Controlling Shareholders' Tax Burden and Corporate Transparency: Does Personal Burden Obfuscate Transparency?

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Data Availability: Data that will be used in this study are available from public sources identified in the paper.

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Abstract: Controlling shareholders wield significant influence over their firms, which can potentially lead to type 2 agency problems, where the interests of minority shareholders are compromised. Their individual tax burden can affect corporate decisions, including dividend payouts and investments, leading to suboptimal decisions that sacrifice the interests of minority shareholders. Building on the concept of type 2 agency problems from prior literature, this study aims to examine whether and how controlling shareholders' individual tax burden can also affect corporate transparency, using the inheritance events of controlling shareholders of chaebol firms. The individual burden on controlling shareholders might lead to an increase in temporary liquidity needs and induce myopic behaviors. The goal of this research is to illuminate how earnings quality and the analyst information environment can be affected by these myopic behaviors of controlling shareholders during inheritance events that increase their individual tax burden.

I. INTRODUCTION

The debate over the benefits and costs of inheritance taxes is a prominent issue in many advanced economies. Inheritance taxes can enhance equality of opportunity and mitigate the accumulation of wealth, but they also impose significant burdens on predecessors. This debate is particularly intense in South Korea, which has the second-highest inheritance tax rate among OECD countries. In Korea, the implications of this tax system are profound, especially given the substantial influence of chaebol firms on the Korean economy.

In Korea, the inheritance tax imposes significant costs on controlling shareholders of large corporations, particularly chaebol firms. Faced with high liquidity needs after an inheritance event, these shareholders seek various means to address their financial obligations. A critical issue arises when controlling shareholders of chaebol firms utilize corporate decisions to meet their liquidity needs, especially under high tax burdens (Chung et al., 2021; Barroso et al., 2023; Na and Jung, 2020). Prior studies have examined the effects of various types of shareholder-level taxes on firm-level decisions such as dividend payouts, tax avoidance, and financial reporting.

This proposal aims to explore the subsequent impact of inheritance tax on corporate transparency. Na and Jung (2020) revealed that, following inheritance events, controlling shareholders tend to increase dividend payouts and decrease future investment levels. This behavior suggests that the self-interest of controlling shareholders drives suboptimal corporate decisions, sacrificing essential cash flow. Extending this context, this proposal seeks to examine how the inheritance tax burden on controlling shareholders affects earnings quality and the information environment of firms. Given that chaebol firms exhibit myopic behavior in response to inheritance events (Na and Jung, 2020), it is plausible that the inheritance tax burden on controlling shareholders significantly impacts corporate transparency.

Exploiting Korean business groups (chaebol firms) as a unique setting, this proposal aims to extend the research on type 2 agency problems. Controlling shareholders usually have a significant influence on firms, enabling them to use corporate assets to yield personal benefits without benefiting outside investors (Baumol, 1959; Jensen, 1986). Decisions driven by controlling shareholders' self-interest can be myopic, possibly sacrificing firm value or the interests of minority shareholders. This myopic behavior can have a subsequent impact on firms, particularly in terms of corporate transparency. This proposal seeks to determine whether controlling shareholders' personal tax burdens affect corporate transparency levels, possibly revealing their intention to obfuscate transparency for their own benefit.

II. INSTITUTIONAL BACKGROUND

Controlling shareholders consider various ways to pay the inheritance tax. Generally, they sell assets, including shares of subsidiaries, utilize dividend payouts, or pledge their shares for loans. To retain control of the firms, they often resort to security-backed loans and high dividend payouts. Some chaebol firms even maintain a policy of high dividends, exceeding net income, to secure funds for inheritance taxes.[1] Additionally, the amount of money borrowed by the owners of major Korean chaebol groups using subsidiary shares as collateral exceeded 7.6 trillion KRW as of early this month, an increase of more than 2 trillion KRW compared to a year ago.[2] It was revealed that these loans were primarily taken out to pay inheritance and gift taxes.

A critical issue is that the individual tax burden on controlling shareholders can lead to suboptimal firm decisions. Using European firms, Barroso et al. (2023) find that an increased burden of individual wealth taxes on controlling shareholders leads to an increase in dividend payouts, which subsequently leads to a reduction in future investments. Similarly, Na and Jung (2020) find that an increased burden of inheritance and gift taxes on controlling shareholders of chaebol firms leads to an increase in dividend payouts, also resulting in a reduction in future investments. Despite using different settings, both papers reveal that firm decisions induced by individual tax burden of controlling shareholders can sacrifice the firm's future value for the self-interest of controlling shareholders.

When facing a high inheritance tax burden, controlling shareholders may adopt a myopic view, prioritizing their immediate liquidity needs over the firms' long-term strategic goals. This short-sighted approach can lead to decisions that compromise corporate transparency, particularly affecting earnings quality and the overall information environment. The resulting reduced transparency can obscure the true financial health of the firm, making it more difficult for investors and other stakeholders to make informed decisions. Such opacity can erode investor confidence and potentially impact the firm’s market valuation. Therefore, this study seeks to expand the understanding of the role of shareholder taxes on corporate transparency.

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[1] Heirs of Chaebol Families Struggling with Astronomical Inheritance Taxes, *Sisajournal*, February 6, 2024.
[2] To Pay Inheritance and Gift Taxes, Owner Families Pledge 7.6 Trillion KRW in Shares as Collateral, *Yeonhapnews*, October 9, 2023.

III. HYPOTHESIS DEVELOPMENT

Na and Jung (2020) and Barroso et al. (2023) showed that controlling shareholders may pass their tax burden onto corporations at the expense of firm value. To uncover further consequences of controlling shareholders' tax burden on firms, this study focuses on the degree of earnings management and financial reporting quality in chaebol firms' post-inheritance periods. To explain the relationship between the inheritance tax burden on controlling shareholders and earnings management, two channels—dividend payout and security-backed loans—are considered.

The increased tax burden on controlling shareholders leads to higher dividend payouts (Barroso et al., 2023; Na and Jung, 2020). This tax burden-induced increase in dividends reduces subsequent investment levels, indicating that firms sacrifice essential cash flows to meet the tax obligations of controlling shareholders. The market reaction to this type of dividend payout is negative (Barroso et al., 2023; Na and Jung, 2020), possibly indicating that investors are concerned about the opportunity costs associated with this decision. If subsequent firm value is affected by the lowered level of investment, firms might anticipate persistent negative stock market reactions. In this context, managers may have incentives to manipulate earnings through discretionary accruals and real earnings management to maintain the appearance of a good firm, thereby alleviating further concerns from the stock market. This earnings manipulation can be an attempt to rationalize the dividend payout and mitigate the negative market perception. By presenting heightened earnings, firms aim to justify the increased dividend payouts and minimize adverse reactions from investors, effectively rationalizing their dividend decisions.

Another channel is the security-backed loan. To address liquidity needs during inheritance events, controlling shareholders in chaebol firms often use security-backed loans. While pledging shares for personal loans allows shareholders to retain control of the firm, it also poses risks such as margin calls and potential loss of control. Share pledging can increase the pledgors' financial leverage, making them more sensitive to share price fluctuations due to the potential risks. Thus, controlling shareholders can have strong incentives to pressure firms into earnings management to defend the value of the share price. By exerting influence over the firm's financial reporting to protect share prices, these actions can lead to earnings manipulation (Dejong et al., 2020). This assumption leads to the following hypothesis:

H1a: Firms are more likely to manipulate accounting numbers when controlling shareholders are subject to inheritance events.

Controlling shareholders' decisions to meet liquidity needs during inheritance events and undertake accounting manipulations would likely impair financial reporting quality. During inheritance events, controlling shareholders' myopic behavior may intensify due to their self-interest. From the firm's perspective, it is important to conceal that firm decisions are heavily influenced by controlling shareholders, as this can exacerbate type 2 agency problems. In this context, managers might obfuscate the quality of financial reports, making it harder for investors to understand and infer future cash flow implications from current accounting information (Li, 2008). Thus, managers' incentives to decrease the quality of disclosure can increase. This assumption leads to the following hypothesis:

H1b: Firms' opaqueness of financial reporting will increase when controlling shareholders are subject to inheritance events.

If chaebol firms engage in earnings management and intentionally reduce the quality of reporting disclosure to obscure information when controlling shareholders are subject to inheritance events, the external information environment, particularly the analyst information environment, can be affected, reducing analysts' forecast accuracy. In this aspect, the inheritance tax burden on controlling shareholders might lead to a lower level of corporate transparency. This leads to the following hypothesis:

H2a: Analyst forecast error and dispersion will increase when controlling shareholders are subject to inheritance events.

If the personal tax burden affects disclosure quality and, consequently, the analyst environment, there is a possibility that firms may distort the analyst environment through the channel of affiliated analysts. Chaebol-affiliated analysts are more likely to overreact to accruals compared to independent analysts by overestimating the persistence of accruals (Yang et al., 2024). When an inheritance event occurs, it puts additional pressure on firms to engage in earnings management to present themselves as good firms and defend their stock prices. This pressure extends to affiliated analysts, compelling them to provide favorable opinions that align with the self-interest of controlling shareholders.

Consequently, this heightened pressure leads to increased bias and favorable reporting from affiliated analysts. This bias exacerbates analyst dispersion and forecast errors, further reducing corporate transparency. When analysts are pressured to provide overly positive evaluations, the quality of their forecasts reduces, leading to greater uncertainty and inconsistency in the information available to investors. If the forecast error of affiliated analysts is higher than that of non-affiliated analysts, it indicates that chaebol firms significantly influence corporate transparency. This influence extends beyond the firm itself, affecting the overall external information environment by providing a distorted view of the firm's financial health. This leads to the following hypothesis:

H2b: Chaebol-affiliated analysts will exacerbate the reduction in corporate transparency when controlling shareholders are subject to inheritance events.

IV. RESEARCH DESIGN

My study will employ a generalized difference-in-differences design with firm and year fixed effects to examine whether controlling shareholders' inheritance tax burden affects chaebol firms' corporate transparency. Compared to the gift tax, the inheritance tax is an event that is harder to be controlled by individuals and can be a significant exogenous shock for chaebol firms.

My treatment sample consists of chaebol firm-year observations that experience the controlling shareholders' inheritance events. The control sample includes firm-year observations from the treatment firms in the pre-event period and chaebol firms that do not experience inheritance events during the same period. The pre-event period is set as five years before the inheritance event, and the post-event period is set as five years after, because taxpayers whose inheritance tax exceeds 20 million KRW can apply for installments for a maximum of five years.[3]

Financial data of firms and analysts' forecasts are available from the DataGuide database provided by FnGuide. Information on security-backed loans can be sourced from firms' financial statements.

4.1. Test for H1

To test H1a, which aims to examine how the inheritance tax burden of controlling shareholders affects earnings management, my study utilizes various proxies for earnings management as dependent variables and uses changes in dividends and security-backed loans as moderator variables:

[3] Inheritance and Gift Tax Article 71-2

$$EM_{it} = \beta_0 + \beta_1 POST_{it} + \beta_2 MODERATOR_{it} + \beta_3 POST_{it} \times MODERATOR + \sum\beta Control$$

$$+ \text{Firm and Year fixed effects} + \varepsilon_{it}, \tag{1}$$

where *EM* represents various proxies for earnings management – accrual-based earnings management (*DA*, *DR_S*) and real earnings management (*ACFO*, *ADISEXP*, *APROD*). *DA* is discretionary accruals following Dechow et al. (1995). *DR_S* is discretionary revenues following Stubben (2010). *ACFO* (abnormal cash flow from operations), *ADISEXP* (abnormal discretionary expenses), and *APROD* (abnormal production costs) are all derived from regressions following Roychowdhury (2006). *POST* is an indicator variable that equals one for the treatment sample, incorporating post-period chaebol firm-year observations experiencing inheritance events into the treatment sample. ΔDIV_{it} and ΔSBL_{it} are considered as $MODERATOR_{it}$, representing the quartile values of changes in dividends and security-backed loans, respectively. Firm size, growth opportunity, leverage, firm age, sales growth, sales volatility, and OCF volatility are included as control variables. I expect β_1 and β_3 to be positive if firms manipulate accounting numbers in response to the heightened burden of inheritance tax on controlling shareholders. The significance of β_3 can be interpreted as evidence of the validity of the dividend payout channel and security-backed loans channel in my assumption.

To test H1b, which aims to examine whether firms obfuscate financial reports to hide that decisions are highly driven by controlling shareholders when controlling shareholders are subject to inheritance events, my study tests whether the readability of MD&A sections of firms is affected by the inheritance tax burden on controlling shareholders using the following model:

$$READABILITY_{it} = \beta_0 + \beta_1 POST_{it} + \beta_2 MODERATOR_{it} + \beta_3 POST_{it} \times MODERATOR$$

$$+ \sum \beta Control + Firm\ and\ Year\ fixed\ effects + \varepsilon_{it}\ , \tag{2}$$

where *READABILITY* is calculated from Flesch's Reading Ease Index, following prior literature that conducts textual analysis using the footnotes of Korean firms' financial reports (Jang and Rho, 2016). *POST* and *MODERATOR* are same as in model (1). Firm size, operating performance, leverage are included as control variables. I expect β_1 and β_3 to be negative if firms' incentives to intentionally decrease the quality of disclosure increase when controlling shareholders are subject to inheritance events.

4.2. Test for H2

To test H2a, which aims to examine whether the analyst information environment is affected by the inheritance tax burden on controlling shareholders, I consider the following model:

$$AF\_ENVIRONMENT_{it} = \beta_0 + \beta_1 POST_{it} + \beta_2 MODERATOR_{it} + \beta_3 POST_{it} \times MODERATOR$$

$$+ \sum \beta Control + Firm\ and\ Year\ fixed\ effects + \varepsilon_{it}\ , \tag{3}$$

where *AF_ENVIRONEMNT* is represented by *AFERROR* and *AFDISP*. *AFERROR* denotes the absolute value of the difference between actual earnings and the median of analysts' forecasts, scaled by stock price. *AFDISP* denotes the standard deviation of financial analysts' forecasts, scaled by stock price. *MODERATOR* represents measures for the degree of earnings management or obfuscation of financial reporting, which is proxied by the absolute value of *EM*, the positive value of *EM*, or *READABILITY*. Analyst following, firm size, earnings volatility, accounting losses are included as control variables. I expect β_3 to be positive if the controlling shareholders' inheritance tax burden leads to decreased transparency in the analyst information environment.

H2b, which serves as an additional test for H2a, aims to examine whether chaebol firms deliberately obfuscate corporate transparency using chaebol-affiliated analysts. I consider the following model:

$$AFERROR_{ijt} = \beta_0 + \beta_1 GA\_GF_{ijt} + \beta_2 NGA\_GF_{ijt} + \beta_3 POST_{it} + \beta_4 POST_{it} \times GA\_GF_{ijt}$$
$$+\beta_5 POST_{it} \times NGA\_GF_{ijt} + \sum\beta Control + Firm\ and\ Year\ fixed\ effects + \varepsilon_{it}\ , \qquad (4)$$

where i is the subscript for a firm, j is the subscript for an analyst, and t is the subscript for a year. GA_GF_{ijt} is an indicator variable that equals one for group analysts' forecasts for firms in the same chaebol business group, and zero otherwise. NGA_GF_{ijt} is an indicator variable that equals one for non-group analysts' forecasts for chaebol business group firms, and zero otherwise (Yang et al., 2024). My main variable of interest is the interaction of *GA_GF* and *POST*. If chaebol-affiliated analysts exacerbate the reduction in corporate transparency due to increased pressure to provide favorable opinions, the coefficient of this interaction term would be positive.

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