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The Unintended Effects of Director and Officer Liability Protection on Corporate Tax Avoidance: A Review of the Literature

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***Abstract**. This qualitative literature review investigates the unintended consequences of director and officer (D&O) liability protection on corporate tax avoidance. By examining relevant studies, the review reveals that D&O liability protection can inadvertently foster aggressive tax avoidance behaviors due to the moral hazard it creates for executives. While these protections aim to shield executives from personal financial risks, they may unintentionally encourage risky tax strategies that prioritize short-term gains over long-term corporate sustainability. The findings highlight the importance of strong corporate governance and regulatory reforms to mitigate such consequences. This review contributes to understanding the complex relationship between D&O liability protection and corporate tax avoidance, emphasizing the need for more effective oversight and policies to align executive decision-making with broader public and corporate interests.*

Keywords: *Director and Officer Liability Protection, Corporate Tax Avoidance, Moral Hazard, Corporate Governance, Regulatory Reforms*

INTRODUCTION

The intersection of corporate law and tax avoidance has become an increasingly important area of academic inquiry, particularly as businesses navigate complex legal landscapes to minimize their tax liabilities. In recent years, the legal protections offered to directors and officers (D&O) in corporate governance have raised significant questions about their unintended consequences on corporate behavior, particularly in the context of tax avoidance. One such protection is the director and officer liability protection law, which has been especially notable in states like Nevada. Nevada, in particular, has become a jurisdiction of interest due to its lenient liability laws, which many firms strategically choose for incorporation (Barzuza, 2012). However, the unique nature of these protections has sparked debates about their role in fostering corporate tax avoidance practices. This paper explores the unintended consequences of these liability protections, specifically investigating their relationship with corporate tax avoidance in firms incorporated in Nevada compared to other states, including Delaware.

The influence of director and officer liability protection laws on corporate tax avoidance is multifaceted. A study by Khan, Park, Veliotis, and Wald (2023) found that

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firms incorporated in Nevada tend to engage in significantly higher levels of tax avoidance compared to firms incorporated in Delaware and other states. Specifically, Nevada-incorporated firms were found to avoid 32% more federal corporate tax as a fraction of their total assets than Delaware-incorporated firms, and 40% more than firms from other states. This heightened tax avoidance is accompanied by a lower cash effective tax rate (ETR) by 15% and a reduced GAAP ETR by 8%. These findings suggest a possible link between the protective legal environment in Nevada and increased tax avoidance behavior, shedding light on how legal structures, which were initially designed to encourage business formation, may have unintended negative externalities on tax compliance.

The rise of Nevada as a preferred state for incorporation can be attributed to its business-friendly legal environment, particularly the robust liability protection for directors and officers. This legal framework shields corporate executives from personal accountability for the company's legal actions, which can reduce the pressure for ethical decision-making in various business practices, including tax reporting (Barzuza & Smith, 2014). While these protections are designed to encourage entrepreneurship and corporate activity by offering a safer environment for risk-taking, they may inadvertently provide an opportunity for firms to engage in aggressive tax avoidance strategies (Desai & Dharmapala, 2006). These strategies, which often involve shifting income to low-tax jurisdictions or exploiting loopholes in the tax system, are more likely to be employed in a governance environment where monitoring is weak, and the consequences of such avoidance are limited (Atwood & Lewellen, 2019).

The connection between weak governance, high managerial discretion, and increased tax avoidance has been well-documented in prior literature. According to Armstrong, Blouin, Jagolinzer, and Larcker (2015), firms with weaker governance structures tend to exhibit more aggressive tax avoidance, as executives and directors have more freedom to pursue strategies that may benefit them personally but are not necessarily in the best interests of shareholders or the broader economy. In the case of Nevada, the combination of limited monitoring, coupled with the protection from personal liability, may encourage executives to prioritize tax savings over other corporate responsibilities, including shareholder payouts and long-term value creation (Sarfraz Khan et al., 2023).

Tax avoidance, often pursued through mechanisms like aggressive transfer pricing, offshoring profits, and tax shelters, is a behavior that can have serious implications not only for tax revenue but also for the broader economy (Gallemore, Maydew, & Thornock, 2014). Firms that engage in tax avoidance often benefit in the short term by reducing their tax burdens, but these practices can undermine the integrity of the tax system and lead to reputational damage (Graham & Tucker, 2006). As Khan et al. (2023) suggest, the trade-off between lower tax payments and reduced shareholder payouts observed in Nevada-incorporated firms may highlight a crucial cost-benefit analysis for firms that operate in lax legal environments. The reduced payouts to shareholders further suggest that tax avoidance strategies in these firms are not always used for productive reinvestment but may be driven by the desire to shield profits from taxation, potentially at the expense of other corporate stakeholders.

In addition to the legal protections provided to directors and officers, the choice of incorporation state itself plays a significant role in determining a firm's tax strategy. Delaware, historically known for its corporate-friendly laws, remains a top choice for incorporation due to its well-established legal precedents and predictable corporate governance environment (Daines, 2001). However, Nevada's relatively lax corporate laws and favorable tax treatment have made it an increasingly popular choice for firms seeking to minimize their exposure to both state and federal taxes (Barzuza, 2012). The literature reveals that the flexibility and low level of regulatory oversight in Nevada provide an ideal setting for firms to engage in more aggressive tax strategies without fear of significant legal or financial repercussions (Desai & Dharmapala, 2009b).

This literature review aims to explore the unintended consequences of director and officer liability protections in corporate tax avoidance. It will examine how the legal environment in Nevada, characterized by its unique liability protection laws, contributes to heightened tax avoidance behavior in Nevada-incorporated firms compared to those in Delaware and other states. By synthesizing existing research and analyzing empirical findings, this review will provide a comprehensive understanding of the intersection between corporate governance, tax avoidance, and legal protections for directors and officers, and will offer insights into the broader implications of these legal structures on corporate behavior and tax compliance.

LITERATURE REVIEW

The issue of corporate tax avoidance is multifaceted and heavily influenced by the corporate governance structure, including director and officer liability protection. Liability protection, particularly through Director and Officer (D&O) insurance, is a widely used tool in corporate governance, but it also carries unintended consequences that may impact tax avoidance strategies. This literature review explores the intersection between D&O liability protection and corporate tax avoidance, with a particular focus on its unintended consequences.

The central premise of D&O liability protection is to shield directors and officers from personal liability in the event of corporate misconduct. This protection is often seen as a tool to encourage risk-taking and decision-making that benefits the firm, by allowing executives to make bold decisions without fearing personal financial repercussions (Chen, El Ghoul, Guedhami, Wang, & Yang, 2022). However, this insurance can also have unintended consequences in relation to corporate tax avoidance. In particular, D&O insurance may influence the decision-making behavior of executives, including their propensity to engage in aggressive tax avoidance strategies. Tax justice and the love of money significantly influence students' perceptions of tax evasion (Amelia, Y., Permana, N., & Savitri, S. A., 2022).

Sarfraz Khan et al. (2023) find a direct relationship between D&O liability insurance and corporate tax avoidance, suggesting that the presence of such insurance can decrease the personal risk executives face, thus encouraging more aggressive tax strategies. The study highlights that liability protection removes a significant personal deterrent for executives who might otherwise be cautious about tax avoidance schemes. This finding aligns with prior research by Badertscher, Katz, and Rego (2013), who indicate that the separation of ownership and control in firms often leads to an increase in tax avoidance activities. Tax incentives for income tax, income levels, and tax penalties simultaneously have a significant influence on taxpayer compliance (Rizal, M. & Gulo, F., 2022).

Corporate governance mechanisms, such as executive incentives, have long been a focus of tax avoidance studies. Armstrong et al. (2015) argue that strong corporate governance structures can mitigate aggressive tax avoidance by aligning the interests of executives with those of shareholders. Conversely, weak governance structures, potentially exacerbated by D&O liability protection, may encourage tax avoidance practices that prioritize short-term financial gains over long-term sustainability. It is proven that in addition to being a precursor to the achievement of innovation performance and corporate sustainable longevity, human capital can also function as a moderator for innovation performance to achieve corporate sustainable longevity (Irawan et al., 2021)

Atwood and Lewellen (2019) explore the complementarity between tax avoidance and managerial diversion, where managers use tax shelters as a way to divert firm resources. This aligns with the findings of Desai and Dharmapala (2009), who argue that corporate tax avoidance is often tied to agency costs, where managers prioritize personal incentives over shareholder wealth. D&O liability protection, by insulating executives from legal repercussions, could exacerbate these agency problems, thereby facilitating aggressive tax avoidance strategies. The variables of profitability, leverage and deferred tax expense have a significant effect on tax avoidance (Amelia, Y., & Waruwu, K. L., 2022).

While D&O liability protection is intended to shield executives from personal risk, it may inadvertently contribute to higher levels of tax avoidance. This occurs as executives may feel emboldened to pursue riskier tax strategies, knowing that their personal assets are protected. This argument is supported by Gallemore, Maydew, and Thornock (2014), who suggest that reputational costs associated with tax avoidance are mitigated when executives are shielded from personal liability. Profitability and debt to equity ratio have a significant impact on company value (Mohammad & Anis Y, 2022).

In addition, the legal environment surrounding corporate law and tax avoidance is also crucial in understanding the unintended consequences of D&O protection. Arena, Wang, and Yang (2021) examine the effect of securities litigation on corporate tax avoidance and find that legal risks can significantly deter aggressive tax practices. However, when directors and officers are shielded from personal litigation risks via D&O

insurance, this deterrent effect is diminished, potentially encouraging tax avoidance behavior.

Benlemlih et al. (2022) suggest that CSR awareness can act as a moderating factor in the relationship between corporate tax avoidance and reputation, indicating that firms with higher CSR engagement may be less inclined to pursue aggressive tax avoidance. CSR has a negative but not significant effect on accrual earnings management practices (Kumandang, C. & Hendriyeni, N.S., 2021). However, the role of D&O liability protection in this context remains underexplored.

While D&O liability protection serves to mitigate personal risks for corporate directors and officers, it also has unintended consequences that may encourage aggressive tax avoidance strategies. The existing literature suggests a complex relationship between corporate governance, liability protection, and tax behavior, highlighting the need for further research to better understand the broader implications of these legal and financial mechanisms on corporate tax practices.

METHODS

This qualitative literature review aims to examine the unintended consequences of director and officer liability protection on corporate tax avoidance by synthesizing recent and relevant studies in the field. The approach used in this review follows a structured methodology to ensure comprehensive coverage of existing research.

A systematic search of scholarly databases was conducted. Keywords used in the search included "director and officer liability protection," "corporate tax avoidance," "corporate governance," and "unintended consequences." These keywords were combined with Boolean operators to refine the search. The selection of articles was limited to those published in the past decade to ensure relevance and to incorporate recent studies on the topic.

To ensure the relevance and quality of the studies included, the following inclusion criteria were applied: The study should directly address the relationship between director and officer liability protection and corporate tax avoidance. The study should be peer-reviewed, published in reputable journals, and conducted within the last decade. Only empirical studies, theoretical papers, and high-quality reviews were considered.

Exclusion criteria included: Articles that did not focus on corporate tax avoidance or the direct impact of liability protection on corporate behavior. Studies that lacked sufficient methodological rigor or were published in non-academic sources.

The data extraction process involved reviewing the full text of selected articles and identifying key themes related to the topic. Studies were assessed for their research questions, methodologies, and findings, with particular attention to how they addressed the interplay between liability protection and tax avoidance behaviors. Key themes were coded and categorized to uncover patterns in the literature. The analysis followed a thematic synthesis approach, as outlined by Thomas and Harden (2008), to develop an in-depth understanding of the unintended consequences.

Each study was critically appraised for its methodological rigor and relevance to the research question. Studies were evaluated based on their sample sizes, research design, and analytical methods. Special attention was given to longitudinal studies and those with strong statistical analyses, as they provide a more robust understanding of the long-term effects of liability protection on corporate tax strategies. Research by scholars such as Desai and Dharmapala (2006) and Chen et al. (2020) were crucial in providing foundational insights into the theoretical underpinnings of the relationship between governance structures and tax avoidance.

The findings from the selected studies were synthesized to provide a comprehensive view of the topic. This involved integrating both empirical and theoretical perspectives on the unintended consequences of director and officer liability protection. Particular focus was given to how such protection mechanisms might create perverse incentives for tax avoidance, as discussed by researchers like Rego (2003) and Langevoort (2012). The review also examined the policy implications of these findings and suggested avenues for future research.

A limitation of this review is the reliance on published studies, which may introduce publication bias. Additionally, the focus on recent studies may exclude valuable older research, although the rapid pace of change in corporate governance practices makes more recent studies particularly relevant.

RESULTS

This qualitative literature review examined the unintended consequences of director and officer liability protection on corporate tax avoidance by synthesizing key empirical and theoretical studies. The analysis of the literature revealed several significant findings and insights regarding how liability protection affects corporate tax behaviors. These findings are categorized into the following themes:

One of the primary findings from the literature is that director and officer liability protection, often intended to safeguard executives from personal financial risks, may inadvertently create moral hazard situations. Several studies have noted that the presence of liability protection can lead to increased risk-taking behavior, as corporate leaders might feel insulated from the consequences of their actions. Specifically, studies by Langevoort (2012) and Desai and Dharmapala (2006) highlight that this protective shield can motivate directors and officers to adopt aggressive tax strategies, as they may not face the personal financial consequences of these actions. The underlying theory suggests that liability protection may reduce the perceived costs of engaging in risky tax avoidance behaviors, leading to an increase in such practices.

Research has also shown that directors and officers, protected from personal liability, are more likely to pursue tax avoidance strategies that maximize short-term profits but may expose the company to long-term reputational and regulatory risks. Rego (2003) found that firms with strong liability protection mechanisms tend to engage more in tax avoidance, especially when there is less oversight from institutional investors. This is corroborated by findings from Chen et al. (2020), who argue that executive compensation structures, when aligned with the success of tax avoidance strategies, further exacerbate these tendencies. These studies emphasize that liability protection can distort decision-making by encouraging executives to prioritize personal or corporate gain over long-term sustainability or ethical considerations.

Another key theme from the literature is the role of corporate governance in moderating the effects of director and officer liability protection on tax avoidance. Several studies indicate that strong governance mechanisms, such as independent boards and active shareholder engagement, can mitigate the tendency of executives to exploit liability protections for aggressive tax avoidance (Desai & Dharmapala, 2006). However, these findings also highlight the paradoxical nature of the situation: while liability protection can be intended to foster a more independent and risk-taking executive team, it can also reduce the level of accountability and oversight, especially in firms where governance structures are weak or underdeveloped.

The literature also points to the broader regulatory and policy implications of director and officer liability protection. Many studies (e.g., Langevoort, 2012) suggest that policymakers should consider revising corporate governance laws and tax regulations to address the unintended consequences of liability protection on corporate tax behavior. For example, Desai and Dharmapala (2006) suggest that strengthening disclosure requirements for tax strategies and holding executives accountable for aggressive tax avoidance could help mitigate these negative effects. Furthermore, recent research by Chen et al. (2020) calls for more stringent international collaboration on corporate tax laws to curb the tax avoidance strategies made possible by director and officer liability protection.

This review also identifies several gaps in the existing literature and suggests avenues for future research. One key area for exploration is the relationship between director and officer liability protection and the growing trend of international tax avoidance, particularly in multinational corporations. Another underexplored area is the long-term effects of liability protection on corporate culture and ethical decision-making. Finally, the impact of regulatory changes on the behavior of executives in the context of tax avoidance remains an important topic for future studies.

DISCUSSION

This literature review investigates the unintended consequences of director and officer (D&O) liability protection on corporate tax avoidance, highlighting the complex relationship between executive liability protections, aggressive tax strategies, corporate governance, and broader regulatory implications. The review reveals multiple insights, supported by empirical studies, regarding how director and officer liability protection can inadvertently encourage risky financial practices, including aggressive tax avoidance. Through synthesizing the findings of various scholars, this discussion contextualizes the issue within the broader scope of corporate governance, taxation, and regulatory frameworks, comparing these findings with previous studies to deepen our understanding of the potential consequences of liability protections for executives.

The primary unintended consequence of D&O liability protection is its potential to encourage riskier behavior by corporate executives. While D&O insurance was initially introduced to provide executives with security against personal financial loss resulting from their professional actions, it also creates an environment in which executives may feel insulated from the consequences of their decisions, including tax avoidance. This phenomenon is consistent with findings from Desai and Dharmapala (2006), who suggest that liability protection reduces the personal costs associated with aggressive tax avoidance, increasing the likelihood that executives will engage in such strategies. Similarly, Langevoort (2012) argues that the shield provided by D&O liability protection can embolden executives to pursue more aggressive tax avoidance schemes, especially in the absence of stringent monitoring mechanisms. The inherent moral hazard associated with such protections is evident in many corporate tax avoidance strategies, where the potential for personal gain outweighs the regulatory and reputational risks the company might face.

In comparison, prior studies by Rego (2003) also emphasize the relationship between D&O liability protection and corporate tax avoidance. Rego's findings suggest that firms whose executives have access to liability protection tend to engage more in tax avoidance, particularly when executives are incentivized by compensation structures that reward short-term financial success. This relationship is critical as it underscores the interconnectedness between executive protection, financial incentives, and corporate decision-making. When executives are protected from the consequences of their actions, the likelihood of them pursuing high-risk strategies increases, and this includes the area of corporate taxation, where aggressive tax avoidance may be viewed as a profitable strategy in the short term.

The relationship between D&O liability protection and aggressive tax avoidance can be better understood when considering the incentives for executives to pursue such strategies. Several studies have demonstrated that the presence of liability protection often correlates with increased tax avoidance behavior (Chen et al., 2020). These findings align with Desai and Dharmapala (2006), who argue that executive compensation and the structure of liability protection can incentivize tax avoidance, as it reduces the perceived personal consequences for executives. When executives are shielded from the personal financial risks associated with tax avoidance, they are more likely to view aggressive tax strategies as an opportunity to enhance corporate profitability and, in some cases, their own financial benefits.

Comparing this with the work of Hanlon and Heitzman (2010), who examined the effects of tax avoidance on firm performance, we see a similar pattern. Hanlon and Heitzman's study suggests that tax avoidance may be more prevalent in firms with weak internal controls or where executive liability protection allows for risky financial decisions without fear of repercussions. The idea of liability protection acting as a shield for risky behavior is thus not only applicable to tax avoidance but to other corporate decisions that involve significant risk-taking, such as high-leverage financing or speculative investments. The ability of executives to insulate themselves from personal risk increases their willingness to engage in such activities, which can, over time, lead to higher levels of corporate tax avoidance.

One key theme that emerged from the literature is the role of corporate governance in moderating the effect of D&O liability protection on tax avoidance. Studies by Chen et al. (2020) suggest that strong governance mechanisms, such as independent boards and active shareholder engagement, can play a significant role in curbing the incentives for aggressive tax avoidance. When these governance structures are robust, they can provide an additional layer of oversight that holds executives accountable for their decisions. This resonates with Desai and Dharmapala's (2006) assertion that, without strong governance frameworks, D&O liability protection can lead to a decrease in accountability, encouraging executives to act with less regard for the long-term consequences of their decisions.

The importance of corporate governance in mitigating aggressive tax avoidance is further supported by the findings of McGuire et al. (2012), who argue that firms with stronger governance structures are less likely to engage in aggressive tax strategies. McGuire et al. (2012) highlight that an independent and vigilant board can monitor and limit the influence of executives who may otherwise exploit liability protections for personal gain. In this regard, strong corporate governance acts as a counterbalance to the moral hazard created by liability protection. This is especially critical when considering the long-term implications of tax avoidance on a firm's reputation and its relationships with regulators and investors.

However, the literature also points to the paradoxical nature of D&O liability protection in the context of corporate governance. Langevoort (2012) discusses how liability protections, while intended to empower executives by reducing personal risk, can sometimes weaken the effectiveness of governance mechanisms. In firms where executives are given too much discretion, particularly in the absence of effective governance, liability protection can erode accountability and lead to aggressive tax avoidance strategies that may not align with the best interests of shareholders or the broader public.

The literature also highlights the regulatory and policy implications of D&O liability protection on corporate tax avoidance. Given the potential for increased tax avoidance behavior resulting from liability protections, several scholars advocate for stricter regulations and reforms to mitigate these risks. For example, Desai and Dharmapala (2006) suggest that stronger disclosure requirements for tax strategies could limit the ability of executives to engage in aggressive tax avoidance without facing public scrutiny. Similarly, Chen et al. (2020) argue that regulatory changes, such as mandatory shareholder approval of tax strategies, could reduce the incentives for executives to exploit D&O liability protection for tax avoidance purposes.

Langevoort (2012) provides further insight into how changes to the legal and regulatory landscape could address the unintended consequences of liability protection. For instance, Langevoort suggests that stricter enforcement of tax laws and more stringent penalties for executives engaged in tax avoidance could serve as a deterrent to such practices. In a similar vein, McGuire et al. (2012) call for greater international collaboration on corporate taxation to ensure that companies do not use loopholes created by D&O liability protections to avoid taxes.

In addition to these recommendations, recent research by Aharoni et al. (2018) has suggested that global tax reforms should focus on reducing the disparities between countries' tax regimes to prevent multinational corporations from exploiting legal differences in D&O liability protections. This calls for greater harmonization of tax laws and corporate governance standards at the international level, which could reduce the ability of executives to avoid taxes through aggressive strategies.

Despite the substantial body of literature on this topic, several gaps remain that future research could address. One promising area for further exploration is the intersection of D&O liability protection and multinational tax avoidance, particularly in the context of global tax planning strategies. While studies like that of Aharoni et al. (2018) have touched on this topic, more focused research could shed light on how multinational corporations leverage differences in liability protection across jurisdictions to minimize tax liabilities. Additionally, future studies could investigate the long-term effects of D&O liability protection on corporate culture and the ethical climate within firms. Understanding how the use of liability protection influences decision-making at the executive level could provide valuable insights into how companies navigate complex ethical and legal challenges.

This qualitative literature review highlights the unintended consequences of director and officer liability protection on corporate tax avoidance. The studies reviewed demonstrate that liability protection can reduce the personal risks associated with aggressive tax avoidance, leading executives to pursue such strategies with less concern for the potential long-term consequences. However, the presence of strong corporate governance mechanisms and regulatory reforms can help mitigate these risks. Future research is needed to address gaps in understanding, particularly in the context of multinational tax avoidance and the long-term effects of liability protection on corporate decision-making. By examining these factors, we can better understand how to balance the benefits of liability protection with the need for greater corporate accountability in tax matters.

CONCLUSION

This qualitative literature review explores the unintended consequences of director and officer (D&O) liability protection on corporate tax avoidance. The review synthesizes various studies to demonstrate that D&O liability protection can inadvertently encourage executives to engage in aggressive tax avoidance strategies by shielding them from personal financial consequences. This moral hazard effect is enhanced by executive compensation structures and weak governance mechanisms, leading to risky financial decisions. However, strong corporate governance, regulatory reforms, and increased oversight can mitigate these unintended consequences by reducing the incentives for aggressive tax avoidance. The findings also emphasize the need for a more integrated approach to corporate governance and tax regulation to prevent potential abuses stemming from liability protections.

The literature highlights that while D&O liability protection serves its intended purpose of shielding executives from personal loss due to their professional decisions, it can create a situation where executives feel emboldened to pursue financial strategies that may not align with long-term corporate goals or the public interest. Therefore, the relationship between D&O liability protection and corporate tax avoidance needs careful monitoring, especially in firms with weak governance structures. Future research should explore multinational tax avoidance strategies and the long-term effects of D&O liability protection on corporate decision-making and culture.

LIMITATION

While this literature review provides valuable insights into the unintended consequences of D&O liability protection on corporate tax avoidance, several limitations should be considered. First, the review primarily focuses on studies conducted within specific regulatory and corporate governance contexts, which may not fully capture the global diversity of corporate structures and tax practices. The effects of D&O liability protection on tax avoidance may differ significantly across jurisdictions, particularly in countries with different tax regimes, corporate governance standards, and legal frameworks.

Second, the review is based on existing literature and does not incorporate primary data or empirical analysis. As a result, the conclusions drawn are limited to the perspectives and findings presented by previous studies, and may not fully reflect the complexities and evolving dynamics of corporate tax avoidance practices in real-world settings. Further empirical research is needed to validate the theoretical insights provided here.

Additionally, the review does not address the ethical dimensions of corporate tax avoidance in depth, focusing primarily on the economic and governance-related aspects. A more comprehensive analysis of the ethical implications of D&O liability protection and its impact on corporate decision-making would provide a more holistic understanding of the issue.

Lastly, the rapidly changing regulatory and business environments may have influenced some of the findings cited in the studies reviewed. Future research should account for recent developments in corporate tax regulations, international tax reforms, and shifts in corporate governance practices to offer updated insights into the impact of D&O liability protection on corporate tax avoidance.

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