we do not double tax. So if a Canadian parent corporation has a foreign subsidiary doing an active business in a treaty country, that foreign business will be taxed in the treaty partner country, and its funds will be repatriated to Canada on a tax-free basis to its parent corporation," he said.

The rule induces Canadian corporations to conduct business through low-tax jurisdictions such as Barbados, Cyprus, or Portugal, to save from the Canadian tax rate.

"It's a form of inversion. It just isn't called that, but it has the same overall economic effect," said Krishna.