'Tax haven' companies may be less risky than investors think

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Companies incorporated in tax havens are often considered more opaque regarding their finances, which could make them risky investments. But a recent study from North Carolina State University finds that many of these companies are actually more transparent than their counterparts in countries that are not tax havens.

"The takeaway here is that companies that are incorporated in tax havens vary widely in terms of their transparency—which has significant ramifications for investors," says Christina Lewellen, author of a paper on the study and an assistant professor of accounting at NC State.

Tax havens are countries with very low tax rates and laws that are conducive to corporate secrecy. Companies incorporated in tax havens could carry more risk for investors than other companies because it might be more difficult to determine what the company is doing—and there are fewer laws in place to hold corporate leadership accountable.

"I wanted to know whether this holds true for companies that are incorporated in tax havens, but actually base their operations in countries that aren't tax havens," Lewellen says. "For example, does a company incorporated in a tax haven still provide opaque financial reports if it is headquartered in a country that requires corporate transparency and has laws in place to hold management responsible for their actions?"

To explore this issue, Lewellen looked at annual report data from publicly traded companies. Specifically, Lewellen collected data from 999 "haven" companies, which are incorporated in tax havens but base their operations in non-haven countries; and from 10,646 "non-haven" companies, which are incorporated and based in non-haven countries.

To assess the transparency of companies' earnings, Lewellen used multiple models to examine how well the financial reports explain firms' underlying financial performance.

"I found that haven companies based in non-haven countries with relatively weak laws protecting investors were substantially more likely than non-haven companies to have 'opaque' financial statements," Lewellen says. "These haven companies pose a greater risk for investors, because it is more difficult to understand the company's finances. This finding is completely consistent with the conventional wisdom on tax haven companies.

"But I also found something surprising: Haven companies based in countries with robust laws protecting investors are actually more transparent than non-haven companies," Lewellen says. "In other words, many companies incorporated in tax havens actually seem to give investors more information than companies incorporated in non-haven countries do."

This finding was particularly pronounced for haven companies with greater capital market incentives—meaning companies that are more reliant on external capital, such as selling stock.

"Investors shouldn't assume tax haven companies pose more information risk—some of them are more transparent than non-tax haven companies," Lewellen says. "This highlights the importance of seeing where companies are actually based, and what sort of investor protections apply in those jurisdictions."

The paper, "Tax haven incorporation and financial reporting transparency," appears in the journal *Review of Accounting Studies*.

More information: Christina M. Lewellen, Tax haven incorporation and financial reporting transparency, *Review of Accounting Studies* (2022). DOI: 10.1007/s11142-022-09676-2

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