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The Merger Mystery

Why Spend Ever More on Mergers When So Many Fail?

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6. Subsidies for Merging Firms

> Eliminating the corporate interest deduction would reduce the incentive to borrow excessively. (Fleischer 2020)

> [...] tax free capital gains—these, among other factors, fuelled the coming of the takeover bid. (Kynaston p. 63)

> A cross-border takeover is to Britain's tax lawyers and accountants what a well-fed wildebeest with a limp is to a pride of lions. And this one, the meatiest one ever to have lumbered across the savannah, would be devoured more greedily than any before or since. From the moment the takeover was conceived, 'tax planners' from City law firm Linklaters and accountants PwC were set to work. (Brooks 2013, p. 95, on Vodafone's $180 bn acquisition of Mannesmann)

> [...] the central bank has, in some profound way, manipulated the market. (Foroohar 2022)

These four quotes relate to different subsidies available to businesses which have made acquisitions. The subsidies are discussed in turn in this chapter. First comes the tax break which has been extended to interest on debt used to fund M&A. Second is the way in which promoters of merger have been allowed to convert 'income' into more lightly taxed 'capital gains'. Thirdly, some cross-border acquisitions have enabled acquirers to reduce the combination's tax bill. And lastly we turn to manipulation of interest rates by central banks, which has had the incidental effect of favouring debt-financed acquisitions.

Subsidising Corporate Debt Used to Fund Merger: Tax-deductible Interest

In most jurisdictions, corporation taxes are levied on the portion of profits due to shareholders but not on the portion paid as interest to

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bondholders—it is puzzling as to why. We have tried to find a persuasive case for this tax break, but failed. In contrast there are compelling arguments that it promotes excessive risk-taking, and should be eliminated.[1] In the meantime, this privileged treatment of interest on borrowing inevitably makes it even easier to transform poor profits into enhanced surpluses for investors via a debt-financed merger.

Brooks (2013) gives revealing illustrations. He reports Spire, acquirer of BUPA hospitals, 'wiping out its taxable profits by paying interest offshore at 10%' (p. 141). And in the case of Thames Water, acquired (with a roundabout structure) by Macquarie, he links 'tax-deductible interest costs, most of it on debt owed to the offshore investors' to the result that 'in the two years to March 2011, from a £1.2bn operating profit the group that own Thames Water paid UK corporation tax of £19m' (p. 211).

Using Merger to Convert Income into More Lightly Taxed Capital Gains

Tax systems vary greatly between countries and over time. But one feature which has been fairly common, and which provides incentives for M&A even where there are no operating improvements to be had, is privileged tax status for capital gains relative to 'income'. An extreme version of this was evident in the UK in the period after the Second World War. Tax rates on personal income (including dividends) were at historically high levels; but capital gains were untaxed. This affected the decisions of shareholders in M&A targets on whether to accept a bid offer with tax-free capital gains, or to reject the offer, in favour of retaining the rights to heavily taxed future dividends from the target. Kynaston (2001) writes:

> [...] reduced dividend payouts to shareholders as a result of increased company taxation since the war, and the natural appeal to shareholders of tax free capital gains—these, among other factors, fuelled the coming of the takeover bid. (p. 63)

1 E.g. Armstrong (2020), Ford (2020b), Vandevelde (2020).

In the UK (and US) today, capital gains are taxed, but at privileged rates. And one of the fields of activity where the disparity has attracted particular criticism is the private equity (PE) industry. The business model of PE companies has been characterised as 'buy out businesses, load them with debt, and sell them' (Wade 2020).[2] They are leading players in M&A: they 'struck deals worth $559 bn worldwide in 2020 [...] More than 8,000 deals were announced [that] year, the most since records began in 1980' (Wiggins 2020b).

Early in this development Brooks (2013, p. 160) explains that the leading players 'made their serious income by putting in a small amount of their own money, typically between 1% and 3% of the investment in a fund, in return for perhaps 20% of the fund's profit. Treated as a capital gain on an investment, this so called "carried interest" would be taxed at a quarter of the top income tax rate...' Chapter 7 explores the Private Equity model in more detail.

International Tax Arbitrage via M&A

When you are teaching an MBA class in which there are almost as many nationalities as students, you soon realise how hard it is to generalise about tax arrangements across jurisdictions. Differences between countries are in some cases not accidental, but jealously preserved, with countries using preferential tax deals to attract multinationals to locate activities there. Sandbu (2021) cites estimates that 40% of global foreign direct "investment" [including M&A] is structured to lower taxes rather than for actual business investment reasons.

Such differences between countries in tax rates on businesses can then create incentives for M&A which have no other commercial logic. Tax rates on some parts of the profits of corporations headquartered in the US have sometimes been significantly higher than the rates in other jurisdictions. Simply redomiciling the business to take advantage of a lower tax regime was not allowed. But merger with a business in the lower tax jurisdiction could enable the combination to pay the lower tax rate. Americans for Tax Justice claimed that US Burger King's acquisition

2 'When you've got the Fed saying debt will stay cheap for years [...] the numbers look buoyant', said Bryce Klempner, partner at consultant McKinsey (quoted in Wiggins 2020b).

of Canadian Tim Hortons and redomiciling of the group in Canada could save some $275 m in US taxes from 2015 to 2018 (Drawbaugh 2014). The pharmaceuticals giant Pfizer sought by M&A to qualify for a lower tax rate by moving its tax base from the US to the UK or Ireland. Such a "tax inversion" motive was explicitly linked to Pfizer's bid for AstraZeneca in 2014 and for Allergan in 2015 (Crow and Ward 2016).

We quoted above Brooks' colourful description of the tax avoidance opportunities afforded by UK Vodafone's acquisition of German Mannesmann. He reported that 'This was serious "tax efficiency", wiping hundreds of millions of pounds every year off the company's tax bill.' (Brooks, p. 100)

The gain at the expense of national finances was then very significant even if the deal delivered no operating gains. As it turned out, the deal yielded disappointing operating results, and £23.5 billion of the investment in Mannesmann was written off in 2006. (Amel-Zadeh, Meeks and Meeks 2016).

Annexe to Chapter 6

Subsidising Corporate Debt: Monetary Policy Reinforcing Tax Policy

In the wake of the 2008 financial crisis, central banks wisely adopted ultra-loose monetary policy, resulting in substantial reductions in interest rates—of the order of 2%.[3] Without the intervention, the financial system was in danger of collapse. The intervention was expected to be short-lived. However, for various reasons the authorities found it convenient to continue rigging interest rates. Politicians have been fearful of restoring interest rates to their level before central bank intervention: this would increase the cost of servicing government debt and be likely to result in (politically unpopular) lower prices for assets such as houses and company shares. There developed an '"asymmetric monetary policy", whereby they supported markets when they plunged but failed to damp them when they were prone to bubbles. Excessive risk-taking in banking was the natural consequence' (Plender 2020).

Rigging the market gave some borrowers an 'exorbitant privilege' (Acharya et al. 2022): the debt was in effect subsidised by the lenders, including individuals with savings accounts or those buying annuities for retirement, for whom lower interest rates mean reduced incomes. The global stock of non-financial corporate bonds doubled in real terms between 2008 and 2019 to $13.5 trillion (Plender 2020). Among the beneficiaries were merging companies: the subsidy further magnified the gain in earnings which could be reported after a debt-funded merger which yielded no operating gains. Debt-finance came to overtake share exchange as the preferred funding mechanism for M&A. Commenting on the study from the Federal Reserve Bank of New York authored by Acharya et al. (2022), Lex (2022) wrote: 'The trillions they were able to raise at alluringly low rates were often ploughed into M&A [...] These dealmaking sprees turned out to be disastrous for those companies...'

3 See, e.g., BT (2010).