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The impact of financial distress on corporate tax avoidance spanning the global financial crisis: Evidence from Australia

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ABSTRACT

Firms have the incentive to engage in corporate tax avoidance when the marginal benefits exceed the marginal costs. In fact, when firms are under financial distress, the benefits of tax avoidance outweigh the costs, increasing the incentive to avoid tax. The Global Financial Crisis (GFC) of 2008 provides a unique setting to consider whether tax avoidance differs from the pre-GFC and post-GFC periods, and whether firm management is compelled to engage in aggressive tax avoidance during periods of severe financial distress. This study examines the impact of financial distress on tax avoidance and in particular, the impact of the GFC on the association between financial distress and tax avoidance. Based on a sample of 203 publicly-listed Australian firms covering the 2006–2010 period, the regression results show that financial distress is significantly and positively associated with tax avoidance across several proxy measures of tax avoidance and financial distress. More importantly, according to the regression results, the association between financial distress and tax avoidance was magnified on account of the GFC.

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1. Introduction

Corporate tax avoidance[3] is an integral part of the capital management strategies of firms (Desai and Dharmapala, 2006; Rego, 2003; Slemrod, 2001). It involves the structuring of arrangements or transactions to take advantage of deficiencies in tax laws and regulations of a jurisdiction (Lisowsky, 2010; Wilson, 2009) or differences in tax law between jurisdictions (Atwood et al., 2012; Desai and Hines, 2009) to significantly reduce the amount of corporate taxes payable. Because corporate taxes represent a major expense item for the firm, management could be motivated to develop strategies to reduce the amount of corporate taxes payable to meet the firm's capital needs. In fact, in an assessment of tax revenue collected during periods of financial crisis, the International Monetary Fund (IMF) emphasizes that credit-constrained firms may be tempted to engage in tax avoidance as an important mechanism to finance their business operations (Brondolo, 2009). The need to conserve capital or to meet the minimum capital needs of the firm is especially important in periods of financial distress so that the firm can maintain credit ratings, meet the requirements of debt covenants or to continue as a going concern. We are thus motivated in this study to examine whether publicly-listed Australian firms engage in tax avoidance more aggressively as a result of financial distress and the associated risk-shifting behavior (Hackbarth et al., 2006; Korajczyk and Levy, 2003).

It is also possible that tax avoidance may be magnified during periods of severe financial stress such as that experienced in 2008 during the Global Financial Crisis (GFC).[4] In May 2008, the Australian Treasury

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[3] In line with existing research (e.g., Chen et al., 2010; Frank et al., 2009), corporate tax avoidance is defined as the downward management of taxable income through tax planning activities. However, we adopt a more aggressive stance regarding this definition. It encompasses tax planning activities that are considered to be aggressive in that they are designed to actively reduce taxable income by exploiting uncertainties or variability in the interpretation of the tax law, taking advantage of areas of the tax law that may fall into the gray area, undertaking arrangements or schemes designed to actively reduce corporate tax liabilities in addition to activities that are illegal.

[4] During the year 2008 in Australia, financial asset prices declined sharply and accessing international capital became increasingly difficult. Business and consumer confidence also fell, as did external demand and domestic spending weakened. By November 2008, Australian equity prices had fallen by around 50% from their peak a year earlier, and they fell further in early 2009. Australian equity markets fell more than the U.S. and global equity markets over this period (The Treasury, 2011). The weaker global economy also resulted in a reduction in demand for Australia's exports, with ensuing falls in volumes and prices leading to later falls in Australia's terms of trade and the exchange rate. The terms of trade fell in Australia by about 10% over the course of the December 2008 and March 2009 quarters, largely reflecting movements in prices of Australian key commodity exports (The Treasury, 2011). In 2008, the Treasury revised down expected tax receipts by AUD$4.9 billion in 2008–09, AUD$12.2 billion in 2009–10, AUD$12.4 billion in 2010–11 and AUD$7.9 billion in 2011–12. These downward revisions to revenue are the result of lower forecasts of capital gains tax, the substantial negative impacts on firm profits, and weaker global growth and falling terms of trade (The Treasury, 2011).

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forecasted a decline in tax receipts by around AUD$40 billion as a direct result of the GFC (The Treasury, 2011). Because of deteriorating economic and financial conditions, firms that face an increased risk of bankruptcy could perceive the potential costs of tax avoidance (e.g., penalties and reputation damage) to be minimal compared with the potential gains (e.g., the ability to continue as a going concern) (Brondolo, 2009; Campello et al., 2010, 2011, 2012). Indeed, if the potential costs of bankruptcy are high enough, firms may be willing to pursue aggressive tax avoidance practices regardless of the risk of being audited by the tax authority (Brondolo, 2009; Campello et al., 2011, 2012).

Tax planning and implementation designed to reduce current income tax expense could therefore be high on the agenda of firm management as a potential turnaround strategy when faced with financial distress. This was a concern of the Australian Taxation Office (ATO) and the Australian Treasury during the GFC. In May 2008, the Commissioner of Taxation Michael D'Ascenzo stated in relation to declining forecast tax receipts during the GFC that (ATO, 2008, p.4): "the changing economic conditions are likely to expose a company's underlying cost structures; with the emphasis sometimes shifting from profits to cash flow. In the drive to cut costs, tax costs could be seen as part of that equation." We are thus further motivated in this study to examine whether the association between financial distress and tax avoidance was magnified as a direct consequence of the GFC.

Based on a sample of 203 publicly listed Australian firms over the 2006–2010 period, the regression results demonstrate that financial distress is significantly and positively associated with corporate tax avoidance across several proxy measures of tax avoidance and financial distress. More importantly, as per the regression results, the association between financial distress and tax avoidance was magnified because of the GFC.

This study contributes to the literature in several important ways. First, it provides unique empirical evidence as to whether corporate tax avoidance is magnified during periods of severe financial distress such as that experienced during the GFC of 2008. In fact, our empirical results show that the association between financial distress and tax avoidance was magnified due to the GFC. To the best of our knowledge, this study is the first to document this association empirically. Second, this study extends the literature by examining the association between financial distress and tax avoidance generally. While prior research provides some evidence of an association between earnings quality or earnings persistence and tax avoidance (e.g., Hanlon, 2005; Phillips et al., 2003), and earnings management and financial distress (e.g., Leach and Newsom, 2007; Rosner, 2003), there appears to be little empirical research that has explicitly examined the association between financial distress and tax avoidance in general terms. Finally, this study provides some valuable insights into tax avoidance in the context of financial distress that should be useful to policymakers, investors and regulators around the world. For example, tax authorities need to be more vigilant with respect to identifying firms that significantly avoid tax, with specific emphasis on those firms under financial distress and in particular, during severe economic downturns. Moreover, knowledge of the link between tax avoidance and the level of financial distress faced by firms will likely be value relevant to investors in assessing risk premiums related to future cash flows and the cost of capital (Hutchens and Rego, 2013).

The remainder of this paper is organized as follows. Section 2 develops our hypotheses. Section 3 discusses the research design. Section 5 summarizes and analyzes the empirical results. Finally, Section 5 concludes the paper.

2. Background and hypothesis development

2.1. Background

Corporate financial distress, according to Altman and Hotchkiss (2006), is a rather vague term which can be further attributed to four generic terms commonly used in business research: *failure*, *insolvency*, *bankruptcy* and *default*. Failure arises when the realized rate of return on invested capital, with allowance for risk consideration, is significantly and continually lower than prevailing rates on similar investments or insufficient revenues to cover costs, and where the average return on investment is constantly below the firm's cost of capital. Insolvency in technical terms refers to another type of financial distress whereby a firm cannot meet its current obligations, possibly due to liquidity concerns. Bankruptcy is also a technical term indicating that the firm is in financial distress and which in most jurisdictions requires a legal declaration involving the courts. Finally, default is usually described in two cases as either technical or legal. Technical default refers to the case where a firm violates a condition of a contract/covenant in place with a creditor. Failure to meet periodic repayments on a loan is more likely to give rise to a legal default. Both types of default are a signal of declining firm performance and financial distress (Altman, 2000; Altman and Hotchkiss, 2006).

Critically, financial distress increases incentives for risk-shifting behavior to occur by shareholders and their agents (i.e., firm management) (Eberhart and Senbet, 1993; Maksimovic and Titman, 1991; Thorburn, 2004). The risk-shifting behavior relates to the asset substitution problem which has been extensively researched in the finance literature. According to Black and Scholes (1973), it is viewing levered equity as a call option on the value of the firm's assets. Moreover, Galai and Masulis (1976) and Jensen and Meckling (1976) show that the positive association between stock value and underlying asset volatility generates an incentive for shareholders to expropriate wealth from bondholders by moving the firm's assets into high-risk projects. This could divert resources away from maximizing shareholders wealth. Indeed, in times of financial distress, risk-shifting behavior increases (Eberhart and Senbet, 1993; Maksimovic and Titman, 1991). While there are several methods to mitigate risk-shifting behavior, more traditional methods (e.g., the use of convertible bonds) are ineffective in times of financial distress (Eberhart and Senbet, 1993). Thus, rational bondholders recognize the incentive to shift risk during financial distress, and price the firm's debt with the belief that shareholders make investment choices toward high-risk, albeit lower value projects (Eberhart and Senbet, 1993). This could lead to a higher cost of capital for financially distressed firms and provide them with further willingness to undertake riskier corporate policies (Edwards et al., 2013).

2.2. Corporate financial distress and tax avoidance

According to Edwards et al. (2013), there are several implications for a firm's tax policy when in financial distress. For example, an increase in the cost of capital, a reduction in access to external funding sources (debt in particular) faced by distressed firms and in general, a willingness of managers to take-on more risk changes a firm's equilibrium position regarding tax avoidance. In equilibrium, a firm will undertake tax avoidance strategies as long as the marginal benefits exceed the marginal costs (Chen et al., 2010). A firm in financial distress may have little option but to adopt a higher risk appetite and become more tax aggressive as the need to raise cash becomes critical, especially as the tax expense is a significant cash outflow even for distressed firms and despite any negative reputational effects.[5] Thus, in times of financial distress, strategies that were previously viewed as more risky or costly for the firm to undertake may become more appealing and viable as the potential benefits of tax avoidance increase.

[5] Tax planning costs include explicit direct costs such as consulting fees paid to outside consultants, possible fines and penalties resulting from Internal Revenue Service (IRS) audits, and salaries and other costs associated with running a tax department. Tax planning costs also include indirect costs such as low rates of return on investments in tax-favored assets (also known as implicit taxes) (Scholes et al., 2005).

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