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What really needs to be done to close tax haven loopholes?

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While media shaming of corporations which profit-shift to a tax haven is an obvious deterrent of such activity, governments need to change tax laws in order to have a real impact

New research supports the long-held suspicion that using tax havens to enhance profitability makes sense for institutions financially, if not ethically.

In their paper, *The interplay between mandatory country-by-country reporting, geographic segment reporting and tax havens: Evidence from the European Union*, the authors investigate the impact of public country-by-country reporting (CBCR) by banks operating in the European Union.

The reporting rules were introduced in 2013 in the hope of allowing governments and regulators to better assess potential profit shifting by corporations seeking to minimise tax.

The research indicates that, on average, European banks with tax-haven operations report significantly higher profit margins. There is also evidence of higher turnover per employee, higher profit per employee, and lower tax rates for operations located in tax havens, relative to non-tax havens.

The OECD has stated that these measures are indicators of profit shifting.

“It’s pretty clear and it’s highly significant from a statistical point of view that the operations in the tax havens are very profitable and the employees there are very productive,” says **Rodney Brown**, a lecturer in the school of taxation and business law at UNSW Business School.

“The result is not super surprising, but it’s never been [possible to be] calculated with as much detail as we’ve been able to do for this paper.”

Brown and his fellow authors – Bjorn Jorgensen, a professor in the department of accounting at the London School of Economics and Political Science, and Peter Pope, a professor in the department of accounting at Bocconi University in Italy – used hand-collected, country-by-country data to draw their conclusions, whereas in the past research into tax-haven impacts have largely been estimates based on aggregated data.

WHAT EXACTLY IS A TAX HAVEN?

The notion of tax havens is clearly not new, though there is some lack of clarity around what exactly the term constitutes.

According to the OECD, a tax haven refers to a country which imposes low or no tax, and in which there is a lack of effective exchange of financial information and an absence of transparency in the operation of legislative, legal or administrative provisions.

Brown et al’s paper examines tax-haven jurisdictions with “light-touch regulatory” regimes. The list includes economic strongholds such as Luxembourg, The Netherlands, Switzerland, Hong Kong and Singapore, along with names such as Bermuda, the Cayman Islands, the Channel Islands, Cyprus, Latvia and the Isle of Man, which have long had a reputation as dubious tax-haven states.

The authors provide deeper insight into the location of EU banks' businesses, including the extent to which they operate in tax havens.

They make three key findings – first, the aforementioned higher profit margins of EU banks with tax-haven operations; second, that the introduction of CBCR rules has not led to changes in the number of geographic segments or country segments reported in banks' annual reports; and third, the evidence suggests EU banks operating in tax havens "strategically aggregate" those geographic segments in a manner consistent with "obfuscation of tax-haven involvement".

In other words, they try to hide their tracks in their annual reports.

HIDING THE TAX HAVEN TRACKS

Brown says it is no secret that in the past many multinational corporations have played "funny games" to conceal their operations under accounting rules that have merely required them to prepare their financial statements under very broad geographical categories such as Australia, the Asia-Pacific, North America and Europe.

That has led, in some circumstances, to business in smaller domiciles being lumped together with the reports of larger regions (for example, operations in Caribbean nations could be rolled together with North American financial statements, or Singapore and Hong Kong business could be part of wider Asia-Pacific operations).

"So, it's consistent with corporations aggregating all of their tax-haven operations into a bigger geographic pot within their financial statements," Brown says.

"And we haven't been able to tell where companies are really operating and if they are operating in these dodgy locations."

There can clearly be a disconnect between where taxable profits are reported, and the location of a corporation's actual economic activities. In this regard, the CBCR rules in Europe provide the prospect of greater transparency.

"By making these banks report on a country-by-country basis, you're going to get a much deeper insight as to where they're operating," Brown says.

He points out that the EU directive is separate from another form of country-by-country reporting involving many OECD nations, including Australia, that requires firms to submit a non-public CBCR report to the tax authorities.

Delving into the data for his paper, Brown says that though there is still often a lack of clarity around where banks hold their assets geographically, the reporting of employee numbers is illuminating.

"So we can sit back and say, for example, that a company has recognised €20 million of profit in the Cayman Islands, yet it has only two employees there. Whereas the company reports €20 million of profit in Belgium where it has 500 employees.

"How does that work? Those employees in the Cayman Islands must be super productive. But, clearly, the Cayman Islands finding is artificial and the company is reporting high profits there because it has a zero tax rate," Brown says.

WHAT REALLY NEEDS TO CHANGE?

Six years since the introduction of the CBCR rules in the EU, Brown says it is apparent that the reforms have not stopped banks aligning themselves with tax havens.

However, the changes facilitate a more extensive analysis of the geographic footprint of EU banks and enable identification of the countries where they operate, and critically, the level of activity disclosed in tax havens.

He is confident the paper's results will inform EU policy-makers currently considering the expansion of public CBCR to all industries.

Brown adds that while media shaming of corporations which profit-shift to tax havens is the most obvious public deterrent of such activities, it will require further government policy actions to truly prompt change.

"As it stands, these corporations publicly state that they fully comply with the prevailing tax legislation. So what they're saying is 'we're following all the rules'. So if governments want to change the outcomes, they need to actually change the tax laws."

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