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SUMMARIES OF PAPERS IN THIS ISSUE

Managers' Stock Price Incentives and Earnings Management Using Tax Expense

Erik L. Beardsley, Mehmet C. Kara, and Connie D. Weaver

This study examines the association between stock price incentives, also known as "portfolio delta," and earnings management using tax expense to beat analysts' forecasts. Further, the study examines whether the association varies with opportunities to manage earnings. Prior research suggests that portfolio delta provides managers with offsetting incentives to manage earnings. That is, greater stock price incentives create a positive "reward effect" that would incentivize managers to engage in more earnings management, while at the same time create a positive "risk effect" that disincentivizes risky behavior such as engaging in earnings management activity.

We predict that the association between portfolio delta and earnings management depends on the level of opportunities afforded to managers to use discretion over financial reporting. Accounting for income taxes provides managers varying levels of opportunities to use discretion over reported tax expense, making it advantageous to use tax expense as the setting to examine our research question. Specific areas within tax expense provide opportunities to exercise discretion, including the extent of valuation allowance, uncertain tax positions, and permanently reinvested foreign earnings. We use these tax-related accounts, as well as the proximity to the earnings analysts' forecast, to construct a measure that captures the level of opportunity to manage earnings using tax expense.

We find that, on average, stock price incentives are not significantly associated with earnings management using tax expense. This result is consistent with the idea that the reward effect and risk effect offset each other, resulting in no more or less earnings management on average. However, we find that as opportunities increase, firms are more likely to manage earnings using tax expense in response to stock price incentives. This evidence suggests that the extent of earnings management actions as a response to incentives depends on the level of opportunity afforded to managers. We therefore conclude that our results suggest that opportunities reduce the risk effect of stock price incentives, resulting in more earnings management.

This study makes the following contributions to the literature. First, it provides a framework for examining the interaction between multiple factors and corporate outcomes. Second, our paper provides additional documentation of how and why earnings management through tax expense is accomplished as well as the broader literature that examines the effects of compensation on misreporting. Third, we contribute to the literature on executive influence on tax expense. Finally, we contribute by developing a measure of opportunity to manipulate earnings through the tax accounts.

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Corporate Tax Disclosure

Jeffrey L. Hoopes, Leslie Robinson, and Joel Slemrod

Public dialogue is increasingly focused on the taxes remitted by large businesses. Tax jurisdictions across the world have enacted, or are considering enacting, increased tax disclosure requirements to induce increased compliance and to raise revenue. However, the use of tax disclosure as a policy instrument should be contingent upon what we know about its consequences, and its success, in the past. This review lays out a framework for thinking about corporate tax disclosure and documents what is known and what is not, in hopes to inform future research and policy. We divide disclosures into two main categories, depending on whether they are mandatory or voluntary. We then subdivide these disclosures into whether they are made publicly or privately (generally to the tax authority) and propose a separate category for disclosures made by third parties which are independent of the corporation or the tax authority.

Considering the pace of new and proposed tax disclosure mandates over the past decade, it is important to understand the effects of the disclosure of tax information. We highlight some of the key conclusions in the literature about the effectiveness and efficiency of corporate tax disclosure regulation, and both its intended and unintended consequences. One big takeaway from the papers that directly evaluate disclosure regimes' ability to raise revenue is their limited ability to achieve their goals. Another large takeaway from this literature is that taxpayers facing nonuniversal mandatory disclosure regimes often take actions to avoid disclosure. These two takeaways from the literature raise additional questions, which we posit in this review piece and suggest areas for future research on corporate tax disclosure.

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The Efficiency of Interactive Voice Response Systems and Tax Compliance: A Field Experiment by the California Franchise Tax Board

Helen Hurwitz and John R. McGowan

Traditional enforcement and normative communication play an important role in tax compliance, but they are either constrained by compliance budgets for audits or have weak results. The service paradigm has gained broad attention in recent years. As a key component of the service paradigm, interpersonal fairness centers around treating taxpayers with respect and considering their needs and concerns. These practices can make taxpayers feel valued and, thus, more willing to cooperate with the tax authorities (Bergman 2003; Braithwaite 2003b; Kirchler 2007; Kirchler, Hoelzl, and Wahl 2008; Siglé, Goslinga, Speklé, van der Hel, and Veldhuizen 2018). Evidence from some countries indicates that enhancing interpersonal fairness improves tax compliance (Feld and Frey 2005; Wenzel 2002, 2006; Murphy and Tyler 2008; Hartner, Rechberger, Kirchler, and Schabmann 2008). However, there is little evidence in the United States.

To shed some light, the California Franchise Tax Board (hereafter, FTB) conducted a field experiment to examine how efficiency of Interactive Voice Response (hereafter, IVR) systems affects tax collection. Call centers have widely used IVR systems to cut costs, but consumers are overwhelmingly dissatisfied with IVR systems (Aspect Communications 2003; Babbitt 2010; Leibovitz 2011), and this dissatisfaction is costly to businesses (Cole 2014). Tax authorities face similar challenges with IVR systems, but taxpayers, unlike consumers, do not have other options, due to the mandatory nature of tax compliance. Therefore, it is unclear whether increasing IVR system efficiency can improve tax collection.

For the experiment, the FTB established a temporary assistance phone line with significantly improved efficiency of connecting callers to live agents and randomly selected 20,778 noncompliant taxpayers to receive notices containing the number of either the temporary phone line or the general assistance phone line. We find that taxpayers calling the temporary phone line (treatment group) pay a significantly larger percentage of tax deficiencies than the control group, and this difference is driven by IVR system efficiency. We also find that improving IVR system efficiency increases the likelihood of making payments within the treatment group. Our research advances the literature on the service paradigm of tax compliance by providing U.S.-based evidence that supports embracing interpersonal fairness principles to encourage tax payments. Since tax collection generally becomes more difficult and costly with time (Government Accountability Office (GAO) 2013; Beers, Hatch, Saldana, and Wilson 2015; CGI Group 2016) and taxpayer calls during the early collection stage provide the tax authorities with a low-cost contact opportunity, our results have implications for the tax authorities seeking to improve tax compliance efficiency under limited compliance budgets.

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Sharing the Wealth: The Effects of Announced TCJA Bonuses on Employee Pay Satisfaction

Michelle Hutchens, Daniel P. Lynch, and Bridget Stomberg

This study investigates how employees' pay satisfaction changed following the public announcement of increases in compensation attributed to the "Tax Cuts and Jobs Act" (TCJA). Many corporations publicly announced plans to share windfalls from the TCJA with rank-and-file employees. We examine the association between these bonus announcements and employees' pay satisfaction. Although employees are better off upon receiving the bonuses, prior literature suggests employees can be dissatisfied with awards they perceive as small or inequitable. By linking the bonuses to a corporate tax windfall, firms provided a reference point for employees to assess fairness. Using a difference-in-differences design, we find a greater decline in pay satisfaction at firms announcing a TCJA bonus relative to firms that do not. We also provide evidence of greater dissatisfaction among employees who perceive their share of the windfall as unfairly small.

We use the TCJA to explore how actions firms take to increase employee compensation in response to a tax windfall affect employees' pay satisfaction. Our evidence of lower employee pay satisfaction following the announcement of TCJA bonuses provides new insight into a likely unintended consequence. Documenting this relation is important given the significant adverse consequences of employee pay dissatisfaction and employee perceptions of inequity. Considering increasing income disparity in the U.S. and a heightened focus on corporate taxes, we provide new and timely insights into how workers respond to changes in compensation linked to corporate tax savings. Overall, we believe our findings will be of interest to managers, practitioners, and academics as they evaluate the effects of the TCJA on workers.

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Evaluating the Commensurate with Income Standard

Richard C. Sansing

This study creates and analyzes a model in which intellectual property (IP) that will generate uncertain future cash flows is sold by a U.S. parent to a subsidiary in another country. The key feature of the model is that the taxpayer has private, imperfect information regarding the future realized value of the IP. Two issues are particularly important when considering the sale of IP. First, the ultimate realized future value of the asset is often highly uncertain at the date of the sale. Second, the taxpayer typically has superior information regarding the probability distribution of future cash flows that the IP will generate than does the tax authority. The purpose of this study is to provide a framework with which to evaluate the commensurate with income (CWI) standard in the presence of both valuation uncertainty and information asymmetry.

If the tax authority challenges the sales price in court, the CWI standard uses the IP's future realized value as a proxy for the value of the IP as of the date of sale. The purpose of using the future realized value is to help the tax authorities counteract the effect of the taxpayer's informational advantage regarding the value of the IP. By using the publicly realized value of the IP as a proxy for its value on the date of the sale, the CWI standard eliminates the taxpayer's informational advantage. This study determines the optimal reported sales price and the firm's expected tax and penalty payments under the CWI standard.

I evaluate the CWI standard by comparing it to an alternative. The alternative is the fair value method, in which the transfer price is equal to the expected value of the IP on the date of sale using all the facts publicly available to the court after the value of the IP is realized. This price includes but is not limited to the IP's realized value. It also determines the expected tax and penalty payments under the fair value method. The taxpayer can selectively disclose its private information in litigation under the fair value method, allowing it to exploit its informational advantage.

I compare the expected tax and penalty payments under both the CWI standard and the fair value method to the tax in a full information benchmark case in which the transfer price is equal to the expected value of the IP on the date of the sale, given the taxpayer's private information, which is the fair private price. The firm's expected payments under the CWI standard are strictly higher than when using the fair private price and the difference is increasing in the penalty rate. The firm's expected payments under the fair value method are weakly lower than when using the fair private price and the difference is decreasing in the penalty rate. Therefore, if the full information benchmark is normatively appropriate, the case for the CWI standard is strongest when penalty rate is lowest; the case for the fair value method is strongest when the penalty rate is sufficiently high.

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Save It for a Rainy Day: Evidence from State Corporate Income Tax Rate Changes

Xiao Song and Ming (Mike) Yuan

We examine the effect of state corporate income tax rate changes on firms' liquidity management. Prior studies have examined the effect of state corporate income taxes on different corporate policies, including capital structure (Heider and Ljungqvist 2015), risk taking (Ljungqvist, Zhang, and Zuo 2017), investment location (Chow, Huang, Klassen, and Ng 2021), and CEO compensation policy (Blouin, Kubick, and Robinson 2020). However, how firms adjust their cash holdings when state corporate income tax rate changes is still underexplored. We use a difference-in-differences design to investigate how firms adjust their cash holdings in response to changes in state corporate income tax rates.

Investigating the effect of state tax rate changes on firms' cash holding is important for the following reasons. First, as state income taxes account for about 21 percent of total income taxes paid by firms (Heider and Ljungqvist 2015), they are a meaningful part of U.S. firms' overall tax burden and can have a material impact on net operating margins (Walczak, Loughead, Boesen, and Fritts 2021). Second, examining how firms change cash holdings in response to state tax rate changes could speak to policymakers by informing them of the potential consequences of state tax rate changes from the perspective of firms.

We investigate the effect of tax increases and tax cuts separately in our empirical analysis. We find that firms respond to tax rate increases in their headquarter states by accumulating more cash holdings, suggesting that the precautionary motive of cash holdings is the dominant driver of liquidity management policy. For a 1 percent state tax rate increase, treated firms, defined as those headquartered in tax-increasing states, increase the mean (median) cash holdings by 2.51 (4.9) percent. We find no evidence of this relationship when the state corporate income tax rate decreases. We also conduct a battery of tests to validate our difference-in-differences research design.

We then explore the heterogeneity in the effect of tax rate changes on cash holdings in several ways. First, we examine the role of internal cash flow and find that the effect of tax rate increases on cash holdings is more pronounced for firms with low and risky cash flows. Second, we find that the effect of tax rate increases on cash holdings is mainly concentrated among firms with more growth opportunities, further supporting the precautionary motive of cash holdings. Third, we document that the effect of tax rate increases on cash holdings is mainly concentrated among financially constrained firms. Overall, these cross-sectional analyses lend strong support for the precautionary motive of cash holdings.

Our study made several contributions. First, our study documents that income tax rate changes at the state level can also affect firms' cash holdings. Second, the difference-in-differences design in this study strengthens the identification of the role of the state tax rate changes on how firms change their cash holdings. Third, understanding the impact of tax rate changes on corporations, an important stakeholder in a state's economic activity, helps policymakers make better decisions on policy changes. Finally, our paper extends literature on the real effects of state income tax shocks by investigating cash holding as another important real effect of state tax rate changes.

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Intertemporal Income Shifting for Investment Reasons: Evidence from Private Firms

Cinthia Valle Ruiz, Domenico Campa, and María-del-Mar Camacho-Miñano

Tax reforms provide researchers with a natural experiment to examine the effects of corporate tax changes on a wide range of managerial and economic behaviors (Slemrod 2018). The intended effect of tax reforms that decrease corporate tax rates is to boost local investment and economic growth, as lower corporate tax rates can free up resources that may subsequently be used for additional corporate investments (Fazzari, Hubbard, and Petersen 1988; Cooper and Priestley 2016). On the other hand, the extant literature documents the existence of unintended effects around tax reforms that decrease corporate tax rates, such as intertemporal income-shifting practices (e.g., Scholes, Wilson, and Wolfson 1992; Guenther 1994; Mills 1996). This kind of behavior can even be exacerbated among private firms because of their lower nontax costs (Badertscher, Katz, Rego, and Wilson 2019), lack of market pressures, and absence of monitoring by external stakeholders. In this study, we first investigate whether private firms engage in intertemporal income shifting in the presence of corporate tax cuts. Next, we analyze some of the real effects of such a decision by investigating whether aggressive intertemporal income shifters increased their investment levels and whether such investments were efficient. Prior research mainly focused on public firms. However, research into private firms is especially relevant since these companies tend to finance future growth through internal financing. Using a sample of 2,650 firm-year observations, our results show that private companies did engage in intertemporal income shifting to gain additional tax savings in the presence of corporate tax cuts. This was particularly observed in the presence of significant investment opportunities and timing pressures to shift income. Additionally, we provide evidence that aggressive intertemporal income shifters, after the tax reform, invested more in labor capital than other firms and that such investments were efficient. Our study sheds light on the potential policy implications of tax reforms for private firms and may be of interest to countries that have either mandated or are in the process of mandating the adoption of new tax regulation (de Mooij, Hebous, and Hrdinkova 2018). Our results suggest that private firms with significant investment opportunities use cash windfalls wisely to efficiently increase their labor investment levels. This should stimulate government authorities to provide private firms with financial support, for example, in terms of tax benefits for new investments, rather than bringing about unintended consequences like opportunistic tax planning strategies to support firms' investment needs. This is especially important for private firms because they do not have easy access to external funds like public firms do.

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