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Tax Reform in the China Context: The corporate tax unit & Chinese enterprise

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Abstract

Research into the relationships between people and organizations that drive social behaviour and institutions in China has produced some profound findings on the structure of society in China. The network structure of private enterprise and the importance of Guanxi are often highlighted. While some scholars of comparative law have investigated the implications these issues have for legal reform/ development in China, too many projects assume that emulation of the laws in developed legal systems is the way forward for China. This ignores the importance of tailoring China's laws to the structure of Chinese society. The debate surrounding the reform of income tax laws in China is no exception with many commentators looking to Western tax laws to solve such severe problems as tax avoidance and low revenue yields. This paper seeks to address some of the issues that arise in applying income tax laws based on those of developed countries to private enterprise in China with a particular focus on the legal design of the income tax unit.

INTRODUCTION

China's income tax laws have developed rapidly over the course of the past quarter century in conjunction with the opening of China and its transition to a (socialist) market economy. During this time there have already been two major reform efforts and numerous other changes that have attempted to create an effective and efficient income tax law. At present, major income tax changes are again being debated. The reform efforts are all predicated on the shortcomings of the current income tax laws. These shortcomings include low tax yield relative to national inome, lack of clarity in the law, distortionary tax effects and high levels of tax avoidane in [1]. For many commentators the problem with China's income tax laws is that they are not yet fully developed along the lines of the income tax laws in place in countries with developed market economies[2] that do not suffer from the serious tax problems that China does[3]. The solution to the problem therefore lies in further reforms aimed at developing a law that mirrors those in place in these countries. This entails, amongst other actions, the refinement of legal definitions and an increase in the detail of the laws to clearly articulate who the taxpayer is and what income they have earned during the tax period.

The income tax unit is one of the key foci of the contemporary debate on income tax reform in China. The tax unit or taxpayer is a fundamental building block of any tax and its definition is critical to the scope of the tax. This is the case with any income

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[1] For an excellent summary of tax revenue problems in China see: OECD (2002). The Current Tax System and Priorities for Reform. China in the World Economy: The Domestic Policy Challenges. Paris, OECD: 623 - 644.

[2] including the USA, UK, Germany, Australia and Canada

[3] For a major recent study looking to foreign tax laws for solutions in China see: China International Taxation Research Institute and IBFD (2004). China Tax Reform and the WTO Accession Project. Amsterdam, IBFD Publications BV.

tax where the law needs to define "whose" income is to be calculated for the relevant period and "who" is liable to pay the tax. In most developed income taxes, the tax unit is defined as both the individual and a company/ body corporate. Most of these taxes also develop rules to deal with other forms of business such as partnerships, trusts and joint ventures. These are sometimes treated as taxpayers in their own right but are more usually treated as transparent vehicles with only the underlying individuals and companies viewed as taxpayers. The essential rationale for the individual/ company tax unit is the concept of legal person where companies are viewed as persons in their own right at law. They have the right to sue and can be sued. More importantly the property of the company is its property and not that of the shareholders. The shareholder's property is shares in the company. The company management has the day to day power to determine the comp

unit and define all the various forms of activities sanctioned by law as "enterprises" thereby creating a uniformity of income tax treatment. The only distinction that remained was that between the domestic and foreign which were covered by the two different enterprise income tax laws. However within these two laws the various business forms were branded as "enterprises" allowing for a single tax unit and uniform treatment. The foreign sector reform was completed in 1991 with the introduction of the FIET Law while the domestic sector reform was finalised in 1993 with the introduction of the DEIT Regulations

generated by the enterprise as opposed to a gain in the private property of a person. In reality, the two concepts will often yield the same results but they are quite distinct and can lead to very different results. When a pure “enterprise” tax unit is used in China’s tax laws (in the sense of an activity as opposed to a person), the laws are operating in an internationally innovative manner. There is little doubt that this

single director/ shareholder company. Here, the same individual is the company management as well as the investor. This company cannot be viewed as independent of this individual and the individual has de-facto control of the company property. At the other extreme a listed company with widely dispersed shareholders is a clear example of a "real" independent body. The shareholders here have very little control of the company's property and genuinely own only their shares.

Serious tax problems can arise when non-independent companies that are mere legal fictions are treated as tax units. Their treatment as a separate tax-unit creates significant tax-arbitrage as well as possible evasion opportunities. The basic root of these opportunities is that a non-independent company allows a person (natural or "real" company[21]) to artificially alter their individual circumstances. As tax treatment is dependent upon a person's circumstances (for example, total annual and type of income, location of residence, economic position etc.), an ability to change these creates arbitrage opportunities. A raft of common tax schemes from an individual using a company to obtain a lower tax rate to the use of tax havens rely upon the artificial separation granted to non-independent companies. In summary, the rationale for the corporate tax unit discussed earlier is significantly diminished, if not eliminated, when a company amounts to nothing more than a legal creation. To make use of the principle of equity again, in these cases it can be seen that the corporate tax unit allows those in a similar position to be treated differently and those in a different position to be treated the same. This is contrary to the principle. Of course, it can be argued that legal incorporation always creates rights and obligations that are different to the pre-incorporation situation. The primary example being limited liability. It may therefore be appropriate to treat any incorporated business differently to a non-incorporated equivalent. However, these minimal differences do not merit the type of different treatment that a "real" company does.

Given the above analysis, the issue that arises is why so many tax systems in Western countries have been able to successfully adopt a corporate tax unit and not suffer dire tax avoidance problems. The answer to this is essentially twofold. The primary reason is that the majority of the market in Western countries is made up of companies that are "real" and independent legal persons as well as independent natural persons. As is pointed out by comparative sociologists such as Biggart and Hamilton[22] and Fei[23], independence and autonomy are deeply rooted ideals in Western society. They can be traced back to classical philosophies, Christianity and nineteenth century politics of democracy[24]. As touched on above, these ideals prompt the introduction of laws and institutions that then reinforce the independence of companies and individuals. The assumption that the market is comprised of independent actors (companies or individuals) is a central tenet of neoclassical economics. The general accuracy of

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[21] I include "real" companies as they too can make use of non-independent companies in tax-planning. For example, a genuinely independent public company may seek to shift its profits offshore using a non-independent subsidiary.

[22] Biggart, N. W. and G. G. Hamilton (1997). On the Limits of Firm-Based Theory to Explain Business Networks: The Western Bias of Neoclassical Economics. The economic organization of East Asian

neoclassical economics in explaining Western economies and markets results from this assumption generally holding true[25]

is done socially through gift-giving, banquets etc. Through the successful pursuit of Guanxi, persons can become part of extensive networks that go well beyond the extended family and friends. The networks are employed to pool resources in the pursuit of business enterprises[31]. The essential point about these network bonds is that they have very real enforceable value in terms of mutual obligation. There is however no written contract or record to show the connection as it is socially and not legally reinforced. There is no need to rely upon legal reinforcement due to the values of Chinese society which, in themselves, provide effective sanctions against those that violate social obligations. The reason for this is the non-presumption of independence and autonomy with instead a presumption of connectivity with the appropriate

In addition to the above factors, the commodification process during the reform period in China has further strengthened the development and use of Guanxi networks. Extensive field and theoretical work by David Wank[33] has considered the role of commodification in developing China's business modalities. The term commodification refers to the conversion of state assets into commodities in China's market economy. There are no clear property rights in relation many valuable State (or former State) assets in China. They are, however, under the control of local government. These assets include resources as critical to enterprise as land and buildings. Control of these assets and the ability to let others use them, has led to the absorption of local officials into Guanxi networks that dominate much of China's economy. In most cases successful private entrepreneurs have strong Guanxi links to local officials if they are not officials themselves. The ability to use these assets subject to "fuzzy" property rights in Guanxi based business networks incorporating local officials as well as entrepreneurs has proven effective and efficient in China. It allows assets to be moved quickly through the network to where they can be effectively used[34]. It has been strongly argued by Hendrischke[35] that the success of this modality of business leads to a demand for "fuzzy" property rights in China. It is worth contrasting this with the politics of democracy in the West where there was a clear drive for clear property rights[36].

In summary the nature of Chinese society in combination with the formerly hostile and current weak institutional environment and the process of commodification of State assets have resulted in a situation in contemporary China where the primary actors are business networks rather than independent companies and individuals[37]. Business is conducted by and through networks held together by strong Guanxi –

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entrepreneurship. Richmond, Surrey, Curzon, McKeown, A. (2001). Chinese migrant networks and

social bonds. The entrenched economic and political strength of these networks and their desire for "fuzzy" property rights as well as the nature of Chinese society mean that there is unlikely to be a change in this situation despite Government attempts to strengthen the institutional environment. More to the point, in many respects, these factors push for the weaker institutional environment.

Commentators such as Biggart and Hamilton[38] concluded that Asian capitalism and

social sanctions as an enforcement. The preference for "fuzzy" property rights adds further reinforcement to this.

Another critical factor to consider is the private sector's aversion to paying income tax. Having considered the rationale for reliance on social networks rather than legal agreements in China, it can be seen that the ability to avoid taxation only adds to this. Business networks have had a new reason to remain invisible in China in the Nineties. During the Eighties they feared a Central Government backlash, now they fear that the Central Government will gather revenue from them. Governmental attempts to strengthen the institutional environment and property rights through initiatives such as the introduction of the Company Law can be counterproductive when social bonds are stronger than legal rights. This is because instead of simply being invisible, networks can make use of the new laws to create legal rights that they are able to readily circumvent. Regulators on the other hand will treat the legal rights as a correct representation of the situation. There is evidence that assets are simply placed into companies and removed at will by networks and that legal entitlements to dividends are simply ignored when profits are shared[40].

In summary, it may be concluded that the adoption of a corporate tax unit in China's income tax will not result in the benefits anticipated based solely upon its successful adoption in Western taxes. The possibilities for tax avoidance and arbitrage are far greater than in Western economies due to the use of social Guanxi connections and networks and the preference for "fuzzy" property rights in China. This stands in stark contrast to the preference for legal agreements and records and clear property rights in the West. It can also be concluded that the benefits of tax avoidance for the private sector may reinforce the desire to rely upon Guanxi rather than contracts.

The above conclusions do not, however, lessen the need for reform of China's income tax unit as considered above. A different solution needs to be found. One possible answer lies in the innovative use of "enterprise" as discussed earlier. The concept of an enterprise as an activity as opposed to a person was adopted in a socialist situation where use of increments in private property to define income was inappropriate. The income of an enterprise in these situations referred instead to profits generated by a commercial activity. This subtle conceptual difference may be a suitable starting point in the development of China's contemporary income tax unit. This is because it does not rely upon the accurate identification of a person's property rights. Another theoretical possibility is to identify and tax the business network itself. This is appropriate conceptually but unlikely from a practical perspective due to the difficulty of identifying the network.

A final issue relevant to China's reform of its tax unit is the need to fit into the international system. As discussed earlier, there are real pressures towards convergence and harmonisation of income tax laws due to the internationalisation of business. Attempts to make use of a radical concept when designing a tax system are therefore likely to be criticized and objected to by international business and organizations. This is because variation creates compliance costs and inefficiencies. However, against this China's effective revenue collection needs to be considered and

[40] Hendrischke, H. (2002). The Role of Social Capital, Networks and Property Rights in China's Privatization Process. Chinese Enterprise Models, University of New South Wales, Sydney, UNSW Centre for Chinese Studies.

it cannot be simply ignored to benefit international interests. China does, after all, represent a significant portion of the world and what it does should therefore be considered a variation of international standards as opposed to a departure from them. Any new concept will therefore need to be reconciled to the internationally standard corporate tax unit.

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