

# The Effects of Taxes on the Market for Corporate Control

Andrew Bird  
University of Toronto

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E-mail: [a.bird@utoronto.ca](mailto:a.bird@utoronto.ca)

## Abstract

Foreign corporations are likely to have tax advantages over US corporations for a variety of reasons, potentially influencing merger and acquisition activity – the key channel for foreign direct investment. If tax rather than productivity differences drive M&A activity, global welfare will be lower, given that ownership will not be arranged to maximize the pre-tax value of assets. I build a theory with both tax and productivity differences among potential acquirers, and develop comparative static implications describing how these differences interact with target firm characteristics to determine equilibrium in the market for corporate control. The theory yields two testable implications: that low-tax foreign bidders are more likely to acquire more profitable target firms than are high-tax domestic bidders, and that increases in available tax deductions lead to decreases in the probability of foreign acquisition. I test for these effects using the universe of all public U.S. M&As from 1990-2010. My empirical strategy exploits both cross-sectional variation in target profitability and industry-level variation in the generosity of investment allowances due to bonus depreciation after 2001. I find clear evidence in support of both predictions. First, a one standard deviation higher target profitability increases the probability that the acquirer will be foreign by 16% (or 2.8 percentage points). This result is robust to controlling for non-tax bidder differences using minority transactions, and is stronger for foreign acquirers resident in tax havens. Second, difference-in-differences estimates imply that the increase in allowances from bonus depreciation caused a 5.3 percentage point drop in foreign acquisitions in the post-reform period, which led to a welfare loss on the order of 5% of assets, or \$360B. These two dimensions of sorting suggest new ways in which domestic taxes can affect FDI and have important consequences for domestic and world welfare.