Leveling the Playfield of Enterprise Competition in China

—The Review on China's New Unified Enterprise Income Tax Law

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Since early 1990s there have been coexisting two sets of enterprise income tax systems in the People's Republic of China. One of the two sets of enterprise income tax systems is the so-called domestic invested enterprise income tax system which is in principle based on the **Provisional Regulations of the People's Republic of China on Enterprise Income Tax** (**PREIT)** of the year 1993, the other is the foreign invested enterprise income tax system which is principally built by the **Income Tax Law of the People's Republic of China on the Enterprises with Foreign Investment and Foreign Enterprises (ITLEIFE)** of the year 1991. On March 16 of this year, China's parliament, the National People's Congress, adopted the landmark law, the **Enterprise Income Tax Law of the People's Republic of China (EITL)** at the closing ceremony of the 5th session and with an overwhelming majority of NPC lawmakers. This 60-article law, which is due to come into effect as of January 1st, 2008, is a key signal of a phase-in end of superior treatments to foreign investors for almost two decades and the unification of the two sets of income tax system mentioned above in China. This article discusses in detail four features of this new unified enterprise income tax law and highlights four controversial problems which deserve further clarification.

I. the Four Reform Features of the EITL

Compared with the two sets of income tax system, the content of provisions of the new unified enterprise income tax law reflects four features of the reform of current enterprise income tax systems in China as follows:

I.1 Feature 1—— Promotion of the principles of tax equality and fair competition

Compared with domestic invested enterprises subject to the application of the **PREIT,** foreign invested enterprises enjoy more favorable treatments in tax incentives and deduction of the calculation of the taxable income under the provisions of the **ITLEIFE,** which has caused the unfairness in tax burden between the two categories of enterprises. The practical income tax burden of domestic invested enterprises is much higher than that of foreign invested enterprises, although the difference of the nominal tax rates provided in the two sets of tax system respectively is only 3%. An estimate based on a national survey of enterprise income tax sources show that average enterprise income tax burden on foreign-funded enterprises is 15% while for the domestic enterprises is 25%, 10 percentage points higher than that on foreign-funded enterprises. Domestic enterprises strongly call for the unification of income tax treatment and the realization of fair competition. [1]

A major move in the **EITL** is to establish a standardized corporate income tax system uniformly applicable to these two types of enterprises and level the playing field to create a fair competitive environment. The tendency can be shown by the unification of the pre-tax deduction rules and tax rates, the changes of the preferential tax policies and etc. Followings are four concrete examples:

Example 1: Unification of legal provisions on the items of the pre-tax deduction and deduction standard.

In the current income tax laws, compared with foreign-invested enterprises, domestic companies are subject to much stricter requirements and narrower scope of items in the pre-tax deduction. An obvious example is the deduction of the salaries paid to employees and the three funds (i.e. employee's welfare costs, employee education expense and employee labor union dues). According to the provision of the **PREIT** and relevant Circulars issued by the Ministry of Finance in 1994, when computing the taxable income of domestic-invested enterprises,

"*Salaries and wages are deductible based on the amount of tax salaries and wages. The bases for calculating the tax salaries and wages shall be determined by the People's Governments of Provinces, Autonomous Regions and Directly Administered Municipalities within the range set down by the Ministry of Finance, i.e. the maximum deductible amount per month is RMB 500 yuan per person and in the developed area, the deductible amount is allowed to be higher but still subject to the limit within 20% of the maximum. Employee's union expenses, employee's welfare costs and employee's educational expenses are respectively deductible at 2%, 14% and 1.5% of the total amount of tax salaries and wages of the enterprise.*"

[1] Tifu, An & Haiyong Wang, On the Incorporation of Two Sets of Corporation Income Tax Systems: Necessity, Feasibility and Urgency, Taxation Research Journal, 2005 (3).

However, under the Rules for the Implementation of the **ITLEIFE**, for the foreign-funded companies, not only salaries and wages, but also benefits and allowances paid by enterprises to employees may be deductible upon approval by the local competent tax offices after examination on the relevant documents provide by the taxpayers. Thus, the stricter limits and narrower scope of deduction items put domestic companies at a disadvantageous status in the competition. This unfairness in the pre-tax deduction is finally overcome by the law unification in the **EITL**. According to Art. 8 of the **EITL** which is to apply to both domestic and foreign-funded enterprises by January 1, 2008,

"*The reasonable expenses incurred by enterprises actually for obtaining income, including the cost, fees, tax expenses, loss and other expenses, shall be deducted in the calculation of the taxable income.*"

The provision of Art. 8 mean that both domestic and foreign invested enterprises will be subject to same standards and scope of pre-tax deduction in computing the taxable income in the near future.

Example 2: Unification of legal provisions on the enterprises taxable income items, the depreciation of fixed assets, the amortization of the intangible assets and long-term prepaid expenses, the valuation method of stock and losses carrying forward , and etc.

Under the current domestic enterprise income tax rules, the gains derived by enterprises from their equity investments including dividends and bonus shall be accounted into the taxable base; however, the after-tax profits (dividends and bonus) received by foreign-invested companies from the distributing companies located in China are exempt from income tax according to the provision of the **ITLEIFE**. [2] Further, to compute the depreciation of fixed assets, for domestic companies, the residual value which can be deducted from the original value of fixed assets is restricted to within 5% of the original value amount, while for foreign-funded enterprises, the deductible residual value is allowed to reach 10%.[3]

The differences as such which are criticized as the root of the inequality of tax

[2] Provisional Regulations of the People's Republic of China on Enterprises Income Tax, Art.5; Detailed Rules for the Implementation of the Provisional Regulations of the People's Republic of China on Enterprise Income Tax, Art. 7.6; Rules for the Implementation of the Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises, Art. 18.

[3] Detailed Rules for the Implementation of the Provisional Regulations of the People's Republic of China on Enterprise Income Tax, Art. 31.1.3; Rules for the Implementation of the Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises, Art. 33.

burden and unfair competition are mostly eliminated in the **EITL**.[4] For example, the gains derived by both domestic and foreign enterprises from their equity investments, according to the relevant provisions in the **EITL,** are taxable income in principle, and the exceptions are only restricted to those dividends and bonus that are satisfied with certain conditions required by the tax law.[5] In this context, a general principle is that both the foreign-invested and domestic companies shall pay tax on their equity investment earnings whereas the tax-exemption treatment of the equity investment are equally applied to both of them. In addition, the **EITL** has provided uniform provisions concerning the depreciation of fixed assets, the amortization of the intangible assets and long-term prepaid expenses, the valuation method of stock and losses carrying forward.

Example 3: Changes of tax incentives and the unification of tax rate at 25%.

For the last two decades, in China, preferential policies towards overseas-funded businesses, which are described as "policies superior to national treatment", have always been important attractions to foreign investment. Consequently, generous tax incentives and the lower tax rate fueled foreign capital influx but also resulted in the dual income tax mechanism which is unfair to domestic companies. The differential tax rate has incurred growing complaints from domestic enterprises, some of which even disguise themselves as overseas-funded ones to dodge tax.

Against this background, the **EITL** wipes off some foreign-investment-oriented tax incentives policies and unifies the income tax rate at 25%.[6] This uniform rate is fixed taking into account the national financial need and the intent to alleviate the heavy tax burden on domestic companies as well as the concern to avoid the dramatic tax increase on the foreign-invested enterprises. It is also considered to be reasonable and favorable in comparison with the average enterprise income tax rates worldwide and in the neighboring countries and regions, especially in the eighteen adjacent countries or regions geographically close to China where the average tax rates are higher than 25%.[7] Therefore, it is predicted that the new tax rate will not undermine foreign investment in China even in face of the drastic international tax competition.

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[4] The Enterprise Income Tax Law of the People's Republic of China, Art. 11, Art. 12, Art. 13, Art. 15 and Art. 18.

[5] The Enterprise Income Tax Law of the People's Republic of China, Art. 6, Art. 26.2 & Art. 26.3.

[6] As to the reformation policies concerning the tax incentives set forth in the Enterprise Income Tax Law of the People's Republic of China, please refer to the Section I.3 of this article.

[7] Comments on the Enterprise Income Tax Law of the People's Republic of China (Draft) made by the Minister of Finance, Mr. Renqing, Jin in the 5th Session of the 10th Standing Committee of the National People's Congress on Mar. 8, 2007.

Further, the clause of transitional period set forth in Art. 57 of the **EITL** counteracts to some extent the impact of the tax increase on the foreign invested enterprises.

Unlike the application scope of the tax incentives provided by the **ITLEIFE,** one of the meaningful reforms of income tax preferences in the **EITL** is that the new tax incentives are applicable not only to enterprises with foreign investment but also to foreign enterprises having establishments or places in China. Under current relevant provisions of the **ITLEIFE,** most income tax incentives are only applicable to enterprises with foreign investment which have Chinese legal personality and foreign enterprises with a foreign legal personality are not eligible for the enjoyment of these tax preferences, which is to a certain extent contradictory to the principle of tax non-discrimination provided in double tax treaties. The new unified enterprise income tax law has changed the unfair situation and enterprises with foreign investment, foreign enterprises having establishments or places in China and domestic invested enterprises are all qualified for enjoying same tax favorable treatments, provided that their business operations belong to the scope of the industrial lines and projects that Chinese government now encourage.

<u>Example 4</u>: Extension of foreign tax credit to the taxable income derived by the foreign enterprises having establishments or places in China which is derived outside China but effectively connected with those establishments or places.[8]

Under the current rules of the **ITLEIFE**, the income tax paid abroad to a foreign state by a business establishment of foreign enterprises in China on the income derived outside China but effectively connected with the establishment is only allowable to be deducted as the expenses from its taxable income and not entitled to crediting against the Chinese income tax payable by the establishment of the foreign enterprise.[9] According to Paragraph 2 of Art. 23 of the **EITL**, the treatment of foreign tax credit is also applicable to those foreign enterprises having establishments in China the same way as to domestic enterprises. Compared with the method of tax deduction, the adoption of the tax credit works more effectively to eliminate the double taxation on the income of the foreign investment made by foreign enterprises having establishments in China, and thus echoes the policy of “national treatment” on foreign-funded companies and the tax equity principle.

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[8] The Enterprise Income Tax Law of the People’s Republic of China, Art.23.1.2.

[9] Rules for the Implementation of the Income Tax Law of the People’s Republic of China for Enterprises with Foreign Investment and Foreign Enterprises, Art. 28.

I.2 Feature 2——Normalizing the enterprise income tax system with reference to international tax usages.

This feature can be shown in four aspects:

Redefinition of the "taxpayers": The EITL defines the taxpayers in Art.1 as "*the enterprises and other organizations that earn income within China*" and precludes single proprietorships and partnerships from the scope of taxpayers of enterprise income tax. Such a definition is basically similar with the relevant provisions of enterprises income tax laws in various counties.

Prior to the EITL, the criteria to define the taxpayers in two sets of income tax laws which are respectively applied to domestic companies and foreign-funded enterprises are in conflict. For the domestic enterprises, the term of "taxpayers" is defined based on the "independent economic accounting criteria" and refers to those independent economic accounting entities which are eligible to open the balance account in the bank, establish its account book and compile account statement independently and are capable of calculating its profits and losses independently.[10] Among these are state-owned enterprises, collectively-owned enterprises, private enterprises, joint operation enterprises, stock enterprises, and the institutions and the social organizations which gain the income from the production, business or any others in China. Such a definition can be traced back to the time when the tax distribution scheme was still prevailing in the finance and tax system in China and the enterprises tax still belonged to the revenue of local governments, and was used to simplify the tax administration. For the foreign-invested companies, the laws categorize taxpayers into two groups: enterprises with foreign investment (EFIs) and foreign enterprises (FEs). EFIs are further divided into three types: Sino-foreign equity joint ventures (EJVs), Sino-foreign cooperative joint venture (CJV) and wholly foreign-owned enterprises (WFOEs). FEs cover foreign companies, enterprises and other economic organizations having establishments or places in China and engaged in production or business operations and those without establishments or places but having income from sources within China. Neither the domestic companies' income tax laws nor the income tax laws applied to foreign-funded enterprises adopts the

[10] Detailed Rules for the Implementation of the Provisional Regulations of the People's Republic of China on Enterprise Income Tax, Art.4.

“legal person” test to define the taxpayers.

In the legislative process of the **EITL**, the proposal to use the “legal person” as the defining criterion of “taxpayers” was widely supported by some tax scholars. To an extreme, there are voices asserting to name the **EITL** with the terms such as “income tax law on legal persons”. However, these radical reformed ideas were not adopted by the lawmakers who are more concerned with the consistency of the **EITL** with the current tax laws. Cautiously, they defined the taxpayers in a relatively vague but broad wording with the intent to cover all the taxpayers under the current income law systems. Not only that, the terms of “enterprises or other organizations that earn income” can be also reasonably interpreted to include those business entities which have no the independent legal personality, such as Sino-foreign cooperative enterprises, joint operation enterprises and private non-business entities, etc.

But the broad interpretation of the “taxpayers” is not unlimited. Paragraph 2 of Art.1 set the boundary in the application of the **ETIL** by excluding single proprietorship enterprises (SPEs) and partnership enterprises (PEs) from the scope of the taxpayers therein. According to the Single Proprietorship Enterprise Law and the Law on Partnership Enterprises in China, neither SPE nor PE has the independent legal personality. The investors of a SPE or PE shall bear unlimited responsibilities for the entities since the division between their individual property and the entity’s property is usually unclear. In the partnership enterprises, individual partners shall pay income tax on their respective share of the partnership’s income, whereas the investor in the single proprietorship enterprise is obligated to pay the individual income tax according to the Individual Income Tax Law of P. R. China. [11]

Categorization of the taxpayers: To be compatible with international tax practice, the **EITL** categorizes taxpayers into “resident enterprise” and “non-resident enterprise”, and taxes resident enterprises on the basis of the resident jurisdiction and non-resident enterprises according to the source jurisdiction.

It is a common practice in income tax laws of many countries that taxpayers are divided into “resident taxpayers” and “non-resident taxpayers” and a resident taxpayer bears unlimited tax liability and a non-resident taxpayer has limited tax liability. However, neither the domestic nor the foreign enterprise income tax law adopts such

[11] Circular of the Ministry of Finance and the State Administration of Taxation concerning the Rules on the Individual Income Taxes on Individual Proprietorship Enterprise and Partner Enterprise Investors, No. 91, [2000].

a categorization of taxpayers. In the **EITL**, Art. 2 introduces the concept of "resident enterprises" and "non-resident enterprises" along with the criteria of "place of registration" and "place of effective management". It stipulates that a resident enterprise in the sense of the **EITL** is "*the enterprise that is set up in China in accordance with Chinese law or that which is established according to the law of a foreign country (region) with its effective management agency located in China,*" [12] whereas a non-resident enterprise refers to "*the enterprise that is set up under the law of a foreign country (region) and has its effective management agency outside China.*"[13] Under Art.3 of the **EITL**, the resident enterprises should perform the unlimited tax obligation and pay tax to Chinese government on their world-wide income, and the non-resident enterprises have the limited tax obligation and pay tax only on their income derived from sources within China.

The advantage of using the "place of registration" test to determine the residence of the enterprise is that this test is easy to be comprehended and identified, but the disadvantage is that it may be taken use of by taxpayers to avoid the resident tax jurisdiction through selecting the incorporation place. That is why in addition to the "place of registration" test, the **EITL** introduces the "place of effective management" test as the complement. The concepts of "effective management" or "head office" are granted with specific meanings in the context of the tax laws. As commonly accepted and applied in various countries' tax laws and practice, they may refer to the administrative center in a company which exercise the effective supervision, control and management over the company, such as the place of the shareholders' general meeting, the location of the board of directors and the domicile place of the persons who are entitled to exercise actual authority or control over the significant business activities in the company. A practical benefit to adopt this test in the **EITL** is to prevent Chinese enterprises from dodging their tax obligations as resident taxpayers by transferring capitals to a tax haven, registering companies out of the territory of China but conducting the business inside China in the name of oversea registered corporations. In the case that a company whose effective management locates in China conducts such a false investment, that company will be treated as a Chinese resident taxpayer and is obliged to pay taxes to Chinese tax authorities on all of its

[12] The Enterprise Income Tax Law of the People's Republic of China, Art.2.2.
[13] The Enterprise Income Tax Law of the People's Republic of China, Art.2.3.

income from sources inside and outside the territory of China. Another benefit incurred by using this test is to bring the domestic enterprise income tax law of China in uniformity with relevant provisions in bilateral tax treaties since this test is highly recommended by both OECD Model Tax Convention and UN Model Double Taxation Convention[14] to settle the conflict problem of the corporate dual residence and embodied in many tax treaties concluded by China. As a result, this will facilitate Chinese tax authorities to exercise the resident tax jurisdiction.

Changes in the administration of tax collection: Prior to the **EITL**, in the current income tax laws, the rules on the administration of tax collection applied to foreign-funded companies differ from those applied to domestic companies. For the former, the income tax is declared in consolidation by its head office locating in China, while for the latter, the taxes shall be paid to the local tax authorities by each enterprise which is qualified as an independent economic accounting entity. It implies that unlike the branches in foreign-funded enterprises, in domestic companies, the profit and the loss of the branch as an independent economic accounting entity could not be combined with the profit and loss statement of the head office. The reason for such a restriction of filing and paying tax on a consolidated basis upon the domestic companies is related both to the revenue sharing system between the central and local governments in China and to a practical motive to reduce the administrative cost and simplify the regulative procedures of income taxation. However, these two distinct treatments in tax collection have biased domestic companies and also turn out to be in conflict with the basic principle enshrined in the civil law which requires the enterprises having a legal personality to bear liability with all the properties it owns.

In the face of these problems, the **EITL** unifies the rules on the administration of tax collection and adopts measures close to the current rules applied to the foreign funded companies. In Art. 50, it provides that,

"*Unless otherwise specified in tax laws and administrative regulations, for the resident enterprises, in principle the place of tax payment is the place of its registration. But in case that the place of the registration of a company is outside the territory of China, the place of tax payment shall be the place where the effective management agency is located. For resident enterprises that establish business establishments in China without legal person qualification, the enterprise income tax*

[14] OECD, Model Tax Convention on Income and on Capital, 2000, Paragraph 3 of Ar.4; UN, Model Double Taxation Convention between Developed and Developing Countries, 2001, Paragraph 3 of Art. 4, selected and edited by Kees van Raad, Fourth edition, 2004, International Tax Center Leiden, pp 356-357.

shall be calculated and paid on a consolidated basis."[15]

Based on this provision, in essence, it is the head office which shall file a consolidated tax return and pay tax for the enterprise since on most occasions the place of the registration of an enterprise is where its head office locates. As to those companies that are registered out of China but have the effective management agency in China, a consolidated tax return shall be filed by its effective management agency located in China so to prevent the company from dodging taxes on its income from sources outside the territory of China.

Furthermore, the **EITL** also unified the rules on the consolidated report and payment of income tax in the group enterprises. Prior to the promulgation of the **EITL**, the parent-subsidiary enterprises in a domestic group company are allowed to pay tax on the consolidated basis as long as they satisfy certain conditions required by law. However, for the foreign-funded group company, there is no legal basis on which it may make a consolidated tax return and pay tax on behalf of the whole enterprises belonged to the group company since in the current income tax laws applicable to the foreign-funded companies a taxpayer therein is a enterprise with a independent legal personality. In the **EITL**, such distinctions are eliminated by Art. 52 which provides a general principle to both domestic and foreign group companies in this regard, i.e. "enterprises may not pay consolidated enterprise income tax". However, in the view of the recent practice and the tax laws reform in many countries which allow certain parent-subsidiary enterprises in a group company to make consolidated tax payment, the EITL leaves the door open by inserting an escape clause, i.e. "unless otherwise prescribed by the State Council". It implies that the State Council is empowered to prescribe the rules for a group company to pay taxes on a consolidated basis under certain conditions.

<u>Incorporation of the rules on indirect foreign tax credit</u>: Under the current income tax laws, international jurisdictional double taxation may be eliminated through the method of direct foreign tax credit provided therein and international economic double taxation arising from transnational dividend distributions among the parent-subsidiary corporations located in different countries can't be avoided, since there is no any rules in current two sets of income tax systems concerning the

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[15] The Enterprise Income Tax Law of the People's Republic of China, Art. 50.

indirect foreign tax credit.[16] However, the irony is that many bilateral treaties China signed with other countries include the provision on the indirect foreign tax credit which requires a Contracting State to give its resident taxpayer a indirect tax credit against the foreign corporate tax paid by the distributing company on the dividend income.[17] This gap between the tax treaties and the domestic tax laws with regard to the indirect tax credit remained to be unresolved until the enactment of the **EITL**. [18] Art. 24 of the EITL stipulates that,

"*For the income from equity investment such as dividends and bonus sourcing outside the territory of China and received by a resident enterprise from the foreign enterprises it directly or indirectly controls, the portion of foreign income tax paid abroad actually by the foreign enterprises which is proportioned to the above mentioned income from equity investment, may be credited against the income tax payable by the resident enterprise within the credit limit prescribed in Art. 23.*"

This article symbolizes the establishment of the foreign indirect tax credit system in China's enterprise income tax laws and provides the domestic companies an incentive to invest abroad. Moreover it fills the gap between tax treaties and domestic tax laws by granting the resident taxpayers the indirect foreign tax credit as required by the treaties.

I.3 Feature 3—— Reform of the tax preference

The readjustment of income tax preference is the main content of the reform of China's enterprise income tax system. Tax preference policies adopted in the **EITL** are aimed to bring into full play of income tax incentives with respect of improving national economic structure, encouraging up-grade of industries and technologies and promoting social harmonization and sustainable development. It also takes into account the latest practice of tax reform in various countries and the current

[16] The tax credit set forth in the current Chinese tax laws only refers to the direct tax credit, please see e.g., Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises, Art. 12; Rules for the Implementation of the Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises, Chapter 7 on the "Foreign Tax Credit"; Provisional Regulations of the People's Republic of China on Enterprises Income Tax, Art. 12; Detailed Rules for the Implementation of the Provisional Regulations of the People's Republic of China on Enterprise Income Tax, Chapter 5 on the "Deduction on the Income from outside of China".

[17] In the agreements for the avoidance of double taxation between China and Japan, China and the U.S., China and Britain, China and Singapore, there are provisions on the indirect tax credit treatment concerning the dividend income. See e.g., Agreement Between the Government of Japan and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, Art. 23.1.2; Agreement between the Government of the United States of America and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Tax Evasion with respect to Taxes on Income, Art. 22.1.2.

[18] An Chen (ed.), Symposium on the International Economics Law (2nd book), China Higher Education Press, 2002, pp. 941－942.

status of international tax competition. The changes in tax preference in the EITL can be briefly summarized into four aspects:

(1) Many indirect tax preferences are introduced into the **ETIL**. As before, tax benefits granted to companies solely relied on the direct tax incentives such as tax reduction and tax exemption, which is harmful for the tax interests of a State in the long term and meaningless to introduce capital-intensive or technology-intensive investments. This situation is enhanced by the introduction of indirect tax incentive measures such as investment credit, investment rebate and accelerated depreciation, etc.

(2) Industry-based tax incentives are replacing the region-based tax incentives as the mainstay in the tax preferences. This tendency is shown in the cancellation of certain tax incentives under the current income tax laws which were designed specifically for foreign-funded companies located in specified regions, such as the lower tax rates applied to foreign investment in the Special Economic Zones, the Economic and Technical Development Zone and the Coastal Economic Open Zones. The generous tax exemption and reduction for the foreign-invested companies of a production nature, and the 50% tax reduction for export-oriented foreign-funded enterprises, are also abolished. Instead, the **EITL** retains the preferential tax policies on the investment in certain industries such as agriculture, forestry, animal husbandry, fisheries and infrastructure projects with key state support (e.g. construction of the harbor, pier, airport, railway, highway, electricity and hydroelectricity). Further, the **EITL** extends the lower tax rate which used to be only applied to the high-tech enterprises located in the High Technology Development Zones to all the high-tech enterprises in the national wide.

(3) The tax preferential policies in the EITL are crafted to promote enterprise innovation and technological development as well as the environmental protection, the energy conservation and the work safety. It can be shown by following articles:

"*The income from engaging in qualified projects of environmental protection, energy and water conservation may be subject to tax exemption or deduction.*" (Art. 27.3);

"*Venture investment enterprises engaging in venture investment which are specially supported by the national policy may offset the taxable income at a certain ratio of the investment amount.*" (Art. 31);

"*The years of depreciation may be shortened or the accelerated depreciation method may be adopted in the case that the fixed assets of the enterprises require accelerated depreciation due to the technology advancement.*" (Art. 32);

"*The research and development expenses incurred in the development of new technology, new products and new skills may be deducted in the computation of the taxable income of the enterprises.*" (Art. 30.1.1);

"*The investment by enterprises on procurement of special facilities for environmental protection, energy and water conservation and safe production may be credited against the enterprise income tax payable at a certain ratio.*" (Art. 34)

(4) The concerns of public welfare and the needs to support the disadvantaged are taken in account in making the tax preferential policies. For example, according to Art. 30 (2), the wages paid by enterprises for job placement of the disabled and of other personnel covered by the national employment settlement policy may be deducted from the taxable income as the expenses of the companies. Further, to promote the public welfare, the **EITL** greatly increases the pre-tax deduction ratio of the charitable donations and provides that the expenses from the charitable donations which are within 12% of the total annual profit are allowed to be deducted form the taxable income (Art. 9). Meanwhile, in the **EITL**, the autonomous authority of ethnic autonomous locality is empowered to decide on the reduction or the exemption of the portion of the enterprise income tax paid by the local enterprises to the locality (Art. 9).

I.4 Feature 4—— Strengthening the regulation on tax avoidance tax

In the face of increasing various tax avoidances by the enterprises in recent years, the anti-avoidance rules become a hot spot in the legislation of the **EITL**.

In the current income tax laws on enterprises and the laws on tax administration and collection, there are only provisions on profits readjustment for transfer pricing transactions between the related enterprises which are based on the arm's length principle and traditional comparative transactional methods. Although the reform and the enhancement of the anti-avoidance tax rules have been taking place rapidly in various countries in the recent years, the anti-avoidance rules in Chinese income tax laws and regulations almost remained the same. It is not until the time when the **EITL** was passed that the legislation of the anti-avoidance rules in China takes a giant leap.

Chapter six of the **EITL -** "Special Tax Payment Adjustment" - is specifically written to deal with the tax evasion and avoidance of companies based on the reference to the legislative and practical experience and latest development both in China and various countries. It contains five major changes:

(1) New regulatory measures are adopted including the cost sharing agreement and the advance pricing arrangements. In the light of the difficulties to apply the comparable uncontrolled price method (CUPM) or the resale price method (RPM) to the intangible assets and the labor service, the **EITL** provides that:

"*In the computation of the taxable income, the cost incurred in the joint development and transfer of intangible assets between the enterprise and its affiliates or the joint provision and the acceptance of labor services between them shall be shared on the basis of the arm's length principle.*" "*Enterprises may report to the tax authority the pricing principle and the calculation method of the transactions agreed upon by its affiliates and itself so to reach the advanced pricing agreement with the tax authority.*" [19]

(2) The powers of supervision and control of tax authorities over tax avoidance are strengthened. According to the **EITL**, the tax authority is granted with the power to assess the taxable income where enterprise fail to provide the information of business transactions with affiliates, or provide false and incomplete information which can not faithfully reflect the affiliated business transaction.[20] As a result, the strengthened powers facilitate tax authorities to combat the tax avoidance.

(3) A general anti-avoidance rule, i.e. the principle of "reasonable business purpose", has been added into the **EITL** and is written in Art. 47,

"*Where enterprises conduct other transactional arrangements which have no a reasonable business purpose and thus reduce their taxable revenue or income, the tax authority has the power to adjust in a reasonable way.*"

This principle has been applied in the taxation in certain developed countries for some time, such as the UK, the US, Germany and France, and in a sense is equivalent to the doctrine of "economic substance"/"sham transaction" and the principle of "substance over form". [21] Unlike special anti-avoidance provisions, general anti-avoidance provisions grant the courts and tax authorities the flexibility to apply the general legal principles into a specific case and the discretion to deny the legitimacy of the transactions based on the lacking of a reasonable business objective

19 The Enterprise Income Tax Law of the People's Republic of China, Art. 41-42.
20 The Enterprise Income Tax Law of the People's Republic of China, Art. 43-44.
21 Victor Thuronyi, Comparative Tax Law, translated by Ding Yi, Peking University Press, 2006, pp. 160-195.

or the inconformity between the economic substance and the legal form. Thus this principle becomes a powerful weapon for the court and the tax authority to deal with various tricky measures taken by the taxpayers to evade tax.

(4) The **EITL** introduces the controlled foreign company (CFC) rules (Art. 45) which aims at preventing companies from avoiding tax by diverting income to the subsidiaries in tax havens and postponing the perform of tax liability. In China, this rule is designed specifically to work against the increasing phenomenon of "false foreign investment", i.e. the foreign (overseas) subsidiaries established in tax havens but actually controlled by resident shareholders in China avoid their tax obligations by purposefully misusing their foreign legal status as the independent taxpayers as well as the laws obligating shareholders to pay taxes only after the distribution of the dividends. Thus, instead of regularly distributing their after-taxing profits to the resident shareholders in China, these controlled foreign subsidiaries in tax havens intentionally hold back their profits and don't distribute them to the resident shareholders in the long run, so that the resident shareholders in China can evade tax payment incurred by dividend income. Against this background, the CFC rules came to exist in Art. 45 of the EITL,

"*Where enterprises controlled by resident enterprises or resident enterprises and resident individuals are set up in the country (region) where the actual tax burden is obviously lower than the tax rate prescribed in Paragraph1of Art.4 of this law, and profits are not distributed or distributed at a reduced rate due to reasons other than reasonable business needs, the portion of the above profits belonging to such resident enterprises shall be included in the income of such resident enterprises in the current period.*"

The wording of this article shows that the CFC rules therein are designed to be specifically applied to shareholders resident in China when certain conditions prescribed are met rather than impose the additional tax burden on the overseas controlled companies. As the Commentary of the Model Tax Convention of the OECD has recognized, the CFC legislation structured in this way is not contrary to the relevant provisions of a double tax convention.[22]

(5) Thin capitalization rules are adopted in the **EITL**. Along with the national policies to loosen the control over the foreign exchange on capital account as well as the reduction of tax incentives given to foreign investment, especially the cut-back of

[22] OECD, Commentaries on the Articles of the Model Tax Convention on Income and on Capital, Commentary on Article 1, Paragraph 23, Condensed Version, July 2005, P64.

the preferential policies on the equity investment, it can be reasonably predicted that thin capitalization will be more and more frequently used by transnational companies as a tool to minimize the tax payment. In the view of this development tendency, the lack of thin capitalization rules in the current income tax laws on enterprises in China becomes an arresting problem and the inclusion of this rule into the **EITL** is regarded to be necessary and is of far-reaching significance. Thin capitalization rule provided in Art. 46 says that,

"The portion of interest expenses incurred by enterprises which is belonged to the loan investment exceeding the prescribed ratio of loan investment to equity investment received by enterprises from their affiliated parties should not be deductible when computing the enterprises' taxable income."

It indicates that during this phase thin capitalization rules in China mainly rely on the method of the "fixed ratio" rather than the "arm's length principle" since the former presents a more objective approach to enhance the law certainty and the efficiency in the tax enforcement, and thus will be helpful to reduce the administrative expenses of tax authorities and the compliance costs of taxpayers. [23]

Ⅱ. The Four Remained Problems in the EITL

The objective of the **EITL** is to lay down basic principles and fundamental rules in the income taxation on enterprises. This predetermines its inherent character of being abstract and general. Thus, it is provided in Art. 59 that further detailed rules shall be formulated by the State Council to implement the law. In the authors' opinions, there are at least four issues in the **EITL** that need further clarification:

<u>Issue 1- Definition of taxpayers.</u> A clear definition of taxpayers is a precondition to guarantee the legality of taxation. In Art. 1 of the **EITL**, the taxpayer is defined as the enterprises and other organizations that obtain income within China but not include single proprietorship and the partnership enterprises. However, what the "enterprises" herein refer to still remains to be ambiguous in the implementation. In Chinese language, the term of "enterprises" may imply the entities which conduct economic activities in production, transportation, trade and etc. [24] In English, the

[23] As to the comparison of the "fix ratio approach" and the "arm's length principle" in the context of the thin capitalization rules in China, please refer to Yixin Liao, Hongyan Chen, On the Perfection of China's Tax Rules of Regulating Thin Capitalization, Journal of Xiamen University (Social Sciences), 2007(1).

[24] The Institute of Linguistic in the Chinese Academy of Social Sciences, Modern Chinese Dictionary (Revised ed.), The Commercial Press, 1997, p. 998.

original meaning of the term “enterprise” is an undertaking or a plan (especially the one of some hardship, complication and risk), a business organization or an institution, and industrious and systematic activities. In Chinese current income tax laws on companies, the term of “enterprises” has not been strictly and precisely defined, but is used as a general usage to cover the organizations, institutes or premises which are conducting business activities and include both the companies with independent legal personality and those branches, establishments or premises which don’t have juridical personality.[25] The term “enterprise” in the EITL should have a broad coverage which includes not only those entities with a business nature but also other institutions or organizations which are ineligible to conduct business activities but obtain the income from their activities”. As legislators didn’t give a general definition of the concept of “enterprise” in the EITL, the scope of the term of “enterprises” therein is still unclear. To solve this problem, considering the legislative experiences and tax practices in various countries, an enumerative list combined with a general exclusive description may be helpful to define the meaning of term “enterprise” and its scope. It may be articulated as follows, “enterprises in this law are the companies, corporations, governmental departments, institutions, social organizations and foundations which are established with the governmental approval or register to be legal persons according to the relevant laws, and also include other entities which don’t have legal personalities but obtain the income not governed by the Individual Income Tax Law.”

Issue 2 – Non-deductible expenses in the calculation of the taxable income. Art. 10 of the ETIL provides eight items of expenses which taxpayers shall not deduct from the taxable income. Compared with Art.19 in the Rules for the Implementation of the Income Tax Law of the People’s Republic of China for Enterprises with Foreign Investment and Foreign Enterprises which stipulates the non-deductible costs and expenses in the taxable income, a noticeable change in the ETIL is the cancellation of a non-deductible expense, i.e. royalties and rents paid between braches of a same enterprise and by a business establishment to its head office. The original purpose of such a provision in Art.19 is to avoid the “double expenses deduction” which may occur between a business establishment set up by a non-resident foreign enterprise in China and its head office located outside China. Because according to

[25] For example, in the international tax conventions, the term of enterprises are applied to the carrying on of any business. See. e.g. OECD, Model Tax Convention on Income and on Capital, Article 3, Paragraph 1 (c), Commentary on Article 3, Paragraph 4, Condensed Version, July 2005, P72.

Art. 20 of the Rules for the Implementation of the Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises, reasonable overhead expenses paid by the business establishment of a non-resident foreign enterprise in China to its head office is allowed to be deducted when computing the taxable income of the business establishment. If the business establishment set up by foreign enterprises in China is further allowed the deduction of the royalties paid to its head office from the taxable income, it would result in the double deduction on the same expense. From this perspective, the preservation of the non-deductibility of the royalties or rents paid by a branch of a non-resident enterprise to its head office is of the critical significance.

A noted fact in the legislative process is that in the Draft of the **ETIL** submitted by the State Council to the National People's Congress, it was stipulated in Art. 10 that both the royalties and rents paid between the business establishments within a same enterprise are non-deductible expenses. However, such provisions were cancelled during the discussion in the meeting of the National People's Congress. In the authors' opinion, this cancellation is inappropriate. The rational behind this concern is that the inherent relationship between two establishments of a same company is different from the relationship between two separate companies who have respectively independent legal personalities. Where a branch share the general administrative expenses allocated by its head office, the head office shall not charge fees or interests for providing the tangible property, intangible property and capital to its branch. Otherwise, the profits earned by the branch will be improperly transferred to its head office, which in essence distorts the actual operational prifits of the branch and deviates from the basic principle of separate entity accounting which requires a permanent establishment should be deemed as a seperate entity in the computation of its profits. [26] Therefore, the cancellation of the royalties and rents paid between the establishments of a same company and by a branch of a non-resident enterprise to the head office from the non-deductible expenses, will hinder the accurate calculation of the taxable income of the establishments set up by non-resident enterprises in the territory of China, and thus may lessen the tax levied on the non-resident foreign

[26] In both UN and OECD Conventions and the Commentaries, the royalties and interests paid by a permanent establishments to its head office is not deductible in the calculation of its income, expect the interest on the money lent by the head office to its permanent establishment to pay off the loans. UN, Model Double Taxation Convention between Developed and Developing Countries, 2001, Paragraph 3 of Article 7; OECD, Model Tax Convention on Income and on Capital, Commentary on Article 7.

enterprises.

Issue 3- Tax exemption on certain income from equity investment. According to Art.26.1.3, the equity investment income including dividends and bonus received by non-resident enterprises having business establishments in China from resident enterprises is tax-exempted The legislative purpose of this article may be understood to include two aspects: the first is to encourage the non-resident foreign enterprises having establishments in China to reinvest in resident enterprises in China; and the second is to eliminate the double taxation on the profit distribution between the invested and investing companies arising . However, such unconditional application of the tax exemption treatment to dividend received by non-resident companies is rare in the view of the international tax practices. In most countries, there are at least two preconditions to apply the dividend exemption on companies: 1) Equity capital of the shareholders is required to reach a certain ratio in the invested company, i.e. substantial participation exemption; 2) The invested company shall conduct positive business activities. These requirements are the safeguard to prevent non-resident enterprises from misusing this tax exemption as the loophole to avoid the tax. Further, the addition of requirements in the application of the dividend exemption is essential for the sake of tax equality, since in accordance with Art.26.1.2, dividend exemption applied to resident enterprises is only confined to "those in conformity with certain conditions". Lacking a similar restriction in dividend exemption on the non-resident enterprises will result in the tax discrimination which the **EITL** tries to get rid of.

Issue 4- Relationship between the bilateral tax treaties and the **EITL**. Art.58 of the EITL follows Art. 28 of the ITLEIFE and stipulates that "*Where the provisions of a tax agreement concluded between the Government of the People's Republic of China and a foreign government are different from the provisions of this Law, the provisions of the agreement shall prevail.*" [27] This indicates the absolute superiority of tax treaties upon the EITL under any conditions. However, the description of Art.58 may become a stumbling block for Chinese tax authorities to combat the abuse of the tax treaties effectively.

The purpose for a State to conclude a international tax treaty is to avoid the double taxation by granting taxpayers who are the residents of a Contracting State of the tax treaty more preferential tax treatments than provided under domestic tax laws.

[27] The Enterprise Income Tax Law of the People's Republic of China, Art. 58.

However, the benefits provided in a tax treaty may be taken used of by a resident of a third country which originally is not entitled to the treaty benefits but then enjoy the preferential treatments by establishing a conduit company in a Contracting State intentionally for the tax purpose. Against this background, the anti-treaty shopping rules are now introduced by many countries into domestic tax laws or tax treaties and commonly recognized as an essential and effective measure to curtail treaty shopping. According to the anti-treaty shopping rules, in the case of treaty shopping, it is domestic laws which shall prevail in the application rather than tax treaties.

In a nutshell, in dealing with the relationship between international tax treaties and the EITL, it is proposed to state as this: “where the conflict arises, in principle the tax treaty shall prevail except in treaty shopping.”