SUMMARIES OF PAPERS IN THIS ISSUE

Influence of Accountability and Penalty Awareness on Tax Compliance

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State revenue departments, constrained by limited resources, must decide how best to spend their limited compliance-enhancing dollars. Since they cannot afford (politically or financially) to aggressively audit their taxpayers, states must explore other less costly methods of increasing tax compliance. This paper presents the results of a behavioral field experiment designed by the researchers and conducted by the Washington Department of Revenue (DOR) using approximately 1,250 firms (sole proprietorships, partnerships, and corporations) as subjects during the 2003 excise tax filing season. The focus was on augmenting the use tax collections from businesses in the construction industry. Use tax has the lowest compliance rate of the major taxes imposed in Washington in part due to its low visibility. The construction industry is especially problematic regarding use tax compliance and has one of the highest non-compliance rates in Washington State.

The experiment measured taxpayer reactions to two manipulated enforcement strategies: accountability and sanction awareness. The accountability treatment, where present, required the business to remit a separate affidavit (Certification of No Use Tax Due, Form Rev. 32-2507) attesting that the responsible person had reviewed all taxable purchases for the time period in question and determined that all use tax due had been paid. The person certifying that the examination occurred was requested to provide his/her title (position) as well as to print, sign, and date the form. In the alternative treatment, no separate affidavit was required.

The sanction manipulation (where present) was included in an educational letter sent to past tax filers. The letter explained the penalties and interest (true and accurate) the DOR could assess if a business owed tax but did not pay.

The results of the experiment indicate accountability and heightened sanctions awareness both lead to increased reporting of the use taxes. The influence of sanctions, however, was significantly greater for firms with declining revenues than for those with positive revenue states. This finding is consistent with the tenets of prospect theory when defining the gain/loss in terms of a firm’s relative revenue state.

This research provides important insights for state and federal policy makers and revenue departments with limited resources for improving tax compliance. In this field study, simple inexpensive mail-based education and enhanced personal accountability significantly influenced compliance.
Investor Response to a Reduction in the Dividend Tax Rate: Evidence from the Jobs and Growth Tax Relief Reconciliation Act of 2003

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This study examines investor reaction to the reduction in federal income tax rates on dividends resulting from passage of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (hereafter, JGTRRA or the Tax Act). The JGTRRA reduced the maximum tax rate on dividend income distributed to individuals through nontax-favored accounts from 38.6 percent to 15 percent, the largest decrease in U.S. history. Recent studies have investigated the clientele response to the JGTRRA from the corporate perspective, finding that firms’ dividend policies provide little evidence of an overall clientele effect (Chetty and Saez 2004; Blouin et al. 2004). This appears to be consistent with research concluding that taxes play a secondary role in corporate distribution decisions (Brav et al. 2005; Jagannathan et al. 2000; Lightner 2006). Alternatively, investor preferences for dividend-paying stocks at the individual level should have increased considerably after the JGTRRA was signed into law. We examine investor reaction to the JGTRRA to determine whether individual investors’ responses to the Tax Act were consistent with an investor-level tax clientele effect for dividends.

If individual investors did react to the JGTRRA, they would be expected to have shifted their investment portfolios toward dividend-paying stocks. If they did, this shift should be evident in stock market trading activity for dividend- versus non-dividend-paying firms. We investigate the existence of a clientele shift associated with the JGTRRA by testing for two observable implications of an investor-level tax clientele effect. First, we test for increased trading volume in dividend-paying stocks around information events that occurred during the policy-making process leading to passage of the Tax Act. Second, we examine changes in shareholder composition of dividend-paying versus non-dividend-paying firms over the period between announcement in the press of the Bush administration’s plan to reduce individual tax rates on dividend income and final passage of the Tax Act.

Our results suggest that individual investors indeed shifted their portfolios toward dividend-paying firms following passage of the JGTRRA. We find dividend yield to be a significant predictor of abnormal trading volume around key dates, including the date on which the plan to reduce dividend taxes was first covered in the press. Moreover, on some of these dates—most notably the first date that the administration proposal to reduce the tax on dividends was reported and the date on which the final version of the legislation actually passed the House and Senate—we find that abnormal trading volume was especially high for dividend-paying firms with higher levels of institutional ownership. This result would be expected if individual investors shifted their portfolios toward dividend-paying firms in response to the new law. In such a case, dividend-paying firms already exhibiting relatively high levels of individual ownership would be expected to exhibit lower levels of abnormal trading volume than their institutionally owned counterparts, as the primary holders of shares in the former group would be less inclined to sell compared to the institutional shareholders. Finally, we find a large and statistically significant negative relationship between dividend yield and the change in institutional ownership during the period beginning just before announcement of the plan to cut taxes on dividends and ending just after the passage of the JGTRRA. Overall, our findings strongly support the existence, at the investor level, of a tax clientele for dividends.
The Usefulness of Disclosures of Untaxed Foreign Earnings in Firm Valuation

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Under current income tax accounting rules, U.S. multinational firms do not record liabilities for taxes on profits earned by their foreign subsidiaries, as long as the firms deem those profits to be indefinitely reinvested in the foreign operations. If the foreign subsidiary repatriates those profits back to the U.S., however, then the U.S. multinational faces an immediate tax liability. Accordingly, the dollar amounts of untaxed foreign earnings and the related unrecorded “off-balance sheet” deferred tax liabilities are substantial for many firms.

Footnotes to annual financial statements provide information on untaxed foreign earnings in two starkly contrasting ways. Some firms disclose the dollar amount of expected tax they would face upon repatriation of foreign earnings. Most firms however do not provide specific dollar estimates of expected repatriation tax liabilities; instead, these firms indicate that an amount is impracticable to estimate, or are silent regarding expected tax effects. However, footnote information on the level of untaxed foreign earnings and foreign effective tax rates can be used to estimate their tax liability if repatriation were to occur.

The main purpose of this study is to examine whether disclosed or estimated repatriation tax liabilities better explain firm value. Firm managers have access to more complete information relative to equity investors, suggesting disclosed repatriation tax liabilities might be more informative. On the other hand, firms have considerable flexibility in designating foreign earnings as “permanently reinvested.” This suggests that estimates of repatriation tax liabilities may be equally or more useful in valuing non-disclosing firms than disclosed repatriation tax amounts are in valuing disclosing firms. We provide empirical evidence on this issue, and we perform tests of the relative accuracy of disclosed versus estimated repatriation tax amounts to explore why one or the other might be more useful in firm valuation.

Our sample includes 210 distinct firms (835 firm-year observations) from the S&P 500 over 2000–2004. Results of price “levels” regressions reveal that both disclosed and estimated repatriation tax liabilities help explain firm value. More importantly, we also find that the impact of expected repatriation tax on firm value is higher for firms that disclose an amount, compared to the impact for firms for which we must estimate an amount. These results are robust across alternative methods for estimating repatriation taxes. Further, to address potential econometric concerns with price levels regressions, we estimate a price “changes” specification based on the relation between stock returns and changes in our variables. These results are consistent with the price levels results.

We then perform tests using the subsample of disclosing firms to assess why disclosed repatriation tax amounts are more useful than estimated amounts in pricing shares. Although disclosed and estimated repatriation tax amounts are positively correlated for this subsample, we find that estimated repatriation tax liabilities are downward-biased relative to firm-disclosed amounts. We also compare the accuracy of disclosed and estimated repatriation tax amounts in explaining actual repatriation taxes on earnings repatriated under the American Jobs Creation Act of 2004. This test reveals that disclosed repatriation tax amounts are significantly more accurate than estimated amounts in explaining actual repatriation taxes due. In sum, these tests help explain why equity investors rely more heavily on firm-disclosed repatriation tax amounts.
The Impact of Auditor-Related Tax Services on Corporate Debt Pricing

Steve Fortin and Jeffrey A. Pittman

We analyze the link between auditor-related tax services and corporate debt pricing. Some partly attribute the watershed financial reporting failures earlier this decade to nonaudit fees impairing auditors’ independence, which has led the SEC to insist that firms disclose details on the fees that they pay their auditors. The SEC argues that this disclosure will provide capital market participants with sufficient information to evaluate the potential impact of various nonaudit services on auditor independence and, in turn, the quality of registrants’ financial statements. We focus on the perceptions of bondholders by estimating the importance of auditor-provided tax services to the at-issue yield spreads on public firms’ straight debt offers. Our study responds to calls for research on the role that taxes play in corporate governance from auditing scholars.

We initiate research on the association between the relative amount of auditors’ tax services and the perceptions of financial statement users. Since the Public Company Accounting Oversight Board (PCAOB), which has the authority to impose further bans on nonaudit services, continues to debate whether these tax services undermine auditor independence, our results may have implications for policymakers eager to restore investors’ confidence in the capital markets. Besides that regulators may prohibit auditors from also providing tax services, the client firms themselves have begun severing this link.

However, this reduction in auditor-related tax services—whether voluntary or mandated by regulators—may be premature since the public accounting profession argues that certain nonaudit engagements enable auditors to become more familiar with their clients, translating into better audits. In a nutshell, the “bundling” of audit and nonaudit services like tax planning might generate positive knowledge spillovers with auditors learning about their clients over successive engagements. Indeed, the only research to date on this matter supports that auditors also delivering tax services improves the quality of firms’ financial reporting. On the other hand, there are legitimate concerns that aggressive tax planning may damage corporate accounting transparency. For example, recent evidence implies that firms exploit tax planning to opportunistically manage their earnings.

However, empirical research seldom examines whether auditor-related tax services shape the perceptions of users of firms’ financial statements. Given that tax-consulting engagements are emerging as the largest source of nonaudit revenues, our analysis helps settle whether perceived audit quality hinges on the relative amount of tax services. After controlling for security-level and other firm-level determinants of debt pricing, we provide strong, robust evidence that bondholders reward public firms paying more tax fees to their auditor with lower yield spreads. In results supporting our second prediction, we find that the relation between auditor-related tax services and yield spreads becomes more negative when we isolate issues made by firms experiencing worse information asymmetry according to prior research. Specifically, we document that the impact of auditor-related tax services in lowering borrowing costs is stronger for shorter maturity bonds and financial firms. Collectively, in sharp contrast to regulators’ concerns, our results imply that debt markets conclude that any reduction in auditor independence is minimal relative to firms becoming better known when public accounting firms provide relatively more tax services to their audit clients.
Incremental Value Relevance of Unrecognized Deferred Taxes: Evidence from the United Kingdom

Stephen Gregory Lynn, Chandra Seethamraju, and Ananth Seetharaman

Until 2000, the United Kingdom allowed the partial method of deferred tax accounting under the standard SSAP No. 15. Under the partial method, deferred tax liabilities that are not expected to reverse over a long enough horizon are not included in the balance sheet deferred tax amount. Instead, SSAP No. 15 required companies to disclose the unrecognized amount in a footnote.

Because it requires strictly more information about deferred taxes than full recognition, under which method there would be no unrecognized-amount footnote disclosures, one may surmise that the partial method is better for investors. Put differently, under the partial method, investors should be able to separately value the recognized and unrecognized components and therefore obtain a more accurate valuation of the firm. However, a number of analytical papers (Sansing 1998; Guenther and Sansing 2000, 2004; Amir et al. 2001) argue against such a proposition. These papers derive an expression for the fair value of the depreciation-related deferred tax liability that is invariant to the timing of reversals. In other words, they would argue that the fair value of the recognized and unrecognized amounts of deferred taxes under SSAP No. 15 is the same, at least for depreciation-related amounts.

In this paper, we test these competing propositions by using data for 1628 U.K. firm-years drawn from the period 1993–1998. We use a design that is based on Amir et al. (1997), and draws on the valuation model of Feltham and Ohlson (1995). Our empirical model can be characterized as a regression of the year-end price on components of book value with an additional earnings term that proxies for residual income (to capture the value of unrecorded goodwill). We disaggregate book value of the firm into net operating assets excluding deferred tax (NOA), net financial assets (NFA), recognized deferred tax (REC) and unrecognized deferred tax (UNREC). As in Amir et al. (1997), we deflate financial statement variables by the number of shares. Our deferred tax data is hand-collected from U.K. annual reports, while the other financial statement data and prices are taken from Compustat Global®. If the market treats recognized and unrecognized deferred tax equivalently, then the coefficients on REC and UNREC should be equal.

Due to the presence of outliers in our data, we estimate the model using Iterated Weighted Least-Squares (IWLS) regression, which in each step down-weights observations that have large residuals in the previous step, and continues until the coefficient estimates converge. We observe significantly positive coefficient estimates on both REC and UNREC. We are unable to reject the hypothesis that the coefficients on REC and UNREC are equal, thereby providing limited support for the conjecture in the theoretical papers mentioned earlier.

Because the results in our study constitute limited support for the conjecture that the timing of reversals is value-irrelevant, they conversely provide some support for full recognition, especially taken together with the finding in Gordon and Joos (2000) that the partial method could be used for earnings management. A limitation of our study is that we do not disaggregate deferred tax based on its source, since disaggregated data are not reported consistently under SSAP No. 15. The theory mentioned earlier holds only for depreciation-related amounts and, therefore, a finer test would separate these amounts.