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China

Prof. Jinyan Li
and He Huang*

Transformation of the Enterprise Income Tax in China: Internationalization and Chinese Innovations

This article reviews the major elements of the enterprise income tax (EIT) system in China and examines the dynamic relationship between international norms and the local Chinese context. After some introductory remarks, the article discusses the fundamental principles, concepts and structural elements of the EIT system and examines its main transformative aspects in terms of form, process and substantive provisions. The article also considers the extent to which international tax norms, China's policy concerns and traditional issues play a role in the new system. The article concludes with some observations on international tax norms.

1. Introduction

The enterprise income tax (EIT) system in China has undergone major reforms over the past 28 years. A Western-style income tax was first introduced in 1980 – the Chinese-Foreign Joint Venture Income Tax (JVIT).[1] Foreign tax terminology, structures and concepts found their way into the JVIT, but the "Chinese characteristics" were overwhelmingly present. Since 1980, the trend has been more "internationalization" as China's economy moves closer to a "market" system. To the Chinese, because the "market" system originated in the West and the market demands "rational" laws,[2] which are predominantly "Western laws", it is important to "transplant" Western laws to China and to harmonize Chinese laws with international norms. Tax law affects the market directly, and the corporate tax is less politically and culturally sensitive (as compared to the individual income tax or sales tax), so the process of "internationalization" was faster and more notable.[3] This is the case with the promulgation of the EIT Law[4] and the EIT Regulations[5] (collectively referred to as "EIT legislation").

The EIT legislation is a hybrid of international tax norms and China's indigenous rules. An earlier article in the *Bulletin* provides a more detailed account of the legislative background of the EIT Law.[6] This article reviews the major elements of the EIT system and examines the dynamic relationship between international norms and the local Chinese context.

Following this Introduction, the article discusses the fundamental principles, concepts and structural elements of the EIT system (see 2.) and examines the main transformative aspects of the new tax system in terms of form, process and substantive provisions (see 3.). The article also discusses the extent to which international tax norms, China's policy concerns and traditional issues play a role in the new system (see 4.). The article concludes with some observations on international tax norms (see 5.).

2. The New Enterprise Income Tax System

2.1. Overview

The process that culminated in the promulgation of the EIT Law was lengthy (13 years) and relatively transparent (earlier drafts were widely debated and commented on). The structure and substantive provisions of the EIT legislation are more sophisticated than those of its predecessors. The Explanatory Notes on the EIT Law and EIT Regulations by the State Administration of Taxation (SAT) are detailed and insightful and, more importantly, available to the public.[7] It is indeed heartening to see such a level of expertise and openness being developed in China in such a short period of time.[8]

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1. Income Tax Law of the People's Republic of China Concerning Joint Ventures with Chinese and Foreign Investment, adopted by the National People's Congress and promulgated on 10 September 1980. It was abolished with the promulgation of the Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises, promulgated by the National People's Congress on 9 April 1991 (hereafter "FIET Law"). The FIET Law has been superseded by the EIT Law (see note 4, infra).
2. See Chen, Jianfu, "The Transformation of Chinese Law: From Formal to Substantial", 37 *Hong Kong Law Journal* 709 (No. 2, 2007); available at ssrn.com/abstract=1099507 (last visited on 27 April 2008).
3. Id.
4. Enterprise Income Tax Law of the People's Republic of China, promulgated in the fifth session of the tenth National People's Congress on 16 March 2007. The Chinese text of the EIT Law is available at the web site of the State Administration of Taxation: www.chinatax.gov.cn.
5. Implementing Regulations of the Enterprise Income Tax Law of the People's Republic of China, promulgated by Decree No. 512 of the State Council on 6 December 2007, effective 1 January 2008. The Chinese text of the EIT Regulations is available at www.chinatax.gov.cn.
6. Li, Jinyan, "Fundamental Enterprise Income Tax Reform in China: Motivations and Major Changes", Bulletin for International Taxation 12 (2007), at 519.
7. They are published on the SAT web site and in tax newspapers and journals.
8. One of the authors, Jinyan Li, was involved in training Chinese tax officials in the early 1990s and has been a keen observer of Chinese tax developments since the mid-1980s.

As explained in more detail elsewhere,[9] the EIT was introduced to achieve the following objectives: ensure the equitable taxation of all enterprises by ending the systematic and serious discrimination against Chinese-owned enterprises; promote the overall and sustainable development of China's economy; be consistent with international tax norms and practices; and improve efficiency in tax administration.[10]

One major tax policy objective is neutrality. All enterprises, irrespective of ownership, are subject to the same rules. By taxing foreign-investment enterprises (FIEs) similarly to domestically-owned enterprises, the EIT reflects capital-import neutrality. The EIT legislation also promotes capital-export neutrality by taxing residents on their worldwide income with a credit given for the taxes paid on foreign income.

Another policy objective is to protect China's tax base. The EIT legislation contains several new anti-avoidance rules applicable to cross-border transactions,[11] a general anti-avoidance rule as well as new rules to secure China's source-based tax jurisdiction (e.g. the meaning of "resident" and "permanent establishment", withholding taxes, and source rules).

A third major policy objective is to use tax policy as an instrument to promote sustainable economic development. Attracting foreign direct investment (FDI) to China remains a key policy concern. Instead of providing FDI-specific tax incentives, the EIT has an internationally competitive tax rate.[12] The tax incentives are targeted at investments in small enterprises, high-tech enterprises, and projects in agriculture, forestry, animal husbandry, fisheries, job-creation, public infrastructure, environmental protection, conservation of energy and water resources, research and development (R&D), and transfers of technology (EIT Law, Art. 27).

The EIT Law and EIT Regulations are organized in eight chapters: (1) general principles dealing basically with "liability to tax", i.e. who is a taxpayer under the EIT and the scope of tax liability for resident and non-resident taxpayers; (2) computation of taxable income; (3) computation of tax payable; (4) tax incentives; (5) withholding of tax at source; (6) special tax adjustments, which contain anti-avoidance rules empowering the tax authorities to make special adjustments to the tax liability determined under the "normal" rules; (7) tax administration; and (8) supplementary provisions.

2.2. Liability to tax

Enterprises are subject to the EIT if they are residents of China or non-residents deriving Chinese-source income. Resident enterprises are subject to tax on their worldwide income, whereas non-resident enterprises are subject to tax only on their Chinese-source income.

2.2.1. Enterprise

The term "enterprise" is not defined in the EIT legislation. According to the SAT Explanatory Notes on the EIT Law, "enterprise" includes, but is not limited to, a corporation. The key is whether an entity is a "legal person" under Chinese civil law.[13] In addition, some non-profit entities are treated as "enterprises" for purposes of the EIT. On the other hand, a sole proprietorship or partnership established in China is specifically excluded from the term "enterprise" (EIT Law, Art. 1). Sole proprietors are subject to the individual income tax.[14] A Chinese partnership is treated as a flow-through entity, and its income or loss is taxed in the hands of the partners. A foreign partnership, in contrast, is taxable as an enterprise under the EIT (EIT Regulations, Art. 3).

According to the SAT Explanatory Notes on the EIT Law, domestic and foreign partnerships are treated differently in order to prevent double taxation and to protect China's tax base. In the case of a Chinese partnership, the assumption is that the Chinese partners are subject either to the individual income tax (if the partner is an individual) or to the EIT (if the partner is an enterprise). Treating a Chinese partnership as a conduit eliminates double taxation of the income earned through the partnership. If a foreign partnership is not taxed as an enterprise, its income would be free from the EIT and the foreign partners would not be taxable in China.

2.2.2. Residence

The EIT Law adopts residence as a basis for determining tax jurisdiction. The term "resident enterprise" is defined as an enterprise established in China or an enterprise that is created under a foreign law but has a place of effective management in China (EIT Law, Art. 2). The term "enterprise established in China" means "an enterprise, non-profit entity, social organization or other type of entity that derives income and is created in accordance with Chinese laws or administrative regulations" (EIT Regulations, Art. 3). As such, the test of residence is a combination of place of incorporation and place of effective management.

The term "place of effective management" refers to "the place where the substantial and overall management and control of the production and business operations, personnel, finances, assets and other matters" are executed. According to the SAT Explanatory Notes on the EIT

9. Li, supra note 6.
10. See Jin, Renqing, Minister of Finance, "Explanation on Draft Enterprise Income Tax Law". The full text of the speech in English is available at www.china-embassy.org/eng/gyzg/t30221.htm (visited on 31 July 2007).
11. EIT Law, Arts. 41-48; EIT Regulations, Arts. 109-123. See 2.7.
12. The Minister of Finance stated (supra note 10): "[T]he level of enterprise income tax rates in the world, especially the neighbouring countries (regions), has to be taken into account. The average enterprise income tax rate is 28.6 percent in 159 countries (regions) around the world in which an enterprise income tax is applied, while that in China's 18 neighbouring countries (regions) is 26.7 percent. The rate of 25 percent set in the Draft is relatively low in the world and will be conducive to enhancing enterprise competitiveness and attracting foreign investment."
13. General Principles of the Civil Law of the People's Republic of China, adopted in the fourth session of the sixth National People's Congress and promulgated on 12 April 1986, effective 1 January 1987, Arts. 36-53.
14. Individual Income Tax Law of the People's Republic of China, adopted in the third session of the fifth National People's Congress on 10 September 1980 and promulgated on 10 September 1980; revised in 1991 and 1999.

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Regulations, the "place of effective management test" requires that the following three conditions be met:

(1) the management must be "effective or substantial", having a real impact on the business operations of the enterprise. This is to be contrasted to a "rubber stamp". The place of effective management is often different from the formal place of governance, which is usually established for tax avoidance purposes. It is not limited to the place where the board of directors holds its meetings. Ultimately, it is a question of fact. In the absence of specific, objective criteria, the test is based on the place where the economic nexus is strongest. This is consistent with the general "substance over form" principle;

(2) the management and control must be "comprehensive". If the management covers only one segment or a non-essential part of the enterprise's business, it does not meet the test; and

(3) the management and control must affect the production and business operations, personnel, finances and assets (substantive business elements). This is the most important condition for the test. If a foreign enterprise is formally managed and controlled outside China but the decisions about the substantive business elements of the enterprise are made in China, the place of effective management is in China.

The SAT is expected to publish detailed rules for determining the place of effective management. Generally speaking, the place of effective management is determined by the place of actual management based on the facts and circumstances of the case. The SAT is prepared to go beyond the common law test in Anglo-Saxon countries.[15]

2.2.3. Establishment or site

If a non-resident enterprise has an "establishment or site" in China, any income that is attributable to the establishment or site is taxable in China. The term "establishment" is defined as "an establishment or site for carrying on production and business operations in China" (EIT Regulations, Art. 5). It specifically includes:
- a place of management, business or office (or place of administration);
- a factory, farm or place of extraction of natural resources;
- a place for providing services. The term "services" includes transportation, warehousing, consulting, scientific research, technical services, education and training, restaurants and hotels, agency, travel, entertainment and processing;
- a place of construction, installation, assembly, repair or exploitation (including a building site, port and place of exploration); and
- a place of conducting other production and business activities.

This definition is very close to the "fixed place of business" type of permanent establishment in the context of Art. 5 of the OECD Model Tax Convention.

In addition, an agent is deemed to be an establishment or site of a non-resident enterprise if the agent is authorized to carry on production or business activities in China on behalf of the non-resident enterprise, such as frequently signing contracts or storing or delivering goods on its behalf. This is similar to the "agency" permanent establishment in the context of Art. 5 of the OECD Model. According to the SAT Explanatory Notes on the EIT Regulations, an agent can be an enterprise or an individual in China. The agent's activities must be "frequent" or "habitual", not incidental or of a short duration. The question of what constitute "frequent" or "habitual" activities is a practical one that should be addressed in a flexible manner.

2.2.4. Source rules

Chinese-source income that is not effectively connected to an establishment or site in China is generally subject to withholding tax at the rate of 20%. The main source rules are in Art. 7 of the EIT Regulations and include the following:

(a) The source of income from the sale of goods is determined by the place of the sales transaction. In the Explanatory Notes on the EIT Regulations, the SAT states that, according to international tax norms, the place of a sales transaction is often the seller's place of business, the place of the customer if the goods are delivered to the buyer/customer, or the place specified in the sales agreement.

(b) The source of service fees is determined by the place where the service activities occur. According to the SAT Explanatory Notes on the EIT Regulations, if a foreign enterprise provides financial insurance services to Chinese residents and collects premiums from them, the fees are sourced in China.

(c) The source of income from the transfer of property depends on the type of property:
- in the case of immovable property, the source is determined by the location of the property;
- in the case of movable property or an establishment or site, the source is determined by the residence of the owner of the movable property or the location of the establishment or site; and
- in the case of shares and other forms of equity investment, the source is determined by the residence of the company whose equity is transferred.

(d) The source of dividends and bonuses is determined by the residence of the corporation paying the dividends and bonuses.

(e) The source of interest, rents and royalties is determined by the residence of the payer. If the payments are borne by an establishment or site, the source is determined by the location of the establishment or site.

15. For more discussion on corporate residence, see Couzin, Robert, *Corporate Residence and International Taxation* (Amsterdam: IBFD Publications BV, 2002).

(f) The source of other types of income will be determined by the tax authorities or the Ministry of Finance.

Income that is sourced outside China but is effectively connected to an establishment or site in China is deemed to be Chinese-source income (EIT Law, Art. 3; EIT Regulations, Art. 8). The SAT Explanatory Notes on the EIT Regulations identify two scenarios. The first is where income is derived from equity or debt investments owned through the establishment or site. For example, if a non-resident enterprise makes an equity or debt investment in another enterprise through an establishment or site in China, the dividend or interest income from the investment is effectively-connected income. The second scenario is where income is derived through assets owned, managed or controlled by an establishment or site in China. For example, if a non-resident enterprise leases real property located in China or abroad which is owned, managed or controlled by an establishment or site in China, the rental income is effectively connected to that establishment or site.

The source rules are obviously intended to protect China's tax base as a net capital-importing country. Enforcing the source rules will be difficult in some cases, such as where a non-resident sells the shares of a Chinese resident company outside China to another non-resident.

2.3. Taxable income

2.3.1. Fundamental principles

Most provisions of the EIT Law (Arts. 5-21) and EIT Regulations (Arts. 9-51) are devoted to the computation of taxable income. The following principles seem to underlie these rules.

First, the determination of taxable income is primarily a legal question. Although financial accounting is often the basis for computing income or loss, the ultimate determination must be governed by the provisions of the EIT Law and EIT Regulations (EIT Law, Art. 21). These legal provisions override any inconsistent financial accounting principles.

Second, income and expenses must be recognized in accordance with the accrual method of accounting (EIT Regulations, Art. 9).

Third, the principle of truthfulness requires that income and expenses be supported by evidence (typically invoices or receipts).

Fourth, the principle of "substance over form" requires that transactions be characterized for tax purposes according to their economic substance, not the legal form.

Finally, the principle of realization requires that income be recognized only when it is "realized", that is, when the income-producing transaction is "realized" or "completed" (SAT Explanatory Notes on the EIT Regulations).

The basic formula for computing taxable income is: taxable income = total income minus (a) excluded income, (b) exempt income, (c) deductions, and (d) loss carry-overs. Each element is discussed briefly below.

2.3.2. Income

"Income" refers to the revenue or income from various sources in cash or in kind. The sources include sales of goods, the provision of services and transfers of property; dividends, interest, rents and royalties; and donations and other types of income. Other types of income include income derived from asset surpluses such as the discovery of unbooked assets, amounts payable that cannot be settled, collections from accounts receivable that were previously written off as bad debts, income from debt-restructuring, subsidies, damages for breach of contract, exchange gains, etc. (EIT Regulations, Art. 22). Income in kind must be converted to a cash amount based on the fair market value of the property or services (EIT Regulations, Art. 13).

Non-taxable or excluded income includes funds received from government finance departments (e.g. government grants), and fees collected for services provided by government agencies, non-profit enterprises or social organizations in accordance with the relevant laws and regulations. Excluded income also includes other amounts designated as non-taxable by the SAT or Ministry of Finance (EIT Regulations, Art. 26). According to the SAT Explanatory Notes, such an "open-ended" category is needed to accommodate the rapid social changes in China, especially the increasing role of non-profit organizations that may charge fees for their activities.

Exempt income includes interest on state bonds, dividends received from a resident company, dividends that are effectively connected to an establishment or site in China of a non-resident enterprise, and income derived by qualifying non-profit organizations.[16] Other items of income may be exempt under Art. 27 of the EIT Law.

The exemption for dividends effectively connected to an establishment in China is intended to prevent the economic double taxation of income derived by a non-resident in China. The exemption does not make sense, however, because China imposes a withholding tax on dividends (EIT Law, Art. 37) and China does not yet have a "branch tax". The exemption results in the inequitable treatment of a non-resident investor investing directly in a Chinese company and a non-resident investor investing through a Chinese branch.

16. EIT Law, Art. 26; EIT Regulations, Art. 84. A qualifying non-profit organization must: (1) be registered as a non-profit organization; (2) carry on public or non-profit activities; (3) use its income, after deducting the reasonable expenses of the relevant activities, for public or non-profit activities; (4) not distribute property; and (5) after termination, must use the remaining assets for public or non-profit purposes. In addition, the founder of a non-profit organization does not have a right to its assets, and the salary expense must be limited to a certain proportion.

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2.3.3. Deductions

Costs, expenses, taxes, losses and other outlays are deductible in computing taxable income. This reflects the principle that income is a net concept. According to the SAT Explanatory Notes, for an item to be deductible, it must be "truthful" or "real" (*zhenshi xing*), legal and reasonable. The expense must have been incurred and it must be supported by evidence. Unlawful expenses, even if deductible under accounting principles, may not be deducted in computing taxable income. The "reasonable test" requires that the expense be "normal" and "necessary" for the purpose of deriving income. For mixed business and personal expenses, a reasonable allocation must be made.

Deductible costs and expenses are generally self-explanatory. They include the costs of wages, salaries and bonuses as well as contributions to basic (mandatory) pension plans, basic medical insurance plans, basic unemployment insurance plans, workers' compensation plans, family-planning insurance plans, housing provident funds, and other social insurance plans. Contributions to supplementary insurance plans, medical insurance plans and other plans approved by the State Council are also deductible.[17]

Financing expenses incurred for income-producing purposes are deductible unless they are required to be capitalized. Interest and other financing expenses must be capitalized during the period the borrowed money is used to acquire or construct a fixed or intangible asset or an inventory that requires at least 12 months to be constructed, but only during the period of acquisition or construction.

The deduction of certain types of expenses is capped. Examples are:
- 60% of entertainment expenses are deductible up to 0.5% of the sales or business revenue of the year (EIT Regulations, Art. 43);
- advertising expenses are deductible up to 15% of the annual sales or business revenue (EIT Regulations, Art. 44);
- expenses for promoting workers' welfare are deductible up to 14% of the total wages and salaries (EIT Regulations, Art. 40); and
- expenses for workers' training and education are deductible up to 2.5% of the total wages and salaries (EIT Regulations, Art. 42).

Deductible "taxes" refer to non-income taxes, such as the consumption tax, business tax, resource tax, education surtax, real estate tax, vehicle and vessel licence tax, and stamp duties, but not the VAT borne by customers. The term "losses" refers to losses from devaluing business assets, lost assets, bad debts, etc. Donations for the purpose of public relief are deductible up to 12% of the annual profit.

Non-deductible items include dividends, taxes paid under the EIT Law, late-payment penalties, fines and penalties, sponsorships, unverified reserves, and other amounts incurred for non-income-producing purposes. As a general principle under the EIT Law, a branch is not a separate enterprise and its income or losses are part of the total income or losses of the enterprise. However, when an enterprise carries on business outside China through a foreign branch, the enterprise is prohibited from offsetting the branch's loss against its income (EIT Law, Art. 17). The SAT Explanatory Notes provide two rationales for this surprising rule. One is to protect China's tax base because a taxpayer may use foreign branches fraudulently to avoid Chinese taxes and such behaviour is difficult for the Chinese tax authorities to detect. The other rationale is to respect the "territorial principle", that is, foreign losses should offset foreign income. For different policy reasons, intra-company payments of management fees, rents, royalties and interest (other than between banks) are not deductible (EIT Regulations, Art. 49). On the other hand, expenses paid by a Chinese establishment or site to its foreign head office are deductible if the expenses are incurred for income-producing purposes and there is sufficient evidence proving the scope and amount of the expenses and if the method of allocation is reasonable (EIT Regulations, Art. 50). This is consistent with Art. 7 of the OECD Model.

2.3.4. Capital assets and inventories

Generally speaking, the "historical cost" or actual cost is deductible. The cost of fixed assets is depreciated using the straight-line method (EIT Regulations, Art. 60):
- 20 years for buildings;
- 10 years for aircraft, trains, vessels, machinery and other production equipment;
- 5 years for other instruments, tools, furniture and other assets used in production and business activities;
- 4 years for aircraft, trains and vessels used in transportation; and
- 3 years for electronic equipment.

Special rules will be stipulated by the government for expenditures and depreciation of fixed assets for enterprises engaged in the exploration of oil, gas and mineral resources (EIT Regulations, Art. 61).

The period of amortization is 10 years for biological assets in forestry production and 3 years for those used in livestock production (EIT Regulations, Art. 64). The cost of intangible assets (including patents, trademarks, copyrights, land-use rights, non-patented technologies, goodwill, etc.) is generally amortized over a period of not less than 10 years. However, the cost of goodwill is deductible when the entire business of an enterprise is sold or the enterprise is liquidated (EIT Regulations, Arts. 65-67).

17. This is the first time that such deductions are authorized by national tax law. For further discussion, see Li, Jinyan, "Enterprise Annuities in China: Regulatory Framework, Practical Challenges, and International Opportunities", 52 *International Pension Lawyer* 39 (2005); and Li, Jinyan, "Enterprise Annuities and Tax Policy in China: Engaged, but Not Yet Married", *Bulletin for International Fiscal Documentation* 12 (2005), at 527.

Long-term prepaid expenses are amortized in instalments during a 3-year period (EIT Regulations, Art. 70). The cost of investment assets is recognized only when the assets are transferred or disposed of (EIT Regulations, Art. 71).

The cost of goods is determined by using the FIFO (first in, first out), weighted-average or specific-tracing method, but not the LIFO (last in, first out) method. The LIFO method may not be used because it tends to "increase the cost of goods sold and reduce profit" during inflationary times (SAT Explanatory Notes on the EIT Law).

When capital assets are disposed of, the net asset value is deductible in computing taxable income (EIT Law, Art. 16). In the case of depreciable assets, this value represents their undepreciated cost.

Losses may be carried forward, but not back, for 5 years (EIT Law, Art. 18). There is no distinction between capital losses and non-capital losses as capital gains are fully taxable.

2.3.5. Taxable income of non-residents

The taxable income of a non-resident enterprise carrying on business in China through an establishment or site is computed in accordance with the rules discussed above. In other words, taxable income is net of deductible costs and expenses. The taxable income of other non-resident enterprises, however, is their gross income.

The taxable income derived from Chinese-source dividends, interest, rents or royalties is the gross amount received (EIT Law, Art. 19). According to the SAT Explanatory Notes on the EIT Law, a non-resident enterprise is also subject to Chinese tax on the gross amount of fees for services provided to enterprises or individuals in China or on the gross premiums for providing foreign insurance to enterprises or individuals in China. The service fees and insurance premiums are treated as Chinese-source income because the payer is in China and the non-resident enterprise is taxable on a gross basis.

2.4. Tax payable

The amount of "tax payable" is determined by multiplying taxable income by the applicable tax rate, less the relevant tax credits (EIT Law, Art. 22).

2.4.1. Rates

The standard rate is 25% (EIT Law, Art. 4). A lower rate (20%) applies to qualifying small low-profit enterprises,[18] and an even lower rate (15%) applies to "key state-supported, new and high-tech enterprises" (EIT Law, Art. 28; EIT Regulations, Art. 93).

The 25% standard rate was believed to be internationally competitive.[19] Small low-profit enterprises are thought to be strategically important in creating jobs and stimulating economic growth in China, but their tax capacity is limited. Therefore, in order to support such enterprises, a lower rate is available to them. High-tech enterprises received preferential treatment under the previous tax system, especially those invested in by foreign companies or located in designated areas. The 15% rate now applies to all qualifying enterprises, irrespective of ownership or location.

2.4.2. Tax credits

The EIT Law recognizes two types of tax credits: (a) foreign tax credits to prevent international double taxation (EIT Law, Art. 23); and (b) tax credits as a form of subsidies for preferred investments, such as venture capital and investment in environmental protection, energy and water conservation, and production safety (EIT Law, Arts. 31 and 34).

2.5. Tax incentives

The EIT legislation provides "tax incentives to industries and projects that are specifically supported and encouraged by the state" (EIT Law, Art. 25). Tax-preferred enterprises include small low-profit enterprises, high-tech enterprises and non-profit enterprises. Tax-favoured investments are those in agriculture and fishing, infrastructure, venture capital, environmental protection and production safety as well as investments in ethnic minority regions, which are often the less-developed regions in China.

Tax incentives take a variety of forms, including:
- full or partial exemption (with or without temporal limitations);
- reduced tax rate (see 2.4.1.);
- accelerated depreciation;
- imputed additional deductions; and
- tax credit.

Different forms of tax incentives are used to provide different degrees of "subsidies". For example, a permanent exemption is available for interest on state bonds, intercorporate dividends and income of eligible non-profit enterprises. A time-limited exemption applies to income from agricultural projects, key infrastructure projects and environmental protection and energy/water conservation projects and to income from the transfer of technology (EIT Law, Art. 27). A full exemption applies to agricultural income from growing vegetables and medicinal herbs and from animal husbandry, but a half exemption applies to income from growing flowers, tea, other beverage crops, spices, certain fisheries, etc. (i.e. 50% of the eligible income is exempt from tax) (EIT Regulations, Art. 86). A three-year full exemption and a three-year half exemption apply to income from envi-

18. "Small low-profit enterprise" is defined in Art. 92 of the EIT Regulations as an enterprise that meets the following requirements: (1) its business is in a non-restricted or non-prohibited sector; (2) in the case of an industrial enterprise, its annual taxable income does not exceed CNY 300,000, the number of employees does not exceed 100, and the value of its assets does not exceed CNY 30 million; (3) in other cases, the annual taxable income of the enterprise does not exceed CNY 300,000, the number of employees does not exceed 80, and the value of its assets does not exceed CNY 10 million.
19. Jin, supra note 10.

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ronmental protection and infrastructure projects (EIT Regulations, Arts. 87 and 88). This tax holiday begins in the year in which the taxpayer earns its first item of revenue from production or business. As such, the tax holiday starts to run even of the taxpayer has a loss. In addition, a permanent partial exemption (10% of qualifying income) applies to income from the production of products by way of comprehensive utilization of resources; this is called the "reduced income inclusion method" because only 90% of the income is included in computing taxable income (EIT Law, Art. 33; EIT Regulations, Art. 99).

The method of imputed deductions is used to encourage certain activities, such as R&D and hiring disabled workers. The tax-deductible amount is deemed to be 150% of the actual expenditure on R&D and 200% of the actual wages paid to disabled workers (EIT Regulations, Art. 95). This is considered to be more effective than an exemption because the taxpayer can get the deduction as soon as the expenditure is incurred (whether or not there is any income) and the deduction increases with the amount of eligible expenses.

High-tech enterprises receive several types of tax incentives, including:

(a) reduced tax rate of 15% (see 2.4.1.);
(b) exemption of income from the transfer of technology (see above);[20]
(c) additional deduction for R&D expenses (i.e. 150% of the actual expense is deductible as a current expense or amortized as a capital expenditure) (EIT Law, Art. 30; EIT Regulations, Art. 95);
(d) accelerated depreciation (EIT Law, Art. 32; EIT Regulations, Art. 98); and
(e) special deductions for eligible investors in high-tech enterprises. If a venture capital enterprise invests in the shares of a new private small or medium-size high-tech enterprise and holds the shares for two or more years, 70% of the investment may be deductible. The deductions may be carried over to the following year (EIT Law, Art. 31; EIT Regulations, Art. 97).

"Green" industries or projects may qualify as "high-tech" enterprises. In addition, 10% of income is excluded from taxable income if it is derived from products made by way of comprehensive utilization of resources in accordance with the standard published by the government (EIT Regulations, Art. 99). Finally, 10% of the expenditure on qualified equipment purchased specifically for the purpose of protecting the environment is creditable against the income tax. This credit may be carried forward for five years (EIT Law, Art. 34; EIT Regulations, Art. 100).

2.6. International tax issues

2.6.1. Jurisdictional principles

The EIT Law adheres to two fundamental principles of tax jurisdiction: (1) global or worldwide taxation of resident taxpayers; and (2) territorial or source-based taxation of non-residents. The worldwide system of taxation is complemented by direct and indirect foreign tax credits to provide relief from international double taxation as well as by an anti-deferral rule or the controlled foreign corporation (CFC) rule (discussed in 2.7.3.).

2.6.2. Inbound rules

Foreign investment into China predominantly takes the form of direct investment. FIEs typically include Chinese-foreign joint venture companies and wholly foreign-owned companies. These companies are generally "resident" in China because their place of incorporation must be in China under Chinese law. As such, a foreign investor is directly taxable in China only on the income received from the Chinese company by way of dividends, interest or royalties. The Chinese tax on these types of income is withheld at source at the standard rate of 20% (EIT Law, Art. 4).

Foreign companies doing business in China through an establishment or site are taxable on the income effectively connected to the establishment or site. The general rules for computing taxable income and the tax payable are the same as for a resident enterprise or an establishment or site of a non-resident enterprise (see 2.3. and 2.4.). However, the tax incentives discussed above are generally not available to non-resident enterprises. There is no "branch tax", which means that the after-tax profit earned through an establishment or site is not subject to a second-level Chinese tax (unlike dividends received from a Chinese resident enterprise).

Income from foreign portfolio investment in China is subject to a 20% withholding tax on the gross amount (EIT Law, Art. 4). This rate is reduced to 10% on dividends paid by FIEs as well as certain interest and royalties (EIT Regulations, Art. 91). In addition to the typical forms of investment income (i.e. dividends, interest, rents and royalties), a withholding tax is levied on income from providing services in China or from engineering projects (EIT Law, Art. 38).

2.6.3. Outbound rules

Chinese residents deriving foreign-source income are subject to the EIT. If the income is taxable in the foreign (source) country, the EIT Law provides a direct foreign tax credit and indirect foreign tax credit (EIT Law, Art. 23).

The direct foreign tax credit system operates on a worldwide basis. There is no distinction between business

20. EIT Law, Art. 27. If the value of the technology transfer does not exceed CNY 5 million, the income is exempt from tax. A tax rate equal to 50% of the normal tax rate applies to any excess.

income and passive income in determining the limit on the foreign tax credit. The credit is limited to the amount of Chinese tax otherwise payable on the foreign-source income. Any excess credit may be carried forward for five years, but not refunded (EIT Regulations, Art. 78).

For the first time, China allows an indirect foreign tax credit. A credit may be claimed for any foreign corporate income tax attributable to the dividends received by a Chinese corporate shareholder from a non-resident corporation that is controlled directly or indirectly by a Chinese resident (EIT Law, Art. 24). The indirect credit is available only if the Chinese resident owns more than 20% of the equity in the non-resident corporation (EIT Regulations, Art. 80).

2.6.4. Effect of tax treaties

The above EIT rules are subject to overriding provisions in China's bilateral tax treaties and the "tax arrangements" with Hong Kong and Macao. Under Chinese law, tax treaties override domestic tax law in the case of inconsistency (EIT Law, Art. 58).

These treaties and arrangements inevitably reduce China's tax jurisdiction as a source country. This is most notable in three areas: (1) definition of "permanent establishment", (2) rate of withholding tax, and (3) higher threshold for source taxation.

The concept of "permanent establishment" is narrower in China's tax treaties because a temporal threshold is imposed or certain activities are excluded from giving rise to a permanent establishment. For example, Art. 5 of the China–Canada income tax treaty[21] provides that a building site, a construction, assembly or installation project or supervisory activities constitute a permanent establishment only if the site, project or activities last more than six months and that the provision of services, including consultancy services, constitutes a permanent establishment if the services are provided for more than six months within a 12-month period. Like other treaties, the China–Canada treaty contains a provision like Art. 5(6) of the OECD Model which excludes some places or sites which are deemed to be an establishment or site under the EIT from being a permanent establishment.[22]

The standard 20% rate of Chinese withholding tax may be reduced by tax treaties as follows:

(a) *Dividends:* 10% in most treaties; 5% in the treaties with Kuwait, Mongolia, Mauritius, Croatia, Slovenia, Sudan, Laos, the Seychelles, South Africa, Barbados, Oman, Bahrain, Mexico, Brunei and Saudi Arabia; 8% in the treaties with Egypt and Tunisia; and 15% in the treaties with Norway, New Zealand, Australia, Brazil and Papua New Guinea. Two rates are provided in some treaties, such as the China–Canada treaty: a lower rate (typically 10%) for dividends if the beneficial owner holds not less than 10% of the voting rights of the paying company, and a higher rate (typically 15%) in other cases.

(b) *Interest:* 10% in most treaties; 5% in the treaty with Kuwait; 7% in the treaty with the United Arab Emirates; 7.5% in the treaties with Jamaica and Cuba; and 15% in the treaty with Brazil. The treaties with Austria, Israel, Venezuela, Saudi Arabia and Algeria have two rates – a lower rate on interest paid to banks or financial institutions and a higher rate on interest paid to others.

(c) *Royalties:* 10% in most treaties; 5% in the treaty with Cuba; 7% in the treaty with Spain; and 8% in the treaty with Egypt. In the treaties with the United Kingdom, Malaysia, Bulgaria, Luxembourg, the Philippines and Tunisia, a lower rate is available with respect to industrial, commercial and scientific equipment or advanced technology.

In addition to a narrow definition of "permanent establishment" and lower rates of withholding tax, China's tax treaties have higher thresholds for source taxation. For example, under Art. 13 of the China–Canada treaty, gains from the disposition of shares in Chinese companies are not taxable in China unless the assets of the Chinese company consist mainly, directly or indirectly, of immovable property situated in China. Under the EIT Law, gains from the sale of shares in Chinese resident companies are taxable in China (see 2.2.4.).

2.7. Anti-avoidance rules

The EIT legislation contains extensive anti-avoidance rules which include transfer pricing rules, thin capitalization rules, a CFC rule and a general anti-avoidance rule. A special interest charge provides real teeth for these rules.

2.7.1. Transfer pricing

The transfer pricing rules are the only anti-avoidance rules that existed in the prior legislation. The EIT Law (Art. 41) now codifies the arm's length principle as follows: "where a transaction between an enterprise and its related parties is not based on the arm's length principle, thereby reducing the taxable income of the enterprise or its related parties, the tax authority is empowered to make reasonable adjustments to the taxable income of the enterprise or its related parties."

A "related party" is not limited to an enterprise. A partnership or individual that is not an "enterprise" under the

21. The China–Canada treaty was concluded on 12 May 1986. It entered into force on 29 December 1986 and became effective on 1 January 1987.
22. A permanent establishment is deemed not to include: (a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise; (b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery; (c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise; (d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or for collecting information, for the enterprise; (e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character; (f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs (a) to (e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

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EIT Law can be a related party (EIT Regulations, Art. 109). A "related party" is an enterprise, organization or individual that has one of the following relationships with the taxpayer enterprise:
- direct or indirect control over such matters as funds, operation, or purchases and sales;
- the party and enterprise are directly or indirectly controlled by the same third person; or
- other relationships due to associated enterprises.

The SAT Transfer Pricing Circular[23] provides more details regarding these relationships. An enterprise is considered to be related to another enterprise where:
- one enterprise directly or indirectly owns 25% or more of the shares of another enterprise;
- two enterprises are directly or indirectly owned or controlled by a third party with a 25% or greater interest;
- an enterprise borrows from another enterprise and the loan accounts for 50% or more of the borrower's own capital, or an enterprise guarantees 10% or more of another enterprise's total loans;
- more than half of an enterprise's senior management (e.g. board members and managers or even an executive board member) is appointed by another enterprise;
- an enterprise's production and/or operational activities rely entirely on the provision of a specific right (e.g. patent or technology) by another enterprise in order to operate normally;
- an enterprise fully supplies or controls the supply of raw materials, parts, etc., to another enterprise for its productive operations;
- an enterprise's products, including prices and the terms of transactions, are totally controlled by another enterprise; or
- an enterprise has actual control of another enterprise's productive operations, trade activities and profits (this relationship includes family relationships and relatives).

The concept of "control" is not defined for purposes of the transfer pricing rules, but it appears to have a very broad meaning and includes both de jure control (direct and indirect) and de facto control. A similarly broad meaning is used for purposes of the CFC rule (see 2.7.3.).

The arm's length methods for making transfer pricing adjustments include (EIT Regulations, Art. 111):
- comparable uncontrolled price (CUP) method;
- resale price method;
- cost-plus method;
- transactional net margin method (TNMM);
- profit-split method; and
- any other arm's length method.

No specific hierarchy is mandated by law, but the order in which the methods are listed indicates some hierarchy. In its Transfer Pricing Circular, the SAT states that the three traditional methods (CUP, resale price and cost-plus) are the basic methods and should be chosen first.

Other arm's length methods may be used if none of the specific methods is suitable (EIT Regulations, Art. 115). The other methods include: (a) the profit level of other enterprises that are the same or similar type of enterprise as the taxpayer (this is essentially a comparable profit method); (b) the taxpayer's costs, plus reasonable expenses and profit margins; (c) a reasonable proportion of the profit of the group of related companies (this appears to be a formulary apportionment method); and (d) other reasonable methods of assessment.

Taxpayers may also use cost sharing agreements with respect to intangible property transactions (EIT Regulations, Art. 112). Such agreements must provide the tax authorities with the relevant documentation to prove that the pricing is reasonable and that the shared costs are proportionate to the anticipated profits. Otherwise, the costs are not deductible.

Advance pricing arrangements (APAs) are recognized as valid agreements between the taxpayer and the tax authorities.[24] The stated objectives are to reduce the cost of transfer pricing audits and inspections and to provide certainty for both taxpayers and the tax authorities. The time period of an APA is two to four years, which generally begins from the year in which the APA application is filed. As of March 2008, over 180 APAs have been concluded, including more than ten bilateral APAs (involving Japan, Korea and the United States). There are no multilateral APAs at this time.[25]

Contemporaneous documents and other documents regarding related-party transactions must be provided to the tax authorities (EIT Law, Art. 114). They include (a) contemporaneous documents in respect of related-party transactions such as pricing, standards for determining expenditures, computation methods and explanatory notes; (b) documents relating to the resale (transfer) price or the ultimate price for the sale of goods or for providing services or licensing the right to use property between related parties; and (c) information such as product price, pricing method and profit level that are comparable to the enterprise being investigated (EIT Regulations, Art. 114).

23. "Tax Administration Rules and Procedures for Transactions between Associated Enterprises", *Guo Shui Fa* (1998), No. 59.
24. The procedures and documentation requirements are set forth in the Transfer Pricing Circular as well as the APA Circular, *Guo Shui Fa* (2004), No. 118.
25. The first bilateral APA was concluded in September 2005 between the taxpayer, the SAT and the National Tax Administration of Japan. The APA was negotiated by the taxpayer and the Shenzhen Local Tax Bureau and was approved under the mutual agreement procedure in the China–Japan tax treaty. A more recent bilateral APA was concluded by the Korean National Tax Service and the SAT on 7 November 2007 regarding Samsung. The APA covers two Chinese subsidiaries of Samsung: one in Suzhou and one in Shandong. As the subsidiaries filed separate applications with their respective tax bureaus, China regards this bilateral APA as "twin APAs". The time required to conclude a bilateral APA varies. The APA between Wal-Mart, the SAT and the United States Internal Revenue Service took six months, whereas the APA with Korea took more than two years.

2.7.2. *Thin capitalization*

The interest expenses on "excessive debt" owed to related parties are not deductible under the thin capitalization rules (EIT Law, Art. 46). According to the SAT Explanatory Notes on the EIT Law, there are two methods for determining whether an enterprise is "thinly" capitalized: a specified debt/equity ratio and a reasonable method. The term "debt to a related party" is defined to include loans made to the taxpayer by a related party via a third party (e.g. a "back-to-back" loan), loans from an arm's length party which are guaranteed by a related party, and other types of indirect debt investments by a related party (EIT Regulations, Art. 119). The acceptable debt/equity ratio is not specified in the EIT Regulations.

2.7.3. *CFC rule*

EIT Law, Art. 45 provides:

> Where an enterprise that is established by a Chinese resident enterprise in a jurisdiction pays tax at a rate obviously lower than the tax rates as stipulated in Article 4 [of the EIT Law] and does not distribute its profits for reasons other than business needs, the amount of profit that should have been distributed to the Chinese shareholder is included in the income of the Chinese resident.

The term "foreign corporation" refers to a non-resident corporation that is controlled by a Chinese resident. "Control" is defined as the ownership of more than 10% of the voting shares and 50% of the total shares of the foreign corporation, or effective control in terms of shares, funds, business management, purchases and sales, and other aspects of the foreign corporation (EIT Regulations, Art. 117). A foreign country's tax rate is "obviously lower" than the standard Chinese tax rate if it is less than 50% of the Chinese rate (i.e. 12.5%) (EIT Regulations, Art. 118).

2.7.4. *General anti-avoidance rule (GAAR)*

The GAAR adopts the "reasonable business purpose test": "Where an enterprise enters into an arrangement that has no reasonable business purpose, thereby reducing its taxable revenue or income, the tax authority has the power to make adjustments based on reasonable methods" (EIT Law, Art. 47). It authorizes the Chinese tax authorities to make an adjustment if the GAAR applies. This is a strong signal of the tax authorities' growing scrutiny of tax avoidance schemes. Presumably, the GAAR applies when a transaction avoids the application of a specific anti-avoidance rule.

2.7.5. *Penalty for avoidance transactions*

The application of any of the above anti-avoidance rules may result in an adjustment to the taxable income, resulting in an additional tax liability. Readjustments can be made at any time during the ten-year period starting with the year in which the avoidance transaction occurred. If additional tax is payable because of the adjustments, a penalty is imposed in the form of additional interest (EIT Law, Art. 48). The interest rate is 5 percentage points over the benchmark lending rate published by the People's Bank of China for the year in which the tax payment occurs.

2.8. Administration

Administrative matters relating to the EIT are in the Tax Administration and Collection Law.[26] The EIT Law clarifies that a "taxation year" is the calendar year (Art. 51) and that no consolidation is allowed for enterprise groups (unless specifically authorized by the State Council) (Art. 53).

2.9. Supplementary provisions

Transitional rules are provided for FIEs that enjoy preferential tax treatment under the previous tax regime (EIT Law, Art. 57). A five-year gradual transition to the new rates is allowed for FIEs that were taxed at much lower effective rates. FIEs that were eligible for a fixed-period tax holiday under the previous tax regime are allowed to exhaust the tax holiday before being subject to the new system. On the other hand, tax holidays that begin in the first profit-making year are terminated if the taxpayer failed to make a profit before 2008. The preferential period of these tax holidays starts in 2008 and ends in 2013. A qualifying enterprise for these transitional rules must have been approved to be set up before 16 March 2007, i.e. the enactment date of the EIT Law (EIT Regulations, Art. 131).

3. Transformative Aspects

3.1. Form, organization and terminology

In many ways, the EIT is a transformed tax. Its name – "Enterprise Income Tax Law of the People's Republic of China" – conveys a sense of maturity by dropping the previous qualifiers for enterprises, such as "foreign-investment enterprises" and "foreign enterprises", and by replacing "Interim Regulations"[27] with "Law". The EIT Law is more extensive and better organized. For example, the JVIT Law (1980) contained 18 articles and the FIET Law (1991) contained 30 articles; in contrast, the EIT Law contains 60 articles, organized in eight chapters.

New principles, concepts and rules are found in each chapter of the EIT Law and EIT Regulations. For example, 28 out of 130 articles of the EIT Regulations are completely new, and 21 articles are substantially new. Only five articles (Arts. 18, 21, 55, 58 and 59) are unchanged from the previous regime.

26. Law of the People's Republic of China on Administration of Tax Collection, promulgated in the 27th session of the seventh National People's Congress on 4 September 1992; amended in the 12th session of the eighth National People's Congress on 28 February 1995; and amended in the 21st session of the ninth National People's Congress on 28 April 2001.

27. Interim Regulations of the People's Republic of China on the Enterprise Income Tax, promulgated by the State Council on 14 December 1993; abolished after the enactment of the EIT Law. The Interim Regulations applied to domestic enterprises.

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The EIT legislation adopts new terminology, such as:
- "resident" and "non-resident" (EIT Law, Art. 2); the idea of residence was used in the FIET Law, but the term "residence" per se was not used;
- "place of effective management" (EIT Law, Art. 2);
- "dividend" (EIT Law, Art. 6); this concept was previously expressed as "profit" or "*li run*" in Chinese;[28]
- "fair market value" (EIT Regulations, Art. 13);
- "supplementary pension plans" and "supplementary health insurance plans" (EIT Regulations, Art. 35);
- "non-profit organizations" (EIT Law, Art. 26);
- "biological assets" (EIT Regulations, Art. 62);
- "arm's length principle" (EIT Law, Art. 41);[29]
- "cost sharing agreement" (EIT Law, Art. 41);
- "advance pricing arrangement" (EIT Law, Art. 41);
- "controlled foreign corporation" (EIT Law, Art. 45; EIT Regulations, Art. 117);
- "thin capitalization", "debt" and "equity" (EIT Law, Art. 46; EIT Regulations, Art. 119); and
- "reasonable business purpose" (EIT Law, Art. 47).

Compared to the massive Canadian Income Tax Act (the print version weights over one kilogram),[30] the EIT Law and EIT Regulations still appear simplistic and rudimentary. However, given the short history of modern income taxation in China, the EIT legislation contains the necessary framework and elements for further developments.

3.2. Substantive transformation

The transformation of China's tax system goes way beyond form and terminology. Each major element of the system contains new, and sometimes "revolutionary", substantive rules. Subjecting all "enterprises" to the EIT ends the dual-track system of enterprise income taxation in China, thereby terminating the systematic tax discrimination against domestically-owned enterprises.[31] The standard rate of 25% symbolizes China's shift in tax competition strategy from FDI-specific measures to a general, lower tax rate. The deductibility rules for determining taxable income provide more certainty to taxpayers with "bright-line" tests (such as those for entertainment expenses and advertising costs) as well as deliver tax subsidies for social purposes (such as contributions to employer-sponsored pension plans, health insurance plans and housing funds (to help employees save for the purchase of a housing unit) and the costs of hiring disabled workers).

The tax incentive measures are more streamlined, emphasizing sustainable economic development. The subsidized investments are selected on the basis of their nature and potential positive impact on economic development as opposed to the previous formalistic approach (who owns the enterprise and where is it located). The format of providing tax incentives is more aligned with the policy objective of a particular tax incentive. For example, a lower rate applies to small low-profit enterprises, which are presumably important in job-creation and innovation and can use the after-tax profit for reinvestment, but get no tax subsidy before becoming profitable. Large enterprises receive tax subsidies in the form of "exaggerated deductions" or exemptions in respect of R&D expenditures, providing employment for the disabled or utilizing "green" technologies. The tax incentives encourage long-term, sustainable investments as opposed to encouraging "footloose" firms[32] as under the previous tax holidays. The new tax incentive measures overcome the problems of "round-tripping"[33] by abolishing the FDI-specific tax holidays.

The international tax rules (discussed in 2.6.) and the new anti-avoidance rules target both "inbound transactions" (such as transfer pricing and thin capitalization) and "outbound transactions" (notably the CFC rule). They recognize China's new position in the global economy as not only a major recipient of FDI, but also an emerging exporter of capital and the associated tax policy issues.

4. Transformation through Hybridization

4.1. International tax norms

Since the very beginning of its modern tax system, China has resisted "cloning" or "transplanting" the tax law of any specific foreign country for several possible reasons. First, no country resembles China closely enough to be used as a model. Second, when it came to borrowing foreign tax ideas, Chinese policymakers preferred to let "hundreds of flowers bloom at the same time" so that useful elements from various regimes could be selected to serve China's needs. China's recent history made copying a Western country's laws politically sensitive. Third, Western countries have been "harmonizing" their international tax rules in recent years (e.g. CFC rules, thin capitalization rules, transfer pricing rules, withholding taxes and jurisdictional rules). Fourth, because China needed to compete for FDI with other developing countries, Chinese policymakers had to study, compare and

28. See e.g. Art. 19 of the Detailed Rules and Regulations for Implementing the Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises, issued by the State Council on 30 June 1991 (hereafter "FIET Regulations").
29. The FIET Law, supra note 1, Art. 13 and the FIET Regulations, id., Arts. 52-57 addressed transfer pricing issues, but did not use or define the term "arm's length principle".
30. Ipsco Inc. v. R., [2002] 2 C.T.C. 2907, 2002 D.T.C. 1421, Para. 26 (T.C.C.). For the structural and drafting features of the Canadian Income Tax Act, see Hogg, Peter, Joanne Magee and Jinyan Li, *Principles of Canadian Income Tax Law* (Toronto: Carswell, 6th ed., 2008), Chap. 1.
31. For China's FDI-specific tax incentives, see Halkyard, Andrew and Ren Linghui, "China's Tax Incentive Regimes for Foreign Direct Investment: An Eassonian Analysis", paper given at a symposium at Queen's University on "Globalization and the Impact of Tax on International Investments" (see law.queensu.ca/announcements/taxSymposiumAnnouncement.html); and Li, Jinyan, "The Rise and Fall of Chinese Tax Incentives and Implications for International Tax Debates", *Florida Tax Review* (forthcoming) (see CLPE Research Paper 5/2008, available at ssrn.com.abstract=1087382).
32. See Li, supra note 31.
33. It is estimated that the round-tripping FDI ratio in China is likely to be around 40% of recorded flows or within the range of 30% to 50%. See Xiao, Geng, *Round-Tripping Foreign Direct Investment and the People's Republic of China* (Japan: Asian Development Bank Institute, 2004); and "Investment outflows to tax havens" in *China Daily (People's Daily Online*, 22 June 2004, available at english.peopledaily.com.cn/200406/22/eng20040622_147138.html (visited on 31 July 2007)).

take into consideration the tax policy of these countries. Therefore, "international tax norms" became a convenient justification for adopting anything that was not home-grown.

Based on the SAT Explanatory Notes, the notion of "international tax norms" seems to encompass ideas, rules, principles and practices from the following sources:
– OECD Model Tax Convention and Commentaries;
– UN Model Tax Convention;
– OECD Transfer Pricing Guidelines;
– statutory rules of one or more foreign countries (including, but not limited to, the OECD Member countries);
– case law of foreign countries (particularly that of common law jurisdictions);
– administrative rulings and practices of foreign countries; and
– World Trade Organization agreements.

International tax norms are used to justify not only pure "international" tax rules, but also general rules. The most direct adoption is perhaps in the area of anti-avoidance rules, especially transfer pricing rules and thin capitalization rules. The adoption of "place of effective management" as a test for residence is predominantly rationalized on the basis of international tax norms. In the Explanatory Notes, the SAT cited the domestic statutory rules in the United States, Sweden, Mexico, the United Kingdom, Japan, France, Germany, Italy, Australia, Belgium, Denmark, India and Thailand (as examples of adopting the place of incorporation test); France, the United Kingdom, Germany, Canada, Argentina, Egypt, Malaysia, Ireland and Luxembourg (as examples of adopting the place of management and control test); and the OECD Model and Commentary on Art. 4.

General tax rules that are explained on the basis of international tax norms include the following:

The standard tax rate and rate of withholding tax are set at rates thought to be internationally competitive.[34]

The deduction of charitable donations up to 12% of the annual profit is "referenced to common international practice" (SAT Explanatory Notes on the EIT Law, Art. 9).

The taxpayer's cost of creating goodwill is non-deductible because, among other reasons, "most countries in the world do not allow the amortization of such costs" (SAT Explanatory Notes on the EIT Law, Art. 12).

One of the explanations for prohibiting the LIFO method of computing the cost of goods sold is that "even free jurisdictions such as Hong Kong limit the use of LIFO and many developed countries limit LIFO in tax law and accounting rules" (SAT Explanatory Notes on the EIT Law, Art. 15);

The five-year loss carry-forward rule is adopted because "the majority of developed and developing countries adopt a loss carry-forward method for 4, 5, 8 or even 10 years, and the 5-year carry-forward rule is the same as that in Germany, Italy, Spain, Portugal, Denmark, Korea, Argentina, etc." (SAT Explanatory Notes on the EIT Law, Art. 18).

In explaining the non-taxation of non-profit organizations, the SAT cited the US Internal Revenue Code and "international norm" (SAT Explanatory Notes on the EIT Law, Art. 26).

The reduced rate for small low-profit enterprises "is referenced to international common practice" and the examples of foreign practice in assessing "small enterprises", which include the United States adopting the standard of sales and number of employees, France using the number of employees as a basic standard, Germany using annual sales and number of employees, and Japan using capital and number of employees (SAT Explanatory Notes on the EIT Law, Art. 28).

The "additional deduction" for R&D expenses and the costs of hiring disabled workers is "commonly used by countries in the world" to encourage investment in specific areas (EIT Law, Art. 30).

Finally, part of the reason for adopting the investment tax credit method to encourage production by way of comprehensive utilization of resources is that the method does not run afoul of the national treatment principle under the WTO (SAT Explanatory Notes on the EIT Law, Art. 34).[35]

4.2. Chinese innovations

Many provisions of the EIT Law and EIT Regulations are unique and innovative, and most of them are intended to protect the tax base. Some examples in the international tax area include:
– foreign partnerships are "taxpayers" for purposes of the EIT, whereas domestic partnerships are not (EIT Law, Art. 2);
– a resident enterprise may not deduct the losses attributable to a foreign branch (EIT Law, Art. 17);
– the capital gains from the disposal of shares in Chinese companies are deemed to be sourced in China (EIT Regulations, Art. 7);
– the insurance premiums collected by a non-resident enterprise from Chinese residents are sourced in China (EIT Regulations, Art. 7; SAT Explanatory Notes on the EIT Regulations, Art. 7); and
– formulary apportionment and other reasonable methods are used to allocate profits from related-party transactions to a Chinese taxpayer (EIT Law, Art. 44; EIT Regulations, Art. 115).[36]

34. Some EU Member States have abolished the FDI-specific tax incentives and reduced their statutory corporate tax rate: see OECD, *Tax Effects on Foreign Direct Investment: Recent Evidence and Policy Analysis* (OECD: Paris, 2007), at 80-81.
35. Previously, the investment tax credit was given to enterprises that purchased Chinese-made equipment; this was challenged by the United States and other countries under the WTO regime. See SAT Explanatory Notes on the EIT Law, Art. 34.
36. These methods were used to assess domestic enterprises under the previous regime. They now apply to cross-border related-party transactions; SAT Explanatory Notes on the EIT Law, Art. 44.

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Other "innovations" include the tax exemption for dividends effectively connected to a Chinese establishment of a non-resident enterprise (EIT Law, Art. 26). The rationale for this rule is to prevent double taxation in China, which, as discussed in 2.3.2., does not seem to make much sense.

Compared to other developing countries competing for FDI inflows, China is "innovative" in abandoning the FDI-specific tax incentives. It is conceivable that many FIEs continue to enjoy tax incentives under the new system. However, FIEs will have to qualify for the incentives based on the nature of the investment, not simply based on the form of ownership or location in a special area.

4.3. Chinese legacies

The legacies of economic transition and Chinese culture find their way into the EIT legislation. For example, in computing taxable income, a taxpayer may deduct a reasonable amount of wages and salaries, which include basic wages, bonuses, allowances, subsidies, year-end wage increases, compensation for overtime work and other expenses relating to the employment of workers (EIT Regulations, Art. 34). Under general accounting principles, such costs are clearly deductible in computing profits. That is why the Canadian Income Tax Act does not have a specific rule on the deductibility of wages and salaries. In China, on the other hand, the wages and salaries of workers of Chinese-owned enterprises (especially state-owned) have been strictly regulated by the government. As late as 2006, the government allowed the standard monthly salary to be raised from CNY 800 to 1,600, and enterprises could deduct only the standard amounts.[37] Enterprises often paid workers above the regulated amounts, but were unable to deduct the payments. This was one form of tax discrimination between Chinese-owned enterprises and FIEs because the latter were not subject to any wage controls. Art. 34 of the EIT Regulations allows a full deduction for wages and salaries as long as the amount is reasonable,[38] thereby eliminating the tax discrimination. Viewed in this light, this rule represents a great step forward in Chinese tax policy.

The previous tax incentive regimes were vastly different, causing serious discrimination against domestically-owned enterprises. Unlike with wages and salaries, the EIT Law does not extend the treatment of FIEs to domestically-owned enterprises. Instead, it provides an entirely new system for both types of enterprises. However, the legacies of the previous regimes are notable. Tax incentives remain a key part of the new tax system. High-tech industries, infrastructure projects and projects in agriculture, fishing, forestry and animal husbandry continue to be eligible for tax incentives.

Another Chinese legacy is the amount of discretion given to the tax authorities, especially in the area of approving the qualifications for tax relief. For example, Art. 35 of the EIT Law provides that detailed measures for implementing tax incentives are to be introduced by the State Council. The State Council promulgated Chapter 4 of the EIT Regulations, specifying the details for tax incentives. The EIT Regulations, in turn, authorize the SAT, Ministry of Finance and other relevant government departments to provide further details for actually implementing most of the tax incentives.

It is also customary in Chinese legal drafting to have a "residual" clause authorizing the government to determine "other" amounts or issues. Examples include:
– "other items" of exempt income (EIT Law, Art. 7);
– "other capital expenditures" that may not be depreciated (EIT Law, Art. 11);
– "expenditures on other intangible assets" that may not be amortized (EIT Law, Art. 12);
– "other income" derived by a non-resident that may be considered taxable income (EIT Law, Art. 19);
– "other tax incentives" may be introduced by the State Council to promote the national economic and social development or to avoid major impact on enterprise business activities caused by sudden incidents (EIT Law, Art. 36); and
– "other methods for assessing the taxable income of related parties" may be used if the taxpayer fails to provide documentation regarding related-party transactions or if the documentation is fraudulent, incomplete or untruthful (EIT Law, Art. 44).

Compared to its predecessors, however, the EIT Law is a vast improvement in reducing the scope of "administrative" decision-making powers. For example, although the qualifying conditions for many tax incentives are determined by the SAT, Ministry of Finance or other government departments, these conditions are published as "administrative rules". Under Chinese law, such "administrative rules" are part of the tax legislation.[39] Under the FIET Law, many tax incentives required "pre-approval" by the tax administration before the taxpayer could receive the incentive.[40] The EIT regime clearly provides taxpayers with more certainty and predictability as the new rules are far more detailed and transparent than any tax rules in China's modern history.

37. "SAT Officials Answer Media Questions about Tax-Deductible Wages for Domestic Enterprises", 19 October 2006, available at the SAT web site: www.chinatax.gov.cn.

38. To the extent that wages remain regulated by the government, the "reasonable" amount may be limited to a specified amount. As the labour market in China becomes more liberalized, the degree of regulation is declining. For more on wage controls in China, see Walder, Andrew G., "Markets and Income Inequity in Rural China: Political Advantage in an Expanding Economy", 67 *American Sociological Review* 231 (No. 2, 2002).

39. "Provisional regulations" or "interim rules" are promulgated by the State Council (similar to the executive branch of government in Western countries), the Ministry of Finance or the SAT under the delegated power of legislation. All of these have the force of law. For more discussion, see Li, Jinyan, "Development and Tax Policy: Case Study of China" (2006), presented at the 1st International Network for Tax Research (INTR) Conference; see papers.ssrn.com/sol3/papers.cfm?abstract_id=1017301.

40. See FIET Regulations, supra note 28, Arts. 67, 70, 72, 73, 74, 75, 80 and 81 and FIET Law, supra note 1, Art. 19. For example, to receive tax incentives, export-oriented enterprises and enterprises in special zones and areas needed "pre-approval" by a tax administration. The following documents had to be submitted by FIEs with the application for export-oriented status: (a) copies of the original approval documents and business licence, and (b) the audit report on the foreign exchange revenue and expenditure of the export products for the year before the application.

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5. Some Thoughts on Codifying International Tax Norms

The Chinese EIT has strong "international" features in terms of structure, terminology and substantive rules. In fact, it may read like a summary of a tax law in Canada or another Western country. Compared to its predecessors, the EIT legislation makes China's tax system more neutral and equitable, more transparent and predictable, and arguably more internationally competitive. It is too early to say whether such a highly hybrid tax system, which looks good on paper, can work well in practice. The SAT has done an excellent job in educating tax officials and the public about the new legislation.

International tax norms clearly provide a convenient and convincing rationale for tax reform in many cases. The increasing integration of China's economy with the global economy naturally requires China's corporate tax system to assimilate, as much as possible, that of other countries which may be exporting capital to China, importing capital from China, or competing with China for FDI inflows.

Incorporating international tax norms into Chinese legislation has some challenges. One is to obtain complete and accurate information on the various sources of international tax norms. Students of international and comparative taxation know the inherent difficulties in this task. Translating the foreign materials into the Chinese language is another daunting task.

Another challenge is to interpret and understand the international norms. Viewed at a general level, an international tax norm may have an obvious meaning. Upon closer examination, however, many "norms" have various nuanced meanings. Like an onion, the appearance of an "international tax norm" may not reveal its true "taste" or "smell" unless its layers are peeled off.

A third challenge is the selection of international tax norms for transplantation. The major determinants are probably the local legal and institutional conditions. The CFC rules have been around for over three decades, but China did not adopt a CFC rule until 2007 because it was irrelevant to China since outbound investment was insignificant. Another example is the use of the term "dividend". This term was not used in the 1980 JVIT Law or the 1991 FIET Law because FIEs and Chinese-owned enterprises were not necessarily organized in the form of companies. In fact, China did not have a company law in 1980 or 1991. Now that the Company Law (1993, revised in 2005) has been implemented for over a decade and the notion of "dividend" is better known in China, "dividend" is used in the EIT Law.

The fact that Chinese courts do not have the general power to interpret tax legislation means that China's tax legislation must "codify" common law principles. One example is the meaning of "corporate residence". In Canada, this is determined by case law to mean the "place of central management and control".[41] The meaning of "place of central management and control" is generally found to be the place where the board of directors meets and makes decisions. Another example is the general anti-avoidance rule. Common law countries have judicial anti-avoidance rules (such as the "substance over form" doctrine, the business purpose test, or sham doctrine) which function as general anti-avoidance rules. Because Chinese courts operate very differently from courts in Canada and many other countries, the common law tests or rules must be codified in the legislation. Such codification has its limitations, which is why the United Kingdom and the United States do not codify them. It will therefore be particularly interesting to see how international tax norms based on common law take their roots in China.

41. See Li, Jinyan, Arthur Cockfield and Scott Wilkie, *International Tax in Canada: Principles and Practices* (Lexis, 2006), Chap. 4.

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