Study: Tax havens and limited regulation increase risk for shareholders

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Some large, publicly held companies are incorporated in tax haven countries, ostensibly to increase value for shareholders. But new research from North Carolina State University and the University of Arkansas finds that many such companies—particularly those headquartered in countries with limited shareholder protections—are more likely to engage in practices that benefit executives at the cost of their shareholders.

"Many of these companies are incorporated in one country—the tax haven—but headquartered in another," says Christina Lewellen, an assistant professor of accounting at NC State and co-author of a paper on the work. "There's long been a theory that being incorporated in a tax haven, such as the Cayman Islands, leaves a company open to theft from executives who could skim off the company's tax savings.

"We've found that another key factor is the regulatory environment of the country where the company is headquartered," Lewellen says. "Specifically, we found evidence that executives of tax haven-incorporated firms are more likely to siphon off tax savings if their companies are headquartered in so-called 'weak governance' countries."

Weak governance countries, such as China, are deemed to have limited rules in place to protect shareholders.

To examine this issue, the researchers evaluated data on more than 14,000 publicly held companies. The data set included information on 1,127 companies that are incorporated in tax haven countries—of which 874 had their headquarters in weak governance countries.

One key finding was that although tax avoidance results in higher cash flows, which is generally associated with higher dividend payout, tax haven companies headquartered in weak governance countries paid an average of 83 percent less in dividends to their shareholders, as compared to other companies in weak governance countries with similar tax avoidance levels.

"That's the opposite of what you'd expect," Lewellen says. "Those tax haven companies should have more cash, since they pay fewer taxes—but shareholders don't see that money. In contrast, we found that tax haven companies with headquarters in well regulated countries do pass on tax savings to their shareholders."

The researchers also found that tax haven companies in weak governance countries do not see any benefit from the cash tax savings in terms of earnings performance. Those companies performed an average of 53 percent lower than other companies in weak governance countries with similar levels of tax avoidance.

"This tells us that the tax haven companies in weak governance countries were not investing their tax savings wisely, if at all," Lewellen says. "And, again, tax haven companies in well regulated countries did not see this lapse in performance; their performance was comparable to their peers.

"One take-away here is that incorporating a company in a tax haven country can benefit shareholders, but is much less likely to do so if the company is headquartered in a country that doesn't take steps to protect shareholder rights."

The paper, "The Complementarity Between Tax Avoidance and Manager Diversion: Evidence from Tax Haven Firms," is published in the journal *Contemporary Accounting Research*. The paper was co-authored by T.J. Atwood of the University of Arkansas.

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