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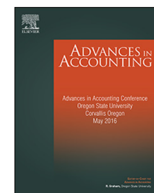

The effect of the interplay between corporate governance and external monitoring regimes on firms' tax avoidance

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ABSTRACT

This study investigates how the interplay between internal corporate governance and the changes in the tax and corporate governance environment in the U.S. during the early 2000s affected firms' tax avoidance levels. Analyses use a panel of U.S. firms for the period 1997–2005 and permanent book-tax difference and cash effective tax rates as proxies for tax avoidance. Results suggest that, relative to other firms, firms with weak-governance during the low-regulation period (years 1997–2000) exhibited lower tax-avoidance levels during the high-regulation period (years 2003–2005) in response to the tighter external monitoring regime. The study adds to the corporate tax avoidance literature by providing evidence regarding the importance of considering external monitoring regimes in the study of the relationship between corporate governance and tax avoidance.

1. Introduction

Corporate scandals and general public concerns led to increased external monitoring activity by tax and financial reporting authorities in the early 2000s. Such increased monitoring was a response to a suspected increase in tax avoidance activities (U.S. Treasury, 1999) and a deterioration of corporate governance institutions (Coffee, 2006).[2] Specifically, the IRS increased both reporting requirements and audit activity in an effort to reduce tax avoidance and Congress empowered the SEC, through the Sarbanes-Oxley Act of 2002 (SOX), to increase internal control requirements for publically traded firms.

In this paper, I provide evidence regarding whether tax avoidance did in fact decrease following the changes in external monitoring. Furthermore, I examine whether firms with weaker corporate governance in the 1990s exhibited lower tax avoidance levels than other firms after the regulatory regime changed.[3] Such weaker corporate governance firms were probably affected to a greater extent than other firms by regulatory regime changes because they were most likely to have weaknesses in their internal controls (Hoitash, Hoitash, & Bedard, 2009; Krishnan, 2005). Therefore, they may have invested resources to improve their internal controls and eliminated certain risks from their tax avoidance activities (KPMG, 2006) that would result in lower tax avoidance levels relative to other firms. My study extends and contributes to our understanding of the interplay between external and internal corporate governance mechanisms on corporate tax avoidance and it is of interest to regulators and academics.

I define *tax avoidance* as a reduction on a corporation's explicit taxes that do not distinguish between real activities undertaken to reduce tax liabilities and targeted tax benefits from lobbying activities (Dyreng, Hanlon, & Maydew, 2008; Hanlon & Heitzman, 2010) nor from those activities that are considered outright illegal tax evasion. This definition fits the context of my study because the effect of increased regulation throughout this period affected areas of tax reporting that transcended tax sheltering activities.

In my analyses, I use estimated permanent book-tax differences and cash effective tax rates (ETR) to measure firms' tax avoidance levels. I implement a difference-in-differences design on an unbalanced panel of large U.S. firms for the period from 1997 to 2005 using fixed-effects

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[2] Examples of corporate governance institutions are independent auditors, investment bankers, and credit rating agencies, which Coffee (2006) identifies as gatekeepers or reputational intermediaries who assure investors about the quality of the "signal" sent by a corporation.

[3] I use the terms regulatory regime changes and external monitoring changes to refer to the combination of tax regulation changes and corporate governance reform that occurred during the early 2000s.

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regressions. To implement the difference-in-differences design and test the effect of regulation changes on firms' tax avoidance levels, I create a discontinuity in the time series by eliminating years 2001–2002 (transition period) from the sample. The sample partition including years 1997–2000 (low-regulation period) captures the period where aggressive tax avoidance activity was booming and most of the high-profile accounting scandals (e.g., Enron, WorldCom) were underway but undetected. The sample partition including years 2003–2005 (high-regulation period) captures the period where the IRS re-focused its efforts to curb aggressive tax reporting and the initiation of the SOX disclosure requirements. Then, I use firms' governance strength during the late 1990s to test the effect of the regulatory regime changes in tax avoidance.

I document that tax avoidance did not, on average, decrease in response to the external regulatory environment changes of the early 2000s, suggesting that firms continued pursuing their tax avoidance strategies because the benefits from pursuing those strategies were greater than the perceived tax compliance costs and detection risks after the external regime change. However, the results indicate lower permanent book-tax differences and higher cash ETRs (*both indicative of reduced tax avoidance*) during the high-regulation period for firms identified as weakly governed prior to the external monitoring changes relative to other firms. The evidence suggests that managers of weakly governed firms may have employed tax avoidance strategies that were not sustainable under the new environment and/or that the efforts to improve their internal controls took resources away from tax planning activities, which resulted in lower tax avoidance levels for such firms. The results are also consistent with managers of weakly governed firms using tax avoidance strategies to achieve short-term profitability goals that became riskier under the tighter external monitoring environment thereby inducing a reduction in their firms' tax avoidance levels.

I contribute to the literature that investigates the relationship between tax avoidance and corporate governance. Earlier evidence in this research stream finds mixed results. For example, several studies document a positive association between tax avoidance and weak corporate governance (e.g., Desai & Dharmapala, 2006; Desai, Dyck, & Zingales, 2007; Lanis & Richardson, 2011, 2012). However, other studies suggest there are alternative explanations for the association between corporate governance and tax avoidance (e.g., Armstrong, Blouin, Jagolinzer, & Larcker, 2015; Seidman & Stomberg, 2017) while others find no association between corporate governance and tax avoidance (Blaylock, 2016). My results indicate a reduction in tax avoidance in the high-regulation period for firms that had weak corporate governance structures in the low-regulation period, providing support for the conclusion of a positive association between tax avoidance and weak corporate governance that depends on the external monitoring environment.

In addition, the analyses in this study are based on a comprehensive corporate governance score that aims to capture the overall strength of firms' corporate governance, which is consistent with the concept that firms' corporate governance requires a combination of both internal and external measures (Brown & Caylor, 2006; Cremers & Nair, 2005). In contrast, many studies in this research area (e.g., Armstrong et al., 2015; Blaylock, 2016; Minnick & Noga, 2010; Seidman & Stomberg, 2017) use single or disaggregated corporate governance measures (e.g., number of independent directors, shareholders' rights protection index) that cannot capture the overall strength and complexity of a firm's corporate governance.

The study complements Desai et al. (2007) by examining the effect of the interplay between the tax environment and corporate governance on tax avoidance in a large sample of U.S. firms. In contrast, Desai et al. study a small sample of Russian firms and a panel of country level (macro) data, documenting results that may not generalize to U.S. firms. For instance, the changes in the U.S. regulatory environment were a combination of administrative and enforcement actions while Desai et al. (2007) primarily studied tax regulatory interventions directed to curb what would be considered outright criminal behavior. My research indicates the importance of considering firms' internal corporate governance as well as their external governance mechanisms in the analysis of corporate tax avoidance.

This study is different from Hoopes, Mescall, and Pittman (2012)—who link increased IRS audit probability to reductions in tax avoidance—in that I focus on the cross-sectional differences in tax avoidance before and after the regulatory changes specific to the early 2000s and condition my analysis on firms' corporate governance strength before the changes took place. I also find some evidence indicating that, for my sample period, the shock to the tax and corporate governance regimes combined with an improvement in firm's corporate governance helps explaining the lower levels of tax avoidance relative to other firms.

The next section discusses the background and the third section develops the hypothesis. The fourth section describes the research design followed by the results section. The last section presents concluding remarks and discusses limitations of the study.

2. Background

2.1. External monitoring environment in the late 1990s

During the late 1990s, the U.S. Treasury and other stakeholders raised concerns regarding the growth in aggressive corporate tax avoidance. The U.S. Treasury (1999) reported an increase in corporations' tax avoidance activities that stressed the IRS's revenue collection efforts and undermined the public's perception of the tax system. The General Accounting Office (GAO) reported that the percentage of large U.S.-controlled corporations reporting no tax liabilities increased from 29.1% in 1996 to 37.5% in 2000 (GAO, 2004) consistent with the increased use of tax avoidance strategies throughout the late 1990s.

Findings from academic research suggest an increase in the gap between financial statement and taxable income during the 1990s that is oftentimes interpreted as an increase in corporate tax avoidance. Desai (2003) documents a decrease in the correlation between financial statement and estimated taxable income during the 1990s that cannot be explained exclusively earnings management and/or stock option deductions. Desai advances an increase in tax sheltering (an extreme form of tax avoidance) as an explanation. Plesko (2007) analyzes tax return data and finds evidence indicating corporate managers can undertake tax-reducing activities that have little impact on their financial statement income, which may partially explain the book-tax gap.

Crenshaw (1999) attributes the increase in tax avoidance during the late 1990s to the weakness of IRS enforcement efforts, corporate greed, and the wide availability of tax planning products in the market. Consistent with Crenshaw's argument, data from the Transactional Records Access Clearinghouse (TRAC, 2014) indicate a steady decrease in the audit rates across all business sizes during this period. For example, audit rates for the largest corporations (i.e., with $250 million assets or more) declined from 46% in 1997 to 31% in 2000.

Crenshaw (1999) also argued that during the late 1990s corporate management saw managing taxes as new way of maximizing profits and cash flow, which is supported by anecdotal evidence indicating that during the 1990s some firms began to use profit centers as the performance measurement model for tax departments (Robinson, Sikes, & Weaver, 2010). Consistent with Crenshaw's argument the Joint Committee on Taxation's investigation of Enron found that Enron used complex tax structures to increase their financial statement income while simultaneously reducing the income they reported to the IRS.[4]

Alongside regulators' claims about aggressive tax planning, the

[4] See Joint Committee on Taxation, 2003 Report of Investigation of Enron Corporation and Related Entities. Regarding Federal Tax and Compensation Issues, and Policy Recommendations (JCS-3-03), February 2003, Vol. 1.

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