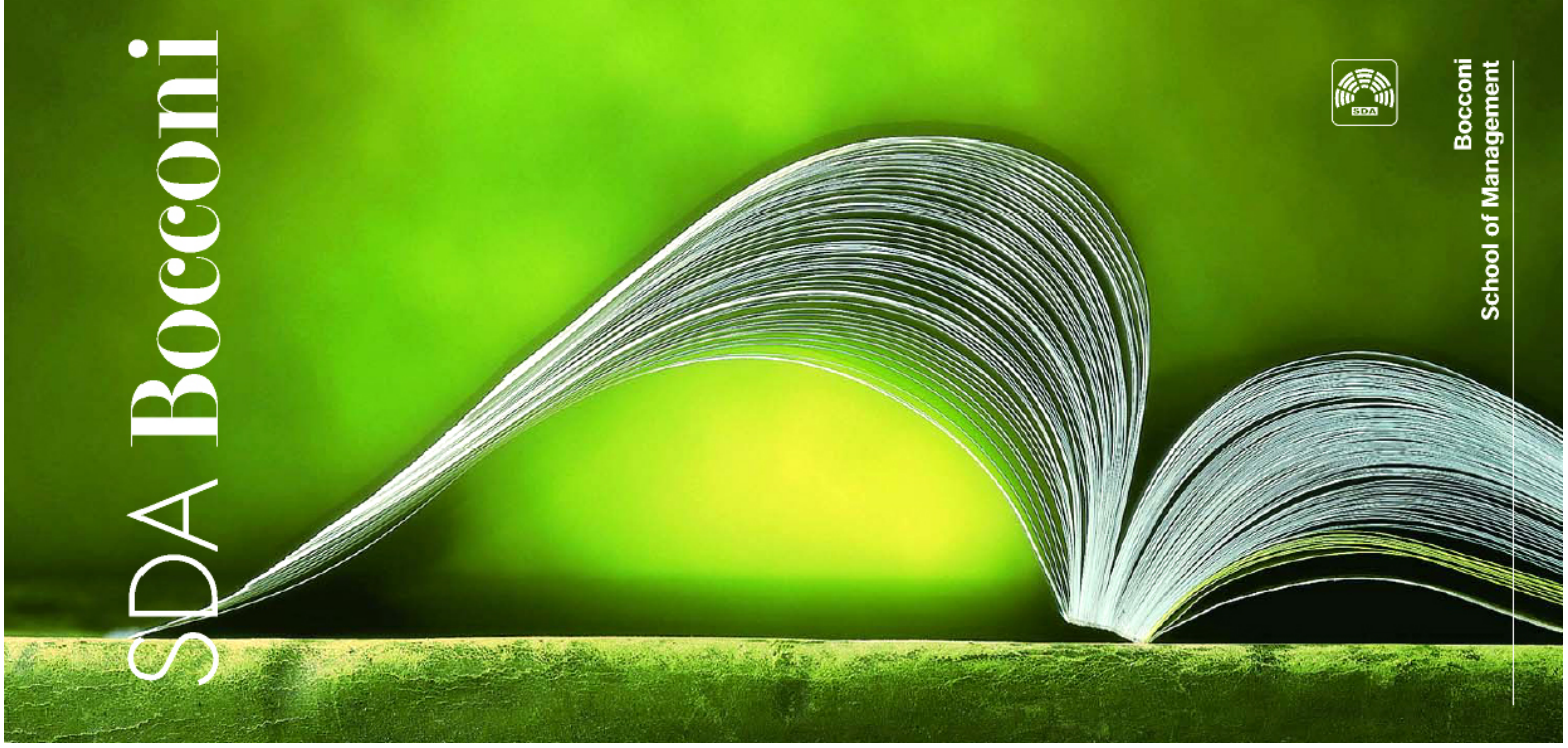

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AGGRESSIVE TAX STRASTEGIES AND CORPORATE TAX GOVERNANCE : AN INSTITUTIONAL APPROACH

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ABSTRACT

This paper deals with the impact of tax-aggressive strategies on corporate governance by adopting an agency perspective of the firm and discusses how certain corporate tax governance measures may limit these kinds of managerial actions. We first clarify a few basic concepts such as tax minimization, effective tax planning, tax avoidance, and tax evasion, which are important to understand in the discussion about aggressive tax behaviour. We further define the regulative concept of effective tax planning as a tax strategy that minimizes not only explicit taxes, but also implicit taxes and non-tax costs, focusing on the agency problems emerging between shareholders and tax managers and we use this key concept as a benchmark to identify what kind of tax-aggressive strategies pose relevant policy issues. By using the agency perspective we also highlight a series of important issues, such as: why and to what extent do managers pursue aggressive tax strategies, why are these strategies used in large companies, do these strategies advance shareholder value, and how can tax savings obtained through these strategies be measured? We conclude that aggressive managerial tax behaviour requires counterbalancing policies which are not limited to the traditional anti-avoidance rules but also include the tools of corporate tax governance; we also suggest that these tools can be divided in two groups: measures aimed at improving corporate governance and measures aimed at dealing with the 'book-tax gap'. The former type of corporate tax governance measures include risk and meta-risk management, disclosure rules, regulation of tax advisors, reporting by stakeholders, and penalties connected with tax avoidance. The latter type of corporate tax governance measures include reconciliation reports and publication of tax returns.

Carlo Garbarino

AGGRESSIVE TAX STRATEGIES AND CORPORATE TAX GOVERNANCE: AN INSTITUTIONAL APPROACH *

1. The interdependence of corporate tax strategies and corporate governance – 2. Effective tax planning and management of corporate non-tax costs – 3. Managerial tax behaviour in an agency framework – 4. Governance tools for limiting aggressive tax strategies

1. The interdependence of corporate tax strategies and corporate governance

In recent years, corporate practice has stretched the boundaries between legal tax planning and illegal tax avoidance (Freedman, 2008), as the focus of corporate tax departments has changed from tax compliance to aggressive, and often arguably illegal, tax planning. Corporate tax departments are increasingly viewed as profit centres bound to pursue a sort of creative compliance, so that in certain cases, the letter and purpose of tax laws are manipulated in order to obtain the most advantageous tax position, through techniques which include, in addition to tax sheltering, tax-enhanced financing structures and tax-efficient reorganizations motivated by business purpose, but which have important tax consequences.[1]

These corporate practices can be loosely labelled as 'aggressive tax strategies' and defined as the behaviour of tax managers who exploit the 'book-tax gap' to advance their own interests, creating a tension between managers and shareholders. A streak of recent studies has interestingly shown that these strategies affect different stakeholders (managers, shareholders, investors) and may involve obfuscatory activities linked to managerial opportunism and diversion of rents (Desai & Dharmapala, 2006a, 2006b); the emerging need to counteract these aggressive tax strategies has generated a policy and an academic discussion on the connections between taxes and corporate governance which has been recently addressed by the OECD (2004, 2006).

From a policy perspective in this scenario, corporate tax rules affect corporate governance and, in turn, corporate governance rules affect corporate tax strategies, in a kind of recurrent loop (Desai, Dick & Zingales, 2004; Friese, Link & Mayer, 2008, p. 31; Hartnett, 2008, p.3; Owens, 2008, p. 9). This dual relationship can be properly defined as the interdependence of corporate tax strategies and corporate governance, with the consequence that corporate tax behaviour can be regulated by corporate tax rules, corporate governance rules, and a combination of the two.

Among tax rules affecting corporate governance (Friese, Link & Mayer, 2008, p. 365), one should distinguish between structural rules (such as those on the distribution of corporate dividends or on reorganizations) and purposive rules (such as those which aim to limit tax avoidance or evasion). While structural tax rules

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[1] For a discussion of the situation in the US, see for example: Anthony (2003, pp. 37–38); Beale (2004b); Joint Committee on Taxation (2003); Morse (2006).

may affect governance even if that is not the primary policy purpose[2] (for example, a classical system for taxation of corporate dividends does not incentivize dividend distributions, and tax-neutral treatment of reorganizations facilitates mergers and acquisitions), anti-avoidance rules and tax sanctions are specifically aimed at impacting on corporate governance by limiting specific tax behaviour of managers (Freedman, 2004). By contrast, governance rules affecting corporate tax strategies are those which have an impact on the process of decision-making around tax strategies and are directed to managers, directors and other individuals involved in that process; these governance rules can be defined as 'corporate tax governance rules' and the situation of the company resulting from their adoption can be defined as '*corporate tax governance*'.

The measures of corporate tax governance which can be adopted in response to aggressive tax strategies include risk and meta-risk management, disclosure rules, regulation of tax advisors, reporting by stakeholders, and penalties connected with tax avoidance, and can be combined with measures aimed at dealing with the 'book-tax gap', such as reconciliation reports and publication of tax returns.

We will be addressing these issues here from a general policy perspective and we will not focus on specific countries' policies.[3] In this paper we will consider the impact of these tax-aggressive strategies on corporate governance by adopting an agency perspective of the firm, and we will then discuss how certain corporate tax governance measures may limit these kinds of managerial actions.

In this first section, we clarify the basic concepts of tax minimization and effective tax planning, which are important to understand in the discussion about aggressive tax behaviour. In section 2, we further define the regulative concept of effective tax planning as a tax strategy that minimizes not only explicit taxes, but also implicit taxes and non-tax costs, focusing on the agency problems emerging between shareholders and tax managers. In section 3, we use the key concept of effective tax planning as a benchmark to identify what kind of tax-aggressive strategies pose relevant policy issues. By using the agency perspective we also highlight a series of important issues, such as: why and to what extent do managers pursue aggressive tax strategies, why are these strategies used in large companies, do these strategies advance shareholder value, and how can tax savings obtained through these strategies be measured? Finally, in section 4, we conclude that aggressive managerial tax behaviour requires counterbalancing policies which are not limited to the traditional anti-avoidance rules but also include the tools of corporate tax governance.

In discussing tax strategies we adopt here an approach based on recent developments of neo-institutional economics which has been extended to the legal study of corporate actors (Demsetz & Lehn, 1985; Fama & French, 1998; Slemrod, 2004; Desai, Dick & Zingales, 2004). Neo-institutional economics, by studying the logic of contracts and economic organizations in competitive markets,[4] shows that institutional arrangements are optimal insofar as they reduce transaction costs.[5] The neo-institutional approach eschews models based on the frictionless ideal markets, focuses on transaction costs to explain the choice between market and non-market solutions, and interprets institutions as a framework in which transaction costs may be reduced. This approach, applied to corporate tax minimization strategies, focuses on the details of the environment in which transactions take place, and suggests an empirical attitude that requires the collection of data on individual transactions rather than on quantitative aggregates. This approach is process-orientated, dynamic, evolutionary, and seeks to identify the principal factors of institutional development within an agency framework of the firm. As a result, this approach rejects market equilibrium analysis and instead places emphasis on the adaptation to disequilibrium, hypothesising that 'inefficiency' gives rise to adaptive efforts to minimize costs.[6]

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[2] For a discussion of governance measures in the US which have an impact, although an indirect one, on tax strategies, see: Bank (2004) and Hartmann (1994).
[3] In the US corporate tax governance rules have been introduced in the wake of recent financial and corporate scandals and are one of the main concerns of the new administration; see in general: Beale (2004); Friese, Link & Mayer (2008, p. 357); Hardesty (2004).
[4] There is a vast literature on this topic; see for example: Demsetz (1988); North (1986a); North (1986b); Williamson (1985); Williamson (1975).
[5] For a general discussion, see: Allen (1991).
[6] The differences between the neo-classical and neo-institutional approach are illustrated by their respective treatment of contractual relations. In the neo-classical framework, the allocative goal of contract law is to promote the efficient allocation of resources. By contrast, the neo-institutional approach recognizes that the

With regard to corporate tax strategies, the neo-institutional approach emphasizes time, uncertainty and the frictions associated with market contracts, and non-market (or relational) contracts (for example, the transaction costs of writing and executing contracts are interpreted as emanating from uncertainty and bounded rationality and a lack of competitive pressures (small number of contractors)). The combination of these factors gives rise to opportunism which is defined as the 'effort to realize individual gains through lack of candour or honesty in transactions', and to the need for governance constraints that discourage parties from being opportunistic. The emphasis of this approach is not on utility-maximizing contracts where the law fills in terms unspecified by the parties, but on adjustment processes that preserve ongoing contractual relations in the face of opportunism.

We place corporate tax strategies within this institutional framework and consider them as institutional arrangements generating transaction costs within the agency structure of the firm. Although we adopt an empirical view of the impact of tax strategies on the value of the firm, a few preliminary definitions are required, as we will be using different terms (tax minimization, effective tax planning, tax avoidance, tax evasion) which have legal usages whose meanings often tend to overlap. Two of these terms (tax minimization and effective tax planning) have a descriptive dimension, while the other two have a normative dimension (tax avoidance and tax evasion).

Tax minimization is defined by Scholes *et al.* as the reduction of explicit taxes with the aim of maximizing after-tax-returns, without considering other dimensions of the transaction or business problem (Scholes, Wolfson, Erickson, Maydew & Shevlin, 2005, p. 544). Firms pursue tax minimization when they look at the reduction of effective tax rates as their primary strategic tax goal, without paying specific attention to non-tax costs and this is a widespread attitude in tax departments. By contrast, we use the concept explicitly coined by Scholes *et al.* of *effective tax planning*, which is defined as a strategy which encompasses not only explicit taxes, but also implicit taxes as well as other non-tax costs that arise in a world of costly contracting (Scholes, Wolfson, Erickson, Maydew & Shevlin, 2005, p. 534). These non-tax costs factored in by effective tax planning are direct costs, the cost of risk, the risk of sanctions, disclosure costs, and agency costs and we will discuss them in some detail in the next section[7]. We consider not only tax costs but also other non-tax costs and we use the effective tax planning concept because we are interested in the behaviour of corporations as a whole in the implementation of such tax strategies.

With regard to the two terms having a normative dimension, *tax evasion* is usually distinguished from *tax avoidance*. The distinction between tax evasion and tax avoidance is a legal one and therefore each jurisdiction has its own concept of tax evasion and tax avoidance Tax evasion is usually defined as an intentional behaviour involving a direct violation of tax law in order to escape payment of taxes, while tax avoidance is defined as a behaviour aimed at reducing tax liability which does not violate the letter of the law, but clearly violates its spirit.

As to tax avoidance, the problem that each tax jurisdiction faces is to define what tax-saving behaviour is legally accepted and this line is usually traced on the basis of the business purpose doctrine. Consequently activities which do not have any goal other than reducing taxes (i.e., activities which do not have any business purpose) are generally considered illegal. When multiple transactions are involved, an additional issue is whether such transactions should be viewed as a whole (the step transaction doctrine and substance over form doctrine).

2. Effective tax planning and management of corporate non-tax costs

Tax is a significant cost factor for companies because minimizing tax will increase profitability, and tax liability is a manageable cost that can be reduced like any other operational cost. An optimal strategy, however, is not necessarily the one that just reduces explicit taxes (tax minimization, as defined here), but a wider strategy that also encompasses implicit taxes and non-tax costs (effective tax planning, as defined

temporal character of contract gives rise to the possibility that one party may breach the contract even when it is inefficient to do so, and that this requires enforcement mechanisms.

[7] For a discussion of these costs see Sartori (2009).

here). Thus the main objective of tax strategies is to reduce explicit taxes (i.e., all present and future taxes), as well as to consider implicit taxes and non-tax costs, in order to ensure that tax minimization is not entirely offset by *implicit taxes* and *non-tax costs*. As envisaged by Scholes *et al.* effective tax planning therefore encompasses different types of non-tax costs such as compliance costs, implicit taxes, transaction costs, the cost of risk, disclosure costs, and agency costs. These costs are briefly considered here.

Effective tax planning must consider the costs directly connected with engaging in tax planning activities, as well as the cost of *implicit taxes*. As underlined by Scholes, 'effective tax planning requires the planner, in making investment and financing decisions, to consider not only explicit taxes (tax dollars paid directly to taxing authorities) but also implicit taxes (taxes that are paid indirectly in the form of lower before-tax rates of return on tax-favored investments)' (Scholes, Wolfson, Erickson, Maydew & Shevlin, 2005, p. 2). A reduction of explicit taxes may cause an indirect increase of the implicit taxes, which emerge when the before-tax rate of return of investments becomes lower. Implicit taxes arise because the before-tax investment returns available on tax-favoured assets over time tend to be less than those available on tax-disfavoured assets (e.g., the reduced yield available on tax-exempt municipal bonds in the United States relative to taxable corporate bonds of equal risk).

Efficient organizational choice is not determined simply by a strategy of minimizing explicit and implicit taxes, because different tax plans generally give rise to differences in other *non-tax costs* such as direct costs, the cost of risk, disclosure costs, and agency costs, so that a weighted trade-off among different variables must be considered in shaping effective tax planning. These non-tax costs are those costs incurred in the marketplace related to the implementation of an effective tax planning strategy; they are due to the fact that information is costly, and not all taxpayers have the same information because of symmetric uncertainty, hidden action, and adverse selection (Scholes, Wolfson, Erickson *et al*., 2005, p. 156). In order to reduce these uncertainty costs, the parties engage in drafting complex agreements such as tax liability covenants, requests for rulings, wind-up options—all of which involve non-trivial additional transaction costs. These internal costs are mainly incurred as the time spent by managers and employees on structuring the tax-saving opportunities that could not be devoted to other activities, while the external costs are primarily the expenses paid to tax consultants as well as any other expenses necessary to set forth the tax planning strategy.

Effective corporate tax planning must also specifically consider the *cost of risk for sanctions* (Logue, 2006), which varies from case to case and is measured by considering the risk propensity of the tax managers and the likelihood of winning a tax litigation. The existing literature on tax evasion assumes that individual taxpayers are risk-averse, but this assumption seems unsatisfactory for a large publicly-held firm because decisions about taxes are made by managers, acting as agents of the shareholders; this aspect is discussed in detail below in section 3 (Slemrod, 2004, p. 882).

As the risk of sanction is a cost factor, the company should implement a tax risk management process that has the right balance between risk of detection and opportunity of reducing taxes (Erle, 2008, pp. 13–17). This corporate tax risk management system leads to a sort of explicit or implicit code of conduct which is specific to each individual company, and intends to establish standards for tax behaviour *vis-à-vis* tax authorities (Freedman, Loomer & Vella, 2008). The output depends on whether managers see tax obligations as normal costs that need to be minimized, or as a social responsibility obligation. While most companies appear to believe that tax is a cost factor, the public interest in corporate social responsibility (CSR) is growing, and paying the taxes legally required is considered an important part of being socially responsible. Reputational costs therefore are increasingly considered in designing the corporate tax risk (Avi-Yonah, 2004, 2005a, 2005b, 2006, 2008).

Other non-tax costs that effective tax planning must take into account are *disclosure costs*. Disclosure costs are those costs connected with communication on tax issues, such as the description of corporate tax strategies together with their relevant exposure (Erle, 2008, p. 21). Two main goals must be conciliated: to give adequate information both to the tax authorities and the shareholders. The problems resulting from a lack of tax risk information are exacerbated in an environment where advisors are able to devise and implement strategies that manipulate the tax laws (Beale, 2004b, pp. 555–57).

The last type of non-tax costs which should be considered in effective tax planning are *agency costs*. This agency dimension opens up a new set of issues because there is an apparent link between tax strategies and increased agency costs in the framework of publicly-held corporations, given the fact that shareholders act as principals while tax managers act as agents in respect to the design and implementation of corporate tax strategies. The problem lies in motivating the agent (the tax managers) to act in the principal's interest (the shareholders) rather than simply in the agent's own interest and here we are specifically interested in those agency problems emerging between shareholders (i.e., the principal) and managers (i.e., the agent) which are related to the strategic tax behaviour of the company in respect both to monitoring costs and exposure to the risk of sanctions. When managers engage in effective tax planning which is a licit tax-saving strategy, the cost of tax risk is relatively low and monitoring cost are relatively low given the fact that relevant information is provided by managers to shareholders through financial statements; in these situations, standard agency costs are borne by shareholders to monitor the managers.

However, when managers engage in aggressive tax behaviour the cost of tax risk increases dramatically because the principal must engage in costly monitoring of the agents to assure the quality of the agent's performance. In addition, tax managers may mischaracterize and obscure these transactions and their purposes in order to minimize the risk of tax audits and tax penalties (Desai & Dharmapala, 2008, p. 13), and such behaviour increases the gap between information available to both managers and shareholders. This creates an information asymmetry which forces the shareholders to devote more resources to monitoring the managers, thus increasing agency costs. In conclusion, information asymmetry between agents and principals is more evident in the presence of aggressive (and obscure) tax planning strategies in which there is an increase of agency costs in order to align the interests of managers with the interests of shareholders.

3. Managerial tax behaviour in an agency framework

The concept of effective tax planning discussed in the previous section is a useful benchmark to discuss managerial tax behaviour in an agency framework of the firm, as it identifies an optimal tax strategy in which, at least in theory, tax reduction is not offset by implicit taxes and other non-tax costs, including the cost of tax risk. Here we make the point that aggressive tax behaviour exposes the company to the risk of tax sanctions (a key factor in an economic analysis of tax evasion)[8] and therefore claim that these strategies are to be considered within the economic models of corporate tax evasion, using an agency framework of the firm.

The economic models of tax evasion examine how the tax rate, probability of detection, and penalty rate affect the decision to evade when there is a costly concealment situation within a principal-agent framework in which shareholders and tax managers operate with respect to corporate tax strategy. The seminal work by Allingham and Sandmo considered the decision about whether to evade and, if so, how much to evade, as a choice under uncertainty in which there is a trade-off between a gain if the evasion is undetected and a loss if the evasion is detected and penalized. In this model non-compliance is determined by the probability of sanctions, and the risk aversion of the taxpayer (Allingham & Sandmo, 1972, p. 324).

As noted by Slemrod thirty years of subsequent analysis have extended this model in a number of dimensions, including: allowing an endogenous probability of sanctions; analyzing evasion jointly with the labour supply decision; incorporating sources of uncertainty other than the chance of audit; and general equilibrium considerations (Slemrod & Yitzhaki, 2002). In particular recent contributions have focused more specifically on *corporate* tax evasion and evidenced that this kind of behaviour cannot be explained by the traditional model for individuals (or closely-held firms). Whereas tax evasion by an individual is a single-person decision problem, tax evasion by companies involves the strategic behaviour of many persons (Slemrod, 2004, p. 882). The firm owner makes the tax-reporting decision without delegating decision-making responsibility, but in large, publicly-held corporations, decisions about tax strategies are made by the agents of the shareholders, i.e., the tax managers (the chief financial officer or the tax director).

[8] Fines for tax avoidance are usually different from those for tax evasion, but this varies from system to system and on a case-by-case basis.

The role of aggressive tax behaviour by managers within an agency framework of the firm poses a new set of issues which are related to the alignment of their interests with those of the shareholders: why and to what extent do managers pursue aggressive tax strategies; do such aggressive tax strategies by managers advance shareholder value; and how can tax savings obtained through aggressive tax behaviour by managers be measured?

The first issue we discuss in this section of the paper—why and to what extent do managers pursue aggressive tax strategies which benefit the company—can be explained by adopting a traditional principal-agent approach by looking at the alignment of interests of managers and shareholders in respect to tax strategies.. In theory, the amount of benefit received by the shareholders resulting from aggressive tax strategies pursued by company managers could be explicitly defined through compensation packages for tax managers. These compensation packages would align the interests of managers with those of shareholders and induce managers to behave as risk-neutral persons managing the corporation's business in line with the principle that corporations should always behave as if they were risk neutral, even if shareholders are not (Crocker & Slemrod, 2005).

In the real world, however, there is an underlying tension between the interests of the principal (the shareholders) and the interest of the agent (the tax managers). Thus, the issue of why and to what extent do managers pursue aggressive tax strategies has been addressed by making different assumptions on the propensity to risk of managers and shareholders with respect to any aggressive tax action to be taken by managers (Slemrod, 2004, p. 891). Some initial models have assumed that shareholders are risk neutral and managers risk averse (Chen & Chu, 2005); subsequently, other models have assumed that shareholders are not risk neutral but maintained the assumption that managers are risk averse (Crocker & Slemrod, 2005). By contrast, a recent line of research has doubted the assumption that the managers are risk averse and discussed situations in which managers are risk-takers engaging in aggressive strategies (Desai & Dharmapala, 2006a, 2006b, 2007, 2008).

In the first model, developed by Chen and Chu, shareholders are characterized as risk neutral and managers as risk averse, with tax managers serving as agents to shareholders, and bearing the risk of being detected and sanctioned. To induce the agents to participate, the contract needs to compensate agents for their risk, so the shareholders will structure the compensation packages of managers to provide incentives for them to act in the interest of shareholders.

The claim by Chen and Chu is that efficient contracting calls for the principal to share the risk with the agent by paying the agent a higher compensation when tax evasion is detected. In order to align the incentives of tax managers with the interests of shareholders, the shareholders can tie the tax managers' compensation to the average effective tax rate or after-tax corporation profitability that affects the share price, or else tie compensation directly to the share price, as through the granting of stock options, so that the shareholders can link the compensation of managers to after-tax profitability. In theory, the agent's compensation should then be contingent on whether or not illegal action is detected. However, since such an *ex post* compensation cannot be legally enforceable, the agent will insist that this risk be compensated *ex ante* through a compensation contract. The compensation contract, however, cannot be contingent upon whether or not evasion is detected, and therefore is an incomplete contract which distorts the behaviour of the agent and creates a cost of internal control.

As a result, in that model, the company as a whole has to balance the trade-off between two considerations: on the one hand, tax evasion can increase its expected after-tax income, but on the other hand, the company also needs to bear not only the risk of sanctions but also the cost of efficiency loss in internal control. Thus, in addition to the income-versus-risk trade-off known in traditional models, there is here an additional trade-off between internal control and expected gain in evasion.

The Chen and Chu model does not factor in the cost of risk of penalties and implies that the risk-neutral shareholders (the principal) will instruct the risk-averse managers (the agents) to evade tax only when the expected profit from evasion is greater than that from reporting honestly, and by a substantial margin which includes compensation to the managers and the cost of internal control. By contrast, in a similar situation in which the cost of risk of penalties is not factored in a shareholder/managers corporate framework, a risk-neutral individual will evade taxes if and only if the expected profit from evasion is greater than that from

reporting honestly and no additional margin is needed. This model tells us that if the expected tax savings from evasion by the corporation is positive and the principal is risk neutral, the agent will not necessarily choose to evade taxes (i.e., that the condition for profitable tax evasion is more stringent for companies than for individuals, because the internal efficiency loss plus the managers' compensation may outweigh the expected gain from evasion).

Aggressive tax behaviour by managers has also been addressed by other approaches which maintain the assumption that managers are risk averse, but also that shareholders are not risk neutral. These approaches highlight that while for individuals and closely-held businesses, risk aversion limits the amount of evasion that is optimal, this does not necessarily occur with large companies where shareholders are not risk neutral, as they hold diversified portfolios which may or may not favour aggressive tax strategies to be pursued by managers acting as agents of the shareholders (Slemrod, 2004).

Thus, there is a clear link between the diversified risk portfolio of the shareholders and of tax managers' behaviour, but to answer how this risk portfolio of shareholders affects tax managers' behaviour is difficult for several reasons. First, there is limited available information as to how the degree of tax aggressiveness varies across different corporations, as well as how shareholders interpret managers' signals concerning the favoured level of 'tax-aggressiveness'. Second, while for individuals, evasion choices involve a cost-benefit calculation combined with certain qualitative elements (such as the perception of fairness of the tax system, taxpayer's sense of duty, propensity to risk of sanctions), for corporations, additional elements which link tax strategies to wider corporate strategies must factored in to explain tax evasion. For example, the goal of corporate tax departments is widely viewed to be the reduction of effective corporate tax rates to enhance global net returns, but exposure to tax sanctions entails reputational risks, and there are relevant non-tax costs in implementing tax strategies.

Finally, there is a recent line of research which has assumed that managers are risk-takers (Desai & Dharmapala, 2006a, 2006b, 2007, 2008) and which addresses the question why aggressive risk-generating managerial action designed to minimize taxes is observed in practice, considering that tax managers have been traditionally assumed to be risk averse in large corporations.

Before these recent studies tax managers have previously been assumed to be risk averse on the basis of a twofold reasoning: first, that the agency mechanism implies that the activities of tax managers come under the monitoring activities of the shareholders; second, that there are difficulties in tying managers' compensation to the reduction of effective corporate rates resulting from their aggressive tax strategies. The consequence drawn from the fact that tax managers were allegedly risk-averse was that firms ended up not to exploit all the possibilities of underreporting which would be theoretically available (the so-called 'undersheltering paradox') (Weisbach, 2002).

As the current cases of aggressive tax strategies by managers appear to deviate from the results of extant research based on the assumption that tax managers are risk averse, an ad hoc explanation had to be found. This explanation has been provided recently by Desai *et al.*, who found that obfuscatory tax avoidance activities can create a shield for managerial opportunism and the 'diversion' of rents without a full transfer of value to shareholders.

The term 'diversion' should be understood as any action benefiting managers and which is not in the interests of shareholders (earnings management that provide benefits to managers and do not benefit shareholders). According to this view, these kinds of aggressive tax strategies involve costs generated by the behaviour through which managers ensure that these strategies are obscured from tax authorities. These costs pile up with direct costs, risk of sanctions, and increased agency costs triggered by shareholders' monitoring (Desai & Dharmapala, 2008). In the light of these recent studies, the undersheltering paradox may thus be explained: shareholders bear the risk of not receiving the benefits of tax reductions and prevent tax managers from acting aggressively because they doubt the value of such aggressive tax behaviour pursued in the absence of good governance. The conclusion is that aggressive tax behaviour is probably linked to situations of poor governance which limit information available to shareholders concerning managerial activities.

Desai and Dharmapala discuss examples of the interaction between tax shelters and various forms of managerial opportunism, illustrating that straightforward diversion and subtle forms of earnings manipulation can

be facilitated when managers undertake tax avoidance activity (Desai & Dharmapala, 2007). An important point made by these contributions is that the view according to which managers avoid taxes once their incentives are sufficiently aligned with shareholders does not incorporate the central tension between managers and shareholders, i.e., that managers may behave opportunistically and in a manner that is not in the interests of shareholders (Desai & Dharmapala, 2006b, pp. 3–4).

This kind of managerial opportunism is directly linked to tax avoidance because a typical aspect of tax avoidance is the need to engage in actions that obscure the underlying intent of the transaction. Such obfuscation can thus simultaneously imply diversion (managers engaging in actions not in the interests of shareholders) and avoidance (managers shielding income from tax authorities). Diversion and avoidance are complementary, insofar as obfuscation reduces the cost of diversion and the likelihood of not being detected. An additional complementarity is linked to the 'book-tax gap' that reduces tax income while inflating book income. Desai and Dharmapala show how within a model where managers are opportunistic, a variety of such complementarities between sheltering and diversion are possible (Desai & Dharmapala, 2006b, 2008, p. 18).

The second relevant issue of this section of the paper is whether aggressive tax actions by managers advance shareholder interests. The traditional view of corporate tax avoidance suggests that shareholder value should increase with tax reduction activities. For example, several studies argue that tax shelters serve as a substitute for interest deductions in determining capital structure, or as proxies for similar tax reduction techniques (Graham & Tucker, 2006). This is a somewhat short-sighted view because the gains to those companies that pursue aggressive tax strategies do not accrue to the shareholders directly, but accrue to them in their role as residual claimants, and are shared with the tax managers through incentivized compensation contracts (Slemrod, 2004; Auerbach, 2006).

Moreover, the view that shareholder value increases with corporate tax minimization activities would be true only if corporate tax minimization activities were costless, as, if that were the case, they would result in a direct transfer of value to shareholders. These tax minimization activities, however, involve non-tax costs which are borne by the company and reduce shareholder value. An additional difficulty in achieving a solid understanding on how the corporate tax benefits percolate down to shareholders is the flexible contractual relationship that affects the behaviour of the corporate managers which has been discussed above.

The issue of transfer of value to shareholders through aggressive managerial tax actions is also addressed in a recent series of papers by Desai *et al.*, which point out that opportunistic managers in large companies can employ tax avoidance to advance their own interests. These studies suggest that if such behaviour allows managers to pursue self-serving objectives, then it may be the case that the net tax benefit is not conveyed to the shareholders (Desai & Dharmapala, 2007, p. 4). These papers challenge the presumption that corporate tax avoidance represents an outright transfer of value to shareholders, and show that incorporating agency issues into the analysis of corporate tax avoidance leads to conclusions that are different from those that would be predicted by a model where managers are perfect agents.

Two small sample studies conducted by Desai *et al.* indicate that the valuation of tax avoidance activities may not conform to the simple story of tax avoidance as a transfer of value to shareholders. First, corporate expatriations—transactions where US firms invert their corporate structure so that a subsidiary in a tax haven becomes the parent entity—provide significant corporate tax savings with limited, if any, operational changes, but markets react negatively to US firms announcing such moves (Chorvat, 2003; Desai & Hines, 2002). Second, an event study of an episode of increased tax enforcement in Russia indicates that these enforcement actions are associated with positive market reactions (Desai, Dick & Zingales, 2004); interestingly, Hanlon (2008) shows that the reaction by the market to announcements of aggressive behaviour is small.

The final issue we address in this section of the paper is the measurement of corporate tax benefits resulting from aggressive managerial action. Tax evasion is usually estimated on an aggregate basis (Slemrod & Yitzhaki, 2002), while in the case of tax avoidance, a specific measure of the sheltered income must be achieved for each taxpayer. The practice of corporate tax avoidance is, however, ahead of current empirical analysis, simply because it is difficult to obtain information about practices that are potentially illegal. In addition to that, publicly-available financial statements and tax returns do not account for the underlying sheltering

structures. These limitations affect policy analysis, and research on tax avoidance and aggressive tax strategies, as they make it difficult to sort out which tax reductions are the result of such strategies.

Corporate tax avoidance can, however, be measured indirectly by considering first the difference between the income reported to capital markets and the income reported to the tax authorities (the so-called 'book-tax gap').[9] As income reported to tax authorities cannot be observed directly and must be inferred using financial accounting data, this approach uses firms' reported tax expenses and grosses up this tax liability by the relevant corporate tax rate (Manzon & Plesko, 2002). Once the inferred value of the firm's taxable income is determined, the book-tax gap can be estimated by subtracting inferred taxable income from the firm's reported pre-tax financial income. While there are a number of important limitations to this approach (Hanlon, 2003), it remains the only available procedure for measuring book-tax gaps, in the absence of direct observation of firms' tax returns.

The problem here is that the book-tax gap does not necessarily reflect corporate tax avoidance activity, and therefore the measurement of tax avoidance must consider other factors. Current research shows that the book-tax gap does not overlap exactly with tax savings resulting from tax avoidance and changes in the book-tax gap can be interpreted by the market not only as evidence of tax avoidance, but also as signals of overall tax planning ability for well-governed firms.

The approach developed in Desai and Dharmapala, for example, essentially isolates the component of the estimated book-tax gap that is not explained by accruals or abnormal accruals (Desai & Dharmapala, 2006a). The accounting literature in recent years has proposed 'earnings management' as another explanation to the book-tax gap, as earnings management is the manipulation of reported income by managers in order to reach bonus targets, avoid reporting losses, and achieve various other aims (Beatty & Harris, 1999; Dechow, Richardson & Tuna, 2003; Graham, 2003; Graham, Lang & Shackelford, 2004; Graham & Tucker, 2006, p. 563; McNichols, 2003). Underreporting may also be obtained through adjustments to realized cash flows that are used in calculating the firm's net income. More refined proxies developed subsequently focus on the abnormal component of accruals, and make various other adjustments. On the basis of extant research, in conclusion, book-tax gaps can be attributable to earnings management, cash flow adjustments, tax avoidance, and other techniques in combination.

4. Governance tools for limiting aggressive tax strategies

We can draw now some policy conclusions from the analysis conducted above in section 3 where we have discussed managerial aggressive tax behaviour within the agency framework of the firm: managers pursue aggressive tax strategies which benefit the shareholders insofar as they are compensated in respect to the reduction of effective rates, but this is an incomplete and relatively obscure contract; managerial aggressive tax strategies do not advance shareholders' value insofar as they involve increased non-tax costs, increased risk of sanctions, and increased agency costs borne by shareholders for monitoring the activities of managers; and finally, these obfuscatory activities can create a shield for managerial opportunism and the diversion of rents in which managers advance their own interests instead those of shareholders.

Thus it appears that aggressive tax strategies not only trigger an increase in non-tax costs (direct costs, risk of sanctions, agency costs), but also involve obfuscatory activities linked to managerial opportunism and diversion of rents, while there are important informational deficiencies highlighted by the 'book-tax gap' debate as to the amount of tax reduction achieved through these aggressive strategies. These situations clearly require adequate counterbalancing policies. OECD guidelines point in that direction as relevant sections of the OECD Report of 2004 define a set of principles of good corporate governance.

The OECD (2004) Principles I–V appear to be violated by those aggressive tax strategies described in section 3. According to Principle I, the corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law, and clearly articulate the division of responsibilities among

[9] See: Beale (2004); Desai (2003); Hanlon (2005); Hanlon, Laplante & Shevlin (2005); Mills & Plesko (2003); Plesko (2007); Shaviro (2007).

different supervisory, regulatory, and enforcement authorities, but aggressive tax strategies engender obfuscatory activities which can create a shield for managerial opportunism and the diversion of rents. According to Principles II and III, the corporate governance framework should protect and facilitate the exercise of shareholders' rights and ensure the equitable treatment of all shareholders, while aggressive tax strategies may not benefit the shareholders.

According to Principle IV, the corporate governance framework should recognize the rights of stakeholders established by law or through mutual agreements and encourage active cooperation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises, while aggressive tax strategies may be creating a tension between managers and shareholders insofar as diversion activities are pursued by managers. Moreover, OECD Principle IV is in line with the growing interest in corporate social responsibility of businesses where tax is viewed as an area where companies have to show value-based behaviour (Avi-Yonah, 2004), and aggressive behaviour runs counter to this kind of corporate social responsibility.

According to Principle V, the corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company, while aggressive tax strategies may favour behaviour through which managers ensure that these disclosures are not made to tax authorities. Finally, according to Principle VI, the corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders, while aggressive tax strategies may create tensions in the sound management of corporate risk by the board.

The problems raised by aggressive tax strategies pursued by companies are typically addressed by increased enforcement and general anti-avoidance rules which tend to lower the return of aggressive managerial tax behaviour and therefore the amount of diversion. The point to make here is that the tools of corporate governance, in addition to these traditional tax tools, may contribute to the solution of corporate problems posed by aggressive managerial tax behaviour. Empirical research and anecdotal evidence suggest that poor governance arrangements may facilitate strategies by managers who can employ corporate tax avoidance to advance their own interests, but also that in well-governed firms the transfer of value of tax-minimizing activities to shareholders is preserved because the opportunities for managerial rent diversion are limited and the exposure to sanctions is low.

The argument supporting corporate governance as a tool to limit aggressive tax behaviour has valid grounds. First, while the impact of change of anti-avoidance rules on aggressive tax behaviour is difficult to model as it involves relevant transaction costs connected with litigation resulting from anti-avoidance audits, corporate governance rules can have a direct impact on managers' decisions, which can be monitored. Second, corporate governance rules that guarantee transparency can protect shareholders from managerial opportunistic behaviour by improving shareholders' ability to monitor or sue the managers for their tax misconduct or by requiring manages to provide more information on tax strategies. Third, corporate governance can favour the alignment of interests of managers with those of shareholders through explicit compensation packages for tax managers. Fourth, companies, by bringing governance principles into their tax decision-making process and by properly evaluating their exposure to tax sanctions through transparent procedures, can convince tax authorities that lower levels of control are needed. Finally, governance rules limiting aggressive managerial tax behaviour do not conflict with anti-avoidance rules and can operate in combination with them.

The importance of corporate governance tools in deterring non-compliance behaviours has also been emphasized by OECD. In 2004, the OECD developed a set of corporate governance standards and guidelines, intended 'to assist OECD and non-OECD governments in their efforts to evaluate and improve the legal, institutional and regulatory framework for corporate governance in their countries, and to provide guidance and suggestions for stock exchanges, investors, corporations, and other parties that have a role in the process of developing good corporate governance' (OECD, 2004, p. 11). The importance of corporate governance tools in deterring non-compliance behaviours has also been emphasized by the OECD in the Final Seoul Declaration (OECD, 2006, p. 3), where it acknowledged that the policy debate 'revealed continued concerns about corporate governance and the role of tax advisors and financial and other institutions in relation to non-compliance and the promotion of unacceptable tax minimization arrangements'.

The measures of corporate tax governance which can be adopted in response to aggressive tax strategies include risk and metarisk management, disclosure rules, regulation of tax advisors, reporting by stakeholders, and penalties connected with tax avoidance. Additional measures can be aimed at dealing with the 'book-tax gap', such as the introduction of sections in corporate tax returns to conciliate book with tax results (Lenter, Slemrod & Shackelford, 2003) and the disclosure by companies of tax information to the public (OECD, 2004, p. 50). We focus here on the measures of corporate tax governance, rather than on 'book-tax gap' measure which have already been extensively addressed (Hanlon, 2003, 2005, 2008; Hanlon, Laplante, & Shevlin, 2005; Manzon & Plesko, 2002; Mills & Plesko,2003); Plesko, 2007).

Corporate rules that impose on the board the *implementation of a tax risk management process* can bring to the board the responsibility for the tax decision-making process and lead to corporate tax risk management systems that establish standards for corporate tax behaviour (Van Blerk, 2005). This is in line with OECD guidelines, according to which, an 'important board responsibility is to oversee systems designed to ensure that the corporation obeys applicable laws, including tax, competition, labour, environmental, equal opportunity, health and safety laws' (OECD, 2004). Proper corporate tax risk management can be ensured by introducing internal specific agencies to monitor this aspect of corporate risk management; this can be done by setting up a proper internal risk-control procedure, which basically requires pre-approval by an internal audit committee and a direct involvement of the board.

In tax risk management, one should distinguish between the tax risk profile of the reporting company and the tax risk profile of the audit or consulting firm. The tax risk profile of the reporting company should include all relevant information about the tax-motivated transactions of the company to guide auditing committees and the board in their task of monitoring the risk of the company. The tax risk profile of the consulting firm should include all relevant information concerning its activity, such as the extent of advising work on tax-driven transactions, as well as the failure rate of the consulting firm in relation to tax benefits of proposed plans that were eventually denied by tax authorities.

Another layer of corporate tax governance tools are those concerning the so-called '*metarisk management*', which are those procedures aimed at managing the risk management of a company in respect to exposure to tax sanctions and generally in respect to audit and enforcement procedures by tax authorities. The idea is that a company establishes its own risk management and enters into covenants or other arrangements with tax authorities, pursuant to which, the lower the tax risk profile of the company, the lower the audit activities of the tax authorities. For example, in the United Kingdom, it has been proposed that the level of intervention by the tax authorities into a company's affairs would depend on a risk assessment given to the company by the tax authorities; the risk being considered is essentially a compliance risk, i.e., the likelihood of failure to pay the right tax, which is assessed on the basis of criteria such as strong corporate governance, effective delivery of internal processes, level of organizational restructuring of the company, and level of complexity of transactions carried out by the company (Freedman, Loomer & Vella, 2008; Ulph, 2008). A similar approach is traditionally taken in the Netherlands with the so-called 'enforcement covenants', which are based on information provided by multinational companies to tax authorities as to the corporate tax risk of the company (Happé, 2008).

Disclosure rules on purported transactions involving aggressive tax behaviour are aimed at increasing the costs of tax avoidance, strengthening the monitoring capabilities of tax authorities and limiting the chances offered by the so-called 'audit lottery' (Baker, 2008, p. 257; Beuchert, 2008, p. 277; Desmond, 2008, p. 265; Morton, 2008, p. 283; Shaviro, 2008, p. 229). Disclosure rules generally are duties imposed on managers to give information on listed transactions to tax authorities and to the public of any risk of tax burden due to failed tax planning. Disclosure rules can also be imposed on advisors, by requesting them to report on listed transactions proposed to clients and to make available lists of clients. Disclosure rules also include the request to make available to tax authorities tax opinions and documents related to listed transactions. These rules are usually backed by strict liability penalties and high reputational costs in case of failure to report the required information. In the US, for example, there are detailed regulations regarding the type of transactions subject to disclosure. These transactions include transactions specifically listed by tax authorities, transactions that were offered to the taxpayer under certain conditions of confidentiality, transactions in which the fees paid by the taxpayer are contingent on whether or not the tax benefit of the proposed planning are at-

tained, transactions that result in significant loss for the taxpayer, and transactions involving a brief asset-holding period (Shaviro, 2008, p. 229).

Regulation of tax advisors tackles aggressive tax behaviour from the supply side and deals with the advisors (investment banks, lawyers, auditing firms, and consulting firms) who propose aggressive tax strategies to taxpayers (Beuchert, 2008, p. 277; Desmond, 2008, p. 265; Korb, 2008, p. 277; Morton, 2008, p. 283). Regulation of tax advisors may include different measures which have been adopted primarily in the US, but also in other countries (Beale, 2004b). First, a requirement can be made for tax advisors to be independent from auditing and accounting firms, making it difficult for an auditing firm to sell a tax strategy to its audit client (Maydew & Shackelford, 2007). Second, stricter rules on independent auditors and stricter professional liability can be introduced, so that adverse opinions by independent auditors could stop aggressive tax strategies though the internal control process (Hardesty, 2004, p. 596). Third, changes in standards of practice of advisors before tax authorities can be changed, such as requiring mandatory 'more likely than not opinions' or disregarding tax opinions sustaining taxpayer's behaviour as having a reasonable basis if rendered by certain types of disqualified advisors, such as those receiving contingency fees. Fourth, disclosure requirements for promoters can be introduced, and this, in turn, enables companies to define the tax risk profile of the advisors in relation to internal tax risk management procedures.

Similarly to disclosure rules, *reporting by stakeholders* is aimed at increasing the monitoring capabilities of tax authorities and the costs of aggressive strategies. The OECD (2004, p. 47) suggests introducing the right of stakeholders to communicate their concerns about perceived aggressive tax behaviour pursued by the company; Sarbanes-Oxley in the US, for example, requires a company to establish a complaint system that allows employees to submit anonymous and confidential complaints on accounting and auditing matters directly to the audit committee. Other countries have adopted similar measures.

With regard to *penalties for managers* in cases of tax avoidance, the OECD (2006, pp. 3–4), in the Final Seoul Declaration, has identified the personal responsibility of managers as a possible tool to defeat aggressive tax planning. Proposals have been advanced that suggest that penalties imposed on the manager directly are more effective in reducing evasion than are those imposed on the company, the reason being that the penalties on the company are diluted, while if the penalties apply to the manager, the company can alter the compensation contract with the tax manager to offset the intended consequences of IRS (or other tax authority) policy (Crocker & Slemrod, 2005, p. 1608). Penalties assessed on the tax managers can also be a more effective tool against evasion because they exacerbate the conflict between the shareholders and the tax managers.

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