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Employee views of corporate tax aggressiveness in China: The effects of *guanxi* and audit independence

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Abstract

This study examines the effects of *guanxi* and audit independence on the corporate tax aggressiveness of Chinese firms. Based on a survey completed by 174 respondents in 2013, we find that two types of *guanxi*: favour-seeking *guanxi* and rent-seeking *guanxi* are significantly associated with ethical judgments of corporate tax aggressiveness. Perceptions of audit independence in-fact are significantly negatively associated with these ethical judgments, whereas audit independence in-appearance is positively associated with them. Further, significantly positive associations exist between perceptions that tax-aggressive activities are good for the firm and its shareholders and favour-seeking *guanxi* and between these perceptions and stronger client-auditor relations. This study provides insights into the association between types of *guanxi* and the propensity of firm management to engage in corporate tax aggressiveness.

Keywords: *Guanxi*; ethical judgments; corporate tax aggressiveness; audit independence, China; survey; international.

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1. INTRODUCTION

The social and political relationships, or interpersonal bonds (*guanxi*), among Chinese entrepreneurs can have a profound influence on business outcomes (Sharkey, 2008; Tu et al., 2013). In China, *guanxi*, or the establishment of relationships or connections with business partners, is considered necessary to acquire resources, obtain approvals or bureaucratic privileges, facilitate the achievement of business outcomes, or reduce the risk that those outcomes will not be achieved (Hwang et al., 2009; Liu et al., 2011).

In this study, we examine the association between *guanxi* and audit independence and ethical judgments of corporate tax aggressiveness³ in Chinese firms that operate in an international context. An evaluation of *guanxi* is important, as relations established between management and auditors and between management and government officials such as tax officials may have a bearing on management's propensity and opportunity to reduce the corporate taxes payable. Prior studies on international corporate tax aggression have demonstrated that, in many Western economies, firms can use elaborate strategies to reduce corporate income taxes, including aggressive transfer pricing, income shifting and the strategic use of debt and tax haven-incorporated subsidies (Slemrod, 2001; Rego, 2003; Braithwaite, 2005; Desai et al., 2006; Taylor & Richardson, 2013). However, little work has been carried out on managers' motivations and capabilities for reducing corporate income taxes in relation-based⁴ cultural and political regimes such as China.

Based on a survey completed by 174 respondents from both listed and unlisted firms in 2013, we find that two types of *guanxi*—favour-seeking *guanxi* and rent-seeking *guanxi*—are significantly associated with judgments of tax avoidance. Perceptions of audit independence in-fact are significantly negatively associated with these judgments, whereas audit independence in-appearance is positively associated with them. Further, significantly positive relations exist between perceptions that tax-aggressive activities are good for the firm and its shareholders and favour-seeking *guanxi* and between those perceptions and stronger client–auditor relations. These results are generalisable across China despite the economic and social diversity of the country's provinces because *guanxi* is pervasive throughout China's social and organisational activities, is culturally rooted, and is critical to achieving business success regardless of whether enterprises are foreign-owned, domestic government-owned, or domestic public-owned (Fan et al., 2012a).

This study contributes to the literature in several ways. Firstly, it extends the recent literature on the business decision-making of Chinese firms (see, e.g., Liu et al., 2011; Tu et al., 2013). It is also the first study to examine the association between favour-seeking *guanxi* and rent-seeking *guanxi* in conjunction with external auditor independence and perceptions of corporate tax aggression by Chinese firms. Given the size of the Chinese economy and the importance of *guanxi* in determining business

³ Corporate tax aggressiveness is defined here as any transaction or event that leads to a reduction in the amount of corporate tax paid by the firm (see, e.g., Dyreng et al., 2010). Tax aggressiveness may be achieved through legitimate methods in accordance with tax legislation provisions or involve structuring transactions or activities with the principal objective of decreasing the amount of corporate tax payable.

⁴ A relations-based economy is one in which transactions are based on personal and implicit agreements (Liu et al., 2011).

decisions and culture, it is important to gain an understanding of the relationship between these two types of *guanxi*, auditor characteristics and corporate tax aggression. Indeed, very little is known about the determinants of corporate tax aggressiveness in relation-based economies such as China. The findings of parallel studies (see, e.g., Liu et al., 2011; Tu et al., 2013) suggest that elements of *guanxi* and auditor characteristics are likely to be important determinants of Chinese business decisions, including decisions regarding tax planning and implementation. The increase in the economic importance and international influence of Chinese firms in recent years renders an assessment of how *guanxi* and audit independence relate to tax avoidance timely. Secondly, we provide additional insights into how relations developed with external auditors and clients may influence management's propensity to engage in tax-aggressive activities. We also provide evidence that, collectively, political connections, bureaucratic privilege, audit–client affiliations, and audit fee dependency are significantly associated with perceptions of corporate tax aggression. These results suggest that adverse effects such as tax aggression may arise from *guanxi*-related business dealings. Thirdly, the results presented herein can be extrapolated to other *guanxi*-related business pursuits in China and other relation-based economies. For instance, *guanxi* (and auditor independence) may exert influence on other corporate activities such as capital management initiatives and board structuring and compensation.

The remainder of this paper is organised as follows. Section 2 presents a brief review of the literature on the topics of *guanxi*, audit independence and corporate tax avoidance in relation-based economies. Section 3 develops our hypotheses. Section 4 discusses the research design. Section 5 summarises and analyses the empirical results, and Section 6 concludes the paper.

2. BACKGROUND

2.1 *Guanxi* and audit independence

Guanxi, which is loosely defined as ‘interpersonal relationships’, is critical in driving social behaviour and decision-making in China (Lovett et al., 1999; Fan et al., 2012a). It involves networks of individuals establishing relations to further business opportunities. Individuals are bonded through mutual obligation to one another rather than through written contracts or records (Lovett et al., 1999; Chua et al., 2009). *Guanxi* may assist in the provision of resources or enable a firm to operate effectively in a difficult environment. In China, *guanxi* networks avoid the use of written agreements, preferring social ties to achieve business objectives (Fan et al., 2013). In many cases, successful private firms have strong *guanxi* links with government officials (Fan et al., 2012a). Thus, Su et al. (2003) suggest that *guanxi* should be classified into favour-seeking and rent-seeking types. Favour-seeking *guanxi* is ‘culturally rooted, signifying social contracts and interpersonal exchanges of resources in a collectivistic society’ (Su et al., 2003, p. 310). Rent-seeking *guanxi*, in contrast, ‘reflects on institutional norms signifying social collusion based on power exchanges in a hybrid Chinese socialist market economy’ (Su et al., 2003, p. 310). Fan et al. (2012a) carried out the first empirical study examining the effects of favour- and rent-seeking *guanxi* on Chinese auditors’ ethical judgments. Their results suggest that both types are associated with those judgments.

The prior literature provides a wealth of evidence indicating that *guanxi* is likely to have an important bearing on managerial incentives and capacity to achieve corporate objectives in relation-based capitalistic regimes in which politics and business ventures are closely linked. For instance, Adhikari et al. (2006) report that firms with political connections had lower effective tax rates over a 10-year period in Malaysia. Fan et al. (2008) show firms with politically connected CEOs to underperform those without connections, whereas Li et al. (2008) note that Communist Party membership helps private entrepreneurs to obtain loans from state financial institutions. Francis et al. (2009) find that firms in China with greater political connections are characterised by higher offering prices in the IPO market. Tu et al. (2013) provide evidence to show that political connections are more important in China, which has higher levels of corruption and law enforcement than developed countries. Based on this accumulated evidence, it is therefore not unreasonable to expect that reliance on social networks and political connections may affect firms' propensity to engage in tax aggression.

Audit independence is a fundamental premise of accounting professionals' code of ethics. It requires accounting professionals to bear in mind that they are required to act with integrity and in an objective manner (i.e., independence in-fact) and also avoid any activities that could create the public perception that their independence is impaired (i.e., independence in-appearance). The audit–client relationship is one of the most important issues in audit independence in-appearance. Audit independence can create real and apparent concerns in the minds of various stakeholders (Fan et al., 2013). Prior studies suggest that corporate tax aggressiveness is negatively associated with audit independence, an issue discussed in further detail in Section 3.

2.2 China's tax laws

China's income tax laws have evolved radically over the past decade (Sharkey, 2004; Deloitte, 2014; Chan et al., 2013a). The country now has transfer pricing, thin capitalisation and controlled foreign company rules, as well as a General Anti-Avoidance Rule (GAAR). The introduction of GAAR in China in January 2008 is contained in the Enterprise Income Tax Law (EITL), EITL Implementing Regulations, and Notice of the State Administration of Taxation on Issuing the Measures for the Implementation of Special Tax Adjustments (for Trial Implementation). The 2008 EITL applies to both domestic and foreign-invested enterprises, generally at the same corporate tax rate (25%), with special rates applying in certain cases. However, the application of GAAR is not coherent in China, with different interpretations and applications being applied in different provinces (Ernst and Young, 2013). Additionally, numerous tax incentives, exemptions, and privileges are provided to firms, depending on their industry sector (e.g., qualified new and high-technology sector firms), geographical location and level of foreign investment. Industry-oriented tax incentive policies are aimed at directing investments into sectors and projects that are encouraged and supported by the state (PWC, 2012).

China's tax law and policy are developed jointly by the State Administration of Taxation (SAT) and the Ministry of Finance (MOF). The SAT is the body charged with collecting tax and enforcing compliance, and is assisted by the state and local tax bureaus at the provincial level (PWC, 2012). Enterprise income tax is imposed on the worldwide income of a resident enterprise (with a credit available for tax paid on foreign-source income), on China-source income, and on income effectively connected with the establishment in China of a non-resident enterprise. The Chinese tax authorities may impose, upon SAT approval, anti-tax avoidance measures if they

suspect that an enterprise has abused preferential tax arrangements, abused tax havens for tax-avoidance purposes, or engaged in activities with no commercial purpose such as transfer pricing or income shifting arrangements that are not at arm's length (PWC, 2012).

2.3 Tax aggression of Chinese firms

According to the US research and advocacy group Global Financial Integrity, China was subject to a US\$3.79 trillion illegal capital outflow between 2000 and 2011 (Global Financial Integrity, 2012). Of the \$US2.83 trillion that flowed illicitly out of China in the 2005–2011 period, \$US595.8 billion ended up as cash deposits or financial assets such as stocks, bonds, mutual funds and derivatives in tax havens (Global Financial Integrity, 2012). Tax havens are jurisdictions that offer beneficial financial, legal and tax regimes, as they impose nil or nominal taxes, have laws or administrative practices that prevent the effective exchange of information, and/or lack transparency with regard to financial and taxation arrangements, including regulatory, legal and administrative provisions, and access to financial records (Hines & Rice, 1990; Wilson, 2009; GAO, 2008a; 2008b; OECD, 2006; 2012).⁵ A significant portion of the capital outflows from China makes a round-trip back to the country as recorded foreign direct investment (FDI). Round-tripped FDI is given preferential treatment vis-à-vis domestic capital in the form of tax concessions and a government guarantee of the loans extended by foreign corporations to domestic firms (Global Financial Integrity, 2012).

Capital flows typically pass through the offshore financial centers of Hong Kong, the Cayman Islands or the British Virgin Islands (BVI) (Buckley et al., 2007; Sutherland et al., 2012). By 2003, the Cayman Islands accounted for 28.3 percent of total Chinese FDI flows. By 2006, it had increased to 44 percent (US\$7.83 billion) (Sutherland et al., 2012). By 2006, the Cayman Islands and BVI together accounted for 47.5 percent of Chinese FDI flows and 25.3 percent of Chinese outward FDI stock. Between 2004 and 2006, the BVI received far less outward Chinese overseas FDI, but accounted for a considerable portion of direct investments back into China. Estimates of the net FDI flows from the Cayman Islands and BVI to China stood at a surplus of around US\$16.5 billion in that period (Sutherland et al., 2012). Overseas FDI to the BVI is generally thought to involve assets recycled through tax havens to accomplish the preferential treatment of foreign capital (Buckley et al., 2007; Luo & Tung, 2007). Capital also leaves China as FDI in such places as Hong Kong and the BVI, only to then be laundered in another jurisdiction and reinvested in China as FDI from Hong Kong or the BVI (Global Financial Integrity, 2012). Large tax rate differentials among group subsidiaries domiciled in variably taxed jurisdictions (e.g. China, Hong Kong, the US, and various tax havens) provide incentives for firms to shift profits and deductible expenses such as interest and royalties among those subsidiaries (Huizinga & Laeven, 2008; Global Financial Integrity, 2012). The tax benefits derived from financial flows to and from tax haven-incorporated firms have important implications for inequality and corruption in China (Global Financial Integrity, 2012).

⁵ The OECD's (2006, 2012) list of 33 tax havens includes the following countries: Anguilla, Antigua and Barbuda, the Bahamas, Bahrain, Bermuda, Belize, the British Virgin Islands, the Cayman Islands, the Cook Islands, Cyprus, Dominica, Gibraltar, Grenada, Guernsey, the Isle of Man, Jersey, Liberia, Malta, the Marshall Islands, Mauritius, Montserrat, Nauru, the Netherlands Antilles, New Caledonia, Panama, Samoa, San Marino, the Seychelles, St. Lucia, St. Kitts and Nevis, St. Vincent and the Grenadines, the Turks and Caicos Islands and Vanuatu.

3. HYPOTHESIS DEVELOPMENT

We now develop several hypotheses about the effects of *guanxi* and audit independence on perceptions of corporate tax aggressiveness.

3.1 Favour-seeking *guanxi*

Favour-seeking *guanxi* comprises: a) the network of relations, including management-tax department relations and broader relations, developed with the government; b) close connections between the maintenance of business relations and financial success; and c) the notion that the achievement of business objectives requires connections or affiliations with the right people. Corporate culture and managerial behaviour may influence the extent and nature of corporate tax avoidance (Dyreng et al., 2010). Faccio et al. (2007) provide evidence to show that politically connected firms are more likely to receive assistance from the government such as the receipt of tax benefits (i.e., favourable tax arrangements and payments). Perceived flexibility in terms of tax-related arrangements and negotiations between a politically connected firm and the government may serve to enhance management's aggression in tax planning and the implementation of strategies to reduce taxes payable. Appointment to a management position and the maintenance of that position may hinge on the existence of political affiliations. Chan et al. (2013b) and Jian and Zhang (2013) assert that management may have incentives to please government officials through generous tax payments. The Chinese government offers tax benefits to foreign-invested enterprises, the nature of which can be dependent on favour-seeking *guanxi*. Jian and Zhang (2013) find that foreign-invested enterprises avoid taxes to a greater extent than their state-owned counterparts based on the tax benefits the government provides them. Politically connected entrepreneurs can obtain preferential treatment from government officials based on the tenets of favour-seeking *guanxi*, which may assist their firm in deriving greater tax benefits. Management may believe that these additional tax benefits will ultimately flow to shareholders, as they serve to boost the firm's after-tax returns. Further, Lo et al. (2010) and Chan et al. (2013b) purport that management may engage in tax-aggressive activities for the purpose of increasing resource retention within the firm, which will also ultimately benefit shareholders. Thus, the government privileges provided to select firms may have overlapping governmental policy initiatives and personal and corporate objectives.

Additionally, politically connected managers may undertake more risky financial (including taxation) projects, as they may be assisted in the event of difficulties by the government or by politically connected financial institutions. Tu et al. (2013) find that politically connected firms receive preferential treatment from the government, and, as a result, acquired higher-quality firms during the full privatisation of state-owned enterprises (SOEs). Political connections may also reduce the likelihood of a tax audit or that the tax audit will result in significant penalties. In a parallel outcome to that reported by Tu et al. (2013), management may potentially abuse its political connections to exploit opportunities that enable the firm to derive greater tax benefits. Indeed, preferential tax treatment may exacerbate already aggressive tax-related activities. Further, Chan et al. (2013b) assert that it is the government that appoints, motivates and disciplines SOE managers, who are in turn required to achieve the social and political objectives of the government. To formally test the influence of favour-seeking *guanxi* on judgments of corporate tax avoidance, we develop the following (directional) hypotheses.

H1a: All else being equal, the effect of favour-seeking *guanxi* is positively associated with ethical judgments of corporate tax aggressiveness.

H1b: All else being equal, the effect of favour-seeking *guanxi* is positively associated with ethical judgments that corporate tax aggressiveness is a good business strategy for the firm and its shareholders.

3.2 Rent-seeking *guanxi*

Rent-seeking *guanxi* comprises: a) bureaucratic privilege, whereby it is acceptable for benefits to be channeled to some parties at the expense of others; and b) the notion that it is acceptable behaviour for dominant parties to make all decisions and deals. In a rules-based economy, this form of *guanxi* is akin to the managing director and chairperson of the firm being the same individual, who, accordingly, is unlikely to be independent. The combined role of managing director and chairperson can significantly impair both a board's important functions of monitoring, disciplining, and compensating senior managers, and its oversight, governance and disclosure policies (Kang et al., 2007). Such duality also enables the CEO to engage in opportunistic behaviour that may exacerbate the degree of information asymmetry between management and shareholders and between the firm and bondholders (Fama & Jensen, 1983; Gul & Leung, 2004). Chan et al. (2013b) find that non-government-controlled Chinese listed firms with a higher percentage of board shareholdings and a CEO who also serves as the board chair tend to be more tax aggressive than SOEs and firms with stronger governance structures. That finding implies that the existence of managers who assert control and attain bureaucratic privilege can diminish management's monitoring capacity and increase the likelihood of tax aggressiveness. To formally test the influence of rent-seeking *guanxi* on corporate tax avoidance, we develop the following (directional) hypotheses.

H2a: All else being equal, the effect of rent-seeking *guanxi* is positively associated with ethical judgments of corporate tax aggressiveness.

H2b: All else being equal, the effect of rent-seeking *guanxi* is positively associated with ethical judgments that corporate tax aggressiveness is a good business strategy for the firm and its shareholders.

3.3 External auditor independence in-fact

We examine the relationship between respondents' opinions regarding judgments of corporate tax aggressiveness in order to determine: a) whether the external auditing firm should be independent in performing an audit; and b) whether the auditor should behave with integrity and objectivity in performing the audit. Frankel et al. (2002) provide empirical evidence showing that the provision of non-audit-related services reduces auditor independence and thereby lowers the quality of the firm's financial information. Alexander et al. (2008) find that the opportunities for firm management to engage in corporate tax aggressiveness increase as audit independence diminishes. Elder et al. (2008) report empirical support for the idea that auditor-provided tax services reduce auditor independence. Finally, Armstrong et al. (2012) find that the higher the proportion of taxation fees provided by the auditor, the lower the level of the firm's effective tax rate. In the Chinese context, Shafer and Simmons (2011) demonstrate that certain dimensions of an ethical culture exert a significant effect on Chinese tax practitioners' intentions to engage in tax-aggressive strategies. We

therefore posit that firms with weak external auditor independence are more likely to engage in tax aggressiveness. To formally test the influence of external auditor independence in-fact on judgments of corporate tax aggressiveness, we develop the following (directional) hypotheses.

H3a: All else being equal, the likelihood of external auditor independence is negatively associated with ethical judgments of corporate tax aggressiveness.

H3b: All else being equal, the likelihood of external auditor independence is negatively associated with ethical judgments that corporate tax aggressiveness is a good business strategy for the firm and its shareholders.

3.4 External auditor independence in-appearance

We now examine the relationship between respondents' opinions regarding judgments of corporate tax aggressiveness and whether the external audit firm should: a) avoid a close relationship with clients; b) avoid an employment offer from a client; and c) avoid dependency on the derivation of fee revenue from a particular client or small client group. In a rules-based or Western economy, independence in-appearance by an external auditor is likely to be negatively associated with the likelihood of a firm engaging in corporate tax aggressiveness. If auditors develop connections with clients and become financially reliant on substantial fees from those clients (particularly fees related to non-audit services), then the auditors' independence is potentially compromised, as they may become reluctant to draw attention to problems with the clients' tax or other business-related activities (Becker et al., 1998; Freise et al., 2008). However, Liu et al. (2011) contend that the relationship between auditor-management affiliations and audit quality depends on the behavioural and business context. In the case of a relation-based economy such as China, linkages developed between external auditors and management appear to be essential to achieving financial (including taxation) objectives and are based on familiarity and trust between the parties concerned (Chua et al., 2009). These authors further contend that auditor-management affiliations increase the likelihood that a firm will receive a clean audit opinion. Similarly, these affiliations may be regarded as essential in achieving the firm's financial (and taxation) objectives and strategies. Further, Gul (2006) finds that Malaysian firms with political connections are characterised by the use of external auditors that exert greater audit effort and charge higher audit fees. Finally, the Chinese audit market is effectively controlled by the government⁶ (Liu et al., 2011). It is therefore not unreasonable to assert that closer connections between external auditors and management may facilitate aggressive tax-avoidance strategies. To formally test the influence of external auditor independence (in-appearance) on judgments of corporate tax aggressiveness, we develop our final set of (directional) hypotheses:

H4a: All else being equal, an external auditor's affiliation with management is positively associated with ethical judgments of corporate tax aggressiveness.

⁶ The Chinese government controls the audit market through the Chinese Institute of Certified Public Accountants (CICPA), which is effectively controlled by the MOF. Further government control of the audit market stems from the services of CICPA being used by local governments (Wang et al., 2008).

H4b: All else being equal, an external auditor's affiliation with management is positively associated with ethical judgments that corporate tax aggressiveness is a good business strategy for the firm and its shareholders.

4. RESEARCH DESIGN

4.1 Sample selection and methodology

The study reported herein used a survey to collect data on perceptions of corporate tax aggression and the benefits of that aggression. The survey instruments comprised: (1) a self-administered questionnaire and (2) two hypothetical cases of corporate income tax aggression (Appendix C). The self-administered questionnaire solicited demographic information (age, gender, qualifications and position) and asked questions about Chinese business personnel's perceptions of *guanxi* (Appendix A) and audit independence (Appendix B). The study sample comprised Chinese business personnel enrolled in an MBA course at either Zhongnan University of Economics and Law or Dongbei University of Finance and Economics who are also currently employed by listed and unlisted companies located in Hubei and Liaoning provinces. Independent instructors recruited the participating MBA students, asking them to complete the questionnaire at the end of class. The instructors provided students with an information sheet and also explained the objectives and importance of the questionnaire and how to complete it. Respondents were assured that their responses would be anonymous and confidential, with no personal information relating to respondents or their employing firm disclosed. Responses were given on a nine-point Likert scale anchored on 'strongly disagree' (1) and 'strongly agree' (9). The survey instrument was translated from English to Chinese by a professional translator. The Chinese version was then pre-tested on the MBA instructors to identify any potential problems with understanding prior to administration to the participating MBA students. A sample of 176 Chinese business personnel studying an MBA course was used to collect information on the two types of *guanxi* and corporate tax avoidance by Chinese firms. Two incomplete survey instruments were excluded from the study, resulting in a final useable sample of 174. Demographic information pertaining to the respondents is provided as Table 1.

Table 1: Demographic attributes of Chinese business personnel that responded to the questionnaire

	1	2	3	4	5	6	7	8	9		
	Strongly Disagree								Strongly Agree		
										Sample size	%
Gender	Male									90	52
	Female									84	48
Education level	Bachelor									131	75
	Master									41	24
	Other									2	1
Age (years)	20–30									111	64
	31–40									60	35
	41–50									3	1
	51 above									0	0
Position	Independent board of director									1	1
	Non-independent board of director									5	3
	Financial controller/manager									17	10
	Department manager									39	22
	General staff									82	47
	Accounting staff									30	18

4.2 Dependent variable

Our dependent variable is: a) a respondent's likely ethical judgment on two tax-aggressive activities (see Appendix C) undertaken by a firm if they were an executive director of that firm and b) the respondent's ethical judgment on whether the business strategy of the firm undertaking those activities was beneficial to the firm and all of its shareholders. The two tax-aggression cases revolve around two important mechanisms by which firms can reduce the corporate taxes they pay. The first case involves the repatriation of funds from a tax haven-incorporated subsidiary located in the BVI back to a parent firm in mainland China. The second involves the shifting of income and borrowings between a mainland Chinese firm and a Hong Kong subsidiary to obtain tax benefits in the form of lower taxes on income and higher deductions on borrowings, depending on where the funds are taxed. It is likely that tax-aggressive firms will incorporate subsidiaries in tax havens to avoid having their foreign income subject to domestic corporate taxes (Desai et al., 2006). Both cases involve tax-aggressive activities by Chinese multinational firms rather than SOEs.

Respondents were asked to indicate their level of agreement with four questions on a 9-point Likert scale ranging from 'strongly disagree' (1) to 'strongly agree' (9). The first two questions, designed to measure the first dependent variable, that is, corporate tax aggressiveness, concerned their perception of whether management had aggressively avoided paying corporate taxes to the government in the two cases. The last two questions, used to measure the second dependent variable, that is, tax business

strategy, concerned the companies' tax business strategy in the two cases. An internal consistency test revealed that the alpha reliabilities of both tax aggressiveness (two items) (58%) and tax business strategy (two items) (62%) were acceptable given the small number of representative items.

4.3 Independent variables

Our independent variables are *guanxi* and audit independence. *Guanxi* includes the two dimensions of favour-seeking *guanxi* and rent-seeking *guanxi*, and audit independence the two dimensions of audit independence in-fact and in-appearance. The level of Chinese business personnel's favour- and rent-seeking *guanxi* orientations were measured using the seven-item *guanxi* scale in Fan et al. (2012b), and their level of perceptions of audit independence in-fact and in-appearance were measured using the seven-item audit independence scale in Fan et al. (2012c). Confirmatory factor analysis (CFA) using analysis of moment structures (AMOS) was performed to assess each original measurement model's goodness-of-fit. The purpose of this exercise was to confirm the most appropriate measurement model for each independent variable in the current sample. Model assessment was conducted using X^2 statistics ($p \geq 0.05$) (Jöreskog and Sörbom, 1993) and $X^2/df < 2$ (Wheaton et al., 1977) and goodness-of-fit indices such as CFI ≥ 0.95 (Bentler, 1990) and root mean square error of approximation (RMSEA) ≤ 0.06 (Hu & Bentler, 1999).

The results of CFA on the *guanxi* variable (i.e., $p = 0.000$, $X^2 = 178.16$, $df = 13$, $X^2/df = 3.41$, comparative fit index [CFI] = 0.93 and RMSEA = 0.12) indicated a very poor fit for the two-factor seven-item model based on the model assessment criteria (refer to the previous section). Thus, model re-specifications were undertaken to find a model that better represented the data. After reviewing the significant values of the modification indices and standardised residual covariance (i.e., larger than two) (Jöreskog & Sörbom, 1989; Steenkamp & Baumgartner, 1998), the items *right people* and *back-door deals* were found to represent misspecifications of the original model. They were therefore deleted incrementally, and the final results (i.e., $p = 0.11$, $X^2 = 7.34$, $df = 4$, $X^2/df = 1.84$, CFI = 0.99 and RMSEA = 0.07) suggested that this short version of the model was most appropriate for the current sample, although the RMSEA value (0.07) was slightly higher than the predetermined criteria (0.06). However, such results are still considered a good fit in the literature (e.g., Cheung & Rensvold, 2002; Du & Tang, 2005; Vandenberg & Lance, 2000). Accordingly, we used the two-factor five-item model in data analysis examining Chinese business personnel's *guanxi* orientations and in further analysis, that is, of those orientations' influence on Chinese business personnel's judgments about tax aggressiveness. The overall reliability coefficient using Cronbach's alpha for favour-seeking *guanxi* is 0.78, and that for rent-seeking *guanxi* is 0.72.

Similarly, the CFA results for the audit independence variable (i.e., $p = 0.000$, $X^2 = 161.68$, $df = 14$, $X^2/df = 11.55$, CFI = 0.79 and RMSEA = 0.25) also indicated a very poor fit for the two-factor seven-item model based on the model assessment criteria. Analysis suggested that the items *resist client pressures to maintain independence* and *avoid dependency on certain clients* represent likely misspecifications of the model. Hence, CFA was conducted again with these two items deleted one-by-one until a satisfactory model was identified. The final results (i.e., $p = 0.19$, $X^2 = 6.07$, $df = 4$, $X^2/df = 1.52$, CFI = 0.99 and RMSEA = 0.06) suggested that the short version of the model was most appropriate for the current sample. Accordingly, it was used to examine Chinese business personnel's perceptions of audit independence and to

further examine their ethical judgments concerning tax aggression. The results of the Cronbach's alpha measure indicated that both audit independence in-fact (0.85) and in-appearance (0.83) were reliable.

4.4 Control variables

Four demographic control variables were included in the study: gender, qualifications, age and position in the firm. Gender (GEN) controlled for differences in the business ethics of the female and male respondents with respect to their judgments concerning corporate tax avoidance. Betz et al. (1989) and Peni & Vähämaa (2010) find firms with female CFOs to adopt a more conservative, risk-averse financial reporting style than their counterparts with male CFOs. Fallan (1999) observes that female students adopt a stricter attitude towards tax evasion than their male peers. It was thus likely that female respondents would tend to take a stricter view of corporate tax aggressiveness than their male counterparts. GEN takes a value of 1 if the respondent is female and of 0 otherwise.

Respondents' age (AGE) was included to control for the level of experience and monitoring capacity (Ferris et al., 2003). Cochran et al. (1984) claim that younger managers are perceived to have greater career growth opportunities because they are more likely, and willing, to make risky corporate decisions and undertake risky activities. Hence, younger managers may also be prepared to undertake risky activities in terms of tax aggression, and thus may have a stronger preference for such aggression.

The qualifications (QUAL) of respondents was also included as a control variable because it was expected that more qualified respondents would make more informed judgments regarding tax-aggressive planning and its effects on the firm and its shareholders. Finally, their position (POS) was included to control for differences in professional ability, knowledge and monitoring capacity with respect to corporate tax avoidance. Recent research (e.g., Frank et al., 2009; Dyreng et al., 2010) suggests that aggressive tax planning is associated with managerial opportunism and capabilities. Managers can use their professional ability and knowledge effectively to gauge whether firms are undertaking risky and aggressive tax planning activities and to monitor compliance with applicable tax laws (Carter et al., 2010).

4.5 Base regression model

Our base ordinary least squares (OLS) regression model is estimated as follows:

$$\text{CTA}_i \text{ or } \text{CTS}_i = \alpha_{0it} + \beta_1 \text{FG}_i + \beta_2 \text{RG}_i + \beta_3 \text{AUDIND}_i + \beta_4 \text{CLREL}_i + \beta_5 \text{GEN}_i + \beta_6 \text{AGE}_i + \beta_7 \text{QUAL}_i + \beta_8 \text{POS}_i + \epsilon_i \quad (1)$$

where:

i = respondents 1 through 174;

CTA = ethical judgment that firm is aggressively avoiding paying tax to the government from executive directors perspective based on two international cases (see Appendix C);

CTS	= ethical judgment that corporate tax planning from executive director's perspective is good for the firm and its shareholders based on two international cases (see Appendix C);
FG	= favour seeking <i>guanxi</i> comprised of three items;
RG	= rent seeking <i>guanxi</i> comprised of two items;
AUDIND	= external auditor independence comprised of two items;
CLREL	= external auditor and client relationship comprised of three items;
GEN	= a dummy variable of 1 if the respondent is female, otherwise 0;
AGE	= age of the respondent in years measured as 1 if the respondent is aged between 20–30 years, 2 if the respondent is aged between 31–40 years, 3 if the respondent is aged between 41–50 years and 4 if the respondent is aged from 51 years;
QUAL	= the highest qualification of the respondent scored as 1 if a bachelor degree, 2 if a post graduate master degree is held and 3 if a post-doctoral degree;
POS	= nature of position held in the firm scored as 1 through to 5 for each of non-independent board, independent board member, financial controller, department head, administration staff and accountant respectively;
ε	= The error term.

5. EMPIRICAL RESULTS

5.1 Descriptive statistics

Table 2 reports the descriptive statistics for the dependent variables (ethical judgment that the firm is aggressively avoiding paying tax (CTA) and ethical judgment that corporate tax planning is good for the firm and its shareholders (CTS)), the independent variables (favour-seeking *guanxi* (FG), rent-seeking *guanxi* (RG), auditor independence (AUDIND) and external auditor–client relationship (CLREL)), and control variables (GEN, AGE, QUAL and POS). Dependent variables CTA and CTS have a mean (standard deviation [s.d.]) of 5.51 (1.33) and 5.10 (1.44), respectively. FG has a mean (s.d.) of 7.95 (1.35), indicating that respondents strongly believed, on average, that the development and maintenance of a network of relationships with individuals likely to be useful in business was a necessary requirement for business success. Their perception was that business is conducted by and through networks held together by strong social relations. RG has a mean (s.d.) of 3.91 (2.11), indicating that respondents maintained a weak belief, on average, that bureaucratic privilege is acceptable and that dominant parties can make all decisions. AUDIND has a mean (s.d.) of 8.33 (1.41), suggesting that respondents strongly agreed, on average, that external auditors should be independent in performing audits and should conduct those audits with integrity and objectivity. Finally, CLREL has a mean (s.d.) of 7.65 (1.60), indicating that respondents strongly agreed, on average, that external

auditors should avoid a close relationship with clients, employment offers from clients and conflicts of interest involving clients. The mean, standard deviation and range of control variables are also presented in Table 2. An acceptable range of variation is observed for all variables, and there is a reasonable level of consistency between the means and medians, reflecting the normality of the distributions.

Table 2: Descriptive statistics—full sample

Variable	N	Mean	Std. Dev.	Minimum	Maximum
CTA	174	5.51	1.33	1	7
CTS	174	5.10	1.44	1	7
FG	174	7.95	1.35	1	9
RG	174	3.91	2.11	1	9
AUDIND	174	8.33	1.41	1	9
CLREL	174	7.65	1.60	1	9
GEN	174	0.48	.501	0	1
AGE	174	1.38	.521	1	4
QUAL	173	2.23	.436	1	3
POS	169	4.63	1.02	1	5

Variable definitions: CTA = ethical judgment that firm is aggressively avoiding paying tax to the government from executive directors perspective based on two international cases (see Appendix C); CTS = ethical judgment that corporate tax planning from executive director's perspective is good for the firm and its shareholders based on two international cases (see Appendix C); FG = favour seeking guanxi comprised of three items; RG = rent seeking guanxi comprised of two items; AUDIND = external auditor independence comprised of two items; CLREL = external auditor and client relationship comprised of three items; GEN = a dummy variable of 1 if the respondent is female, otherwise 0; AGE = age of the respondent in years measured as 1 if the respondent is aged between 20–30 years, 2 if the respondent is aged between 31–40 years, 3 if the respondent is aged between 41–50 years and 4 if the respondent is aged from 51 years; QUAL = the highest qualification of the respondent scored as 1 if a bachelor degree, 2 if a post graduate master degree is held and 3 if a post-doctoral degree; POS = nature of position held in the firm scored as 1 through to 5 for each of non-independent board, independent board member, financial controller, department head, administration staff and accountant respectively.

5.2 Correlation results

The Pearson pairwise correlation results are reported in Table 3. We find significant correlations (with predicted signs) between CTA and CLREL, between GEN and CTS and FG, and between CLREL and GEN. Table 3 also shows that only moderate levels of collinearity exist between the independent variables. We computed variance inflation factors (VIFs) when estimating our base regression model to test for signs of multicollinearity between these variables. No VIFs exceeded 5, and thus multicollinearity was deemed not to be a problem in our study (Hair et al., 2006).

Table 3: Pearson correlation results

	CTA	CTS	FG	RG	AUDIND	CLREL	GEN	AGE	QUAL	POS
CTA	1.00									
CTS	0.50**	1.00								
FG	0.12	0.23*	1.00							
RG	0.11	0.10	0.37**	1.00						
AUDIND	-0.01	0.05	0.47**	-0.07	1.00					
CLREL	0.20*	0.18*	0.49**	0.03	0.68**	1.00				
GEN	-0.16*	-0.14*	-0.14*	-0.03	-0.08	-0.12	1.00			
AGE	-0.02	0.00	0.16*	0.14*	0.08	0.12	-0.15	1.00		
QUAL	-0.02	0.04	0.08	-0.07	0.00	0.10	0.07	0.25*	1.00	
POS	0.03	0.01	-0.09	-0.06	0.07	-0.01	0.09	-0.35*	-0.03	1.00

Variable definitions: see Table 1 for variable definitions.

*, **, and *** indicate significance at the .10, .05, and .01 levels, respectively. The *p*-values are one-tailed for directional hypotheses and two-tailed otherwise.

5.3 Regression results

Table 4 reports the regression results for our base regression model. We find that CTA has a significantly positive association with FG ($p < .10$), RG ($p < .05$) and CLREL ($p < .10$), and a significantly negative association with AUDIND ($p < .10$). The respondents judged firms engaged in aggressive tax activities to be more likely to have established favour- and rent-seeking *guanxi* networks. Additionally, they judged that firms engaged in these activities also tended to have stronger client–auditor relations (auditor independence in-appearance) and weaker auditor independence (auditor independence in-fact). Thus, the results support H1a, H2a, H3a and H4a. We also find CTS to have a significantly positive association with FG ($p < .05$) and CLREL ($p < .10$). The respondents believed that tax aggressive activities are good for the firm and its shareholders when favour- but not rent-seeking *guanxi* relations were in place. These results support H1b, but not H2b. Further, respondents who believed that tax-aggressive activities are good for the firm and its shareholders tended to have stronger opinions about client–auditor relations (auditor independence in-appearance), thus supporting H4b. No significant difference is observed between CTS and AUDIND, and hence H3b is not supported. Moreover, female respondents tended to judge firms as less tax-aggressive than their male counterparts. The other control variables are not significant. Our model has variably significant predictors, but low absolute adjusted R-square values (8.8% or 14%), possibly because of the dispersion in those values around a line of best fit. Although the adjusted R-square values are small in absolute terms, they do not detract from the usefulness of our model, as we find a consistent and reliable association between CTA or CTS and the predictor variables.

Overall, our regression results show that the two types of *guanxi*, favour-seeking and rent-seeking, are significantly associated with ethical judgments about corporate tax aggressiveness. Perceptions of audit independence in-fact are significantly negatively associated with these ethical judgments, whereas audit independence in-appearance is

positively associated with them. Further, we find significantly positive relations to exist between perceptions that tax-aggressive activities are good for the firm and its shareholders and both favour-seeking *guanxi* and stronger client–auditor relations.

Table 4: Regression results—base regression model

$$CTA_i \text{ or } CTS_i = \alpha_{0i} + \beta_1 FG_i + \beta_2 RG_i + \beta_3 AUDIND_i + \beta_4 CLREL_i + \beta_5 GEN_i + \beta_6 AGE_i + \beta_7 QUAL_i + \beta_8 POS_i + \varepsilon_i$$

Variable	Predicted sign	CTA	Predicted sign	CTS
Intercept	?	.3.283 (2.914)**	?	.2.14 (1.736)*
FG	(H1a) +	.173 (1.850)*	(H1b) +	.263 (2.583)**
RG	(H2a) +	.107 (2.073)**	(H2b) +	.043 (.761)
AUDIND	(H3a) –	-.169 (-1.871)*	(H3b) –	-.118 (-1.215)
CLREL	(H4a) +	.163 (1.928)*	(H4b) +	.147 (1.731)*
GEN	?	-.374 (-1.819)*	?	-.352 (-1.556)
AGE	?	.088 (.398)	?	-.018 (-.074)
QUAL	?	.089 (.362)	?	.324 (1.207)
POS	?	.180 (1.675)	?	.080 (.668)
Adj. R ² (%)		14.00%		8.80%
N		174		174

Variable definitions: See Table 2 for variable definitions.

*, **, and *** indicate significance at the .10, .05, and .01 levels, respectively.

^aCoefficient estimates with the *t*-statistics in parentheses.

5.4 Robustness checks

We performed several robustness checks to assess the reliability of the regression results reported in Table 4. First, we carried out the Breusch–Pagan/Cook–Weisberg test for heteroskedasticity, as the variability of a dependent variable such as CTA or CTS may be unequal across the range of values of a predictor variable. This test tests the null hypothesis that the error variances are all equal versus the alternative that they are a multiplicative function of one or more variables. Using either CTA or CTS as the dependent variable, the Breusch–Pagan/Cook–Weisberg test indicated that our data is homoscedastic, as we obtained small chi-square values and non-significant *p*-values. Second, we dropped all of the control variables from the regression model, and obtained similar results for FG, RG, AUDIND and CLREL. Third, we entered the

control variables consecutively into the regression model,⁷ and our main findings remained unchanged. Finally, we added each of our four independent variables successively into the regression model to test the stability of the regression coefficients and robustness of our results. On the whole, the regression coefficients for FG, RG, AUDIND and CLREL were stable and statistically significant (with the predicted signs).

6. CONCLUSIONS

In this study, we examine the association between *guanxi* and audit independence and ethical perceptions of corporate tax aggressiveness in Chinese firms that operate in an international context. Based on a survey completed by 174 respondents in 2013, we find that two types of *guanxi*, favour-seeking *guanxi* and rent-seeking *guanxi*, are significantly associated with ethical judgments of tax aggressiveness. Perceptions of audit independence in-fact are significantly negatively associated with these judgments, whereas audit independence in-appearance is positively associated with them. Further, significantly positive relations exist between perceptions that tax-aggressive activities are good for the firm and its shareholders and both favour-seeking *guanxi* and stronger client-auditor relations. This study contributes to the literature on the importance of *guanxi* in influencing managerial activities, opportunism and business outcomes. It also empirically demonstrates that audit independence and the client–auditor relationship play a critical role in influencing managerial behaviour.

This study is subject to several limitations. First, the sample was drawn from respondents asked to make judgments regarding *guanxi*, auditor independence and tax avoidance as if they were the CEO of a firm. Second, our base regression model may have been incomplete. For example, the role of tax authorities could have an effect on international tax avoidance activities. Future research should consider this issue.

⁷ Entering control variables progressively into a regression model provides an indication of whether a particular control variable is significantly driving the model outcomes (Hair et al., 2006).

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8. APPENDICES

8.1 Appendix 1: *Guanxi* orientation

a. Favour-seeking *guanxi*

- 1) In business, it is important to maintain a good network of relationships
- 2) Maintaining good relationships is the best way to enhance business
- 3) Doing business involves knowing the right people
- 4) Developing the right contacts helps in the smooth running of a business

b. Rent-seeking *guanxi*

- 1) Back-door deals are alright as long as those involved in the process benefit
- 2) Bureaucratic privilege, which benefits some parties at the expense of others is to be expected
- 3) It is acceptable behaviour for the dominant parties to a deal to make all the decisions.

(Source: Fan et al., 2012b)

8.2 Appendix 2: Code of professional ethics

Do you regard it as reasonable to expect auditors:

a. Independence in-fact

- 1) to be independent in performing an audit?
- 2) to act with integrity and objectivity in performing an audit?
- 3) to resist clients' pressures to maintain independence?

b. Independence in-appearance

- 4) to avoid a close relationship with clients?
- 5) to avoid an employment offer from a client?
- 6) to avoid dependency on fees from certain clients?
- 7) to avoid a conflict of interest with clients?

(Source: Fan et al., 2012c)

(The *guanxi* scale is extracted from survey questionnaire. The respondents were asked to circle the one answer that best describes his/her view of each question using a nine-point Likely scale from 'Strongly disagree' (1) to 'Strongly agree' (9)).

8.3 Appendix 3: Corporate tax aggression cases

Situation 1

Company A manufactures steel in China. It is listed on the Shanghai stock exchange. The management of Company A decides to list on the New York Stock exchange and establish an offshore subsidiary in the British Virgin Islands (BVI). BVI is characterised by secrecy laws making it difficult for tax authorities to trace the flow of profits from a company to the BVI and then back to mainland China. Thus Company A transfers profits to a holding company in the BVI and waits for two years, when it then sends the profits back to mainland China disguised as 'foreign investment', which is either not taxed or taxed at a lower rate than in China.

Situation 2

Company A also establishes a subsidiary in Hong Kong, which is listed on the Hong Kong stock exchange. Company A makes large profits which are sent to a subsidiary in Hong Kong. The transfer of funds from Company A to the Hong Kong company is disguised as service fees or dividends. Management of company A has sent the funds to Hong Kong because they are subject to relatively

lower corporate tax rates (16.5% in Hong Kong as opposed to 25% in mainland China) meaning that overall tax payable for the corporate group is lower. At the same time, the Hong Kong company borrows funds in Hong Kong and then sends the funds back to company A for its use. Company A can claim a greater corporate tax deduction on the borrowed funds owing to the tax rate differences between China and Hong Kong.

Assume you are currently an executive director working for Company A who had nothing to do with the establishment of any of the above tax arrangements. Please answer each question, circling **one** number that best describes the extent of your agreement.

1. I believe that Company A is aggressively avoiding paying tax to the government with respect to **Situation 1**.

1	2	3	4	5	6	7	8	9
Strongly Disagree								Strongly Agree

2. I believe that Company A is aggressively avoiding paying tax to the government with respect to **Situation 2**.

1	2	3	4	5	6	7	8	9
Strongly Disagree								Strongly Agree

3. In respect of **Situation 1**, I believe that the business strategy of Company A is good for the firm and all of its shareholders.

1	2	3	4	5	6	7	8	9
Strongly Disagree								Strongly Agree

4. In respect of **Situation 2**, I believe that the business strategy of Company A is good for the firm and all of its shareholders.