International Journal of Accounting Research

Wegener and Labelle, Int J Account Res 2017, 5:1
DOI: 10.4172/2472-114X.1000153

Research Article

Open Access

Is Business Ethics the 'Last Rampart' Against Tax Aggressiveness?

Wegener M[1]* and Labelle R[2]

[1]University of New Brunswick Saint John, Faculty of Business, 100 Tucker Park Road, Saint John, New Brunswick, E2L 4L5, Canada
[2]HEC Montréal, Department of Accounting Studies, 3000, Chemin de la Côte-Sainte-Catherine, Montréal, Québec, H3T 2A7, Canada

Abstract

This study examines the relationship between business ethics and tax aggressiveness. Building on the conceptual model of corporate moral development, we hypothesize and find a negative association between the level of business ethics and tax aggressiveness. For our sample of U.S. firms, companies with a higher level of business ethics are less likely to be tax aggressive. Our results are robust to the use of two proxies for tax aggressiveness: the 'mainstream' effective-tax-rate measure and the unrecognized tax benefit, which have been identified as capturing the least and the most aggressive tax positions respectively. While we support our business ethics prediction in both our models, we also find a positive relationship between the quality of corporate governance (measured without ethical characteristics generally associated with good corporate governance) and tax aggressiveness. Our interpretation of these results is that, while ethical firms are concerned about paying their fair share of taxes, shareholders' interest still comes first.

Keywords: Business ethics; Corporate governance; Corporate moral development model; Effective tax rate; Tax aggressiveness; Unrecognized tax benefit

Introduction

During the 2012 shareholders annual meeting of Starbucks, CEO Howard Schultz announced record earnings and linked this performance to a form of 'moral capitalism'. This concept, based on the Caux Round Table principles for business ethics,[1] involves the reconciliation of private interests with the public good [1-3]. Moral capitalism, at a time when firms can no longer avoid dealing with the issue of corporate social responsibility (CSR), is becoming a reference in the business world. It is especially true in difficult economic times when it can be argued that social needs are greatest. We have witnessed business leaders, such as Miller [4], coming together to publicly recognize the necessity of participating in the collective effort. Corporate income tax is one mechanism allowing, or requiring, firms to take on a share of this collective effort, since it reallocates part of the wealth they create. In the perspective of moral capitalism, no firm, except maybe what Reidenbach and Robin [5] identify as the amoral organization, should attempt to evade the tax system. The reality is quite different as more or less aggressive tax planning activities to minimize the tax burden undeniably exist. The scandal which revealed KPMG's involvement in tax evasion is unquestionably a notable illustration [6]. The case of Starbucks, abovementioned for their allegiance to moral capitalism, is even more noteworthy as the Seattle-based group was, in the same year, blamed for its practices of tax avoidance in the UK [7]. The relationship between moral capitalism or business ethics[2] and corporate tax conduct is after all not so obvious. Consistent with existing research [8,9], we view tax aggressiveness, a facet of tax avoidance,[3] as downward management of taxable income through more or less aggressive tax planning activities. Given that taxes are an important cost of doing business and an instrument of wealth distribution, tax aggressiveness presents an interesting governance and ethical dilemma as it may be desired by some shareholders but decried by other stakeholders. Tax avoidance seems to be a widespread practice despite increasingly compelling external ethical guidance from such sources as the Caux Round Table and the UN Global Compact. This raises the question as to whether business ethics can be successful when regulations fail and thus be viewed as the taxpayer's last rampart against the urge to escape tax [10]. Do corporations consider their tax obligations fulfilled when they do not break the letter of the law? A 'legalistic' behavior corresponds to a low level of business ethics in the corporate moral development (CMD) model developed by Reidenbach and Robin [5]. The role of business ethics as a substitute for, or complement to, governance in controlling opportunistic tax management behavior is often presumed despite scarce empirical support. We fill this gap in the literature for several reasons. First, the relationship between ethics and tax is a concern in public policy, as shown by the extensive and long-lived research on ethics and tax at the individual level. Second, empirical studies on related topics, especially studies on CSR and corporate tax behavior [11-13], fail to tackle the specific role of business ethics as a possible deterrent of tax aggressiveness. Testing the direct link between business ethics and tax aggressiveness seems particularly important given that Lanis and Richardson [13] find CSR strategy, which includes business ethics, to be a driver of the relationship between CSR and tax aggressiveness. We propose that business ethics might not just drive the relationship, but in fact be directly associated with lower tax aggressiveness. Given the scarcity of literature on the relationship between tax aggressiveness and business ethics, we first build upon the conceptual model of CMD

[1]The Caux Round Table is an international organization of senior business executives founded in 1986 to promote ethical business practices. It met for the first time in 1986 in Caux, Switzerland. The Caux Round Table principles are considered to be the first international code of ethics for business (Asgary and Mitschow, 2002).

[2]Following Carroll (1991), we consider that ethics and morality are essentially synonymous in the organizational context.

[3]Except in the section dealing precisely and technically with tax aggressiveness measurement, we do not truly distinguish between 'tax avoidance' and 'tax aggressiveness'. Consequently we use both concepts interchangeably.

***Corresponding author:** Wegener M, University of New Brunswick Saint John, Faculty of Business, 100 Tucker Park Road, Saint John, New Brunswick, E2L 4L5, Canada, Tel: +1 506 6485534; E-mail: matthew.wegener@unb.ca

Received April 10, 2017; **Accepted** April 21, 2017; **Published** April 26, 2017

Citation: Wegener M, Labelle R (2017) Is Business Ethics the 'Last Rampart' Against Tax Aggressiveness? Int J Account Res 5: 153. doi:10.4172/2472-114X.1000153

proposed by Reidenbach and Robin [5] to theoretically ground the association between the two concepts. We then empirically test the relationship. Our empirical tests build upon the lines of literature that examine closely related topics, such as studies on the association between 1) governance mechanisms and tax aggressiveness [14] 2) CSR or business ethics and accounting behavior, like earnings management [15-18] and 3) CSR and tax aggressiveness [11,12]. Consistent with this literature, our hypothesis based on the CMD model predicts a negative association between the level of business ethics and tax aggressiveness. We conduct our empirical analysis on a sample of U.S. firms for the period from 2009 to 2011. We find that firms with a higher level of business ethics are less likely to take advantage of the flexibility in tax rules to minimize the amount of tax they pay. Our results are robust to the use of two proxies for tax aggressiveness, the effective tax rate (ETR)[4] and unrecognized tax benefit (UTB). The ETR can be considered as the 'mainstream' measure for tax aggressiveness. It has also been taken as a reference to motivate an unprecedented tax reform [19]. The Base Erosion and Profit Shifting (BEPS) project, launched by the G-20 through the OECD, affirmed 'that some multinationals use strategies that allow them to pay as little as 5% in corporate taxes when smaller businesses are paying up to 30%' (OECD, 2013a).[5] This phrase sums up the basic rationale that justifies the project itself and shows that the ETR is publicly considered as a relevant indicator to evaluate corporate tax behavior. UTB is the difference between a company's tax position on its tax return and the benefits it recognizes in its financial statements. The ETR and UTB have been identified by Lisowsky et al. [19] as two distant measures on the tax avoidance continuum: ETR captures the least aggressive tax positions while UTB captures the most aggressive ones. We support our prediction of a negative relationship between business ethics and tax aggressiveness in both our models (ETR and UTB). However, we find a positive relationship between the quality of corporate governance, measured free of ethical corporate governance characteristics, and tax aggressiveness. Our interpretation of these results is that, while ethical firms are concerned about paying their fair share of taxes, the interest of shareholders to reduce taxes still prevails when it comes to governance.

Theory, Concepts and Hypothesis Development

Since taxes are closely regulated, the issue of tax aggressiveness is often addressed as a matter of compliance to various tax and governance regulations rather than as a matter of ethics. However, public opinion and part of the business community have recently considered the issue of tax avoidance to fall into the realm of ethics. According to a 2012 survey conducted in Great Britain by the Institute of Business Ethics, tax avoidance is perceived as the second most important business ethics issue, just after executive pay, that the British public thinks business needs to address [20]. In this section, we first elaborate on the link between ethics and tax, clarify the relevant concepts, review the literature and finally develop our hypothesis.

The relation between ethics and tax conduct at the individual level *vs.* at the corporate level

The link between ethics and tax compliance has been extensively examined at the individual level, for tax payers as well as tax practitioners [21-23]. The relation between ethics and individual tax behavior has been studied for a long time – at least 500 years according to McGee [24] and has drawn enough attention to create a research domain on its own, generally referred to as tax ethics. More specifically, Doyle et al. [23] explain that tax avoidance has been included in the tax literature as one of the dimensions within the broader domain of tax ethics.

While the influence of ethics on individual tax behavior is well established, the effect of ethics on tax conduct at the corporate level is less obvious. At the individual level, the concept of tax ethics refers to the norms of behavior governing citizens as taxpayers in their relationship with the government [25]. It is considered one of the major factors in determining voluntary compliance. At the corporate level, the link between ethics and tax behavior is merely assumed. Thus, our study is among the first to examine this link empirically. As Hanlon and Heitzman [26] notice, the factors affecting individual tax avoidance and compliance (tax rates, probability of detection, risk-aversion, and civic duty) are well studied in public economics and many of these factors should apply to the corporate tax payer as well. However, additional issues, mainly caused by the separation between ownership and control, arise in corporations making our research undoubtedly relevant.

A conceptual framework for the association between business ethics and tax aggressiveness: The corporate moral development (CMD) model [5] The CMD model by Reidenbach and Robin [5] offers an interesting and relevant lens to examine the issue of corporate tax conduct. It is generally acknowledged that twisting the tax rules to avoid tax is not illegal but is operating within the letter rather than the spirit of the law. In other words, most aggressive tax planning activities can be seen as manifestations of a 'legalistic' rather than 'ethical' attitude adopted by firms. These legalistic and ethical perspectives correspond to distinct stages in the conceptual model of CMD. Building on a large number of business cases, Reidenbach and Robin [5] propose a conceptual model of organizational moral development inspired by the work of Piaget [27] and Kolhlberg [28] on child and individual moral development. The framework comprises five stages of organizational moral development: 1) the amoral organization; 2) the legalistic corporation; 3) the responsive corporation; 4) the proactive emergent ethical organization and 5) the ethical organization. Generally speaking, but also more specifically on the tax compliance issue, most firms stand between stages 2 and 4 on the scale of CMD, as there are very few firms in the two extremes stages (1 and 5). At stage 1, the *amoral* organization shows a 'winning at any cost' attitude, including disobedience to laws, codes or regulations. The concern for ethics, if it exists at all, is usually on an after-the-fact basis when caught in some wrongdoing. In terms of tax behavior, an amoral organization would be a fraudulent corporate taxpayer. At stage 2, the *legalistic* organization exhibits preoccupation for compliance with the letter of the law as opposed to the spirit of the law. This general characterization suits tax matters particularly well. Corporations generally consider that they fulfill their tax obligations when they do not break the rules, in other words, when they respect the letter of the law. In this perspective, there is little to prevent corporate taxpayers from managing their affairs and manipulating the rules and the information provided in order to pay as little tax as possible. At this stage, there is also little regard to stakeholders other than shareholders. The stage 2 legal oversight perspective prevails until the level of business ethics is sufficiently developed and the firm becomes more aware of and reacts to external pressures and thus reaches stage 3. At stage 3, the *responsive* organization begins to pay attention to values other than productivity and a sense of legality. It begins to strike a balance between profits and doing right. In terms of taxes, this balance means respecting unwritten rules – the spirit of the law – or the idea that firms should contribute to public good through taxation and consequently

[4]The effective tax rate is calculated by dividing the accounting tax expense by the pre-tax accounting result.

[5]The corporate tax rates provided in the direct quote are effective tax rates, consistent with the report they are based on (OECD, 2013b).

adopt reasonable tax planning practices. At stage 4, the *emergent ethical* organization is one in which management actively seeks a greater balance between profits and ethics and recognizes the social contract between the business and society. This type of organization deliberately or proactively contributes to public good through taxation. The final stage of organizational moral development is the *ethical* organization [5]. The ethical corporate taxpayer could be a firm that would give primacy to stakeholders' rather than shareholders' interests. We presume that these five stages form a continuum from the amoral (stage 1) to the ethical organization (stage 5). As Robin and Reidenbach [5] notice, 'two organizations can be in the same stage but one may be more advanced. It is possible that a corporation which is classified as a legalistic corporation may also manifest certain characteristics of a responsive corporation'. Along this continuum, the level of business ethics increases and we aim to examine whether the tax behavior evolves with this level of ethics.

Relevant literature

Even if the relationship between business ethics and corporate tax behavior is suggested not only by theory, but also by recent accusations against large corporations of scheming to avoid paying taxes (for example, Google or Apple), it has rarely been investigated. In their review of tax research, Hanlon and Heitzman [26] acknowledge that the existing studies on the association between corporate tax avoidance and firm-level characteristics (e.g., internationalization level, leverage, manager effects, ownership, governance, or incentive structures) cannot explain the variation in tax avoidance very well. Since Hanlon and Heitzman [26], studies have examined other determinants of corporate tax behavior, in particular CSR [11,12]. We contribute to this stream of research. Lanis and Richardson [11] and Hoi et al. [12] examine the association between CSR and tax avoidance. Using a sample of Australian companies and their own 'broad based disclosure index' to measure CSR, Lanis and Richardson [11] find a negative relationship between the level of CSR disclosure and tax aggressiveness. However, their main contribution stemmed from their analysis of the drivers of the relationship. According to Lanis and Richardson [11] social investment commitment and CSR strategy, measured with ethics, are the elements of CSR activities that have a negative impact on tax aggressiveness. Hoi et al. [12] also examine the empirical association between CSR and tax avoidance. Hoi et al. [12] build upon Lanis and Richardson [11] by using several measures for tax avoidance, a large sample of U.S. firms, and a third-party source to measure CSR activities (negative social ratings obtained from KLD Research & Analytics, Inc.). Their results suggest that firms with excessive irresponsible CSR activities are more aggressive in avoiding taxes. Using 20 tax aggressive Australian corporations matched with 20 non-tax aggressive corporations based on industry classification, corporation size and time period, Lanis and Richardson [13] test the proposition that tax aggressive corporations disclose additional CSR information in their annual reports. The increased level of disclosure is to alleviate potential public concern over the negative community impact of corporate tax aggressiveness, and to demonstrate that they are meeting community expectations in other ways. They find a positive and statistically significant association between corporate tax aggressiveness and CSR disclosure. They claim that this result, which can be viewed as contradictory to the negative relationship found in their previous study, provides empirical evidence in support of legitimacy theory We wish to contribute to this stream of research by more precisely focusing on business ethics to deepen our understanding of the determinants of corporate tax conduct. The intermingled use of various CSR and business-ethics-related concepts in the literature, in corporate communication, and in the media has led to a certain confusion between these concepts [29]. While these concepts overlap, they are distinct, yet they tend to be used almost interchangeably in academic literature. Joyner and Payne [30] and Joyner et al. [31] propose we clarify definitions to help distinguish the difference between concepts. Ethics is essentially equivalent to morality in the organizational context [32]. De George defines business ethics as a field of 'special' ethics, dealing specifically with ethical dilemmas arising in the context of doing business. Velasquez [33] defines business ethics as 'a specialized study of moral right and wrong. It concentrates on moral standards as they apply particularly to business policies, institutions, and behaviors'. CSR on the other hand 'encompasses the economic, legal, *ethical*,[6] and discretionary expectations that society has of organizations at a given point in time' [34]. Business ethics and CSR are obviously not mutually exclusive. They are interrelated and somewhat interdependent, nevertheless distinct. We believe that it is relevant to also include in our literature review studies that examine the association between business ethics and financial reporting quality. Indeed, financial reporting quality is partly driven by accounting choices the companies make. Similar to tax rules, the accounting rules are likely to be twisted, and legalistically rather than ethically applied. Choi and Pae [16] find a positive association between corporate commitment to business ethics [35] and financial reporting quality. Companies with a higher level of ethical commitment are engaged in less earnings management, recognize economic bad news on a timelier basis, and have more accurate accruals. Labelle et al. [36] find a negative association between business ethics and earnings management (the higher the earnings management the worse the financial reporting quality). However, they use a fairly narrow definition of business ethics as the firm's propensity to implement a stakeholder-oriented policy such as promoting diversity and employment equity in their management systems and programs.

Overall, previous research has failed to specifically address business ethics as a determinant of corporate tax aggressiveness. Yet, tax ethics has been extensively studied and found to be an important factor at the individual level and the association between business ethics and corporate tax behavior can be theoretically justified. We hypothesize that business ethics is negatively associated with tax aggressiveness.

Hypothesis: Companies with a higher level of business ethics, in other words, at a higher stage of CMD, are less likely to take advantage of the flexibility in tax rules to minimize the amount of tax they pay.

Research Design

In this section, we elaborate on the research design developed to test our hypothesis. First, we thoroughly explain and justify the measures we use for our main variables, tax aggressiveness and business ethics. As they cannot be observed per se, we build on the existing literature to define proxies for these concepts. Then, we briefly present our control variables. Next, we introduce our models. Finally, we describe the process of sample constitution.

Measurement of corporate tax aggressiveness

Tax aggressiveness is appraised by the firm's propensity to manage its taxable income downward through more or less aggressive tax planning activities. Abusive tax avoidance, the 'worst case' of tax aggressiveness, often breaches the law such as the judge-made substance-over-form rules in the United States or section 245 of the Income Tax Act in Canada. Aggressive tax planning does not go so far as to breach the law. However, it is so close to tax avoidance that an

[6]Italics added by the authors.

outside observer would find some degree of artificiality or abnormality in it. It would also be difficult to establish beforehand whether or not a court would find it illegal. Strictly speaking, aggressive tax planning is not illegal which distinguishes it from abusive tax avoidance. In the United States, a tax position is not considered as aggressive when 'it is more likely than not, based on the technical merits, that the position will be sustained upon examination'.[7] Therefore, an 'uncertain tax position' is considered as aggressive tax planning to some degree. In summary, Aggressive tax planning arrangements often have some legal basis in a very technical sense, but they go beyond what the legislator intended when the law was passed. In general, aggressive tax planning arrangements are made for the primary purpose of avoiding the payment of the required taxes, and thus could be in violation of the law [37]. It is possible to divide potential tax reduction arrangements into several categories. Together they form a tax aggressiveness continuum from fraud to legitimacy. Those categories may be paralleled to the CMD stages proposed by Reidenbach and Robin [5]. At one end of the continuum, tax evasion or fraud includes fraudulent failure to file tax returns, substantial understatement of income, inadequate books and records, lying, deceit and concealment.[8] The perpetration of fraudulent tax activities corresponds to the amoral organization or stage 1 of the CMD framework. At the other end of the continuum, tax planning may fully respect the intention of the legislator and even go further, which is coherent with stage 5 of the CMD framework. Between these two extremes of the continuum, there are levels of tax aggressiveness. The legalistic corporation at the second stage of the CMD model is expected to adopt legitimate tax planning activities that only comply with the letter of the law. At the third stage of CMD, a corporation is ready to go a step further and be responsive to external pressures by adopting more acceptable tax policies. At stage 4, the emergent ethical organization deliberately and proactively complies with the spirit of the law or with the intent of the legislator. Many indicators have been used in previous research to capture tax aggressiveness activities. However, most studies, such as Stickney and McGee [38] or Gupta and Newberry [39], use ETR. We decide to use two proxies for tax aggressiveness. First we select the ETR, while controlling for non-repatriated foreign income, as it can be considered the 'mainstream' measure for tax aggressiveness. Second we opt for the UTB suggested by Lisowsky et al. [19]. The ETR and UTB represent opposite ends of what Lisowsky et al. [19] describe as a tax avoidance continuum. The use of these two proxies will make our empirical results more robust by capturing what Lisowsky et al. [19] considered the least and most tax aggressive behaviors.

Measurement of business ethics

We use the score compiled by Sustainalytics Global Platform (SGP) edited by Sustainalytics as a measure or proxy for the firms' level of business ethics, our main variable of interest. Sustainalytics is a firm specialized in environmental, social and governance (ESG) research and analysis. This responsible investment research firm serves mainstream investors that integrate ESG information and assessments into their investment decisions. As in Labelle et al. [36], the scores provided by SGP are used to represent the firms' levels of moral development or business ethics. Business ethics is one of the firms' characteristics assessed by Sustainalytics who also compile performance indicators in other ESG areas. The overall ESG score is a weighted average and business ethics generally only accounts for 10% of the overall score. The business ethics score is a weighted average compilation of sixteen indicators. The value for each indicator ranges from 0 to 100. The weights are determined by Sustainalytics' expert analysis of the key issues applicable for the firm and hence indicators that are not relevant to the firm being measured are not included. The indicators that make up the business ethics score include: business ethics related controversies or incidents, policy on bribery and corruption, programmes to combat bribery and corruption, whistleblower, policy on responsible investment, membership in initiatives promoting sustainable buildings, policy on money laundering, policy on genetic engineering, clinical trial protocols, signatory to UN Global Compact, signatory to UN Principles for Responsible Investment, member of UNEP Finance Initiative, Equator Principles and related reporting, policy on animal testing, policy on animal welfare, and tax transparency. Each of these areas is generally assessed based on the quality and clarity of the programs in place within the firm to combat unethical behavior. As such, it measures the strength of the boundaries in place to restrict management from unethical behavior and thereby limits acceptable business decisions to those that are ethical. Because the measure of tax transparency could potentially be associated with tax aggressiveness, we reduce the business ethics score accordingly to obtain our proxy for business ethics.

Control variables

In addition to controlling for foreign income (FI), our models control for corporate governance qualities that are not related to ethics, and several other firm characteristics that could impact a firm's tax aggressiveness. Tax aggressiveness may indeed go under the governance radar when not bound by ethics as current regulation gives primacy to shareholders. As a consequence, the board of directors is mainly concerned with the interests of shareholders and not as much about other stakeholders'. The latter have their own protection or enforcement systems based on the laws and regulations governing labor, environmental, consumers and tax matters. However, as Desai and Dharmapala [41] point out, there are times when tax sheltering can be used by management to extract excess rents from shareholders. To this effect, Desai and Dharmapala [40] use agency theory to predict a counterintuitive negative relationship between corporate governance and tax aggressiveness. Lanis and Richardson [14] point out that while Desai and Dharmapala's [40] agency theory argument has received empirical support, the results are far from conclusive. Lanis and Richardson [14] argue that agency theory alone cannot account for this negative link between tax aggressiveness and corporate governance, and extend the consideration to stakeholder theory and corporate social responsibility. We use the Sustainalytics G.2 Corporate Governance score to appraise the level of corporate governance. This measure assesses the quality of disclosures, independence and diversity. While these aspects of corporate governance indicate the quality as it pertains to the functions of monitoring and strategic guidance, they do not restrict behavior, and thus are free from ethical consideration. Following Frank et al. [8], we control for financial performance (FP), firm size (SIZE), and leverage (LEV) as they can impact tax planning. A firm's financial performance will dictate the size of the residual income remaining for shareholders. As tax expenses will reduce this residual income, firm's with worse financial performance will have greater incentive to reduce taxes to protect shareholders' interests. Larger firms are more visible and receive higher levels of scrutiny. This will increase the likelihood that any tax manipulations would be detected and thus give incentive to be less tax aggressive. Higher leveraged firms will have higher interest expenses, and will thus pay less tax. Controlling for financial performance, as assessed by management in the firm's financial statements, also allows us to control for any prior earnings

[7]Paragraphs 740-10-25-6 of FASB Accounting Standards Codification, inherited from FIN 48 (FASB, 2006).

[8]Bloomberg BNA Tax and Accounting Center, ¶3830.03.C. Indicia of Fraud.

management. We also include net property, plant and equipment to measure capital intensity (CI) and research and development (R&D) as they could potentially impact our tax aggressiveness measure due to the firm having more tax write-offs.

In summary, the regression models estimated to investigate the relationship between tax aggressiveness and business ethics are the following:

$$TA_{jt}=\alpha_0+\alpha_1 BE_{jt}+\alpha_2 CG_{jt}+\alpha_3 FI_{jt}+_4 FP_{jt}+\alpha_5 SIZE_{jt}+\alpha_6 LEV_{jt}+\alpha_7 IND_{jt}+\alpha_8 R\&D_{jt}+\alpha_9 CI_{jt}+\varepsilon_{jt} \quad (1)$$

Where:

TA_{jt}: Tax aggressiveness of firm j in year t; as mentioned above, *TA* is measured both by ETR (effective tax rate as measured by the income tax expense divided by pre-tax income) and UTB (unrecognized tax benefit);

BE_{jt}: Level of business ethics for firm j in year t is proxied by the Sustainalytics G.1 Business Ethics indicator with the G.1.4 Tax Transparency component removed;

CG_{jt}: Corporate governance score of firm j in year t is Sustainalytics G.2 Corporate Governance indicator;

FI_{jt}: The ratio of foreign pre-tax income divided by the prior-periods total assets;

FP_{jt}: Financial performance is measured by the ratio of pre-tax income divided by total assets (ROA) of firm j in year t-1;

$SIZE_{jt}$: The natural log of total assets of firm j in year t;

LEV_{jt}: Leverage of firm j in year t or the ratio of long-term debt divided by total assets;

IND_{jt}: Industrial sector of firm j;

$R\&D_{jt}$: The ratio of research and development expense divided by the prior-periods total assets;

CI_{jt}: Capital intensity or the ratio of net property, plant and equipment divided by total assets.

Sample and data collection

The sample consists of all United States firms with business ethics data available from Sustainalytics and financial information available from Compustat for the period from 2009 to 2011. The sample began with 1,169 firm-year observations which met these criteria. We remove firms with pre-tax losses from the sample due to the potential impact on the measurement of ETR. For instance, if a firm with a pre-tax loss paid taxes, the resulting ETR would be negative creating the incorrect impression that they were tax aggressive. On the other hand, if a firm with a pre-tax loss received a refund, the ETR would be positive. This would give the incorrect impression that the firm paid taxes. We remove 106 firms with pre-tax losses to avoid these potential measurement issues. To ensure our results are not contaminated by outliers, we also remove 28 observations with an ETR above 55% as they fall outside of the relevant range provided by the BNA Tax and Accounting Center (0% to 55%). Since firms with pre-tax losses have been removed, a negative tax expense would not likely be due to the normal operations of the firm. To this effect, the negative ETR that would be calculated due to the negative tax expense would not necessarily represent the firm being tax aggressive but would likely be the result of extraordinary events and hence we also classify them as outliers and remove 50 observations with negative tax expenses. The final sample for the ETR model was 985 firm-year observations. The UTB is a reserve that relates to the open tax positions in the current and prior two periods [19]. Therefore, consistent with Lisowsky et al. [19], we average over three years all of the variables in the UTB model. Since our sample only consists of three years, this results in the UTB model using cross-sectional data rather than panel data. The year with the least number of observations in our beginning sample was 2009 with 369 firms. Only six firms from 2009 were not included in both 2010 and 2011. Since the UTB model requires all three years to be averaged, the six observations were removed leaving a final sample of 363 firms.

Empirical Results

Descriptive statistics

Table 1 provides descriptive statistics for the sample. All but the UTB values are measured using the firm-year observations from the ETR model. When outliers are removed, the ETR, one of our proxies for tax aggressiveness, ranges from 0 to 53.97%. The mean ETR is 28.88%, which is lower than the 35% regular tax rate for corporations in the United States. This is likely related to the high level of pre-tax foreign income reported by the firms in our sample. As Table 1 shows, the mean pre-tax foreign income is $1,106 million. As the mean total pre-tax income is $2,438 million, foreign income contributes roughly 45% of the reported pre-tax income. As the majority of countries outside of the United States have tax rates below 35%, having a high level of foreign income results in a tax rate lower than 35%. Similar to Hoi et al. [12] and Lisowsky et al. [19], the UTB in our sample is highly skewed. While the values range from 0 to $6,759 million, the mean is only $387.14 million and the standard deviation is $960.31 million. Therefore we use the natural log of the UTB as our second proxy for tax aggressiveness. An examination of Table 1 also shows a wide variation in both business ethics and corporate governance scores. BE ranges between 13 and 98.2 with a 59.86 mean and a 14.67 standard deviation. CG ranges between 28.96 and 98.33 with a 59.54 mean and a standard deviation of 10.31. This provides indication that our sample has a good representation of

Variable	N	Mean	Standard deviation	Minimum	Maximum
ETR	985	0.2888	0.095	0	0.5397
UTB (in millions)	363	387.14	960.31	0	6759
BE	985	59.86	14.67	13	98.2
CG	985	59.54	10.31	28.96	98.33
Total assets (in millions)	985	36301	115480	87.2	1913902
Pre-tax income (in millions)	985	2438	5029	13.8	73257
Pre-tax foreign income (in millions)	985	1106	3700	-1100	61746
Income tax expense (in millions)	985	717	1808	0	31051

ETR: Effective tax rate as measured by the income tax expense divided by pre-tax income; UTB: Unrecognized tax benefit; BE: Level of business ethics is Sustainalytics G.1 Business Ethics indicator with the G.1.4 Tax Transparency component removed; CG: Corporate governance is Sustainalytics G.2 Corporate Governance indicator.

Table 1: Descriptive statistics.

both high and low business ethics and corporate governance firms. Tables 2 and 3 provide the correlation matrices for the variables in the ETR and UTB models respectively. An examination of Table 2 reveals a negative correlation between CG and ETR. As lower levels of ETR represent higher levels of tax aggressiveness, this implies that firms with superior corporate governance quality, as measured by Sustain analytics with ethical characteristics removed, are more tax aggressive. There is also a positive and statistically significant relationship between CG and BE in both matrices. This suggests that more ethical firms have superior monitoring and strategic corporate governance mechanisms, it also raises concerns that the empirical support for Desai and Dharmapala's [40] prediction of a negative relationship between corporate governance and tax aggressiveness could be driven by ethical considerations rather than their agency theory argument. This would support Lanis and Richardson's [14] consideration that agency theory alone cannot predict the link between corporate governance and tax aggressiveness. These findings reflect the more intuitive consideration that paying lower taxes is in the best interest of shareholders. The positive association between corporate governance quality and tax aggressiveness would thus be in line with the corporate governance's role in protecting shareholders. For the UTB model, Table 3 shows the correlation between CG and UTB is 0.221 and statistically significant at a p-value of less than 0.01. Higher levels of UTB represent higher tax aggressive levels. To this effect, the positive correlation between CG and UTB is consistent with the negative correlation between CG and ETR, providing further indication that corporate governance is aligned with the interests of shareholders.

BE on the other hand does not have a statistically significant correlation with either ETR or UTB. While this univariate test does not provide support for our prediction of a negative relationship between business ethics and tax aggressiveness, it could be related to the lack of control variables. CG is correlated to BE and both of our measures of tax aggressiveness. The relationship between BE and TA likely depends upon considering the impact of the relationship between CG and TA.

Multivariate analysis

Table 4 provides the results from our OLS regressions of tax aggressiveness (either ETR or UTB) on BE with control variables and industry fixed effects. Two models were run. The first model, using ETR to proxy for tax aggressiveness has an adjusted R^2 of 23.27%. BE, our independent variable of interest is positive and statistically significant with a p-value less than 0.05. As lower levels of ETR represent greater levels of tax aggressiveness, a positive relationship with ETR supports a negative relationship with tax aggressiveness and thus supports the hypothesis that more ethical firms are less aggressive with their taxes. Referring back to Table 1, BE has a standard deviation of 14.67. Therefore, a single standard deviation increase in BE, for the ETR model, would represent an increase in the ETR of 0.0073 or 0.73% and a two standard deviation increase would result in an increase in ETR of 0.0147 or 1.47%. While these values appear to have a low economic significance, according to Table 1, the mean pre-tax income for firms in our sample is $2,438 million. This means an increase of one standard deviation in BE would result in an average increase of $17.8 million in taxes paid. An increase of two standard deviations would mean an average increase in taxes paid of $35.8 million.

Variable	ETR	BE	CG	LEV	SIZE	ROA	FI	R&D	CI
ETR	1								
BE	0.038	1							
CG	-0.099***	0.272***	1						
LEV	0.036	0.096***	0.038	1					
SIZE	-0.066**	0.04	0.117***	-0.049	1				
ROA	0.138***	-0.031	0.086***	-0.049	-0.336***	1			
FI	-0.28***	-0.026	0.152***	-0.104***	-0.014	0.363***	1		
R&D	-0.331***	-0.041	0.061*	-0.177***	-0.14***	0.15***	0.29***	1	
CI	0.124***	0.147***	0.232***	0.212***	0.022	0.035	0.015	-0.237***	1

ETR: Effective tax rate as measured by the income tax expense divided by pre-tax income; BE: Level of business ethics is Sustainalytics G.1 Business Ethics indicator with the G.1.4 Tax Transparency component removed; CG: Corporate governance is Sustainalytics G.2 Corporate Governance indicator; LEV: The ratio of long-term debt divided by total assets; SIZE: The natural log of total assets; ROA: The ratio of pre-tax income divided by total assets; FI: The ratio of foreign pre-tax income divided by the prior-periods total assets; R&D: The ratio of R&D expense divided by the prior-periods total assets; CI: The ratio of net property, plant and equipment divided by total assets.

***p<0.01, **p<0.05, and *p<0.1

Table 2: Pearson correlation matrix for the ETR sample.

Variable	UTB	BE	CG	LEV	SIZE	ROA	FI	R&D	CI
UTB	1								
BE	0.073	1							
CG	0.221***	0.277***	1						
LEV	-0.081	0.090*	0.053	1					
SIZE	0.649***	0.011	0.057	-0.067	1				
ROA	0.036	-0.022	0.073	-0.138***	-0.223***	1			
FI	0.234***	-0.002	0.157***	-0.123**	-0.03	0.439***	1		
R&D	0.124**	-0.042	0.055	-0.212***	-0.152***	0.052	0.242***	1	
CI	0.687***	0.016	0.129**	-0.069	0.556***	0.038	0.172***	0.092*	1

UTB: The natural log of the unrecongized tax benefit; BE: Level of business ethics is Sustainalytics G.1 Business Ethics indicator with the G.1.4 Tax Transparency component removed averaged over three years; CG: Corporate governance is Sustainalytics G.2 Corporate Governance indicator averaged over three years; LEV: The three year average ratio of long-term debt divided by total assets; SIZE: The natural log of total assets averaged over three years; ROA: The three year average ratio of pre-tax income divided by total assets; FI: The three year average ratio of foreign pre-tax income divided by the prior-periods total assets; R&D: The three year average ratio of R&D expense divided by the prior-periods total assets; CI: The three year average ratio of net property, plant and equipment divided by total assets.

***p<0.01, **p<0.05, and *p<0.1

Table 3: Pearson correlation matrix for the UTB sample.

The second model employed includes UTB as the dependant variable. The UTB model has a higher explanatory power with an adjusted R^2 of 66.44% consistent with Lisowsky et al. [19]. The coefficient for BE is negative and statistically significant at a p-value of less than 0.1. This negative relationship indicates that more ethical firms take fewer uncertain tax positions or reserve in their tax returns. It provides further support for the hypothesis that a firm's level of business ethics is negatively related to its tax aggressiveness. However, while we support our prediction of a negative relationship between business ethics and tax aggressiveness in both our models, any social benefit appears to be outweighed by the interests of the shareholders. The negative relationship between CG and ETR found in the correlation matrix remains in the multivariate results in Table 4. Furthermore, the magnitude of the relationship, which is statistically significant at a p-value of less than 0.01, is greater than the magnitude of the relationship between BE and ETR. From an economic significance perspective, an increase of one standard deviation in CG would result in a decrease in ETR of 1.13% (10.31 × -0.0011). This represents an average decrease in taxes paid of $27.6 million. In terms of absolute value, this decrease is almost $10 million more than the increase in taxes resulting from a single standard deviation increase in BE. In the UTB model, the coefficient for CG is positive and statistically significant at a p-value less than 0.05. Not only do firms with higher levels of corporate governance have lower ETR, but they also appear willing to take more uncertain tax positions. This gives the impression that while ethical firms are concerned about paying their fair share of taxes, the interests of the shareholders still come first. Table 4 also shows a statistically significant relationship between foreign income (FI) and ETR with a magnitude of -0.5248. This result corroborates our explanation of why the mean ETR is beneath the minimum U.S. corporate tax rate of 35%.

Summary and Conclusion

This study investigates the relationship between business ethics and corporate tax aggressiveness, while taking the quality of corporate governance measured without ethics into consideration, as well as other variables likely to affect the corporate tax policy. We theoretically establish the association between business ethics and tax aggressiveness using the corporate moral development model developed by Reidenbach and Robin [5], in which business ethics and statutory governance are presented as complements in organizational culture. We hypothesize that companies with a higher level of business ethics or, in other words, at a higher stage of CMD, are less likely to take advantage of the flexibility in tax rules to minimize the amount of tax they pay. We test our hypothesis on a sample of U.S. firms for the period from 2009 to 2011. In accordance with our hypothesis, we find that more ethical firms are less likely to be tax aggressive. Our results are robust to the use of two proxies for tax aggressiveness: ETR and UTB, which are supposed to capture respectively least and most aggressive tax positions [20]. Interestingly, we also find a positive relationship between corporate governance quality, when ethical corporate governance characteristics are removed, and tax aggressiveness. This result is noteworthy since it is contrary to what prior literature predicts [41] and fuels the public debate about the role corporate governance should play in corporate tax behavior. As paying lower tax increases net income, and consequently maximizes returns, it can be viewed as being of benefit to shareholders. The positive association between corporate governance quality, free of ethical consideration, and tax aggressiveness suggests that this benefit outweighs any potential agency costs. Even if the positive association between corporate governance quality and tax aggressiveness is in line with the role of corporate governance, which gives primacy to the protection of the shareholders' interests, tax aggressiveness draws public outrage. Firms, and their executives, have to manage 'tensions between corporate objective of maximising profits for shareholders and meeting their obligations to pay democratically agreed taxes' [42]. In practice, it is often reflected by great differences between corporate talks and corporate actions. As an illustration, Starbucks was blamed to have 'told investor's one thing and the taxman another' [7]. Ultimately, since 'contrived avoidance cannot easily be

	ETR Model			UTB Model		
Independent variable	Coefficient	Standard error	t-Stat	Coefficient	Standard error	t-Stat
BE	0.0005**	0.0002	2.36	-0.0073*	0.0044	-1.65
CG	-0.0011***	0.0003	-3.53	0.0143**	0.0062	2.27
SIZE	-0.0005	0.0026	-0.19	0.6961***	0.0528	13.26
LEV	-0.0322	0.0235	-1.38	0.0432	0.3219	0.13
ROA	0.3313***	0.0818	4.05	0.4017	0.6481	0.62
FI	-0.5250***	0.0755	-6.95	3.7209***	1.1576	3.21
R&D	-0.5183***	0.0631	-8.21	2.6168*	1.3559	1.93
CI	0.0097	0.0257	0.38	0.0016***	0.0002	8.53
Intercept	0.3504***	0.0563	6.22	-2.3998***	0.598	-4.01
Industry fixed effects	Yes			Yes		
N	985			363		
R Squared	0.2451			0.6792		
Adjusted R Squared	0.2327			0.6644		

The ETR model is estimated using a firm-year two-way cluster adjustment as recommended by Petersen (2009).

ETR: Effective tax rate as measured by the income tax expense divided by pre-tax income; UTB: The natural log of the unrecognized tax benefit; BE: Level of business ethics is Sustainalytics G.1 Business Ethics indicator with the G.1.4 Tax Transparency component removed. For the UTB model, BE is averaged over three years; CG: Corporate governance is Sustainalytics G.2 Corporate Governance indicator. For the UTB model CG is averaged over three years; LEV: The ratio of long-term debt divided by total assets. For the UTB model Lev is averaged over three years; SIZE: The natural log of total assets. For the UTB model Size is averaged over three years; ROA: The ratio of pre-tax income divided by total assets. For the UTB model ROA is averaged over three years; FI: The ratio of foreign pre-tax income divided by the prior-periods total assets. For the UTB model FI is averaged over three years; R&D: The ratio of R&D expense divided by the prior-periods total assets. For the UTB model R&D is averaged over three years; CI: The ratio of net property, plant and equipment divided by total assets. For the UTB model Cint is averaged over three years.

***p<0.01, **p<0.05, and *p<0.1

Table 4: OLS regression of tax aggressiveness, using either effective tax rate (ETR) or the natural log of the unrecognized tax benefit (UTB), on business ethics including control variables and industry fixed effect.

reconciled with claims of ethical business conduct' [41], Starbucks 'chose' to be responsive to external pressures and paid, despite apparent losses in the UK, 'in an attempt to "please" customers' [42]. The case of Starbucks may indicate that ethics is actually the last rampart against the urge to escape tax [10], even though it might not occur in the way anticipated. Interpreting this in light of the CMD model, some firms at a higher level of business ethics are 'proactive' and agree on their own that corporate tax obligations presuppose unwritten rules of ethical behavior. Some others do not deliberately observe the ethical rules they put forward but are responsive to external pressures and forced to respect them since public opinion seems to no longer tolerate corporate hypocrisy, i.e., 'say one thing but do something entirely different' [42]. In the end, this results in a negative association between business ethics and tax aggressiveness and should encourage policymakers to have firms make public commitment on ethics. Our work undoubtedly contributes to the literature since, to our knowledge; it is the first to empirically examine the link between ethics and tax behavior at the corporate level, while there is extensive literature on this relationship at the individual level. It responds to a call by Hanlon and Heitzman [27] for further research on the factors explaining tax avoidance. It also responds to a call from Lanis and Richardson [11,13] for further investigation on the role of corporate ethics in driving corporate tax policy. We acknowledge that this study is subject to several limitations. As always, it is complicated to isolate a factor as the unique explanation for a specific corporate behavior. This is especially complex as our study covers a period when the issue of tax avoidance has drawn a significant amount of attention. This has probably encouraged regulators to react to and take a stance on corporate tax conduct. Another limitation of our work relates to omitted variables. There are many factors that could potentially impact both business ethics and a firm's tax position. To this effect, we concede that our study is probably subject to endogeneity problems. However, Larcker and Rusticus [43] highlight that solutions to deal with this type of problem are often difficult to implement and may lead to other kinds of biases. Finally, we recognize the limitation of making generalizations for other countries based on our results for US firms. As tax avoidance is a world-wide phenomenon, it would be interesting to examine whether, in different legal, institutional, tax and accounting systems, the association between business ethics and tax aggressiveness remains.

References

1. Carlson P, Blodgett SM (1997) International ethics standards for business: NAFTA, Caux principles and corporate codes of ethics. Review of Business, 18: 20-23.
2. Asgary N, Mitschow MC (2002) Toward a model for international business ethics. Journal of Business Ethics 36: 239-246.
3. Young S (2003) Moral Capitalism: Reconciling Private Interest with the Public Good, San Francisco: Berrett- Koehler Publishing.
4. Miller J (2010) ABC news. Warren Buffet: read my lips, raise my taxes.
5. Reidenbach RE, Robin DP (1991) A conceptual model of corporate moral development. Journal of Business Ethics 10: 273-284.
6. Gleckman H, Borrus A, McNamee M (2005) Inside KPMG mess, Bloomberg.
7. Tom B (2012) Reuters. Special report: How Starbucks avoids UK taxes.
8. Frank MM, Lynch L, Rego S (2009) The Accounting Review 84: 467-496.
9. Chen S, ChenX, Cheng Q, Shevlin T (2010) Are family firms more tax aggressive than non-family firms? Journal of Financial Economics, 95: 41-61.
10. Vidal JP (2011) Pourquoi se préoccuper d'éthique en fiscalité? Revue de l'Association de planification fiscale et financière 31: 193-224.
11. Lanis R, Richardson G (2012) Corporate social responsibility and tax aggressiveness: An empirical analysis. Journal of Accounting and Public Policy 31: 86-108.
12. Hoi CK, Wu Q, Zhang H (2013) Is corporate social responsibility (CSR) associated with tax avoidance? Evidence from irresponsible CSR activities. The Accounting Review 88: 2025-2059.
13. Lanis R, Richardson G (2013) Corporate social responsibility and tax aggressiveness: A test of legitimacy theory. Accounting, Auditing & Accountability Journal 26: 75-100.
14. Lanis R, Richardson G (2011) The effect of board of director composition on corporate tax aggressiveness. Journal of Accounting and Public Policy 30: 50-70.
15. Merchant K, Rockness J (1994) The ethics of managing earnings: An empirical investigation. Journal of Accounting & Public Policy 13: 79-94.
16. Choi TH, Pae J (2011) Business ethics and financial reporting quality: Evidence from Korea. Journal of Business Ethics 103: 403-427.
17. Hong Y, Andersen ML (2011) The relationship between corporate social responsibility and earnings management: An exploratory study. Journal of Business Ethics 104: 461-471.
18. Vidal JP (2015) Overview of the BEPS Project. In J-P Vidal (3rd eds), Introduction to International Tax in Canada 35-58.
19. Lisowsky P, Robinson L, Schmidt A (2013) Do publicly disclosed tax reserves tell us about privately disclosed tax shelter activity? Journal of Accounting Research 51: 583-629.
20. Institute of Business Ethics (2012) Attitudes of the British public to business ethics.
21. McGee R, Ho S, Li A (2008) A comparative study on perceived ethics of tax evasion: Hong Kong vs the United States. Journal of Business Ethics 77: 147-158.
22. Maciejovsky B, Schwarzenberger H, Kirchler E (2012) Rationality versus emotions: The case of tax ethics and compliance. Journal of Business Ethics 109: 339-350.
23. Doyle E, Frecknall-Hughes J, Summers B (2014) Ethics in tax practice: A study of the effect of practitioner firm size. Journal of Business Ethics 122: 623-41.
24. McGee R (2006) Three views on the ethics of tax evasion. Journal of Business Ethics 67: 15-35.
25. Song YD, Yarbrough TE (1978) Tax ethics and taxpayer attitudes survey. Public Administration Review 38: 442-452.
26. Hanlon M, Heitzman S (2010) A review of tax research. Journal of Accounting and Economics, 50: 127-78.
27. Piaget J (1997) The Moral Judgment of the Child. London: Kegan Paul, Trench, Trubner and Co. Reidenbach
28. Kolhlberg L (1984) The Psychology of Moral Development, Harper & Row, San Francisco.
29. Fassin Y, Van Rossem A, Buelens M (2010) Small-business owner-managers' perceptions of business ethics and CSR-related concepts. Journal of Business Ethics 98: 425-53.
30. Joyner BE, Payne D (2002) Evolution and implementation: A study of values, business ethics and corporate social responsibility. Journal of Business Ethics 41: 297-311.
31. Joyner BE, Payne D, Raiborn C (2002) Building values, business ethics and corporate social responsibility into the developing organization. Journal of Developmental Entrepreneurship 7(1): 113-131.
32. Carroll AB (1991) The pyramid of corporate social responsibility: Toward the moral management of organizational stakeholders. Business Horizons 34: 39-48.
33. Velasquez MG (1999) Business Ethics: Cases and Concepts, Prentice Hall, Englewood Cliffs.
34. Carroll AB (1979) A three-dimensional conceptual model of corporate performance. Academy of Management Review 4: 497-505.
35. Choi T, Jung J (2008) Ethical commitment, financial performance, and valuation: An empirical investigation of Korean companies. Journal of Business Ethics 81: 447-463.
36. Labelle R, Francoeur C, Gargouri RM (2010) Ethics, diversity management and financial reporting quality. Journal of Business Ethics 93: 335-353.

37. Canada Revenue Agency (2013) Aggressive tax planning.

38. Stickney CP, McGee VE (1982) Effective corporate tax rates: The effect of size, capital intensity, leverage, and other factors. Journal of Accounting & Public Policy 1: 125-152.

39. Gupta S, Newberry K (1997) Determinants of the variability in corporate effective tax rates: Evidence from longitudinal data. Journal of Accounting and Public Policy 16: 1-34.

40. Desai MA, Dharmapala D (2006) Corporate tax avoidance and high-powered incentives. Journal of Financial Economics 79: 145-79.

41. Sikka P (2010) Smoke and Mirrors: Corporate social responsibility and tax avoidance. Accounting Forum 34: 153-68.

42. The Week (2013) Starbucks "chooses" to pay tax for first time in five years.

43. Larcker DF, Rusticus TO (2010) On the use of instrumental variables in accounting research. Journal of Accounting and Economics 49: 186-205.