DISCUSSION OF "HOW DOES TAX AVOIDANCE AFFECT CORPORATE TRANSPARENCY?"

ABFER 2018

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"Let's never forget that the public's desire for transparency has to be balanced by our need for concealment."

This Discussion

- Motivation/contribution
- The basic story
- Possible other papers to consider
- Empirics
- Exposition
- Concluding thoughts

Motivation/Contribution

- “The mixed evidence from the prior literature on the effect of tax avoidance on financial reporting quality and corporate transparency motivates our examination of this association.”
  - Mixed evidence - true!
  - It would probably be asking too much to reconcile the disparate results in prior studies
  - What does this paper bring to the table that is new?
    - Nonlinearity due to aggressiveness in tax avoidance

The Basic Story (as I understand it)

- Effect of tax avoidance on transparency depends on whether it is aggressive tax avoidance or non-aggressive tax avoidance
- Non-aggressive tax avoidance
  - Generally good news
  - Managers have incentives to disclose good news
  - Leads to increased transparency
- Aggressive tax avoidance
  - Inherently complex, aiding in personal rent extraction
  - Incentives to obfuscate to reduce scrutiny by tax authorities
  - Both lead to decreased transparency

Example of a complex tax strategy

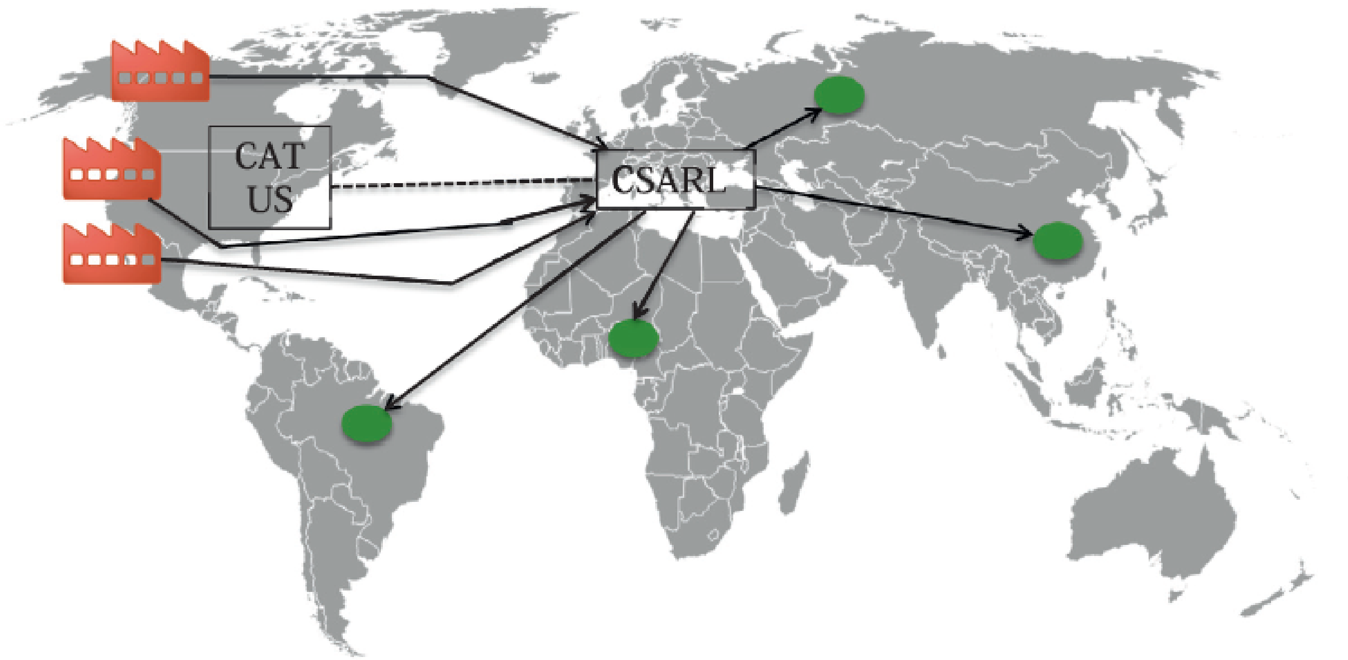
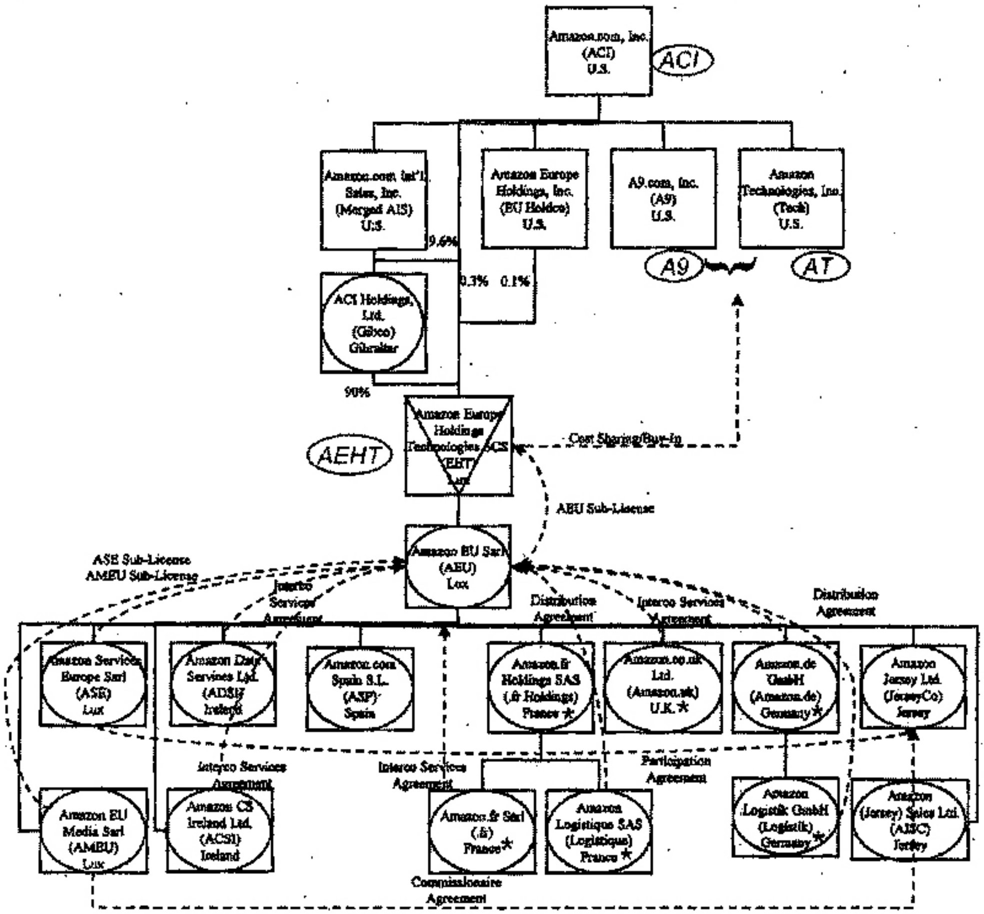


Fig. 1. Caterpillar's tax strategy.
This figure illustrates the legal title chain for replacement parts in Caterpillar's tax strategy. Caterpillar used its Swiss subsidiary, CSARL, as its global purchaser of replacement parts (U.S. Senate, 2014). In the figure, the arrows represent the legal title flow of the replacement parts. The factories represent third-party suppliers of replacement parts. The circles represent independently owned Caterpillar dealers, who in turn sell replacement parts to the end customers. According to the Senate report, over the period 2000–2012, Caterpillar shifted U.S. taxable income of more than $8 billion to its Swiss subsidiary CSARL, avoiding about $2.4 billion in U.S. tax.

Example of a complex tax strategy



Agreements in Existence:

- Buy-In I and II, and Amended Cost Sharing agreements between EHT, A9 and Tech.
- Sub-license agreement between EHT and AEU.
- Sub-license agreement between AEU and ASE.
- Sub-license agreement between AEU and AMEU.
- Commissionaire agreement between AMEU and JerseyCo.
- Participation agreement between ASE and JerseyCo.
- Intercompany services agreements between AEU with .co.uk, Amazon.de, Logistik, .fr, ACSI and ADSI, respectively.
- Intercompany distribution agreements between AEU with Logistik and Logistique, respectively.

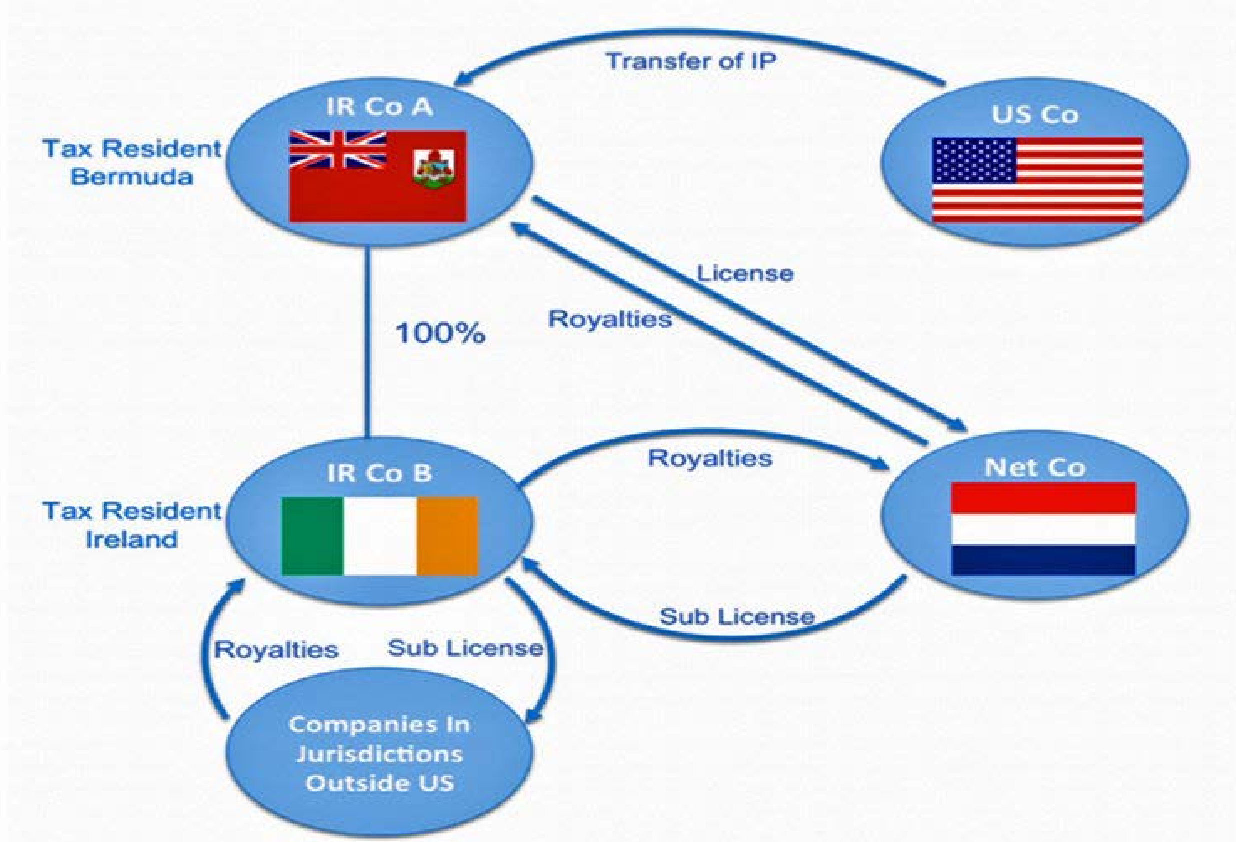
Agreements Modified:

- Short form cost sharing between A9 and EHT.

amazon.com

Example of complex tax strategy

Exhibit 1: Illustration of the double Irish and Dutch sandwich



Source: Pearse Trust, Morgan Stanley Research

The Basic Story (as I understand it)

- Expects firms to use non-aggressive tax avoidance to be first, with some using aggressive tax avoidance
- Leads to non-linear relation, e.g.:

$$\begin{aligned} AbsDA = {} & \alpha_0 + \alpha_1 Tax\ Avoidance + \alpha_2 Tax\ Avoidance^2 + \alpha_3 LnTA + \alpha_4 LEV \\ & + \alpha_5 ForInc + \alpha_6 PPE + \alpha_7 Intang + \alpha_8 PTROA + \alpha_9 PTCFO + \alpha_{10} NOL \\ & + \alpha_{11} MB + \alpha_{12} BigN + \alpha_{13} TradeVol + \alpha_{14} AnlstCover \\ & + Year\ fixed\ effect + Industry\ fixed\ effect + \varepsilon \end{aligned}$$

(Model 1)

Possible other papers to consider

- Armstrong, Blouin, Jagolinzer, and Larcker (2015)
  - Also examines nonlinearity, in their case tax avoidance and governance

- Gallemore and Labro (2015)
  - Examines internal information quality (IIQ) and tax avoidance
  - Better IIQ results in more tax avoidance, particularly when firms' operate more uncertain environments
  - IIQ proxies include: management forecast accuracy, restatements from unintentional errors

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Corporate governance, incentives, and tax avoidance ☆

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A B S T R A C T

We examine the link between corporate governance, managerial incentives, and corporate tax avoidance. Similar to other investment opportunities that involve risky expected cash flows, unresolved agency problems may lead managers to engage in more or less corporate tax avoidance than shareholders would otherwise prefer. Consistent with the mixed results reported in prior studies, we find no relation between various corporate governance mechanisms and tax avoidance at the conditional mean and median of the tax avoidance distribution. However, using quantile regression, we find a positive relation between board independence and financial sophistication for low levels of tax avoidance, but a negative relation for high levels of tax avoidance. These results indicate that these governance attributes have a stronger relation with more extreme levels of tax avoidance, which are more likely to be symptomatic of over- and under-investment by managers.

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The importance of the internal information environment for tax avoidance[☆,☆☆]

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ABSTRACT

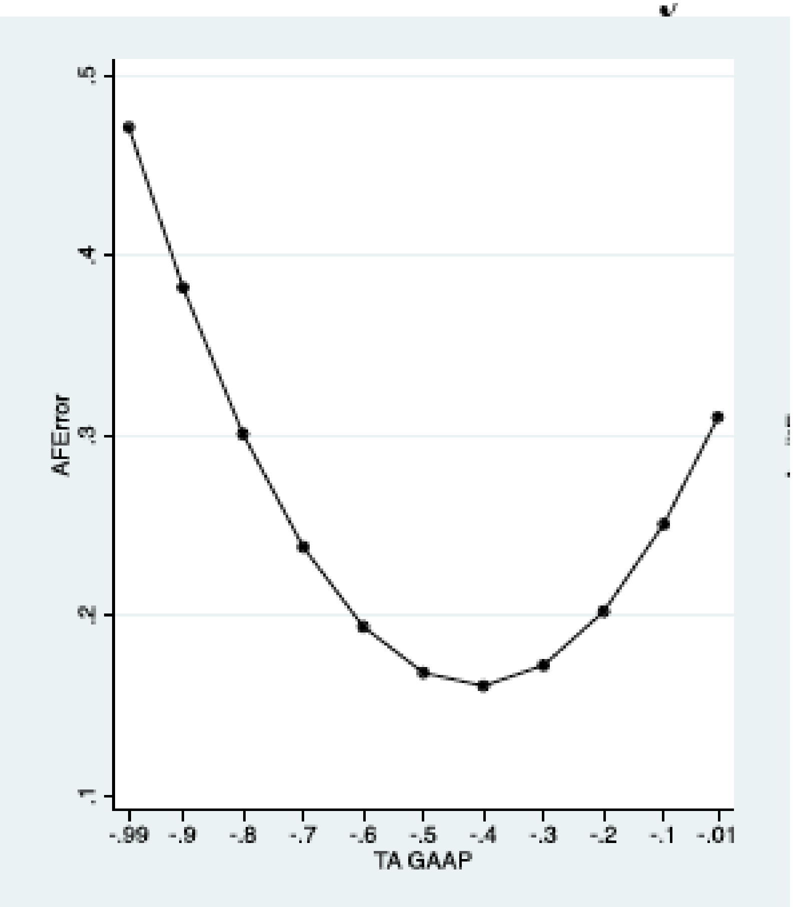
We show that firms' ability to avoid taxes is affected by the quality of their internal information environment, with lower effective tax rates (ETRs) for firms that have high internal information quality. The effect of internal information quality on tax avoidance is stronger for firms in which information is likely to play a more important role. For example, firms with greater coordination needs because of a dispersed geographical presence benefit more from high internal information quality. Similarly, firms operating in a more uncertain environment benefit more from the quality of their internal information in helping them to reduce ETRs. In addition, we provide evidence that high internal information quality allows firms to achieve lower ETRs without increasing the risk of their tax strategies (as measured by ETR volatility). Overall, our study contributes to the literature on tax avoidance by providing evidence that the internal information environment of the firm is important for understanding its tax avoidance outcomes.

Empirics

- Given the importance of tax aggressiveness for the paper, why not use a measure of tax aggressiveness?
  - Uncertain tax benefits (UTB)
    - Firm’s own estimate of tax benefits that would be lost if scrutinized by an all-knowing tax authority
    - Mandated for publicly traded firms since 2007
    - Independent of researcher decisions
    - Not perfect – subject to financial reporting discretion

Empirics

- Could extremely high or low ETRs reflect volatile firm-years?



Empirics

- Measures of transparency likely related to underlying volatility
  - Absolute value of discretionary accruals
  - Standard deviation of discretionary accruals over 5 yrs
  - Restatements from errors
  - Absolute value of analyst forecast errors
  - Audit fees
  - Stock price synchronicity
  - Bid-ask spread
  - Stock price crash risk

Empirics

- Suggestions for dealing with volatility
  - Replace ETRs with non-tax ratios such as ROA and see if extremely high or low ratios result in similar patterns
  - Control for volatility in regressions
  - Correlation matrix for main dependent and independent variables

Empirics

- Some exogenous variation in tax avoidance / tax aggressiveness would be nice
  - Hard to tell causal story without it
  - Does have SOX test in table 6 but more of a shock to dependent variable than it is to tax avoidance

Some nitpicky expositional comments

- “Anecdotal evidence based on recent tax scandals…” (p. 7)
  - Cites Enron, Dynegy, Tyco – all over 15 years old
- Predictions were hard to follow
  - Avoidance is ETR*(-1)
  - Transparency measures increase when transparency decreases

Conclusions

- I like the paper
  - Important research question with mixed prior results
  - Combines tax and financial reporting
  - Intuitive explanation
- Hopefully my suggestions will improve the paper