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Dual entrenchment and tax management: Classified boards and family firms[☆]

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ABSTRACT

This study examines whether and how multiple managerial entrenchment devices within a firm, specifically the structure of the board of directors and family firm status, interact to influence tax management. Using a sample of 4,000 U.S. public firm-year observations covering the period 1999–2013, we find that the classified board structure and family firm status are both negatively related with tax avoidance. However, accounting for the interaction between board structure and family firm status, we also find that the negative associations between both entrenchment measures and tax management apply *only* where the other entrenchment mechanism is absent. In further analysis, we find that higher levels of monitoring by institutional investors neutralize the interaction between the presence of a classified board and family firm status. Our evidence highlights that governance/monitoring mechanisms can interact in complex ways, including an offsetting effect between potentially redundant dual-level entrenchment mechanisms, to influence tax management behavior.

1. Introduction

Factors associated with the tax management practices of corporations have been the subject of a stream of literature that has developed rapidly since the early 2000′s, motivated largely by high-profile instances of aggressive corporate tax avoidance reported in the popular press,[1] government reports lamenting lost revenues due to such practices,[2] and government actions aimed at curbing them.[3] A branch of this literature explores corporate tax management in an agency theory context (e.g., Desai & Dharmapala, 2006), and studies have recently begun to consider the impact of firm characteristics associated with managerial entrenchment on tax management activity (e.g., Badertscher, Katz, & Rego, 2013; Chen, Chen, Chen, & Shevlin, 2010; McGuire, Wang, & Wilson, 2014; Minnick & Noga, 2010). We contribute to this literature by investigating the interplay between multiple managerial entrenchment devices coexisting within the firm (i.e., dual entrenchment) as determinants of tax management. Specifically, we examine whether the classified board and family ownership structures, as measures of entrenchment, influence tax management activity differently where both are present within the firm.[4]

Firms must consider the tradeoff between the marginal benefits and costs of acting in a more aggressive manner when deciding on tax transactions. These are very important decisions as the benefits, which relate to the increased cash flows from managing the payment of taxes,

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[1] Examples include the hundreds of billions of dollars shifted by U.S. corporations to tax haven countries recently detailed in the Panama Papers (Mindock & Sirota, 2016) and the prominent tax shelter scandals around the turn of the century (e.g., Enron).

[2] Examples include 1) a 2016 report by the United States Government Accountability Office, 2016 which states that 42.3% of all large U.S. corporations and 19.5% of profitable large U.S. corporations reported no tax liability in 2012 and 2) a 2016 report by the Internal Revenue Service, 2016 (IRS) in which it estimates that total corporate underreporting of income tax over the 2008–2010 period was approximately 41 billion dollars annually on average.

[3] Examples include the Department of the Treasury's 2014 and 2016 implementation of new rules to curb corporate inversions, the 2010 implementation of Schedule UTP to the federal corporate income tax return (for large companies, a detailed listing of uncertain tax positions), the 2004 implementation of Schedule M-3 to the federal corporate income tax return (for large companies, a detailed breakdown of the differences between financial statement and taxable income), the 2004 amendment to IRC §6111 requiring tax advisors to disclose information about tax shelter transactions, and the 2003–2004 congressional hearings on tax shelters.

[4] Following previous research, for the purposes of this study, we define tax management broadly to represent the extent to which firm managers engage in tax planning to manage the reduction of tax-related cash outflows, tax liabilities, and/or tax expense. As discussed later, we focus on the tax avoidance aspect of overall tax management in our tests, operationalizing avoidance as the levels and volatility of cash effective tax rates (Dyreng et al., 2008; Hanlon & Heitzman, 2010; Minnick & Noga, 2010).

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can be significant. On the other hand, potentially consequential costs include the transaction costs directly associated with making tax decisions, penalties assessed on such behavior by the tax authorities, the reputational and political costs that may result, and agency costs related to rent extraction made possible by more complex and obscure transactions (Desai & Dharmapala, 2006). Given the intricacies of decision making and the variability in agency and other issues as potentially significant tradeoff components, firms with different characteristics that can impact these issues may commit to different levels of activity when making decisions in the tax policy context. Further interest in examining this area is initiated by researchers who call for additional investigations into agency concern effects on or deeper firm-level determinants of tax management strategy (e.g., Hanlon & Heitzman, 2010; Shackelford & Shevlin, 2001).

Among studies that consider a governance perspective, consistent with agency theory, a few investigate how firm characteristics that enable strong managerial entrenchment (e.g., board and ownership structure) impact tax management. With respect to board structure, Minnick and Noga (2010) explore the roles of compensation and corporate governance in tax management. Their results are consistent with expectations within a typical agency conflict perspective. That is, they find that compensation packages and certain corporate governance mechanisms have a significant effect on tax management efforts and focus. Particularly, they document that firms with classified boards engage in lower levels of tax management, which is consistent with the notion that such firms exhibit lazy tendencies as a result of the entrenchment of directors and managers. This evidence is also consistent with other studies which find that the classified board structure can entrench management, potentially leading to lower performance and value (e.g., Bebchuk & Cohen, 2005; Faleye, 2007).

Several recent studies provide evidence that ownership structures which facilitate managerial entrenchment, such as dual class ownership (McGuire et al., 2014) and concentrated insider ownership (Badertscher et al., 2013), are also associated with lower levels of tax management. In examining family firms, Chen et al. (2010) explicitly consider whether the unique agency conflict that exists between family shareholders and minority shareholders differentially impacts a firm's level of tax management. The authors posit that family owners have higher stakes in terms of the benefits and costs associated with tax management behavior relative to non-family owners. Further, agency issues, which include price discounting imposed by minority external shareholders who anticipate rent extraction or other entrenchment consequences by family shareholders, may impose additional tax management-related costs. Their main finding that family firms exhibit less tax management behavior, therefore, suggests that family owners weight the costs of tax management, particularly price discounting from perceived entrenchment, more heavily than the benefits derived from the resultant tax savings.[5]

We investigate the interaction between board structure and family firm status (i.e., dual entrenchment) as determinants of tax management, focusing on the avoidance dimension of tax management. In particular, we regress measures of tax avoidance (cash effective tax rates and variability in cash effective tax rates) on two entrenchment indicator variables identifying firms with classified vs. unitary boards and family vs. non-family firms, along with an interaction between them. Our results using a sample of 4000 firm-year observations covering the period 1999–2013 suggest that accounting for the interaction between two significant measures of entrenchment within a firm is important. Specifically, we find that the classified board structure and family firm status are both negatively related with tax avoidance, consistent with the evidence in Minnick and Noga (2010) and Chen et al. (2010), respectively. However, we also find that the negative associations between both of our entrenchment measures and tax management apply only where the other entrenchment mechanism is not present. That is, our evidence indicates that multiple strong entrenchment mechanisms that exist concurrently can negate each other's effects completely with respect to tax management, rather than strengthening each other or leaving one redundant. These results hold for our measures of both levels and riskiness of tax avoidance.

In additional analysis, based on the documented general resistance of institutional owners to entrenchment mechanisms, notably the classified board structure (Bebchuk, 2003; Klausner, 2003), we examine whether high levels of institutional ownership impact our main findings. Results indicate that monitoring by institutional investors neutralizes the interaction between board structure and family firm status, which shows that internal and external governance/monitoring mechanisms can interact in complex ways in this setting.

Our research is similar to Minnick and Noga (2010) and Chen et al. (2010) in that we explore corporate tax management in the board structure and ownership settings. However, our study differs from theirs on a few important dimensions. First, we characterize the classified board and family ownership structures as independent measures of managerial entrenchment in an agency context and introduce the notion of interactive effects between them where they coexist within a firm. Accordingly, we address new and interesting questions involving the presence of potentially redundant dual-level entrenchment strategies on tax management behavior. Second, we expand on the Chen et al. (2010) finding of an offsetting interaction between family firm status and institutional ownership. By considering the monitoring role of institutional investors in neutralizing multiple dimensions of entrenchment and the interaction between them, we explore a more complex interplay between external and internal governance/monitoring mechanisms. Finally, unlike Minnick and Noga (2010) and Chen et al. (2010), which focus solely on levels of tax avoidance, we examine these entrenchment effects relative to both levels and riskiness of tax avoidance activity (e.g., Dyreng, Hanlon, & Maydew, 2016; Guenther, Matsunaga, & Williams, 2017; Hutchens & Rego, 2015).

This paper contributes to the literature in several ways. First, we extend the literature regarding the Desai and Dharmapala (2006) agency theory view of tax avoidance by examining the effects of board structure and ownership structure on tax management strategy (e.g., Badertscher et al., 2013; Chen et al., 2010; McGuire et al., 2014; Minnick & Noga, 2010). Specifically, we show that, on average, where two levels of managerial entrenchment coexist within a firm (e.g., a classified board in a family firm), the interactive dual-level entrenchment effect can completely negate the individual influences of both entrenchment devices on managers' behavior. To our knowledge, the finding of such interactive effects between multiple entrenchment devices concurrently existing within a firm is new to the literature. Further, this study expands our understanding of how different governance/monitoring mechanisms combine to influence firm decisions by examining board structure, ownership structure, and institutional ownership, as well as interactive relationships between these factors, in a tax planning context. We highlight the interplay between internal (board structure and family firm status) and external (institutions) governance/monitoring factors on corporate tax management. In addition, this study utilizes the interface between the legal framework of a firm's organizational and board structures and accounting via tax management behavior. In this way, our evidence also informs policymakers concerned with how firms' governance/monitoring characteristics interact (in an agency setting) to influence corporate tax reporting behavior.

The remainder of this paper is organized as follows: Section 2 provides a review of relevant prior literature and develops our hypothesis. Section 3 discusses the methodology and data used in this study. Section 4 presents the results of our analyses, and Section 5 concludes.

[5] Steijvers and Niskanen (2014) also examine the impact of family firm status on tax management using survey data from private family and non-family firms in Finland between 2000 and 2005. Consistent with Chen et al. (2010), they find that private family firms engage in less tax management activity than private non-family firms.