Disclosure of Corporate Tax Reports, Tax Enforcement, and Insider Trading

Reassessing Tax Policies and Tax Coordination

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Disclosure of corporate tax reports I

- We study whether it is desirable or not to make firm's tax statements public in an environment with insider trading.
- In the United States the tax return information was public from the time of Civil War and it was restricted only in 1976, when the Tax Reform Act of 1976 made the tax return confidential.
- In 2002, Senator Charles Grassley, chairman of the Senate Finance Committee, wrote a letter to the Secretary of the Treasury and the Chairman of the SEC to put forward for consideration the question of whether the corporate tax returns should be made public and the effect the disclosure of the tax return would have on public welfare.

Disclosure of corporate tax reports II

- The responses of the SEC and the Treasury Department were negative.
- In 2003, a bill that asked for public disclosure of corporate tax return information was submitted to the Congress but it did not pass.
- In 2012 the *President Obama's Framework for Business Tax Reform* called for an increase in disclosure of annual corporate income tax: "Corporate tax reform should increase transparency and reduce the gap between book income, reported to shareholders, and taxable income reported to IRS. These reforms could include greater disclosure of annual corporate income tax payments."

Disclosure of corporate tax reports III

- On February 28, 2013, the European Union Parliament approved country-by-country reporting for European banks of data on employees, profits, and taxes paid.
- On 2017, both the European Parliament and the European Commission proposed directives where the role of transparency to fight against tax avoidance was emphasized (European Parliament, 2017, and European Commission, 2017).
- Country-by-country reporting by large firms: they have to publish information for every country they operate in rather than providing a single set of information at global level.
- Items of this country-by-country information to be disclosed: profit made before tax, the amount of income tax due in each country, and the actual payments made to each country's treasury during that year.

Disclosure of corporate tax reports IV

- Nordic countries have already a longer tradition of disclosure of both personal and corporate taxes paid.
- Disclosure of the tax returns for foreign-owned and large domestically-owned firms took place in Australia in 2015.
- Slemrod et al. (2012) conducted an empirical analysis for Japan regarding the effect of public disclosure of tax reports of businesses up until its abolition in 2005. They conclude that tax disclosure induces a strong change in behavior resulting in insignificant changes in tax collection.
- This debate took place in the absence of empirical evidence and theoretical framework that could show the effects of the public disclosure of the corporate tax report (Hasegawa et al., 2013)

Disclosure of corporate tax reports V

- Our paper, aims to partially fill in the lack of theoretical models that study the effect of disclosure of the tax report on financial markets and on tax compliance.
- Managerial incentives to misreport and tax authority incentives to disclose.

Framework I

- In our setup, the tax agency observes the market value of the firm and can infer partially its cash flow. Then, the manager optimally manipulates the market value of the firm through the tax report, which can be potentially observed by the market maker/dealer.
- Insider trading or managerial compensation through options: incentives for low current market value and large future market value.

Framework II

- We consider two scenarios: the tax report is made public or it is not.
- When the tax report becomes public, the dealer uses this information in setting the bid-ask prices in the trading stage so that this endogenous public signal ends up playing a crucial role on market performance.

Summary of the timing of the model

1. The nature draws the realization of the project's payoff $y \in \{0, 1\}$. The project is successful with probability s.
2. The manager observes his private information about the firm's payoff. The manager is strategic, he chooses the probability p of reporting truthfully $\theta = 1$.
3. Agents trade in the financial market (the manager is engaged in insider trading or receives option compensation).
4. The tax agency chooses, conditional on the tax report and the price of the firm in the stock market, the costly intensity (effort) m of inspection to maximize the expected net revenue R collected from taxpayers.
5. Investors receive their payoffs (cash-flows of the firm net of taxes and penalties).

Disclosure: Ask and Bid prices

$$A(1) \equiv A(\theta = 1) = E\left[V \middle| \ \omega = 1 \text{ and } \theta = 1 \right] = 1 - \tau,$$

$$A(0) \equiv A(\theta = 0) = E\left[V \middle| \ \omega = 1 \text{ and } \theta = 0 \right],$$

$$B(1) \equiv B(\theta = 1) = E\left[V \middle| \ \omega = -1 \text{ and } \theta = 1 \right] = 1 - \tau,$$

$$B(0) \equiv B(\theta = 0) = E\left[V \middle| \ \omega = -1 \text{ and } \theta = 0 \right].$$

Equilibrium under disclosure of tax reports

- The equilibrium probability of telling the truth by a strategic manager when the project is successful is $p_D = 0$.

No Disclosure: Ask and Bid prices

$$A_{ND} = E\left[\, V \middle|\ \omega = 1\right],$$

$$B_{ND} = E\left[\, V \middle|\ \omega = -1\right].$$

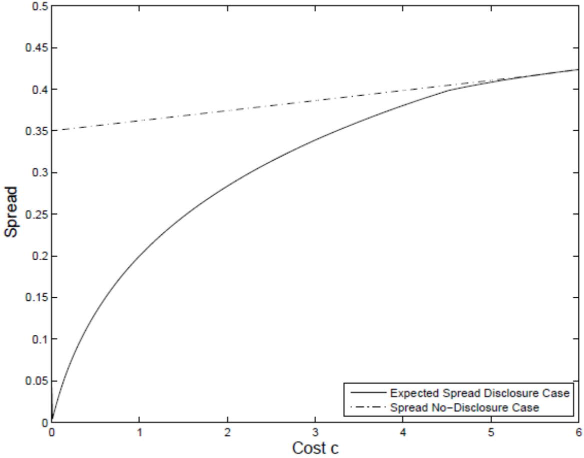
Equilibrium under no-disclosure of tax report

- If the auditing cost c is not too high the strategic manager chooses $p_{ND} > 0$.
- If the auditing cost c is high the strategic manager chooses $p_{ND} = 0$, so he always submits a false report.
- If $p_{ND} = 0$, tax reports are totally non-informative so that the auditing intensities are obviously equal in both the disclosure and no-disclosure case.

Market performance

- Two indicators:
- **(1)** The bid-ask spread $A - B$ is inversely related with the liquidity (or depth) of the market since a large spread means that prices are very sensitive to the direction of trade so that buyers end up paying a large price while sellers end up getting a low price.
- A large spread is detrimental for the liquidity/uninformed traders as its expected cost of trading becomes also large.
- **(2)** The expected trading profit of the manager.

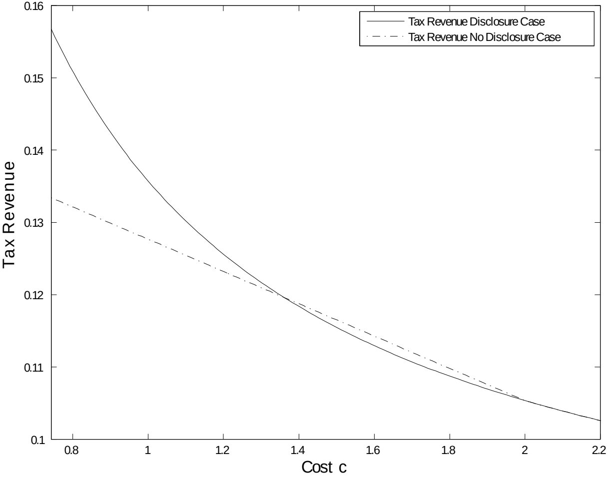
The Effect of Auditing Cost on the Spread



Tax Revenue Comparison I

- The net tax revenue collected by the tax agency may be smaller or larger when the tax report is disclosed than when the tax report is not disclosed.

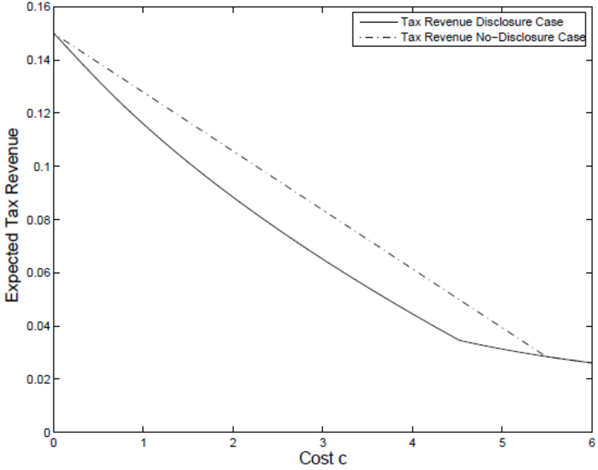
Tax Revenue Comparison II



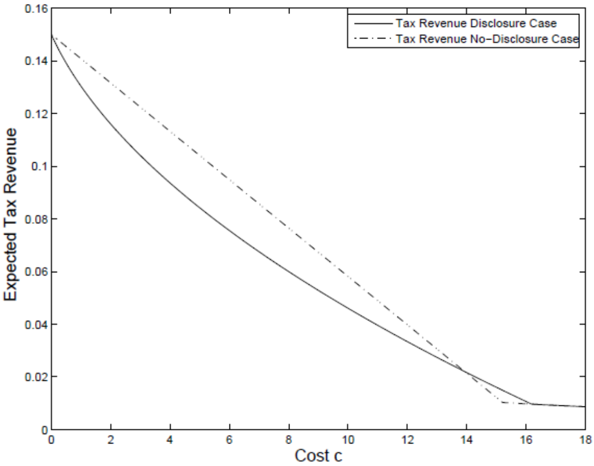
Extension I

- Costs faced by the manager for tax misreporting:
  - Fixed reputational cost
  - Cost proportional to the amount of fines (compensation to the firm).

Extension II



Extension III



Conclusion I

- Insider trading model where an endogenous public signal resulting from the interaction between a firm and a tax auditing agency may affect trading in the financial market.
- When the tax report is disclosed, it is optimal to cheat always.
- However, if the tax report is not disclosed, the manager tends to tell the truth more often.

Conclusion II

- Even if the disclosure of the tax report improves market performance, the tax agency might decide not to make public the tax report because of the negative impact on its expected net revenue.
- Policy implication: disclosure of corporate tax reports should not be left in the discretionary hands of the tax enforcement agency but established by law if the efficient functioning of financial markets is the prevalent objective of lawmakers.