THE ACCOUNTING REVIEW
Vol. 89, No. 3
2014
pp. 991–1023

American Accounting Association
DOI: 10.2308/accr-50678

Incentives for Tax Planning and Avoidance: Evidence from the Field

John R. Graham
Duke University

Michelle Hanlon
Massachusetts Institute of Technology

Terry Shevlin
University of California, Irvine

Nemit Shroff
Massachusetts Institute of Technology

ABSTRACT: We analyze survey responses from nearly 600 corporate tax executives to investigate firms' incentives and disincentives for tax planning. While many researchers hypothesize that reputational concerns affect the degree to which managers engage in tax planning, this hypothesis is difficult to test with archival data. Our survey allows us to investigate reputational influences and, indeed, we find that reputational concerns are important—69 percent of executives rate reputation as important and the factor ranks second in order of importance among all factors explaining why firms do not adopt a potential tax planning strategy. We also find that financial accounting incentives play a role. For example, 84 percent of publicly traded firms respond that top management at their company cares at least as much about the GAAP ETR as they do about cash taxes

---

We appreciate helpful comments from John Harry Evans III (senior editor), David A. Guenther (editor), two anonymous referees, Jennifer Blouin, Jeff Hoopes, Pei Hui Hsu (discussant), Allison Koester, Becky Lester, Pete Lisowsky, Ed Maydew, Ryan Wilson, Ben Yost, and participants at the 2011 UNC Doctoral Course, 2011 AAA Western Regional Meetings, University of Nebraska, The University of Texas Tax Readings Group, and University of Washington Brownbag presentation. Thanks to the following people for helpful comments on the development of survey questions: Jennifer Blouin, Merle Erickson, Ken Klassen, Peter Merrill, Lil Mills, Sonja Rego, Richard Sansing, Stephanie Sikes, Joel Slemrod, and Ryan Wilson. We also appreciate the support of PricewaterhouseCoopers, especially Peter Merrill, and the Tax Executives Institute, especially Tim McCormally, in asking firms to participate and in reviewing the survey document. Finally, each author is grateful for the financial support of the Fuqua School of Business, Paton Accounting Fund at the University of Michigan, and the Paul Merage School of Business at the University of California, Irvine.

A previous version of this paper was entitled "Inside the Corporate Tax Department: Insights on Corporate Decision Making and Tax Planning."

Supplemental materials can be accessed by clicking the links in Appendix B.

Editor's note: Accepted by David A. Guenther.

Submitted: September 2012
Accepted: November 2013
Published Online: December 2013

paid and 57 percent of public firms say that increasing earnings per share is an important outcome from a tax planning strategy.

Keywords: *tax avoidance; tax planning; reputation; financial accounting incentives.*

JEL Classifications: *D83; G31; M41.*

Data Availability: *Survey responses are confidential. Other data are available from public sources identified in the paper.*

I. INTRODUCTION

In this paper, we examine the determinants of managers' willingness to engage in tax planning strategies by directly asking tax executives about their incentives via a survey.[1] Although prior research discusses some of the incentives for firms to engage (or not engage) in tax planning, the empirical evidence on these incentives is mixed, likely because of difficulties in measuring tax planning strategies and managerial incentives using archival data (Hanlon and Heitzman 2010). The primary benefit of using a survey is that we gain direct insights about (stated) managerial motives, which are unobservable using archival data.[2] Our intent is to conduct new tests, as well as complement and extend the predictions and evidence found in empirical-archival studies. Accordingly, we use prior literature as the basis for our survey questions and focus on research questions that are difficult to address with archival data or that have mixed and conflicting empirical evidence.

Our first objective is to investigate whether reputational concerns are a significant factor when firms make decisions about tax planning. Some have conjectured that reputational concerns lead some firms to limit tax planning. For example, Bankman (2004) suggests that a firm that aggressively avoids taxes may be labeled a "poor corporate citizen," which might adversely affect product market outcomes. In addition, an Ernst & Young (2011) report discusses a new breed of tax activism where activist groups and the media bring attention to companies not paying "their fair share" as discussed further below. Hanlon and Slemrod (2009) attempt to test the hypothesis that reputation matters using both a sample of firms accused of tax sheltering as well as a sample of firms listed by the Citizens for Tax Justice as being poor corporate citizens for having low tax rates. The authors find some limited evidence consistent with reputational concerns being a viable disincentive to engage in tax planning. They document a more negative market reaction to news of using a tax shelter for firms in the retail industry relative to firms in non-consumer products industries.[3] However, in a study of 113 firms subject to public scrutiny for having engaged in tax shelters, Gallemore, Maydew, and Thornock (2014) find no evidence of a reputation effect in terms of CEO and CFO turnover, auditor turnover, lost sales, increased advertising costs, and decreased media attention. Indeed, doubts about whether reputation effects for tax avoidance exist are conveyed in a *Wall Street Journal* article by Alan Murray who states: "Lying to the IRS doesn't

[1] Throughout this paper we use the terms "tax avoidance" and "tax planning" interchangeably. We follow Hanlon and Heitzman (2010) and define tax avoidance broadly as the reduction of explicit cash taxes, which includes all transactions from investing in a municipal bond to engaging in tax shelters.

[2] We recognize that the survey approach has limitations as well, such as a potential reluctance to truthfully disclose tax planning and avoidance activity. Below we discuss both the benefits and costs of the survey approach.

[3] Hanlon and Slemrod (2009) also test advertising and brand value but find insignificant results. Hanlon, Mills, and Slemrod (2007) examine corporate tax non-compliance and report a negative and significant coefficient on advertising expense (scaled by assets) in a regression where tax deficiency (scaled by sales) is the dependent variable. While not their central hypothesis, the authors offer an *ex post* explanation that this result may be due to negative publicity from being a bad corporate citizen (Hanlon et al. 2007, 201).

generate the same public outrage as lying to shareholders. In some quarters of the country, it is almost seen as a patriotic act" (Murray 2002, A4).

An important limitation of tests that examine the reputational consequences for firms that were publicly identified as engaging in tax shelters is that the sample includes firms that chose to engage in the shelter and were caught. The researchers in these studies cannot account for the possibility that *ex ante* reputation concerns deter the firms, and the strategies, that are most likely to result in reputation penalties. In other words, whether reputation concerns constrain tax planning is not measurable in archival tests of tax shelter firms because strategies that firms do not employ because of reputational concerns are not observed.[4] Another method of testing reputation and tax planning would be to correlate proxies of reputation and tax planning measures. Tests of this nature are useful but identification is difficult because reputation is a difficult construct to measure and outcomes of tax planning strategies are not always reflected in financial statements, as discussed by McGill and Outslay (2004), particularly their discussion of how Enron's tax strategies were not reflected in financial statement measures.[5]

The survey approach is valuable in this setting because we can directly ask tax executives: "Why did your company not engage in a tax strategy?" Our survey results provide evidence that the potential for an adverse effect on company reputation significantly constrains firms' incentives to engage in tax planning strategies, with 69 percent of our survey respondents, including 72 percent of publicly traded respondents, indicating that reputation concerns are "important" or "very important." Indeed, concern about reputation ranks second only to the concern that a tax strategy might not pass the judicial standard of "business purpose/economic substance."[6]

We then use our data to examine the determinants of these reputation concerns in terms of the types of firms that are concerned about reputation. We find that publicly traded companies, larger companies, more profitable companies, and companies in the retail industry are significantly more concerned about the adverse reputation consequences of tax planning. We also test whether concerns about reputation are associated with higher tax rates, measured several ways. We find evidence consistent with reputation concerns being significantly associated with higher long-run cash effective tax rates (ETRs) and lower probabilities of engaging in tax shelters as measured by the Lisowsky (2010) score.

Our second objective is to examine the role of financial accounting effects in tax planning decisions. Primarily, we are referring to the fact that when reported tax expense (i.e., the GAAP ETR) is lower, reported financial accounting earnings are higher.[7] There is an extensive literature on book-tax trade-offs that examines the relation between tax planning and financial reporting choices (Shackelford and Shevlin 2001). In addition, recent studies suggest that tax departments are often operated as profit centers (Robinson, Sikes, and Weaver 2010), firms employ tax strategies with the goal of improving accounting outcomes (e.g., Desai and Dharmapala 2006), and tax policy responsiveness is constrained by accounting effects (Shackelford, Slemrod, and Sallee 2011). We

[4] The limitation of the absence of a counterfactual is recognized by these previous authors. In addition, as the other authors also note, some firms engage in tax shelters but are not caught, and thus are not identified as shelter firms in archival-empirical papers.

[5] Although not testing reputation *per se*, related studies have tested the effect of political costs on effective tax rates using size as a proxy for political costs (Zimmerman 1983) and whether the company is in the defense industry (McIntyre, Gardner, Wilkins, and Phillips 2011; Mills, Nutter, and Schwab 2013). We discuss anecdotal evidence below.

[6] We discuss business purpose and economic substance below.

[7] Engle, Erickson, and Maydew (1999) examine companies' use of debt-equity hybrid securities and how these securities allowed the firm to treat the security as debt for tax purposes (i.e., deduct interest expense for tax purposes) but treat the security as equity for financial accounting purposes, thus improving their debt-equity ratios, and thereby highlighting the balance sheet ratio focus in that setting.

extend this line of inquiry by asking companies directly about their prioritization of tax and accounting goals. We find that 47 percent of the tax executives in publicly traded companies state that top management values the GAAP ETR more than the cash taxes paid and in another 37 percent of public firms the two metrics are equally valued by top management. Thus, in 84 percent of the public companies, the accrual accounting measure of taxes that affects reported accounting earnings is at least as important as the cash taxes paid. In cross-sectional analyses, we find evidence consistent with the prioritization of accounting earnings over cash taxes being significantly more likely when the firm is under greater capital market scrutiny, as proxied by being publicly traded, having high analyst following, or having high institutional ownership. For example, as compared to the 84 percent of public companies noted above, only 48 percent of private firms respond that the GAAP ETR is at least as important as cash taxes paid. Thus, our data provide direct evidence on how important accounting earnings are to companies with capital market incentives.

We also ask the respondents (1) about the frequency with which accounting, law, investment, or tax consulting firms propose tax planning strategies to their firm as a way to increase financial accounting earnings, (2) whether accounting concerns are important when deciding whether to engage in tax planning, and (3) about the trade-off between *cash taxes* and financial accounting earnings per share (EPS) in the context of tax planning. Our survey evidence suggests that financial accounting earnings are important. For example, 32 percent of all firms in our sample (35 percent of the public firms) indicate that the tax planning strategies marketed to their firm were "always" or "often" marketed as a way to increase earnings. Further, we find that 61 percent of the surveyed companies (71 percent of the public and 23 percent of the private companies) say that it is important that a tax strategy does not reduce EPS and 49 percent of the surveyed companies (57 percent of the public and 22 percent of the private companies) respond that it is important that the strategy actually leads to higher EPS.[8] The stated importance of financial accounting earnings on the incentive to engage in tax planning provides direct evidence on the predictions and hypotheses about the interaction of financial statement effects and tax planning put forth in recent studies.[9]

We also examine determinants of the importance rating of financial concerns and find that the primary driver is capital market incentives. Publicly traded firms, larger firms, firms with high analyst following, and firms with high institutional ownership are significantly more concerned than other firms about the financial reporting effects of tax planning strategies. Overall, we conclude that capital market scrutiny is the primary determinant of the extent to which financial reporting considerations affect tax planning incentives. With respect to the consequences, we do not find consistent evidence that firms that say financial reporting considerations are important for tax planning have different outcomes in terms of their GAAP or cash ETRs and tax sheltering probabilities as conventionally measured in the literature.

Our paper contributes to the literature on determinants of corporate tax avoidance by directly asking tax executives about reputational concerns—a factor difficult to test with archival data. We provide evidence that reputational concerns are an important factor that limits the extent to which companies engage in tax planning. Our paper also contributes to the book-tax trade-off literature through our direct inquiry of executives about the effects of financial accounting on tax planning decisions.

Next, Section II discusses the survey methodology. Section III provides descriptive statistics about our sample firms and discusses tests of non-response bias. Section IV presents survey questions and results and Section V concludes.

---

[8] The differences in importance ratings between public and private companies are statistically significant at the $p < 0.10$ level or better in the comparisons above.

[9] Examples include Robinson et al. (2010), Shackelford et al. (2011), Graham, Hanlon, and Shevlin (2011), Hanlon (2012), and Desai and Dharmapala (2009a).

II. SURVEY METHODOLOGY AND SAMPLE[10]

We developed our survey instrument with the support of the Tax Executives Institute (TEI) and PricewaterhouseCoopers (PWC).[11] We solicited feedback from several academic researchers, TEI, and PWC on the survey content and design. Survey Sciences Group (SSG), a survey research consulting firm, assisted with the survey formatting and programed an online version. We had two companies beta test the survey and we made revisions based on their suggestions. The final survey contained 64 questions, most with subparts. The paper version of the survey was 12 pages long. There were many branching questions and, as a result, many firms were directed to answer only a portion of the questions. Please see Appendix B for a link to a downloadable version of the survey.

We emailed an invitation initially on August 9, 2007 to the 2,794 member firms of TEI. We examined the list of *Fortune* 500 companies and identified 45 firms that were not members of TEI. For these firms, PWC supplied the tax executive's name and email address. Three email invitations were returned as undeliverable. On August 15, 2007, we sent a letter via two-day express mail to 15 companies for which we did not have email addresses. A total of 2,806 companies received invitations to complete the survey. SSG sent three email reminders throughout August and September. We then sent a paper version of the survey along with a letter with instructions of how to complete the questionnaire online during the last week of September and the first week of October. We closed the online survey on November 9, 2007.

A total of 804 firms accessed the survey. Sixty of these companies entered no more than two responses and thus we deleted them from our sample, leaving 744 usable responses. The response rate for our survey is 26.5 percent, which compares favorably to many prior survey studies.[12] Because our interests are about U.S. firms incentives for tax planning and avoidance, we eliminate 11 firms that indicate they are not subject to the U.S. corporate income tax (i.e., businesses not taxed at the entity level, such as S corporations and other flow-through entities). We also eliminate 29 companies that indicate that they did not file a corporate income tax return based on the assumption that these companies are not C corporations. We restrict the sample further by eliminating firms that are subsidiaries of foreign parents since their tax planning incentives are likely to be affected by the tax rules and enforcement in the parent's home country. This leaves 595 remaining firms on which we conduct our analyses. The sample size varies across questions due to branching or incomplete responses for a particular question.

There are caveats and limitations to survey research. First, firms that decide to answer the survey may be systematically different than firms that do not answer the survey. We address this concern by comparing our survey respondents to the typical Compustat firm to get a sense of the size and other characteristics of our sample firms relative to the typical sample of firms included in the extant literature. In addition, we also compare firms that responded to the survey with firms that did not respond, with the data tabulated and discussed below in Section III.

---

[10] The survey has four parts. One section asks detailed questions about reputational and financial accounting concerns, the subject of the current paper. Another section gathers general demographic and descriptive questions about the companies, which we use for conditional analyses. A third section of the survey explores location and reinvestment/repatriation decisions, which is the focus of Graham et al. (2011). A fourth section focuses on the 2004 American Jobs Creation Act and repatriation decisions in response to that Act, including sources and uses of cash repatriated. The analyses of the data from this fourth part of the survey is summarized and discussed in Graham, Hanlon, and Shevlin (2010). The discussion in this section closely follows that in Graham et al. (2011) and Graham et al. (2010) because the survey instrument is the same across the three papers.

[11] TEI is an association whose members are top executives responsible for the tax affairs of U.S. and foreign businesses. The member companies are from a wide range of industries. TEI was founded in 1944 and provides networking opportunities, conferences, and educational opportunities for its members.

[12] For example, Graham, Harvey, and Rajgopal (2005), Brav, Graham, Harvey, and Michaely (2005), Slemrod and Venkatesh (2002), Graham and Harvey (2001), Slemrod and Blumenthal (1996), and Trahan and Gitman (1995) report response rates of 10.4 percent, 16 percent, 9–12 percent, 9 percent, 21.8 percent, and 12 percent, respectively.

Another concern with survey-based research is that it is plausible that survey respondents do not answer truthfully. There is no way to completely eliminate this possibility; however, we took many precautions in an effort to encourage truthful responses. For example, when asking about an aggressive tax strategy, we did not directly ask whether the firm of the survey respondent engaged in tax shelters. Rather, we asked how often tax strategies were marketed to the firm, did the extent of marketing change over time, and what factors affected firms' choices to *not* engage in such a strategy. Thus, we are able to gather insightful data while at the same time mitigating the inclination to lie or to simply not respond to the survey.[13]

Finally, other concerns about surveys include the possibility that respondents may not have understood some questions or may have answered questions randomly. We attempted to mitigate these concerns by having academics, practitioners, and a set of beta firms carefully review the survey before it was distributed. We also employed a professional survey consulting firm to assist in programming the survey online and in designing the questions. We employ cross-sectional tests that suggest that respondents did not answer the questions randomly. However, our results should still be interpreted cautiously in light of these potential caveats.

III. DESCRIPTIVE STATISTICS AND NON-RESPONSE BIAS TESTS

We gather demographic information on the survey instrument and merge the survey responses of public firms with data from Compustat to obtain more detailed information. Table 1 presents the descriptive statistics of our sample firms. Survey responses indicate that 76.6 percent of our sample firms are publicly listed. The average firm in our sample has $8.8 billion in assets (*Assets*), with the average public (private) firm having $10.4 billion ($2.3 billion) in assets (untabulated). Survey responses also indicate that the average firm in our sample has 19.2 percent of its assets in foreign locations (*Foreign Assets*) and a *GAAP ETR* of 30.5 percent.[14] Finally, our survey data indicate that 46.3 percent of our sample firms have a U.S. net operating loss carryforward (*US NOL*).[15]

Additional data from Compustat indicate that the average public firm in our sample has $5.7 billion in sales (*Sales*), a market capitalization (*MVE*) of $8.3 billion and earns a 6.5 percent return on assets (*ROA*). The sales and asset growth (*Sales Growth; Asset Growth*) for the average public firm in our sample are 14.1 percent and 13.6 percent, respectively. Only 25 percent of the public firms in our sample invest in R&D or advertising (*R&D Intensity; Advertising Intensity*) and the average *R&D Intensity* (*Advertising Intensity*) is 2.6 percent (1.4 percent), where *R&D Intensity* (*Advertising Intensity*) is R&D (advertising) expense scaled by assets. The average public firm in our sample is followed by nine analysts (*Analyst Following*) and has 50.7 percent institutional ownership (*Institutional Ownership*). Further, the average public firm has unsigned abnormal

[13] We took the efforts just described to avoid untruthful responses, but realistically we have no reason to believe that tax directors colluded and lied about the relative importance of financial accounting and reputation effects in their tax planning activities. Our survey results obtained through direct questioning of tax executives triangulate and confirm archival empirical literature on book-tax trade-offs and go one step further to ask about the importance of reporting increases in after-tax reported earnings when tax planning.

[14] *GAAP ETR* is defined as the total income-tax expense scaled by pre-tax book income.

[15] We compare our data to Compustat and find that 39 percent of Compustat firms in 2006 report an NOL carryforward (measured as having a positive tax loss carryforward that, when measured by Compustat, does not distinguish among state, federal, or foreign). Next, we find that of our survey respondents that are also on Compustat, 40 percent have NOLs (per the Compustat variable) and this percentage is statistically indistinguishable from the 39 percent reported for the entire Compustat population. Thus, our sample is similar to the Compustat population with respect to reported net operating loss carryovers. Upon further examination, we find that a substantial number of these firms have a positive federal current tax expense. Thus, it appears that these firms pay U.S. taxes despite the federal net operating loss carryover. One explanation is that the firms have acquired losses that are not immediately available for use against the acquiring company's taxable income (e.g., the losses are limited under Section 382). We recognize also that current tax expense may not be equivalent to cash taxes paid and may represent some accounting accruals. Overall, to the extent that the NOLs are not immediately usable, the firms that have these NOLs are not non-tax-paying firms and the results should be interpreted with this in mind.

TABLE 1
Descriptive Statistics and Survey Responses

Variable	Source	n	Mean	SD	P25	P50	P75
Firm Characteristics							
Public	Survey	594	0.766	0.424	1.000	1.000	1.000
Assets	Survey	561	8,761.920	24,568.590	460.874	1,263.950	4,895.170
MVE	Compustat	396	8,283.130	20,149.600	677.902	1,871.670	5,976.440
Sales	Compustat	400	5,717.750	11,550.020	545.586	1,490.750	5,281.160
MB	Compustat	387	3.316	2.861	1.704	2.380	3.818
ROA	Compustat	396	0.065	0.085	0.024	0.063	0.108
Foreign Income	Compustat	400	0.021	0.037	0.000	0.002	0.028
Foreign Assets	Survey	538	0.192	0.219	0.000	0.100	0.320
Leverage	Compustat	400	0.206	0.187	0.044	0.173	0.316
Sales Growth	Compustat	395	0.141	0.223	0.036	0.095	0.187
Asset Growth	Compustat	396	0.136	0.276	−0.004	0.068	0.184
US NOL	Survey	527	0.463	0.499	0.000	0.000	1.000
R&D Intensity	Compustat	400	0.026	0.044	0.000	0.000	0.036
Advertising Intensity	Compustat	400	0.014	0.034	0.000	0.000	0.010
Financial Reporting Incentives							
Analyst Following	Compustat	455	9.114	8.361	2.000	7.000	14.000
Institutional Ownership (%)	Compustat	455	0.507	0.412	0.000	0.652	0.869
|Abnormal Accruals|	Compustat	376	0.090	0.087	0.029	0.064	0.122
Altman's Z-score	Compustat	369	4.404	3.411	2.314	3.840	5.569
Tax Planning Proxies							
GAAP ETR (survey response)	Survey	439	0.305	0.162	0.273	0.339	0.376
GAAP ETR	Compustat	349	0.307	0.168	0.273	0.334	0.375
Cash ETR	Compustat	345	0.282	0.245	0.152	0.251	0.352
3-Yr Cash ETR	Compustat	351	0.274	0.233	0.149	0.250	0.335
P(Tax Shelter)	Compustat	358	0.944	0.143	0.966	0.992	0.999
DTAX	Compustat	219	0.029	0.124	−0.019	0.007	0.069

The above data are obtained either through survey questions or from Compustat (year 2006).
All continuous variables are winsorized at 1 percent and 99 percent of the distribution and all dollar amounts are in millions.
All variables are defined in Appendix A.

accruals (*|Abnormal Accruals|*) amounting to 9 percent of its total assets and a financial distress score (*Altman's Z-Score*) of 4.4 based on Altman (1968, 2000).

In terms of tax planning proxies used in prior research, we find that the average public firm in our sample has an annual cash ETR (*Cash ETR*) of 28.2 percent, a three-year cash ETR (*3-Yr Cash ETR*) of 27.4 percent, a 94.4 percent probability of investing in a tax shelter using Lisowsky's (2010) measure (*P(Tax Shelter)*), and tax aggressiveness score of 0.03 based on the discretionary permanent book-tax differences (*DTAX*) measure proposed by Frank, Lynch, and Rego (2009).[16] These values are largely consistent with that documented in prior research. For example, Chyz (2013) finds that the median *P(Tax Shelter)* in his sample ranges from 80 percent to 94 percent with higher values for larger firms and Rego and Wilson (2012) find a mean value of 0.03 for *DTAX* in their sample. Although consistent with prior research, the high probability of engaging in tax shelters (*P(Tax Shelter)*) raises questions about the interpretation of the variable. We note that for

[16] *Cash ETR* is defined as total income taxes paid scaled by pre-tax income. *3-Yr Cash ETR* is defined as the sum of the numerator over the preceding three years scaled by the sum of the denominator of the same three years (Dyreng, Hanlon, and Maydew 2008). All variables are described in Appendix A.

the purpose of our paper, we are interested in capturing the cross-firm variation in the probability of engaging in tax shelters with *P(Tax Shelter)* rather than the absolute magnitude of this variable.

Table 2 presents descriptive statistics for the average Compustat firm, the average survey respondent, and the average survey non-respondent.[17] Our average surveyed firm is larger than the average Compustat firm in terms of *Assets, MVE,* and *Sales*. Our average surveyed firm has a smaller cash-to-asset ratio (*Cash*) and a smaller market-to-book (*MB*) ratio relative to the average Compustat firm. Further, the firms we surveyed have on average a higher *ROA,* a higher *GAAP ETR,* a higher *P(Tax Shelter)*, and lower *Asset Growth* and *Sales Growth* rates. However, we find that the average survey respondent and the average Compustat firm are similar in terms of *Leverage,* the probability of having a net operating loss carryforward (*US NOL*), and *3-Yr Cash ETR*. Overall, the firms we surveyed and our respondents are different than Compustat firms along many dimensions and, therefore, our results might not generalize to all Compustat firms.

Comparing respondents to non-respondents with Compustat data, we find that the average respondent firm is statistically no different than the average non-respondent firm in terms of firm size (i.e., *Assets, MVE,* and *Sales*), *Leverage, Cash, MB, NOL, GAAP ETR, 3-Yr Cash ETR,* and growth (i.e., *Asset Growth* and *Sales Growth*). However, the respondent firms have, on average, a higher *ROA* and a higher *P(Tax Shelter)* than non-respondent firms. We know of no obvious biases that arise for our tests because of these differences. However, we recognize that it is possible that the companies that decided to answer the survey are different from those that did not. If there is such a difference, then our results may not generalize to all firms.

IV. INCENTIVES AND DISINCENTIVES OF TAX PLANNING

Reputational Concerns

A great deal remains unknown about firms' incentives for tax planning and avoidance (Hanlon and Heitzman 2010). One of the primary factors of interest in our study is whether reputational concerns are an important factor for firms when considering tax planning strategies. Bankman (2004) suggests that a firm that aggressively avoids taxes may be labeled a "poor corporate citizen," which might adversely affect product market outcomes. Indeed, some anecdotal evidence is consistent with such statements. For example, a recent *New York Times* article profiled GE and their tax avoidance activities (Kocieniewski 2011). GE responded on their webpage, claiming they do not avoid taxes and pay the legally owed amount. In the public comments to the original online article, several people made statements such as "I will never buy GE products again" (please see Appendix B for the link to the downloadable version of the article).[18]

Prior research examines reputational effects for firms accused of engaging in tax shelters, but the evidence is somewhat mixed. Specifically, Hanlon and Slemrod (2009) use a sample of 109 events to investigate the market reaction to the news of a firm engaging in a tax shelter. Their tests document relatively small negative market reactions and, in some cases, a positive market reaction if the company was not previously thought to be a "tax avoider." The authors also document that firms in retail industries have more negative market reactions to news of tax sheltering, consistent with the likelihood of a consumer backlash for retail firms.

---

[17] Where the survey respondent or non-respondent is publicly traded and on Compustat, we gather data for the company from Compustat.

[18] Interestingly, GE's reported effective tax rate on their financial statements went from 7.4 percent on their 2010 annual report to 21.6 percent on their 2011 annual report, which GE released after the press coverage. Another example is found in the experience of Starbucks in the U.K. in 2012. Starbucks was the subject of intense scrutiny in the U.K. for its lack of tax payments in the country. Picketers went to the Starbucks stores and the topic was often in the U.K. press. Starbucks responded by saying they would "voluntarily" pay additional taxes in the U.K. in the amount of £10 million or $16 million (http://money.cnn.com/2012/12/06/news/companies/starbucks-uk-taxes/index.html).

TABLE 2

Non-Response Bias Test

	All Compustat (1)		All Firms We Contacted with Available Data (2)		Survey Non-Responders with Available Data (3)		Survey Responders with Available Data (4)		p-value			
	n	Mean	n	Mean	n	Mean	n	Mean	1 vs. 2	1 vs. 4	2 vs. 4	3 vs. 4
Assets	5,940	3,584.52	1,507	9,467.91	946	9,886.57	561	8,761.92	0.00	0.00	0.57	0.40
MVE	5,445	2,371.95	1,292	8,313.35	896	8,326.71	396	8,283.13	0.00	0.00	0.98	0.97
Sales	5,913	1,722.33	1,346	5,481.50	946	5,381.61	400	5,717.75	0.00	0.00	0.72	0.62
Leverage	5,923	0.19	1,345	0.22	945	0.22	400	0.21	0.00	0.21	0.24	0.11
Cash	5,939	0.20	1,341	0.14	945	0.13	396	0.15	0.00	0.00	0.31	0.17
MB	5,445	4.36	1,283	3.30	896	3.29	387	3.32	0.00	0.00	0.92	0.90
ROA	5,913	−0.04	1,342	0.05	946	0.04	396	0.07	0.00	0.00	0.00	0.00
NOL	5,940	0.39	1,352	0.43	946	0.44	406	0.40	0.01	0.61	0.34	0.19
GAAP ETR	4,240	0.26	1,263	0.30	824	0.29	439	0.30	0.00	0.00	0.38	0.26
3-Yr Cash ETR	4,054	0.27	1,166	0.28	812	0.28	354	0.27	0.47	0.76	0.48	0.35
P(Tax Shelter)	4,742	0.62	1,184	0.93	828	0.92	356	0.95	0.00	0.00	0.06	0.02
Asset Growth	5,693	0.35	1,330	0.15	934	0.15	396	0.14	0.00	0.00	0.55	0.43
Sales Growth	5,500	0.25	1,327	0.14	932	0.14	395	0.14	0.00	0.00	0.74	0.65

All dollar amounts are in millions.
All Compustat variables are measured in the fiscal year ending in 2006 and are winsorized at 1 percent and 99 percent of the distribution.
Column (1) consists of all the firms on Compustat except for firms with a negative book value, firms whose names indicate they are limited partnerships, and firms incorporated outside the United States.
Column (2) includes all the firms that were sent a survey (described earlier in the manuscript) that we could match to and retrieve the data from Compustat.
Column (3) consists of the group of firms that are on Compustat and that we sent a survey to but did not receive a response.
Column (4) includes the survey responders with data available on Compustat.
All variables are defined in Appendix A.

Two concurrent papers provide mixed evidence. Gallemore et al. (2014) employs a database of 113 firms that were subject to public scrutiny for having engaged in tax shelters and find no evidence that firms or CEOs/CFOs bear significant reputational costs. They measure reputational costs in terms of CEO and CFO turnover, changes in advertising expense, auditor turnover, or decrease in sales. Further, they find no decrease in firms' tax avoidance activities after being accused of tax shelter activity. A working paper by Austin and Wilson (2013) examines the tax reporting behavior of firms with greater customer orientation based on the hypothesis from Hanlon and Slemrod (2009) that such firms will bear higher reputational consequences from engaging in tax avoidance. While they find no evidence of differences in cash taxes paid between firms labeled consumer-oriented and firms that are not labeled consumer-oriented, the authors find that consumer-oriented firms report higher GAAP ETRs. The authors interpret their evidence as suggesting that firms use the discretion inherent in financial reporting to report benefits of tax planning more conservatively.

These conflicting results in part reflect the limitations of the empirical-archival methodology for examining reputational consequences of tax planning and avoidance. For example, empirical-archival studies such as Hanlon and Slemrod (2009) and Gallemore et al. (2014) only examine firms whose tax strategies were discovered.[19] However, if firms that have the most to lose from a reputational hit simply refrain from engaging in aggressive tax planning for fear of its adverse consequences, studies that address only firms with identified tax strategies might underestimate the effect of adverse reputation concerns on tax avoidance. For example, it is plausible that firms publicly identified as engaging in tax shelters are the firms for whom reputation concerns are the least important.

To address these limitations and to contribute to this line of inquiry, we directly ask tax executives why they do not engage in tax planning strategies.[20] First, we ask "Has your company ever considered but decided not to implement a tax planning strategy proposed and/or marketed by an accounting, law, investment, or tax consulting firm?" Out of the 509 companies that responded, 77.6 percent or 395 firms answered yes (untabulated). Of these respondents that answered yes, we then asked "What factors were important in your company's decision not to implement the tax planning strategy that was proposed?" The responses are presented in Figure 1 and in Table 3, Panels A and B. The most important reason for not implementing a tax strategy is because "the transaction lacked business purpose or economic substance," with 86.0 percent of respondents saying it is important.[21] This result is reasonable because the IRS often uses general doctrines such as business purpose and economic substance to deny tax benefits for transactions that may be technically legal but contrary to the intent of the tax law (see Scholes et al. 2014).

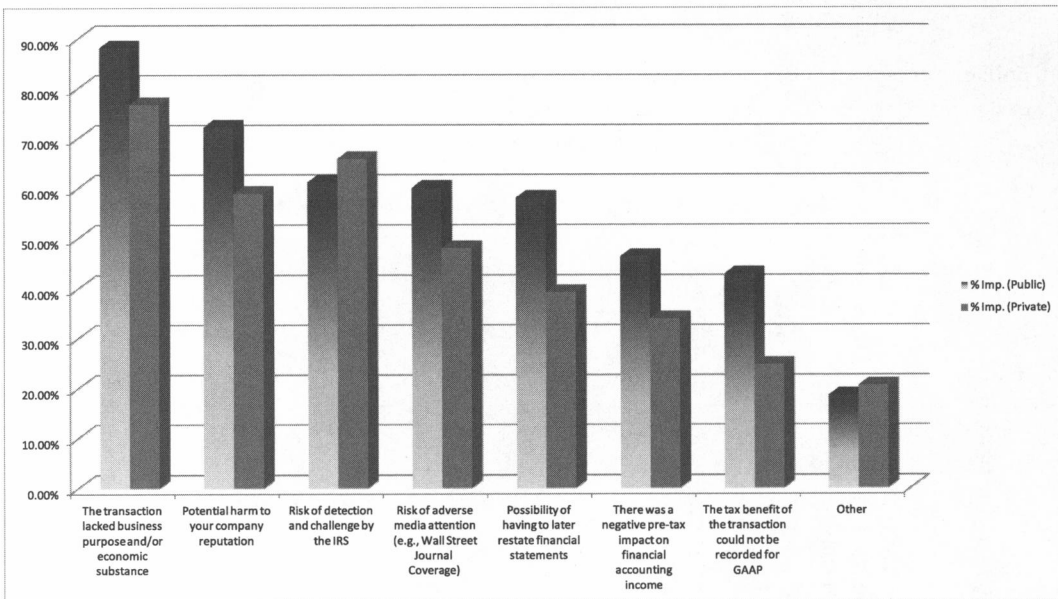
---

[19] As discussed in the "Introduction" section, tests of the effective tax rate and the relation to reputation are sparse in the literature, likely because reputation is difficult to measure and because an event to make the low rates salient is necessary to conduct an empirical test.

[20] We note that Ernst & Young (2011) report that 57 percent of tax directors state that threat of negative media attention is a somewhat or significant concern. They report that 58 percent of companies with annual revenues of at least $5 billion report that negative media attention is a significant concern, consistent with our results. However, we note that the E&Y results are published in a marketing brochure that states that E&Y can help to proactively manage tax risk. Second, the report does not provide any details on how the questions were asked or what types of companies answered the questions in a particular way. Third, the E&Y report attributes part of the focus by the media to the financial crisis bailouts (Ernst & Young 2011, 28), whereas our survey was conducted prior to the financial crisis and, thus, shows that the concerns about reputation existed before the crisis. Fourth, we ask questions about reputation generally and about media attention separately because only a subset of firms are big enough to attract media attention but most firms have a reputation to protect.

[21] For the judiciary to recognize a transaction or business choice as valid according to tax law, the action must be deemed to have a genuine business purpose (i.e., above and beyond the avoidance or reduction of tax) and economic substance (i.e., a meaningful change to the taxpayer's economic position other than reducing income taxes). We note that after our survey period, the U.S. codified the economic substance doctrine. Related to our discussion of financial accounting incentives to engage in tax planning below, interestingly the codification (1) mentions financial accounting benefits as a business purpose, but (2) prohibits financial accounting benefits that arise solely from federal income tax savings as providing a valid business purpose. Thus, it seems it would likely be much more difficult now to pitch tax planning strategies to increase reported earnings as now the tax plan must have a valid business purpose other than financial accounting benefits that arise solely from tax savings.

FIGURE 1
Incentives and Disincentives to Engage in Tax Planning



This figure presents the responses to the survey question: "What factors were important in your company's decision not to implement the tax planning strategy that was proposed?" The survey provides a five-point rating scale ranging from 0 to 4 with a rating of 0 labeled "Not at all important" and a rating of 4 labeled "Very important." This figure presents the percentages of respondents that gave a rating of 3 or 4 for each factor. The results are shown separately for public and private firms.
The corresponding data in table form are in Table 3. Note that we reorder the responses for presentation purposes to be in order of importance rating. On the survey instrument, however, the factors were listed in the following order: (1), (6), (7), (3), (4), (5), (2), other.

The second most important reason preventing firms from engaging in tax planning is "potential harm to firm reputation," with 69.5 percent of the firms responding that this is important or very important.[22] This evidence supports Bankman's (2004) claim and the hypothesis and evidence in Zimmerman (1983) that firms may bear reputational and political costs for being labeled a "poor corporate citizen." Related to reputation, the factor "risk of adverse media attention," received a relatively high importance rating with 57.6 percent of firms answering that this factor is important or very important (see Figure 1 and Table 3, Panel A). Concern over media coverage is consistent with statements made by companies about a "*Wall Street Journal* test"—that is, if the strategy would look bad on the front page of the *WSJ*, then the company should not do it.[23] Table 3, Panel

[22] We report results for statistical differences across the rankings of the factors in Table 3, Panels C and D. The tests generally indicate that the importance rank of the higher listed factor is significantly greater than that for all lower listed factors.

[23] As stated publicly by a GE company representative, "At the same time, from a somewhat more defensive perspective, a key role of the tax department, a key part of the mission statement, is to manage risks, both legal and reputational, whether it's . . . a '*Wall Street Journal*' test or simply wondering whether, if it were discussed publicly, would this strategy, whether legal or not, hurt the company's reputation" (Larsen, Beran, D'Avino, and Hawkins 2007).

TABLE 3

Incentives and Disincentives to Engage in Tax Planning

Panel A: Survey Responses

What Factors were Important in Your Company's Decision Not to Implement the Tax Planning Strategy that was Proposed?	Percent Important (All Firms)	Percent Important (Public Firms)	Percent Important (Private Firms)
1. The transaction lacked business purpose and/or economic substance	86.0%	**88.2%**	**76.7%**
2. Potential harm to your company reputation	69.5%	**72.2%**	**58.9%**
3. Risk of detection and challenge by the IRS	62.1%	61.2%	65.8%
4. Risk of adverse media attention (e.g., Wall Street Journal Coverage)	57.6%	**60.0%**	**47.9%**
5. Possibility of having to later restate financial statements	54.2%	**58.0%**	**39.2%**
6. There was a negative pre-tax impact on financial accounting income	43.8%	**46.2%**	**33.8%**
7. The tax benefit of the transaction could not be recorded for GAAP	39.2%	**42.8%**	**24.7%**
8. Other	19.0%	18.5%	20.5%

Panel B: Comparison of Factors

	Sig. at the 10% Level or Better
Is Factor (1) > (2) [and thus, (1) > (3) to (8)]	Yes
Is Factor (2) > (3) [and thus, (2) > (4) to (8)]	Yes
Is Factor (3) > (4)	No
Is Factor (3) > (5) [and thus, (3) > (6) to (8)]	Yes
Is Factor (4) > (5) [and thus, (4) > (6) to (8)]	Yes
Is Factor (5) > (6) [and thus, (5) > (7) to (8)]	Yes
Is Factor (6) > (7) [and thus, (6) > (8)]	Yes
Is Factor (7) > (8)	Yes

(continued on next page)

TABLE 3 (continued)

Panel C: Firm Characteristics Conditioned on Survey Responses

		Factor							
		(1) Economic Substance		(2) Harm to Reputation		(3) Detection by IRS		(4) Adverse Media Attention	
Firm Characteristic	**Mean**	**Imp.**	**Not Imp.**	**Imp.**	**Not Imp.**	**Imp.**	**Not Imp.**	**Imp.**	**Not Imp.**
Firm Size ($ Mil.)	9,897.04	12,035.37	8,345.69	12,621.88	9,010.22	9,807.75	12,943.57	**11,621.59**	**5,909.09**
GAAP ETR (%)	32.3%	31.0%	29.4%	31.1%	32.0%	29.8%	34.6%	30.5%	30.6%
3-Yr Cash ETR (%)	29.7%	27.1%	36.4%	28.2%	24.7%	29.3%	33.7%	29.8%	27.0%
P(Tax Shelter)	94.3%	95.5%	95.8%	95.3%	96.0%	95.7%	92.9%	95.5%	94.2%
DTAX	0.03	0.03	0.00	0.02	0.02	**0.03**	**−0.02**	0.02	0.04
ROA	0.07	0.08	0.04	0.08	0.05	**0.08**	**0.04**	0.08	0.06
Leverage (%)	20.8%	**20.9%**	**12.5%**	21.6%	21.0%	20.2%	24.2%	21.9%	20.8%
US NOL (%)	46.3%	43.6%	33.3%	42.9%	43.3%	44.7%	43.3%	41.3%	47.7%
Advertising Intensity (%)	1.5%	1.4%	0.7%	1.3%	1.9%	1.5%	1.0%	1.3%	1.4%
R&D Intensity (%)	2.6%	**2.3%**	**4.7%**	**2.0%**	**3.3%**	2.0%	3.1%	**1.7%**	**2.9%**
Retail Industry (%)	9.0%	9.3%	7.7%	10.8%	4.7%	9.6%	5.7%	11.0%	9.1%
|Abnormal Accruals|	0.09	0.08	0.10	0.08	0.08	0.08	0.10	0.08	0.09
Analyst Following	9.13	**10.38**	**6.38**	**10.29**	**7.75**	9.31	10.30	**10.32**	**7.22**
Institutional Ownership (%)	50.8%	53.3%	58.6%	52.0%	52.5%	52.9%	54.8%	52.3%	46.4%
Altman's Z-score	4.40	4.78	5.56	4.79	4.01	4.48	5.77	4.92	4.56

(continued on next page)

TABLE 3 (continued)

Panel D: Firm Characteristics Conditioned on Survey Responses

		Factor							
		(5) Restate Financial Statements		(6) Negative Financial Accounting Impact		(7) Tax Benefit Not Recorded for GAAP		(8) Other	
Firm Characteristic	**Mean**	**Imp.**	**Not Imp.**	**Imp.**	**Not Imp.**	**Imp.**	**Not Imp.**	**Imp.**	**Not Imp.**
Firm Size ($ Mil.)	9,897.04	8,952.61	12,638.72	10,722.13	8,052.91	10,248.54	9,853.55	3,402.86	11,446.61
GAAP ETR (%)	32.3%	31.1%	29.3%	31.1%	30.6%	33.6%	29.6%	**26.7%**	**31.2%**
3-Yr Cash ETR (%)	29.7%	29.6%	27.5%	**23.9%**	**29.0%**	**25.8%**	**37.7%**	27.0%	25.2%
P(Tax Shelter)	94.3%	94.7%	96.9%	95.7%	95.6%	95.1%	96.6%	94.1%	94.5%
DTAX	0.03	0.02	0.02	0.01	0.02	0.03	0.01	0.03	0.04
ROA	0.07	0.08	0.06	0.08	0.06	0.08	0.06	0.04	0.07
Leverage (%)	20.8%	22.7%	21.0%	20.2%	21.5%	21.6%	22.1%	17.0%	20.3%
US NOL (%)	46.3%	46.0%	41.0%	44.7%	42.9%	44.7%	38.6%	30.0%	41.1%
Advertising Intensity (%)	1.5%	1.3%	1.3%	1.5%	1.6%	1.1%	1.5%	1.1%	1.7%
R&D Intensity (%)	2.6%	2.1%	3.1%	2.6%	2.1%	2.4%	2.2%	**4.3%**	**2.2%**
Retail Industry (%)	9.0%	9.8%	8.2%	10.6%	13.8%	7.7%	10.3%	4.3%	12.0%
|Abnormal Accruals|	0.09	0.09	0.08	0.08	0.09	0.08	0.08	0.08	0.09
Analyst Following	9.13	9.35	9.95	**10.42**	**8.71**	10.56	9.82	8.76	10.59
Institutional Ownership (%)	50.8%	52.6%	49.4%	**55.3%**	**46.2%**	59.1%	51.9%	43.8%	55.8%
Altman's Z-score	4.40	4.37	4.47	4.71	5.12	4.75	5.29	4.47	4.64

(continued on next page)

TABLE 3 (continued)

Panel E: Determinants of Reputation Related Concerns

		Dependent Variable	
Variables	**Pred. Sign**	**(1) Rank "Harm to Reputation" as Important Marginal Effect (Z-statistic)**	**(2) Rank "Adverse Media Attention" as Important Marginal Effect (Z-statistic)**
Log(Assets)	+	0.06###	0.03#
		(3.24)	(1.33)
ROA	+	0.32##	0.24#
		(1.99)	(1.44)
Leverage	?	−0.01	0.00
		(−0.05)	(0.00)
US NOL	?	0.05	0.06
		(0.64)	(0.79)
R&D Intensity	?	−0.38	−1.51*
		(−0.52)	(−1.84)
Advertising Intensity	+	−0.18	−0.28
		(−0.21)	(−0.30)
Retail Industry Indicator	+	0.16###	0.10
		(2.77)	(1.02)
Analyst Following	+	0.00	0.04
		(−0.06)	(0.82)
Institutional Ownership	+	−0.01	−0.04
		(−0.08)	(−0.31)
|Abnormal Accruals|	−	−0.27#	−0.30
		(−1.43)	(−1.08)
Standard Errors Clustered by Industry		Yes	Yes
Number of Observations		237	238
Pseudo R^2		6.9%	4.6%

(continued on next page)

TABLE 3 (continued)

Panel F: Consequences of Reputation Related Concerns

	Dependent Variable: Tax Avoidance Proxy				
	(1)	(2)	(3)	(4)	(5)
	3-Yr Cash ETR	*DTAX*	*GAAP ETR*	*P(Tax Shelter)*	*P(Tax Shelter)*
Variables	**Coefficient (t-statistic)**	**Coefficient (t-statistic)**	**Coefficient (t-statistic)**	**Coefficient (t-statistic)**	**Coefficient (t-statistic)**
Rank "Harm to Reputation" as Important	0.04[#]	−0.02	0.00	−0.05[###]	−0.02[##]
	(1.52)	(−0.56)	(−0.12)	(−3.70)	(−1.93)
ROA	−0.19***	0.23	−0.16***	0.38*	—
	(−2.89)	(1.66)	(−3.10)	(1.91)	
R&D Intensity	−0.66**	−0.07	−0.39	−0.59	—
	(−2.64)	(−0.20)	(−1.11)	(−1.53)	
Advertising Intensity	−0.07	−0.20	0.32	−0.03	−0.08
	(−0.25)	(−0.84)	(1.10)	(−0.17)	(−0.69)
Sales Growth	−0.11**	−0.05	0.00	−0.05	−0.02
	(−2.09)	(−1.31)	(−0.05)	(−1.27)	(−0.49)
Leverage	0.11	−0.11	0.02	0.03	—
	(1.00)	(−1.51)	(0.33)	(0.46)	
Cash Holdings	0.02	0.06	−0.04	−0.02	−0.15***
	(0.28)	(0.67)	(−0.46)	(−0.23)	(−2.82)
Foreign Income	0.19	0.58**	−0.28	0.35**	—
	(0.64)	(2.43)	(−1.19)	(2.61)	
US NOL	−0.05**	0.01	−0.02	0.04**	—
	(−2.66)	(0.21)	(−1.04)	(2.11)	
Log(Assets)	0.00	0.02	0.00	0.04***	—
	(−0.20)	(1.43)	(0.50)	(5.61)	
PPE	−0.03	−0.01	0.01	−0.01	0.00
	(−0.83)	(−0.42)	(0.66)	(−0.26)	(−0.06)
Intangibles	0.08	−0.03	0.04	−0.01	−0.05
	(0.79)	(−0.45)	(0.51)	(−0.21)	(−0.63)

(continued on next page)

TABLE 3 (continued)

Variables	Dependent Variable: Tax Avoidance Proxy				
	(1) *3-Yr Cash ETR* Coefficient (t-statistic)	(2) *DTAX* Coefficient (t-statistic)	(3) *GAAP ETR* Coefficient (t-statistic)	(4) *P(Tax Shelter)* Coefficient (t-statistic)	(5) *P(Tax Shelter)* Coefficient (t-statistic)
Standard Errors Clustered by Industry	Yes	Yes	Yes	Yes	Yes
Number of Observations	220	141	229	228	228
R^2	9.3%	24.2%	9.5%	35.3%	3.4%
Incremental R^2 from "Harm to Reputation" factor	0.8%	0.4%	0.0%	2.6%	0.6%

*, **, *** (#, ##, ###) indicate significance at the 10%, 5%, and 1% level, respectively, using a two-tailed (one-tailed) t-test.
In Panels A, C, and D, bold fields indicate a statistically significant difference in the average rating between groups at the 10 percent level or better.
The survey provides a five-point rating scale ranging from 0 to 4 with a rating of 0 labeled "Not at all important" and a rating of 4 labeled "Very important."
The percentages listed in Panel A under "Percent Important" are the percentages of respondents who gave a rating of 3 or 4 for that particular factor.
We reorder the responses in Panel A for presentation purposes to be in order of importance rating. On the survey instrument, however, the factors were listed in the following order: (1), (6), (7), (3), (4), (5), (2), other.
Panels C and D present the descriptive characteristics for firms based on their factor ratings. For a description of items respondents listed in the "other" factor, see footnote 30.
Panel E presents the results from probit regressions of importance of reputation on its determinants. The dependent variable in Panel E is an indicator variable that takes on the value of one if the firm ranks the factors "Harm to Reputation" and "Adverse Media Attention" as important or very important.
Panel F presents the results from OLS regressions of the consequences of firms' reputation related factor ratings on tax planning proxies.
All variables are defined in Appendix A.

A, also shows that among public firms, both "potential harm to reputation" and "adverse media attention" is considered significantly more important ($p < 0.05$) than at private firms with 72.2 percent and 60 percent of public firms giving these factors a rating of important or very important compared to 58.9 percent and 47.9 percent of private firms, respectively. This difference between public and private firms is consistent with the additional scrutiny that public firms are under from investors and other market participants. We note that the percent of firms concerned about media attention is significantly lower ($p < 0.10$) than the percent concerned about reputation generally, likely because only a sub-set of firms are prominent enough to be mentioned in the media.

"Risk of detection and challenge by the IRS" is the third most important reason executives give for not engaging in tax planning strategies, with 62.1 percent of the firms rating the factor as important or very important. This result is related to prior work that finds that IRS scrutiny discourages tax avoidance (Hoopes, Mescall, and Pittman 2012; Mills and Sansing 2000; Mills 1998, 1996). There is not a statistical difference between public and private firms for this factor. The remaining factors deal with financial reporting incentives; we discuss these factors below along with other related questions about financial accounting.

Table 3, Panels C and D present the descriptive characteristics for firms based on their responses to the survey question detailed in Table 3, Panel A, along with univariate tests of differences in these characteristics. We focus on the reputation factors in this section and discuss the financial accounting factors below, generally not discussing other factors because they are not our primary research interest in this paper.

Firms that responded that reputation and adverse media attention are important in their decision to not engage in a tax planning strategy are larger on average (significantly so for the adverse media attention factor) and have significantly higher *Analyst Following* than firms rating these factors as unimportant, consistent with the former firms being more in the public eye and under more scrutiny. The data also reveal that the firms that rate reputation and adverse media attention as important are more likely to be in the retail industry—although the difference in the likelihood is not statistically significant. Another characteristic that is statistically different between the firms that rated the reputation-related factors as important and those that did not is *R&D Intensity*, although we offer no explanation for this result. We now turn to multivariate tests of determinants of high reputation concerns when firms engage in a tax planning strategy.

Determinants of Reputation Concerns

In order to examine the determinants of rating reputation concerns as important, we construct two indicator variables for firms indicating that "potential harm to firm reputation" and "risk of adverse media attention" are important or very important reasons for not engaging in a tax planning strategy. We then estimate separate probit regressions with these indicator variables as the dependent variable and firm characteristics as the independent variables. Table 3, Panel E presents the marginal effects from the regressions with the variable definitions in Appendix A and all variables winsorized at the 1 percent and 99 percent level.[24]

[24] We cluster the standard errors in the regression by industry to deal with residual correlation in the standard errors. However, we do not include industry fixed effects because we are interested in the characteristics of the firms that are the underlying determinates of the reputation concerns and because we want to test the effect of being in the retail industry relative to other industries. In untabulated tests we estimate the regressions with industry fixed effects and find that our inferences are unaffected (i.e., the coefficients on our test variables are significant at the one-tailed 10 percent level or better and have similar magnitudes as those reported in the paper). Note also that we only have one observation per firm in time so firm and time fixed effects cannot be included.

Column (1) of Table 3, Panel E presents the regression results when the factor "potential harm to firm reputation" is the dependent variable. We find that the marginal effects for *Log(Assets)*, *ROA*, and *Retail Industry* indicator are positive and statistically significant at the $p < 0.05$ level or better (see Column (1)). The positive relation between retail industry membership and reputation concerns suggests that firms with more consumer orientation are more worried about reputation, for example, in the form of a consumer backlash, consistent with Hanlon and Slemrod (2009). We also find that firms with larger magnitudes of abnormal accruals (*|Abnormal Accruals|*) are marginally less concerned about potential harm to their reputation from tax planning. This result is potentially consistent with the notion that firms that are not worried about reputation are also not worried about engaging in aggressive financial accounting.

Column (2) in Table 3, Panel E presents the regression results when the factor "risk of adverse media attention" is the dependent variable. Consistent with the discussion above, we find that large firms and more profitable firms rate adverse media attention as a significantly more important reason not to engage in tax planning strategies relative to small firms and less profitable firms. While the data show that retail industry membership is positively related to the factor rating, the coefficient is not statistically significant (estimated coefficient = 0.10; one-tailed p-value = 0.154).

The Effect of Reputation Concerns on Measures of Tax Planning

We next correlate the survey responses with tax planning outcomes using standard measures from prior literature. To the extent that reputation concerns limit tax planning activities, we should observe less tax avoidance as measured by the common proxies that are observed by external parties. However, to the extent the proxies used in the literature do not measure the effects of tax planning strategies precisely and/or the effect of reputation on turning down marketed tax planning strategies is not correlated with other more generic tax planning, we may not observe a relation in the archival data. We employ regression analysis to examine the effect of "harm to firm reputation" (i.e., the rating from our survey data) on firms' tax planning behavior as measured by their *3-Yr Cash ETR*, *P(Tax Shelter)*, *DTAX* (from Frank et al. 2009), and the firm's *GAAP ETR*.

The results in Table 3, Panel F are consistent with firms worried about reputation having a higher cash effective tax rate and a lower likelihood of engaging in a tax shelter as reflected by the significant coefficients for "Rank 'Harm to Reputation' as Important" in Columns (1), (4), and (5). Because Lisowsky (2010) computes the predicted value of the probability of a tax shelter (*P(Tax Shelter)*) with a model that includes the following variables that we use as control variables, *ROA*, *R&D Intensity*, *Leverage*, *Foreign Income*, *US NOL*, and *Log(Assets)*, we estimate our regression both with and without these control variables. We find that our main test variable, the ranking of "harm to reputation," is statistically significant in the predicted direction in both specifications. The data in Columns (2) and (3) of Table 3, Panel F show that the relation of the reputation factor rating to the *DTAX* measure and *GAAP ETR* is insignificant.[25] Overall, we interpret the evidence as consistent with firms more concerned about reputation being less likely to engage in tax shelters and somewhat more likely to report a higher cash effective tax rate. Table 3, Panel F also reports the incremental R^2 obtained by adding the reputation factor in the above

[25] We also estimate the regressions using the rating for the factor "risk of adverse media attention" from the survey as the independent test variable. In these untabulated regressions, the rating reaches statistical significance only when *P(Tax Shelter)* is the dependent variable (Coeff. = −0.023; t-stat = −1.41)—i.e., when firms fear adverse media attention, they are less likely to engage in a tax shelter.

regressions. We find that reputation concerns increase the explanatory power of the *3-Yr Cash ETR* model by 9.4 percent (i.e., from 8.5 percent to 9.3 percent) and the explanatory power of the *P(Tax Shelter)* model by 8.1 percent (i.e., from 32.7 percent to 35.3 percent).[26]

In summary, our evidence is consistent with reputation concerns being important for corporate decision-making with respect to tax planning. Reputational concerns are significantly more important for firms under capital market pressure in terms of being publicly traded, larger, and having more analyst following, and with a greater chance of consumer backlash, such as in the retail industry. Further, tax executives who say reputation concerns have prevented them from engaging in a tax planning strategy do have a significantly lower likelihood of engaging in a tax shelter as measured by Lisowsky's (2010) tax shelter score and some evidence of a higher long-run cash ETR.

Financial Accounting Concerns

Financial reporting incentives often conflict with incentives to lower taxes because reductions in taxable income frequently result in lower financial accounting earnings (Scholes, Wilson, and Wolfson 1992; Shackelford and Shevlin 2001). Thus, a stream of literature has focused on what is known as the book-tax trade-off, documenting that companies often choose accounting methods and or forgo taking actions that would lower taxes because they do not want to report lower accounting earnings (or that the companies take actions to increase accounting earnings at the cost of increased taxes). For example, early studies on whether to adopt or abandon LIFO (Dhaliwal, Frankel, and Trezevant 1994) document that companies with financial reporting incentives (e.g., risk of violating debt covenants) are more likely to forgo the tax benefits of the LIFO method. Matsunaga, Shevlin, and Shores (1992) similarly show that companies will forgo the tax benefits of disqualifying incentive stock options to avoid the associated financial statement costs. In addition, Erickson, Hanlon, and Maydew (2004) show that firms that fraudulently overstate financial accounting earnings pay cash taxes on those overstated earnings at a median rate of 8 cents on the dollar to increase "paper" earnings.[27] Finally, although not in the line of book-tax trade-off literature, Graham et al. (2005) and Bens, Nagar, Skinner, and Wong (2003) both provide evidence consistent with managers being willing to spend cash to increase accounting earnings and earnings per share.

Indeed, recent research takes this idea further, conjecturing that some tax planning is engaged in, and incentives are provided specifically with the objective of, affecting financial reporting. For example, Robinson et al. (2010) report that some firms view their tax department as a profit center (i.e., "a contributor to the bottom line"). They state that that "a profit center performance model is effective in motivating tax departments to reduce financial ETRs, but ineffective in motivating tax

[26] Our overall explanatory power is marginally lower than prior research, in part because we do not include year or industry fixed effects. For example, Armstrong, Blouin, and Larcker (2012) obtain R^2s around 9.4 percent, Rego and Wilson (2012) obtain R^2s around 14.9 percent, and S. Chen, X. Chen, Cheng, and Shevlin (2010) obtain R^2s around 12.5 percent in their regression of cash ETR after including year and industry fixed effects. The R^2 in our regression increases to 13.5 percent when we include industry fixed effects. We are unable to include year fixed effects because we have just one observation per firm.

[27] Studies that demonstrate that accounting earnings are affected when tax planning is done include Maydew (1997), who provides evidence that firms shifted taxable income to maximize the tax value of net operating losses in the face of tax rate changes by testing the shifting of financial accounting income, and Guenther (1994) who examines earnings management around the Tax Reform Act of 1986. See Shackelford and Shevlin (2001) for a complete review of the literature. In addition, for a review of the literature on earnings management and some of the determinants of earnings management, e.g., debt or compensation contracts, avoiding reporting a loss, meeting or beating analysts' forecasts, maintaining credit ratings, etc., see Dechow, Ge, and Schrand (2010).

departments to reduce cash ETRs." In addition, Armstrong et al. (2012) examine the association between tax executive incentives (via compensation packages) and corporate tax planning. They find evidence that tax director compensation is associated with lower GAAP ETRs but has no relation with the cash ETR. They conclude that tax executives are incentivized to focus on the GAAP ETR rather than narrowly focus on cash taxes paid.[28]

Why the focus on financial accounting tax rates? Graham et al. (2011, 141–142) suggest several reasons why top managers are concerned about GAAP ETR and reported earnings. First, a lower GAAP ETR increases reported after-tax earnings and earnings have been shown to be positively associated with firms' stock returns and market value. Some managers likely believe stock prices are inefficient in the sense that investors fixate on reported earnings without adjustment, thus motivating these firms' managers to focus on financial statement effects of their tax plans. Second, GAAP-based financial accounting numbers are often used in contracts to determine covenant thresholds in debt contracts and bonuses paid to managers. Finally, Graham et al. (2011) highlight that the GAAP ETR is an important benchmark that is compared across firms.

While there is prior research on the topic of the book-tax trade-off, and the evidence is generally consistent that financial accounting outcomes are important in tax reporting decisions, the validity of the evidence is often debated. For example, in many studies the researcher must estimate what the companies' results would have looked like had an alternative action been taken (for discussions, see Erickson et al. 2004; Shackelford and Shevlin 2001) and in some studies the sample size is small (Erickson et al. 2004), casting doubt on the conclusion that firms will sacrifice cash taxes to increase accounting earnings. Thus, to provide direct evidence on the relative importance of accounting earnings and cash taxes (i.e., the importance of accounting effects when firms tax plan), we ask tax executives several questions on the topic.[29]

We first examine the financial-accounting-related responses to the question discussed in the previous section, "Has your company ever considered but decided not to implement a tax planning strategy proposed and/or marketed by an accounting, law, investment, or tax consulting firm?" The data show (Figure 1 and Table 3, Panel A) that the factor, "risk of having to later restate financial statements," was rated by 54.2 percent of the firms (58 percent of public firms) as very important or important. In addition, the factors "negative pre-tax impact on financial statement income" and "tax benefit could not be recorded for GAAP" garner ratings of 43.8 percent and 39.2 percent, respectively (46.2 percent and 42.8 percent for public firms,

[28] Desai and Dharmapala (2009a) discuss Enron in this context stating, "In summarizing various transactions, the JCT concluded that Enron's management set high financial accounting goals and realized quickly that tax-motivated transactions could generate sizable financial accounting benefits. Accordingly, Enron looked to its tax department to devise transactions that increased financial accounting income. In effect, the tax department was converted into an Enron business unit, complete with annual revenue targets. The tax department, in consultation with outside experts, then designed transactions to meet or approximate the technical requirements of tax provisions with the primary purpose of manufacturing financial statement income." (They also use Dynegy as an example as well. See their paper for details, as well as Desai and Dharmapala [2006, 2008] for further discussion.)

[29] The exact methods managers use to reduce the GAAP ETRs are not completely known. We do not ask about specific transactions in our survey. At a basic level, we conjecture that the manager will prioritize tax strategies that generate a permanent book-tax difference (or tax credit) over strategies that generate a temporary book-tax difference where possible since the former not only reduces taxable income, but also lowers the GAAP ETR increasing after-tax accounting earnings. Managers may also engage in transactions (real or accrual) that primarily serve to lower the GAAP ETR. For example, if they re-structure their foreign operations or, indeed, even start foreign operations in order to defer the U.S. income tax, then this will allow them the flexibility to choose to designate the foreign earnings as permanently reinvested. In such a case, the company does not have to accrue the future U.S. taxes that would be due upon repatriation, increasing after-tax accounting earnings (for additional details, see Shackelford et al. 2011; Graham et al. 2011).

respectively). Thus, a large minority of firms—roughly 40 to 45 percent—are less likely to engage in tax planning if there is a risk that financial statements will have to be restated as a result or if they cannot record the tax savings for accounting purposes.[30] The test statistics in Table 3 reveal that public firms rate financial accounting concerns as significantly more important than do private firms, as one would expect.

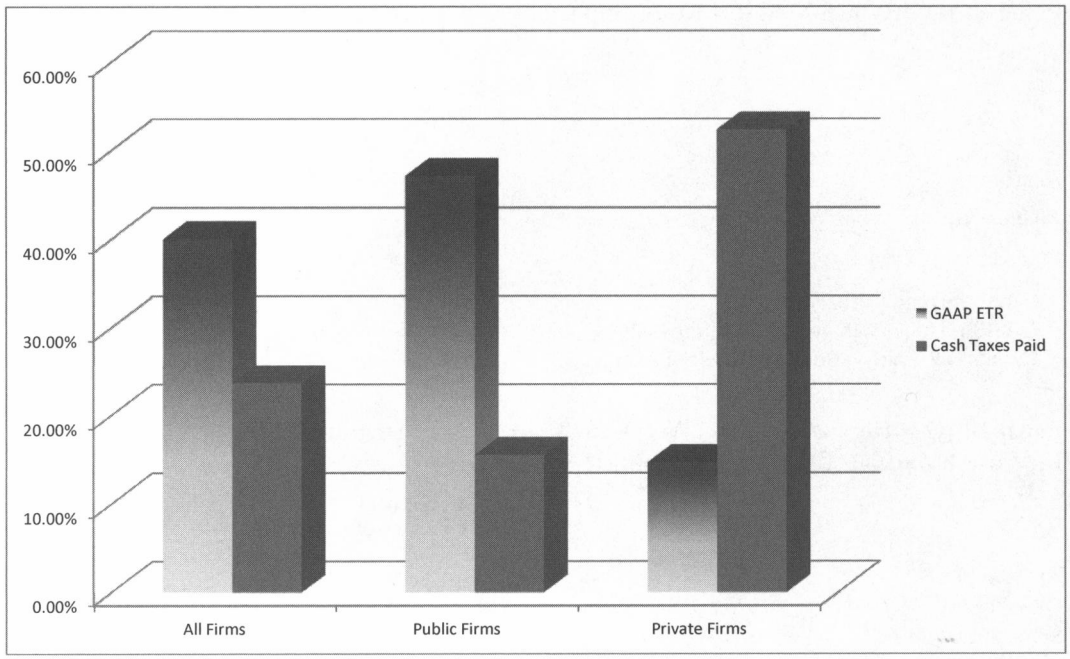
Next, we examine responses to the question "Which metric is more important to top management in your company?" The possible answers to the question as listed in the survey instrument are (1) GAAP ETR, (2) cash taxes paid, or (3) both are equally important. Figure 2 and Table 4, Panel A present these data. Of the 513 firms that responded to this question, 40 percent of the respondents indicate that the GAAP ETR is the most important metric, a number significantly larger than the 23.7 percent of firms that state that the cash taxes paid is the most important metric; 36.4 percent report that the two metrics are equally important. Thus, many of the firms rate the GAAP ETR as more important, or at least equally important, as cash taxes to top management of the company. The data also reveal that, consistent with expectations, management at public companies is significantly more likely to place a higher value on the GAAP ETR, and managers at private companies are significantly more likely to place a higher value on cash taxes paid. Specifically, 47.1 percent of public companies rate the GAAP ETR as the more important metric compared to only 15.5 percent of them indicating that cash taxes is the more important metric. In sharp contrast, 52.3 percent of the private companies rate cash taxes paid as more important compared to only 14.7 percent of private companies rating the GAAP ETR as most important (the percentages are statistically different). Overall, our finding that top management at 76.4 percent of our sample firms (84.5 percent of public firms) value the GAAP ETR metric at least as much or more than cash taxes provides direct evidence on the importance of accounting earnings and GAAP ETRs specifically.

We also ask questions to directly address the hypotheses put forth in Robinson et al. (2010), Armstrong et al. (2012), and Desai and Dharmapala (2006, 2009a, 2009b). Each of these studies suggests that tax avoidance strategies are engaged in with a *primary motivation* to improve accounting performance metrics. We begin by asking managers "How often are tax planning strategies proposed [by an accounting, law, investment, or tax consulting firm] as a way to increase financial accounting earnings?" Table 4, Panel B indicates that 5.2 percent of our respondents answered that tax planning strategies are "always" pitched as a way to increase earnings, 26.8 percent said it was "often" the case, 50.7 percent responded that this was "sometimes" the marketing strategy, and 17.4 percent said that this "never" was part of the pitch. Partitioning the firms into public and private indicates that the "increase financial accounting earnings" pitch was significantly more often made to public firms (34.6 percent of public firms responded it was "always" or "often" the pitch, while for 22.4 percent of private firms this was the case).

To further examine the importance of financial accounting effects when considering a tax planning strategy, we examine the responses to the question "When evaluating a tax planning strategy that saves cash taxes, how important is it that the tax planning strategy..." (1) does not reduce EPS, or (2) leads to reporting a higher EPS. The results from these questions are reported in

[30] We also included a space for respondents to fill in labeled "other." Forty-four firms listed a response in this "other" space. Of these responses, 16 mention that the fees, administration, and personnel costs were too high; six respondents answered that the strategy was not in line or conflicted with operational goals; along the lines of reputation, two answered that their company wanted to be a "good corporate citizen," one answered they were worried about their image in front of employees, and one said "We didn't want to draw attention to ourselves"; two said the transaction had low merit; one said they tried to get approval from a private letter ruling and failed; one said it would have hurt relations with the government; and one said the result of the transaction would violate debt covenants. The complete text of these and the remaining responses are available upon request.

FIGURE 2
Importance of Financial Accounting versus Tax Minimization Incentives to Engage in Tax Planning



This figure presents the responses to the survey question: "Which metric is more important to the top management at your company?" The available answers included (1) GAAP ETR, (2) Cash Taxes Paid, and (3) Both are equally important. This figure presents the percentages of respondents that answered GAAP ETR or Cash Taxes Paid.
The corresponding data in table form are in Table 4, Panel A.

Figure 3 and Table 4, Panel C. We find that 60.8 percent of surveyed companies say that it is important (rating of 3 or 4) that a tax strategy does not reduce EPS, and 49.5 percent respond that it is important that the strategy actually leads to higher EPS. The right-most columns of Panel C (and Figure 3) present the data for public and private firms separately. Public firms, not surprisingly, attach significantly higher importance ratings to both EPS questions relative to private firms. The stated importance of financial accounting factors on a corporate decision contributes to the recent literature emphasizing the importance of the interaction of financial statement effects and tax planning (e.g., Robinson et al. 2010; Shackelford et al. 2011).

Determinants and Tax Planning Consequences of Financial Accounting Concerns

Table 3, Panel D (Columns (5), (6), and (7)) and Table 4, Panels D and E present descriptive statistics and univariate tests for the sample firms based on how they responded to questions related to the importance of financial accounting effects. Table 3, Panel D reveals that firms that rated the risk of a negative financial accounting impact as important (Column (6)) have significantly higher *Analyst Following* and *Institutional Ownership* than firms not rating the risk of a negative financial accounting outcome as important. This result is consistent with increased capital market pressure leading to greater weights put on financial accounting. Otherwise, beyond the public/private split in

TABLE 4

Financial Accounting Incentives and Disincentives to Engage in Tax Planning

Panel A: (Q1) Which Metric is More Important to the Top Management at Your Company? (n = 503)

	All Firms	Public Firms	Private Firms
GAAP ETR	40.0%	**47.1%**	**14.7%**
Cash Taxes Paid	23.7%	**15.5%**	**52.3%**
Both are equally important	36.4%	37.4%	33.0%
Comparison of Factors	p-value	p-value	p-value
GAAP ETR = Cash Taxes Paid	0.000	0.000	0.000
GAAP ETR = Both are equally important	0.359	0.037	0.005
Cash Taxes Paid = Both are equally important	0.000	0.000	0.029

Panel B: (Q2) How Often Are (Were) the Tax Planning Strategies Proposed as a Way to Increase Financial Accounting Earnings? (n = 501)

	Percent of Firms	Percent of Public Firms	Percent of Private Firms
Always	5.2%	**6.4%**	**0.9%**
Often	26.8%	28.2%	21.5%
Sometimes	50.7%	50.9%	49.5%
Never	17.4%	**14.5%**	**28.0%**

Panel C: (Q3) At Your Company, When Evaluating a Tax Planning Strategy that Saves Cash Taxes, How Important is it that the Tax Planning Strategy... (n = 501)

	Percent Important (All Firms)	Percent Important (Public Firms)	Percent Important (Private Firms)
A. ...does not reduce earnings per share (EPS)	60.8%	**71.2%**	**23.4%**
B. ...leads to reporting a higher earnings per share (EPS)	49.5%	**57.0%**	**22.4%**

(continued on next page)

Table 3, Panel A and these two characteristics, the groups of firms in Table 3, Panel D, Columns (5)–(7) look similar in their characteristics whether they answered that financial accounting was important or not important (i.e., these other characteristics are not significantly different across the two groups). We note that Table 3, Panels C and D include only public firms and, thus, the most important driver of capital market pressure is held constant.[31]

Table 4, Panels D and E present descriptive data for the remaining questions about the importance of financial accounting effects. We first examine the differences in firm characteristics based on their stated relative importance of GAAP ETR and cash taxes paid. Note that we can only present the descriptive statistics for publicly traded firms because these data are obtained from

[31] The *3-Yr Cash ETR*s are statistically different—we investigate the consequences of financial accounting concerns below.

TABLE 4 (continued)

Panel D: Descriptive Statistics and Univariate Tests

		Q1		
		Which Metric Is More Important To the Top Management At Your Company?		
Firm Characteristic	**Mean**	***GAAP ETR***	**Cash Taxes Paid**	**Both Are Equally Imp.**
Firm Size ($ Mil.)	9,897.04	**9,910.40**	**3,843.54**	9,029.99
GAAP ETR (%)	32.3%	31.4%	30.4%	36.2%
3-Yr Cash ETR (%)	29.7%	**25.9%**	**37.6%**	30.7%
P(Tax Shelter)	94.3%	**96.4%**	**91.4%**	92.4%
DTAX	0.03	0.04	0.06	0.01
ROA	0.07	**0.09**	**0.02**	0.07
Leverage (%)	20.8%	**17.3%**	**26.8%**	22.9%
US NOL (%)	46.3%	**33.3%**	**65.2%**	48.6%
Advertising Intensity (%)	1.5%	1.4%	1.6%	1.6%
R&D Intensity (%)	2.6%	2.3%	3.5%	2.6%
Retail Industry (%)	9.0%	9.1%	10.2%	7.4%
|Abnormal Accruals|	0.09	0.08	0.10	0.10
Analyst Following	9.13	**10.15**	**6.56**	9.35
Institutional Ownership	50.8%	**54.5%**	**40.7%**	52.8%
Altman's Z-score	4.40	**5.39**	**3.13**	3.77

Panel E: Descriptive Statistics and Univariate Tests

		Q2		Q3–A		Q3–B	
		Tax Strategies Pitched to Increase Earnings		Tax Strategy Does Not Reduce EPS		Tax Strategy Leads to Higher EPS	
Firm Characteristic	**Mean**	**Often**	**Not Often**	**Imp.**	**Not Imp.**	**Imp.**	**Not Imp.**
Firm Size ($ Mil.)	9,897.04	7,896.22	8,743.08	7,986.86	6,628.66	9,496.85	9,451.59
GAAP ETR (%)	32.3%	36.7%	31.1%	35.6%	29.8%	34.2%	31.2%
3-Yr Cash ETR (%)	29.7%	**23.2%**	**32.5%**	29.3%	29.4%	30.2%	27.6%
P(Tax Shelter)	94.3%	93.3%	95.1%	**93.7%**	**98.0%**	92.8%	95.3%
DTAX	0.03	0.02	0.03	**0.03**	**0.08**	0.03	0.02
ROA	0.07	0.08	0.07	**0.07**	**0.06**	0.08	0.06
Leverage (%)	20.8%	21.5%	20.5%	20.5%	22.0%	19.6%	21.2%
US NOL (%)	46.3%	49.3%	44.3%	43.8%	49.5%	47.2%	44.0%
Advertising Intensity (%)	1.5%	1.2%	1.6%	1.5%	2.2%	1.7%	1.6%
R&D Intensity (%)	2.6%	**2.4%**	**2.6%**	2.6%	2.2%	2.6%	2.4%
Retail Industry (%)	9.0%	**4.0%**	**12.2%**	8.4%	11.6%	5.9%	11.5%
|Abnormal Accruals|	0.09	0.10	0.08	**0.08**	**0.11**	0.10	0.09
Analyst Following	9.13	9.22	9.14	9.08	9.10	9.17	8.93
Institutional Ownership (%)	50.8%	**56.8%**	**48.1%**	51.6%	48.3%	**54.6%**	**46.0%**
Altman's Z-score	4.40	4.34	4.51	4.62	4.01	**4.75**	**3.91**

(continued on next page)

TABLE 4 (continued)

Panel F: Determinants of Rating *GAAP ETR* as Important

	Dependent Variable: *GAAP ETR* Rating	
Variables	**Coefficient**	**z-statistic**
Log(Assets)	−0.008	−0.33
ROA	1.604***	3.50
Leverage	−0.303**	−2.06
US NOL	0.053	0.52
R&D Intensity	−0.773*	−1.66
Analyst Following	0.016	0.49
Institutional Ownership	0.138*	1.54
|Abnormal Accruals|	−0.434	−1.14
Altman's Z-score	0.006	0.45
Pseudo R^2	23.83%	
n	174	

*, **, *** Indicate significance at the 10 percent, 5 percent, and 1 percent levels, respectively, using a two-tailed t-test. Bold fields indicate a statistically significant difference in the average rating between public and private firms at the 10 percent level or better.

Panel A includes responses to the question listed in the top half of the panel and statistical tests between the factors in the bottom half of the panel.

For the questions in Panel C, the survey provides a five-point rating scale ranging from 0 to 4 with a rating of 0 labeled "Not at all important" and a rating of 4 labeled "Very important." The percentages listed in Panel C under "Percent Important" are the percentages of respondents that gave a rating of 3 or 4 for that particular factor.

Panel F includes probit regression results where the dependent variable is 1 if the company rated the GAAP ETR as the most important metric to top management relative to cash taxes paid; the dependent variable is set to 0 if cash taxes paid was the most important metric (firms that said both metrics are equally important are excluded from the analysis).

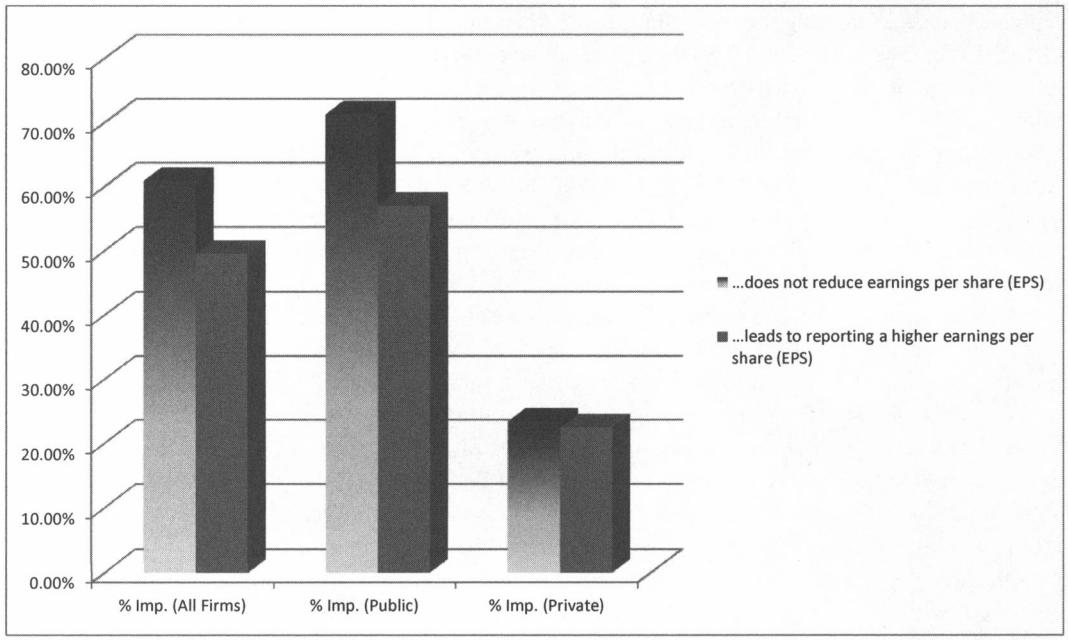
All variables are defined in Appendix A.

Compustat and only 15 percent (i.e., 61 firms) of the public firms responded that top management at their company values cash taxes paid the most. Thus, in some cases inferences are based on fairly small samples (e.g., due to data constraints the three-year cash ETR is only available for 31 of the 61 firms that said cash taxes paid are important).

Beyond being publicly traded, *Firm Size, Analyst Following,* and *Institutional Ownership* are also significantly higher for the firms that answered that GAAP ETR is more important than cash taxes paid. Thus, we conclude that the primary determinant of rating the GAAP ETR as more important than cash taxes paid is being under capital market scrutiny. The data also reveal that firms that rate GAAP ETR as more important than cash taxes paid have a significantly higher *ROA,* less *Leverage,* and fewer *US NOLs*. That these firms have lower leverage is not surprising because debt does not generally affect GAAP ETRs. More specifically, because the interest on debt is generally deductible/expensed for both tax and book purposes, it affects both the numerator and denominator of GAAP ETR creating no additional incentive to lever up. In terms of the other characteristics in Panel Table 4, Panels D and E, there do not appear to be consistently significant differences between the subsamples of firms based on whether they answered financial accounting concerns are important or not important.

Panel F of Table 4 presents probit regression results of determinants of rating GAAP ETR as more important than cash taxes (dependent variable set to 1 if the company rated GAAP ETR as most important to top management). The data are consistent with higher *ROA,* lower *Leverage,* lower *Foreign Income,* lower *R&D Intensity,* and higher *Institutional Ownership* being significantly associated with rating the GAAP ETR as important (note again that all firms are publicly traded in

FIGURE 3
Financial Accounting Incentives and Disincentives to Engage in Tax Planning



This figure presents the responses to the survey question "At your company, when evaluating a tax planning strategy that saves cash taxes, how important is it that the tax planning strategy...": (1) does not reduce earnings per share (EPS), or (2) leads to reporting a higher earnings per share (EPS). The survey provides a five-point rating scale ranging from 0 to 4 with a rating of 0 labeled "Not at all important" and a rating of 4 labeled "Very important." This figure presents the percentages of respondents that gave a rating of 3 or 4 for each factor.
The results are shown separately for public and private firms.
The corresponding data in table form are in Table 4, Panel C.

this test). The association of higher *ROA* and higher *Institutional Ownership* are indicative of greater capital market pressures. *Analyst Following* is positive but insignificant (the variable is correlated with size and institutional ownership, however). The *Leverage* result is consistent with the univariate result described above and likely due to the fact that leverage generally provides a debt shield and saves cash taxes but does not generally affect a GAAP ETR to a great extent because the interest is expensed from financial accounting income as well as deducted from taxable income. Thus, increasing leverage would be valuable for tax purposes to firms that rate cash taxes as more important, but as not valuable to firms that rate the GAAP ETR as more important.[32]

[32] Note that many studies in the book-tax trade-off literature use leverage as a proxy for likelihood of covenant violations (under the contracting view of accounting) and find that firms with more leverage are often more willing to trade cash taxes for higher accounting earnings to avoid covenant violations. Our results are not necessarily inconsistent with this prior literature. The prior studies examined the book-tax trade-off for pre-tax accounting earnings effects (LIFO versus FIFO, disqualifying stock options, and paying additional cash compensation). We asked about the GAAP ETR not pre-tax accounting earnings. Most income-based covenants for debt contracts are based on earnings before taxes and, thus, the GAAP ETR is not as important for debt-contracting purposes (for a discussion, see Hanlon and Heitzman 2010).

We also examine consequences of rating a certain metric as important via univariate tests of data in Table 4, Panels D and E. We examine four tax planning outcome variables commonly used in the literature: *3-Yr Cash ETR*, *P(Tax Shelter)*, *DTAX*, and the *GAAP ETR* (same as we did in the reputation tests). One might expect that firms responding that the top management cares about the GAAP ETR have lower GAAP ETRs as a result of their active efforts to reduce it. However, there are a number of reasons why we may not observe such an effect in the data. With respect to the relation between financial reporting incentives and tax planning proxies, there is a potential endogeneity problem. For example, firms that have a high GAAP ETR may respond that top management values the GAAP ETR because they want to lower the rate. In other words, top management cares about the GAAP ETR because their company has not been able to lower it to the target level. Another potential problem is that firms may *want* a low GAAP ETR but this is not easily achieved (Hanlon and Heitzman 2010).

Univariate tests of the tax planning variables are in Table 4, Panels D and E. The data reveal that firms that rate the GAAP ETR as most important have the same *GAAP ETR* but a significantly lower *3-Yr Cash ETR* relative to firms where top management values cash taxes as the most important metric. To the extent one expects a high rating of the GAAP ETR to manifest in lower *GAAP ETR*s and a high rating of cash taxes paid to manifest in lower *3-Yr Cash ETR*s, these results are counter-intuitive.[33] To examine these data further, we first compare the medians for the subsamples to mitigate concerns of outliers in our potentially small subsamples. We find different inferences for the *3-Yr Cash ETR* when we look at the medians—the median *3-Yr Cash ETR* is significantly lower for firms indicating that cash taxes paid is more important than GAAP ETR, consistent with expectations (untabulated). Specifically, the median *3-Yr Cash ETR* is 26.1 percent (19.5 percent) for firms rating GAAP ETR (cash taxes paid) as the more important metric. This difference is statistically significant at the 10 percent level (one-tailed p-value = 0.085). Thus, the medians in our data reveal that firms that say top management cares more about cash taxes paid have lower median cash ETRs.

We also examine forward-looking tax planning metrics in the event that past ETRs do not reflect current preferences (untabulated). We find that the mean (median) *GAAP ETR* in the year following the survey is 28.6 percent (32.6 percent) for firms that rate the GAAP ETR as important and 34.5 percent (35.1 percent) for firms that rate cash taxes paid as important. The forward looking *3-Yr Cash ETR*s for these groups are 39.4 percent (30.9 percent) and 33.2 percent (28.2 percent), respectively. However, the differences in cash and GAAP ETRs are not statistically significant across the groups at conventional levels of significance. In summary, using forward-looking measures, the data are consistent with expectations (albeit insignificantly)—i.e., companies that say the GAAP ETR is important have a lower GAAP ETR relative to firms that say the cash taxes are more important and companies that say the cash tax paid is important have a lower *3-Yr Cash ETR* relative to firms that say the GAAP ETR is more important.

V. CONCLUSIONS

Our paper uses a survey to ask nearly 600 tax executives about their firms' experiences with respect to tax planning and avoidance. We focus on questions that are difficult to address using archival data. The executives indicate that reputation is very important, with 70 percent of firms

[33] We note, however, that we asked about cash taxes paid and not the cash ETR and, thus, the higher importance rating for cash taxes paid may not necessarily manifest in a lower cash ETR since they are not exactly the same measure. We also estimate regressions of the tax metrics (separately) on the rating of the importance of the GAAP ETR and the cash ETR and find similarly insignificant results. In the interest of space, we do not tabulate these results.

rating it as important or very important in their decision to avoid a tax planning strategy and 58 percent of firms rating the risk of adverse media attention as important or very important. The use of survey data for such a research question is critical because the archival data employed in most of the extant literature contains only firms that engaged in a strategy and were subsequently caught. If firms that are worried about adverse reputation effects do not engage in tax planning, then these firms are not in the archival data and this could affect inferences. We also find that financial accounting concerns are important, with 61 percent of firms (71 percent of public firms) stating that it is important that a tax planning strategy not harm reported earnings per share. In addition, 76 percent of firms rate the GAAP ETR as being at least as important as cash taxes paid.

Our study contributes to the literature on determinants of tax avoidance by providing evidence consistent with reputation effects being an important factor in tax planning decisions. Bankman (2004) speculates that reputation effects are important and points to some state tax authorities' use of lists of shame of noncompliant taxpayers (e.g., http://www.revenue.wi.gov/html/delqlist.html). However, the role of reputation has been debated in the literature and has resulted in conflicting evidence (for discussions, see Hanlon and Slemrod 2009; Gallemore et al. 2014). Our survey enables us to ask tax directors directly whether reputation matters and to conduct cross-sectional tests regarding the type of company for which reputation concerns are most important, which we find to be public firms, retail firms, larger firms, and more profitable firms.

Our study also contributes to the literature on the book-tax trade-off and the importance of financial accounting earnings versus cash flows. While there is a long line of literature on the book-tax trade-off, there are many concerns about "as if" computations by researchers and small sample sizes. Our study triangulates these prior studies and uses responses directly from company representatives to evaluate their prioritization of cash taxes paid versus the accounting measure of income tax expense.

REFERENCES

Altman, E. 1968. Financial ratios, discriminant analysis and the prediction of corporate bankruptcy. *Journal of Finance* 23: 589–609.

Altman, E. 2000. Predicting financial distress of companies: Revisiting the Z-score and Zeta models. *Working Paper*, Stern School of Business, New York University.

Armstrong, C., J. Blouin, and D. Larcker. 2012. The incentives for tax planning. *Journal of Accounting and Economics* 53: 391–411.

Austin, C., and R. Wilson. 2013. *Are Reputational Costs a Determinant of Tax Avoidance?* Working paper, The University of Iowa.

Bankman, J. 2004. An academic's view of the tax shelter battle. In *The Crisis in Tax Administration*, edited by H. J. Aaron, and Slemrod, J. 9–37. Washington, DC: Brookings Institute.

Bens, D., V. Nagar, D. Skinner, and F. Wong. 2003. Employee stock options, EPS dilution, and stock repurchases. *Journal of Accounting and Economics* 36: 51–90.

Brav, A., J. Graham, C. Harvey, and R. Michaely. 2005. Payout policy in the 21st century. *Journal of Financial Economics* 77: 483–527.

Chen, S., X. Chen, Q. Cheng, and T. Shevlin. 2010. Are family firms more tax aggressive than non-family firms? *Journal of Financial Economics* 95 (1): 41–51.

Chyz, J. A. 2013. Personally tax aggressive executives and corporate tax sheltering. *Journal of Accounting and Economics* 56 (2–3): 311–328.

Dechow, P., W. Ge, and C. Schrand. 2010. Understanding earnings quality: A review of the proxies, their determinants and their consequences. *Journal of Accounting and Economics* 50: 344–401.

Desai, M., and D. Dharmapala. 2006. Corporate tax avoidance and high-powered incentives. *Journal of Financial Economics* 79: 145–179.

Desai, M., and D. Dharmapala. 2008. Taxation and corporate governance: An economic approach. In *Tax and Corporate Governance*, edited by W. Schöen, 13–30. New York, NY: Springer.

Desai, M. A., and D. Dharmapala. 2009a. Earnings management, corporate tax shelters, and book–tax alignment. *National Tax Journal* 169–186.

Desai, M. A., and D. Dharmapala. 2009b. Corporate tax avoidance and firm value. *Review of Economics and Statistics* 91 (3): 537–546.

Dhaliwal, D., M. Frankel, and R. Trezevant. 1994. The taxable and book income motivations for a LIFO layer liquidation. *Journal of Accounting Research* 32 (2): 278–289.

Dyreng, S., M. Hanlon, and E. Maydew. 2008. Long-run corporate tax avoidance. *The Accounting Review* 83: 61–82.

Engle, E., M. Erickson, and E. Maydew. 1999. Debt-equity hybrid securities. *Journal of Accounting Research* 37: 249–274.

Erickson, M., M. Hanlon, and E. Maydew. 2004. How much will firms pay for earnings that do not exist? Evidence of taxes paid on allegedly fraudulent earnings. *The Accounting Review* 79 (2): 387–408.

Ernst & Young. 2011. 2011–2012 Tax risk and controversy survey: A new era of global risk and uncertainty. New York, NY: E&Y.

Frank, M. L., Lynch, and S. Rego. 2009. Tax reporting aggressiveness and its relation to aggressive financial reporting. *The Accounting Review* 84: 467–496.

Gallemore, J., E. L. Maydew, and J. R. Thornock. 2014. The reputational costs of tax avoidance. *Contemporary Accounting Research* (forthcoming).

Graham, J., and C. Harvey. 2001. The theory and practice of corporate finance: Evidence from the field. *Journal of Financial Economics* 60: 187–243.

Graham, J., M. Hanlon, and T. Shevlin. 2010. Barriers to mobility: The lockout effect of U.S. taxation of worldwide corporate profits. *National Tax Journal* 63: 1111–1144.

Graham, J., M. Hanlon, and T Shevlin. 2011. Real effects of accounting rules: Evidence from multinational firms' investment location and profit repatriation decisions. *Journal of Accounting Research* 49: 137–185.

Graham, J. R., C. Harvey, and S. Rajgopal. 2005. The economic implications of corporate financial reporting. *Journal of Accounting and Economics* 40: 3–73.

Guenther, D. 1994. Earnings management in response to corporate tax rate changes: Evidence from the 1986 Tax Reform Act. *The Accounting Review* 69 (1): 230–243.

Hanlon, M. 2012. Testimony before the U.S. House of Representatives Committee on Ways and Means. (February 8). Washington, DC: Government Printing Office.

Hanlon, M., and S. Heitzman. 2010. A review of tax research. *Journal of Accounting and Economics* 50: 127–178.

Hanlon, M., L. Mills, and J. Slemrod. 2007. An empirical examination of corporate tax noncompliance. In: A. Auerbach, J. Hines, and J. Slemrod, In, *Taxing Corporate Income in the 21st Century*, New York, NY: Cambridge University Press.

Hanlon, M., and J. Slemrod. 2009. What does tax aggressiveness signal? Evidence from stock price reactions to news about tax shelter involvement. *Journal of Public Economics* 93 (February): 126–141.

Hoopes, J. L., D. Mescall, and J. Pittman. 2012. Do IRS audits deter corporate tax avoidance? *The Accounting Review* 87: 1603–1639.

Kocieniewski, D. 2011. G.E.'s strategies let it avoid taxes altogether. *The New York Times* (March 24).

Larsen, R. G., R. D. Beran, R. D'Avino, and W. D. Hawkins. 2007. Session 5: Developing a global corporate tax risk strategy. *Taxes—The Tax Magazine* (June): 83–94.

Lisowsky, P. 2010. Seeking shelter: Empirically modeling tax shelters using financial statement information. *The Accounting Review* 85 (5): 1693–1720.

Matsunaga, S., T. Shevlin, and D. Shores. 1992. Disqualifying dispositions of incentive stock options: Tax benefits versus financial reporting costs. *Journal of Accounting Research* 30 (Supplement): 37–76.

Maydew, E. 1997. Tax-induced earnings management by firms with net operating losses. *Journal of Accounting Research* 35 (1): 83–96.

McGill, G., and E. Outslay. 2004. Lost in translation: Detecting tax shelter activity in financial statements. *National Tax Journal* 57 (3): 739–756.

McIntyre, R., M. Gardner, R. Wilkins, and R. Phillips. 2011. *Corporate Taxpayers and Corporate Tax Dodgers 2008–10*. A Joint Project of Citizens for Tax Justice & The Institute on Taxation and Economic Policy. Available at: http://www.ctj.org/corporatetaxdodgers/CorporateTax DodgersReport.pdf

Mills, L. 1996. Corporate tax compliance and financial reporting. *National Tax Journal* 49 (3): 421–435.

Mills, L. 1998. Book-tax differences and Internal Revenue Service adjustments. *Journal of Accounting Research* 36 (2): 343–356.

Mills, L., S. Nutter, and C. Schwab. 2013. The effect of political sensitivity and bargaining power on taxes: Evidence from federal contractors. *The Accounting Review* 88 (3): 977–1005.

Mills, L., and R. Sansing. 2000. Strategic tax and financial reporting decisions: Theory and evidence. *Contemporary Accounting Research* 17 (Spring): 85–106.

Murray, Alan. 2002. Inflated profits in corporate books is half the story. *Wall Street Journal* (July 2): A4.

Rego, S., and R. Wilson. 2012. Equity risk incentives and corporate tax aggressiveness. *Journal of Accounting Research* 50: 775–810.

Robinson, J., S. Sikes, and C. Weaver. 2010. Performance measurement of corporate tax departments. *The Accounting Review* 85: 1035–1064.

Scholes, M., P. Wilson, and M. Wolfson. 1992. Firms' responses to anticipated reductions in tax rates: The Tax Reform Act of 1986. *Journal of Accounting Research* 30: 161–187.

Scholes, M., M. Wolfson, M. Erickson, M. Hanlon, E. Maydew, and T. Shevlin. 2014. *Taxes and Business Strategy: A Planning Approach*. Fifth edition. Englewood Cliffs, NJ: Pearson.

Shackelford, D., and T. Shevlin. 2001. Empirical research in accounting. *Journal of Accounting and Economics* 31: 321–387.

Shackelford, D., J. Slemrod, and J. Sallee. 2011. *A Unifying Model of How the Tax System and Accounting Rules Affect Corporate Behavior*. Working paper, University of Michigan.

Slemrod, J., and M. Blumenthal. 1996. The income tax compliance cost of big business. *Public Finance Quarterly* (October) 24: 411–438.

Slemrod, J., and V. Venkatesh. 2002. The income tax compliance cost of large and midsize businesses. A report to the IRS LMSB Division. Available at: http://www.bus.umich.edu/otpr/WP2004-4.pdf

Trahan, E. A., and L. J. Gitman. 1995. Bridging the theory-practice gap in corporate finance: A survey of chief financial officers. *Quarterly Review of Economics and Finance* 35 (Spring): 73–87.

Zimmerman, J. 1983.Taxes and firm size. *Journal of Accounting and Economics* 5: 119–149.

APPENDIX A

Variable Definitions

Variable	Definition
3-Yr Cash ETR	*3-Yr Cash ETR* is computed as the ratio of the sum of the cash ETR numerator for the preceding three years and sum of cash ETR denominator for the preceding three years, where Cash ETR is the cash effective tax rate defined as the sum of total tax paid (data TXPD) divided by pretax income (data PI).
|Abnormal Accruals|	*Abnormal Accruals* is computed using the modified Jones model (Jones 1991; Dechow et al. 1995). Specifically, we use absolute value of the residuals from the industry-year-level regressions of total accruals on the difference between the change in sales and the change in receivables, total property plant, and equipment, and the inverse of total assets. We require a minimum of 20 observations in each industry-year pool in order to estimate the regression. In other words, we estimate the following regression at the industry-year level: $TA_{it} = \beta_0 + \beta_1 ATINV_{it} + \beta_2 DREVMINDDRECT_{it} + \beta_3 PPE_{it} + \varepsilon_{it}$ where: $TA_{it} = (IB_{it} - OANCF_{it})/AT_{it-1}$; $PPE_{it} = PPEGT_{it}/AT_{it-1}$; $ATINV_{it} = 1/AT_{it}$; and $DREVMINDDRECT_{it} = [(SALE_{it} - SALE_{it-1}) - (RECT_{it} - RECT_{it-1})]/AT_{it-1}$. We recover the residual and take the absolute value, such that Discretionary Accruals $= \|\varepsilon_{it}\|$. The above variables are defined in terms of Compustat data items.
Advertising Intensity	*Advertising Intensity* is the ratio of advertising expense (data XAD) scaled by total assets (data AT). Missing advertising expense data are coded as 0.
Altman's Z-score	*Altman's Z-score* is the bankruptcy score from Altman (1968, 2000). In terms of Compustat data items it equals: $1.2 \times [ACT - LCT]/AT + 1.4 \times RE/AT + 3.3 \times EBIT/AT + 0.6[PRCC\_F \times CSHO]/LT + 0.999 \times SALE/AT$.
Analyst Following	The number of analysts following a firm in I/B/E/S. We assume that analyst following is 0 for public firms not covered by I/B/E/S.
Assets	*Assets* is defined as worldwide assets and corresponds with Compustat data item AT.
Asset Growth	*Asset Growth* is the changes in total assets scaled by lag total assets (data AT).
Cash ETR	*Cash ETR* is the cash effective tax rate defined as the sum of total tax paid (data TXPD) divided by pretax income (data PI).
DTAX	*DTAX* is an estimate of discretionary permanent book tax differences computed following Frank et al. (2009). *DTAX* is computed as the residual from the following equation estimated at the industry-year level with at least 20 observations: $PERMDIFF = \beta_0 + \beta_1 INTANGIBLES + \beta_2 UNCON + \beta_3 MI + \beta_4 CSTE + \beta_5 \Delta NOL + \beta_6 LAG\ PERMDIFF + \varepsilon_{it}$ where: $PERMDIFF = (PI - (TXFED + TXFO)/0.35 - TXDI/0.35)/LAG\ AT$; $INTANGIBLES = INTAN/LAG\ AT$; $UNCON = ESUB/LAG\ AT$;

(continued on next page)

APPENDIX A (continued)

Variable	Definition
	$MI = MII/LAG\,AT$; $CSTE = TXS/LAG\,AT$; $\Delta NOL = (TLCF - LAG\_TLCF)/LAG\,AT$. The above variables are defined in terms of Compustat data items.
Firm Size	*Firm Size* is defined as the book value of worldwide assets (data AT).
Foreign Assets	*Foreign Assets* is proportion of foreign assets over total assets.
Foreign Income	*Foreign Income* is foreign pre-tax income (data PIFO) divided by total assets (data AT).
GAAP ETR	*GAAP ETR* is the GAAP effective tax rate defined as total tax expense (data TXT) divided by pretax accounting income (data PI).
Institutional Ownership (%)	The percentage of the firm's equity held by institutional investors in year *t*. Calculated from data provided in the Thomson-Reuter's Institutional Holdings (13F) Database. Set equal to 0 if the data are missing.
Leverage	*Leverage* is the ratio of long-term debt (data DLTT) plus the debt included in current liabilities (data DLC) to total assets (data AT).
MB	*MB* is the market-to-book ratio (MVE/data CEQ).
MVE	*MVE* is the market value of equity (data PRCC_F multiplied by data CSHO).
NOL	*NOL* is an indicator variable that equals 1 if the firm has a positive tax loss carry-forward (TLCF) on Compustat.
PPE	*PPE* is defined as the book value of gross property, plant, and equipment scaled by total assets (data PPEGT/AT).
P(Tax Shelter)	The likelihood that a firm is participating in a tax shelter in a given year computed using the methodology in Lisowsky (2010). We obtain these data from Pete Lisowsky.
Public	*Public* is an indicator variable that takes on the value of 1 for publicly traded firms.
R&D Intensity	*R&D Intensity* is the ratio of research and development expense (data XRD) scaled by total assets (data AT). Missing R&D data are coded as 0.
Retail Industry	An indicator variable that takes on the value of 1 if the firm is the retail industry (based on two-digit SIC codes between 52 and 59), and 0 otherwise.
ROA	*ROA* is return-on-assets defined as net income (data NI) divided by total assets (data AT).
Sales	*Sales* is defined as worldwide net sales and corresponds to Compustat data item SALE.
Sales Growth	*Sales Growth* is the changes in sales scaled by lag sales (data SALE).
US NOL	*US NOL* is an indicator variable that equals 1 if the firm has a U.S. net operating loss carryforward (from survey responses).

Appendix A provides a detailed description of the procedure used to compute each variable used in our analyses. Our data are obtained either through survey questions, Compustat (year 2006), I/B/E/S, or Thomson Reuters. All continuous variables are winsorized at 1 percent and 99 percent of the distribution and all dollar amounts are in millions. The variables are listed in alphabetical order.

APPENDIX B

Tax Survey: http://dx.doi.org/10.2308/accr-50678.s1

GE and Taxes: http://dx.doi.org/10.2308/accr-50678.s2