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Tax planning, corporate governance and equity value

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ABSTRACT

Tax planning by firms is a highly significant activity. After audit fees, tax related services are the largest source of fee income for UK accounting firms. When viewed in terms of its impact, tax planning is the major source of the corporation tax gap amongst large firms (HMRC, 2010). Although traditionally tax planning has been viewed as benefiting shareholders via increased after tax earnings, more recently the underlying motivation has been questioned. Desai and Dharmapala (2006) argue that when an information asymmetry exists between managers and shareholders with respect to tax planning, it can facilitate managers acting in their own interests resulting in a negative association between tax planning and firm value. Using a sample of UK quoted firms from 2005 to 2007 and data drawn from *International Accounting Standard 12 Income Taxes* (IASB, 2010) Effective Tax Rate (ETR) reconciliations, this paper reports such a negative relationship. Further, the relationship is robust to the inclusion of corporate governance measures which could be expected to moderate the potential implications of a tax related shareholder–manager information asymmetry. An innovation of this paper is in using the ETR reconciliations to examine sub-categories of tax planning activities. The paper contributes to the debate of who determines, and benefits from tax planning conducted by firms. Its findings have direct policy relevance for shareholders and tax administrations in monitoring and controlling firms' tax planning activities.

1. Introduction

Fees for tax services are the most significant source of fee income for UK accounting firms after audit fees (Accountancy, 2007). Typically, such fees amount to 24 per cent of total fee income received by the UK's 60 largest accounting firms (Accountancy, 2007). Whilst some of the advice relates to routine compliance matters it is reasonable to speculate that advice on tax planning comprises a significant element of the fee income. Reliable estimates of the scale of tax planning are notoriously difficult to make primarily due to lack of agreement on definitional and related measurement issues (National Audit Office, 2007). Recently HM Revenue and Customs (HMRC) has published estimates of the "tax gap" i.e. the difference between the theoretical liability and the amount collected. The latest available estimates are for 2008–2009 (HMRC, 2010) and show a corporation tax gap of £6.9 billion, equivalent to 13.9% of the theoretical liability. For the largest corporate groups administered by its Large Business Service (LBS), HMRC (2010) disaggregates the corporation tax gap into "tax avoidance issues" and "technical issues".[1] In the three year sample frame examined in this paper HMRC (2010) estimates that

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[1] HMRC (2010) defines technical issues as "uncertainty about the correct tax treatment, through mistakes to culpable errors in, or omissions from, the company tax return". This definition would therefore include the effects of tax evasion.

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tax avoidance contributes 77.4%, 87.5% and 92.9% of the estimated LBS corporate tax gap of £3.1 billion (2004–2005), £3.2 billion (2005–2006) and £2.8 billion (2006–2007) respectively, the balance being attributable to "technical issues" including evasion. These estimates have been criticised for underestimating the extent of the gap and their publication has led to debates on both the actions of tax payers and concerns over the performance of HMRC (Financial Times, 2010). Tax planning is clearly a significant activity both in terms of fees and tax saving.

This paper examines shareholders' valuation of corporate income tax planning.[2] In the absence of access to confidential tax return data we use the term *tax planning* to describe all activities designed to produce a tax benefit.[3] Although reducing tax can lead to higher after tax profits there are actual and potential costs that inhibit firms from maximising after tax profits through tax planning. In addition to direct paid costs in the form of salaries and fees, indirect paid costs can arise, for example, when corporate restructuring is a necessary condition for obtaining the desired tax benefit. Potential costs can exist to the extent that tax planning can be challenged by a tax administration which can also then lead to reputational costs. Empirical evidence from the US that suggests tax planning costs act as a significant constraint on corporate tax planning activity may explain what Weisbach (2002) describes as the "undersheltering puzzle" i.e. why firms do not appear to minimise tax liabilities.

More recent US research has suggested further costs, in the form of agency costs, lead shareholders to discount the value of firms by reference to levels of tax planning activity (Desai & Dharmapala, 2006). They argue the lack of transparency associated with tax planning provides managers with a "screen" or cover to hide self serving actions (Desai & Dharmapala, 2006). A survey by Henderson Global Investors (2005) found a reluctance on the part of managers to disclose tax related risk management information to shareholders. This lack of awareness on the part of shareholders can lead to information asymmetry between managers and shareholders facilitating moral hazard. A related concern of shareholders is that managers who are "aggressive" with respect to tax planning may also be "aggressive" in their financial reporting decisions (Frank, Lynch, & Rego, 2009). Against this setting it is also relevant to consider the role of corporate governance mechanisms in moderating any relationship between tax planning and firm value (Desai & Dharmapala, 2006).

Shareholder concerns may also be driven by general attitudes towards tax planning. Since the mid 1990s there is strong evidence of changing attitudes. At the supranational level the European Union (EU) and Organisation for Economic Cooperation and Development (OECD) have both acted to protect corporate tax revenues by initially focussing on combating "tax competition" between states (European Union, 1999; OECD, 1998). These initiatives were designed to limit the extent to which individual states could use tax policy to influence firms' location decisions. Subsequently the EU and OECD's focus moved to enhancing legal and administrative procedures to ensure consistent and effective administration of tax legislation. In particular, the European Union (2004) set out steps to improve the ease at which information on corporate tax payers can be passed between tax authorities and non-tax supervisory bodies. In its "Seoul Declaration" the OECD's *Forum on Tax Administration* announced its intention to study the role of tax intermediaries in "*unacceptable tax minimisation arrangements*" (OECD, 2008). More recently the OECD (2009) has focused on the banking industry as both a supplier and user of "*aggressive tax planning arrangements*".

The UK's HMRC has played a leading role in the above initiatives and this is reflected in recent changes within UK tax legislation and tax administration. The Permanent Secretary for Tax at HMRC, David Hartnett, describes 2004 as "*a tumultuous year in the tax administration's efforts to counter tax avoidance*" (Hartnett, 2009). In that year the HMRC's Anti-Avoidance Group (AAG) was established to develop and deliver the HMRC's anti-avoidance activities (Tailby, 2009). Also in 2004 new legislation (*The Disclosure of Tax Avoidance Schemes*) was enacted to provide HMRC with early information on the marketing of "aggressive" tax planning arrangements (HMRC, 2006).[4] A change of approach has also been adopted in implementing existing legislation with the HMRC's use of risk assessments to direct administrative effort to examining firms where the estimated level of corporate tax risk is highest (Freedman, Loomer, & Vella, 2007; HMRC, 2007).

Tax planning by firms is of wider public interest since it can affect the level of provision of public goods which can then contribute to social issues (Slemrod, 2004). Non-Governmental Groups in the UK such as Oxfam (2009), Christian Aid (2009) and Trade Union Congress (2009) have all examined the issue from a social justice perspective. A similar line was taken by The Guardian (2009) in a series of newspaper articles.

The measure of "tax planning" used in this paper is initially defined as the difference between a firm's current tax provision as disclosed in its annual financial statements and the (notional) level of tax that would be payable if its profit before tax was subject to tax at the UK statutory rate. We accept this is an imperfect measure of the outcome of tax planning activities for a number of reasons. Firstly, the measure would fail to detect tax planning that results in income not being subject to tax whilst also being excluded from accounting income. As discussed below strong incentives act against this scenario. Secondly, the measure includes non-discretionary differences between accounting and tax definitions of income

[2] All subsequent references to tax are to corporate income tax unless otherwise stated.

[3] Using only publicly available information replicates the position facing shareholders and therefore distinctions between (legal) tax avoidance and (illegal) tax evasion and intermediary concepts such as "acceptable tax avoidance" and "aggressive tax planning" cannot be made. In recognition of this we use the term tax planning to describe the observed effects though, as subsequently discussed, we would expect tax avoidance to be the main form of tax planning. Earlier studies that use the term tax avoidance make an implicit assumption as to the legality of the underlying tax planning processes. However, when referring to official reports we use the terminology adopted in the report for the sake of consistency.

[4] More recently the Government has established a "study programme" to establish the feasibility of introducing a "General Anti-Avoidance Rule" (GAAR) into UK domestic legislation (HM Treasury, 2010).