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October 3, 2016

The Honorable Mary Jo White
Chair

Keith Higgins
Director, Corporation Finance Division
Securities and Exchange Commission

100 F Street, NE
Washington, DC 20549-0609

Re: Comments on the Disclosure Requirements in Regulation S-K

Dear Chair White and Mr. Higgins:

Thank you for the opportunity to comment on the SEC's Disclosure Effectiveness Initiative. The purpose of this letter is to provide information relevant to the SEC's questions regarding the disclosure of tax information as part of the review of business and financial disclosure requirements in Regulation S-K applicable to periodic reports.

I do not make an explicit recommendation.[1] We certainly know some of the costs and benefits of certain proposed disclosures, and we should consider these costs and benefits as we do the social math required to regulate financial markets. But, I believe that we simply do not know enough to know how large these costs or benefits are, and, as a result, whether the resultant sum is positive or negative. Invariably, some of the calculation also requires moral judgements as well as economic judgements.

Given our simple lack of knowledge related to the outcomes of required tax-related disclosures, it would be wise that whatever policy the SEC undertakes, it undertakes gradually. If possible, it would be useful that the policy be implemented in such a way that explicitly makes possible future academic research regarding the outcome of the policy.[2]

[1] I attempt to provide an impartial view in this letter. Sometimes arguments are made that simply defend whatever policy is seemingly in the economic or social interest of the commenter, and, any logical or academic argument is merely used to provide justification (what Watts and Zimmerman (1979) call the "market for excuses").

[2] As, for example, the SEC did when implementing Reg SHO, in somewhat randomly assigning the treatment. Random assignment is likely not possible in a disclosure context, but, for example, assigning arbitrary size thresholds at which disclosure becomes mandatory, and, gradually phasing in more companies to the disclosure regime would enable rigorous academic study.

While I do not make a specific recommendation, I will provide information regarding one potential mandatory disclosure the SEC could consider, and that others have advocated—the public disclosure of country-by-country (CbyC) reporting. CbyC reporting is currently mandated for many multinational corporations under US Treasury Regulations (REG–109822–15), put in place this summer.[3,4] In this letter, I provide a discussion of some benefits and costs of mandatory public disclosure of CbyC reports.

Useful Information. CbyC reporting mandates, among other items, country-by-country reporting of income and taxes paid. If made public, these reports may provide valuable information to investors.[5] This information would:

1. *Enable investors to estimate the macroeconomic and geopolitical risks to which the combined firm is subject.*

   Academic research has documented the rise in multinational operations of U.S. firms. Recent research suggests that the fraction of publicly traded U.S. incorporated firms that have significant operations in foreign jurisdictions has risen from just over 40% in 1988 to close to 70% in 2012 (Dyreng, Hanlon, Maydew and Thornock 2016). As firms become more multinational, they are exposed to the economic risks of the countries in which they operate. These risks include currency risk, banking risk, expropriation risk, election outcome risk, regime change risk, legislative risk, etc. Requiring firms to disclose earnings and taxes from each country in which they operate will help investors place appropriate weights on the country-wide risks faced by the firm as a whole.

   For example, if two companies operate in Brazil where inflation is high, but one company only derives five percent of its income from Brazilian operations, while the other derives 25 percent of its income from Brazilian operations, an investor would likely weigh Brazilian currency risk differently when determining capital allocations decisions between the two companies. The two main sources of geography based disclosure (current disclosures of significant subsidiaries in Exhibit 21 and segment reporting disclosures) do not provide sufficient detail to allow an investor to appropriately weigh exposure to the economic risks faced from one country to the next.[6]

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[3] CbyC reporting mandates reporting of a variety of financial items, including revenues generated from related parties, revenues generated by unrelated parties, pre-tax income, taxes paid, accrued tax expense, net book value of tangible assets, and the number of employees for the ultimate parent entity of a multinational enterprise group that has annual revenue for the preceding annual accounting period of $850,000,000 or more. The SEC should carefully consider if all of these items, or only a selected portion, should be publically disclosed. Further, if CbyC reporting is required publically, it may be prudent to allow some time to pass with only private CbyC reporting before public disclosure is mandated.

[4] If the SEC did adopt public disclosure of CbyC reporting, it would not necessarily be the first country to do so beyond extractive and financial industries. In early September of 2016, the U.K. Government gave power to HM Treasury to make public country-by-country reports. As of this writing, it is yet to be seen whether HM Treasury will exercise this authority.

[5] The academic literature is somewhat mixed on the usefulness of tax information to investors. For example, there is some evidence that the market does value tax-related information (Hanlon et al. 2005; Hanlon and Shevlin 2005; Hanlon 2005). However, when looking at disaggregated tax information, there is little evidence regarding the usefulness of specific tax note disclosures (Raedy, Seidman and Shackelford 2011).

[6] Exhibit 21 reporting is insufficient because it only documents where companies have material subsidiaries. Immaterial subsidiaries are not reported, and in no case do we know the magnitude of the firm's presence in a country.

2. *Allow investors to understand the risks associated with the firm's tax arrangements*.

   Firms operate in a tax environment filled with complexity and uncertainty. Knowing precisely where income is recognized and how much tax has been paid on that income, would allow investors to better understand firms' future tax obligations. Moreover, while some countries have a relatively stable and predictable tax systems (the laws, enforcement of those laws, etc.), others do not. CbyC reports would help investors to estimate the risk that the firm's tax positions might be overturned.

3. *Provides information that would allow investors to assess the risks of financial misstatement that arise from operating in multiple jurisdictions.*

   Dyreng, Hanlon and Maydew (2012) show that the financial accounting risks are not evenly spread geographically. They show that unusual accrual practices are more likely to originate in countries with weak rule of law and in tax haven countries. That is, they show that the institutional environment of the countries in which firms operate affect their earnings quality, even though foreign affiliates of U.S. multinational firms are theoretically subjected to the same auditing standards as U.S. firms. Knowing where income originates will allow investors to better understand and appreciate these risks.

Practicability. Any disclosure regime mandates that specific rules and regulations be written which define what is to be disclosed, by who, and when. Registrants must then actually comply with the mandated disclosure rules. Basing an SEC disclosure on a disclosure requirement mandated by another regulator minimizes compliance costs, as companies will already be preparing the CbyC reports for private disclosure to tax authorities.[7] Basing an SEC mandated disclosure on an existing regulation also reduces costs and complications to the SEC in creating the disclosure requirement.[8]

Other Considerations. There are other potential benefits to disclosure of CbyC reports that would accrue to areas not generally considered to be under the SEC's purview. For example:

Country-level pretax income and tax expense disclosures <u>*may*</u> *constrain tax avoidance strategies.*

The academic literature has provided some evidence that disclosure of tax-related information may constrain tax planning. For example, Dyreng, Hoopes and Wilde (2016) provide evidence that after a set of firms in the U.K. was required to increase disclosure of geographic operations, their effective tax rates increased, consistent with disclosure

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Segment reporting is insufficient because the mandated items that are reported are not informative enough, and because firms pick the segments about which they report (for example, if the segment is called "Latin America", investors are still without sufficient information regarding interest rate exposure in Brazil). Even CbyC reporting would not provide all information that may be useful, but it could easily serve as a basis for investors to be able to ask questions during conference calls, etc.

[7] Of course, piggy-backing off of another regulatory rule also eliminates the ability to precisely define parameters that would optimally be different in a tax reporting context, as compared to a financial reporting context (Hanlon and Shevlin 2005). It also raises the possibility that firms may manipulate their report *because* it is made public, while a private report would have been unmanipulated (Bozanic, Hoopes, Thornock and Williams, 2016).

[8] Overlapping disclosure requirements have precedent: Part of the basis for Schedule UTP mandated by the IRS is the firm's ASC 740-10 disclosure (Bozanic, Hoopes, Thornock and Williams, 2016).

decreasing their tax planning. However, there is other, more mixed, evidence regarding disclosure and decreases in tax planning. Hoopes, Robinson and Slemrod (2016) fail to find evidence that large Australian firms change their tax behavior after being subject to increased tax disclosure. Hasegawa, Hoopes, Ishida and Slemrod (2013) also fail to find a response to tax planning activities by Japanese firms after a system of tax disclosure was repealed in Japan.

One important consideration in the current case is that CbyC reporting would contain much more information about firms' tax activities than the disclosures examined in Dyreng, Hoopes, Wilde (2016), Hoopes, Robinson and Slemrod (2016) or Hasegawa, Hoopes, Ishida and Slemrod (2013), and so firms' behavioral responses may be very different.

There is precedent for SEC mandated rules aimed at achieving objectives beyond the SEC's traditional role.[9] Title 15, Section 77g(a)(1) (Information Required in Registration Statement) notes that the Commission may require disclosures "necessary or appropriate in the public interest or for the protection of investors." Whether the SEC ought to exercise its authority to mandate disclosures outside of the scope of investor protection is an important and interesting question, but the law provides the legal ability for the Commission to do so.

Costs of Disclosure. Above I discuss potential benefits to public disclosure of CbyC reports. There are also potential costs that should be considered.[10] That additional disclosure involves costs is supported by Hoopes, Robinson and Slemrod (2016) and Hasegawa, Hoopes, Ishida and Slemrod (2013). Both papers find some evidence that firms (and individual taxpayers) took action to escape mandatory tax disclosures, suggesting that taxpayers found the disclosure regime costly. Both studied disclosure regimes contained far less information than would be disclosed in CbyC reporting.[11] However, the precise nature of these costs is unclear—all that is clear is that marginal firms that could take action to avoid the disclosure did so.

1. *Proprietary costs*

   Certain parts of a business' operations, including its tax function, may suffer as competitors and other interested parties become aware of a business' activities. For example, if firms are developing a new business segment in a country, competitors will be able to understand better the extent to which that development is happening if public CbyC reporting is disclosed.

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[9] A recent example is the reporting of the use of Conflict Minerals, mandated under Section 1502 of the Dodd-Frank Act. Further, Dodd-Frank actually mandated some public disclosure of geography-based tax information within the extractive industry in the U.S.

[10] Other costs of publically disclosing CbyC reporting are noted in Cockfield and MacArthur (2015). It should be noted that given the Treasury Regulations, affected companies would already be compiling and reporting this information to the tax authorities. As a result, these costs apply only to the publicity of CbyC reports, and not to their mandatory private disclosure.

[11] Another consideration is that reputation effects are unlikely to be constant across firms. For example, retailers and other consumer facing firms will feel the largest impact of reputation based costs.

2. *Reputation costs*

Large multinational enterprises operate in a complex world.[12] Public disclosure of CbyC reports may have reputational costs for firms that are completely tax compliant, but whose complicated financial situation may be misunderstood by the public, potentially resulting in consumer boycotts, etc. Hoopes, Robinson, and Slemrod (2016) find preliminary evidence that, among small private firms in Australia, public disclosure of tax-related information caused consumers to have more negative attitudes about firms subject to disclosure. However, using more aggregated data, Gallemore, Maydew and Thornock (2014) fail to find a reputational cost of news of firms using tax shelters, while Hanlon and Slemrod (2009) do find a small negative market reaction to news that firms used tax shelters. De Simone, Hoopes, Lester and Melvin (2016) provide several examples of firms that receive negative publicity for their tax dealings in the news, including how these firms respond.

3. *Increases in tax planning*

Armed with information about their competitors' tax planning activities, some firms may feel compelled (or pressured by shareholders) to increase their tax planning activities to remain competitive. Further, as firms can use competitors' disclosures to benchmark, they will be more easily able to justify their own planning if it becomes apparent that everyone else is planning just as aggressively.

I appreciate the opportunity to comment on the SEC's Disclosure Effective Initiative.

Sincerely,

Jeffrey L. Hoopes

[12] This said, some multinational enterprises may well be organized in a complicated way precisely because of taxes.

About the Author

Jeff Hoopes is an assistant professor at the University of North Carolina at Chapel Hill. He graduated with his Ph.D. from the University of Michigan, and does research related to corporate taxation and financial accounting.

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