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If corporate tax reform is high on the national economic agenda, the time is none too soon, a new study in a leading accounting journal suggests. While criticism of the current law most commonly targets its high statutory rate, the new research raises an equally important issue – that the system imposes a serious disadvantage on

In the words of the paper, “ownership concentration has explanatory power for variation in tax avoidance... Results indicate an increase in the use of tax shelters, which is a costly activity in the sense that tax shelters occupy the more complex segment of the spectrum of tax avoidance.”

How does this occur? Institutional owners “need not explicitly and specifically promote tax avoidance,” the study explains. “Managers likely have heightened incentive to show better after-tax performance in order to justify their compensation to new institutional investors...In this scenario taxes are just another line-item expense, and institutional owners do not have to explicitly dictate which line item... managers should manage better.”

And tax manipulation, the study suggests, presents an inviting way for managers to do so, given the byzantine complexities of the IRS code.

Comments Mozaffar Khan of the University of Minnesota, who carried out the study with Suraj Srinivasan of Harvard Business School and Liang Tan of George Washington University, “One can’t help being struck by the malleability of corporate taxation that emerges when company managers confront increased institutional ownership. Evidently out of eagerness to impress their new owners, managers are able to substantially reduce taxes owed and taxes paid within the next year or 18 months. Hopefully, our findings will spur efforts to simplify the tax code and level the playing field, so that companies that lack the means of bigger firms to exploit the current system do not have to carry the corporate tax burden to the extent they do today.”

The findings reinforce those of a paper in the current ***Accounting Review*** that deals with similar issues. The paper, by Andrew Bird and Stephen A. Karolyi of Carnegie Mellon University, in the journal’s January/February edition, finds that a 10 percent increase in institutional ownership "precedes declines in effective tax rates on the

reshuffling between the Russell 1000 index, which includes the thousand largest companies in the U.S. equities market, and the Russell 2000, which consists of the following 2000 firms in size. As the Khan, Srinivasan and Tan (KS&T) paper explains, "Russell Investments assigns these value-weighted indices based on their market value on the last trading day of May each year...At the threshold between the 1000 and 2000 indices...small changes in relative market capitalization can result in reassignment from one index to another...While firms on either side of the threshold are similar in size, firms at the top of the Russell 2000 have ten times the index weights of firms at the bottom of the Russell 1000. Firms at the bottom of the 1000 index therefore have low institutional ownership, while firms at the top of the 2000 have high institutional ownership."

Of vital importance to researchers, this shifting about is beyond the control of the companies involved, since small, quasi-random differences in size rankings at the threshold can dictate listing in one index or the other. This randomness provides an ideal way to test the effect of institutional investors on tax behavior and other aspects of corporate governance.

KS&T analyzed the taxation effect during a 19-year period when Russell Investments employed this assignment method (another, slightly different method is used today). They focused on quasi-indexers, institutional investors with passive and diversified holdings, whose "investment mandate," the professors write, "limits their flexibility to vote with their feet and thereby provides an incentive for them to influence managerial actions. This influence can be exercised through institutional investors' say on pay and through support for other activist shareholders...who promote a particular action." How this influence affected taxes was measured for firms' fiscal years following index reshufflings, in most cases a period of 18 months.

As they expected, the professors found that firms at the top of the Russell 2000, with their high index weight, had significantly more institutional ownership than those at the bottom of the Russell 1000 – almost 20% more in fact. Whether measured by

Austin and three co-authors. Combined with these other results, KS&T write, "we view the positive relation between ownership concentration and tax avoidance as quite robust."

And, considering the robustness of the finding, shouldn't the problematic effects on taxation engendered by institutional ownership lead the institutions to discourage this avoidance? After all, as KS&T note, "quasi-indexers manage pension and other funds for large portions of the general public."

Here the professors demur. Comments Prof. Khan, "Given the fiduciary duty of fund managers to their constituencies and the many issues involved in company governance besides taxation, one needs to be careful about prescribing management strategies. Rather than scolding companies and institutional investors, the priority should be to simplify corporate taxation so that the opportunities for avoidance we document are no longer a temptation for big firms and a bane for smaller ones."

The study, entitled "Institutional Ownership and Corporate Tax Avoidance: New Evidence," is in the March/April issue of ***The Accounting Review***, published six times yearly by the **American Accounting Association**, a worldwide organization devoted to excellence in accounting education, research, and practice. Other journals published by the AAA and its specialty sections include *Accounting Horizons, Auditing: A Journal of Practice and Theory, Issues in Accounting Education, Behavioral Research in Accounting, Journal of Management Accounting Research, Journal of Information Systems, Journal of Financial Reporting,* and *The Journal of the American Taxation Association.* In addition, the AAA is in the process of inaugurating *Journal of Forensic Accounting Research.*