

Zusatztext in englischer Sprache zur  
kumulativen Dissertation zum Themengebiet:

## **The Effect of Management Structure and Manager Liability on Tax Avoidance**

vorgelegt von

**Henning Giese**  
Haslangstraße 49  
85049 Ingolstadt

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Erstgutachter: Prof. Dr. Reinald Koch

Zweitgutachterin: Prof. Dr. Dominika Langenmayr

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# 1 Introduction

Tax avoidance is one of the predominant topics of the 21<sup>st</sup> century. The current OECD initiative on base erosion and profit shifting (OECD, 2021) and the European Union tax policy agenda (EU, 2021) highlights the importance of this issue. Despite the public interest in tax avoidance (Asay et al., 2021), the empirical tax literature has documented that not all corporations engage in tax avoidance. This so-called under-sheltering puzzle (Weisbach, 2002) is surprising, given that fewer tax expenses lead to higher cash flows and, therefore, higher enterprise values (Jacob et al., 2021). Hence, part of the tax avoidance literature attempts to analyze factors that can explain heterogeneity in the degree of corporate tax avoidance behavior.

Starting with Hines and Rice (1994), these studies have focused on firm- and country-level determinants of the heterogeneity in corporates' tax burden. For example, size, leverage, foreign operations, capital intensity, and return on assets have been identified as determining factors (Gupta and Newberry, 1997; Lisowsky, 2010; MacKie-Mason, 1990; Rego, 2003; Wilson, 2009). Since these determinants only partly explain corporate tax avoidance behavior, employees with decision-making power, such as CEOs and CFOs, were included. In the management literature, it is widely accepted that explaining corporate behavior and performance (e.g., Bertrand and Schoar, 2003; Chatterjee and Hambrick, 2007) should consider the personal abilities, attitudes, and characteristics of the involved managers. Following these findings, in tax studies, the manager has been identified as an important determinant of tax avoidance (Dyreng et al., 2010). One strand of this literature documents the link between management compensation and tax avoidance. Phillips (2003) shows that using after-tax performance measures for management compensation helps firms to reduce their tax expenses. He observes this effect for business unit managers but finds no significant relationship for the compensation of CEOs. Gaertner (2014) and Armstrong et al. (2012)

complement this study and document similar influences for CEOs (Gaertner, 2014) and tax directors (Armstrong et al., 2012). A second strand focuses on the managers and their characteristics, attitudes, and skills. Dyreng et al. (2010) evaluate the effects of 908 executives that move across firms over time and find the existence of a manager-fixed effect on company's tax avoidance. Koester et al. (2016) show that managers with high resource management abilities are more successful in reducing the effective tax rate. Additionally, Feller and Schanz (2017) provide evidence that the implementation of tax planning methods varies with respect to the tax manager's level of influence within the company. Others document a positive relationship between managers' private tax evasion (Chyz, 2013), overconfident (Chyz et al., 2019), narcissistic CEOs (Olsen and Stekelberg, 2016), and corporate tax avoidance. In contrast, managers with a military background (Law and Mills, 2016) and female CEOs (Francis et al., 2014) are less tax aggressive.

While these studies document the manager's relevance in corporate tax avoidance, the scope of these prior studies is limited to two dimensions. They focus mostly on top-level management, whereas lower-level management of the head office and managers of subsidiaries are widely disregarded. Moreover, existing studies focus on individual managers and ignore the influence of management and organizational structure.

Another factor that could explain the heterogeneity in companies' tax avoidance behavior is the difference in the possibility of being sanctioned for aggressive tax avoidance. The rationale behind this is that aggressive tax avoidance strategies often make use of an uncertainty in the tax code that could be deemed illegal. Generally, higher penalties and a higher probability of detection should be associated with less tax evasion by individuals (Allingham and Sandmo, 1972). Empirical literature, however, documents mixed results (Beck, Jon, and Jungs, 1991; Park and Hyun, 2003). This gained knowledge may not be transferable to the corporate setting (Slemrod, 2004) owing to differences in individual and

corporate behavior. Following this argument, Crocker and Slemrod (2005) show that within a principal-agent framework, penalties imposed on the manager are more effective in reducing tax evasion than penalties imposed on the corporation. Concerning a higher probability of detection, Atwood et al. (2012) and Hoopes et al. (2012) document a reducing effect of (perceived) enforcement on tax avoidance. However, none of these studies investigate the effect of tax evasion penalties imposed on managers (and corporations) on aggressive tax avoidance.

Given the lack of prior studies on these aspects, this dissertation assesses the effect of management structure and manager liability on tax avoidance. More precisely, each study in this dissertation concentrates on a different aspect of management structure or manager liability on tax avoidance. The first study analyzes how corporations can implement a management structure that fosters shifting profits from high tax to low tax subsidiaries. It further investigates whether such structures are used by MNEs, and if so, whether they are effective. The second study analyzes the structure of the tax department. It investigates whether a centralized tax department is associated with an efficient tax management that reduces tax liability and tax risk. The third study focuses on the deterring effect of penalties for tax evasion on aggressive tax avoidance. It analyzes the different effects of penalties imposed on managers and corporations on the degree of corporate tax aggressiveness. The three studies taken together contribute to the overall research question of this dissertation on how management structure and manager liability can help explain the differences in the degree of corporate tax avoidance.

## 2 Abstracts

### **Tax Avoidance and Vertical Interlocks within Multinational Enterprises**

This paper investigates to what extent multinational enterprises (MNEs) strategically choose subsidiary managers in order to facilitate tax planning. Using a cross-section data set taken from the AMADEUS database, we show that managers that jointly work for a foreign subsidiary and the parent company (VMIs) are more frequently observed in MNEs with a higher potential for profit shifting. Additionally, we show that the implementation of VMIs is motivated by an internal principal agent conflict arising from conflicting interests between the MNE and high-tax subsidiary managers. Hence, we find VMIs more frequently in high-taxed subsidiaries. Finally, we show that the use of VMI structures is successful in terms of lowering the effective tax rate of the MNE.

### **The Effect of Tax Department Structure on Tax Avoidance and Tax Risk**

Even though several studies examine employees with decision-making power to explain corporate tax avoidance behavior, they largely ignore the influence of the tax department. Thus, this study investigates whether a centralized tax department is associated with significantly efficient tax management in reducing tax liability and tax risk. It employs a hand-collected data set for European listed multinational enterprises, obtained from a major professional networking website. Accordingly, three key findings emerge: Significantly centralized tax departments relate to an overall lower effective tax rate and tax risk; tax employees working outside the home country are more likely to be located in tax complex countries; and the location of tax employees in tax complex countries is associated with lower tax risk. Hence, this study illuminates the internal workings of the tax department, helping explain the variation in tax avoidance and tax risk across firms.

### **Tax Evasion Penalties and Aggressive Tax Avoidance**

Whether the deterrence of sanctioning multinational enterprises (MNEs) for tax evasion and the possibility to penalize managers reduces aggressive tax avoidance behavior is hitherto unknown. Using a hand-collected dataset for European listed MNEs, I examine the association between tax evasion penalties for corporations as well as managers in headquarter countries and the degree of aggressive tax avoidance by MNEs. The rationale behind this is that aggressive tax avoidance strategies often exploit uncertainty in the tax code that could be deemed illegal. I report three key findings: (1) penalties levied on corporations are not associated with a reduction in the degree of tax aggressiveness; (2) enhanced prison time and larger fines for managers are associated with a lower level of tax aggressiveness; (3) a higher level of enforcement enhances these findings. My results suggest that countries trying to reduce aggressive tax avoidance behavior should increase fines for tax evasion imposed on managers.

### 3 Articles of the Cumulative Dissertation

#### Tax Avoidance and Vertical Interlocks within Multinational Enterprises

Authors	<p>Dr. Markus Gamm, Chair Business Administration and Business Taxation, Catholic University of Eichstätt-Ingolstadt, Auf der Schanz 49, 85049 Ingolstadt</p> <p>Henning Giese, Chair Business Administration and Business Taxation, Catholic University of Eichstätt-Ingolstadt, Auf der Schanz 49, 85049 Ingolstadt</p> <p>Prof. Dr. Reinald Koch, Chair Business Administration and Business Taxation, Catholic University of Eichstätt-Ingolstadt, Auf der Schanz 49, 85049 Ingolstadt</p>
Conferences	<p>Gamm, M., H. Giese, and R. Koch. 2018. Tax avoidance and the use of joint managers within multinational enterprises. 41<sup>st</sup> Annual Congress of the European Accounting Association, Milano.</p> <p>Gamm, M., H. Giese, and R. Koch. 2018. Tax avoidance and the use of joint managers within multinational enterprises. 8<sup>th</sup> EIASM Conference on Current Research in Taxation, Muenster.</p> <p>Gamm, M., H. Giese, and R. Koch. 2018. Tax avoidance and the use of joint managers within multinational enterprises. Annual Doctoral Conference of the Oxford University Centre for Business Taxation, Oxford.</p> <p>Gamm, M., H. Giese, and R. Koch. 2018. Tax avoidance and the use of joint managers within multinational enterprises. 4<sup>th</sup> Vienna Doctoral Consortium in Taxation, Vienna.</p> <p>Gamm, M., H. Giese, and R. Koch. 2020. Tax avoidance and the use of joint managers within multinational enterprises. EAA 36<sup>th</sup> Doctoral Colloquium in Accounting, Bucharest (accepted).</p>

Contribution	The article is joint work with Dr. Markus Gamm and Prof. Dr. Reinald Koch. Markus Gamm developed the original idea, which was further developed by Henning Giese and Reinald Koch. Henning Giese performed the data work, the analysis and interpretation of results. He also wrote the first draft of the paper. Reinald Koch advised him in all of these steps and was involved in revising the original draft.
Project timeline	The project started after Henning Giese's matriculation as a PhD Student in March 2017. The paper was first presented in 2018 and was completed in 2021.

This study investigates the extent to which MNEs strategically choose subsidiary managers to facilitate tax planning from high-to-low-taxed subsidiaries. Tax planning via profit shifting relies on the idea that – from an MNE's perspective – profits should be allocated to low tax subsidiaries to reduce the MNE's overall tax burden and thus maximize after-tax profits and firm value. For a multinational firm with a parent company  $P$  and two foreign subsidiaries,  $H$  (located in a high-tax country) and  $L$  (located in a low-tax country), one would assume that shifting profits from subsidiary  $H$  to  $L$  is desirable from a group perspective. The problem arises as to whether managers act per the MNE's interest (internal principal agent conflict). Suppose the subsidiary managers (and not the parent company managers) are responsible for the profit shifting decision, then the manager of the high-tax subsidiary  $H$  may not automatically be willing to accept a transfer of profits. Whereas parent company managers act to maximize the MNE's after-tax profit, subsidiary managers may try to maximize the after-tax profit of the individual unit if manager compensation or other personal benefits are linked to the individual unit's performance. This study proposes vertical manager interlocks (VMIs) as a solution. VMIs are managers with concurrent positions for the MNE headquarter and a foreign subsidiary.

This study shows that VMIs are more frequently observed in MNEs with a higher potential for tax-efficient profit shifting. Additionally, the study provides evidence that these structures are motivated by the above-described internal principal agent conflict since VMIs are placed significantly more frequently in high-tax subsidiaries than in low-tax subsidiaries. Finally, the study shows that VMIs explain some of the cross-sectional heterogeneity in corporate tax avoidance. MNEs that use VMI structures to a larger extent report, on average, a significantly lower effective tax rate.

## The Effect of Tax Department Structure on Tax Avoidance and Tax Risk

Authors	Henning Giese, Chair Business Administration and Business Taxation, Catholic University of Eichstätt-Ingolstadt, Auf der Schanz 49, 85049 Ingolstadt  Prof. Dr. Reinald Koch, Chair Business Administration and Business Taxation, Catholic University of Eichstätt-Ingolstadt, Auf der Schanz 49, 85049 Ingolstadt
Conferences	Giese, H., and R. Koch. 2021. The effect of tax department structure on tax avoidance and tax risk. 1 <sup>st</sup> Virtual Congress of the European Accounting Association, virtually.  Giese, H., and R. Koch. 2021. The effect of tax department structure on tax avoidance and tax risk. 105 <sup>th</sup> Annual Meeting of the American Accounting Association, virtually.  Giese, H., and R. Koch. 2021. The effect of tax department structure on tax avoidance and tax risk. 77 <sup>th</sup> Annual Congress of the IIPF, virtually.
Contribution	The article is joint work with Prof. Dr. Reinald Koch. Reinald Koch developed the original idea. Henning Giese further developed this idea in close consultation with Reinald Koch. Henning Giese hand-collected the data, performed the analysis and interpretation of the results. He is also mainly responsible for writing the current draft.
Project timeline	The project began in August 2019. The data collection took place in December 2019 and January 2020. As part of a new cooperation with Prof. Dr. Caren Sureth-Sloane (University of Paderborn), the article will be revised and afterwards prepared for submission.

This study investigates whether a centralized tax department is associated with a more efficient tax management that reduces tax liability and risk. Generally, the optimal level of centralization is achieved by minimizing the total cost of knowledge transfer and foreign employee control

(Nagar, 2002). If tax department employees are only located in the home country, communication costs and costs associated with the coordination of subsidiaries to act according to the MNE tax strategy can be saved. However, if tax department employees work across MNE subsidiaries, coordination costs – as rooted in operational costs such as language differences and especially implementing and monitoring the overall tax strategy – increase. As tax avoidance schemes today are complex (Sikka and Hampton, 2005) and require the interplay of different subsidiaries across multiple jurisdictions, centralized coordination may be associated with tax avoidance. In contrast, rapid tax legislation changes and several subsidiaries mean that MNEs with decentralized tax departments may face lower tax risk.

Using a unique dataset of tax department employee locations extracted from their résumés on a major professional networking website for European STOXX600 companies, we test whether the organizational form of the tax department is associated with tax avoidance and tax risk. The study documents that a centralized tax department is associated with a lower effective tax rate (ETR) and lower tax risk. If centralized tax departments are favorable in terms of lowering the ETR and reducing tax risks, the pending question remains, why do MNEs locate tax personnel outside their home country? Therefore, we analyze the location of MNEs' tax personnel outside the home country and how these investments influence tax risk. Conditional on establishing a subsidiary in the country, employees are more frequently in jurisdictions with complex tax systems (using the tax complexity index by Hoppe et al., 2018). Placing tax personnel in countries with a complex tax system also improves the tax department's lower tax risk performance.

## Tax Evasion Penalties and Aggressive Tax Avoidance

Author	Henning Giese, Chair Business Administration and Business Taxation, Catholic University of Eichstätt-Ingolstadt, Auf der Schanz 49, 85049 Ingolstadt
Conferences	-
Contribution	This is a single authored paper.
Project timeline	A pre-study of this project was conducted in 2018. The project resumed in March 2021. After presentations at conferences, the paper is planned to be submitted in 2022.

This study investigates the deterring effect of tax evasion penalties and enforcement on tax aggressiveness. While aggressive tax avoidance, in general, is not a crime, it often involves an extensive level of interpretation of the tax code. Such an interpretation always bears the threat of being deemed illegal by tax authorities, resulting in evasive tax behavior that may be sanctioned. Prior literature documents that the more severe these penalties, the less likely tax evasion on an individual level should occur (Allingham and Sandmo, 1972). Following this argument, a higher level of penalties imposed on managers should be associated with a lower level of tax aggressiveness. The same may be true for the possibility of sanctioning MNEs since manager actions leading to penalties imposed on the MNE could also prove costly for the respective manager. However, it is unclear whether managers associate aggressive tax avoidance actions with tax evasion. Also, they could believe that their actions would not be discovered. Furthermore, managers could sustain from changing their prior tax aggressive behavior to avoid raising attention. Moreover, it is far from certain that MNEs will pass the fines on to the manager. All of these cast doubt on the effectiveness of penalties.

Using hand-collected data on the severity of MNE's home country tax evasion penalties for a panel of European listed companies, this study documents that penalties imposed on MNEs are not associated with a lower level of tax aggressiveness. In contrast, the MNE's home

country's maximum prison time and the fine level imposed on managers are associated with the MNE's degree of aggressive tax avoidance. This study finds prison time to be more effective than fines. Building on prior literature, this study finds that the association between maximum prison time and aggressive tax avoidance is more pronounced in countries with a high degree of enforcement. Collectively, these results provide evidence that more threatening penalties imposed on managers are more effective in reducing the degree of MNE tax aggressiveness.

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