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THREE ESSAYS ON: ETHICS AND RESPONSIBILITY IN TAXATION

by

James Matthias Plečnik

A Dissertation

Submitted in Partial Fulfillment of the

Requirements for the Degree of

Doctor of Philosophy

Major: Business Administration

The University of Memphis

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DEDICATION

I dedicate this dissertation to my family and to the Catholic Church. My family has helped me to succeed in academics and so many other endeavors, and The Catholic Church has given me peace, education, and employment.

ACKNOWLEDGEMENTS

I am indebted to my dissertation chair, Dr. John Malloy, for his endless mentoring and support over my years in graduate school. I also thank my entire dissertation committee: Zabihollah Rezaee, Charles Bailey, Frances Fabian, and Craig Langstraat. You have all been helpful during my time in the Ph.D. program.

Finally, I would like to thank Jacqueline Woodall. She helps Ph.D. students more than many professors.

ABSTRACT

Plečnik, James Matthias. Ph.D. The University of Memphis. August 2015. Three Essays on: Ethics and Responsibility in Taxation. Co-Major Professors: John Malloy, Ph.D., Zabihollah Rezaee, Ph.D.

This dissertation presents three papers that examine the impact of ethics on the field of taxation. Many observers assert that the field of taxation is without morals; that is, tax preparers and taxpayers attempt to exploit the system as much as possible to increase their profitability. In my dissertation I explore the ethical and unethical practices of corporations, individual taxpayers, and tax preparers. To accomplish my goals I have employed three different research methodologies: Archival, Experimental, and Legal.

Paper 1 discusses ethics and taxation at the corporate level by testing the impact of Corporate Social Responsibility and Financial Sustainability on tax avoidance/aggressiveness. Paper 1 uses archival methodology to support its hypotheses, and I find that corporations that are both Financially Sustainable and involve themselves in Corporate Social Responsibility are less likely to engage in aggressive tax behavior.

Paper 2 discusses ethics and taxation at the individual level by testing the impact of an ethical prompt and the IRS's name on an individual's acceptance of tax evasion. Paper 2 uses experimental methodology to support its hypotheses, and I find that an ethical prompt can reduce the acceptance of tax evasion. I also find that being exposed to the IRS's name increases the acceptance of tax evasion.

Finally, Paper 3 analyzes a significant issue in taxation—S corporation reasonable compensation. This paper uses Legal research methodology to reach its conclusions. First, I discuss the recent cases relating to S corporation compensation. Second, and more importantly, I find that many tax preparers are engaged in dubious ethical practices in the

area of S corporation compensation. That is, tax preparers are filing returns that have no "reasonable basis" of success based on reasonable compensation precedent. This implies that these tax preparers are in violation of Circular 230 and can be penalized by the IRS.

The acceptance of tax evasion (and aggressive tax avoidance) appears to be common at the corporate, individual taxpayer, and tax preparer levels. These papers propose solutions to prevent tax evasion from occurring, and these proposals are useful for standard setters and professional organizations attempting to reduce tax evasion.

TABLE OF CONTENTS

CHAPTER		PAGE
1: Introduction		1
2: The Effects of Corporate Responsibility and Economic Sustainability on Tax Avoidance		
I.	Introduction	5
II.	Literature Review and Hypothesis Development	11
III.	Research Design	15
IV.	Sample Selection and Summary Statistics	22
V.	Empirical Results	30
VI.	Robustness Checks	33
VII.	Conclusion and Contributions	39
3: The Impacts of an Ethical Prompt and the IRS's Name on the Acceptance of Tax Evasion		
I.	Introduction	41
II.	Background—Tax Evasion	44
III.	Hypothesis Development	49
IV.	Design and Execution of the Study	57
V.	Results	62
VI.	Conclusion and Implications	76
4: Disregard for Professional Standards—The S corporation Reasonable Compensation Issue		
I.	Introduction	80
II.	Relevant Law	81
III.	Relevant Cases	86
IV.	Winning a Reasonable Compensation Case	99
V.	Ethical/Professional Responsibility Consequences	103
VI.	Implications for Tax Preparers and Taxpayers	107
VII.	Implications for Public Policy	108
5: Conclusion		110
References		112
Appendices		118
IRB Approval		132

LIST OF TABLES

TABLE		PAGE
2.1.	CSR Score Categories and Subcategories	23
2.2.	CSR Categories and Performance Score by Industry	24
2.3.	Descriptive Statistics	26
2.4.	CSR, Economic Sustainability, and Tax Avoidance Evidence from Firm-Year Regression	28
2.5.	CSR, Economic Sustainability, and Tax Avoidance Evidence from Firm-Year Regression—Robustness Test	35
3.1.	Descriptive Statistics	63
3.2.	Pearson Correlation Coefficients	66
3.3.	Moderated Mediation (Figure 1) using PROCESS procedure (Hayes 2013)—Ethical Prompt	68
3.4	Moderated Mediation (Figure 2) using PROCESS procedure (Hayes 2013)—Ethical Prompt	72
3.5	Moderated Mediation (Figure 2) using PROCESS procedure (Hayes 2013)—Legal Prompt	75
4.1	Glass Blocks Penalties	95

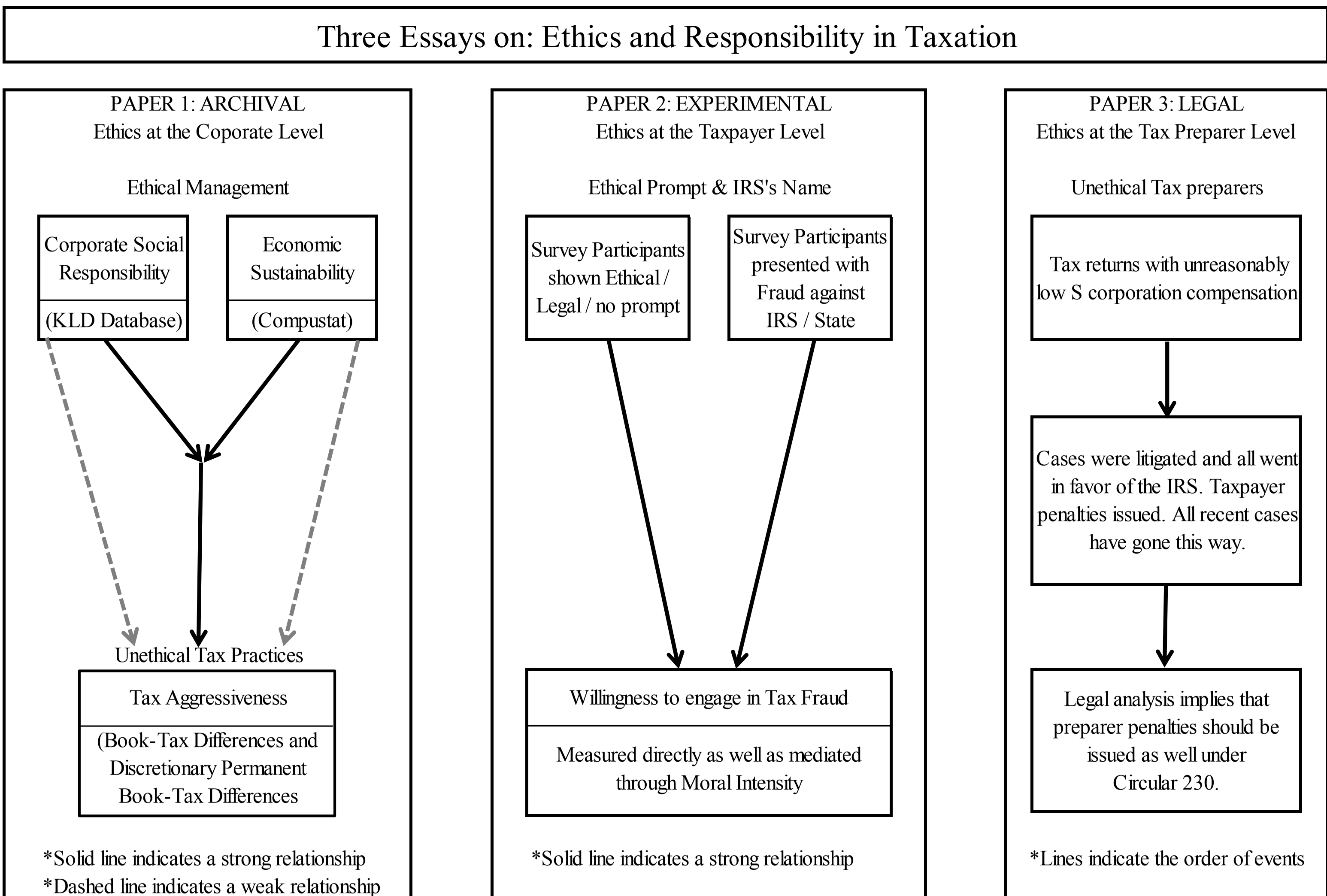
Note:
The first number in the "TABLE" column indicates the dissertation chapter number, while the second number indicates the table number in the specific chapter.

CHAPTER 1

INTRODUCTION

My dissertation is visually summarized in Figure 1.1 on the following page. Broadly, my dissertation discusses the ethical behaviors of corporations, individual taxpayers, and tax preparers. I study the ethical behavior of corporations with archival methodology in Paper 1. I study the ethical behavior of individual taxpayers with experimental methodology in Paper 2. Finally, I study the ethical behaviors of tax preparers with legal research methodology in Paper 3. More in depth summaries of the three papers are found after Figure 1.1 in the latter portion of this introductory section.

Figure 1.1
Visual Depiction of Dissertation



My first paper (Chapter 2) investigates the joint impacts of corporate social responsibility (CSR) and economic sustainability on tax aggressiveness. Scholars assert that CSR and economic sustainability represent responsible governance, and that overly aggressive tax behavior is not compatible with responsible governance. Therefore, I predict that firms exhibiting both positive CSR and economic sustainability will be less likely to engage in aggressive tax behaviors. To test my hypotheses I use archival methodology supported by the Compustat and KLD databases. My findings indicate that (1) CSR disclosures (primarily environmental, social, and governmental) are negatively related with aggressive tax behavior (2), economic sustainability measures are negatively associated with aggressive tax behavior, and (3) that the relationship between CSR and tax aggressiveness is strengthened for economically sustainable firms. Based on these findings, my results imply that CSR is a strong predictor of tax aggressiveness only in cases where firms are economically sustainable. My study's results should inform public policy as they help regulators better identify which firms are likely to engage in tax aggressiveness.

My second paper (Chapter 3) investigates the impacts of an ethical prompt and the IRS's name on the acceptance of tax evasion. In line with Mazar (2008) I hypothesize that an ethical prompt will reduce an individual's acceptance of tax evasion. I also hypothesize that that dealing with the IRS will increase an individual's acceptance of tax evasion. To test my hypotheses I distributed a Qualtrics survey to 100 participants using Amazon Mechanical Turk. Participants were randomly assigned to groups that received either an ethical prompt, a legalistic prompt, or no prompt. Further, participants dealt with either their national revenue collection agency or their state revenue collection

agency. My findings indicate that (1) an ethical prompt reduces the acceptance of tax evasion, and (2) that dealing with the IRS's name increases the acceptance of tax evasion. My findings should inform public policy. Revenue collection agencies should find a method to instill ethics into the taxpaying population—perhaps by using the mechanisms of Circular 230. The IRS should also work to improve their tarnished reputation to improve revenue collection. The IRS could also avoid the negative impact of their reputation by allowing states to collect a greater percentage of United States revenue.

My third and final paper (Chapter 4) studies the issue of "reasonable compensation" in S Corporations. This issue has existed since just years after the inception of the S Corporation itself. Three recent cases demonstrate the current enforcement strategies of the IRS and the legal issues faced by S Corporations. I focus on these three recent cases to demonstrate the legal hurdles faced by S Corporations which try to pay low (or no) salaries to their officers. The major issues the courts focused on were the employee status of the officer (if the officer is not an employee no salary can be required), and the officer's current wage compared to expert testimony on the reasonable salary level. The taxpayers lost (in large part) all three of these recent cases. The above discussed legal research is augmented with an analysis based on the professional standards violations which occurred. In this analysis I focus on the potential preparer penalties under Treasury Circular 230. I assert that my analysis shows that the IRS is not limited to just penalizing taxpayers in reasonable compensation cases. The IRS can pursue tax preparers for Circular 230 penalties as S Corporation reasonable compensation is settled law.

CHAPTER 2

THE EFFECTS OF CORPORATE RESPONSIBILITY AND ECONOMIC SUSTAINABILITY ON TAX AVOIDANCE

I. INTRODUCTION

In this paper I examine whether various sustainability metrics are associated with corporate tax avoidance behavior. Corporate tax avoidance is a continued focus in accounting literature (e.g., Hanlon and Heitzman 2010), and sustainability is becoming greater focus in recent years (e.g., Dhaliwal et al., 2012; Hoi et al. 2013). Academics have called for more research on the relationship between sustainability and tax avoidance (Hanlon and Heitzman 2010; Sikka 2010), and my investigation of this relationship is motivated by two streams of literature. The first stream of literature is the well-established area of tax avoidance. Prior studies (e.g., Hanlon and Heitzman 2010; Hoi et al. 2013; Klassen and Lapante 2012) suggest that tax avoidance is a sometimes aggressive and socially irresponsible behavior that costs a host nation significant revenue. Hanlon and Heitzman (2010, 137) state that "tax avoidance represents a continuum of tax planning strategies where something like municipal bond investments are at one end, and terms such as 'noncompliance', 'evasion', 'aggressiveness' and sheltering' [are] closer to the other end." This study focuses on the later end of the continuum as these behaviors are thought to be reputationally detrimental to companies even in some cases when they are not technically illegal (Hanlon and Hetizman 2010; Hoi et al. 2013). I use five measures of tax avoidance drawn from Hoi et al. (2013) and McGuire et al. (2012). Two measures focus on general tax avoidance and three have been found to measure aggressive tax planning.

The second stream of literature is the emerging area of Corporate Social Responsibility (CSR) disclosures. CSR disclosures involve the seven broad areas of: Community, Corporate governance, Diversity, Employee Relations, Environment, Human Rights, and Product (the KLD Database's categories). A full breakdown of each of these categories is found in the descriptive statistics section in Table 2.1. Recently CSR literature has been focused on how firms with a superior CSR profile experience a lower cost of capital (e.g. Dhaliwal et al., 2012) and less earnings management (e.g. Kim et al. 2012). Only very recently have tax avoidance and sustainability performance disclosures been viewed together. Lanis and Richardson (2012) found that CSR disclosures had a negative association with a single broad measure of tax avoidance (not aggressiveness). Expanding on these results, Hoi et al. (2013) found that highly negative CSR disclosures had a positive association with measures of tax aggressiveness. I further build on these findings and show that positive disclosures have a negative association with tax aggressiveness — but this relationship is much stronger when a firm also has strong economic results.

I follow Dhaliwal et al. (2012) as well as Moser and Martin (2012) and define CSR broadly as corporate activities that affect all of the firm's stakeholders (e.g., shareholders, employees, communities, government, customers). I expect there to be a negative association between CSR and aggressive tax behavior as these aggressive behaviors have been shown to drain money from governments (Klassen and Laplante 2012) thereby preventing valuable services to communities. In line with Hoi et al. (2013) and Lanis and Richardson (2012) I expect that firms exhibiting positive CSR activities will be less likely to engage in aggressive tax avoidance as they will be mindful of the

impact aggressive tax avoidance has on the residents of a nation.. I also expect that positive CSR firms may also value positive disclosures from a risk theory perspective. Godfrey et al. (2009) and Minor and Morgan (2011) find evidence in support of a risk management approach to CSR disclosures. Their results suggest that reducing irresponsible CSR activities and/or increasing responsible CSR activities can enhance a firm's positive CSR reputation. A positive CSR reputation improves the perceptions of a company in the market from a political, regulatory, and social perspective. Tax aggressiveness has been discussed as a negative disclosure in the area of responsibility (Hoi et al. 2013; Lanis and Richardson 2012). This implies that aggressiveness would not be consistent with a positive CSR disclosure strategy from a risk perspective.

I follow Jain et al. (2014) and note that there are two primary dimensions to sustainability: CSR and Economic Sustainability. In Jain et al. (2014) the first dimension, CSR, has been shown to be related to tax avoidance and aggressiveness. I assert that CSR disclosures are representative of a responsible corporate culture (e.g., Hoi et al. 2013; Kreps 1990) or are a form of risk protection strategy. As Tax Aggressiveness is often seen as a symptom of a weak culture (Hoi et al. 2013) that is potentially risky (Hanlon and Heitzman 2010), I expect that there is a negative relationship between tax aggressiveness and CSR.

I expect that the firms which pursue strategies that result in sustainable and strong results in both CSR and economic sustainability will be less likely to avoid taxes aggressively when compared to peer firms. Prior literature has found some associations between CSR and tax avoidance, and prior literature has also found associations between economic sustainability and tax avoidance. However, the results for each individually

have been mixed. Rather than simply re-attempting the same questions with a revised model I combine my two sustainability metrics (CSR and economic sustainability) as a way to measure firms pursuing a long-term combined sustainability approach, and I expect that such firms are less likely to engage in the arguably morally suspect and potentially risky behaviors of aggressive tax avoidance. Such firms have both their ethical position and their financial position to lose if they are irresponsible.

This paper's goal to focus on how sustainable companies do not involve themselves in aggressive tax avoidance behavior, I focus on tax avoidance proxies that measure more aggressive tax behaviors that prudent firms might consider irresponsible. These tax behaviors also can be seen as negative disclosures harming a company's reputation. In line with this reasoning, I use a group of tax avoidance proxies that have been shown to measure behaviors on the more aggressive end of the tax avoidance spectrum. Hanlon and Heitzman (2010) define the continuum of tax avoidance in a manner such that clearly accepted and legal tax avoidance methods like municipal bond investments are at one end, and clearly illegal methods such as non-compliance are at the other end. Aggressiveness and sheltering are defined as far nearer to non-compliance than they are to municipal bond investments, and thus I focus on the tax avoidance proxies shown to measure sheltering and aggressiveness primarily. My measures of choice are in line with prior literature and are as follows: Wilson's (2009) tax-sheltering probability measure, Frank et al.'s (2009) discretionary book tax differences, and Desai and Dharmapala's (2006) discretionary book tax differences. According to Hoi et al. (2013) and Lisowsky (2010) these measures are the best fit to capture aggressive tax practices such as tax sheltering.

While measures of aggressive tax avoidance are the primary focus of my study, it is also my goal to show that only aggressive tax avoidance is shunned by positive CSR firms. Therefore I also test two other proxies that have been shown to exist on the less aggressive end of the tax avoidance spectrum. I use the Effective Tax Rate and the Cash Effective Tax Rate to contrast with my measures of aggression. In line with Hoi et al. (2013), I expect that socially and economically responsible firms are averse to aggressive tax avoidance, but would have no issues using non-aggressive tax avoidance. For example, few would raise issues against a firm due to their investment in tax exempt municipal securities — even if it significantly reduced their effective tax rate.

To measure my discussed proxies I use Compustat for the general financial and tax information, and KLD to compile a score that represents the positive CSR profile of a company. My primary focus is to test the impact of CSR on tax aggressiveness, economic sustainability on tax aggressiveness, and the combined impact of both sustainability variables on tax aggressiveness.

Using a sample of firms over the period of 2003-2010, I find tentative results that show that firms with positive CSR scores are less likely to aggressively avoid taxes, but that this effect is only marginally significant. However, when CSR is interacted with the study's economic sustainability variables the effect is highly significant for all measures of tax aggressiveness. These results show that in general more CSR disclosures indicate a socially responsible company in the area of tax aggressiveness, and that this effect is much stronger when a company has a combined strategy of economic and social sustainability. Further, in line with my expectation that responsible firms are willing to use non-aggressive tax avoidance. I do not find significant associations between my

sustainability metrics and my tax avoidance variables that represent non-aggressive behavior. This implies that responsible firms are willing to achieve tax savings by using non-aggressive tax avoidance (e.g., municipal bond purchases).

My findings can also be interpreted from the risk theory perspective. Firms with strong fundamentals may often be driven to using CSR as a method of increasing reputation to protect their gains. Such firms that have strong fundamentals being protected with CSR will be unwilling to take aggressive tax positions as they will risk damaging their business reputation and harming their fundamentals.

My findings both support and expand upon the results found by Hoi et al. (2013) and Lanis and Richardson (2012). Their research showed that highly irresponsible CSR activities represented a poor corporate culture and resulted in more tax aggressiveness. My study's findings are the first to find a link between positive CSR disclosures and tax aggressiveness — this is in large part due to the addition of the financial sustainability variables. My findings add to a growing body of literature which indicates that CSR has an impact on tax avoidance. While Hoi et al. (2013) showed that highly negative behaviors led to more tax avoidance, my study shows that positive behaviors lead to less, but only for firms that are economically sustainable. Other firms might be engaged in CSR as a form or window dressing to hide poor performance (Davidson 2004).

My study's results should inform public policy in that regulators can better identify which firms are likely to engage in tax aggressiveness. Historically, though not all aggressive tax policies are illegal, they are more often challenged and overturned by regulators earning the government revenue (Hanlon and Heitzman 2010). Therefore, this study can be used as a method of identifying potential targets for the IRS.

II. LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

The Impact of CSR Disclosures on Tax Avoidance

Consistent with Dhaliwal et al. (2012) I define CSR activities broadly by using all of the major components in the KLD Database. CSR activities are corporate actions widely regarded as having a significant impact on all of the firm's stakeholders including shareholders, employees, communities, government. KLD's CSR disclosures involve the seven broad areas of: Community, Corporate governance, Diversity, Employee Relations, Environment, Human Rights, and Product.

In one of taxation's most famous quotes, 2nd Circuit Court of Appeals Judge Learned Hand wrote[1]: "Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes." Academic literature has taken a different stand, however, and framed aggressive tax avoidance as a moral issue. Prior literature has recently examined the definitions (Hanlon and Heitzman 2010) and potential negative impacts (Klassen and Laplante 2012) of aggressive tax avoidance behavior. Prior literature has also described tax avoidance and aggressiveness as being related to CSR behavior (Hoi et al. 2013; Lanis and Richardson 2012). Aggressive tax avoidance through sheltering or income shifting can have the side effect of depriving local or selected governments of revenue (Klassen and Laplante 2012). The negative perceptions of aggressive tax avoidance has resulted in scholars (e.g., Hoi et al. 2013; Lanis and Richardson 2012) asserting that tax aggressiveness is an irresponsible behavior that is contrary to CSR. Other scholars believe that CSR behaviors are more related to risk management (Godfrey et al. 2009; Minor and Morgan 2011). That is, being involved

[1] *Helvering V. Gregory* (1934)

in more CSR activities provides good press for a firm from an overall marketing perspective. As tax aggressiveness represents a negative disclosure this view also expects that positive CSR activities are contrary to aggressive tax behavior.

In line with some prior studies, I postulate that one explanation of CSR disclosures is that they are representative of a responsible corporate culture (Kreps 1990). Corporate culture can be viewed as the shared beliefs in a firm that indicate the right or optimal way of doing business and interacting with the community (Hermalin 2001, Kreps 1990). The effects of corporate culture have proven to be long-term (Cronqvist 2007) and highly influential on firm policies. For example, Frank et al. (2011) found that aggressive financial and tax reporting was associated with a risk-taking corporate environment.

Following the reasoning that CSR disclosures are a strong indicator of corporate culture as implied by Hoi et al. (2013) and Kreps (1990), I postulate that companies with high CSR scores (a responsible corporate culture) would be more likely to feel that paying taxes (thereby supporting government programs) is a moral imperative. Survey research also supports the assertions of Hoi et al. (2013) and Kreps (1990). Specifically, the survey findings in Cruz et al. (2000) indicate that tax practitioners consider aggressive tax reporting to be an ethical issue. The surveyed practitioners believed that resisting significantly aggressive tax positions was a matter of justice, fairness, and morality.

From a risk management perspective Godfrey et al. (2009) and Minor and Morgan (2011) find evidence that positive CSR represents a valuable disclosure to a company. Their results suggest that reducing irresponsible CSR activities and/or increasing responsible CSR activities can enhance a firm’s reputation. As tax

aggressiveness has been discussed as a negative disclosure in the area of responsibility (Hoi et al. 2013; Lanis and Richardson 2012), this would imply that firms aiming for positive disclosures also aim for positive disclosures in the tax area as well (i.e., no involvement in aggressive tax avoidance).

This risk management approach results in identical expectations to the ethics based approach. Under both theories a company involved in positive CSR activities does not want to be involved in the behavior of aggressive tax avoidance. On one hand CSR might represent a positive corporate culture that dislikes aggressive tax behavior. This is thought to be the case (e.g., Hoi et al. 2013; Lanis and Richardson 2012) because companies with high CSR scores are theoretically good corporate citizens as they are involved in positive environmental, social, and corporate governance behaviors. On the other hand CSR might be indicative of a disclosure regime aimed at building/maintaining company reputation (Godfrey et al. 2009; and Minor and Morgan 2011).

However, I also expect that sustainable firms will only shun aggressive tax avoidance, not tax avoidance entirely. To test this assertion I contrast my tax aggressiveness measures with tax avoidance measures shown not to measure only aggressiveness. I expect that there will not be an association between tax avoidance and my interaction between CSR and economic sustainability for non-aggressive tax measures. I postulate that this is the case because responsible firms are concerned with the risks and moral issues with aggressive behavior. However, I also expect that socially and economically responsible firms will have no qualms with using non-aggressive tax avoidance. For example, few would begrudge a firm their investment in tax exempt

municipal securities even if it significantly reduced their Effective Tax Rate. From this discussion H1 is derived.

H1: There is a negative association between Corporate Social Responsibility and Tax Aggressiveness

The Impact of Economic Sustainability on Tax Avoidance:

While no firm specifically wants negative attention from regulators or the press, firms in an economically sustainable position have more to lose than peer firms. Aggressive forms of tax avoidance are thought to be behaviors that cause reputational harm and potential economic consequences (Hanlon and Heitzman 2010). If a firm pushes tax boundaries beyond what either the public or revenue agencies are willing to support, the negative results can be significant, and economically sustainable firms have more to lose.

Jain et al. (2014) found that there was an association between economic sustainability and CSR. If CSR and tax aggressiveness are both understood to be disclosure variables it is reasonable to assume that economic sustainability variables also have an association with tax aggressiveness as CSR does (Hoi et al. 2013). Based on this discussion hypothesis 2 is derived.

H2: There is a negative relationship between economic sustainability and tax aggressiveness.

The Combined Impact of CSR and Economic Sustainability

I expect that firms which pursue strategies that aim for both high CSR and economic sustainability will be less likely to avoid taxes aggressively when compared to other firms. Prior literature has found some associations between CSR and tax

avoidance, as well as associations between economic sustainability and tax avoidance (Hoi et al. 2013; Lanis and Richarson 2012). I combine these two sustainability metrics (CSR and economic sustainability) as a way to measure firms pursuing a combined sustainability approach.

From the risk based perspective, firms pursuing this combined approach are essentially attempting to protect success with their strong disclosures. If an economically sustainable firm with strong CSR disclosures is caught in aggressive tax behavior it might lose significant reputation as tax aggressiveness is a disclosure that runs contrary to their strong and ethical appearance. I expect that such firms are less likely to engage in the potentially risky behavior of aggressive tax avoidance. Anecdotally, a firm like Starbucks suffered extraordinary backlash when its responsible image was tarnished with aggressive tax avoidance. Firms like Chevron or Texaco, however, lack the polished image of a Starbucks and suffer less backlash for their aggressive tax behaviors. Based on this discussion, Hypothesis 3 is derived:

> **H3:** The association between tax aggressiveness and CSR is stronger for firms with high ratings in economic sustainability measures.

III. RESEARCH DESIGN

III(a). Variables and Constructs

Measures of Tax Avoidance

As it is the goal of this paper to test the impacts of CSR and economic sustainability on aggressive tax behavior. I primarily focus on proxies for tax avoidance which prior literature has tied to aggressive tax behavior. Each measure of tax avoidance

is a generalization with its own limitations (Hanlon and Heitzman 2010; Lisowsky 2013), so I utilize five different measures to test my theory for contrast and robustness purposes.

Following prior literature I use three measures that are specifically tailored to capture aggressive tax planning. Then, for comparative purposes, I use two general tax avoidance measures (Effective Tax Rate and Cash Effective Tax Rate). By contrasting measures that capture aggressiveness against general tax avoidance measures I am able to determine if a sustainability focused company is avoiding only aggressive tax practices. It is my goal to determine whether or not responsible companies are avoiding potentially abusive tax practices, not all practices that reduce taxes.

The first tax aggressiveness measure is the total book-tax difference (BTD). The BTD reflects activities which create permanent and temporary differences between financial statement and book income. According to prior research (e.g. Wilson 2009) a larger BTD represents more tax sheltering behavior as well as a higher probability of a firm receiving audit adjustments from the IRS. BTD is calculated by taking the difference between tax and financial statement income. Higher values in the BTD variable indicate higher levels of tax avoidance. BTD is generally considered to exist at the more aggressive end of the tax avoidance spectrum (Hanlon and Heitzman 2010)

The second tax avoidance measure is the discretionary permanent book-tax differences (DTAX). As this measure indicates permanent differences between book and tax incomes it is considered to be representative of highly aggressive tax avoidance (Frank 2009, McGuire et al. 2012). DTAX is the residual of a regression of permanent book-tax differences on non-tax planning items, state tax expense, change in net operating loss, and minority interest. By regressing permanent book tax differences on

non-aggressive items that reduce the tax rate, the residual represents only the most aggressive tax practices. Higher values in the DTAX indicate higher levels of tax avoidance.

The third method of measuring tax aggressiveness requires the use of an additional logit regression in line with Kim et al. (2011) and Wilson (2009). This method estimates the probability of a firm having a tax shelter in any given year. Tax shelters can take almost any form, and are illegal when they do not exhibit "economic substance" or a "business purpose."

Following Kim et al. (2011) and Wilson (2009), if a firm is in the top quartile in terms of tax shelter probability I code a dichotomous variable (SHELTER) to a 1. If not, I code it to 0. In my logit regression the SHELTER variable serves as the sole dependent variable tested. According to Lisowsky (2010), this variable represents the most aggressive tax behaviors making it important to my study.

Next, to ensure that CSR activities impact only aggressive tax avoidance behavior, I analyze two measure of general tax avoidance. The first measure of non-aggressive tax avoidance discussed is the book effective tax rate (ETR). The proxy for book effective tax rate measures tax avoidance activities that directly influence net income. It is perhaps the most commonly used and well established method for demonstrating tax avoidance in accounting literature (e.g., Dyreng et al. 2010; Robinson et al. 2010). That said, it is a fairly straightforward approach that ignores activities such as cash deferred taxes that are paid in a later period. This weakness is dealt with by the final proxy to be discussed in this section. The ETR is calculated by dividing total tax

expense by pre-tax book income less special items. A lower value for the ETR variable indicates higher tax avoidance behavior.

The final measure discussed in this section is the cash effective tax rate (CETR). Unlike the ETR, it captures the cash flow aspect of tax avoidance. According to Dyreng (2008), managers often treat tax avoidance as a practice of minimizing cash taxes paid. Beyond this intuitive cash-flow based reasoning, the CETR also recognizes strategies that involve deferred cash taxes, even when they do not impact the current period's financial statements. The CETR is calculated by dividing cash taxes paid by pretax book income less special items. A lower value for the CETR variable indicates more tax avoidance behavior. Further details on the calculation of all tax avoidance proxies are provided in Appendix A.

Measures of Environmental, Social, and Governance Sustainability

Unlike the recent work by Hoi et al. (2013), I focus not on highly negative CSR events but use the more conventional scoring methodology in line with Dhaliwal et al. (2012). To measure the level of CSR in a given firm I use the KLD database. Each of the seven categories in the KLD database includes a set of sub categories (potential strengths). If a company has the specific strength, the value is coded to a 1. Otherwise the subcategory is coded to 0. The seven main categories are: Community, corporate governance, diversity, employee relations, environment, human rights, and product.

Measures of Economic Sustainability

Following Jain et al. (2014) I define economic sustainability with the performance measures of Return on Assets, and Return on Equity. For robustness I will also test three

other measures of economic sustainability: A firm's Market to Book Ratio, a firm's stock return, and various firm growth metrics.

Financial and CSR Sustainability Interaction

My main variable of interest and primary contribution to the literature is the interaction between the measure of CSR and the various measures of economic sustainability. By combining these two sustainability metrics I can determine if firms that focus on economic and CSR related sustainability are more likely to avoid the potentially suspect/risky behaviors of aggressive tax avoidance. Prior literature has found mixed results for each of the underlying variables (CSR sustainability and economic sustainability).

III(b). Model Design

Main Regression Model

Following the work of Hoi et al. (2013), Chen et al. (2010), and Frank et al. (2009), I run the following regression as the cornerstone of my analysis. My model expands on the work in Hoi et al. (2013) as it focuses on a broad range of CSR activities and analyzes the impact of economic sustainability.

$$\begin{aligned} AVOIDANCE_{it} = {} & \beta_0 + \beta_1 CSR_{it} + \beta_2 FSA_{it} + \beta_3 FSE_{it} + \beta_4 CSR*FSA_{it} + \beta_5 CSR*FSE_{it} \quad \textbf{(1} \\ & + \beta_6 ABS_DA_{it} + \beta B_7 CASH_{it} + \beta_8 LEV_{it} + \beta_9 \Delta NOL_{it} + \beta_{10} NOL_{it} \\ & + \beta_{11} FI_{it} + \beta_{12} PPE_{it} + \beta_{13} INTANG_{it} + \beta_{14} EQINC_{it} + \beta_{15} R\&D_{it} \\ & + \beta_{16} EMP_{it} + \beta_{17} \Delta SALE_{it} + \beta_{18} SIZE_{it} + \beta_{19} MB_{it} + \textit{Year Dummies} \\ & + \textit{Industry Dummies} + \varepsilon_{it}, \end{aligned}$$

where $AVOIDANCE_{it}$ represents four of the measures of tax avoidance discussed earlier including two of the measures of tax aggressiveness and the two measures of general tax avoidance. CSR_{it} represents the Corporate Social Responsibility score obtained from the KLD database and it is interacted with the two measures of economic sustainability: FSA_{it} and FSE_{it}. When dealing with economic sustainability I intend to test both valuation and volatility measures. FSA_{it} (Financial Sustainability — Assets) represents either a company's Return on Assets while FSE_{it} (Financial Sustainability — Equity) represents either a company's Return on Equity.

Logit Regression Model

To test the SHELTER variable I run a logit Model in line with Lisowsky (2010) to test the most aggressive tax behavior:

$$\begin{aligned} SHELTER_{it} = {} & \beta_0 + \beta_1 CSR_{it} + \beta_2 FSA_{it} + \beta_3 FSE_{it} + \beta_4 CSR{*}FSA_{it} + \beta_5 CSR{*}FSE_{it} \\ & + \beta_6 ABS_DA_{it} + \beta B_7 CASH_{it} + \beta_8 LEV_{it} + \beta_9 \Delta NOL_{it} + \beta_{10} NOL_{it} \\ & + \beta_{11} FI_{it} + \beta_{12} PPE_{it} + \beta_{13} INTANG_{it} + \beta_{14} EQINC_{it} + \beta_{15} R\&D_{it} \\ & + \beta_{16} EMP_{it} + \beta_{17} \Delta SALE_{it} + \beta_{18} SIZE_{it} + \beta_{19} MB_{it} + \textit{Year Dummies} \\ & + \textit{Industry Dummies} + \varepsilon_{it}, \end{aligned} \quad \textbf{(2}$$

where the dependent shelter variable and logit methodology are the only changes from model 1 above. SHELTER represents arguably the highest levels of tax aggressiveness according to Lisowsky (2013). This method estimates the probability of a firm having a tax shelter in any given year. Following the referenced method, if a firm is in the top quartile in terms of tax shelter probability I code a dichotomous variable (SHELTER) to a 1. If not, I code it to 0. In this regression the SHELTER variable serves as my sole dependent variable tested.

In line with prior literature I also include a number of control variables in both models that have shown to be influential in taxation studies. These variables control for earnings quality, corporate governance, firm performance, tax issues, and other firm characteristics. Appendix A presents the detailed descriptions of each variable used in the two models in this section.

Prior literature has shown that the absolute value of performance adjusted abnormal accruals (ABS_DA) is negatively related to CSR (Kim et al. 2012) and positively related to certain forms of tax avoidance (Frank et al. 2009), therefore it is used as one of the key control variables to ensure the results are not driven by earnings quality. Next, Net Operating Loses (NOL) and the change in Net Operating Loses (ΔNOL) are included as controls, as losses that are carried forward or backward can significantly change or even wipe away a tax liability without any tax planning being used. Another factor that has shown a significant impact on tax avoidance behavior is a company's foreign operations (FI). In general, when dealing with a US based company the presence of foreign operations implies that some portion of the firm's income will be taxed overseas. With the fact that the tax rates in the United States are higher than most other countries, prior research has shown that having foreign operations drives tax avoidance behavior and thus it must be controlled for.

Other more general control variables include a company's liquidity (CASH), leverage (LEV), size (SIZE), growth (ΔSALE and MB), investment in property plant and equipment (PPE), amount of intangible assets (INTANG), and investment in Research and Development (R&D). Finally, I include dummy variables to control for fixed effects. Year fixed effects are used, as are industry fixed effects.

IV. SAMPLE SELECTION AND SUMMARY STATISTICS

Sample Selection

I estimate my regressions with two data sources. For my CSR metric I use the KLD database in the years from 2003-2010. I use this timeframe as the KLD database drastically increased its coverage to 3,000 companies as of 2003. To calculate my financial sustainability measures as well as my measures of tax avoidance I use the Standard and Poor's Compustat database. Compustat also proves the information for all of the studies control variables. Following prior tax avoidance literature (Hoi 2013; McGuire 2012) I exclude utilities (SIC codes 4900-4949) and finance companies (SIC codes 6000-6999) due to their unique industry characteristics.

After removing all observations with incomplete Compustat or KLD data required to calculate the variables used in my models, my initial sample is composed of 2656 unique firms and 11352 firm-year observations covering the period of 2003-2010.

TABLE 2.1
CSR Score Categories and Subcategories

Main Categories	Sub-Categories	Max Strength (Perfect Score)	Actual Max Strength	Actual Mean Strength
Community	1 Charitable Giving, 2 Innovative Giving, 3 Non-U.S. Charitable Giving, 4 Support for Education, 5 Support for Housing, 6 Volunteer Programs, and 7 Other Strengths	7	5	0.192
Corporate Governance	1 Compensation, 2 Ownership, 3 Political Accountability, 4 Transparency, and 5 Other Strengths	5	3	0.173
Diversity	1 Board of Directors, 2 CEO, 3 Employment of the Disabled, 4 Promotion, 5 Women and Minority Contracting, 6 Work/Life Benefits, 7 Gay and Lesbian Policies, and 8 Other Strengths	8	7	0.62
Employee Relations	1 Health and Safety, 2 Retirement Benefits, 3 Union Relations, 4 Cash Profit Sharing, 5 Employee Involvement, and 6 Other Strengths	6	5	0.29
Environment	1 Beneficial Products and Services, 2 Clean Energy, 3 Pollution Prevention, 4 Recycling, and 5 Other Strengths	5	4	0.141
Human Rights	1 Labor Rights, 2 Relations with Indigenous Peoples, and 3 Other Strengths	3	2	0.0041
Product	1 Benefits the Economically Disadvantaged, 2 Quality, 3 R&D/Innovation, and 4 Other Strengths	4	3	0.075
Total Score	The sum of all of the above seven main categories.	38	29	1.4951

TABLE 2.2
CSR Categories and Performance Score by Industry

Industries	Total Strength	Community	Corporate Governance	Diversity	Employee Relations	Environment	Human Rights	Product
Mining	0.776	0.201	0.125	0.185	0.188	0.088	0.022	0.015
Food	2.33	0.338	0.243	1.22	0.422	0.211	0.021	0.025
Textiles/Print/Publish	1.76	0.168	0.182	0.593	0.312	0.294	0.001	0.144
Chemicals	2.113	0.284	0.155	0.722	0.321	0.441	0	0.101
Pharaceutucals	1.54	0.221	0.142	0.733	0.374	0.145	0	0.058
Extractive	1.27	0.153	0.177	0.198	0.292	0.141	0.003	0.025
Manf:Rubber/Glass/etc…	1.764	0.322	0.165	0.442	0.221	0.184	0.014	0.088
Manf: Metal	1.153	0.071	0.124	0.211	0.388	0.284	0	0.086
Manf: Machinery	1.355	0.121	0.122	0.314	0.312	0.134	0.002	0.167
Manf: Electrical Eqpt	1.247	0.145	0.153	0.4132	0.185	0.184	0.008	0.178
Manf: Transport Eqpt	1.895	0.184	0.172	0.588	0.452	0.1165	0	0.146
Manf: Instruments	1.412	0.129	0.155	0.594	0.231	0.145	0.001	0.128
Manf: Misc	1.955	0.214	0.221	0.751	0.217	0.051	0.029	0.145
Computers	1.668	0.181	0.182	0.852	0.411	0.152	0.001	0.112
Transportation	1.311	0.142	0.141	0.622	0.311	0.041	0.003	0.079
Utilities	1.901	0.184	0.182	0.711	0.285	0.441	0.001	0.016
Retail: Wholesale	0.821	0.118	0.151	0.341	0.114	0.044	0	0.081
Retail: Misc	1.62	0.153	0.152	0.871	0.234	0.085	0.015	0.074
Retail: Restaurant	1.423	0.15	0.133	0.932	0.241	0.011	0.003	0.015
Financial	1.525	0.273	0.332	0.625	0.221	0.008	0.005	0.055
Insurance/Real Estate	0.433	0.143	0.191	0.334	0.091	0.003	0	0.001
Services	0.801	0.132	0.121	0.682	0.981	0.021	0	0.032
Mean	1.457863636	0.1830455	0.16913636	0.587918	0.309273	0.146568182	0.005864	0.0805

Summary Statistics

Table 2.1 presents the categories and subcategories of the social responsibility score (CSR_{it}) used in our study. It is calculated in line with Dhaliwal et al. 2012. It excludes categories that were recently added to the KLD database as I attempt to have a consistent set of variables across the entire period of 2003-2010. My findings are largely in line with Dhaliwal et al. 2012 in terms of averages, as I adopt Dhaliwal et al.'s (2012) sample restrictions. Table 2.2 presents an industry breakout for each social responsibility category. The main test includes all categories in line with Dhaliwal et al. (2012), while a robustness test excludes the corporate governance and employee relations categories in line with Ghoul (2011).

TABLE 2.3
Descriptive Statistics

Panel A: Measures of Tax Avoidance

Variable	n	Mean	Std. Dev.	Median
$SHELTER_{it}$	6,532	0.2542	0.4132	0
$DTAX_{it}$	6,252	0.0121	0.1001	0
DD_BT_{it}	4,328	-0.00012	0.0821	0.0029
ETR_{it}	8,958	0.2925	0.2531	0.2921
$CETR_{it}$	8,622	0.2412	0.3175	0.2554

Panel B: Sustainability Measures and Control Variables

Variable	n	Mean	Std. Dev.	Median
CSR_{it}	11,352	1.458	1.521	1.5
FSA_{it}	11,352	0.0486	0.3141	0.1055
FSE_{it}	11,352	0.0681	0.3811	0.13441
ABS_DA_{it}	11,352	0.1523	0.2017	1.651
$CASH_{it}$	11,352	0.2351	0.3517	0.3354
LEV_{it}	11,352	0.2101	0.2431	0.3012
NOL_{it}	11,352	0.4731	0.5441	1
ΔNOL_{it}	11,352	0.0314	0.3464	0.0014
FI_{it}	11,352	0.0213	0.04621	0.0403
PPE_{it}	11,352	0.3123	0.2654	0.3854
$INTANG_{it}$	11,352	0.3412	0.2741	0.36544
$R\&D_{it}$	11,352	0.0434	0.0914	0.0454
$\Delta SALE_{it}$	11,352	0.1484	0.3147	0.2134
$SIZE_{it-1}$	11,352	7.0048	0.16147	7.6841
MB_{it-1}	11,352	3.3134	5.1342	3.7462

n = number of observations
Panel A presents the descriptive statistics on all of our five tax avoidance measures that are sued in our two regression models. The initial sample includes 11352 firm-year observations for which data for our sustainability variables and control variables are available. Appenxi A contains detailed information on the calculation of all varaibles.

Table 2.3, panel A reports the summary statistics information on all five of my tax avoidance measures. As I use a wide variety of highly different tax avoidance proxies spanning from low aggression to extremely high aggression, I have significantly different samples for each proxy. SHELTER has a sample size of 6,532, DTAX has a sample size of 6,252, DD_BT has a sample size of 4,328, and our non-aggressive measures — CETR and ETR — have sample sizes of 8622 and 8958 respectively.

SHELTER, DTAX, and DD_BT are consistent with the findings of recent literature[2]. The sample means for my non-aggressive tax measures of ETR and CETR are .2925 and .2412 respectively, and they remain fairly consistent over the majority of US based tax avoidance literature including recent works such as McGuire et al. (2012) and Hoi et al. (2013).

Table 2.3, Panel B presents the descriptive statistics for my sustainability variables. For CSR my sample contains 11,352 observations and a mean value of 1.458[3]. In terms of economic sustainability, my performance variable of Return on Assets has a mean value of .0486 and a sample size of 11,352. My other performance variable, Return on Equity, has a mean value of .0681 and a sample size of 11,352.

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[2] Our sample mean value for BTD and our sample mean for DTAX also vary only slightly from the amounts found in Hoi 2013, Frank et al 2009, and Chen 2010. When considering the restrictions the use of the KLD database has placed on the sample start date (we start in 2003 when KLD drastically increased the number of firms it covered) the differences are minimal.

[3] These numbers are similar to those found in Dhaliwal et al 2011.

TABLE 2.4

CSR, Economic Sustainability, and Tax Avoidance
Evidence from Firm-Year Level Regression

	$DTAX_{it}$ OLS		DD_BT_{it} OLS		ETR_{it} OLS		$CETR_{it}$ OLS	
Variable Name	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7	Model 8
Sustainability Variables								
CSR_{it}	-0.2514 *	-0.3251	-0.3417 **	-0.3656	0.1254 *	0.1156	0.1184 *	0.1286 *
	(-8.89)	(-6.85)	(-8.85)	(-7.85)	(7.83)	(6.55)	(9.63)	(8.98)
FSA_{it}	-0.1621 **		-0.5211 *		0.1984 *		0.2181	
	(-1.86)		(-4.23)		(4.25)		(4.68)	
FSE_{it}		-0.1861 *		-0.4351		0.3212		0.3141
		(-1.21)		(-3.21)		(3.45)		(3.96)
CSR_{it} * FSA_{it}	-1.253 ***		-0.9251 ***		0.1823 *		0.2121	
	(-4.21)		(-3.21)		(2.35)		(4.35)	
CSR_{it} * FSE_{it}		-1.326 ***		-1.1223 **		0.2362		0.1589
		(-4.69)		(-3.47)		(2.36)		(5.38)
Control Variables								
ABS_DA_{it}	0.0048	0.0059	-0.142	-0.152	0.0421	0.0494	0.0134	0.0121
	(0.72)	(0.64)	(-3.12)	(-3.01)	(2.21)	(2.19)	(1.29)	(1.12)
$CASH_{it}$	0.0071	0.0095	-0.031	-0.28	-0.0348	-0.0484	-0.01984	-0.0214
	(0.92)	(0.75)	(-3.98)	(-4.28)	(-1.61)	(-1.78)	(-1.53)	(-1.61)
LEV_{it}	0.0292 *	0.02944 ***	0.0094 *	0.011 ***	-0.04522 *	-0.0486 ***	-0.0345 ***	-0.0458 *
	(1.92)	(1.92)	(1.454)	(1.523)	(-3.21)	(-4.28)	(-2.54)	(-2.64)
NOL_{it}	0.0154 ***	0.0187 ***	0.0045 ***	0.0064 ***	-0.0281 ***	-0.0348 ***	-0.0184 ***	-0.1984 ***
	(5.34)	(5.21)	(2.64)	(2.75)	(-4.641)	(-5.941)	(-4.581)	(-4.82)
ΔNOL_{it}	0.0434 ***	0.0641 ***	-0.0284 ***	-0.0312 ***	0.0691 ***	0.0741 ***	0.0641 ***	0.0621 ***
	(2.84)	(2.74)	(-1.52)	(-1.63)	(3.10)	(3.84)	(2.34)	(2.14)

TABLE 2.4 (continued)

	$DTAX_{it}$		DD_BT_{it}		ETR_{it}		$CETR_{it}$	
	OLS		OLS		OLS		OLS	
Variable Name	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7	Model 8
FI_{it}	0.1467 ***	0.1456 ***	-0.2984 ***	-0.318 ***	-0.1901 ***	-0.234 ***	-0.1408 ***	-0.154 ***
	(2.76)	(2.64)	(-14.85)	(-13.94)	(-3.21)	(-4.81)	(-2.38)	(-2.64)
PPE_{it}	0.0142 ***	0.0152 ***	0.124 ***	0.1214 ***	-0.0482 ***	-0.058 ***	-0.0248 ***	-0.0341 ***
	(1.13)	(1.24)	(2.11)	(1.80)	(-2.31)	(-2.41)	(-2.21)	(-2.37)
$INTANG_{it}$	-0.0042	-0.0059	-0.0001	-0.0001 *	0.00841	0.0094 **	0.0067	0.0084 *
	(-0.31)	(-0.41)	(-0.03)	(-0.03)	(0.91)	(0.82)	(0.69)	(0.74)
$EQINC_{it}$	-0.8142 **	-0.865 *	-1.4094 **	-1.5214 *	-1.2151 ***	-1.341	-0.8746	-0.8431 *
	(-2.21)	(-3.14)	(-5.10)	(-4.90)	(-1.94)	(-2.31)	(-1.34)	(-1.41)
$R\&D_{it}$	0.1564 ***	0.15685 ***	-0.0356 ***	-0.0341 ***	-0.14811 ***	-0.1594 ***	-0.12474 ***	-0.1341 ***
	(3.45)	(4.21)	(-1.78)	(-1.84)	(-3.84)	(-3.74)	(-2.941)	(-3.14)
EMP_{it}	0.0038	0.0043 *	0.0031 ***	0.0034	-0.008 ***	-0.0091	-0.0034 ***	-0.0028
	(1.25)	(1.34)	(2.17)	(2.24)	(-1.31)	(-1.24)	(-0.81)	(-0.84)
$\Delta SALE_{it}$	0.0294 ***	0.0314 ***	-0.0042 ***	-0.00483 ***	-0.0821 ***	-0.0351 ***	-0.0741 ***	-0.0841 ***
	(3.23)	(2.94)	(-0.82)	(-0.96)	(-5.81)	(-5.98)	(-5.64)	(-5.47)
$SIZE_{it}$	-0.0091 ***	-0.0084 ***	-0.0075 ***	-0.0084 ***	-0.0051 ***	-0.00841 ***	-0.0021 ***	-0.0034 ***
	(-5.14)	(-4.84)	(-4.29)	(-6.74)	(-0.42)	(-0.48)	(-0.31)	(-0.29)
MB_{it}	-0.0012	-0.0013 *	-0.00029	-0.00031	0.0005 *	0.0008	0.00019	0.00028
	(-0.28)	(-0.37)	(-1.73)	(-1.81)	(1.91)	(1.81)	(1.21)	(1.31)
Intercept								
Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Adjusted R^2	0.1325	0.1358	0.4298	0.4201	0.2389	0.2318	0.1984	0.1922
Number of Observations	6252	6252	4328	4328	8958	8958	8622	8622

*, **, *** Indicate significance at the 10 percent, 5 percent, and 1 percent levels, respectively.
t-statistics and z-statistics, reported in parentheses, are based on standard errors clustered at the firm level.

V. EMPIRICAL RESULTS

Table 2.4 presents our main results for my regressions using the valuation measures as the proxies for economic sustainability. The four OLS based dependent variables are DTAX, DD_BT, CETR, and ETR. In total, there are two general tax avoidance measures (ETR and CETR) and the two measuring aggressive behavior (DTAX, DD_BT). In line with Peterson (2009), I cluster standard errors at the firm level.

The first independent variable of interest is CSR. The theory of Hoi et al. (2013) implies that socially responsible companies will avoid aggressive tax behavior on moral grounds. I find that there is a negative relationship between CSR and tax avoidance; however, the significance is mixed across the four OLS proxies. For the first tax aggressiveness proxy, DTAX, I find a negative coefficient for CSR (-0.2514) which significant at the .1 level in Model 1 (defining financial sustainability as an asset based measure), and a negative coefficient for CSR (-0.3251) which is not significant at conventional levels for Model 2 (defining financial sustainability as an equity based measure). For the second tax aggressiveness proxy, DD_BT, I find a negative coefficient for CSR (-0.3417) which significant at the .05 level in Model 3 (asset based financial sustainability), and a negative coefficient for CSR (-0.3656) which is not significant at conventional levels in Model 4 (equity based financial sustainability). For the first general tax avoidance (non-aggressive) proxy, ETR, I find a positive coefficient for CSR under Model 5 (0.1254) and Model 6 (0.1156), however, neither is significant at conventional levels. For the second general tax avoidance proxy, CETR, I find a positive coefficient for CSR under Model 7 (0.1184) which significant at the .1 level, and a positive but insignificant coefficient for CSR in Model 8 (0.1286).

The directions of the coefficients lend some credibility to the statement that socially responsible firms are less likely to avoid. However, only DD_BT has significance at the .05 level or greater. Though this does imply that the relationship between CSR and tax avoidance is stronger when dealing with aggressive tax behavior, the inconsistent significance levels leave H1 only marginally supported.

When viewing the measures of economic sustainability (FSA and FSE) we find a similar set of results to those discussed above — that is, mixed significance with a stronger relationship when using measures of aggressiveness rather than general avoidance. For the first tax aggressiveness proxy, DTAX, I find a negative coefficient for FSA (-0.1621) which significant at the .05 level in Model 1 (defining financial sustainability as an asset based measure), and a negative coefficient for FSE (-0.1861) which is significant at the .1 level in Model 2 (defining financial sustainability as an equity based measure). For the second tax aggressiveness proxy, DD_BT, I find a negative coefficient forFSA (-05211) which significant at the .1 level in Model 3 (asset based financial sustainability), and a negative coefficient for FSE (-0.4351) which is not significant at conventional levels in Model 4 (equity based financial sustainability). For the first general tax avoidance proxy, ETR, I find a positive coefficient for FSA under Model 5 (0.1984) which is significant at the .1 level, and for Model 6 I find a positive coefficient for FSE (0.3212), however, it is not significant at conventional levels. For the second general tax avoidance proxy, CETR, I find a positive coefficient for FSA under Model 7 (0.1184) and a positive coefficient for FSE in Model 8 (0.1286). Neither is significant at conventional levels.

The mixed significance across both measures of economic sustainability results in only marginal support for H2.

Finally, I test the interaction between CSR based sustainability and economic sustainability. For the first tax aggressiveness proxy, DTAX, I find a negative coefficient for my interaction (-1.253) which significant at the .01 level in Model 1 (defining financial sustainability as an asset based measure), and a negative coefficient for my interaction (-1.326) which is also significant at the .01 level for Model 2 (defining financial sustainability as an equity based measure). For the second tax aggressiveness proxy, DD_BT, I find a negative coefficient for my interaction (-0.9251) which significant at the .01 level in Model 3 (asset based financial sustainability), and a negative coefficient for my interaction (-1.1223) which is significant at the .05 level in Model 4 (equity based financial sustainability). For the first general tax avoidance (non-aggressive) proxy, ETR, I find a positive coefficient for my interaction under Model 5 (0.1823) which is significant at the .1 level, and a positive coefficient for my interaction (0.2362) Model 6 which is not significant at conventional levels. For the second general tax avoidance proxy, CETR, I find a positive coefficient for my interaction under Model 7 (0.2121) and a positive coefficient under Model 8 as well (0.1589), however, neither is significant at conventional levels.

The above results for H3 highly significant. Firms that pursue both economic sustainability and financial sustainability are much less likely to involve themselves in aggressive tax practices. The interactions between CSR and FSA/FSE are highly significant for all measures of aggressive tax avoidance. This supports the assertion that firms pursuing a strategy of economic and social sustainability are not likely to engage in

aggressive tax practices. Another result of Table 2.4 is that the two general tax avoidance measures lack significance. This implies that responsible firms are unwilling to engage in aggressive tax practices, but they are not averse to legitimately decreasing there liabilities by non-aggressive means. Few would begrudge a firm an investment in a tax free security, for example. Based on this discussion we find that H3 is supported.

The strong support for H3 in contrast to the weak support for H1 and H2 indicates that firms which pursue a combined sustainability approach (i.e., both CSR and economic sustainability) are most likely to engage in responsible tax behaviors. Firms with only high levels of CSR based sustainability might be weak firms engaging in positive disclosures to manage perceptions (H1). Firms with only high economic sustainability may represent pure profit seeking ventures with no regard for the common good (H2).

My results show that firms which have both high levels of economic and CSR base sustainability are the least aggressive in their income tax reporting. This falls in line with the expectations of Hoi et al. (2013) who perceive sustainability to represent a responsible corporate culture and tax aggressiveness to represent irresponsible corporate behavior. The findings are also in line with Godfrey et al. (2009) and Minor and Morgan (2011). They believe that sustainability metrics represent positive disclosures and tax aggressiveness represents a negative disclosure. Therefore, management seeking positive disclosures (e.g., CSR) would be unlikely to engage in overly aggressive tax avoidance as to avoid negative disclosures.

VI. ROBUSTNESS CHECKS

In line with Ghoul (2011) I recognize that not all categories of CSR activities in the KLD database are necessarily representative of ethical behavior. Activities classified

as being related to corporate governance or employee relations are perhaps more representative of standard management practices that are used to motivate employees and run a profitable company. Such activities include: Retirement benefits, union relations, cash profit sharing, employee involvement, compensation practices and ownership practices.

TABLE 2.5

CSR, Economic Sustainability, and Tax Avoidance
Evidence from Firm-Year Level Regression

	$DTAX_{it}$ OLS		DD_BT_{it} OLS		ETR_{it} OLS		$CETR_{it}$ OLS	
Variable Name	**Model 1**	**Model 2**	**Model 3**	**Model 4**	**Model 5**	**Model 6**	**Model 7**	**Model 8**
Sustainability Variables								
CSR_{it}	-0.2312 *	-0.2965 *	-0.3343 **	-0.3454	0.1211	0.1133	0.1264 *	0.1143
	(-8.56)	(-6.76)	(-8.21)	(-7.78)	(7.90)	(6.57)	(9.645)	(8.88)
FSA_{it}	-0.1458 *		-0.4956 *		0.1884 *		0.2053 *	
	(-2.01)		(-4.11)		(4.33)		(4.58)	
FSE_{it}		-0.1785 *		-0.4123		0.3123		0.3171 *
		(-1.31)		(-3.43)		(3.55)		(3.85)
CSR_{it} * FSA_{it}	-1.135 ***		-0.8952 **		0.1799 *		0.2122	
	(-4.65)		(-3.11)		(2.34)		(4.34)	
CSR_{it} * FSE_{it}		-1.313 ***		-1.1342 **		0.2212		0.1487
		(-4.89)		(-3.12		(2.39)		(5.78)
Control Variables								
ABS_DA_{it}	0.0046	0.0062	-0.151	-0.149	0.0422	0.0503	0.0144	0.0134
	(0.74)	(0.66)	(-3.14)	(-3.11)	(2.21)	(1.93)	(1.30)	(1.02)
$CASH_{it}$	0.0075	0.0089	-0.029	-0.25	-0.0359	-0.0454	-0.01979	-0.0201
	(0.89)	(0.73)	(-3.98)	(-4.22)	(-1.64)	(-1.79)	(-1.34)	(-1.59)
LEV_{it}	0.0299 **	0.02965 **	0.0093 **	0.012 ***	-0.04424 *	-0.0445 ***	-0.0333 ***	-0.0461 ***
	(1.97)	(1.94)	(1.469)	(1.544)	(-3.43)	(-4.29)	(-2.44)	(-2.75)
NOL_{it}	0.0134 ***	0.0191 ***	0.0059 ***	0.0067 **	-0.0291 ***	-0.0334 ***	-0.0179 ***	-0.1832 **
	(5.24)	(5.24)	(2.59)	(2.78)	(-4.651)	(-5.923)	(-4.605)	(-4.79)
ΔNOL_{it}	0.0454 ***	0.0655 ***	-0.0276 **	-0.0321 ***	0.0678 ***	0.0734 ***	0.0633 ***	0.0591 *
	(2.82)	(2.69)	(-1.55)	(-1.73)	(3.11)	(3.98)	(2.31)	(2.21)

TABLE 2.5 (continued)

	$DTAX_{it}$		DD_BT_{it}		ETR_{it}		$CETR_{it}$	
	OLS		OLS		OLS		OLS	
Variable Name	**Model 1**	**Model 2**	**Model 3**	**Model 4**	**Model 5**	**Model 6**	**Model 7**	**Model 8**
FI_{it}	0.1364 ***	0.1443 ***	-0.2976 ***	-0.323 ***	-0.1821 ***	-0.232 ***	-0.1308 ***	-0.144 ***
	(2.47)	(2.78)	(-14.79)	(-13.72)	(-3.22)	(-4.92)	(-2.35)	(-2.74)
PPE_{it}	0.0155 ***	0.0149 **	0.134 ***	0.1124 ***	-0.0491 ***	-0.061 ***	-0.0255 ***	-0.0312 **
	(1.14)	(1.27)	(2.12)	(1.76)	(-2.49)	(-2.33)	(-2.11)	(-2.41)
$INTANG_{it}$	-0.0048	-0.0062	-0.0001	-0.0002 **	0.00911	0.0084 **	0.0087 *	0.0091 **
	(-0.42)	(-0.45)	(-0.03)	(-0.03)	(0.89)	(0.92)	(0.71)	(0.68)
$EQINC_{it}$	-0.8242 **	-0.889 *	-1.4111 **	-1.5123 *	-1.2149 ***	-1.234	-0.8121	-0.7861 *
	(-2.33)	(-3.23)	(-5.22)	(-4.91)	(-1.96)	(-2.11)	(-1.31)	(-1.39)
$R\&D_{it}$	0.1554 ***	0.14675 ***	-0.0299 ***	-0.0323 ***	-0.14922 **	-0.1543 ***	-0.12121 ***	-0.1291 ***
	(3.32)	(4.34)	(-1.74)	(-1.79)	(-4.01)	(-3.56)	(-2.912)	(-3.21)
EMP_{it}	0.0034	0.005 *	0.0032 ***	0.0029	-0.009 **	-0.0081	-0.0033 ***	-0.0025
	(1.35)	(1.37)	(2.22)	(2.19)	(-1.32)	(-1.25)	(-0.92)	(-0.79)
$\Delta SALE_{it}$	0.0278 ***	0.0335 ***	-0.0051 **	-0.00478 ***	-0.0911 ***	-0.0349 ***	-0.0732 ***	-0.0741 ***
	(3.24)	(2.99)	(-0.81)	(-0.89)	(-6.02)	(-6.08)	(-5.44)	(-5.21)
$SIZE_{it}$	-0.0094 ***	-0.0094 **	-0.0071 ***	-0.0078 ***	-0.0049 ***	-0.00833 **	-0.0011 ***	-0.0029 ***
	(-5.15)	(-4.92)	(-4.31)	(-6.67)	(-0.45)	(-0.50)	(-0.41)	(-0.30)
MB_{it}	-0.0014	-0.0017 *	-0.00033	-0.00032	0.0004 *	0.0009	0.00022	0.00029
	(-0.31)	(-0.38)	(-1.81)	(-1.74)	(1.92)	(1.82)	(1.22)	(1.21)
Intercept								
Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Adjusted R^2	0.1402	0.1398	0.4325	0.4211	0.2541	0.2641	0.2111	0.2165
Number of Observations	6252	6252	4328	4328	8958	8958	8622	8622

*, **, *** Indicate significance at the 10 percent, 5 percent, and 1 percent levels, respectively.
t-statistics and z-statistics, reported in parentheses, are based on standard errors clustered at the firm level.

Table 2.5 presents the results of the main regressions (Models 1-8) while excluding the KLD categories of employee relations and corporate governance. For the first independent variable of interest (CSR) I find similar results to the main tests. The first tax aggressiveness proxy, DTAX, results in a negative coefficient for CSR (-0.2312) which significant at the .1 level in Model 1 (defining financial sustainability as an asset based measure), and a negative coefficient for CSR (-0.2965) which is also significant at the .1 level for Model 2 (defining financial sustainability as an equity based measure). For the second tax aggressiveness proxy, DD_BT, I find a negative coefficient for CSR (-0.3343) which significant at the .05 level in Model 3 (asset based financial sustainability), and a negative coefficient for CSR (-0.3454) which is not significant at conventional levels in Model 4 (equity based financial sustainability). For the first general tax avoidance (non-aggressive) proxy, ETR, I find a positive coefficient for CSR under Model 5 (0.1211) and Model 6 (0.1133), however, neither is significant at conventional levels. For the second general tax avoidance proxy, CETR, I find a positive coefficient for CSR under Model 7 (0.1264) which significant at the .1 level, and a positive but insignificant coefficient for CSR in Model 8 (0.1143).

The above results are largely in line with the main test of H1. That is, there is not a strong relationship between CSR and tax avoidance/aggressiveness.

My robustness test for H2 finds similar results to the main tests as well. For the first tax aggressiveness proxy, DTAX, I find a negative coefficient for FSA (-0.1458) which significant at the .1 level in Model 1 (defining financial sustainability as an asset based measure), and a negative coefficient for FSE (-0.1785) which is significant at the .1 level in Model 2 (defining financial sustainability as an equity based measure). For the

second tax aggressiveness proxy, DD_BT, I find a negative coefficient for FSA (-0.4956) which significant at the .1 level in Model 3 (asset based financial sustainability), and a negative coefficient for FSE (-0.4123) which is not significant at conventional levels in Model 4 (equity based financial sustainability). For the first general tax avoidance proxy, ETR, I find a positive coefficient for FSA under Model 5 (0.1884) which is significant at the .1 level, and for Model 6 I find a positive coefficient for FSE (0.3212), however, it is not significant at conventional levels. For the second general tax avoidance proxy, CETR, I find a positive coefficient for FSA under Model 7 (0.2053) and a positive coefficient for FSE in Model 8 (0.3171). Both are significant at the .1 level.

The mixed significance across both measures of economic sustainability results in only marginal support for H2 just as in the main test of H2.

Finally, I test the robustness of the interaction between CSR based sustainability and economic sustainability. For the first tax aggressiveness proxy, DTAX, I find a negative coefficient for my interaction (-1.135) which significant at the .01 level in Model 1 (defining financial sustainability as an asset based measure), and a negative coefficient for my interaction (-1.313) which is also significant at the .01 level for Model 2 (defining financial sustainability as an equity based measure). For the second tax aggressiveness proxy, DD_BT, I find a negative coefficient for my interaction (-0.8952) which significant at the .05 level in Model 3 (asset based financial sustainability), and a negative coefficient for my interaction (-1.1342) which is significant at the .05 level in Model 4 (equity based financial sustainability). For the first general tax avoidance (non-aggressive) proxy, ETR, I find a positive coefficient for my interaction under Model 5 (0.1799) which is significant at the .1 level, and a positive coefficient for my interaction

(0.2212) Model 6 which is not significant at conventional levels. For the second general tax avoidance proxy, CETR, I find a positive coefficient for my interaction under Model 7 (0.2122) and a positive coefficient under Model 8 as well (0.1487), however, neither is significant at conventional levels.

Overall the robustness tests for each hypothesis find similar results to the main tests of H1, H2, and H3.

VII. CONCLUSION AND CONTRIBUTIONS

My study finds that firms that score high in both social and financial responsibility are far less likely to engage in aggressive tax avoidance behavior than their less responsible peers. My paper contributes to a fast growing body of CSR literature in accounting (Dhaliwal et al. 2012; Hoi et al. 2013; Lanis and Richarson 2012) as I provide insight on the impacts of both social and financial responsibility on the tax avoidance behavior of firms. Unlike prior research which focused on one dimension of responsibility and one dimension of tax avoidance, this paper compares the impacts of social and financial responsibility on both aggressive and non-aggressive tax avoidance behavior.

These findings are relevant to public policy as I have provided a more comprehensive profile of what firms are most likely to engage in aggressive tax avoidance. Firms that are engage extensively in corporate social responsibility activities and maintaining economic fundamentals are less likely to use the most aggressive tax schemes. Tax shelters and permanent book tax differences are far more common in less responsible peer firms. This could allow regulators to target more precisely companies that might be using suspect tax planning. Targeting said companies could earn nations

revenue that would otherwise be lost. As a cautionary note to regulators, however, highly responsible firms appear more than willing to engage in less aggressive methods of tax avoidance. This explains why larger firms are still quite often able to pay somewhat low rates even though they are not found to be taking on aggressive tax avoidance.

My Study is limited by the data used. Like all archival tax studies using public data, my study is unable to determine which "aggressive" tax behaviors are actually illegal. While prior literature (e.g., Wilson 2009) supports the claim that tax aggressiveness proxies are likely to capture some illegal (and thus unethical and risky) behaviors, there is no way to ensure that any given tax aggressiveness proxy actually represent unethical behavior without access to private company or IRS data. While obtaining this type of data is difficult, it would provide a good opportunity for future research in this area. Future researchers can also expand upon this study by using new measures of tax avoidance. As CSR can be seen as a positive disclosure reducing risk, the creation and use of new "Tax Risk" proxies could be a focus of future research.

CHAPTER 3

THE IMPACTS OF AN ETHICAL PROMPT AND THE IRS'S NAME ON THE ACCEPTANCE OF TAX EVASION

I. INTRODUCTION

A large component of the U.S. income tax reporting system relies on voluntary taxpayer compliance. While some forms of income tax reporting involve information easily verifiable by the IRS (e.g., W2 income), a significant amount of information is almost unverifiable (e.g., undocumented cash-based income for small projects). The fact that the IRS relies heavily on unverifiable information has resulted in significant noncompliance (approximately $450 billion annually[1]). While some scholars (e.g., Slemrod 2007) claim that tax evasion (tax fraud) is a largely unsolvable problem, others see potential solutions. Specifically, Mazar et al. (2008) suggest that findings of their ethics research could be used to curb tax evasion, and to my knowledge, the primary findings of Mazar et al. (2008) have yet to be applied to the tax evasion setting. Mazar et al. (2008) study the positive impacts of an ethical prompt on the reporting honesty of their experiment's participants. They find that ethical prompts are effective fraud deterrents even in settings where participants can commit fraud without the risk of being caught.

Following Mazar et al. (2008), my study puts forth a potential solution to the tax evasion problem. I propose that an ethical prompt should be coupled with the delivery mechanisms contained in the IRS's tax preparer code of conduct—Circular 230. Under

[1] The estimated tax gap per the IRS was $385 billion in 2006 even after enforcement actions were undertaken to close it from the original $450 billion. http://www.irs.gov/uac/IRS-Releases-New-Tax-Gap-Estimates;-Compliance-Rates-Remain-Statistically-Unchanged-From-Previous-Study

Circular 230, tax preparers are mandated to prompt taxpayers on certain issues. A mandated ethical prompt delivered through Circular 230 would ensure that taxpayers are made aware of their moral obligations to the financial status of the nation. However, my study also recognizes that part of the underlying tax compliance problem in the U.S. is the reputation of the IRS itself. I theorize that there are two potential reasons for why American citizens would be more willing to commit fraud against the IRS than against another agency. First, the IRS is an organization lacking the public's approval[2] and trust (Scholz and Lubell 1998). Second, as the IRS is a national organization as opposed to a local organization[3], the IRS lacks close proximity to American citizens. Jones (1991) states that the proximity of a moral issue is the feeling of nearness (social, cultural, psychological, or physical) that an individual has to an act in question. For example, layoffs at an employee's work unit have a greater moral proximity to an individual than layoffs at an overseas office. According to Jones (1991), it is intuitive that people care more about others who are close to them (either socially, culturally, psychologically, or physically). Jones (1991) theorizes that a lack of proximity reduces the perceived severity of immoral acts.

My study uses experimental methodology and provides each participant with a case involving tax evasion. To test the impact of the IRS's name on the acceptance of tax evasion I show half of the participants a case involving fraud against the IRS, and half of the participants a case involving fraud against their state's revenue collector. Each

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[2] In the wake of various IRS scandals Gallup has found a sharp downward trend in the perceptions of the IRS. http://www.gallup.com/poll/162764/americans-views-irs-sharply-negative-2009.aspx

[3] It should also be noted that state governments overall have higher approval when compared to their federal counterparts. See, for example, a recent Pew Poll: http://www.people-press.org/2013/04/15/state-govermnents-viewed-favorably-as-federal-rating-hits-new-low/

participant is also treated with either an ethical prompt, a legal prompt, or no prompt to test whether or not tax fraud can be reduced as predicted in Mazar et al. (2008). 100 Participants were drawn from the United States in order to investigate these relationships.

First, I find that the IRS is a less effective revenue collector than its state level counterparts. That is, participants felt that tax fraud against the IRS was a less morally problematic issue, and participants who dealt with the IRS in their case were more likely to admit that they would commit tax fraud if the chance arose. Second, my study's results found that the ethics based approach found in Mazar et al. (2008) applies to the tax evasion setting. In line with Mazar et al. (2008), I find that ethical prompts can reduce the acceptance of tax evasion.

My study has several implications for public policy. To avoid the negative effects that their name has on taxpayers, the IRS must work on a long-term rehabilitation of their image. Another option would be the nation placing a greater focus on state level revenue collection to avoid the IRS's image and proximity issues. Revenue collecting organizations can also attempt to reduce tax fraud by mandating (or suggesting) the dissemination of ethical prompts to taxpayers. The IRS could either require tax preparers to deliver an ethical prompt to taxpayers, or tax preparers (or organizations supporting them) could voluntarily adopt the practice of delivering a prompt to reduce client risk.

The remainder of this paper is organized as follows. Section III discusses the somewhat unique fraud of tax evasion; Section IV develops my hypotheses; Section V discusses the design and execution of my study; Section VI discusses the descriptive statistics, Pearson correlations, and main regression results; and finally, Section VII concludes the paper and proposes possible future research.

II. BACKGROUND—TAX EVASION

I posit that tax evasion is a form of fraud that cannot be properly confronted with the standard IRS approach of legal threats. In many cases, enforcement of tax law is not simply difficult, it is nearly impossible without the consent of the taxpayer. Therefore, threats of punishment arguably have little impact on a taxpayer—the taxpayer is aware that the threats cannot be carried out. The prime example of unenforceable tax policy leading to rampant tax evasion is the cash-based self-employed taxpayer. Many—if not most—taxpayers involve themselves in some cash-based transactions. These transactions are almost untraceable by the IRS. For example, a taxpayer may mow a lawn, fix a car, or prepare a tax return without leaving a paper trail. While all of these are minor examples of cash-based self-employment income, entire businesses can be run on the concept of tax evasion. For example, restaurants that give customers discounts for cash payments (then fail to report their cash revenue) can run undetectable—and potentially large-scale—tax evasion schemes.

Prior research into self-employed taxpayers indicates that the above referenced anecdotes are true. That is, prior literature indicates vastly higher amounts of tax evasion for the self-employed portion of the population. Pissarides and Weber (1989) use novel methodology to show that the average self-employed taxpayer evades taxes at over twice the rate of their peers. According to fraud theory these high tax evasion rates are expected. Basic fraud theory is often anchored around the observations of Cressy (1950, 1953), and these works comprise the basis for constructing the fraud triangle (i.e., the three conditions that are required to support fraud). Normally, for fraud to occur there must be 1) Opportunity, 2) Rationalization, and 3) Financial Pressure. In the case of self-

employed individuals the opportunity side of the fraud triangle is an especially weak point of the tax system. There is no efficient or effective way the IRS can eliminate the opportunity for tax fraud when dealing with some cash-based taxpayers. Barring undercover agents, oppressive surveillance, or absurd amounts of obvious fraud, the opportunity for tax evasion is nearly unchecked in many situations.

As the opportunity is nearly endless for some taxpayers, and because financial pressure is a variable the IRS cannot impact, that leaves the only solution to preventing tax fraud on the rationalization side of the fraud triangle. One explanation of how individuals rationalize fraud is found in Mazar et al. (2008). Their study asserts that individuals can internally categorize dishonest acts into honest/moral acts. In the tax evasion context, a poor small business owner could potentially categorize their fraudulent actions as ethical when dealing with customers in cash (and subsequently failing to report the revenue to the IRS). The small business owner might rationalize that their unreported income allows them to make a higher profit to support their poor family. Even before analyzing my study's data, I noted that a significant number of taxpayers used the comments section to categorize tax fraud into a beneficial act. For example:

> "I see very little risk in doing this, and the money would be better spent by Pat."
>
> "$4,000 could make the difference for some people getting on a type of assistance or not and therefore would allow the assistance to go to someone else. It also generates other revenues by being spent into the economy."
>
> "I would understand if a friend did it because you never know someone's situation. If I had to I would do the same."

These anecdotal categorization-based rationalizations are supported in tax research. For example, Andreoni et al. (1998) found that participants appeared to rationalize tax fraud by claiming that fraud was a reasonable response when dealing with a “bad” government. However, Mazar et al. (2008) did find that an ethical prompt was able to significantly reduce this behavior of rationalization, and I hope to find that their research applies to the tax evasion context. Based on the unique structure of tax fraud, the problem cannot be confronted with more conventional means.

Prior behavioral tax literature has attempted to find methods that prevent highly aggressive or illegal tax strategies from being used; however, little progress has been made. Cuccia et al. (1995) found that the two types of legalistic prompts that the IRS uses are largely ineffective at reducing preparer aggression. I postulate that legalistic preparer-targeted prompts are ineffective because taxpayers influence the aggressiveness of tax preparers (Cloyd and Spiker 1999; Hite and McGill 1992; Spilker et al. 1999). Some research has shown that tax preparers are not the problem, but preparers actually support the revenue collection system by attempting to avoid taking high risk positions that their clients propose (Kadous and Magro 2001; Kadous et al. 2008). Researchers postulate (Kadous and Magro 2001; Kadous et al. 2008) and commonsense indicates that tax preparers prefer to work with low risk tax positions to avoid the possibility of preparer penalties. However, a large portion of tax evasion comes from the simple omission of revenue (or the padding of expenses) on the part of clients. These behaviors are generally not observable by the tax preparers. Therefore, whether the preparer is aware of the fact or not, they may be preparing a fraudulent return on behalf of the taxpayer. Regardless of the professional and ethical requirements placed on the preparer, he/she cannot prepare

correct returns if the taxpayer never tells the preparer about omitted income. Based on the above discussion I perceive taxpayers to be the drivers of tax evasion, and thus they will be my study's target. While I recognize that it is undoubtedly easier to enact policies that focus on tax preparers rather than taxpayers (there is a substantially smaller number of preparers and they often are part of organizations that can disseminate information such as a code of ethics), there are methods to target and prompt taxpayers in the law today—specifically, Circular 230[4].

Under Circular 230—a code of professional conduct—various requirements are placed on the tax preparer. One such requirement is that tax preparers ask taxpayers if they have foreign bank accounts[5]. It appears that such a requirement is the IRS's attempt at prompting taxpayers into honestly complying with tax laws. This same mechanism could be used to deliver other prompts, such as the ethical prompt that I suggest in this study. An ethical prompt delivered through Circular 230 could reach a large number of taxpayers and decrease a taxpayer's ability to rationalize potential tax fraud.

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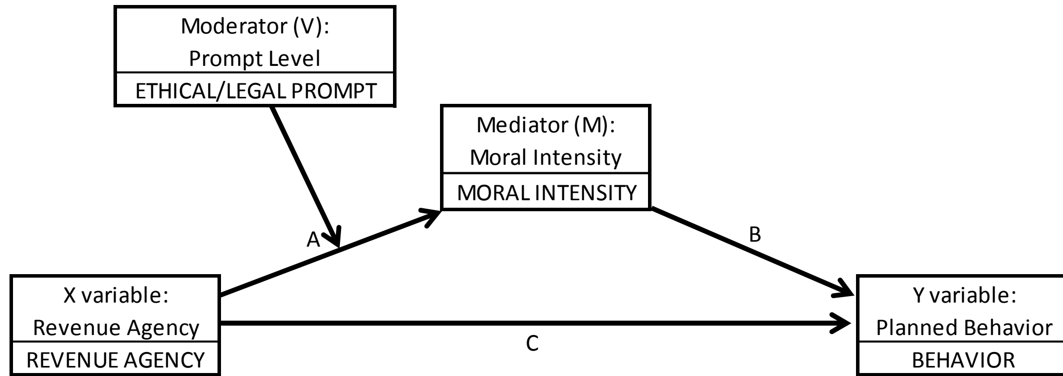
[4] Circular 230 is provided in the following link; however, various other documents expand upon the basic pronouncements within. http://www.irs.gov/pub/irs-pdf/pcir230.pdf

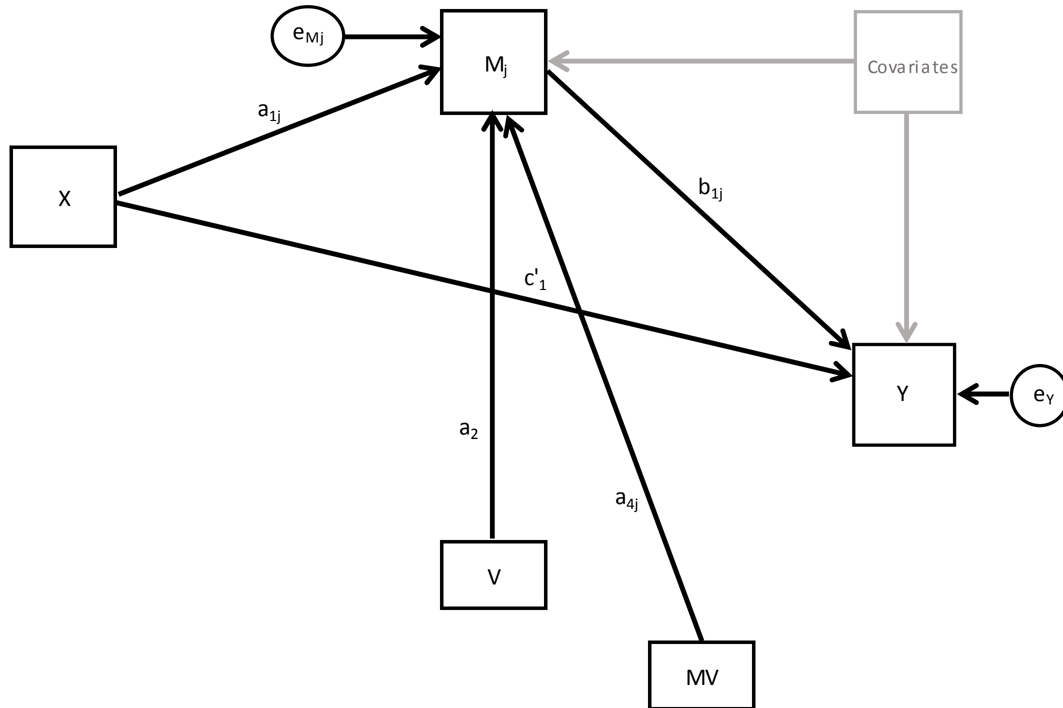
[5] Explicit guidance on applying Circular 230 in the area of foreign bank accounts: http://www.irs.gov/pub/irs-utl/fbar_document_on_irs_gov_ver_08-04-10.pdf

FIGURE 3.1
Moderated Mediation Model from Hayes (2013)

Panel A: Conceptual Model:



Panel B: Statistical Model:



Notes:
X is the causal variable, M is the mediator, V is the moderator, and Y is the outcome.
a, b, and c' are the regression coefficients in the estimation models of M ansd Y; and e_{Mj} and e_Y are errors in the estimates of M and Y respectively.
The names of the constructs are in the top portion of the boxes in Panel A.
The names of the variables as used in Tables 1-4 are in capital letters in the bottom portion of the boxes in Panel A.

III. HYPOTHESIS DEVELOPMENT

Model Design

My hypotheses are developed around a "Moderated Mediation Model" (Figure 1). Using Figure 1 I aim to test the impacts of the IRS's name and an ethical prompt on the acceptability of tax fraud. Figure 1 is adapted from Hayes's (2013) PROCESS document and is tested by using his PROCESS tool. This methodology is gaining popularity in accounting literature (e.g., Bailey 2015; Schmidt 2014) and it replaces older methods proposed by Barron and Kenny (1986). The dependent variable (BEHAVIOR) is measured by the participant's response to whether or not they would commit tax fraud. The independent variable (REVENUE AGENCY) is manipulated at two levels. Participants are presented with either a case dealing with the IRS or their state revenue collection agency. The moderator variable is ETHICAL/LEGAL PROMPT. Participants randomly receive either an ethical prompt, a legal prompt, or no prompt. The mediator variable is the participant's ranking of the moral intensity (MORAL INTENSITY) of the scenario provided to them.

I first posit that the IRS's name has an impact on the acceptance of tax evasion. This relationship might be direct (Relationship C in Figure 1), or indirect though moral intensity (Relationships A and B in Figure 1). Many known cases of abuse have been perpetrated by the IRS, and the IRS has historically been used as a weapon by various political administrations[6]. Due in part to the IRS's behavior, recent survey findings by

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[6]The following link relates to the recent IRS scandal under a Democratic administration: http://online.wsj.com/news/articles/SB10001424052702303603904579493831524666494.
The following link relates to the 2006 IRS scandal under a Republican administration: http://online.wsj.com/news/articles/SB114291044305003774?mg=reno64-wsj&url=http%3A%2F%2Fonline.wsj.com%2Farticle%2FSB114291044305003774.html

polling organizations (e.g., Gallup[7]) have found that the IRS suffers from significant disapproval. Therefore, I expect that rationalizing tax fraud is made easier simply by the fact taxpayers are dealing with the IRS. While individuals generally dislike organizations which take money from them, the IRS's name likely exacerbates the problem.

I posit that there are two major reasons that the IRS's name makes taxpayers more likely to commit tax fraud. The first reason, related to the above discussed disapproval of the IRS, is a lack of trust. Rousseau et al. (1998) define trust as "a psychological state comprising the intention to accept vulnerability based upon positive expectations of the intentions or behavior of another," and Scholz and Lubell (1998) show that many taxpayers do not consider the IRS a trustworthy organization. In the tax evasion setting, it appears that few United States citizens feel that the IRS exhibits positive intentions or behaviors. Therefore, I speculate that the participants are unlikely to feel guilty being dishonest with the IRS.

Apart from my speculation, business literature has shown that trust plays an integral part in facilitating the successful operation of various types of organizations. When an organization lacks the trust of those who interact with it (in this case, taxpayers) the costs to the organization are potentially high. Dirks and Ferrin (2001) showed that subordinates lacking trust in their organization are less willing to engage in various behaviors that support their organization. Robinson (1996) showed that subordinates are prone to enter a state of "withdrawal" when they lack trust in their organization. As a final example, Bies and Tripp (1996) showed that subordinates are likely to retaliate against an entity they distrust. I assert that the public's lack of approval and trust in the

[7]The IRS received only 41% approval in a recent American public opinion poll http://www.gallup.com/poll/162764/americans-views-irs-sharply-negative-2009.aspx

IRS allow participants to more easily rationalize their retaliation against the IRS: Tax fraud.

The second likely reason that the IRS is an inefficient revenue collection agency is psychological or social distance. According to Jones (1991), if the victim of an unethical act is distant from an individual, that individual will view the act as less severe. Measures of Jones's concept of distance have generally been broad in prior literature. Many studies (e.g., Barnett and Valentine 2004; Carlson et al. 2002) assume that entities or individuals either physically far from or unaffiliated with an individual are broadly perceived as more physically, socially, and psychologically distant. I take this approach in my study and postulate that the IRS is distant to the participant in a broad sense when compared to state revenue authorities (physically, socially, and psychologically). Due in part to distance, I postulate that tax fraud against the IRS will be seen as less severe than tax fraud against a state revenue agency. To test the impact of distance in my study I randomly assign participants to a case which deals with either the IRS or their state's revenue agency.

In summation, I expect that those taxpayers dealing with the IRS will be more capable of rationalizing fraudulent behavior against the IRS than against their state's revenue agency due to both distance and distrust. Taxpayers believe they are taking money from an untrustworthy agency that has a substantial distance from them.

From this discussion H1(a) is derived:

H1(a): Individuals dealing with the IRS will be more willing to commit tax fraud than those dealing with their state agencies.

According to the issue contingent model in Jones (1991), an individual perceives moral intensity based on the facts of a situation and then translates that intensity into behavior. In line with Jones's (1991) theory I posit that the hypothesized relationship in H1(a) is mediated by an issue's moral intensity as seen in Figure 1, Panel A. The proposed mediating variable, moral intensity, is defined as a construct that captures the extent of issue-related moral imperative in a situation (Jones 1991). Jones (1991) hypothesizes that moral intensity precedes moral decision making and moral intensity eventually impacts behavior.

Jones (1991, 384) argues that his view "is intuitive, theoretical, and empirical. From an intuitive perspective, because moral reasoning takes time and energy (e.g., gathering facts, applying moral principles, and making moral judgments [Velasquez, 1982]), it is likely that moral agents will economize on efforts devoted to moral reasoning when moral stakes are low." To summarize Jones's (1991) sentiment in my study's setting: First, a taxpayer judges the moral intensity of tax evasion based on the agency being defrauded, then the taxpayer translates that intensity into action (i.e., they decide whether or not to commit fraud). If the participant perceives "the stakes are low" (i.e., not morally intense) they will not engage in advanced reasoning and simply default to the logical course of action. Tax evasion is logical from a purely financial perspective if a taxpayer is dealing with untraceable income, and I postulate that my descriptive statistics will show that tax evasion is the default choice of most Americans. If, however, the participant perceives tax evasion as a morally intense act they may reason the situation through and decide against tax evasion on moral grounds.

I hypothesize that taxpayers experience less moral intensity when dealing with the IRS (Figure 1, Panel A, Relationship A) as they feel their small contribution to a very large and distant organization simply won't make a difference. That is, the relationship in H1(a) is mediated by moral intensity (see Figure 1) From this discussion H1(b) is derived.

H1(b): Individuals dealing with the IRS will experience less moral intensity than those dealing with their state.

Furthermore, as asserted by Jones (1991), increased moral intensity leads to increased moral considerations and internal deliberations. This increased intensity will lead to less willingness to commit tax fraud (Figure 1, Panel A, Relationship B. From this discussion H1(c) is derived.

H1(c): Individuals who perceive higher moral intensity will be less willing to commit tax fraud.

I now move to develop the hypotheses relating to the moderator variable (V) in Figure 1, Panel A. Jones (1991) believes that a combination of moral intensity and personal ethics drive behavior; however, some scholars doubt that ethical reasoning ever enters the minds of individuals considering fraud. These scholars (e.g., Allingham and Sandmo 1972; Becker 1968; Hechter 1990; Lewicki 1984) believe that individuals decide whether or not to commit crimes based only on the economic tradeoffs of a particular situation. According to Becker (1968), potential criminals are simply rational actors deciding whether they are better off committing a crime or doing the right thing. Ethics have essentially no place in these agency based theories. If it is profitable to rob banks because the laws punishing bank robbers are low, people will rob banks at a significant

rate. However, I expect to find that my ethical prompt will discourage the acceptance of tax evasion, based on the findings of Mazar et al. (2008). Mazar et al. (2008) discard the pure agency theory viewpoint and instead theorize that individuals value their ethics and honesty, and individuals will not perform acts that destroy their self-concept of honesty. Following the theory and results of Mazar et al. (2008), even if the punishment for bank robbery were minimal, most people would still not rob banks as they would be forced to negatively update their self-concept. That said, Mazar et al. (2008) theorize that individuals are able to keep a clear conscience while still performing some dishonest actions. This is possible if individuals internally categorize unethical actions as ethical. For example, an individual might rob a bank and keep a positive (ethical) self-concept if the bank owed the robber money. The robber would simply categorize the robbery as money being repaid. The findings of Mazar et al. (2008) show, however, that prompting an individual with an ethical code makes it harder to justify such a moral re-categorization.

In line with the reasoning in Mazar et al. (2008), I propose that taxpayers would be less likely to rationalize (re-categorize) tax evasion if they were provided with an ethical prompt by their tax preparer just prior to potential dishonest reporting. While there are few examples of research regarding ethical prompts in accounting literature, a handful of relevant studies do exist. Davidson and Stevens (2013) consider the impact of a code of ethics on manager behavior and investor confidence. They find that a simple code of ethics does improve manager behavior and investor confidence when the code is certified by the manager. Black and White (2012) test how effective various types of prompts (including the AICPA code of ethics) are at discouraging illegal behavior. They find that

the AICPA code of ethics is the most viable prompt tested—perhaps due to its references to responsibility and duty.

When considering all business literature there are a greater number of examples (e.g., Griffin and Mahon 1997; Helin and Sandstrom 2007; Preston and O'Bannon 1997; Stevens 1994); however, the results of these studies are mixed. In line with Moyes and Park (1997), I postulate that the mixed results found in ethics research stem from the fact that the majority of ethical prompts are poorly conceived and not informative to decision making. Moyes and Park (1997) surveyed CFOs on their agreement with ethical codes. While they found that most CFOs agreed with the principles within the codes presented to them, the CFOs stated that the impact the codes had on decision making was minimal. The codes of ethics imparted no new knowledge and were "merely common sense."

Lere and Gaumnitz (2003) postulate that codes of ethics should have "uniqueness" so that codes are not perceived as "merely common sense." To accomplish this in the tax evasion setting I will use an ethical prompt presenting the purpose and mission of a revenue collection agency in a way that the taxpayer is not accustomed to seeing. Participants must certify the prompt (in line with Davidson and Stevens 2013), and the prompt will present information about a taxpayer's duty to support the mission of the revenue collection agency and the nation (in line with Black and White 2012). This approach differs substantially from the IRS's current public relations strategy. In its "Taxpayer Bill of Rights," the IRS states that its goal is to: "Provide America's taxpayers top-quality service by helping them understand and meet their tax responsibilities and enforce the law with integrity and fairness to all.[8]" If there is a section of the Internal

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[8] An excerpt from the taxpayer bill of rights: http://www.irs.gov/pub/irs-pdf/p1.pdf

Revenue Code which states the benefits that the IRS provides to the nation, as well as a citizen's duty to support these benefits, I am unaware of it.

In line with Mazar et al. (2008) and research that has built off that study in accounting literature (e.g., Davidson and Stevens 2013), I expect that prompting the taxpayer with the moral value of tax compliance will reduce the acceptance of tax evasion. When given an ethical prompt it should be much more difficult to rationalize tax evasion by claiming the system is unfair and unhelpful as taxpayers appeared to in Andreoni et al. (1998). I expect that the ethical prompt provided will act as a moderating variable (for Relationship A in Figure 1, Panel A. Therefore the ethical prompt will indirectly decrease the acceptance of tax evasion by increasing moral intensity as noted in H1(c). I posit that these ethically prompted participants will be less likely to act on their instinctual dislike of the IRS when they are faced with the benefits it provides. From this discussion H2(a) is derived:

H2(a): The relationship between the revenue agency presented and moral intensity will be strengthened by an ethical prompt.

To provide evidence that an ethical prompt is more effective than the more common alternative choice—a legal prompt—I also test a legal prompt for comparative purposes. I postulate that legal threats will be not be an effective means of reducing tax fraud as the punishments threatened could only apply if the participant was caught. Catching certain forms of tax evasion is nearly impossible, and the case presented to participants explicitly makes clear that the tax evasion in question will likely not be discovered. The legal prompt is based on the statement found above the signature line of the IRS's Form 1040. From this discussion H1(b) is derived:

H2(b): The relationship between the revenue agency presented and moral intensity will not be weakened by a legal prompt.

IV. DESIGN AND EXECUTION OF THE STUDY

Participants

One hundred eighty-four United States participants were directed to my study through an online survey-taking tool: Amazon Mechanical Turk (hereafter MTurk)[9]. The use of MTurk participants is becoming more popular in social science literature (Brandon 2013; Berinsky et al. 2012), in part because MTurk participants are drawn from a large subject pool and are readily available to researchers. Various studies have also found that MTurk participants are at least as representative of the overall population as the student pools that are frequently used in social science research (Berinsky et al. 2012; Paolacci 2010; Renekamp 2012). Furthermore, studies run with MTurk participants have successfully replicated a wide range of judgment decision making research (Horton and Chilton 2010; Paolacci 2010).

Each participant was paid a $1.50 flat fee for their participation. While the compensation rate in my study appears low when compared to the lab experiments often conducted in social science research, my experiment was designed to last no more than 10 minutes. The average actual time spent on the survey was slightly under 5 minutes. This resulted in an hourly compensation rate of over $18.00/ hour. This rate is well above

[9] A Canadian sample was also obtained with MTurk. After preliminary analysis I decided to focus only on the U.S. sample for this study as the Canadian sample and U.S. sample exhibited opposing relationships between national and local agencies. This opposing relationship appears to relate to theory that is not discussed in this study.

the federal minimum wage[10], and is also significantly higher than the average hourly rate on MTurk according to Horton and Chilton (2010). Further, Berinsky et al. (2012) found that rates well below those used in my study garnered significant participant interest on MTurk. My results are in line with the findings of Berinsky et al. (2012). That is, I obtained my entire sample is under 24 hours. MTurk is able to operate at a high speed and low cost as participants do not demand the additional compensation that they require when they must come into a lab. Physically showing up is far more difficult and time consuming than simply clicking through a brief survey online, and thus, MTurk results in costs savings without reducing participant motivation or quality (Bloomfield and Rennekamp 2009).

Software Utilized

To participate in my study participants entered the MTurk interface a selected a link which then brought them to the Qualtrics Survey Software website (hereafter Qualtrics). To participate, participants had to pass a short screening process. The screening and main survey took place on the Qualtrics website. Doing the survey on the native MTurk interface would not have been feasible as MTurk lacks the functionality to set up different treatment groups. However, Qualtrics can randomly assign participants into various treatment conditions after a participant is linked to a survey. Qualtrics also can ensure that each treatment condition is shown at an equal rate, and this feature was used in my study. This general approach is suggested in Berinsky et al. (2012) and has been recently used in accounting research (e.g., Rennekamp 2012).

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[10] The federal minimum wage: http://www.dol.gov/dol/topic/wages/minimumwage.htm, updated in 2009

Instrument

My study's full instrument is seen in Appendix B. In the first phase, I obtained the informed consent of all participants who attempted the survey in line with Institutional Review Board guidelines. In the second phase, I screened out unwanted participants. While individuals of almost any age can file a tax return, those not working are generally not required to file a tax return. This is because most non-working participants meet certain criteria allowing them to avoid filing a personal income tax return—usually due to low income levels[11]. I determined that the opinions of non-filers were less relevant to my study, as I am trying to obtain the responses of taxpayers. Therefore, I screened out all potential participants who had not been working in the United States for three or more years at a job paying more than $10,000/year. This ensures that all participants are somewhat experienced taxpayers who have dealt with the IRS. As the level of income required to file a tax return changes when a participant is married, I also asked the marital status of the participants. This marital status variable was also used as a covariate in my study, as the tax code drastically changes the relationship between an individual and the IRS once they are married[12].

Once the screening process was completed, the participants advanced to the third phase of the instrument and were randomly assigned to receive either an ethical prompt, a legal prompt, or no prompt. Those in the ethical prompt group received the following prompt:

[11] An IRS tool designed to inform taxpayer if they are required to file a tax return. Low income often allows taxpayers to avoid filing: http://www.irs.gov/uac/Do-I-have-to-File-a-Tax-Return%3F

[12] http://www.irs.com/articles/how-getting-married-affects-your-taxes

The (IRS/Local Agency) relies on the honesty and integrity of taxpayers. The revenue collected by the (IRS/Local Agency) provides the primary financial support of the (federal/state) government, and the (federal/lstate) government promotes programs supporting the health, safety, and financial wellbeing of (American families/families in your state). Insufficient (IRS/Local Agency) revenue can damage these programs and the people who benefit from them.

Those participants in the legal prompt group received the following prompt based on the signature line of the IRS's Form 1040:

Misstating tax information is an offense that is subject to the penalties of perjury. Taxpayers should ensure to the best of their knowledge and belief that all tax forms filed are true, correct, and complete.

All other participants received no prompting before they entered the fourth phase of the instrument—the scenario portion of the task. In the scenario portion of the task participants were given a paragraph to read in which an individual is engaging in tax fraud. An income level in the mid $30,000's was chosen in the scenario to mirror the median income for an individual in the United States. This estimate is based on recent data from the United States Census Bureau[13]. Each participant was randomly assigned to a scenario dealing with either the IRS or their state revenue agency. The only difference in each scenario is the revenue agency that is being defrauded as seen below:

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[13] Personal income levels in the United States updated as of 2012: http://www.census.gov/compendia/statab/2012/tables/12s0678.pdf

Pat is a taxpayer in (the United States/your state). Pat's primary income this year came from a job at a local business paying a salary of $30,000 per year. Pat also did $4,000 of other work on the side for extra money. Pat's $30,000 salary from the local business was paid by direct deposits, while Pat's other income of $4,000 was paid in cash. While preparing the current year's tax return, Pat realizes that additional money will have to be paid to the (IRS/state revenue agency) due to the $4,000 of other income. While Pat knows that legally the cash income of $4,000 should be reported, Pat also knows that this income would be hard for an audit to find. Pat could use the extra money to pay expenses and decides not to report any of the $4,000 of cash income to avoid paying more taxes to the (IRS/state revenue agency).

After reading the scenario the participant entered the fifth phase, and the participant was brought to a brief questionnaire built to measure the moral intensity of the tax evasion case. The questionnaire is based on the components of moral intensity discussed in Jones (1991), and these components were measured in line with Leitsch (2004). To measure the components of moral intensity I asked participants to respond to six statements using a 7-point Likert scale. Appendix C contains a full comparison of my survey, Leitsch's (2004) survey, and Jones's (1991) factors of moral intensity.

After the dimensions of moral intensity had been measured, participants entered the final phase of the instrument. As judgment and behavior are thought to follow from moral intensity (Jones 1991), I explicitly asked participants if they would judge a friend unfavorably for engaging in the behavior portrayed in the case, and then I asked the participants if they would engage in this behavior themselves. I provided a text box for

participants to explain their responses. I also used the final phase to collect demographic information to be used as covariates. I collected information on the gender of the participants as the association between fraud and gender is the topic of recent studies[14]. I collect information on the political orientation of the participants as the approval of the IRS varies based on a taxpayer's political orientation[15]. Finally, I asked if the participants or those close to them have been audited, as an audit could increase negative feelings and behaviors towards a revenue agency.

V. RESULTS

Validation Checks and Eliminated Participants

One hundred and eighty-four participants attempted to complete the survey. Of that number 19 failed the first validation check in which they were asked if they had heard about the fictional "L333T" tax form. Sixty-five more participants were screened out because they either did not make enough money to file income tax returns, they were not "experienced" tax payers who had paid taxes for 3 or more years, or they lived in a state without an income tax. Of the 100 remaining participants, 6 were eliminated due to spending an extremely short amount of time reading the case (under 10 seconds). This left a sample of 94 participants to be used in my analyses.

[14] See, for example, Steffensmeier et al. (2013)

[15] http://www.gallup.com/poll/162764/americans-views-irs-sharply-negative-2009.aspx

Table 3.1
Descriptive Statistics

	N	Min.	Max.	Mean	SD
BEHAVIOR	94	0	1	0.46	0.501
JUDGEMENT OF FRIEND	94	0	1	0.27	0.444
MORAL INTENSITY	94	6	42	17.55	7.639
REVENUE AGENCY	94	0	1	0.52	0.502
ETHICAL PROMPT	94	0	1	0.34	0.476
LEGAL PROMPT	94	0	1	0.31	0.450
GENDER	94	0	1	0.64	0.483
MARITAL STATUS	94	0	1	0.38	0.489
POLITICAL ORIENTATION	94	1	7	4.59	1.700
AUDITED	94	0	1	0.13	0.335

Notes:

BEHAVIOR = Whether or not the participant stated that they would commit tax fraud. 1 if the participant would commit tax fraud, 0 otherwise.

JUDGEMENT OF FRIEND = Whether or not the participant stated that they would judge a friend who commited tax fraud. 1 if the participant would judge a friend, 0 if otherwise.

MORAL INTENSITY = Total moral intensity score based on Leitsch's (2004) questionaire. The questionaire is based on Jones' (1991) dimensions of moral intensity (Appendix A). Range 6-42 after reverse coding responses about the percieved intensity of tax evasion.

REVENUE AGENCY = 1 if the participant's case made reference to the IRS, 0 if the participant's case made reference to their state.

ETHICAL PROMPT = 1 if the participant was presented an Ethical Prompt, 0 otherwise.

LEGAL PROMPT = 1 if the participant was presneted a Legal Prompt, 0 otherwise.

GENDER = Stated gender, 1 if the participant is male, 0 if the participant is female.

MARITAL STATUS = 1 = Married, 0 = Single.

POLITICAL ORIENTATION = Range 1-7. The higher the number the more liberal the participant.

AUDITED = 1 if the participant or someone close to them has been audited, 0 otherwise.

Descriptive Statistics

Table 3.1 shows the descriptive statistics for all variables used in my study, after deletion of the invalid responses as discussed above. Fifty-two percent of the participants dealt with a case involving the IRS, while the remaining forty-eight percent dealt with a case involving their state's revenue agency. Thirty-four percent of participants received an ethical prompt before the case, thirty-one percent received a legal prompt, and the remaining participants received no prompt. The sample was comprised largely of unmarried (62%) males (64%). The political orientation of the participants averaged 4.59 on a scale of 1-7 (where a higher number indicates more liberal participants). Thirteen percent either had been audited or knew someone close to them who had been audited.

It should be noted that some of the descriptive statistics seem to imply that governments in the United States have significant revenue collection problems. The participants in my study did not feel that small scale tax fraud was an intense ethical issue. The participants reported an average moral intensity score of 17.55, which is 32.08% of the possible total score (variable range 6-42). As the theory in Jones (1991) suggests, this low level of moral intensity appears to lead to a high acceptance of tax fraud. Almost three quarters of the participants stated that they would not judge a friend for knowingly engaging in tax fraud, and many of these participants went on to justify this response in the comment section. A full list of For example:

> "If a friend did this, I would not look down on them. I know my friend would not act maliciously. While he did not pay all of his taxes he paid a very major portion and the rest is being used for something needed, not wanted (expenses versus a trip to the casino)."

> "I would not think anything less of a friend of mine that would do the same thing as Pat. I know personally that my friend's financial situations are not great and would not fault them for such a decision. If I really needed the funds I would consider doing the same as Pat."

> "I wouldn't judge a friend for deciding not to report the income, but I wouldn't do it because I don't think it's worth the risk."

Almost half of the participants (46%) stated that they would engage in the behavior if the possibility presented itself. Some participants admitted that they would not only would engage in tax fraud when possible, but that they already had knowingly engaged in tax fraud in the past. For example:

> "I have failed to pay taxes on self-employed income before so it would be hypocritical of me to say otherwise, even though I understand why we have to pay taxes and why it's important that everyone does it."

> "We pay enough taxes as it is, if a person is able to find some tax free work then I believe it should not have to be reported. It's like a yard sale, technically you should report that too but no one does."

> "If I ever have a chance to screw the government out of money, I will take it. They have no qualms with doing it to anyone else."[16]

[16] A full list of the comments provided by U.S. participants is found in Appendix D

TABLE 3.2

Pearson Correlation Coefficients

	BEHAVIOR	JUDGEMENT OF FRIEND	MORAL INTENSITY	REVENUE AGENCY	ETHICAL PROMPT	LEGAL PROMPT	GENDER	MARITAL STATUS	POLITICAL ORIENTATION
JUDGEMENT OF FRIEND	-0.553 ***								
MORAL INTENSITY	-0.595 ***	0.701 ***							
REVENUE AGENCY	0.025	-0.002	-0.219 **						
ETHICAL PROMPT	-0.029	-0.077	0.063	0.059					
LEGAL PROMPT	0.080	-0.037	-0.052	-0.098	-0.480 ***				
GENDER	0.025	0.002	-0.003	0.165	0.027	0.020			
MARITAL STATUS	-0.108	-0.028	-0.193 *	-0.077	-0.104	-0.047	-0.090		
POLITICAL ORIENTATION	0.036	-0.037	-0.058	0.008	0.123	0.053	-0.028	0.025	
AUDITED	0.161	-0.014	-0.007	-0.080	-0.073	0.120	0.089	0.223 *:	-0.038

Notes:

Significance levels, two-tailed, are ***0.01; **0.05; *0.10.

n = 94 for all items

Correlation Matrix

Table 3.2 shows the Pearson correlation coefficients for all variables used in my study. I find a significant negative correlation between the revenue agency involved (REVENUE AGENCY) and the moral intensity of tax evasion (MORAL INTENSITY). That is, if the IRS was featured in the case, the participant felt less moral intensity. The REVENUE AGENCY variable has no other significant correlations with other variables implying that a relationship between REVENUE AGENCY and BEHAVIOR is likely to be indirect if one exists (as hypothesized in H1(b) and (c). I also find a significant negative correlation between those who feel tax evasion is a more morally intense act (MORAL INTENSITY) and those who would actually engage in tax evasion (BEHAVIOR). That is, those who feel tax evasion is a significant moral issue are less likely to engage in tax evasion. All of the discussed correlations are consistent with the hypotheses that are formally tested below.

TABLE 3.3

Moderated Mediation (Figure 1) Using PROCESS procedure (Hayes 2013) — Ethical Prompt

Panel A: Regression of MORAL INTENSITY on REVENUE AGENCY and Demographic Covariates

Variable	Predicted Sign		Coefficient Estimate	t-statistic	p-value
Intercept			24.1619	7.4158	0.0000
REVENUE AGENCY (IRS & STATE)	-	a_{1j}	-6.6085	-2.4405	0.0176
ETHICAL PROMPT	+	a_2	-1.7447	-0.5940	0.5548
REVENUE AGENCY * ETHICAL PROMPT		a_{4j}	5.4412	1.4024	0.1660
AUDIT			1.7509	0.5218	0.6038
POLITICAL ORIENTATION			-0.4523	-0.7908	0.4322
GENDER			-0.4478	-0.2146	0.8308
MARRIED			-3.8630	-1.8796	0.0650
R^2 16.40 %					
n 65					

Panel B: Regression of PLANNED ACTION on MORAL INTENSITY and Demographic Covariates

Variable	Predicted Sign		Coefficient Estimate	t-statistic	p-value
Intercept			4.8302	3.0355	0.0024
MORAL INTENSITY	-	b_{1j}	-0.3272	-4.2078	0.0000
REVENUE AGENCY (IRS & STATE)		c'_1	-1.0971	-1.3572	0.1747
AUDIT			1.7178	1.2155	0.2242
POLITICAL ORIENTATION			0.3223	1.3658	0.1720
GENDER			-0.0418	-0.0553	0.9559
MARRIED			-1.7744	-2.2384	0.0252
R^2 (Nagelkirk) 62.25 %					
R^2 (Cox-Snell) 46.56 %					
n 65					

Panel C: Indirect effect of REVENUE AGENCY on PLANNED ACTION

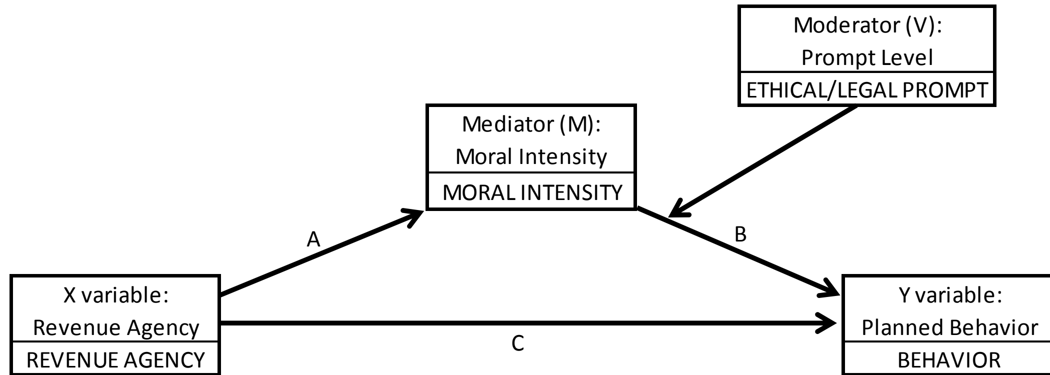
			Bootstrapped 95% Confidence Interval (10,000 iterations)	
	Effect	Boot SE	Lower Limit	Upper Limit
INDIRECT EFFECT	0.3819	1.2446	-2.1273	2.8515

Statistical Analysis of the Moderated Mediation Models

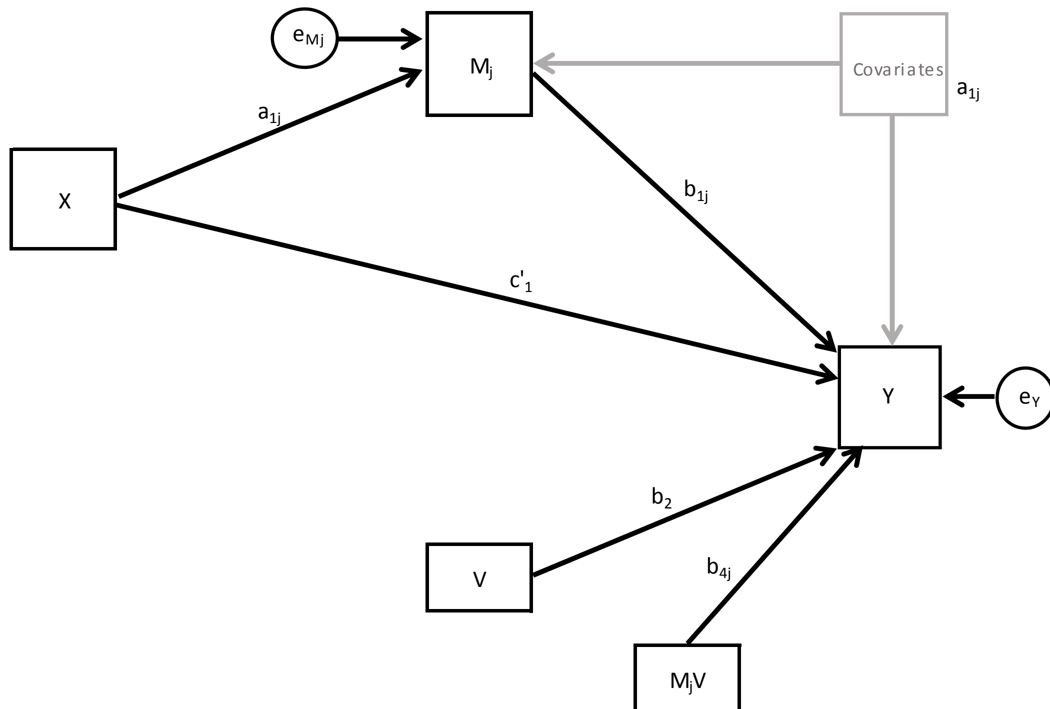
The hypothesized relationships shown in Figure 1 were tested using Hayes (2013) SPSS PROCESS tool. In Table 3.3 I find that the moderator variable (ETHICAL PROMPT) has no statistically significant impact on Relationship A in Figure 1 as hypothesized in H2(a), ($p>0.1$). However, while the moderator variable did not impact Relationship A in Figure 1, I did find that it had a statistically significant impact on Relationship B in Figure 1. This unexpected finding may be explained by Jones (1991). Jones (1991) posits that moral reasoning takes place after moral intensity is discerned by an individual. Moral intensity is primarily "issue contingent" according to Jones (1991). That is, the facts of a scenario, not an individual's morals, are considered when a participant is rating an issue's moral intensity. An individual's morals impact their behavior only when moral intensity is being translated into planned action. If an ethical prompt is to have an impact it should have its impact on an individual when they are using their ethical reasoning skills. Therefore, it is reasonable to expect that the moderating impact of the ethical prompt should be shifted from Relationship A in Figure 1 to Relationship B in Figure 1. I shift the location of the legal prompt based on similar reasoning. If Jones' assertion that moral intensity is primarily related to the issue is correct, intensity should not be moderated by a legal prompt either. The fear of retribution might change planned behavior, but not the moral status of the act in question—the circumstances primarily impact intensity. In line with these unexpected findings I revise Figure 3.1 and replace it with Figure 3.2. Figure 3.2 is also drawn from Hayes's (2013) PROCESS document.

FIGURE 3.2
Alternative Moderated Mediation Model from Hayes (2013)

Panel A: Conceptual Model:



Panel B: Statistical Model:



Notes:
X is the causal variable, M is the mediator, V is the moderator, and Y is the outcome.
a, b, and c' are the regression coefficients in the estimation models of M ansd Y; and e_{Mj} and e_Y are errors in the estimates of M and Y respectively.
The names of the constructs are in the top portion of the boxes in Panel A.
The names of the variables as used in Tables 1-4 are in capital letters in the bottom portion of the boxes in Panel A.

Using the above mentioned revised theory I perform an alternative analysis. Table 3.4 displays the results of the "Moderated Mediation (Figure 3.2)" model that is used to test the impact of the IRS's name and an ethical prompt on the acceptance of tax evasion. The "Moderated Mediation" effect is tested by Hayes's (2013) PROCESS tool (based on Preacher and Hayes's [2004] bootstrapping approach) which separates the indirect and direct effects in the model[17]. The variables used in the main test are the dependent variable BEHAVIOR, the independent variable REVENUE AGENCY, the mediator MORAL INTENSITY, the moderator ETHICAL PROMPT, and the covariates of AUDIT, POLITICAL ORIENTATION, GENDER, and MARRIED. The total observations available for Table 3.4 are 65 as Table 3.4 directly contrasts the ethical prompt condition with the no prompt condition and excludes all observations using the legal prompt.

[17] The Sobel test is excluded as recent studies argue that the Sobel test is only suitable for large samples, and that the bootstrapping approach is the superior method for testing mediation (e.g., Preacher and Hayes 2008; Wood et al. 2008)

TABLE 3.4

Moderated Mediation (Figure 2) Using PROCESS procedure (Hayes 2013) — Ethical Prompt

Panel A: Regression of MORAL INTENSITY on REVENUE AGENCY and Demographic Covariates

Variable	Predicted Sign		Coefficient Estimate	t-statistic	p-value
Intercept			23.4523	7.6125	0.0000
REVENUE AGENCY (IRS & STATE)	-	a_{1j}	-4.7579	-2.2853	0.0259
AUDIT			1.1821	0.3501	0.7275
POLITICAL ORIENTATION			-0.3200	-0.5595	0.5780
GENDER			-0.0195	-0.0091	0.9927
MARRIED			-4.1855	-2.0212	0.0478
R^2 14.83 %					
n 65					

Panel B: Regression of PLANNED ACTION on MORAL INTENSITY and Demographic Covariates

Variable	Predicted Sign		Coefficient Estimate	t-statistic	p-value
Intercept			7.9024	3.0676	0.0022
MORAL INTENSITY	-	b_{1j}	-0.6363	-3.3655	0.0008
REVENUE AGENCY (IRS & STATE)		c'_1	-1.3206	-1.5044	0.1325
ETHICAL PROMPT	-	b_2	-6.6844	-2.1845	0.0289
MORAL INTENSITY * ETHICAL PROMPT		b_{4j}	0.4448	2.2436	0.0249
AUDIT			2.3030	1.4272	0.1535
POLITICAL ORIENTATION			0.5811	1.9517	0.0510
GENDER			0.1840	0.2082	0.8351
MARRIED			-2.1156	-2.1815	0.0291
R^2 (Nagelkirk) 68.38 %					
R^2 (Cox-Snell) 50.95 %					
n 65					

Panel C: Indirect effect of REVENUE AGENCY on PLANNED ACTION

			Bootstrapped 95% Confidence Interval (10,000 iterations)	
	Effect	Boot SE	Lower Limit	Upper Limit
INDIRECT EFFECT	0.9113	1.5504	0.0126	4.9952

Table 3.4 includes two regressions based on Figure 2 that are used to test the direct and indirect relationships of interest. These regressions were generated using Hayes's (2013) SPSS PROCESS tool. The first regression, in Table 3.4, Panel A, tests the relationship between REVENUE AGENCY and the mediator variable: INTENSITY (Relationship A in Panel A of Figure 3.2). My results indicate that when participants dealt with the IRS they experienced a lower level of moral intensity (a_{1j} = -4.7579, p <0.05). This negative coefficient is consistent with H1(b) which predicts that cheating against the IRS is seen as less morally intense when compared to cheating against the state.

The second regression, in Table 3.4, Panel B, primarily tests the relationship between MORAL INTENSITY and BEHAVIOR moderated by ETHICAL PROMPT (Relationship B in Panel A of Figure 2). In Panel B of Table 3.4 I find that participants who perceive higher levels of moral intensity are less likely to accept the behavior of tax evasion, in line with my predictions in H1(c) (b_1 = -0.6363, p<0.01). I also find that the ethical prompt has a negative relationship with the acceptance of the behavior of tax evasion (b_2 = -6.6844, p = <0.05), and that the effect of the ethical prompt is contingent on the participant's moral intensity. This is evidenced by the statistically significant interaction between a participant's moral intensity and the participant's exposure to the ethical prompt (b_{4j} = 0.4448, p <0.05). I postulate that this positive coefficient indicates a small degree of diminishing returns when dealing with both intensity and an ethical prompt. For example, if a participant already has a high level of moral intensity, then the addition of an ethical prompt is slightly less able to impact a participant's behavior as the participant already recognizes that tax evasion is wrong. This overall finding indicates

that an ethical prompt can reduce tax fraud as predicted in H2(a), and is in line with Mazar et al. (2008). Their study asserted that ethical prompts should be applied to the tax fraud setting, and my study now provides support to their assertion.

Finally, in Table 3.4, Panel C, the indirect relationship between REVENUE AGENCY and BEHAVIOR is displayed. A bias-corrected bootstrap confidence interval for the positive indirect effect was entirely above zero (0.0126 to 4.9952). This indicates that the IRS's name increases an individual's acceptance of tax evasion. There was no evidence that the IRS's name influenced a participant's acceptance of tax evasion independent of its effect on perceived moral intensity ($c'_1 = -1.3206$, $p>0.1$).

TABLE 3.5

Moderated Mediation (Figure 2) Using PROCESS procedure (Hayes 2013) — Legal Prompt

Panel A: Regression of MORAL INTENSITY on REVENUE AGENCY and Demographic Covariates

Variable	Predicted Sign		Coefficient Estimate	t-statistic	p-value
Intercept			17.2197	4.8439	0.0000
REVENUE AGENCY (IRS & STATE)	-	a_{1j}	-4.7934	-2.4598	0.0170
AUDIT			0.9705	0.3511	0.7268
POLITICAL ORIENTATION			0.5340	0.9099	0.3668
GENDER			1.8887	0.9160	0.3636
MARRIED			-3.1255	-1.5387	0.1295
R^2 14.89 %					
n 62					

Panel B: Regression of PLANNED ACTION on MORAL INTENSITY and Demographic Covariates

Variable	Predicted Sign		Coefficient Estimate	t-statistic	p-value
Intercept			8.5242	2.7918	0.0052
MORAL INTENSITY	-	b_{1j}	-0.6300	-2.7896	0.0053
REVENUE AGENCY (IRS & STATE)		c'_1	0.3763	0.4176	0.6762
LEGAL PROMPT	-	b_2	-2.7608	-0.8863	0.3755
MORAL INTENSITY * LEGAL PROMPT		b_{4j}	0.2124	0.9931	0.3206
AUDIT			4.2234	1.7175	0.0859
POLITICAL ORIENTATION			0.1789	0.4994	0.6175
GENDER			0.8890	0.8776	0.3802
MARRIED			-2.9437	-2.4058	0.0161
R^2 (Nagelkirk) 75.64 %					
R^2 (Cox-Snell) 56.65 %					
n 62					

Panel C: Indirect effect of REVENUE AGENCY on PLANNED ACTION

	Effect	Boot SE	Bootstrapped 95% Confidence Interval (10,000 iterations) Lower Limit	Upper Limit
INDIRECT EFFECT	2.0020	4.7656	0.5297	18.8796

Having tested the effectiveness of the ethical prompt, I now move to test if the legal prompt is effective. Table 3.5 displays the results of the "Moderated Mediation (Figure 2)" model that is used to test the impact of the IRS's name and a legal prompt on the acceptance of tax evasion. These regressions were again generated using Hayes (2013) SPSS PROCESS tool. The variables used in this test are identical to the prior test but LEGAL PROMPT is used in place of ETHICAL PROMPT.

Table 3.5's findings largely mirror Table 3.4's in that the IRS's name is still correlated with an increased acceptance of tax evasion due to the decrease in moral intensity that the IRS's name causes. However, the moderating variable in Table 3.5, Panel B (LEGAL PROMPT), does not have a significant relationship with BEHAVIOR ($b_2 = -2.7608$, $p>0.1$). The interaction between LEGAL PROMPT and INTENSITY is also not significant ($b_{4j} = 0.2124$, $p>0.1$). These findings are consistent with H2(b)'s prediction that a legal prompt is not an effective means of reducing tax evasion at the taxpayer level. This finding is in line with prior behavioral tax literature which found that legal prompts did not decrease aggressive tax behavior at the tax preparer level (e.g., Cuccia et al. 1995).

VI. CONCLUSIONS AND IMPLICATIONS

In this study I have integrated the suggestions of Mazar et al. (2008) into the behavioral tax setting. Based on a sample of 94 United States taxpayers I find that an ethical prompt can reduce the intent to engage in tax evasion—although the moderating effect did not occur where initially hypothesized. I also find that a legal prompt does not have this helpful impact. Furthermore, taxpayers feel that committing tax evasion against the IRS is less morally intense than committing tax evasion against a state revenue

collection agency. Through the use of Hayes's (2013) PROCESS tool and a "Moderated Mediation" model I also show that the IRS's name has a positive indirect effect on a participant's intent to engage on tax fraud. That is, participants dealing with the IRS express a greater willingness to cheat when compared to those participants dealing with their state's revenue collection agency. Overall, my findings suggest that an ethical prompt can decrease tax fraud, while the IRS's name increases tax fraud.

This study has at least three public policy implications. First, as participants felt fraud against the IRS was less morally problematic than fraud against the states, perhaps a greater focus can be placed on state level revenue collection. Currently the IRS collects over 60% of all tax revenue in the United States[18]. If states collected a larger percentage of the United States' revenue the overall tax compliance rate might increase. This could be achieved without reducing total federal revenue if the states collected a larger amount of revenue then transferred it to the federal government. Second, assuming IRS distrust accounts for some of the IRS's revenue collection problems (i.e., not just distance from the citizenry), the IRS could work on a long-term strategy to improve its image. Finally, as the ethical prompt delivered to participants appears to have the ability to reduce tax fraud, this ethics-based approach should be appropriate for the IRS and other revenue collection agencies. It should be noted, however, that Shu et al. (2011) found results that could potentially help the IRS, and the IRS ignored the findings. It is unrealistic to assume that I will be more successful than prior researchers in my attempts to change IRS policy. Fortunately, there are other methods of applying this research, and one potential application of this research entirely avoids dealing with the IRS. Non-governmental

[18] http://www.taxpolicycenter.org/briefing-book/background/numbers/revenue-breakdown.cfm

entities such as the American Institute of Certified Public Accountants (AICPA) can circumvent the IRS's authority and instruct their membership to provide an ethical prompt to taxpayers. As tax preparers generally prefer less risky clients (Kadous and Magro 2001; Kadous et al. 2008), issuing a prompt to reduce client fraud (and by extension client risk) could be a valuable use of tax preparer time—even if it is not required by law.

Limitations

My study is limited by the fact that participants are not actually presented with the option of cheating. While some studies (e.g., Mazar et al. 2008) allow participants to cheat and obtain additional compensation, my study is designed to allow participants to comment on whether or not they would cheat to obtain additional compensation. This allows a realistic depiction of the tax evasion scenario, but it also removes the participant from the actual act of cheating. My study is also limited by the fact I place all state revenue agencies into the same category. Each state has a distinct culture, and while the average individual in the United States appears to favor state agencies over federal agencies, this view might vary based on the state.

Implications for Future Research

Future behavioral tax research should continue to explore tax fraud at the taxpayer level. While anecdotal, some participants expressed that the acceptability of tax fraud was related to the income level of the perpetrator. That is, a low income taxpayer committing tax fraud was acceptable, while a high income taxpayer committing tax fraud was unacceptable. While my instrument collected only minimal data on the income of participants, a modified instrument could collect detailed data on a participant's income

and manipulate the income levels in the case as well. Another extension of this study could test various ethical prompt formulations. When ranking the Moral Intensity of tax evasion, participant responses implied that participants simply did not believe that their small contribution to the government would make a difference. An ethical prompt targeted at changing that belief might have a dramatically larger impact on the acceptance of tax fraud. As a final extension, I postulate that certain taxes are dramatically more popular than others due to their association with popular programs. While polling only exists at the program level (i.e., the popularity of the tax has not been tested), I assert that the popularity of certain government programs (e.g., Social Security, Medicare) implies that Social Security or Medicare tax fraud would be viewed unfavorably. If research were able to establish this finding, the government could attempt to associate taxes with popular programs to make tax fraud less palatable. It should be noted that this practice is already common at the state level, which could account for the relative popularity of state taxes.

CHAPTER 4

DISREGARD FOR PROFESSIONAL STANDARDS —THE S CORPORATION REASONABLE COMPENSATION ISSUE

I. INTRODUCTION

As a pass-through entity, the S Corporation is a valuable tax planning tool that has seen significant usage since its creation in 1958. One of the benefits of the pass-through status of the S Corporation is that income can flow to the owners without being uniformly classified as salaries. This often allows owners to avoid both self-employment and payroll taxes by simply opting to pay the S Corporation owners either a low salary or none whatsoever.

Based on the potential room for abuse when S Corporations are directed by their owners to pay low or nonexistent salaries, the IRS has long since had a policy of reasonable compensation. The consideration of reasonable compensation began in earnest just a few years after "subchapter S" was placed into the (IRC) Internal Revenue Code[1]. Recently and in fact for some time, popular opinion has lead S Corporation owners into a series of common practices. Most worked — and perhaps still work — under the opinion that by and large a reasonable compensation IRS audit was triggered not when an S Corporation salary was too low, but when it was zero[2]. Therefore a common policy came to exist in which companies would pay a paltry S Corporation salary as a method of audit avoidance. Once the paltry salary was paid, S Corporation owners felt comfortable directing their businesses to initiate sham loans and other

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[1] See for example, *P. Krahenbuhl v Commr,* 27 TCM 155, Dec. 28,860(M), TC Memo. 1968-34.

[2] See for example, http://www.forbes.com/sites/steveparrish/2012/12/05/navigating-s-corp-tax-planning-savvy-tips-and-tricks/

distributions to their shareholders/owners in the forms of profit distributions or loan repayments.

Recent cases, however, have demonstrated that the IRS is stepping up its enforcement policies in regard to reasonable compensation. In the first case a non-zero salary of $24,000 (plus other benefits) was deemed unreasonable and increased almost four fold. This shows that the strategy of paying a low salary to avoid red flags is perhaps not as effective as it once was. In another instance, a fairly unsuccessful company with de minimis (less than $10,000) income was hit by a series of reclassifications which lead to the S Corporation owner receiving $62,000 in wages. In a final recent case a situation of even greater financial impact occurred when a salary of $24,000 (plus commissions) was deemed unreasonable compensation and a significant portion of officer drawings were reclassified to salary. In all of the cases the IRS levied significant penalties[3] against the owners of the S Corporations beyond even the additional tax liabilities created from reclassifying distributions and loans into salaries.

II. RELEVANT LAW

The basis for reasonable compensation law lies under IRC 162(a)(1) which states that a business can deduct "a reasonable allowance for salaries or other compensation for personal services actually rendered." Thus, historically, the concept of reasonable compensation was put in place to prevent high salaries being deducted rather than prevent low or non-existent salaries from being paid. The simple one-sentence line in IRC 162(a)(1) took on a far greater purpose when S Corporation came into being and began their proliferation.

[3] Every case in this article discussed in detail involved additional taxes under section 6651(a)(1) and additional penalties under section 6656.

Subchapter S of Chapter 1 of the Internal Revenue Code allows business to elect for the classification of small business corporation — also known as the S Corporation[4]. While the use of these corporations is restricted by a set of general rules[5] as well as certain industry and international business restrictions[6], they are commonly used due to the fact that section 1366 allows income from the S Corporation to flow through to the owners[7]. This allows S Corporations to avoid the possibility of double taxation that exists with C Corporations — among other differences. Profit distributions from S Corporations are taxed at an individual's ordinary rates.

While profit distributions are taxed at ordinary rates, wages are taxed at ordinary rates but are also subject to FICA and FUTA and these taxes are levied on wages paid to a company's employees. FICA, as guided in part by sections 3101 and 3111, requires payment of 6.2 percent of each dollar in social security taxes, and 1.45 percent in Medicare taxes for a total of 7.65 percent. This amount is paid once by the employer[8]

[4] S Corporations are defined by Sections 1361-1379.

[5] 1361(b)(1) lists the basic eligibility and ineligibility requirements. To be eligible a corporation must make the election and not: Have more than 100 shareholders, have as a shareholder a person (other than an estate, a trust described in subsection or an organization) who is not an individual, have a nonresident alien as a shareholder, and have more than 1 class of stock. S corporations can exceed 100 shareholders in some cases as 1361(c)(1) treats all members in a family as a single shareholder.

[6] Under sections 1361(b)(2), S Corporations cannot be: A financial institution which uses the reserve method of accounting for bad debts an insurance company subject to tax under subchapter L, a corporation to which an election under section 936 applies, a Domestic International Sales Corporation or former Domestic International Sales Corporation

[7] 1366(a)(1) states that a shareholder receives their pro rata share of the corporation's items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder, and nonseparately computed income or loss.

[8] See Section 3111

and once by the employee[9]. In the case of a closely held S Corporation, where the taxpayer is both the employer and employee he or she must furnish 15.3 percent (7.65 x 2)[10]. Furthermore, section 3301 states that a 6[11] percent "FUTA" (Federal Unemployment Tax Act) tax be applied to wages to support unemployment programs[12].

In cases dealing with taxable years 2012 or later yet another payroll tax is applied to self-employment income. The Patient Protection and Affordable Care Act[13] modified sections 1401(b)(2)(A), 3101(b), and 3201(a) to add an additional 0.9% tax to self-employment income, wage income, and Railroad Retirement Tax Act compensation respectively. This tax is applied to income levels over 200,000 for single taxpayers and 250,000 for joint filers[14]. While none of the recent cases discussed within this paper deal with income levels affected by this new tax, it should be considered for tax planning purposes in similar scenarios with higher income levels.

Based on the numerous levels of taxation applied to wages paid to employees it is clear that many S Corporation's officers would hope to avoid the employee classification to avoid additional taxation. Avoiding the employee classification immediately eliminates the possibility of payroll taxes leaving all withdrawals from the corporation to be classified as more favorably taxed distributions. Generally the employee debate in S

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[9] See Section 3101

[10] IRS Publication 15-A states that these taxes apply to the first $117,000 in 2014 and 118,500 in 2015

[11] While 6.0% is the stated FUTA amount, Section 3302(a)(1) does allow for a credit against that total for state unemployment taxes paid.

[12] 3306(b)(1) caps this obligation at $7,000.

[13] P.L. 111-148 and P.L. 111-152

[14] See 1401(b)(2)(A) and 3101(b)(2)

Corporation reasonable compensation cases is simple and uncontentious, however[15]. That is, in general, an officer is considered to be an employee[16], though there are exceptions to the general rule. The employee classification can be avoided if the officer provides minimal services to the firm. According to section 31.3121(d)-1(b) of employment tax regulations, an officer is only classified as an employee when they perform more than minor services and when they receive remuneration in any form (e.g., the remuneration could be in the form of dividends while being in substance wages). While this regulation opens to door to the reclassification of distributions into salary by the IRS[17], it also provides for the avoidance of paying wages to fairly inactive officers.

While not being an employee would be one way to avoid all salaries, once the officer is established as an employee the goal is to have the S Corporation pay them the lowest possible salary. While a salary of zero is the lowest by definition, a salary of zero constitutes a red flag for the IRS, and most tax advisors assert that this should be avoided[18]. Still, even while avoiding the use of a non-existent salary, the S Corporation can obviously pay wages that are absurdly low. For example, paying an active and successful real estate broker $5,000 in a market where the average is $100,000 is obviously unreasonable. But what if the salary were $65,000? The fact of the matter is

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[15] See for example *DAVID E. WATSON, PC v. US*, 668 F.3d 1008 (8th Cir. 2012), *Glass Blocks Unlimited v. COMMISSIONER OF INTERNAL REVENUE*, 2013 T.C. Memo 180 (T.C. 2013), *Sean McAlary Ltd., Inc. v. COMMISSIONER OF INTERNAL REVENUE*, 2013 T.C. Summary Opinion 62 (T.C. 2013). In all three cases the taxpayer, IRS, and court had no disagreement on employee status.

[16] One definition of employee under Section 3121(d) is “any officer of a corporation.”

[17] 31.3121(a)-1(c) notes that the form of the remuneration is irrelevant. This opens the door to the reclassification of distributions/loans/etc… into salary.

[18] See for example: S Corporations and Salary Payments to shareholders http://www.nysscpa.org/cpajournal/2006/506/essentials/p46.htm

there is no hard and fast code section that can be cited to substantiate a reasonable salary, and the majority of this article will detail the current approach of the IRS and the courts in determining what a reasonable salary is.

In the cases discussed in this article the taxpayers often used dubious approaches when determining their salaries in an effort to keep wages low. When such dubious methods are employed by taxpayers the opportunity exists for the IRS to impose penalties on the unpaid payroll taxes. Sections 6651(a)(1) and 6656 impose a penalties on unpaid FICA and FUTA taxes. This penalty can be avoided only if the taxpayer can show that they underpaid their payroll taxes due to reasonable cause rather than willful neglect. Reasonable care is defined in Sec 301.6651-1(c)(1)[19], Proced. & Admin Regs. Willful neglect is defined primarily through the Supreme Court precedent of *United States v. Boyle*, 469 US 241[20]. The penalty under 6651(a)(1) is equal to 5% of the back taxes owed for each month the taxes are unpaid — with a maximum 25% penalty possible. The penalty under 6656 imposes a penalty of 10% on the underpayment of tax if the failure to file exceeds 15 days.

The IRS has also spoken out beyond the court room by issuing Rev. Rul. 74.44, 1974-1 C.C. 287. This revenue ruling explicitly deals with a situation in which S Corporation owners receive dividends in lieu of salary. The IRS states that those dividends are to be reclassified into wages subject to payroll taxes. A recent series of

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[19] Sec 301.6651-1(c)(1) states that "a taxpayer who wishes to avoid the addition to the tax for failure to file a tax return or pay tax must make an affirmative showing of all facts alleged as a reasonable cause for his failure to file such return or pay such tax on time in the form of a written statement containing a declaration that it is made under penalties of perjury."

[20] In *US v R.W. Boyle*, SCt, 85-1 USTC ¶13,602, 469 US 241, 105 SCt 687, the Supreme Court defines willful neglect as "intentional failure or reckless indifference."

cases shows a redoubled effort of S Corporation salary enforcement in line with the above expressed IRS position, starting with *David E Watson PC v US*[21].

III. REVEVANT CASES

DEWPC v Commissioner

David Watson was a highly experienced CPA who had decades of accounting experience. After a career working for public accounting firms he founded David E. Watson, P.C. (herein DEWPC), a privately held S Corporation for which he was the sole employee and owner. Despite his experience, this company paid him only $24,000 per year in salary. That said, the total amount of money flowing from DEWPC to Watson was $203,651 and $175,470 in 2002 and 2003 respectively. Everything above the 24,000 in Salary and minor expense reimbursements were classified as dividends. A somewhat incriminating factor that was uncovered later was that the extraordinarily low salary was never documented, and DEWPC could present no witnesses to support the amount[22].

The above facts resulted in the IRS investigating DEWPC. Their investigation led the IRS to determine that more salary was due Watson, and thus he owed back payroll taxes for the years 2002 and 2003. On top of the delinquent taxes, the IRS issued penalties and charged interest. DEWPC eventually brought the case before the District Court[23]. In the District Court case the IRS utilized a compensation expert who used

[21] *DAVID E. WATSON, PC v. US*, 668 F.3d 1008 (8th Cir. 2012)

[22] There were no documents reflecting the salary discussions, and no partner at the firm DEWPC contracted to testified at trial

[23] See *DAVID E. WATSON, PC v. US*, 757 F. Supp. 2d 877 (S.D. Iowa 2010).

market comparisons to determine a reasonable salary[24]. Eventually the IRS emerged largely as the winning party. The District Court ruling resulted in Watson's salary being increased significantly. Furthermore, taxes, penalties, and interest were applied to DEWPC as the low salary was found to be the result of willful neglect under sections 6651(a)(1) and 6656[25] — rather than reasonable cause. Watson appealed the case to the 8th Circuit.

Once in the hands of the 8th Circuit the court's first objective was the determination of the officer's employee status. As noted in the relevant law section, should the officer not be classified as an employee they could not be due wages and the profit distributions would likely stand. In this case, however, based on the facts and circumstances in which paperwork verified that the officer was the S Corporations sole employee, the commissioner and taxpayer had no disagreement[26]. Watson was undoubtedly an employee of DEWPC. Moving to the concept of the actual number to be declared as reasonable compensation, Mr. Watson argued that two major problems occurred in the District Court ruling. First, the certified business valuation expert was

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[24] Igor Ostrovsky (a general engineer and compensation expert for the IRS with years of experience) cited AICPA salary statistics and used them to apply a "reasonable" billing rate to Mr. Watson. Ostrovsky testified that a general engineer for the IRS serves acts as a consultant on audits, and assists revenue agents in the valuation of businesses, depreciation, tangible and intangible assets, and reasonable compensation, amongst other things.

[25] Willful neglect was found as the court ruled that the distributions were disguised wages. This implies that the taxpayer was willfully ignoring their tax obligation.

[26] *DAVID E. WATSON, PC v. US*, 668 F.3d 1008 (8th Cir. 2012), Note 5 on Page 7 states that all parties agreed on Mr. Watson's employment status.

unqualified to testify on reasonable salaries, and second, that the reclassification of dividends into salaries subject to FICA taxes is not supported by law[27].

In regards to the argument against the business valuation expert's competence as a reasonable compensation authority, the court explored a number of avenues discussed by the petitioner and respondent. First, while DEWPC noted that the official certification of the expert was in business valuation—not compensation—the court found that this particular expert had experience in 20-30 reasonable compensation cases and precedent states that practical experience is not ranked below academic experience or qualifications[28]. Second, Watson asserted that the fact that the expert changed his opinion during the case — nearly halving what he considered reasonable compensation by the end of the trial — meant that the expert was abusing his discretion. The 8th Circuit noted, however, that the decrease in reasonable compensation occurred due to Watson's own testimony bringing to light new facts. These revisions are considered acceptable behavior under federal law[29].

Simply put, the court found no reason to doubt the experienced expert witness' opinion on what a reasonable salary would be, and thus they moved to the larger issue of the legality of enforcing reasonable compensation law. DEWPC's arguments in the next

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[27] *DAVID E. WATSON, PC v. US*, 668 F.3d 1008 (8th Cir. 2012) page 3-4. The taxpayer repeatedly argued throughout the case that no statute, regulation, or rule requires a minimum salary. As the District Court required a minimum salary they were going beyond the bounds of law per the taxpayer. This line of reasoning excludes the notable case history on the topic discussed throughout this piece.

[28] See for example: Roach 644 F.3d at 764, *United States v. Anderson*, 446 F.3d 870, 875 (8th Cir.2006); *Fox v. Dannenberg*, 906 F.2d 1253, 1256 (8th Cir.1990). All of these cases involve courts accepting practical experience as qualifying an individual for the task of being an expert witness, even without academic training in the area.

[29] See Fed. R. Civ. P. 26(a)(2), (e)(2)

major portion of the case appeared to be aimed at changing a long tradition of enforcing reasonable compensation in S Corporations[30]. DEWPC repeatedly defended their position by stating that there is no statute, regulation, or rule requiring minimum compensation. DEWPC argued that instead taxpayer intent should be the deciding factor in the case. As DEWPC intended to pay out dividends, the dividend classification should be upheld and the minimum salary drawn should be left at the intended $24,000.

While the court did not find evidence of a minimum compensation standard written explicitly in the code or regulations in line with the assertions of DEWPC, they did note that federal law has long since had reasonable compensation standards written into it. Section 162(a)(1) states that a "reasonable allowance for salaries or other compensation for personal services actually rendered" is deductible. Granted, these standards were enacted to limit unreasonably large deductions, but the reasonable compensation has been used to increase salary amounts to a minimum wage in court precedent[31]. Further, the underlying basis for a reasonable compensation case is the bedrock principle of taxation: Substance over form[32]. While DEWPC prepared the

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[30] See for example, *P. Krahenbuhl v Commr*, 27 TCM 155, Dec. 28,860(M), TC Memo. 1968-34.

[31] While the overall list is significant, some major cases include: *Joseph Radtke*, S.C. [90-1 ustc ¶50,113], 895 F.2d at 1197, *Yeagle Drywall Co. v. Comm'r* [2003-1 ustc ¶50,141], 54 F.App'x 100 (3d Cir. 2002); *Spicer Accounting, Inc. v. United States* [91-1 ustc ¶50,103], 918 F.2d 90, 93 (9th Cir. 1990)

[32] The list would be near endless; however, see for example the list the court perceived useful to mention: "*Gregory v. Helvering* [35-1 ustc ¶9043], 293 U.S. 465, 469-70 (1935)); *True v. United States* [99-2 ustc ¶50,872], 190 F.3d 1165, 1173-74 (10th Cir. 1999) (stating that "substance over form" is a "fundamental tax principle [that] operates to prevent the 'true nature of a transaction from being disguised by mere formalisms, which exist solely to alter tax liabilities'" (quoting *Comm'r v. Court Holding Co.* [45-1 ustc ¶9215], 324 U.S. 331 (1945)); *Leisure Dynamics, Inc. v. Comm'r of Internal Revenue* [74-1 ustc ¶9328], 494 F.2d 1340, 1345 (8th Cir. 1974)" ("For tax purposes, we must concern ourselves with actualities rather than the

transactions in the form of high dividends and a small salary, in reality, a large portion of the dividend was—in substance not form—compensation for services which should then be subject to all manner of employment related taxes.

Based on the preponderance of precedent that specifically supported the use of reasonable compensation in S Corporation cases and the principle of substance over form, the court found that DEWPC's argument was flawed.

As the court found neither line of DEWPC's reasoning compelling they determined that the findings of the expert who nearly quadrupled the salary of Watson (from $24,000 to $91,044) were binding to the taxpayer. Furthermore, as DEWPC was unable to show that the low salary was due to reasonable cause[33], DEWPC was subject to additional fines and penalties. In the end, the total amount in taxes, penalties, and fines amounted to $23,431.23. The fines resulted from the lack of timely filing of the form 941 under sections 6651(a)(1) and 6656.

Defeat in the appeals court, however did not completely end the efforts of Watson and DEWPC. DEWPC promptly appealed the case to the Supreme Court; however, the writ of certiorari was declined[34]. Hence the original District Court decision stood and it represented the first of three recent cases demonstrating the current enforcement of S Corporation salaries.

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refinements of title; our concern is with the substance, not form.")" — *DAVID E. WATSON, PC v. US*, 757 F. Supp. 2d 877 (S.D. Iowa 2010) page 4

[33] Sec 301.6651-1(c)(1) states that for "a taxpayer who wishes to avoid the addition to the tax for failure to file a tax return or pay tax must make an affirmative showing of all facts alleged as a reasonable cause for his failure to file such return or pay such tax on time in the form of a written statement containing a declaration that it is made under penalties of perjury."

[34] 133 SCt 364, (SCt) Cert. denied (10/01/2012).

Glass Blocks v Commissioner

Fredrick Blodgett was the owner of a construction supply S Corporation that was facing difficult times. As the real estate market crashed, demand for his company's primary product —Glass Blocks — was declining. Blodgett's income from his S Corporation was $877 in 2007, and $8,950 in 2008. To keep the business running $55,000 was contributed to the company by Blodgett and his then fiancé. Blodgett did not file a form 941 in 2007 or 2008 as he decided he would not pay out a salary to himself in those years. While a salary wasn't paid, however, significant distributions were. In 2007 $30,844 was distributed to Blodgett, and in 2008 $31,644 was transferred.

The lack of payroll forms filed triggered an employment tax audit for 2007 and 2008. The audit eventually revealed the underlying transactions noted above, i.e., the suspicious set of contributions and distributions in lieu of a salary. While the appeals court case discussed earlier is cited within the Glass Blocks case in support of reasonable compensation as a minimum wage (representing more than just the reasonableness of a salary deduction as seen in section 162), there are a number of differences. Perhaps the largest is that the taxpayer in *DEWPC* actually was given a salary — albeit a small one[35]. In *Glass Blocks* the payroll of the S Corporation in question simply stopped paying a salary creating what could be considered a red flag. Further, Glass Blocks suffered from an even greater number of documentation problems. While there were $55,000 in contributions and $62,488 of distributions in the two years in question, no documentation was presented for these transactions at trial. Simply put, it would appear the audit was

[35] DEWPC paid Mr. Watson 24,000 plus expenses *DAVID E. WATSON, PC v. US*, 668 F.3d 1008 (8th Cir. 2012) Page 2

caused by a lack of payroll documentation, and the problems were compounded by other missing documents.

As in *DEWPC*, the Tax Court first determined the employee status of Mr. Blodgett. As Blodgett admittedly worked for the company (though he debated the number of hours) and was the company's only full time employee, there was no disagreement that he deserved employee classification. The Tax court then dealt with two primary issues: The character of the contributions as well as the distributions and amount of reasonable compensation. In regards to the character of the contributions, Glass Blocks argued that the contributions were loans, and thus, the distributions were loan repayments. As noted above, a significant problem existed with the taxpayers' assertion of the form of a loan: No documentation. Glass Blocks's schedule L (Balance Sheet Per Books) showed no loans. Furthermore, the 1120S had no interest expense. There were also no loan repayment schedules or agreements.

In the past, courts have identified a number of factors to be used in making the capital contribution versus loan determination: "(1) the names given to the instruments, if any, evidencing the indebtedness; (2) the presence or absence of a fixed maturity date and schedule of payments; (3) the presence or absence of a fixed rate of interest and interest payments; (4) the source of repayments; (5) the adequacy or inadequacy of capitalization; (6) the identity of interest between the creditor and the stockholder; (7) the security, if any, for the advances; (8) the corporation's ability to obtain financing from outside lending institutions; (9) the extent to which the advances were subordinated to the claims

of outside creditors; (10) the extent to which the advances were used to acquire capital assets; and (11) the presence or absence of a sinking fund to provide repayments."[36]

Citing the above general rules in 1986, a similar situation occurred with another construction component company in *Roth Steel Tube Co v Commissioner*[37]. In this 6th Circuit case the distinction between loans and capital contributions was thoroughly explored. The eventual conclusion of the court in *Roth* was that if the expectation of repayment was contingent on the success of the borrower's business — as opposed to a legally binding obligation regardless of a company's underlying economic circumstances — the transaction represented a capital contribution. The repayment did not appear to be done on schedule to the court, but in fact payments were made whenever the funds were available and Blodgett requested them. The end result was that the Tax Court found the contributions to be capital contributions and not loans[38].

With the above finding that the contributions to the S Corporation were indeed equity rather than debt, the question moved to what the reasonable amount of salary should be. The fact that zero salary was paid certainly implied that at least a portion of the distributions should be classified as salary because Blodgett was the only full time

[36] See for example *Raymond*, 511 F.2d at 190-91; *Austin Village, Inc. v. United States* [70-2 ustc ¶9620], 432 F.2d 741, 745 (6th Cir. 1970); Berthold v. Commissioner [68-2 ustc ¶9670], 404 F.2d 119, 122 (6th Cir. 1968); *Smith*, 370 F.2d at 180.

[37] *Roth Steel Tube Co. v. CIR*, 800 F.2d 625 (6th Cir. 1986)

[38] *Roth Steel Tube Co. v. CIR*, 800 F.2d 625 (6th Cir. 1986), page 4: "The Tax Court found that repayment of the advances made by taxpayer were dependent on the financial success" of the business, hence the contributions resembled equity.

employee. The other labor in the business was carried out by an unspecified number of day laborers[39].

Unlike in *DEWPC*, no expert witnesses took part in the trial. However, the taxpayer and commissioner did attempt to use a similar methodology to what the business valuation expert employed in *DEWPC*. Both parties analyzed the number of hours worked multiplied by an industry standard for the type of job. Glass Blocks argued that $15,860 was reasonable based on the fact Blodgett worked only 20 hours a week (or 1040 hours a year) and the fact that he should be billed at a similar rate to accounts relievable clerks, accounts payable clerks, or shipping clerks (plus the average annual salary for an S Corporation officer in the durable goods trade). Per Glass Blocks and Blodgett, this amounted to 15.25 hourly, or the aforementioned $15,860 per year.

The commissioner pointed out that Blodgett was not just an accounts receivable clerk, accounts payable clerk, or a service clerk. He was all of the above as well as other miscellaneous jobs. On top of this fact, in the original IRS audit file Blodgett was documented as stating that he worked 40 hour weeks[40, 41]. Quite interestingly, using Blodgett's hourly rate of 15.25 multiplied by the original 40 hour work week estimate in the IRS file resulted in a reasonable compensation figure of $31,720 (2080 x 15.25). This is ironically nearly equal to the $30,844 in 2007 and the $31,644 in 2008 that Glass

[39] *Glass Blocks Unlimited v. COMMISSIONER OF INTERNAL REVENUE*, 2013 T.C. Memo 180 (T.C. 2013) Page 2. While Blodgett had a group of day laborers he carried out all of the managerial functions in the firm and there was no debate over his employee classification.

[40] *Glass Blocks Unlimited v. COMMISSIONER OF INTERNAL REVENUE*, 2013 T.C. MEMO 180 (T.C. 2013) PAGE 5

[41] Quite damagingly, the taxpayer's own website states his business is the largest of its kind on the continent and is open 40 hour weeks. http://glassblocksoc.com/company.html (retrieved 2/1/2014)

Blocks paid to Blodgett. Simply put, Blodgett's own testimony implied that all of the distributions were salary even without an increased hourly rate.

With the court now classifying all of the contributions as capital contributions and all of the distributions as salary, the only remaining issue was the payroll tax related penalties. Based on the issues discussed above it appeared to the court that Blodgett and Glass Blocks were disguising salaries to decrease taxes. Thus, the penalty under sections 6651(a)(1) and 6656 applied due to the fact the court perceived that Glass Blocks and Blodgett were involved in willful neglect rather than reasonable cause. The taxes and penalties per quarter are seen below[42].

TABLE 4.1
Glass Blocks Penalties

Tax period ended	Employment tax	Addition to Tax sec. 6651(a)(1)	Penalty sec. 6656
3/2007	$ 1,179.78	$ 448.32	$ 58.99
6/2007	1,179.78	430.62	58.99
9/2007	1,179.78	412.92	58.99
12/2007	1,179.78	395.23	58.99
3/2008	1,210.38	387.33	60.52
6/2008	1,210.38	369.17	60.52
9/2008	1,210.38	351.01	60.52
12/2008	1,210.38	332.86	60.52
	9,560.64	3,127.46	478.04

In summation, the court took the commissioners position on each and every issue, and this recent ruling reflects not only the IRS's continued focus on S Corporation salaries, but also the pitfalls of poorly documented transactions.

[42] *Glass Blocks Unlimited v. COMMISSIONER OF INTERNAL REVENUE*, 2013 T.C. MEMO 180 (T.C. 2013) PAGE 1 penalties as calculated by sections 6651(a)(1) and 6656.

Sean McAlary v Commissioner

The most recent S Corporation reasonable compensation case occurred in *Sean McAlary, Inc. v. Commissioner*. The case was heard under the provisions of section 7463[43] of the IRC, and as such it is a summary opinion not subject to review[44] unlike the twice appealed *DEWPC* case discussed earlier. In the early 2000's Sean McAlary obtained his California real estate broker's license and formed Sean McAlary Ltd, Inc.—an S Corporation. In the minutes of Sean McAlary Ltd, Inc.'s board of directors meeting it was stipulated that: "The Annual Base Compensation shall be $24,000 when the number of Affiliates is not more than ten (10). Annual Additional Compensation in the amount of $10,000 shall be earned for each increment of ten (10) Additional Affiliates. No Additional Compensation shall be earned for any partial increment of ten (10) Affiliates."[45] This amounted to the best documented salary terms in any of the cases discussed in this article. However, Sean McAlary Ltd, Inc. issued no W2 and filed no payroll tax forms during 2006—the year in question. Instead, $240,000 was distributed from the S Corporation to Mr. McAlary.

As in the prior two cases, the court first determined whether or not the officer qualified as an employee due wages. Based on the fact that Mr. McAlary was the sole

[43] Per section 7463, if the deficiency amount is not in disputes and it does not exceed—
7463(a)(1) $50,000 for any one taxable year, in the case of the taxes imposed by subtitle A,
7463(a)(2) $50,000, in the case of the tax imposed by chapter 11,
7463(a)(3) $50,000 for any one calendar year, in the case of the tax imposed by chapter 12, or
7463(a)(4) $50,000 for any 1 taxable period

[44] The taxpayer may select to deal with their case under the small claims procedures. The cases are less formal and faster (http://www.ustaxcourt.gov/about.htm), however, per 7463(b) "a decision entered in any case in which the proceedings are conducted under this section shall not be reviewed in any other court and shall not be treated as a precedent for any other case."

[45] *Sean McAlary Ltd., Inc. v. COMMISSIONER OF INTERNAL REVENUE*, 2013 T.C. Summary Opinion 62 (T.C. 2013), page 2

employee of the S Corporation and the fact he had an employment contract with the S Corporation there was no doubt on the issue and both parties agreed to Mr. McAlary's employment status[46]. Next, with the IRS utilizing the same compensation expert that brought them victory in *DEWPC*, they made the case that reasonable compensation for Mr. McAlary was $100,755. This number was reached using the same type of methodology discussed in *DEWPC*, i.e., the hourly rate for a local real estate broker in the area was multiplied by the total number of hours worked. Per the California Occupational Employment Statistics Survey for 2006, the median wage for a real estate broker was 48.44 per hour, and this was multiplied by 2080 hours (40 hours per week x 52 weeks in a year). The compensation expert demonstrated that without the salary, the profit margin of the business was 44.7% — well over the industry average. With the salary expense of $100,755 on the books, however, the profit margin approximated the industry average[47].

While of course any amount of compensation would exceed the 0 that was paid in 2006, the $100,755 in wages over quadrupled the wages stipulated in the board minutes documented by the taxpayer. Sean McAlary Ltd, Inc. argued that reasonable compensation should be no more than the contractual terms in the referenced minutes, i.e., $24,000[48]. The court was not persuaded by the terms based on the often cited case of *Charles Schneider & Co v Commissioner*. Based on that case, the court noted that in situations where a single individual (in this case, Sean McAlary) holds the positions of

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[46] *Sean McAlary Ltd., Inc. v. COMMISSIONER OF INTERNAL REVENUE*, 2013 T.C. Summary Opinion 62 (T.C. 2013), (fn 3)

[48] The amount was 24,000 + additional compensation if the business expanded significantly (it did not). *Sean McAlary Ltd., Inc. v. COMMISSIONER OF INTERNAL REVENUE*, 2013 T.C. Summary Opinion 62 (T.C. 2013), page 2

both employer and employee during a salary negotiation, the negotiations are not arm's length and not firmly binding in the court room[49]. Thus, the court chose to ignore the meeting minutes and move to declare a higher number as reasonable compensation.

While the court rejected the taxpayer's salary agreement, they did not fully accept the expert witness' testimony either. They determined that using a 48.44 per hour wage (the median for the area and industry) was unreasonable due to the low amount of experience held by the taxpayer. Thus, citing cases that have demonstrated that any number of factors can be considered in a reasonable salary case[50], the court selected (perhaps somewhat arbitrarily) $40 as a reasonable hourly rate for Sean McAlary.

The final issue discussed was that of interest and penalties on the unpaid reasonable salary that the court had determined. The taxpayer pushed against the penalties slightly more than in the other cases discussed. Sean McAlary argued that he had relied on his tax preparer in good faith. This defense has shown to be a useable[51] but not absolute[52]. The factors the court can consider in this instance include but are by no means limited to: "(1) The adviser was a competent professional who had sufficient expertise to justify reliance, (2) the taxpayer provided necessary and accurate information to the adviser, and (3) the taxpayer actually relied in good faith on the adviser's

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[49] *Charles Schneider & Co., Inc. v. Commissioner*, 32 T.C.M. (CCH) 555, 1973 T.C. Memo 130 (T.C. 1973) is an example in which the taxpayer held both the employee and employer positions and the contracts resulting from that arrangement were not binding.

[50] *K & K Veterinary Supply, Inc. v. COMMISSIONER OF INTERNAL REVENUE*, 2013 T.C. Memo 84 (T.C. 2013), *Charles Schneider & Co., Inc. v. Commissioner*, 32 T.C.M. (CCH) 555, 1973 T.C. Memo 130 (T.C. 1973), *Joly v. Commissioner*, T.C. Memo. 1998-361, 1998 WL 712528, at *4, aff'd without published opinion

[51] *United States v. Boyle*, 469 U.S. 241, 105 S. Ct. 687, 83 L. Ed. 2d 622 (1985).

[52] *Freytag v. Commissioner*, 89 T.C. 849, 888 (1987), aff'd, 904 F.2d 1011 (5th Cir. 1990)

judgment."[53] However, the only information the taxpayer put forth to support his claim of good faith reliance was that he met the preparer at a business conference and was impressed. The taxpayer provided no evidence that he did the research necessary to judge the tax preparer's competence. As the taxpayer could not demonstrate good faith reliance, the penalties were applied on top of the payroll taxes owed.

While un-citable based on the rules used to run the trial[54], the case does demonstrate that even the documenting of a salary means little if the salary is deemed to be too low. However, if the low salary had been paid rather than none at all — a red flag in a small business audit — the company might not have been audited to begin with. The case also shows the flexibility of the courts to ignore the assertions of both the taxpayer and the commissioner when they believe both sides to be unreasonable. While the IRS was largely victorious, the court did not accept their estimate in full[55].

IV. WINNING A REASONABLE COMPENSATION CASE

A common theme can be noted throughout the recent three cases having to do with reasonable compensation. The wages paid to the S Corporation's employees were

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[53] See for example Neonatology *Assocs., P.A. v. Commissioner*, 115 T.C. 43, 98 (2000), aff'd, 299 F.3d 221 (3d Cir. 2002), *Ellwest Stereo Theatres, Inc. v. Commissioner*, T.C. Memo. 1995-610,

[54] 7463(b) "a decision entered in any case in which the proceedings are conducted under this section shall not be reviewed in any other court and shall not be treated as a precedent for any other case."

[55] The court discounted part of the compensation expert's testimony, and this may account for why the ending reasonable compensation figure was below the IRS's assertions. *Sean McAlary Ltd., Inc. v. COMMISSIONER OF INTERNAL REVENUE*, 2013 T.C. Summary Opinion 62 (T.C. 2013), (fn 10)

either non-existent[56] or a small fraction of the total amounts distributed to the shareholders[57]. Perhaps worrisome for taxpayers, the most impactful verdict — *DEWPC* at the appellate level — actually featured a taxpayer putting forward a fairly strong case when compared to *Glass Blocks* and *Sean McAlary*. DEWPC paid its officer a salary of $24,000 (i.e., they at least avoided the red flag of paying a salary of zero) but still ended up subject to the level of reasonable compensation estimated by the IRS's expert witness.

Therefore, it would seem that the only way to either avoid or win litigation in this area is to pay a somewhat higher salary beyond token amounts of $10,000 or $20,000. Taxpayers can follow the strategy used by the IRS's expert witness and analyze local salary figures for their industry, then select the most conservative estimate based on these figures. A conservative — but not extraordinarily low — salary would be high enough that the IRS would not have a large victory if it were overturned, and thus a battle of the deficiency might never begin as the costs for the IRS would outweigh the potential benefits.

Of course there is more than one way to win a reasonable compensation case. While recent precedent has been focused on the level of salary due an employee, another way to win an S Corporation salary case is to prove that the officer is not an employee, or the officer is an employee who performs no more than minor services. In neither of these situations does the S Corporation face the stiff requirements of section 31.3121(d)-1(b) which allows for a substance over form classification of distributions (e.g., the remuneration could be in the form of dividends while being in substance wages). In none

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[56] *Glass Blocks Unlimited v. COMMISSIONER OF INTERNAL REVENUE*, 2013 T.C. Memo 180 (T.C. 2013), *Sean McAlary Ltd., Inc. v. COMMISSIONER OF INTERNAL REVENUE*, 2013 T.C. Summary Opinion 62 (T.C. 2013)

[57] *DAVID E. WATSON, PC v. US*, 668 F.3d 1008 (8th Cir. 2012),

of the court cases discussed thus far was the S Corporation officer's employee status debatable. It was a fact agreed upon by all parties (i.e., taxpayer, IRS, and court) in each case[58].

Though it necessitates looking back approximately two decades[59], there was a case in which the non-employee status of an officer was used a successful defense. *Davis v. United States of America*[60].

An Example of Winning a Reasonable Compensation Case — *Davis vs. U.S.*

In *Davis*, the taxpayers were husband and wife officers of an S Corporation. They did not pay out any salaries to themselves and the IRS audited their returns from 1987-1989 and determined that there were $2,336 in FICA and FUTA taxes due as the IRS reclassified some profit distributions and loan repayments as wages. The taxpayers filed for a refund of the $2,336 and attempted all possible administrative remedies to obtain it. They failed in their attempts, but worse still, the IRS actually stepped up their assessment against the taxpayer by reclassifying all payments of any kind made to either the husband or wife into wages. This resulted in a total assessment of $39,220.66.

Having no other administrative options to solve their dispute, the taxpayers brought their case to the District Court of Colorado. The taxpayers presented to the court the fact that while the husband was the president of the corporation, he had almost no

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[58] See for example *DAVID E. WATSON, PC v. US*, 668 F.3d 1008 (8th Cir. 2012), *Glass Blocks Unlimited v. COMMISSIONER OF INTERNAL REVENUE*, 2013 T.C. Memo 180 (T.C. 2013), *Sean McAlary Ltd., Inc. v. COMMISSIONER OF INTERNAL REVENUE*, 2013 T.C. Summary Opinion 62 (T.C. 2013). In all three cases the taxpayer, IRS, and court had no disagreement on employee status.

[59] Another substantially older case exists which saw the taxpayer achieve victory at the appellate level: *Trucks, Inc., DC* Neb., 84-1 ustc ¶9418, 588 FSupp 638. Aff'd, per curiam

[60] *Davis*, No. 93-C-1173 (D. Colo. 1994).

duties in the corporation. This was easily provable by the fact that he worked as a ski instructor, truck driver, and a heavy equipment operator. As noted earlier, officers who perform only minor duties are not entitled to remuneration[61]. Therefore the court found that all of the distributions reclassified to the husband were not subject to payroll taxes.

The wife's situation was slightly more complicated as she admittedly worked in the corporation as a secretary. She presented undisputed evidence stating that she worked 12 hours a month, and had her accountant act as an expert witness and value her time at 8 dollars per hour[62]. Using the figures that the taxpayer asserted resulted in a total payroll tax liability of only $647.32. Interestingly, the IRS did not dispute any of the taxpayers assertions on reasonable hourly rate or hours worked. Instead they asked the court to use its common sense to determine the true value of the wife's services. Unimpressed with that line of reasoning, the court ruled that the total payroll tax due from the wife's minor salary was $647.32 as the taxpayer asserted at trial.

Thus, the taxpayer had a near total victory as they decreased their FICA and FUTA (plus penalties) from $39,220.66 to $647.32. The husband's defense — in which he showed he was not an employee — was fully successful, while his wife's defense brought her reasonable compensation level down to almost nothing. The wife's defense, however, would most likely prove markedly less effective in new cases as the IRS is now actively utilizing expert witnesses in S Corporation reasonable compensation cases.

Interestingly, this case has never been cited in any other reasonable compensation cases even though it appears as if it could be a valuable tool for S Corporation owners that are also employees.

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[61] section 31.3121(d)-1(b) of employment regulations

[62] *Davis*, No. 93-C-1173 (D. Colo. 1994). Page 2

V. ETHICAL/PROFESSIONAL RESPONSIBILITY CONSEQUENCES

While the consequences to the taxpayer are now clear based on the three cases discussed, it should be noted that there appear to be ramifications for the tax professionals involved based on the guidance issued in Treasury Circular 230[63]. Circular 230 is a code of professional conduct that applies to most tax preparers[64] and it delineates a number of situations in which tax preparers may and may not be penalized. In all of the major recent cases the court determined that the taxpayer's position was unreasonable to the point that penalties were necessary at the taxpayer level[65]. With my legal analysis supporting the IRS's position that the tax positions taken were unreasonable, I move to determine if this implies the preparers are also subject to penalties under the guidance of Circular 230.

A basic tenant of Circular 230 is that practitioners may not sign returns if the practitioner knows — or reasonably should know — that the return lacks a reasonable basis of success. If the tax practitioner violates this reasonable basis standard they can be subject to financial penalties, or they can have their ability to practice before the IRS revoked. The term reasonable basis is not explicitly defined in the IRC or associated regulations, but it is known to be a standard below "More Likely than Not," "Substantial

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[63] Code of Federal Regulations. Reg. §10.0 through Reg. §10.93

[64] According to section 10.3 of Circular 230, the following groups may practice before the IRS and are subject to the rules of Circular 230: Attorneys, CPAs, Enrolled Agents, Enrolled Actuaries, Enrolled Retirement Plan Agents, Registered Tax Return Prepares, as well as certain government officers subject to limitations.

[65] *DAVID E. WATSON, PC v. US*, 668 F.3d 1008 (8th Cir. 2012), *Glass Blocks Unlimited v. COMMISSIONER OF INTERNAL REVENUE*, 2013 T.C. Memo 180 (T.C. 2013), *Sean McAlary Ltd., Inc. v. COMMISSIONER OF INTERNAL REVENUE*, 2013 T.C. Summary Opinion 62 (T.C. 2013). In all three cases the taxpayer was found to have an unreasonable position and penalties and interest were imposed on the delinquent taxes.

Authority," and "Realistic Possibility,[66]" but above a claim that is simply arguable. Convention attributes a percent of approximately 20-25%[67] to the "Reasonable Basis" standard as it is below the "Realistic Possibility" standard which was formerly defined explicitly as a "one in three[68]" chance of victory upon challenge. It should also be noted that the "Reasonable Basis" standard only applies to positions explicitly disclosed to the IRS — the preparer must attach a description of the potentially suspect position to the tax return[69]. To take an undisclosed position on a tax return (as in all discussed cases) the tax preparer must ensure that the position has "Substantial Authority." As noted this standard is in between the most stringent "More Likely than Not" standard and the "Realistic Possibility" standard. Historically "Substantial Authority" is perceived to be approximately 40-45%[70]

While it is certainly difficult to predict the percent chance of achieving a victory (and avoiding penalties) when a position is challenged, at the extreme ends of the spectrum it is somewhat obvious. For example, in a case in which all related precedent

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[66] Regs. Sec. 1.6662-3(b)(3)

[67] While the standards are no longer explicitly given percent values in the tax code, tax practitioners tend to agree that the Reasonable Basis Standard is approximately a 20-25% chance of victory upon challenge. For example, see:
http://www.journalofaccountancy.com/Issues/2010/May/20092347.htm;
http://www.nysscpa.org/cpajournal/1996/JAN96/f380196.htm

[68] IRC 6694-2(b)(1) before 2008 amendment which removed the explicit "one and three" guidance.

[69] Section 6694(a)(2)(B) allows the use of the "Reasonable Basis" standard if the position is explicitly disclosed, however, this obviously constitutes a redflag for audits.

[70] "Substantial Authority is known to be under the 50% required for "More Likely than Not," and is assumed to be approximately 40-45%. See for example:
http://www.journalofaccountancy.com/Issues/2010/May/20092347.htm;
http://www.nysscpa.org/cpajournal/1996/JAN96/f380196.htm

disagrees with a tax preparer's position, it seems clear that the position will not survive a challenge. Two recent cases demonstrate circumstance in which preparer penalties apply. In *Franke v. Commissioner* the tax preparer misused the religious entity classification on a tax return in a clear violation of tax law[71]. More in line with this paper's reasonable compensation discussion, in *US v. Cruz*, the tax preparer significantly misstated deductions and credits on the returns they filed resulting in the IRS initiating a lawsuit based in part on the provisions of Circular 230[72]. In one of the many incorrect returns filed by the tax preparers in *Cruz*, there was an instance in which the tax preparer filed a return that did not report any salary paid to a corporate officer but did report distribution income. While this issue was not the main focus of *Cruz*, it is a situation almost identical to the facts found in *Glass Blocks, McAlary,* and *DEWPC,* and it comprised part of a preparer penalty case. *Cruz* resulted in the tax preparers being barred from practice before the IRS under the rules of Circular 230. However, no financial preparer penalties were levied due to the court being unable to determine the monetary value of the errors the tax preparers caused.

My analysis of the three main cases and other sources discussed herein indicates that there is no doubt that the taxpayers were in the wrong based on half a century of reasonable compensation precedent. While there are ways to win reasonable compensation cases, the taxpayer and tax preparer must structure the situation drastically differently (e.g., *Davis*) than they did in *McAlary, Glass Blocks,* and *DEWPC*. Cases similar to these three have been litigated to the point that claiming the taxpayer has a

[71] Franke v. COMMISSIONER OF INTERNAL REVENUE, 2011 T.C. Memo 10 (T.C. 2011).

[72] US v. Cruz, 618 F. Supp. 2d 1372 (S.D. Fla. 2008).

"Reasonable Basis" is not persuasive in the least — The taxpayers clearly underpaid themselves based on the work they provided their companies. Furthermore, ignorance is not a defense when dealing with reasonable compensation cases. Section 6694-2(b) notes that when determining the probability of success of a tax position we must assume that the practitioner is reasonable and well informed on tax law. The recent prevalence and long history of reasonable compensation cases implies that practitioners should be aware of the issue. The very fact that cases like *Glass Blocks* received Tax Court Memo opinions implies tax preparers lack a "Reasonable Basis" if they file returns with low/no compensation. While it would be an aggressive position for the IRS to take, the law is settled and preparer penalties should be incurred in all cases similar to *Glass Blocks, McAlary,* and *DEWPC* based on the rules in Circular 230.

In the main cases discussed it appears that the tax preparers who filed the returns on behalf of the taxpayers were supporting obviously incorrect positions lacking reasonable basis. Therefore, the practitioners should suffer the preparer penalties outlined in Circular 230. Regulation 10.50 of Circular 230 grants the Secretary of the Treasury the authority to censure, suspend, or disbar any practitioner from practice before the IRS while Section 6694 deals specifically with the monetary penalties involved. Under Section 6694(a)(1), tax preparers who file an unreasonable return can be penalized the greater of $1,000 or 50% of the income derived from the unreasonable return. In more extreme circumstances tax preparers can be penalized the greater of $5,000 or 50% of the income derived from the unreasonable return[73].

[73] See section 6694(b)

VI. IMPLICATIONS FOR TAX PREPARERS AND TAXPAYERS

Though legal analysis I have demonstrated the general issues surrounding S Corporation reasonable compensation. It has historically been a frequently litigated area that impacts thousands of business and carries significant potential tax liabilities in many cases[74]. It appears that the IRS increased the monetary margins of their victories in each of the cases thanks in large part to the usage of expert witness testimony. The very fact that the expert witness called to the stand in *DEWPC* and *Glass Blocks* had 20-30 cases of reasonable compensation experience with the IRS should serve as an indication of how dedicated the IRS is to this issue. Taxpayers themselves should consider the acquisition of an expert witness to support their testimony in order to combat the IRS when determining a reasonable salary. However, it should also be noted that in each of the main cases discussed the taxpayer made at least one large mistake. In each case the taxpayer failed to properly document various transactions, and in the most recent two cases the taxpayer fell for the tempting trap of paying a salary of zero — a red flag for the IRS. These issues can be avoided by future taxpayers by paying a low but not extraordinarily salary and documenting work hours and types of labor furnished properly. *Davis* showed that reasonable compensation cases can be won by properly documenting either low levels of employment or no employment, so it is perhaps time that taxpayers dust off the unused precedent in *Davis* to help win future cases by following its approach.

From the tax preparer perspective I have also discussed the professional responsibility matters not covered explicitly in these main cases. Though a separate matter from the taxpayer related rulings in the cases discussed, it appears that in each of

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[74] According to Stumpff, "The Reasonable Compensation Rule," 19 Va. Tax Rev. 371 (Fall 1999)

these cases the tax preparers involved violated major provisions of Circular 230. Based on the current iteration of Circular 230, tax preparers should be cautious when preparing the returns of tax payers who claim low or nonexistent salaries. The issue of S corporation reasonable compensation is well known, and turning a blind eye to it amounts to a breach of professional conduct that could potentially be fined.

VII. IMPLICATIONS FOR PUBLIC POLICY

Due to the notable tax savings taxpayers receive by avoiding the self-employment tax it seems obvious that taxpayers will continue to use S corporations as a means of hiding income from the self-employment tax. While the IRS certainly has an interest in reducing this behavior, they must view the matter from a cost benefit perspective as well. Compared to other types of tax audits, the amounts in many S corporation reasonable compensation cases seem paltry. For example, in *DEWPC* the amount won by the IRS was $23,431.23— arguably an insignificant victory considering the fact that the IRS had to fight the case up to the appellate level. With the temptation on the taxpayer side so strong and the cost of litigation so high it would seem that reforming the S corporation self-employment tax loophole could be of benefit to the United States. While S corporations are often described as "corporations taxed as partnerships" that is not strictly true. As a general rule the distributive share of a partner's income[75] is subject to self-employment tax while only the distributed share is subject to the self-employment tax in S corporations.

A common sense proposal for eliminating this type of reasonable compensation litigation without removing all of the favorable tax benefits of S corporations would be to

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[75] 1.1402(a)-2

harmonize S corporation taxation with partnership taxation while reducing the other taxes paid by S corporations. Scholars support this position as it would retain the intended preferential treatment of small businesses while eliminating the complex and costly issue of S corporation reasonable compensation[76]. If formatted as a tax neutral proposal this approach would have only benefits for all parties involved as the entire S corporation salary process would be effectively irrelevant. If, however, the government fails to reform reasonable compensation law, it appears that the IRS could take an aggressive stance and penalize all preparers who participate in reasonable compensation cases. While reasonable compensation law is hard to enforce, the law is settled and preparers should be aware of that.

[76] See for example: S Corp Taxation: Level the playing field (tax notes)

CHAPTER 5

CONCLUSION

While taxation is often considered a purely monetary matter, this dissertation has focused on the ethical decisions made in the field of taxation. Each of my papers point out significant unethical activities that are being perpetrated on a regular basis by corporations, individual taxpayers, and tax preparers.

In Chapter 2, I found that firms engaged in both social and financial responsibility were less likely to participate in aggressive tax avoidance behavior when compared to their less responsible peers. The flipside of this finding is that CSR alone does not predict ethical tax behavior. Some firms appear to be engaging in CSR disclosures to appear more ethical while still engaging in aggressive (and potentially illegal) tax avoidance. These findings can hopefully be used to better target tax evaders, but the current corporate environment does not seem to be highly ethical in the area of taxation.

In Chapter 3, I found that an ethical prompt could reduce tax evasion. I also found that participants dealing with the IRS (rather than their state) were more accepting of tax evasion. However, the descriptive statistics indicate that the vast majority of participants were at least somewhat accepting of tax evasion. Almost three-quarters of my participants would not judge their friend for committing tax evasion. Furthermore, almost half of my participants admitted that they would evade taxes when presented with the opportunity. While the ethical reminder does have an impact, the average individual does not seem averse to tax evasion.

In Chapter 4, I found that CPAs and tax preparers were engaged in filing tax returns that had no reasonable basis of being upheld on an audit. These tax returns

reported unreasonably low salary figures to avoid paying Social Security and Medicare taxes. This finding is perhaps the most troubling as tax preparers are intended to prevent corporations and individuals from committing tax fraud. Instead of tax preparers preventing fraud, I found that there have been a large number of cases in which the tax preparers were not following the guidance of the tax preparer code of conduct, Circular 230. While these tax preparers are in clear violation of Circular 230, my review of cases and literature revealed that the IRS has rarely cited reasonable compensation as a reason for issuing a preparer penalty. It seems very likely the IRS could pursue all tax preparers who prepare returns which report unreasonable compensation.

In conclusion, all three of my papers analyze tax evasion/aggressiveness as an ethical issue. I have discussed significant ethical infractions at every level of the tax system: Corporations, individual taxpayers, and tax preparers. I assert that my policy suggestions can help to reduce these infractions, but I also recognize that much more effort is required on the part of researchers and organizations if unethical tax practices are to be prevented.

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APPENDIX A
Variable Definitions

Variable	Definition
Measures of Aggressive Tax Avoidance (From and measured as in Hoi et al. 2013)	
$SHELTER_{it}$	We use Wilson's (2009) sheltering probability to capture incidence of the most aggressive avoidance practices as follows. We use the regression model reported in Wilson (2009, Table 5, Column 3). The sheltering probability equation is: $\beta X = \beta_1 BTD_{it} + \beta_2 DAP_{it} + \beta_3 LEVit + \beta_4 SIZE_{it} + \beta_5 ROA_{it} + \beta_6 FOREIGN\ INCOME_{it} + \beta_7 R\&D_{it}$ where $SHELTER_PROB_{it}$ is the sheltering probability for firm i in year t; BTD_{it} is a book-tax difference measure as defined by Kim et al. (2011); DA_{it} is discretionary accruals from the performance-adjusted modified cross-sectional Jones Model; LEV_{it} is firm leverage; AT_{it} is the log of total assets for firm i in year t; ROA_{it} is return on assets; $FOREIGN\ INCOME_{it}$ is a dummy variable set equal to 1 for firm-years that report foreign income, and 0 otherwise; and $R\&D_{it}$ is research and development expense ratio. Following Kim et al. (2011), we define BTD_{it} as book income less taxable income scaled by lagged assets (AT_{it}). Book income is pretax income (PI_{it}) in year t. Taxable income is calculated by summing current federal tax expense ($TXFED_{it}$) and current foreign tax expense ($TXFO_{it}$) and dividing by the statutory tax rate and then subtracting the change in net operating loss carryforwards ($TLCF_{it}$) in year t. If current federal tax expense is missing, then total current tax expense is calculated by subtracting deferred taxes ($TXDI_{it}$), state income taxes (TXS_{it}), and other income taxes (TXO_{it}) from total income taxes (TXT_{it}) in year t. Following Rego and Wilson (2012), we rank $SHELTER_PROB_{it}$ each year and create a dummy variable to capture those firms that have high sheltering probability. $SHELTER_{it}$ is an indicator variable that equals to 1 if the firm's estimated sheltering probability is in the top quartile in that year, and 0 otherwise.
$DTAX_{it}$	Frank et al. (2009) discretionary permanent book-tax difference for firm i in year t. $DTAX_{it}$ is the eit from the following regression estimated by two-digit SIC code and fiscal year: $PERMDIFFit = \beta_0 + \beta_1 INTANG_{it} + \beta_2 UCON_{it} + \beta_3 MI_{it} + \beta_4 SCTE_{it} + \beta_5 \Delta NOL_{it} + \beta_6 LAGPERM_{it} + \varepsilon_{it}$; where: $PERMDIFF_{it} = BI_{it}\ [(CFTE_{it} + CFOR_{it})/STR_{it}] - (DTE_{it}/STR_{it})$; BI_{it} = pre-tax book income (PI) for firm i in year t; $CFTE_{it}$ = current federal tax expense (TXFED) for firm i in year t; $CFOR_{it}$ = current foreign tax expense (TXFO) for firm i in year t; DTE_{it} = deferred tax expense (TXDI) for firm i in year t; STR_{it} = statutory tax rate in year t; $INTANG_{it}$ = goodwill and other intangibles (INTAN) for firm i in year t; $UNCON_{it}$ = income (loss) reported under the equity method (ESUB) for firm i in year t; MI_{it} = income (loss) attributable to minority interest (MI) for firm i in year t; $CSTE_{it}$ = current state income tax expense (TXS) for firm i in year t; $DNOL_{it}$ = change in net operating loss carryforwards (TLCF) for firm i in year t;

APPENDIX A (continued)

Variable	Definition
	and $LAGPERM_{it}$ = one-year lagged PERMDIFF for firm i in year t. We follow the method in Frank et al. (2009) to handle the missing value problems in estimating $DTAX_{it}$. If minority interest (MI), current foreign tax expense (TXFO), income from unconsolidated entities (ESUB), or current state tax expense (TXS) is missing on Compustat, then we set MI, CFOR, UNCON, or CSTE, respectively, to 0. If current federal tax expense (TXFED) is missing on Compustat, then we set the value of CFTE to: total tax expense (TXT) less current foreign tax expense (TXFO) less current state tax expense (TXS) less deferred tax expense (TXDI). If information for goodwill and other intangibles (INTAN) is missing on Compustat, then we set the value for INTANG to 0. If INTAN = C, then we set the value of INTANG to that for goodwill (GDWL).
DD_BT_{it}	Desai and Dharmapala (2006) discretionary book-tax difference (DD_BT) for firm i, year t. DD_BT is equal to $\mu_i + \varepsilon_{it}$, from the following fixed effect regression: $BT_{it} = \beta_1 TA_{it} + MI_{it} + \varepsilon_{it}$, where BT_{it} is the Manzon and Plesko (2002) book-tax difference measure (described below); TA_{it} is Dechow et al. (1995) total accruals measure for firm i in year t, scaled by the lagged value of assets; μi is the average value of the residual for firm i over the sample period; and εit is the deviation of the residual in year t from firm i's average residual. BT_{it} is defined as (U.S. domestic financial income – U.S. domestic taxable income- Income taxes (State) - Income taxes (Other) - Equity in Earnings)/lagged assets = (PIDOM - TXFED/Statutory tax rate - TXS - TXO - ESUB)/AT_{t-1}. Firms with 0 or negative taxable income are assumed to have attenuated incentives, at the margin, to engage in tax-sheltering activity. We follow prior literature, e.g., Desai and Dharmapala (2006), and include only firm-years with positive TXFED.
ETR_{it}	Effective Tax Rate. It is calculated by taking a firm's total tax expense and dividing it by their pre-tax book income. ETRs with negative denominators are deleted. The ETR is windsorized to ensure that no ETR exceeds 1 or is less than 0.
$CETR_{it}$	Cash Effective Tax Rate. It is calculated by taking a firm's cash taxes paid and dividing it by pre-tax book income less special items. CASHETRs with negative denominators are deleted. The CASHETR is windsorized to ensure that no CASHETR exceeds 1 or is less than 0.

APPENDIX A (continued)

Variable	Definition
Sustainability Measures	
CSR_{it}	Calculation of CSR variable demonstrated in Table 2
FSA_{it}	Return on Equity (Model 1), and Standard Deviation of Return on Equity (Model 2)
FSA_{it}	Return on Assets (Model 1), and Standard Deviation of Return on Assets (Model 2)
Control Variables	
ABS_DA_{it}	Absolute value of discretionary accruals for firm i, year t, where discretionary accruals are computed using the modified Jones model including lagged ROA as an additional regressor;
$CASH_{it}$	Cash holding for firm i, year t, defined as cash and marketable securities (CHE) divided by lagged assets (AT);
ROA_{it}	Return on assets for firm i, year t, measured as operating income (PI ┐ XI) scaled by lagged assets (AT);
LEV_{it}	Leverage for firm i, year t, measured as long-term debt (DLTT) scaled by lagged assets (AT);
NOL_{it}	A dummy variable coded as 1 if loss carry forward (TLCF) for firm i is positive as of the beginning of the year t;
ΔNOL_{it}	Change in loss carry forward (TLCF) for firm i, year t, scaled by lagged assets (AT);
FI_{it}	Foreign income (PIFO) for firm i, year t, scaled by lagged assets (AT). Missing values in PIFO are set to 0;
PPE_{it}	Property, plant, and equipment (PPENT) for firm i, year t, scaled by lagged assets (AT);
$INTANG_{it}$	Intangible assets (INTAN) for firm i, year t, scaled by lagged assets (AT);
$R\&D_{it}$	Research and development expense ratio for firm i, year t, measured as research and development expense (XRD) scaled by lagged assets (AT). Missing values in XRD are set to 0;
$DSALE_{it}$	Changes in sales (SALE) scaled by lagged sales for firm i, year t;
$SIZE_{it-1}$	Natural logarithm of the market value of equity (PRCC_F X CSHO) for firm i at the beginning of year t; and
MB_{it-1}	Market-to-book ratio for firm i, at the beginning of year t, measured as market value of equity (PRCC_F X CSHO), scaled by book value of equity (CEQ).

Appendix B: Instrument

First Phase—Informed Consent:

This survey is part of a study that is being carried out by a researcher at the University of Memphis. The study has been approved by the Institutional Review Board at the University of Memphis.

In this survey you will be asked questions concerning your attitudes about the income tax system. There are no known risks associated with this research and all responses are anonymous. Your responses to the questions in this survey will contribute to research that may be helpful to society.

If you have any questions or comments you may contact me at:

jmplcnik@memphis.edu

You can also contact the Institutional Review Board at the University of Memphis: irb@memphis.edu

If you consent to participating in this study please click the "next" button. If you do not consent please close this window.

Second Phase—Screening Questions:

Please carefully read and answer the following questions. All responses are anonymous as no personal identifying data is being collected.

Are you married?

1) Yes
2) No

Select the option which best describes your/you and your spouse's[1] income from all sources.

1) Under $4,000
2) $4,000 to $9,999
3) $10,000 to $19,999
4) $20,000 to $50,000
5) More than $50,000

How many years have you/you and your spouse been receiving income?

1) Less than 1 year
2) 1 to 2 years
3) 3 to 4 years
4) 5 or more years

Are you familiar with Tax Form L3337 on income exclusion?

1) Yes
2) No

Third Phase—Ethical Prompt/Legal Prompt/No Prompt

Ethical Prompt:

The (IRS/Local Agency) relies on the honesty and integrity of taxpayers. The revenue collected by the (IRS/Local Agency) provides the primary financial support of the (federal/state) government, and the (federal/state) government promotes programs supporting the health, safety, and financial wellbeing of (American families/families in your state). Insufficient (IRS/Local Agency) revenue can damage these programs and the people who benefit from them.

Legal Prompt:

Misstating tax information is an offense that is subject to the penalties of perjury. Taxpayers should ensure to the best of their knowledge and belief that all tax forms filed are true, correct, and complete.

No Prompt: N/A

Forth Phase—Tax Evasion Scenario

Please carefully read the following scenario. I am interested in your reactions to the scenario.

Pat is a taxpayer in (the United States/your state). Pat's primary income this year came from a job at a local business paying a salary of $30,000 per year. Pat also did $4,000 of other work on the side for extra money. Pat's $30,000 salary from the local business was paid by direct deposits, while Pat's other income of $4,000 was paid in cash. While preparing the current year's tax return, Pat realizes that additional money will have to be paid to the (IRS/state revenue agency) due to the $4,000 of other income. While Pat knows that legally the cash income of $4,000 should be reported, Pat also knows that this income would be hard for an audit to find. Pat could use the extra money to pay expenses and decides not to report any of the $4,000 of cash income to avoid paying more taxes to the (IRS/state revenue agency).

Fifth Phase—Moral Intensity Questionnaire

Please carefully read and answer the following questions. All responses are anonymous as no personal identifying data is being collected.

1) Most people would consider it wrong that Pat did not report the $4,000 in cash income.
Disagree 1. 2. 3. 4. 5. 6. 7. Agree

2) There is a very small likelihood that Pat's decision will actually cause any harm.
Disagree 1. 2. 3. 4. 5. 6. 7. Agree

3) Pat's decision will cause harm in the immediate future.
Disagree 1. 2. 3. 4. 5. 6. 7. Agree

4) Pat's decision will harm few people if any.
Disagree 1. 2. 3. 4. 5. 6. 7. Agree

5) Pat's decision will affect people in Pat's community.
Disagree 1. 2. 3. 4. 5. 6. 7. Agree

6) The overall harm done as a result of Pat's decision will be small.
Disagree 1. 2. 3. 4. 5. 6. 7. Agree

Final Phase—Debriefing Questionnaire

Please carefully read and answer the following questions. All responses are anonymous as no personal identifying data is being collected.

If a friend of yours made the same decision as Pat, would you think less of them for doing so?

1) Yes
2) No

Would you have done the same thing as Pat?

1) Yes
2) No

Please briefly explain your answers to the last two questions.

Please select your gender.

1) Male
2) Female

Please indicate your political orientation.

Conservative 1. 2. 3. 4. 5. 6. 7. Liberal

Have you or someone close to you ever been audited by a tax authority?

1) Yes
2) No

Appendix C:
Jones's Factors of Moral Intensity as Measured by Leitsch and Current Study

JONES 1991 FACTOR	JONES 1991 DESCRIPTION	LEITSCH 2004 SURVEY	SURVEY FOR CURRENT SETTING
Social Consensus	"the degree of the social agreement that a proposed act is evil (or good)." (Jones 1991, 375)	"Most people would agree that (the decision-maker's decision) is wrong"	Most people would consider it wrong that Pat did not report the $4,000 in cash income.
Probability of Effect	"a joint function of the probability that the act in question will actually take place and the act in question will actually cause the harm (benefit) predicted." (Jones 1991, 375)	"There is a very small likelihood that (the decision maker's) decision will actually cause any harm"	There is a very small likelihood that Pat's decision will actually cause any harm.
Temporal Immediacy	"the length of time between the present and the onset of consequences of the moral ac in question (shorter length of time implies greater immediacy)." (Jones 1991, 376)	"(The decision-maker's) decision will cause harm in the immediate future"	Pat's decision will cause harm in the immediate future.
Concentration of Effect	"an inverse function of the number of people affected by an act of given magnitude." (Jones 1991, 377)	"(The decision-maker's) decision will harm a few people (if any)"	Pat's decision will harm few people, if any.
Proximity	"the feeling of nearness (social, cultural, psychological, or physical) that the moral agent has for victims (beneficiaries) of the evil (beneficial) act in question." (Jones 1991, 376)	"(The decision maker's) decision will affect his/her co-workers".	Pat's decision will affect people in Pat's community.
Magnitude of Consequences	"is defined as the sum of the harms (or benefits) done to victims (of beneficiaries) of the moral act in question." (Jones 1991, 374)	"The overall harm (if any) done as a result of (the decision-maker's) decision will be small"	The overall harm done as a result of Pat's decision will be small.

Appendix D:
Comments Provided by U.S. Participants

1) “If the money is not accountable there is no real obligation to file it with the IRS. Big companies use loopholes all the time to get away with paying their share of taxes, how much harm really, is a average Joe like pat really going to do? Not much. Nothing.
2) lots of people do it
3) It is unreported income so I am not going to willfully penalize myself when I don't need to.
4) In a completely black & white sense, it's wrong to not pay the taxes, but there are so many reasons to justify it not being that big of a deal in the grand scheme of things that I wouldn't think poorly of someone doing what Pat did. If the amount not paid taxes on were more significant, I'd feel differently, but for a low-middle class person trying to get by, I'd have a hard time coming down too hard on them and if I were in that situation, I'd consider doing the same.
5) We pay enough of our money to the government and a lot of the money we don't get to decide how it should get spent so I think that keeping some extra for ourselves is fine.
6) While I understand someone not wanting to participate in a broken system in some capacity, I probably still wouldn't not report it myself. I'm just too paranoid.
7) If someone was making that salary and wanted to cut the corners, I cannot tell them how to live their life nor think less of them for that. I would not do it, personally.
8) I do not see what Pat did as a big deal. However, I am not the type of person to lie, in general, let alone a government agency.
9) It annoys me when people don't pay their full share and use the same roads and governement funded items that I use. While pat individually is causing minor harm, when everyone does it, the problem is drastic. I would definitely have ann issue with a friend doing this and would inform them of it. We cannot complain about corporate welfare and businesses not paying their fair share when we do it ourselves.
10) $4,000 is a relatively small amount compared to the millions hidden by other individuals but $4,000 is a large amount to someone making a salary like Pat receives
11) I would want to keep the money for myself, the taxes collected would be very small.
12) I wouldn't judge anyone for doing what they think is best for themselves.
13) I imagine that I would not think that cash payments would be taxable. If we tax those, why don't we tax everyone on their birthday for any cash or gifts that they get? If the top 1% paid taxes on everything that they legally should, then I doubt that we would need to tax anyone making less than 100,000/yr. I could go both ways on this though, I would feel guilty and possible would not be able to do it.
14) I want the moeny I earned
15) I feel that I would do the same thing because of the cost benefit ratio for myself.
16) I don't judge Pat for how he pays his taxes.

17) Taxes are high enough as it is. Can't blame him for trying to save a little bit of money.
18) I would think less of my friends for doing this since it's like lying/stealing. I would not have done the same as Pat because I think it's wrong.
19) I would report all the income because it is the right thing to do. I would not think let of Pat because it is not a huge deal in the scheme of things.
20) If you're able to pay it then I think you should. If you're barely getting by I could understand a little more about the decision but still think it's the wrong thing to do.
21) If a friend did this, I would not look down on them. I know my friend would not act maliciously. While he did not pay all of his taxes he payed a very major portion and the rest is being used for something needed, not wanted (expenses versus a trip to the casino). I certainly don't judge my friends on one action, right or wrong. I probably would do the same as Pat, I hate to admit it. If my financial situation was dire enough I would consider holding back on mostly untraceable taxes to pay expenses, I would probably do it. But I would have to have a very good reason, getting caught I understand is very very painful, money-wise.
22) I would think the person who did this wasn't honest. I would never lie or cheat on my taxes. It's not worth it.
23) I am not sure. Years ago(2-3), i would never have done that. It has been so hard lately to make ends meet, for most citizens. that coupled with the knowledge that the burden of paying taxes falls on the 97% of citizens who barely make enough money to affad food.
24) It's tough to survive.
25) I pay my taxes, so should he
26) If it was my friend doing something like this i would let him know what i think. I would never do anything like that.
27) People already have to pay entirely too much in taxes. Citizens should be able to make a certain amount of cash without having to report it.
28) Economic times haven't been good since 2008/9 and both State and Federal Gov't are not responsible with the tax dollars they receive. That said, I would not do the same thing as it sets a bad example for my children.
29) I think that you should just be honest in life. to bite the bullet and to just accept what is done.
30) The government already spends way too much money on useless things, and policitians incomes are insanely high, 4 is an insignificant amount that harms no one.
31) Because so much of my occupation and financial security revolves around financial transparency, I'd probably still report it...but I can absolutely understand not doing so. I worked as a waiter for a long time, I know how tempting unreported taxable income can be, especially when it's cash and untraceable.
32) I am not responsible for my friend's accountability or responsibility. On the second, I wouldn't have done the same thing as Pat. IRS receives report from business owners as well, and they can find discrepencies in the report.

33) Considering the lack of benefits the government provides middle class families, I see no reason to put in what we aren't getting back. Personally haven't done it but I would understand anyone who felt compelled
34) I wouldn't judge a friend for deciding not to report the income, but I wouldn't do it because I don't think it's worth the risk.
35) I consider cheating on taxes to be illegal, not smart, and disrespectful to other people who pay all of their taxes. It's not something I would do. Even on the chance of not getting caught, I would have an underlying feeling of fear and dread knowing that my actions could come back to bite me.
36) I don't even think income tax is a good thing, or something the government should be doing at all. We should have something like the fair tax, where there is no income tax at all, and there is a federal sales tax instead.
37) Both my wife and I earn extra money this way and report it to the IRS.
38) We pay enough taxes as it is, if a person is able to find some tax free work then I believe it should not have to be reported. It's like a yard sale, technically you should report that too but no one does
39) I think that most people in her situation would do the same, since there is little likelihood that they would get caught. I would not blame any of my friends for doing the same as I would act in the same way.
40) I understand Pat's position. Truly I do. She's not making much money and is on the edge of poverty in this country, especially depending on where she lives, like a big city or something. I've been pulled to do the same exact thing, so I wouldn't judge her or think less of her. However, I'm trying to live as honestly as possible and would probably be scared I'd be audited, hah, so I wouldn't do the same thing. I always try to claim everything, even small freelance jobs.
41) Judge not lest ye be judged. I don't have a dog in this fight. I would probably report my cash earnings cause I am chicken, but I do have a good accountant and he would minimize any damage, so that may sway my opinion. Pat can do whatever he wants. He is already paying taxes. There used to be no income tax at all in this country until the democrats took over.
42) I don't care about my friends' financial decisions. And, given my political orientation and the policies of the current US administration, I wouldn't want to provide the IRS with another reason to harass me by filing a fraudulent tax return.
43) If I was only making $30000/ year and made 4k extra on my own and knew there was very little chance of anyone finding out I would probably do the same. $4,000 is a lot of money when you only make 30k a year.
44) While I woudn't think less of a friend for avoiding paying taxes, I wouldn't feel right doing it because I would know I owed the taxes on the money I earned. Plus, I would be afraid that I might get caught and then would be penalized for not declaring the money when I was supposed to.
45) He is avoiding paying his fair share of taxes. I would pay my share and avoid the risk of tax fraud.
46) I wouldn't do it because I would be afraid to, but I certainly wouldn't think less of anyone for it. The IRS is an illegal private corporation anyway.

47) Since I would probably avoid reporting it, I can't fault or think less of my friend for doing the same. I wouldn't have reported it since it's such a small amount, and businesses are encouraged to avoid millions in taxes.
48) Really don't think the government should be able to take your money at all, bad enough they take out taxes. So what if you make money on the side, but of course its a problem because the government cant make money off of it.
49) My philosophical views are my guide.
50) I think it's unethical to do this because there is a lot of government services and infrastructure that supports your ability to do this work on the side, much more than people immediately realize. I consider it freeloading because it is shirking your responsibilities to pay your fair share.
51) I
52) I would not want to break the law.
53) The consequences associated with not reporting all income from all sources is too great to risk.
54) This is probably a common occurrence, but I believe honesty is best policy.
55) We are citizens of a great country, it is our civic duty to follow rules and laws - which include paying your taxes. We do not get to pick and choose which laws we follow.
56) I see very little risk in doing this, and the money would be better spent by Pat.
57) I wouldn't hold it against someone for hiding income, but personally I would never do it. The trouble that could come from it would be much worse than just paying the tax.
58) I would be disappointed in my friend for not contributing their share. I would not have made the same decision because of both the guilt and fear of consequences I would have.
59) I would've have done the same because the amount is so small. The additional income is akin to a gift
60) While I realize that it is important to state all income, sometimes, a lot of people don't realize that it's important to state income from all sources so I wouldn't think any less of them for doing so.
61) I likely wouldn't have reported it; it would not have been necessary.
62) I honestly know that I am supposed to report the income, but at the same time, if I got paid in cash, I probably wouldn't simply because I wouldn't have even kept record of it, most likely.
63) Tax reform is something we need to really work on and self reporting income is one of the many problems with the current system.
64) It's a small amount of cash money. When the government goes after guys like Mitt Romney I will start worrying about people like Pat.
65) It's against the law to not repeat income, whether it's under the table or through a business. People rely on the tax payments to fund schools, roads and so forth.
66) my wife does the taxes so she would have reported it.
67) I HAVE NO BUSINESS TELLING A FRIEND HOW TO HANDLE INCOME AND I WOULD NOT REPORT THE INCOME AS IT WOULD BE HARD TO PROVE I RECEIVED IT.
68) Lots of people cheat on their taxes it is not that big of a deal

69) If I ever have a chance to screw the government out of money, I will take it. They have no qualms with doing it to anyone else.
70) It is such a small amount of money and I'm sure it happens all the time so I wouldn't think less of them. I personally would not have done the same though.
71) I have side jobs and pay my taxes, regardless.
72) I understand that some people wouldn't have any misgivings about doing this, but it's still criminal behavior. And I wouldn't do it, for fear of being caught, and then labeled as a criminal.
73) I think because of the small amount it wouldn't change how I felt about anyone if they didn't report it. I personally would have done so because I don't have a problem with paying taxes. Obviously if Pat made a lot more money it would be wrong if he didn't report it. I think because his salary is so low he really shouldn't be paying taxes in a fair world anyway.
74) I KNOW PEOPLE WHO HAVE DONE THIS.
75) I have failed to pay taxes on self-employed income before so it would be hypocritical of me to say otherwise, even though I understand why we have to pay taxes and why it's important that everyone does it.
76) I choose to be accurate and report all my sources of income in the event that the IRS decides to audit my tax returns. This ensures that I will not encounter any problems in the long run. I choose not to judge individuals who do not accurately report all their income as it is not my place to judge; I do not know about the person's circumstances or situation, so it is not my place to decide whether or not their actions are right.
77) If someone I knew did this, it would not really affect what I thought about them - I would simply think of their decision as primarily an economic risk that they chose to make based on cost-benefit analysis. Similarly, I would probably do the same thing that Pat did - the cost-benefit analysis suggests to me that this would be the correct decision, regardless of the economic effects that my decisions might have on others.
78) You gotta say the truth
79) It is the law to report all sources of income. Until it is not the law, then it is a problem for me and other law abiding citizens. His action is wrong according to the law.
80) The government gets more than enough of our money.
81) I make all of my money tax free on Amazon and I would never think of not claiming it on taxes. I would feel really bad and guilty and I would be upset if my friends did what Pat did.
82) Income tax, although we are all condition to accept it, is nothing but legalized theft. It's oppressive and it is wrong. No tax should be based on income, and they should all be based on consumption.
83) A lot of people get cash for various odd jobs whether from family or helping out someone. I don't think many report that, if any.
84) I do not believe that it is right to "skip out" on paying any tax obligations that you may have to pay.
85) $4,000 could make the difference for some people getting on a type of assistance or not and therefore would allow the assistance to go to someone else. It also

generates other revenues by being spent into the economy. I am not in a position that I could readily not report any income.

86) It's not a large enough money to move the needle as far as as a grave injustice is concerned. It just wouldn't matter to me.
87) I would not look down on someone for this especially since I would do it myself. If it was mor money say 8000 or more that would have a much more tax bill and would take money from people that could use it through government programs then I would not do it and may look down on a person that did.
88) why not do the same thing as pat? it seems to work for him
89) Cheating taxes is wrong, and i would never do it.
90) I understand that many people would do this if they had the chance. A lot of people think the IRS wouldn't catch on to what they are doing and this leads them to not report on their extra income. Personally, I would report the extra income. The reason why is that if I get audited and they see discrepancies in my reporting I could face jail time.
91) I dont think its the worse thing you can do. People pay enough to the government.
92) I expect them to to the right thing that reporting the cash payment in his taxes. I want to make sure i am doing the right thing and don't want to get in trouble. Rather just play it safe.
93) I think I would have done the same thing and not reported the money
94) Being a libertarian, I consider all taxation to be theft. Hiding money so a thief won't find it is not wrong.
95) I would not think too much less of my friend, but I would be disappointed. I would not do it even if I knew for sure I wouldn't get audited. It's just not right. Everyone needs to support the government.
96) The government gets enough out of me and I never see anything back...when I can keep some I do and I don't feel bad about it
97) i would understand if a friend did it beacuse you never know someones situation. If i had too i would do the same
98) It is morally wrong, but I could understand his choices given his circumstances. He may have been short on money that could be used better elsewhere.
99) everyone hates paying taxes.everyone avoids it as much as possible.who among us volunteers to pay taxes?most people if there's little chance of being caught would have acted in the same way
100) I have been in a situation before where I would owe on taxes if I reported extra income. I barely make enough to get by, as it is. I can't just shell out $5k, and if I could, I would gladly pay the taxes."

IRB APPROVAL

Hello,

The University of Memphis Institutional Review Board, FWA00006815, has reviewed and approved your submission in accordance with all applicable statuses and regulations as well as ethical principles.

PI NAME: James Plecnik

CO-PI:

PROJECT TITLE: The Joint Impacts of an Ethical Prompt and the IRS' Name on the Acceptance of Tax Evasion

FACULTY ADVISOR NAME (if applicable): Charles Bailey

IRB ID: #3692

APPROVAL DATE: 4/20/2015

EXPIRATION DATE:

LEVEL OF REVIEW: Exempt

Please Note: Modifications do not extend the expiration of the original approval

Approval of this project is given with the following obligations:

1. If this IRB approval has an expiration date, an approved renewal must be in effect to continue the project prior to that date. If approval is not obtained, the human consent form(s) and recruiting material(s) are no longer valid and any research activities involving human subjects must stop.

2. When the project is finished or terminated, a completion form must be completed and sent to the board.

3. No change may be made in the approved protocol without prior board approval, whether the approved protocol was reviewed at the Exempt, Exedited or Full Board level.

4. Exempt approval are considered to have no expiration date and no further review is necessary unless the protocol needs modification.

Approval of this project is given with the following special obligations:

Thank you,

James P. Whelan, Ph.D.

Institutional Review Board Chair

The University of Memphis.

Note: Review outcomes will be communicated to the email address on file. This email should be considered an official communication from the UM IRB. Consent Forms are no longer being stamped as well. Please contact the IRB at IRB@memphis.edu if a letter on IRB letterhead is required.