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journal homepage: [www.elsevier.com/locate/jacceco](http://www.elsevier.com/locate/jacceco)Does U.S. foreign earnings lockout advantage foreign acquirers?<sup>☆</sup>Andrew Bird<sup>a</sup>, Alexander Edwards<sup>b</sup>, Terry Shevlin<sup>c,\*</sup><sup>a</sup> *Tepper School of Business, Carnegie Mellon University, Pittsburgh, PA, United States*<sup>b</sup> *Rotman School of Management, University of Toronto, Toronto, ON, Canada*<sup>c</sup> *The Paul Merage School of Business, University of California at Irvine, Irvine, CA, United States*

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## ABSTRACT

We hypothesize and find evidence consistent with foreign firms being tax-favored acquirers of U.S. targets with greater locked-out earnings because they can avoid the U.S. tax on repatriations. This effect is economically significant; a standard deviation increase in lock-out is associated with a 12% relative increase in the likelihood that an acquirer is foreign. We also find evidence that foreign acquirers of the target firms are more likely to be residents of countries that use territorial tax systems, as the tax advantages for a foreign firm acquiring a U.S. target with locked-out earnings are even greater for these acquirers.

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## 1. Introduction

Various business and political leaders in the United States have expressed concerns that the U.S. system of taxing multinationals effectively subsidizes foreign takeovers (White, 2014; Hatch, 2014). Prior research on mergers and acquisitions (M&A) demonstrates how variation in tax rates (Scholes and Wolfson, 1990; Arulampalam et al., 2010) and in tax systems (Huizinga and Voget, 2009; Feld et al., 2016) impact the market for corporate control. As a result, firms under a worldwide tax system are tax-disadvantaged acquirers. Furthering this line of inquiry, we posit that firms under a worldwide tax system are also tax-favored targets of foreign acquirers. We find that U.S. firms with locked-out earnings are tax-favored to foreign acquirers (or equivalently tax-disfavored to U.S. acquirers).

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Foreign earnings “lockout” results when firms avoid or delay foreign earnings repatriation. Under the U.S. worldwide tax system, taxes owing to the U.S. government on the earnings of foreign subsidiaries are deferred until those earnings are repatriated to the U.S. Consequently, firms’ repatriation decisions are sensitive to the level of repatriation taxes (Desai et al., 2001; Hines and Hubbard, 1990) and tax incentives lead to higher overseas cash holdings (Foley et al., 2007). Hanlon et al. (2015) and Edwards et al. (2016) demonstrate that firms use “trapped cash” to make suboptimal foreign investments, increasing total lockout.<sup>1</sup> A foreign acquirer may be able to free a target’s foreign subsidiaries’ locked-out earnings from the U.S. worldwide tax system using “out-from-under” strategies, utilizing trapped cash elsewhere and liquidating suboptimal foreign investments so the proceeds may be more efficiently redeployed.<sup>2</sup>

To test this hypothesized relation between tax lockout in target U.S. firms and the nationality of acquirers – foreign versus U.S. – we use a sample of 4611 majority acquisitions of U.S. public company target firms from 1995 to 2010. We measure lockout using the hand-collected balance of permanently reinvested earnings (PRE) reported in the tax footnote. Employing a probit model, we observe a positive association between the target firm’s level of PRE and the probability that the acquirer is foreign. The effect is economically significant: a standard deviation increase in PRE is associated with a 12% relative increase in the likelihood that an acquirer is foreign. These findings suggest that potential U.S.-based acquirers of U.S. targets with trapped cash and suboptimal foreign investments are losing out to foreign acquirers.

Building upon these initial findings and improving identification of our main hypothesized effect, we posit that foreign acquirers of U.S. target firms with higher levels of tax lockout are more likely to be residents of countries that use territorial tax systems. In a territorial system, foreign earnings are subject to low or no home country tax, thereby eliminating the lockout effect.<sup>3</sup> Categorizing acquisitions according to acquirer tax systems, we observe a significant association between our lockout measures and foreign acquisitions occurring under the territorial (as opposed to worldwide) tax regime.

In an additional test we exploit an exogenous change in the tax system for a subset of acquirers: during our sample period, five OECD countries switched from worldwide to territorial tax systems. As it is unlikely that switching tax systems increased incentives to acquire U.S. firms with higher levels of tax lockout for reasons other than taxation (e.g., general preference for targets with greater foreign activity or higher profitability), this test allows for stronger causal identification. Taken together, these tests provide strong evidence that the relationship between a target’s level of locked-out earnings and the likelihood of an acquirer being foreign is concentrated in acquiring firms that operate under territorial tax systems.

Our findings suggest that U.S. potential acquirers of U.S. target firms with greater levels of locked-out earnings are losing out to foreign acquirers.<sup>4</sup> These results speak directly to the current U.S. policy debate on repatriation taxes as well as the broader issue of the relative merits of territorial versus worldwide (with deferral) taxation systems. These findings are also relevant to those countries considering a transition between worldwide and territorial tax systems, as notably undertaken by the U.K. and Japan. Likewise, this examination of the relationship of tax systems, lockout, and foreign acquisitions of U.S. target firms highlights a facet of the current worldwide tax system and may serve to inform its adjustment or alteration.

The subsequent section of this paper provides institutional information and discusses prior literature. Section 3 describes the hypotheses. Section 4 details the sample selection and research design. Section 5 presents our findings. Section 6 discusses additional analyses. Section 7 concludes.

## 2. Institutional background and prior literature

### 2.1. U.S. tax and accounting treatment of foreign earnings

The U.S. taxes its multinational corporations on a worldwide basis. For a single legal entity, worldwide earnings are taxed immediately in the period earned. For firms comprised of multiple legal entities, however, U.S. taxation of income earned in foreign subsidiaries is typically deferred until repatriation. This U.S. tax is reduced by foreign tax credits associated with foreign taxes paid on foreign earnings. This calculation is complicated by foreign operations in multiple jurisdictions, but the residual tax due is approximately equal to any excess of the U.S. tax rate over the weighted average rate of the foreign jurisdictions. Given the option of deferral and the high U.S. corporate tax rate, there is a potential policy concern that foreign investment by U.S. multinationals is inefficiently subsidized, so that firms are induced to reinvest their earnings abroad even when the potential returns are lower than those available domestically, effectively “locking out” these earnings.

Under U.S. Generally Accepted Accounting Principles, the expectation future U.S. tax payments associated with foreign earnings requires firms to record a deferred tax expense and the related deferred tax liability. However, Accounting Stan-

<sup>1</sup> For clarity, we use the term “trapped cash” to describe the U.S. repatriation tax-motivated foreign cash and passive investments holdings of U.S. multinationals. We discuss issues with measuring trapped cash in Section 6.3.

<sup>2</sup> In addition to unlocking past locked-out earnings, with planning, some future non-U.S. earnings of the new entity could avoid U.S. repatriation taxes that would exist under the old structure. Also, following the acquisition, the foreign acquirer could increase income shifting out of the U.S. and into low tax jurisdictions. These additional factors are also likely drivers of our hypothesized effect. Empirically, these are difficult to disentangle, as proxies for lockout are correlated with proxies for future profits and the potential for income shifting is difficult to observe from public data. The focus of this study is on unlocking past lockout but we discuss these other factors with the research design.

<sup>3</sup> The incentives for a worldwide-system foreign acquirer to target a U.S. firm with locked-out earnings could still exist if the statutory tax rate in the acquirer’s country is lower than the U.S. rate. However, our sample includes few acquisitions from worldwide-system countries with low tax rates.

<sup>4</sup> In addition, this specific issue is currently being discussed and speculated upon in the business press (see for example “Abetting Foreign Takeovers” – *Wall Street Journal*, August 4, 2015 – and “A Tax Inversion in All But Name” – *New York Times*, August 8, 2014).

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