



The separation of ownership and control and corporate tax avoidance [☆]



Brad A. Badertscher ^{a,1}, Sharon P. Katz ^{b,2}, Sonja O. Rego ^{c,*}

^a Notre Dame University, 371 Mendoza College of Business, Notre Dame, IN 46556-5646, USA

^b Columbia Business School, Uris Hall, 3022 Broadway, Room 605A, New York, NY 10027, USA

^c Indiana University, Kelley School of Business, 1309 E. 10th St., Bloomington, IN 47405-1701, USA

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ABSTRACT

We examine whether variation in the separation of ownership and control influences the tax practices of private firms with different ownership structures. Fama and Jensen (1983) assert that when equity ownership and corporate decision-making are concentrated in just a small number of decision-makers, these owner-managers will likely be more risk averse and thus less willing to invest in risky projects. Because tax avoidance is a risky activity that can impose significant costs on a firm, we predict that firms with greater concentrations of ownership and control, and thus more risk averse managers, avoid less income tax than firms with less concentrated ownership and control. Our results are consistent with these expectations. However, we also consider a competing explanation for these findings. In particular, we examine whether certain private firms enjoy lower marginal costs of tax planning, which facilitate greater income tax avoidance. Our results are consistent with the marginal costs of tax avoidance and the separation of ownership and control both influencing corporate tax practices.

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1. Introduction

In this study we investigate the impact of ownership structure on corporate tax avoidance. Shackelford and Shevlin (2001) note that little is known about the cross-sectional differences in the willingness of firms to minimize taxes. They

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* Corresponding author. Tel.: +1 812 855 6356.

E-mail addresses: bbaderts@nd.edu (B.A. Badertscher), sk2280@columbia.edu (S.P. Katz), sorego@indiana.edu (S.O. Rego).

¹ Tel.: +1 574 631 5197.

² Tel.: +1 212 851 9442.

point out that insider control is an important but understudied organizational factor that impacts corporate tax avoidance. We take advantage of a unique sample of firms with privately-owned equity but publicly-traded debt and examine whether variation in the separation of ownership and control (i.e., the extent of inside ownership) influences income tax avoidance at private firms.³

Our sample includes private firms that are majority-owned by the firm's managers (i.e., management-owned firms) and private firms that are owned by private equity (PE) firms (i.e., PE-backed firms).⁴ As a result, our research setting exhibits substantial variation in the separation of ownership and control, as reflected in the proportion of stock owned by the firm's managers.⁵ Due to their public debt, sample firms are required to file financial statements with the Securities and Exchange Commission (SEC). These filings allow us to utilize audited financial information and examine corporate tax practices while holding financial reporting requirements constant. Moreover, because the private firms in our sample are subject to less public scrutiny than publicly-traded firms (Givoly et al., 2010), they place less weight on financial reporting decisions and more weight on tax reporting decisions, relative to public firms (e.g., Penno and Simon, 1986; Beatty and Harris, 1998). All of these features enhance the power of our empirical tests.

Our first analysis compares the income tax avoidance of management-owned and PE-backed private firms. We predict that management-owned firms avoid less tax than PE-backed firms because management-owned firms have more highly concentrated ownership and control than PE-backed firms. Our prediction is based on Fama and Jensen's (1983) theory that when equity ownership and corporate decision-making are concentrated in just a small number of decision-makers, these owner-managers will likely be more risk averse and thus less willing to invest in risky projects. Since tax avoidance is a risky activity that can impose significant costs on firms and their managers (e.g. Desai and Dharmapala, 2008; Hanlon and Heitzman, 2010; Rego and Wilson, 2012), we conjecture that firms with more highly concentrated ownership and control (and thus more risk averse managers) avoid less income tax than firms with less concentrated ownership and control. Because PE firms do not randomly select firms to acquire (e.g., PE firms generally acquire firms with stable profits and cash flows, low leverage, and little risk of financial distress, as documented in Opler and Titman, 1993), we follow the Heckman (1979) procedure to mitigate potential selection bias in our sample of management-owned and PE-backed private firms.⁶ Using the Heckman procedure and several measures of corporate tax avoidance, we find that management-owned firms avoid significantly less income tax than PE-backed firms. These results suggest that firms with more concentrated ownership and control tolerate less tax risk.

We evaluate the robustness of our results in a variety of ways. First, we compare the tax avoidance of firms with higher rates of managerial stock ownership to the tax avoidance of firms with lower rates of managerial stock ownership, utilizing settings that either exclude PE-backed firms (e.g., management-owned firms compared to employee-owned firms) or include only PE-backed firms (e.g., minority-owned PE-backed firms compared to majority-owned PE-backed firms). In each case we find that firms with higher rates of managerial stock ownership avoid less income tax than firms with lower rates of managerial stock ownership, consistent with tax avoidance increasing in the separation of ownership and control. Second, because PE firms may select firms to acquire based on specific observable attributes, we also perform our tests based on propensity score matched samples of management-owned and PE-backed firms, both with and without the Heckman (1979) procedure. Inferences based on results for these tests are substantially similar to those for tests that only utilize the Heckman (1979) procedure.

We next consider a competing explanation for why management-owned firms avoid less income tax than PE-backed firms. Given their reputation for reducing portfolio firms' costs of debt with lenders (e.g., Kaplan and Stomberg 2009; Demiroglu and James, 2010; Ivashina and Kovner, 2011), PE firms may also be able to reduce portfolio firms' marginal costs of tax avoidance, resulting in greater tax avoidance at PE-backed firms than at management-owned firms.⁷ We examine this competing explanation by identifying subsets of firms that likely have lower marginal costs of tax avoidance. We first partition PE-backed firms based on whether the PE-backed private firm is owned by: (1) a PE firm that owns many vs. fewer portfolio firms, and (2) a large vs. a small PE firm (based on total capital under PE firm management). We predict private firms owned by PE firms that own many portfolio firms avoid more income tax than private firms owned by PE firms that own fewer portfolio firms. We also predict that private firms owned by large PE firms avoid more income tax than private firms owned by smaller PE firms. Our predictions are based on PE firms' economies of scale and scope, which should reduce

³ For the remainder of this paper we refer to firms with private equity and public debt as "private" firms and firms with public equity and public debt as "public" firms. We note that sample firms are on average larger, have higher credit and earnings quality, and are financially stronger than private firms that do not issue public debt (Cantillo and Wright, 2000; Denis and Mihov, 2003; Bharath et al., 2008; Katz, 2009; Givoly et al., 2010).

⁴ PE firms, such as The Blackstone Group, The Carlyle Group, and Kohlberg Kravis & Roberts, manage investment funds that generally buy mature businesses via leveraged buyout transactions.

⁵ To illustrate, the mean (median) proportion of stock owned by managers at management-owned firms is 66.4 (79.4)% but just 8.9 (4.2)% at PE-backed private firms (see Table 2). In contrast, the mean (median) proportion of stock owned by managers at S&P 1500 public firms is 5.7 (2.5)%, with an interquartile range of 3.8% (based on ownership data obtained from ExecuComp, 1992–2010).

⁶ If PE firm acquisition choices are correlated with target firm tax planning, then PE firm ownership could be endogenously related to tax avoidance in our sample of private firms. Sections 3.2 and 4.7.1 discuss the endogeneity issues that surround our empirical tests and the various methods we adopt to mitigate potential selection bias.

⁷ We define the marginal costs of tax avoidance in a manner consistent with Brickley et al. (2009), where marginal costs are the incremental costs associated with a decision (p. 38). In our study, we predict the incremental costs of implementing a particular tax strategy are lower for some PE-backed firms, due to the economies of scale and scope of their PE firm owners.

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