Tax Evasion and Managerial Incentives: Evidence from the FATCA and Offshore Mutual Funds

By: Si Cheng, Massimo Massa, and Hong Zhang

Discussant: Stephen G. Dimmock

Summary

- Interesting and important topic
- Foreign Account Tax Compliance Act (FATCA) made it more difficult for US investors to evade US taxes with investments in offshore mutual funds
- FATCA provides a clean natural experiment for examining tax evasion and investment

Summary

- Compare offshore mutual funds sold to US investors with offshore funds not sold to US investors
- Following FATCA, relative to unaffected funds, offshore funds sold to US investors:
  - Increase risk-adjusted performance by about 2.6 percentage points per year
  - (Very) small reduction in fees
  - Moderate reduction in flows
  - Increase in measures associated with informed trading
- For stocks held by affected offshore funds, improvement in information efficiency → real effects on market efficiency

The Story

- US investors can choose between investing in taxed onshore funds or investing in untaxed offshore funds
- Investors care about after-tax returns. Offshore funds are attractive even if have lower pre-tax returns.
- Offshore fund managers do not exert as much effort in generating returns, as can attract investment due to tax advantages
- After FATCA, offshore funds cannot rely on tax advantage to attract investors, allocate more effort to producing alpha

Framework

- Conceptual framework for the paper is based on a duopoly model from Sialm and Zhang (2020)
  - Tax efficiency constrains investment strategies (lower turnover, avoid high dividend stocks, etc.) → tax efficiency reduces pre-tax returns
  - Funds specialize: (1) focus on pre-tax returns and not tax efficiency or (2) focus on after-tax returns and tax efficiency
  - If tax-exempt investors are a very large fraction of the market, then pre-tax returns of both strategies the same. Otherwise, pre-tax return of tax-exempt investors higher.
- Pre-FATCA, offshore funds have fewer constraints on investment strategy, which should make it easier to generate high returns

Competition Between Offshore Funds

- In a duopoly model, with one taxable onshore fund and one untaxed offshore fund, offshore fund could survive with a lower pre-tax return
- In a competitive market for offshore funds (1,200+ funds), unclear that offshore underperformance could survive
  - Offshore funds compete with onshore funds & other offshore funds
- Pre-FATCA, offshore managers who could generate an extra 2.6% alpha per year would have a strong incentive to do so to attract flows away from other offshore funds
  - Offshore investors have stronger incentive to chase performance because receive all of the alpha instead of only after-tax-alpha
- Is there measurable heterogeneity in competition for offshore funds based on investment styles or location?

The Level of Fees

- Leaving aside competition between offshore funds, fees are a choice variable for funds
- Suppose a fund has the ability to attract flows at current level of fees and performance, but could increase performance by 2.6% per year with more effort. Why not improve gross performance by 2.6%, and raise fees by almost 2.6%?

Comparison Group

- The tests compare offshore funds sold to US investors with offshore funds not sold to US investors
- Conceptually, the more interesting comparison is the trade-off faced by a US citizen deciding where to invest
- Compare offshore funds sold to US citizens and US based funds sold to US citizens

Other Comments

- Prior to FATCA, should offshore funds sold to US investors have earned a risk premium to compensate for legal risk (tax penalties, potential jail time)?
  - Non-US investors could arbitrage away such a risk premium?