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Research note

Tax aggressiveness in family firms and the non-linear entrenchment effect

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ABSTRACT

This article examines whether family firms are more tax aggressive than nonfamily firms when family involvement is greater. By testing our predictions on a panel of listed Italian firms, we find that the family status has a moderating non-linear effect on corporate tax aggressiveness, as too much family involvement (which is otherwise beneficial) causes the detrimental outcome of higher tax aggressiveness. As a novelty to the literature, we show that family involvement has a non-linear impact on tax aggressiveness in family firms, as concerns about a family versus minority conflict arise when the family is too entrenched.

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1. Introduction

Tax aggressiveness (Hanlon & Heinzman, 2010; Shackelford & Shevlin, 2001) generally originates in an agency framework in which managers behave opportunistically and extract rents from tax savings at the expense of shareholders (Desai & Dharmapala, 2006). Because tax manipulations consist of temporary or permanent modifications of reported accounting numbers (Graham, Raedy, & Shackelford, 2012; Slemrod & Yitzhaki, 2002), we would expect that the higher the tax aggressiveness, the lower the earnings quality (Ayers, Jiang, & Yeung, 2009; Badertscher, Phillips, Pincus, & Rego, 2009; Frank, Lynch, & Rego, 2009; Hanlon, 2005).

Only two studies (Chen, Chen, Cheng, & Shevlin, 2010; Steijvers & Niskanen, 2014) specifically investigate tax aggressiveness in a family context, both grounded in agency theory and finding that family firms are less tax aggressive than nonfamily firms. In an agency framework, ownership concentration is the most typical feature of family involvement, producing the following two countervailing effects on the governance of corporations: an alignment (or incentive) effect,[1] which makes monitoring of management more efficient, and an entrenchment effect, which makes it easier for opportunistic owners to expropriate minority owners (Morck, Wolfenzon, & Yeung, 2005). In the investigation of the impact of family involvement on firms' tax aggressiveness, Chen et al. (2010) document the relevance of the alignment effect due to family ownership, whereas Steijvers and Niskanen (2014) support that the salience of family socio-emotional wealth favors an alignment effect.

In some institutional contexts (including the Italian context), the entrenchment effect prevails, originating from the high concentration of ownership and the active involvement of the family in the management of the firm. These impel the family to divert resources from the firm, addressing their own purposes at the expense of minority shareholders.

Supporting the fact that family firms cannot be considered homogeneous across different institutional contexts, in this article, we question how different levels of family involvement impact the tax aggressiveness of the firm by testing whether family firms that are too entrenched are more tax aggressive than their counterparts. Our findings demonstrate a non-linear impact of family entrenchment on tax aggressiveness, which has not been measured in the literature so far.

2. Research design

2.1. Definition of variables

The dependent variable is the effective tax rate, which is the most commonly used proxy for tax aggressiveness. Following the dominant literature (Hanlon & Heinzman, 2010), we adopt the GAAP effective tax rate (*ETR*), measured as the total expense for

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[1] An alignment effect occurs when the manager/agent aligns his own interests with those of the owner/proprietor, reducing the concerns about managerial expropriations.

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income taxes scaled by pre-tax income. Thus, a larger *ETR* would imply a lower tax aggressiveness of the firm, and *vice versa*.

The explanatory variables designate the firm as family or nonfamily based on the measurement of family proprietorship in the equity and family activity in the management of the firm. First, following Villalonga and Amit (2006), we assign a general indicator of family status (*FAMILY*) as 1 if the founder (or acquirer) or a member of the founding (or acquiring) family, by either blood or marriage, is an officer, director, or block-holder with at least 5% of voting rights.

Second, we measured the involvement in the ownership and management of the firm using the indicator *INVOLVEMENT*. The concentration of equity in the hands of the main block-holder serves as a proxy for family involvement in ownership, and it is measured in the following three different ways: *i) OWN25*, which is assigned to be 1 if the shares held by the main block-holder are more than 25% of equity, and 0 otherwise; *ii) OWN50*, which is assigned to be 1 if the shares held by the main block-holder are more than 50% of equity, and 0 otherwise; and *iii) OWNERSHIP*, which is the percentage of ownership held by the main block-holder. The shares held by different individuals of the same family group are summed to total the main block-holder's ownership, as described above.

The involvement of the family in the ownership is captured by the interaction of the variable indicator *FAMILY* and the variables measuring involvement in ownership (*FAMILY*INVOLVEMENT*).

The involvement of the family in management is also captured using the interaction term between *FAMILY* and the indicator *INVOLVEMENT*, which, in this step, measures the involvement of the family in the managerial activities of the firm. We measure involvement in management using the following three alternate variables: *i) CEODUAL*, which is 1 if the CEO and chairperson are the same individual, and 0 otherwise; *ii) AFF50*, which is 1 if the board is composed of a majority of members who are the main block-holder's affiliate directors, and 0 otherwise; *iii) AFFILIATE*, which counts the number of the main block-holder's affiliate directors sitting on the board.

A set of additional financial controls is used in the empirical test: profitability (*ROA*, measured as the operating income scaled by lagged total assets); leverage (*LEV*, measured as long-term debt scaled by lagged total assets); capital intensity (*PPE*, that is property, plant and equipment scaled by lagged total assets); intangible intensity (*INTANG*, measured as intangible assets deflated by lagged total assets); size (*SIZE*, that is equal to the logarithm of total assets), and market value of the firm (*MB*, measured as market value scaled by lagged total assets).

We also included dummy period fixed effects (η_t) and dummy industry fixed effects (η_j).

2.2. Regression model

The basic regression model adopted is described as follows:

$$ETR_{it} = \alpha_0 + \alpha_1 FAMILY_{it} + \gamma_1 ROA_{it} + \gamma_2 LEV_{it} + \gamma_3 SIZE_{it} + \gamma_4 PPE_{it} + + \gamma_5 INTANG_{it} + \gamma_6 MB_{it} + \eta_t + \eta_j + \varepsilon_{it} \quad (1)$$

This model resembles the model adopted in previous literature (Chen et al., 2010), and it simply predicts a linear impact of the family indicator on the tax aggressiveness of the firm. In this article, we reconsider the linear relationship and expand the model in Equation (1), testing the moderating effect of family involvement in ownership and management on the tax aggressiveness of the firm. The model is able to test this moderating effect of *INVOLVEMENT* on the *FAMILY-ETR* relationship, which is described as follows:

$$ETR_{it} = \alpha_0 + \alpha_1 FAMILY_{it} + \alpha_2 INVOLVEMENT_{it} + \alpha_3 FAMILY *INVOLVEMENT + \gamma_1 ROA_{it} + \gamma_2 LEV_{it} + \gamma_3 SIZE_{it} + \gamma_4 PPE_{it} + \gamma_5 INTANG_{it} + \gamma_6 MB_{it} + \eta_t + \eta_j + \varepsilon_{it} \quad (2)$$

To achieve a more in-depth analysis, we progressively expand Equation (2) into a non-linear quadratic relationship, as follows:

$$ETR_{it} = \alpha_0 + \beta_1 FAMILY * INVOLVEMENT_{it} + \beta_2 FAMILY *INVOLVEMENT_{it}^2 + \gamma_1 ROA_{it} + \gamma_2 LEV_{it} + \gamma_3 SIZE_{it} + \gamma_4 PPE_{it} + \gamma_5 INTANG_{it} + \gamma_6 MB_{it} + \eta_t + \eta_j + \varepsilon_{it} \quad (3)$$

The non-linear relationship in Equation (3) is a peculiar situation of the linear relationship with a moderator effect in Equation (2), and it also carries information about the exact position of the inflection point over the continuum of the explanatory variable.

We run the regression using the panel Tobit model econometric approach, censoring the observations of *ETR* out of the range (0,1) and warding off the influence of faulty observations and the consequent eventuality of distorted estimates (Zimmerman, 1983). Finally, we test the absence of collinearity (unreported VIFs) and the absence of perfect correlation (Table 1) in our estimates. We adopt the Huber/White robust covariance matrix in order to correct heteroscedasticity.

2.3. Sample description

The sample comprises a panel of 183 companies listed on the Milan Stock Exchange, and it covers the six years between 2006 and 2011, leading to an unbalanced sample of 1098 firm-year observations. Descriptive statistics and a test of difference in means between family and nonfamily firms are reported in Table 2.

Family firms represent 77% of our sample, which is not far from the percentage found in previous research in Italy (Cascino, Pugliese, Mussolino, & Sansone, 2010; Faccio & Lang, 2002; Prencipe & Bar-Yosef, 2011; Prencipe, Bar-Yosef, Mazzola, & Pozza, 2011). This amount is much higher than the percentages reported in US-based research, which is close to 35% (Anderson & Reeb, 2003; Villalonga & Amit, 2006). In our sample, ownership seems to be highly concentrated in the hands of the ultimate owner and higher in family firms (53.72%) compared with nonfamily firms (42.61%). This offers circumstantial evidence that the controlling families in Italy generally own very large percentages of the equity, which is completely different from the 16% reported in the US (Villalonga & Amit, 2006). Additionally, on average, the main block-holder's affiliate directors who sit on the board are significantly more numerous in family firms (5.14) than in nonfamily firms (3.12), suggesting that proprietors may have larger managerial powers in family firms compared to nonfamily firms. These circumstances support the relevance of our analysis due to the peculiarity of the institutional setting investigated in this article, documenting a seemingly extensive involvement of block-holders in family firms.

Our sample reports a censured and trimmed effective tax rate (*ETR*) with a mean of 0.36 and a median of 0.35, which is quite close to the statutory tax rate for the period and varied between the minimum rates of 0.37 in 2006 and 2007 and 0.32 since 2008. Table 2 provides a breakdown of the censuring and trimming procedures adopted to clarify *ETR*.

3. Results and discussion

The results of the regression analysis described in Eqs. (1) and (2) are presented in Tables 3 and 4.

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