

FEATURED PERSPECTIVES

A Comparison of Tax Planning in China and the U.S.

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Tax planning has been gaining popularity with Chinese enterprises in recent years. A dark side of this booming business, however, exposes many new legal issues worthy of exploration to understand and predict the tax law development in China.

Most Chinese tax scholars maintain that tax planning is a carefully prearranged and well-designed scheme of organizing income and investment affairs to reduce taxes. In the Chinese discourse, tax planning is subject to legal constraints and should be lawful. There is even a dangerous misconception that defines tax planning as a gray area of potential deceitfulness.

Before the economic reform, the tax system in China almost had no room in a planned economy so that all state-owned enterprises (SOEs) were not required to pay enterprise income tax. The government, as owner of the SOEs, took all profits instead of taxing the enterprises. Though the tax system started to develop in 1978 when China began its gradual transformation into a market economy, it remains much less comprehensive and systematic than the U.S. tax system. The biggest problem with the Chinese tax system is its lack of a rights-based tax notion that emphasizes the taxpayer's rights as a fundamental constraint on the government's power to tax. The Chinese tax system is built on the basis of taxpayers' obligations rather than taxpayers' rights. There is only one article on taxation in the Chinese constitution, article 56, which in its entirety states, "It is the duty of citizens of the People's Republic of China to pay taxes in accordance with the law." Therefore, it is difficult to form a rights-based tax notion both in the opinions of government and taxpayers.

The National People's Congress (NPC), China's legislature, does not effectively control the government budget, and broad tax rules are subject to the tax bureau's wide discretion and interpretation. With the constitutional amendment in 2004 adding both a human rights protection article and a private property protection article, and the promulgation of the Property Law in 2007, there is now a direct constitutional foundation on which to reconstruct China's tax system on the basis of taxpayers' rights.

However, tax planning with the goal of tax minimization has intrinsic legal risks, especially in China. A thin line divides legal tax planning and illegal tax planning (including tax evasion and tax fraud, but sometimes tax avoidance). Although tax avoidance is legitimate in the U.S., it is usually illegitimate in China by the tax bureau's explanations. The line between legitimate and illegitimate tax planning is very vague and easy to cross. If a tax planner crossed that line, he would fall into the minefields of tax evasion and tax fraud, facing serious penalties varying from administrative fines to criminal prosecutions. On the surface, tax planning should be legal and generally allowed, in line with prevalent Chinese views. Further analyses, however, are necessary to define the boundary of tax planning in the Chinese context. First, to judge the legality of a tax planning scheme, one incidental yet complex question is to qualify the scope of the law — that is, whether numerous and constantly changing departmental interpretation replies should also be counted. If so, is it too high a risk for a tax planner? Second, should the legality of a tax planning scheme depend on the tax planner's subjective opinion? How can a tax plan

be deemed legal if the tax planner's intent is determined by the tax authorities? Third, though the tax avoidance could be attributed to the compliance awareness of the taxpayer, it has more to do with loopholes and double taxation of a tax system. In a country like China, which is still in its infancy of developing its tax laws, is it appropriate to characterize tax avoidance as illegal and therefore excluded from tax planning?

Most U.S. tax policy researchers and tax law practitioners maintain that taxpayers have a right to minimize taxes and that legitimate tax planning should not be curtailed. It is a truism of the tax law — a right well embedded in the U.S. tax system. Judge Learned Hand, in such cases as *Helvering v. Gregory* (2d Cir. 1934) and *Commissioner v. Newman*, CA-2, 1947, waxed eloquently on this point, and other judges have followed suit.

In China, on the contrary, it is not wise to assume that any such right to tax planning exists when determining the appropriate response to shelters. The State Administration of Taxation (SAT), the highest tax authority in China, can change the scope of any right to tax planning at any time merely by changing the regulation or through its interpretation. There are obvious distinctions between U.S. and Chinese tax laws concerning the right to tax planning.

First, in the United States, the right to tax planning stems from the case law, while in China there is no specialized tax court to provide sufficient judicial remedies of the right. As with any law, the theory of taxation tends to become distorted in its implementation. The process of lawmaking breaks it down into specific areas of application (quite apart from the influence of lobbyists and interest groups), and the original theory disintegrates through the process of case-by-case interpretation. Courts in most legal systems play a major role in fighting tax avoidance. Although U.S. courts defer to Treasury regulations on close or doubtful questions, taxpayers do occasionally succeed in convincing courts that specific regulations are inconsistent with the Internal Revenue Code, overreaching, or otherwise invalid.

In China, however, courts are generally not confronted with many tax cases. Tax authorities or tax bureaus end most tax disputes. Normally, the administrative division or the criminal division of a Chinese court deals with tax cases. A lawsuit is administrative if tax bureaus are defendants, while tax crimes go through prosecutions. Some cases are even litigated; most tax issues before Chinese courts are procedural, which are quite different from substantive disputes in U.S. tax cases. In the United States, substantial tax disputes typically include two categories: A taxpayer might claim that a tax agency made a wrong explanation on a legal provision; or a taxpayer might claim that lower-level rules violate upper-level regulations or laws. In China, however, courts do not have a judicial review power. It is the authority of the Standing Com-

mittee of the NPC to interpret the constitution and laws. Although the Supreme People's Court can issue so-called judicial interpretations that bind all levels of Chinese courts, it cannot determine the unconstitutionality of laws or regulations. Without judicial review, even though there is a clear case that the central or local governments wrongfully applied or interpreted tax laws, it is still difficult to successfully seek judicial remedy. Recently, some local courts handled several resource tax cases dealing with substantial issues such as the definition of resources and the validity of the expanded scope of resources by local tax bureaus. If it is valid, the taxpayers would pay more resource taxes than they had planned. The resource tax is a small part of the Chinese tax system, but it is encouraging that courts in China are changing their attitudes toward substantial tax lawsuits.

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Second, the United States is a federal nation while China is a centralized country. The SAT always has final explanatory power regarding ambiguous tax laws. In the U.S., a tax on people living in New York could not apply to someone living in New Jersey. If people do not like the higher taxes in New York, they are free to move to New Jersey. As a unitary state, however, China only has national tax laws and regulations. Although provinces have the legislative jurisdiction of tax issues, those provincial tax regulations are subject to national laws. Article 8 of the Legislation Law provides that the “basic economic system and basic systems of finance, taxation, customs, banking and foreign trade” can only be governed by law — that is, the NPC has the exclusive legislative ability to tax. In practice, however, because of abstract and broad wording of the NPC tax laws, the SAT monopolizes the important interpretation power, which determines the implementation of tax laws.

The Chinese tax regime is still at a rudimentary stage, with only three tax laws enacted by the NPC: the Tax Collection Law (2001), the Enterprise Income Tax Law (2007), and the Individual Income Tax Law (enacted in 1980 and last revised in 2008). These three tax laws are supplemented by detailed implementation regulations formulated by the State Council, which relied heavily on drafts prepared by the SAT. In addition, as a more responsive governance method, many tax notices, circulars, and replies are formulated by other branches of the central government, such as the SAT,

the Ministry of Finance, and the General Administration of Customs. Generally, in China the institution that formulates the rules has the power to explain them; it is therefore easy to understand that the administration in China has the final say of the real meanings of tax rules and regulations. Besides, tax judicial interpretations exist only in the name. Compared with frequent civil and commercial law interpretations, the Supreme Court in China is almost silent on tax disputes, except for a few explanations concerning tax crimes. In reality, administrative interpretations are the main source of tax law explanations in various forms of notices, replies, circulars, supplementary rules, and provisional regulations.

According to the prevailing theory in the United States, taxation itself is not seen as a fundamental good but is justified as a necessary limitation on individual freedom. But in China, both legal history and legal culture emphasize that taxation is a privilege of the government and that people are morally indebted to pay tax. Only recently, especially after the enactment of the Constitution of 1982 and the Property Law of 2007, is the private property right enshrined by law. In the tax law field, it has been argued that the broad discretion of tax authorities should be limited by the protection of private property.

Third, the economic structure in the U.S. is very much market oriented, while in China it is still transitioning from a planned economy to a market economy. Taxpayers often face different uncertainties when tax planning. Tax planning depends more on the macro-market economy and the overall legal environment rather than detailed tax rules.

In contrast to the Washington consensus, which refers to market, deregulation, and rule of law, China's development choice emphasizes a pragmatic approach to economic reforms and support for a larger role for the state in guiding the economy and ensuring equitable growth. It is agreed that tax policies cannot work without tax planning. But in China, taxpayers must do their tax planning in an economy that the government, instead of the market, rules. Without clear property rights and some contract protections, taxpayers would choose tax evasion or tax fraud rather than tax planning. Meanwhile, many entrepreneurs in China complain that most tax officials are business school graduates and have little law expertise and taxpayer-oriented ideas. Thus, managers in China prefer to keep a good relationship with tax bureaus, considering it more efficient than tax planning.

The new tax reform of 2007 pays more attention to taxpayers' rights than before, but some articles still leave room for the free will of the government. For example, what the 2007 Enterprise Income Tax Law achieves in protecting the rights of taxpayers is highlighted in the system of advance pricing arrangements. As stipulated in article 42:

[an] APA can be achieved between taxation organs and enterprises concerning the pricing principles and computation methods to be adopted in relevant transactions after their negotiation and confirmation on the application of enterprise.

Correspondingly, the ensuing Provisional Regulations on Enterprise Income Tax formulated by the State Council on Delegation manifests the idea of tax laws as protecting the rights of taxpayers. As article 113 prescribes:

The advance pricing arrangement, as stated in Article 42 of the new Enterprise Taxation Income Law, refers to the agreement that enterprises reach with taxation authorities after negotiation under the principle of independent transaction concerning their principles and computation methods in their relevant transactions in the coming year.

The word "agreement" emphasizes the coordination of taxation authorities and enterprises and highlights the legal power and rights protection.

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However, there are still some clauses in the new law that misplace power and rights, leaving room for the abuse of power and hardly protecting taxpayers' rights. For example, article 47 stipulates that "the taxation authority is entitled to make adjustment in a scientific way in case the amount of enterprises' taxation is lessened due to their acts without any rational commercial purpose." This provision falls into the category of general antiavoidance rules in the sixth chapter, theoretically referred to as an "all-details-including item." The adoption of general antiavoidance rules can fill in the blank of antiavoidance items in the previous interim regulations of enterprise income tax and foreign-funded enterprise income tax laws. The purposes are to facilitate taxation authorities to counter tax evasion, safeguard national tax revenue, and balance tax burdens.

However, because the new general antiavoidance rules fail to master the essentials of tax evasion, unexpected consequences may result. For example, the words "without rational commercial purpose" are ambiguous, making the discretion of the taxation authorities hardly bound. How should the phrase "without rational commercial purpose" be defined? Article 120

in the new Regulations of the Implementation of Enterprise Income Tax Law stipulates “irrational commercial purpose mentioned in Article 47 in the new Enterprise Income Tax Law refers to the deeds which aim to reduce, exempt from or delay paying taxes.” Such stipulations are still ambiguous as there is no clarification on the criteria to be used to judge whether it is with or without rational commercial purpose, the result of which is that taxation authorities may find it hard to exercise the legal rules, or they are likely to abuse their discretion power in that the right to judge the commercial purpose lies in their hands. For another, deeds “without rational commercial purposes” do not necessarily aim to avoid taxes. To determine whether to adjust policies by such criteria on enterprises whose taxable income or amount is decreased might very well hurt the property right and free management right of the withholding enterprises. In a modern commercial society, “rational commercial purpose” is not simply the value that enterprises pursue; conversely, enterprises with foresight also show great concern to their social responsibilities and make efforts to maintain a sustainable, healthy, and stable development of the social system in their own development, which is in their pursuit of maximum profit. If one enterprise makes donations for public welfare, and its taxable income or amount is therefore reduced, tax authorities reserve the right to make adjustments in a scientific way in accordance with article 47. Article 9

of the law will then be made null — it is prescribed that part of the donation for public welfare can be deducted before tax therein — and the management’s freedom will be severely hurt. Therefore, deeds “without rational commercial purpose” are not necessarily to evade taxes. What tax authorities should forbid in antiavoidance is not an act “without rational commercial purposes” but a specific act that “aims merely at taxation interests.”

In our opinion, the right to tax planning should be established for the following reasons. First, the legal system in China has improved significantly in the last 30 years, particularly in the commercial area, but the tax laws lag behind. As one of the most important public law areas, tax law must straighten relations between the government and taxpayers. The right to tax planning is one of the crucial property rights for taxpayers. Second, tax planning includes two levels. One is the taxpayer’s right to tax planning; the other is government’s power to tax planning. Both levels should be legalized and implemented efficiently. The tax policies cannot work by themselves without taxpayers’ participation and planning. Third, the right to tax planning is an effective way to control the governments’ power. From a historical view, property rights in Chinese law pay more attention to the “interests” but not the limitation of the government. The right to tax planning can be used to limit tax bureaus’ power. ◆