THE JOURNAL OF THE AMERICAN TAXATION ASSOCIATION
Vol. 43, No. 2
Fall 2021
pp. 1–6

American Accounting Association
DOI: 10.2308/atax-10766

SUMMARIES OF PAPERS IN THIS ISSUE

The Association between Auditor Provided Tax Planning and Tax Compliance Services and Tax Avoidance and Tax Risk

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Our study fills a number of gaps in the research examining the impact of auditor provided tax services (APTS) on tax outcomes by testing for separate associations between auditor provided tax compliance and tax planning services and tax avoidance and tax risk. Due to data limitations, the extant research tends to assume that tax non-audit services (NAS) capture the variation in tax planning (and not tax compliance) services provided to audit clients (e.g., McGuire, Omer, and Wang 2012; Hogan and Noga 2015; Francis, Neuman, and Newton 2019; Cook, Kim, and Omer 2020). However, it is important to examine tax planning and tax compliance NAS with greater precision because these services have unique purposes and are performed by different professionals (AICPA 2011) and thus are likely related to corporate tax outcomes in different ways.

Research by Klassen, Lisowsky, and Mescall (2016) suggests that audit firms providing higher levels of *tax compliance* services are less inclined to support tax avoidance as it could threaten their reputation. While reputational threats are also likely relevant for auditors providing higher levels of *tax planning,* the desire of companies to minimize taxes by leveraging auditors' global reach and intimate understanding of their clients (Maydew and Shackelford 2007) is a primary reason why companies engage their auditors for tax planning services. Consistent with auditors being more effective tax planners relative to third-party providers, in-house professionals, and law firms, we observe greater tax avoidance when tax planning services are higher but not when tax compliance services are higher. Additional analysis also reveals that our tax avoidance results are more pronounced for clients of auditors with more tax expertise and longer tenure as well as for firms with higher tax and operational complexity. We also find that our tax avoidance results hold only when firms also engage their auditors for tax compliance work. This reveals an important complementary role for tax compliance and is consistent with auditors advising on strategies that reduce effective tax rates only when they can better observe and control the information provided to tax authorities.

To the extent that greater tax risk increases the chances of overturned tax positions and financial reporting restatements (Demere, Li, Lisowsky, and Snyder 2019), then auditor-tax planners have stronger incentives than non-auditor tax providers to reduce tax risk because of their heightened sensitivity to litigation and reputational threats (Lennox 2016; Klassen et al. 2016). Although prior research has found evidence consistent with a tax risk management role for in-house corporate tax compliance functions (Chen, Cheng, Chow, and Liu 2021), there is no evidence that external compliance providers also fill this role. If reputational consequences for auditors providing tax compliance services also increase in tax risk, then we would also expect a negative association between tax compliance NAS and tax risk. Our empirical results suggest that tax planning NAS are negatively associated with tax risk measured with uncertain tax benefits, and the volatiles of GAAP and cash effective tax rates, while tax compliance is not associated with any measure of tax risk.

Collectively, our results suggest that companies paying their auditors for tax planning advice are more effective tax planners (in terms of higher tax avoidance, and lower tax risk) than firms that do not engage their auditor for tax work. Our study's unique hand-collected panel dataset provides a more precise and nuanced perspective on the role auditors play in tax outcomes.

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Published Online: Month 2021

Implicit Taxes of U.S. Domestic and Multinational Firms during the Past Quarter Century

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An implicit tax is the reduced pretax rate of return that demand for tax-favored assets creates. Tax rate analyses that only consider explicit taxes may lead to incomplete findings and possibly overstate the net tax-related benefits accruing to firms (Shackelford and Shevlin 2001). We use two tests consistent with prior literature (Jennings et al. 2012; Wilkie 1992) to capture variation in implicit taxes at the firm level for U.S. domestic and multinational (MNE) firms. The first test is an OLS regression analysis that provides somewhat indirect evidence of differences in implicit taxes between domestic firms and MNEs. In the second test we present a more direct measure of the extent of implicit taxes separately for MNEs and domestic firms. Evidence across multiple decades allows us to demonstrate that MNEs bear approximately 32 percent lower implicit tax costs and thus enjoy overall tax advantages relative to domestic firms.

We posit that domestic firms and MNEs have different levels of exposure to the market frictions that slow implicit tax formation, and these differences may result in different states of implicit tax equilibrium for MNEs and domestic firms. We identify several possible sources of friction and find significant differences between MNEs and domestic firms that help explain the consistently lower implicit taxes for MNEs versus domestic firms and why the two groups may be at different points in the transition to market equilibrium with regard to implicit taxes.

We also examine the impact of each market friction on implicit tax formation on a friction-by-friction basis and find evidence that firms with high product concentration and lower product similarity exhibit approximately 35 percent lower implicit taxes. As MNEs have a higher product concentration and lower product similarity relative to domestic firms, these results support the conclusion that these frictions contribute to the overall implicit tax advantage for MNEs. In an additional test we combine, as the data allow, several of the frictions together in a principal components analysis and find evidence that a combination of frictions helps to explain the overall implicit tax advantage for MNEs. Further research is warranted as to how various other combinations of frictions within different firms may affect implicit taxes.

Our study contributes to the implicit tax literature in a number of ways. Our primary contribution is to extend the general framework of Jennings et. al (2012) to an international setting to estimate and compare the levels of implicit taxes for domestic firms versus MNEs during the 25 years ended in 2012. We find that implicit taxes are higher, on average, for domestic firms than they are for MNEs during our sample period and that MNEs enjoy a significantly lower overall tax burden than their domestic competitors. We also contribute to the literature examining why implicit taxes are higher for domestic firms than MNEs. Inherent in implicit tax theory are important assumptions that the market is competitive with no barriers to entry, and no significant market frictions exist that would slow or impede new competitors. Our findings on the impact of market frictions on implicit tax levels challenge those assumptions.

The direct policy implications of our findings are somewhat unclear for a number of reasons. First, our findings are subject to the inherent difficulty in measuring implicit taxes at the firm level. Second, U.S. policymakers would be somewhat limited in directly addressing implicit tax differences because these frictions likely arise from a combination of market forces, foreign laws and regulations, and competitive environments, over which U.S. policymakers have little say. Third, our findings suggest that a reduction in the U.S. corporate tax rate or tax relief targeted at domestic operations is more likely to be offset by an increase in implicit taxes for domestic firms than for MNEs.

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The Effects of Prefilled Tax Returns on Taxpayer Compliance

Marcus M. Doxey, James G. Lawson, and Shane R. Stinson

We extend prior taxpayer compliance literature by examining the effects of prefilled tax returns on taxpayer reporting decisions. Following the example of numerous European countries, U.S. senators proposed the Tax Filing Simplification Act of 2017 (TFSA17) to allow the government to complete returns on behalf of taxpayers, who could then accept or revise the prefilled return. However, returns prepopulated under TFSA17 would only include "known" income items (such as W-2 or 1099 income) while ignoring undocumented income. Based on the omission bias—the preference for causing harm by omission rather than commission (e.g., Baron and Ritov 2004; Bostyn and Roets 2016)—we hypothesize that such prefilled returns could actually lower compliance compared to self-completed returns if taxpayers find it easier to accept an incorrect prefilled return than to actively misreport income on their own.

We also test changes to prefilled returns that could improve compliance. We hypothesize that prefilled returns estimating undocumented income will limit misreporting by omission and force taxpayers back into a "commission" frame. Additionally, we re-examine the common finding that individuals perceive refunds as gains and taxes due as losses—framing that encourages those owing taxes to make more aggressive tax reporting decisions than those expecting a refund (e.g., Brink and Lee 2015). This pattern of results is predicated on prospect theory (Kahneman and Tversky 1979) and the neutral reference point taxpayers begin with on a blank return—zero tax due or refund. Using omission theory, we hypothesize that prefilled returns shift individuals' neutral reference points to the prefilled return's initial settlement position. As a result, taxpayers should experience equivalent pain (pleasure) from subsequent increases (decreases) in tax liability regardless of their initial refund or tax due position.

We test our hypotheses with two experiments using experienced taxpayers. The first manipulates prepayment position (refund or tax due) between participants and reporting method (self-completed or prefilled with no/low/accurate/high estimates) within participants. The second manipulates both prepayment position and reporting method between participants. We measure taxpayer compliance by the percentage of undocumented cash tips participants report.

As predicted, we find that prefilled tax returns ignoring undocumented income lower taxpayer compliance compared to traditional self-completed returns. However, compliance improves as government-provided estimates of undocumented income approach true income, eventually surpassing compliance in self-completed returns. Moreover, we find that when the government overestimates undocumented income, taxpayers are likely to adjust their prefilled returns for accuracy, but not for evasion. Also as expected, we find that prefilled returns eliminate compliance differences between individuals facing refund versus tax due positions.

The study's results suggest that prefilled returns could increase the tax gap if they ignore undocumented income. However, the government could potentially improve revenue collection if prefilled returns estimate undocumented income. Further, explaining when and why reference points change contributes both to the tax literature (e.g., Falsetta, Rupert, and Wright 2013; Austin, Bobek, and LaMothe 2020) and to the broader prospect theory literature. The results suggest that prior findings on taxpayer aggressiveness in a tax due position will not hold in a prefilled return setting. Finally, while omission theory suggests reference points shift to an omission's outcome, prior tests have been inconclusive (e.g., Baron and Ritov 1994). By providing evidence of a reference point shift to the omission outcome, we contribute new evidence to the psychology literature on reference points and omission frames.

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The Interactive Effect of Time Pressure and Client Preference on Tax Professionals' Information Search Emphasis, Judgments, and Recommendations

Robert A. Ewing and Brian C. Spilker

This study examines whether time pressure affects the degree to which tax professionals exhibit confirmation bias as they search for tax authority to recommend tax return filing positions to clients. This is an important issue because time pressure is a pervasive feature of the tax environment and tax professionals commonly search large databases of information to find information necessary to provide tax compliance and tax planning advice to clients. To the extent tax professionals search for tax authority in a manner biased toward the client's preferred positions, they will have inflated perceptions of the strength of the evidence supporting the position and are susceptible to providing overly aggressive tax advice to clients.

To address our hypotheses, we conducted a web-based experiment. In our experiment, 84 tax professionals searched a database of court cases to determine if a client should be treated as an investor or a dealer with respect to certain real estate sales. We manipulated client preference (investor-preferred versus dealer-preferred) and time pressure (low versus high) between subjects. Participants' task objective was to save to an electronic notebook the cases they would cite in a memo resolving the client's investor versus dealer issue.

Our results support our hypotheses. We find that the effect of client preference on information search emphasis and the associated confirmation bias varied by time pressure condition. Specifically, professionals in the high time pressure condition saved proportionally more cases with outcomes consistent with client preference (i.e., positive cases) than cases with outcomes contrary to client preference (i.e., negative cases) compared to professionals in the low time pressure condition. We find that the confirmation bias enhanced by time pressure inflated professionals' evidential support assessments, which led professionals to more strongly recommend the client-preferred position. More specifically, we find that a positive indirect effect of client preference on recommendations through information search emphasis and evidential support assessments (i.e., information search emphasis and evidential support assessments are mediators) was stronger for professionals searching under high (versus low) time pressure (i.e., time pressure is a moderator). That is, we find moderated mediation.

Our results indicate that concerns about confirmation bias should be elevated when tax professionals work under increasing time pressure. With an understanding of how time pressure can influence confirmation bias in information search, professionals and their firms can take steps to manage time pressure and its potential biasing effects.

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Short Selling and Tax Disclosure: Evidence from Regulation SHO

Thomas R. Kubick, Thomas C. Omer, and Xiao Song

This study examines whether the threat of short selling affects tax footnote readability. This research question is important because while a tax footnote is the primary source of firms' tax information, there is little evidence whether other stakeholders, such as market participants, affect financial statement tax disclosures.

From May 2005 to August 2007, the Securities and Exchange Commission (SEC) initiated a pilot program under Regulation SHO, temporarily exempting one-third of the Russell 3000 index firms from short sale price tests (pilot firms), reducing short selling costs. We use this regulatory shock to examine whether the prospect of short selling affected tax disclosures. To address several limitations with Regulation SHO as a natural experiment (Black, Desai, Litvak, Yoo, and Yu 2021), we employ inverse probability weighting with regression adjustment (IPWRA).

Results suggest that, before the pilot program, there is no significant difference between the pilot and non-pilot firms. During the Regulation SHO period, pilot firms had significantly higher tax footnote readability than non-pilot firms. This significant difference disappears when the program ends. We also find a significant difference in tax footnote readability between tax aggressive pilot firms and tax aggressive non-pilot firms during the Regulation SHO period.

In additional analyses, we observe that pilot firms led by executives whose personal wealth is likely more affected by a decrease in stock price have greater tax footnote readability than non-pilot firms during the pilot period. We also document that pilot firms that increase tax footnote readability experience a reduction in future short interest. We find that pilot firms with less readable tax footnotes experience lower future stock returns, providing validity to the notion that tax footnote readability could signal overvaluation. Finally, we find that tax aggressive pilot firms include more disclosures related to jurisdiction, international subsidiaries, foreign transactions, tax uncertainty, valuation allowance, and tax benefits than tax aggressive non-pilot firms.

Our study advances the influence of short selling risk on tax disclosures, which is the primary source of information related to firms' tax planning strategies. This study also extends the literature on the association between tax avoidance and short selling (Chi, Pincus, and Teoh 2014; Guo, Chi, and Cook 2018). We also contribute to the tax literature by identifying a unique adversarial party's effect on firms' tax footnote disclosure. In doing so, we complement studies examining the effect of scrutiny by the SEC and the Internal Revenue Service (IRS) on financial statement tax disclosure (Kubick, Lynch, Mayberry, and Omer 2016; Bozanic, Hoopes, Thornock, and Williams 2017). Our study also extends the linguistic analysis literature by providing a more in-depth view of how firms change their financial statement tax disclosures. Finally, we advance the literature utilizing Regulation SHO by acknowledging issues raised by Black et al. (2021) and implementing analyses addressing non-randomization of treatment and control groups.

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Mitigating Advocacy Bias: The Effect of the Reviewer Role on Tax Professional Judgment

Mary E. Marshall

This study examines the effect of the reviewer role on tax professionals' advocacy bias, which occurs when advocacy attitudes inappropriately influence what should be an objective evidence evaluation. Prior research establishes the prevalence of advocacy bias across experience levels and its negative effects on both tax professionals and their clients. Recent studies have found limited evidence that the review process mitigates advocacy bias, but only when specific cues exist. This study compares judgments of preparers and reviewers to examine whether the reviewer role mitigates advocacy bias.

The professional expectations of tax professionals do not vary by role; that is, the AICPA and IRS expect all tax professionals to act with objectivity and advocacy, regardless of their role within a firm. However, firms may define expectations differently by role given the requirement that reviewers provide feedback. In addition, the audit literature highlights reviewers' abilities to be more objective because they are more focused on assessing reasonableness rather than developing—and defending—a conclusion. I predict that reviewers approach engagements with a heightened focus on objectivity (e.g., with less bias) because they focus on meeting the expectations associated with reviewing.

In an experiment randomly assigning 75 tax professionals to the reviewer and preparer roles, I find reviewers are significantly less likely to exhibit advocacy bias than preparers. Advocacy attitudes did not vary by role, but the influence of advocacy attitudes on evidence evaluation was stronger for preparers. Further, reviewers also employ a more organized and consistent decision process than those in a preparer role. As advocacy bias is a form of motivated reasoning, this study provides initial evidence that role theory may provide insight into mitigating other manifestations of motivated reasoning.

The study also contributes to practice. Because occupying the reviewer role appears to limit the influence of advocacy attitudes on evidence evaluation, preparers may increase objectivity by engaging in deliberate self-review processes before completing an assignment. Similarly, reviewers who perform an independent evaluation of evidence, rather than retracing a preparer's steps, may also be more likely to make objective judgments. Further, this paper also contributes to our understanding of recent developments in the tax practice environment. As more work is automated or offshored, firms expect less experienced staff to complete increasingly complex tasks, including review.

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