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Income Tax at 100 Years : Essays and Reflections on the Income War Tax Act

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Jinyan Li

INTERNATIONAL
TAXATION IN
CHINA



A Contextualized Analysis

IBFD

International Taxation in China: A Contextualized Analysis

Why this book?

Chinese tax law affects corporations engaged in cross-border transactions with China. It may also impact the development of the international tax regime as China is increasingly engaged in international tax reform efforts, such as the G20/OECD BEPS Project. Chinese tax law is thus important to taxpayers, tax professionals and policymakers worldwide. However, it is a challenge to find comprehensive information and insightful analysis of Chinese tax law in English. *International Taxation in China: A Contextualized Analysis* meets that challenge.

This book deals with the Chinese international tax regime, focusing on the enterprise income tax and tax treaties. First, it covers the standard topics: inbound and outbound rules, withholding taxes, transfer pricing, tax avoidance, and base erosion and profit shifting. It then sets forth the technical tax rules in their specific Chinese legal and institutional context, for example, the approach of Chinese courts to the interpretation and application of tax law and the crucial role played by the State Administration of Taxation, which are significantly different from the role of their counterparts in Western countries. Examples, tables and detailed footnotes are used to help explain the rules in the legislation and the law in practice. Throughout the work, the author seeks to shed light on the Chinese way of thinking about international taxation.

"In sum, this book is a mature work by a scholar at the top of her game. For anyone with an interest in Chinese international taxation, the book is rewarding on several levels; for anyone with a professional need to understand Chinese international tax policy and practice, the book should be your 'go-to' source." (Preface by Brian J. Arnold)

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Foreword

This is the second time that I have had the opportunity to provide a foreword for a book by Jinyan Li. The first time was in 2003; I am pleased and honoured to be asked to say a few words about her latest book.

I have known Jinyan since 1991. She is a former colleague, a friend and a collaborator on several articles and projects, most recently on projects for the United Nations. Jinyan is a remarkable person and is at the peak of a remarkable career. She arrived in Canada from China in 1985 as a graduate student and only a few years later was teaching tax law with me at a Canadian law school. She was a prolific scholar from the outset – her first book, *Taxation of Foreign Investment in the People's Republic of China* (with Alex Easson), was published in 1989, and a second, *Taxation in the People's Republic of China*, in 1991. However, Jinyan did not want to be known solely as an expert on Chinese tax law; she was determined to become an expert in Canadian and international tax law as well, and in this she has succeeded brilliantly. She is recognized among the front rank of comparative tax researchers, the author of *International Taxation in the Age of Electronic Commerce: A Comparative Study* (2003) and a co-author of the leading text on Canadian income tax law (P.W. Hogg, J.E. Magee and J. Li, *Principles of Canadian Income Tax Law*, now in its 7th edition). Her expertise, particularly with respect to tax reform in China, has led to consultancies with the International Monetary Fund (IMF), the OECD and the United Nations.

The present book deals with international taxation in China, focusing almost exclusively on the enterprise income tax (EIT) and tax treaties. It is an excellent reference work for those unfamiliar with Chinese international tax, and the standard topics – technical aspects of the EIT and China's treaties, inbound and outbound rules, withholding taxes, transfer pricing, tax avoidance, and base erosion and profit shifting (BEPS) – are thoroughly covered. The author also describes the approach of Chinese courts to the interpretation and application of tax law and the crucial role played by the State Administration of Taxation (SAT). The roles of Chinese courts and the SAT are significantly different from the role of their counterparts in Western countries, and it is critically important for investors in China and their professional advisers to understand how they operate.

But the book is not merely descriptive. The author has taken a comparative, contextual approach to her subject. China has had an income tax law

only since 1980, and the EIT is a “legal transplant” – that is, most of its technical features and principles have been borrowed directly from the international tax laws of other countries. However, the Chinese legal and institutional culture remains very distinct. Throughout the book, the author demonstrates how this cultural context affects the way the EIT works in practice (as she puts it, “any gap between tax rules on paper and tax rules in action may be quite significant”). She also explains in detail the tax policy aspects of the EIT, noting that with China’s rise as a world economic power, it is now in a position to influence developments in international tax, as well as to be influenced by them.

This book benefits from Jinyan’s long experience as a tax academic and reflects her mastery of both Chinese and international tax law. The book’s frequent comparisons of the Chinese approach to international tax with those of other countries and emphasis on the how the EIT and China’s tax treaties actually work in practice make it a valuable tool for tax professionals. It is well written and refreshingly free from academic jargon. In sum, this book is a mature work by a scholar at the top of her game. For anyone with an interest in Chinese international taxation, the book is rewarding on several levels; for anyone with a professional need to understand Chinese international tax policy and practice, the book should be your “go-to” source.

Brian J. Arnold
Senior Adviser
Canadian Tax Foundation
Toronto, Canada
March 2016

Preface

Writing this book has been a most enjoyable experience. I am amazed by how much the Chinese tax system has matured and how sophisticated Chinese tax scholarship has become over the past two decades. I felt empowered to tackle the subject as a “hybrid”: a Chinese-educated, Canadian-trained and internationally exposed tax researcher. Writing this book has further made me realize that the world of international taxation may be quite simple at a high level but is very complex on the ground. After all, tax law is merely an instrument, and its functions differ based on the underlying cultural values, national interests and policy objectives of different countries. I could not believe my good fortune in being able to work with Chinese international tax materials and appreciating (at least I think) where they are coming from. I have tried to function as a “conduit” between the Chinese international tax system and those of the West.

Writing this book has also been a humbling experience. I learned how much more I need to learn. I am also in awe of the power of modern technologies that bring so much tax research information (both in Chinese and in English) to my fingertips. When I wrote my books on Chinese taxation in the late 1980s and early 1990s, I had to travel to China for research. This time, most of my “travels” were online.

This book deals with international taxation in China, focusing on the enterprise income tax (EIT) and tax treaties. This is largely because the international aspects of the individual income tax (IIT) are rather simplistic and are likely to be reformed in the near future. The international aspects of the EIT reflect the Chinese thinking on international taxation. Even though the base erosion and profit shifting (BEPS) initiatives will lead to some changes, these changes will reinforce the fundamental values and principles of the current system. For that reason, this book takes a contextual approach to presenting the technical materials.

This book covers the standard topics of international taxation. In order to situate the technical discussions, the book explains the Chinese context in terms of the meaning of tax law, the role of the courts, the functions of the State Administration of Taxation (SAT) and the investment and business environment for inbound and outbound transactions. To make the book accessible to readers, I have included examples, tables and a consolidated presentation of the EIT Law and EIT Implementation Regulations. Research sources and references are in the footnotes and appendixes.

The research conducted for this book is part of a larger tax transplant project (with Thaddeus Hwong) funded by the Social Sciences and Humanities Research Council (SSHRC) of Canada. A team of excellent student researchers assisted me in this project. Stephen Xiaoyi Ji, Christina Huaning Li, Leo Xin Xu and Robert Watkins assisted with research. Nicholas McIsaac and Patrick Egit edited earlier drafts of the manuscript and shared with me their enthusiasm and good humour. I owe special thanks to Murphy Lai Jiang, who carefully tracked down the Chinese original of each source cited in the footnotes, double checked the English translation and ensured compliance with IBFD publication style and formatting.

My understanding of the Chinese tax system has benefited greatly from the input of many individuals, including a number from the SAT, as among them JIN Dongsheng, LIAO Tizhong, TAN Heng, WANG Yukang, ZHANG Zhiyong and XU Shanda. It was enriched from reading the work of such scholars as CUI Wei, LIU Jianwen, LIAO Yixin, QIU Dongmei, TANG Gongliang and XIONG Wei. In addition, students who took my Chinese International Taxation course at the University of Sydney and Tsinghua University asked many challenging questions, which stimulated further research. State Shi, a practitioner of Chinese tax and a former student, kindly reviewed some of the draft chapters.

The best way to learn is to teach. Over the years, I have participated in the training of Chinese tax officials and consultancy missions with the IMF, the OECD, the Asian Development Bank and the United Nations. These were all extremely valuable learning opportunities for me, even though I was the “teacher” and “expert”. I learned to appreciate the Chinese way of thinking about taxation and international tax relations, the difference between “rule by law” and “rule of law” and the implications of this difference for the tax system. I also observed first-hand the impressive development of the tax system and tax talent in China. I want to thank Victor Thuronyi of the IMF for the opportunity of serving my first mission to China, in 1992.

I am privileged to have IBFD publish this book. I have been associated with a number of IBFD publications in the past and rely on its products in my research. Jane Kerr of IBFD has been extremely helpful in setting the framework and the “tone” for this book and, more importantly, in tolerating my repeated delays in finishing the manuscript. I want to thank her. I also want to thank an anonymous reviewer who provided constructive feedback on an earlier draft. Marek Kruk-Strzelecki, Werner Kapp and

Chris McLaren did a wonderful job editing the manuscript and saving me from some embarrassing errors.

Any work of this nature and size is bound to have some errors. I remain solely responsible for them.

Brian Arnold is a mentor and friend. I thank him for giving me an opportunity to become his colleague in 1991 and introducing me to the wonderful world of international taxation, and I cannot thank him enough for writing the Foreword for this book. Neil Brooks supervised my doctoral dissertation and has been an inspiration and role model for me ever since. I want to dedicate this book to him.

My joy in writing this book is vicariously shared by my husband, Alex, and my daughter, Joan-Shiao, as my progress (or lack of it) was often part of our dinner conversations. They have been great cheerleaders. Without their love and support, I would not have had enjoyed it that much.

Jinyan Li
Toronto, Canada
April 2016

Sample chapter

Chapter 1

Introduction

1.1. Purpose of this book

This book is about international taxation in the People’s Republic of China (“China”).¹ It examines the international aspects of the enterprise income tax (EIT)² system and Chinese double tax agreements or arrangements (DTAs). It does not discuss in any detail the individual income tax (ITT), although DTA provisions concerning individual incomes are explained in chapter 5.

This book covers the standard topics of international taxation, ranging from tax jurisdiction to transfer pricing and base erosion and profit shifting (BEPS). It is intended to provide readers with a rich, contextualized analysis of technical and policy features of the Chinese domestic and treaty rules as well as a sense of their practical implications.

Readers of this book are assumed to be tax professionals, students, researchers or policy makers. Chinese international taxation is important for various reasons. The rise of China as a leading capital importer and capital exporter means that the Chinese tax treatment of cross-border transactions is a real, practical issue. China has transformed from being a norm-taker (an importer of international tax norms) to being a norm-shaker (a meaningful contributor to the reform of such norms, as evidenced in the G20/OECD BEPS Project). Such transformation makes it imperative for the international community to better appreciate where China is coming from, and perhaps more importantly, where China might be heading in terms of defining its claim over the international income tax base. After all, the Chinese international tax rules regulate not only the relationship between tax-

1. This book does not cover Hong Kong, Macau or Taiwan, because they are regarded as “foreign” jurisdictions for purposes of domestic tax laws and tax treaties. China has entered into a tax arrangement with Hong Kong and Macau and negotiated one with Taiwan. For further discussion, *see* chs. 4 and 5.

2. CN: 中华人民共和国企业所得税法 [Enterprise Income Tax Law of the People’s Republic of China] 2007 (“EIT Law”); and CN: 中华人民共和国企业所得税法实施条例 [Implementation Regulations of Enterprise Income Tax Law of the People’s Republic of China] 2007 (“EIT Regulations”). A consolidated text of the EIT Law and EIT Regulations in English and Chinese is provided in appendix A. A summary of the individual income tax is provided in appendix B.

payers and the Chinese government but also the relationship between China and other countries. In light of China's rising economic (and political) influence and the Chinese approach to relationships, which is different from the Western approach in many respects, one ignores China at one's peril.

1.2. Structure and content

1.2.1. Structure

There are 11 chapters in this book. Chapters 2 and 3 lay the foundation for the rest of the book. Chapters 4 and 5 discuss tax treaties and treaty interpretation. Chapters 6-9 examine the inbound and outbound rules. Chapters 10 and 11 analyse two main anti-avoidance rules – transfer pricing and the general anti-avoidance rule (GAAR) – and China's efforts in reforming these rules in light of the G20/OECD BEPS recommendations.³

1.2.2. Overview and tax treaties

Chapter 2 discusses the EIT as a policy instrument in terms of its technical design, its role in raising revenue and regulating economic activities and its application by the State Administration of Taxation (SAT) and the courts. It also discusses the somewhat unique relationship between taxpayers and the tax authorities and processes of resolving tax disputes. More specifically, chapter 2 highlights the role of the SAT and Chinese courts in the EIT system. Chinese legal, institutional and cultural background is offered to emphasize the importance of Chinese context for applying those rules that may appear familiar to readers. It then presents the *CIMFRA* case⁴ to illustrate this point.

Chapter 3 provides an overview of the main features of the EIT in general and the international tax aspects in particular. It highlights the hybrid nature of the EIT: transplants of foreign rules and local Chinese features.

Chapter 4 presents a comprehensive review of the evolution of the treaty network, the relationship between tax treaties and domestic law, and treaty

3. For final BEPS reports prepared by the OECD and approved by G20 summit, *see* OECD, *BEPS 2015 Final Reports* (OECD 2015). China's reaction to BEPS measures is discussed in ch. 10 and ch. 11.

4. For a discussion of the *CIMFRA* case, *see* ch. 2.

interpretation principles and practices. It discusses two important international tax cases in China – *PanAmSat*⁵ and *Donghwa*.⁶

Chapter 5 provides a high-level discussion of the provisions of Chinese DTAs and the SAT's interpretation of these provisions. It also examines the anti-abuse rules in the DTAs and the SAT's practices.

1.2.3. Inbound rules

Chapters 6 and 7 look at the inbound rules. As with chapters 8 and 9, they explain the substantive rules and identify the design features, legislative scheme and policy, notable Chinese characteristics, and the regulatory and business context for the application of these rules.

Chapter 6 focuses on non-resident enterprises doing business in China through a physical presence (such as a business establishment, project site or business agent). It provides an in-depth analysis of the permanent establishment and attribution of profit provisions of DTAs.

Chapter 7 is about withholding taxes on payments to non-resident enterprises. These payments include dividends, interest, royalties and certain service fees. In addition, Chinese-source gains from the transfer of property are subject to withholding tax. Treaty relief under articles 10, 11, 12 and 13 of DTAs is discussed. Chapter 7 also discusses anti-treaty abuse measures in the DTAs and the GAAR in the context of offshore indirect transfers.

1.2.4. Outbound rules

Chapter 8 focuses on the taxation of resident companies, including foreign-invested companies (FICs), and the tax treatment of foreign-invested partnerships (FIPs). FICs and FIPs are the dominant vehicles for foreign direct investment (FDI) in China. Technically, FICs are residents of China for EIT purposes. Because of the foreign equity ownership, FICs are subject to certain specific rules, most of which are anti-avoidance rules, such as transfer pricing rules, thin capitalization rules and the GAAR. FIPs are flow-through entities for EIT purposes, and the applicable tax rules are

5. For a discussion of the *PanAmSat* case, see ch. 4.

6. For a discussion of the *Donghwa* case, see ch. 4.

currently less sophisticated. The chapter explores the taxation of the entities as well as the non-resident investors.

Chapter 9 discusses the taxation of resident companies earning foreign-source income. It notes the fact that the outbound rules are less sophisticated than the inbound rules. The main reason is that, until recently, China was a net capital importer and emphasized source-based taxation. The outbound rules examined in chapter 9 are the direct and indirect foreign tax credit rules and controlled foreign corporation (CFC) rules. The foreign tax credit rules provide relief from international double taxation, while the CFC rules prevent international tax avoidance. These rules are currently being strengthened in efforts to implement the BEPS recommendations. The chapter also presents the only court decision on transfer pricing – the *ZFC* case.⁷

1.2.5. Transfer pricing, GAAR and BEPS

Chapter 10 is devoted to transfer pricing. Transfer pricing is an area currently undergoing significant changes. The chapter explains the somewhat unique Chinese approach to transfer pricing. In addition to discussing the transfer pricing issues and the transfer pricing methods, this chapter discusses why the SAT regards location-specific advantages (LSAs) as relevant in transfer pricing assessment and how the SAT identifies, evaluates and allocates profits to intangibles. It also presents the proposed country-by-country (CbC) reporting measures. The discussions make reference to a Public Consultation Draft of Special Tax Adjustment Measures released by the SAT in September 2015.⁸

Chapter 11 discusses the GAAR and its significance in the Chinese international tax system. It examines the design of the GAAR and the SAT's interpretation in specific tax avoidance scenarios. Some of the discussion revisits the importance of Chinese legal, institutional and cultural contexts, as the application of the GAAR is closely linked to these concepts.

7. For a discussion of the *ZFC* case, see ch. 10.

8. CN: 特别纳税调整实施办法(征求意见稿)[Measures for the Implementation of Special Tax Adjustments (Consultation Draft)] 2015(“Special Tax Adjustment Measures(Consultation Draft)”). This document is to replace an earlier version of the measures, CN: 国税发[2009]2号, 国家税务总局关于印发《特别纳税调整实施办法(试行)》的通知 [Guoshuifa [2009] No. 2, Measures for the Implementation of Special Tax Adjustments (Trial)].

Both chapters 10 and 11 address the issue of BEPS and China's localization measures. Transfer pricing rules and the GAAR are the main legal instruments for the SAT to combat BEPS problems. At the time of writing (April 2016), the SAT has made bold moves in making China's concerns known to the global community while taking concrete steps in protecting China's tax base and national interest.

1.3. Analytical approach

1.3.1. An outsider's approach

This book is written from the perspective of an "outsider" who has been studying Chinese tax law⁹ since the mid-1980s and played a very modest role in its development.¹⁰ This perspective is informed by the analytical framework of comparative law and legal transplants. It is shaped by the author's innate instinct of looking at things in their context and in light of their original intent and purpose. This perspective has also benefited tremendously from three decades of teaching and writing about Canadian and international tax law.¹¹

The study of tax transplants or comparative tax law is relatively recent.¹² Largely owing to language barriers and the complexity of tax laws, com-

9. Other books by the author include: A. Easson & J. Li, *Taxation of Foreign Investment in the People's Republic of China* (Kluwer 1989); J. Li, *Taxation in the People's Republic of China* (Praeger 1991) ("Li (1991)"); and *China's Tax Reform Options* (T. Fulton, D. Xu & J. Li eds., World Scientific 1998). The author also co-writes (with Su Tian) the China chapter of the IBFD online publication on Transfer Pricing (J. Li & T. Su, *China (People's Rep.) – Transfer Pricing*, Topical Analyses IBFD) and contributes regularly to the Bulletin for International Taxation on Chinese tax issues.

10. The author has been an expert consultant on missions organized by the International Monetary Fund, Asian Development Bank and the United Nations to China in connection with tax reforms. She has also participated in training missions organized by the IMF and the OECD.

11. See, for example, P.W. Hogg, J.E. Magee & J. Li, *Principles of Canadian Income Tax Law, 4th-8th editions* (Carswell); B.J. Arnold, T. Edgar & J. Li, *Materials on Canadian Income Tax, 10th edition* (Carswell 1993); J. Li, A. Cockfield & J.S. Wilkie, *International Taxation in Canada, 1st-3rd editions* (LexisNexis 2014); J. Li, *International Taxation in the Age of Electronic Commerce: A Comparative Study* (Canadian Tax Foundation 2003); and R.L. Doernberg, W. Hellerstein, L. Hinnekens & J. Li, *Electronic Commerce and Multijurisdictional Taxation* (Kluwer Law International 2001).

12. O. Marian, *The Discursive Failure in Comparative Tax Law* 58 Am. J. Comp. L., p. 415 (2010); R.S. Avi-Yonah, N. Sartori & O. Marian, *Global Perspectives on Income Taxation Law* (Oxford 2011); H. Ault & B.J. Arnold, *Comparative Income Taxation: A*

parative tax law research is “torturous”.¹³ It is perhaps more so in respect of Chinese tax laws for both Chinese and non-Chinese speakers. For Chinese speakers, reading international tax materials is like reading a foreign language, because legal transplants resulted in the translation of a large amount of foreign rules and terms literally into Chinese. The words are familiar, but the concepts are foreign. For non-Chinese speakers, studying Chinese tax law is not easy because of the lack of materials published in English.

This book suffers much less from these barriers, although it is not immune to them.¹⁴ The author approaches the Chinese tax system with sufficient knowledge about foreign tax rules and understands the tax language, whether it is Chinese or English.

1.3.2. Analysing the EIT as a legal transplant

1.3.2.1. Evidence of legal transplant

The EIT is largely a legal transplant. “Legal transplant” is a term coined by Alan Watson to refer to the “moving of a rule or a system of law from one country to another, or from one people to another”.¹⁵ There is a rich body of literature documenting the evidence of legal transplants as the “most fertile source of legal change in the world”.¹⁶

The idea of an income tax was transplanted into China in the late 1920s,¹⁷ but the first income tax law was enacted in 1980.¹⁸ China’s traditional tax

Structural Analysis, 3rd edition (Kluwer Law International 2010); V. Thuronyi, *What Can We Learn from Comparative Tax Law?* 103 Tax Notes, p. 459 (2004); and M.A. Livingston, *Law, Culture, and Anthropology: On the Hopes and Limits of Comparative Tax* 18 Can. J. L. & Jur., p. 119 (2005).

13. Ault & Arnold, id.

14. The author of this book is certainly not alone in being able to do this kind of research. There are a growing number of researchers who have published in English about Chinese tax laws. Their work is referred to throughout this book.

15. A. Watson, *Legal Transplants: An Approach to Comparative Law* p. 95 (University of Georgia Press 1974).

16. E.g. O. Kahn-Freund, *On Uses and Misuses of Comparative Law in Selected Writings/Otto Kahn-Freund* (Carswell 1978); and J. Chen, *Modernisation, Westernisation and Globalisation: Legal Transplant in China in One Country, Two Systems, Three Legal Orders: Perspectives of Evolution* p.91 (J. Oliveira & P. Cardinal eds., Springer 2009).

17. Li (1991), *supra* n. 9.

18. CN: 中华人民共和国中外合资经营企业所得税法 [Income Tax Law of the People’s Republic of China Concerning Chinese-Foreign Equity Joint Ventures] 1980 (invalid as from 1991)(“EJVIT Law”).

system¹⁹ originated in 2023 BC, when the first state was created. It was home-grown until after the first Opium War, in 1842.²⁰ After the Opium Wars, Western influences became a factor and China introduced a toll charge (*li jin*), stamp duties and customs duties. In 1928, income tax legislation was drafted, but never enacted, by the nationalist (or Guomindang) government. All taxes were abolished and replaced with a new system soon after the establishment of the People's Republic. The function of taxation diminished when the socialist economic structure was entrenched and private ownership of property and entrepreneurship were limited. During the late 1970s, when China embarked on the path of economic reforms, taxation was revived when non-public actors were allowed to operate in the economy and some individuals were allowed to become rich. A reference to income tax was made in the 1979 Chinese-Foreign Equity Joint Venture Law.²¹

The Chinese-foreign equity joint venture income tax (EJVIT)²² was introduced in 1980, and it is the seed of the current EIT. The EJVIT includes features found in income tax laws of other countries but is not a carbon copy of any specific country's law. The structure of the EJVIT law and many key concepts reflect international tax norms.²³ American tax scholars such as Harvey Dale, Oliver Oldman, Stanley Surrey, Richard Pomp and Jerome Cohen were among the early international experts who provided training to Chinese officials.²⁴ Evidence of their teachings can be found in the EJVIT law. Subsequent income tax laws, especially the 2007 EIT Law, continue to include foreign tax principles, norms, concepts and rules. As such, the EIT is a hybrid of home-grown and transplanted rules.

19. Traditional taxes include land taxes and excises on salt, tea, liquor and other goods.

20. For an excellent account of the history of taxation in China and its relationship to culture, see L. Weng, 纵横捭阖-中国财税文化透视, 第二版 [*Comprehensive Analysis of Chinese Fiscal and Tax Culture 2nd edition*] (China Financial and Economic Publishing House 2011) (in Chinese).

21. CN: 中华人民共和国中外合资经营企业法 [Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures] 1979 (amended 1990, 2001). It states in article 8: "From the gross profit earned by an equity joint venture, after payment of the venture's income tax in accordance with the provisions of the tax laws of the People's Republic of China ... the net profit shall be distributed to the parties to the venture in proportion to their respective contributions to the registered capital."

22. EJVIT Law, *supra* n. 18.

23. See Easson & Li, *supra* n. 9.

24. R.D. Pomp and S.S. Surrey, *The Tax Structure of the People's Republic of China*, 20 Virginia J. of Intl. L. 1 (1979).

Evidence of tax transplants goes beyond formal laws. The interpretation of domestic laws by reference to international tax norms and best practices is often adopted. One example is the Special Tax Adjustment Measures (Consultation Draft).²⁵ This document reflects the international tax norms on transfer pricing, thin capitalization and controlled foreign corporation rules. China's extensive tax treaty network also encourages the convergence of Chinese tax laws with those of other countries.

1.3.2.2. The common core of international taxation

The EIT contains tax rules that are viewed as “autonomous”, capable of being incorporated into any country's corporate income tax system, and thus form a common core of an international tax regime. As explained further in chapter 2, the architectural design and technical features of the EIT are in line with the international norm. For example, a corporation is taxed as a separate person, a standard international norm. The scope of Chinese tax jurisdiction is defined by residence of the corporation and source of income. The transfer pricing provisions read similar to those found elsewhere.

1.3.2.3. The local context

Analysis of the EIT is insufficient and incorrect if it is done without due consideration of the Chinese local context. The transplantation of the common core of international taxation does not mean the transplants remain unchanged in China. Even if the transplants remain unchanged in form, they inevitably acquire some Chinese characteristics in reality, due to the cultural context in China.

As a policy instrument, the EIT is used to achieve objectives that are sensitive to China's national interests. Because tax laws depend on general laws (such as corporate law, contracts, property law and administrative law), the application of the “common core” provisions of the EIT may be shaped by the unique Chinese legal context.

More importantly, the transplantation of the common core does not necessarily lead to convergence in the institutions or processes for tax law in general. This means that transplanted tax laws are formulated and administered by institutions through processes that are as divergent as before. As

25. Special Tax Adjustment Measures (Consultation Draft), *supra* n. 8.

discussed in more detail in chapter 2, the administrative system in China and the legal and institutional culture in China have not changed much.²⁶ As such, the gap between tax rules on paper and tax rules in action may be quite significant. “Tax administration matters – a lot!”²⁷ In China, this is particularly true.

1.3.3. Chinese insiders’ perspective

1.3.3.1. Research sources

This book discusses Chinese international tax rules by relying on Chinese local materials. The Chinese perspective developed from synthesizing such materials informs the discussions and analysis throughout this book. The Chinese materials include legislative materials and secondary sources. Most of the materials are produced by the SAT. Other sources include journal publications, popular media reports and court cases.

The SAT is the primary source of information on Chinese international taxation. It plays a critical role in drafting tax law, making legislative interpretation, administering the tax legislation and resolving tax disputes. As such, the SAT’s publications provide valuable insights. During the past decade or so, the SAT has become increasingly transparent through the publishing of its views on its website (chinatax.gov.cn) and in print publications.²⁸ As explained in more detail in chapter 2, the SAT’s “informal” views are often regarded as “law”, even if they do not have the formal status of legislation. More importantly, perhaps, under Chinese law, some of the SAT’s pronouncements do have the status of legislation and the force of law.²⁹ This is a unique feature of Chinese tax law. These SAT measures give meaning to domestic legislation and treaty provisions and fill in legislative gaps.

Court cases are not a formal source of law. There are few tax cases in general. However, the four cases related to international taxation (i.e. *CIMFRA*, *Donghwa*, *PanAmSat* and *ZFC*) are fascinating, in that they

26. See ch. 2.

27. R. Bird, *Taxation and Development*, The World Bank 34, p. 4 (Oct. 2010).

28. In the SAT system, China Tax Press publishes books, China Taxation Magazines publishes: 中国税务 [journal China Taxation], 涉外税务 [journal International Taxation in China] and 税务研究 [journal Taxation Research], and China Taxation Newspaper Publisher publishes 中国税务报 [China Taxation News].

29. See ch. 2.

provide an inside view of the Chinese tax dispute resolution process. These cases also highlight the fact that transplanting foreign processes and institutions presents a greater challenge than transplanting technical tax rules.

Scholarly tax research in China is wide in coverage and huge in quantity. In spite of some excellent pieces, in general, as noted by a Western-trained researcher, “there is little professional writing that goes beyond the regurgitation of written rules”.³⁰ However, some writings by Chinese researchers are impressive and insightful.

Views published on websites and blogs can also be informative, even though it is sometimes difficult to verify the authenticity of the sources. They are occasionally relied on in this book when no other research sources are available.

In addition to Chinese materials, this book benefits from the timely briefings in English about Chinese tax developments by professional firms, as well as thoughtful commentaries in English by tax practitioners in China.

1.3.3.2. Critical analysis

This book discusses Chinese international tax rules as they appear in legislation, as well as in practice. It situates the discussions in the Chinese context. Research materials are critically evaluated and analysed. Great care was taken in ensuring the accuracy of the sources.

This book does not take positions on controversial issues such as BEPS. Instead, it presents the issues as they are and explains the Chinese approach to such issues. It aims at informing readers and inviting them to draw their own conclusions.

1.3.4. (Implicit) comparative approach

This book is not about comparative taxation. It does not explicitly compare the Chinese international tax rules with those of another country or the international tax regime evidenced in the OECD or UN Model Tax

30. W. Cui, *Two Paths for Developing Anti-Avoidance Rules*, 17 Asia-Pacific Tax Bull. 1 (2011), Journals IBFD.

Convention.³¹ However, this book strives to make it easier for readers to compare the Chinese rules with the rules of their home jurisdiction or treaty rules by following the basic structure of international taxation (i.e. inbound rules, outbound rules, transfer pricing and anti-avoidance rules). Identifying similarities and differences through such comparisons makes it easier to understand the Chinese rules. As such, an implicit comparative approach is encouraged on the part of readers.

This book makes explicit comparisons in some areas to highlight, inter alia, the influence of international tax norms in China, the “openness” of Chinese law drafters to advanced foreign ideas and the possible direction of Chinese tax reform. Canada and the United States are used as comparators for the simple reason that the author is more familiar with these two jurisdictions, especially Canada. Such comparative discussions are meant to be illustrative only.

1.4. Scholarly ambitions and practical aspirations

1.4.1. Scholarly ambitions

This book aims at contributing to knowledge by providing a contextualized analysis of the Chinese international tax system. More specifically, it aims to add to the literature on comparative tax law in several ways. To begin with, it lends support to the school of thought in comparative law which maintains that the process of legal transplantation is indicative of the autonomy of law.³² Many international tax rules are incorporated into the EIT.

More significantly, this book shows that law, including corporate income tax law, is embedded in society and that, therefore, legal transplants can survive and thrive only if there is a fit between them and the environment of the borrowing country. The discussions in this book lend support to the claim that “law is deeply ensconced in a particular cultural context”.³³ Throughout this book, the inherent logic of the transplanted rules, such as jurisdictional rules, foreign tax credit rules and transfer pricing rules, is

31. See *OECD Model Double Taxation Convention on Income and on Capital* (2014), Models IBFD; and *United Nations Model Double Taxation Convention between Developed and Developing Countries* (2011), Models IBFD.

32. A. Watson, *From Legal Transplants to Legal Formants*, 43 *Am. J. Com. L.* 3, p. 469 (1995).

33. Kahn-Freund, *supra* n. 16.

revealed, but, at the same time, the “local” modifications to suit China’s needs are discussed.³⁴

This book also shows the validity of the theory of co-evolution of the transplant and local culture:³⁵

“Legal irritants” cannot be domesticated; they are not transformed from something alien into something familiar, not adapted to a new cultural context, rather they will unleash an evolutionary dynamic in which the external rule’s meaning will be reconstructed and the internal context will undergo fundamental change.

The transplantation of corporate income tax in 1980 triggered a transformation of relationships between enterprises and the government in China. Transplanted tax rules, such as transfer pricing rules, unleashed an evolutionary process in China that led to a reimagination of the arm’s length principle that underlay transfer pricing rules.³⁶ Similarly, the transplanted GAAR has been reconstructed from a tax shield (preventing abuse of the law) to a double-edged sword that protects the tax base by preventing abuse of existing law as well as filling in the legislative gaps.³⁷

What is also fascinating in terms of comparative tax law research is the potential boomerang effect of legal transplants. This book provides some evidence on that. Owing to China’s increasing influence on international tax governance (through the G20, UN and OECD), the reconstructed international tax rules may be returned to their place of origin – Western countries. An example is the Chinese reimagined transfer pricing rules. Interpreting the arm’s length principle to require arm’s length results, not just arm’s length prices, is gaining broader recognition.³⁸

34. J.L. Nolan, *Legal Accents, Legal Borrowing: The International Problem-Solving Court Movement* (Princeton University Press 2009); and G. Teubner, *Legal Irritants: How Unifying Law Ends up in New Divergences*, in *Varieties of Capitalism* (P.A. Hall & D. Soskice eds., Oxford 2001).

35. Teubner, id., at p. 12. See also F.A. Hayek, *Notes on the Evolution of Systems of Rules of Conduct*, in *Studies in Philosophy, Politics and Economics* p. 66 (Routledge 1967).

36. See ch. 10.

37. See ch. 11.

38. J. Li, *China and BEPS: From Norm-Taker to Norm-Shaker*, 69 Bull. Intl. Taxn. 6/7, p. 355 (2015), Journals IBFD.

1.4.2. Practical aspirations

This book aspires to be relevant to tax professionals and anyone who wishes to learn how tax rules actually work in China. Since tax policy is the most practical thing in taxation, this book explains the background and policy reasons for the design of certain tax rules in order to elucidate their meaning. It also presents the necessary regulatory context and business transactions before delving into a discussion of technical tax rules. Simple examples are used to illustrate the application of complex rules. However, this book is not intended to provide detailed technical commentaries. Instead, it aims to explain the tax rules in a way that enables readers to appreciate not only the meaning of current rules but also why they have been introduced and how they are applied.

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