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Corporate governance, incentives, and tax avoidance ☆

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ABSTRACT

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.

1. Introduction

We examine the role of governance in tax planning decisions to help resolve the debate in the governance and tax literatures about whether a link exists between firms' corporate governance structures, including managers' incentive-compensation contracts, and corporate tax avoidance. The debate exists, in part, because prior research relies on Desai and Dharmapala's (2006) theory that provides counterintuitive predictions about the link between governance and tax avoidance decisions. In particular, Desai and Dharmapala (2006) argue that tax avoidance and managerial rent extraction can be complementary if tax avoidance reduces corporate transparency which, in turn, increases the opportunity for managers to divert corporate resources for personal benefit. Hence, their theory suggests that reducing tax planning can

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simultaneously reduce managerial diversion. Desai and Dharmapala further assume that well-governed firms are more likely to have internal control mechanisms to prevent such diversion and argue that a negative relation between managers' equity incentives and tax avoidance will only manifest in well-governed firms. In contrast, they assume that poorly governed firms will not use equity incentives to encourage tax avoidance because they lack the governance mechanisms to prevent managerial diversion.

While Desai and Dharmapala's theory is provocative, it has a number of important limitations. For example, Desai and Dharmapala fail to acknowledge that equity incentives are, themselves, an important governance mechanism (i.e., managers' equity incentives result from endogenous decisions by the board of directors that are, in part, aimed at mitigating agency problems). It is also unclear why well-governed firms would be more likely to rely on equity incentives than poorly-governed firms. If anything, prior studies suggest that managerial equity incentives can substitute for other governance mechanisms where more direct monitoring is either too costly or infeasible (e.g., Demsetz and Lehn, 1985; Core and Guay, 1999). Prior studies also suggest that poorly-governed firms (where managers have "control of the board") are more likely to over-pay managers in the form of equity (Bebchuk and Fried, 2006). Moreover, these same managers should have strong incentives to reduce tax payments and personally capture the resulting economic benefits (because of the lax oversight). Therefore, similar to their well-governed counterparts, poorly-governed firms should also exhibit a negative relation between equity incentives and tax avoidance. This chain of reasoning calls into question Desai and Dharmapala's conjecture that the relation between equity incentives and tax avoidance should only exist in well-governed firms.

In contrast to Desai and Dharmapala, we adopt a more traditional view of the role of governance on firms' tax avoidance. Under our alternative agency-theoretic view, tax avoidance is one of many risky investment opportunities available to management. Similar to other investment decisions, unresolved agency problems can lead managers to select a level of tax avoidance that differs from what shareholders would prefer. We do not assume that tax avoidance necessarily results in opportunities for managerial diversion. Rather, as with other agency problems, we assume that the various governance mechanisms in place, including managers' incentive-compensation contracts, can mitigate agency problems with respect to tax avoidance.

Other papers directly examine the link between corporate governance and tax avoidance. Minnick and Noga (2010) investigate whether several measures of corporate governance are associated with a variety of proxies intended to capture firms' level of tax avoidance, but find little evidence of a link. Rego and Wilson (2012) find that firms at which managers have relatively large risk-taking equity incentives engage in more tax avoidance. However, they fail to find evidence of a relation between other governance mechanisms and tax avoidance. Finally, in a concurrent study, Robinson et al. (2012) report evidence that audit committee financial expertise is generally positively associated with tax planning, but that this association is negative when tax planning is thought to be risky (i.e., aggressive). Overall, the relationships among corporate governance, managerial equity incentives, and tax avoidance are mixed and result in inconclusive inferences in the existing literature.

One common theme across prior studies is that inferences are based on estimates of how governance relates to the conditional *mean* of the tax avoidance distribution. However, the relationship between governance and the (conditional) average level of tax avoidance may not accurately describe the relationship in other parts of the tax avoidance distribution. Rather than rely solely on traditional econometric methods (i.e., ordinary least squares regression) that only provide estimates of the average relationship, we also estimate a series of quantile regressions to assess the relation across the entire tax avoidance distribution. This research design follows naturally from our conjecture that the relationship between corporate governance and tax avoidance will differ at relatively high and low levels of tax avoidance. In particular, boards that are more knowledgeable about the net benefits of tax strategies should encourage more tax planning at lower levels of tax avoidance because this improves cash flows with little accompanying risk. Conversely, more knowledgeable boards should discourage additional tax avoidance when the level is high because the increased costs (e.g., regulatory or reputational) are more likely to outweigh the marginal benefit of additional tax savings.

We examine a sample of firms between 2007 and 2011 and find that CEOs' risk-taking equity incentives exhibit a positive relationship with the average level (i.e., conditional mean) of tax avoidance. This result is analogous to the positive relationship between risk-taking equity incentives and earnings management reported by Armstrong et al. (2013) and is consistent with our characterization of tax avoidance as a risky positive expected net present value investment from the perspective of CEOs. More importantly, we find that this relationship is stronger for higher levels of tax avoidance, which suggests that managerial risk-taking incentives are an important determinant of aggressive tax positions that are likely to entail more risk.

We also examine how other governance mechanisms relate to observed levels of tax avoidance. In particular, we examine two important attributes of the board: financial expertise (to measure knowledge of the costs and benefits of tax avoidance) and independence (to measure the ability and incentive to monitor managers' tax avoidance decisions). We find that the relation between boards' financial expertise and independence and the level of tax avoidance differs considerably across the tax avoidance distribution. Specifically, we find that board financial expertise and independence both have a *positive* relation with tax avoidance for low levels of tax avoidance, which is consistent with under-investment in tax avoidance in the absence of monitoring. We also find that board financial expertise and independence both have a *negative* relation with tax avoidance for high levels of the tax avoidance, which is also consistent with over-investment in tax avoidance in the absence of monitoring. Collectively, these findings suggest that more financially sophisticated and more independent boards attenuate relatively extreme levels of tax avoidance, which are likely to be symptomatic of unresolved agency problems.