Non-disclosure of geographic earnings can be a marker of income-shifting activities

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Multinational corporations that choose not to disclose geographic earnings are more likely to engage in income-shifting activities, says a study from UofT's Rotman School.

Toronto – Policy makers, lobby groups and citizens should take note—those who understand corporate tax avoidance behavior will be in a better position to deter it.

A recent study by Prof. Ole-Kristian Hope, who holds the Deloitte Professorship of Accounting at the Rotman School of Management at the University of Toronto, along with Mark (Shuai) Ma and Wayne B. Thomas from the Michael F. Price College of Business at the University of Oklahoma, indicates that non-disclosure of geographic earnings can be a marker of tax avoidance.

Starting in 1998 it was no longer mandatory for U.S. multinational companies to disclose geographic earnings in their financial reports—disclosure was optional under the Statement of Financial Accounting Standards No. 131 (SFAS 131). The study shows that between 1998 and 2004, firms that chose not to disclose geographic earnings had worldwide effective tax rates that were 4.1 (5.2) percentage points lower than firms that continued to disclose geographic earnings (controlling for numerous other factors that are known to affect tax avoidance).

Coincidence? The study proves not. Before implementation of SFAS

131—when all firms were required to disclose geographic earnings in their financial reports—eventual non-disclosers' effective tax rates were on par with those that continued to disclose these numbers voluntarily.

It appears that under SFAS 131 managers were able to (legally or illegally) shift profits from high- to low-tax foreign jurisdictions without much risk of exposure (a practice that ultimately diminished the tax revenues of governments in high-tax jurisdictions). To conceal their behavior, they avoided voluntarily disclosing any information related to these activities. "If you care about tax avoidance then you want as much transparency about these activities as possible," says Hope.

In 2004, the implementation of new tax-reporting regulations (Schedule M-3), which required businesses to disclose significantly more detailed information regarding foreign profits to the Internal Revenue Service, shone a light on the problem. With the introduction of this new regulation, geographic segment disclosures are less important in terms of masking tax avoidance behavior (at least to the IRS). Specifically, controlling for other factors, after Schedule M-3 came into effect the role of non-disclosure of geographic earnings in explaining tax avoidance is diminished.

"The key takeaway is that there is clear value to greater transparency regarding firm's foreign activities," explains Hope. "As an outsider, this is the only way that we can learn about how [businesses] are conducting themselves, including monitoring the extent to which firm's avoid taxes."

More information: The paper is online at papers.ssrn.com/sol3/papers.cf … ?abstract_id=2021157

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