CEO-Board Social Ties and Corporate Tax Avoidance

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Background

Prior studies find that:

- CEOs play an important role in the development of corporate tax avoidance (Dyreng, Hanlon, & Maydew, 2010);
- CEOs are responsible for the firm's tax strategies (Chyz & Gaertner, 2017); and
- CEO's innate characteristics are associated with engagement in corporate tax avoidance (Christensen, Dhaliwal, Boivie, & Graffin, 2015; Chyz, 2013; Law & Mills, 2017; Olsen & Stekelberg, 2015).

Considering that CEOs are unlikely to be a tax expert (Dyreng, Hanlon, & Maydew, 2010), it is not clear in the literature ***how*** CEOs affect corporate tax avoidance.

This study proposes that one of the potential channels for CEOs to affect corporate tax avoidance is through their **social ties with the independent directors (CEO-board social ties).**

How CEO-board social ties impact corporate tax avoidance?

1. CEO-board social ties hinder independent directors' willingness to monitor (and the act of monitoring) the CEO's decisions (Adler & Kwon, 2002; Fracassi & Tate, 2012). Hence, self-interested CEOs are likely to take the opportunity of weak monitoring to pursue corporate tax avoidance;
2. CEO-board social ties can facilitate internal information sharing because CEOs know that the socially connected independent directors will support (e.g., through assistance in the implementation of tax avoidance strategies or connecting them to experts external to the firm) initiatives and decisions of the CEO (Fink, 2005; Hoitash, 2011).

Hypothesis: ***Ceteris paribus, CEO-board social ties are positively associated with corporate tax avoidance***

Results

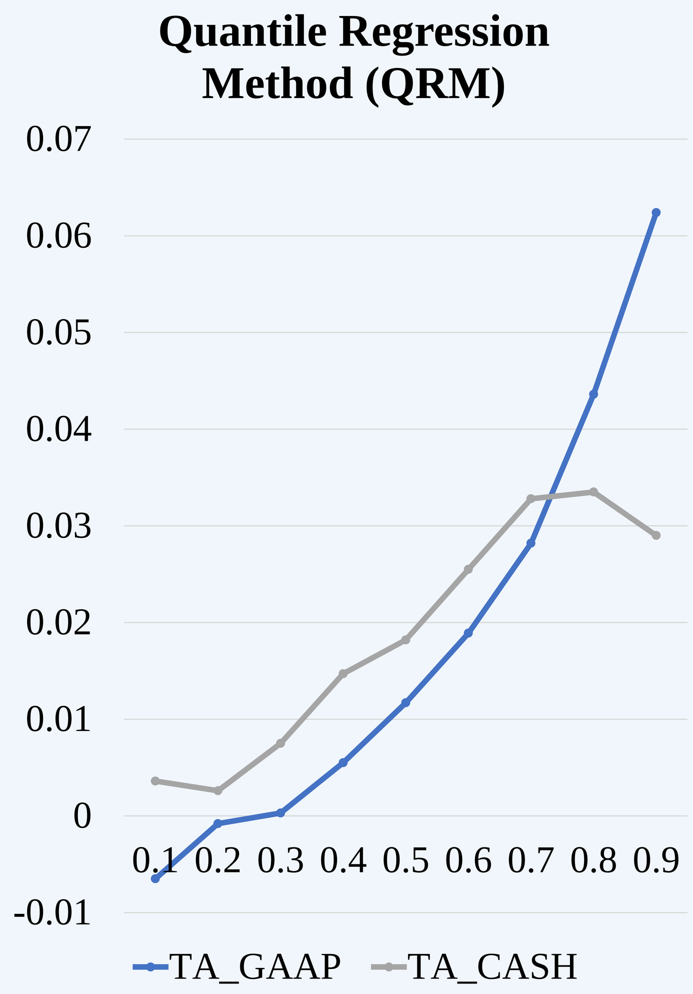
VARIABLES	(1) *TA_GAAP*	(2) *TA_CASH*
Constant	-0.4414***	-0.3714***
	(-15.04)	(-10.18)
ALLTIE	0.0238***	0.0164***
	(4.73)	(2.81)
Controls	Yes	Yes
Industry& Year FE	Yes	Yes
Observations	19,037	18,509
Adjusted R-squared	0.0951	0.1180

The results from ordinary least square (OLS) regression show that the coefficient on *ALLTIE* (i.e., CEO-board social ties) is positive and significantly correlated with corporate tax avoidance of a firm. These results suggest that:

as the proportion of socially connected independent directors in a firm increase, the firm increases their corporate tax avoidance.

Robustness and Additional Tests

1. By using difference-in-difference (DiD) design, we find that the level of TA_GAAP and TA_CASH decrease upon the occurrence of the death and/or retirement of socially connected independent directors.
2. The positive association between CEO-board social ties and corporate tax avoidance is likely to be driven by socially connected independent directors who have financial expertise.
3. The positive association between CEO-board social ties and corporate tax avoidance is enhanced by the purchase of non-audit tax services from a tax expert auditor and the firm's taxable income persistence, and is hindered by the level of the CEO's inside debt holdings.
4. The positive association between CEO-board social ties and corporate tax avoidance is more pronounced at the higher levels of engagement (i.e., at the right tail of the distribution) and the difference (i.e., between upper and lower quantiles).
5. The results show a positive and statistically significant association between CEO-board social ties and the alternative proxies (3-year TA_GAAP, 3-year TA_CASh, and BTD).
6. The employment ties (TIEEMP) are positive and significantly associated with corporate tax avoidance while the other sources of CEO-board social ties are generally insignificant.
7. There is a positive and statistically significant association between CEO-audit committee social ties and corporate tax avoidance.



Methods

The impact of CEO-board social ties on corporate tax avoidance is examined using a tax avoidance model proposed by prior studies (Armstrong et al., 2015; Bruynseels & Cardinaels, 2014; Hoi, Wu, & Zhang, 2013)

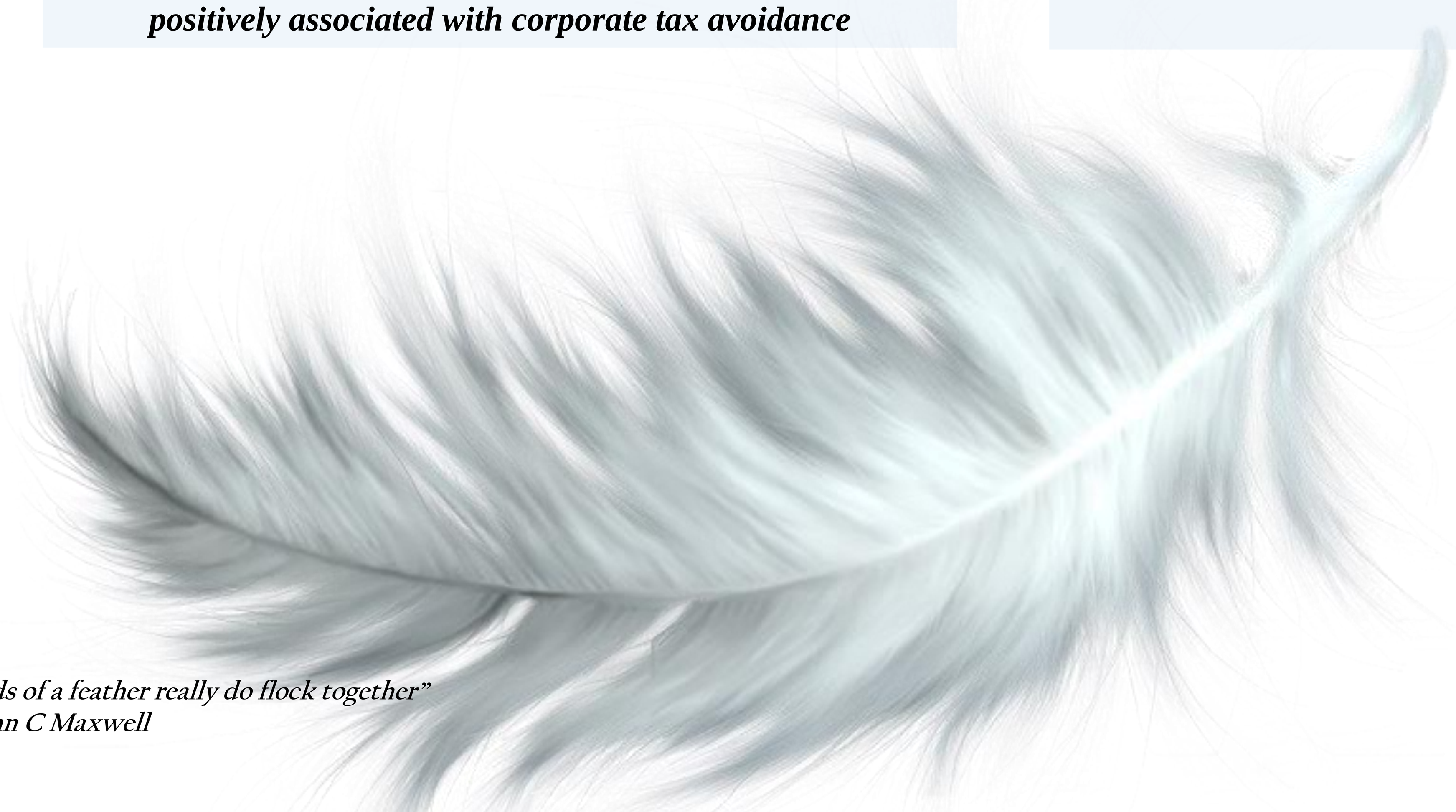
$$TA_{i,t} = \alpha_0 + \alpha_1 ALLTIE_{i,t} + \alpha_2 SIZE_{i,t} + \alpha_3 ABS\_DA_{i,t} + \alpha_4 ROA_{i,t} + \alpha_5 LEV_{i,t} + \alpha_6 EQINC_{i,t} + \alpha_7 CASH_{i,t} + \alpha_8 NOL_{i,t} + \alpha_9 CHNOL_{i,t} + \alpha_{10} FI_{i,t} + \alpha_{11} BTM_{i,t} + \alpha_{12} CH\_SALE_{i,t} + \alpha_{13} PPE_{i,t} + \alpha_{14} RD_{i,t} + \alpha_{15} BOARDINDP_{i,t} + \alpha_{16} DUAL_{i,t} + \alpha_{17} BOARDSIZE_{i,t} + YEAR\ FE + INDUSTRY\ FE$$

The dependent variables used in this study are two proxies of corporate tax avoidance (TA), namely Generally Accepted Accounting Principles (GAAP) effective tax rate (*TA_GAAP*) and cash effective tax rate (*TA_CASH*).

All variables are collected from databases, including BoardEx and Compustat, for the period 2000 to 2016.

Contribution

1. This study extends a broader literature that links CEO characteristics to corporate tax avoidance. By using social network theory, we demonstrate that CEOs utilize their social connections with independent directors to affect corporate tax avoidance.
2. This study extends literature on the consequences of CEO-board social ties by finding that CEO-board social ties are positively associated with corporate tax avoidance.
3. While socially connected directors may encourage openness and knowledge transfer between the CEO and board of directors, they may also underperform in their monitoring role due to mutual trust and reciprocity effect with the CEO. Therefore, the existence of socially connected independent directors must be considered by investors.
4. Policymakers may need to reconsider the definition of independence (i.e., tighten the definition of "independent directors" or expand the definition of "affiliated person") to enhance board independence in fact.



"Birds of a feather really do flock together"
– John C Maxwell

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