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Corporate tax aggressiveness and the maturity structure of debt[☆]

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ABSTRACT

We investigate the association between tax aggressiveness and corporate debt maturity, and we find strong evidence that shorter debt maturity is more prevalent for tax aggressive firms. The results survive numerous robustness tests, including controlling for compensation-induced incentives for risk-taking, firm and CEO effects, changes regressions, and instrumental variables estimation. The results suggest that lenders view tax aggressiveness as a risky activity and therefore restrict the maturity structure of debt to provide a monitoring mechanism for debt contracts with tax-aggressive borrowers. We conclude that tax aggressiveness has a meaningful influence on debt contracting.

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1. Introduction

The existing literature on the association between corporate tax aggressiveness and debt contracting provides mixed results. Results in Graham and Tucker (2006) and Richardson, Lanis, and Leung (2014) suggest that tax aggressive firms have, on average, lower leverage ratios by choice. However, Hasan, Hoi, Wu, and Zhang (2014) find that tax aggressiveness is associated with greater loan costs and more stringent collateral and security requirements. While it is empirically difficult to be pin down whether the negative association between tax aggressiveness and leverage is primarily driven by lender or borrower choice, it is clearer that borrowers do not prefer more costly loans with greater covenant and security requirements. We analyze the relation between tax aggressiveness and debt maturity to provide further clarity on the impact of tax aggressiveness on debt contracting, and we find consistent evidence that tax aggressive firms have debt contracts with shorter maturity.

Evidence on the economic impact of tax aggressiveness on the firm is mixed. Aggressive tax planning can provide benefits to the firm, such as cash flow savings (Mills, 1998) and relief of financial constraints

(Edwards, Schwab, & Shevlin, 2016), which theoretically would result in greater firm value (Faulkender & Wang, 2006; Desai & Dharmapala, 2009). However, the value implications of the potential positives associated with tax aggressiveness depend on the risks of strategies pursued. Research has focused on the downside to tax aggressiveness such as IRS audit risk (Mills, 1998; Wilson, 2009), stock price crashes (Kim, Li, & Zhang, 2011), and negative stock returns due to the revelation of the use of illegal shelters (Hanlon & Slemrod, 2009), among others.

Because debt and equity investors have asymmetric payoff functions, they have different preferences for the risk of firm activities. Debt investors use several contracting features to moderate the firm's ability and incentives to pursue excessive risk after using debt in the firm's capital structure. While loan pricing, collateral requirements, and loan security are debt contract features the lender can use to moderate the firm's ability and incentive to pursue aggressive tax planning (Hasan et al., 2014), funding the firm's assets with short-term debt exposes the firm to "rollover risk." Rollover risk is the potential that lenders will not renew debt financing on previous terms (or at all), and this threat can control potential conflicts of interest between equity and debt investors (Jensen & Meckling, 1976; Myers, 1977; Smith & Warner, 1979). Frequent renegotiation/re-pricing of debt – due to having shorter rather than longer-maturity debt – limits the shareholders' or managers' incentives to pursue policies that do not maximize firm value at the expense of debt investors (Childs, Mauer, & Ott, 2005). We expect that debt investors will require more frequent debt renegotiation via shorter maturity of loans to tax aggressive firms.

[☆] Data availability: all data used in this study are obtained from public sources.

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We analyze the debt maturity of 10,967 U.S. firm-years over the 1993–2012 period, and find consistent evidence that tax aggressive firms have shorter maturity debt. Specifically, we estimate the effect of tax sheltering activities on the percentage of total debt that matures within three years, and find a strong and robust positive relation between tax aggressiveness and the proportion of short-term debt in the firm's capital structure. We assume that debt maturity is an important non-price loan term that is used by lenders to manage credit risk associated with tax aggressiveness. Our estimates suggest that lenders view tax aggressiveness as a risky activity and restrict the maturity structure of debt in the presence of greater tax aggressiveness.

This research contributes to literature on corporate tax aggressiveness, corporate debt maturity, and debt contracting. With respect to research on corporate tax aggressiveness, our work provides additional evidence that creditors view tax aggressive activities negatively when structuring loan contracts (Hasan et al., 2014). The results provide additional evidence that tax aggressive strategies are viewed as risky strategies by investors, consistent with results in studies of executive compensation vega (Rego & Wilson, 2012), executive compensation inside debt (Kubick, Lockhart, & Robinson, 2014), and stock price crash risk (Kim et al., 2011).

In a related study, Platikanova (in press) finds that firms with lower effective tax rates and greater reserves for uncertain tax benefits have a higher proportion of short maturity debt. However, effective tax rates are a common measure of tax avoidance, but not necessarily tax aggressiveness, and uncertain tax benefit reserves are subject to important limitations and weaknesses (Hanlon & Heitzman, 2010; De Simone, Robinson, & Stomberg, 2014). In contrast, we use a common measure of tax aggressiveness in all of our tests, as this measure reflects the likelihood of engaging in tax planning behaviors that are on the aggressive end of the spectrum (Hanlon & Heitzman, 2010). Our work complements the Hasan et al. (2014) analysis of the impact of tax aggressiveness on loan contracting, as the authors of that study analyze loan spreads, collateral, and covenants, but do not analyze debt maturity. Finally, our study provides indirect evidence suggesting that the lower leverage ratios among tax aggressive firms reported in Graham and Tucker (2006) and Richardson et al. (2014) are a result of lender actions instead of a choice by management to operate with lower leverage ratios. Just as we would not expect borrowers to prefer loans with greater loan spreads and more stringent collateral and security requirements (Hasan et al., 2014), we do not expect that borrowers will prefer greater levels of rollover risk and lender monitoring via short debt maturity if they are pursuing aggressive tax planning.

2. Background and hypothesis development

2.1. Debt maturity

Capital structure research has emphasized the importance of agency costs and information asymmetries for optimal leverage ratios and optimal debt maturity. Both market frictions can result in significant debt overhang and asset substitution problems, potentially affecting the firm's investment decisions (Jensen & Meckling, 1976; Myers, 1977). With risky debt outstanding, managers face an "over-hang problem" with incentives to pass-up some positive net present value projects because bondholders will gain a larger share of the project's value. Managers also face an "asset substitution problem" with incentives to accept some negative net present value projects that have a large upside return but (a more probable) lower downside return. Debt investors recognize the potential for these ex post investment distortions, and protect their positions ex ante by adjusting loan pricing, security, seniority, maturity, and other debt contract features (e.g., Jensen & Meckling, 1976; Myers, 1977; Barclay & Smith, 1995; Rajan & Zingales, 1995; Kim & Mauer, 1997; Goswami, 2000; Johnson, 2003; Gottesman & Roberts, 2004; Billett, King, & Mauer, 2006; Daniels, Ejara, & Vijayakumar, 2010).

Myers (1977) emphasizes that debt maturity can be one important solution to the agency costs of debt that result from the overhang and asset substitution problems. Essentially, the manager's incentives to depart from firm value-maximizing policies are decreased when they soon have to renegotiate existing debt. Childs et al. (2005) study the interaction of investment and financing policies in a model including agency costs of debt resulting from shareholder-bondholder conflicts over investment policy. They emphasize that frequent renegotiation/re-pricing of debt (e.g., due to shorter maturity) makes the value of the debt less sensitive to changes in firm value. Therefore, lenders have an effective tool in debt maturity to protect their investment. This interpretation of debt maturity is also modeled in Flannery (1986), Diamond (1991), discussed in Easterbrook (1984) and Rajan and Winton (1995), and is the focus of DeAngelo, DeAngelo, and Wruck (2002), among others.

2.2. Tax aggressiveness

Research aimed at determining whether shareholders value the tax aggressive policies of firms has yielded mixed results. On one hand, tax aggressive policies can minimize the tax burden, increasing liquidity and cash flows available to both debt and equity investors. However, because tax aggressive activities are opaque in nature, whether the associated benefits outweigh the risks is uncertain. Hanlon and Slemrod (2009) find evidence of negative stock returns upon the news release that a firm has employed tax shelters. However, Desai and Dharmapala (2009) find a positive association between firm value and tax aggressiveness if the firm has good governance characteristics. Hill, Kubick, Lockhart, and Wan (2013) find a positive association between long-window abnormal stock returns and corporate lobbying expenditures aimed at tax legislation and regulation among firms not identified as tax aggressive. Further, Rego and Wilson (2012) find a positive relation between tax aggressiveness and executive compensation vega, suggesting that managers with compensation sensitive to increases in risk (i.e., volatility of stock returns) are more tax aggressive.

Debt investors prefer more liquidity and cash flow to less, but not at the expense of excessive risk that might result in IRS penalties and other costs (e.g., management time, litigation, etc.). Edwards et al. (2016) find that tax avoidance strategies can moderate the effects of financial constraint through cash flow savings. Law and Mills (2015) analyze tone of 10-K filings and find that financially constrained firms pursue more aggressive tax planning. Research aimed at understanding the association between debt contracts and corporate tax policy has concluded that tax aggressive firms borrow less (Graham & Tucker, 2006; Richardson et al., 2014), but on more stringent and costly terms (Hasan et al., 2014). However, the interpretation of the former result is due to demand-side forces, whereas the interpretation of the latter result is due to supply-side forces. Specifically, Richardson et al. (2014) analyze the leverage ratios of tax aggressive firms and find that these firms have lower leverage ratios, especially among those firms with more outside directors on the board. The authors interpret the results from the view that the outside directors provide financial theory expertise, and thus, these firms are more equipped to understand that tax aggressive policies provide less benefit of operating with greater leverage ratios. The Hasan et al. (2014) study however, takes the opposite view in that supply-side forces result in greater costs of borrowing in the private debt markets. Specifically, they find a positive association between tax avoidance and private loan spreads, collateral, and covenant requirements. Further, the authors find that the positive association between tax avoidance and bank loan spreads is magnified for firms with greater information and agency risks, in addition to greater probability of being audited by the IRS.

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