

Earnings Management and Corporate Tax Shelters

Mihir A. Desai
Harvard University and NBER
mdesai@hbs.edu

Dhammika Dharmapala
University of Connecticut and University of Michigan
dhammika@umich.edu

Abstract

This paper reviews recent evidence analyzing the link between earnings management and corporate tax avoidance. A real-world tax shelter is dissected to illustrate how tax shelter products enable managers to manipulate reported earnings. A stylized example is developed that generalizes this view of corporate tax avoidance and empirical evidence consistent with this view is also discussed. The paper concludes by considering the implications of this view for how shareholders and boards should view managerial efforts to reduce corporate tax obligations.

Keywords: Earnings management; Tax avoidance; Tax shelters
JEL Codes: G30; H25; H26; J33

Earnings Management and Corporate Tax Shelters

I. Introduction

The influence of taxes on corporations has largely been considered within a framework where taxes are involuntary payments that influence financing and investment choices on the margin. Such a framework does not dismiss the role of taxes but views them as inescapable environmental factors that must be weighed against a variety of other factors, such as those emphasized in the Modigliani and Miller (1958) framework for understanding corporate financing decisions. Consequently, most scholarly attention has been focused on how taxes change capital structure, dividend or investment decisions. Is the characterization of corporate taxes as an unavoidable burden consistent with contemporary practice?

Accounts of rising corporate tax avoidance suggest that a pure compliance function no longer characterizes the way corporations and managers consider their corporate tax obligation. U.S. Treasury department officials have characterized corporate tax avoidance as “what may be the most serious compliance issue threatening the American tax system today.” Such assessments typically point to aggregate measures of tax avoidance including measures of the growing difference between income reported to tax authorities and capital markets, declining effective tax rates on public financial statements and the growing share of firms with no tax liability. For example, Yin (2003) reports effective tax rate reductions in the S&P 500 from an average of 28.9% in 1995 to 24.2% in 2000 and GAO (2004) reports that 32.7% of large U.S. corporations reported no tax liability in 1995 and that percentage rose to 45.3% by 2000.

These trends raise a variety of important issues for scholars and practitioners. For scholars, a basic question is: has corporate tax avoidance become more prevalent and if so why? A related set of questions for practitioners can then be addressed: how should shareholders and boards view efforts to reduce corporate tax obligations? Should managers be rewarded for such efforts?

The accounts of rising corporate tax avoidance have led some scholars to reframe these questions in an even more provocative way. Given low levels of detection and penalties, why don't all firms avoid corporate taxes? In other words, why are firms paying taxes at all given the

likelihood that they could reduce tax obligations without suffering significant consequences? This somewhat more cynical set of questions, as posed by Weisbach (2002a), raises even more puzzles about how managers and firms view corporate tax obligations.

This paper attempts to address these questions by reviewing recent research on the prevalence and determinants of corporate tax avoidance. This recent research embeds corporate tax avoidance decisions within an agency framework that emphasizes managerial motivations. In doing so, this research attempts to analyze the determinants of firm heterogeneity in undertaking corporate tax avoidance. Such a research agenda requires defining corporate tax avoidance, devising a measure of corporate tax avoidance, and then analyzing what determines variation in firm choices about tax avoidance. The results point towards a variety of factors that run counter to the typical characterizations of why firms engage in tax avoidance. Specifically, they suggest that opportunistic managers can employ the technologies of tax avoidance to advance their own interests, creating a tension between managers and shareholders on tax avoidance.

Before going any further, it is worth emphasizing that defining corporate tax avoidance is non-trivial. Many scholars suggest that corporate tax avoidance activities – or the use of corporate tax shelters, a largely synonymous term – are most effectively defined by what they are *not*. Many corporate transactions – including the most elemental financing choice of whether to finance oneself with debt rather than equity – have important, but typically secondary, tax consequences. Such decisions are primarily motivated by an underlying business purpose. Thus, even though they may generate tax benefits, they are not typically considered instances of corporate tax avoidance. This intuition for how to define corporate tax avoidance has become established in tax law through the “economic substance,” “business purpose,” and other “anti-avoidance” doctrines (e.g. Weisbach, 2002b). Such doctrines create exceptions to the otherwise applicable tax law in order to deny tax deductions generated by activities that are deemed to be purely or primarily motivated by tax avoidance. As with obscenity, though, the most functional definition of corporate tax avoidance may be a somewhat more facetious one. Michael Graetz has defined tax shelters as transactions that are “done by very smart people that, absent tax considerations, would be very stupid.”

In the following, we begin by discussing how corporate tax avoidance decisions can be embedded within a broader agency framework. In order to clarify the intuition behind this alternative view of corporate tax avoidance, we dissect a real corporate tax shelter and distill its lessons to develop a simple stylized example. These examples illuminate how corporate tax avoidance activities need not advance the interests of shareholders. Then, we outline a method for measuring tax avoidance and discuss large-sample results on the determinants of corporate tax avoidance decisions. These results indicate that corporate tax avoidance decisions are not merely transfers from the state to the shareholders. We conclude with some implications for managers and scholars.

II. Managerial Motivations for Corporate Tax Avoidance

Why do firms engage in tax avoidance? A simple and prevalent view in existing research is that tax shelters represent a means of reducing tax obligations and little more. As such, these investigations frame the use of tax shelters within the literature on non-debt tax shields (as in DeAngelo and Masulis (1980)), as one of many transactions that can reduce taxes. Graham and Tucker (2005), for example, estimate the degree to which tax shelters substitute for debt as a means of reducing tax obligations. This framework, however, ignores the distinctive nature of tax shelters – that they serve no economic purpose other than tax avoidance – and abstracts from any notion of managerial motivation.

A first pass at incorporating managerial motivations into an analysis of corporate tax avoidance suggests that managers with interests more closely aligned with shareholders would behave more like residual claimants and engage in tax avoidance more aggressively to advance the interests of their shareholders. Within this framework, the historic unwillingness of managers to engage in corporate tax avoidance can be explained as a reflection of a principal-agent problem that put a natural brake on corporate tax avoidance, as agents were unwilling to pursue actions that advanced shareholder interests. This intuition has the added benefit of tying together the rise of incentive compensation and increased levels of corporate tax avoidance over the last fifteen years. Essentially, shareholders want managers to avoid taxes and managers, once their incentives are sufficiently aligned, engage in tax avoidance. However, this view does not incorporate the central tension between managers and shareholders – that managers may behave

opportunistically and in a manner that is not in the interests of shareholders. How could this opportunism be related to tax avoidance?

A critical dimension of corporate tax avoidance is the need to engage in actions that obscure the underlying intent of the transaction. Indeed, tax avoidance often demands such obfuscation to guarantee the tax benefits. Such obfuscation, however, can simultaneously provide a shield for managers engaging in a variety of diversionary activities. As such, the technologies of diversion – managers engaging in actions not in the interests of shareholders – and sheltering – managers shielding income from tax authorities – may well be complementary. Specifically, engaging in sheltering may reduce the marginal costs of diverting income. As discussed below, such an interpretation of corporate tax avoidance appears to be consistent with anecdotal and systematic evidence provided in recent research.

Desai and Dharmapala (2005) outline a model where managers can be opportunistic and a variety of such technological complementarities between sheltering and diversion are possible. Several conclusions emerge from this model. First, the relationship between tax avoidance decisions and managerial high-powered incentives is ambiguous and depends on the relationship between the technologies of avoidance and diversion. Specifically, technological complementarities between sheltering and diversion make tax avoidance *less* likely when managerial interests are more closely aligned with shareholder interests. This results stands in contrast to the simple intuition that increased incentive alignment results in more tax avoidance.

The intuition for this contrary result is that more high-powered incentives make managers behave more like shareholders; if the technologies are not complementary, then this will increase avoidance. If, however, avoidance and sheltering are positively related, then an opposing force can overturn this result and increased high-powered incentives can result in reduced sheltering. The second related result from this model is that while the average relationship is ambiguous across firms and a function of this technological relationship, the governance characteristics of firms will mediate this opposing force. Consequently, better-governed firms will have a more positive relationship between high-powered incentives and tax sheltering decisions, regardless of the average relationship between incentives and tax avoidance. These two theoretical results are examined in large sample research described below.

It should be emphasized that in the US context the term “diversion” should be understood broadly. While it is usually defined as the straightforward looting of the firm, any actions benefiting managers that are not in the interests of shareholders can be understood as diversionary. In particular, the examples below focus on the use of earnings management in ways that provide benefits on managers and that do not benefit shareholders.

III. Examples of Tax Avoidance

Prior to turning to more systematic evidence on the relevance of these alternative views of tax avoidance, it is useful to consider real world examples of how tax avoidance works and to illuminate its underlying motivations. This exercise requires finding a case where the details have become public; this is of course more likely in extreme situations. The example below is drawn from the activities of Enron; however, as the testimony of the actors makes clear, the lessons for managerial motivations are not limited to this extreme context.

A report by the Joint Committee on Taxation (hereafter JCT) of the US Congress (2003) provides a unique perspective on how central earning manipulation was to Enron’s extensive use of tax shelters. 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.”

One example of such a transaction was “Project Steele.” As Enron had already guaranteed that it would not pay taxes well into the future through previous tax shelters, this transaction was motivated by the fact that it would create \$133 million in pretax financial accounting income. Ironically, in order to generate favorable tax treatment, Enron admitted that its “purported principal business purpose for the transaction was to generate financial accounting income.” In addition to the fact that no current tax savings were generated, it is also useful to note that the very complex structure, as shown in Figure 1, was extremely costly to undertake. Project fees were estimated at over \$11 million. As such, shareholders did not benefit from

material tax savings, were manipulated by managers with financial accounting goals, and paid considerable fees in the process.

How representative is such a transaction in depicting what motivates corporate tax shelters? The documents released through the JCT's investigations reveal that the purveyors of the transaction recognized the centrality of financial accounting benefits to corporate tax shelters. Bankers Trust, the advisor to Enron on this transaction, initially showed a variant on the final structure that did not provide financial accounting benefits. Internal documents reveal that Bankers Trust concluded "that it would not receive much, if any, interest for the tax benefits alone but if the transaction were redesigned to provide for financial accounting benefits, as well, then corporate clients would be extremely interested and would pay a substantial fee....other less expensive alternatives exist to generate equivalent tax benefits." As such, it appears clear that tax avoidance opportunities are usefully bundled with earning management by purveyors of those shelters.

That market makers in tax shelters viewed tax benefits as incidental to the motivations for tax shelters indicates that the agency view of corporate tax avoidance has merit. Evidence on Dynegy in Desai and Dharmapala (2005) suggests a very similar dynamic, as does evidence on Tyco and Parmalat in Desai (2005) and on tax avoidance worldwide in Desai, Dyck and Zingales (2004).

In view of the complexity of the transactions involved, it is helpful to distill the main lessons of these examples into a simple stylized example. Table 1 provides such an example that helps fix ideas on the alternative views of tax avoidance. Consider a firm that generates pretax earnings of \$100 in each of 2 periods. The firm faces a statutory corporate tax rate of 35%. There is a tax avoidance strategy that is available to the firm that would reduce the effective rate to 30%. For simplicity, assume that all earnings (net of tax payments and managerial compensation) are paid out as dividends to shareholders each period. The firm is assumed to have shareholder value of \$100 at the end of period 2. This can be viewed either as the continuation value of its future earnings stream, or as the liquidation value of its assets. It is also assumed that there are no personal taxes and no discounting across periods 1 and 2. The tax deductibility of executive compensation is ignored.

Suppose that the firm's incumbent CEO will retire at the end of period 1. The example in the table contemplates three alternative executive compensation arrangements and their consequences for sheltering decisions:

- a salary of \$10, paid to the CEO in period 1
- a bonus scheme that pays the CEO the salary of \$10 *and* 50% of (after-tax) earnings in period 1 in excess of \$65
- a stock-based compensation scheme that gives the CEO a salary of \$10 in period 1 *and* a 1% ownership stake in the firm in period 2. This could take the form of options that vest in period 2, or a restricted stock grant that cannot be traded until period 2.

The traditional view of corporate tax avoidance is illustrated in Panel A of Table 1. Here, there is assumed to be no opportunity for the CEO to manipulate reported earnings, and so reported earnings are equal to true earnings in each period. The firm's after-tax earnings depend on whether or not it engages in tax sheltering. A firm's value at the beginning of each period is the liquidation value of the firm and subsequent dividends, ignoring the manager's compensation. The subsequent rows depict managerial compensation and shareholder value (net of this compensation) under each of the three alternative compensation arrangements.

Under the traditional view, engaging in tax avoidance clearly raises after-tax shareholder value, regardless of the compensation scheme. However, managers being paid salaries alone will not have any incentive to pursue the tax avoidance strategy. Indeed, if sheltering involves even a small effort cost, the manager will strictly prefer not to do so. Moving to an incentive compensation scheme of either the bonus or stock ownership will induce the manager to shelter, and thereby enhance shareholder value.

As discussed above, tax shelters are often bundled with earnings manipulation opportunities. This alternative view of earnings manipulation is illustrated in Panel B of Table 1. In this example, engaging in the tax shelter strategy enables the manager to move \$25 of pretax earnings from period 2 to period 1 (as shown in the second row). It is useful to revisit the sheltering decisions in this case. If only salaries are employed, manager and shareholder payoffs are unaffected by the possibility of earnings management. However, if managers are facing earnings bonuses, earnings manipulation enables the manager to realize the earnings-based

bonus¹ and provides an incentive to engage in the tax sheltering strategy. This happens even if, as in the case depicted in the table, the costs to shareholders from the increased compensation exceed the tax benefits – that is, the net effect of the earnings manipulation and tax sheltering on shareholder value is negative.

Moving from a bonus scheme to options induces the manager to abandon the tax shelter, in spite of its tax benefits as his compensation is reduced. In essence, an option-based compensation plan places the CEO in the position of a period-2 stockholder, who is harmed by the earnings manipulation to a degree that offsets the tax benefits.² This example thus illustrates the possibility that a greater reliance on stock-based incentive compensation can induce managers to reduce tax avoidance activity. This example thus makes clear that incentive based arrangements need not increase tax avoidance, as suggested by the alternative view of tax avoidance, particularly when tax avoidance is bundled with earnings manipulation. Moreover, the real world example above suggests that this stylized example is representative of many of the tax avoidance activities that have been executed in the US in recent years.

As this example is stylized, it is useful to address a number of caveats. First, if it were possible for the manager to decouple the tax shelter and the earnings manipulation, then she would do so in this example. However, in reality, it may not be possible for the manager to credibly signal to investors that these activities have been decoupled. Second, it may seem that the size of the bonus and the extent of earnings manipulation are unrealistically large here, so that in practice tax benefits are likely to exceed the costs to shareholders from earnings manipulation, even under a bonus arrangement. However, it should be remembered that the example assumes that there are no real costs of earnings manipulation. If the sheltering and manipulation scheme involves real costs (e.g. by diverting the time and effort of managers from the generation of true earnings), then the losses to shareholders would be correspondingly larger.

¹ More generally, in a situation characterized by uncertainty and mispricing, earnings manipulation may enable managers to sell their stock in the company at inflated prices, with consequences that are essentially similar to those illustrated in Table 1.

² The net consequences of tax sheltering for shareholder value are ambiguous under the stock option compensation arrangement. Period-1 shareholders benefit while shareholders who enter in period 2 are harmed. This asymmetry, however, is incidental to the main point which is to illustrate a scenario in which options can dissuade managers from engaging in tax avoidance.

While it is difficult to extrapolate from these examples, it is helpful to see that the alternative view of tax avoidance is manifest in the few examples of tax shelters that are public. In a related vein, Graham and Tucker (2005) report that the tax deductions associated with tax shelters are extremely large. In their sample, they report that the typical tax deduction is \$1 billion per firm per year, or nine percent of assets for these firms. Such large deductions are far greater than any conceivable tax obligations for these firms and are hard to reconcile with any purely tax-driven motivation. The view that embeds tax avoidance decisions in an agency framework seems to correspond better to what we know about corporate tax avoidance than does the simple view that corporate tax avoidance is a value transfer from the state to shareholders.

IV. Measuring Corporate Tax Avoidance and Testing the Agency Hypothesis

While these examples motivate the basic intuition for the alternative view of tax avoidance, does this view receive support in large sample research? The conceptual difficulties in defining corporate tax avoidance are matched by difficulties in constructing a quantitative measure of the phenomenon. Desai and Dharmapala (2005) provide such a measure based on so-called “book-tax gaps” – the difference between financial income, as reported by the firm to its shareholders and the SEC (using generally accepted accounting principles, GAAP) and the tax income it reports to the IRS.³ This difference can be directly observed by those with access to tax return data and has been used as a proxy for corporate tax avoidance. However, there are two problems with this approach. The first is that tax returns are confidential, and thus the book-tax gap is not directly observable to most researchers or to investors. Second, book-tax gaps may be due to factors other than tax avoidance. In particular, the accounting literature in recent years has emphasized the phenomenon of earnings management - the manipulation of reported income by managers in order to reach bonus targets, to avoid reporting losses, and to achieve various other aims.

The first of these problems can be addressed by estimating firms’ taxable income using observable financial reporting data. In particular, Manzon and Plesko (2002) develop an approach that involves using a firm’s reported tax expense in their financial statements, and grossing up this amount by the corporate tax rate in order to estimate its financial income. This

³ An alternative approach (Graham and Tucker, 2005) uses involvement in tax shelter-related litigation as a proxy for corporate tax avoidance. However, the number of firms involved in such litigation is small, and so this measure is not suitable for a large-sample approach.

estimated tax income can then be subtracted from the firms' reported pretax financial income in order to compute the estimated book-tax gap. While there are a number of important caveats to this approach (reviewed e.g. in Hanlon (2003)), it remains the only available procedure for measuring book-tax gaps, in the absence of direct observation of firms' tax returns. Moreover, it has the advantage of being similar to what investors can measure.

In order to incorporate the effects of earnings management, Desai and Dharmapala (2005) implement a procedure that seeks to correct the book-tax gap, as estimated using the approach described above, for the influence of earnings management. In the accounting literature, a widely-used proxy for earnings management is the use of accruals - adjustments to realized cash flows made by managers in computing the firm's net income - as these provide a measure of the extent of managerial discretion in the reporting of the firm's income. More refined proxies developed subsequently focus on the "abnormal" component of accruals, and make various other adjustments (Jones, 1991; Dechow, Sloan and Sweeney, 1995; Dechow, Richardson and Tuna, 2003). The approach developed in Desai and Dharmapala (2005) essentially isolates the component of the estimated book-tax gap that is not explained by accruals or abnormal accruals.

If the book-tax gap for firm i in year t (as estimated using the Manzon-Plesko (2002) approach), scaled by the lagged value of assets, is denoted by $BT_{i,t}$, and the total accruals for firm i in year t , scaled by the lagged value of assets, is denoted by $TA_{i,t}$, it is possible to measure tax avoidance via the following regression specification:

$$BT_{i,t} = \beta_1 TA_{i,t} + \mu_i + \epsilon_{i,t} \quad (1)$$

where μ_i is the average value of the residual for firm i over the sample period, and $\epsilon_{i,t}$ is the deviation in year t from firm i 's average residual μ_i . The residual from this regression (i.e. the component of $BT_{i,t}$ that cannot be explained by variations in accruals, and hence by earnings management) can be interpreted as a measure of tax avoidance activity. In particular, the residual book-tax gap $\mu_i + \epsilon_{i,t}$ represents a more precise measure of tax sheltering activity than would the uncorrected $BT_{i,t}$.

The tax avoidance measure obtained using this methodology (averaged across all firms in the sample for each year from 1993 to 2001) is plotted in Figure 2, drawn from Desai and Dharmapala (2005). The variability of this measure across firms in each of these years is also

represented in the figure, revealing a substantial increase in the variation across firms from the mid-1990s to the end of the sample period.⁴ This figure reflects rising levels of tax avoidance over the sample period (consistent with the anecdotal evidence), but also indicates that firms vary substantially with respect to these decisions.

In order to test the implications of the agency model discussed above, this measure of tax avoidance can be related to the nature of managerial incentives. Desai and Dharmapala (2005) use a panel of over 900 firms over the period 1993-2001 to analyze the relationship between these variables. The basic specification they use is:

$$TS_{i,t} = \beta_0 + \beta_1 IC_{i,t} + \text{Firm Fixed Effects} + \text{Year Dummies} + \text{Controls} + v_{i,t} \quad (2)$$

where $TS_{i,t} = \mu_i + \epsilon_{i,t}$ is the measure of tax avoidance derived from Equation (1), $IC_{i,t}$ is a measure of incentive compensation, and $v_{i,t}$ is the error term. The power of managerial incentives ($IC_{i,t}$) is measured using a number of proxies, in particular the fraction of managerial compensation at firm i in year t that consists of stock option grants. The model includes firm effects (and so relies on within-firm variation over time), year effects, and a variety of control variables.

The results (see Table 2 in Desai and Dharmapala (2005)) indicate a negative relationship between the incentive compensation and tax avoidance measures, contradicting the traditional view of corporate tax avoidance as simply a means of reducing tax obligations. Moreover, there appears to be no compelling explanation of this finding in terms of reverse causality (see Desai and Dharmapala (2005) for a discussion). This negative relationship, however, is consistent with the theory outlined in Section II above, where managerial opportunism is an important consideration and complementarities between tax avoidance and managerial opportunism may exist. Moreover, this view is supported by further analysis that focuses on the differences in the governance characteristics of the firms in the sample.⁵ The negative relationship appears to be driven primarily by firms with relatively weaker governance environments, where managerial opportunism is likely to be a more important factor.

⁴ Of course, as with the estimation of firms' taxable income, there are many important caveats to the construction of the tax avoidance measure. These primarily center on the possibility that earnings management activity is not adequately captured by the various accruals measures. Desai and Dharmapala (2005) discuss the robustness of this measure of tax avoidance to these concerns.

⁵ Governance characteristics are measured using the index constructed by Gompers, Ishii and Metrick (2003); an alternative measure, based on institutional ownership, is also used.

Within the framework outlined in Section II above, the negative relationship between the incentive compensation and tax avoidance can be understood as follows. Higher-powered compensation schemes align managers' incentives with maximizing shareholder value, dissuading them from acts of opportunism that are complementary with tax sheltering, and hence inducing them to reduce tax avoidance activity as well. For example, consider a manager who can use a tax shelter to not only reduce tax obligations, but also to manipulate financial reporting to move earnings into the current period, and sell stock in the firm at temporarily higher prices. A compensation scheme based on stock options will reduce the incentive to engage in this type of earnings manipulation, and will also reduce the manager's benefits from using the tax shelter, possibly to such a degree as to offset its tax benefits.

V. Conclusions

The simple intuition that corporate tax avoidance represents a transfer of value from the state to shareholders has been challenged by recent research that finds that this view does not appear to be validated in the data. This research points to an alternative view, emphasizing that tax avoidance demands obfuscatory actions that can be bundled with diversionary activities, including earnings manipulation, to advance the interests of managers rather than shareholders. The results from large sample analysis, along with the illustrations provided in the stylized and real-world examples, all indicate that conceptualizing corporate tax avoidance within an agency perspective provides a fuller and more accurate depiction of the motivations driving this phenomenon.

This analysis also relates to a wider theme - the importance of financial reporting objectives in understanding managerial responses to tax incentives. Corporate finance and tax scholars can usefully consider reporting consequences when studying or designing taxes, given the primacy of reporting objectives to managers. Similarly, investors must consider how to evaluate tax avoidance activities to ensure that shareholder interests are actually being advanced.

Recent efforts by large U.K. institutional investors, including the Henderson Group, to ask firms to disclose tax payments on a country-by-country basis may signal that disclosure of tax activities can be a useful step forward in managing the tension between legitimate tax avoidance and actions that detract from shareholder value. In their report, "Responsible Tax", Henderson encourages such disclosure in order to ensure that managers only undertake tax

avoidance activities that are legitimate and serve some nontax purpose. This report builds on interviews with several U.K.-based multinational firms which often bypass tax avoidance opportunities that appear too complex. The fact that investors and some managers are recognizing a potential tension between tax avoidance and shareholder interests suggests that managers, shareholders and boards should reconsider the manner in which tax activities are reviewed and supervised within firms.

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Table 1: Tax Avoidance and Managerial Motivations - A Stylized Example

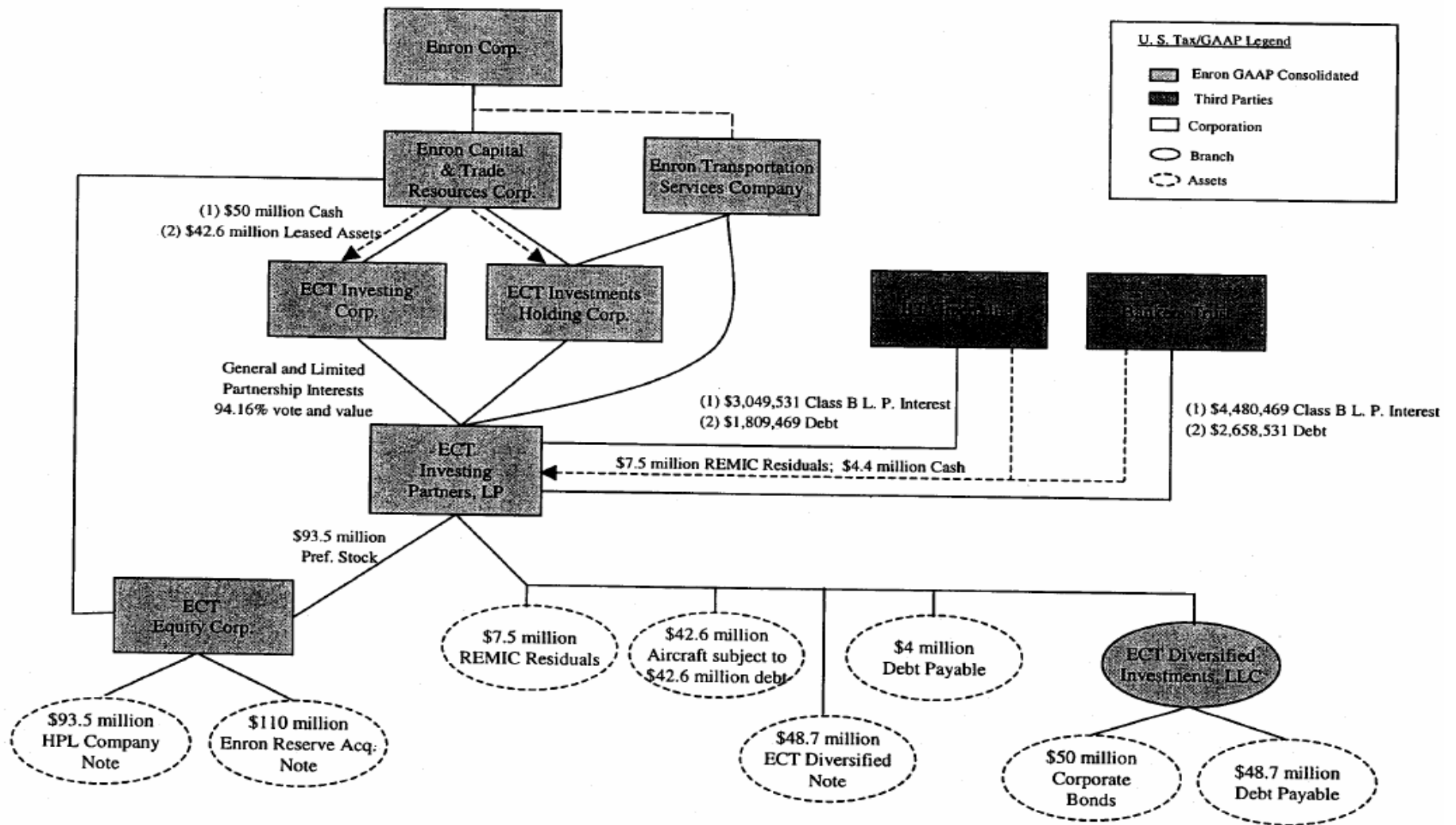
Period	<i>Panel A: Typical View of Tax Avoidance</i>				<i>Panel B: Earnings Manipulation View of Tax Avoidance</i>				
	1		2		1		2		
True Earnings	100.00		100.00		100.00		100.00		
Reported Pretax Earnings	100.00		100.00		125.00		75.00		
	No Sheltering	Sheltering	No Sheltering	Sheltering	No Sheltering	Sheltering	No Sheltering	Sheltering	
After Tax Earnings	65.00	70.00	65.00	70.00	65.00	87.50	65.00	52.50	
Cum-dividend Firm Value	230.00	240.00	165.00	170.00	230.00	240.00	165.00	152.50	
Three Alternative Compensation Arrangements									
<i>Salary</i>	Payoffs for Manager on Salary	10.00	10.00		10.00	10.00			
	Cum-dividend Shareholder Value	220.00	230.00		220.00	230.00			
<i>Earnings Bonus</i>	Payoffs for Manager on Salary with 50% Earnings Bonus for aftertax earnings > 65	10.00	12.50		10.00	21.25			
	Cum-dividend Shareholder Value	220.00	227.50		220.00	218.75			
<i>Stock option</i>	Payoffs for Manager on Salary with 1% Second Period Ownership	10.00	10.00	1.65	1.70	10.00	10.00	1.65	1.53
	Cum-dividend Shareholder Value	218.35	228.30	163.35	168.30	218.35	228.48	163.35	150.98

Notes: This table illustrates the discussion in Section III of the text. The firm in this example generates pretax earnings of \$100 in each period (1 and 2) and has a value of \$100 at the end of period 2. It faces a tax rate of 35% in the "no sheltering" scenario, and a rate of 30% with sheltering. All earnings (net of tax payments and managerial compensation) are paid out as dividends each period. "Firm value" refers to the value of the firm ignoring managerial compensation, while "shareholder value" is net of this compensation. All values are cum-dividend (i.e. including the dividend to be paid that period). There are no personal taxes and there is no discounting across periods 1 and 2. The tax deductibility of executive compensation is ignored.

Figure 1: Dissecting a Real World Tax Shelter

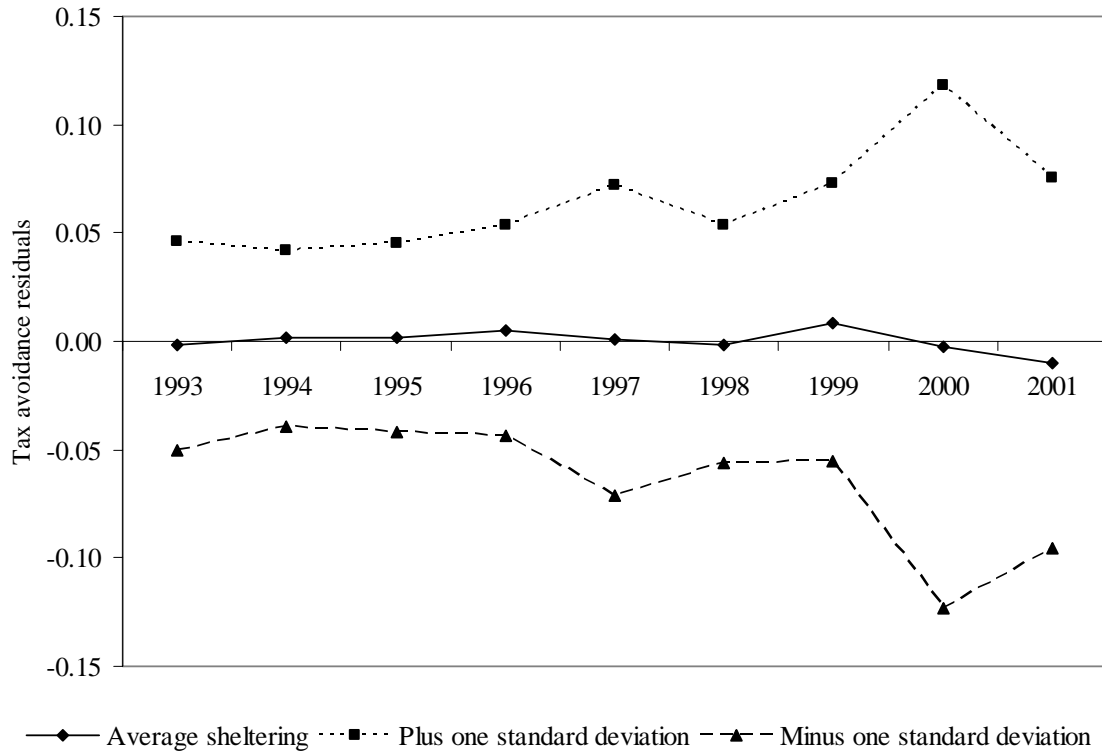
Project Steele Structure as of October 31, 1997

Confidential



Notes: This figure is drawn from JCT (2003) and depicts a tax shelter adopted by Enron in 1997.

Figure 2: The Evolution of Tax Avoidance Residuals, 1993-2001



Notes: The figure plots the mean average tax sheltering measure discussed in the text from 1993 to 2001 along with the mean plus and minus one standard deviation of that tax sheltering measure. This figure is drawn from Desai and Dharmapala (2005).