

Ownership, tax and intercorporate

loans in China

Wei Huang

University of Nottingham Ningbo, China

Abstract

Purpose –This paper aims to investigate the interconnections between corporate ownership, tax system

and controlling shareholder tunneling through intercorporate loans in an emerging market setting. Using difference-in-differences tests,

the author analyzes changes of controlling shareholders tunneling through

intercorporate loans among Chinese listed companies around this reform. More

importantly, the author reveals that foreign-invested firms experienced larger reductions of intercorporate

loans than domestic firms. In addition, the author documents positive stock market reaction to the tax reform announcement for firms that exhibited higher level of tunneling prior to the reform, indicating market

expectation of reduced principal-principal conflict post-reform. Keywords China, Ownership structure, Tax, Intercorporate loans

Paper type Research paper

1. Its stock markets and institutional

environment for listed companies remain under strong political influence and significantly

less developed compared to the Western developed countries such as the USA (Jiang et al.,

2010; Liao et al., 2014). However, the legal system governing China 's enterprises has already

seen many developments in the recent decade. For instance, to regulate company behavior

and improve investor and creditor protection, China 's first company law was promulgated

in 1993 and subsequently modified in 1999, 2004, 2005 and 2013.

foreign investors. Previously, listed firms were governed by a tax law established in

1994

under which all domestic firms pay income tax at the flat tax rate of 33 per cent and foreign-

invested firms established in China enjoyed 15 per cent preferential tax rate. In essence, tax

exemptions were used as one of the major incentives for attracting foreign direct investment by Chinese central and local governments. On 13 March 2007, The National People's

Congress passed a new EIT Law which took effect on 1 January 2008 and unified tax rates

for both types of firms to 25 per cent. Foreign-invested firms established prior to January

2008 were allowed a 5-year transition period during which they pay 18, 20, 22, 24 and 25 percent tax. Cross-country studies by La Porta et al. (2002), Klapper and Love (2004) and Aggarwal

and Goodell (2009) suggest that common law determines national financing preferences and

the legal and regulatory environment is a key determinant of controlling shareholder expropriations of minority interests, which is often referred to as "Tunneling" (Johnson et al.,

2000). This line of research has focused on legal protection for investors and enforcement of

laws whereas studies on tax laws and controlling shareholder tunneling are scant. According to Xu et al. (2011), tax enforcement can act as a corporate governance mechanism

and tax authorities play a positive role in decreasing agency costs in Chinese firms.

Although the tax reform is not a reform on corporate internal governance mechanisms, firm's response to the new tax regime is dependent on firm ownership and control. In a similar vein, Wong et al.

reactions may capture the effects of the reforms because of the negative association between

tunneling and shareholder value (Jiang et al., 2010 ;Peng et al., 2011 ;Jiang et al., 2015). Using difference-in-differences (DiD) tests, we document significant reductions of

intercorporate loans among Chinese listed firms after the 2008 EIT reform. Research background and hypotheses development

2.1 Controlling shareholders tunneling in China

Tunneling, defined as expropriations of minority interests by firm controlling shareholders, is a

worldwide phenomenon (Johnson et al., 2000 ;Claessens et al., 2002 ;Lins, 2003 ;Buchuk, et al.,

2014) as corporations in most parts of the world are controlled by a dominant shareholder,

namely the controlling shareholder (La Porta et al. (2010) ,Liu and Tian (2012) , Jian and Wong (2010) ,Qian and Yeung (2015) and Jiang et al. (2015) have focused on intercorporate loans from listed firms to their related-parties to study tunneling. Liu and Lu

(2007) ,Lo et al. (2010) ,Lo and Wong (2011) ,Shevlin et al. (2012) and Suet al. (2013) have

examined tunneling through related-party sales. (2011) focus on asset acquisitions involving related-parties. (2009 ,2010) and Huang (2016) document tunneling through related-parties loan guarantees. Studies such as Liu

and Tian (2012) ,Liet al. (2011) ,Chen et al. (2012) and Liao et al. (2014) reveal that a major

secondary privatization reform among China 's listed companies took place in 2005, often

referred to as non-tradable shares reform or split -share structure reform, improved corporate

governance and reduced tunneling among Chinese firms.

Occupancy (NOFO) from mandated disclosures in 2005 financial reports as a direct measure

of intercorporate fund transfer where controlling shareholders directly take funds away from listed firms without matching business transactions (e.g. asset sales or

product sales/
purchases)[

2]. 2.2 Hypotheses development The tax reform in China decreases the tax rate from 33 to 25 per cent for domestic

enterprises, where prior evidence suggests that such tax rate decrease leads to lower extent of profits to be booked in the pre-reform period than the post-reform period so as to achieve

tax savings. Stated differently, firms are more likely to shift out (tunnel) profits in the pre-

reform period than in the post-reform period. This argument is generally in line with studies on international tax competition which posits cross-country profit shifting for tax reasons

(Azémar and Corcos, 2009). For Chinese firms, Lin et al. (2012) find that the 2007 tax reform

in China motivates publicly listed firms to engage in downward earnings management prior

to the reform. Similar findings are obtained from Lin et al. (2014) that use public and private

firms in China. In sum, these studies clearly demonstrate that the anticipated tax rate decrease (as a result of tax reform) motivates firms to manage earnings downwards using accruals.

shareholders whereas they may be as incentivized as domestic shareholders to manage earnings downwards using accruals which are time reversing. More importantly, the abandonment of the multiple-tier tax rates system and the unification of tax rates for both

domestic and foreign-invested firms after the 2008 tax reform effectively remove tax-motivated income shifting among related parties that were previously subject to differential

tax rates. This again indicates that the tax reform may affect earnings management and tunneling differently. Finally, the reform has direct but differential effects on

firm financial

soundness by relaxing tax burden on domestic firms whereas increasing that on foreign-

invested firms. According to Peng et al. (2011), controlling shareholders are less likely to

tunnel when firms are in less healthier financial position. All in all, the above arguments

lead to the conjecture that intercorporate loans tunneling reduced more among foreign-invested firms compared to domestic firms. Therefore, we hypothesize that: H1. Intercorporate loans reduced after the EIT reform. H2. The treatment effect of the EIT reform on intercorporate loans is positive for domestic firms compared to foreign-invested firms. In addition to the direction of tax rate changes and the presence of foreign ownership, the type of corporate control, namely, government control or private control, also has strong implications for firm response to the tax reform.

Research (CSMAR) database. (2015) which use hand-collected sample from 2005 financial reports. This offers

significant advantage in overcoming sampling bias and allows us to capture time variations in

the intensity (or severity) of intercorporate loans. We use the tax reform as a natural experiment by adopting a DiD approach in line with

An (2012), Liu and Tian (2012), Liao et al. (2014) and Huang (2016) to analyze changes of

tunneling activities responding to the reform. (2015) suggest natural experiments as a “State-of-the-Art Solution” to endogeneity in accounting and finance research. We estimate a model including an intercept α , year dummies $YEAR_t$, industry dummies IND_i and an error term ϵ_{it} as follows:

$$Prob(Tunneling_{it}) = \alpha + \beta_1 EITREF_{it} + \beta_2 DOM_{it} + \beta_3 DOM_{it} * EITREF_{it} + \beta_4 Controls_{it} + \beta_5 YEAR_t + \beta_6 IND_i + \epsilon_{it}$$

$Prob(Tunneling_{it})$ denotes the probability of tunneling in a Probit model where the dependent

variable is a dummy DNOFO which takes the value of 1 if the firm-year observation reported positive value of NOFO.

Following the prior literature, Controls it indicates a list of control variables for our models which we also report in Panel A. According to Lins (2003) and Laeven and Levine (2008), non-controlling large shareholders can monitor controlling shareholders. Institutional investors perform a monitoring role in China (Yuan et al., 2008). Firms under state control have more incentives for income shifting (Lo et al., 2010; Liu and Tian, 2012), CEO duality increases earnings management (Liu and Lu, 2007), small board tends to be more efficient and board independence reduce earnings management (Klein, 2002), and larger accounting firms have higher audit quality and audit opinion matters in China (DeFond et al., 1999). These aspects of corporate governance are further controlled using the following variables: CONTEST, the ratio between the second-tier largest (number 2 plus number 3) shareholders percentage holding and the largest shareholder percentage holding; INSSH, the percentage of institutional investors' shareholdings; CEOD, a dummy which equals to 1 if the CEO is also the chairman of the board and 0 if otherwise; BOARD, the size of the board; BIND, the percentage of the board members who are independent; BIG4, a dummy variable which equals to 1 if the auditor is a "Big 4" accounting firm and 0 if otherwise; AUOP, a dummy which equals to 1 if the auditor opinion is qualified ("standard and unreserved" in Chinese term) and 0 if otherwise. (2015), we use income statement item General and Administrative Expenses deflated by total assets to measure the agency cost between managers and shareholders and denote this as AGENCY. In addition, we control for the influence of size and leverage using the log of

market

capitalization LOGMC and the financial leverage LEV calculated as the book value of debt

divided by the total value of debt and market capitalization. Finally, we follow Huang (2016)

to control for firm exposure to global economic condition using the percentage of sales from

overseas markets OVERS. After winsorization, NOFO accounts for 4.84 per cent of total assets value (NOFOTA) for firms reported positive NOFO values.

DTUNNEL refers to two dummy variables for tunneling:

(1) DNOFO, a dummy equals to 1 if the firm has a positive amount of NOFO reported in the year prior to its reform and 0 if otherwise. (2) DOREC, a dummy that equals to 1 if the firm's ORECTA in the year prior to its reform is higher than the median value of the all observations in year 2006 and 0 if it is lower than the median value. Table I.

Descriptive statistics of variables

Variable	Obs.
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NOFOTA	0.36*
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ORECTA	0.20*	0.33*	CONTEST	/C00.06*	/C00.01	0.02*
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GOV	0.15*	0.01	/C00.03*	/C00.25*
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AGENCY	/C00.01	0.08*	0.11*	0.08*	/C00.05*
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BIG4	0.04*	/C00.03*	/C00.05*	/C00.01	0.14*	/C00.06*
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AUOP	/C00.06*	/C00.25*	/C00.29*	/C00.04*	0.04*	/C00.20*	0.04*
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CEOD	0.08*	0.02*	0.03*	/C00.09*	0.26*	/C00.07*	0.07*	0.01
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BOARD	0.04*	/C00.03*	/C00.04*	0.01	0.26*	/C00.06*	0.12*	0.04*	0.15*
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BIND	/C00.03*	/C00.02*	/C00.02*	0.00	/C00.07*	/C00.01	0.04*	0.00	/C00.08*	/C00.34*
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INSSH	/C00.06*	/C00.11*	/C00.20*	/C00.07*	0.19*	/C00.03*	0.16*	0.14*	0.09*	0.11*	0.02*
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LEV	0.16*	0.09*	0.16*	/C00.14*	0.27*	/C00.22*	0.11*	/C00.10*	0.17*	0.16*	/C00.02*	0.00
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LOGMC	/C00.02*	/C00.14*	/C00.24*	/C00.11*	0.20*	/C00.18*	0.33*	0.20*	0.07*	0.19*
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0.08* 0.52* /C00.12*

OVERS /C00.03* /C0

0.02* /C00.05* 0.00 /C00.06* 0.02* /C00.04* 0.04* /C00.06* /C00.03* 0.00 /C00.01
/C00.03* /C00.02*

Notes: *p<0.05; See Table I for variable definitions

Table II. DNO. NOF.

We control for firm

market capitalization (LOGMC) and price-to-book ratio (PB) prior to the five-day event window we adopt for the tests. Adding the coefficients on EITREF and DOM/C3EITREF we

obtain the effect of the reform on domestic firms which are consistently negative suggesting

domestic firms are also less likely to tunnel through NOFO after the EIT reform. b1 gives tunneling firms' average stock return response to the EIT reform, and b4 and b5 correspond to the potential treatment effects in line with our hypotheses. 4. Results DiD regressions reported in Table III H1, H2 and H3 on the effects of the EIT reform on intercorporate loans. We are most interested in the coefficients on EITREF which give the

effect of the reform on foreign-invested firms, the coefficients on DOM/C3EITREF which give

the treatment effect of the reform on domestic firms above the foreign-invested firms, and

the coefficients on DOM/C3EITREF/C3GOV which give the difference in the treatment effects

between government controlled domestic firms and private controlled domestic firms.

In the Probit Models 1 and 2, the negative coefficients on EITREF suggest foreign firms are less likely to tunnel through NOFO after the EIT reform. The treatment effect on the

domestic firms is positive in models 1 and 2 according to the coefficients on DOM/C3EITREF. This is in line with our H2. Hence, H1

is also supported. In the revised Probit Model 3, the coefficient on DOM/C3EITREF/C3GOV is

negative and 5 per cent significant. Therefore, the difference between the treatment effect on government controlled domestic firms and private controlled domestic firms is negative. H3 is supported.

DFONO	DFONO	DFONO	NOFOTA	NOFOTA
DOM	/C00.130*** (/C03.74)	/C00.137*** (/C03.28)	/C00.098** (/C02.28)	/C00.567 (/C01.32) /C00.376 (/C00.77)
EITREF	/C00.962*** (/C020.21)	/C00.984*** (/C013.66)	/C00.917*** (/C012.30)	/C011.510*** (/C017.39) /C08.352*** (/C010.12)
GOV	0.288*** (8.97)			
DOM*EITREF	0.173*** (3.97)	0.099** (1.98)	0.141** (2.43)	1.356** (2.51) 0.197 (0.34)
DOM*EITREF*GOV	/C00.120** (/C02.35)			
CONTEST	/C00.118*** (/C04.22)	/C00.059** (/C02.00)	/C01.050*** (/C03.11)	
AGENCY	0.009** (2.53)	0.005 (1.34)	0.221*** (4.09)	
BIG4	0.061 (1.24)	0.050 (0.97)	0.127 (0.26)	AUOP /C00.294*** (/C06.15) /C00.290*** (/C05.91) /C08.979*** (/C010.45)
CEOD	0.154*** (5.09)	0.093*** (2.97)	1.808*** (4.70)	
BOARD	/C00.015** (/C02.40)	/C00.023*** (/C03.57)	/C00.133* (/C01.81)	
BIND	/C00.007*** (/C03.20)	/C00.007*** (/C03.16)		/C00.034 (/C01.48)
INSSH	/C00.000 (/C00.66)	/C00.001** (/C02.19)	/C00.015** (/C02.36)	
LEV	0.008*** (12.09)	0.006*** (9.71)	0.084*** (9.54)	
LOGMC	0.060*** (4.46)	0.053*** (3.85)	0.254 (1.57)	
Observations	17,686	15,894	15,349	17,686 15,894
Notes: Robust z-statistics in parentheses; *** p<0.01; ** p<0.05; * p<0.1. (1) (2) (3) (4) (5)				
Method Probit Probit Probit Tobit TobitDep. SeeTable I for variable de finitions (continued)				
Table III.				

NOFOTA ORECTA ORECTA ORECTA

DOM /C00.041 (/C00.08) 0.746*** (4.56) 0.464*** (2.71) 0.463*** (2.63)
 EITREF /C07.974*** (/C09.44) /C02.189*** (/C011.63) /C01.165*** (/C04.02)
 /C01.283*** (/C04.24)
 GOV 2.709*** (6.64) /C00.356*** (/C03.38)
 DOM*EITREF 0.643 (0.94) /C00.499*** (/C02.83) /C00.388** (/C02.11) /C00.160 (/C00.80)
 DOM*EITREF*GOV /C01.213** (/C02.01) /C00.505*** (/C03.66)
 CONTEST /C00.607* (/C01.70) 0.345*** (4.76) 0.313*** (4.02)
 AGENCY 0.197*** (3.51) 0.184*** (12.53) 0.186*** (12.23)
 BIG4 /C00.213 (/C00.45) /C00.936*** (/C09.89) /C00.906*** (/C09.30)
 AUOP /C08.794*** (/C09.96) /C03.135*** (/C011.57) /C03.290*** (/C011.73)
 CEOD 1.176*** (2.95) 0.294*** (3.85) 0.398*** (4.87) BOARD /C00.238*** (/C03.18)
 0.066*** (3.67) 0.086*** (4.61)
 BIND /C00.034 (/C01.49) 0.068*** (11.27) 0.067*** (11.03)
 INSSH /C00.024*** (/C03.55) /C00.017*** (/C013.46) /C00.015*** (/C011.67)
 LEV 0.073*** (7.92) 0.025*** (11.95) 0.028*** (12.72) LOGMC 0.228 (1.41) 0.001
 (0.02) 0.007 (0.16)
 Observations 15,349 17,682 15,894 15,349 Table III.IJAIM
 27,1
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measures, we observe that the EIT reform had stronger impact on firms with more tunneling problems. Regarding the type of control, NOFO suggests tunneling was more prevalent among government-controlled firms whereas ORECTA suggests it was less

prevalent among government-controlled firms prior to the EIT reform. Both NOFO and ORECTA show government controlled domestic firms had larger reduction of tunneling after the EIT reform compared to private controlled domestic firms and support H3. As a robustness check, we further control for possible influence on intercorporate loans because of firm exposure to the global financial crisis of 2008-2009 which coincide

with the start of the EIT reform although we expect the influence of the tax reform to

be longer lasting because of the transitional tax rates foreign-invested firms suffer because of during 2008-2012. We measure firm exposure to the global economic condition using the percentage of sales from overseas markets (OVERS) and further control this variable in Table IV regressions. The results reported in regressions 1-3 suggest that OVERS has no effect on intercorporate loans. Our findings are unaffected by this further control variable. The regressions 4-6 are based on firm-year observations with zero overseas sales only. Our findings generally remain unchanged with this particularly strong sample restriction. The validity of the DiD tests we performed relies on the “parallel trend” assumption, which in the context of this paper requires similar trends in the tunneling measures during the pre-reform era for both the treatment and control groups. Therefore, we now perform a diagnostic test on this assumption.

DFONO NOFOTA ORECTA DFONO NOFOTA ORECTA

DOM /C00.079* (/C01.77) 0.126 (0.24) 0.478** (2.52) /C00.065 (/C01.17) 0.501 (0.74) 0.410* (1.67)

EITREF /C00.920*** (/C011.99) /C08.203*** (/C09.23) /C01.492*** (/C04.66) /C00.805*** (/C08.44) /C06.801*** (/C06.21) /C01.537*** (/C03.82)

GOV 0.258*** (7.39) 2.328*** (5.14) /C00.546*** (/C04.38) 0.187*** (4.07) 1.373** (2.25) /C00.822*** (/C04.45)

DOM*EITREF 0.154** (2.46) 0.712 (0.94) /C00.180 (/C00.80) 0.045 (0.56) /C01.238 (/C01.24) /C00.142 (/C00.47)

DOM*EITREF*GOV /C00.170*** (/C03.11) /C01.607** (/C02.40) /C00.460*** (/C02.86) /C00.123* (/C01.73) /C00.257 (/C00.29) /C00.512** (/C02.17)

OVERS /C00.000 (/C00.11) /C00.005 (/C00.57) /C00.002 (/C01.16)

Observations 12,612 12,612 12,612 7,088 7,088 7,088

Notes: Robust z-statistics in parentheses; *** p<0.01; ** p<0.05 * p<0.1. (1) (2) (3) (4) (5) (6)

Probit Tobit Tobit Probit Tobit Tobit

Dep. Var. Regressions 1-3 are based on all firm-year observations.

t-stat

Panel A: The propensity of tunneling (DNOFO) around the EIT reform

2004-2007 0.388 2,476 0.361 2,873 0.028* 1.77

2008-2013 0.183 7,524 0.225 4,982 /C00.042*** /C05.75

Panel B: Change of tunneling intensity per year between 2004 and 2007

Variable DNOFOTA /C00.125 1,781 /C00.472 2,076 0.347 1.47

DORECTA /C00.463 1,781 /C00.656 2,076 0.192 1.36

Notes: The samples used in this table correspond to those used in Tables V and VIDID regressions. DORECTA is the change of “other receivables”-to-Assets ratio compared to the previous year-end; *** $p < 0.01$; ** $p < 0.05$; * $p < 0.1$ Loans in China

125 DNOFOTA is the change of NOFO-to-

Assets ratio compared to the previous year-end. although market reactions do not suggest a treatment effect similar to that reported in

Table III, the two intercorporate loan measures consistently suggest tunneling firms experienced value gains responding to the new EIT law. 5. Conclusion

Institutional reforms in emerging markets aimed at removing market frictions can alleviate

the problem of controlling shareholder expropriations of minority interests, or tunneling. This paper documents that a recent tax reform in China which abolished its old multiple-tiers tax system by introducing a new unified-rate tax system for Chinese domestic

enterprises and foreign-invested enterprises led to reduced tunneling through intercorporate loans among its listed companies. Our evidence reveals that tax incentives used by the Chinese government to attract foreign investment under its old tax system facilitates expropriations of minority interests by firm controlling shareholders.

CAR (/C01,3) CAR (/C01,3) CAR (/C01,3) CAR (/C01,3)

Panel B: Determinants of stock excess returns

DNOFO 2.429*** (3.85) 2.424*** (3.77) DOREC 3.027*** (5.25) 2.951*** (5.00) DOM 1.126** (2.37) 0.951* (1.96) 1.076** (2.20) 0.855* (1.73)

GOV /C00.020 (/C00.04) 0.322 (0.66)
 DNOFO*DOM /C01.204 (/C01.38) /C01.184 (/C01.14)
 DOREC*DOM /C00.748 (/C00.91) /C00.448 (/C00.46)
 DNOFO*DOM*GOV 0.029 (0.03)
 DOREC*DOM*GOV /C00.044 (/C00.04)
 LOGMC 0.352*** (2.89) 0.329*** (2.70) 0.352** (2.07) 0.266* (1.66)PB 0.289***
 (4.61) 0.230*** (3.72) 0.300*** (4.64) 0.238*** (3.76)Observations 1,249 1,249 1,204
 1,204
 R-squared 0.241 0.255 0.244 0.260
 Notes: The dependent variable in Panel B regressions is CAR(/C01,3), the (t /C01t otþ3)
 5-day cumulative
 abnormal returns around the date the new EIT law was passed by The National People
 's Congress, 13th
 March 2007 (t0). Robust t-statistics in parentheses; *** p<0.01; ** p<0.05; *
 p<0.1IJAİM
 27,1
 126 (2010) for regulations related to tunneling through intercorporate loans and
 "other
 receivables "as a vehicle for tunneling in China. (2015), the China Security Regulatory
 Commission (CSRC) noticed the
 pervasiveness of this type of tunneling practice and o fficially named it as a
 "Non-Operational
 Fund Occupancy "problem in 2006. (2015) using a similar setting analyze changes of
 earnings management activities two
 important corporate reforms: the code of corporate governance (CCG) in 2002 and the
 split share
 structure reform (SSR) in 2005 and find earnings quality improved particularly after the
 CCG
 implementation. Mean SD Minimum Maximum
 Panel A: Summary statistics
 CAR(-1,3) 1249 3.98 7.10 /C08.46 27.92
 DNOFO 1249 0.33 0.47 0.00 1.00ORECTA 1249 3.57 5.22 0.00 28.73
 GOV 1204 0.63 0.48 0.00 1.00

DOM 1249 0.54 0.50 0.00 1.00LOGMC 1249 3.47 0.41 2.53 4.82PB 1249 4.57 3.38 0.89
23.81

Dep. Notes

1. See Jiang et al. 2. According to Jiang et al.

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