Engineering Shareholder Value through Expatriation

Research Proposal
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Abstract

This paper investigates whether corporations engaging in tax inversion transactions achieve the stated goal of reducing effective tax rates and, more importantly, whether the expatriation improves operating efficiency, reduces the firms' cost of capital and increases shareholder value. Out of a sample of several thousand publicly traded firms, only several dozen firms over several decades have chosen to expatriate, raising questions as to the level to which the benefits of such a decision exceed the costs. Using a data set supplemented with hand collection, I explore additional firm, transaction, and target country characteristics that influence the decision to execute a tax inversion as well as the operational and valuation effects of the inversion.

I expect to find that firms with high levels of foreign source income and high effective tax rates will expatriate to counties with whom they have significant business relationships, with extremely low corporate tax rates, and with high levels of legal, economic, and financial development by making an operationally beneficial acquisition. I further expect that the expatriated firms will enjoy lower effective tax rates, lower cost of capital, improved operating performance, and increased valuation.

Introduction

Over the past 30 years, CEOs of more than 10,000 publicly traded firms have made cost-cutting M&A, relocation, and tax planning decisions, yet the sample of firms that have undertaken tax-motivated expatriations is extremely small, raising questions as to what drives the decision to invert (and the country in which to re-domicile) and whether the benefits significantly outweigh the costs.

Bermuda and the Cayman Islands were red hot tax havens in the 1980s and early 1990s until several acts of Congress reduced the frequency of firms seeking refuge there. In recent years, Ireland has been the lucky benefactor of American tax avoidance affection.

This paper explores several strands of research relevant to the many moving parts in a corporate inversion transaction, including firm and country-level characteristics, operational performance, cost of capital, and stock market performance.

I begin with an investigation into the characteristics surrounding inversion transactions. Commonalities in firm characteristics, such as age, size, industry, operating performance (especially profitability), capital structure (especially the relevance of interest expense in income stripping), payout policy (dividends and repurchases), asset mix (especially intangibles), growth opportunities, previous acquisition experience, state of incorporation (including any tax-motivated domestic relocations), participation in Repatriation Holiday opportunity afforded by the American Jobs Creation Act, level of accounting accruals (especially taxes), aggressiveness of accounting policies, choice of auditor, level and dispersion of foreign source income, institutional and foreign ownership, and other evidence of tax avoidance behavior may provide insight into the mystery of the seemingly diversified portfolio of firms that have expatriated.

CEO characteristics, such as share ownership, options grants, tenure, entrenchment, path of ascendancy, and political contributions, as well as board characteristics, such as independence, may also influence the expatriation decision, as could domestic macroeconomic conditions, including interest rates, inflation, unemployment, GDP growth, and currency strength, along with stock market conditions and the political environment.

Most importantly, however, should be the characteristics of the country of target domicile. Although firms choosing to re-domicile may do little more than change their address, at least some level of consideration should be given to factors such as legal, economic, and financial development, strength and stability of the currency, and other geopolitical risks in addition to the corporate tax rate structure.

Review and analysis of the data yield the following hypothesis:

H1: Corporations realize a reduction in effective tax rates following tax inversion.
H2: Corporations improve operating efficiency following tax inversion.
H3: Corporations realize a decrease in cost of capital following tax inversion.
H4: Shareholders realize an abnormal increase in value following tax inversion.

The remainder of the paper is organized as follows:
Section 2 reviews the literature on tax inversions. Section 3 provides a background on international tax laws and acts of Congress intended to discourage inversion. Section 4 describes the sample selection and methodology. Section 5 presents results.
Section 6 discusses implications and policy recommendations.

Literature Review

There is extensive merger and acquisition literature regarding abnormal announcement returns, buy and hold abnormal returns, and changes in operating efficiency and cost of capital, which I will review. I will also do a brief survey of international tax law.
The literature on tax inversions is almost as sparse as the transaction is infrequent. Desai and Hines (2002), Cloyd, Mills, & Weaver (2002), Chorvat (2004 & 2014) have all explored various aspects of tax inversions, most based on earlier samples.

Sample Selection

The sample consists of approximately 70 firms which, since 1983, have engaged in “tax inversion” transactions. Additional subsamples will include international mergers and acquisitions as well as firms which have changed their domicile.

Data Sources

CRSP: price and return data

Compustat: accounting data

Thomson Financial's Worldscope database (firm-level sales growth, total assets, ownership, cash holdings, and SIC codes)

CLSA and S&P ratings : investor protection

FTSE ISS Corporate Governance Index

Country level variables

Anti-director rights variable from Djankov, La Porta, et al 2006

Rule of law and risk of expropriation (La Porta 1998)

Additional data may be hand collected from financial reports.

Method

A variety of tests will be run to evaluate each of the hypotheses.

Conclusion

Corporations undertake multiple strategies to reduce costs and improve shareholder value. Strategic tax planning is relatively low hanging fruit in that regard. When the benefits of these strategies are exhausted, more aggressive strategies are explored. Tax inversion is high on that list.

Relinquishing American corporate citizenship is a decision not to be taken lightly. Unless corporations can deliver significant shareholder value, it is generally not a wise decision. Of course, as with most corporate actions, not all firms realize the same benefits, which is why it is important to understand the characteristics of firms and target countries into which firms have most successfully engineered shareholder value through expatriation.