Study highlights benefits of tax planning for companies facing financial constraints

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Credit: Lukas Blazek.

A recent study of more than 2,000 companies finds that corporations feeling the pinch of financial constraints can benefit significantly from taking a more aggressive stance in their tax planning strategies. One takeaway of the finding is that tax authorities should look closely at the activities of companies facing financial constraints to make sure their tax activities don't become too aggressive.

Financial constraints aren't unusual and occur when a company can't afford to fund a project that would increase its value. Sometimes the constraints are caused by an external event—like a pandemic—that leaves companies with less income than they were anticipating. Sometimes the factors causing a constraint are specific to a single company, such as corporate mismanagement.

"Business researchers are interested in how companies respond to sudden changes in their financial constraints," says Nathan Goldman, co-author of the study and an assistant professor of accounting in the Poole College of Management at North Carolina State University. "But it's difficult to separate various confounding variables from the financial constraints that companies are facing. However, my co-authors and I realized that the Pension Protection Act of 2006 (PPA) gave us a great opportunity to examine financial constraints."

The PPA increased pension funding requirements by almost 500% for all companies that had defined-benefit pension plans. For example, before the PPA, if a company had $400 million in pension obligations, and $100 million in pension assets, it would have 30 years to fund 90% of its obligations. In other words, it could set aside an additional $9 million per year for 30 years. But the PPA changed that, and the same company would have been required to fund 100% of its obligations within seven years—or an additional $43 million per year.

"The PPA imposed new demands on the financial resources of these 'pension firms' - and that means many were suddenly facing financial constraints," Goldman says.

To assess the impact of these financial constraints, the researchers looked at data from 2,647 publicly traded companies: 730 pension firms and 1,907 companies that did not provide defined-benefit pension plans to their employees.

"We found that pension firms were able to recoup 19% of their investment shortfall by modifying their tax strategies," Goldman says. "That is a significant amount of money."

The benefits of the tax strategies can vary in terms of whether they are one-time benefits—such as R&D expenses—or recurring savings—such as relocating operations to locations with lower taxes.

Ultimately, the researchers found that there were three key takeaway messages for the business community.

"One: firms facing financing constraints should consider turning to tax planning as a way of generating capital without increasing debt or equity," Goldman says. "Two: tax planning alone cannot solve liquidity demands. However, the average firm generated a significant amount of cash to offset investment that would otherwise be lost. And, lastly, the taxing authority should more carefully scrutinize tax positions of financially constrained firms—since these firms are more likely to be increasing the aggressiveness of their deductions, and thus have a higher likelihood of being overturned."

More information: John L. Campbell et al, Do Financing Constraints Lead to Incremental Tax Planning? Evidence from the Pension Protection Act of 2006†, *Contemporary Accounting Research* (2021). DOI: 10.1111/1911-3846.12679

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