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Tax Avoidance and Corporate Governance Mechanisms: Evidence from Tehran Stock Exchange

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ABSTRACT

This study aims to investigate the relationship between certain mechanisms of corporate governance and tax avoidance in companies listed on the Tehran Stock Exchange during the years 2011-2015. In this regard, the effect of some corporate governance indices (number of board members, non-duty members, managerial ownership and institutional ownership) on tax avoidance was investigated. The sample comprises 104 companies listed in the Tehran Stock Exchange. Eviews software was used for analyzing the data and multiple regression was used to test the hypotheses. Results indicated that there is no significant relationship between number of board members, proportion of non-duty members, institutional ownership and tax avoidance. Furthermore, there is no significant relationship between managerial ownership and tax avoidance.

Keywords: Tax Avoidance, Anti-tax, Income Tax Evasion, Tax Evasion
JEL Classification: H26

1. INTRODUCTION

At the beginning of the twentieth century and by the formation of public joint stock companies, a great shift occurred in the area of economics and management. This phenomenon has led to the development of industry and economy as well as the separation of management from ownership, and subsequently, conflict of interest and agency problems. The community of various groups of company stakeholders highlighted the issue of contracts, including implicit and explicit ones. It is obvious that every group of stakeholders seeks their specific interests, benefits that sometimes could be conflicting. Corporate governance was introduced to make balance between different groups of stakeholders. Corporate governance is a multi-dimensional concept, which is accountable for the transparency and responsibility, and preserving equity and rights of the stakeholders are the fundamental concepts of corporate governance. The main question here is that the interests of which group should the company consider. The shareholders or all the stakeholders? The shareholder approach (agency theory) considers the company in service of its owners that is the shareholders. On the other hand, the stakeholder approach tries to meet the needs of not only the shareholders but also other interested groups.

The base of the stakeholder's theory is that apart from shareholders, companies must pay attention to other parts of the society because of company growth and their profound impact on society. Regardless of this, as mentioned above, there may be conflicts of interest between stakeholders. The strategy of a company may provide benefits for the shareholders and managers in elimination or reduction of taxes. However, this strategy may be detrimental for the government (Mashaiekhi and Seyyedi, 2015). Theoretical foundations and empirical evidences suggest that tax avoidance can be a tool to save taxes and reduce company costs, and consequently, increase shareholder wealth (Huseynov and Klamm, 2012). However, some researchers argue that companies that make use of tax havens have no social responsibility, and the market has a negative reaction toward these companies, and thereby, the value of the companies fall (Hanlon and Heitzman, 2010). According to the 20-year perspective document of the country, until the end of the 5-year economic development program, the government should acquire its current expenses from non-oil revenues, which are mainly provided by taxation. However, statistics indicate that tax revenues make up a very small share of the country's revenue sources. Hence, the government should seek to increase its tax revenues, and in this regard, the importance of studies related to tax and factors affecting tax revenues of the government become more apparent (Mashaiekhi and Seyyedi, 2015). This study investigates whether or not corporate governance is an effective factor on tax avoidance. In other words, this study attempts to examine how strong corporate governance affects tax avoidance. For this purpose, the concepts of corporate governance and tax avoidance as well as the relevant theoretical foundations will be raised. Then, after a review of the literature, the research hypotheses will be offered. The findings will be interpreted and finally, the last section of this study provides the conclusion.

2. THEORETICAL PRINCIPLES

Tax is a part of income and assets, which is collected in order to pay for public costs and the implementation of fiscal policies to maintain economic, social and political interests via rules and official and administrative levers of government. Some experts believe that tax is a sum of money that the government obtains from individuals, companies and public institutions for the general strengthening of the government and public supply according to rules and regulations (Sarvestani, 2012). As the payment of tax transfers wealth from the company and its owners to the government, most companies design and implement their management practices in such a way that minimizes their tax obligations (Mehrani and Seyyedi, 2014).

In accounting literature, tax avoidance has been defined in both broad and narrow dimensions. Broadly speaking, tax avoidance is defined as the apparent decline in tax per each Rial of accounting profit before tax. Some define tax avoidance as taking legal actions in order to reduce tax liabilities. In a narrow sense, conceptual distinction between tax evasion and tax avoidance is rooted in legality of the payers' actions. Tax evasion is a misdemeanor, while the payer refuses to report his taxable income or wealth, takes an illegal action, which exposes him to legal actions by the tax authorities. In contrast, tax avoidance is done within the framework of tax laws and the payer has no reason to worry about the probable investigation of his actions (Jahromi, 2012). The striking and challenging point is that there is no universally accepted definition about the characterization and structures or tools of tax avoidance and aggressive tax. Definitions and terms used in this regard are different according to conditions and communities (Hasseldine and Morris, 2013). Tax evasion is a kind of violation of the law, but tax avoidance is the use of a legal vacuum, or in other words, the formal abuse of the law where exemptions and incentives are legal. Another difference between tax evasion and tax avoidance can be the difference between reactions to disclosure. In tax avoidance, the person is not concerned about the disclosure of his act, because he has not committed any illegal act; however, in tax evasion, disclosure of the person's act can have legal consequences, crime and punishment. Although the purpose of both is to exclude tax, but the way to achieve it is different and can distinguish these two issues (Hanlon and Heitzman, 2010). Empirical evidences indicate that a variety of factors including the existence of numerous exemptions in tax structure can also affect tax evasion and tax avoidance. Studies indicate that although exemptions considered in the rules generally have supportive purposes of some regions, sectors and industries, we must be careful that exemptions and incentives cannot always have a positive feedback, because it can bear a negative effect on people's attitudes toward causing a kind of bribery by the government against the people, which may affect the performance and behavior of other taxpayers (Zehi and Khani, 2010). Some researchers argue that implementing tax avoidance policies can have a negative effect on society. Especially when a company has intentionally or solely executed a plan for the sole purpose of tax avoidance, and that it seems not willing to pay a fair share of its income for the provision of public goods to the government, and this failure causes irreversible harm to the community (Lanis and Richardson, 2011).

3. LITERATURE REVIEW

Armstrong et al. (2015) examined the impact of governance on tax avoidance. They found a positive relationship between the percentage of non-duty members and tax avoidance. They also found that companies with greater institutional ownership have more tax avoidance.

Richardson et al. (2014) examined whether or not incentives granted to managers lead to reduction in tax avoidance. The results of their study indicated that the company's financial status, tax allocation of managers and rewards and incentives tied to the performance of managers is positively and significantly associated with tax avoidance.

Armstrong et al. (2015) investigated the relationship between corporate governance ownership, management incentives and tax avoidance. The results of their study indicated that there is a positive relationship between the independence of board members and financial complexity with a lower level of tax avoidance.

Dhaliwal et al. (2011) conducted a study to investigate the relationship between tax avoidance and the amount of cash held in the company. The results of their study indicated that there is a negative relationship between tax avoidance and the amount of cash. They also found that this negative correlation is weaker in companies with stronger governance mechanisms.

Lanis and Richardson (2011) concluded that the number of non-duty members of the board have a negative and significant relationship with aggressive tax policies. In other words, the greater the number of non-duty board members, the lower the company is inclined to financial management.

Minnick and Noga (2010) conducted a study in which they looked for the effects of features of corporate governance principles on tax management. They indicated that rewards act as incentives for managers to invest in long-term and tax-reducing plans. The findings also indicated that tax management has benefits for the shareholders, and tax management is positively associated with increased profit of shareholders.

Mashaiekhi and Seyyedi (2015) conducted a study and investigated corporate governance and tax avoidance in companies listed on the Tehran Stock Exchange. The relationship between some important standards of corporate governance including institutional ownership, board independence and board size with tax avoidance were studied. For this purpose, 146 companies listed on the Tehran Stock Exchange during 1992-2012 were investigated. The results indicate that there is no significant relationship between corporate governance and tax avoidance.

Rezaei and Azimi (2015) conducted a study to investigate the relationship between corporate governance mechanisms and tax management in companies listed on the Tehran Stock Exchange. In order to test the hypothesis, 80 companies were selected during 2004-2011. The results indicated a significant relationship between independence of board members and the variables of effective cash tax rate, long-term effective cash tax rate, effective commitment tax rate and effective long-term commitment tax rate.

Babajani and Abdi (2010) conducted a study to investigate the relationship between corporate governance and companies' taxable profits in which the relationship between corporate governance and taxable profits was investigated. This investigation was conducted through investigating the relationship between some of the most important criteria for corporate governance including the number of non-duty members in the board, the combinational role of the executive (duality of the tasks of the executive) and institutional shareholders by examining the percentage difference between expressed and certain taxable profit. The results indicated that there is no significant difference between the average percentage difference of expressed and certain taxable profit in companies that meet the standards of corporate governance principles compared to those that do not have corporate governance standards in place. Whereas, in both companies, the percentage difference has been significant between the expressed and certain taxable profit.

3.1. Hypotheses

Based on the theoretical principles and research objectives, the following hypotheses are raised:

- H_1: There is a significant relationship between the number of board members and tax avoidance.
- H_2: There is a significant relationship between non-duty members and tax avoidance.
- H_3: There is a significant relationship between managerial ownership and tax avoidance.
- H_4: There is a significant relationship between institutional ownership and tax avoidance.

4. METHODOLOGY

Considering the research objectives, this study is an applied and quasi-experimental research in its nature. Multivariate linear regression equation was used for data analysis and hypotheses testing. All required data was extracted from the real data of companies included in the CD of the Tehran Stock Exchange. Eviews software was used to analyze the data.

4.1. Population and Sample

The population of the study is the accepted companies listed in the Tehran Stock Exchange.

The time domain of this study is the years 2011-2015.

Systematic elimination method has been used for sampling and the companies that possessed all the following conditions were selected as samples:

1. In order to increase comparability, the financial period should end in March.
2. The company should have be listed on the Tehran Stock Exchange before 2011.
3. The required information related to these companies should be available.
4. The companies should not include banks and financial institutions (investment companies, financial intermediaries, holding and leasing companies), because their financial disclosures and structures are different.
5. The company should not have a year change or activity change within the time domain.

By applying the above-mentioned conditions among the companies listed on the Tehran Stock Exchange, 104 companies were selected as samples of this study.

4.2. Variables

Features of corporate governance principles including the number of board members, non-duty board members, managerial ownership and institutional ownership are the independent variables in this study. Tax avoidance is considered as dependent variable. Specific features of the company including company size and financial lever have been considered as control variables that we will be discussed in later sections.

4.3. Dependent Variable

Tax avoidance: Represents tax avoidance of company i in year t. The pattern used to operationalize tax avoidance is the pattern introduced by Mehrani and Seyyedi (2014), which is as follows.

Statutory rate of tax - actual rate of tax = tax avoidance.

4.4. Independent Variables

Corporate governance principles including the number of board members, non-duty board members, managerial ownership and institutional ownership are independent variables in this study.

Board size (BZ): Total number of company board members.

Percentage of non-duty board members (ND) is equal to the number of non-duty board members divided by the total number of board members.

Percentage of managerial ownership (CMP) is equal to the percentage of shares held by members of the board.

Percentage of institutional stock ownership (INSINV) equals the percentage of shares held by state and public corporations.

4.4. Control Variables

Specific features of the companies including size and financial leverage have been considered as control variables in this study.

Size of the company ($SIZE_{i,t}$) is obtained through natural logarithm of the company's market value.

Financial leverage ($LEV_{i,t}$) is obtained by dividing the company's total debt to total assets. Jensen (1986) indicated that high debt levels cause problems of representative. We used the division of total debts by book value of equities as the debt ratio.

4.5. Data Analysis

In order to test the hypothesis, the multivariate linear regression model was used in this study.

$$\text{Tax avoidance}_{it}=\alpha_1+\alpha_2 BZ_{it}+\alpha_3 ND_{it}+\alpha_4 CMP_{it}+\alpha_5 INSINV_{it}+\alpha_6 SIZE_{it}+\alpha_7 LEV_{it}+\varepsilon$$

5. FINDINGS

5.1. Results of Descriptive Statistics

Table 1 represents the descriptive statistics of the data used in this study. Results of data analysis indicate that average tax avoidance is equal to 0.181 and its standard deviation is 0.0637; the average number of board members equals 5.805 and its standard deviation is 0.554; the mean of the ratio of non-duty members is equal to 0.489 and the standard deviation is 0.256; the average managerial ownership is 5.271 and the standard deviations is 15.39; the mean of institutional ownership is equal to 7.586 and the standard deviation is 58.51; the average size of the company is 6.093 and the standard deviation is 0.577, and the mean of financial leverage is equal to 0.618 and the standard deviation is 0.245. The results of Jarque and Bera test for all variables indicate abnormality of the variables. According to abnormality of variables, the researcher used mathematical function for the parity of data.

5.2. Results of the Statistical Tests of the Hypotheses

Considering that the analyzed data are combined data, we should first determine the type of model estimation using the Chow (F Limer) test. The result of Table 2 indicates that the error rate calculated for Arch test for the hypotheses is more than 0.05; therefore, this indicates that the hypotheses are not inconsistent. The results of the table indicate that the significance level of the Limer test is more than 0.05. Therefore, the pooling method is used to estimate the models in this study.

5.3. Results of the Assumptions

There is a significant relationship between the number of board members and tax avoidance.

- H_0: There is no significant relationship between the number of board members and tax avoidance.
- H_1: There is a significant relationship between the number of board members and tax avoidance.

It can be observed in Table 3 that the significance level of the t-test for the variable "number of board members" is more than 5% ($P > 0.05$); therefore, H_0 is approved and H_1 is rejected. Consequently, we can say that the relationship between the two variables is rejected and the hypothesis is not confirmed. Therefore, it can be said that there is no significant relationship between the number of board members and tax avoidance. By increasing the number of board members, it is possible to reduce the company's control, and thus, the board will seek to reduce tax.

There is a significant relationship between the ratio of non-duty members and tax avoidance.

- H_0: There is no significant relationship between the ratio of non-duty members and tax avoidance.
- H_1: There is a significant relationship between the ratio of non-duty members and tax avoidance.

It can be observed in Table 4 that the significance level of the t-test for the variable "number of non-duty members" is <5% ($P < 0.01$); therefore, H_0 is rejected and H_1 is approved. Therefore, it can be said that the relationship between the two variables is rejected and the hypothesis is not confirmed. Therefore, it can be said that there is no significant relationship between non-duty members and tax avoidance. The reason for this could be because the role of non-duty members regarding corporate governance and supervision of managers assigned to Iranian companies has only remained as a name, and or the simultaneous membership

Table 1: Results of descriptive statistics of variables

Variables	Index	Average	Standard deviation	Skewness	Kurtosis	Jarque and Bera (error)
Tax avoidance	Tax avoidance	0.181	0.0637	−1.0306	3.709	102.96 (0.00)
Members of the board (number)	BZ	5.805	0.554	−1.068	14.92	3177.96 (0.00)
Non-duty members ratio	ND	0.489	0.256	−0.702	2.600	46.22 (0.00)
Managerial ownership	CMP	5.271	15.93	3.205	12.46	2832.49 (0.00)
Institutional ownership	INSINV	7.586	58.51	21.106	468.08	4755236 (0.00)
Company size	SIZE	6.093	0.577	0.731	4.56	84.68 (0.00)
Financial leverage	LEV	0.618	0.245		6.86	370.27 (0.00)

Table 2: Limer test

Description	Dissimilarity			Limer test		
	Statistic	Significance level	Dissimilarity	Statistic	Significance level	Method
1st hypothesis	1.98	0.159	None	0.987	0.539	Pooling
2nd hypothesis	2.60	0.107	None	0.988	0.538	Pooling
3rd hypothesis	0.356	0.784	None	1.581	1.00	Pooling
4th hypothesis	2.141	0.143	None	0.989	0.534	Pooling

of non-duty board members in several companies may lead to the reduction in their effectiveness.

There is a significant relationship between managerial ownership and tax avoidance.

- H_0: There is no significant relationship between managerial ownership and tax avoidance.
- H_1: There is a significant relationship between managerial ownership and tax avoidance.

It can be observed in Table 5 that the significance level of the t-test for the variable of managerial ownership is more than 5% ($P > 0.05$); therefore, H_0 is rejected and H_1 is approved. Therefore, we can be 99% sure that tax avoidance is affected by managerial ownership, or in other words, managerial ownership has a significant relationship with tax avoidance. T-test results indicate that the relationship is negative and this means the reversal effect of the independent variable on the dependent variable, so that the rising managerial ownership would lead to reduction of the ratio of tax avoidance. This means that companies with higher managerial ownership have higher tax avoidance. Shareholders are usually expected to prefer tax avoidance. Nevertheless, research results suggest that family owners are more concerned than others are about the potential fines and damage to reputation arising from governmental audits and have less inclined toward tax avoidance (Chen et al., 2010).

There is a significant relationship between institutional ownership and tax avoidance.

- H_0: There is no significant relationship between institutional ownership and tax avoidance.
- H_1: There is a significant relationship between institutional ownership and tax avoidance.

It can be observed in Table 6 that the significance level of the t-test for the variable of institutional ownership is <5% ($P < 0.01$); therefore, H_0 is confirmed and H_1 is rejected. Therefore, it can be said that the relationship between the two variables is rejected and the hypothesis is not confirmed. Thus, it can be said that there is no significant relationship between institutional ownership and tax avoidance. Perhaps it would be justified in such a way that the lack of adequate supervising performance of institutional owners is probably due to the fact that institutional owners in Iran are mostly companies and governmental institutions (Pourheydari and Amininia, 2014).

6. CONCLUSION

This study sought to find the answer to the question whether the characteristics of corporate governance affect tax avoidance of companies. In this regard, the criteria including the number of board members, percentage of non-duty members, managerial ownership and institutional ownership were used as corporate governance principles. In testing the first hypothesis, no significant relationship was observed between the number of board members and tax avoidance. The results of this hypothesis indicate that by an increase in the number of board members, control over the company may reduce, and therefore, board members seek to reduce their tax. The results of testing this hypothesis are consistent with the research conducted by the (Mashaiekhi and Seyyedi, 2015). There is no significant relationship between non-duty board members and tax avoidance in testing the second hypothesis. The reason for this could be because the role of non-duty directors in corporate governance and supervision of managers assigned to Iranian companies has only remained as a name, and or the simultaneous membership of non-duty board members in several companies may lead to reduced effectiveness. The results of testing this hypothesis are consistent with research conducted by

Table 3: Estimation of the model for the first hypothesis

Tax avoidance$_{it}$=α_1+α_2BZ$_{it}$+α_3SIZE$_{it}$+α_4LEV$_{it}$+ε				
Description	**Coefficient**	**Standard deviation**	**t-statistic**	**Significance level**
Members of the board (number)	0.0106	0.0243	0.418	0.676
Company size	−0.0547	0.029	−1.85	0.064
Financial leverage	0.067	0.0134	5.014	0.00
Constant value	0.253	0.0914	2.76	0.0059
Coefficient of determination	0.048			
F statistic	8.85			
F significance level	0.00			
Durbin–Watson statistic	2.00			

Table 4: Estimation of the model for the second hypothesis

Tax avoidance$_{it}$=α_1+α_2ND$_{it}$+α_3SIZE$_{it}$+α_4LEV$_{it}$+ε				
Description	**Coefficient**	**Standard deviation**	**t statistic**	**Significance level**
Non-duty members ratio	0.019	0.0117	1.622	0.105
Company size	−0.0556	0.0294	−1.88	0.059
Financial leverage	0.0724	0.0138	5.24	0.00
Constant value	0.268	0.0732	3.67	0.00
Coefficient of determination	0.053			
F statistic	9.71			
F significance level	0.00			
Durbin–Watson statistic	1.98			

Table 5: Estimation of the model for the third hypothesis

$\text{Tax avoidance}_{it}=\alpha_1+\alpha_2 CMP_{it}+\alpha_3 SIZE_{it}+\alpha_4 LEV_{it}+\acute{\varepsilon}$				
Description	**Coefficient**	**Standard deviation**	**t statistic**	**Significance level**
Managerial ownership	−0.0312	0.0013	−22.55	0.00
Company size	−0.0257	0.0209	−1.22	0.220
Financial leverage	0.0376	0.0096	3.899	0.00
Constant value	0.239	0.0520	4.59	0.00
Coefficient of determination	0.520			
F statistic	187.04			
F significance level	0.00			
Durbin–Watson statistic	1.94			

Table 6: Estimation of the model for the fourth hypothesis

$\text{Tax avoidance}_{it}=\alpha_1+\alpha_2 INSINV_{it}+\alpha_3 SIZE_{it}+\alpha_4 LEV_{it}+\acute{\varepsilon}$				
Description	**Coefficient**	**Standard deviation**	**t statistic**	**Significance level**
Institutional ownership	−0.001	0.0018	−0.52	0.567
Company size	−0.0509	0.0299	−1.702	0.089
Financial leverage	0.0676	0.0134	5.013	0.00
Constant value	0.269	0.0741	3.63	0.00
Coefficient of determination	0.049			
F statistic	8.91			
F significance level	0.00			
Durbin–Watson statistic	2.004			

(Lanis and Richardson, 2011; Mashaiekhi and Seyyedi, 2015; Rezaei and Azimi, 2015). There is no significant relationship between managerial ownership and tax avoidance in testing the third hypothesis. Shareholders are usually expected to prefer tax avoidance. However, research results suggest that family owners are more concerned than others about the potential fines and damage to reputation arising from government audits and have less incentive for tax avoidance. Therefore, it can be concluded that there is no significant relationship between institutional ownership and tax avoidance. Perhaps it would be justified in such a way that the lack of adequate supervising performance of institutional owners is probably due to the fact that institutional owners in Iran are mostly companies and governmental institutions. Results of testing this hypothesis are consistent with the research conducted by Armstrong et al. (2015) and Pourheydari and Aminінia (2014).

Although, a significant relationship was expected between corporate governance and tax avoidance, therefore, according to theoretical principles, and some empirical evidences, several reasons can be explained for the results of this study. Evidence suggests that there is a positive relationship between tax avoidance and diagnostic and expressed tax differences and it can be argued that the government is more willing to obtain higher tax than that of the expressed tax by the companies that avoid tax, and thus, assign higher taxes for this group of companies. As a result, tax avoidance may be a useful action in reducing the actual tax in these circumstances, and this is why the companies that intend to reduce their taxes look for other solutions such as conservatism, earnings management, tax evasion, etc. In addition, the market and other groups may have a negative reaction toward companies that avoid tax, and these actions lead to a negative reputation for the company.

6.1. Suggestions and Limitations of the Study

Results indicate that institutional ownership has a significant impact on tax avoidance. Institutional owners are recommended to more accurately monitor the activity of tax planning as it may result in opportunistic behavior of managers. Similar to other studies, conducting this study encompassed some difficulties that should be considered in the generalization of results. First, it was not possible to exercise some tax avoidance patterns according to environmental conditions and relevant laws. Furthermore, failure to provide certain required information such as tax rate, percentage of free floating shares and annual losses led to elimination of a considerable number of companies from our sample group, and thus, reduction in the study sample. According to the results of this study, some suggestions for future studies can be provided as follows:

1. Investigating tax avoidance and social responsibility of companies.
2. Investigating the effect of other issues in corporate governance including type of auditing, and internal controls.
3. Investigating the effect of ownership type on tax policy and tax avoidance of companies.

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