Tax Risk: Some Thoughts and Comments

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Tax Avoidance Literature Evolution

• TAMU Effect
  – Tax Avoidance Measure Use
    • 4-6 measures of avoidance commonly included

• Tax Avoidance vs Tax Aggression
  – What is aggression-The notion of a continuum

• Hanlon and Heitzman
  – Pick measure(s) and provide reasons

• Tax Risk
  – Why a particular measure represents tax risk
What Is Tax Risk?

• Tax risk is:
  – The potential that a chosen action or activity, or the failure to take action or pursue an activity, will lead to a tax outcome that is different than initially expected.

• Tax risk arises from the interaction of uncertainty of investments/operations and the uncertainty inherent in the tax law.

• Economic risk is necessary for tax risk.
  – Spread of possible payoffs from investment
    • Guenther et al. 2013
MINIMAL INTERACTION

ECONOMIC RISK

Depreciation

TAX LAW
LOW TAX RISK

ECONOMIC RISK

Depreciation

TAX LAW
SUBSTANTIAL INTERACTION

- Depreciation/Acquisitions
- Mergers/Acquisitions
- Foreign Operations

ECONOMIC RISK

TAX LAW
High Tax Risk

ECONOMIC RISK

TAX LAW

Depreciation
Mergers/Acquisitions
Foreign Operations
COMPONENTS

• Risk factors associated with the interaction between economic risk and tax law

• Note that all of these categories are also related to incentives and issues related to the reporting of non-tax outcomes
Tax Risk and the Relation to Tax Outcomes

- Tax outcomes quantify the overall result of the tax strategy.
  - Combination of successes/failures of individual transactions
  - The same outcome can be achieved in many ways
    - In other words, the same outcome can describe both minimal and substantial interactions between economic risk and the tax law.

- Tax outcomes are likely incomplete measures of tax risk.
  - Effect of tax risk on tax outcomes is unknown
  - Most (least) complete when the interaction is minimal (substantial)
Guenther et al., 2013-Comments

Concepts-All Related but tested separately
  - Avoidance-CashETR
  - Aggression-UTB
  - Tax Risk –SD of CashETR

Is it informative to use standard risk measures to assess tax risk?
  - Related because of the interaction

• I agree that increased uncertainty reflects tax risk
  - Still missing is the contribution of tax risk to overall risk.
Hutchens and Rego 2013 - Comments

• UTB focus
  – Financial reporting incentives (conservative vs aggressive)
    • UTB does represent uncertainty
    • However, uncertainty related to both financial reporting and tax risk
    • Also related to DTAX, SHELTER, SD CashETR, stock return volatility

• Cost of Equity Capital model
  – Control variables
    • Concerns, Beta, R&D Discretionary Accruals