

Original Paper

Tax Avoidance and M&A

Joohyun Lim^{1*}

¹ Baewha Women's University, Jongno-gu, Seoul, South Korea

* Joohyun Lim, Ph.D., Assistant Professor of Tax Accounting, Baewha Women's University, 34 Pillun-daero 1-gil, Jongno-gu, Seoul, 03039, South Korea

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Abstract

This paper examines the relationship between tax avoidance and M&A efficiency in the sample of 243 completed M&As in Korea. I find a negative relationship between tax avoidance and M&A returns. This result suggests that tax avoidance increases information asymmetry between shareholders and managers because it increases corporate opacity. It makes shareholders unable to monitor and control even if managers make opportunistic M&A decisions.

Keywords

tax avoidance, mergers, acquisitions, M&A

1. Introduction

A company's appropriate investment is a prerequisite to maintaining sustained growth. Without adequate investment, a company's growth potential would be weakened, resulting in poor economic fundamentals. On the other hand, over-investment beyond the appropriate level will not only put pressure on an entity's cash flows, but may also entail economic costs that hinder corporate growth. Excessive investment, which is not supported by proper return on investment, leads to opportunity costs and a cash crunch for companies, making the growth base vulnerable.

Mergers and Acquisitions (M&A) are one of the largest and most easily observable forms of corporate investment. "Acquisition" means that one company acquires management rights by acquiring shares or assets of another company, and "Merger" refers to two or more companies being legally merged into one. The purpose of this M&A is to overcome the internal growth limits of existing companies and to reduce the time and investment costs required to participate in new projects, management know-how, secure external credit of skilled professionals and companies, expand market share through acquisitions of competitors, and obtain profits from acquiring and selling high-value companies.

Managers will have to make M&A decisions to maximize corporate value and shareholder benefits. However, sometimes managers make investment decisions that do not meet the best interests of shareholders in order to maximize their own profits (Berle & Means, 1932, Jensen & Meckling, 1976). Jensen (1986) argues that managers have an incentive to enjoy privileges from empire building, which expands the size of enterprises. He predicts that companies with abundant cash flows are more likely to engage in value-destroying acquisitions than to distribute profits to shareholders.

In this paper, I investigate the effects of tax avoidance on M&A performance. Tax avoidance refers to the act of reducing explicit tax regardless of the legality of a transaction (Hanlon & Heitzman, 2010). When an entity conducts a tax avoidance, the direct tax burden decreases, resulting in an increase in post-tax operating cash flows. This will result in an increase in investment resources within the entity. Therefore, managers who is planning M&A have an incentive to avoid taxes to secure cash flows. However, tax avoidance increases the opacity of enterprises, facilitating opportunistic behavior of managers (Chen & Chu, 2005; Crocker & Slemrod, 2005; Slemrod, 2004; Desai & Dharmapala, 2005, 2006). From the perspective of agency theory, tax avoidance complicates the transaction structure of the company, increasing the opacity of the company and information asymmetry between managers and shareholders, and making it difficult to prevent managers from making inefficient investments. If shareholders could not monitor and control the M&A decisions of managers that reduce shareholder value and increase personal benefits to managers would be allowed because of tax avoidance, M&A profitability would be lower.

I study the relation between tax avoidance and M&A efficiency in a sample of 243 completed M&A in South Korea provided by S&P Capital IQ. I find a negative association between the tax avoidance and M&A announcement returns. This result suggests that tax avoidance increases information asymmetry between shareholders and managers because it increases corporate opacity. That makes shareholders unable to monitor and control even if managers make opportunistic M&A decisions.

The remainder of the paper proceeds as follows. The next section reviews prior literature and develops my hypotheses. Section 3 describes the sample and research design. Section 4 presents the empirical results. Section 5 concludes.

2. Related Research and Hypothesis Development

2.1 Tax Avoidance and Information Asymmetry

Agency theory explains the conflict of interest between managers and shareholders. The conflict is caused by managers to choose actions to maximize their own utility. These actions arise when there is information asymmetry between managers and shareholders. Information asymmetry between managers and shareholders can reduce investment efficiency by creating imperfections such as moral hazard and adverse selection.

A prior study that sheds light on tax avoidance and its relationship to corporate value from the perspective of the agency theory framework revealed that tax avoidance facilitates opportunistic

behavior by managers, thus decreasing corporate value (Chen & Chu, 2005; Crocker & Slemrod, 2005; Slemrod, 2004). According to Desai and Dharmapala (2005, 2006), tax avoidance will complicate the corporate transaction structure and makes it easier to manage earnings, and makes it a good environment to pursue managers' private interests. In line with this view, Desai and Hines (2002) and Hanlon and Slemrod (2009) confirmed the market reacted negatively to managers' tax avoidance.

Tax avoidance is generally done through complex and opaque transactions to reduce the likelihood of detection by tax authorities, so there is high uncertainty about future performance (Katz et al., 2015). It is also used as an opportunistic means for managers by using tax avoidance strategies that investors cannot understand (Chen et al., 2010). Balakrishnan et al. (2012) revealed that there was a negative relationship between tax avoidance and financial reporting transparency. This means that the company with active tax avoidance has a relatively less transparent information environment, and it essentially increases financial and organizational complexity to reduce the traceability of the tax authorities.

From these previous studies, it can be seen that active tax avoidance increases the complexity of a company's finance and organization, thus increasing the information asymmetry between the manager and outside shareholders.

2.2 Mergers and Acquisitions Performance

Previous studies suggest that mergers and acquisitions (M&A) are being pursued by various motive. Companies are pushing for M&A to create synergy through greater market dominance, a scale economy, a range economy, and reduced risks from diversification (Bradley et al., 1988; Seth, 1990). M&A are also used as a means of expanding managerial control by acquiring inefficiently operated firms (Dodd & Ruback, 1977; Jensen & Ruback, 1983). In terms of agency costs, managers may be interested in acquisitions for their own private interests because they benefit from corporate growth. The moral hazard model shows that managers execute investments for their own benefit even if their net present value is negative. Managers engage in M&A that increase the size of the company to enjoy their own private utility rather than maximizing shareholders' wealth (Jensen & Meckling, 1976). Jensen (1986) argues that empire-building managers would take over rather than increase payouts to shareholders because as companies grow, the resources they control increase and their power becomes stronger. Murphy (1985) find evidence that managers also do M&As as a way to increase their compensation because the compensation are related to the size of the enterprise.

M&A for managers' private utility may have a negative impact on shareholders' wealth. Morck et al. (1990) stated that M&A under the motive of these managers reduce the value of the acquiring company. Masulis, Wang, and Xie (2007) said that M&A performance of these companies is poor because managers are likely to cause agent problems by pursuing personal interests when management rights can be stably protected. Yoo et al. (2013) examine the association between financial reporting quality and firm decision-making regarding investment in the form of M&A. They find that firms with higher-quality accounting make more profitable M&As, suggesting that firms with higher-quality

accounting are less likely to make opportunistic M&A investment decisions because financial accounting reporting quality acts as an effective monitoring mechanism to control managers' behavior. These prior studies show that managers have an incentive to decide on mergers and acquisitions to maximize their profits due to agency problem. It can also be seen that in order to avoid such agency problem in the process of M&A, managers should be monitored effectively.

2.3 Hypothesis Development

A monitoring system is required to mitigate management opportunistic investment decisions under information asymmetry conditions between managers and external suppliers of capital. Jensen (2000) stresses the importance of a monitoring system to curb managers' incentives for overinvestment. The board's ability to effectively monitor management depends on the information available.

I predict that managers who is planning M&A have an incentive to avoid taxes to secure cash flows. However, tax avoidance increases the opacity of enterprises, facilitating opportunistic behavior of managers. In addition, tax avoidance complicates a company's transaction structure, making it difficult to prevent managers from making inefficient investments by increasing the company's opacity and information asymmetry between managers and shareholders. If the board of directors or shareholders cannot monitor and control M&A decisions that reduce shareholder value and increase individual profits for managers due to tax avoidance, M&A profitability would be lower.

H: There is a negative association between the tax avoidance and M&A returns.

3. Sample and Research Design

3.1 Sample Description

The M&A sample utilized in this study is extracted from the S&P Capital IQ database. The acquiring firms are Korean firms publicly traded on the Korea Stock Exchange. Information from the annual financial statement of the acquiring company is available from the KIS-VALUE databases and information about the stock return data of the acquiring company is available from the Fn-Guide or KIS-VALUE databases. In total, 243 M&As are identifiable between January 1, 2003 and December 31, 2011.

Table 1 presents sample distribution of the M&A sample by year. It shows a general increase in the number of M&As until 2008, sharp decreases in 2009, and increases again after 2010.

Table 1. Sample Distribution

Year	Number	Percentage
2003	3	1.23
2004	1	0.41
2005	7	2.88
2006	14	5.76
2007	31	12.76
2008	53	21.81
2009	25	10.29
2010	42	17.28
2011	67	27.57
total	243	100

3.2 Empirical Models

I examine the association between tax avoidance and M&A profitability. As such, I test hypothesis with firm acquisition-level controls in the following model:

$$CAR_{i,t} = \beta_1 + \beta_2 TAXAVOID_{i,t-1} + \beta_3 SIZE_{i,t-1} + \beta_4 LEVERAGE_{i,t-1} + \beta_5 ROA_{i,t-1} + \beta_6 OCF_{i,t-1} + \varepsilon_{i,t} \quad (1)$$

Where,

CAR: 5-day cumulative abnormal returns.

TAXAVOID: tax expense divided by income before tax.

SIZE: firm size, the natural logarithm of total assets of firm at the beginning of the fiscal year.

LEVERAGE: leverage ratio, the book value of debt scaled by the total book value of equity.

ROA: return on assets, net income scaled by the total book value of assets.

OCF: operating cash flow, operating cash flow from cash flow statement scaled by the total book value of assets.

I measure M&A returns using market-adjusted stock returns of acquirers around the time of initial announcement of M&A, since the market reaction around this time captures both the ex ante investment selection and the expected value of ex post decision-making. I compute a acquirer's 5-day Cumulative Abnormal Returns (CAR) centered on the M&A announcement date. The KOSPI value-weighted return is used for market returns. I define tax avoidance (TAXAVOID) as effective corporate tax rate, measuring it as tax expense divided by income before tax and then I multiply it

by—1 so that this variable increases as tax avoidance increases. Here, the variable of interest is the tax avoidance (TAXAVOID) and β_2 is expected to be a positive (-) value if the hypothesis is adopted. I consider four control variables which are firm size (Size), leverage (Leverage), Returns on assets (ROA) and Operating Cash Flow (OCF). I measure Size as the log transformation of the total assets and Leverage as total liability divided by total equity. I also measure ROA as net income divided by total assets and OCF as operating cash flow divided by total assets.

4. Results

4.1 Descriptive Statistics and Correlations

Table 2 lists the descriptive statistics resulting from hypothesis testing. The mean (median) 5-day acquirer cumulative abnormal returns (CAR) is 1.33% (0.91%), which means, in Korea, that the market reaction on the announcement date of the M&A is positive on average. For tax avoidance variable, the average (median) value for the firm in the sample is -0.2070 (-0.2135).

Table 2. Summary Statistics

Variable	Mean	Median	StdDev	Q1	Q3
CAR	0.0133	0.0091	0.1036	-0.0400	0.0528
TAXAVOID	-0.2070	-0.2135	0.3977	-0.2686	-0.1089
SIZE	26.8416	26.3456	2.0952	25.0626	28.6111
LEVERAGE	1.0578	0.7832	1.0255	0.3548	1.2924
ROA	0.0496	0.0528	0.0735	0.0200	0.0913
OCF	0.0541	0.0484	0.1006	-0.0023	0.1183

CAR: 5-day cumulative abnormal returns.

TAXAVOID: tax expense divided by income before tax.

SIZE: firm size, the natural logarithm of total assets of firm at the beginning of the fiscal year.

LEVERAGE: leverage ratio, the book value of debt scaled by the total book value of equity.

ROA: return on assets, net income scaled by the total book value of assets.

OCF: operating cash flow, operating cash flow from cash flow statement scaled by the total book value of assets.

Table 3 presents Pearson correlations. Panel A of table 3 reports variable correlation related to hypothesis. The market perceives M&A to be more profitable when the firm have lower tax avoidance, ROA and higher leverage.

Table 3. Pearson Correlation Matrix

Variable	TAXAVOID	SIZE	LEVERAGE	ROA	OCF
CAR	-0.1711***	-0.0780	0.1489**	-0.1295**	-0.0820
TAXAVOID		-0.0377	-0.1484**	0.0965	0.0758
SIZE			0.1999***	0.2034***	0.2740***
LEVERAGE				-0.3413***	-0.1902***
ROA					0.4666***

1) All variables are defined in Table 2.

2)*** indicates significance at the 1% level, ** at the 5% level, and * at the 10% level.

4.2 Multivariate Analysis

Hypothesis states that there is negative association between tax avoidance and M&A returns. Table 4 reports the results of the multivariate testing of hypothesis based on the estimation in Equation (1). As predicted, the results show that the coefficients of tax avoidance (TAXAVOID) on CAR are negative and significant at the 5% level. This is because tax avoidance increases information asymmetry between shareholders and managers, making it difficult for shareholders or boards to monitor opportunistic M&A decisions by managers.

Table 4. OLS Regression Analysis of the Association between Financial Reporting Quality of Acquirer Firms and Acquirer Returns

$$CAR_{i,t} = \beta_1 + \beta_2 TAXAVOID_{i,t-1} + \beta_3 SIZE_{i,t-1} + \beta_4 LEVERAGE_{i,t-1} + \beta_5 ROA_{i,t-1} + \beta_6 OCF_{i,t-1} + \epsilon_{i,t}$$

Variable	dependent variable: CAR	
	Coeff.	t Value
Intercept	0.1081	1.23
TAXAVOID	-0.0408	-2.44**
SIZE	-0.0043	-1.23
LEVERAGE	0.0385	1.04
ROA	-0.1028	-0.96

OCF	-0.0008	-0.01
F-value	2.52**	
N	243	
Adj-R ² (%)	3.04%	

1) All variables are defined in Table 2.

2)*** indicates significance at the 1% level, ** at the 5% level, and * at the 10% level.

5. Conclusion

In this study, I investigate the association between tax avoidance and firm decision-making regarding investment in the form of M&A. I find that firms with higher tax avoidance make less profitable M&As, as evidenced by 5-day cumulative abnormal returns (CAR). Tax avoidance complicates the company's transaction structure, thereby increasing the company's opacity and information asymmetry between managers and shareholders, thus preventing shareholders or board members from effectively monitoring the manager's opportunistic behavior when making investment decisions for mergers and acquisitions.

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Note

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