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Focus BUSINESS LAW

Making a meal of Timmy's

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Alice Joseffer

The real story of the Burger King-Tim Hortons transaction is not the inversion of a U.S. company to the "low tax haven" of Canada. Rather, the deal exemplifies artful cross-border planning for investors.

As American Judge Learned Hand stated, "There is nothing sinister in so arranging one's affairs as to keep taxes as low as possible...Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands...To demand more in the name of morals is mere cant."

But when Burger King Worldwide (BKW) and Tim Hortons Inc. (THI) announced a "potential strategic transaction," some U.S. politicians characterized it as an unpatriotic tax dodge and flight by BKW to Canada as part of a "flood of these dangerous tax inversions." Administrative and legislative proposals aim to shut down inversions, perhaps retroactively.

The principle that one can "do right" by reducing taxes is tempered by statutory and judicial requirements, including business purpose. The announcement emphasized the purposes of anticipated global expansion and opportunity for shareholders to participate in "long-term value creation potential." Boards of directors must "do right" by shareholders.

There lies the rub, as 3G Special Situations Fund, a Cayman Islands partnership, is the beneficial owner of 69.22 per cent of BKW shares. Additional Caymans Islands entities, including 3G Capital Partners, Ltd., are considered beneficial owners. According to media reports, 3G principals are residents of Brazil. Other direct and indirect owners of BKW may not be U.S. citizens or residents and feel no patriotic duty to subject global profits to layers of U.S. tax.

The transaction reflects standard cross-border planning objectives: minimize tax on operations, minimize tax on repatriation of profits in relevant jurisdictions, pay a single level of cross-border tax on profits, and avoid anti-deferral regimes. The plan includes, for example, a B.C. unlimited liability company (ULC), a hybrid entity taxed as a corporation in Canada but disregarded under U.S. rules. Berkshire Hathaway will invest in the ULC, which will convert to corporate status. Similarly, use of an Ontario partnership avoids corporate tax rules.

A Canadian numbered company owned by the partnership will acquire THI in a plan of arrangement. A Delaware corporation owned by the ULC will merge into BKW. After the transactions, BKW and THI will become indirect subsidiaries of the ULC and the partnership.

THI shareholders will exchange cash plus ULC shares for THI shares or elect to receive only cash or only shares. BKW shareholders will receive ULC shares and partnership units, or elect to

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Getting serious about corporate offenders

Bruce McMeekin

Over the past year, five important developments have arisen in Ontario in the sentencing of corporations for regulatory offences.

First, compliance with a post-offence regulatory order or direction should not be considered a mitigating factor.

The Court of Appeal found that if you have been ordered to do something, it is because you have failed to comply with the legislation at issue. Treating compliance with an order as a mitigating factor undermines deterrence—the primary sentencing factor—because it rewards the defendant for action that it should have taken before an offence happened, and creates an incentive to put off compliance: *Ontario (Ministry of Labour) v. Flex-N-Gate Canada Co.* [2014] O.J. No. 261. Some statutes, like the *Environmental Protection Act*, specifically exclude compliance with an order as a mitigating factor in sentencing. This compares with voluntary pre-offence attempts at compliance that fall short of due diligence. They continue to be a mitigating factor on sentence.

Second, a more uniform code of regulatory justice akin to the *Criminal Code* could be coming. Section 15 of the *Regulatory Modernization Act* permits the Crown to request a more severe penalty for convictions under a provincial statute when it is of the opinion that a previous conviction under another statute is relevant as an aggravating factor in sentencing for the current conviction.

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Section 15 was applied for the first time in *Ontario (Ministry of Labour) v. J.R. Contracting Property Services* [2014] O.J. No. 1065. The employer and two individuals were convicted under the *Occupational Health and Safety Act*. The defendants had no prior OHSA convictions. However, one of the individual defendants was sentenced to a very rare continuous jail term. The judge was concerned with the defendant's "disturbing" failure to pay all but one of the fines levied against her for prior unrelated convictions under the Environmental Protection Act.

Third, trial justices have no jurisdiction to impose fines concurrently. They must be levied consecutively: *Flex-N Gate*.

This is problematic when a statute provides for large minimum fines for some offences, such as in the *Ontario Water Resources Act*. If a company is convicted for more than one offence arising out of a common event, the court has little or no room to ensure the total fine imposed is proportional to the defendant's moral blameworthiness for the event. It becomes even more problematic when the mandatory 25 per cent victim impact surcharge of the actual fine (for fines in excess of $1,000) is added. Justices do not have the discretion to waive the surcharge, despite the Court of Appeal having found that the surcharge is akin to a fine.

Fourth, the company's ability to pay may no longer have the same weight as a mitigating factor on the quantum of fine. Last year the Court of Appeal in *R. v. Metron Construction Corp.* [2013] O.J. No. 3909 found that for an indictable criminal offence, a crippling fine that could put the company into bankruptcy was not objectionable so long as it was proportional to its moral blameworthiness for the crime. In regulatory matters, the ability to pay has historically been accepted as a significant factor in the sentencing of corporations in combination with the economic activity in issue, the actual or likely harm caused to the public and the prescribed maximum penalty. That has usually translated into fines that can be paid by defendants but are not so "affordable" that they are merely licence fees for wrongdoing. Otherwise, deterrence is not served. That may no longer be true. The legislature's reliance on large minimum fines prescribed by statute restricts the discretion of trial justices to impose proportional sentences. The courts have also started to rely on *Metron* to support fines in regulatory matters greater than what may be payable by the defendant (for example, *J.R. Contracting*), despite the Court of Appeal in *Metron* having justified the fine on the basis that the moral blameworthiness for the criminal offence (in comparison to a regulatory offence) demanded it.

Fifth, justices have very little discretion to impose fines lower than minimums prescribed by statute. In exceptional circumstances, Justices can impose fines less than the prescribed minimums if the minimum would be oppressive or otherwise not in the interests of justice. The *Charter* protection against cruel and unusual punishment—section 12—may also be available to insulate *individuals* from crushing regulatory fines, as demonstrated over the past year in criminal prosecutions wherein the courts have refused to apply mandatory surcharges when there is no realistic chance that they can be paid: *R. v. Michael* [2014] O.J. No. 3609. With the decision in *Metron*, however, Justices may be less concerned about the effect of minimum fines on a corporation's financial health.

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Inversion: Transaction an example of sound cross border tax planning

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receive only partnership units, exchangeable for ULC shares. BKW shareholders will be taxed on the exchange of BKW shares for ULC shares, but not for units in the partnership. Tax will be deferred until units are exchanged for ULC shares or sold.

An inverted foreign parent company is taxed as a U.S. corporation if it is owned by at least 80 per cent of the former parent's stockholders. If there is at least 60 per cent continuity of ownership, but less than 80 per cent, the new foreign parent is not taxed like a domestic corporation, but U.S. tax on gains from transfers of assets to the new entity cannot be offset by foreign tax credits. Corporations with substantial economic activity in the foreign country are exempt from the anti-inversion provisions. Because the ULC will not be owned by at least 80 per cent of BKW's former shareholders, it will not be taxed as a U.S. corporation.

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Much of the media coverage has focused on corporate tax rates, perhaps because transaction participants emphasized that BKW's effective U.S. tax rate is comparable to Canadian rates. If this transaction were about rates, there would seem to be no advantage. But there are other key differences in the U.S. and Canadian tax systems.

A U.S. corporation is subject to tax on its worldwide income and also on its foreign subsidiaries' profits when those profits are repatriated to the U.S. Profits are subject to a second level of tax when distributed to shareholders as dividends. If a shareholder is not a U.S. citizen/resident taxpayer, but is a resident of a country with which the U.S. has a tax treaty, the shareholder may be subject to U.S. tax at a preferential treaty rate. If not, the shareholder is subject to a U.S. tax of 30 per cent. The U.S. and Brazil do not have a tax treaty; Canada and Brazil have a tax treaty. U.S. federal tax on foreign profits could be 65 per cent.

Capitalizing a company with debt permits a foreign investor to repatriate profits in a U.S. company as a return of principal (tax-free) and interest, which may be subject to U.S. tax at 30 per cent unless reduced by a treaty. To the extent the interest is deductible under U.S. earnings-stripping limitations, the taxable income of the company is reduced. U.S. earnings-stripping limitations can be factors in inversions. The BKW-THI transaction includes a U.S. $9.5 billion debt commitment to the ULC and BKW.

The volume and importance of Canada-U.S. business expansions over many decades is well-known. Their business significance is not diminished by the fact that, like the BKW-THI transaction, they were structured to be tax-effective for the stakeholders.

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