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BURGERS, DONUTS, FINANCE, POLITICS, AND YOU

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ABSTRACT. Is tax inversion the next new financial strategy for hotels and restaurants in the U.S.? With Burger King and Tim Hortons’ announcement, the stock prices of both companies have seen an increase. This article addresses the concept of tax inversion and highlights its effects on the corporations involved, the shareholders, the industry, the regular consumers, and the government.

The wave of new and exotic food items: First was the cronut, a croissant-doughnut pastry that debuted in New York; then came the wonut, its cousin from Chicago, a cross between a waffle and doughnut. A few weeks ago, a new proposal of high finance in the fast-food world could bring yet another striking product to our taste buds—a Bur-nut or perhaps a Dough-ger! Burger King, a well-known U.S.-based burger establishment, announced the purchase of Canadian doughnut chain Tim Hortons. If completed, this will make Burger King the world’s third largest fast-food conglomerate, right behind McDonald’s and Yum! Brands (Snider, 2014). However, this acquisition is drawing a lot of press, even garnering the attention of lawmakers in Congress. Could it be that people don’t think burger and donuts will taste good together? Well, the issue is more of money, and more specifically, of tax inversion.

WHAT IS TAX INVERSION?

Tax inversion is not a new concept. Tax inversion happens when a U.S. company becomes the subsidiary of a foreign firm or when it buys a foreign firm and, as a result, moves its legal address outside the United States and becomes subject to the tax laws of the foreign country instead of the United States. This move does not necessitate any personnel moves at all. From executives to employees, everyone can still stay in the United States, live in the United States, and work in the United States. This “address” move allows the new company to transfer some of its income to their new address and pay lower taxes than in the United States. Whether it is the U.S. company buying shares and/or assets of a foreign company or vice versa does not matter. The key is the change of the legal location from the United States to a foreign land that has a more business-friendly tax structure. This tax strategy has been in place for years, but it also has become very popular over the last few years among multinational U.S. corporations who are trying to find ways to lower expenses and bring more of the revenues earned to the bottom line. By paying lower foreign taxes, these U.S. corporations can escape the 35% U.S. corporate tax in favor of the lower corporate taxes, such as the 12.5% of Ireland, 21% in the United Kingdom, and in Burger King’s case, 15% in Canada.

Most companies who had gone through the tax inversion process thus far were pharmaceutical companies. According to Thomson Reuters, there have been 22 tax inversion cases since 2011 (Raice, 2014), the latest one...
on the news being Walgreens and Alliance Boots from Switzerland, which did not materialize. The fact that one is seeing more news coverage of the tax inversion of Burger King and Tim Hortons rather than all those that came before is perhaps due to the household name and the brand of Burger King.

WHY THE INCREASE IN TAX INVERSION?

As mentioned, the U.S. corporate tax rate is high and the government also taxes U.S. companies on all earned income, whether such earnings are produced within the U.S. borders or abroad. For U.S. companies that have units or establishments in other parts of the world, this is a key point, because most foreign countries, in addition to having lower corporate tax rates, also do not levy tax on income earned outside the border of their countries. Thus the earnings after tax for a U.S. company are much lower, percentage-wise, when compared to their international competitors. Coupled with the U.S. corporate tax being the highest among the 34 members of the Organization for Economic Cooperation and Development ("Corporate tax in America," 2014), having a legal address is the United States might not be the best for the bottom line or for the creation of higher shareholders’ value.

This phenomenon is so popular that the U.S. Congress is discussing bills to curb this tax elusion strategy. President Obama commented that such an act is “unpatriotic.” And others are saying that if Burger King deserts the United States, then Americans should desert Burger King and patronize other U.S. burger places such as McDonald’s and Wendy’s. Why such outcry? Let us look at one estimate from the Wall Street Journal: “the White House estimates that the U.S. Treasury could have about $20 billion of lost taxes over the next decade” (CNBC Staff, 2014). This does not include other tax inversion deals that are currently pending or those that were completed in the last few years. In today’s economy, when every penny counts, $20 billion is not a small sum.

IS TAX INVERSION REALLY BENEFICIAL?

This question is not simple to answer. Depending on the party affected, from the government, to the food industry, to the corporations involved, to the shareholders, to the regular consumers, tax inversion might be good or not so good.

For the government, it is obvious that tax inversion is not beneficial because of the loss in tax revenues. Since 1996, the U.S. government has been trying to modify and restrict the benefits of such tax practices, and additional laws were added in 2004 (Raice, 2014). Though Congress agrees that a new set of rules is needed, neither the Democrats nor the Republicans have put forth a concrete bipartisan plan as yet, and the White House is reportedly considering various actions as well (McKinnon, 2014).

For the industry, if a merger/acquisition is done correctly, synergies can be reaped and the industry as a whole will have stronger companies to provide goods and services. With the companies’ stand to be more profitable, there may be expansion of locations and other positives. Some may argue that such mergers might lead to less competition, but it is doubtful that will happen, because there are so many restaurants in the United States and all over the world.

For the corporations involved, the favorable tax treatment is very enticing. Any profits earned outside the United States under the new company will be now be taxed at the lower rate of the foreign country. Therefore, more income will flow to the bottom line, increasing earnings per share and other profitability indices. Without needing to make any changes in operational structure or relocation of executives and employees, those expenses and others can also be saved. Some may even argue that such savings plus the savings in taxes will now afford corporations the opportunity to increase wages for fast-food employees. The company simply has a new foreign “home.” After all, this is totally legal. This is not tax evasion. It is no different from a company moving from one state in the U.S. to another to take advantage of state taxes.
In the case of Burger King and Tim Hortons, it is really not just the tax savings. The prices of their stocks increased by almost 20% after the announcement (Snider, 2014). When every fast-food place, including Subway, is expanding into breakfast items to capture more sales, having Tim Hortons’ as a partner will build the competitive edge of Burger King and vice versa. Tim Hortons has a lot to offer, including its premium coffee, and Burger King can assist Tim Hortons to expand more into the lunch and dinner business. These two corporations can leverage each other’s experience and undoubtedly increase international growth opportunities through cobranding, in similar fashion to Yum Brand housing KFC, Taco Bell, and Pizza Hut under one roof.

Politically, although some may think that this deal would be like the Walgreens–Alliance Boots deal, which Walgreens backed out of (reportedly because of the concerns of political backlash on its business), this deal is different. The Burger King–Tim Hortons proposal is financed partly through Warren Buffett’s Berkshire Hathaway. From the standpoints of both money and politics, Buffett has the funds and he is also an ardent Obama administration supporter. The Republicans and Democrats in Congress still need to agree on any new tax law; President Obama may deem tax inversion unpatriotic, but this deal might carry a different tone (Vardi, 2014) and might be completed without the backlash.

For the individual shareholders who own shares in the company taking advantage of a tax inversion, depending on the investment goal, this could spell trouble. If the investor is a regular retail investor with funds in nonretirement accounts, the investor will need to pay taxes on the capital gains when the deal is signed, sealed, and delivered (Wood, 2014). Worse still, if there is no cash distribution and only a stock swap, an investor will receive the stock of the new company, which is at a higher rate than that at which the current company stock was purchased. In this case, the investor will need to come up with personal funds to pay the capital gains tax at a rate that varies depending on the investor’s tax bracket.

Regular customers in the United States might now be able to purchase Tim Hortons doughnuts in more locations. The merger could provide a wider variety of menu items when the two corporations begin sharing locations, much as KFC, Pizza Hut, and Taco Bell do. With the savings in taxes, hopefully the prices of the food items will not need to increase to supplement the added costs of healthcare in the United States or increase of minimum wages.

However, would Burger King’s move be viewed really as deserting the USA and opting for north of the border, and would customers follow what some politicians have said they would do and desert Burger King to support U.S.-based burger places such as McDonald’s and Wendy’s? Or would customers of Tim Hortons now patronize Burger King because they see Tim Hortons and Burger King as one brand? As of September 12, 2014, on a U.S. News website poll, 52.49% of its readers voted yes to the tax inversion plan of Burger King.

In addition to the restaurant industry, Marcato Capital Management, which owns a small stake in InterContinental Hotels Group, has retained investment banker Houlihan Lokey to seek possible U.S. partners in a tax inversion proposal. It has been rumored that Starwood and Wyndham are investigating the possibilities (Lorenzetti, 2014).

In the end, perhaps Burger King’s move is nothing but one more step in its series in the high finance world. In the last 20 years, Grand Metropolitan of Britain, who then merged with Guinness, and then became Diageo, had owned Burger King. Diageo then sold Burger King to a private equity firm, which was finally taken private by 3G capital of Brazil, and relisted itself with the stock exchange again in 2012. The latest move will include Mr. Buffett’s stake of reportedly $3 billion with a 9% coupon return (“Seventh time lucky,” 2014). Mr. Buffett does not make deals without a profit, and he is backing this deal. Tim Hortons is also no stranger to change of ownerships. Tim Hortons opened its first store in 1964 as Tim Horton Donuts; it was part of the Wendy’s family and then spun off to become a Canadian public company.
So, will it be a Bur-nut or Dough-ger? We shall see.

AUTHOR NOTE

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