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# EFFECT OF FOREIGN INVOLVEMENT ON CORPORATE TAX NONCOMPLIANCE

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**Abstract**
*There exists a potential decline in tax revenue to government among firms with foreign involvement. The main aim of the study is to examine the impact of foreign involvement on corporate tax noncompliance. The study focuses on the effects of foreign CEO, the percentage of foreign executive board members, and the ratio of stocks owned by foreign directors on corporate tax noncompliance. Data on manufacturing firms were utilized based on data availability from 2015 to 2019. Generally accepted accounting principle effective tax rate was utilized as a primary measure of tax noncompliance and fixed effect technique of regression analysis. Controlling for profitability, leverage, firm size and board size, the findings of the study revealed a significant negative effect of the percentage of foreign executives' shareholding on GAAP ETR. Our result is robust to using cash effective tax rate as an alternative proxy for tax noncompliance. The implication of this finding is that an increase in foreign executive shares will reduce tax proceeds. Given the corporate tax implication, regulatory authorities should weigh the cost and benefit of a benchmark for foreign directors' equity ownership*

Keywords. *Corporate governance; Effective tax rates; foreign directors; tax noncompliance*
JEL Codes. *H26; H29*

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## Introduction

Corporate governance presents the procedures within which firms satisfy the rights of the involved parties, including shareholders, creditors, and government. To achieve punctual corporate tax remittance, companies are permitted to take advantage of reliefs while filing tax returns under the tax laws.

Developing countries make frequent calls to developed nations for investment in their countries which mostly translate into investments in the form of multinational companies in developing economies (Salihu, Annuar & Obid, 2015). The involvement of these multinationals could be in equity involvement, thereby appointing their representatives on the board of directors. The presence of foreign involvement in developing countries presents numerous advantages, including employment generation and increased economic growth. Multinational firms usually structure their operations to avoid taxes (Christensen & Murphy, 2004). Given this assertion, it is likely that foreign executive board members may prefer accounting practices that increase tax noncompliance. It is therefore not out of place to conduct a study of this nature and verify this position.

Available literature shows an increase in corporate tax noncompliance arising from a concurrent surge in corporate accounting scandals due to earnings management. These scandals were largely due to unethical accounting practices. That is, companies engaged in aggressive earnings management have high effective tax rates with inadequate cash to offset. One variant of these unethical accounting practices is large book tax differences (Frank, Lynch, & Rego, 2004). This entails reporting large sums as declared profits to the shareholders while the tax returns show lower taxable profits. This is also applicable to Nigeria firms where the contribution of corporate firms to internally generated revenue is low. The manufacturing sector in Nigeria has foreign board members. Among these companies are foreign CEO-led companies. Also, effective tax rate is significantly lower than 30% of the company tax rates (see Table 2). Therefore, it is not out of place to investigate the nexus between foreign involvement and corporate tax noncompliance in Nigeria.

The CEO and chief financial officer (CFO) are principal signatories to the amounts as declared in financial statements. Prior studies on tax noncompliance suggest that CEOs who depend on various incentives could employ more earnings management and eventually avoid tax (Francis, Hasan, & Sun, 2012). Dyreng, Hanlon, and Maydew (2010) state that a CEO can encourage tax noncompliance by controlling the firm's tax department. This can be achieved by assigning the position of the chief financial officer to a tax expert with incentives to manage taxes downward. On the other hand, foreign CEOs may discourage tax evasion from avoiding reputational costs. Foreign directors, therefore, may act conservatively in determining the firm's tax status. What incentivizes foreign CEOs to reduce tax payments remain unclear, which needs to be investigated further. Hence, this study examines whether the position of the CEO explains tax noncompliance.

Although some researchers have paid attention to tax noncompliance and board governance, such as Armstrong, Blouin, Jagolinzer, and Larcker, (2014), Dyreng, Hanlon and Maydew, (2010), not much is known regarding the influence of foreign directors on corporate taxes. Available empirical works, such as Huizinga and Nicodeme (2003), and Salihu, Annuar, and Obid, (2015), ignore the role of foreign CEO and the percentage of foreign directors' shares. The study helps regulators and other stakeholders in developing an equitable and fair national tax policy in Nigeria. Specifically, this study will identify firm-specific factors that may increase tax revenue. Thus, this study will give insight into how foreign directors may affect corporate taxes. Controlling shareholders will also benefit from the study in determining the board structure that may reduce tax payments. Also, it will add to the literature on board governance and tax noncompliance.

This study is different from the study of Salihu, Annuar, and Obid, (2015) as it investigates the effect of both foreign CEO and foreign directors' shareholdings on tax noncompliance. The Inland Revenue Service would find the findings of this study useful because the variables that may reduce tax revenue would be tested. The rest of the paper is arranged as follows. The following section appraises related prior studies on foreign involvement on tax noncompliance and theoretical considerations. Section three presents the methodology, variable measurements, and the empirical model. The last section entails the results, discussion, conclusion and recommendations.

## Review of Literature

### *Review of Related Empirical Studies*

Taxes signify an important expense to a firm, and investments from tax savings increase shareholders' wealth (Francis, Hassan, Wu, & Yan (2014). Armstrong, Blouin, Jagolinzer, and Larcker (2014) view tax noncompliance as an investment opportunity available to executives. However, they argue that agency problem could arise from managers' engagement in excessive tax noncompliance for their own involvement.

Demirguc-Kunt and Huizinga (1999) investigated the development of foreign ownership among companies in Europe and the effects of foreign ownership on corporate income taxation.

The study utilized firm-level data from 1988-1995. The sample consisted of eighty countries bank level data. The analysis showed that foreign ownership improves corporate income tax rate. That is, at the country level, foreign ownership and company tax burdens are positively associated. In other words, domestic tax burden positively impacts the profit earned among foreign banks. This is an indication of profit shifting practices of multinationals and foreign tax credit they enjoy.

Grubert and Mutti (1991) examined the relationship between taxes, tariffs, and transfer pricing on multinational corporate decision making of US firms. They examined three aspects of US multinational corporate entities. These include the ability to shift earnings between low tax and high tax countries, the extent to which host countries impact the distribution of earnings, and the effect of all these factors on trade patterns. The study analyzed cross-sectional data. It was found that companies shift income among countries to avoid taxes. Countries with high effective tax rates and tariffs face lower real investment from samples of multinational companies. Also, the import and export of goods are high for low tax countries.

Huizinga and Nicodeme (2003) examined the trends in the foreign ownership of companies in Europe and the effects of foreign ownership on corporate income taxation. It was argued that economic integration in Europe has not led to a ‘race to the bottom’ regarding corporate income taxes. Using firm-level data, their analysis showed that foreign ownership share in Europe stood at around 21.5% in 2000. Further analysis revealed that a one percent increase in foreign ownership increases the average corporate income tax rate between 0.5 to 1%. That is, company tax burdens are positively related to foreign ownership at the country level. The result suggests that company tax policies in Europe are in part motivated by the desire to export corporate tax burdens.

Salihu, Annuar, and Obid (2015) investigated the effect of foreign investors’ involvement on corporate noncompliance in Malaysia. They observed that foreign investment inflows into developing countries had become a cause for concern. This is because an opportunity for profit shifting across their various operating outlets has made multinational companies tax avoidant in host countries. The study utilized data from annual reports and accounts of FTSE Bursa Malaysia Top 100 firms for the financial periods of 2009, 2010, and 2011. Foreign involvement was proxied by the proportion of shares held by foreign investors, substantial shareholding by foreign investors, and the proportion of foreign directors on the boards of the companies while tax noncompliance was proxied by effective tax rate (accounting, cash, and cash flow). The study utilized dynamic panel data using the system GMM estimator. The results showed significant positive relationships between foreign investor involvement and the four measures of tax noncompliance among large Malaysian companies. Evidence suggests the possibility of multinational companies exploiting their international scales of operations to avoid taxes in both host and parent countries. Despite varying tax incentives granted for equity ownership in Malaysia, the study failed to utilize proportional equity ownership of foreign investors.

Egger, Eggert, and Winner (2010) examined the extent to which foreign plant ownership and domestic plant ownership impact tax payment. They utilized a dataset of 507,542 firm-year observations of foreign and indigenous firms. It was found that in Europe, debt shifting is lower than profit shifting among firms. In low tax countries, multinational companies were found to earn more than indigenous companies. However, this is less when compared with high tax countries. Evidence suggests that corporate tax disbursement of multinational firms is less than that of indigenous companies in countries where corporate tax rate is higher than that of countries where the corporate tax rate is low.

Based on the review above, the following hypotheses are tested:
i) Foreign CEO does not significantly affect tax noncompliance.
ii) Percentage of foreign directors does not significantly affect tax noncompliance.
iii) Foreign director shareholdings does not significantly affect tax noncompliance.

**Theoretical Framework**

Various theories that explain the plausible relationship between foreign involvement and tax noncompliance can be identified. These theories include agency theory, legitimacy theory, and stakeholder theory. However, the most appropriate theory, based on prior studies, is agency theory. Studies on corporate governance are mostly viewed from the agency relationship. Agency conflict in firms is managed by applying corporate governance mechanisms.

Tax planning is important for all parties to a firm. To maximize firm value, shareholders may be inclined to minimize tax costs. Like earnings management, tax noncompliance is seen as an agency problem, especially where information asymmetry exists between shareholders and management. Although beneficial to shareholders, management may extend tax noncompliance to its limits, which leads to tax noncompliance and evasion. This is punishable by the relevant Inland Revenue Service when discovered. The central issue in corporate governance is how to align the involvement of management with that of the shareholders. One way to achieve the congruence of involvement is by tying management compensation to performance. Management has incentives to extend tax noncompliance beyond shareholders' expectation, especially when management compensation tied to after tax profits and cash flow.

**Methodology and Model Specification**

This study used the ex-post factor research design. The sample consisted of listed manufacturing firms on the Nigeria Stock Exchange from 2015 to 2019. These companies' reports were retrieved from the respective companies' websites for the financial years 2015 to 2019. For analysis, this study excluded firms with less than two-year data, not listed before 2015, not constantly traded/submitted returns, and missing information on directors' shareholdings. We obtained 92 firm-year observations of an unbalanced panel data.

In analyzing the data, fixed effect regression technique (for an unbalanced panel data) was utilized to correct for endogeneity. Stata statistical package 15.0 was used to run the data to test the hypothesis of the study. Tax noncompliance as a dependent variable on foreign directors is given below:

*TAX NONCOMPLIANCE =f(Foreign Involvement)* (1)

Using proxies for tax noncompliance and foreign involvement in (1) gives:
*GAAPETR =f(COEFOR, FOREIGN, FORSHARE)* (2)

In line with Salihu, Annuar, and Obid (2015), we included control variables (board size, firm size, profitability and leverage). Thus, we have:
*GAAPETR=f(COEFOR, FOREIGN, FORSHARE, firm size, leverage, profitability, board size)* (3)

Transforming (2) above into a linear relation, we have:

$$GAAPETR_{it} = \alpha + \beta_1 CEOFOR_{it} + \beta_2 FOREIGN_{it} + \beta_3 FORSHARE_{it} + \beta_4 FIRMSIZE_{it} + \beta_5 LEV_{it} + \beta_6 PROFIT_{it} + \beta_7 BS_{it} + \varepsilon_{it} \quad (4)$$

Table 1. Measurements and Definition of Variables

| Variables | Definition |
|---|---|
| Explained Variable: | |
| GAAPETR | Accounting effective tax rate is measured as the ratio of total tax expense to the total income before tax (Guenther, 2014). |
| CASH ETR | Total cash paid for taxes divide by total income before tax (Chyz, Gaertner, Kausar, & Watson, 2015). |
| Independent Variables: | |
| CEOFOR | Defined as a dummy variable 1 if the CEO is a foreigner and 0 if otherwise |
| FOREIGNER | Defined as the ratio of foreign executive board members to the sum of directors (Salihu, Annuar, & Obid 2015) |
| FORSHARE | The ratio of shares owned by foreign directors to the total outstanding shares |
| Control Variables | |
| Firm size | Logarithm of total assets (Katz, Khan, & Schmidt, 2015) |
| Leverage | Total liabilities divided by total assets (Yongbo, 2014) |
| Profitability:ROA | Ratio of profit before involvement and tax to total assets (Kubata, Lietz, & Watrin, 2015). |
| Board Size | Logarithm of board size |

Source: Researcher's review (2020)

This study regressed firm *i*'s effective tax rate in year *t* on proxies for foreign directors and a set of control variables. The main coefficients of involvement are $\beta 1$, $\beta_2$ *and* $\beta_3$, which captured the influence of foreign directors' characteristics on tax noncompliance.

**Results and Discussion**

Table 2 provides descriptive results. The mean of GAAP ETR is 27.95%, which means firms have 27.95% of their earnings before tax provided as projected tax liability. This is consistent with Salihu, Annuar, and Obid (2015), who found 22.68% for big Malaysian firms. The average amount for CASHETR is 22.77%. This means firms actually paid 22.77% of their earnings before tax to Federal Inland Revenue Service during the period. Deductively, both the estimated tax liability and taxes paid by the sampled firms during the period is less than the company income tax rate of 30%, which indicates tax noncompliance practices. It also suggests that tax investigations might be ineffective. Tax investigation could be carried out but firms may still lobby their way in paying lower than expected value after-tax investigation. The mean value of foreign CEO is 66.30%. This implies that 66.30% of the sampled firms have foreigners as CEOs. That is, foreigners are not only board members but hold critical positions on boards. This could be because of the expertise needed to manage most manufacturing firms since foreigners are mostly highly skilled.

Table 2. Descriptive Statistics

| Variable | Mean | Std deviation | Minimum | Maximum |
|---|---|---|---|---|
| GAAPETR | .2795921 | .215007 | -.0520153 | 1.706463 |
| CashETR | .2277248 | .4779305 | -.6085832 | 4.428108 |
| CEOFOR | .6630435 | .4752599 | 0 | 1 |
| FOREIGNERS | .2638971 | .2015359 | 0 | .6363 |
| FORSHARE | .0025474 | .0240486 | 0 | .2307 |

| | | | | |
|---|---|---|---|---|
| FIRM SIZE | 7.646166 | .5858715 | 6.458759 | 8.983825 |
| Lev | .4950795 | .169207 | .1819315 | 1.260909 |
| Roa | .1825488 | .1424469 | -.1070499 | .7926759 |
| Bs | .981874 | .1038316 | .7781513 | 1.255273 |

Source: Authors Computation 2020

Table 2 also shows that 26.38% of the board members are foreigners. This is slightly below the 30% benchmark required for minorities in any group to be effective. However, the maximum value is 63.63%, and the minimum is zero. This implies that while some firms could have more than half of foreigners as their board members, some firms do not have any foreigner as a board member. The ratio of shares held by foreign directors has the lowest mean of 0.25%. This suggests a very low quantum of share held by foreign directors in the sampled firms. This is possible because most of the foreigners are either sitting on the board for foreign investors or are merely appointed based on expertise.

Table 3. Correlation Matrix Table

| | Etr | Cashetr | Ceofor | Foreign | Forshare | FS | LEV | ROA | BS |
|---|---|---|---|---|---|---|---|---|---|
| Etr | 1 | | | | | | | | |
| Cashetr | 0.6909 | 1 | | | | | | | |
| | 0.0000 | | | | | | | | |
| ceofor | -0.0929 | -0.1615 | 1 | | | | | | |
| | 0.3784 | 0.1242 | | | | | | | |
| Foreign | 0.1056 | -0.0013 | 0.4882 | 1 | | | | | |
| | 0.3162 | 0.9899 | 0.0000 | | | | | | |
| Forshare | 0.0178 | 0.0011 | 0.0725 | -0.1377 | 1 | | | | |
| | 0.8665 | 0.9919 | 0.4919 | 0.1904 | | | | | |
| Fs | -0.3889 | -0.2067 | 0.3162 | 0.2171 | -0.2020 | 1 | | | |
| | 0.0001 | 0.0481 | 0.0021 | 0.0371 | 0.0535 | | | | |
| Lev | 0.0528 | 0.1512 | -0.0972 | 0.1892 | -0.0230 | 0.0252 | 1 | | |
| | 0.6170 | 0.1504 | 0.3568 | 0.0709 | 0.8279 | 0.8113 | | | |
| Roa | -0.0843 | -0.0596 | -0.1910 | -0.2087 | -0.0588 | -0.1648 | 0.1669 | 1 | |
| | 0.4246 | 0.5725 | 0.0682 | 0.0459 | 0.5774 | 0.1164 | 0.1118 | | |
| Bs | 0.0155 | 0.1164 | 0.0181 | 0.2135 | 0.1368 | 0.5205 | 0.1729 | -0.2272 | 1 |
| | 0.8833 | 0.2691 | 0.8642 | 0.0410 | 0.1935 | 0.0000 | 0.0992 | 0.0294 | |

Source: Stata output, 2020

Table 3 shows the Pearson correlation matrix of the variables. We opted for the Pearson correlation instead of Spearman correlation as the former correlation reduces sensitivity to extreme values. Variables of involvement must be related to one another but must not over correlate. None of the correlations shown above is higher than the benchmark of 0.80. While foreign CEO is negative and insignificantly related to GAAP ETR and CASH ETR, foreign director's shareholding is positively related to GAAP ETR and CASH ETR although insignificant at all levels. Ratio of foreign executives has a positive impact on GAAP ETR but is negatively associated with CASH ETR. In both cases, the effect is insignificant. Correlation above 0.80 raises a concern of multicollinearity. The highest correlation value is between GAAP ETR and CASHETR, which suggests they could be used as substitutes. The lowest value for multicollinearity is 0.011, which is between foreign directors' shareholding and cash ETR.

Table 4. Fixed Effect Regression Results of Equation (4)

| Dependent variables | Coefficients | t-values | Sig |
|---|---|---|---|
| Constant | 4.372733 | 3.81 | 0.000 |
| Ceofor | -0.0897545 | -1.20 | 0.313 |
| Foreign | 0.2787868 | 1.49 | 0.140 |
| Forshare | -2.048479** | -1.99 | 0.050 |
| Ta | -0.5141096*** | -4.18 | 0.000 |
| Lev | -0.1086078 | -0.64 | 0.524 |
| Roa2 | -0.3229307 | -0.90 | 0.370 |
| Lbs | -0.0593708 | -0.12 | 0.908 |
| **R-sq within** | **0.3571** | | |
| **R-sq between** | **0.2730** | | |
| **R-sq overall** | **0.1820** | | |
| **F.Stat** | **5.32*** ** | | **0.0001** |

Source: Stata output, 2020
Note: Sig at 10%, 5% and 1% respectively: *, **, ***

Table 4 depicts the result of the fixed effect regression. Although insignificant, the coefficient of foreign CEOFOR is negative, which suggests that foreign CEOs may favor lower tax rates. However, there is insufficient evidence to show that foreign CEOs affect tax noncompliance practice. Therefore, we fail to reject the first hypothesis of the study. This implies that foreign CEOs do not influence tax noncompliance practices. Therefore, firms should not be averse to having foreign CEOs on their boards as they pose no threat to the maximization of tax revenue. This is not different from the a priori expectation of foreign CEOs being cautious in establishing the firm's tax position. The result is in line with critical mass theory as minorities are not expected to be effective when they are below 30%. However, CEOs in practice are expected to affect the firm's tax position.

The percentage of foreigners, although positive, is insignificant, suggesting that foreigners on the board do not influence tax noncompliance practice. Therefore, this study fails to reject the second hypothesis of the study. This contradicts the findings of Salihu, Annuar, and Obid (2015). This implies that the percentage of foreigners on the board does not influence tax noncompliance practices. Therefore, firms should not limit the number of foreigners on their boards. This finding is in line with critical mass theory as the average proportion of foreigners on the board is less than 30%. Also, this is inconsistent with the a priori expectation of foreign directors having conservative orientation and risk-averse.

Contrary to a priori expectation, the ratio of foreign directors' shares is negative and significantly affects tax noncompliance at 5%. This suggests that as the ratio of foreign directors' shares increases, effective tax rates reduces. This study, therefore, rejects the third hypothesis of the study. This implies that foreign directors' shareholdings influence tax noncompliance practices. This finding is coherent with that of Salihu, Annuar, and Obid (2015) and contradicts the evidence provided by Huizinga and Nicodeme (2003).

The model's explanatory power is 0.3571, which shows the combined effect of the independent variables in determining the differences in tax noncompliance practice of the sampled firms. The F statistic is 5.32, which indicates that the fitness of the model is at less than 1% level of significance. Overall, this study provides evidence that foreign directors' shareholding is a predictor of corporate tax position.

**Robustness**

We further conducted sensitivity analyses to test the validity of the results. The following regression was run after replacing GAAP ETR with CASHETR as it captured the actual variation in tax noncompliance:

$$CASHETR_{it} = \alpha + \beta_1 CEOFOR_{it} + \beta_2 FOREIGN_{it} + \beta_3 FORSHARE_{it} + \beta_4 FIRMSIZE_{it} + \beta_5 LEV_{it} + \beta_6 PROFIT_{it} + \beta_7 BS_{it} + \varepsilon_{it}$$

Table 5. Cash ETR Model Results

| | Coefficients | T.Values | Sig |
|---|---|---|---|
| Constant | 9.316943 | 3.31 | 0.001 |
| Ceofor | -0.0661205 | -0.31 | 0.761 |
| Foreign | -0.0054335 | -0.01 | 0.991 |
| Forshare | -6.794223*** | -2.70 | 0.009 |
| Ta | -1.183279*** | -3.93 | 0.000 |
| Lev | -0.21043 | -0.51 | 0.614 |
| Roa2 | -1.880632** | -2.14 | 0.036 |
| Lbs | 0.4770469 | 0.38 | 0.705 |
| **R-sq within** | **0.2973** | | |
| **R-sq** | **0.0154** | | |
| **R-sq** | **0.0596** | | |
| **F.Stat** | **4.05*** ** | | **0.0009** |

Source: Stata output, 2020

Note: Sig at 10%, 5% and 1% respectively: *, **, ***

Table 5 depicts the result of the fixed effect regression based on the results of Hausman test. Like GAAP ETR, the effect of a foreign CEO is insignificant, which suggests it is not effective in explaining tax noncompliance practice. Also, the percentage of foreign directors is found to be insignificant. However, like the GAAPETR model, the percentage of foreign executive shares is negatively significant at 1%. This suggests that an increase in the shareholdings of foreign directors will reduce cash ETR. The model's explanatory power is 0.2973, which shows the combined effect of the independent variables in predicting tax noncompliance practice of the sampled firms. The F statistic is 4.05, which indicates that the fitness of the model is at less than 1% level of significance.

**Conclusion and Recommendation**

This study examines the nexus between foreign directors and tax noncompliance. In contrast to earlier studies, this is the first study to the researcher's knowledge that examines the effect of foreign CEO on tax noncompliance. Our result confirms the proposition of the critical mass theory that minorities should be not less than 30% to be effective. Evidence provided shows that foreign directors' shareholdings influence tax noncompliance practices.

The implication of the finding is that what matters in establishing firms' tax position is not the mere composition of board members but their shareholdings. Given the corporate tax implication, firms should weigh the cost and benefit of a benchmark for foreign directors' equity ownership. Our results should be taken with caution because we only focused on manufacturing firms and excluded non-financial firms.

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