

Corporate profiling of tax-malfeasance: A theoretical and empirical assessment of tax-audited Australian firms

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Abstract

Tax avoidance and tax evasion represent serious breaches of corporate social responsibility which threaten a country's revenue base. This study gathers these related issues under the umbrella term *tax malfeasance*. Using the annual reports of 203 firms over the 2006–2009 period, we find that firms that were audited by the Australian Taxation Office tend to exhibit values that significantly differed from those of non-audited firms, and those differences were linked to tax malfeasance via notions in Cressey's (1950) *fraud triangle*. Our results show that firms who are prone to engage in tax malfeasance can be profiled and that such a profile may be a useful means to fairly and cost-effectively target tax audits.

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1. INTRODUCTION

Over the past decade, an explosion "... in the variety and volume of literature on corporate social responsibility (CSR) ..." has included many assessments of CSR breaches (Sikka, 2010, p.153), including efforts to aggressively minimize corporate-tax payments (Lanis and Richardson, 2012; Hasseldine and Morris, 2013). Much of this expansive literature succeeded in its intent to empirically verify the presence of corporate social malfeasance (CSM), in particular with respect to corporate failures to meet tax obligations (such as tax malfeasance)⁴. This study transposes processes that are commonly highlighted in the extant literature by empirically building a corporate profile of how firms that are perceived as being likely to engage in tax malfeasance (as evidenced by tax audit/review) differ from the majority of firms who continually meet their CSR obligations.

Under a CSR mandate, firms are expected to contribute a fair share of their profits to fund the governance, infrastructure and social goods/services of the society in which they operate and/or to offset their use of the common resources being funded (policing, legal and security, physical infrastructure (for example roads, communications and power), education, research, hospitals, etc). While it is acceptable for taxpayers to use *tax planning* to work within tax laws, rules and procedures to ensure reasonable tax bills, society frowns on overly *aggressive tax behavior*. The *aggressive tax behaviors* of tax avoidance and evasion are grouped into tax malfeasance, because both wrongfully deprive "... government of revenues needed for the provision of infrastructures, and for public services and public utilities" (Otusanya, 2011, p.316), with the former considered a social wrong and the latter a criminal act.

A key premise in this study is that behaviors and acts that lead to tax malfeasance are closely linked with those that lead to civil and criminal fraud.⁵ Therefore, fraud-prevention models like Cressey's (1950) *Fraud Triangle* can be adapted so as to provide insight into the motivators/pressure, thinking/rationalization and choices/opportunities of those firms who commit tax malfeasance. The insights were used to structure and guide our enquiry as to how the antecedent processes of tax malfeasance tend to alter the attributes of firms with a propensity to engage in tax malfeasance from patterns that are likely to be common in those who faithfully discharge their tax obligations. The Cressey (1950) *Fraud Triangle* attribute structure (*pressure, rationalization and opportunity*) is unlikely to be as meaningful in the latter firms as it is in the former. Thus, the reviewed attributes were gathered in terms of

⁴ Malfeasance is a legal term (see for example West's Encyclopaedia of American Law, 2008; Nolo's Plain-English Law Dictionary, 2009) encompassing acts that are seen in civil courts as wrongful and/or in criminal courts as criminal. Tax malfeasance encompasses tax avoidance (as a social wrong) and tax evasion (as a criminal act). In civil actions, misfeasance and nonfeasance are terms related to malfeasance, but both suggest less malice of intent and nonfeasance is a failure to perform a contracted or socially expected act or action.

⁵ Fraud is a nebulous term with many overlapping definitions (for example West's Encyclopaedia of American Law, 2008; Nolo's Plain-English Law Dictionary, 2009; Merriam-Webster Dictionary, 2013; Oxford Dictionary, 2013) which can be denoted as a deceit, deception, and/or breach of trust designed to gain the perpetrator (or related person or group) a wrongful advantage and/or to induce a wrongful disadvantage on another party (for example person or firm). Fraud is always a social wrong (such as a civil law violation or other bad act) and its more virulent forms (based on intent and level of harm) tend to be legislated as lesser or major criminal offenses (such as a misdemeanour or a felony).

more neutral categories (such as general, transfer pricing, perceived risk and operational features), and Cressey's (1950) *Fraud Triangle* was used to develop insight into the import of differences in the reviewed attributes.

Based on the qualitative analysis, a sample of 203 firms was drawn from Australia's top 300 publicly-listed firms over the 2006–09 period. Quantitative analysis of the sampled firms found that those who had been audited for tax malfeasance by the Australian Taxation Office (ATO) displayed similar values for key attributes, and that the values for those attributes tended to be significantly different for the non-audit firms. For Cressey's (1950) *Fraud Triangle*, the reviewed attributes involved mostly opportunity, with some involving pressure and only one that involved rationalization. Further, an interesting (inferred) qualitative finding, given the extensive command-control-and-reporting systems (CCRS) used to identify and prevent agents and employees from acting in ways that put the firm's reputation and/or its wealth at risk, was that individuals or groups who perpetrate tax malfeasance must be in a position to exploit weaknesses in the firm's CCRS or must have the authority, power, and control to create and sustain such weaknesses.⁶ The sustained presence of CCRS weaknesses was found to form a large part of the attribute profile of tax-audited firms in our sample.

The analysis carried out in this study shows that developing a corporate profile that is strongly suggestive of tax malfeasance is feasible and potentially quite useful. Such profiles should help tax authorities (for example the ATO) to fairly and cost-effectively target tax audits. Further, given that many of the profile attributes are pathways to facilitate the camouflage and commission of tax malfeasance, another benefit of revealing them as potential audit triggers could be to make tax malfeasance more difficult and risky for corporate-tax malefactors. While most of the analysis results are consistent with theory and literature-based expectations, there were two surprising departures. Specifically, tax-audited firms appear to have relatively high effective tax rates (ETRs) and tend to use big-4 auditors more extensively than non-audited firms. The first unexpected analysis outcome suggests that in terms of Cressey's (1950) *Fraud Triangle*, ETRs may be more of a *pressure* to engage in tax malfeasance than an *outcome*. The second unexpected analysis outcome is consistent with the James Hardie Group (JHG) review finding (see below) that firms who engage in CSM tend to so convolute their affairs that 'big-4' auditor involvement becomes a necessity. Further, the finding that the external auditor firms of tax-audited firms derive a significantly greater amount of non-audit fees from tax-related services than those of non-tax-audited firms adds to worries over auditor independence being compromised. Again, this outcome can be explained by the self-inflicted greater tax complexities of the tax-audited firms. When considered as a whole, these findings suggest that (for the sampled tax-audited firms and the JHG) a propensity for tax malfeasance appears to be a dubious strategy (for example, gross gains are often more than offset by significantly increased complexity leading to higher costs, risks and distractions from other key strategic and operating concerns).

⁶ However, tax authorities tend to hold firms accountable for any tax malfeasance committed in their name and rarely (if ever) prosecute the agents or employees who physically perpetrated the tax malfeasance.

The rest of this paper is organized as follows. Section 2 considers how Cressey's (1950) *Fraud Triangle* adds insight to corporate tax malfeasance. Section 3 provides an overview of the JHG to show how tax malfeasance can arise as an entanglement of other CSM. Section 4 reviews the evidence of tax malfeasance. Section 5 discusses the research scope and hypotheses. Section 6 summarizes the research design. Section 7 reports the findings, and Section 8 concludes.

2. TAX MALFEASANCE INSIGHT FROM CRESSEY'S (1950) FRAUD TRIANGLE

Cressey's (1950) *Fraud Triangle* has for over 60 years and with few changes, helped auditors comprehend and illustrate the driving factors that can encourage and allow trusted employees of the firm to engage in fraud (see for example Wolfe and Hermanson, 2004; Kassem and Higson, 2012)⁷. Indeed, Cressey's (1950) *Fraud Triangle* has been linked to financial statement fraud by numerous accounting researchers (see for example Wells, 1997; Montgomery, Beasley, Menelaides & Palmrose, 2002; Coenen, 2007; Skousen, Smith & Wright, 2008).

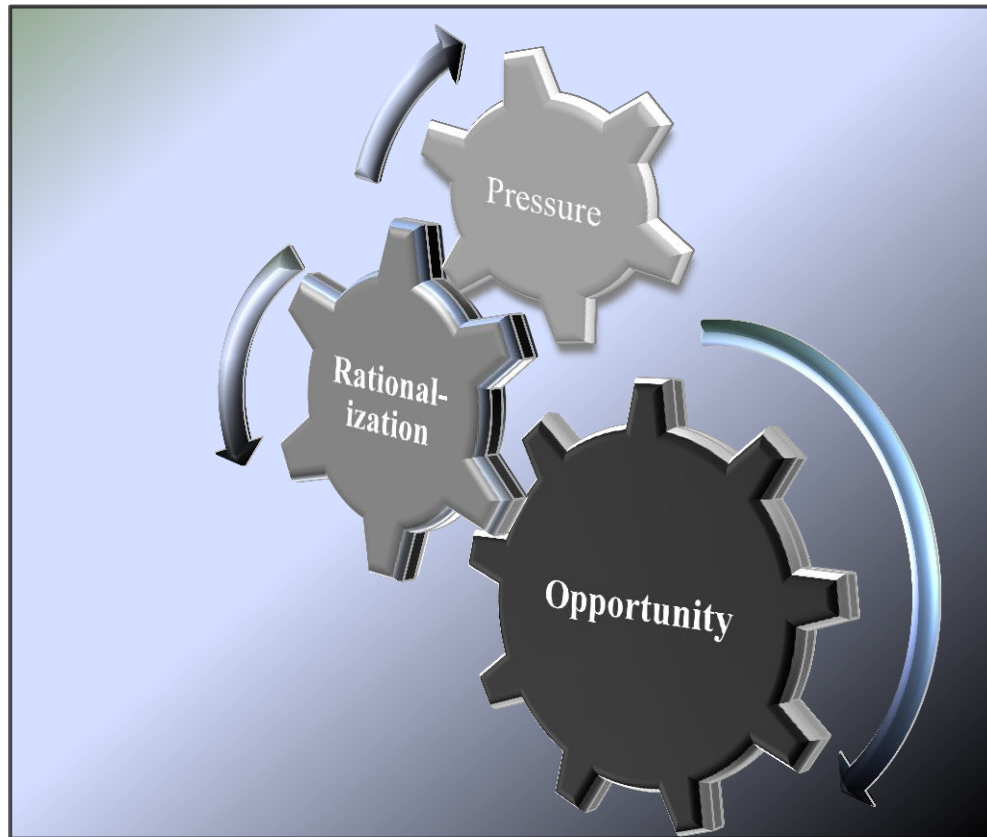
In Figure 1, we adapt Cressey's (1950) *Fraud Triangle* from its original inflexible triangle to a meshed set of "progressing gears" where removal of any of the driving gears stops the process and the:

Pressure Gear (for example debts, a desire for material wealth or status, and/or employment performance pressure) can initiate the process, then;

Rationalization Gear can erode/discount moral qualms about the action, concern over its effects on others, and/or fear of the risks/consequences of being caught; and then

Opportunity Gear reflects a perpetrator's search for, and/or creation of, opportunities to commit fraud/malfeasance.

⁷ It should be noted that Cressey's (1950) Fraud Triangle was incorporated into auditing standards by the American Institute of Certified Accountants (AICPA) in its Statement of Auditing Standards No. (SAS) 99: Consideration of Fraud in a Financial Statement Audit (AICPA, 2002).

Figure 1: Antecedent drivers/enablers of fraud and corporate tax malfeasance

Source: Adapted from Cressey's (1950) *Fraud Triangle*.

While Cressey's (1950) *Fraud Triangle* and much of the related literature (implicitly) focus on individuals defrauding employers or breaching trust with clients, Figure 1 is also applicable to acts of CSM. However, individuals perpetrating CSM tend to have great authority, power and control within their firms as evidenced by their capacity to over-ride their firm's command-control-and-reporting systems (CCRS) that are (or should be) designed to discourage and/or highlight any defalcations and other malfeasance.

In terms of Cressey's (1950) *Fraud Triangle*, pressure to engage in bad acts can arise from performance-linked pay (a status-based need for their firms to perform well, etc.) and rationalization of tax malfeasance becomes easier if, instead of sharing society's moral outrage toward tax malfeasance (in particular, tax avoidance), senior management views tax *as a cost of business* and believe that (as with other costs) their duty is to minimize it⁸. Further, the opportunity to successfully commit and hide corporate tax malfeasance usually requires that the perpetrators: significantly degrade the relevant aspects of their firm's CCRS; instigate a culture of active connivance and/or passive acquiescence among the accounting staff (where possible); and co-opt,

⁸ Corporate rationalization of CSM and other bad acts often draws from a variant of Friedman's (1970) infamous proposition that: "The [only] social responsibility of business is to increase its profits."

corrupt and/or confuse the relevant internal and external auditors, regulators and tax authorities (see, Sikka and Hampton, 2005; Sikka, 2013).

As noted previously, unlike perpetrators of CSM, perpetrators of frauds against employers or clients often lack the requisite influence to create and/or enhance opportunities for fraud and must, therefore, seek out and exploit flaws in the CCRS. Thus, in cases of fraud, it is sensible for auditors to examine for evidence of pressure (for example gambling debts, living beyond ones visible means, addiction, etc.) and to look for breaches of the CCRS. However, that scope of audit review (while necessary) is insufficient for tax malfeasance and other CSM audits. Specifically, auditors need to recognize that CSM perpetrators often have the requisite authority, power and control to over-ride or otherwise subvert their firm's CCRS. Hence, auditors seeking to provide assurance of the absence of CSM need to greatly expand their audit scope to include degradation of the target firm's CCRS and culture and a capacity to influence, threaten or suborn their firm's internal auditors and/or (supposedly independent) external reviewers. While it can be argued that some executives engaged in tax malfeasance may feel that they are not committing a social wrong, they are aware of punishment and are likely to seek to obscure any acts of tax malfeasance.

3. OVERVIEW OF THE JAMES HARDIE GROUP

A library of articles, books and blogs have been written on the extensive CSR failures of the James Hardie Group (JHG). Fortunately, an overview of this firm is more appropriate to the needs of our study than a definitive and exhaustive case study. The following overview of the JHG strongly suggests that while it is unclear whether the JHG intended to commit tax malfeasance, the complexities, intrigue, and disjointedness of efforts to evade its legal and CSR duties to people harmed by its asbestos-based products inevitably led it into actions that (from a business rationale) were dubious and that the tax authorities of several nations interpreted as being tax malfeasance.

During the 20th century, the collection of firms that are now called the JHG had the great misfortune of becoming the preeminent supplier of asbestos-based fiber board and many other asbestos-based products. That misfortune was intensified and compounded into CSM when the JHG chose to continue producing, promoting and supplying asbestos-based products long after it was readily apparent that processed asbestos was a highly toxic product that (even when produced and/or used as directed) was likely to injure, profoundly disable and eventually kill those who are exposed to it or its dust. The decision to continue its asbestos-based-product lines further enmired the JHG in asbestos-based liability, which threatened the survival of the entire group, and (in terms of Cressey's (1950) *Fraud Triangle*) added pressure to rationalize and commit further bad acts. Thus, the original asbestos-driven CSM of the JHG was potentiated and compounded by devious efforts to disassociate JHG from and/or otherwise evade its asbestos-related liabilities estimated at AUD\$1.54 billion (Jackson, 2004). Initial efforts (1995–2000) to separate the JHG group assets from its asbestos-related liabilities were limited to asset-stripping its subsidiaries who were directly involved in promoting and selling asbestos-based products (ACTU, 2007). After finding that the Australian legal system was not satisfied with the AUD\$293 million of net value left in the asset-stripped subsidiaries, the JHG moved its operations and AUD\$1.9 billion in assets to the Netherlands in 2001 and later (2010) underwent

another restructuring and move to Ireland to become an Irish *Societas Europea* company.

While this devious maneuvering enabled the JHG to evade much of its CSR to those harmed by its asbestos-based products, it also ensnared the JHG and its principals in an ever-expanding quagmire of legal and tax complications and difficulties. Specifically, seven JHG principals were found guilty of misleading the Australian Stock Exchange (ASX) as to the magnitude of JHG's asbestos-related liability and the future accessibility of asbestos-related claims to assets that were moved offshore from Australia in 2001 (Sky News, 2012). Furthermore, the asset transfers and corporate restructurings were so complex, oblique and obtuse that audits (by various tax agencies situated in different jurisdictions) found multiple tax errors and tax malfeasance in the structuring, timing and documentation of the related tax filings. These latter effects are of great interest to this study, along with how the JHG's cupidity led to evasion of its legal and social responsibilities and caused it to blunder into transactions that were seen as tax malfeasance.⁹

The asset-stripping, corporate restructuring, and moves to other jurisdictions enabled JHG to leverage tax concessions from the Australian Government in 2004 on any future income that it transferred to a voluntary compensation fund established as a charity by the JHG. In seeking to take advantage of this concession, a series of transactions between JHG firms were crafted to reduce withholding taxes payable in the U.S. by shifting wealth as dividends to Australia and then to transfer the resulting net after-tax wealth to an off-shore subsidiary in Malta.¹⁰ However, the ATO Commissioner used GAAR provisions in the *Income Tax Assessment Act 1936 (Cth)* to reorganize the transaction to increase the JHG taxable capital gains by AUD\$478.2 million and added another AUD\$387.7 million in taxes, penalties and interest. An appeal of that decision, seeking to reduce the amount payable by AUD\$240 million was refused and the assessed taxes, penalties and interest were up-held.¹¹ The JHG corporate reorganization and move to Ireland also created tax issues with the U.S. Internal Revenue Service (IRS). Specifically, in June 2008 the IRS issued a *Notice of Proposed Adjustment* that stated that JHG did not qualify for the limitations of benefit provision under the amended United States–Netherlands Income Tax Treaty for 2008 and subsequent years.¹² In connection with the JHG proposal to re-domicile its corporate base from the Netherlands to Ireland, it incurred a tax liability that arose from a capital gain on the transfer of its intellectual property from the Netherlands to a

⁹ This type of manoeuvring and its extent are neither peculiar to the JHG nor even uncommon. Desai and Hines (2002) argue that firms are able to accentuate their international corporate tax avoidance activities of thin capitalization, transfer pricing and income shifting through the use of tax haven incorporated entities.

¹⁰ Specifically, the firms involved were James Hardie Industries Ltd., James Hardie (Holdings) Inc and RCI Pty Ltd.

¹¹ RCI Pty Ltd v FC of T 2010 ATC 20–207. The key issue was whether the provisions of Part IVA, specifically section 177F(1)(a), entitled the Commissioner to make the determination, as well as a further determination under section 177F(2) that the tax benefit shall be deemed to be included in the assessable income of RCI as a net capital gain by virtue of section 102–5 of the Income Tax Assessment Act 1997 (Cth).

¹² Under the limitations of benefit provision, a 5% dividend withholding tax is applicable and no interest or royalty withholding taxes are applied to payments made by U.S. subsidiaries to Dutch subsidiaries. Under the amended U.S.–Netherlands Income Tax Treaty, 30% U.S. withholding taxes could be applicable.

newly-formed James Hardie entity (James Hardie Technologies Ltd.) located in Bermuda (a tax haven) and tax resident in the Republic of Ireland and the exit from the Dutch Financial Risk Reserve Regime. The JHG was subject to considerable uncertainty with regards to the quantum of tax liabilities that should be recognized from these transactions. The JHG recorded tax adjustments of USD\$380.7M in the 2011 fiscal year, reflecting a USD\$32.6M tax charge arising from corporate restructure and a non-cash expense of USD\$345.2M following the dismissal of RCI Pty Ltd.'s appeal of the 1999 disputed amended tax assessment (James Hardie Annual Report, 2011).

The JHG case study is important to this study in that it shows that when large firms engage in major CSM, they often run afoul of tax issues and/or may compound their CSM with efforts to enhance their gains through tax malfeasance. The JHG case is typical of firms who are engaged in complex CSM. Specifically, the process involves the interleaving of several key elements: tax havens, funds transfers, debt transfer, withholding taxes and international re-structuring. In this study, we propose, test and empirically show that several important attributes of publicly-listed firms are indicative of behaviors that tax authorities will want to audit. The JHG case suggests that even if the primary incentive by a firm is a CSM other than tax malfeasance, tax malfeasance and/or misfeasance is almost inevitable as an element of such behaviors.¹³

4. EVIDENCE OF TAX MALFEASANCE

4.1 The ATO's perspective on tax malfeasance

In recent years, publicly-listed Australian firms have come under increasing scrutiny by the ATO and the tax authorities of other nations. The ATO (2010) is emphasizing, in various tax-compliance programs, that there is a significant tax-revenue-erosion risk by reason of the timing and/or structuring of international dealings by very large firms (such as those with more than AUD\$100M in market capitalization), 68 per cent of which have offshore affiliates, with some incorporated in tax havens. These observations suggest that the ATO believes major Australian firms have a substantial potential for tax malfeasance and that some engage in that proficiency, regularly and persistently. While unconscionable at any time, the behaviors that the ATO is worried about are particularly pernicious during and shortly after the global financial crisis when most governments experienced significant declines in tax revenue, combined with a substantial rise in costs and commitments to their constituents.¹⁴

¹³ See note 1; and misfeasance tends to be bad behavior that lacks the intent to harm that is present in malfeasance. However, the tax statutes of most developed countries put an onus on taxpayers to be aware of and obey tax laws. Thus, the ignorance of misfeasance is rarely an effective defense if indicted for tax malfeasance.

¹⁴ Activities that spurred the tax reviews/audits in Australia included: income shifting, strategic debt placement, withholding taxes, R&D expenditure deductions, bad debt deductions, interest expense deductions and the use of tax havens (ATO, 2010).

4.2 Other commentaries on tax malfeasance

The following commentaries, among other things, highlight how the elements of Cressey's (1950) *Fraud Triangle* (as adapted for this study (see Figure 1 above) aptly illustrate the three drivers of tax malfeasance:

Pressure is described by Dhaliwal, Newberry and Weaver (2005) and Beattie, Goodacre and Thomson (2006) when they note that corporate tax payments can adversely affect a firm's financial position, financial performance, liquidity, operational results and cash flows. And that, in an effort to optimize these attributes, firms may organize specific arrangements, transactions or events to avoid or evade the corporate taxes that would otherwise be payable;¹⁵

Rationalization can be seen in the Minnick and Noga (2010) observation that, at an extreme, tax malfeasance activities may be viewed by top management as an integral part of normal business processes that are justified by the objective of enhancing corporate profitability and shareholder returns (see also, Friedman, 1970); and

Opportunity creation is clear in the Desai and Dharmapala's (2006; 2009) observation that international-tax malfeasance activities typically involve a transfer of income and debt among jurisdictions, in an attempt to obtain a benefit by *arbitraging income recognition* across variable tax rates.¹⁶

5. RESEARCH SCOPE AND STATEMENT OF HYPOTHESES

Our study seeks to determine whether firms that tend to engage in tax malfeasance can be profiled, based on key attributes. Such corporate profiling should be of great value to tax authorities as a means to fairly and more cost-effectively target their audit effort. In determining whether such a profile can be developed and likely to be useful, we searched for key differences in general-tax, transfer-pricing, corporate-governance, external-auditor use-and-independence and operational attributes of publicly-listed Australian firms. Knowing those differences will enhance our understanding of how specific attributes are associated with corporate tax malfeasance and may suggest their role in facilitating that activity. Attributes identified with tax malfeasance were also related to the JHG, which in many decades of engagement in serious CSM¹⁷, also

¹⁵ Dyreng et al. (2008) found that successful long-run tax-malfeasance firms tend to be associated with significantly higher leverage. Higher leverage adds to corporate pressure (via higher interest payments and expenses) and can encourage recklessness by corporate managers via reduced financial consequences to shareholders (if the firm is bankrupted by back-taxes, penalties, and interest) by shifting much of the risk (but little or no benefits) to creditors.

¹⁶ It is also likely that firm size is a powerful multiplier in corporate tax malfeasance. Rego (2003) claims that larger firms can achieve economies of scale with tax planning and have the resources and incentives to reduce corporate income taxes. Hanlon, Mills, & Slemrod (2005) also find that larger firms tend to have greater tax deficiencies relative to their actual tax liability.

¹⁷ For example, selling asbestos-based products long after it became apparent that asbestos caused chronic injury leading to debility and death, seeking to isolate the majority of its assets from the legitimate claims of those injured by its products, lying to the ASX, moving its assets offshore to evade litigation, etc.

attracted many years of scrutiny by the ATO and other tax agencies around the world. What we are seeking in this study are corporate attributes that individually and/or in combination are a likely indicator of corporate tax malfeasance, even if those actions are ancillary or adjunct to other CSM. The general null hypothesis of: “*the absence of statistically-significant differences between tax-audited and non-tax-audited firms*” reflects the stated intent of this study and is tested through the examination of four subsidiary null hypotheses, asserting: *the absence of statistically-significant differences between tax-audited and non-tax-audited firms*, in terms of their:

H₁: general tax attributes;

H₂: transfer pricing attributes;

H₃: perceived risk attributes; and

H₄: operational features/attributes.

A concern of this study is the risk of biases arising in the sample selection and analysis, so this is addressed in the research design (see below). Specifically, sampled firms are selected so that the predilection for tax malfeasance of the sampled firms is isolated from irrelevant differences. Thus, the sampled firms should be reasonably similar in size and in the legal and business environments in which they operate. The next section discusses how these objectives are served by the design of the sampling process, the choice of variables and the empirical analysis.

6. RESEARCH DESIGN

The universe of firms analyzed in this study is drawn from the top 300 publicly-listed Australian firms, with exclusions designed to ensure a statistically valid sample. A four-year sample period was selected as part of a trade-off between longer periods yielding better statistics but greatly raising the risk of data fouling (for example due to time-based trends and/or survivorship bias). The years 2006–09 were chosen for the sample period because they are the most recent years of publicly available financial data at the time this study was carried out.

The first exclusion of firms ensured data continuity by eliminating firms that did not file annual financial reports continuously throughout 2006–09 and reduced the initial sample by 20 firms (such as those that reported for only part of the review period because they were newly incorporated, taken-over, merged with other firms, etc.). The second exclusion reduced the sample firms by 61 firms that were deemed to have little opportunity to engage in tax malfeasance because they are closely regulated.¹⁸ The third exclusion removed 16 firms from the sample because they followed a different reporting standard (such as U.S. GAAP).

After the sample was finalized at 203 firms, the research methodology then involved splitting the sample firms into those that during 2006–09, were: (1) tax-audited; and (2) not-tax-audited. During the 2006–09 period of our study, the ATO (and other tax

¹⁸ The excluded firms consisted of: (1) 39 financial firms, (2) 11 insurance firms, and (3) 11 property partnership or trust entities.

authorities) audited the financial accounts of 30 firms to consider several issues as reported in Table 1. The most significant types of tax aggressiveness presented in Table 1 involve corporate restructuring (16.67%) and the deductibility of interest expenses (13.34%). Other important types of tax aggressiveness include asset disposals under capital gains tax, the deductibility of intellectual property, R&D expenses and tax losses, and the offshore income tax exemption (10%).

Table 1: Types of tax aggressive activities pursued by firms in the sample

Types of tax aggressiveness	Incidence	
	No. of firms	Frequency (%)
Corporate restructuring	5	16.67
Deductibility of interest expenses	4	13.34
Asset disposals – capital gains tax	3	10.00
Deductibility of intellectual property	3	10.00
Deductibility of R&D expenses	3	10.00
Deductibility of tax losses	3	10.00
Offshore income tax exemption	3	10.00
Claiming of capital gains tax losses	2	6.67
Acquisition of dividend franking credits	1	3.33
Deductibility of bad debts	1	3.33
Deductibility of concession fees	1	3.33
Deductibility of pre-contract work expenses	1	3.33
Totals	30	100.00%

It is worth noting that being the subject of audit/review activity by the ATO is not *per se* evidence of tax-malfeasance guilt. In fact, many (if not most) taxes do not meet the desired trait of being fully neutral (for example not affecting economic choice) and as a result, many corporate transactions and events have tax consequences with ensuing potential tax benefits/costs accruing to the choice of how to conduct an underlying transaction. While most tax authorities deem that there is no tax malfeasance if tax benefits result as part of an overall business objective. However, if the tax benefits are believed to arise from a scheme designed wholly (or mostly) to avoid income taxes, then an effort is made to apply general anti-avoidance regulations (for example in Australia, Part IVA of the *Income Tax Assessment Act 1936* (*Cth*)).

Finally, selected data were hand-collected from the annual reports of the sample firms. The finalized sample of firms yielded 812 firm-year observations with approximately 14.78 per cent of the firm-year observations relating to firms who *were* tax audited or reviewed over the period.

7. DIFFERENCES BETWEEN TAX-AUDITED AND NON-TAX-AUDITED FIRMS

As mentioned previously, this study seeks to determine if tax-audited firms have *stand-out* attributes that distinguish them from non-tax audited firms. If such *stand-out* attributes can be determined, they should be of great value to tax authorities in planning who, what and when to audit for corporate tax malfeasance. Given that attributes tested in this study are very often pathways to facilitate the camouflage and

commission of corporate tax malfeasance, if they become generally known as audit triggers, revealing them could make the commission of corporate tax malfeasance more difficult and risky for corporate-tax malefactors. The following subsections are organized in terms of the subsidiary null hypotheses introduced in Section 5 of the paper (above).

The reviewed attributes are classified in our results (see Tables 2–5) in terms of Cressey's (1950) *Fraud Triangle* of: pressure (P), rationalization (R), or opportunity (O). It is interesting that one (3.8%) of the reviewed attributes is classified as *rationalization*, eight (30.8%) are classified as *pressure* and 17 (65.4%) are classified as *opportunity*. In fact, *rationalization* is rarely in itself a bad act, *pressure* is inducement to behave badly, but many have sufficient integrity 'to rise above it' and the *opportunity* to behave badly (for example the degrading of preventative controls) is usually intended to facilitate a bad act (such as by enabling it and/or evading punishment). Thus, it is not surprising that the reviewed attributes classified as rationalization/excuses are rare and those classified as opportunity/outcomes are quite common.

7.1 General tax attributes

ETRs are used as proxies of corporate tax avoidance because effective tax planning can reduce a firm's tax liability without necessarily reducing the accounting income reported in its financial statements (ATO, 2006; Rego, 2003; Richardson and Lanis, 2007). As noted previously, while tax planning is a socially accepted activity, both tax avoidance and tax evasion are considered to be tax malfeasance. Given that reduced ETRs are an expected key goal of tax malfeasance, low ETRs are likely to be present in firms engaged in effective corporate tax malfeasance, however, they may also be present (to a lesser degree) in firms not so engaged.

Analysis of 10 *general tax attributes* (including the one outlined above) found (see Table 2) that, vis-à-vis non-tax-audited firms, tax-audited firms have significantly higher: ETRs; carried-forward tax losses; negative adjustments to *prima facie* income tax (owing to lower tax rates applied to operations in overseas jurisdictions) and negative adjustments to *prima facie* income tax (relating to R&D expenditure); uncertainty in the estimation of tax liabilities; likelihood of having a subsidiary incorporated in an OECD (2006) listed tax haven; and chance of being subject to withholding taxes.¹⁹ Based on these results, the subsidiary null hypothesis H_1 is rejected and the alternative (of statistically significant differences in *general tax attributes*, between tax-audited and non-tax-audited firms) is accepted.

The findings on ETR1 and ETR2 run counter to what we anticipated, suggesting that in terms of Cressey's (1950) *Fraud Triangle*, the magnitude of income tax expense may be less of a tax malfeasance outcome than a pressure factor (for example high rates may create a pressure/desperation for firms to engage in tax malfeasance). The *tax payable log* and the *tax payable/total revenue* findings are consistent with the above analysis, in that they are higher for the tax-audited firms than for the non-tax-

¹⁹ Differences in mean values are statistically significant at the 10% level of analysis or better where indicated in Table 2.

audited firms, and the values of these two attributes were statistically significantly different.

The above four findings are all the more surprising, given that the *negative adjustment to prima facie income tax expense due to lower overseas tax rates* showed that the audited firms were very likely using transfers and other off-shore maneuverings to reduce their taxes-payable. Thus, among other things, the findings in Table 2 suggest that the taxes payable of tax-audited firms were very high relative to non-audited firms and may have been even higher if they had not engaged in what the ATO interpreted as probable tax malfeasance.

Finally, the general tax attributes of the JHG (see Table 2) are consistent with the findings for the tax-audited firms, except that many JHG attribute values are larger and the observed values for their *tax payable/total revenue* and *carried forward tax losses* are significantly lower than those of the non-audited firms. However, these lower values may reflect a *special tax deal* the JHG negotiated with the Australian government in 2004.

Table 2: General tax attributes

Item description/ <i>fraud-triangle</i> classification		Firm attributes (4 yr. avg.)			Statistical measures	
		JHG	Audited	Non-audited	t-stat	One-tailed p-value
ETR1 (total income tax expense/pre-tax financial accounting income)	P	-66.12	20.41	15.88	-2.307	0.009***
ETR2 (total income tax expense/operating cash flows)	P	39.49	21.63	17.65	-2.366	0.009***
Tax payable (log)	P	16.58	14.45	11.35	-4.171	0.000***
Tax payable/total revenue	P	0.83	1.40	1.21	-1.516	0.065*
Negative adjustment to <i>prima facie</i> income tax expense due to lower overseas tax rates	O	-16.04	-13.30	0.22	1.832	0.034**
Logarithm of negative adjustment to <i>prima facie</i> income tax expense due to R&D)	O	-460000	-1573492	-914040	1.109	0.134
Carried forward tax losses (log)	P	8.43	14.36	11.16	-4.587	0.000***
Has the company recorded tax as a critical uncertainty or uncertain re calculating tax estimates? (1=Y; 0=N)	O	1	0.63	0.34	-6.862	0.000***
One or more subsidiaries in an OECD listed tax haven (1=Y; 0=N)	O	1	0.57	0.30	-6.388	0.000***
Subject to withholding taxes (1=Y; 0=N)	R	1	0.70	0.48	-5.649	0.000***

P = pressure/inducement; R = rationalization/excuse; and O = opportunity/outcome.

The t-test assumes unequal variances.

*, **, and *** indicate significance at the .10, .05, and .01 levels, respectively.

7.2 Transfer pricing attributes

The purpose of most transfer-pricing rules is to ensure that international related-party transactions are conducted on an *arm's-length* basis so that profits are not shifted to the most favorable tax jurisdiction to minimize a firm's income tax liability (Hamilton, Deutsch, and Raneri, 2001; Eldenburg, Pickering, and Yu, 2003). Multinational firms can lower group tax by strategically setting artificial intercompany transfer prices. The *comparability concept* is pivotal to applying the arm's length tax principle (Arnold and McIntyre, 2002; Sikka and Willmot, 2010)²⁰.

An important tax compliance issue is that many firms do not prepare or maintain sufficient documentation on how they established what they call an *arm's length* inter-company transfer price. This *faux pas* may then be compounded by poor disclosure of related-party transactions in the financial accounts and/or the divergent treatment of international business transactions by the firm generally (Newberry and Dhaliwal, 2001). Moreover, the lack of documentation also raises the concern of the ATO and can give rise to amended tax assessments being issued to the firm as a result of transfer-pricing audits (ATO, 2010).

Transfer pricing can also involve the shifting of profits to a subsidiary that is incorporated in a tax haven that has relatively low (if any) corporate tax (Grubert and Mutti, 1991; Harris, Morck, Slemrod, and Yeung, 1993; Desai, Floey, and Hines, 2006; Wilson, 2009; Slemrod and Wilson, 2009). Further, Shackelford, Slemrod, and Sallee (2007) claim that more complicated transfer-pricing arrangements often involve intangible assets (for example R&D expenditure), for which it can be difficult to establish a fair value and taxable income can be transferred internationally. In fact, they claim that tax avoidance opportunities for transfer pricing are greatest amongst multinational firms with high profit margins that are generated from intangible assets (for example the pharmaceutical industry).

Analysis of the transfer pricing attributes (see Table 3) found that, vis-à-vis non-tax-audited firms, tax-audited firms have significantly higher: levels of debt forgiveness, frequency of debt transfer within the corporate group, numbers of interest-free loans, numbers/amounts of payments to group subsidiaries of non-monetary consideration in lieu of cash given without accompanying commercial justification, probability of inadequately-disclosed transfer-pricing support, non-disclosure of differences between inter-group interest rates charged and arm's-length interest rates and/or non-disclosure of supporting commercial reasons for such differences.²¹ Based on these results, the subsidiary null hypothesis H_2 is rejected and the alternative (of statistically significant differences in *transfer pricing attributes*, between tax-audited and non-tax-audited firms) is accepted.

Finally, Table 3 also indicates that the JHG, like the tax-audited firms in our sample, has significant elements of debt forgiveness, debt transfer, interest free loans and non-disclosure of transfer pricing support documentation.

²⁰ The arm's-length principle is generally applied in practice by establishing comparability between the conditions in a controlled transaction (such as transaction between the associated enterprises involved) and the conditions in uncontrolled transactions (such as transactions between independent parties) United Nations (UN, 2009).

²¹ Differences in mean values are statistically significant at the 1% level of analysis in Table 3.

Table 3: Transfer Pricing Attributes

Item description/ <i>fraud-triangle</i> classification		Firm attributes (4 yr. avg.)			Statistical measures	
		JHG	Audited	Non-audited	t-stat.	One-tailed p-value
Existence of debt forgiveness	O	1	0.15	0.10	-2.767	0.000***
Existence of debt transfer	O	1	0.08	0.05	-2.887	0.000***
Existence of interest-free loans	O	1	0.60	0.45	-3.906	0.000***
Non-monetary consideration without commercial justification	O	0	0.21	0.10	-3.733	0.000***
Non-disclosure of transfer pricing support documentation	O	1	0.92	0.90	-2.497	0.006***

P = pressure/inducement; R = rationalization/excuse; and O = opportunity/outcome.

The t-test assumes unequal variances.

*, **, and *** indicate significance at the .10, .05, and .01 levels, respectively.

7.3 Risk attributes

A sound framework of risk management in a firm should produce a system of risk oversight and internal control to ensure systems are effective, that strategic, operational, tax and financial risks are identified, and that policies, procedures, tools and charters are in place to manage and monitor risks. Risk management and internal control are an integral part of the governance structure of firms (ASX, 2007).

Corporate compliance programs undertaken by tax authorities (for example the ATO) stress that a strong governance structure with associated internal controls tends to reduce the likelihood that a firm will engage in tax malfeasance. Tax-risk oversight is seen as an essential component of an effective corporate governance structure by tax authorities (ATO, 2010). Further, stakeholders are increasingly interested in whether firms have adequate risk management and internal control systems in place to mitigate tax risks, particularly given the complexity of tax laws and possible uncertainties regarding legal interpretation and application of those tax laws in practice (Coles, Naveen, and Naveen, 2006; Erle, 2008).²²

Tax authorities consider that oversight of the tax-risk-management process is a responsibility of the board of directors (ATO, 2010) because meeting tax responsibilities is an ethical issue, with the corporate reputation at risk if tax arrangements become the subject of public scrutiny and/or legal action (Erle, 2008). While senior management has responsibility for implementing adequate processes, policies and putting systems in place to ensure that corporate tax risks are minimized (ATO, 2010), oversight by the board of directors ensures that senior management is diligent in those duties. The oversight by the board of directors should verify that the corporate culture and its assurance processes ensure that income tax expenses are

²² Tax risks comprise compliance risks, transactional risks, operational and reputational risks (KPMG, 2005).

fairly and accurately calculated and that the firm does not engage in arrangements or schemes with the primary objective of tax malfeasance (Erle, 2008).

The directors of many firms acknowledge that tax cannot be managed independently from other business activities and can have a significant influence on decisions made as a result of transactions undertaken (KPMG, 2005)²³. Nevertheless, there appears to be a clear disparity in the understanding of tax considerations between the board of directors, internal audit and the tax department in many firms (KPMG, 2005).²⁴

Our paper examines two important aspects of risk management of tax-audited versus non-tax-audited firms. The first aspect of risk management (RISK1) is whether the board has drafted a formal integrated risk management policy that deals with risk oversight and internal control. ASX Corporate Governance Council's Principle 7 states that the firm should establish a sound risk management policy that deals with risk oversight, risk management, the firm's risk profile and internal control. It is part of the board's oversight role to verify the establishment and implementation of a risk management system. Management should establish and implement a system for identifying, assessing, monitoring and managing risk in the firm.

The second aspect of risk management (RISK2) is whether the CEO/CFO affirms that the firm's risk management, internal compliance and control systems are operating effectively and efficiently. A firm should (ideally) have some means of analyzing the effectiveness of its risk management and internal compliance and control system and of the effectiveness of its implementation. According to ASX Recommendation 7.2, the CEO/CFO should affirm to his/her board, formally and in writing, that the firm's risk management and internal compliance and control system is operating effectively and efficiently.

Analysis of the above discussed attributes and three other perceived risk attributes (see Table 4) found that, vis-à-vis non-tax-audited firms, tax-audited firms have significantly: weaker risk oversight and internal control systems; less effective risk management systems in place; more intensive use of the services of a big-4 auditor; reduced independence in their external auditor; and more expenditure on the tax related services of a big-4 auditor.²⁵ Based on these results, the subsidiary null hypothesis H_3 is rejected and the alternative (of statistically significant differences in *risk attributes*, between tax-audited and non-tax-audited firms) is accepted.

While the JHG implemented both aspects of risk management since 2003, this occurred after the capital gains tax audit issue which occurred as a result of the

²³ The results of a survey of board members indicate that 14% of firms had board-approved taxation objectives (KPMG, 2005).

²⁴ In a survey of board members, regular formal reviews of the tax department by internal audit were carried out in only 22% of firms. Furthermore, only 10 percent of tax departments felt that they were widely understood outside the tax function (KPMG, 2005). Although board members of surveyed firms do not regard reputational risk as acceptable, there is a gap between risk attitudes and actual tax behaviour as evidenced by compliance issues of firms with tax authorities (Erle, 2008; ATO, 2010). This disparity is reflected in fundamental differences in financial, operational, risk and tax characteristics of firms facing tax compliance issues and those that are not subject to tax authority audit.

²⁵ Differences in mean values are statistically significant at the 10% level of analysis or better where indicated in Table 4.

corporate restructure in 1998 (see above). Moreover, these controls are only as good as the willingness of the firm's principals to implement and act on them; rather than using them as mere window dressing to enhance perception of the firm's public reputation.

Aggressive tax reporting might be constrained by the external auditors of accounting firms. However, it is possible that non-audit services could impair the independence provided to an audit client (Brown, Falaschetti, and Orlando, 2010). There is ongoing debate about the suitability of accounting firms providing non-audit services (Larcker and Richardson, 2004). Critics contend that the substantial fees paid to auditors (especially fees for non-audit services) increase the financial reliance of the auditor on the client (Becker, DeFond, Jiambalvo, and Subramanyam, 1998). Thus, auditor's independence may be compromised as they become reluctant to highlight problems in the client's financial reports (Frankel et al., 2002). The use of a big-4 audit firm may have a significant bearing on corporate tax malfeasance given that these firms often provide specific services designed to reduce the taxable income of firms. Badertscher et al. (2009) claim that implementation of successful tax malfeasance strategies (for example complex tax shelter transactions) may require the use of high-priced consultants such as those working at big-4 audit firms. In Table 4, we find that ATO audited firms use a big-4 auditor more extensively than non-tax audited firms, the external auditors of firms subject to tax audit activity are less independent compared to those of non-tax audited firms, and that these external audit firms derive a significantly greater amount of non-audit fees from taxation related services.²⁶

Finally, in relation to the JHG, Table 4 shows that a big-4 external auditor is used which appears to be even more non-independent than those of the tax audited firms. Finally, taxation services constitute a relatively large proportion (40%) of total fees paid by JHG to its external auditor, which is much greater than the tax audited firms, who were significantly (5% level) greater than the non-audited firms.

²⁶ See note 22, above.

Table 4: Risk attributes

Item description/ <i>fraud-triangle</i> classification		Firm attributes (4 yr. avg.)			Statistical measures	
		JHG	Audited	Non-audited	t-stat.	One-tailed p-value
RISK1: Formal integrated risk management policy on risk over-sight & management & internal control (1=Y; 0=N)	O	1	0.927	0.935	-1.578	0.058*
RISK2: Certification by CEO/CFO that the firm's risk management, internal compliance & control systems are operating effectively and efficiently (1=Y; 0=N)	O	1	0.818	0.912	-2.674	0.002***
Employment of a big-4 external auditor (1=Y; 0=N)	O	1	0.927	0.835	-4.895	0.000***
External auditor non-independence	O	40.35	35.411	28.119	-2.685	0.003***
Taxation services performed by big-4 auditor	O	40.00	22.759	15.829	-1.685	0.047**

P = pressure/inducement; R = rationalization/excuse; and O = opportunity/outcome.

The t-test assumes unequal variances.

*, **, and *** indicate significance at the .10, .05, and .01 levels, respectively.

7.4 Operational attributes

As noted in Section 6 of the paper (above), the research design in this study sought (via careful exclusion of categories of firms from the initial sample of firms, choice of variables, and type of analysis) to highlight the predilection for tax malfeasance of the sampled firms and to exclude or isolate any irrelevant differences. This subsection analyzes key operational attributes to determine if they add insight into the predilection for corporate tax malfeasance, and whether it might be useful for future research to expand their consideration, especially those (for example firm size and leverage) that might add to the outcomes of future research.

Analysis of the operational attributes (see Table 5) found that, vis-à-vis non-tax-audited firms, tax-audited firms are significantly more likely to: be larger, be more profitable, be more debt intensive in their capital structure, have a higher proportion of foreign derived revenue as a share of total assets, have more foreign-controlled subsidiaries, use subsidiaries domiciled in one or more tax havens (see OECD, 2006) and be subject to withholding taxes.²⁷ Based on these results, the subsidiary null hypothesis H_4 is rejected and the alternative (of statistically significant differences in *operational features/attributes*, between tax-audited and non-tax-audited firms) is accepted.

Finally, Table 5 also shows that the JHG (like the tax-audited firms) is relatively large, highly leveraged and has an extensive network of foreign incorporated subsidiaries. The JHG, due (in part) to obligations arising from past-CSM issues and ongoing

²⁷ Differences in mean values are statistically significant at the 10% level of analysis or better where indicated in Table 5.

efforts to evade those obligations, has a negative return on its assets, a lower than average capital expenditure scaled against total assets, relatively lower foreign revenue scaled against total assets and relatively more foreign subsidiaries as a proportion of total subsidiaries.

Table 5: Operational attributes

Item description/ <i>fraud-triangle</i> classification		Firm attributes (4 yr. avg.)			Statistical measures	
		JHG	Audited	Non-audited	t-stat.	One-tailed p-value
Firm size (log)	P	21.53	21.54	20.02	-9.603	0.000***
Firm leverage (square root)	P	0.99	0.72	0.63	-9.026	0.000***
Return on assets	P	-7.57	6.50	5.40	-0.979	0.0832*
Capital expenditure/total assets	O	3.64	11.95	7.19	-1.014	0.0788*
Foreign revenue/total assets	O	87.16	279.37	181.76	-0.765	0.0987*
Foreign incorporated subsidiaries	O	50.67	35.07	30.40	-1.648	0.050**

P = pressure/inducement; R = rationalization/excuse; and O = opportunity/outcome.

The t-test assumes unequal variances.

*, **, and *** indicate significance at the .10, .05, and .01 levels, respectively.

8. CONCLUSION

Tax malfeasance, as a pooling of the social wrong of tax avoidance and the criminal act of tax evasion, is a variant of or closely allied with fraud. On that basis, this study adapts Cressey's (1950) Fraud Triangle to visualize corporate tax malfeasance as a process involving corporate tax malefactors who: (1) are under pressure to enable the firm to wrongfully benefit by failing to fully discharge its tax obligations; (2) rationalize away the wrongful nature of the associated breach of CSR; and (3) can create opportunity to commit tax malfeasance by breaching, bypassing or otherwise overriding the firm's CCRS that should otherwise make tax malfeasance infeasible, or at least more difficult to achieve. Further, based on Cressey's (1950) *Fraud Triangle*, we argued that firms engaging in tax malfeasance are likely to exhibit many traits in common and that many of those traits, being of little use to firms who honor their tax obligations, will tend to be isolated to and thus indicative of corporate tax malfeasance.

We found that the tax-audited firms have statistically significant differences vis-à-vis the non-tax-audited firms, and that tax-audited firms can also be clearly associated with tax malfeasance. Moreover, a review of corresponding attributes of the JHG tended to have mean values that were closer to those of the tax-audited firms than the non-audited ones, and the few values that ran counter to this trend were explainable by corporate losses arising from previous CSM and by tax concessions negotiated by the JHG.

The findings of this paper have several important policy implications, including:

- Tax malfeasance is closely allied with or is a variant of fraud. Thus, fraud-prevention models like Cressey's (1950) *Fraud Triangle* can give valuable insight into tax malfeasance antecedent processes in the form of pressure, rationalization and opportunity;
- A model of the motivators/pressure and the thinking/rationalization of tax malfeasance perpetrators and how they find or create tax malfeasance opportunities increase our understanding of how the antecedent processes of tax malfeasance tend to shift their firm's attributes away from patterns that are normal to firms who faithfully discharge their tax obligations;
- Top 300 publicly-listed Australian firms audited by the ATO for suspected tax malfeasance have common attributes that are markedly different from those of equivalent firms that were not audited. This suggests that firms who engage in tax malfeasance can be profiled, based on key attributes;
- Many attributes of tax-audited firms are relevant not only to the JHG, but also to other major firms currently being reviewed or audited by the ATO;
- A corporate-tax-malefactor profile should be useful to tax agencies in targeting their tax compliance programs, including risk reviews and audits; and
- Given that many of the profile attributes are pathways to facilitate the commission and camouflage of tax malfeasance, another benefit of revealing them as potential audit triggers may be to make tax malfeasance more difficult and risky for corporate-tax malefactors.

As corporate stakeholders (particularly shareholders) bear the brunt of firms being found guilty of tax malfeasance, it is not surprising that they are increasingly concerned about the competence of a firm's CCRS (Henderson Global Investors, 2005; KPMG, 2005). Competency in such systems should include being able properly identify and resolve tax risks, complex tax laws/regulations and uncertainties regarding the actual interpretation and application of tax laws and regulations (Slemrod, 2004; 2007). If CCRS are inadequate (and especially if they are degraded so as to be inadequate), it is a high-risk indicator for corporate tax malfeasance and thus should be a prime tax review or audit trigger.

Our findings suggest and cross-link fundamental theoretical and empirical linkages between corporate attributes and tax malfeasance, so they should be of significant interest to stakeholders, policymakers and regulators. Finally, as the corporate attributes identified in this study are likely to facilitate the commission and camouflage of tax malfeasance, exposing them to public scrutiny is likely to make corporate tax malfeasance more difficult and risky for firms in practice.

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