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Customer concentration and corporate tax avoidance☆

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A B S T R A C T

Firms with a concentrated corporate customer base need to hold more cash and have a stronger incentive to manage earnings upwards. Since tax planning can increase both cash flow and accounting earnings, firms with a concentrated customer base may be more likely to engage in tax avoidance. We find evidence of a positive association between the level of corporate customer concentration and the extent of tax avoidance. In addition, we find that the positive relation between corporate customer concentration and tax avoidance is more pronounced when a firm has a lower Market Share in its industry, enjoys less revenue diversification, and engages less in real earnings management. In contrast to corporate major customers, governmental major customers provide stable cash flow to suppliers, which is likely to alleviate supplier firms' need for tax avoidance. We find that firms engage in lower levels of tax avoidance when they have a governmental major customer, and that this association is less pronounced under Democratic presidencies. Taken together, our findings indicate that a firm's customer concentration (i.e., corporate and governmental major customers) has a significant effect on the extent to which it avoids taxes.

1. Introduction

The significant variation in the level of tax avoidance among public firms has attracted much academic attention (e.g., Dyreng et al., 2008). Prior studies show that the level of corporate tax avoidance is affected by: (1) financial characteristics (Gupta and Newberry, 1997; Rego, 2003; Graham and Tucker, 2006; Lisowsky, 2010), (2) governance and executive compensation (Phillips, 2003; Desai and Dharmapala, 2006; Rego and Wilson, 2012), (3) ownership structure (Chen et al., 2010; Cheng et al., 2012), and (4) external stakeholders such as labor unions (Chyz et al., 2013), the Internal Revenue Service (IRS) (Hoopes et al., 2012), and independent auditors (McGuire et al., 2012). Surprisingly, there is little evidence on how a firm's customer concentration, an important feature of its business operation, relates to the extent of its tax avoidance. In this study, we examine the differential effect of corporate and governmental customer concentration on tax avoidance.

Customer concentration measures how concentrated a supplier's customer base is, and is one of the most important characteristics of the supplier–customer relationship.[1] The extant literature finds a significant association between customer concentration and (1) supplier financial policy (Titman and Wessels, 1988; Banerjee et al., 2008; Wang, 2012; Cohen and Li, 2013; Itzkowitz, 2013), (2) supplier performance and risk (Ravenscraft, 1983; Kalwani and Narayandas, 1995; Piercy and Lane, 2006; Patatoukas, 2012; Dhaliwal et al., 2013; Dhaliwal et al., 2016; Campello and Gao, 2014), and (3) supplier financial reporting quality (Raman and Shahrur, 2008; Hui et al., 2012). However, few studies have addressed how customer concentration affects the supplier's relationship with another important stakeholder, the government, through tax payment.[2]

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[1] We use the terms firm, supplier, and supplier firm interchangeably in this paper.

[2] A concurrent paper by Cen et al. (2014) also shows that firms with major customers have higher levels of tax avoidance. Our study differs from theirs in at least the following four ways. First, we differentiate between corporate and governmental major customers and find that these two types of major customers have opposite effects on tax avoidance. Second, we contend that firms with major corporate customers have incentives to engage in tax avoidance because of the cash flow risk inherent in their business model; furthermore, we show that the level of tax avoidance is associated with the level of cash flow risk (e.g., when the customer

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