Incentives to Invert and the Market for Foreign Takeovers

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Tax Inversions and the M&A Market

Incentives to invert (get new foreign parent):

- Reduce tax on foreign income
- Reduce tax on domestic income

Not unique to inversions; similar incentives in M&A market for foreign takeovers of US companies:

- More transactions
- Bigger effects on tax revenues
- Bigger effect on economic efficiency and location of economic activity

Taxes and Inbound Acquisitions

How do characteristics of targets affect competition between foreign and domestic acquirers?

Key difference: foreign acquirers face lower effective tax rates (on average).

1. Locked-out earnings/PRE [Bird, Edwards and Shevlin (2015)]
   - Policy: worldwide/territorial?
2. Profitability [Bird (2015)]
   - Policy: statutory rate/regulating income shifting
3. Tax shields [Bird (2015)]
   - Policy: choosing the tax base

Sample: acquisitions of publicly traded US firms, 1990/1995 - 2010

Lock-out and Taxation of Foreign Earnings

- Notable consequence of worldwide system + deferral: locked-out earnings
- Measure locked-out earnings as PRE (accounting designation)
- Inversions are one way to unlock, is foreign takeover another?
  - 'hopscotch', 'out-from-under', etc.
- If so, US targets with more PRE should be more likely to be acquired by foreign companies

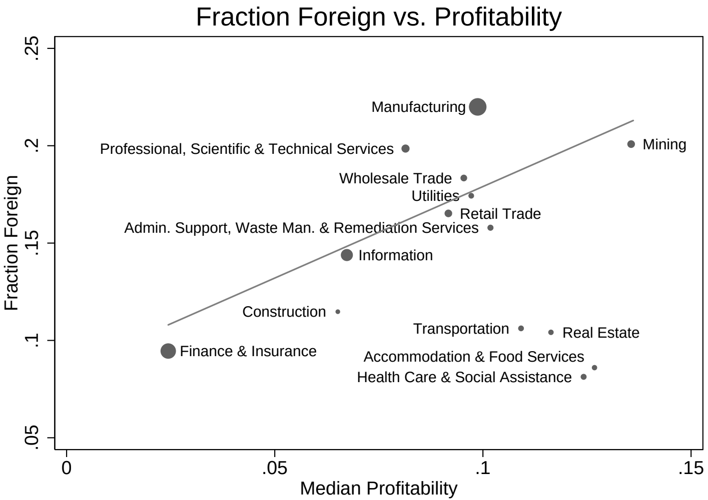
Lock-out Results

- Target with some PRE is 4.4 percentage points more likely to be acquired by a foreign company than one without
  - After controlling for foreign income or sales of the target
- Foreign preference for PRE is concentrated in acquirers from countries with territorial systems
- Acquirers from UK and Japan increased their preference for PRE after switching from worldwide to territorial system

$\longrightarrow$ Lock-out caused by worldwide system encourages foreign acquisitions of US companies

Profitability and Statutory Rate

- Difficult in US context to see the effect of statutory rate on M&A $\longrightarrow$ doesn't change much
- So investigate effect of tax differences indirectly, by looking at effect of target profitability on identity of acquirer
- In theory, foreign bidders are more likely to acquire more profitable target firms – given profit yields more after tax cashflow



- Foreign acquirers are preferentially sorting into industries with higher median profitability

Effects of Profitability

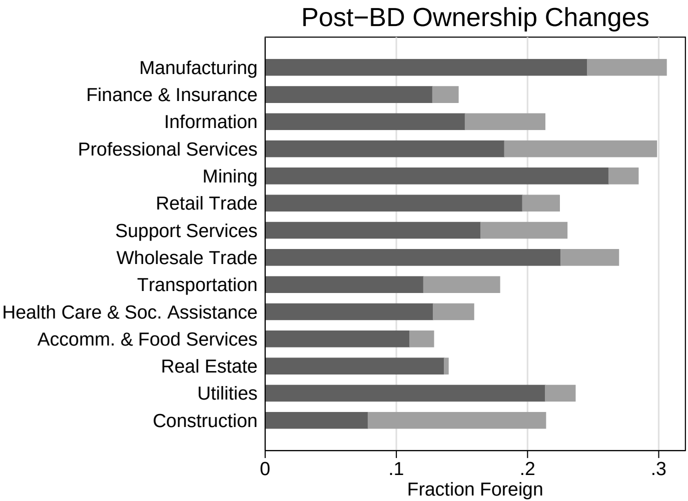
- One standard deviation higher target profitability increases probability the acquirer will be foreign by 2.8 percentage points
  - Using cross-sectional variation in target profitability
- This preference could be due to non-tax acquirer differences, but...
  - Robust to controlling for confounding factors using minority transactions
  - Stronger for acquirers from tax havens, as expected given their especially low tax rates

Tax Shields and Bonus Depreciation

- Foreign bidders are less likely to acquire targets with more tax deductions – given deduction saves less tax
  - If ETR $= 0$, don't need tax shields
- To test this proposition, would like exogenous shock to tax deductions $\longrightarrow$ use bonus depreciation

Empirical strategy:

- Compare across industries: manufacturing industry got big increase in tax deductions relative to real estate industry
- Expect to see decline in foreign takeovers in manufacturing relative to real estate post-bonus depreciation



- After bonus depreciation, probability foreign falls in high-effect industries relative to low-effect industries $\longrightarrow$ reform explains 5.3 percentage point fall in foreign takeovers

Consequences and Implications

1. Worldwide system, high statutory rate/big ETR differences and wide tax base encourage foreign takeovers
2. Territorial system, small ETR differences/reduced income shifting and narrow tax base encourage domestic takeovers

- Domestic tax policy choices matter for foreign takeovers/inversions
- Effects on tax revenues, ownership efficiency, HQ activity, domestic asset prices
- Who owns assets matters for real productivity – are foreign takeovers too high or too low on net?