What does tax aggressiveness signal? Evidence from stock price reactions to news about tax avoidance in Korea

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Abstract

The present study examines the market reaction to news of corporate tax aggressiveness from 1990 to 2012. On average, the sample shows a statistically significant negative stock price reaction of 0.5 percent in response to news of involvement in tax aggressiveness. The market reacts less negatively for firms with a higher cash effective tax rate (ETR), indicating that the firm is not aggressive enough, resulting in news of tax aggressiveness being considered in a positive light. The companies spending high advertising expenses get more negative market reactions, suggesting that negative market reaction may be based on the loss of reliability of the firm and a customer backlash. For governance, measured using the percentage ownership of the controlling shareholder and of foreign shareholders, the results do not indicate a significant difference in market reactions between poorly governed and well governed companies. However, the estimated coefficient CASH ETR is positive and significant only for firms with higher proportions of foreign shareholders than the sample median proportions of foreign shareholders.

1. Introduction

Shareholders typically expect firms to minimize corporate tax payments to maximize the value of the firm; thus, tax avoidance has been rampant throughout recent decades. In the present study, a broad search of Mediagao1) from 1990 to 2012 was conducted to identify Korean companies involved in tax avoidance. The form of tax avoidance changes over time. In the nineties, about the most common tax avoidance strategies involved gift and estate tax evasion by using abnormal stock transactions, the change of type of income to take advantage of to lower tax rates, and recognition of expenses not reported for tax purpose. Notable companies involved in the above-mentioned transaction included Hanjin, Hyundai, Daerim, and Taepyeongyang among others. Some companies engaged in these tax avoidance transactions changed the companies’ name or were forced into reorganization. In the 2000s, the form of tax avoidance was focused on tax havens: engaging in off-shore financing and backdoor listing. Currently, many listed

1) Media portal services articles from KINDS(Korean Integrated Newspaper Database System), contents from Korea Press Foundation and more than 20 Korean media related organizations, media groups and web sites. Among the several search sections, I only captured articles from national daily news paper section.
companies operate through tax haven, as least in part. As mentioned above, the form of tax avoidance has changed over 22 years and in ever-increasing efforts to maximize the value of the firm and to escape the supervision of tax authorities.

This paper examines the consequence of tax aggressiveness from the perspective of market reaction to news of tax aggressiveness in Korea; this is focused on the analysis of the viewpoint of benefits and costs of corporations of being tax aggressive. There is a considerable body of literature that examines tax avoidance; however, there is very little rigorous research on the firms that engage in tax aggressiveness. Specifically, prior literature has not investigated the market response to news of corporate tax aggressiveness in Korea.

The sample is extracted from searches of newswire in Mediagaon for the term “Talse”2 along with "Corporation" between January 1, 1990 and December 31, 2012. “Tax aggressiveness” in this paper is defined as a broad range of activities including tax avoidance, tax savings, and tax evasion as well as downward manipulation of taxable income through tax planning that may or may not be considered fraudulent tax evasion.

On average, companies in the sample underwent a statistically significant negative stock price reaction of 0.5 percent when news of involvement in tax aggressiveness emerged. Several consequence of tax aggressiveness of cross-sectional variation in the return are pointed out below. The market reacts less negatively for firms with a higher cash ETR, thereby indicating a perception that the firm is not aggressive enough, and resulting in the news of tax aggressiveness being taken as a positive signal. The company spending higher advertising expenses get more negative market reaction to the news of tax aggressiveness, suggesting that negative market reaction may constitute the loss of reliability of the firm and a customer backlash. For governance, considering the percentage of controlling shareholder and the percentage of foreign shareholders, the results do not indicate a statistically significant difference in market reactions between poorly governed and well governed companies. However, the estimated coefficient CASH ETR is positive and significant only for firms with higher proportions of foreign shareholders than the sample median proportions of foreign shareholders.

The remainder of the paper is organized as follows. Section 2 presents the theoretical background of the study with a review of prior literature on the market responses to corporate misdeeds by using an event-study methodology and relevant empirical tax research. Section 3 presents and discusses hypotheses. Section 4 discusses the sample and research design along with event date and univariate statistical test. Section 5 reports and discusses statistical significance and regression results of the study. Section 6 provides concluding remarks.

2) Talse means tax avoidance in Korean. The terminology represented by tax aggressiveness in Korean could be listed as follows: Talse, Jesehoip, Choijing, JosePotal according to professionals including CPAs and CTAs. I choose the word of Talse corporation since most it is seen on the articles more often.