

THE RELATIONSHIP BETWEEN TAX RISK AND ACQUISITION PRICE PREMIUM

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ABSTRACT

The objective of this study is to evaluate the extent to which financial-statement based proxies for tax risk (i.e. tax reserves) are associated with purchase price in the context of acquisitions. More specifically, we look at the target's tax risk (tax positions that increase the uncertainty of future outcomes) in relation to the acquisition premium paid by the acquirer. Consistent with other studies, we utilize the level of a firm's tax reserves (as reported under FIN 48) as the measure that best captures tax risk. The results display that tax risk has a negative and statistically significant relationship with acquisition premium, suggesting that the bidder pays a lower premium when the target firm has tax reserves on their balance sheet. The result is consistent with the argument that aggressive tax behavior by a target may create a significant liability to the acquirer after the takeover. From these results, we insinuate that the acquirer incorporates tax risk into the merger and acquisition terms.

JEL: M400, M490

KEYWORDS: Tax Risk, Acquisition Price Premium, Proxy for Tax Risk

INTRODUCTION

In this study, the relationship between tax risk and acquisition price premium is empirically examined. As noted by Hanlon & Heitzman (2010), there is an incomplete understanding of how acquirers handle the tax risk of their targets. The field of mergers and acquisitions (M&A) has seen multiple merger waves over the past decade keeping it as one of the top categories for SEC Comment letters (Lussier, 2014). Due to the interdisciplinary nature of M&A, the wealth of research from academics in economics, finance, accounting, management, etc. has made significant contributions to our understanding of the field. These include the effect of industry shocks and regulation, the role of deal competition, information asymmetry and agency problems, and pricing acquisitions (Hanlon and Heitzman, 2010). This paper primarily emphasizes the contributions made by the accounting discipline – more specifically the role tax characteristics play in pricing mergers and acquisitions.

Prior research suggests that tax characteristics affect the structure and pricing of mergers and acquisitions (DeAnglo and Masulis, 1980; Erickson, 1998; Kaplan, 1989; Henning et al, 2000; Chow et al. 2015). While the empirical investigations in this arena are well established, there remains an unexplored issue that is an avenue for interesting research. Little is known how acquirers handle targets with prior uncertain tax positions. Specifically this paper examines the question: does the existing level of tax risk of a target firm affect acquisition price premiums? While it may seem obvious that a level of tax risk will affect acquisition price, there are some reasons why the relation between tax risk and acquisition price premiums is an empirical question. First, to the best of our knowledge, there is no prior empirical evidence that uncertainty regarding a firm's future tax outcomes leads to higher (lower) acquisition price premiums. Second, evidence suggests that similar to investors placing premiums on firms whose managers have financial expertise (Bartov et al. 2002), investors could also place a premium on firms whose managers demonstrate tax

avoidance expertise – leading to a higher price for firms with higher tax risk. The debatable sides of this issue are very interesting and current in light of the fact that corporate tax avoidance behavior is a growing concern for regulators in the United States. The rest of the paper is organized as follows: the first section discusses prior research and develops the hypothesis. Following is a section that explains the research design and discusses the sample selection process. Next, the results are presented and discussion of supplemental analyses is followed by the final section that offers conclusions.

LITERATURE REVIEW

With a new era of business comes a new focus on tax risk management. As Ernst and Young (2011) point out, increased uncertainty combined with globalization and the effects of the global financial crises are posing new financial and reputational risks to companies. Based on a survey conducted by Ernst and Young, 88 percent of large company respondents indicate that the importance of managing tax risk and controversy is heightened and will continue to do so in coming years (Ernst and Young, 2011). In the U.S., acquiring companies assume potential tax liabilities of target companies in certain transactions, therefore creating a significant risk to the acquirer. Professionals have long emphasized the importance of paying particular attention to target firm tax compliance and contingent tax liabilities (Ayers et al. 2003, Frank et al. 2009).

Tax risk and its effects have been a focus of many accounting research studies. There are mixed perspectives when it comes to actually characterizing tax risk. Guenther et al. (2013) attempt to distinguish between the concepts of tax risk, tax avoidance and tax aggressiveness while relating all constructs to overall firm risk. In that study, tax risk is seen as the ability of a firm to sustain its tax positions over time. Following the study made by Guenther et al. (2013), the proxy used to measure tax risk is the standard deviation of annual cash effective tax rates (ETR) measured over a five year period. In a subsequent publication, Hutchens and Rego (2013) analyze the extent to which proxies for aggressive tax avoidance best capture a firm's tax risk. They posit that tax risk is defined as:

“all tax related risks and uncertainties associated with a firm's operating, investing and financing decisions, including uncertainty in the application of tax law to company facts, the risk of audit, including assessments of additional tax, interest, and penalties, and uncertainty in the financial accounting for income taxes” (Hutchens and Rego, 2013).

They utilize discretionary permanent book-tax differences, tax shelter prediction scores, cash ETR and unrecognized tax benefits (UTB) as proxies for aggressive tax avoidance. They argue that these measures capture tax consequences for transactions with great levels of uncertainty with respect to future tax payments. Their study suggests greater tax risk increases uncertainty regarding a firm's future after-tax cash flows and thus should impact a firm's implied cost of equity capital. Hutchens and Rego (2013) provide consistent evidence that the total amount of tax reserves (UTBs), disclosed under Interpretation No. 48 (FIN 48), is positively associated with the implied cost of equity capital, and thus is the best measure given the other proxies of tax risk. The other proxies, discretionary book-tax differences, tax shelter prediction score and cash ETR did not capture tax risk (Hutchens and Rego, 2013).

Lisowsky et al (2013) show evidence that the contingent liability for income taxes, otherwise known as tax reserves, is a superior predictor of tax-shelter activity. Weaving tax research into merger and acquisition (M&A) research provides many interesting research outcomes. In previous works of Henning et al. (2000), investigation is made into the effect of a target's tax status on acquisition structure. Specifically tax status includes: the target's marginal tax rate, the taxes paid by both the acquirer and target firm, as well as the cost of the target's net operating loss (NOL) to the acquirer. No such account was made for tax risk as a factor within this study. Rego and Wilson (2012) examine equity risk incentives as a determinant of tax aggressiveness, and propose that it motivates managers to make risky investment and financing decisions. Rego and Wilson (2012) also vie that aggressive tax avoidance represents risky activity and can create

significant uncertainties to the firm over an extended period of time. Given that an acquisition is a significant investment decision, it can be argued that the existing tax risk of the target firm plays a major factor in determining the price paid by the acquirer as well.

Furthermore, Koester (2011) specifically analyzes whether or not investors view tax reserves as value increasing or value decreasing. This study finds that tax reserves are positively associated with stock price. Although this association is present, it does not necessarily address the question of whether greater tax risk increases the rate of return investors require from their equity investments in a firm (Hutchens and Rego, 2013). However, it does bring to question whether or not the presence of tax risk is captivated in acquisition price. The intersection of tax research and merger and acquisition (M&A) offers many possible interpretations of the effects tax risk will have on acquisition premiums. Mukherjee et al (2004) provide many noteworthy motives of M&A transactions including: synergy, diversification, tax considerations, management incentives, purchase of assets below replacement cost, and breaking value. Much of the literature discussed here focuses on tax characteristics and the effects they have in M&A. Frischmann et al (2008) provide evidence that a firm's initial disclosure of tax reserves relative to permanent uncertain tax positions is positively associated with abnormal stock returns in the 3-day window around the initial disclosure. This ultimately suggests investors view uncertain tax avoidance as value enhancing. However, most tax strategies that are inherently risky and involve greater uncertainty with respect to future outcomes, involve significant costs. Balakrishnan et al (2012) provide evidence that tax aggressiveness reduces corporate transparency. Results consistent with Desai and Dharmapala (2006, 2009) suggest that aggressive tax avoidance obscures financial reporting trickling down to increased agency costs. Furthermore, if aggressive tax avoidance is challenged and disallowed by tax authorities, companies may need to pay back tax, potential fines, and could possibly suffer reputational damage (Chen et al. 2010). In addition, Hasan et al (2014) report that banks and bondholders charge a higher borrowing cost and impose more covenants in contracting with tax aggressive borrowers. In sum, increasing tax aggressiveness, or in this study tax risk, can pose significant costs to a firm.

Brigham and Ehrhardt (2012) sustain the most appropriate rate to value a company is the target's cost of equity. As Hutchens and Rego (2013) suggest, if tax risk influences investors assessments of the distribution of a firm's future after tax cash flows relative to those for the market, then tax risk should be associated with cost of equity capital. They find support that tax risk is positively related to cost of equity capital. Inferring that cost of equity capital is an appropriate valuation measure used in merger and acquisitions, and tax risk has a proven association with cost of equity capital, we posit that tax risk is going to effect the purchase price in the M&A transaction. Desai and Dharmapala (2009), Wilson (2009) and Koester (2011) all provide evidence that tax avoidance is associated with a higher firm valuation only in well-governed companies. Based on these findings and others, one would suspect that if tax avoidance is undertaken primarily for maximizing shareholder value, and seen positively by acquiring firms and shareholders, then there would exist a positive relation between the premium acquirers are willing to pay and the targets existing tax risk. Alternatively, the contributions of Banks and Kinney, 1982; Barth and McNichols, 1994; Cohen et al. 2009 find evidence consistent with other contingent liabilities being negatively valued by investors. Also, the negative reputation effect that is associated with a firm being viewed as a "poor corporate citizen" that is unwilling to pay taxes and "cheat" would lend explanation to a negative association between target tax risk and acquisition premiums paid. The conflicting evidence leads to an interesting research question; one that hopefully with the findings of this study, will contribute to reducing the ambiguity around the effects of target tax risk in mergers and acquisitions.

H1: The existing tax risk of a target company will be associated with the acquisition premium paid by the acquiring company.

DATA AND METHODOLOGY

The sample consists of mergers and acquisitions of publicly listed targets announced during the period of 2007 – 2014 available on the Securities Data Company U.S. Mergers and Acquisitions (SDC) database. Thomson Reuters SDC database provides details of global mergers and acquisitions activity, including individual deal details and terms and conditions. The M&A database content covers over one million deals, including 300,000+ US-target and 700,000+ non-US-target transactions announced since the 1970s. Each acquisition for this study needs to meet the following criteria: (i) both the acquirer and target are public, U.S. companies, (ii) the acquirer owns 100% of stock after the transaction is completed, (iii) neither the acquirer nor target are in Standard Industry Classification (SIC) codes of 67**, 60**, 61**, 62**, and 49**, (iv) the acquisition premium recorded in SDC is positive, and (v) the acquirer and target company have financial statement data available from COMPUSTAT. The SIC codes indicate the real estate investment industry, financial institutions and utilities. The reason for their exclusion is due to the regulations of these industries and the likelihood that will affect tax risk tolerance (Hutchens and Rego, 2013). The final sample consists of 190 acquisitions.

Table 1 provides the variables utilized in this study and their definitions. Based on the plethora of prior accounting research, tax reserves is utilized in this study as the proxy for tax risk. A firm's contingent liability for income taxes, referred to as tax reserves, informs financial statement users of tax positions that have a relatively high level of uncertainty based on tax laws. In 2006, FASB Interpretation No. 48 Accounting for Uncertainty in Income Taxes (FIN 48) was issued to address the diversity in accounting for uncertainty in income taxes observed in practice (Koester, 2011). FIN 48 requires all publicly traded companies to record tax reserves on the balance sheet and also disclose details in the footnotes of the financial statements about the tax reserves. It is required that a firm record any tax reserve that has a fifty percent chance or less of being successfully upheld based on tax laws and regulations (ASC 740-10-10-25-6). The FASB required public companies to adopt the provisions of FIN 48 beginning after December 15, 2006.

Table 1: Variable Definitions

Variable	Definition
PREM	ratio of the final offer price to the target trading price four weeks prior to the deal announcement data.
TAX_RISK _{TAR}	1 for the number of non-zero unrecognized tax benefits on the target firm's balance sheet, 0 otherwise
SIZE _{TAR}	The total value of target company assets
SIZE _{ACQ}	The total value of acquirer company assets
MULTI	1 for more than one bidder, 0 otherwise
TENDER	1 for tender offers, 0 otherwise
SYNERGY	1 for synergistic acquisitions, 0 otherwise

This table defines the variables included in the empirical model.

The dependent variable is acquisition premium. Common among the acquisition literature, acquisition premium is used as the pricing proxy (Beckamn and Haunschild, 2002; Kisgen et al. 2009; Denis and Macias, 2013; Krishnan et al. 2007). Acquisition premium (*PREM*) is defined as the ratio of the final offer price to the target trading price four weeks prior to the deal announcement data. TAX_RISK_{TAR} represents the proxy for tax risk, which is tax reserves, measured by the amount of tax reserves reported on the target firm's balance sheet. Firms receive a 1 if they report tax reserves and 0 otherwise. Other variables are included to control for factors regarding the target firm, acquiring firm, and deal characteristics that prior research has shown to impact acquisition premiums (Reuer et al. 2012; Jarrell and Pouslen 1989; Asquith

et al (1983, 1987); Schwert, 2000, Haunschild, 1994) To control for target and acquirer firm characteristics, firm size (value of total assets) of each the acquirer and target firms is included, denoted by $SIZE_{ACQ}$ and $SIZE_{TAR}$ respectively. Controls for deal characteristics include the following variables: MULTI, SYNERGY, and TENDER. Jarrell and Poulsen (1989) and Haunschild (1994) suggest that acquisition premiums are affected by competitive bids. The variable, MULTI, is used to control for the presence of other bidders. It equals 1 if there is more than one bidder and 0 otherwise. Data regarding the number of bidders were available from the SDC database. Slusky and Caves (1991) suggest that an acquirer will pay a higher premium for a target when there is ‘good fit’ between the companies, i.e. the acquisition is synergistic. To control for synergies between the acquirer and target, we follow the study by Rumelt (1974) that considers synergistic activities when two firms serve common customers, use common distribution channels, or use related technologies of production. A classification scheme similar to other studies (e.g. Haunschild, 1994; Ravenscraft and Scherer, 1987) is used in which an acquisition was coded as related (denoted by a ‘1’) when the two-digit Standard Industry Classification (SIC) code of the target and acquiring firm matched. Otherwise the synergy was coded ‘0’. Another variable indicates whether the acquisition was made with a tender offer (TENDER) with 1 for a tender offer and 0 otherwise. Consistent with other studies, acquisition premiums paid by bidders may be higher when there is an active M&A market. The intensity of M&A activities is captured by using year controls for the announcement of the acquisition. The following regression model incorporates the above variables to examine whether tax risk is accounted for in the acquisition price premium (H1):

$$PREM = \beta_0 + \beta_1 TAX_RISK_{TAR} + \beta_2 SIZE_{TAR} + \beta_3 SIZE_{ACQ} + \beta_4 TENDER + \beta_5 MULTI + \beta_6 SYNERGY + \varepsilon. \tag{1}$$

RESULTS AND DISCUSSION

Table 2 displays the descriptive statistics for the sample. The average premium for the sample is \$51.05. The mean size of the target firms is approximately \$1.376 million, and the mean size for the acquiring firms is \$22.678 million. Table 3 presents the Pearson (Spearman) correlation coefficients for each of the variables. Pearson coefficients are reported above the line, while Spearman coefficients are reported below the line. Bold coefficients represent significance at the .001 and .05 significance levels. Italicized coefficients represent significance at the .10 level. Preliminary statistics provided in the correlation table suggests that tax risk indeed does play a factor in the acquisition premium.

Table 2: Descriptive Statistics

Variable	N	Mean	Std Dev	Minimum	Maximum
PREM	190	51.05	47.08	0.22	432.21
TAX_RISK_TAR	190	0.82	0.39	0.00	1.00
SIZE_TAR	190	1,376.49	2,785.72	6.70	17,590.00
SIZE_ACQ	190	22,677.56	57,616.06	13.40	665,614.00
MULTI	190	0.05	0.21	0.00	1.00
TENDER	190	0.29	0.45	0.00	1.00
SYNERGY	190	0.66	0.48	0.00	1.00

*This table presents descriptive statistics for each variable included in the empirical model. TAX_RISK_TAR is equal to ‘1’ if there are tax reserves reported, and zero otherwise. SIZE_TAR and SIZE_ACQ are both in millions of dollars. The empirical model is as follows:
 $PREM = \beta_0 + \beta_1 TAX_RISK_TAR + \beta_2 SIZE_TAR + \beta_3 SIZE_ACQ + \beta_4 TENDER + \beta_5 MULTI + \beta_6 SYNERGY + \varepsilon.$*

From Table 3, we observe a significant negative correlation between tax risk and premium. This would suggest that the premium is lower for target firms that report tax reserves on their financial statements. We can also see that PREM (premium) is correlated with the size of the acquirer and the exhibition of multiple bidders.

Table 3: Pearson (Spearman) Correlation Coefficients, N = 190

	PREM	TAX_RISK _{TAR}	SIZE _{TAR}	SIZE _{ACQ}	MULTI	TENDER	SYNERGY
PREM		-0.14578	-0.07235	0.12922	0.15080	0.06692	0.06065
TAX_RISK _{TAR}	-0.11152		0.19755	0.02729	-0.02187	-0.02600	-0.02787
SIZE _{TAR}	-0.19124	0.39272		0.06559	-0.02504	-0.13499	0.04749
SIZE _{ACQ}	0.17614	0.12662	0.36373		0.02454	0.05963	-0.12333
MULTI	0.15382	-0.02187	-0.03185	0.07092		0.18546	0.10857
TENDER	0.12579	-0.02600	-0.05977	0.20683	0.18546		0.14227
SYNERGY	0.00759	-0.02787	0.11641	-0.07868	0.10857	0.14227	

Pearson (Spearman) correlation coefficients are reported above (below) the line. Bold represents significance at the .001 and .05 levels. Italicized represents significance at the .10 level.

Table 4 presents the results of whether the target's existing level of tax risk, as measured by whether or not the target firm has reported non-zero tax reserves on the balance sheet, is associated with the acquisition premium that is paid by the acquirer of that company. Ordinary least squares (OLS) regression is the technique utilized. The variance inflation factor (VIF) is included in Table 4. Values for each of the variables is below the threshold where multicollinearity becomes a concern.

Table 4: Regression Analysis Results of Acquisition Premium and Tax Risk

Parameter	Predicted Sign	Estimate	T Value	Variance Inflation Factor
Intercept		43.8416	3.46***	
TAX_RISK _{TAR}	+/-	-18.4603	-2.09**	1.04248
SIZE _{ACQ}	?	0.0001	1.93**	1.07213
SIZE _{TAR}	?	-0.0005	-0.43	1.02989
MULTI	+	32.3471	1.98**	1.04403
TENDER	+	2.5750	0.34	1.08096
SYNERGY	+	7.3343	1.00	1.05505
Year dummies		YES		
N		190		
R ²		0.0999		
Adjusted R ²		0.0443		

***, **, and * indicate significance at the .001, .05, and .10 levels respectively. The table presents the results of OLS regression of the following empirical model: $PREM = \beta_0 + \beta_1 TAX_RISK_TAR + \beta_2 SIZE_TAR + \beta_3 SIZE_ACQ + \beta_4 TENDER + \beta_5 MULTI + \beta_6 SYNERGY + \epsilon$. TAX_RISK_TAR is equal to '1' if there are tax reserves reported, and zero otherwise. SIZE_{TAR} and SIZE_{ACQ} are both in millions of dollars and represent the value of total assets of the target and acquirer, respectively. MULTI equals '1' if there are multiple bidders, zero otherwise. TENDER equals '1' if there is a tender offer made, zero otherwise. SYNERGY equals '1' if both the acquirer and target company have the same 2 digit SIC code.

As Table 4 shows, tax risk has a negative and statistically significant coefficient, suggesting that bidders pay a lower premium when the target firm exhibits tax risk by including tax reserves on their balance sheet. The result is consistent with the argument that aggressive tax avoidance by a target may create a significant liability to the acquirer after consummation of the takeover. From these results, I insinuate then that the acquirer incorporates tax risk into the price of the target. Results on the control variables are somewhat consistent with prior studies even though the level of significance varies across the prior studies and our own results. The results suggest a significantly positive relationship between the size of the acquirer, the existence of multiple bidders, and whether the transaction is a tender offer and acquisition premium (Schwert, 2000; Barger et al. 2008). Although insignificant, a positive coefficient suggests that the bidder also pays a higher premium when the acquisition is synergistic (Haunschild, 1994).

CONCLUSIONS AND LIMITATIONS

M&A activity is accelerating and as businesses grow in complexity and geographic reach, the challenges and risks related to tax increase significantly. There are financial as well as reputational risks that can be costly if not managed proactively. The purpose of this study is to evaluate the extent to which financial-statement based proxies for tax risk (i.e. tax reserves) impact the purchase price in the context of acquisitions. More specifically, we look at the target's tax risk (tax positions that increase the uncertainty of future outcomes) in relation to the acquisition premium paid by the acquirer. Employing regression analysis of 190 acquisitions in years 2007 – 2014, our results show that tax risk is indeed accounted for in acquisitions. In fact, acquisition premiums are lower when tax risk is present for a target firm. In this study, tax risk is captured by whether or not the target firm reports tax reserves in their financial statements. The result aligns with the argument that aggressive tax avoidance, insinuated by the presence of tax reserves by a target firm, may create a significant liability to the acquirer after consummation of the takeover. Overall, the evidence is consistent with the argument that corporate tax risk may reflect agency problems and therefore become a source of a contingent liability for the acquiring firm.

Several robustness checks and sensitivity tests could be utilized to augment the results of this study. For example, alternative measures could be used to measure acquisition premium and tax risk. Schwert (2000) computes the premium as the target cumulative abnormal returns (CARs) 63 trading days before the date of the acquisition announcement to 126 days after the date of the acquisition announcement. While the disclosures required under FIN 48 should give a somewhat better view of a taxpayer's uncertain tax positions, the disclosures still do not have the specificity that would allow a perfect view of the issues and amounts at risk. Therefore, alternate measures from previously cited studies may supplement the proxy used in this study to capture tax risk.

A recent study by Raman et al. (2013) finds that financial reporting quality possibly impacts acquisition premiums. This could be included as another control variable in the current study. Another potential factor that is related to takeover premium is target net operating losses (NOLs). Profitable acquirers may pay a higher premium for companies with NOLs because of the potential tax savings. It also possible that tax risk could be correlated to a target company's overall risk-taking policies, which could be the explanation for the lower premium that it receives. These alternative adjustments to the current study could have the potential to paint a different picture regarding tax risk and acquisition premiums. This paper adds to the literature stream of understanding how target characteristics affect M&A transactions. This study also extends the corporate tax literature by demonstrating a valuation effect of tax risk from the perspective of a knowledgeable investor. The fact that acquisition premium is a measure of target shareholder gain; the results here also speak to a cost of tax risk to shareholders. They receive a lower premium in takeover transactions when tax risk is present.

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