SUMMARIES OF PAPERS IN THIS ISSUE

Tax-Related Corporate Political Activity Research: A Literature Review

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Academic researchers and the public have long shared an interest in whether and how corporate political activity (CPA) relates to taxes and tax policy. In this paper, we summarize four decades of tax-related CPA research. We identify three core questions and organize our literature review around these questions: (1) Which firms are likely to engage in tax-related CPA? (2) What do firms expect to gain from participating in politics? And (3) how do firms achieve their political goals? In discussing each question, we highlight contributions made by prior studies and identify themes to guide future research. We also provide detailed information on available data and resources for interested researchers.

Tax has traditionally been one of the most popular policy areas of corporate interest, and corporate interest in shaping tax policy continues to grow. Prior research advances a number of different, sometimes competing, theories to explain which firms engage in CPA. Although different researchers offer different theories, empirical studies generally show that size and industry factors are important determinants of corporate political participation. Beyond the determinants of CPA in general, research suggests (1) firms that invest in CPA in general are more likely to invest tax-related CPA, (2) those that invest in one type of tax-related CPA strategy (e.g., lobbying) are more likely to invest in another tax-related strategy (e.g., a PAC), and (3) relative firm investment in tax-related CPA is likely to endure over time.

Evidence on the value of corporate political investments is more mixed. Both academics and nonacademics are keen to measure the effectiveness of CPA, especially at the firm level, but face a number of data and research design challenges. The third question, how firms engage, is perhaps the least explored. We offer a model for thinking about how firms make strategic political decisions (Hillman and Hitt 1999) and review recent tax-related CPA studies in light of this model.

The goal of tax-related CPA is to shape tax law, as well as to seek new tax benefits and maintain existing ones. The questions we use to organize our literature review—which firms engage, what do firms expect to achieve, and how do firms engage—are interrelated. The more researchers understand about the tax policy process and how firms engage in it, the better we can address lingering puzzles about which firms engage in tax-related CPA and what they expect to achieve.

We hope that our review will aid researchers interested in tax-related CPA literature, as well as those interested in tax planning and tax avoidance more generally. The tax law is not exogenous. Corporations work to proactively shape the tax law, and we challenge all tax researchers to think about how political processes impact tax planning and tax outcomes overall.
The Potential of Tax Surprises to Affect Measures of Tax Avoidance and Researchers’ Inferences

Chelsea Rae Austin

Defining and measuring firms’ tax avoidance plays a central role in tax research. While generally not explicitly stated, many researchers imply that their interest is in tax avoidance that is the expected result of deliberate firm activities (for ease of prose, “deliberate tax avoidance”), rather than the result of factors outside the firm’s control (“tax surprises”). For instance, multiple previous studies examine the effect of executive compensation on tax aggressiveness (e.g., Rego and Wilson 2012; Armstrong et al. 2012; Phillips 2003). In none of these studies do the authors explicitly state they are interested in the deliberate choices of managers, yet the premise of their hypotheses is that managers’ incentives are related to their tax avoidance choices. Although researchers may want to investigate tax avoidance from firms’ deliberate choices, researchers’ measures of tax avoidance do not always distinguish between tax reduction from deliberate choices and tax surprises, i.e., an unanticipated change in the tax liability of the firm. Because tax surprises affect firms’ tax accounts, they can cause firms to appear more or less aggressive than their deliberate activities would suggest. This study examines complications caused by tax surprises when measuring tax avoidance by focusing on one specific type of surprise tax savings—the unanticipated tax benefit from employees’ exercise of stock options.

Stock option exercise can result in substantial tax savings, but a firm’s actions or inactions only indirectly determine the timing and magnitude of this savings. Once an option holder exercises an option, the firm receives a tax deduction equal to the firm’s realized cost of the option—the difference between the stock price on the date of exercise and the strike price of the option (Rue et al. 2003). When a firm grants an option to an employee, it records a tax benefit based on its estimate of when the option will be exercised and the value of the option at that time. Because a firm does not control the timing or magnitude of the exercise of employee stock options (ESOs), deviations between the firm’s expected tax deduction and the realized tax deduction results in a tax surprise.

The cash effective tax rate ($CASHETR$) reflects the entire tax benefit from ESO exercise, including the tax surprise. I suggest that researchers interested in firms’ deliberate tax avoidance adjust cash effective tax rates by adding back the excess tax savings from the exercise of stock options disclosed in the financing section of firms’ statement of cash flows, $CASHETR_{\text{WITHOUT}}$. This disclosure is the firm’s positive tax surprise from ESO exercise. Because of the financial reporting rules in place during 2006–2017, the GAAP effective tax rate ($GAAPETR$) does not reflect surprise tax savings from ESO exercise. Using all three of these measures of tax avoidance ($CASHETR$, $CASHETR_{\text{WITHOUT}}$, and $GAAPETR$), I explicitly consider the impact of tax surprises in the measurement of tax avoidance and the potential impact to researchers’ inferences about tax avoidance. I show that using surprise tax savings from ESO exercise is concentrated in a subset of firms similar across a number of known determinants of tax avoidance and that using $CASHETR$ to measure deliberate tax avoidance can lead to both Type I and Type II errors.

These results are important for several reasons. First, they provide evidence that tax surprises can affect inferences about firms’ deliberate tax avoidance and, thus, that researchers should control for identifiable tax surprises. This study also aids future researchers in interpreting different relations between the variable of interest and $GAAPETR$ and $CASHETR$ in studies of deliberate tax avoidance. This study also adds to tax literature by explaining the effects of ASC 718 (during the years 2006–2017) on the reporting of firms’ tax benefit from ESOs and by describing the effects of the surprise tax benefit from ESOs on estimates of firms’ effective tax rates. This is especially important, as the reporting of the surprise tax savings from ESO exercise is changing for fiscal years beginning after December 15, 2017. Under the new rules, firms will recognize the surprise tax savings in recognized tax expense. This means that $GAAPETR$ will be affected by surprise tax savings from ESO exercise following the rule change. Finally, this study adds to the literature that examines the mismeasurement of tax avoidance (i.e., Dyreng et al. 2008; Henry and Sansing 2014).
The Determinants and Consequences of Tax Audits: Some Evidence from China

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There is little empirical evidence as to how tax authorities choose which firms to audit. Moreover, prior research seldom analyzes the role that actual tax audits play in disciplining firms. Accordingly, we contribute to extant research by relying on large samples to gauge both the determinants of tax audits and their ex post consequences. In examining data obtained from a local tax office in China, we find that firms are more likely to be selected for audits when their effective tax rates are lower, book-tax differences are larger, and income-decreasing discretionary accruals are larger. These results imply that the tax authority pays closer attention to firms whose financial statements show evidence of tax avoidance. Our analysis implies that the tax authority builds its audit selection model by relying on accruals, as well as effective tax rates and book-tax differences.

Next, we analyze how firms change their tax aggressiveness after being audited. Since the selection of an audit is not random, our examination of firms’ responses to tax audits could be subject to a sample selection bias. To alleviate this concern, we first apply propensity score matching (PSM) to match each audited (treatment) firm with a non-audited (control) firm. We then employ a difference-in-differences research design that controls for firm fixed effects and time fixed effects. Consistent with a fall in tax aggressiveness after firms are audited, we find that firms significantly increase their effective tax rates, reduce their book-tax differences, and reduce the absolute magnitude of their income-decreasing discretionary accruals after being audited by the tax authorities. We do not find any perceptible changes in income-increasing discretionary accruals after tax audits.

We triangulate our arguments by conducting two additional analyses. First, we expect that learning partly explains how firms respond to tax audits. Learning will be concentrated in younger firms as they would have less prior experience with tax audits. It follows that tax audits will have a greater impact on younger firms as they are likely to learn more from the experience. Second, we argue that Chinese firms are eager to repair their damaged relations with the government after a tax audit uncovers tax avoidance. Such political considerations should matter more to firms operating in industries where state influence is more pervasive. Generally consistent with these expectations, we find that the effects of tax audits are concentrated in younger firms and in industries where the government plays a larger role.

We make three primary contributions to extant research. First, we report evidence on the characteristics of firms that are selected for tax audits. This helps resolve how tax authorities devote their limited resources in constraining corporate tax avoidance and sustaining government tax revenues. Second, we contribute by showing that in addition to effective tax rates and book-tax differences, downward earnings management indicates tax aggressiveness to tax authorities when book-tax conformity is high. Finally, in contrast to prior research suggesting that U.S. firms initially become more tax aggressive after undergoing an IRS audit, we find that private firms in China become less tax aggressive immediately after an audit. One possible explanation is that detected tax avoidance in China has much more severe negative implications for firms’ links with the government. It follows that Chinese firms that have undergone a tax audit have strong incentives to rebuild their relationship with the government immediately afterward by paying more taxes. Consequently, our study contributes by highlighting the importance of political considerations in shaping firms’ responses to regulatory oversight.
Income Shifting Using a Cost Sharing Arrangement

Lisa De Simone and Richard C. Sansing

This study investigates the use of a cost sharing arrangement (CSA) by a multinational corporation (MNC) to shift income from valuable intangible property (IP) offshore. We model two structures relevant to an MNC that has pre-existing IP developed in the United States that it wishes to develop further: (1) a benchmark case in which the U.S. parent (USP) and a low-tax foreign subsidiary (FS) retain ownership of their IP, and (2) the USP and FS enter into a CSA. In the benchmark case, worldwide income attributable to the IP is divided between the USP and FS in proportion to the relative values of the IP that each entity retains. In a CSA, the USP receives all of the income attributable to the IP that is earned in the United States, and the FS receives all of the income attributable to the IP that is earned outside the United States. In addition, the USP and FS make payments to one another to compensate for the expected value of the IP as of the date the CSA is formed, which can deviate substantially from the worldwide income that is eventually earned. We evaluate the circumstances under which a CSA enables a U.S. MNC to shift income to a FS, relative to the income allocation in the benchmark case.

We identify three factors that influence the relative attractiveness of a CSA: the operating intangible effect, the undervaluation effect, and the enforcement effect. The operating intangible effect can shift income to foreign jurisdictions under a CSA if the USP owns and retains valuable operating intangibles that increase foreign income, such as a globally recognized brand or trademark. This occurs because the U.S. Treasury regulations assume that operating intangibles used by the USP only increase domestic income. To the extent this assumption is violated, using a CSA allocates more income to foreign jurisdictions.

The undervaluation effect can shift income to the low-tax FS under a CSA if the MNC can exploit its information advantage over the tax authority to understate the value of the USP’s net contribution. The undervaluation effect reflects the extent to which the taxpayer has superior information regarding the value of its IP, compared with the tax authority.

The enforcement effect arises from the extent to which the tax authority can use the realized value of the IP to retroactively restate its original reported value under the “Commensurate with Income” standard in U.S. transfer pricing regulations. This restatement can occur when the realized value of the project substantially exceeds the expected value used by the taxpayer to determine the payments at the inception of the development project.

Our research is timely given increased scrutiny of MNC income shifting behavior, particularly with respect to the use of intangibles and CSAs. Our study contributes to the income shifting literature by providing a deeper and more nuanced understanding of a key income shifting mechanism employed by numerous large, U.S. MNCs—the use of IP to shift income to low-tax foreign jurisdictions via a CSA. Our study offers important insights to both policymakers and academic researchers by identifying settings in which CSAs and enforcement mechanisms can either promote or inhibit income shifting to low-tax countries.
Joint Audit Engagements and Client Tax Avoidance: Evidence from the Italian Statutory Audit Regime

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This study examines whether clients that engage better-connected individual auditors show comparatively higher levels of tax avoidance. We take advantage of a unique feature of the Italian statutory audit environment to track individual auditors who are cross-appointed to multiple joint audit engagements. These collaborations between individual auditors working for the same or different accounting firms generate professional networks that can disseminate tax expertise among individuals. We find that clients that engage better-connected auditors show comparatively lower levels of effective tax rates. Our findings suggest that joint audit engagements can facilitate the transfer of valuable tax expertise between individual auditors, and improve our understanding of professional accountant networks. Our results are robust to controlling for characteristics of client companies, individual auditors, audit firms, as well as alternative network connections at the board and shareholder levels.

We also perform a battery of sensitivity analyses. Although we use instrumental variables and auditor fixed effects models, we cannot completely rule out the possibility that auditor centrality proxies for an unidentified aspect of individuals’ innate abilities, which allow them to both gain a central position in the network and better advise their clients on tax planning. We encourage future research, perhaps in an experimental setting, to confirm the specific mechanisms that drive the association between auditor centrality and client tax avoidance. Despite these limitations, we believe that our study extends prior research in a number of ways.

To our knowledge, our study is among the first to demonstrate that in a joint audit environment, individual auditor professional networks have consequences for tax outcomes. We contribute to the emerging literature in accounting that examines how social networks affect companies’ outcomes by examining an alternative conduit of information spillover beyond board interlocks. Further, while prior studies suggest that auditors learn internally from their own firms’ training resources, our findings suggest that auditors can also learn externally from their professional networks. Despite the fact that our analysis focuses on one local network, we believe our results are generalizable to other joint audit settings, and networks of professional accountants, such as those found in France, Denmark, Sweden, and Finland.