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The effect of stock market pressure on the tradeoff between corporate and shareholders' tax benefits

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ABSTRACT

The Taiwanese government offers firms that invest in qualified projects in emerging high-tech industries two mutually exclusive tax incentives—a corporate 5-year tax exemption or shareholder investment tax credits. This study examines whether corporate managers take shareholder tax benefits into account in their corporate tax planning. The results show that privately held firms are more likely than listed firms to choose shareholder investment tax credits and forego corporate tax benefits. Listed firms with relatively high earnings response coefficients tend to choose a corporate 5-year tax exemption, as it can enhance reported after-tax earnings. Further, in the 5-year period following their choice of a particular tax incentive, firms choosing a corporate 5-year tax exemption exhibit significantly lower earnings persistence than those choosing shareholder investment tax credits. Taken together, these results suggest that stock market pressure has a significant effect on firms' choices between corporate and shareholder tax benefits, and that the choice of tax incentives has an effect on future earnings quality.

1. Introduction

To promote technological advancement, the Taiwanese government provides two mutually exclusive tax incentives to stimulate investment in qualified high-tech industries.[1] Companies that invest in the qualified industries can select either a 5-year exemption from corporate income tax on income derived from those investments or they can pass the tax incentive to their shareholders by granting shareholders investment tax credits of up to 20% (for corporate shareholders) or 10% (for individual shareholders) of the qualified

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[1] The qualified emerging hi-tech industries are regarded as strategically important to Taiwan's technological advancement and are specified in Articles 8 and 9 of the Statute for Upgrading Industries (Taiwan).

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investment amount.[2] As only one of the two alternatives can be selected, the choice of tax incentive is an important tax planning decision as to whether firms should keep the tax benefit at the corporate level or pass it to their shareholders. In Taiwan, the overall tax revenue losses resulting from these two tax incentives during the 1999–2005 period amounted to about US$3.6 billion.[3] The magnitude of the tax-savings from the two tax incentives is so significant that the choice between the two alternatives is generally regarded as one of the most important tax planning decisions made by managers in Taiwan.

The choice between shareholder tax benefits and corporate tax exemptions offered to managers of Taiwanese firms provides researchers with an opportunity to examine whether firms take shareholder taxes into account when making corporate tax planning decisions. Prior studies have addressed the role of capital market incentives in firms' tax planning concerns (Cloyd et al., 1996; Klassen, 1997; Armstrong et al., 2012; Graham et al., 2014). These studies, however, focus on the trade-off between corporate tax benefits and financial reporting costs. They have not addressed if and how capital market incentives affect a firm's choice between corporate and shareholder tax benefits. This study empirically investigates whether firms consider shareholder tax benefits when making corporate tax planning decisions in the presence of capital market pressure.

Scholes et al. (2015) emphasize in their classic textbook *Taxes and Business Strategy: A Planning Approach* that effective tax planning should take "all parties" into consideration. The Taiwanese context, in which firms choose either a corporate 5-year tax exemption or shareholder investment tax credits, constitutes a rare opportunity to empirically investigate how firms make the trade-off between corporate and shareholder tax benefits in tax planning.

Maximizing the overall tax benefits for a firm and its stockholders is contingent upon accurate forecasts of the firm's profitability in the 5-year period following the qualified investment. *Ex-ante*, if the projected tax-savings from a corporate 5-year tax exemption exceed those of shareholder investment tax credits, firms should choose a corporate 5-year tax exemption. Conversely, if the aggregate amount of shareholder investment tax credits exceeds the tax-savings of a corporate 5-year tax exemption, then the firm should choose shareholder investment tax credits and thereby shift the tax benefits directly to its stockholders.

Consider, as an example, an investment of $100 million in a qualified project. If the firm chooses shareholder investment tax credits, its shareholders may directly obtain tax credits of up to $20 million (for corporate shareholders) or $10 million (for individual shareholders). Conversely, if the firm chooses a corporate 5-year tax exemption, assuming that the rate of return on the project is a constant 20% per annum and the corresponding corporate tax rate is 25%,[4] the firm's overall tax savings during the 5-year period will be (undiscounted) $25 million in total. In the latter case, the shareholders pay the associated incremental individual income taxes, while the company distributes the tax-exempt earnings in the form of dividends. Thus, the optimal decision is based on the trade-off between corporate and shareholder tax savings.

In addition to creating tax savings for either firms or shareholders, the choice between the two tax incentives may also affect firms' reported earnings. Firms that choose a corporate 5-year tax exemption can directly reduce their corporate income tax expenses, whereas firms that pass investment tax credits to their shareholders still have to pay corporate income tax. Thus, *ceteris paribus,* firms choosing a corporate 5-year tax exemption will report greater after-tax earnings in their financial statements than firms choosing shareholder investment tax credits. Consequently, when choosing a tax incentive, firms are also making a trade-off between corporate financial reporting costs and shareholder tax benefits.

This study conducts empirical tests in the following two ways. First, I compare the tax planning decisions of privately held and listed firms.[5] Compared with listed firms, privately held firms, which do not have stock price pressure from the capital market, are more likely to choose shareholder investment tax credits, thereby giving

[2] The credit rate depends on the type of shareholder. The credit rate is 20% for corporate shareholders and 10% for individual shareholders. Firms that choose a corporate 5-year tax exemption must relinquish the application for shareholder investment tax credits, and *vice versa*, with no alteration being allowed after the choice is made.

[3] Financial Data Center, Ministry of Finance (Taiwan), Statistics on Tax Revenues of Profit-Seeking Enterprise Income Tax (1999–2005).

[4] Taiwan's corporate income tax rate is essentially a flat rate of 25% for taxable income above NT$100,000.

[5] Privately held firms' stocks are not listed on either of the two stock exchanges. Hence, privately held firms are not subject to stock price pressure from the capital market.