Journal of Accounting and Economics 57 (2014) 132–148

Contents lists available at ScienceDirect

Journal of Accounting and Economics

journal homepage: www.elsevier.com/locate/jae

Investors' reaction to the use of poison pills as a tax loss preservation tool ☆

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ARTICLE INFO

Article history:
Received 6 October 2012
Received in revised form
9 January 2014
Accepted 13 February 2014
Available online 12 March 2014

JEL classification:
G34
H25
K34
M41

Keywords:
Taxes
Net operating losses
Poison pills

ABSTRACT

The recent economic downturn resulted in firms generating significant tax losses, which they risked losing if they experienced an ownership change. In response, a number of loss firms adopted poison pill plans. We document a significant negative market reaction to the announcement of 62 poison pill adoptions related to net operating losses (NOLs), suggesting that in general investors do not consider management's claim that the pills are adopted to preserve a valuable tax asset to be credible. However, we find cross-sectional variation consistent with investors considering whether a pill is legitimately adopted to preserve the NOL or to entrench management.

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1. Introduction

The economic downturn beginning in 2008 resulted in many firms generating significant tax losses and suffering steep declines in market value. The combination of these two events exposes firms to a tax law that significantly reduces valuable tax assets if a firm experiences an ownership change. As a result, the number of loss firms whose boards adopted poison pills to protect their net operating losses (NOLs), hereinafter referred to as "NOL poison pills," dramatically increased beginning in 2008. We examine the market reaction to the announcement of 62 NOL poison pill adoptions. We observe a significant negative market reaction, suggesting that in general investors do not consider management's claim that the pills are adopted to preserve a valuable tax asset to be credible. However, we find cross-sectional variation that is consistent with investors considering whether a pill is legitimately adopted to preserve the NOL or to entrench management.

☆ The authors appreciate helpful comments from S.P. Kothari (the editor), an anonymous referee, Jennifer Blouin, Cristi Gleason, Terry Shevlin, Bridget Stomberg, and workshop participants at the University of Connecticut. The authors are also grateful to FactSet SharkRepellent for providing data on poison pill adoptions.

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http://dx.doi.org/10.1016/j.jacceco.2014.02.002
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Table 1
Distribution by year of NOL and non-NOL poison pill adoptions.

Calendar year	NOL poison pill sample	non-NOL poison pill sample
2000	1	222
2001	0	288
2002	4	199
2003	3	109
2004	1	91
2005	5	100
2006	5	91
2007	5	82
2008	12	126
2009	45	198
2010	23	47
2011	24	56
2012	15	73
Total	143	1,682

Shark Repellent provided us with the data on NOL and non-NOL poison pill adoptions.

Net operating losses often represent one of the most significant assets of loss firms. For instance, the mean (median) value of total federal NOL carryforwards for our sample of 62 firms adopting NOL poison pills between 2000 and 2012 is $1,165 million ($284 million), which equals 128 percent (37 percent) of total assets. When an ownership change triggers Section 382 of the Internal Review Code, many firms lose almost the entire value of their NOLs. Specifically, our sample of firms adopting an NOL poison pill would lose 93 percent of the value of their federal NOLs on average if an ownership change were to trigger Section 382.[1] Thus, the growth in NOL poison pills beginning in 2008 is not surprising. Table 1 shows that in each of the three years prior to 2008, only five firms adopted NOL poison pills. In 2008, the number more than doubled to twelve firms, and then almost quadrupled in 2009 to 45. The number fell to 23 and 24 in 2010 and 2011, respectively, and then to 15 in 2012. Table 1 also shows that non-NOL poison pill adoptions increased from 2007 to 2008 and again from 2008 to 2009, but the percentage increases were smaller than those of NOL poison pills. The increase in the number of NOL poison pills attracted the attention of proxy advisory firms, such as RiskMetric and Institutional Shareholder Services (ISS). In particular, RiskMetrics is concerned that the motivation behind adopting NOL poison pills is managerial entrenchment rather than the protection of valuable tax assets. Given the increase in the number of NOL poison pills, the economic magnitude of the NOLs at stake, and the attention of proxy advisory firms, it is important to understand how investors respond to their adoption. Do investors view NOL poison pills as a tool to protect a valuable tax asset or as a tool to entrench management?

Poison pills (also known as shareholder rights plans) are typically used as an anti-takeover device because they significantly dilute the percentage of a company's stock owned by the acquiring investor whose purchase triggers the poison pill. If an investor's purchase of shares triggers the poison pill, all shareholders except the investor acquiring more than the trigger amount are permitted to purchase shares of the firm's stock at a 50 percent discount while the acquiring shareholder is denied that benefit. Section 382 of the Internal Revenue Code limits a firm's ability to use its NOLs if one or more of a firm's five percent shareholders increases its ownership in the aggregate by more than 50 percentage points.[2] When Section 382 applies, the amount of federal NOLs a firm may use to offset taxable income in future years is limited to the market value of the firm's stock immediately prior to the ownership change multiplied by the long-term tax exempt rate.[3] Because Section 382 tracks increases in ownership by greater than five percent shareholders, the trigger percentage for NOL poison pills is typically around 4.99 percent.[4]

The threat of losing a valuable asset as a consequence of complex IRS rules would seem to provide a compelling case for adopting a poison pill plan. Nonetheless, proxy advisory firms such as RiskMetrics Group continue to oppose the adoption of poison pill plans. RiskMetrics Group notes that entrenchment is a concern because the ownership change necessary to trigger an NOL poison pill is significantly lower than the ownership change that is necessary to trigger non-NOL poison pills, which is generally around ten percent (RiskMetrics Group, 2009). However, not all proxy advisory firms oppose NOL poison

[1] The 93 percent reduction is a comparison of the total federal NOL prior to the ownership change to the annual NOL limitation under Section 382. See Appendix B for an example of how the limitation is calculated.

[2] The increase is calculated relative to the shareholder's lowest percentage ownership of stock at any time during the testing period. The testing period is a rolling three-year window that ends on the testing date. See Appendix A for a detailed example of how the Section 382 limitation is triggered. Section 382 was created to prevent trafficking of tax benefits such as NOLs and built-in losses between profitable and unprofitable companies.

[3] Section 382 only applies to federal NOLs.

[4] Poison pills are not the only means through which firms attempt to protect their NOL related deferred tax asset. In 2002, United Airlines got a bankruptcy court order that prevented the trustee of its employee-owned shares from selling enough shares to trigger Section 382. At the time, United's NOLs were valued at over $4 billion and United claimed to expect to use them to offset future taxable income.

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