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Tax avoidance, cost of debt and shareholder activism: Evidence from Korea

Youngdeok Lim *

Australian School of Business, University of New South Wales, Sydney, NSW, Australia

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ABSTRACT

This paper examines the impact of tax avoidance on the cost of debt and its interaction effect with shareholder activism. Using Korean firms, I find a negative relationship between tax avoidance and the cost of debt, supporting the trade-off theory. Further tests reveal that the negative relationship becomes stronger when the level of institutional ownership is high. It becomes even stronger after 1998, when the shareholder rights of institutional investors were strengthened. It suggests that the managerial opportunism theory has an additional explanation for tax avoidance activities. My findings indicate that tax avoidance reduces the cost of debt through trade-offs and creates a managerial rent diversion, which is mitigated in firms with larger institutional holdings.

1. Introduction

This paper investigates the impact of tax avoidance[1] on the cost of debt and its interaction effect with shareholder activism in publicly-held firms. The Hyundai Automotive Group, a Korean chaebol (business group), faced allegations that it created massive slush funds through the unusual method of deflating its operating profits and inflating losses. In fraudulent accounting practices, the opposite—inflating profits and deflating losses to lure investors—is more common. As a result, a prosecution official stated, "We're investigating to determine the overall scale of the slush funds the Hyundai Automotive Group established by adopting such accounting measures. If my probe into the group reveals that it did not pay taxes and used the money for business or lobbying purposes, it will face additional charges for tax evasion and appropriation of company funds in the conduct of business or bribery. Investigators are collecting mountains of evidence (Chosun Ilbo, 17 April 2006)." In response, the group announced that its chairman promised to donate $1.1 billion worth of personal assets to society and apologized for causing concerns to the public over the scandal. As a result, the chairman was sentenced to 3 years in prison for creating the large slush funds.

The first objective of this paper is to investigate whether tax avoidance as a tax-favored activity reduces the cost of debt. The cost of the debt of a firm is determined by the characteristics of the firm and those of the bond issue that affect default risk, agency costs, and the information asymmetry problem (Bhojraj and Sengupta, 2003). Graham and Tucker (2006) and Lim (2010) suggest that tax-favored activities, such as tax shelters and tax avoidance, are a substitute for the use of debt. Graham and Tucker (2006) examine 44 tax shelter cases that were issued as a Notice of Deficiency by the Internal Revenue Services (IRS). These cases indicate that firms use less debt when they engage in tax sheltering. Using the tax avoidance measure modified from Desai and Dharmapala (2006), Lim (2010) determines the existence of a substitution effect of tax avoidance for the use of debt for a large sample of Korean firms. These results were consistent with the results of Graham and Tucker (2006). If tax avoidance is a substitute for the use of debt (Graham and Tucker, 2006; Lim, 2010), it could increase financial slack, reduce expected bankruptcy costs, enhance credit quality, lower default risk, and therefore reduce the cost of debt.

* Tel.: +61 2 9385 6081; fax: +61 2 9385 5925.
E-mail address: youngdeok.lim@unsw.edu.au

[1] I define tax avoidance as a tax savings that arises from both the general tax reduction methods and tax shelters that are occasionally of questionable legality to minimize tax liability. In other words, the tax avoidance measure conceptually captures the cumulative number of transactions to minimize tax liabilities (Desai and Dharmapala, 2006). Both Korean and American firms are expected to have strong incentives to increase financial income and decrease taxable income, thereby suggesting that the differences in tax laws and accounting standards between the US and Korea could have little effect on the interpretation of tax avoidance. Also Korean firms could avoid tax burden by the tax savings derived from legal tax reduction methods. Korean tax law permits firms to only deduct expenses for tax purposes, not for financial purposes, as follows: depreciation for the special assets class, allowance for depreciation, bad debt losses caused by extinctive prescriptions, and the allowance for retirement pensions.

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This supports the trade-off hypothesis that the debt-substitution effect of tax avoidance would reduce the cost of debt, an issue not investigated in Graham and Tucker (2006) and Lim (2010).

Second, this paper investigates managerial opportunism theory on the relationship between tax avoidance and cost of debt by examining the effect of shareholder activism on the relationship. From an agency perspective, tax avoidance would reduce the transparency of firms, and permit managers with the opportunity to extract rents from outside investors, creating a shield for managerial opportunism and the diversion of rents (Desai and Dharmapala, 2006; Desai et al., 2007; Desai and Dharmapala, 2009; Wilson, 2009). Desai and Dharmapala (2006) and Desai et al. (2007) argue that corporate tax sheltering and the diversion of rents by managers are interrelated and complementary. Desai and Dharmapala (2009) find that the average effect of tax avoidance on firm value was not significantly different from zero. However, it is found to be positive for well-governed firms, which indicates that a higher quality of corporate governance, measured as a higher level of institutional ownership, leads to a favorable effect of tax avoidance on firm value. Tax avoidance could cause agency conflicts between management and debtholders, since managerial rent diversions induce information asymmetry and create moral hazard problems. However, institutional investors possess greater incentives and capacity to monitor managerial performance (Shleifer and Vishny, 1986; Chung et al., 2002; Hartzell and Starks, 2003; Bhojraj and Sengupta, 2003; Desai and Dharmapala, 2009).[2] Thus, the higher the level of institutional ownership, the greater is the degree of scrutiny to which managerial actions are subjected, and the less important is the conflict of interests between the management and debtholders. Institutional investors could reduce the cost of debt by alleviating agency problems, thereby decreasing opportunities for the managerial rent diversion of tax avoidance.

Using Korean firms, I examine the impact of tax avoidance on the cost of debt. I further investigate the effect of shareholder activism on the relationship between tax avoidance and the cost of debt. Shareholder activism was defined as a level of ownership by institutional investors (Desai and Dharmapala, 2009) and an exogenous variation of institutional investors in 1998 in Korea. For example, the Sovereign Asset Management Corporation,[3] which emerged as the biggest shareholder of the SK Group, one of chaebols in Korea, stated that for the SK to recover, radical reforms were necessary. Sovereign stated that it planned to renovate the corporate governance of the SK to clean up the company, and added that it would work with the management team of SK to achieve such goals. Sovereign expressed the view that the SK must discontinue its old business practices and strive to regain shareholder and market trust, stating that "Investment in the SK will transform a corporate tragedy into a triumph of corporate governance." I anticipate that institutional investors reduce the cost of debt by alleviating agency problems, thereby increasing the negative effect of tax avoidance on the cost of debt. Furthermore, I expect that the impact of institutional investors on tax avoidance and the cost of debt increased after 1998, when shareholder rights related to institutional investors, including foreign investors, were strengthened in Korea.

I estimate the tax avoidance measure modified from Desai and Dharmapala (2006). My results indicate that there is a negative relationship between tax avoidance and the cost of debt for a large sample of Korean firms, supporting the trade-off hypothesis. Further tests reveal that the relationship becomes stronger when the ownership of institutional investors is high, becoming even stronger after 1998, indicating that managerial opportunism arguments have an additional explanation for tax avoidance. I find that the influence of shareholder activism on the negative relationship between tax avoidance and the cost of debt was greater when controlling for the other governance effects in 1998. These results are robust for a wide variety of tests, including the relationship between tax avoidance and firm value, changes in the tax rate, the decomposition of institutional investors, the additional control for the probability of bankruptcy, and alternative measures. My findings indicate that tax avoidance reduces the cost of debt through trade-offs and creates a managerial rent diversion, which is mitigated in firms with larger institutional holdings. Also, these suggest that bondholders view institutional investors as a monitoring vehicle that decreases the opportunities for managerial rent diversion by mitigating agency costs.

Korea provides a good research setting for exploring these research questions in terms of five aspects. First, unlike in the US, taxable income data necessary to calculate the tax avoidance measure is directly available from annual reports and does not need to be estimated (Desai and Dharmapala, 2006). This reduces the measurement error of tax avoidance and provides a large sample of evidence. Second, traditionally, Korean firms have heavily relied on bank financing (Baek et al., 2004) and experienced the financial crisis that began in 1997.

Since chaebols, such as the Daewoo Group, Kia Group, and Hanbo Group, went bankrupt, debtholders suffered from this process and became vulnerable to managerial malfeasance or diversions. Weak investor protection in Korea enabled controlling shareholders to expropriate other investors, including minority shareholders and debtholders. This caused debtholders to become interested in mitigating agency conflicts between controlling shareholders and debtholders through good corporate governance in Korea. Third, Korean corporate governance has characteristics that are particularly suitable to my research questions. In 1998, after the financial crisis, the Korean government reformed shareholder rights. This source of exogenous variation of institutional investors permits the investigation of the causal effect of institutional investors on tax avoidance and the cost of debt. Fourth, Korean companies were required to disclose their ownership in the annual report using standard types of security holders until 2003. These security holders include governments, government-related companies, security firms, insurance firms, banks, individual investors, and foreign investors. This makes it possible to decompose institutional investors and investigate the impact of the types of institutional investors on cost of debt (e.g., Elyasiani and Jia, 2010).[4] Finally, the Korean government has shown interest in the increasing number of tax avoidance activities and has designed a policy to effectively prevent such activities in 2006, thereby making tax avoidance an appropriate issue to examine in Korea.

This study makes the following contributions to the literature. First, this paper makes significant contribution to previous literature by investigating the relationship between tax avoidance and *cost of debt* and further applying the *agency perspective* to the relationship. To my knowledge, this is the first attempt to explicitly examine the impact of tax avoidance on the pricing of corporate debt, which also provides some insight into the bond market reaction to the substitution effect of tax avoidance for the use of debt (Graham and Tucker, 2006; Lim, 2010). Also, this paper considers agency costs for the analysis of corporate tax avoidance on the cost of debt and investigates whether institutional investors, as shareholder activists, alleviate managerial opportunism and affect the negative relationship between tax avoidance and the cost of debt.

[2] It is also an empirical issue as to whether all type of institutional investors would have an effective monitoring role. I discuss this issue in detail in Section 5.5.3.

[3] Sovereign Asset Management possesses over 20 years' experience in the international capital market.

[4] The requirement was removed in 2004. Since the policy took effect, Korean companies no longer voluntarily disclose this information in their annual report. The problem in obtaining institutional ownership data causes me to define the sample period as 1994–2003.