

Can Revenue Authorities Constrain Tax-Induced Income Shifting in A Politically Controlled Environment

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The Political Economy of Corporate Tax Avoidance

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Discussant Comments

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Overview of the Papers

If you don't want anyone to know, don't do it

Chinese Proverb

A nation's treasure is in its scholars

Research Questions

- Lin, et al.
 - ◆ What is the impact of tax enforcement on corporate tax avoidance through intragroup income shifting in China?
 - ◆ Does a Chinese corporation's political ties reduce the effectiveness of tax enforcement?
- Liu, et al.
 - ◆ Do turnovers of Chinese municipal political leaders (political incentives) impact corporate tax avoidance?
 - ◆ What factors contribute to this phenomenon (age, opportunity)

Research Questions

- Lin, et al. – Explore both incentive and opportunity!

Incentive for income / deduction shifting

- Differential tax rates within provinces
- Lower taxes with no impact on consolidated net income

Increased tax enforcement of transfer pricing mitigates opportunity

Increased political connections constrains increased tax enforcement



Opportunity for income / deduction shifting

- Separate tax returns filed by group members
- Consolidated income statement filed by group members

Research Questions

- Liu, et al. – Explore both incentive and opportunity!

Incentive for tax avoidance

- Corrupt public officials turn a blind eye to tax avoidance (fraud)

Political tournaments encourage new political leaders to solicit more tax \$; break established political connections

Increased tenure reduces the incentive to police tax avoidance; age impacts aggressiveness of leaders



Opportunity for income / deduction shifting

- Political ties to municipal political leaders
- Political leaders only influence enforcement, not legislation

Research Findings

- Lin, et al.
 - ◆ Firms with more subnational income shifting opportunities report lower ETRs for the firm's industry and size (economically significant)
 - ◆ Better tax enforcement in the headquarters region constrains income shifting tax avoidance by 83% (economically significant)
 - ◆ Political connections attenuate the constraining effect that tax authorities have on avoidance associated with shifting opportunities (key {new} contribution).

Research Findings

- Liu, et al.
 - ◆ Firms avoid less tax in the early period (first two years) of local politicians' terms, but more in the remaining terms.
 - ◆ The political cycle of corporate tax avoidance tends to be more evident in regions whose leaders are younger (≤ 45) and promoted from lower ranks.

Takeaways

- Lin, et al. (p. 5)

In a politically controlled economy, connections between business and government influence enforcement, so strengthening tax administration alone is insufficient to deter tax avoidance unless a country has compatible political and business environments.

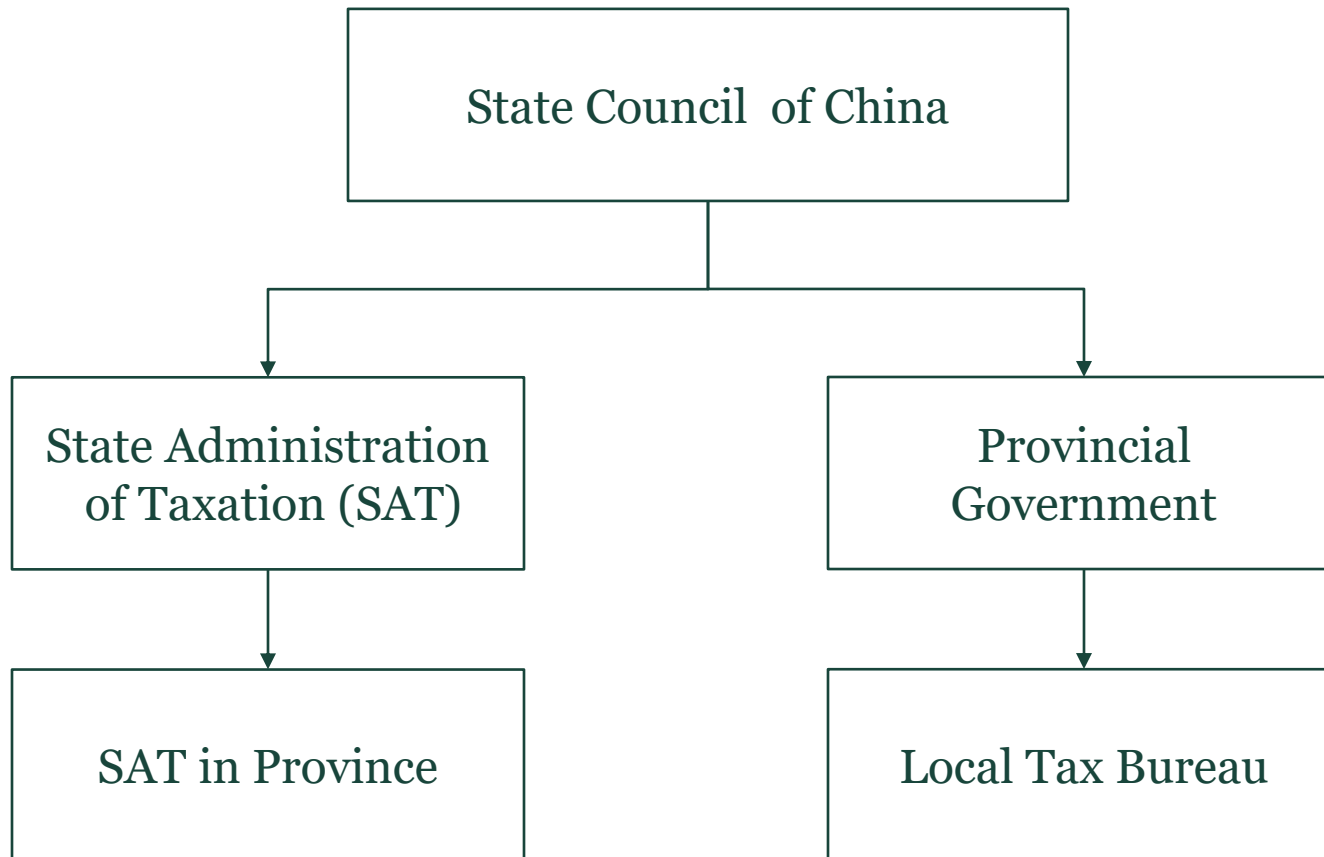
- Liu, et al. (p. 35)

[In China], the effects of political incentives on corporate tax avoidance are economically meaningful, and the mechanism – entirely different from channels such as the political uncertainty, the political connection, and the collusion between politicians and firms – suggests a new consideration for assessing the impact of politicians' policy preferences on corporate decisions and understanding the determinants of tax avoidance.

Overall Comments

- Enjoyed reading the papers!
 - ◆ Well written
 - ◆ Unique natural settings
 - ◆ Timely topic – China signs on to the BEPS action items
 - ♣ Article 7: Permanent establishment
 - ♣ Articles 8-10: Transfer pricing
 - ♣ Article 13: Transfer pricing implications, CbC reporting
 - ◆ Contribute to an under-researched area related to corporate tax avoidance: the role of political connections / incentives

Institutional Details



Yukun Sun, November 17, 2014 (SSRN)

Institutional Details

- Differential tax rates: 2004-2008
 - ◆ Corporate income tax rate for domestic firms, both state-owned and private, is 33%.
 - ◆ The corporate income tax rate for foreign firms is 30%.
 - ◆ For newly established ***foreign-owned firms***, the tax rate is 0% for the first two years after generating a profit, and 15% for years 3-5 after generating a profit.
 - ◆ Because of tax competition among different subnational governments, a local government may give preferable tax rules to firms so as to attract investments.

Institutional Details

- Time line for Chinese tax and institutional reform



¹ The tax collecting bureau separated into the State Administration of Taxation and local tax bureaus

² The act instituted a new policy where the national tax bureau collects corporate tax for all firms established in or after 2002, while local tax bureaus collect corporate tax from domestic private firms established before 2002.

³ Implemented to allow previously non-tradable shares to be freely tradable at exchanges.

Institutional Details

- Brys, B., et al. (2013), “Tax Policy and Tax Reform in the People's Republic of China”, OECD Taxation Working Papers, No. 18, OECD Publishing {p. 137}
 - ◆ Local level tax bureaus act as windows for the tax authorities to interface with taxpayers and to implement the tax laws and regulations.
 - ◆ Businesses need to stay up to speed ... on how they (laws and regulations) are practiced by local level tax bureaus.
 - ◆ Audits are carried out by independent tax audit / investigation teams at the local level.
 - ◆ ***Taxpayers need to know exactly what the tax authorities' motives are, as well as their underlying agenda, if any.***

Institutional Details

- Brys, B., et al. (2013)
 - ◆ On average, OECD countries raise more than 60% of their revenues from direct taxes, while this is only 38% in China.
 - ◆ Corporate income taxes raise about 8% of tax revenues in the OECD; these revenues are significantly higher in China which raises ***more than 15% of revenues from the enterprise income tax.***
 - ◆ The non-tax revenues raised funds of about 2.5% of GDP in 2010. About 80% of these revenues were raised by sub-central levels of government, mainly because sub-central ***tax revenues and transfers received from central government are insufficient*** to finance sub-central expenditure including spending on education, health, pensions, social welfare and urban maintenance.

Institutional Details

- Brys, B., et al. (2013)
 - ◆ Sub-central levels of government in China do not have their own taxing powers. The revenues of the taxes that are levied either finance expenditure of the central level of government (central taxes), is assigned exclusively to the sub-national government level (sub-national taxes), or is shared between central and sub-central governments (shared taxes).
 - ◆ Sub-central corporate income taxes come last, as ***corporate tax revenue is mobile***, highly cyclical, geographically concentrated and tends to shift the tax burden to non-residents.

Institutional Details

- Organizational structures in China
 - ◆ State-owned enterprises
 - ◆ Publicly-traded domestic enterprises
 - ◆ Private enterprises
 - ◆ Wholly Foreign-Owned enterprises – WOFE (“woofie”)



Institutional Details

◆ WOFE

The most popular structure for foreign enterprises in China. In this type of structure, the foreign investor does not form a joint venture with a Chinese party, and instead creates and bears the funding burden for its own limited-liability company, which it then registers in China. There are several advantages to this type of investment, which avoids the host of issues encountered in the search for and selection of a Chinese partner. In lacking a Chinese partner, however, this type of enterprise is forbidden from engaging in several business activities within China.

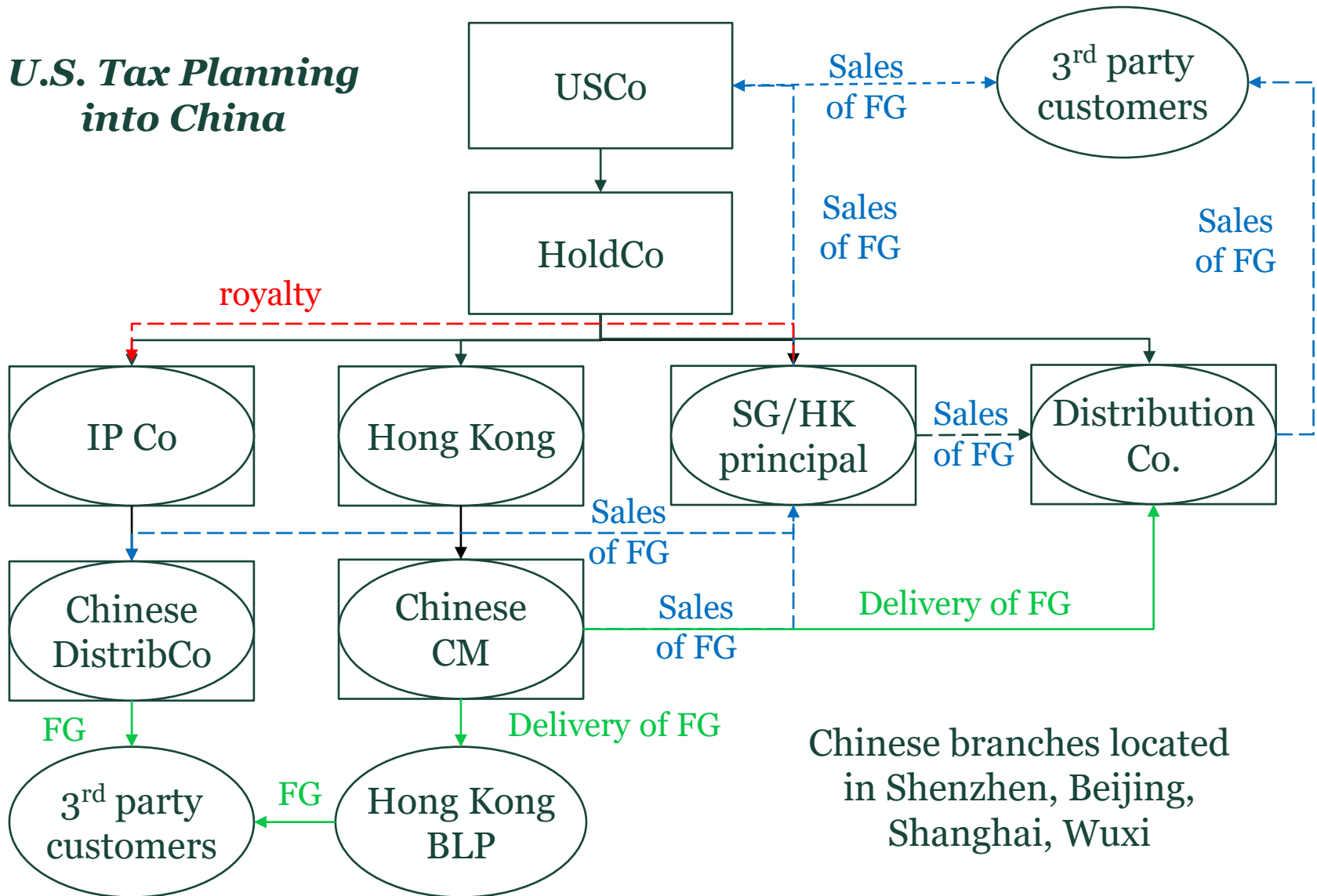
Institutional Details

- Organizational structures in China

| Year | All corporations | SOE | Private | FOE |
|------|------------------|-------|---------|--------|
| 2004 | 264,713 | 8.57% | 76.42% | 15.01% |
| 2005 | 263,914 | 6.65% | 78.07% | 15.29% |
| 2006 | 293,823 | 5.27% | 79.75% | 14.98% |
| 2007 | 331,500 | 3.55% | 81.67% | 14.78% |

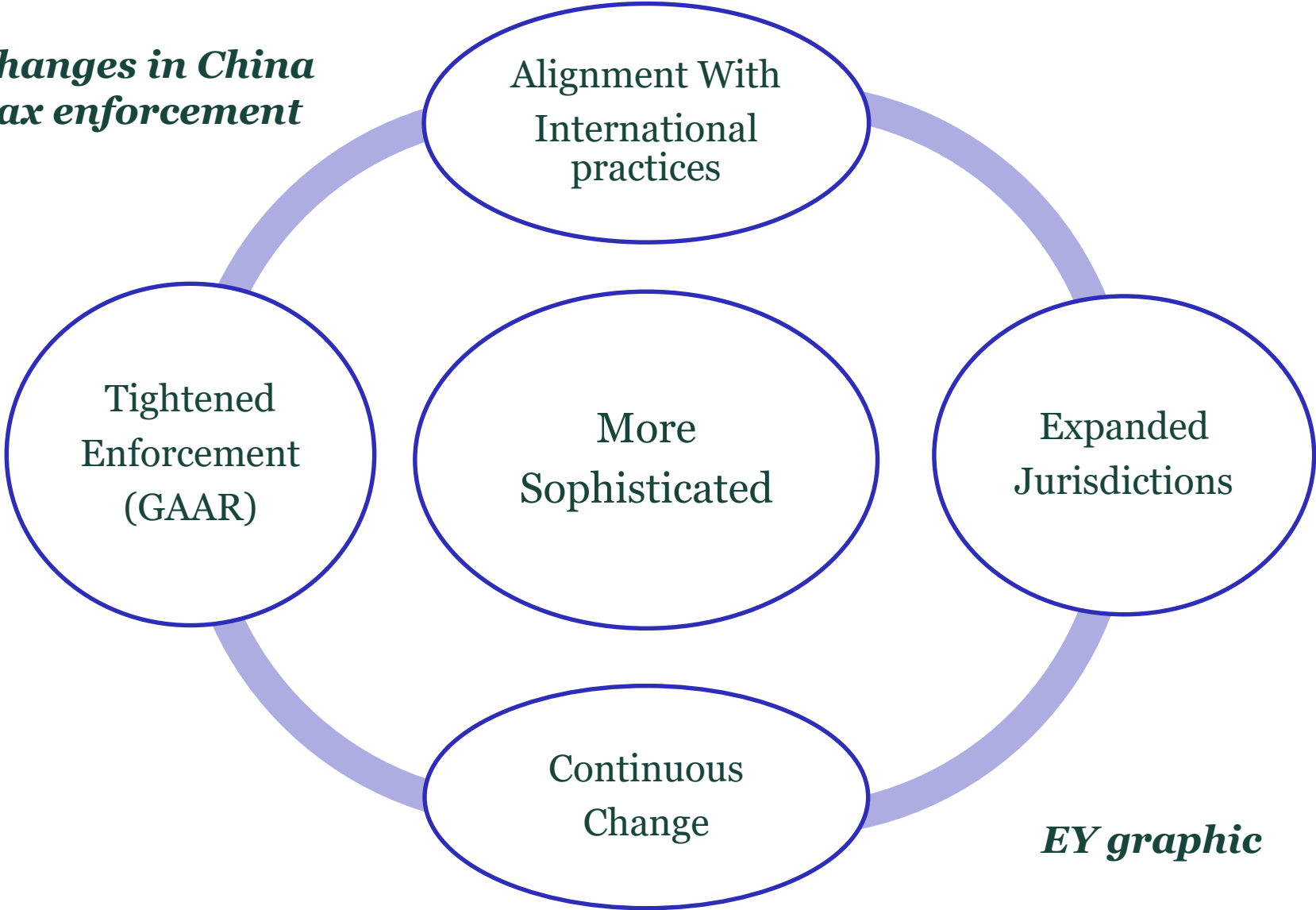
Yukun Sun, November 17, 2014 (SSRN)

Institutional Details



Institutional Details

*Changes in China
tax enforcement*



EY graphic

Institutional Details

- SAT – 15 unacceptable tax practices (25 September 2014)
 - ◆ BEPS
 - ◆ Double / multiple non-taxation
 - ◆ Aggressive tax planning
 - ◆ Tax regimes that are not transparent
 - ◆ Holding structures or transactional arrangements without economic substance
 - ◆ Deduction of inappropriate costs
 - ◆ Loss incurred by Chinese subsidiaries with single / simple functions
 - ◆ Treaty abuse

Institutional Details

- ◆ Unreasonable over-pricing of intangibles
- ◆ Remuneration inconsistent with function and contribution to value creations
- ◆ High-tech company with low profit margins
- ◆ China's location specific advantages not observed
- ◆ Losses transferred from foreign entities to the Chinese subsidiaries
- ◆ Refusal to provide data / information / documentation to Chinese tax bureau on request
- ◆ Hybrid mismatch arrangements for the purpose of tax avoidance

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Questions for the Authors

He who asks a question is a fool for five minutes; he who does not ask a question remains a fool forever

Chinese Proverb

Questions for the Authors

- Why do we care about organizational structure?
 - ◆ Private – no tension between tax and financial reporting (Cloyd and Stock, 1995) – tax evasion / corruption
 - ◆ Domestic public – aggressive tax avoidance and / or evasion
 - ◆ SOE – tax evasion / corruption
 - ◆ WFOE / FOE – aggressive tax avoidance (home country sanctions if engage in corruption) – ***tax aligned supply chain***

Question: How are Chinese publicly traded organized?

Questions for the Authors

- Which financial accounting method(s) were the sample corporations using?
 - ◆ ASBE – accounting standards for business enterprises
 - ♣ Recognition of deferred tax not mandatory
 - ♣ Either tax payable method or income statement-based
 - ◆ China Accounting Standards, 2006
 - ♣ Substantially converged with IFRS
 - ♣ Mandatory beginning 1/01/07

Questions for the Authors

- ETR measure
 - ◆ Lin, et al., "*as Chinese firms do not disclose cash taxes*" (fn. 27).
 - ◆ Li, et al., "*We define effective tax rate, TAX, as income tax payable over reported pre-tax profit*" (p. 19)

Questions for the Authors

- Another paper to consider: *Corporate Tax Avoidance and Government Corruption: Evidence from Chinese Firms*, Yukun Sun, November 17, 2014 (SSRN)
 - ◆ This paper examines how the ownership structure of a firm influences tax avoidance.
 - ♣ Sample split into state-owned enterprises, private domestic corporations, and foreign corporations.
 - ◆ Uses the ***payable income tax*** divided by taxable income to get the effective tax rate.
 - ◆ According to Transparency International's Corruption Perceptions Index, China has been ranked between 72nd and 78th out of 178 countries in recent years.

Questions for the Authors

◆ Findings

- ♣ Finds that private domestic firms hide more profits compared with the other two types of firms.
- ♣ The effect of corruption on tax avoidance for private domestic firms is twice the effect of corruption on tax avoidance for foreign firms and state-owned enterprises.
- ♣ Corruption is measured by the number of convictions per thousand government employees in each province.

Questions for the Authors

- ◆ ***Take-away:*** Firms evade more tax when dealing with a more corrupt government.
- ◆ Another reason foreign firms hide less profit is because of the culture of the companies. The multinational firms tend to be more transparent and less corrupt (DeBacker, Heim, and Tran, 2012; Braguinsky and Mityakov, 2013). Firms may face punishment by their home countries, so they would hide less profit. According to a report by Transparency International, out of 39 countries that make foreign bribery a crime, 7 countries actively enforce it and 12 countries moderately enforce it. The countries that are heavily invested in China either actively enforce it (the United States, Germany, and the United Kingdom) or moderately enforce it (Japan, France, and South Korea).

Questions for the Authors

- ◆ For both authors, does this paper provide another way to think about enforcement – does the nature of tax avoidance associated with the sample of corporations you examine tend toward aggressive tax avoidance or corruption?

Final Thoughts

- Both papers make incremental and important contributions to our understanding of tax avoidance as it relates to political connections.
 - ◆ Extension of the findings to other economies? FOEs?
 - ◆ Has China changed the dynamics of tax avoidance since 2008 through more aggressive enforcement of transfer pricing (eliminate arm's length) and adoption of BEPS-type documentation
- A better description (organization chart) of how domestic corporations are structured to achieve tax avoidance would be helpful to the reader.
- Some bubble charts using Tableau would be cool!

Final Thoughts

One more thing ...

xie xie!