Session One:

Compliance of Large Business Entities

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An Examination of FIN 48: Tax Shelters, Auditor Independence, and Corporate Governance

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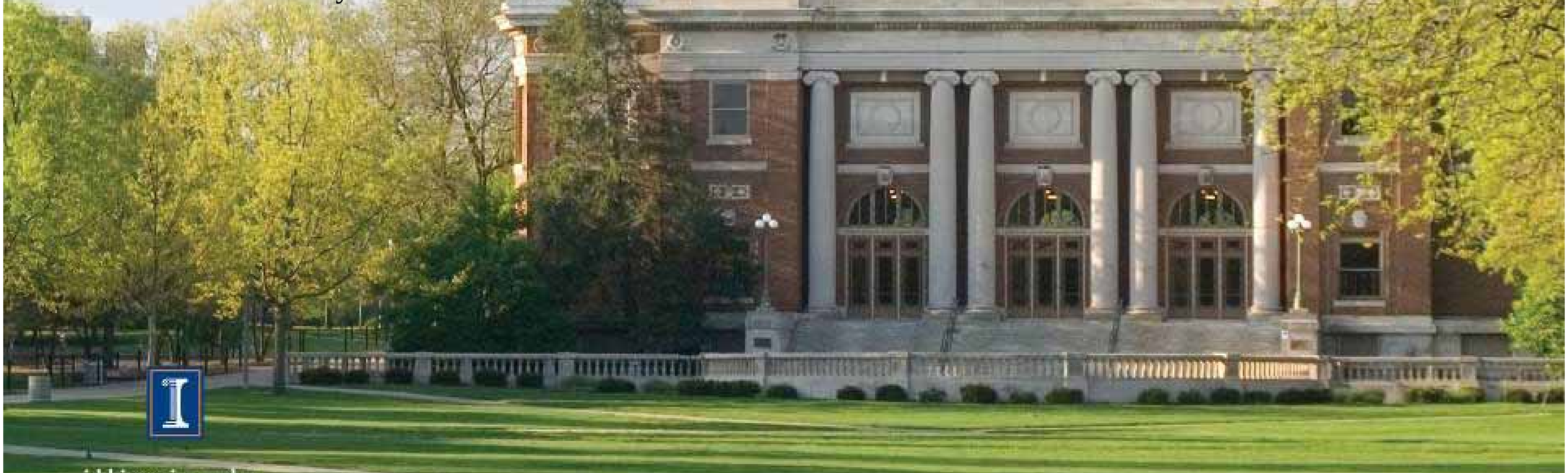

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Disclaimer

Confidential tax return data are obtained from the IRS via LMSB-RWI and OTSA. These data are not publicly available.

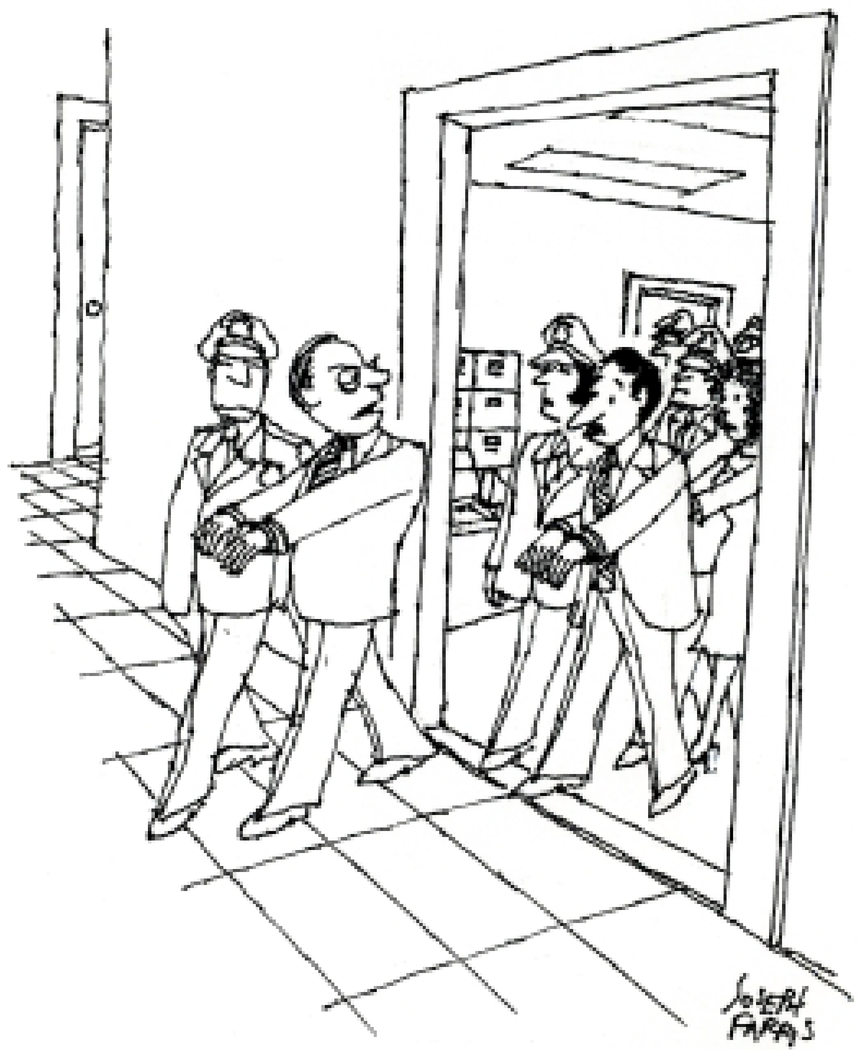
Because tax return data are confidential and protected by data non-disclosure agreements under the Internal Revenue Code, all statistics are presented in the aggregate; no statistics with three or fewer observations are disclosed.

Any opinions are those of the authors and do not necessarily reflect the views of the Internal Revenue Service.

Overview

- Do FIN 48 reserves reflect tax sheltering activities?
- Does firm monitoring affect on the informativeness of the reserve with respect to tax shelters?
- Link FYE 2007 DFIN 48 reserves (CY positions) to contemporaneous tax shelter activity.
- DFIN 48 reserves (CY) reflect tax shelters, but:
  - More so for important audit clients. Audit firms' independence of their clients is high.
  - Corporate governance does not play a mediating role.

Motivation



"Whose idea was it that we give full disclosure?"

Motivation

- Identifying tax aggressiveness proxies has broad implications for researchers, investors, lenders, analysts.
- Song and Tucker (2008, 11)
  "[B]ecause of the manner in which the language of FIN 48 is crafted it is almost certainly the case that the non [tax] sheltering component of the reserve is relatively small."
  "[T]he FIN 48 liability is a better, more explicit proxy for tax sheltering activity than [book-tax differences]."
- Hanlon and Heitzman (2009, 95)
  - "Even the unrecognized tax benefits disclosed under FIN 48 is not the panacea because this account is also affected by financial reporting incentives."

Motivation

- Monitoring in a tax setting
  - Mitigates managerial rent extraction when aggressive tax positions are taken (Desai and Dharmapala 2006).
  - Focus has been on corporate governance
  - What about the financial reporting of an aggressive tax position? Auditor too can play a role in improved reporting.
- Given the incentives to misappropriate and misreport tax shelters, under what monitoring regimes is the FIN 48 reserve more or less informative of tax shelters?

Contribution

- Empirically test & validate DFIN48 Reserve (CY) as a reasonable measure for tax aggressiveness.
- Examine role of internal *and* external monitoring on the reporting of tax shelter benefits.
- Specify conditions under which DFIN48 Reserve (CY) is more/less informative of tax sheltering:
  - Increasing auditor client importance improves accrual.
  - Accrual quality is not affected by corporate governance.
  - Future work should consider auditor role.

Hypotheses

- H_1 (null): FIN 48 reserves do not reflect tax sheltering activities.
- Tension:
  - Positive Association: FIN 48 compliance; Statement on Standards for Tax Services.
  - Negative (or No) Association: Fear of providing a "roadmap" to IRS; Financial reporting aggressiveness.

Example

Assume tax liability is $500 *before* considering the current year uncertain tax position generating $100 in tax benefits.

Non-shelter Position		Shelter Position		Shelter Position	
Dr. Tax Expense	400	Dr. Tax Expense	400	Dr. Tax Expense	400
Cr. Cash	400	Cr. Cash	400	Cr. Cash	400
Dr. Tax Expense	50	Dr. Tax Expense	60	Dr. Tax Expense	40
Cr. UTB	50	Cr. UTB	60	Cr. UTB	40

Proper Accrual	Proper Accrual (+)	Under Accrual (-)
Benchmark Case	**Tax Aggressiveness**	**Tax & Financial Aggressiveness**

Hypotheses

- H_2 (null): The degree to which tax shelter activity is reflected in the FIN 48 tax reserve is not affected by auditor client importance (H2a) or corporate governance (H2b).
  - What is the role of monitoring on the accrual quality of the reserve to reflect tax shelters?

Hypotheses

- Auditor Client Importance
  - Auditor independence impaired due to client bonding?
  - If stronger link between FIN 48 reserve and tax shelters, cost of audit failure is high, infer high independence.
- Corporate Governance
  - What are incentives to report tax shelters in FIN 48 reserve, given the proprietary costs of disclosure?
  - Well-governed firms: managers not stealing, better s/h oversight = more informative disclosures?

Research Design

- H1: DReserveCY = f(TaxShelterCY, Controls)

0 / 1 $

Reportable
(Listed, Non-Listed)

$M3TotalBTD,
$M3PermBTD

- H2: DReserveCY = f(TaxShelterCY, Monitoring, Interaction, Controls)

H2a: Client
Importance

H2b: Good
Governance

Dependent Variable: DReserveCY

FIN 48

On July 1, 2007, we adopted the provisions of FIN 48 which had the following impact on our financial statements: increased current assets by $228 million, long-term assets by $1.1 billion, long-term liabilities by $2.1 billion, and retained deficit by $395 million; and decreased income taxes payable by $394 million. As of June 30, 2008, we had $3.2 billion of unrecognized tax benefits of which $2.3 billion, if recognized, would affect our effective tax rate. As of July 1, 2007, we had $7.1 billion of unrecognized tax benefits of which $5.3 billion, if recognized, would affect our effective tax rate. Our policy is to include interest and penalties related to unrecognized tax benefits in income tax expense. Interest totaled $121 million in fiscal year 2008. As of June 30, 2008 and July 1, 2007, we had accrued interest related to uncertain tax positions of $324 million and $863 million, respectively, net of federal income tax benefits, on our balance sheets.

The aggregate changes in the balance of unrecognized tax benefits were as follows:

(In millions)

Year Ended June 30,	**2008**
Balance, beginning of year	**$ 7,076**
Decreases related to settlements	**(4,787)**
Increases for tax positions related to the current year (Δ**ReserveCY**)	**934**
Increases for tax positions related to prior years	**66**
Decreases for tax positions related to prior years	**(80)**
Reductions due to lapsed statute of limitations	**(14)**
Balance, end of year	**$ 3,195**

During fiscal year 2008, we reached a settlement with the Internal Revenue Service (“IRS”) on its 2000-2003 examination. As a result, we reduced our unrecognized tax benefits by $4.8 billion and recognized a tax provision reduction of $1.2 billion. We are under audit by the IRS for the tax years 2004-2006. We do not believe it is reasonably possible that the total amount of unrecognized tax benefits will significantly increase or decrease within the next 12 months as we do not believe the examination will be concluded within the next 12 months. As a result of our settlement related to the 2000-2003 examination, we paid the IRS approximately $3.1 billion during the first quarter of fiscal year 2009.

Controls

- Tax Avoidance
  - ETR (-), CashETR (-), TotalBTD (+), PermBTD (+), and DTAX (+)
- Tax Complexity (+)
  - R&D, M&A, ForeignSales, IntDiff, MinorityInt, EquityEarn.
- Accounting Quality
  - USDefTax (-), LogAssets (+), Newcap (-), Litigious (+), DisclosQual (+) (from Gleason and Mills 2002)
  - DiscAccrual (-), Leverage (-), MTB (+), ROA (+)
  - H2a only: Auditor-Provided Tax Services

Sample Selection	
S&P 1500 Index as of January 1, 2007	1,500
Less: Non calendar year-end firms	(452)
Less: REITs	(42)
Less: Merged/acquired during 2007, no filing	(50)
Less: Unable to match to tax return data	(63)
Less: Negative values for DReserveCY	(13)
Less: Missing data to compute regression variables	(32)
Final Sample as of December 31, 2007 (H1)	848
Auditor Client Importance Tests (H2a)	842
Corporate Governance Tests (H2b)	753

Table 1 Panel B

Tax Shelter Counts (IRS Form 8886)	
Total reportable transactions	951
Number of firms disclosing reportable transactions	101
Mean number of reportable transactions where *Reportable*=1	9
Median number of reportable transactions where *Reportable*=1	1

Tax Shelter Counts (IRS Form 8886)				
		# of Reportable Transactions		
		Total	Mean	Median
# of Firms with 1 Reportable Transactions	51	51	1	1
# of Firms with 2-10 Reportable Transactions	37	141	4	3
# of Firms with >10 Reportable Transactions	13	759	58	26

Table 1 Panel B

Tax Shelter Dollar Values (IRS Schedule M-3)	n	Mean ($M)	Median ($M)	Aggregate ($M)
# of Firms that completed M-3 Part II Line 12	48			
Total BTD generated from tax shelters	42	-92.60	-19.37	-3,889.26
Temporary BTD generated from tax shelters	38	-66.07	-22.76	-2,510.81
Permanent BTD generated from tax shelters	12	-114.87	-10.78	-1.378.45
Effect of tax shelters on pre-tax financial earnings	33	-205.33	-8.84	-6.775.73
Effect of tax shelters on taxable income	48	-222.19	-31.75	-10,664.99

Table 2 Panel B

Panel B: Correlations

	ΔReserveCY		*Reportable*		*Listed*		*Non-listed*		*\$M3TotalBTD*	
ΔReserveCY			0.26	***	0.15	***	0.25	***	0.19	***
Reportable	0.26	***			0.51	***	0.93	***	0.29	***
Listed	0.19	***	0.50	***			0.28	***	0.20	***
Non-listed	0.26	***	0.93	***	0.28	***			0.28	***
\$M3TotalBTD	0.24	***	0.25	***	0.13	***	0.23	***		
\$M3PermBTD	0.15	***	0.15	***	0.01		0.15	***	0.54	***

Table 3: H1 Summary Results

Dependent Var: D ReserveCY Variables of Interest	TaxShelterCY defined as:				
	Reportable	Listed	Non-listed	$M3 TotalBTD	$M3 PermBTD
TaxShelterCY	10.50*	7.21	12.96**	0.51**	7.85
PermBTD	0.02**	0.02**	0.02**	0.02***	0.02**
TaxShelterCY	10.56*	8.20	12.54*	0.39*	6.15
DTAX	0.02*	0.02*	0.02*	0.02*	0.02*
TaxShelterCY	10.85*	9.86	12.62*	0.40*	6.72
ETR	-0.14	-0.24	-0.56	-0.82	0.17
TaxShelterCY	10.61*	10.30	12.29*	0.40**	6.71
CashETR	-0.50	-0.47	-0.81	-0.15	-0.17
TaxShelterCY	11.15*	9.21	13.18*	0.48*	7.93
TotalBTD	0.01	0.01	0.01	0.01	0.01

Table 4: H2a Summary Results

Dependent Var: D ReserveCY Variables of Interest	TaxShelterCY defined as: Reportable	Listed	Non-listed	$M3 TotalBTD	$M3 PermBTD
When TaxAvoid=PermBTD:					
TaxShelterCY	-1.23	-26.78***	-1.38	0.31	-6.24***
ClientImportance	132.74	156.41	143.16	197.49*	256.26**
ClientImportance× TaxShelterCY	**829.46****	**783.71****	**965.90*****	**20.68*****	**857.11*****
		+1s in CI = $25.8M increase in *D ReserveCY*.			
When TaxAvoid=DTAX:					
TaxShelterCY	-0.40	-12.95***	-0.46	0.29	-6.62***
ClientImportance	168.56	200.21*	183.08	271.52**	306.16**
ClientImportance× TaxShelterCY	**873.24****	**835.31***	**992.29****	**13.06****	**719.39*****

Table 5: H2b Summary Results

	TaxShelterCY defined as:				
Dependent Var: D ReserveCY Variables of Interest	Reportable	Listed	Non-listed	\$M3 TotalBTD	\$M3 PermBTD
When TaxAvoid=PermBTD:					
TaxShelterCY	16.48**	17.70	17.71*	0.10	0.58
GoodGov	3.86*	2.64	3.68	0.15	0.90
GoodGov× TaxShelterCY	-10.75	-12.63	-10.79	0.78*	12.09
When TaxAvoid=DTAX:					
TaxShelterCY	16.91*	19.77	18.01	0.04	0.06
GoodGov	4.47**	3.33	4.34*	1.21	1.71
GoodGov× TaxShelterCY	-11.34	-17.29	-11.93	0.61*	9.78

Robustness Checks

- Results qualitatively identical when:
  - *ClientImportance* equals
    - Audit Fees paid by firm / Total Audit Fees of auditor office region
    - Audit Fees paid by firm / Total Audit + Non-Audit Fees of auditor office region
  - *ClientImportance* is centered on the sample mean
  - Use E-Index and O-Index splits (Bebchuk et al 2009) instead of G-Index variations

Thank You!