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Effects of Strategic Tax Behaviors on Corporate Governance

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EFFECTS OF STRATEGIC TAX BEHAVIORS ON CORPORATE GOVERNANCE

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ABSTRACT
This paper addresses agency tensions and conflicts that may emerge between managers (agents) and shareholders (principals) as a result of aggressive tax planning strategies adopted by publicly held corporations. The interactions between corporate governance and taxation are bilateral and biunique: in fact, on one side, the manner in which corporate governance rules are structured affects the way a corporation fulfills its tax obligations; on the other side, the way tax designs (from the government perspective) and related tax strategies (from the corporation perspective) are planned influences corporate governance dynamics.

This research investigates such bilateral relationship limiting the analysis to the specific tensions that emerge between managers and shareholders when publicly held corporations engage in strategic tax behaviors. Therefore, the purpose of the research is to analyze the connection between corporate governance and strategic tax behaviors, first, by using tax law to better understand corporate governance dynamics and, second, by using corporate governance rules to better understand tax strategies.

The research agenda requires (i) to analyze the general relationship between corporate governance and taxation (chapter one), (ii) to define strategic tax behaviors (chapter two), (iii) to investigate the strategic tax behaviors that may have an impact on corporate governance dynamics (chapter three), and (iv) to conclude.

INTRODUCTION

This paper addresses agency tensions and conflicts that may emerge between managers (agents) and shareholders (principals) as a result of aggressive tax planning strategies adopted by publicly held corporations.

Since a corporation is a *sui generis* taxpayer, defined by Professor Schon as a “taxpayer that doesn’t exist”, it is not clear (i) who bears the corporate tax, (ii) who should be entitled, in the corporate governance context, to comply with tax law, (iii) who should plan the tax strategies, and (iv) who should be responsible for corporate tax

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2 As a general matter, multilateral interactions between corporate governance dynamics, taxes (both at the corporate and at the shareholder level) and risk can be easily found in practice, but this research will be mainly focused on the interactions caused by aggressive tax planning strategies.

3 The research will be focused on U.S. publicly held corporations, even though the same kind of conflicts may emerge in other business structures and in other developed jurisdictions which face the same basic problems. Only within the context of corporations, R. H. Kraakman, *The anatomy of corporate law: a comparative and functional approach*, Oxford; New York, 2004, Oxford University Press, at 2, underlines three different conflicts: “those between managers and shareholders, those among shareholders, and those between shareholders and the corporation’s other constituencies, including creditors and employees”.

obligations\textsuperscript{5}. Therefore, the peculiarity of a corporation for tax matters gives rise to a new challenge, the core of which is the investigation and analysis of the bilateral interactions between corporate governance and taxation.

The interactions between corporate governance and taxation are bilateral and biunique: in fact, on one side, the manner in which corporate governance rules are structured affects the way a corporation fulfills its tax obligations; on the other side, the way tax designs (from the government perspective) and related tax strategies (from the corporation perspective) are planned influences corporate governance dynamics. For example, allowing corporations to keep two different and separate sets of books (one for accounting purposes, the other for tax purposes)\textsuperscript{6} makes it easier for tax managers to obtain both tax savings and promising financial statements even though a critical financial status is present. On the other way around, the way tax rules are designed may influence the way corporations comply with their substantial and formal tax obligations\textsuperscript{7} as well as the manner in which they structure their ownership and governance dynamics.

This research investigates such bilateral relationship limiting the analysis to the specific tensions that emerge between managers and shareholders when publicly held corporations engage in strategic tax behaviors\textsuperscript{8}. Therefore, the purpose of the research is to analyze the connection between corporate governance and strategic tax behaviors, first, by using tax law to better understand corporate governance dynamics and, second, by using corporate governance rules to better understand tax strategies\textsuperscript{9}.

The research agenda requires (i) to analyze the general relationship between corporate governance and taxation (chapter one), (ii) to define strategic tax behaviors (chapter two), (iii) to investigate the strategic tax behaviors that may have an impact on corporate governance dynamics (chapter three), and (iv) to conclude that a general anti-avoidance tax rule has the power to regulate corporate governance dynamics, on one hand, decreasing agency costs, transaction costs, and information asymmetry, and, on the other hand, increasing transparency and aligning interests of shareholders with those of managers.

\textsuperscript{5} W. Schon, *Tax and corporate governance: a legal approach*, W. Schon, *Tax and Corporate Governance*, Munich, 2008, Springer, at 31, emphasizes that “contrary to the situation of the individual taxpayer, the different aspects of tax life are not concentrated in a single person: while a natural person has to pay taxes on his own income and wealth, has to file her own tax declaration and has to pay her own share of taxes, in the corporate context, responsibilities are dispersed, thus leading to opportunistic behavior, principal-agent-conflicts, moral hazard and other failures well known from the economic theory of the corporation”.

\textsuperscript{6} See J. Anthony, *Stopping the Enron End-Runs and Other Trick Plays: The Book-Tax Accounting Conformity Defense*, 2003 *Colum. Bus. L. Rev.* 35, 2003, at 37-38, who clarifies that “in accounting for business transactions in the United States, it has long been the case that keeping two different sets of books (one for financial reporting and one for income tax reporting) is permissible and “generally accepted.” A company can often effect a transaction that in economic substance begins at “point A” and ends at “point B,” but account for the path taken in one manner in its financial statements and in a markedly different manner in the company’s income tax returns”.


\textsuperscript{8} The OECD is also giving attention to this linkage between corporate governance and tax. In Oecd, *Final Seul Declaration*, Seul, 2006, OECD Publishing, at 5, it has been expressed the objective to expand “the 2004 Corporate Governance Guidelines to give greater attention to the linkage between tax and good governance”.

CHAPTER ONE: THE CAUSAL INTERDIPENDENCE BETWEEN CORPORATE GOVERNANCE AND TAXATION

1.1 INTRODUCTION

The purpose of this chapter is to give an overview, with reference to the current literature\(^{10}\), of the interaction between corporate governance and taxation. Such interaction, as it has been already underlined, is bilateral and biunique\(^{11}\).

1.2 THE INFLUENCE OF TAX LAW ON CORPORATE GOVERNANCE DYNAMICS: ADVANTAGES AND DISADVANTAGES

A good corporate governance environment\(^{12}\) can be achieved by policy makers through direct regulatory action or through tax laws\(^{13}\).

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\(^{11}\) In fact, on one side, the way corporate governance rules are structured influences the way a corporation fulfills its tax obligations; on the other side, the way tax designs and tax strategies are planned influence corporate governance dynamics. The fact that tax laws may influence corporate governance is also emphasized by the OECD. See Oecd, *OECD Principles of Corporate Governance*, Paris, 2004, OECD Publishing, at 31, according to whom “corporate governance requirements and practices are typically influenced by an array of legal domains, such as *(omissis)* tax law”. See A. Friese, S. Link and S. Mayer, *Taxation and Corporate Governance - The state of the art*, W. Schon, *Tax and Corporate Governance*, Munich, 2008, Springer, at 357, according to whom firstly “tax systems can influence corporate governance. E.g., taxes can encourage or discourage reorganizations or the payment of dividends to shareholders. They can also affect decisions on whether and how corporate reorganizations and mergers or takeovers take place, in this way having effects on the ongoing governance of corporate groups and on the market for corporate control. Tax obligations and incentives may also have an influence on the way in which companies comply with their obligations of internal and external reporting, especially accounting”. Secondly, “rules and mechanisms of corporate governance influence the way in which companies fulfill their tax obligations”.

\(^{12}\) Even though a single ideal model of appropriate corporate governance does not exist, in 2004 the OECD developed, in conjunction with national governments, a set of corporate governance standards and guidelines (i.e. the “good” corporate governance principles), with the purpose “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” (page 11, ibid.). The good corporate governance principles can be summarized as follows:
The purpose of this paragraph is to briefly analyze whether tax law is an efficient policy tool to reach a corporate governance objective. In specific, we wish to address the question whether utilizing tax law (i.e. tax expenditure or tax penalties) to achieve this objective is preferred over direct regulatory action (i.e. subsidies and penalties – or direct expenditures) and to what extent this choice will encourage publicly held corporations to adopt good corporate governance dynamics.

According to the literature, tax law has three different objectives: (i) increasing the revenue for necessary governmental functions, (ii) redistributing wealth among the society and (iii) influencing specific behaviors. Tax laws may also have unexpected consequences. For example, a tax provision with the mere objective to increase the revenue of a specific country may also indirectly influence the behavior of certain individuals or entities. Therefore, tax laws can influence corporate governance dynamics

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1. 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 different supervisory, regulatory and enforcement authorities;
2. The corporate governance framework should protect and facilitate the exercise of shareholders’ rights;
3. The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights;
4. The corporate governance framework should recognize the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises;
5. 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;
6. 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.

For purposes of this research, we will assume that governance dynamics and rules are appropriate if they meet the above standards and guidelines.

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13 Even if the primary objective of this research is not to emphasize the importance of good corporate governance, but how to reach such goal, we wish to briefly investigate the reasons why both developed and developing jurisdictions should impose (or at least encourage) publicly held corporations to adopt a good corporate governance environment. We believe that good corporate governance principles may have at least two positive effects on economy: first, they would provide the right incentives for managers to refrain from behaving opportunistically but rather in the interest of the company (recte, the shareholders); second, they would augment the proper functioning of a free market economy. This is true because good corporate governance lowers the cost of capital and encourage a more efficient use of resources. See Oecd, OECD Principles of Corporate Governance, Paris, 2004, OECD Publishing, at 13. In fact, according to the OECD, “good corporate governance practices will help improve the confidence of domestic investors, reduce the cost of capital, underpin the good functioning of financial markets, and ultimately induce more stable sources of financing”. In this regard, the OECD has underlined that “as companies play a pivotal role in our economies and we rely increasingly on private sector institutions to manage personal savings and secure retirement incomes, good corporate governance is important to broad and growing segments of the population” (page 3).

14 See R. Avi-Yonah, The Three Goals of Taxation, 60 Tax L. Rev. 1, 2006, at 3, who underlines that taxation has three goals: first of all, “taxes are needed to raise revenue for necessary governmental functions, such as the provision of public goods”; second, “taxation can have a redistributive function, aimed at reducing the unequal distribution of income and wealth that results from the normal operation of a market-based economy”; third, taxation can also “be used to steer private sector activity in the directions desired by governments”.

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directly (i.e. as a direct consequence of specific tax policy choices) or indirectly (i.e. as an indirect consequence of the way the tax system operates).

Since both tax law and direct regulations can potentially achieve the goal of good corporate governance, the issue we are concerned with is what tool is preferable in terms of efficiency, equity and simplicity.  

1.2.1 THE USE OF TAX LAWS AS A REGULATORY TOOL FOR CORPORATE GOVERNANCE

The existing literature has underlined two main advantages in using tax rules rather than direct regulations for encouraging publicly held corporations to have good corporate governance dynamics.

First, a simplicity argument can be raised in favor of tax laws over direct regulations. The use of tax laws instead of direct regulations allows governments to rely on an existing and established system (the tax system). The costs incurred by governments to slightly modify an existing and established system would be lower than the costs needed to create, manage and administer a new system (i.e. the regulatory system). In other words, the administrative costs incurred by governments would be higher for putting in place a new regulatory system compared with the alternative of utilizing an existing tax system. Moreover, the fact that governments can rely on a well known system is likely to increase the effectiveness of the process since the impact of tax rules on corporate governance dynamics would probably be faster than that of direct regulations. New direct regulations would require governments to create a new system for the implementation and supervision of the new regulations, increasing administrative costs and delaying the impact on corporate governance.

Some authors also believe that the time and resources expended by taxpayers to interact with the tax system would be less than the time and resources that would be spent to comply with a new regulatory system. In other words, compliance costs would be

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which tax rules are special provisions and therefore tax expenditures, and which tax rules are just tax rules; simply part of the warp and woof of a tax structure”


17 See S. S. Surrey, Tax Incentives as a Device for Implementing Government Policy: a Comparison with Direct Government Expenditures, 83 Harv. L. Rev. 1970, at 717. Contra, K. Hartmann, Comment: the Market for Corporate Confusion: Federal Attempts to Regulate the Market for Corporate Control through the Federal Tax Code, 6 DePaul Bus. L. J. 1994, at 191, according to whom “It is not the mere use of the tax system that makes a particular provision simple, rather, it is a substantive decision to have a simple program. While it is true that direct programs are often overstructured and inefficient, the answer does not necessarily lie in using the tax system, but in designing a simple system for administering a direct plan. Furthermore, the greater simplicity often found in tax code provisions, as opposed to direct programs, may merely reflect a lack of scrutiny and foresight in planning the tax provisions”.

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lower using pre-existing tax laws, since tax provisions are considered as less complicated than other provisions, because they are already established and thus known 18.

Second, the use of the tax system rather than a regulatory system would promote the private decision making process of individuals. In fact, while the use of tax laws (and more specifically of tax expenditures) would give a choice to taxpayers whether to comply with the policy request of the governments or not, direct regulations would not leave such choice to taxpayers, but to the government, favoring a government-centered decision making process. This argument has been raised by the literature in the context of using tax laws or direct regulations in solving social problems 19. In our opinion, it is not clear whether the same argument can be raised with reference to corporate governance. Moreover, it seems to us that the argument is weak because, depending on how the regulations and penalties are structured, a tax system may favor a government-centered decision making process while a regulatory system may well favor a private decision making process 20.

1.2.2 THE USE OF DIRECT REGULATIONS AS A REGULATORY TOOL FOR CORPORATE GOVERNANCE

Three main arguments can be raised in favor of direct regulations rather than tax laws as policy tools for encouraging publicly held corporations to adopt good corporate governance dynamics. These three arguments are based on the interaction between the economic principles of taxation (i.e. equity and efficiency) and the agency framework.

First of all, an equity argument can be made. A principle of horizontal equity prescribes that “individuals” at the same level of well being should have the same tax burden 21, while a principle of vertical equity prescribes that the government should be actively involved in income redistribution among “individuals” according to a tradeoff between equity and efficiency based on the ability to pay principle 22. Since tout court tax incentives or tax penalties would have a stronger impact on taxpayers with a high taxable income rather than taxpayers with a low taxable income or with losses, and tax

20 A. Friese, S. Link and S. Mayer, Taxation and Corporate Governance - The state of the art, W. Schon, Tax and Corporate Governance, Munich, 2008, Springer, at 394. The Authors underlines how “as long as a direct fine is compared with an indirect tax penalty it seems very unlikely that there is any difference for the affected individual because the after-tax costs of the regulatory measure are equal in both cases. If the regulated conduct was prohibited instead, a tax would obviously be more flexible”.
22 In general, on the principle of vertical equity see Ibid., at 59 and followings.
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incentives and tax penalties are regressive measures\(^\text{23}\), the use of tax laws, for purposes that are different from mere redistribution or the increase of the government’s revenue, has an impact on the equity issues \textit{supra} mentioned. For example, a taxpayer with zero tax liability would not be affected by a provision prescribing, as a tax penalty, the non-deductibility of certain expenses. Nevertheless, it is our opinion that this argument is weak for at least two reasons: (i) as already mentioned, corporations are \textit{sui generis} taxpayers to whom it is doubtful that equity principles should apply\(^\text{24}\); (ii) not every tax expenditure is more regressive than a direct expenditure and this depends on how the tax expenditures are structured compared with direct expenditures\(^\text{25}\).

Second, an efficiency argument could also be raised. The use of tax law rather than direct regulations would seem inefficient because it creates a distortion in the allocation of resources and therefore in the behavioral responses to tax law. Nevertheless, in our opinion, also this criticism is weak for at least two reasons: (i) direct regulations may also create a distortion in the allocation of the resources; (ii) the use of tax law as a policy tool is not inefficient when there is an overall increase of positive externalities\(^\text{26}\).

The third and most important criticism to the use of tax expenditures in the corporate governance context relates to the endemic conflict between managers and shareholders that characterizes publicly held corporations. In fact, corporate managers may not be efficiently reactive to tax incentives or tax penalties imposed on corporations, since they are not the direct addressees of these measures. Based on a cost/benefit analysis managers may well prefer bad corporate governance dynamics, which would allow them to opportunistically increase their interests, instead of a tax benefit or instead of incurring a tax penalty. On the contrary, following this argument, a regulatory system may easily take into account the agency framework in which managers operate. Therefore, using tax incentives or tax penalties the government would waste more resources in order to obtain the same objective. However, in our opinion, also this last argument is weak because it is based on wrong assumptions. First, this argument is based on the assumption that managers do not bear the corporate tax\(^\text{27}\). This assumption seems to be wrong since managers, in the short term, indirectly bear the corporate tax, because it reduces their powers. The above argument is based on a second wrong assumption, which is the fact that the tax measures cannot be addressed directly to managers. Professor

\(^{23}\) See K. Hartmann, \textit{Comment: the Market for Corporate Confusion: Federal Attempts to Regulate the Market for Corporate Control through the Federal Tax Code}, 6 DePaul Bus. L. J. 1994, at 194. According to the Author, “This regressivity is a function of two factors. First, individuals with income under taxable levels do not benefit from a deduction. Secondly, because less wealthy individuals are taxed at lower marginal rates, tax deductions are marginally less beneficial to them”.

\(^{24}\) Since, economically, corporations do not pay taxes because people end up bearing the burden of tax, it is doubtful that the equity principles should apply to corporations.

\(^{25}\) In fact, we may have both a direct expenditure related to income (which would then be regressive) and a tax expenditure non related to a progressive income tax, (therefore not regressive).

\(^{26}\) See J. Slemrod and J. Bakija, \textit{Taxing Ourselves. A Citizen’s Guide to the Debate over Taxes}, Boston, 2004, Mit Press, at 122. The Author clarifies that “when the difficulty of obtaining necessary information, the presence of activities with spill over effects, or monopoly leads markets to function inefficiently – when the invisible hand fails – taxes do not necessarily detract from efficiency. On the contrary, they may correct an inefficiency”.

Slemrod clarifies that penalties imposed on corporate tax managers are more effective in reducing evasion than are those imposed on shareholders. Therefore, even in the context of encouraging certain corporate behaviors, tax incentives or tax penalties imposed on managers may be more effective than if imposed on the corporations or the shareholders.

1.3 THE INFLUENCE OF CORPORATE GOVERNANCE RULES ON TAX PLANNING

In the previous subchapter we have briefly and generally analyzed why tax laws can influence corporate governance dynamics. In this subchapter we are interested in giving an overview of why corporate governance rules can affect the way a corporation fulfills its formal and substantial tax obligations.

The OECD countries all agree that once national tax laws have been enacted, they need to be enforced. It has already been underlined that one of the ways to enforce tax law rules (i.e. to increase corporate tax compliance) is to use corporate governance tools.

The objectives of corporate tax managers in the United States, as well as in other developed jurisdictions, have changed from passive compliance to aggressive tax planning (most often illegal, but certainly illicit because against the spirit of the law).

If we conduct the relationship between shareholders and managers within a principal-agent framework, one may think that if managers are encouraged to follow shareholders’ interests, they would probably act in order to reduce the tax burden and maximize the after tax profit. On the other hand, if managers are not encouraged to follow shareholders’ interests, they would most likely behave opportunistically maximizing their own interests. Therefore, if the corporate governance rules would not encourage managers to behave for the shareholders’ interest (i.e. if there is diversion) managers would be tempted to report to the market higher income even if this would cause higher income to be reported on the tax return (and consequently higher taxes) because this would inevitably cause an increase of the value of the corporations making it more prestigious.

However, this is only partially true, because it wrongfully assumes that shareholders want managers to minimize the corporate tax burden. There are three reasons why public shareholders may not want managers to engage in aggressive tax planning:

1. In order to reduce risks of legal challenges and penalties, any transaction that does not have a real business purpose and is designed solely to avoid taxes has to be

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mischaracterized and obscured by managers. These opaque transactions make it harder for outside investors (current and future shareholders and bondholders) to control insiders (i.e. managers). Utilizing opaque transactions, smart tax managers may easily behave opportunistically maximizing their profits and causing extra costs unseen by the shareholders\(^{33}\). As a result, corporate governance rules that do not guarantee strong transparency can benefit the private interests of managers to the detriment of shareholders. The vice versa is also true: under good corporate governance rules which grant transparency, it is more difficult to shelter taxable income. Thus, better corporate governance can reduce tax avoidance.

2. The interest of investors in corporate social responsibility has extremely increased in recent years\(^ {34}\). Public investors seem to be interested in ethical behaviors of corporations. Therefore, good corporate governance which grants alignment of interests and transparency would prevent managers from engaging in strategic tax behaviors.

3. The third reason is related to a recent finding of the literature. Professor Slemrod has suggested that corporations should always behave as if they are risk-neutral, even if shareholders are not, because shareholders have already diversified the risk by holding diversified portfolios based on the assumption that corporations are risk-neutral\(^ {35}\). Therefore, an alignment of interests, given by good corporate governance principles, would induce managers to behave as risk-neutral persons managing the corporation’s business.

CHAPTER TWO: STRATEGIC TAX BEHAVIORS AND TAX COMPLIANCE

2.1 THE DEFINITION OF STRATEGIC TAX BEHAVIORS: TAX EVASION, TAX AVOIDANCE AND LICIT SAVINGS OF TAXES

For purposes of this paper, strategic tax behaviors (or aggressive tax planning strategies) are all those actions designed solely to minimize corporate tax obligations whose legality may be under doubt.

Three categories of tax behaviors can be identified: tax evasion, tax avoidance and licit tax savings\(^ {36}\). Tax evasion can be synthetically defined as intentional illegal behavior, i.e. behavior involving a direct violation of tax law, in order to escape payment of taxes.


\(^{35}\) J. Slemrod, The Economics of Corporate Tax Selfishness, 57 National Tax Journal 2004, at 882.

Licit tax savings can be defined as commonly accepted forms of behaviors which are neither against the law nor against the spirit of the law. Tax avoidance can be defined as all illegitimate (but not necessarily illegal) behaviors aimed at reducing tax liability which do not violate the letter of the law, but clearly violate its spirit. The scope of each of these concepts varies from country to country depending on government’s policies, court decisions, tax authorities’ attitudes and public opinion. In this study, strategic tax behaviors are thus all behaviors identified as tax evasion or tax avoidance.

This tri-partition is not generally accepted by economists. Professor Slemrod\textsuperscript{37}, for example, splits strategic tax behaviors into two categories: tax avoidance when the behaviors are legal and tax evasion when they are not.

As mentioned before, I believe that while it is clear that tax evasion is illegal (and illicit) and licit tax savings is legal (and licit), the legality of tax avoidance has to be proved on a case by case basis. Every different jurisdiction has its own anti-avoidance rules and therefore the same transaction could be classified as legal in one jurisdiction while simultaneously regarded as illegal in another jurisdiction. Thus, the problem that every developed tax jurisdiction has to face is defining what tax behaviors should be considered legal.

Theoretically, according to the best literature, the line between licit and not licit should be traced on the basis of the business purpose principle. Consequently, every activity which does not have any meaning other than reducing taxes (rectius, every activity which does not have any business purpose) should be considered illicit and therefore illegal. On the other hand, corporate transactions that are motivated by real business reasons and have important (yet secondary) tax advantages cannot be considered illicit. The issue then becomes, when analyzing multiple transactions, whether such transactions should be viewed as a whole or should be split into parts that gave rise to the tax savings and parts that did not. It is not one of the goal of this paper to investigate the raised issue.

The concept of tax avoidance is strictly related to the concept of tax shelter. There is not consensus between scholars on how to define tax shelters. Broadly, they can be defined as transactions or arrangements “designed to reduce or defer taxation, typically in an artificial manner”\textsuperscript{38}. However it is not clear whether the term refers only to transactions that technically violate the letter of the law or whether it refers to all kinds of transactions engaged into for the sole purpose of reducing the tax burdens and without any business reasons. Professor Bankman defines a tax shelter as a (1) tax motivated; (2) transaction unrelated to a taxpayer’s normal business operations; that (3) under a literal reading of some relevant legal authority; (4) produces a loss for tax purposes in excess of any

\textsuperscript{37} J. Slemrod and J. Bakija, \textit{Taxing Ourselves. A Citizen’s Guide to the Debate over Taxes}, Boston, 2004, Mit Press at 144. Therefore, following this approach, while the cost of tax avoidance is given only by expenditures on professional assistance, the cost of tax evasion is also the exposure to the uncertainty of an audit and any attendant penalties for detected evasion.

\textsuperscript{38} B. Larking, \textit{IBFD International Tax Glossary}, Amsterdam, 2005, IBFD.
economic loss; (5) in a manner inconsistent with legislative intent or purpose. Thus, tax shelters are transactions that are against the spirit of the law and usually do not have any business purpose, but they are entered only for tax reasons. They are often not foreseen by policy makers and are usually resolved ex post. In the meanwhile they can produce high tax savings for the single corporations, but they create high inefficiency cost for society. In fact, Professor Slemrod explains that tax shelters "use up real resources (including the time and effort of the lawyers, accountants, and investment bankers who devise the shelters) that could have otherwise been devoted to some socially productive purpose, they divert resources toward particular types of investments or other activities that help facilitate such avoidance behavior, and they require tax rates to be higher than they otherwise would have to be to raise a given amount."

The reason why it is important to distinguish between licit and non licit saving of taxes is due to the fact that only illicit saving of taxes has to be obfuscated (in order to appear licit) and therefore might give the possibility to opportunistic managers to increase their personal interests.

### 2.2 THE INCREASING PRACTICE OF TAX AVOIDANCE

As a matter of fact, tax consequences are motivating factors in many corporate decisions, both ordinary and extraordinary, and full compliance is no longer the characterizing feature of how tax managers consider corporate tax obligations. Lately, as some academics have underlined, many managerial actions designed solely to minimize taxes at the corporate (but not shareholder!) level, have been observed in practice. Therefore, in the last decades there have been increases of tax avoidance and such increases have been proven by the growing difference between tax income (i.e. income reported to the tax authorities, determined according to the tax principles) and book income (i.e. income reported to the public, determined according to the accounting principles).
Two main issues related to this finding are: (i) whether or not such activities are in the interest of the shareholders; (ii) why tax managers engage in such activities.

2.3 ARE STRATEGIC TAX BEHAVIORS FOR THE INTERESTS OF THE SHAREHOLDERS? TAX MINIMIZATION STRATEGIES AND EFFECTIVE TAX PLANNING

Strategic tax behaviors increase interests of shareholders if they result in a transfer of value from the state to the firm. However, this is true if and only if such activities cost less than the resulting transfer of value. Mere tax minimization strategies (i.e. reduction of explicit taxes to the maximum extent possible), which seem to be widely adopted in practice, do not consider the whole dimension of the business problem.

A broader concept of effective tax planning should be used to evaluate whether a tax planning strategy results in a net increase of value of the shareholders. In fact, an effective tax planning strategy does not consider only the role of explicit taxes, like a mere tax minimization approach does, but considers also the other costs that arise in a world of costly contracting (like, for example, transaction costs, administrative costs and exposure to risk of sanctions). This approach is based on the fact that tax-minimizing strategies introduce significant costs along the non-tax dimension, like the corporate governance dimension.

Therefore, the approach adopted in this research is to evaluate a tax planning strategy (referred to hereinafter also as effective tax planning analysis) comparing the reduction of explicit (which has a direct impact on profitability) and implicit taxes with the costs (administrative costs, risk of sanctions, compliance costs and corporate governance costs) which may not have any impact (at least in the short run) on profitability. Interesting studies have been conducted by the literature, in order to analyze the relation between firms’ value and strategic tax behaviors. Historically it has been thought that tax minimization strategies (i.e. mere reduction of explicit taxes) should increase the stock market value of a company. However, recently it has been proven that an increase in tax enforcement and therefore a higher level of tax compliance can increase (rather than decrease) the stock market value of a company.

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44 In other word the research is going to investigate whether or not tax avoidance strategies interfere with the existing conflicts between managers and shareholders.


46 See M. A. Desai, A. Dick and L. Zingales, Corporate governance and taxation, 2004, American Law and Economics. Association annual meeting (also on www.ssrn.com), at 2: “increased levels of tax enforcement reduce the return to sheltering income and, by the same logic, reduce the amount of private benefits. Most interestingly, for low levels of statutory tax rates in weak corporate governance environments, an increase in the extent of tax enforcement increases the amount outside shareholders will receive (even accounting for the higher amount of taxes
Therefore, while the traditional view of corporate tax minimization suggests that shareholder value should increase with tax minimization activities, the agency perspective suggests that corporate governance should be an important determinant of the valuation of the impact of tax minimization on the value of the firm.

In fact, it has been underlined as tax planning strategies that look only at the minimization of taxes are wrong, since a variety of costs must be taken into account: besides the costs directly connected with the engagement in such activities, implicit taxes, compliance costs, risks factors and corporate governance costs must also be taken into account. We emphasize the importance of the impact of tax planning strategies on corporate governance, since both the increase of agency costs and the decrease in transparency imply a negative impact on corporate governance.

It seems that recent corporate tax shelters (i.e. (1) tax motivated; (2) transaction unrelated to a taxpayer’s normal business operations; that (3) under a literal reading of some relevant legal authority; (4) produces a loss for tax purposes in excess of any economic loss; (5) in a manner inconsistent with legislative intent or purpose\(^47\)), are not put in place after an accurate effective tax planning analysis, but they merely focused on tax minimization strategies rather than effective tax planning and therefore they do not take into account all of the above costs.

Two examples have been shown by the recent literature in order to prove that tax minimization strategies do not have a clear positive impact on firms’ value because they do not take into account the whole dimension of the costs/benefits analysis:

1. Corporate inversions (i.e. a “paper” transaction through which a multinational group reorganizes its ownership structure in a way so that the parent corporation of the group becomes a foreign corporation (instead of an American one)): it has been shown that markets do not always react positively to announcements of such moves\(^48\).

2. Tax enforcement policies in Russia: in recent studies it has been shown that stronger tax enforcement policies in Russia may be associated with positive market reactions\(^49\).

An institutional approach suggests that an efficient organizational choice is not determined simply by minimizing explicit taxes, because different tax plans generally give rise to differences in transaction and other non-tax costs, so that a complex weighted trade-off among different variables must be considered. Different ways of organizing economic activities and particularly different corporate governance patterns give rise to differences both in transaction costs and tax costs. Hence the efficient organizational choice is not necessarily the one that minimizes taxes, but a wider strategy that encompasses both taxes and transaction costs.


The effective tax planning analysis is complicated because traditional tax evasion models for individuals\textsuperscript{50} cannot explain behaviors of corporations, since a corporation involves “the strategic behaviour of more than one person, thereby changing the relation between the firm and its manager and, in the process, distorting the incentives of the latter” (...) In fact, “beside the risk of detection considered in the traditional individual tax evasion literature, the firm also needs to bear the cost of efficiency loss in internal control”\textsuperscript{51}.

Therefore, the analysis requires first to consider what explicit taxes and implicit taxes are and to what extent it is possible to reduce them and then to underline the direct and indirect costs along the non-tax dimension.

\textbf{2.3.1 REDUCTION OF EXPLICIT TAXES}

The main objective of tax planning strategies is to reduce explicit taxes (i.e. reduce all present and future taxes, levies, imposts, duties, deductions, withholdings, assessments, fees or other charges imposed, levied, collected withheld or assessed by any governmental authority). Nevertheless, as it has already been pointed out, such reduction must be evaluated within an effective tax planning analysis, in order to make sure that tax minimization is not entirely offset by direct and indirect costs.

The amount of tax savings depends on the level of taxes that the taxpayer could save through the use of a tax planning strategy and therefore, indirectly, on the tax rate. In the literature, it has been proven that a higher tax rate increases the return to tax avoidance strategies and hence the amount of sheltered income\textsuperscript{52}.

\textbf{2.3.2 COSTS}

As it has been already underlined, strategic tax behaviors (i.e. actions designed solely to minimize corporate tax obligations\textsuperscript{53}) may be costly: the first cost is the one directly connected with the engagement in such activities; the second cost is the exposure to the uncertainty of an audit and any attendant penalties that may emerge (related to this cost is the higher compensation for managers since they bear - at least assuming their personal responsibility for corporate tax obligation - the risk of not legal activities); the third cost is given by the implicit taxes that may emerge as a consequence of a specific tax planning strategy; the fourth cost is compliance cost; finally, the last cost is the so

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\textsuperscript{53} See \textit{infra}.
called corporate governance cost, which is related to the obscuration of these actions from tax authorities and to the increase of the agency costs: in fact, the necessary obfuscation may create an incentive for managers to obtain self-serving objectives at the same time\textsuperscript{54}, and will therefore enforce shareholders to induce managers not to engage in such collateral activities\textsuperscript{55}, increasing agency costs and transparency issues.

2.3.2.1 Direct costs

The direct costs are the costs directly connected with the engagement in tax planning activities. These costs may be internal or external. The internal costs are mainly given the time spent by managers and employees on structuring the tax saving opportunities that could not be devoted to other activities. The external costs are mainly given by the expenses for tax consultants and the other expenses necessary to set forth the tax planning opportunity.

2.3.2.2 Exposure to risk of sanctions

Tax risk for managers includes both the risk of overpaying taxes and the risk of being audited by the tax authorities for under-reporting the income and thus paying less tax than legally required\textsuperscript{56}. In this sub-chapter we are interested in evaluating the second aspect of the problem.

As it has already been underlined, tax planning strategies may be illegal and therefore subject to penalties. However, in the case of tax evasion and tax avoidance, the corporation’s payoff depends on whether or not it is investigated by tax authorities, and,

\textsuperscript{54} See M. A. Desai and D. Dharmapala, \textit{Earnings Management and Corporate Tax Shelters}, 2006, SSRN.
\textsuperscript{55} As clearly underlined by R. H. Kraakman, \textit{The anatomy of corporate law : a comparative and functional approach}, Oxford; New York, 2004, Oxford University Press, at 21, the problem of agency costs “lies in motivating the agent to act in the principal’s interest rather than simply in the agent’s own interest”.
\textsuperscript{56} Therefore, one of the goal for the board is to implement tax strategies that ensure that taxes are not overpaid but that legal obligations are fulfilled (taking into account a right balance between risk and opportunity). This goal must be included in a so called tax code of conduct, intended to establish standards for tax behaviors. The output depends on the way managers see tax obligations: normal costs that need to minimized as a duty to shareholders or a social obligation as a duty to the society? Depending on the answer to this easy question, the output of the code of conduct may be extremely different. Nevertheless, it seems that “most companies take a position closer to the idea that ‘tax is a cost factor’ and therefore a decision needs to be made on how aggressive tax management should be and what level of risk is acceptable for the company”. (B. Erle, \textit{Tax Risk Management and Board Responsibility}, W. Schon, \textit{Tax and Corporate Governance}, Munich, 2008, Springer, at 12). In this framework, B. Erle, at 13-17 describes the tax risk management system, taking into account the following components: risk strategy (i.e. the need to connect the tax planning strategy with the general business strategy of the corporation), risk management and control (i.e. the need to consider tax as an integral part of the internal control and the risk management system of a business), communication (i.e. the need to consider the tax department as both an internal and external contact point), processes and technology (i.e. need to document processes and controls in order to allow evaluation and improvement), understanding of business dynamics (i.e. the tax department needs to understand the dynamics and strategies of the business), compliance (i.e. the tax department must be aware of the tax issues throughout the business in order to be able to fully comply with the tax system), accounting (i.e. the tax department must understand the business through the accounting principles), planning (i.e. the tax department should be involved in the business strategies of the corporation at an early stage of the projects), coverage (i.e. the tax department has cover all taxes adequately).
assuming it is, whether tax authorities consider the strategy as illegal, and therefore subject to penalties or not\textsuperscript{57}.

The choice of individual taxpayers is based on three factors: (i) the probability of detection and punishment, (ii) the penalty structure and (iii) the risk aversion of the taxpayer\textsuperscript{58}. Nevertheless, if this is true in the individual taxpayers’ framework, it does not mean it is necessarily true from the perspective of corporate taxpayers\textsuperscript{59}.

In fact, the corporate taxpayers’ tax attitude toward risk must be analyzed within the agency framework. Even if shareholders (as principals) may provide general guidance with regard to the corporation’s tax attitude toward risk, managers (as agents) make the practical tax choices.

We have seen before that, since recent research has suggested that corporations should always behave as if they are risk-neutral, even if shareholders are not, due to the fact that shareholders have already diversified the risk by holding diversified portfolios based on the assumption that corporations are risk-neutral\textsuperscript{60}, an alignment of interests,\textsuperscript{61} given by good corporate governance principles, would induce managers to behave as risk-neutral persons managing the corporation’s business.

\subsection*{2.3.2.3 Implicit taxes}

A reduction of explicit taxes may cause an indirect increase of the so called implicit taxes. Implicit taxes emerge when the before-tax rate of return of investments is lower after having minimized the tax rate.

An example may help to explain this concept: if the before-tax rate of return of an investment is 10% and the tax rate is 30\% (therefore the after-tax rate of return of the investment would be 7\%), implicit taxes emerge if a reduction of the tax rate consequential to a tax planning strategy results in a before-tax rate of return of the investment lower than 10\%. Now, assuming we can reduce the tax rate from 30\% to 13\%,

\begin{itemize}
\item \textsuperscript{57} “The tax declaration decision is a decision under uncertainty. The reason for this is that failure to report one’s full income to the tax authorities does not automatically provoke a reaction in the form of a penalty. The taxpayer has the choice between two main strategies: (1) He may declare his actual income. (2) He may declare less than his actual income. If he chooses the latter strategy his payoff will depend on whether or not he is investigated by the tax authorities. If he is not, he is clearly better off than under strategy (1). If he is, he is worse off. The choice of a strategy is therefore a non-trivial one.” See M. G. Allingham and A. Sandmo, \textit{Income tax evasion: a theoretical analysis}, 1 Journal of Public Economics 323-338, 1972, at 324.
\item \textsuperscript{58} According to J. Slemrod, \textit{The Economics of Corporate Tax Selfishness}, 57 National Tax Journal 2004 at 882, “the framework is entirely amoral: taxpayers are neither honest nor dishonest, but merely rational calculators of what is in their best interest”.
\item \textsuperscript{59} Ibid., at 882, explains how the standard Allingham–Sandmo approach to tax evasion needs to be modified when applied to public corporations. “The assumption of risk aversion seems unsatisfactory for a large publicly– held firm, because presumably the shareholders hold diversified portfolios, implying that the firm should behave as if it is risk– neutral, even if its shareholders are not. If the decision–maker acts in a risk–neutral manner, the model must contain some other factor that rules out corner solutions (i.e., no evasion at all if evasion is worse than a fair gamble, or reporting no tax liability at all if it is better than fair), such as more evasion increasing the probability of detection or penalties.”
\item \textsuperscript{60} Ibid., at 882.
\item \textsuperscript{61} The alignment of interests through corporate governance tools will be dealt with in chapter 4.
\end{itemize}
we also have to make sure that the investment rate of return does not go below 8%. In fact, assuming the rate of return is 8%, the after tax-tax rate of return of this second investment would still be 7% despite the tax rate reduction from 30% to 13%.

Therefore, the tax strategy would be convenient only if the implicit taxes (i.e. the reduction of the rate of return) are not higher than the saved explicit taxes.

The reason why implicit taxes may emerge is that in a hypothetical efficient market, assuming different economic investments or activities are taxed differently, the demand for investments would adjust affecting the before-tax rate of return in a way that, ceteris paribus, would make a tax-free investment’s rate of return equal to the after-tax rate of return of a taxable investment. Strategic tax behaviors are therefore based on the assumption that taxpayers are not rational and markets are not efficient, otherwise there would not be any advantages in engaging in strategic tax behaviors besides the short term advantages that pioneer investors could have.

In conclusion, effective tax planning strategies require managers to consider not only the reduction of explicit taxes but also the impact of “taxes” that are paid indirectly as a lower rate of investment\textsuperscript{62}, in addition to all the other costs.

### 2.3.2.4 Compliance costs

Compliance costs “represent the time and resources expended by taxpayers to interact with the income tax system. These costs include the value of individuals’ time spent learning about the tax law, maintaining records for tax purposes, completing and filing tax forms, and responding to any correspondence from the IRS or to an IRS audit. Compliance costs also include amounts paid to others to conduct any of these tasks on behalf of an individual or a business”\textsuperscript{63}. If compliance costs are too high, taxpayers may have an advantage not to comply with the tax system (therefore reducing compliance costs) if the risk of detection and the other costs are relatively low. In other words, since compliance is also costly, the compliance costs should also be taken into account in the process of evaluating a tax planning strategy.

### 2.3.2.5 Corporate governance costs

\textsuperscript{62} In fact, as correctly underlined by M. S. Scholes, Wofson, M.A., Erickson, M., Maydew, E.L., Shevlin, T., Taxes and Business Strategy: A Planning Approach, Upper Saddle River, 2005, Pearson Prentice Hall, at 2, “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)”. In fact, “implicit taxes arise because the before-tax investment returns available on tax-favored assets are less than those available on tax-disfavored assets”. An example of implicit taxes is the “reduced yield available on tax-exempt municipal bonds in the United States relative to taxable corporate bonds of equal risk”. The reduced yield can be considered an implicit tax (at 6).

Finally, effective tax planning strategies must take into account the non-tax dimension, such as transaction costs, disclosure costs and agency costs. Such dimension will be analyzed in a specific chapter, which focuses with the effects of strategic tax behaviors on corporate governance dynamics. The conclusion will be that strategic tax behaviors have a bad impact on corporate governance dynamics, since they increase transaction costs, disclosure costs and agency costs so to neglect the OECD good corporate governance principles.

2.4 WHY TAX MANAGERS ENGAGE IN TAX PLANNING

Since tax is a significant cost factor for companies, and one of the main goals of managers is to achieve good financial statements, it would seem that managers follow tax minimization strategies in order to increase the profitability of the company. Nevertheless it is not clear the extent to which managers should pursue themselves in order to minimize the corporate tax burden. In fact, if on one hand, tax minimization may increase the corporate profitability (assuming the effective tax planning analysis has a positive result), on the other hand the payment of taxes is considered to be an important factor of social responsibility.

The public interest in corporate social responsibility of corporations has extremely increased recently. Paying a fair amount of taxes also infers ethical behavior that corporations are generally required to present to the public. Therefore, as it has been underlined by the literature, tax “has become an ethical and reputational issue and the board is responsible to ensure awareness of tax issues throughout the organization”.

Therefore, there is a tradeoff between socially responsible behaviors and aggressive tax planning and we should use this tradeoff in order to trace a line between tax strategies managers should engage in and those they should not. According to the literature, a tax manager is required to minimize the corporate tax burden to the extent it is legal, socially acceptable and economically convenient.

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64 “In recent years, many companies have come to view their tax liability in any given tax year as a manageable cost that they can reduce like any other ordinary operational cost”. See Y. Keinan, Corporate Governance and Professional Responsibility in Tax Law, 17 Journal of Taxation and Regulation of Financial Institutions 10-25, 2003, at 12.

65 Several studies have been conducted in this field: R. Avi-Yonah, Corporate social responsibility and strategic tax behavior, W. Schon, Tax and Corporate Governance, Munich, 2008, Springer, at 185, note 6.


67 “Companies need to balance the demands of reducing tax to become more competitive and at the same time being good citizens and thus paying taxes”. See Ibid. at 219.

68 See R. Avi-Yonah, Corporate social responsibility and strategic tax behavior, W. Schon, Ibid., at 197: “From the corporation’s perspective, it thus seems that whatever our view of the nature of the corporation, it should not be permitted to engage in strategic behavior that is designed solely to minimize its taxes. From an artificial entity perspective such behavior undermines the special bond between the state and the corporation it created. From the real entity perspective such behavior is as unacceptable as it would be if all individual citizens engaged in it. And from an aggregate perspective strategic tax behavior does not leave the state adequate revenues to fulfill the increased obligations imposed on it by forbidding corporations to engage in CSR”.

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The first and more obvious reason why managers engage in tax planning is related to the duty of loyalty and duty of care principles. According to these principles, managers are required to act in good faith, with the degree of diligence, care and skill which prudent people would use in similar positions and under similar circumstances and in the best interest of the corporation\textsuperscript{69}. Therefore, managers have to minimize the corporate tax burden using the degree of diligence, care and skill which prudent people would use and to the extent that this minimization is in the best interest of the corporation. In other words, according to these principles, managers should minimize the corporate tax burden to the extent it is legal, socially acceptable and the effective tax planning analysis has positive results.

The duties of care and loyalty create a sort of alignment of interests between shareholders and managers\textsuperscript{70}, which in turn creates an incentive for managers to behave in the interest of the corporation and the shareholders.

The issue then becomes to what extent tax managers should engage in tax planning. As it has been underlined, the analysis is related to the propensity the corporation has to engage in activities associated with risk. The extent to which managers should engage in strategic tax behaviors is related to the corporation’s attitude toward risk, which should be clarified by the shareholders. If the corporation (\textit{recte} the shareholders) is risk-averse, it is clear that no risky strategic tax behaviors should be followed by managers. On the other hand, if the corporation has a tendency to risk, managers are expected to engage in strategic tax behaviors to the extent of such tendency\textsuperscript{71}, assuming the overall effective tax planning analysis (which takes into account the risk factor) has a positive result. However, within the context of publicly held corporations we have already taken the position that managers should always behave as if they are risk-neutral.

The duties of care and loyalty are not the only reason why managers may have an interest in minimizing the corporate tax burden. As it will be explained in the next chapter, strategic tax behaviors may require the managers to obfuscate the underlined transactions (in order to minimize the risk of a tax audit) and this obfuscation may create an incentive for the managers themselves to behave opportunistically increasing their personal interests.

A third reason why managers engage in tax planning is related to an intuition of professor Avi-Yonah. In fact, as it has been pointed out, since the corporate tax has the

\begin{itemize}
  \item \textsuperscript{70} W. Schon, \textit{Tax and corporate governance: a legal approach}, W. Schon, \textit{Tax and Corporate Governance}, Munich, 2008, Springer, at 46 clarifies that “this is due to the fact that the paramount incentive for shareholders to invest money in a firm is a high return on investment which is dependent on the dividends and capital gains they derive from the company’s operations. As dividends are paid out of profits, which have been subject to corporate income tax, the interest of the shareholders goes for the after-tax profit rather than for the pretax profit. The same holds true for capital gains in shares which reflect the increase in value of the company’s assets on a net basis. This makes the minimization of the corporate tax burden an integral part of the managers’ duty of care”.
  \item \textsuperscript{71} Ibid.at 20-21.
\end{itemize}
potential to regulate (recte, restrict) manager’s power\textsuperscript{72}, the minimization of it would increase managers power. The argument is based on the simple consideration that corporate taxes reduce the resources in the hands of managers and therefore the power of corporate management\textsuperscript{73}. According to this view, the managers are engaging in strategic tax behaviors in order to have more resources to exercise their powers and therefore increase their personal interests. An argument in favor of this theory is the fact that managers never engage in aggressive tax strategies with the sole purpose to reduce shareholders’ level of taxes\textsuperscript{74}.

CHAPTER THREE: THE EFFECTS OF TAX MINIMIZATION STRATEGIES ON CORPORATE GOVERNANCE

3.1 STRATEGIC TAX BEHAVIORS AND AGENCY PROBLEMS

An agency problem “arises whenever the welfare of one party, termed the “principal”, depends upon actions taken by another party, termed the “agent”. The problem lies in motivating the agent to act in the principal’s interest rather than simply in the agent’s own interest. Moreover, “because the agent commonly has better information than does the principal about the relevant facts, the principal cannot assure himself that the agent’s performance is precisely what was promised, without incurring additional costs. As a consequence, the agent has an incentive to act opportunistically, skimping on the quality of his performance, or even diverting to himself some of what was promised to the principal. This means, in turn, that the value of the agent’s performance to the principal will be reduced, either directly or because, to assure the quality of the agent’s performance, the principal must engage in costly monitoring of the agents”\textsuperscript{75}. Therefore, many academics firmly believe that legal strategies are needed in order to reduce agency costs. Many agency problems may emerge in the context of publicly held corporations. In this work, we are only interested in the agency problems emerging between shareholders (i.e. the principal) and managers (i.e. the agent). It is within this agency framework that it


\textsuperscript{73} In order to support this intuition, the Author underlines how managers are the strongest supporters of the corporate tax repeal while they are much more lukewarm about dividend tax relief, since dividend tax would avoid the pressure to distribute dividends. See Ibid., at 12.

\textsuperscript{74} See J. Slemrod, \textit{The Economics of Corporate Tax Selfishness}, 57 \textit{National Tax Journal} 2004, at 891, according to whom “tax savings that accrue directly to the shareholders would not, on average, be pursued quite as aggressively by public corporations”.

is extremely important to evaluate the impact of strategic tax behaviors and in specific of tax avoidance.

When managers engage in aggressive tax planning which is not clear licit savings of taxes strategies (i.e. they engage in transactions designed solely to avoid or evade taxes), they have to mischaracterize and obscure these transactions and their purposes in order to minimize the risk of tax audits and tax penalties\(^{76}\). However, such mischaracterization increases the gap between information available to managers on one side and shareholders on the other side. This increased information asymmetry forces the shareholders to devote more resources in monitoring the managers, thus increasing agency costs on one hand and negatively affecting corporate governance on the other. In fact, considering that the core problem of the corporate governance is the information asymmetry between agents and principals\(^{77}\), this problem would be more evident in the presence of aggressive (and obscure) tax planning strategies. In order to align the interest of managers to the interest of shareholders, the agency costs would increase.

It is not clear whether such increase may have an impact on the value of shares\(^{78}\) and, as a consequence, on manager’s compensation. As already explained, in our view, a tax strategy should only be examined within an effective tax planning analysis, without considering other specific objectives which may be misleading. For example, mere tax minimization strategies seem to increase the short term advantage of managers, because, as it has been pointed out by Professor Avi-Yonah, the corporate tax has the potential to regulate (recte, restrict) managers power\(^{79}\); therefore, any tax strategies should follow a comprehensive tax planning analysis and not specific objectives such as increasing the value of the shares (which may be a misleading indicator of the effectiveness of the tax strategy) or increasing the short term interests of the managers.

3.1.1 MANAGERS’ PRIVATE BENEFITS THROUGH DIVERSION: AN ADDITIONAL CORPORATE GOVERNANCE COST

\(^{76}\) M. A. Desai, A. Dick and L. Zingales, *Corporate governance and taxation*, 2004, at 2, clarifies that “any transaction that does not have a real economic purpose and is designed solely to avoid taxes risks legal challenges and penalties. As a result, corporations are often induced to mischaracterize the purpose of many transactions aimed at reducing their tax burden. These forms of concealment involved in sheltering make a company’s financial affairs more opaque to outside investors. And this opacity makes it harder for outside investors to control insiders. As a consequence, tax systems that induce sheltering can worsen corporate governance”.

\(^{77}\) As noted by R. H. Kraakman, *The anatomy of corporate law: a comparative and functional approach*, Oxford; New York, 2004, Oxford University Press, “the core of the difficulty is that, because the agent commonly has better information than does the principal about the relevant facts, the principal cannot costlessly assure himself that the agent’s performance is precisely what was promised”.

\(^{78}\) Ibid. at 22.

Corporate tax strategies aimed at pure tax minimization (in particular through tax sheltering) generate direct implementation costs and exposure to risk of tax sanctions/regulatory control, so that managers typically ensure that these actions are obscured from tax authorities, thereby pursuing self-serving objectives and creating additional costs. The economic issue is therefore to assess whether this agency problem has an impact on the linear causation where corporate tax savings positively impact the value of the firm.

Therefore, “while tax avoidance per se should increase the after-tax value of the firm, this effect is potentially offset, particularly in poorly-governed firms, by the increased opportunities for rent diversion provided by tax shelters. Thus, the net effect on firm value should be greater for firms with stronger governance institutions”80. However, in our opinion, the increased opportunity for rent diversion is only one of the factors that an effective tax planning analysis must take into account.

3.2 TAX MINIMIZATION STRATEGIES AND TRANSPARENCY

One of the main principles suggested by the OECD to policy makers for good corporate governance is based on disclosure and transparency. In fact, “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”81. Through a high level of transparency, managers (or insiders in general) cannot divert income and cannot increase their interests to shareholders’ detriment. The literature has proven that a higher tax rate increases the level of tax avoidance and evasion, and a higher level of tax avoidance and evasion increases the level of diversion82, while stronger tax enforcement reduces it.

As previously underlined, tax minimization strategies may require managers to mischaracterize or obscure some transactions or the purposes of some transactions. Such mischaracterization would have a bad impact on accurate disclosure, since managers may be forced to manipulate financial and operating results in order to obscure certain transactions.

Moreover, aggressive tax minimization strategies have an effect on risk that could not be disclosed.

80 See at 2.
82 See M. A. Desai, A. Dick and L. Zingales, Corporate_governance_and_taxes, 2004, at 3: “a higher tax rate increases the return to tax avoidance strategies and hence the amount of sheltered income. More interestingly, this rate increase will also lead to an increase in the amount of private benefits, since insiders can more easily appropriate sheltered income”.
3.3 A BETTER CORPORATE GOVERNANCE WITH A GENERAL ANTI-AVOIDANCE PRINCIPLE?

There are many instruments that governments can use as a response to aggressive tax planning. They can be classified into two categories: preventive measures on one side and following measures on the other.

While the first group of measures tries to prevent, in a comprehensive way, any aggressive tax planning strategies which qualify as tax avoidance or tax evasion ex ante, the second group identifies the current strategic tax behaviors on the market and tries to stop them ex post with specific juridical instruments. An example of the second type of measures is an amendment to a statute or regulation as a response to a specific loophole. An example of the first type of measures is a general anti-avoidance rule. In this research we take the position that a general anti-avoidance rule would be preferable than ad hoc specific anti-avoidance rules.

In the absence of an anti-tax avoidance provision and, in general, in the absence of strong tax enforcement policies, both managers and shareholders seem to have an advantage in engaging in aggressive tax planning. On the contrary, a general anti-avoidance rule, as well as other strong tax enforcement policies, would lower the return to tax avoidance strategies and would guarantee a higher level of transparency in the corporate governance dimension. Moreover, the higher transparency would reduce the amount of income diversion, private benefits and would reduce the agency costs. In other words, since strategic tax behaviors reduce tax revenues and have a negative impact on corporate governance, an anti-avoidance rule may have a positive impact not only on tax compliance (i.e. guaranteeing a higher level of compliance with the tax system), but also on corporate governance (since it would grant lower information asymmetry between managers and shareholders and therefore lower agency costs and higher level of disclosure of information).

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83 According to J. Bankman, The Tax Shelter Problem, LVII National Tax Journal 925, 2004, at 927-928, governments “can be expected to respond to a shelter by amending the statute, regulation or other authority upon which the shelter is based. However, longstanding legislative practice is to give that amendment (and all other laws as well) only prospective effect. The amendment will make the shelter uneconomic for new purchasers, but will not affect the validity of transactions entered into prior to the enactment of the amendment. The government can also be expected to challenge the legitimacy of a shelter adopted before the effective date of the amendment. The government will argue, first, that the taxpayer has misread the literal language of the authority on which it is relying and, second, that the taxpayer has ignored authority to the contrary. The government will also attack the shelter under the so–called economic substance doctrine. That common–law (i.e., judge–made) doctrine holds that even a transaction that otherwise complies with a governing statute can be disregarded for tax purposes if it lacks significant non–tax motive or effect”.

84 General arguments in favor of a general anti-avoidance rule are given by J. Freedman, Defining Taxpayer Responsibility: In Supporto of a General Anti-Avoidance Principle, British Tax Review 332-357, 2004
CONCLUSIONS

In conclusion, it seems that antiavoidance rules have a regulatory function for corporate governance because they lower agency costs, information asymmetry, transaction costs and they higher the level of transparency. In fact, we have shown as aggressive tax strategies, having a negative impact on tax compliance, should be fought by governments not only in order to increase revenue, but also because fighting them would have a positive impact on corporate governance. In other words, anti-avoidance tax rules (and, more specifically, a general anti-avoidance tax rule) has the implicit effect to regulate corporate governance dynamics.

On the other side, better corporate governance seems to have a positive impact on tax compliance. One could argue that good corporate governance would result in strong alignment of interests of shareholders and managers and therefore managers would behave in the interest of the shareholders minimizing the corporate tax burden through the use of aggressive tax planning strategies. As it has been already explained, this argument is weak for at least three reasons. First, recent studies regarding corporate social responsibility have shown as public shareholders view corporate tax obligations as a corporate social responsibility and therefore they do not want managers to engage in aggressive tax planning. Second, good corporate governance results in a high level of transparency and such transparency would indirectly prevent managers from engaging in strategic tax behaviors. Third, since shareholders diversify the risk holding diversified portfolios based on the assumption that corporations are risk-neutral, therefore corporations should always behave as if they are risk-neutral and an alignment of interests, given by good corporate governance principles, would induce managers to behave as risk-neutral persons managing the corporation’s business.

In conclusion, the more important finding of this paper is that strategic tax strategies have a negative impact on corporate governance, because they tend to increase agency costs, transaction costs and they have a negative impact on transparency. Therefore, anti-avoidance measures seem to have a positive impact (on tax compliance, but also) on corporate governance.

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85 In fact, M. A. Desai and D. Dharmapala, Corporate Tax Avoidance and High Powered Incentives, 79 Journal of Financial Economics 145, 2006, at 148, underline that “the simple intuition that increased alignment of shareholder and manager interests would lead to greater tax sheltering activity is theoretically only a special case, and empirically not operative. While the underlying rationale for our interpretation (that sheltering and diversion are complementary) could appear counterintuitive, it is consistent with a growing body of legal and anecdotal evidence”.

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