Judge Ideology and Corporate Tax Avoidance

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Abstract: The paper studies whether and how federal judiciary affects corporate tax avoidance. Judge ideology predicts the rulings in tax cases, with liberal judges more likely to rule against corporations. Consistent with managers understanding the implication of judge ideology in tax issues, we find that firms engage in less aggressive tax avoidance when Circuit Court and Tax Court judges are more liberal. This effect is economically significant and robust across various measures of tax avoidance. We further find that managers cope with liberal judge ideology through shifting less income overseas, conducting more foreign tax avoidance and acquiring more services from professional tax planners. Firms also avoid liberal judges through forum shopping. Finally, our evidence shows that IRS enforcement complements the judge ideology effect. Overall, our paper introduces the judicial branch as a key determinant of corporate tax avoidance and contributes to a complete picture of tax enforcement.

JEL: M40, M41
Keywords: tax avoidance; judge ideology; income shifting; IRS; forum shopping

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1. Introduction

U.S. Federal tax collection involves joint efforts from all three branches of the federal government, i.e., the legislative branch, the executive branch, and the judicial branch.[1] The legislative branch, including the Senate and the House of Representative, introduces and passes federal tax laws, which are codified in the United States Codes (hereafter U.S.C., usually under Title 26: Internal Revenue Code (hereafter IRC)).[2] The executive branch, i.e., the Internal Revenue Service (a bureau of the Department of Treasury, hereafter IRS), administers tax law and enforces tax collections.[3] The judicial branch, another important player in the overall formation and enforcement of tax policy, comprises of a hierarchy of court system that connects the other two branches. Conflicts between the taxpayer and IRS arises because of differences in how they interpret tax laws, which are inherently ambiguous. Courts are the ultimate course to resolve these disputes, and as such, they shape and determine tax laws and policies through their decisions. However, despite its critical role in tax collections, prior studies on corporate tax avoidance have focused almost exclusively on the legislative and executive branches' impact and paid little attention to the judicial branch.[4, 5] To fill this gap in the literature, our

[1] We focus our discussion on the U.S. federal corporate income tax. Our paper is also relevant to state income taxes because most states use federal taxable income as the starting point and make adjustments on certain items (PricewaterhouseCoopers [2017]).

[2] After a bill is passed in both the House and the Senate, it becomes a law after the President approves it or both Chambers of Congress pass it by two-thirds majority following the President's veto (1 U.S.C. § 106a).

[3] Other federal agencies that collect taxes include The Alcohol and Tobacco Tax Trade Bureau and U.S. Customs and Border Protection, which collects exercise tax on alcohol, tobacco and firearms, and customs duties, respectively.

[4] Our paper uses tax avoidance, tax aggressiveness, tax planning and tax strategies interchangeable in this paper to refer to transactions that reduce firms' explicit tax liabilities. Such transactions range from "more legal," such as municipal bond investments, to "more illegal," such as abusive tax shelters (Hanlon and Heitzman [2010]).

[5] For example, Bagcchi [2016] studies the effect of the Congress and the President. Hoopes, Mescall and Pittman [2012], DeBacker, Heim, Tran and Yuskavage [2015], Kubick, Lockhart, Mills and Robinson [2017], and Ayers, Siedman, and Towery [2018] document IRS enforcement's impact on corporate tax avoidance. Collins and Shackelford [1992], Matsunaga, Shevlin and Shores [1992] and Scholes, Wilson and Wolfson [1992] study the economic effects of the Tax Reform Act of 1986.

paper explores whether and how the position of the judicial branch affects corporate tax avoidance and the enforcements against it.

The position of judiciary in tax disputes depends critically on the ideology of judges, who have discretions in interpreting the codes. The root cause of the discretion is that U.S. tax laws are voluminous and can be vague and ambiguous due to their complex nature and lawmakers' divergent political views (Mashaw [1985], Logue [2005], Kopczuk [2006]).[6] The ambiguity leaves room for corporations and the IRS to interpret the tax laws differently. Specifically, during tax planning, corporations believe that their tax strategies comply with the letter of the law and are legal. In ex post, many such strategies are challenged by the IRS, who believes that they allow companies to receive tax benefits unintended by the Congress (Blank [2009], Lawsky [2009]). When such disputes are filed in federal courts, they are in the hands of federal judges, who, following their own ideology, take advantage of the ambiguity and use interpretation of tax codes to determine whether the transaction is permissible or not, and project their views of justice onto society (Richards and Kritzer [2002], Weisbach [2003], Cross [2007], Hanlon and Heitzman [2010]).

Judge ideology generally falls along the conventional liberal-to-conservative continuum in U.S. politics (see George [1998] for a review). In the context of corporate taxation, traditional definition of liberal versus conservative suggests that liberals (Democrats) are in favor of government (to increase tax revenue), and conservatives (Republicans) are in favor of corporations (Howard [2002]). This definition is generally consistent with congressional records from politicians of both parties and voter surveys.[7] Judges are no exceptions: prior research find that in tax cases, liberal judges are more likely to rule for the government than

[6] As discussed in Scalia [1989], it may be futile to guess the "genuine" legislative intent because in the majority of the case, the Congress, rather than intended a single result or meant to confer discretion upon the agency (IRS in the case of tax law), simply didn't think about the matter at all.

[7] During the legislation of the two Bush Tax Cuts in 2001 and 2003, and the Tax Cut and Jobs Act of 2017, the vast majority of the votes in the Congress were casted along the party line.

for corporations, compared to conservative judges (Nixon [2002], Staudt, Epstein and Wiedenbeck [2006], Epstein, Landes and Posner [2013]), reducing the benefits of corporate tax avoidance. The likelihood of a dispute with the IRS, which imposes legal fees on firms and opportunity cost of time and efforts on managers, also increases because the IRS is more likely to challenge corporations when tax lawsuit outcomes are more likely to be pro-government (Internal Revenue Manual, Howard and Nixon [2003], Fogel [2003], Blank and Staudt [2012]). We therefore hypothesize that when judge ideology is more liberal, firms will engage in less aggressive tax avoidance. We name this prediction the "Tax Collection Hypothesis."

However, judge ideology's effect on corporate tax avoidance through tax litigations can be mitigated or even overwhelmed by firms' financial reporting incentives. First, tax planning is used as an earnings management tool to improve cash flows and earnings (Cook, Huston and Omer [2008], Graham et al. [2014], Edwards, Schwab and Shevlin [2016]). If firms have a strong incentive to improve their financial results, that is, the benefits of tax avoidance in financial reporting dominates its related tax litigation cost, they may still engage in tax avoidance but use more sophisticated tax planning including foreign tax planning and forum shopping to mitigate the effect of liberal judges.

Second, liberal judge ideology may even increase tax avoidance because it increases the risks of securities class action lawsuits (Choi and Pritchard [2012], Huang, Hui and Li [2019]). These lawsuits are usually filed in federal courts after firms experience a significant drop in their stock prices, e.g., following an earnings disappointment (Kasznik and Lev [1995], Skinner [1997]), or suspicious earnings manipulation practices (Hopkins [2017]). When firms face higher securities litigation risk, they may engage in more tax planning to boost earnings. In addition, compared to other earnings management tools such as accruals manipulation, tax planning is not subject to SEC scrutiny and delivers cash flow benefits to shareholders. Thus, when other methods of earnings management are more costly, firms are more likely to plan

their tax strategies based on incentives to improve earnings and avoid securities class action lawsuits. We refer to using tax avoidance to improve financial results as the "Financial Reporting Hypothesis." In summary, the effect of judge ideology on tax avoidance is an empirical question.

We follow prior literature in legal research and use the partisanship of judges' appointing Presidents to measure their ideology (Sunstein, Schkade, and Ellman [2004]). That is, we label judges appointed by Democratic Presidents as liberal judges and those appointed by Republican Presidents as conservative judges. We focus on judges in the Tax Court, the District Courts, and the Courts of Appeals (i.e., the Circuit Courts), because the first two are lower courts that handle the majority of tax cases and last one has jurisdiction over appeals from the lower courts. Empirically, based on how judges are assigned to cases in these courts, we calculate the probability that liberal judges preside over a tax case in each court.

Using these measures, we first find that firms avoid less tax when the judge ideology of the Tax Court and the Circuit Court that has jurisdiction over the firm are more liberal. The effect is not only statistically significant, but also economically significant. We do not find results for District Courts, consistent with that their ideology preferences are highly constrained by those of the Circuit Courts (Howard [2005]). Our results are also economically significant. A one-interquartile increase in how liberal judge ideology is in the Circuit Court (Tax Court) is associated with a 12.5% (15%) reduction in firms' predicted uncertain tax benefits. This result is robust to alternative proxy for tax aggressiveness, including actual reported uncertain tax benefits, the amount of future settlement of uncertain tax benefits, cash effective tax rates, and GAAP effective tax rates.

Next, we use cross-sectional tests to examine how firms' financial reporting incentives influence judge ideology's effect on tax avoidance. Following our previous discussion of "Financial Reporting Hypothesis," high financial reporting incentives may motivate firms to

commit more tax avoidance to mitigate the effect of judge ideology on securities class action lawsuit risks. We also expect financial reporting incentives to have a stronger effect on tax planning when other earnings manipulation tools are more constrained. Both lead to a weaker deterrence effect of liberal judge ideology on tax avoidance. Using the percentage of institutional ownership and the past usage of incoming-increasing discretionary accruals as measures of financial reporting concerns and costs of accruals manipulation in the current period respectively, we find evidence consistent with our conjecture.

To better understand the mechanism of how the judicial branch influences firms' strategy involved in tax avoidance, we first explore firms' cross-border income shifting. U.S. based multinationals pay federal tax on worldwide income but can defer U.S. tax indefinitely on profits left overseas. Thus, firms can lower their effective tax rate by shifting income from the U.S. to jurisdictions with lower taxes. However, since firms' income shifting are subject to challenges by tax authorities, they adjust the extent of profit shifting in response to the tax enforcement level of the jurisdiction (Klassen and Laplante [2012]). Consistent with liberal judges increases the cost of shifting income overseas, we document that firms shift less income overseas when federal judges are more liberal. Specifically, we find that a one standard deviation increase in judge ideology, i.e., more liberal, in the Circuit Court (Tax Court) is associated with a 9.5% (8.2%) reduction in outbound income shifting.

Second, we examine three areas on how firms mitigate the impact of liberal judge ideology: 1) tax avoidance outside of federal court's jurisdiction, 2) resources spent on professional tax services, and 3) forum shopping in tax litigations. First, we find that consistent with federal judges' preoccupation with U.S. income tax, when judges are more liberal, firms are less aggressive in their U.S. federal income tax planning, but more aggressive in their foreign income tax planning, i.e., an increase in U.S. federal tax rate increases but a decrease in foreign income tax rate. Next, using the amount of tax fees paid to auditors and the

percentage of total fees paid to auditor for tax services as measures of demand for tax planning resources, we find that as judges becomes more liberal, firms use more tax planning resources. Third, managers strategically choose the venue to resolve tax disputes. Specifically, the likelihood of choosing the Tax Court is lower when its judges are more liberal, but higher when Circuit Court judges, whose ideology is carried out by the District Courts (Huang et al. [2019]), are more liberal.

Finally, we test the interplay between the executive branch and judicial branch, i.e. whether IRS efforts complement or substitute judge ideology. Our results suggest that liberal judge ideology's deterrence effect on tax avoidance is accentuated when firms are more likely to be audited by the IRS. This finding is consistent with a complementary relation between the IRS and judges' political leaning. In other words, the executive branch and judicial branch reinforce each other in fight against corporate tax avoidances.

Our paper contributes to two separate streams of literature. The first stream is on the determinants of corporate tax avoidance (Shackelford and Shevlin [2001], Hanlon and Heitzman [2010]). Prior studies typically focus either on firm characteristics, such as firm size, ownership structure, and managerial incentives (Rego [2003], Chen et al. [2010], Dyreng, Hanlon and Maydew [2010]), enforcements by the IRS (Hoopes et al. [2012], DeBacker et al. [2015], Nessa et al. [2017], Kubick et al. [2017], and Ayers, Siedman, and Towery [2018]), or actions from the legislative branch, such as the passage of a new tax law or modification of existing tax laws (e.g., Collins and Shackelford [1992], Matsunaga, Shevlin and Shores [1992] and Scholes, Wilson and Wolfson [1992]). We document that, consistent with the significant influence of the judicial branch over tax collections, managers consider judge ideology in corporate tax planning activities. By drawing from theories in political science, we provide a timely response to Dyreng and Maydew's [2017] call for tax research that goes beyond financial accounting.

In addition, our evidence on the effect of judge ideology and its interplay with managers and the IRS contributes to a comprehensive understanding of how the tax system functions. Specifically, in response to the stricter interpretation of tax laws by the judicial branch, managers shift less income overseas. They also switch tax planning resources to foreign jurisdictions and demand more professional tax service, presumably to improve the effectiveness of tax avoidance. They even engage in forum shopping to avoid liberal judges. On the other side, the complementary relation between the IRS and the judicial branch suggests that they reinforce each other against corporate tax avoidance. In summary, our finding broadens the understanding on tax planning and show how different branches of the government jointly influence corporate tax avoidance.

Second, our paper contributes to the legal studies and political science literature. Unlike empirical legal studies that that examine how judge ideology influence tax litigation outcomes (Schneider [2001], Howard [2005], Staudt, Epstein, and Wiedenbeck [2006], Esptein, Landes and Posner [2013]), we are the first to show that the judicial branch affects firms' ex-ante actions in tax, i.e., tax planning strategies. This is especially important for tax disputes because, unlike other types of lawsuits which are typically filed in the court before settlement discussion begins (e.g., securities class action lawsuits), most tax disputes are settled between firms and the IRS before cases are filed in courts (Gerdes et al. [2001]). Therefore, only studying case outcomes severely understates the judicial branch's influence in taxation (Priest and Klein [1984]). By documenting judge ideology's influence over firms' ex-ante actions, we reveal the extent of ideology's total impact in corporate taxation. In summary, our paper highlights a key consequence of the political appointments on corporate tax decisions, and provides important insights not only to academics, but also to investors and lawmakers.

2. Background and Literature Review

2.1 Prior Studies on Corporate Tax Avoidance

Corporate tax avoidance is an important issue for businesses and governments, and has attracted attentions from taxpayers, politicians and media. In 2001, corporate underreporting is estimated at $29.9 billion, or an underreporting rate of 17.4%, of which large corporations (with more than $10 million in assets) make up $25 billion (IRS [1996, 2004]). Not surprisingly, researchers in accounting, finance, economics and law have spent a significant amount of efforts to understand the determinants and consequences of corporate tax avoidance (see review in Hanlon and Heitzman [2010]).

The main objective of corporate tax planning is to reduce income tax (Hanlon and Heitzman [2010]). As shareholders are only entitled to after-tax earnings of the firms, managers are provided with strong incentive to engage aggressive tax planning. For example, CEOs and tax directors often have bonus based on after-tax earnings performance (Phillips [2003], Armstrong, Blouin and Larcker [2012], Gaertner [2014]), and their equity compensation motivates them to be aggressive in tax planning (Rego and Wilson [2012]). Moreover, prior research finds that fiduciary duties encourage executives to avoid more taxes (Cheng et al. [2017] and forced CEO turnover is more likely when the firm pays a high tax rate relative to its peers (Chyz and Gaertner [2018]).

Another important motivation for managers to engage in tax saving is the financial accounting incentive, in which case, tax planning is used as an earnings management tool. Graham et al. [2014] find that 84 percent of publicly traded firms respond that top management at their company cares at least as much about the GAAP effective tax rates (ETR) as they do about cash taxes paid, and 57 percent of public firms say that increasing earnings per share is an important outcome from a tax planning strategy. Similarly, Wilson [2009], and Frank et al. [2009] shows positive association between firms actively engaged in tax sheltering and more aggressive financial reporting practices. This is consistent with the argument in Desai et al.

[2007] that due to the conflict of interest between managers and shareholders, managers can use complex tax strategies to divert corporate resources for private use.[8]

Tax avoidance can lead to reputational damage and attract regulatory attentions. Graham et al. [2014] show that reputational concerns is the second important factor explaining why firms do not adopt a potential tax planning strategy. Similarly, Chen, Schuchard, and Stomberg [2018] find that tax avoidance can attract unfavorable media attention. Anecdotally, in 2004, the Senate passed a legislation that would have required the IRS to disclose the name of any corporation required to pay a penalty attributable to a tax shelter transaction (Blank [2009]). Consistent with the reputation cost, Austin and Wilson [2017] find that consumer-oriented firms are less tax aggressive. Similarly, Dyreng et al. [2016] document that firms significantly decrease their tax aggressiveness after their tax planning activities receive negative publicity using a sample of UK firms.

2.2 Tax Enforcements

Prior studies on the enforcement of tax avoidance generally focus on the executive branch, the IRS, which administers tax laws by translating them into detailed regulations, rules and procedures and enforces tax laws through audits (for a detailed discussion of IRS audits, see Appendix A.1).[9] Consistent with its importance, prior studies find that firms engage in less tax avoidance when IRS enforcements increase. For example, Hoopes et al. [2012] imply that firms undertake less aggressive tax positions when the expected probability of IRS audit is

[8] Whether tax avoidance increases or decreases shareholder value remains an open question. Hanlon and Slemrod [2009] and Hoopes, Robinson and Slemrod [2018] find evidence consistent with the market reacting positively to evidence that a firm is trying to reduce taxes when their financial reports would lead one to believe the firm is not tax aggressive. Cheng, Huang, Li and Stanfield [2012] and Khan, Srinivasan and Tan [2017] find that increased investment from hedge fund activists and institutional investors in general are associated with increases in tax avoidance.

[9] Common documents and publications issued by IRS to provide guidance to taxpayers include regulation, revenue rulings, revenue procedure, private letter ruling, technical advance memorandum, notice and announcements (Hickman [2009]). Also see IRS website: https://www.irs.gov/newsroom/understanding-irs-guidance-a-brief-primer.

higher.[10] Kubick et al. [2017] find that IRS assesses more tax per agent hour from nearby taxpayers during audits.

The judicial branch, on the other side, has a large impact on tax collection through its rulings and interpretations of the laws (see Appendix A.2 for details on how tax cases are processed in various federal courts).[11] Specifically, judiciary in U.S. resolves the disputes between IRS and taxpayers, as well as makes common laws and sets precedents. However, despite the importance of the judicial branch in tax collection, there is little evidence of its effects on corporate tax avoidance decisions.

2.3 Ideology and Tax Enforcements

Our study uses ideology to measure attitude towards corporate tax avoidance. The traditional definition of liberal versus conservative suggests that in issues that involve a corporation and the government (e.g., corporation taxation, regulation), liberal ideology is in favor of the government and conservatives are in favor of the corporation (Howard [2002]). In taxation context, this translates into the lower tax stance of conservatives. As the Republican Party platform states: "*Republicans advocate lower taxes, reasonable regulation, and smaller, smarter government*" (Republican National Committee [2004, 2008]). Prior legal studies (e.g. Howard and Nixon [2002] and Howard [2005]) argue that the root of such difference is likely because of the pro-government stand taken by the liberals and that government spending depends on tax collections.

[10] However, using assignments to IRS's Coordinated Industry Case program, Ayers, Seidman and Towery [2018] find that when firms already face relatively high chance of audits, increasing the probability further does not deter tax avoidance.

[11] There are five federal courts that have jurisdictions over disputes between taxpayers and the Government. All tax cases are first tried in one of three lower level trial courts: the U.S. Tax Court, the U.S. District Courts, and the U.S. Court of Federal Claims, with the vast majority in the first two. Tax cases tried in the U.S. Tax Court and the U.S. District Courts can be appeals to the U.S. Courts of Appeals in which the taxpayer resides, and subsequently to the U.S. Supreme Court. See section 5 and Appendix for a detailed discussion of tax disputes.

There is ample evidence from all three branches of the government consistent with this definition. In terms of legislation, Republican Presidents are far more likely to have tax cuts on their agenda than Democratic ones (Bagchi [2016]) and Republican Congressmen and Senators are more likely to vote in favor of tax cuts than their Democratic peers. During the legislation of the two Bush Tax Cuts in 2001 and 2003, and the Tax Cuts and Jobs Act of 2017, the vast majority of the votes in the Congress were casted along the party line.[12] The preference of the legislators likely represent that of their constituents. Pew Research Center survey found that the most polarizing issue for 2018 Midterm Election voters is the Tax Cuts and Jobs Act of 2017, with 78% of voters who support GOP candidate in their district approve of the tax law, compared to just 11% of Democrats (Pew Research Center [2018]).

There is also abundant evidence that ideology plays a significant role in taxation in the executive branch. For example, Scholz and Wood [1998] and Bagchi [2016] find that Democratic controlled Congress allocates larger budgets and more personnel resources to IRS. Anecdotally, from 2011 to 2018, the Republicans in Congress repeatedly cut IRS budgets, leading to a one-third decrease in its enforcement staff (Eisinger and Kiel [2018]). Not surprisingly, IRS enforcements vary with the President's ideology, with more corporate audits when it is under a Democratic administration than under a Republican one.

Given how ideology shapes actions in the other two branches, it is not surprising that judicial decisions also vary systematically with ideology. Both legal and political science studies find that ideology is among the most important of judges' personal attributes

[12] During the passage of the Economic Growth and Tax Relief Reconciliation Act of 2001, all 216 Republican Congressmen and only 13 out of 210 Democratic Congressmen voted "Yea." The Jobs and Growth Tax Relief Reconciliation Act of 2003 was supported by 218 out of 229 Republicans but only 7 out of 205 Democrats in the House. Similarly, the Tax Cut and Jobs Act of 2017 passed without support from a single Democratic Congressman or Senator. In 2017, Republicans passed one of the most sweeping tax cut in the last thirty years (Tax Cuts and Jobs Act of 2017) when they controlled both the House of Representative and the Senate, and have a Republican President. The most important change included in the reform is for corporate tax, including lowering the federal corporate tax rate from 35 percent to 21 percent (Auerbach [2018]). The legislative history of the bill shows that most votes were on a party-line. On the other side, no Democrat voted for the bill in the House or the Senate. The Congressmen and the Senators' votes are consistent with their voters.

influencing civil liberties and economic lawsuit outcomes (Johnston [1976], Tate [1981], Segal and Cover [1989], Staudt, Epstein, and Wiedenbeck [2006]). Even judges admit that ideology plays a role in their decisions (Wald [1987], Edwards [1991], Edwards [2002], Posner [2005]).[13, 14] In tax cases, liberal judges are more likely to rule for the government than for corporations, compared to conservative judges (Nixon [2002], Staudt, Epstein and Wiedenbeck [2006], Epstein, Landes and Posner [2013]).

The root of judicial discretion in tax cases is that the U.S. tax laws are vague and ambiguous due to their complex nature and lawmakers' divergent political views (Mashaw [1985], Logue [2005], Kopczuk [2006], Scholes et al. [2015]).[15] An example of such ambiguity is the economic substance doctrine, developed in the landmark Supreme Court case of *Gregory v. Helvering* 293 U.S. 465 in 1935. Under this doctrine, the tax treatment of a transaction is legal if it satisfied the two-prong test, whether the corporate possessed a non-tax business purpose in pursuing the transaction, and that the transaction meaningfully improved the corporation's economic position (apart from reducing its tax liability) (*Gregory v. Helvering* 293 U.S. 465 1935, *Knetsch v. United States* 364 U.S. 361 1960). Over the years, firms, the IRS, and even courts have disagreed on whether transactions have non-tax business purposes and whether firms' economic position improved "meaningfully" (Flesher and Quinn [2014]).

[13] For a more extreme example, in an interview with the New York Times in 2017, retiring judge Richard A. Posner (from the seventh circuit) described his approach to judging as follows: "*I pay very little attention to legal rules, statutes, constitutional provisions. A case is just a dispute. The first thing you do is ask yourself — forget about the law — what is a sensible resolution of this dispute? The next thing is to see if a recent Supreme Court precedent or some other legal obstacle stood in the way of ruling in favor of that sensible resolution. And the answer is that's actually rarely the case. When you have a Supreme Court case or something similar, they're often extremely easy to get around*" (Liptak [2017]).

[14] Note that even though judges are constrained by precedents, they can ignore or distinguish away precedents that they do not like when the precedents are not precisely on point, or when conflicting lines of precedent exist, they can follow those precedents which they like best (Wald [1986], Hoffman, Raabe, Young, Nellen, and Maloney [2018]).

[15] Some prior studies in legal research have argued that uncertainty and complexity in tax law can be a desirable feature because potential tax evaders will be less able to predict the law (Kaplow [1992], Osofsky [2011]). See Kaplow [1992], Weisbach [2002], Shaviro [2004] and Logue [2005] for discussions on the tax system as both a rule-based and a standards-based legal regime.

Tax avoidance is a tax compliance continuum with most corporate tax strategies falling between the two extremes, tax frauds on one end and legal avoidance on the other (Shaviro [2004], Logue [2005], Lawsky [2009]).[16] To avoid tax, new strategies are constantly invented by accounting firms, banks, investment advisors, and law firms (Senate Committee Report on U.S. Tax Shelter Industry [2003]). Even though there has been thousands of IRS guidance and court decisions regarding tax positions, using them to determine if a new tax strategy is permissible or not is almost always difficult (Weisbach [2003] and Hanlon and Heitzman [2010]). This is because court decisions on tax positions are highly fact specific and contingent, and that it is difficult to determine the degree of similarity between a new tax strategy and one from a prior case (Davis and Mason [2003]). This point is not only recognized by legal scholars, but also well understood by the IRS (IRS [1989]) and the accountants (AICPA [2009]).[17] As summarized by the Joint Committee on Taxation in a U.S. Senate hearing, "*taxpayers and tax administrators have struggled in determining the line between legitimate 'tax planning' and unacceptable 'tax shelters'*" (Joint Committee on Taxation [2002]).

Prior empirical studies find consistent evidence that in corporate taxation cases, liberal judges are more likely to vote in favor of government, and conservative judges for corporations. Using all U.S. Supreme court cases between 1940 and 2005 that involves an interpretation of the Internal Revenue Code, Staudt, Epstein and Wiedenbeck [2006] find that liberal Justices are far more likely to vote with the government while conservative Justices systematically vote for corporation tax payers. Howard [2005] and Epstein, Landes and Posner [2013] find similar

[16] The IRS defines tax frauds as willfully making false statements in a tax return (I.R.C. § 7206(1), 2006). It is a felony offense with serious consequences. In fiscal year 2016, there are 49 indictments of corporate tax fraud with a 97% incarceration rate (IRS [2016]). In the same year, civil fraud penalties accounted for 0.02% of all civil penalties levied by the IRS in business income taxes ($0.2 million out of $979 million, IRS [2016])

[17] For example, in 2003, the IRS stopped providing advance rulings on whether a split-off transaction can be treated as a nontaxable event under section 355, stating that the issue was too fact-intensive and would be resolved only on examination after the transaction (Rev. Proc. 2003-48, 2003-29 Internal Revenue Bulletin, IRS [2003]). The IRS publishes a list of areas in which rulings will not or will not ordinarily be issued, because of "the inherently factual nature of the problems involved" in the third revenue procedure of each year. The most recent one includes 212 specific questions and problems and 25 general areas (Rev. Proc. 2019-3, 2019-1 I.R.B., IRS [2019]).

results in the Tax Court, the District Courts and the Court of Appeals. Consistent with liberal judges' pro-government tendency, in a recent working paper, Heitzman and Ogneva [2018] find that industry-wide tax-planning induced equity risk premium is higher when Tax Court judges are more liberal.

3. Hypothesis Development

Judge ideology can affect the benefits of corporate tax avoidance through tax litigations. As discussed in the Section 2.3, liberal judges are more likely to rule for the government and against corporations than conservative judges in tax cases. The adverse outcome of tax lawsuits when judges are more liberal lowers the net benefits of corporate tax avoidance and gives firms less incentive to engage in tax planning.

Note that only taking into account judge ideology's effect on the "observed" tax case outcomes significantly underestimates its overall influence in tax avoidance. As judges make the ultimate decision of whether a tax strategy is legal or not, their influence looms over the entire life cycle of tax collections. Specifically, when making the tax planning decisions, firms would consider judge ideology's effect on three fronts: 1) the expected odds of having a dispute with the IRS, 2) the outcome from negotiating with the IRS, and 3) the court's decision in tax lawsuits if negotiation fails, with studies using observed tax cases only considering the last one. The first aspect is because the IRS is more likely to audit corporations when judges are more liberal (Howard and Nixon [2003], Blank and Staudt [2012]). Specifically, using state level audit data from 1960 to 1988, Howard and Nixon [2003] find that judges in a Court of Appeals become more liberal, the IRS increases audits of corporations from the states under that court's jurisdiction.

For the second aspect, it is not surprising that both corporations and the IRS factor their winning odds in the negotiation, given the importance of judge ideology in tax outcomes. As described by Blank and Staudt [2012], throughout the entire tax dispute process, "*the parties*

negotiate in the shadow of litigation." The IRS explicitly requires its officers to review the strengths and weaknesses of the respective positions taken in the case and propose settlement and penalties based on the "hazards of litigation," i.e., the likelihood that it will prevail in a lawsuit (Internal Revenue Manual, Gutman [1995], Fogel [2003], also see Appendix A). Companies and their tax advisors also estimate their chance of a favorable court outcome during the negotiation.[18, 19]

Taken together, liberal judge ideology is associated with less favorable outcomes in tax disputes, tougher IRS enforcements and worse negotiation outcomes, all of which lowering the net benefit of corporate tax avoidance. Thus, we hypothesize that when judge ideology is more liberal, firms will engage in less aggressive tax avoidance, and name it the "Tax Collection Hypothesis."

However, judge ideology's effect on tax avoidance can be mitigated or even overwhelmed by firms' financial reporting incentives. As discussed in Section 2.1, one important motivation for managers to engage in tax avoidance is to improve earnings and cash flows (Cook, Huston and Omer [2008], Graham et al. [2014], Edwards, Schwab and Shevlin [2016]). For firms with a strong financial reporting incentive, tax avoidance's benefit in improving earnings may dominate its cost in heightened tax litigation risk. As a result, these

[18] In fact, companies sometimes have to make explicit, albeit imprecise, judgements on how likely their tax positions will be upheld in courts. For example, in the American Jobs Creation Act of 2004, Congress introduced a 20% tax understatement penalty related to "reportable transactions," i.e., transactions that the IRS has identified as "having a potential for tax avoidance or evasion" (IRC § 6707A(c)(1)). One of the conditions for companies to avoid paying reportable transaction penalty is to have a reasonable belief that the treatment is the proper treatment, which is defined as a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the IRS (in court) (IRC § 6664 (d)(4)(ii), Treasury Regulation § 1.6662-4(g)(4)(i)). Relatedly, a tax advisor who instructs clients on a tax position is essentially forecasting whether a court would strike down the position (Lawsky [2009]).

[19] Smith [1993] describes how judges sometimes facilitate companies and the IRS arrive at a consensus by offering his opinion: "*In the typical chambers conference, the judge first will ask each party to explain its case and how it expects to prove that case. After both sides have spoken, the judge may try to focus them on mutual areas of agreement or suggest a procedure for coming to agreement. The judge also may ask the parties if they would be interested in hearing the judge's tentative views on how he or she would rule in the case, assuming the parties presented the evidence they said they would present. The judge sometimes will give his or her views as a percentage, as in: 'I think there is a 60% chance I will rule for the petitioner on this issue.' Giving views in this way often lends to quick settlements on the stated percentage basis.*"

firms do not reduce tax avoidance when facing liberal judges, but instead use strategic tools, such as foreign tax planning and forum shopping, to mitigate liberal judges' effect.

Furthermore, District and Circuit Courts also have jurisdiction over securities class action lawsuits. Because liberal ideology is associated with higher expected litigation costs in such lawsuits (Choi and Pritchard [2012], Huang, Hui and Li [2019]), judge ideology in these courts may indirectly affect tax avoidance through securities litigation for two reasons. First, companies can use tax planning to improve cash flows and earnings and avoid missing targets (Cook, Huston and Omer [2008], Graham et al. [2014], Edwards, Schwab and Shevlin [2016]), which can cause stock price decline and trigger securities class action lawsuits (Kasznik and Lev [1995], Skinner [1997]). Second, heightened securities litigation risks can increase the attractiveness of tax avoidance as an earnings management tool. This is other earnings management tools, such as accruals manipulation, are constrained by securities litigation risk (Donelson, McInnis and Mergenthaler [2013], Hopkins [2017]). When firms engage in less accruals manipulation as a result of heightened securities litigation risk, the marginal benefits of using tax avoidance to improve earnings increases. At the same time, less upward earnings management reduces the marginal cost of tax avoidance because it allows managers to be more aggressive in tax planning without increasing book-tax differences, which, if too large, can attract regulatory attention (Cloyd, Pratt and Stock [1996], Mills [1998], Mills and Sansing [2000], Phillips, Pincus and Rego [2003], Hanlon [2005]). That is, firms are substituting accruals manipulation with tax avoidance (Erickson, Hanlon and Maydew [2004], Lennox, Lisowsky and Pittman [2013]). We refer to the positive effect of liberal ideology on tax avoidance through securities litigation risk as the "Financial Reporting Hypothesis."

In summary, the effect of judge ideology on tax avoidance activity is an empirical question. We state our hypothesis in the form of the "Tax Collection Hypothesis" as the following:

H1: When judges are more liberal, companies engage in less aggressive tax avoidance.

4. Variable Measurement and Research Design

We measure the judge ideology in the Courts of Appeals (also known as the Circuit Courts), the Tax Court, and the District Courts because these three courts have exclusive jurisdiction over almost all federal tax cases in the U.S.[20] Even though the losing party in the Courts of Appeals can appeal the case to the U.S. Supreme Court, it rarely hear tax cases (Hoffman [2018]), and thus have less impact than lower courts in tax collections.[21]

Of the three courts, we expect circuit court judge ideology to have the most significant influence on corporate tax avoidance for the following reasons.[22] First, the decisions in the Tax Court and the District Courts trials are subject to mandatory review by the Circuit Courts if the losing party appeals. Thus, Tax Court and District Court judges will likely consider the ideology of the Circuit Court judges when deciding cases (Randazzo [2008]). Second, Circuit Court decisions are binding in the trial courts within its jurisdiction. That is, both the Tax Court and the District Courts should follow the case precedent in the Circuit that has jurisdiction over the case. Note that as discussed in Appendix A, after the "Golsen rule" [*Golsen v. Commissioner, 54 TC 742 (1970)*], even though the Tax Court is a national court, it is required to follow the precedent in the Circuit that will handle the potential appeal, i.e., the Circuit that has jurisdiction over the corporation's headquarter state, even if it disagrees with the decision

[20] The other federal courts that have jurisdiction over tax disputes between the IRS and solvent corporations are the U.S. Court of Federal Claims, and its appellate court, the U.S. Court of Appeals for the Federal Circuit. However, as discussed in Appendix A, they handle a very small minority of tax cases compared to District Courts and the Tax Court. Nonetheless, in a sensitivity test, we include the ideology of the judges on the US Court of Federal Claims and its appellate court separately as control variables in the main analysis and find that they do not explain firms tax avoidance.

[21] The dearth of tax cases heard in the Supreme Court has been attributed to their technical nature (Richards [2001]). Justice Scalia once said, "*The constitutional work can be dull, too, but it's not like the tax code. Philosopher-kings do not read the Internal Revenue Code, believe me*" (McQueen [1992]). Similar remarks have been made by other justices. For example, "*'This is a tax case. Deny.' That was [Justice] Brennan's normal reaction to a [certiorari] request in a tax case.*" (Woodward and Armstrong [1980]).

[22] This is consistent with Cross [2007], who argued that, "*In large measure, it is the circuit courts that create U.S. law. They represent the true iceberg, of which the Supreme Court is but the most visible tip. The circuit courts play by far the greatest legal policymaking role in the United States judicial system.*"

(Hoffman et al. [2018]). Because of the "Golsen rule," the IRS also requires its appeals officers to consider the most recent legal precedent of the applicable Circuit in its settlement offer (IRM 8.6.4.1.6, IRS [2007]). Given the importance of the Circuit Courts, firms are likely to incorporate the ideology of their judges in tax planning. Consistent with these arguments, Huang, Hui and Li [2019] find that Circuit Court ideology's effect on securities class action lawsuit filings dominates that of the District Courts.

Between the Tax Court and the District Courts, we expect that the ideology of the Tax Court judges to be more important. First, Circuit Court defer more to Tax Court decisions than District Court decisions, likely due to the specialized nature of tax cases and the expertise of Tax Court judges (Lederman [2013]). Second, the Tax Court is more lenient than the District Courts in enforcing the rules of evidence and permits marginally questionable material to enter as evidence by the taxpayer. The additional discretion can enhance the effect of the ideology in case outcomes (Tucker [1993]). Third, compared to District Court judges, Tax Court judges face less severe outcomes if their decisions are reversed by the Circuit Courts. Decisions in both lower courts are subject to mandatory and routine reviews by Circuit Courts, and reversals by the Circuit Courts embarrass lower court judges, damage their reputation, and reduce their chances of promotion to a higher court (Savchak, Hansford, and Songer [2006]). As District Court judges have more venues to be promoted to, e.g., Circuit Courts, the Supreme Court, while most Tax Court judges spend their entire judicial career in the Tax Court, District Court judges have more career concerns and a reversal is more costly to them. Taken together, compared to District Court judges, Tax Court judges are less constrained by the ideological preferences of the Circuit Court and more likely to make decisions based on their own ideology (Howard [2003]). Consistent with this view, Howard [2005] find that Tax Court judges decide case in a far more ideological manner than those of the District Courts.

In summary, we expect circuit court judge to heavily influence corporate tax avoidance because of its dominance in the judicial system. The Tax Court, due to Circuit Court's deference and the expertise of its judges, also has significant impact in corporate tax decisions. We expect the District Court to have the least amount of impact on corporate tax avoidance based on their judges' incentive, experience, and the constraints from the Circuit Courts.

Empirically, based on how judges are assigned to cases in these courts, we calculate the probability that liberal judges preside over a tax case in each court and use it as measures of judge ideology in the court. In the lower courts, i.e., the Tax Court ($Liberal\ Tax\ Court$) and the District Courts ($Liberal\ District\ Court$), it is the percentage of judges that are appointed by Democratic Presidents; and in Circuit Courts ($Liberal\ Circuit\ Court$), it is the probability that a randomly selected three judge panels are dominated by Democratic President appointees.

To test Hypothesis 1, we estimate the following OLS regression:

$$\begin{aligned} UTB = {} & a + b_1 \cdot Liberal\ Circuit\ Court + b_2 \cdot Liberal\ Tax\ Court \\ & + b_3 \cdot Liberal\ District\ Court + Controls + Circuit\ FE \\ & + Industry \times Year\ \ FE + \varepsilon \end{aligned} \tag{1}$$

where UTB is the predicted uncertain tax benefits computed following Rego and Wilson [2012]. We use the UTB because it captures a firm's tax planning actions at the more aggressive end of tax avoidance continuum. In particular, Lisowsky, Robinson, and Schmidt [2013] document strong evidence that UTB is significantly positively associated with tax shelter participation, while other commonly used tax avoidance proxies are not. Since FIN 48 became effective for fiscal years beginning after December 15, 2006, actual uncertain tax benefits data are not available for observations prior to 2007. Therefore, we adopt the predicted uncertain tax benefits (UTB) measure from Rego and Wilson [2012] as our main measure. A greater amount of *UTB* indicates more aggressive tax planning. Following the prediction of H1

that liberal court ideology leads to less corporate tax avoidance, we expect the coefficient of judge ideology, i.e., b_1, b_2 and b_3, to be significantly negative.

We follow prior research and include a number of firm characteristics that have been shown to be associated with tax aggressiveness (e.g., Rego and Wilson [2012], Lisowsky et al. [2013], Klassen et al. [2016], Gallemore, Gipper, and Maydew [2018]). Specifically, we control for firm size ($Size$), market-to-book ratio (MTB), leverage ($Leverage$), asset intensity ($Inventory\ Intensity$, $R\&D\ Intensity$, $Capital\ Intensity$, $Intangibility$), pre-tax profitability ($Pretax\ ROA$), income from foreign operations ($Foreign\ Income$), multinationality ($Foreign\ Indicator$), advertising expenditures ($Advertising\ Expense$), sales growth ($Sales\ Growth$), an indicator for loss carrying forward (NOL), and change in loss carrying forward (ΔNOL). We also include circuit fixed effects to account for unobservable differences in firms across circuits as well as industry-year fixed effects to control for industry conditions year to year. Control variables are defined in Appendix B.

5. Empirical Results

5.1. Sample Description

Table 1 Panel A reports the sample selection procedures. We start with all observations in *Compustat* from 1996 to 2016. We require firms to be incorporated in the U.S. and headquartered in one of the U.S. states. We eliminate firm-years with missing data that are necessary for constructing variables for our tests. Our main sample includes 66,222 firm-year observations from 9,232 unique firms. The sample sizes used in some regression tests are smaller due to additional data requirements.

Descriptive statistics of the variables included in Equation (1) are reported in Table 2 Panel A. In our sample of 66,222 firm-year observations, both the mean (median) values of UTB are 0.08, or 0.8% of lagged total assets. With respect to other tax avoidance proxies, our sample has a mean (median) annual cash ETR of 24.3% (22.1%), GAAP ETR of 29.1%

(33.6%), reported UTB of 1.1% (0.3%) of total assets. These statistics are similar to those reported in prior studies (e.g., Dyreng et al. [2010]; Rego and Wilson [2012]; Hoopes et al. [2012]; Bozanic, Hoopes, Thornock, and Williams [2016]). The mean (median) firm-year observation in our sample has total assets of $2,597 ($220.2) million, market-to-book ratio of 2.66, leverage of 21.7% (of total assets), inventory of 10.5% (of total assets), *R&D* of 6.9% (of total assets), *PPE* of 28.9% (of total assets), intangible assets of 17.2% (of total assets), pre-tax ROA of -0.01, foreign income of 0.8% (of total assets), advertising expense of 1.3% (of total assets), and sales growth of 17.3%. Of the sample firm-years, 28% report positive foreign income and 48% has loss carrying forward.

Panel B of Table 2 presents the Pearson correlations among the regression variables. As for the correlations between the control variables, most of the correlations are small, except that *Foreign indicator* is highly correlated with *Foreign Income* and *Firm Size.* These high correlation coefficients are not surprising given that multinational firms are on average larger. An examination of variance inflation factors suggests that multicollinearity is not a major concern for the regressions.

Panel C of Table 2 reports the mean and standard deviation of judge ideology over time. The statistics shows a significant time series variation over time, for instance, ideology of circuit (district) judge range from 0.322 (0.407) in 1996 (2009) to 0.484 (0.544) in 2016, a 50.3% (33.7%) difference. The ideology of tax court ranges from 0.174 in year 2011 to 0.436 in 2016, a even bigger 150.6% variation. The large variation supports the insertion from Huang et al. (2019) that judge ideology is a powerful measure of judiciary attributes that enables extensive studies on how political appointments of judges influence corporate decisions.

5.2. Relation between Judge Ideology and Tax Avoidance

Table 3 presents the regression results of judge ideology on UTB. Columns (1), (2), and (3) report results for $Liberal\ Circuit\ Court$, $Liberal\ Tax\ Court$, and

$Liberal\ District\ Court$, respectively. As reported in Column (1), the coefficient on $Liberal\ Circuit\ Court$ is significantly negative at the 1% level (t = -3.47). This suggests that firms consider judge ideology (at the circuit court level) to be an important factor in determining their tax aggressiveness. The result is consistent with the prediction of the "Tax Collection Hypothesis" that firms are less tax aggressive when the judges at the circuit court are more liberal. On the flipside, this also implies that firms would take advantage of more conservative circuit judges by increasing their level of tax aggressiveness. In terms of economic significance, a one-interquartile-range increase in $Liberal\ Circuit\ Court$ is associated with a decrease in UTB of 0.001, or approximately a 12.5% reduction.

Column (2) shows that the coefficient on $Liberal\ Tax\ Court$ is significantly negative at the 5% level (t = -2.08). This is again consistent with our prediction and are in line with our results on $Liberal\ Tax\ Court$. To gauge the economic impact of tax court judges, our estimated coefficient of -0.014 translate into an approximately 15% decrease in tax aggressiveness for a one-interquartile-range increase in $Liberal\ Tax\ Court$. These suggest that Tax Court judge ideology has a discernable effect on firms' tax aggressiveness, comparable to that of the Circuit Court judges.

In Column (3), we report the results for judge ideology at the district court level. Interestingly, our results suggest that judge ideology at the district court level does not have a statistically significant impact on tax aggressiveness, as evidenced by the insignificant coefficient on $Liberal\ District\ Court$ (t = 0.53). The lack of influence of the District Court judge ideology compared to that of the Tax Court is consistent with prior studies that document judge ideology to be more important in Circuit and Tax Court decisions than in District Court decisions (Howard [2003, 2005, 2010]).

In Columns (4), we include $Liberal\ Circuit\ Court$ and $Liberal\ Tax\ Court$ together in the regression and find similar results, both statistically and economically. The inferences

are also similar when we consider all three judge ideology measures in the same model (Column 5). In particular, Chi-square tests show that the estimated coefficient of $Liberal\ District\ Court$ is significantly smaller than those of $Liberal\ Circuit\ Court$ (F = 9.73; p-value <0.01) and of $Liberal\ Tax\ Court$ (F = 4.35; p-value <0.05). This result is also consistent with Howard [2010], which finds that the District Court, but not the Tax Court, is strongly influenced by the ideology of the Court of Appeals.

In terms of the results on the control variables, we find that UTB is positively associated with firm size, R&D intensity, the size of foreign operations, and advertising expenses, and it increases with leverage, capital intensity, intangibles, sales growth, and change in NOL. The coefficients on the control variables are similar to those reported in previous research (e.g., Rego and Wilson [2012], Lisowsky et al. [2013], Klassen et al. [2016], Gallemore et al. [2018]).

Overall, our findings are consistent with our prediction that firms consider judge ideology at both circuit and tax court levels to be important consideration in their tax planning decisions. Firms are less (more) tax aggressive when they are more likely to face liberal (conservative) judges in circuit or tax court.

5.2.1. Robustness – Alternative Proxies for Tax Avoidance

To ensure that the results are robust to alternative proxies for tax avoidance, we estimate Equation (1) by replacing our main dependent variable of UTB with: (i) the natural logarithm of the reported amount of FIN 48 unrecognized tax benefits ($Ln(UTB)$) (Lisowsky et al. [2013]); Blouin, Gleason, Mills, and Sikes [2010]) (ii) the natural logarithm of the amount of future settlement of uncertain tax benefits over the next three years ($Ln(Settlement_{t+1,t+3})$) (Robinson, Stomberg, and Towery [2016]; Bauer and Klassen [2017]), (iii) cash effective tax rates ($Cash\ ETR$), and (iv) GAAP effective tax rates ($GAAP\ ETR$) (Dyreng, Hanlon, and Maydew [2008]; Hoopes et al. [2012]; Graham et al. [2014]). The results are reported in Table

4.[23]

In Column (1), the results using reported FIN48 UTB are consistent with those using predicted UTB in our main test, despite the significant loss of sample size due to the post-2007 availability of FIN48 tax reserves data. In particular, both $Liberal\ Circuit\ Court$ and $Liberal\ Tax\ Court$ are associated with a significant decrease in uncertain tax positions. The size of the effect is approximately 18.7% and 7.6% lower in reported UTB for a one-interquartile range increase in $Liberal\ Circuit\ Court$ and $Liberal\ Tax\ Court$, respectively. Results in Column (2) suggest that the decrease in firms' uncertain tax positions also spillover to the size of future settlement of UTB. The economic significance of the effect on future settlement of UTB is comparable to that of the effect on UTB: a one-interquartile range increase in $Liberal\ Circuit\ Court$ and $Liberal\ Tax\ Court$ is associated with a decrease in future settlement by approximately 26.7% and 8.4%, respectively.

In terms of the effects on ETR, we find that both $Cash\ ETR$ and $GAAP\ ETR$ are significantly higher when judge ideology at circuit or tax court is more liberal. For $Cash\ ETR$, our estimates imply that a one-interquartile range increase in $Liberal\ Circuit\ Court$ and $Liberal\ Tax\ Court$ is associated with an increase in $Cash\ ETR$ by approximately 0.71 and 0.58 percentage points. The effects are similar on $GAAP\ ETR$, in which a one-interquartile range increase in $Liberal\ Circuit\ Court$ and $Liberal\ Tax\ Court$ is associated with an increase in $GAAP\ ETR$ by approximately 0.77 and 0.38 percentage points.

Overall, the results using alternative measures of tax aggressiveness offer similar inferences as in the main analysis, such that firms are less (more) tax aggressive when Circuit and Tax Court judge ideology tilts toward the liberal (conservative) side.

[23] We do not include District Court ideology ($Liberal\ District\ Court$) because Table 3 shows that it is not associated with tax avoidance, consistent with prior literature (Howard [2003, 2005, 2010]). Table 3 also shows that including $Liberal\ District\ Court$ in the model does not affect the inferences on Circuit Court and Tax Court ideology. Therefore, we omit $Liberal\ District\ Court$ from the analysis hereafter.

5.3. Judge Ideology and Tax Avoidance Conditional on Financial Reporting Incentives

Next, we test the association between judge ideology and managers' tax avoidance condition on the financial reporting incentives. As discussed earlier, based on the "financial reporting hypothesis," firms with a stronger financial reporting incentive and more constraints on other earnings management tools are more likely to make tax planning decisions to improve earnings, mitigating or even reverse judicial ideology's effect on tax avoidance. As such, we expect the association between ideology and tax avoidance to become weaker when financial reporting incentives are stronger, and when other earnings management methods are more costly.

To conduct the test empirically, we use two proxies a) the percentage of institutional ownership, and b) past income-increasing discretionary accruals. Specifically, we expect firms are more concerned about earnings disappointments when there is a larger percentage of institutional ownership. Prior studies suggest that firms with higher percentage of institutional holders concern more about beating earnings targets to maintain its valuation (Bartov et al., [2002]; Kasznik and McNichols [2002]; Chu et al. [2019]). Further, because accruals manipulation reverses in the subsequent periods, we use past upward accruals manipulation as a measure of the flexibility firms have in the current period to use accruals to inflate earnings. Overall, we expect firms with stronger incentives to manage earnings or less flexibility in other earnings management tools to consider judge ideology to a lesser degree in tax planning. This results in positive coefficients on the interactions between institutional ownership and past accruals with judge ideology.

Table 5 reports the findings of the tests. We use the base regression model of Table 3 for the tests and supplement it with the interaction between institutional ownership (IO, measured as the percentage of institutional holdings) and past earnings management ($PastEM$, defined as the number of years the firm has positive abnormal accruals during the last five

years) with judge ideology. The interaction terms in all columns are significantly positive, consistent with our expectations. The effect of financial reporting incentive is economically significant. For example, for firms in the top decile of institutional ownership, the net effect of judge ideology on tax avoidance are insignificant (*t*-stats of -1.29 and -0.64 for the ideology of Circuit Court and Tax Court respectively). Similarly, firms with positive abnormal accruals in at least four out of the last five years do not consider Tax Court judge ideology in tax planning ($-0.148 + 4 \times 0.037 = 0$).

5.4. Relation between Judge Ideology and Income Shifting

Next, to further our understanding of corporations' response to the judicial system, we study how judge ideology affect a specific type of tax avoidance, shifting taxable income out of U.S.. Multi-jurisdictional profit shifting using transfer pricing has become a popular method of tax avoidance in recent years (Bartelsman and Beetsma [2003]; Eversen [2006]; Klassen and Laplante [2012]). For U.S. multinationals, shifting income out of the U.S. to low tax jurisdictions allow them to defer tax liability under the worldwide tax system of the U.S during our sample period. A theoretical model from De Waegenaere, Sansing, and Wielhouwer [2006] suggests that an increase in the probability of transfer-price rule inconsistency induces more aggressive auditing by governments. Empirical research, such as Klassen and Laplante [2012], Beuselinck, Deloof and Vanstraelen [2015], has shown that firms adjust their extent of profit shifting in response to the strictness of income shifting regulation in U.S. and other countries.

Not surprisingly, the IRS challenges many firms' transfer pricing practices, alleging that they do not follow arm's length principle (Blair and Femia [2018] and evade U.S. taxes. Many such challenges are very complex and have to be settled in the Courts (e.g., Xilinx Inc.

v. Commissioner, 9th circuit, 2009). We predict that when judge ideology is more liberal, firms will perceive higher tax enforcement and thus shift less income out of the U.S..[24]

Following prior research (e.g., Collins et al. [1998]; Klassen and Laplante [2012]; De Simone, Huang, and Krull [2018]), we estimate income shifting by regressing total foreign pre-tax return on sales ($FRoS$) on worldwide pre-tax return sales (RoS) and proxies for tax-motivated income shifting incentives ($LowFTR \times FTR$, $HighFTR \times FTR$). Specifically, we estimate Equation (2) below:

$$FRoS_{i,t} = \beta_0 + \beta_1 RoS_{i,t} + \beta_2 HighFTR_{i,t} + \beta_3 LowFTR_{i,t} \times FTR_{i,t} + \beta_4 HighFTR_{i,t} \times FTR_{i,t} + Circuit\ FE + Industry \times Year\ FE + \varepsilon_{i,t} \quad (2)$$

The intuition of this approach is that a firm's expected foreign profitability ($FRoS$) is explained by the firm's worldwide profitability (RoS). To the extent that the firm's unexpected foreign profitability, given by the residuals of the regression model, is correlated to the tax incentive variables ($LowFTR \times FTR$, $HighFTR \times FTR$) in a predicable manner, we infer such correlations as evidence of tax-motivated income shifting. In particular, when a firm's average foreign ETR is less than the U.S. statutory rate ($FTR \leq 0$), this firm would have an incentive to shift income out of the U.S. This outbound income shifting would reflect in a negative β_3, the coefficient on ($LowFTR \times FTR$), because lower values of FTR would be associated with higher foreign profitability. On the contrary, when a firm's average foreign ETR is higher than the U.S. statutory rate ($FTR > 0$), this firm would have an incentive to shift income into the U.S from other high-tax foreign jurisdictions. This inbound income shifting would reflect in a negative β_4, the coefficient on ($HighFTR \times FTR$), because higher values of FTR would be associated with lower foreign profitability.

[24] The effect of judge ideology on inbound income shifting, i.e., shifting income from foreign jurisdiction to the U.S., however, is uncertain. We do not have strong reasons to believe that US tax enforcement would have a deterrence or encouraging effect on how US firms' shifting foreign income (from high tax jurisdictions) into the US. This is especially unlikely considering the limited resources of the IRS.

Due to their incentives to increase tax revenue paid to the U.S. government, liberal judges are tougher on shifting income *out* of the U.S.. However, the costs of shifting foreign income *into* the U.S. likely depend on tax enforcements in foreign jurisdictions. Therefore, we predict that both $Liberal\ Circuit\ Court$ and $Liberal\ Tax\ Court$ will be associated with lower outbound income shifting. To test our prediction, we interact $Liberal\ Circuit\ Court$ and $Liberal\ Tax\ Court$ with the FTR variables ($HighFTR$, $LowFTR \times FTR$, $HighFTR \times FTR$) and estimate the model over our sample period from 1997 to 2016.[25]

In Table 6 Column (1) we report the baseline results without including our judge ideology variables. The coefficients on the tax incentive variables are significantly negative ($LowFTR \times FTR$, $HighFTR \times FTR$), providing strong evidence that U.S. multinational engage in both outbound and inbound income shifting, consistent with the results documented in Klassen and Laplante [2012]. In Column (2), we tabulate the estimation results of the model with our judge ideology variables as well as their interaction with the FTR variables included. We find that firms engage in less outbound income shifting when the ideology of circuit and tax court judges is more liberal, as evidenced by the significantly positive coefficient on the two interaction terms $LowFTR \times FTR \times Liberal\ Circuit\ Court$ and $LowFTR \times FTR \times Liberal\ Tax\ Court$ (at the 1% and 5% levels, respectively). In terms of economic significance, one-standard-deviation increases in $Liberal\ Circuit\ Court$ and $Liberal\ Tax\ Court$ are associated with decreases in outbound income shifting by approximately 9.5% and 8.2%, respectively. The interaction between judge ideology and inbound income shifting incentive

[25] Gutman [1993] gives an example of how the IRS considers the "hazards of litigation": "*Unless there is an IRS policy to the contrary, the hearing officer in the appeals office (of the IRS) makes a settlement offer on the basis of the quality of the case set up by the auditor and the hazards of litigation. For example, if the officer thinks that the IRS has only a 30-percent chance of succeeding in litigation, an offer will be made to settle the case for 30 cents on the dollar.*" Note that the IRS generally will not settle based on hazards of litigation if it believes the taxpayer has only a minimal chance (10% or less) of ultimately prevailing (Gercken, Heyvaert, Rendon and Wiggin [1998]).

variables are not significant at the conventional level, suggesting that inbound income shifting is not affected by judge ideology.

5.5. Tax Avoidance in Domestic and Foreign Income

In this section, we study how managers mitigate the effect of judge ideology by conducting tax planning outside of the jurisdiction of U.S. courts. Because the IRS and the U.S. federal courts are only concerned with U.S. taxes, when judge ideology is more liberal, the costs of tax avoidance in the U.S. increases while that in foreign jurisdiction remains unchanged. Thus, when judges are more liberal, firms will likely conduct less tax avoidance in the U.S., but more in foreign countries.

Empirically, we examine the effect of judge ideology on $Domestic\ ETR$ (federal total tax expense over domestic income) and $Foreign\ ETR$ (foreign total tax expense over foreign pre-tax income). If firms reduce their U.S. tax avoidance and increase their avoidance of foreign taxes on foreign income when judges become more liberal, judge ideology should be positively associated with $Domestic\ ETR$ and negatively associated with $Foreign\ ETR$.

Our results (tabulated in Table 7) support this prediction.[26] Consistent with our expectation, both $Liberal\ Circuit\ Court$ and $Liberal\ Tax\ Court$ are significantly negative in Column (2), indicating that firms pay less tax and have more tax avoidance in foreign countries when U.S. judges are more liberal. On the other hand, in Column (1) which tabulates the $Domestic\ ETR$ regression, the coefficients are significantly positive, consistent with liberal judges increasing taxes and reduces tax avoidance in U.S..

5.6. Judge Ideology and Forum Shopping

To examine another method of how firms can mitigate the impact of liberal ideology,

[26] The sample size is smaller because foreign pre-tax income (PIFO), the denominator of $Foreign\ ETR$, is only defined for multinational firms.

we investigate whether managers forum shopping the litigation venue to resolve disputes with the IRS based on judge ideology in various courts. Forum shopping between the Tax Court and the District Courts is well-known in the profession due to the differences between the two courts. First, the District Courts require companies to pay the full tax deficiency before filing a case (a tax refund case) while the Tax Court does not (a tax deficiency case). Thus, litigation in the District Courts are usually more expensive for companies than those in the Tax Court. Second, Tax Court judges are tax specialists while District Court judges are generalists, usually without tax expertise. Other differences include precedents in the forum, trial location, government attorneys, evidentiary rules, procedural rules, settlement authority and opportunities, publicity of proceedings, and new issues (see Appendix A for a detailed discussion). In fact, Berall [1992] has argued that "*choice of forum is perhaps the single most important decision in planning for tax litigation*."

Given that companies can engage in forum shopping between the Tax Court and the District Courts for tax disputes (Eynon and Stevens [1995], Maloy [2005]), and that judge ideology affects tax case outcomes, it is intuitive that managers' forum choice is in part driven by the ideology of the judges in the two courts. As Howard [2010] argues, between the Tax Court and the District Courts, "*litigants should also be encouraged to choose the court that offers the greatest chance of a conservative judge because the more conservative the judge, the more likely the support for the taxpayer opposing the IRS.*" That is, ceteris paribus, the more liberal the judge ideology in the Tax Court, compared to that in the District Court, corporations are less likely to choose the Tax Court over the District Court.[27] Using a shorter time horizon in earlier years (1994-2000) and both corporate and individual tax cases, Howard [2007] finds that when the Tax Court judge ideology becomes more liberal, less tax lawsuits are filed in the

Tax Court as compared to the District Court.[28] However, since most tax disputes are brought by individuals, it is not clear if the same pattern exists when we focus on corporation tax lawsuits.

Table 8 reports the finding of the tests. The dependent variable is the number tax court cases over the sum of tax court and district court cases at district in year t ($Tax\ Court\ Cases\ /\ Total\ Tax\ Litigations$). Columns (1) and (2) report results using OLS and Tobit regression, respectively. In both columns, $Liberal\ Tax\ Court$ are significantly negative, indicating managers arbitrary choose the venue of litigation to resolve tax disputes with the IRS, the negative sign is consistent with our prediction that more liberal the tax court judge is, the less likely firms file lawsuits with them. $Liberal\ District\ Court$ is insignificant and $Liberal\ Circuit\ Court$ is significantly positive. The finding is consistent with our previous findings that district court judge ideology have little impact on firms' tax decisions. In addition, the significant and positive coefficient of $Liberal\ Circuit\ Court$ is consistent with our prediction of forum shopping. Prior studies (e.g. Huang et al. 2019) suggests that district court judges, because of the review pressure and the jurisdiction hierarchy under circuit court judge, circuit court judge ideology better captures the ideology district court judges than their own partisanship of appointments. As such, significant positive $Liberal\ Circuit\ Court$ is consistent with a higher likelihood of venue choice in tax courts, when the judge in district judge system is more liberal.

5.7. Judge Ideology and the Demand for Auditor-Provided Tax Services

To shed light on the interplay between judge ideology and firms' tax planning inputs, we examine the effects of judge ideology on firms' demand for professional tax services.[29]

[28] Forum shopping has also been documented in other lawsuits, such as patent litigation (Moore [2001]), bankruptcy reorganization (LoPucki [1991], Parikh [2013]), and tort (White [2006]).

[29] External professional tax services include those provided by law firms, financial institutions (i.e., commercial and investment banks), and accounting firms (i.e., auditors and non-auditors) (Klassen et al. [2016]; Gallemore et

Prior studies find that auditor-provided tax services is a significant input in tax planning relied on by firms. For example, McGuire et al. [2012] find that tax expert auditors can help firms to achieve greater tax savings. Klassen et al. [2016] find that, compared to internal tax planning, auditors are more conservative in their provision of tax strategies and hence firms take on less uncertain tax positions when they have their auditor sign their tax returns, as compared to internally signed tax returns. De Simone et al. [2015] find that auditor-provided tax services can improve tax-related internal control quality.

Ex ante, it is not clear whether firms may demand more tax services when judges are more liberal. On the one hand, if firms need more sophisticated tax planning to circumvent liberal judges' pro-government interpretation of tax laws, we expect higher demand for tax planning. On the other hand, less tax avoidance associated liberal ideology may suggest lower demand of tax planning services. To test the question, we consider two alternative measures of firms' demand of auditor-provided tax services (e.g., Armstrong et al. [2012]; Donohoe and Knechel [2014]; Klassen, Lisowsky, and Mescall [2016]). First, we use the natural logarithm of the amount of tax fees paid to the auditor ($Ln(Tax\ Fees)$). Second, we use the proportion of tax fees to total fees paid to the auditor ($Tax\ Fees/Total\ Fees$). Results using the two alternative measures, reported in Table 9, suggest that firms use more tax services provided by their auditors when judge ideology becomes more liberal. Specifically, the estimated coefficients of $Liberal\ Circuit\ Court$ and $Liberal\ Tax\ Court$ are positive and significant for both measures, respectively. Our findings thus suggest that although the observed tax avoidance reduces when the judges are more liberal, firms employ more resources in terms of professional assistances to circumvent the judiciary branch.

5.8. IRS Audits and Judge Ideology's Effect on Corporate Tax Avoidance

al. [2018]). We focus on auditor-provided tax services because the data on other types of services are not publicly available.

Lastly, we study how the judicial branch and the executive branch, i.e., the IRS, complement or substitute each other in enforcing tax collections. Specifically, we examine judge ideology's effect on tax avoidance conditional on the capability and efforts of IRS. Although prior studies (e.g. Howard and Nixon [2003]; Blank and Staudt [2012]) show that the IRS increases their efforts when judges are more liberal, it is not clear on the effectiveness of their effort. In other words, we do not know whether the efforts from the IRS strengthens or weakens judge ideology's the deterrence effect on corporate tax avoidance.

Our ex ante prediction on the test is not clear. At one side, we expect that as the IRS exerts more effort in auditing, firms place a heavier weight of judge ideology in their tax decisions. This is because IRS scrutiny increases the likelihood of tax disputes and tax litigations, leading to a greater impact of judge ideology on the net benefit of tax avoidance. On the other hand, as IRS exert more efforts in collecting the evidence against avoidance, it may increase the merit of the case and reduce the judges' discretion in making decisions. This results in a decrease in the importance of judge ideology in tax cases and firms are less likely to consider it in tax decisions.

To measure IRS's collection efforts, we use the likelihood of receiving an IRS audit (Hoopes et al. [2012]), which is a detailed examination of a taxpayer's return to determine whether the taxpayer complies with tax codes. During the audit, the IRS seeks justification and verification of the reported income and expenditures. It is the most powerful tool of the IRS. As such, more audits conducted by the IRS represent a greater effort to enforce tax collection. If the IRS audit effort complements judge ideology, we would expect that the effect of judge ideology on corporate tax avoidance to be greater when firms have a higher probability of being audited.

Empirically, we measure audit likelihood using the size-adjusted IRS audit probability ($IRS\ Audit$), estimated as the decile rank of the residual of regressing IRS audit probability on

firms size and year fixed effects. We include it along with its interaction with judge ideology in the Circuit Courts and the Tax Court in Equation (1). The results are reported in Table 10. In general, we find results consistent with our prediction that judge ideology's deterrence effect on tax avoidance is stronger when firms are more likely to be subjected to an IRS audits, suggesting a complementary relation between the judicial and the executive branches in deterring tax avoidance. The interaction between $IRS\ Audit$ and $Liberal\ Circuit\ Court$ and $Liberal\ Tax\ Court$ are both negative and statistically significant at the 5% level (in Columns (1) and (2)). Note that when we include both interaction terms in the regression, $Liberal\ Circuit\ Court \times IRS\ Audit$ is negative but no longer significant. Together with the findings in Panel A, our findings suggest that the circuit court and tax court coordinate with the IRS in different ways. This could be due to that the Tax Court is more specialized in tax issues, and is thus less affected by firms' information advantage of the IRS, but more constrained by the quality of evidence collected by the IRS.

6. Conclusion

Our paper examines whether and how the judiciary branch affects corporate tax avoidance. Despite its critical role in tax matters, prior studies have focused on the legislative and executive branches' impacts and paid surprisingly little attention to the judicial branch. Our paper aims to fill this gap in the literature.

Using appointing presidents' partisanship as a measure of judiciary's position on corporate tax avoidance, we find that firms are less likely to use aggressive tax strategies, when the ideology of the Tax Court and the Circuit Court that has jurisdiction over the firm are more liberal. The effect is economically significant and robust across various measures of tax avoidance, including a specific type of tax avoidance, shifting income to foreign jurisdictions. Further analyses show that managers respond to liberal judge ideology with more professional tax service, more aggressive tax planning in other jurisdictions and forum shopping in tax cases.

Last, our evidence shows that the judicial branch and the executive branch complement each other in tax collection.

As the first paper studying the relation between the judiciary branch and corporate tax avoidance, we broaden the understanding on the determinants of tax planning and help paint a more complete picture of how the three branches of the government jointly influence corporate tax. More importantly, our paper demonstrates how managers respond to the judicial branch through various ways of avoiding tax, and complementary relation of the IRS and the judicial branch against tax avoidance. Our study also adds to recent studies on judge ideology's impact in securities class action lawsuits (Huang, Hui and Li [2019]) and contributes to legal studies and political science literature by providing additional evidence of judge ideology's effect in business and finance context. As a result, our paper sheds light on the consequence of the political appointments of judges, and have implications not only to academics, but also to investors and lawmakers.

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Appendix A: Tax Dispute Procedure

A.1 IRS Audits

A tax dispute begins with an IRS audit, where the IRS examines the corporation's accounts and financial information to ensure information is reported correctly according to the tax laws and to verify the reported amount of tax is correct (IRS website). Audits to large corporations (those with assets larger than $10 million) are carried out by the IRS examiners in the Large Business & International (LB&I, the Large and Mid-Size Business Division before 2010) Division. In 2015, the LB&I completed audits on more than 11% of large corporations, much higher than the audit rate of smaller corporations (0.9%) (GAO [2017]). Audits in LB&I are further divided into two groups: Coordinated Industry Cases (CIC) and Industry Cases (IC). CIC involves very large corporations with complex issues, where a team of Revenue Agents and Specialists audit on a continual basis at the corporation.[30] According to GAO [2003], the IRS continuously audit about 1,100 of largest corporations under the CIC program, all of which have assets of more than $250 million. IC are generally less complex and audited by one Revenue Agent. For IC, the LB&I chooses returns to audit based on a variety of selection models.[31] During the audit, the IRS Revenue Agent will routinely request information from the corporation and propose adjustments.

After an audit is concluded, if there are unagreed issues that result in tax deficiency, the IRS will issue a 30-day letter notifying the corporation the right to appeal the examiner's adjustment with the Office of Appeals within 30 days (IRM 4.46.5.7.1). After receiving the 30-day letter, the company can file a protest to request an appeal with the Office of Appeals or

[30] The IRS uses a point criteria to identify CIC cases. The factors used in computing the point criteria includes: gross assets, gross receipts, operating entities, multiple industry status, total foreign assets, total related transactions, and foreign tax (IRM 4.46.2.5). The IRS can also include cases that it believes has sufficient complexity.

[31] In the GAO [2017] report titled "IRS Return Selection," the LB&I identifies 14 selection methods. One of the method is the Discriminant Analysis System, a mathematical system that ranks returns based on their probability of being profitable to audit.

pursue its claim directly in court (IRS Pub 5, 1999). The Office of Appeals is an independent organization within the IRS which aims to resolve tax controversies without litigation (IRS [2003]). An appeals officer or settlement officer will review the strengths and weaknesses of the respective positions taken in the case and propose settlement based on IRS's "hazards of litigation," i.e., the likelihood that the corporation will prevail in a lawsuit. It is important to note that the Internal Revenue Manual (IRM) specifically require the appeals officer to consider the most recent legal precedent applicable to the corporation, based on the circuit court that has jurisdiction over the corporation's headquarter (*Golsen v. Commissioner of Internal Revenue* 1970, IRM 8.6.4.1.6, IRS 2007).[32] If the corporation does not respond to the 30-day letter, i.e., skips the appeal system, or if an agreement cannot be reached with the Appeals, the IRS will issue a Notice of Deficiency, also referred to as the 90-day letter (IRS Section 6212 (a)).

If the company disagrees with the IRS determination in the notice, it can file a petition against the Commissioner of Internal Revenue in a federal court.[33]

A.2 Federal Courts for Tax Cases

A.2.1 Overview

Corporations can either choose the Tax Court, i.e., a deficiency case, within 90 days of the notice (26 U.S. Code § 6213 (a)), or pay the full deficiency under protest, file an administrative claim for refund with the IRS, and file a refund case in either the district courts (Section 7422; 28 U.S.C. § 1346) and the Court of Federal Claims (Section 7422; 28 U.S.C. §

[32] The IRM 8.6.4.1.6 (4) requires that the appeals officer to evaluate the case if "Golsen Rule" is applicable. In the *Golsen v. Commissioner of Internal Revenue*, the Tax Court held it would follow the rule of law laid down by the Court of Appeals to which an appeal in the case before it would lie (54 T.C. 742 1970). The IRM 8.6.4.1.6 (6) requires that the appeals officer modify the tentative agreement if the law or legal precedent relied upon to formulate the tentative agreement changes.

[33] During the litigation process, the company can continue to negotiate with the IRS (if filed in the Tax Court) or the DOJ (if filed in the District Court or the Court of Federal Claims). Both IRS counsels and DOJ attorneys are explicitly required to consider the litigation hazards in offering settlements (I.R.M. 35.5.2.4, DOJ Tax Division Settlement Reference Manual [2012]).

1491).[34, 35] The vast majority of the tax cases are handled in the Tax Court, with a minority filed in the District Courts and very few in the Court of Federal Claims.[36]

The Tax Court is a national court established by Congress under the Article I of the Constitution. The court is exclusively a tax tribunal with limited jurisdiction as described in IRC Sec. 7442, which includes income, estate, gift, and certain excise taxes under Chapters 41-45 of the Code. It is also the only forum which does not require taxpayers to pay tax before filing suits. Taxpayers can sue the IRS for tax refund in the District Courts and the Court of Federal Claims. There are 94 District Courts in the US. Corporations, if choose to file the case in a District Court, must file it in the district of its principle place of business or office, i.e., its headquarters (28 U.S.C. $1402(a)(2) 2006). The Court of Federal Claims is a special trial court that has nationwide jurisdiction over cases that claims money damage against the United States. Tax cases make up about 6% of its cases (404 out of a total of 6,372 cases from 2009 to 2014, US Courts).

If the losing party wants to appeal a decision from the Tax Court or the District Courts, the Circuit Court with jurisdiction over the corporation's headquarter state will handle the appeal. It is important to note that even though the Tax Court is a national court, it follows the precedent of the relevant Court of Appeals, just like the District Courts (*Golsen v. Commissioner of Internal Revenue* 54 T.C. 742 1970). Appeals from the Court of Federal

[34] A corporation that has already filed Chapter 7 or Chapter 11 bankruptcy before the tax issue arises can also petition in the U.S. Bankruptcy courts (IRS Pub 908), another Article I court established by the Congress in 1984 (U.S. Code Section 151). Each district court has its own bankruptcy court, with judges appointed by the circuit court for a renewable term of 14 years (28 U.S.C. § 152). Bankruptcy court decisions can be appealed first either to the district court or, in a few circuits, to the Bankruptcy Appellate Panels (BAP) of the circuit (28 U.S.C. § 158). The decision of the district court or the BAP can be appealed to the circuit court. There are some circumstances of a direct appeal to the circuit court after the passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (George 2007).

[35] Once the corporation has filed a case in the Tax Court, it cannot dismiss the petition and file a refund case for the same tax and the same year in a District Court or in the Court of Federal Claims (26 U.S.C. § 6512(a)).

[36] Caron [1994] reports that during the five-year period of 1988-1992, there are 35,931, 952 and 185 tax cases in the Tax Court, District Courts, and the Court of Federal Claims respectively. During 2012-2017, there were on average 63 tax cases filed in the Court of Federal Claims each year (https://www.uscfc.uscourts.gov/reports-statistics).

Claims will go to the U.S. Court of Appeals for the Federal Circuit. Last, the U.S. Supreme Court will decide whether to hear appeals from all Courts of Appeals. As discussed in Section 4, the Supreme Court only reviews less than 1% of the appeals and prior research has argued that they are not particularly inclined to hear tax cases (Richards [2001]).

A.2.2 Other Differences among Courts

Besides whether the tax deficiency has to be paid (tax payment only required only for the Tax Court)[37] and the appellate jurisdiction (Court of Appeals in regional circuits vs. Court of Appeals of Federal Claims), the most significant differences among the three courts are their judges' background and tax case volume. Specifically, the Tax Court exclusively handles tax related issues and all its judges are tax specialists. The District Courts and the Court of Federal Claims have generalist judges, i.e., their judges are typically not tax specialists. However, due to its jurisdiction over monetary claims against the United States, the Court of Federal Claims have a higher proportion of cases in tax than District Courts (Caron [1994]). Thus, legal literature refers to judges in the Court of Federal Claims as Hybrid, i.e., between "generalists" and "specialists" (Bittker and Lokken [1989]).[38, 39]

[37] Even though tax court only hears deficiency cases, corporations can mitigate the interest accrual and file in the Tax Court by paying a deposit of tax before receiving the Notice of Deficiency (IRC 6603) or a tax payment after receiving the Notice of Deficiency (IRC 6213(b)(4)).

[38] Following the same definition, the Court of Appeals in regional circuits have generalist judges while the Court of Appeals in Federal Claims have hybrid judges.

[39] Another difference between judges in the District Courts and those in the Tax Court and the Court of Federal Claims is their tenure. Judges from all three courts are appointed by the U.S. President, subject to the confirmation of the US Senate. District Court (an Article III court) judges have life tenure while judges from the other two courts (both Article I courts) have a term of 15 years. However, Tax Court judges can usually request to be reappointed when their term expires (I.R.C. 7447(b)(3)), regardless of the political party of the sitting president (Cords [2012]).

Other differences among the three trial courts include trial location[40], government attorneys, [41] evidentiary rules, procedural rules, settlement authority and opportunities, publicity of proceedings, and new issues (see Henkel [2007], Greenaway [2009] and Howard [2010] for detailed discussions of the differences among the courts with regard to tax cases).

[40] Tax Court judges travel nationwide to conduct trials in 74 designated cities (14 of them are only for small tax cases, i.e., those with less than $50,000 in dispute) (Panuthos [2015]). The chief judge of the Tax Court schedules the court's trial sessions and assigns a specific judge to each city. When a taxpayer files a petition, it chooses the location of trial (one of the 74 cities). After the Commission of the IRS has filed his answer, the case will be calendared for trial. Each tax court case has one presiding judge. The trial schedule is set about five months before the trial, when the corporation will know the trial date and the trial judge (Metcalf and Prosser [2014]).

[41] The IRS represents the US government in the Tax Court while the Department of Justice in the District Courts and the Court of Federal Claims.

Appendix B: Variable Definitions

Variable	Definition and Construction
$Liberal\ Circuit\ Court$	The probability that a three-judge panel randomly selected from a circuit court has at least two judges appointed by Democratic presidents, that is, $[C(x,3)+C(x,2)\times C(y-x,1)]$ / $C(y,3)$, where y is the total number of judges in the circuit court, and x is the number of judges in the circuit court who were appointed by Democratic presidents. $(a,)$ is the number of combinations of selecting b objects from a distinct objects. We measure $LiberalCircuitCourt$ at the end of each month and assign each firm-year observation to a circuit court-month based on the firm's headquarters at the beginning of the year. Historical headquarters information is extracted from firms' 10-K filings. Circuit court judges' appointing presidents are obtained from the Federal Judicial Center's website
$Liberal\ Tax\ Court$	The percentage of judges from the Tax Court that are first appointed by Democratic presidents. We measure $LiberalTaxCourt$ at the end of each month and assign each firm-year observation to a month based on the beginning of the year. Tax court judges' appointing presidents are obtained from the U.S. Tax Court's website
$Liberal\ District\ Court$	The percentage of judges from a District Court that are appointed by Democratic presidents. We measure $LiberalDistrictCourt$ at the end of each month and assign each firm-year observation to a district court-month based on the firm's headquarters at the beginning of the year. Historical headquarters information is extracted from firms' 10-K filings. District court judges' appointing presidents are obtained from the Federal Judicial Center's website
$Predicted\ UTB$	Predicted uncertain tax benefits (UTB), computed following Rego and Wilson (2012): *Predicted UTB* = –0.004 + 0.011×*Pre-tax ROA* + 0.001×Size + 0.01×*Foreign Sale* + 0.092×*R&D Intensity* + 0.002×*DiscAccruals* + 0.003×*Leverage* + 0.000×*MTB* + 0.014×*SG&A* – 0.018×*Sales Growth*, where *Pre-tax ROA* is pre-tax income scaled by lagged total assets; *Foreign Sale* is total foreign sales scaled by total sales; *R&D Intensity* is R&D expenditures scaled by lagged total assets; *DiscAccruals* is discretionary accruals from the performance-adjusted modified cross-sectional Jones model; *Leverage* is long-term debt scaled by lagged total assets; *MTB* is market-to-book ratio; *SG&A* is selling, general & administrative expenses (XSGA) scaled by lagged total assets. *Sales Growth* is three-year average growth rate in sales over year *t* –2 to year *t*.
$Cash\ ETR$	Cash effective tax rate, defined as cash tax paid (TXPD) divided by pre-tax book income (PI). We require both numerator and dominator to be positive. This variable is truncated at 1.
$GAAP\ ETR$	GAAP effective tax rate, defined as total tax expense (TXT) divided by pre-tax book income (PI). We require both numerator and dominator to be positive. This variable is truncated at 1.
$Domestic\ ETR$	Federal GAAP effective tax rate, defined as federal tax expense (TXFED + TXDFED) divided by pre-tax domestic book income (PI – PIFO). We require both numerator and dominator to be positive. This variable is truncated at 1.
$Foreign\ ETR$	Foreign GAAP effective tax rate, defined as foreign tax expense (TXFO + TXDFO) divided by pre-tax foreign book income (PIFO). We require both numerator and dominator to be positive. This variable is truncated at 1.
$Ln(UTB)$	Natural logarithm of the three-year average UTB; three-year average UTB is defined as the sum of unrecognized tax benefits (TXTUBEND) from *t*–1 through *t*+1 divided by 3.

$Ln(Settlement_{t+1,t+3})$	Natural logarithm of the sum of settlements from the UTB roll forward (TXTUBSETTLE) from *t*+1 through *t*+3.
$Ln(HavenSub)$	Natural logarithm of one plus the number of material subsidiary located in a tax haven. We thank Scott Dyreng for providing Exhibit 21 data.
$Size$	Natural logarithm of total assets (AT).
MTB	Market to book ratio, calculated as PRCC_F×CSHO/CEQ.
$Leverage$	Long-term debt (DLTT) scaled by lagged total assets (AT), set to zero if missing.
$Inventory\ Intensity$	Inventory (INVT) scaled by lagged total assets (AT), set to zero if missing.
$R\&D\ Intensity$	Research and development expenditures (XRD) scaled by lagged total assets (AT), set to zero if missing.
$Capital\ Intensity$	Property, plant, and equipment (PPENT) scaled by lagged total assets (AT), set to zero if missing.
$Intangibility$	Intangible assets (INTAN) scaled by lagged total assets (AT), set to zero if missing.
$Pretax\ ROA$	Pre-tax income (PI) scaled by lagged total assets (AT).
$Foreign\ Income$	Pre-tax foreign income (PIFO) scaled by lagged total assets (AT).
$Foreign\ Indicator$	An indicator variable that equals one if pre-tax foreign income (PIFO)>0, zero otherwise.
$Advertising\ Expense$	Advertising expenditures (XAD) scaled by lagged total assets (AT), set to zero if missing.
$Sales\ Growth$	Three-year average growth rate in sales (SALE) over year *t* –2 to year *t*.
NOL	An indicator variable that equals one if the firm has a net operating loss carry-forward (TLCF) and zero otherwise.
ΔNOL	The difference between year *t* and year *t* –1's net operating loss carry-forward (TLCF) scaled by lagged total assets (AT), set to zero if missing.
$IO\ Decile$	The decile rank of the fraction of shares owned by institutions in year *t*.
$PastEM$	The number of years the firm has a positive abnormal accrual estimate [Kothari, Leone, and Wasley 2005] over a 5-year period from year *t*–5 to *t*–1.
$FRoS$	Foreign return on sales. Defined as foreign pre-tax income (PIFO) divided by total foreign sales. Foreign sales are total sales in which GEOTP=3.
RoS	Worldwide return on sales. Defined as worldwide pre-tax income (PI) divided by total sales.
FTR	The difference between a firm's foreign effective tax rate and the U.S. statutory tax rate, a proxy for firms' annual incentive to shift income. *FTR* is calculated as (*TE*/*PTI*) – *US_STR. TE* is the sum of foreign tax expense (*TXFO* + *TXDFO*) for firm *i* from period *t*–4 to *t*. *PTI* is the sum of foreign pre-tax income over the same period. *US_STR* is the average statutory corporate tax rate for the U.S. over the same period.

$HighFTR$	An indicator variable that equals one if the value of *FTR* is greater than zero, zero otherwise. This variable indicates firm-year observations when a firm's average foreign tax rate exceeds the U.S. statutory tax rate.
$LowFTR$	An indicator variable that equals one if the value of *FTR* is less than or equal to zero, zero otherwise. This variable indicates firm-year observations when a firm's average foreign tax rate is less than the U.S. statutory tax rate.
$Tax\ Court\ Cases$	The number tax cases in Tax Court at district *d* in year *t*.
$District\ Court\ Cases$	The number tax cases in District Court at district *d* in year *t*.
$Total\ Tax\ Litigation$	The number tax cases in Tax Court and District Court at district *d* in year *t*.
$Firm\ Count$	The number of Compustat firms at district *d* in year *t*.
$Tax\ Fees$	The amount of tax fees paid to the auditor (in thousands) in year *t*.
$Audit\ Fees$	The amount of audit fees paid to the auditor (in thousands) in year *t*.
$Other\ Fees$	The amount of non-tax, non-audit fees paid to the auditor (in thousands) in year *t*.
$Total\ Fees$	The amount of total fees paid (audit, tax, and others) to the auditor (in thousands) in year *t*.
$Ln(Audit\ Fees)$	Natural logarithm of the amount (in thousands) of audit fees paid to the auditor in year *t*.
$Ln(Tax\ Fees)$	Natural logarithm of the amount of tax fees paid to the auditor (in thousands) in year *t*.
$Ln(Other\ Fees)$	Natural logarithm of the amount of non-tax, non-audit fees paid to the auditor (in thousands) in year *t*.
$IRS\ Audit$	The decile rank of the size-adjusted IRS audit probability of the firm in year *t*. The size-adjusted IRS audit probability is the residuals from a regression of IRS audit probability on firm size (log of total assets) and year fixed effects. IRS audit probability is the number of face-to-face corporate audits completed in IRS fiscal year *t* divided by the number of 1120 returns filed in calendar year *t* –1 in a given IRS asset size (Hoopes, Mescall, and Pittman 2012).

Table 1: Sample Selection Procedure

		N
All available firm-years in Compustat, 1996 – 2016		200,900
Less: Firm-years not incorporated in a US State	(86,169)	115,115
Less: Firm-years with headquarters not in a US state	(2,263)	114,667
Less: Firm-years with missing total assets	(1,175)	111,229
Firm-years with data available for all variables in main tests	(45,007)	66,222

Table 2 Descriptive Statistics and Correlation matrix

Panel A: Descriptive Statistics

This panel reports the descriptive statistics of variables during the sample period (1996-2016). Variable definitions are in Appendix B.

	N	Mean	SD	P25	P50	P75
Liberal Circuit Court	66,222	0.398	0.179	0.250	0.388	0.564
Liberal Tax Court	66,222	0.310	0.064	0.269	0.318	0.364
Liberal District Court	66,222	0.468	0.147	0.375	0.476	0.545
Predicted UTB	66,222	0.008	0.031	0.003	0.008	0.014
Cash ETR	52,292	0.243	0.221	0.056	0.221	0.348
GAAP ETR	52,909	0.291	0.177	0.209	0.336	0.382
Domestic ETR	37,277	0.245	0.185	0.058	0.294	0.336
Foreign ETR	17,722	0.305	0.246	0.143	0.266	0.390
UTB/AT	25,752	0.011	0.022	0.000	0.003	0.011
$Ln(UTB)$	25,752	2.299	2.149	0.497	1.928	3.834
$Ln(Settlement_{t+1,t+3})$	11,567	1.065	1.559	0.000	0.095	1.792
$Ln(Haven\ Sub)$	31,328	1.014	1.077	0.000	0.693	1.791
Size (in millions)	66,222	2,596.7	9,810.9	36.2	220.4	1,159.5
Size	66,222	5.375	2.371	3.615	5.400	7.057
MTB	66,222	2.657	7.960	0.963	1.835	3.385
Leverage	66,222	0.217	0.309	0.000	0.122	0.315
Inventory Intensity	66,222	0.105	0.160	0.000	0.024	0.158
R&D Intensity	66,222	0.069	0.161	0.000	0.000	0.072
Capital Intensity	66,222	0.289	0.295	0.077	0.188	0.407
Intangibility	66,222	0.172	0.254	0.000	0.065	0.249
Pretax ROA	66,222	-0.007	0.232	-0.073	0.042	0.11
Foreign Income	66,222	0.008	0.030	0.000	0.000	0.003
Foreign Indicator	66,222	0.280	0.448	0.000	0.000	1.000
Advertising Expense	66,222	0.013	0.035	0.000	0.000	0.007
Sales Growth	66,222	0.173	0.372	-0.005	0.079	0.214
NOL	66,222	0.479	0.500	0.000	0.000	1.000
ΔNOL	66,222	0.094	0.485	0.000	0.000	0.003
IO	66,222	0.332	0.352	0.000	0.197	0.674
PastEM	65,752	1.911	1.197	1.000	2.000	3.000
FRoS	9,398	0.051	0.053	0.020	0.036	0.061
RoS	9,398	0.117	0.085	0.058	0.099	0.151
FTR	9,398	-0.063	0.170	-0.159	0.070	0.012
HighFTR	9,398	0.036	0.101	0.000	0.000	0.012
LowFTR	9,398	-0.098	1.074	-0.159	-0.070	0.000

Panel B: Correlations

This table reports the correlation among variables during the sample period (1996-2016). Shaded values are significant at two-tailed 10% level. Variable definitions are in Appendix B.

		1.	2.	3.	4.	5.	6.	7.	8.	9.	10.	11.	12.	13.	14.	15.	16.	17.
1.	*Predicted UTB*																	
2.	*Liberal Circuit Court*	-0.01																
3.	*Liberal Tax Court*	-0.00	0.19															
4.	*Liberal District Cour*	0.01	0.23	0.20														
5.	*Size*	0.01	-0.10	-0.02	0.02													
6.	*MTB*	0.00	0.02	0.02	0.00	0.04												
7.	*Leverage*	-0.03	-0.04	0.05	0.00	0.16	-0.06											
8.	*Inventory Intensity*	-0.02	-0.03	0.03	0.00	-0.08	-0.03	-0.03										
9.	*R&D Intensity*	0.02	0.13	0.00	0.02	-0.28	0.05	-0.02	-0.08									
10.	*Capital Intensity*	-0.03	-0.14	0.02	-0.05	0.23	-0.03	0.35	-0.10	-0.19								
11.	*Intangibility*	-0.03	0.01	0.02	-0.01	0.18	0.02	0.24	-0.09	-0.03	-0.13							
12.	*Pretax ROA*	0.02	-0.06	-0.01	-0.01	0.31	0.06	-0.12	0.02	-0.32	-0.01	-0.12						
13.	*Foreign Income*	0.00	-0.01	-0.04	0.01	0.28	0.04	-0.02	0.03	-0.06	-0.03	-0.05	0.11					
14.	*Foreign Indicator*	0.01	-0.01	-0.03	0.06	0.40	0.03	-0.03	0.03	-0.08	-0.12	0.06	0.14	0.63				
15.	*Advertising Expense*	-0.01	0.03	0.00	0.02	-0.02	0.02	0.00	0.16	-0.03	-0.04	0.12	-0.05	0.02	0.00			
16.	*Sales Growth*	-0.04	0.05	0.01	-0.00	-0.11	0.05	0.10	-0.04	0.16	0.08	0.02	-0.16	-0.05	-0.11	0.01		
17.	*NOL*	0.01	0.08	0.02	0.05	-0.05	0.01	0.02	-0.06	0.11	-0.13	0.13	-0.08	0.02	0.09	0.00	0.03	
18.	*ΔNOL*	0.01	0.07	0.03	0.02	-0.25	-0.02	0.03	-0.05	0.26	-0.09	0.09	-0.36	-0.07	-0.11	0.01	0.08	0.21

Panel C: Summary Statistics of Judge Ideology

This table reports the annual mean and standard deviation of *Liberal Circuit Court*, *Liberal Tax Court* and *Liberal District Court* during the sample period (1996-2016). Variable definitions are in Appendix B.

	Liberal Circuit Court		*Liberal Tax Court*		*Liberal District Court*	
	Mean	Std. Dev.	Mean	Std. Dev.	Mean	Std. Dev.
1996	0.322	0.112	0.316	0.010	0.443	0.146
1997	0.342	0.118	0.327	0.009	0.447	0.138
1998	0.388	0.119	0.369	0.025	0.471	0.131
1999	0.412	0.141	0.364	0.000	0.487	0.132
2000	0.453	0.140	0.348	0.012	0.507	0.123
2001	0.462	0.143	0.318	0.000	0.504	0.122
2002	0.435	0.152	0.328	0.007	0.479	0.123
2003	0.395	0.153	0.293	0.027	0.457	0.124
2004	0.367	0.164	0.277	0.005	0.441	0.127
2005	0.360	0.171	0.269	0.000	0.437	0.129
2006	0.348	0.170	0.269	0.000	0.426	0.129
2007	0.334	0.169	0.269	0.000	0.417	0.127
2008	0.329	0.180	0.252	0.013	0.414	0.131
2009	0.329	0.180	0.248	0.003	0.407	0.140
2010	0.355	0.188	0.214	0.028	0.426	0.149
2011	0.388	0.205	0.174	0.026	0.451	0.154
2012	0.420	0.226	0.271	0.019	0.479	0.166
2013	0.438	0.214	0.349	0.018	0.493	0.170
2014	0.464	0.215	0.380	0.020	0.525	0.179
2015	0.474	0.210	0.433	0.000	0.537	0.179
2016	0.484	0.212	0.436	0.011	0.544	0.179
All Years	0.398	0.179	0.310	0.064	0.468	0.147

Table 3: Judge Ideology and Corporate Tax Avoidance

This table reports the results for the effect of judge ideology on corporate tax avoidance using OLS regressions. Variable definitions are in Appendix B. Industry FE is based on two-digit SIC codes. Intercepts are included but not tabulated. The *t*-statistics (in parentheses) are based on standard errors clustered by states. ***, **, and * indicate statistical significance at the 1%, 5%, and 10% levels based on two-tailed tests, respectively.

Dependent variable: *Predicted Uncertain Tax Benefits* (UTB)

	(1)	(2)	(3)	(4)	(5)
Liberal Circuit Court	-0.0033***			-0.0033***	-0.0036***
	(-3.47)			(-3.22)	(-3.31)
Liberal Tax Court		-0.0136**		-0.0134**	-0.0135*
		(-2.08)		(-2.12)	(-1.97)
Liberal District Court			0.0004		0.0006
			(0.53)		(0.67)
Size	0.0011***	0.0011***	0.0011***	0.0011***	0.0011***
	(8.47)	(8.49)	(8.61)	(8.49)	(8.78)
MTB	0.0001*	0.0001*	0.0001*	0.0001*	0.0001*
	(1.88)	(1.88)	(1.79)	(1.88)	(1.76)
Leverage	-0.0034***	-0.0034***	-0.0033***	-0.0034***	-0.0034***
	(-5.17)	(-5.19)	(-5.68)	(-5.18)	(-5.57)
Inventory Intensity	0.0023	0.0023	0.0031	0.0023	0.0031
	(1.17)	(1.18)	(1.58)	(1.17)	(1.58)
R&D Intensity	0.0910***	0.0910***	0.0913***	0.0910***	0.0915***
	(31.51)	(31.56)	(28.70)	(31.52)	(28.95)
Capital Intensity	-0.0055***	-0.0054***	-0.0052***	-0.0055***	-0.0052***
	(-6.12)	(-6.08)	(-5.19)	(-6.12)	(-5.25)
Intangibility	-0.0001**	-0.0001**	-0.0011**	-0.0010**	-0.0011**
	(-2.11)	(-2.11)	(-2.12)	(-2.11)	(-2.13)
Pretax ROA	-0.0010	-0.0009	-0.0009	-0.0010	-0.0010
	(-0.90)	(-0.90)	(-0.89)	(-0.90)	(-0.95)
Foreign Income	0.0212***	0.0212***	0.0191***	0.0212***	0.0192***
	(3.53)	(3.56)	(2.89)	(3.54)	(2.90)
Foreign Indicator	-0.0004*	-0.0004*	-0.0004	-0.0004*	-0.0003
	(-1.82)	(-1.88)	(-1.42)	(-1.84)	(-0.93)
Advertising Expense	0.0347***	0.0347***	0.0351***	0.0348***	0.0352***
	(7.08)	(7.06)	(7.21)	(7.08)	(7.12)
Sales Growth	-0.0317***	-0.0317***	-0.0317***	-0.0317***	-0.0317***
	(-42.43)	(-42.42)	(-43.68)	(-42.44)	(-43.62)
NOL	-0.0002	-0.0002	-0.0002	-0.0002	-0.0002
	(-1.21)	(-1.24)	(-0.92)	(-1.20)	(-0.81)
ΔNOL	-0.0031***	-0.0031***	-0.0031***	-0.0031***	-0.0031***
	(-4.41)	(-4.41)	(-4.62)	(-4.41)	(-4.64)
Circuit FE	Yes	Yes	Yes	Yes	Yes
Industry × Year FE	Yes	Yes	Yes	Yes	Yes
N	66,222	66,222	66,222	66,222	65,405
Adjusted R^2	0.32	0.32	0.32	0.32	0.32

Table 4: Judge Ideology and Corporate Tax Avoidance: Alternative Proxies

This table reports the results for the effect of judge ideology on corporate tax avoidance using OLS regressions. Control variables are the same as those in Table 3. Variable definitions are in Appendix B. Industry FE is based on two-digit SIC codes. Intercepts are included but not tabulated. The *t*-statistics (in parentheses) are based on standard errors clustered by states. ***, **, and * indicate statistical significance at the 1%, 5%, and 10% levels based on two-tailed tests, respectively.

Dependent Variable:	(1) $Ln(UTB)$	(2) $Ln(Settlement_{t+1,t+3})$	(3) $Cash\ ETR$	(4) $GAAP\ ETR$
Liberal Circuit Court	-0.5709**	-0.7935*	0.0232**	0.0249**
	(-2.05)	(-1.96)	(2.39)	(2.40)
Liberal Tax Court	-0.8164**	-0.9002**	0.0609*	0.0407***
	(-2.02)	(-2.15)	(1.81)	(3.08)
Control Variables	Yes	Yes	Yes	Yes
Circuit FE	Yes	Yes	Yes	Yes
Industry × Year FE	Yes	Yes	Yes	Yes
N	25,752	11,567	52,292	52,909
Adjusted R^2	0.64	0.47	0.16	0.07

Table 5: Judge Ideology and Corporate Tax Avoidance: Conditional on Financial Reporting Incentives

This table reports the results for the effect of judge ideology on corporate tax avoidance, conditional on financial reporting incentives, using OLS regressions. Control variables are the same as those in Table 3. Variable definitions are in Appendix B. Industry FE is based on two-digit SIC codes. Intercepts are included but not tabulated. The *t*-statistics (in parentheses) are based on standard errors clustered by states. ***, **, and * indicate statistical significance at the 1%, 5%, and 10% levels based on two-tailed tests, respectively.

Dependent variable: *Predicted Uncertain Tax Benefits* (UTB)

	(1)	(2)
$Liberal\ Circuit\ Court$	-0.0059***	-0.0044***
	(-3.52)	(-3.22)
$Liberal\ Circuit\ Court \times IO\_Decile$	0.0005***	
	(2.84)	
$Liberal\ Circuit\ Court \times PastEM$		0.0007*
		(1.87)
$Liberal\ Tax\ Court$	-0.0167**	-0.0148**
	(-2.18)	(-2.02)
$Liberal\ Tax\ Court \times IO\_Decile$	0.0012**	
	(2.64)	
$Liberal\ Circuit\ Court \times PastEM$		0.0037***
		(4.05)
IO_Decile	-0.0004***	
	(-3.01)	
$PastEM$		-0.0011**
		(-2.64)
Control Variables	Yes	Yes
Circuit FE	Yes	Yes
Industry × Year FE	Yes	Yes
N	66,222	65,752
Adjusted R^2	0.31	0.24

Table 6: Judge Ideology and Cross-border Income Shifting

This panel reports the results for the effect of judge ideology on tax-motivated income shifting between the U.S. and foreign countries. Control variables are the same as those in Table 3. Variable definitions are in Appendix B. Industry FE is based on two-digit SIC codes. Intercepts are included but not tabulated. The *t*-statistics (in parentheses) are based on standard errors clustered by states. ***, **, and * indicate statistical significance at the 1%, 5%, and 10% levels based on two-tailed tests, respectively.

	(1)	(2)
Dependent variable:	$FRoS$	$FRoS$
RoS	0.2248***	0.2104***
	(26.68)	(23.52)
$HighFTR$	-0.0026***	0.0242***
	(-2.02)	(4.33)
$LowFTR \times FTR$	-0.0851***	-0.1247***
	(-10.01)	(-8.59)
$HighFTR \times FTR$	-0.0428***	-0.0471**
	(-6.73)	(-2.26)
$Liberal\ Circuit\ Court$		-0.0034
		(-0.44)
$HighFTR \times Liberal\ Circuit\ Court$		-0.0205***
		(-3.58)
$LowFTR \times FTR \times Liberal\ Circuit\ Court$		0.0320***
		(2.81)
$HighFTR \times FTR \times Liberal\ Circuit\ Court$		-0.0058
		(-1.38)
$Liberal\ Tax\ Court$		-0.0090
		(-0.33)
$HighFTR \times Liberal\ Tax\ Court$		-0.0542***
		(-2.88)
$LowFTR \times FTR \times Liberal\ Tax\ Court$		0.1023**
		(2.52)
$HighFTR \times FTR \times Liberal\ Tax\ Court$		0.0096
		(-0.14)
Circuit FE	Yes	Yes
Industry × Year FE	Yes	Yes
N	9,398	9,398
Adjusted R^2	0.38	0.39

Table 7: Judge Ideology and Corporate Tax Avoidance in Domestic and Foreign Income

This table reports the results for the effect of judge ideology on tax avoidance in domestic and foreign incomes using OLS regressions. Control variables are the same as those in Table 3. Variable definitions are in Appendix B. Industry FE is based on two-digit SIC codes. Intercepts are included but not tabulated. The *t*-statistics (in parentheses) are based on standard errors clustered by states. ***, **, and * indicate statistical significance at the 1%, 5%, and 10% levels based on two-tailed tests, respectively.

Dependent Variable:	(1) *Domestic ETR*	(2) *Foreign ETR*
Liberal Circuit Court	0.0471***	-0.0555**
	(3.68)	(2.17)
Liberal Tax Court	0.0360**	-0.2089*
	(2.57)	(-1.88)
Control Variables	Yes	Yes
Circuit FE	Yes	Yes
Industry × Year FE	Yes	Yes
N	37,277	17,722
Adjusted R^2	0.15	0.11

Table 8: Judge Ideology and Forum Shopping

This table reports the results for the effect of judge ideology on the choice of litigation forum. The dependent variable ($Tax\ Court\ Cases/Total\ Tax\ Litigation$) is the number Tax Court cases over the sum of Tax Court and District Court cases at district *d* in year *t*. Column (1) and (2) report results using OLS and Tobit regression, respectively. Control variables are the same as those in Table 3. Variable definitions are in Appendix B. Industry FE is based on two-digit SIC codes. Intercepts are included but not tabulated. The *t*-statistics (in parentheses) are based on standard errors clustered by states. ***, **, and * indicate statistical significance at the 1%, 5%, and 10% levels based on two-tailed tests, respectively.

Dependent variable: $Tax\ Court\ Cases/Total\ Tax\ Litigation$

	OLS	Tobit
	(1)	(2)
Liberal Circuit Court	0.8400***	1.5288***
	(3.45)	(4.21)
Liberal Tax Court	-3.7015***	-6.4357***
	(-3.88)	(-3.98)
Liberal District Court	-0.2525	-0.6289
	(-0.70)	(-0.95)
Litigation/Firm Count	0.5910	1.3586**
	(1.14)	(2.19)
Annual Trend	-0.0506***	-0.0866***
	(-6.98)	(-7.10)
Sample Period	1996 - 2012	1996 - 2012
District Fixed Effects	Yes	Yes
Cluster SE	State	State
N	358	358
Adjusted R^2 / Pseudo R^2	0.57	0.44

Table 9: Judge Ideology and Demand for Professional Tax Services

This table reports the results for the effect of judge ideology on the use of auditor-provided tax services using OLS regressions. Control variables are the same as those in Table 3. Variable definitions are in Appendix B. Industry FE is based on two-digit SIC codes. Intercepts are included but not tabulated. The *t*-statistics (in parentheses) are based on standard errors clustered by states. ***, **, and * indicate statistical significance at the 1%, 5%, and 10% levels based on two-tailed tests, respectively.

	(1)	(2)
Dependent Variable:	$Ln(Tax\ Fees)$	$Tax\ Fees\ /\ Total\ Fees$
$Liberal\ Circuit\ Court$	1.0597**	0.0287***
	(2.06)	(3.62)
$Liberal\ Tax\ Court$	3.0679***	0.0518*
	(2.72)	(1.84)
$Ln(Audit\ Fees)$	0.8070***	-
	(19.40)	
$Ln(Other\ Fees)$	0.0808***	-
	(10.69)	
Control Variables	Yes	Yes
Circuit FE	Yes	Yes
Industry × Year FE	Yes	Yes
N	74,588	74,588
Adjusted R^2	0.27	0.09

Table 10: Judge Ideology and Corporate Tax Avoidance: IRS Enforcement

This panel reports the results for the interaction effect of judge ideology and IRS audit probability on corporate tax avoidance using OLS regressions. Control variables are the same as those in Table 3. Variable definitions are in Appendix B. Industry FE is based on two-digit SIC codes. Intercepts are included but not tabulated. The *t*-statistics (in parentheses) are based on standard errors clustered by states. ***, **, and * indicate statistical significance at the 1%, 5%, and 10% levels based on two-tailed tests, respectively.

Dependent variable: *Predicted Uncertain Tax Benefits* (*UTB*)

	(1)	(2)	(3)
Liberal Circuit Court	-0.0025**		-0.0031**
	(-2.44)		(-1.98)
Liberal Circuit Court × IRS Audit	-0.0002**		-0.0001
	(-2.54)		(-0.35)
Liberal Tax Court		-0.0125*	-0.0122*
		(-1.88)	(-1.92)
Liberal Tax Court × IRS Audit		-0.0003**	-0.0003**
		(-2.00)	(-1.97)
IRS Audit	0.0001**	0.0001**	0.0001**
	(2.23)	(2.18)	(1.99)
Control Variables	Yes	Yes	Yes
Circuit FE	Yes	Yes	Yes
Industry × Year FE	Yes	Yes	Yes
N	66,222	66,222	66,222
Adjusted R^2	0.32	0.32	0.32