Journal of Accounting and Economics 56 (2013) 311–328

Contents lists available at ScienceDirect

Journal of Accounting and Economics

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

Personally tax aggressive executives and corporate tax sheltering ☆

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ARTICLE INFO

Article history:
Received 12 June 2012
Received in revised form
17 September 2013
Accepted 20 September 2013
Available online 29 September 2013

JEL classification:
K3
L5
H30
H3

Keywords:
Tax aggressiveness
Tax sheltering
Executive personal traits
Stock option exercise backdating

ABSTRACT

This paper investigates whether executives who evidence a propensity for personal tax evasion (suspect executives) are associated with tax sheltering at the firm level. I adapt recent research to identify the presence of these executives and examine associations between suspect executive presence and firm-level measures of tax sheltering. The results indicate that the presence of suspect executives is positively associated with proxies for corporate tax sheltering. In addition, firm-years with suspect executive presence have significantly higher cash tax savings relative to firm-years without suspect executive presence. I also investigate the firm value implications of suspect executive presence and find that increases in tax sheltering are incrementally more valuable for firms that have suspect executives than similar increments made by firms that do not have suspect executives.

1. Introduction

In this study I examine whether executives with a propensity to engage in questionable transactions for personal tax gain are more likely to do the same for corporate tax purposes. Adapting the techniques in Dhaliwal et al. (2009) and Cicero (2009), I identify executives (suspect) with evidence of individual tax evasion through manipulative stock option exercise backdating then test for associations between the presence of these executives and corporate tax sheltering. My tests cover firm-years with and without suspect executive presence allowing me to control for stationary firm characteristics and better capture the impact suspect executives have on corporate tax sheltering.[1] I find that executives who appear willing to push the envelope for personal tax savings appear to do the same at the firms they manage. My study advances recent research

☆ I appreciate helpful comments from Jerry Zimmerman (editor) and an anonymous reviewer. This study stems from my dissertation completed at the University of Arizona. I thank my dissertation committee: Dan Dhaliwal (chair), Dan Bens, Kirsten Cook, and Oliver Li for their guidance on this project. I also thank Ken Anderson, Don Bruce, John Campbell, Joe Carcello, Bryan Cloyd, Scott Dyreng, Michelle Hanlon, Pete Lisowsky, LeAnn Luna, Terry Neal, and Logan Steele. I appreciate suggestions from workshop participants at the University of Arizona; McGill University; Notre Dame University; University of Arkansas; University of Houston; Southern Methodist University; University of Tennessee; and Virginia Tech University. Finally, I gratefully acknowledge financial support from the Deloitte Foundation's Doctoral Fellowship Program.

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[1] I focus on CEOs and other top executives including executives designated as Board Chairman, CFO, President, or Chief Operating Officer, consistent with Dhaliwal et al. (2009) and similar to Dyreng et al. (2010) who focus on the 5 most highly compensated executives.

0165-4101/$ - see front matter
http://dx.doi.org/10.1016/j.jacceco.2013.09.003

including Dyreng et al. (2010) by isolating a personal attribute that helps researchers add to our understanding of the cross-sectional variation in corporate tax sheltering (Shevlin, 2002) and tax aggressiveness (Shevlin, 2007).

A number of recent academic studies have explored the determinants of corporate tax avoidance, but only Dyreng et al. (2010) examine whether individual top executives have incremental effects on their firms' tax avoidance that cannot be explained by characteristics of the firm.[2] Unlike Dyreng et al. (2010) I focus on the most severe or aggressive form of tax avoidance, namely, corporate tax shelters. Tax sheltering is differentiated from the more benign "avoidance" documented by Dyreng et al. (2010) in that the main goal of sheltering is to lower tax liabilities by exploiting discontinuities in the tax law (Department of the Treasury Report (7-1999), 2009). In some cases, sheltering could enter gray areas of the law when, for example, it does not exhibit "economic substance" or a "business purpose", that is, when a shelter is created solely for evading tax rather than for fulfilling a non (or pre-) tax economic need (Lisowsky, 2010). Focusing on sheltering provides an empirical setting to align evidence of manipulative executive behavior for personal tax gain with constructs of tax aggressiveness at the firm level. My results extend the work by Dyreng et al. (2010) who do not link tax avoidance to specific executive biographical characteristics or managerial styles. Thus, their study provides evidence of an executive impact on tax avoidance, but is unable to tell us how or why.

Research in the finance and management literatures links personal traits such as CEO narcissism (Chatterjee and Hambrick, 2007) and underlying psychological "attitudes" (Graham et al., 2012) to corporate financial policy choices including debt ratios, debt maturity, and acquisition activity. Cronqvist et al. (2012) go beyond an observation of personal traits and examine whether specific *actions* a CEO takes in his/her personal life affects the actions they take in their professional life. Specifically, they show that when CEOs take on larger amounts of leverage in their personal finances, they also take on larger amounts of leverage at the firms they manage. My study contributes to this literature by investigating an additional action the CEO takes in their personal lives (i.e., tax evasion). The tax setting of my study is novel because extreme risk-taking with tax aggressiveness may result in unique negative externalities to the firm such as fines, penalties, losses in reputation, and tighter monitoring by external parties such as the Internal Revenue Service.

For my empirical tests I combine large sample estimates of corporate tax sheltering probability with data on suspect executive presence from the Thomson Financial Insiders Database of equity and equity derivative transactions. Because firms generally do not disclose their tax shelter involvement I use the *TSSCORE* inferred shelter probability score from Lisowsky (2010). Lisowsky (2010) notes that his results support the use of *TSSCORE* as a reliable way to identify the most severe forms of tax aggressiveness.[3] I document a significant positive relation between suspect executive presence and *TSSCORE*, suggesting that executives who appear to evade personal taxes are more likely to shelter at the firm-level.

Next, I examine the timing of differences in tax sheltering before, during, and after suspect executive tenure. Relative to periods with suspect executive presence, I find that tax sheltering probability is lower in both time periods before suspect executive arrival and time periods after suspect executive departure. Furthermore, reductions in sheltering before suspect arrival are statistically indistinguishable from reductions in tax sheltering after suspect executive departure. This result further supports the role of suspect executives in corporate tax sheltering.

In supplemental analyses I document evidence of a negative association between suspect executive presence and cash effective tax rates (*CETR*), but no such relationship with GAAP effective tax rates (*ETR*). Although both are likely noisy measures of corporate tax sheltering, including these tests helps align my results with prior research (Chen et al., 2010; Dyreng et al., 2010; Higgins et al., 2013; Chyz et al., 2013; and others). These tests also provide some evidence of whether tax sheltering translates into cash or GAAP tax savings and highlights the relative importance to suspect executives of financial reporting tax expense versus cash taxes paid.

An additional question given my findings is whether the presence of suspect executives benefits shareholders. On one hand, suspect executives impose costs on the firm. Cicero (2009) estimates that stock option exercise backdating results in an average tax cost to the firm of $85,326 from reduced corporate tax deductions.[4] In addition, the use of corporate tax shelters increases the potential for penalties and back taxes assessed against firms, as well as the potential for higher agency costs (Desai and Dharmapala, 2009; Chen et al., 2010). On the other hand, backdating stock options could signal executive expertise in general and corporate tax savvy in particular, suggesting suspect executives could improve firm value through tax sheltering. In empirical analyses, I find no evidence that tax sheltering or suspect executive presence is individually related to firm value. Consequently the total effect of suspect executive presence and tax sheltering on firm value appears to be zero. However, I find that increases in tax sheltering are incrementally more valuable for firms that have suspect executives than similar increments made by firms that do not have suspect executives.

In addition to the studies mentioned above, my paper also contributes to the accounting literature by providing an additional explanation for the cross-sectional variation in the levels of corporate tax avoidance. Though empirical studies have identified factors that impact tax avoidance (Gupta and Newberry, 1997; Phillips, 2003) significant unexplained cross-sectional variation remains (Desai and Dharmapala, 2006; Dyreng et al., 2008; Shackelford and Shevlin, 2001). My results

[2] See Hanlon and Heitzman (2010) for a review of the recent literature documenting determinants of tax avoidance. I define tax aggressiveness as activities along the higher/more uncertain end of the tax avoidance continuum framework described in Hanlon and Heitzman (2010).

[3] I thank Petro Lisowsky for providing me with his *TSSCORE* measure. The *TSSCORE* measure is constructed using a more comprehensive set of determinants but is similar in design to the *SHELTER* measure from Wilson (2009) and Rego and Wilson (2012).

[4] Reduced corporate tax deductions are the result of a lower compensation expense that results from a lower spread between strike price and opportunistically back-dated stock price. See Section 2.1 and footnote 10 for more detail.