ISSN NO. 2320-5407

Journal homepage: http://www.journalijar.com

INTERNATIONAL JOURNAL OF ADVANCED RESEARCH

RESEARCH ARTICLE

Does Corporate Governance affect tax planning? Evidence from American companies

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Manuscript Info

Manuscript History:

Received: 12 November 2013
Final Accepted: 29 November 2013
Published Online: December 2013

Key words:
Agency theory, corporate social responsibility, tax governance, American firms JEL Classification: H29, M14, G34.

Abstract

The objective of this research is to investigate the influence of corporate governance on tax planning. Our paper adopts the agency theory and the corporate social responsibility point view to discuss haw companies can achieve a successful tax planning strategy. Using a sample of 300 American companies for the period study 1996-2009, we find that the presence of corporate social responsibility committee, stock options and independent directors constitute fundamental factors of corporate tax planning. However, we don't find significant relations between board size and the corporate effective tax rates.

Introduction

The study of the interactions between corporate governance and taxation is considered a classical and recent topic at the same time. In fact, this double perception is due to the evolutions of the taxation studies during the last decade. The attention paid to the taxation increases and the companies become increasingly conscious of the importance of a new reconsideration of the tax variables at the time of decisions making.

The concept of the corporate social responsibility and its effects on the tax field, the development of competences as regards taxation, the need for revealing relevant tax information for the investors or the need for establishing a management system of the tax risks produced an emergent current of the literature based on an economic and legal context.

Most studies treating the corporate governance concentrate on the suitable regulation framework for the introduction of the principles of the corporate governance. Consequently, the attention was given to the legal practices and information disclosure and to the principles of ethical control. However, little attention was paid to the relation between corporate governance and tax optimization.

The succession of the scandals on a world level especially in the United States and in Europe and the multiplicity of the aggressive tax shelters focussed on the need for reconsidering the relations between corporate governance and taxation.

The review of the recent theoretical literature enabled us to highlight the role assigned to the corporate governance in the success of tax optimization. Thus, a new orientation is developed to insist on the mobilization of the components of corporate governance.

We contribute to the large literature on tax planning by proposing a complementary theoretical framework. We add a new angle to existing studies by involving the influence of corporate social responsibility on corporate tax planning.

The rest of paper is organized as follows. In the next part, we present the theoretical framework of our study. Then, we expose our sample and data. Next, we present the descriptive statistics and empirical results. The final section concludes.

2. Agency Theory: tax perspective

Inspired by the role of taxes in diffusion property in the American economy, Berle and Means (1930) launched the study of the agency problem. They showed that directors named by shareholders can pursue their own interests. (Desai, 2007) The relation between taxation and corporate governance was neglected during the later decades.

While the specialists in public finance did not incorporate the agency problems in their analysis, a recent literature suggests that the reconsideration of this relation can produce new streams of research in the real effects of the fiscal policies on the corporate governance. The rediscovery of this link was stimulated by two developments.
Firstly, the abundance of the tax shelter showed the advantage of the corporate governance particularly in the context of managerial malfeasance. Secondly, the extent of the corporate tax rates is highly related to the levels of property concentration.

Desai et *al*., (2007) showed that the interaction between corporate governance and taxation produces three distinct predictions which can be tested within different frameworks. Initially, the characteristics of the tax code, like the structure of the rates and nature of their implementation, the influence of the managerial actions and thus the measurement of the agency problem.

Secondly, the nature of the corporate governance, the protections given to the external investors, the influence of the tax code. Thirdly, tax avoidance is not represented simply in a transfer of financial resources from state to shareholders; rather, managers can capture a share of the advantages of tax avoidance.

In answer to the advanced interrogations, Desai et *al*., (2007) develop a model which presents a series of original assumptions of the reciprocal action between the robustness of the institutions of the corporate governance and the tax code. Their model predict that the increases in the corporate tax rates should cause greater increases in benefit of institutions having a strong corporate governance. The managers or the shareholders control of the companies with weaker governance can avoid taxes.

Desai and Dharmapala (2009) examine tax optimization within the conceptual framework of agency; they suggest that the opportunist managers employ the techniques of tax optimization to advance their own interests with those of the shareholders. The latter often do not encourage the activities of tax minimization because they generate costs which exceed tax incentives due to the managerial opportunism.

Within a framework of agency, Chen et *al*., (2010) and Desai and Dharmapala (2009) argue that the activities of tax planning can facilitate managerial opportunism such as the earnings management and the diversion of resources.

Seidman and Stomberg (2011) consider that tax planning is a framework of evaluation of agency conflicts. The minimization of payment of the fiscal burdens improves the shareholder value. However, the strategy of tax planning is expensive for the managers. The latter must devote a part of the corporate resources to pay remunerations of the consultants. Moreover, they invest their time to implement tax strategies.
The managers face also risks concerning their reputation in the case of failure of their strategies. In order to overcome these various costs, the shareholders must incite the managers to involve themselves in tax optimization.
These authors suggest that motivating incentives can reduce the agency conflicts and thus produce a more important tax planning**.**

The agency theory does not provide a complete explanation of the relation between corporate governance and tax optimization. Specifically, the agency theory concentrates on the link between managers and shareholders, while the social responsibility focused on the link between the company and the stakeholders. (Public administrations, tax authorities, political groups and customers). The social responsibility permit a better comprehension of the notions interpreted by the agency theory.

3. Corporate social responsibility: a complement of agency theory

The corporate social responsibility emerged in the Fifties in the United States. The American design is based primarily on ethics. However, in Europe, the social responsibility aims at sustainable development. Jenkins (2001) showed that the American companies started from the years 1990 to publish regularly their codes of conduct.

He announced that the company modifies its code of conduct in order to improve its image and particularly to answer to the pressures of the company.

The large companies are supposed to develop a code of conduct since they are most visible to the public. The elements composing this code constitute a set of answers to the company needs. (Jenkins, 2001)

Rubinstein (2006) advance two main reasons which justify the development of the concept of corporate social responsibility. Firstly, the development of the American pension funds took part in the improvement of the corporate governance. Secondly, the socially responsible investment is a subject of substantial development in the American companies.

This investment increased the presence of socially responsible shareholders within the listed companies. Consequently, the approach of social responsibility was followed by several companies.

Stakeholder and legitimacy theories are based on the premise that there is an implicit social contract between the company and the society, the terms of this contract are established based on the hopes of several groups of the society. (Roberts, 1992; Deegan, 2002)

These two theories claim that companies seek the legitimacy of their business activities through different reference groups in the society. For example, political government organizations, groups, trade unions, communities and employees who have influence on the company. (Waller and Lanis, 2009). The company can show its legitimacy by carrying out its business in the manner that its reference groups consider socially responsible. More the degree of influence of the reference groups is important, more probably that the company will be inclined to continue its business activities in a legitimate way (Gray et *al*., 1995).

By applying the ideas of these two theories in taxation, Landolf (2006) and Schön (2008) consider that the company can show its legitimacy in the society and maintain its good reputation by conforming to the tax law.

Richard and Lanis (2011) suggest that the corporate social responsibility represents a significant factor which affects the corporate tax planning. This influence is exerted through the boards of directors. The authors show that independent directors answer better the needs and interests of the company. Moreover, these directors will control the aggressive tax policies.

4. Corporate Governance mechanisms and tax planning

4.1. CEO compensation

Scholes et *al*., (2002) support that it is well necessary to consider the tax implications as well for the employer as for the employee to understand the compensation policy. Scholes et *al*., (2002) show that the variation of the corporate tax rates produce arbitrations between salaries, bonus, differed profits and compensation in the form of options.

The debate of the alignment of interests between managers and shareholders was in the middle of the research of the specialists in corporate finance who were interested in the agency problems. The tax laws influence the nature of the optimal contract between managers and shareholders by changing the nature of the incentives (differed or current compensation).

Crocker and Slemrod (2005) developed an ideal model explaining the contractual relation between the shareholders and the tax directors. The authors emphasized on the effect of the compensation policies on tax planning. They suggest that the remuneration of the tax responsible persons will have to be proportional to the effective tax rate.

The differences related to the tax deductions, the temporal effect and the different tax treatments of the incentive plans imply that the compensation of the managers is influenced by the corporate fiscal policy. (Scholes and wolfson, 1992; Hall and Liebman, 2000)

The mode of compensation of administrators and managers could be a central factor that encourages them to act according to their own interests which may diverge from those of the company. A compensation based on the performance after imposition of the company encourages administrators and managers to choose aggressive tax strategies.

Thus, the manager is motivated to cooperate with the tax professionals in order to identify, develop and carry out the strategies of tax planning.

The expected advantages of the manager‘s responsibility should be more important than the additional salaries which must be paid to remunerate the manager for the undergone additional risk and the provided effort. Consequently, the measurement of the performance after imposition should be used like a variable in the contract of remuneration.

This measurement is advantageous only for the manager if his participation in the efforts of tax optimization will lead to a difference between the accounting incomes before and after tax.

Prior research related to the measurement of the performance after imposition concentrated only on the determinants of the CEO compensation by using the income after imposition (Newman 1989; Cams and Guffey 2000; Atwood et *al*., 1998; Dhaliwal et *al*.. 1992) and do not provide any proof concerning the effectiveness of compensation after imposition in the reduction of the corporate tax burdens.

Linn and Park (2005) show that the CEO compensation is aligned with investment opportunities. Their conclusions are based on two elements: firstly, the companies supporting the control costs attract the qualified directors by suggesting an important compensation. Secondly, these companies try to reduce the agency conflicts through incentive compensation.

Schizer (2000) conclude that the tax laws are conceived to prevent the taxpayers from avoiding the capital gains taxes. While protection can be limited, the tax law ensures that stock-based compensation plays an incentive factor for the managers.

4.2. Board of directors

According to an agency prospect, the board of directors represents the principal internal mechanism of control of the opportunist behaviour of managers. This mechanism is used to align the interests of shareholders and managers (Jensen, 1993). The size and the composition of the board of directors influence the control effectiveness.

The board of directors is responsible for the strategic direction of the company, the environment of control and the implementation of an internal monitoring system as well as the communication with the shareholders. Each company develops its own strategy of tax management according to the diversity of the constraints and the influences of the outside contributors such as customers, competitors and investors. The board of directors must clarify his fiscal control.

Adams (2009) suggests that when the control is intensive, the independent directors do not receive exhaustive strategic information from the company's direction. Moreover, these directors perceive that their principal function is limited to the control of the direction. Consequently, they feel reluctant to implement strategic organizations.

Minnick and Noga (2010) advance that the staggered boards of directors involve high effective tax rates. Their results corroborate the point of view of Chen and Zhao (2008) which recommend that corporate managers having this type of board of directors are not interested in tax planning . The empirical procedure used is inspired by the works of Wintoki et *al*., (2010).

5. Sample and data Description

5.1. Sample Description

Our sample is based on 300 large American firms (S&P 500) during the period 1996-2009. Data is extracted from various sources. Financial accounting data is drawn from Compustat database and governance data is extracted from IRRC or proxy statements. The choice of our sample composed of S&P 500 firms is based on the arguments introduced by Dyreng et *al*., 2008; Johnston, 2003; Minnick et Noga, 2010. These authors consider that larger firms manage their taxes more effectively.

5.2. Data Description

The variables retained in this study are classified into three categories. The first category relates to the dependent variable (tax planning). The second category relates to the independent variables inherent to the internal mechanisms of the corporate governance. The last category integrates the variables of control.

Independent variable
ETR_{it}: the effective tax rate, measured as the report between the corporate tax income and pretax income, within the framework of the corporate governance, Minnick and Noga (2010) use the ETR in their study conducted on a sample of American companies.
Dependent variables
CSR_{it}: presence of the committee of corporate social responsibility, it is a binary variable which takes 1 if the board of directors is composed of a committee of social responsibility, 0 if not. This committee is concerned with social, environmental and economic affairs of the company. It integrates transparency and values of conformity and ethics.

We suggest the following assumption:
"*There is a positive and significant relation between the presence of the committee of social responsibility and tax planning".*

OPT_{it}: this variable represents the percentage of the stock options granted to managers, it is measured by the relationship between the value of the options and the total compensation. Desai and Dharmapala (2006) and Seidman and Stomberg (2011) referred to this measurement to study the impact of incentive compensation on the minimization of the fiscal charges.

According to standard FAS 123, the companies must enter the costs generated by stock-based compensation as loads. Consequently, they can benefit from the tax incentives of this type of compensation granted to managers. According to Seidman and Stomberg (2011), the companies which profit from important tax deductions, due to Stock options based compensation, do not employ other tax planning activities.
We postulate the following hypothesis
"There is a positive and significant relation between the stock- options based compensation and the corporate tax planning".

INDit : the percentage of the outside directors serving on the board. A director is independent when he has no link of interest with the firm either his team. (Beasley and Petroni 2001; Fernández and Arrondo, 2005). In a tax context, Minnick and Noga (2010) conclude that the the increase of the independent directors increases the domestic tax rates. Richardson and Lanis (2011) shows that companies having a high percentage of outside directors can reduce significantly the aggressive tax planning.
So, we suggest the following hypothesis
"There exists a positive and significant relation between the high presence of independent directors and corporate tax planning".

BSIit : board size is measured by the logarithm of the total number of directors sitting on the board. Richardson et *al*., (2011) used this variable to estimate the effect of the board on the corporate tax aggressiveness. Jensen (1993) believes that a smaller board of director plays a better monitoring function whereas a larger board of director is easier for the CEO to control.
We extend the findings of Jensen (1993) in a tax context and we suggest that a smaller board may be more favorable to tax planning strategies because the monitoring of the CEO becomes more intense. Then, the opportunistic behavior of the CEO is reduced, as a result of compression of interest conflicts.
We suggest the following hypothesis
"There is a negative and significant relation between the board size and the corporate tax planning".

Control Variables
ROA it: the return on assets, defined as the report between the net income and the total of assets. Dyreng et *al*., (2008) and Minnick and Noga (2010) employed this variable to control the performance in their studies of tax optimization.

6. Results
6.1. Descriptive statistics

According to table 1, we notice an average of 10,828 administrators composing the board of directors of the companies. Several studies showed that the optimal size of the boards , in terms of performance, varies between 10 and 12. The minimal size of the board of directors is 4 administrators. However, the large boards of directors are composed of 22 administrators. With regard to the board size, the standards of the corporate governance do not dictate policies concerning the number of administrators sitting on the board. We note that the boards of directors are strongly dominated by independent administrators (0.74%). This predominance may support the independence of the boards of directors. The companies listed on New York and NASDAQ stock exchange should have a majority of independent directors.

We note that the percentage of the options granted to managers is on average 34, 4%. This result proves that the options constitute a significant portion of the total compensation. Murphy (1999) mention that from the Nineties, the stock-options appear among the essential components of the plans of CEO compensation plans.

Concerning the variable presence of the committee social responsibility, we note that 28.54% of the boards of directors are composed of this type of committee. The number of the companies having this committee climbed these last years, this fast progression is due to the importance of the role assigned to the members of this committee. The responsible of social responsibility verifies the legal conformity of the corporate activities including the payment of the fiscal burdens.

Table 1. Descriptive statistics

Variables	Observations	Mean	Standard-Deviation	Minimum	Maximum
BSI	3699	10.828	2.984	4	22
IND	3699	0.746	0.175	0	16
OPT	3801	0.344	0.985	0	0.985

Table 2. Descriptive statistics

Variables		Frequency	Percentage
CRS	0	2652	71.46%
	1	1059	28.54%

In order to better explore the differences between the companies having a committee of social responsibility and those which have other types of committee, we consider, on this level, a binary variable to carry out Mean comparison tests. We allot value 1 for the companies having a committee of social responsibility, 0 if not.

We will present in what follows the mean differences of the variable effective tax rates, board size and percentage of the independent directors between companies having committee of social responsibility and companies having other types of committee.

Table3. Mean-Comparaison tests

		Mean comaprison Test				
		t	df	Sig. (bilateral)	Mean Difference	Standard Deviation Difference
ETR_{it}	Hypothesis of equal variances	-0,321	1194	0,748	-0,00850	0,02646
BSI_{it}	Hypothesis of inequalvariances	8,629	1110,002	0,000	0,12970	0,01503
IND_{it}	Hypothesis of inequal variances	9,240	1132,688	0,000	0,21361	0,02312

From the statistics presented above, we can affirm that a priori:
- The effective tax rates of the companies having a committee of social responsibility are not significantly different from those of the companies not presenting this committee in its composition of the board.

The size of boards having a committee of social responsibility (CRS) is significantly different from companies which have not this type of committee. The board size is large in the presence of CRS.

The percentage of independent directors is higher in the companies having a committee of social responsibility.

7. Model Estimation

The developments of the agency theory inspired some recent empirical works which shows the contribution of the corporate governance to the tax function. The scarcity of the empirical investigations carried out constitute a motivation to try to better clarify the relations between the various variables of the corporate governance and tax planning.

The special attention given recently to the tax governance verifies the relevance of this research orientation which has just been explored. Our contribution consists in proposing a new extension of the work carried out while focussing on the combination of several mechanisms which describe the tax governance within the company.

Our methodological framework consists of three stages. In the first stage, we check the appropriate model of estimation. We have to test for the presence of individual effects of each Tunisian firm. In a second step, we specify whether the fixed effect or the random effect should be considered in estimating model parameters. The last step consists on estimating the coefficients of our variables.

We use the Fisher test, as a preliminary test, to verify the existence of individual effects in our sample. The p-value of this test entails the rejection of the null hypothesis (absence of individual effects). Therefore the Fischer test reveals the existence of specific effects across american firms. Consequently, our model is not homogeneous.

Then, we use the Hausman test to specify the nature of these individual effects. Thus, the Hausman test (1978) tests the null hypothesis which stipulates that the coefficients estimated by the efficient random effects estimator are the same as the ones estimated by the consistent fixed effects estimator. (Woolridge, 2001)

According to the results presented in table 4, we notice that the p- value of Hausman test is < 0.05 which means that random effects are non consistent. In fact, the fixed effects are privileged in our study. The econometrics of the panel data allows controlling the heterogeneity of the observations of our sample of American firms in their individual dimensions.

Table 4 Results of Hausman test

Hausman test	
Null Hypothesis	Difference in coefficients not systematic
Prob>chi2	0.0009

After setting up the effect of the econometric model, we are interested in verifying the absence of bias and problems that can affect the significance of the coefficients of the variables. We will make the necessary corrections if they exist. Among the potential problems that can arise at the time of our estimations, we quote essentially the heteroscedasticity and the multicolinearity .

We compute variance inflation factors (VIFs) when estimating our regression models to test for signs of multicolinearity between the independent variables. As no VIF exceeds five, multicolinearity is not problematic in our study (Hair et *al*., 2006).

Then, we apply Breusch-Pagan test to detect heteroscedasticity in our sample. The statistics of the test follows the chi square distribution. The "p-value" is less than the significance level (5%), which leads us to reject the null hypothesis and to conclude the heteroscedasticity of our model.
To examine the association between effective tax rates and governance variables, we estimate the following model using “areg” to mitigate heteroscedasticity problems.
Our Model is presented as follows:

$$\boldsymbol{TIE_{it} = \alpha_{i} + \beta_{1i}\, CSP_{it} + \beta_{2i}\, IND_{it} + \beta_{3i}\, BSI_{it} + \beta_{4i}\, OPT_{it} + \beta_{5i}\, ROA_{it} + \varepsilon_{i}}$$
$$i = 1,\ldots, N \qquad t = 1, \ldots, T$$

*i presents the companies of our sample.

* t presents time indicator.
***ε** presents standard error.

Table 5 presents the results of our estimation:

The variable CSR is significant and have a positive influence on the corporate tax planning. This result confirms our theoretical hypothesis. The committee of corporate social responsibility improves the use of ethics when applying tax strategy. The social responsibility is in favour of acceptable tax planning. We consider that corporate social responsibility is complementary to the mechanisms of corporate governance.

The variable IND has a negative impact on the effective tax rate; it is significant with the threshold 1%. Thus, we confirm our theoretical assumption. The high percentage of the outside administrators within the board of directors support tax planning. The Sarbanes-Oxley Act (2002) establishes strict new rules concerning corporate governance and assumes that firms with outside directors are more effective in monitoring management. The presence of independent directors constitutes an efficient mechanism of corporate governance that enhances the reduction of tax burdens.

The variable OPT is negative and significant with the threshold 10%. Thus, we can conclude that the percentage of options granted to CEO reduces the effective tax rate. We confirm our theoretical assumption which postulates a positive relation between tax planning and stock-based compensation. The significativity of this variable confirms the idea supported by Desai and Dharmapala (2006). The idea expresses that the conflicts of agency are reduced if tax optimization is improved by incentive compensation.

Our results corroborate the findings of Minnick and Noga (2010) and Philips (2003). The stock-options constitute an incentive mode of compensation in the long run. Since tax planning is an objective of long run, the companies concentrate on the granting the stock- options to motivate the CEOs in order to involve them in a tax planning strategy. The presence of an incentive stock-options compensation reduces the taxable income and limits the tax avoidance activities. (Dessai and Dharmapala, 2006). Moreover, Graham et *al*., (1998) consider that incentive compensation is a strategy of tax planning.

The variables ROA and BSI are not significant at different levels. On the basis of these results, we consider that theses variables haven't any relations with the effective tax rate of our sample.

Table 5 Effect of governance on corporate tax planning

Independent variables	Dependent variable : tax planning	
	Coefficients	p-value
$CSP_{(it)}$	-0.08	0.009
$IND_{(it)}$	-0.13	0.056
$BSI_{(it)}$	-0.01	0.875
$ROA_{(it)}$	0.16	0.167
$OPT_{(it)}$	-0.07	0.094
Constant	0.49	0.009

8. Conclusion

Within the framework of this article, we showed that the agency theory represents the more adapted theoretical framework to study the practice of tax planning. Taxation can generate activities of managerial opportunism which diverge from the interests of the shareholders.
The establishment of the adequate mechanisms of corporate governance decreases the dispersion of the interests and concentrates on the shared interest. We also announce that the agency theory is interested in the relations within the company whereas the presence of other stakeholders is relevant for tax decision making. (Desai, 2006)
Indeed, we supplemented our theoretical analyses by integrating the thoughts of the corporate social responsibility**.**
The empirical studies suggested in the field of the tax governance try to determine the explanatory power of the mechanisms of corporate governance on tax optimization. Our results support the positive effect of the incentive compensation plans on the CEO performance. Indeed, the adopted compensation policy motivates the CEOs to decrease the corporate fiscal charges. (Philips, 2003; Dhaliwal, 2000; Minnick and Noga, 2010).

The empirical results related to the variables CEO compensation confirm the theoretical assumption of the negative relation between the effective tax rate and the percentage of the options granted to the CEO.
The corporate social responsibility and the independent directors boost the tax planning strategy.

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