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Incentives for corporate tax planning and reporting: Empirical evidence from Australia

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ABSTRACT

This study extends prior research on the willingness of firms to significantly decrease their corporate taxes. It specifically examines the associations between corporate tax avoidance and the reported significant uncertainty of a firm's tax position, the tax expertise and tax affiliations of its directors, and the performance-based remuneration incentives of its key management personnel. Based on a dataset of 200 publicly listed Australian firms over the 2006–2010 period (1000 firm years), we find that the reported uncertainty of a firm's tax position, the tax expertise of its directors, and the performance-based remuneration incentives of its key management personnel are significantly positively associated with tax avoidance. Conversely, firms with board members who have at least one tax-related affiliation are significantly negatively associated with tax avoidance.

1. Introduction

Corporate taxes can adversely affect a firm's financial position, financial performance, liquidity, operational results and cash flows (Grubert and Mutti, 1991; Shackelford and Shevlin, 2001; Dhaliwal et al., 2005; Beattie et al., 2006). This study extends prior research on the willingness of firms to aggressively decrease their corporate taxes. It specifically investigates the associations between corporate tax avoidance[2] and the reported significant uncertainty of a firm's tax position, the tax expertise and tax affiliation of its directors, and the performance-based remuneration incentives of its key management personnel. We examine the association between the reporting of uncertain tax positions and tax avoidance given that the Australian Taxation Office (ATO) requires firms to report uncertainties regarding tax positions, tax payable and tax recovery. The management and disclosure of tax risks by firms has come under increasing scrutiny by the ATO. Prior research has either provided little in the way of relating specific corporate governance and remuneration attributes to corporate tax avoidance or provided mixed results. We thus examine the associations between tax avoidance and specific board attributes such as tax experience, tax affiliation, and the performance-based remuneration incentives of key management personnel to determine whether managerial opportunities, incentives and capabilities exacerbate or impede the likelihood of tax-aggressive planning.

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[2] Corporate tax avoidance is defined in this study as any transaction or event ("passive" or "aggressive") that leads to a reduction in the amount of corporate taxes paid by a firm (see, e.g., Dyreng et al., 2008). Tax avoidance may be achieved through legitimate methods in accordance with tax legislation provisions. In fact, tax reduction methods may be either passive (complying with tax provisions) or aggressive (structuring transactions or activities with one of the principle objectives to decrease the amount of corporate taxes). Tax avoidance may alternatively be achieved through illegal means or means that are not in compliance with tax legislation provisions. These particular methods constitute tax evasion.

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Australian firms have come under increased monitoring by the ATO and other tax authorities such as the Internal Revenue Service (IRS) for a range of corporate tax avoidance activities. In particular, income shifting, strategic debt placement, research and development deductions, bad debt deductions, interest expense deductions, and the use of tax havens have recently been major areas of the ATO's focus (2010, 2012). In fact, according to the ATO: "Australia's top 200 listed companies are deriving significantly more of their income from overseas sources. Multinational groups may attempt to structure their global operations to minimize tax costs by, for example, maximizing the proportion of their profits recorded in low-tax jurisdictions" (ATO, 2012, p. 43). Recent media releases have also emphasized the ability of multinational firms operating in Australia (e.g., Apple, Google and Starbucks) to exploit the differences in tax laws, rules and regulations across multiple jurisdictions to significantly decrease the amount of corporate taxes they pay internationally (Australian Financial Review, 2012).

Using a dataset of 200 publicly listed Australian firms over 2006–2010 (1000 firm years), we find that the reported uncertainty of a firm's tax position, the tax expertise of its directors, and the performance-based remuneration incentives of its key management personnel are significantly positively associated with corporate tax avoidance. On the other hand, firms with board members who have at least one tax-related affiliation are significantly negatively associated with tax avoidance.

This study makes several important contributions. First, it investigates the association between corporate tax avoidance and a firm's reported uncertainties of its tax position, which has not been explicitly examined in prior studies. Our findings suggest that the disclosure of uncertainty related to the calculation of a firm's tax position is significantly positively associated with tax avoidance. Indeed, firms are likely to disclose tax uncertainties due to their participation in complex and obfuscatory tax avoidance activities. Risky or aggressive tax planning may obscure the firm's actual performance and decrease the information content of its taxable income. Second, this study examines the associations between tax avoidance and other variables such as directors' tax expertise, directors' affiliations with tax-related bodies (e.g., with *The Board of Taxation* and/or *The Institute of Taxation*), and the performance-based remuneration incentives of key management personnel, and is one of the first to do so. Third, this study complements other recent studies on tax avoidance carried out in the US (e.g., Armstrong et al., 2012; Cheng et al., 2012; McGuire et al., 2012) by analyzing the tax-motivated activities of publicly listed Australian firms on which there is negligible evidence in the literature.

The remainder of the paper is organized as follows. Section 2 considers the related theory and develops hypotheses. Section 3 reports the research design. Section 4 provides the empirical results. Finally, Section 5 concludes the paper.

2. Background and hypotheses development

Dyreng et al. (2008) observe that the behavior of key executives may have a significant effect on the level and nature of corporate tax avoidance as a result of how they influence the internal control and risk functions of firms and their management. In fact, Frank et al. (2009) find a positive association between tax and financial reporting aggressiveness. They provide examples of firms engaging in the earnings management of taxable profits and financial profits simultaneously, with their book income managed upward ("aggressive financial reporting") and their taxable income managed downward ("aggressive tax reporting") during the same reporting period. Firms that exhibit aggressive tax and financial earnings management strategies at the same time tend to have concomitant aggressive investing, financing, operating and compensation strategies (Frank et al., 2009).

Revsine et al. (2004) claim that the tax footnotes in a firm's annual report may be used to provide a more informed assessment of its current and future performance. They also argue that an increase in deferred tax liability may be an early signal of deteriorating earnings quality. Moreover, studies by Lev and Nissan (2004), Hanlon (2005) and Hanlon et al. (2007) find that larger book-tax differences (BTDs) are significantly associated with earnings persistence and timeliness. Thus, the disclosure of uncertainties related to the derivation of tax estimates may decrease the informativeness of BTDs. For example, uncertainties in the derivation of tax estimates due to the existence of operations in variably taxed jurisdictions could result in adjustment uncertainty via differential tax rates in the book-tax reconciliation statements.[3]

In this paper, we argue that variables pertaining to the reported uncertainty of a firm's tax position, the tax expertise and tax affiliations of its board members, and the remuneration-based incentives of its key management personnel are significant determinants of corporate tax avoidance.

2.1. Reported uncertainty of a firm's tax position

Recent research has considered the reporting of uncertain tax positions supported by complex international arrangements as indicative of aggressive tax behavior (e.g., Mills et al., 2010; Rego and Wilson, 2012; Lisowsky et al., 2013).[4] Aggressive tax strategies impose significant uncertainty for a firm in terms of applying tax legislation and deriving tax estimates. Uncertainties over current tax liability (or current tax asset) estimates may be reported in a firm's financial statement notes if its management

[3] Assistant Australian Treasurer David Bradbury further emphasizes that: "large multinational companies that use complex arrangements and contrived corporate structures to avoid paying their fair share of tax should not be able to hide behind a veil of secrecy" (The Treasury, 2012, p. 2). To that end, the ATO now requires large firms to report on their tax positions from 2012 if required, specifically as they relate to the likelihood of tax liabilities and any tax uncertainties the firm may have in terms of its reportable transactions (ATO, 2012).

[4] Consistent with Hanlon and Heitzman's (2010) study, tax positions or determinations are viewed conceptually as falling along a continuum from highly certain ("least aggressive") to highly uncertain ("most aggressive").