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Tax Havens and Effective Tax Rates: An Analysis of Private versus Public European Firms☆

Aziz Jaafar*, John Thornton[1]

The Business School, Bangor University, Hen Goleg, College Road, Bangor, Gwynedd LL57 2DG, United Kingdom

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Abstract

We examine the impact of tax haven operations on the effective corporate tax burdens of publicly listed and privately held firms domiciled in Europe. In particular, we consider how European firms' tax haven operations interact with factors such as listing status and home-country tax reporting systems to determine the relative tax burdens of publicly listed and private firms. Our main empirical results show that tax haven operations are associated with lower effective tax rates for both private and public firms, and that the impact of tax havens in lowering effective tax rates is more pronounced for private firms than for public firms. Home country characteristics are also important determinants of effective tax rates for both private and public firms with tax havens. Given that firms use tax havens as tax avoidance mechanism in lowering tax burdens regardless of their listing status, regulatory and tax enforcement bodies should focus on private as well as public firms.

JEL Classification: H20; M41
Keywords: Effective tax rates; Publicly listed firms; Private firms; Tax havens

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* Corresponding author. Tel: +44 1248 383226; fax: +44 1248 383228.
E-mail addresses: a.jaafar@bangor.ac.uk (A. Jaafar), j.thornton@bangor.ac.uk (J. Thornton).
[1] Tel: +44 1248 388545; fax: +44 1248 383228.

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1. Introduction

The use of tax havens as a tax avoidance mechanism has come under increasing scrutiny from regulatory authorities and policymakers, especially in the context of the fiscal crisis that has afflicted many countries in recent years (Dyreng & Lindsey, 2009; Maffini, 2010; Markle & Shackelford, 2012a; Taylor & Richardson, 2012). Tax havens are jurisdictions that impose no or very low corporate taxes and hence offer firms the ability to reduce their overall tax burdens in their home country. Accordingly, firms with affiliates in tax havens may experience lower overall tax burdens than firms without such affiliates because of the opportunities for intra-firm profit shifting from high-tax to low-tax jurisdictions (Desai, Foley, & Hines, 2006). The use of tax havens among multinationals is ubiquitous. For example, in 2010 all but 2 of the 100 largest U.K. firms had affiliates in tax haven jurisdictions (Grice, 2011), and 83 of the 100 largest publicly listed U.S. firms (in terms of revenue) reported having subsidiaries in jurisdictions listed as tax havens or financial privacy jurisdictions (Government Accountability Office (GAO), 2008). The European Commission estimates that around 1 trillion Euros (about US$1.3 trillion) is lost annually across the European Union (E.U.) member states mainly as a result of the exploitation of tax havens (Murphy, 2012).

Thus far, empirical studies examining the link between tax haven operations and corporate tax burdens have focused exclusively on the experience of publicly listed firms and generally show that such firms with tax haven affiliates are able to reduce their tax burdens in their home country (e.g., Dyreng & Lindsey, 2009, Harris, Morck, Slemrod, & Yeung, 1993, Markle & Shackelford, 2012a, 2012b). Empirical research on the tax behavior of private firms is an area that is generally relatively under-researched. The lack of evidence on the effective tax burden of these firms is unfortunate for at least two reasons: first, private firms are more numerous than publicly listed firms and they typically make an important contribution to the economy[2]; and second, although public and private firms generally face the same tax regime, extant studies show that private firms are not constrained by financial reporting when reducing their tax burdens. That is, private firms are more likely to accept reductions in financial accounting income to lower their tax bills relative to public firms (e.g., Ball & Shivakumar, 2005; Garrod, Kosi, & Valentincic, 2008; Klassen, 1997; Kosi & Valentincic, 2013; Peek, Cuijpers, & Buijink, 2010; van Tendeloo & Vanstraelen, 2008).

In this paper, we aim to offer a more comprehensive understanding of the impact of tax haven operations on corporate tax burdens. First, we compare the impact of tax havens on the tax burden of private and public firms. Second, we look at the impact of a firm's home tax reporting system, i.e., the worldwide tax system (WWTS) and the territorial tax system (TTS), on firms' effective tax burdens. The WWTS has been adopted by only a few countries, including the U.S. and the U.K., and imposes the same tax rate on repatriated foreign profits as domestic profits; in contrast, under the TTS repatriated profits are not taxable, which allows firms to locate their operations or to shift profits to foreign

[2] In 2010, for instance, private firms accounted for 86% of U.S. firms with 500 or more employees (Asker, Farre-Mensa, & Ljungqvist, 2014) and they generate 69% of private-sector employment, 59% of sales and 49% of aggregate pre-tax income.