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Using Tax Havens Secretly Is Bad for Shareholders

Tax havens are used for more than just saving money. When companies take advantage of their lack of transparency for more sinister activities, shareholders can lose out.

When Enron collapsed in 2002 investigators were faced with a convoluted network of subsidiaries and offshore partnerships stretching from the Cayman Islands to Mauritius. A total of 881 offshore subsidiaries were found in havens outside OECD regulatory jurisdictions creating a corporate structure which had, not only allowed Enron to avoid paying taxes, but paved the way for its CFO, Andrew Fastow, to transfer considerable resources to companies he and his friends controlled outside the corporation. By creating Special Purpose Entities they were able to siphon off at least US$42 million, enriching themselves to the detriment of the company's shareholders.

Over the last 12 months OECD governments have become more active and vocal in their attempts to stop companies moving operations offshore into tax free, or low tax, havens. To-date the debate, between officials and business, has been very much focused on concern over the loss of tax revenue. What has been overlooked are the alternative motives organisations may have for taking their activities offshore, and the lack of transparency these havens provide making it difficult for pension funds and passive shareholders to shine a light on activities which could actually erode share value.

In 2007, the OECD estimated that between US$5 trillion and US$7 trillion was being held in off-shore accounts. By 2012, this figure had more than quadrupled to between US$21 trillion and US$32 trilion (according to PricewaterhouseCoopers data). In fact, a recent investigation by U.S. organisation, Citizens for Tax Justice **found** three out of four Fortune 500 firms are active in countries known for their low or no tax policies, while an ActionAid **study** found that just two of the companies listed on the U.K.'s FTSE 100 have no subsidiaries in tax havens.

Big business may argue that corporations' legal duty to maximise shareholder value necessitates the use of offshore finance to reduce and simplify taxes. However, there is growing evidence that, for some, the motive to set up subsidiaries in known tax havens may be more sinister and to the detriment of the firms shareholders.

Good business or ulterior motives?

A common way to pursue aggressive tax planning is to transfer material or immaterial assets – such as patents or trademarks – to a subsidiary in a low tax country and then charge the mother company for the use of these assets. This requires one company. Having additional subsidiaries does not further improve the ability to save taxes.

Which raises questions as to why corporations operating in these countries typically have a more complex structure, with a greater number of subsidiaries and hierarchical depth.

The reality is that this complexity, coupled with tax havens' typical lack of transparency, makes monitoring difficult and provides managers and controlling owners with opportunities to pursue goals that are not necessarily aligned with maximising shareholder value. This could include tying up cash flow that might otherwise be paid out to shareholders, stockpiling cash for inefficient acquisitions or, in extreme cases like Enron, outright theft through third party transactions.

Who is heading offshore?

In our recent paper Corporate Tax Havens and Shareholder Value, Stefan Zeume, Assistant Professor of Finance at the University of Michigan and I examined data from 17,331 publicly-listed firms from 52 countries to establish the motives for establishing subsidiaries in low, or no, tax countries, and to examine the impact this has on shareholder value, with surprising results.

Roughly one in six of the firms examined had at least one tax haven subsidiary. These companies tended to be larger, older and more highly levered organisations. They grew at a slower rate but were ultimately more profitable. Not surprisingly they were also less vulnerable to changes in their home countries' tax rate.

To add depth to our findings we looked at what happened when the countries in which they operated became signatories to Tax Information Exchange Agreements (TIEAs). These bilateral agreements were designed by the OECD to enable high tax countries to request information from foreign banks in known tax havens about individuals or corporations suspected of holding funds from their country's banking systems.

Transparency increases shareholder value

While TIEAs do not directly affect tax rates or rules in either country, they provide a degree of transparency and a means for detection and regulatory enforcement, releasing information which may help non-controlling owners and market analysts to monitor corporate activity. In other words they make it more difficult for companies to engage in dubious activities such as hiding resources or illegally transferring money.

We found that companies with subsidiaries in havens which became signatories to a TIEA increased their shareholder value by an average of 2.5 percent - for the average firm this equates to an increase in value of approximately US$3.7m.

While it is difficult to attribute this increased value directly to the cessation of stealing or other illegal activities, analysis showed it was unlikely to have been driven by a reduction in managerial slack or other operational efficiencies that may have come about as a result of the increased monitoring.

The positive effect of TIEAs on firm value was more pronounced in firms with more complex structures, those with strong exposure to tax havens and firms that were weakly governed with less institutional ownership thus more vulnerable to controlling and less transparent owner/managers.

Haven hopping

Interestingly, about one third of the firms examined, responded to the signing of a TIEA by 'haven hopping' — that is strategically moving their subsidiaries from the tax havens that became signatories to those that did not.

As TIEAs have been shown to only weakly increase the cost of aggressive tax behaviour, it is unlikely the move was part of any tax-saving strategy; suggesting firms were more concerned the increased monitoring may make it more costly for managers to engage in dubious activities.

Protecting share value

This research is not about whether companies should or should not move off-shore to avoid paying taxes at home. It acknowledges that tax havens are becoming increasingly part of today's corporate strategy and to the extent they reduce taxes they do provide benefit for shareholders. But shareholders should be aware that unless activities conducted in these environments are done openly they will be worse off. To this end pension funds and institutional investors should actively seek transparency and endorse the OECD's policy agenda in this area.

When companies set up a network of companies outside their home country it should set off a red light. There may be sound reasoning behind their strategy but it is also a sign managers may have ulterior motives.

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