RISKY BUSINESS: 
THE PROSOPOGRAPHY OF CORPORATE TAX PLANNING

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We trace the history of corporate tax planning from a compliance-focused activity to a profit-enhancing endeavor to a risk management center. Tax directors of U.S. multinational corporations face unprecedented global pressures from taxing jurisdictions seeking to increase their share of the enterprise’s worldwide taxes. Increasingly, corporations must consider the risks that a tax strategy will impose on them, not only in terms of potential lost revenue, but also in terms of reputation and market share. We discuss the components of tax risk management in today’s global environment and speculate how future corporate tax planning will change in light of the Organisation for Economic Co-operation and Development Base Erosion and Profit Shifting project.

Keywords: corporate tax, tax avoidance, book-tax differences, accounting for income taxes
JEL Codes: H25, H26, M41, M48

What has been will be again, what has been done will be done again; there is nothing new under the sun.

(Ecclesiastes 1:9)

I. INTRODUCTION

Tax departments of U.S. corporations currently face unprecedented challenges when tax planning in the global marketplace. When devising tax strategies, the tax director must consider not only the accuracy of tax compliance in each of the jurisdictions
affected by the transactions, but also (a) whether the transaction is reported correctly in the financial statements, (b) any corporate governance implications, and (c) whether public disclosure of the strategy threatens the corporation’s reputation. As tax jurisdictions feel more pressure to increase revenues, while at the same time reducing tax rates, tax authorities have become more aggressive in challenging structures that shift income out of one jurisdiction and into another. The Organisation for Economic Co-operation and Development (OECD) Base Erosion and Profit Shifting (BEPS) project (OECD, 2013a, 2013b) is likely to significantly change how cross-border transactions are planned and reported. Increased demands for more transparency in reporting the “tax aggressiveness” of a particular transaction will stress resource-strapped corporate tax departments and force firms to become more efficient in global data collection and management. Tax risk (controversy) management now occupies the primary focus of most corporate tax departments.

In this paper, we trace the history of corporate tax planning from a compliance-driven activity to a profit-enhancing function to a risk management center. We add our thoughts as to the future of global tax planning in a world where tax aggressive behavior has become less tolerated by both tax authorities and society in general.

II. A SHORT HISTORY OF CORPORATE TAX PLANNING

A. Corporate Tax Departments as Cost Centers

Until the mid-1990s, corporate tax departments tended to function as cost centers within the enterprise (Ernst & Young, 2004). As such, management rewarded cost efficiency and cost minimization (i.e., filing accurate tax returns on a timely basis). Tax departments were described as “back-room functions” and “afterthoughts” (Deloitte LLP, 2008). A typical “mission statement” of a tax department functioning as a cost center would be to “comply with all taxing statutes applicable to the jurisdiction in which the Company does business in a manner which minimizes all associated tax liabilities within the limits allowed by such statutes” (Freischlag, 1977). The goals to accomplish this mission included maximizing cash flows, complying with tax laws, and using “legal” methods to tax plan.

Since the enactment of the corporate income tax in 1913, taxpayers have attempted to use corporations to reduce their taxes, most often through income shifting to take advantage of differential shareholder or jurisdictional tax rates.1 In the Revenue Act of 1913, Congress created an exception to treating corporations as separate taxpayers when such corporations were formed to circumvent the imposition of the graduated surtax on individuals (Office of Tax Policy, 2000). Congress subsequently passed anti-deferral provisions in 1921, 1932 (the predecessor to section 367 on outbound transfers of property to a foreign corporation), 1934 (personal holding companies), 1937 (foreign

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1 See Liu (2014) for an interesting analysis of the interplay between individual and corporate tax rates in the United States in the first two decades of the 20th century.
personal holding companies), and 1962 (subpart F); the latter arising from the increasing use of foreign tax havens (notably the Bahamas and Switzerland) by U.S. corporations after World War II.2

Until the 1981 Economic Recovery Tax Act, legislators and the media generally viewed corporations as contributing their “fair share” of federal income tax revenues, or perhaps it is more accurate to say that they did not view corporations as not contributing their fair share of federal income tax revenues. For most of the period from 1940–1980, corporate tax revenues comprised between 20 percent and 40 percent of total federal income tax revenues. Most of the public and congressional “outrage” regarding taxes was directed at high income individuals who were paying no or low income taxes because of various preferences in tax laws. The tax shelter phenomenon of the 1970s primarily involved individuals investing in partnerships to achieve tax deferral, conversion of ordinary income to capital gain, or maximization of tax deductions through leverage (Joint Committee on Taxation, 1983a).

1. The Growing Tension Between Book and Taxable Income

As the percentage of federal tax receipts derived from corporate income taxes decreased in the early 1980s, impassioned debates arose as to whether, and the extent to which, highly profitable (from a book perspective) corporations should contribute to the federal tax coffers. This debate was fueled by generous tax breaks given to corporations in the 1981 Tax Act as a means of stimulating the U.S. economy. Included in the bill were such economic incentives as lower corporate (and individual) tax rates and accelerated depreciation deductions. A Joint Committee on Taxation (1983b) analysis of corporate book effective tax rates in 1982 revealed wide disparities in U.S. and worldwide effective tax rates by industry. Industries with the lowest average effective tax rates included aerospace, chemicals, and financial institutions. Industries with the highest effective tax rates included pharmaceuticals, tobacco, trucking, and computers. The Joint Committee also concluded that a decline in corporate effective tax rates contributed to the reduced contributions by corporations to total federal tax receipts.

Congress recognized that loss corporations (e.g., Chrysler Corporation) would not be able to use the tax benefits of accelerated depreciation and credits currently, and even if the tax benefits could be carried forward and used in future years, the net present value of the benefits would be reduced, diminishing the incentive to buy new equipment. As a result, Congress enacted safe harbor leasing, which enabled loss corporations to “sell” tax benefits, such as depreciation deductions and investment credits, to profitable corporations (e.g., General Electric, IBM) through a lease arrangement (i.e., the profitable corporation received the tax benefits and the loss corporation received cash and new equipment).

Profitable corporations wasted no time in purchasing these tax reduction assets. For example, General Electric paid approximately $350 million for tax benefits with

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2 The Office of Tax Policy (2000) and the Joint Committee on Internal Revenue Taxation (1961) provide summaries of these anti-deferral acts and describe the corporate tax behavior that precipitated such legislation.
a present value of $632.8 million (Stickney, Weil, and Wolfson, 1983). For the period 1981–1984, General Electric reported $9,577 million of book profits and received a net refund of almost $100 million in federal income taxes (i.e., the company purchased enough tax reduction attributes to eliminate not only its current taxable income but also taxable income from prior and future years) (Citizens for Tax Justice, 1985). Because most of the tax reduction attributes acquired were in the form of depreciation deductions, General Electric recorded a deferred tax expense for these book-tax differences, increasing the company’s accounting effective tax rate for 1981 to 36 percent. Fearful that it may have effectively eliminated the corporate income tax as a source of revenue, Congress repealed safe harbor leasing within months of its enactment. The corporate income tax share of federal revenues dropped to 6 percent in 1984.

Public interest groups and academic researchers made public the fact that major U.S. corporations were not paying any federal income taxes (and in some cases were getting tax refunds), while at the same time were reporting record amounts of book profits. For example, in August 1985, Citizens for Tax Justice (1985) released a report that identified 50 large U.S. corporations paying zero or less taxes during 1981–1984.

An extreme example was General Dynamics Corporation, which reported cumulative before-tax book income of more than $2 billion over the period 1973–1983, yet accumulated a net operating tax loss carryover of $3.1 billion over the same period (Wheeler and Outslay, 1986). General Dynamics accomplished this disparate result by applying the completed contract method of accounting for tax purposes (which significantly deferred tax liabilities) and the percentage completion method of accounting for book purposes (which approximated accrual accounting). Paradoxically, the company reported book effective tax rates during this period in excess of 40 percent (the top corporate marginal tax rate during this period was 46 percent) because the book-tax difference created by the use of different methods of accounting resulted in a temporary difference that was recorded as a deferred tax expense. Several newspapers ran front page headlines of the story.

The reaction to these studies was twofold. Citizens for Tax Justice (1985, p. 19) concluded that the “corporate tax system is a mess” and should be reformed to tax companies on “what they really earn — not on some figment of their tax accountant’s imagination.”

In marked contrast, Stickney, Weil, and Wolfson (1983, p. 454) saw no need for General Electric to apologize for minimizing its tax obligations using legal means, stating:

GE may find itself in an uncomfortable public-relations situation because it received a $103.8M net refund of tax payments in 1981 and will realize substantial future tax benefits from tax-transfer leases. Still, in doing so it paid $349 million or so to various companies to help them benefit from the tax subsidies arising from investment in capital assets. If Congress wished these subsidies to be widely available, then GE deserves some thanks for helping make them so.

Congress responded by enacting the Tax Reform Act of 1986, which shifted an estimated $120 billion of income taxes away from individuals and toward corporations over the period 1987–1991 (Joint Committee on Taxation, 1987). One provision Congress enacted to accomplish this objective was the creation of a corporate alternative minimum tax (AMT) to ensure that “whenever a company publicly reports significant earnings, that company will pay some tax for the year” (Joint Committee on Taxation, 1987, p. 433). One of the adjustments made to a corporation’s taxable income to compute the AMT base was the Book Untaxed Reported Profits (“BURP”) adjustment, which required the corporation to add back to taxable income one-half of the amount by which the corporation’s adjusted net book income exceeded its alternative minimum taxable income before the adjustment.

When the “BURP” adjustment was proposed, economists voiced concern that corporations would artificially reduce their book income in 1987 to reduce the difference between book income and taxable income (Sunley, 1986). Academic researchers who examined whether corporations did indeed manage their earnings to reduce the AMT found evidence of such behavior in corporations that were most likely to be subject to the AMT (Gramlich, 1991; Boynton, Dobbins, and Plesko, 1992; Manzon, 1992; Dhaliwal and Wang, 1992). Such studies initiated other research that investigated the potential tradeoffs between book and taxable income when investing in a tax strategy, particularly for publicly-traded corporations subject to SEC reporting requirements (see Hanlon and Heitzman (2010) and Graham, Ready, and Shackelford (2012) for a summary of this literature).

3. The Scholes and Wolfson Paradigm Shift in Effective Tax Planning

Coincident with the passage of the Tax Reform Act of 1986, and no doubt influenced by the anticipated reactions of corporations and individuals to the magnitude of the changes enacted, two academic researchers at Stanford University (Scholes and Wolfson, 1992) introduced a framework for tax planning that broadened how taxes should be incorporated in decision making. Where previously tax planning focused on tax minimization, Scholes and Wolfson (1992) expanded the concept to include consideration of the tax implications of a proposed transaction for all of the parties to the transaction. Their planning approach took into consideration differences between geographic tax jurisdictions, the incentives of all parties to a contract, implicit as well as explicit taxes (i.e., differences in before-tax rates of return on tax advantaged versus tax disadvantaged assets), tax clienteles (high and low marginal tax rate taxpayers), and the costs of implementing a tax planning strategy. Key to their concept of effective tax planning was the exploitation of differential tax treatment of transactions to different parties to the transactions (“tax arbitrage”).

Scholes and Wolfson provided a framework from which to test hypotheses about corporate reactions to tax law changes. Scholes and Wolfson did not inject consideration
of any “social responsibility” in tax planning. Rather, the authors viewed their framework as potentially helping social planners “avoid being beaten by other social planners and by tax planners” when designing a tax system (Scholes and Wolfson, 1992, p. 9). Not everyone interested in social planning found this approach edifying. In their review of the Scholes and Wolfson book, Sims and Sunley (1992, p. 455) observed that:

The tension between moderation in tax planning and private optimization (endeavors that, when pressed to the extremes that neither Congress nor the Treasury ever anticipated), are a prime source of complexity, unfairness, and perceived unfairness in the system. [This text] … is about maximizing private wealth at the expense of the income tax. It is about private optimization without remorse.

B. Tax Departments as Profit Centers

Beginning sometime in the mid-1990s, publicly-traded corporations began to transform their tax departments from cost centers to profit centers (Robinson, Sikes, and Weaver, 2010). The tax department shifted its focus from cost efficiency and cost minimization to “enhancing shareholder value.” Management charged tax departments with the goals of increasing earnings per share, producing a higher return on investments, and reducing cash taxes.

Tax strategies that enhance shareholder value do so by increasing the corporation’s earnings per share (EPS), usually by increasing after-tax profit (i.e., reducing the company’s income taxes). Such strategies focus on reducing the corporation’s effective tax rate (ETR), usually through investment in permanent book-tax differences, including shifting income to lower tax jurisdictions. The change in EPS can be projected to increase a corporation’s market capitalization (shareholder value) using the following “multiplier” formula:

\[ \Delta \text{market capitalization} = \Delta \text{EPS} \times \text{P/E multiple} \times \text{number of shares outstanding}, \]

where \( \Delta \text{EPS} \) is the change in the corporation’s earnings per share due to a change in ETR, \( \Delta \text{market capitalization} \) is the change in the corporation’s market capitalization, and \( \text{P/E multiple} \) is the corporation’s stock price divided by earnings per share.\(^3\)

The testimony of Brunswick Corporation before the House Ways and Means Committee (Zelisko, 2014) provides evidence that corporations consider the multiplier model

\(^3\) McGill and Outslay (2004) provide a more detailed discussion of this model.
in devising tax strategies. As part of her testimony advocating making the R&D credit permanent, the company’s Vice President of Taxes stated:

> When the Company speaks to the analyst community, the Company forecasts an annual effective tax rate which the analysts then plug into their discounted cash flow and earnings models. When the R&D tax credit expires, as it did at the end of 2013, the Company has to forecast its effective tax rate for 2014 without the R&D tax credit, which increases the Company’s overall effective tax rate. A higher effective tax rate on the same level of earnings translates to lower EPS, i.e., earnings per share. Lower EPS times the same multiple the marketplace gives to the Company can mean a lower share price.

The transition of corporate tax departments to profit centers came to the attention of Congress and the public in the high profile financial collapses of Enron Corporation and WorldCom. In her written testimony before the Senate Committee on Finance hearings regarding Enron Corporation (Joint Committee on Taxation, 2003a), Lindy Paull, then Chief of Staff of the Joint Committee on Taxation, observed that:

> In the mid-1990s, Enron’s management began to view the role of its tax department as more than managing its Federal income tax liabilities. Rather, Enron’s tax department became a source for financial statement earnings, thereby making it a profit center for the company. With an emphasis on short-term profitability and cash flow, Enron used various techniques to generate current financial statement net income …

Documents related to some of the structured transactions marketed to (and bought by) Enron Corporation by investment banks, law firms, and accounting firms touted the financial accounting benefits from the investment over the cash tax savings (Joint Committee on Taxation, 2003b).

The transformation of tax departments to profit centers was evident in “Reengineering Tax Summits” presented by the World Research Group, a trade organization that began in the mid-1990s. The 1999 summit included workshops entitled “Strategically Budgeting Your Global Tax Department for Increased Shareholder Value” and “Hiring and Retaining Tax Professionals that Add to the Bottom Line” (World Research Group, 1999). The 2000 summit (World Research Group, 2000) offered seminars on topics such as “Reengineering Income Tax with FAS 109,” “Mapping International Tax Tactics to Increase Shareholder Value,” “Mapping Advanced Planning to Drive Down Effective Tax Rates,” and “Developing a Comprehensive Scoreboard for Benchmarking
Your Tax Reengineering.” The latter seminar advertised the importance of the topic as follows:

Not only is the forward-thinking corporate tax department studying their competitor’s tax rates and methodologies … Have the changes made a difference for the bottom line? Have we changed our image within the finance department from compliance to a value-added corporate partner?

Just in case the change in culture met with resistance, there was a workshop entitled “Examining Ethical Issues in Reengineering Tax Departments” that was described as follows:

Is the best answer always the right answer? Ethically? Morally? Legally? Or does it even matter? Does it make a difference if you cannot sleep at night because of decisions you make? This unusual presentation will offer a series of hypothetical scenarios based on situations a forward-thinking executive may face in his/her efforts to provide a quality tax department and value to the company’s bottom line. Here you will start to consider how to handle a variety of issues which can threaten the success of adding to shareholder value.

The speakers at these seminars included not only tax directors of Fortune 500 companies, but also individuals from the international public accounting firms.

A survey of Fortune 1000 tax directors revealed that the accounting effective tax rate was the “single most important metric in evaluating tax departments,” exceeding “cash tax savings” by a 3-to-1 margin (Clark, Martire, & Bartolomeo, Inc., 2000, p. 13). These tax directors also identified the accounting effective tax rate as being the most important factor in driving tax departments overall objectives over cash flow by a margin of 46 percent to 24 percent. In a more recent survey, Graham, et al. (2014) find that 47 percent of the tax executives in publicly traded firms state that top management values the GAAP ETR more than cash taxes paid, and in another 37 percent of public firms the two metrics are equally valued by top management.

1. Corporate Indulgence in Highly Structured Tax Shelters

One approach corporations took to enhance earnings was to invest in one-time transactions that were euphemistically referred to as “tax shelters.” Such activities were brought to light in a Forbes magazine article entitled “The Hustling of X-Rated Shelters” (Novack and Saunders, 1998). The article focused on how tax advisers and corporations were becoming increasingly aggressive in promoting and adopting tax strategies that lacked economic substance and were designed solely to reduce taxes. This article precipitated a frenzy of activity investigating the extent to which such activities were depleting U.S. tax revenues.
In July 1999, the U.S. Department of the Treasury (1999) published a report entitled *The Problem of Corporate Tax Shelters: Discussion, Analysis, and Legislative Proposals*, which noted that:

While corporate tax payments have been rising, taxes have not grown as fast as have corporate profits. One hallmark of corporate tax shelters is a reduction in taxable income with no concomitant reduction in book income. The ratio of book income to taxable income has risen fairly sharply in the last few years. Some of this decline may be due to tax shelter activity.

At the Enron hearings, Senator Grassley vowed to enact legislation that would impose significant monetary penalties on investors and promoters of tax shelters and require additional disclosure of participation in and promotion of such shelters (Grassley, 2003). Senator Grassley fulfilled his promise with the passage of the American Jobs Creation Act of 2004. Included in the Act were 21 new or modified provisions that imposed penalties related to tax shelters and new disclosure rules that required a corporation to inform the Treasury of its participation in a “reportable transaction” by attaching a disclosure statement to its federal income tax return (Form 8886). The definition of a reportable transaction includes “listed transactions,” which are defined as a transaction that was the same as or substantially similar to one of the types of transactions that the IRS had determined to be a tax avoidance transaction as identified by notice, regulation, or other form of published guidance. The IRS has identified 34 listed transactions to date, only four of which have been added to the list since 2004, a testament to the effectiveness of these rules in curtailing use of abusive tax shelters.

2. Income Shifting to Low-Tax Jurisdictions

At the same time that corporations were investing in one-time transactions to meet short-term earnings management goals (sometimes referred to as the “magic penny”), U.S. corporations also began to reorganize their international operations to provide a more sustainable reduction in their effective tax rates. These “tax efficient supply chain management” (TESCM) programs aligned the company’s operations (manufacturing, marketing, research and development, and distribution) in countries that lightly tax such income. These strategies generally relied on the use of “check-the-box” (hybrid) entities and transfer pricing to shift income to lower tax rate countries without invoking the U.S. anti-deferral rules. The effectiveness of these TESCM strategies is evident in the decline in the effective tax rates of companies employing these strategies. For example, IBM’s ETR decreased from 41 percent in 1994 to approximately 24 percent today, while Google’s ETR decreased from 31 percent in 2005 to 16 percent in 2013.

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4 Donohoe, McGill, and Outslay (2013) provide a more in-depth discussion of this tax planning strategy.
C. Tax Departments in an Age of Transparency ("Risk Centers")

1. The Creation of the Public Company Accounting Oversight Board

Congress responded to the Enron collapse and other financial accounting improprieties by passing the Sarbanes-Oxley Act in 2002, the goals of which were to enhance corporate responsibility, enhance financial statement disclosures, and combat corporate and accounting fraud. The Act also created the Public Company Accounting Oversight Board (PCAOB) to oversee the activities of the auditing profession.

The provisions of the Act that most affected corporate tax planning were directed at auditor independence (Title II). Title II generally prohibits auditors from engaging in nine activities (e.g., bookkeeping) that would otherwise threaten their independence. An activity not on the list is the provision of tax services. The Act (Title II, section 201(h)) requires the audit committee of the Board of Directors to approve, in advance, an engagement by the auditor to provide non-audit services, including tax services. The Act also (Title IV, section 404) requires management to establish and maintain adequate internal controls and procedures for financial reporting and to have the auditor attest that the controls are in place and adequate. Finally, the Act (Title X) states a “sense of the Senate” is that the CEO should sign the corporate tax return, but we know of no instance where this occurs.

The PCAOB expanded on Title II of the Sarbanes-Oxley Act by implementing rules that further restrict the provision of tax services by the corporation’s independent auditor. In particular, Rule 3522 prohibits the auditor from providing any non-audit service related to marketing, planning, or opining in favor of the tax treatment of a transaction that is either a “confidential transaction” or a transaction that represents an “aggressive tax position.” An aggressive tax position is one recommended by the auditor and a “significant purpose of which is tax avoidance, unless the proposed tax treatment is at least more likely than not to be allowable under applicable tax laws.” Aggressive tax positions include the listed transactions discussed previously. Moreover, in “Staff Questions and Answers” related to Rule 3522, the PCAOB ruled that it was permissible for the auditor to advise an audit client on the tax consequences of alternative ways of structuring the transaction provided that it was “more likely than not” that the transaction was allowable under applicable tax laws and a significant purpose of the transaction was not “tax avoidance.”

The PCAOB-mandated change in the relationship between the auditor and the corporate tax department dramatically changed the dynamic and focus of the tax department. In the post-Sarbanes-Oxley era, the tax department focus shifted to matters related to corporate governance, accuracy of the financial statement tax accounts, disclosure requirements, and reputation. Matthew McKenna, Senior Vice President of Finance at PepsiCo, Inc., observed that what was “new” at Pepsi post-Sarbanes-Oxley was
the external focus on taxes (McKenna, 2006). He identified the tax department’s new constituencies as including the SEC, FASB, audit committee, external auditors, IRS, and stock analysts (McKenna, 2006, p. 44).6

Similarly, a survey conducted among senior tax executives at Fortune 500 companies on behalf of the Tax Council Policy Institute revealed that “avoiding a financial statement error” was the most important tax management objective (83 percent), with “achieving financial statement benefits” (e.g., a reduced effective tax rate) second (50 percent), and “achieving cash tax savings” third (39 percent) (Tax Council Policy Institute, 2006, pp. 33). In its *Global Tax Risk Survey*, Ernst & Young LLP (2006) identified “ensuring tax accounts and disclosures in financial departments are correct” and “tax risk management” as the two leading measures of tax department performance. Whereas in 2004, accounting for income taxes in the financial statements consumed 9 percent of the tax department’s budget, by 2006, it consumed 23 percent of the budget (in 2014, the percentage likely exceeds 50 percent). In addition, more than half of the respondents indicated their companies were more risk averse than before Sarbanes-Oxley, and the focus was on “fundamental” tax planning as opposed to highly complex transactions. Finally, a more recent survey finds that 72 percent of publicly traded respondents rate the potential for an adverse effect on company reputation as “important” or “very important”, ranking second only to the concern that a tax strategy might not pass the judicial standard of “business purpose / economic substance” (Graham, et al., 2014).

2. Transparency Through Tax Return Disclosures of Book-Tax Differences

Prior to 2004, a corporation reconciled its book income with its taxable income on Schedule M-1 of IRS Form 1120. This schedule, comprised of ten lines, asked for a summary of the company’s book-tax differences and did not differentiate them as being either temporary or permanent, as defined by generally acceptable accounting principles. Schedule M-1 provided some researchers with the ability to track trends in book-tax differences over time (Plesko, 2002), but the data were too broad to be used as a tool for identifying transactions to audit. As a result, the IRS and Treasury jointly announced the creation of new Schedule M-3 in 2004, which required a much more extensive delineation of book-tax differences (more than 60 tax return items) and was designed to help IRS agents identify items warranting further scrutiny in a more efficient manner.

Schedule M-3 promised more than it has delivered. The IRS continues to analyze and make public the size and nature of book-tax differences reported on Schedule M-3

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6 Along these lines, Donohoe and Knechel (2014) find that external auditors charge tax aggressive firms an audit fee premium, which increases with management’s uncertainty about the sustainability of tax positions if audited by tax authorities (i.e., disclosed tax reserves). Further, they find that unless tax uncertainty is high, the provision of auditor-provided tax services creates knowledge spillovers that alleviate this fee premium.
The analyses to date show that book-tax differences fluctuate over time, but there have been no “smoking guns” that indicate an increase or decrease in the general level of corporate tax aggressiveness. Beginning in 2014, only corporations with assets of $50 million or more are required to fill out the detailed book-tax differences schedules (up from $10 million), reflecting a recognition that the cost to taxpayers to provide this level of detail exceeded the benefit to the IRS.

Consistent with the high costs of disclosure, Donohoe and McGill (2011) find investors believed \textit{ex ante} that the substantial increase in book-tax difference disclosures would increase future tax burdens and/or tax compliance costs. Investors also appeared to believe that Schedule M-3 may be more costly for firms with the types of book-tax differences that attract additional IRS scrutiny (e.g., discretionary permanent differences) and weak corporate governance. The authors also find evidence that corporations may have reduced discretionary permanent book-tax differences prior and subsequent to the implementation of Schedule M-3, suggesting that it had some real effects on firm behavior.

3. Transparency Through Financial Statement Disclosures of Uncertain Tax Positions

In 2006, the FASB adopted \textit{FIN 48: Accounting for Uncertainty in Income Taxes}, which was issued because “diverse accounting practices have developed resulting in inconsistency in the criteria used to recognize, derecognize, or measure benefits related to uncertain tax positions” (p. FIN48-2). Succinctly, FIN 48 allows a corporation to recognize the financial statement effects of a tax position when it is more likely than not (a greater than 50 percent probability), based on the technical merits, that the position will be sustained upon examination. Tax positions that pass the more-likely-than-not threshold are subject to a measurement step, whereby the corporation must map out the potential outcomes of the strategy, assuming it is audited by the IRS and litigated to the court of highest jurisdiction, and assign probability assessments to each outcome. The corporation can recognize the tax benefit that is cumulatively more than 50 percent likely of being realized. FIN 48 also requires a tabular reconciliation of the total amounts of unrecognized tax benefits at the beginning and end of the period.

The corporate community expressed concern that FIN 48 disclosures would provide the IRS with a “road map” to aggressive tax positions (some analysts likened the disclosures more to a compass), which has turned out not to be the case.

The effects of FIN 48 on corporate tax planning behavior has been the subject of much academic research. The literature to date is summarized exhaustively in Blouin and Robinson (2014), who characterize most of the academic literature as investigating whether firms (a) changed their reporting behavior in anticipation of adopting FIN 48 and (b) became less tax aggressive after adopting FIN 48. They conclude that research to date has shown that firms did alter their reporting behavior to avoid recognizing pre-FIN 48 aggressive tax positions, but the jury is still out on whether FIN 48 influenced a firm’s level of aggressiveness in implementing tax strategies.
Blouin et al. (2007) summarize hand-collected disclosures related to tax reserves ("unrecognized tax benefits" or UTBs) from 2005 through the first quarter of 2007. In Table 1, we expand their analysis to compare the relative ranking of the “top 30” companies reporting UTBs (scaled by total assets) under FIN 48 at the beginning of 2007 and in 2013. It is evident from Table 1 that some companies maintained their relative ranking with respect to UTBs, while others made significant increases or decreases in the ranking. Does this mean the companies that moved up became more tax aggressive, while the companies that moved down became less tax aggressive? Or are the changes idiosyncratic? In the case of Clear Channel Outdoor, the company’s balance in its UTB at the end of 2013 is actually less than the balance at the end of 2007, while its assets have increased. One could argue that this company is less tax aggressive in 2013 than it was in 2007.

4. Transparency Through Tax Return Disclosures of Uncertain Tax Positions

Disappointed by the lack of specificity in FIN 48 financial statement disclosures, the IRS unveiled Schedule UTP of Form 1120 in 2010, which requires some corporations to report their uncertain tax positions identified under FIN 48 (now codified as ASC 740-10-25) and provide a “concise description” of the nature of the uncertain tax position. For 2014, only those corporations with assets of $10 million or more and that file audited financial statements and a Form 1120 are required to complete the schedule.

The IRS announced its intention to issue Schedule UTP in 2010. The reason given for developing the schedule was to help the IRS identify quickly and efficiently significant issues (uncertain tax positions) underlying the tax return through increased transparency and information flow. To say that the announcement of Schedule UTP sent tremors through corporate tax departments would be an understatement. Much time and effort was spent strategizing how to meet the disclosure requirements without disclosing the specific nature of the uncertain tax return position itself. The IRS’s most recent data on Schedule UTP filing statistics indicates that over the first three years of the schedule, corporations reported, on average, 2.5 uncertain tax positions. The three most frequent uncertain tax positions have been the research and experimentation credit, transfer pricing, and (depending on the analysis) either capitalization under section 263 or trade or business expenses under section 162. This is not surprising given the complexity and judgment inherent in these calculations. Nevertheless, the IRS announced that it has discovered “problems” with the quality of firms’ descriptions of their uncertain tax positions.

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7 Announcement 2010-9, 2010-7 I.R.B. 408.
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<td>0.013</td>
<td>17</td>
<td>-10</td>
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<td>0.016</td>
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<td>0.041</td>
<td>10</td>
<td>0.020</td>
<td>12</td>
<td>-2</td>
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<td>Pharmaceutical Products</td>
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<td>11</td>
<td>0.035</td>
<td>3</td>
<td>8</td>
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<tr>
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<td>Electronic Equipment</td>
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<td>12</td>
<td>0.002</td>
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<td>13</td>
<td>0.005</td>
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<td>Ingersoll-Rand</td>
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<tr>
<td>Du Pont (EI) De Nemours</td>
<td>Chemicals</td>
<td>0.034</td>
<td>17</td>
<td>0.017</td>
<td>12</td>
<td>5</td>
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Table 1, Continued

<table>
<thead>
<tr>
<th>Company</th>
<th>Industry</th>
<th>FIN 48 Adoption (1/1/07)</th>
<th>Fiscal Year-End 2013</th>
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<tr>
<td></td>
<td></td>
<td>UTB$</td>
<td>UTB/Asset</td>
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<tr>
<td>Schlumberger Ltd.</td>
<td>Petroleum and Natural Gas</td>
<td>764</td>
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<td>Wyeth</td>
<td>Pharmaceutical Products</td>
<td>1,174</td>
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<td>Amgen Inc.</td>
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<td>Qwest Communication International</td>
<td>Communication</td>
<td>654</td>
<td>0.031</td>
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<tr>
<td>Kimberly-Clark Corp</td>
<td>Business Supplies</td>
<td>490</td>
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<td>Ebay Inc.</td>
<td>Business Services</td>
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<td>Praxair Inc.</td>
<td>Chemicals</td>
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<td>Baxter International Inc.</td>
<td>Pharmaceutical Products</td>
<td>405</td>
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<tr>
<td>Transocean Ltd.</td>
<td>Petroleum and Natural Gas</td>
<td>303</td>
<td>0.026</td>
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<tr>
<td>Honeywell International Inc.</td>
<td>Measure and Control Equip.</td>
<td>744</td>
<td>0.024</td>
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<tr>
<td>International Business Machines Corp.</td>
<td>Business Services</td>
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<tr>
<td>AT&amp;T Inc.</td>
<td>Communication</td>
<td>6,275</td>
<td>0.023</td>
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<tr>
<td>Apache Corp.</td>
<td>Petroleum and Natural Gas</td>
<td>563</td>
<td>0.023</td>
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</table>

Note: This table reports unrecognized tax benefits (UTB), in thousands (UTB$) and scaled by total assets (UTB), for the 30 largest non-financial firms as of FIN 48 adoption (as originally reported by Blouin et al. (2007)) and updated as of fiscal year-end 2013.
Because of the newness of Schedule UTP, academic research examining taxpayer behavior, either reporting or tax planning, is scant. Abernathy, Davenport, and Rapley (2013) find that stock returns around the development of Schedule UTP are negative, consistent with investors’ concern that Schedule UTP would impose costs on firms. However, they do find a positive stock price reaction to the release of the final draft of Schedule UTP, in which the IRS eliminated the requirement that taxpayers estimate a maximum tax paid if the uncertain tax position were disallowed. This positive reaction was incrementally larger for more tax-aggressive firms. Towery (2012) matches confidential Schedule UTP data with financial statement disclosures and finds that firms report lower financial accounting reserves for uncertain tax positions on their financial statements, but do not report lower tax benefits on their tax returns, suggesting that firms changed their financial reporting behavior to avoid disclosure on Schedule UTP. This evidence is consistent with the FIN 48 reporting behavior discussed previously.

Where the tug of war between disclosure and confidentiality goes from here remains to be seen. If the IRS does not see improvement in the quality of the concise descriptions accompanying uncertain tax positions, it has stated that the only remaining recourse will be to relax its self-imposed policy of restraint on tax accrual work papers.10 What civility remains between the IRS and corporate America will be severely strained if that path is taken.

III. THE MERCURIAL NATURE OF DEFINING TAX RISK

A primary focus of corporate tax departments today is on risk management. In its most general sense, risk connotes the potential of losing something of value weighed against the potential to gain something of value. Tax risks can be segregated by those risks that impact the execution of a tax strategy and those risks that result from the tax strategy itself.

Every tax department must map out what components of risk it seeks to manage and within what parameters that risk should be managed. In a panel discussion at the 2007 Tax Council Policy Institute Tax Policy and Practice Symposium entitled “Understanding the Global Tax Arena” (Larsen et al., 2007), Robin Beran, Director, Corporate Tax and Assistant Treasurer at Caterpillar Inc., described seven components of the company’s risk analyses as follows:

1. **Transactional**: the application of court decisions and regulations to specific transactions — what is the magnitude of the cash impact?
2. **Operational**: inherent risks in everyday business operations;
3. **Compliance**: statutory risks associated with tax return preparation, completion, and submission;
4. **Financial accounting**: risk associated with tax accounting, financial statements, and internal controls — what is the magnitude of the impact on profit?;

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(5) **Portfolio**: aggregate impact of transactional, operational, and compliance risks;

(6) **Management**: the failure to manage the above listed risks in a manner consistent with corporate tax risk policies; and

(7) **Reputation**: the risks that impact the company’s image as perceived by the public — *The Wall Street Journal* test.\(^{11}\)

The Company assigns one of three risk levels to every transaction within each component: *low* (i.e., the structure or transaction is completely consistent with the applicable laws), *medium* (i.e., the structure or transaction is consistent with the applicable laws, administrative rules, and judicial decisions of the applicable jurisdictions in all significant respects), or *high* (i.e., the structure or transaction is not consistent with the applicable laws, administrative rules, and judicial decisions of the applicable jurisdictions in some significant respect, or the company cannot determine the level of significance or consistency for any reason, or the structure of the transaction is not consistent with outside advice in some significant respect).

Vodafone has a formal tax risk management manual in which management articulates the company’s approach to tax planning.\(^{12}\) The company is guided by the following principles:

Vodafone believes its obligation is to pay the amount of tax legally due in any territory, in accordance with rules set by governments. In so doing it is not able to determine the “fair” amount of tax to pay. … It is not appropriate for the details of the Group’s tax affairs to appear in the public domain. Vodafone will however only enter into transactions which would be fully justifiable should they become public. … Tax risk is ideally managed by the prevention of unnecessary disputes. The avoidance of all tax dispute would suggest an overly prudent position that is not in line with our main objective to enhance shareholder value … Appetite for risk: Vodafone’s appetite for risk is governed by its “more likely than not” principle enshrined in the code of conduct. Consistency and transparency of application across the group is essential. All tax function members should act proactively to ensure and continually improve our tax risk decision making. Further definition of the components for interpreting and assessing risk are available in supporting documents.

Lost in much of the discussion regarding risk and what makes a corporation “aggressive” (investing in a transaction that requires the recording of a tax reserve under FIN 48?) are the Treasury’s tax reporting and disclosure rules. Figure 1 summarizes the rules that apply to disclosures of tax positions and the impositions of penalties. Under the current reporting rules (section 6662), a taxpayer can avoid penalty with “adequate

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\(^{11}\) Ironically, Caterpillar Inc. found itself in the *Wall Street Journal* as a result of an examination by the Senate Permanent Subcommittee on Investigations regarding its transfer pricing of spare parts sold through its Swiss subsidiary (Haggerty, 2014).

disclosure” of a tax position that is based on one or more authorities and has as little as a 15 percent chance of being sustained on its merits (referred to as “reasonable basis”). Such a position would require a full reserve for financial accounting purposes. Small wonder that most corporations (e.g., Vodafone) only invest in positions that meet the more likely than not threshold, although more-likely-than-not is still more art than science and is in the eye of the beholder.

IV. WHERE DO WE GO FROM HERE?

At the end of the day, the question becomes: why do we care about defining and identifying aggressive tax planning? We can think of three groups who have a vested interest in the ultimate outcomes of tax planning strategies:

1. **The government:** Do these activities deprive the government of tax revenues in ways that were unintended or unanticipated when the legislation or regulations associated with the tax strategy were written?

2. **Shareholders:** What is the degree of tax risk (variability of tax outcomes) inherent in the tax strategies employed by management (e.g., transfer pricing)? Can the shareholders identify the company’s tax risk profile from proxies such as the effective tax rate (GAAP or cash), the UTB, or book-tax differences? As Blouin (2014) points out, the real issue is not why do corporations invest in tax planning, but rather why some companies do more tax planning than others? What kind of disclosures inform interested parties as to whether the corporation has over-invested in tax strategies such that the benefits of the investment (lower explicit taxes) are less than the potential costs associated with the investment (e.g., costs due to audit adjustments, loss of reputation, impact on financial statements)?
(3) *Management:* How sustainable are these tax strategies and how do they contribute to both shareholder value and management compensation and retention? Will public disclosure of these tax strategies harm the company’s reputation and result in a loss of sales or customer loyalty?\(^{13}\)

Tax risk management will become even more important as other countries aggressively seek more revenue from real or perceived aggressive cross-border tax strategies. The OECD’s BEPS project (OECD, 2013a, 2013b) will bring with it more demands for transparency.\(^ {14}\) The reporting environment for tax departments today has clearly intensified, as illustrated in Figure 2.

Ernst & Young’s (2014) tax risk and controversy survey reveals that 89 percent of worldwide respondents are somewhat or significantly concerned about the media coverage on the taxes some companies are paying or their seemingly low effective tax rates. Almost two-thirds felt that tax administrators were now challenging existing structures due to changes in the law or changes in their enforcement approach. Further, 69 percent experienced more aggressive, focused tax enforcement and a sense that mutually constructive relationships between taxpayers and authorities are becoming strained.

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13 Both Starbucks and Google have been under siege for not paying their “fair share” of taxes. Both have been subject to Internet petitions to pay more taxes.

14 See Donohoe, McGill, and Outslay (2012 and 2013) for a more detailed discussion.
Finally, corporations will have to reconsider whether paying taxes is part of a greater social responsibility. Aggreko, a U.K. corporation, states in its financial statement for 2013:

We recognise the importance of the tax we pay to the economic development of the countries in which we do business, and we aim to be transparent with our stakeholders in terms of the geographic spread of where we pay tax.

The BEPS project which would impose country-by-country reporting of a company’s income and taxes may push the social responsibility issue into the boardroom sooner rather than later, whether corporations are ready for it or not.

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DISCLOSURES

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