

An investigation on Impact of Institutional ownership and company proprietorship on Tax Aggressive Policy

Moradi Mahdi¹ and Kazemzadeh Fariba²

¹Associate Professor of Accounting, Ferdowsi University of Mashhad, Mashhad Iran

²Department of Accounting, Shirvan Branch, Islamic Azad University, Shirvan, Iran

Abstract: This study was evaluating the impact of institutional possession and company possession on tax aggressive policy structure in corporations listed Iranian capital stock market. Sample of the analysis was consisting of 90 corporations throughout 2007 and 2010. Moreover, method for testing the analysis hypothesis was “Logistic Regression Analysis.” Findings showed that important relationship exists between tax statuses of the company with tax aggressive policy of company and additionally there wasn't important relationship between corporate possession and tax aggressive policy.

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Introduction:

Taxes are natural resources of financing government and cost of companies. Therefore, we need suitable policies by management in order to reduce taxes with regard to their present value are important. Incentive of companies for smoothing earnings is minimized amount of tax. Since, higher profits lead to higher taxes and following it can withdrawal of liquidity. Thus, it will be an incentive for companies and their managers in order to minimize taxes all of revenue and cost will be managed by the managers. Along with separation of ownership and management, the managers manage the company as agent of owners (shareholders). With regard to the formation of the agency conflict will increase in other words managers do possible opportunistic behavior and make decisions against benefits of shareholders. Designed actions by management can reduce tax and decrease costs and rise benefits of directors, shareholders and public significantly. Consequently, benefits of tax aggressive policy outweigh the costs of tax and punishment policies. The aim of this study was evaluating the impact of institutional possession and company possession on tax aggressive policy structure in corporations listed Iranian capital stock market.

Literature Review:

A potential source of differences between accounting earnings and taxable income, at least a suspected source, is “aggressive” reporting for book or tax purposes with firms reporting high income to shareholders and/or low income to taxing authorities (Hanlon and Heitzman 2010). While recent research documents evidence consistent with book – tax differences containing information about pre-tax

earnings quality (Hanlon 2005; Weber 2009; Lev and Nissim 2004), differences between book and taxable income can also be construed as signals of corporate tax avoidance. Mills (1998) finds that the magnitude of IRS proposed adjustments is positively related to the excess of book income over taxable income. Donohoe and McGill (2011) find investors believe ex ante the substantial increase in book-tax difference disclosures will increase future tax burdens.

While the traditional theory of corporate tax avoidance suggests shareholder value increases with tax avoidance activities (Graham and Tucker 2006), an agency theory perspective is corporate tax avoidance increases the opportunities for managerial rent extraction (Desai and Dharmapala 2009). According to this alternative view, complex tax avoidance activities can create a shield for managerial opportunism and the diversion of rents. Consistent with the agency perspective, Dhaliwal et al. (2011) find a negative relationship between tax aggressiveness and firm cash holdings but only for firms with weak corporate governance structures. Desai and Dharmapala (2009) finds a positive relationship between tax avoidance and firm value but only for firms with strong corporate monitoring.

A measure of persistent tax aggressiveness based on the ability to pay a low amount of cash taxes per dollar of pre-tax earnings over long time periods is the long-term cash effective tax rate (CETR) (Dyreng et al. 2010). This measure captures both permanent and temporary differences and is beneficial because it bypasses tax accrual effects present in the current tax expense (Chen et al. 2010). Further it avoids year-to-year volatility in annual effective tax rates (Hanlon and Heitzman 2010). CETR has been used to measure persistent tax aggressiveness in several contexts including tax

shelters (Wilson 2009), family firms vs. non-family firms (Chen et al. 2010), and earnings quality (Ayers et al. 2009).

Closely related to our research question, Khurana and Moser (2009) find the level of short term institutional ownership predicts greater tax aggressiveness using the five year cash effective tax rate (Dyreng et al. 2008) and total permanent differences (Rego and Wilson 2008).

Institutional ownership has an important effect on tax reporting, it is also reasonable to expect institutional investors choose to invest in firms based on their tax reporting strategies (Desai et al. 2007; Cronqvist and Fahlenbrach 2009). To address this causality issue, we include lead-lag analysis to determine Granger causality (Granger 1969) and changes specification and find evidence of simultaneous causality. We find all clusters of institutional investors are more likely to invest in firms that tilt toward low cash tax rates, however in the presence of transient institutional shareholders corporate managers appear to engage in further tax avoidance.

Our paper is closely related to contemporaneous research by Khurana and Moser (2009) (hereafter KM). Differences between our paper and KM emerge from our objectives to find what sources of tax aggressiveness are associated with institutional ownership. Our study complements KM findings that short term institutional investment is associated with firms that display relatively more tax aggressiveness.

Khurana and Moser (2009) find that firms with higher levels of long-term institutional ownership are less tax aggressive because institutional owners are more concerned with long-term consequences of aggressive tax strategy. In contrast, higher levels of short-term institutional ownership lead to more tax aggressive as they focus on more short-term profits making. Chen et al. (2010) find that family firms are less tax aggressive. They argue that family owners with high shareholdings can enjoy more benefits from tax savings.

Since, importance of tax is one of the most important costs of companies and it will lead to withdrawal liquidity and decrease earnings of shareholders. Therefore, tax always is considered by shareholders, executive managers and CEO and tax policy (audacious or conservative) are missions which pay attention with managers and share holders. Stock market always has positive legal breaks. Therefore, these policies can be paid attention base on agency cost and agency theory (Chen, Cheng and T. Shevlin 2010).

In agency relationship, aim of owners is maximizing wealth and for achieving this purpose must be monitored and evaluated actions of agent.

Therefore, there is a question “do difference of ownership structure has impact on performance?” in other words, if owners of company consists of different groups like government, financial institution, banks and others will have impact on performance? According to answers of the questions, we can do suitable actions and decision makers pay attention more to combination of ownership in order to optimal performance. Hence, investigation of relationship between corporate ownership and performance of company in order to evaluate better and more accurate tax policies is essential. Tax aggressive actions sometimes as a reduction of taxable income through tax planning that can be legal or illegal. Chen *et al* (2010), showed that in corporations tax aggressive activities are not only tax savings also it possible that any kind of cost to expose.

Frank *et al* (2009), believed that the positive relationship exists between audacious financial reporting and tax aggressive policy which was included decline earnings management of taxable income and increase booked earnings management. The amount of tax aggressive policy depends on fraud in accounting. Tax aggressive policy is related to this probability which company by removing corporate governance or other actions do determine and manipulation of company's accounts (Lennux *et al*, 2012).

Dyreng, Hanlon and Maydew (2008), developed a new measure for managing and long-term management and administration of tax manipulating which is based on ability of companies in the payments of taxes per dollar in cash profit after tax and interest in long-term. This measure called effective long term cash tax rate. They found effective annual cash tax rate is not capable prediction of effective long term cash tax rate and therefore it is not a good agent of long-term tax trick. Some evidence present of the persistence and stability of annual cash tax rate. Low rate of annual effective cash tax rate are considerable more stable than high rate of annual effective cash tax rate. Chen, Cheng and T. Shevlin (2010), in this study, do Joint stock companies have more tax aggressive policy compare with non-joint stock companies? The results found that taxes represent significant costs for businesses and stakeholders and generally expected that shareholders use tax aggressive policy. Joint stock companies use more tax aggressive policy in comparison non joint stock companies. Joint stock companies owners tend to use tax advantages as result of ignoring nontax cost which originated from potential discount that could be covered by rent. Owners of joint stock companies are more worry about penalties and loss of reputation originated from

the audit of financial reporting standards. Steijver and Niskanen (2011), studied the impact of governance and ownership of senior executives (CEO) on decisions and behavior based on tax aggressive policy in private corporations. The data of 600 small and medium joint and non joint companies collected in during 2000 and 2005. The paper concluded that joint stock private companies compare with non joint stock private companies have tax aggressive policy. Furthermore, the results indicate that joint stock companies which their managers have less ownership more tend to tax aggressive policy. Finally, the result shows that a external manger in among executive managers leads to improve controlling effectiveness. Lanis and Richardson (2011), investigated impact of in their study board composition on tax aggressive policy. Logic regression results for the sample of 32 companies, including 16 companies with audacious tax policy and 16 companies without tax aggressive policy shows that high share of external members in managers board will reduce chance of reducing and audacious behavior. Least squares regression indicate that analysis sensitivity of 401 companies confirm the main results of board composition and audacious behavior. Garbarino (2008), studied a research on effects of tax aggressive policy on strategy of organizations through accept of agent vision and discussed about how and limiting audacious actions of managers. It also can be used to represent a range of views on issues of importance to consider the following issues: why and how much managers need follow audacious tax strategies and why these strategies are used in large companies whether these strategies can improve shareholder value and how can be measured about amount of saving. Concluded that the tax courageous behavior management techniques that are required to have a length of inner balance, and escape trick against the traditional rules of limiting the tax administration and the company's financial methods need to be using tools. Lanis and Richardson (2011), investigated the relationship between tax aggressiveness and social responsibility of companies based on a sample of 408 companies in during 2008 and 2009 in Australia; the regression results show a negative relationship between aggression and social responsibility of corporate.

Methodology:

The study included companies listed in Tehran Stock Exchange and following conditions (criteria) must be considered in the sample:

- 1) The companies should be listed before (2007)
- 2) Date financial firms should lead to the end of March each year.
- 3) The companies should be activated during (2007) to 2010.

- 4) The companies should not change their financial periods.
- 5) The companies' availability of information is required.

This research seeks to influence of institutional ownership and corporate ownership on tax aggressive policy.

In order to answer the following hypotheses were formulated:

H₁: Significant relationship exist ratio of tax aggressive policy and ratio of ownership concentration.

H₂: Significant relationship exists between corporate ownership and tax aggressive policy

H₃: Significant relationship exists between tax statuses in prior years and ratio of tax aggressive policy

H₄: Significant relationship exists between tax statuses, corporate ownership and ratio of ownership concentration

Process variables and hypothesis testing

►Independent variable:

1- Corporate Ownership:

Based on public rule of companies, if companies which over 50% of their share is belong to direct and indirect government they will be governmental companies and they are range of [0, 1]

2- Rate of ownership concentration:

For institutional investors can use this index as an alternative method to compute this ranking for each company based on the formula "Hrfindal - Hershman" which is defined as follows:

This index increased based on rate of concentration and if whole of the share belongs to one person, maximum value will be calculated as much as 10000 units. While, structure of ownership is and all of shareholders have equal share and also HHI index will have the lowest value and it will be calculated equivalent of 1000/N:

$$HHI = \sum (p_i / p \times 100)^2$$

3- Corporate Tax status:

If tax of two previous years and the prior year will be 1 and 0 otherwise.

► Dependent variable:

Audacious tax policy:

If auditing report contains the clause of tax, the company will have tax aggressive policy and use number 1 and use number 0 otherwise.

According to the theoretical foundations and other external research, relationships between variables regression of the model to test the research hypotheses are defined as follows:

$$\text{TaxAgg}_{it} = \alpha + \beta_1 \text{Type}_{it} + \beta_2 \text{HHI}_{it} + \beta_3 \text{tax}_{i,t} + \epsilon_{it}$$

Type= corporate ownership
 HHI= rate of corporate ownership concentration
 TaxAgg = Tax aggressive policy
 Tax = Tax Status of Companies
 ε_{it} = The remainder (error)
 Dependent variable in a logistic regression, the likelihood function is discussed as follows:

$$\ln\left(\frac{Pi}{1 - Pi}\right) = \beta_0 + \beta_1 x_i$$

Hypotheses test:

Hypothesis 1: A significant relationship exists between companies tax status and tax aggressive policy.

Table 1: Summary of model for the first hypothesis

Sig.	χ^2	Cox & Snell R Square	Nagelkerke R Square
.0170	5.678	.570	.770

In the above table, the χ^2 statistic and its significance level indicate that independent variable has effect on the dependent variable. Therefore companies' tax status has a significant effect on the tax aggressive policy. Furthermore, in logistic regression, at least 5.7 and at most 7.7 (approximately the lower and upper bounds) percent of variability of the tax aggressive policy variable is accounted for by companies tax status.

Table 2: Result of logistic regression

	B	S.E.	Wald	Df	Sig
Tax status	-1.012	.4330	5.462	1	.0190
Constant	.3180	.2680	1.409	1	.2350

Considering Wald statistic and the significance level of the independent variable, with the confidence of the 95 % there exists a significant relationship between companies tax status and tax aggressive policy.

Hypothesis 2: A significant relationship exists between type of companies ownership and tax aggressive policy.

Table 3: Summary of model for the second hypothesis

Sig.	χ^2	Cox & Snell R Square	Nagelkerke R Square
.635	.226	.002	.003

As the χ^2 statistic is equal to .226 and its significance level (.635) is more than .05, the independent variable (type of companies ownership) doesn't have a significant effect on the dependent variable (tax aggressive policy). In addition, Cox & Snell and Nagelkerke R squares show that at least .2 and at most .3 percent of variability of the tax aggressive policy variable is accounted for by type of companies' ownership.

Table 4: Result of logistic regression

	B	S.E.	Wald	Df	Sig
Type of ownership	.221	.466	.225	1	.635
Constant	-.141	.238	.352	1	.553

Considering Wald statistic and the significance level of the independent variable, with the confidence of the 95 % , the model is not significant. Therefore, there is not a significant relationship between type of ownership and tax aggressive policy.

Hypothesis 3: A significant relationship exists between rank of corporate ownership concentration and tax aggressive policy.

Table 5: Summary of model for the third hypothesis

Sig.	χ^2	Cox & Snell R Square	Nagelkerke R Square
.061	3.513	.036	.048

As the χ^2 statistic is equal to 3.513 and its significance level (.061) is more than .05, the independent variable (rank of corporate ownership concentration) doesn't have a significant effect on the dependent variable (tax aggressive policy). Furthermore, Cox & Snell and Nagelkerke R squares in logistic regression shows that at least 3.6 and at most 4.8 percent of variability of the tax aggressive policy variable is accounted for by rank of corporate ownership concentration.

Table 6: Result of logistic regression

	B	S.E.	Wald	Df	Sig
rank of corporate ownership concentration	.000	.000	3.301	1	.069
Constant	-.738	.414	3.182	1	.074

Considering Wald statistic (3.301) and the significance level of the independent variable (.069), with the confidence of the 95 %, the model is not significant. Therefore, there is not a significant relationship between rank of corporate ownership concentration and tax aggressive policy.

Hypothesis 4: A significant relationship exists between companies' tax status, type of ownership, rank of corporate ownership concentration and tax aggressive policy.

Table 7: Summary of model for the first hypothesis

Sig.	χ^2	Cox & Snell R Square	Nagelkerke R Square
0.047	7.963	.080	.106

In the above table, the χ^2 statistic (7.963) and its significance level (.047) indicate that independent variables have effect on the dependent variable (tax aggressive policy). Furthermore, in logistic regression, at least .106 and at most .080 percent of variability of the tax aggressive policy variable is accounted for by companies' tax status, type of

ownership, rank of corporate ownership concentration.

Table 8: Result of logistic regression

Variable	B	S.E.	Wald	Df	Sig
Tax status	-.915	.441	4.308	1	.038
Type of ownership	.107	.493	.048	1	.827
rank of corporate ownership concentration	.000	.000	1.984	1	.159
Constant	-.276	.478	.334	1	.564

Considering Wald statistic and the significance level of the independent variables, only tax status variable with Wald statistic of .038 and significance level of .038, has a significant and negative relationship with tax aggressive policy while type of ownership and rank of corporate ownership concentration variables do not have a significant relationship with dependent variable. The negative coefficient of tax status variable showed that these companies have tax aggressive policies.

Conclusion:

In this paper, we investigate the relation of institutional ownership with tax aggressive. As Chen et al. (2010) point out that while tax aggressiveness leads to tax savings, it also exposes a firm to potential penalties imposed by the IRS, to implementation costs, and to agency costs. Therefore, it remains an empirical question whether greater institutional ownership affects tax aggressiveness.

Overall, our paper adds to the recent research on what factors contribute to tax aggressiveness. For example, Badertscher et al. (2009) finds that private firms are generally more tax aggressive than public firms and private firms that are majority-owned by private equity firms exhibit more tax aggressiveness than other privately-held companies. In contrast, Chen et al. (2010) find that family firms are generally less tax aggressive than non-family firms. However, prior research has not examined the influence of institutional ownership on the tax aggressiveness of firms. We attempt to fill this gap in the literature by examining the impact of institutional ownership and

the horizon of institutional owners on tax aggressiveness.

As noted previously, prior research examining the effect of institutional ownership on firm behavior provides mixed empirical evidence. On the one hand, institutional shareholders may effectively monitor and discipline managers to ensure that they maximize long-term value by discouraging tax aggressive behavior. Supporting this view, Bushee (1998) finds that large stockholdings of institutional shareholders prevent managers from reducing research and development expenditures in quarters when the firm fails to meet short-term earnings goals. In addition. Moreover, recent research points to the tax aggressive activities of firms owned by institutional owners. For example, Badertscher et al. (2009) find that firms with substantial private equity ownership engage in significantly greater tax aggressive behavior than non-private equity firms. Thus, there are conflicting predictions on how institutional ownership can affect tax aggressiveness.

As result of this research investigated impact of corporate ownership (governmental, private and institutional ownership) on tax aggressive policy. Thus, in the present study had compared with local and international researches.

In according to the first hypothesis is approved. In other words, prior tax status had impact on tax aggressive policy it can be concluded that if companies had increased tax in prior years, managers and owners by reducing and rising costs, would have declined tax. The result of this research is consistent with researches of Freise *et al* (2008) and Desai and Dharmapala (2006).

Corporate ownership and composition of shareholders is a controlling tool and corporate governance and cost of tax is always important for executive managers and also shareholders of companies. Therefore, audacious tax policy is one of missions which are done by shareholders for evaluating managers' action. Hence, this policy is important based on agency cost and agency theory. If tax aggressive policy is not beneficial for shareholders, it can be harmful and have negative impact on stock exchange market. The result indicates that corporate ownership had impact on agency theory; therefore significant relationship exists between corporate ownership and tax aggressive policy. However, based on this study this relationship is significant. Results of this study is consist of Steijver and Niskanen (2011), Chen *et al* (2010), Fama and Jensen (1983).

Further more, research in Czech Republic show that high rate of concentration on ownership along with higher performance and more control on managers can improve performance of companies.

Hence, if managers use tax policies which are beneficial for owners, we have significant relationship between rate of concentration and tax aggressive policy. As result of the first study is approved and in according to correlation in the second and third were rejected. Rejection of hypotheses had not impact on fourth hypothesis can approve fourth hypothesis. Results of research is consistent with Steijver and Mervi (2011), Chen, Cheng and Shevlin, (2010), Fama and Jensen (1983) Balsam and Marquardt (2000).

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