# Ownership, tax and intercorporate loans in China

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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 amongChinese 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 reformannouncement for firms that exhibited higher level of tunneling prior to the reform, indicating market expectation of reduced principal-principal con flict 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 in fluence and signi ficantly less developed compared to the Western developed countries such as the USA ( Jiang et al., 2010;Liao et al.,2 0 1 4 ). 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 ’sfirst company law was promulgated in 1993 and subsequently modi fied 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 investmentby 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 uni fied 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) andAggarwal
and Goodell (2009) suggest that common law determines national financing preferences and
the legal and regulatory environment is a key determinant of controlling shareholderexpropriations 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 Xuet 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.,2 0 1 0 ;Peng et al.,2 0 1 1 ;Jiang et al.,2 0 1 5 ). Using difference-in-differenc es (DiD) tests, we document signi ficant 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, de fined 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) ,Loet al. (2010) ,Lo and Wong (2011) ,Shevlin et al. (2012) andSuet al. (2013) have
examined tunneling through related-party sales. (2011) focus on asset acquisitions involving related-parties. (2009 ,2010)a n d Huang (2016) document tunneling through related-parties loan gua rantees. Studies such as Liu
and Tian (2012) ,Liet al. (2011) ,Chen et al. (2012) andLiao 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 awayfrom listed firms without matching business transactions (e.g. asset sales or

product sales/
purchases)[
2]. 2.2 Hypotheses developmentThe 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 extentof 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) pro fits in the pre-
reform period than in the post-reform period. This argument is generally in line with studieson international tax competition which posits cross-countries pro fit shifting for tax reasons
(
Azémar and Corcos, 2009 ). For Chinese firms, Linet 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 Linet 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, theabandonment of the multiple-tiers tax rates system and the uni fication 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

firmfinancial
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 co ntrol 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 a nd 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) andHuang (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 a, year dummies YEAR t, industry dummies IND iand an error term «itas follows:
Prob Tunnelingit ðÞ or Tunnelingit¼aþb1EITREF itþb2DOM it
þb3DOM it* EITREF itþlControls it
þgYEAR tþdIND iþ«it
Prob(Tunneling it) denotes the probability of tunnelin g 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 itindicates a list of control variables for our models which we also report in Panel A. According to Lins (2003) andLaeven 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 ( Loet al., 2010 ;Liu and Tian, 2012 ),
CEO duality increases earnings management ( Liu and Lu, 2007 ), small board tends to be
more ef ficient 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 plusnumber 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 sizeof the board; BIND, the percentage of the board members who are independent; BIG4, adummy 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 quali fied ( "standard
and unreserved "in Chinese term) and 0 if otherwise. (2015) ,w eu s e
income statement item General and Administrative Expenses de flated by total assets to
measure the agency cost between managers and shareholders and denote this as AGENCY.In addition, we control for the in fluence 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, NOFOaccounts for 4.84 per cent of total assets value (NOFOTA) for firms reported positive NOFO
values.

DTUNNEL irefers 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 statisticsof variablesVariable Obs.

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

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 de finitions
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 coef ficients on EITREF and DOM/C3EITREF we
obtain the effect of the reform on domestic firm which are consistently negative suggesting
domestic firms are also less likely to tunnel through NOFO after the EIT reform. b1gives tunneling firms 'average stock return response to the EIT reform, and b4andb5 correspond to the potential treatment effects in line with our hypotheses. 4. Results DiD regressions reported in Table III H1,H2andH3on the effects of the EIT reform on intercorporate loans. We are most interested in the coef ficients on EITREF which give the
effect of the reform on foreign-invested firms, the coef ficients on DOM/C3EITREF which give
the treatment effect of the reform on domestic firms above the foreign-invested firms, and
the coef ficients 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 coef ficients 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 coef ficients on DOM/C3EITREF. This is in line with our H2. Hence, H1
is also supported. In the revised Probit Model 3, the coef ficient on DOM/C3EITREF/C3GOV is

negative and 5 per cent signi ficant. 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 15,349Table III.IJAIM
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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 moreprevalent 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 in fluence 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 in fluence of the tax reform to

be
longer lasting because of the transitional tax rates foreign-invested fir m sw e r es u b j e c tt o
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 measuresduring the pre-reform era for both the treatment and control groups. Therefore, we nowperform 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
VariableDNOFOTA /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 andVIDID regressions. DORECTA is the change of “other receivables ”-to-Assets
ratio compared to the previous year-end; *** p< 0.01; ** p< 0.05; * p< 0.1Loans 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 uni fied-rate tax system for Chinese domestic
enterprises and foreign-invested enterprises led to reduced tunneling through intercorporateloans among its listed companies. Our evidence reveals that tax incentives used by theChinese government to attract foreign investment under its old tax system facilitatesexpropriations 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<0.1IJAIM
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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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