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ABOUT THE JOURNAL

The importance of China on the global economic stage cannot be ignored, and its unique legal and tax systems are of great inters to international scholars and business people alike. China's tax system is acquiring western features while remaining entrenched in its rich cultural and historical roots. This makes for interesting study, analysis and comparison as its laws are becoming more accessible.

The Journal of Chinese Tax & Policy focuses on the policy, administrative and compliance aspects of the Chinese tax system. It also welcomes comparative studies between China and other countries. The Journal is an internationally peer-reviewed scholarly publication.

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Editorial

The 2015 issue 1 of the *Journal of Chinese Tax and Policy* features articles addressing current policy debates in China from a comparative perspective.

A Comparative Study of Transfer Pricing Taxation System between China and Australia by Long and Huang is a contribution to the discussion on the improvement of China's transfer pricing taxation system. The article began with an overview of Chinese transfer pricing policies. Data revealed that China had experienced extraordinary tax loss on transfer pricing at RMB 30 billion in financial year 2012-2013. This article then chose Australia as the representative of the developed countries, compared the transfer pricing policies between China and Australia and finally concluded with approaches in improving transfer pricing taxation policies in China.

Yang's article analyses the causes of "corporate inversion" in the United States (U.S.), by comparing the taxation system between China and the US, this article aims to explore whether China will suffer the same debacle of corporate inversion as the US did. For illustrative purpose, this article identifies the penalties imposed by the new tax regulations in the U.S. such as IRC §7874 and Notice 2014-52 and examines the impact. The author finally concludes that it is most likely affirmative for the new tax regulations to be applicable to a Chinese multinational corporation.

Eva Huang

Sydney, September 2014

VAT Rate Structure in China: Implications of the EU Experience

A Comparative Study of Transfer Pricing Taxation System between China and Australia

Long Zhaohui[☆] **Huang Shuoyu**

Abstract: As defined, transfer pricing is the setting of price for goods and services or intangible assets sold between related entities within an enterprise. In international economic activities, international companies could shift transfer pricing in order to achieve best profit in a way setting major profit into an entity within a country which has relatively lower tax rate. Under economic globalization, international business contributed enormously in the growth of global economy, which explains why transfer pricing has growing concern among policy makers all around the world. Currently, we have already founded a relatively complete transfer pricing taxation policies, and empirically developed for decades. However, as we are in our 'starter' period, there are still huge gap between us and developed countries. Recent data shows that we had experienced extraordinary tax loss on transfer pricing at RMB 30 billion in financial year 2012-2013. Meanwhile, Australia, where china imports most of ores and wools from and exports technique products and textile to, these two country have had an integral business relationship and relies on each other. This article would basically compare transfer pricing in these two countries and would come up with approaches in approving transfer pricing taxation policies in China.

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1. Introduction

In recent years, Chinese anti-avoidance work continues to face serious challenges. In 2005, the world's top 500 invested in Shenzhen to set up a technology company. In 2006, the company's main business revenue has exceeded 10 billion yuan and its operating profit amounted to more than 200 million yuan. In just over three years after the exemption period, the company transformed the business mode from feed processing into the processing mode, the processing fee income to sales revenue. Later, the main business income of the company has undergone a sharp decline, while operating profit also significantly reduced, which, according to estimation, even seriously affected Shenzhen's GDP level in the year. In 2012, Shenzhen Municipal Office, SAT has successfully completed the "transfer pricing" audit to this company and recovered over 100 billion yuan of taxes, the process lasting one and a half year.

At the G20 St. Petersburg Summit in 2013, OECD proposed 15 base erosion and profit-shifting (BEPS) Plan of Action, and then many countries revised international tax rules to curb tax avoidance of global multinationals and erosion of the tax group. October 2015, 15 projects on BEPS Action Plan launched significant achievements in transfer pricing and in making up a series of regulatory gaps in the domestic tax rules and institutions. It also provides a good example of multilateral cooperation to jointly cope with the international tax challenges.

In this international tax reform, China participated as a partner of OECD in the BEPS Action Plan, and China's State Administration of Taxation (SAT for short) has established a special leading group to comprehensively promote BEPS Action Plan. 2013-2015, China's position and statements submitted by the SAT to the OECD are no less than 1000, which made important contributions to the successful completion of the achievements of BEPS Action Plan. After 15 reports were completed, the group organized personnel to translate them quickly, comprehensively and actively learned from the results of OECD work, and had a choice to combine localization BEPS results with our reality, introducing series of regulations and normative documents to strengthen anti-avoidance management, such as "anti-avoidance management approaches", and "property management approaches of indirect transfer between the non-residents and enterprises". Combined with BEPS achievements, our anti-avoidance laws and regulations have been further improved. The tax authorities around our country carried out special anti-avoidance filing investigations 265, of which 188 were finished and which had contributed 58 billion to tax increase.

Australia, as the G20 major economies and the world's major exporter of agricultural products and energy minerals, has mature market economy systems which match with its own sound legal systems and regulatory modes of governance. As China's important economic partner countries, the largest importer of energy minerals, and the important part of Anglo-American legal systems, Australian's methods and regulatory models on BEPS really deserves Chinese learning.

This article will briefly describe the two country's existing laws and regulations related to transfer pricing and its development and improvement process. Comparing the two different requirements and regulation on transfer pricing issues, it can further improve possible directions and recommendations for our transfer pricing regulations. Through the analysis of transfer pricing in Australia, it provides references for further cooperation between Chinese and Australia enterprises, promotes bilateral cooperation in the tax authorities, thus deepening their economic and trade cooperation

2. The Overview of Chinese Transfer Pricing Policies

2.1 The Taxation Norms of Chinese Transfer Pricing

Our Transfer Pricing Tax Administration comes from the "Interim Measures of Shenzhen Special Economic Zone enterprises with foreign investment and related transactions business of tax administration," Shenzhen promulgated in 1987. In 1991, the National People's Congress passed the "People's Republic of China Foreign Investment Enterprise and Foreign Enterprise Income Tax Law" (hereinafter referred to as Tax Law) and related implementation details, therefore our transfer pricing systems and management began to be gradually formed. In 2008, the new Enterprise Income Tax Law has been carried out. The following year, SAT issued "Implementation Measures of Special Tax Adjustments (Trial)" (the "Implementation Measures"), which has made further improvement of China's transfer pricing regulations systems.

China has also actively participated in and promoted BEPS (Base Erosion and Profit Shifting) Plan of Action, and uplifted international tax management to a new level. According to Chinese transfer pricing, the adjustment methods for transfer pricing include the comparable uncontrolled price method, resale price method, cost plus pricing and other reasonable methods. However, due to the limitation from experience and cost, China often adopts cost-plus and profit margin methods in the course of practice. But the adopted methods are relatively simple and rarely involve in the transfer of tangible or intangible assets and other complex issues, and they lack researches on the issue of comparability in the practice, which is considered the most important by the international community. For example, OECD, in the item 8 of BEPS action plan, defines intangible assets as "the non-financial assets that companies can own or control non-physical form in commercial activities, and the use or transfer of this type of asset need to be compensated when it occurs in the case of Independent Trade." It is divided into commercial marketing and trading intangible assets. In China, the definition of intangible assets mainly roots from the accounting standards and the "Implementation Measures of Special Tax Adjustments (Trial)". "Implementation measures" take consideration of the expansion of intangible assets advocated by OECD, but still can’t comprehensively consider the marketing intangible assets. In addition, because of cost and lack of information, China's transfer pricing audit in practice focuses on large companies, SMEs less involved.

2.2 Our Tax Incentives and Policy Reform of Foreign Investment Enterprises

At beginning of reform and opening up, Chinese government gave foreign investment enterprises many preferential tax policies to encourage foreign investment in China, such as investment incentives in corporate income tax areas, industrial enterprises in two exemptions and three halved, tax incentives in basic industry, tax rebates in reinvestment. These policies played an important role for China to attract foreign investment, but also resulted in unfair tax burden between domestic and foreign investment enterprises. According to the survey, before the "unified tax" in 2008, nominal rate of income tax rate between foreign-funded enterprises in China and domestic enterprises, are 33%, but its actual rate only 15%, far below the level of the tax-funded enterprises, especially the state-owned big and medium enterprises, resulting in unfair competition.

In 2008, China promulgated the new "Enterprise Income Tax Law", in which income tax system of foreign and domestic enterprises are combined and its basic tax rate is 25%. But those enterprises that originally enjoy the policies like "two exemptions and three half-free " or even "five exemptions and five half-free", will continue to enjoy them until original tax laws expire. But to those unprofitable enterprises who did not enjoy tax benefits, their preferential time period shall be calculated from the year 2008. The central government tighten foreign preferential tax policies while at the same time some local governments still introduce foreign investment, even at the introduction of local policies and incentives. November 2014, the State Council issued " The Notice on Clearance of Specification of Tax and Other Preferential Policies," which was used to clean up local tax incentives and also marked the further tightening of incentives for foreign investment enterprises.

"Unified tax" could lead some foreign companies to withdraw from the Chinese market, but it will help create a fair market environment, eliminate unfair competition, optimize resources and allocation of production factors to promote the development of domestic enterprises.

2.3 Regulation and Punishment of Transfer Pricing Tax in China

Compared to Western countries, China's current transfer pricing punishment still exists a big gap. When our transfer pricing tax avoidance under investigation, in most cases it is only adjusted with little cash penalties, reducing the risk of transfer pricing tax avoidance by multinational companies, so that some companies caught a chance. China's "business dealings between associated enterprises Tax Management Regulations" merely regulated the punishment about the behaviour of "relevant companies fail to submit their annual returns about business transactions with related party to the competent tax authority," but no specific provisions for transfer pricing behaviour punishment. In 2008, China implemented the new "Enterprise Income Tax Law"; in 2009, China promulgated the "Special Tax Adjustments (Trial)", effectively regulated the transfer pricing practices, and has made considerable progress in anti-avoidance of transfer pricing but still did not make transfer pricing tax avoidance severely punished. Coupled with the local government investment impulse, so that China's tax laws to a large extent suffer Administrative intervention. Law enforcement don’t have strong independence, which could eventually lead to that the transfer pricing enforcement to multinationals is lax.

China's lack of tax professionals caused difficulties for supervision and audit. According to tax officials, every probability of foreign-funded enterprises being audited is about eight hundredths in accordance with the existing human, material and technical means. Taking Suzhou as an example, the anti-avoidance staff in all districts and counties of Suzhou Municipal, SAT are a total of only 15 people, but have to supervise more than 7900 foreign companies opened. A serious shortage of personnel objectively could not finish many foreign audits, which also makes foreign-funded enterprises increase awareness of luck.

There is a big gap on technology between our tax departments and foreign-funded companies. Since foreign companies, especially well-known multinationals with more advanced and diverse systems and software generally, our tax departments can't control and supervise so many complex systems, resulting in the information channels of tax departments not perfect. The information between China and foreign enterprises is not asymmetric, which makes law enforcement and anti-avoidance tax authorities can't carry out the work smoothly.

2.4 The Internationally Bilateral or Multilateral Cooperation on Transfer Pricing

We actively cooperate with all parties in international economy. Up to October 2016, international tax agreements that China signed into force with foreign countries reached 97.[1] November 17, 1988, China and Australia signed Tax treaties, and introduced on January 1, 1991. These international tax treaties effectively regulate the behavior of multinational corporations to pay taxes and strengthen international tax cooperation. However, compared to the increasingly complex international economic situation and tax structure, our country should further strengthen international tax cooperation, and actively seek the right to speak on the international tax affairs.

In 2014, China has signed "Australia FTA" with Australia. In terms of openness, Australia eventually reduced tariffs of all Chinese products to zero while China eventually reduced most products in Australia to zero; and in service areas, the two have made promises to each other, promises covering many sectors and high-quality open; in the field of investment, the two countries agree to grant each other the most-favored- nation treatment from the date of the Agreement entering into force while significantly reduce investment review thresholds, to increase market access opportunities for business investment, predictability and transparency. Agreement includes total of more than 10 areas, covering trade in goods and services, investment and rules. It also covers "21st century economic and trade issues" like e-commerce and government procurement.

3. The Transfer Pricing Tax systems in Australia

3.1 Australia's Tax Structure

Australia is a federal state in the southern hemisphere, made up of six states and two directly administered territories. Commonwealth of Australia is composed by the federal central government, state government and local government. Accordingly, the taxation systems are thus differentiated into three levels of government taxation system.

[1] The information originates from ATO. http://www.chinatax.gov.cn/n810341/n810770/

Federal taxation includes income tax, goods and services tax, fringe benefits tax, of which income tax consists of personal and corporate income tax. After 1942, income tax is levied by the federal government independently according to income classification while they will collect medical tax according to income level. High-income individual income tax is up to 47%, while whose annual income is less than $ 66,667 yuan can enjoy preferential tax policies, the maximum reduction up to 445 Australian dollars. Small businesses whose annual turnover is less than two million Australian dollars can enjoy tax benefits, up to $ 1,000. Income tax is the main source of government tax revenue in Australia, accounting for 58% of total Australia tax revenue in 2014-2015.[2] Australia is a high-income country where personal income tax threshold is lower but tax burden is higher, which expands the tax base groups, increases national tax awareness, and thereby improves the citizen tax consciousness. GST (Goods and Service Tax) is the tax on goods or services that is taxed on customers. General tax expenses are included in the price of commodities at 10% of the value of the goods or services levy. Fringe benefits tax refers to the taxation of non-wage benefits provided by employers to employees outside a tax, such as employer-provided transportation, lodging, entertainment, interest-free or below-market interest rates loans and other benefits. State and local government taxes cover payroll taxes, capital gain tax (CGT), and stamp duty.

Australia is a high-tax country. The Australian tax revenue in GDP reached 25.8% in the statistics of American Heritage Foundation in 2015, higher than China's 22 percent; but still lower than most developed countries (such as Japan 28.3%, Germany 40.6%, Spain 37.3%, US 26.9%, UK 39%). At the same time as a developed country, Australia is the 'profitable financial', that is the government financial abundant without spending pressures. When government revenue grows faster than GDP growth or income is greater than expenditure needs, the government will adopt tax cuts, so the Australian taxation growth and GDP growth rate remains basically consistent.

3.2 Australian Tax Authorities

Australia Taxation Office is a collection organ for Australian tax revenue and for the public to provide tax services. Since Australia's high taxes and tax systems, ATO is also the government institution playing an important role in the lives of ordinary people. ATO is consistent with its Australian taxation systems, implementing the IRS (Internal Revenue Service), state and local tax bureaus. ATO tertiary institutions are independent without any administrative and operational relations, and they exercise taxation rights independently and enjoy a part of the tax legislative power to make legislation based on practice, thus enhancing the feasibility of tax laws and the flexibility to address complex issues. Meanwhile, in the face of transfer pricing issues, ATO had no rights to directly formulate tax laws, but gave detailed guidance and requirement to corporate transfer pricing on the basis of tax laws and practice; for example, a simplified version of the Simultaneous Preparedness Requirements

[2] The information originates from Australia Bureau of Statistics website. http://www.abs.gov.au/ausstats/abs@.nsf/mf/5506.0

on Transfer Pricing, as promulgated in 2014, has facilitated small and medium-sized companies.(Zhouzi Ji, 2014).

Meanwhile, when enterprises or individuals have a dispute over tax affairs, FCT (Federal Commission of Taxation) will be responsible for the judicial component of the tax. Important FCT laws and regulations will be listed as official bills for future practice.

3.3 Main Contents in Australian Transfer Pricing

The current transfer pricing tax systems in Australia were based primarily on ITAA (Income Tax Assessment Act) 1936 , ITAA 1997 and TAA (Taxation Administration Act) 1953.[3] Meanwhile, the tax law amendment passed by the House of Representatives and the Federal Senate in June 2013, has yield remarkable results in addressing tax base erosion and profit-shifting. To properly deal with transfer pricing issues, ATO issued a series of tax regulations, of which TR97/20 detailed the application and implementation of fair and independent transaction principles about transfer pricing in ITAA1936. And latest legislation, including TR (Taxation Ruling) 2014/8, TR2014 / 6, PS LA (practice Statement replaces law Administration) 2014/2, PS LA 2014/3, further extend and expand the regulations related to transfer pricing on Income Tax Assessment Act and International Tax Agreements Act. Meanwhile, Australia's transfer pricing rules clearly show that Australia is trying to be consistent with the OECD guidelines and the principle of fairness.

The methods of Australian transfer pricing divide into TNMM (Transaction Net Margin Method), the cost plus method, resale price method, profit split method and the comparable uncontrolled price method, which keeps consistence with the OECD Transfer Pricing Guidelines. Meanwhile, ATO want to analyze specific issues, to find the optimal solution for each different case, and has no preference to transfer pricing adjustment methods.

Meanwhile, in order to effectively control the transfer pricing tax avoidance, ATO has described APA (Advance Pricing Arrangement) in detail in the related regulations (TR95 / 23, PS LA 2011/1). Similar to our existing systems, Australia’s APA process also includes the three parts: application- consultation - signing. In Australia, both large enterprises (annual profit of more than $ 2.5 billion) and small and medium enterprises can take the initiative to apply for APA in the ATO and are required to disclose annually through the annual report. The ATO has been enthusiastic about APA. Starting from the first relevant law enacted in 1995, the ATO further simplify APA forms for SMEs that are required to answer only 56 questions. It will also greatly reduce APA cost for SMEs enterprises to encourage SMEs to participate in APA, but also reduces the cost of ATO audit, thereby controlling all kinds of risks.

[3] The information originates from ATO website. https://www.ato.gov.au/

3.4 Intangible Assets Pricing in Australia

Because the intangible assets are unique and they often lack comparable market value, also, because intangible assets always are regarded as special trade secrets exist within the enterprise; it is difficult for the external agencies to define the value of intangible assets value. In actual practice, it adds a lot more difficulties for tax authorities because comparable uncontrolled laws often can't be used. Therefore, as China, Australian mainly applies for the PSM in pricing for intangible assets. ATO thinks PSM has stronger feasibility of complex administrative process than the traditional method and it also to be more likely to accepted and recognized by both the government and enterprises (Markham, 2004). But at the same time, the PSM also has its limitations. Because the PSM does not rely on an independent external data, the resulting data may be subjective and arbitrary. Although ATO agrees with the subjectivity of PSM, they think the risk of applying PSM is exaggerated.

On the pricing for intangible assets, ATO abandoned the traditional method, instead, they adopted non-profit comparison method based on transactions, PSM and formula apportionment. These methods are regarded as indirect application of the principle of fair trade by ATO. It is "a compromise when direct comparative law can't be applied in case (Markham, 2004)".

3.5 Australian Transfers Pricing Regulation and Punishment

ATO actively participated and promoted BEPS Action Plan, and also published a statement -- under the environment of BEPS, Australia should focus on the full impact of electricity supplier network, hybrid mismatch and restore international and domestic tax and the reduce of future BEPS from the perspective of opportunity rules, the transparency, certainty and predictability and other issues.[4] Australian IRS TR98 / 16 expressly provides for transfer pricing penalties (Bonu). In the regulations, as for the different behavior of transfer pricing, Australia may impose an extra tax of 10-50%; and extra 20% of tax for persons responsible for deliberately obstructing ATO audit the income transfer pricing, that is, the income taxes can be up to 70%. TR98 / 16 discussed the different motives of transfer pricing tax avoidance and detailed the different penalties for various different specific issues, which made it intuitive and feasible.

In addition to establish the departments of dealing with holding tax, transfer pricing and international tax issues of international tax, meanwhile there was a specialized team that deals with transfer pricing issues. In addition, while the Australia ATO is dealing complex cases, they often seek for the advice of external economists. Meanwhile, as for the regulation, the Australian authorities have different concerns for large enterprises, small and medium enterprises. For example, in 2010 and 2014, they have published two guidebooks on transfer pricing issues. In the regulatory process, ATO mainly concerns for related corporate lending, mergers and acquisitions and restructuring, research and development costs of large enterprises, and negative profits and low taxation of small and medium enterprises. This

[4] The information originates from ATO website https://www.ato.gov.au/Media-centre/Speeches/Other/BEPS-Action-Plan-Update/

arrangement allows more focus on the relevant regulation of authorities, and also improves supervision; facilitate the execution of the program.

4. Mirror Australian Experience and Improve China Transfer Pricing Tax System

4.1 Perfection of APA

APA is the agreement between tax authorities and enterprises through cooperative manner with the manner of voluntariness, equality, mutual trust, which effectively deals with transfer pricing issues and potential transfer pricing disputes. According to APA annual SAT report on December 2015, as of December 31, 2014, China's tax authorities have signed total number of 70 unilateral APAs and 43 bilateral APAs. With the perfection of our tax policy, we must be also fully aware of the big gap between China and the developed countries in the APA. From the one calendar year from 2014 to 2015, Australian completed 19 bilateral APAs and 12 unilateral APA,[5] while over the same period ,[6] China only completed 6 bilateral APAs and 3 unilateral APA.

APA is intended to reducing management costs and effort of the tax authorities and to help companies to reduce the risk of transfer prices through cooperation. The arrangement of the APA process in China is still relatively tedious and time-consuming. From a formal application to completion takes longer time (one-third of six bilateral APAs of 2014 took over three years to reach, the average time was more than two years, while in the same period in Australia, bilateral pricing arrangements took an average of 20 months, and the area of bilateral APAs area relatively fixed. Therefore, China needs to continue to improve the APA, to simplify the application process in the future with the APA expectations of workload continuing to increase. Also, China also needs to improve work efficiency, which further reduces administrative costs of tax authorities and help businesses reduce the risk of transfer prices. We can learn from the Australian experience, focus on the analysis of specific cases. As for the less risky businesses or SMEs, the process can simplify. In this way, it not only reduces the cost of small and medium enterprises, and encourages more enterprises to participate in the APA, but also saves the tax authorities of manpower and material resources.

4.2 Expansion of the Transfer Pricing Methods

When we are dealing with transfer pricing issues, although the basic adjustment method used is consistent with international and OECD, but in practice, due to the limitations of experience and information, transfer pricing methods are more limited, which further cause the difficulty of solving complex problems. When we expand the transfer pricing methods, we must firstly establish a sound mechanism to strengthen information supervision. We should start from the following aspects: the

[5] The information originates from ATO website https://www.ato.gov.au/Business/International-tax-for-business/In-detail/Advance-Pricing-Arrangements/Advance-pricing-arrangements/

[6] Due to the fiscal year in Australia begins at July in the year and ends at June in the following year, we take data of Australia from July 1st, 2014 to June 30th, 2015 and data of China from January to December, and make comparison between them.

first is to establish an information communication mechanism with multinational corporation; the second is to deepen cooperation with state tax authorities under the premise of autonomy and, strengthen exchanges and communication, further to sign the agreements related to tax; the third is to strengthen supervision of the Chinese subsidiaries of multinational companies. These measures are intended to achieve the purpose of sufficient information for the tax department on enterprise's reasonableness assessment on the profit distribution in the value chain of the Group, which further solves current problems of information inequality between government and enterprises.

At the same time, our country should strengthen the training relevant personnel; strengthen education, especially business education on tax. In order to train a large number of talents with professional knowledge, we can start from two aspects: one is to develop strong and professional tax team dedicated to practice, to solve the problem of professional personnel shortage; the other one is to organize a group of academic experts with rich experience, to build a solid theoretical foundation for the country in the management of complex and volatile international situation and to make the voice of China heard by the world in the field of transfer pricing, and to provide advice to our tax department as a private think tank.

4.3 Increasing Intensity of Punishment and Supervision

Through the foregoing analysis, we can see that there are big shortages in the regulation and punishment of tax system in our country still. First, China needs to strengthen legislation. From the perspective of national conditions, China should combine practice and learn from foreign advanced experience, and further promote the legal process of transfer pricing, and also promoting China's tax uniformity. Meanwhile, China can also learn the practice of Australia to put attention on the details of the proposed disposal methods and to put different focus for different types of enterprises, rather than auditing only the large companies and neglecting SMEs. Meanwhile, it is also important to pay attention to our own experience and international practice. The independent legislation should be adapted to the international regulatory form, and also in conformity with China's national conditions; secondly, strict law enforcement. There should be separation of powers between administration and enforcement. With the introduction of foreign capital, we should also pay attention to the supervision of foreign-funded enterprises. Other than that, we should always firmly obey the introduction of regulations and policies, and actively clean up the foreign investment tax incentives set by focusing on penalties, reducing the chances of illegal enterprises.

At the same time, because the transfer pricing legislation is still in its infancy, we have to do it step by step. Through the 'mild' reform, at the request of the smallest touch group's interest, we should improve the regulatory transfer pricing. As the example of transfer pricing of intangible assets, because our country is still in net import stage of intangible assets (such as technology, trademarks, etc.), although China has become the world's largest exporter of high-tech products, our products are often made of foreign technology, and also our factory is only responsible for assembly and packaging. Since cross-border trade of intangible assets in our country is destined to be a long-term presence in the country, and we are still the transferee for the transfer of intangible assets, supervision of intangible assets in our country must be taken seriously. First, under the guidance of OECD action plan, China needs to pay attention to the definition of intangible assets, and clear the ownership of intangible assets, fully taking the links of value creating of intangible assets into account. Applying to Western experiences and lessons learned in the process of transfer pricing of intangible assets, together with national conditions, China should select the best priority method that suites for the condition of available information and resources. And for more, we should strengthen supervision in this process, and actively solve the problem of tax avoidance. Second, our country mainly uses the PSM in pricing of intangible assets, so we can't ignore the problem of defining risks of the profits split method of intangible assets.

Therefore, under BEPS international circumstance, we must proceed from China's national conditions, combine with the international situation, considering the problems and challenges of tax encountered in practice, and further to achieve the improvement of legislation, strict law enforcement and supervision strengthen.

4.4. Promote Technological Development

From the weak technology of the intangible transfer pricing in our country, it is not difficult to see the situation: in the multinational companies and joint ventures in present stage, since foreign investment provides "advanced management experience" and "advanced production technology," which causes foreign investment to grasp the policy direction of most practical problems. Taking the bag production enterprises as an example, foreign investors produce leather domestically, and then they establish the joint venture factories in China. Foreign investors import leather from the parent company and the price is much more expensive than Chinese leather of the same level. Then the joint venture plants sell the products to parent company at low prices, which finally led to the transfer of profits. So, in order to solve the transfer of profits from the perspective of enterprise, enhancing the voice right of business is a top priority.

By the advantage of technology and brand, multinational companies clamp Chinese partners, so our business is at a disadvantage in long-term. Therefore, China must vigorously develop science and technology, and apply them in daily production and manufacturing enterprises, and then realize the transformation of "from 'Made in China' to 'Chinese wisdom made'".

In addition, multinational technical advantages also caused certain obstacles for our tax department audit. The promoting of the development of technology can also improve the daily audit work of the tax department. Also, accounting software and systems development is a key reason to improve the efficiency of the tax department. To a certain extent, it can also decrease the challenge of shortage professionals in tax department.

CORPORATE TAX INVERSION: A LESSON LEARNED FROM THE UNITED STATES FOR CHINA

James G.S. Yang

Abstract: This article discusses the causes of "corporate inversion" in the United States (U.S.) today. It points out three tax loopholes in the U.S. tax law. They are the worldwide income tax system, the highest tax rate in the world, and no U.S. taxation on foreign-sourced income until dividends are distributed. This article also attempts to compare the U.S. tax law with that in China. The purpose is to explore whether China will suffer from the same debacle of corporate inversion as the U.S. did. It was appalling to find out that, in addition to the same worldwide income tax system, China imposes tax on the foreign-sourced income completely and immediately without a chance of deferring the tax liability. This defect makes the Chinese tax system the worst in the world. There was indeed a lesson to be learned from the U.S. for China. This article further provides an example in determining the tax liability without and with corporate inversion. The purpose is to illustrate the tax savings by using a corporate inversion strategy. In order to curtail the abuse of a corporate inversion, recently, the United States Congress enacted IRC §7874 and the Internal Revenue Service issued Notice 2014-52. This article reveals penalties imposed under these new tax regulations. It also serves as a warning to the Chinese multinational corporations.

1. Introduction

Currently, there is a quite serious tax revolt going on in the United States (U.S.) today -- corporate tax inversion. Many U.S. multinational corporations move their tax domicile from the U.S. to a lower-tax foreign country, but they do not change their physical operations. All productions, sales and personnel do not move. They still remain in the U.S. as it used to be. Actually, they only change the headquarters address. What is the reason for making such a move? What causes this rather weird phenomenon? What is the purpose? This article attempts to identify the source of the problem. More importantly, could it happen in China? If affirmative, it could lead to quite a detrimental impact. Is there a lesson to be learned from the United States' past tax experiences for China in the future? Answers to these questions sustain the substance of this article.

2. What is a Corporate Tax Inversion?

In the field of international taxation, a transaction always involves two countries. The tax rate, more often than not, is different between them. A corporate tax inversion is a tax strategy aimed at taking advantage of the difference in tax rates between two countries. The ultimate goal is to reduce the tax liability in the U.S. There are many different approaches to reach this goal. The simplest way is to merge a U.S.-based corporation with a corporation in a foreign country and move its tax domicile to that country. The other strategy is to change the tax authority of a transaction from the U.S. government to a foreign jurisdiction. With the same token, the taxing entity of a transaction can be changed from a U.S. corporation to a foreign counterpart. This strategy will avoid the U.S. taxing authority.

In a more complicated stratagem, a U.S. parent corporation may own a controlled foreign corporation. The former may attempt to distribute the earnings of the latter, but it would incur the U.S. tax. Hence, it would set up another controlled foreign corporation and make it become the parent corporation of the other two corporations. Ostensibly, the parent-subsidiary relationship between the old U.S. corporation and the new foreign parent corporation is flipped around. The former U.S. corporation was a parent company but now becomes a subsidiary corporation. The new foreign parent corporation was a subsidiary but now becomes a parent corporation. That is why this transaction is called "corporate tax inversion." The first controlled foreign corporation now can distribute its earnings as dividends to the new foreign parent corporation without going through the hands of the former U.S. parent corporation. The dividends are now beyond the tax jurisdiction of the U.S. taxing authority, because the new foreign parent corporation is no longer a U.S. corporation. In other words, a controlled foreign corporation is employed as a vehicle to avoid the U.S. taxation.

There may be more strategies to accomplish this same goal, as will be elaborated on later. They all fall into the arena of corporate tax inversion. What is the reason that causes this rather strange tax avoidance scheme? This phenomenon will be answered in the next section.

3. How is a Multinational Corporation Taxed?

In order to understand the defects of the U.S. international tax law, it is necessary to identify the two different taxation systems in the world today. The tax policy determines the taxable amount of a multinational corporation in its own host country.

3.1 Territorial Income Tax System versus Worldwide Income Tax System

A multinational corporation always earns income from not only its own country, but also from a foreign country. Should its host government impose income tax on the former only, or on both? If it is the former, it is known as the "territorial income tax system." If it is the latter, it is termed "worldwide income tax system." From the taxpayer's point of view, the former is more beneficial than the latter; whereas, from the government's standpoint, the latter is more preferable than the former.

The countries that adopt the "territorial income tax system" include Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Estonia, Finland, France, Germany, Hungary, Iceland, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Russia, Slovak Republic, Slovenia, South Korea, Spain, Sweden, Switzerland, Turkey, and the United Kingdom.

The countries that adopt the "worldwide income tax system" encompass Chile, China, Greece, Ireland, Israel, Mexico, Poland, and the United States.[7]

3.2 Strategy for Two Different Taxing Systems

Since there is a difference between the above two taxing systems, there exists a tax loophole. A multinational corporation is now given a choice. What is the best strategy? The difference lies in whether the income earned from another country should be taxed in its own host country. Obviously, the "territorial income tax system" results in less tax liability than that of the "worldwide income tax system." The answer is the former. A multinational corporation must be aware of the difference among these countries.

This observation can be evidenced by the fact that as many as twenty-eight (28) countries adopt the former, while as few as eight (8) the latter. This is not a coincidence, because the former yields better benefits for the taxpayers. Further, and surprisingly enough, the two major economic powers—the U.S. and China—adopt the latter, rather than the former. What is the consequence of this taxation policy? It should not be shocking that corporate tax inversion shall occur in the countries that adopt the latter.

[7] Matheson, Thornton, Perry, Victoria, and Veung, Chandara, "Territorial vs. Worldwide Corporate Taxation: Implications for Developing Countries," working paper of *International Monetary Fund*, WP/13/205, 2013.

4. Loopholes and Lessons to be Learned from the U.S. Tax Law

The strategy of a corporate tax inversion did not happen without a reason. Actually, it is not new. It began as early as 1982. However, it became more rampant in the past decade. It now reaches a crisis proportion in the last two years. It even has caught the attention of the U.S. Treasury Department. The debacle was rooted in four basic deficiencies in the U.S. tax law, as pointed out below.

4.1 Taxable on Worldwide Income

When a U.S. multinational corporate within and without the U.S. territories, its income must be identified as either "U.S.-sourced income" or "foreign-sourced income." Both are taxable in the U.S.[8] Nevertheless, the latter is given the right to claim a "foreign tax credit."[9] The U.S. adopts the "worldwide income tax system," as mentioned above. As a result, wherever a U.S. multinational corporation earns income, it is always taxable in the U.S. Taxability of income depends on who earns it, rather than where it was earned. For example, if GM moves to Canada to manufacture cars, no matter whether the cars are sold to customers in Canada or to customers in the U.S., both sources of income are taxable in the U.S. With the same token, if GM deposits its money in a bank account, no matter whether it is a bank in Canada or a bank in the U.S., both sources of interest income are taxable in the U.S. as well. Is this tax policy fair to GM?

If the answer is negative, there exists a tax loophole. It will definitely encourage GM to give up its U.S. citizenship and move its tax domicile to Canada. In this way, GM can avoid its U.S. tax liability on the part of the cars sold to customers in Canada. In other words, GM would have changed from a "worldwide income tax" country to a "territorial income tax" country.

On the contrary, consider a foreign corporation that is contemplating a move to the U.S. If the U.S. government imposes tax on its income not only from the U.S. but also from its own foreign home country, this will certainly discourage the corporation in moving from a foreign country to the U.S. For example, a Chinese bicycle corporation sells its bicycles to customers in China as well as customers in the U.S. Its income from the Chinese side is not taxable in the U.S. If it gives up its Chinese citizenship and moves its tax domicile to the U.S., the income from the Chinese side will be subject to taxation in the U.S. The U.S. tax policy on "worldwide income tax" would discourage this Chinese corporation in a move from China to the U.S. This is a tax loophole and a lesson to be learned from the U.S.

4.2 Taxed at the Highest Rate in the World

Without a doubt, different countries have different tax rates. The difference in tax rates among the countries will definitely breed tax loopholes as well. The current maximum federal corporate tax rate in the U.S. is 35 percent.[10] However, a

[8] Internal Revenue Code (IRC) §862(a).
[9] IRC §901(a).
[10] Ibid, §11(b)(1)(D).

corporation's income is also subject to the income tax at the state level, which is about 4.1 percent on average, totaling 39.1 percent (35%+4.1%).

Compared to the other industrialized countries, on the upper end, they are Japan (37.0%), France (34.4%), Belgium (34.0%), Portugal (31.5%), Germany (30.2%), Australia (30.0%), Mexico (30.0%), and Spain (29.2%). On the lower end, they are China (25%), the United Kingdom (21.0%), Panama (20%), Chile (20.0%), Finland (20.0%), Iceland (20.0%), Turkey (20.0%), Czech Republic (19.0%), Hungary (19.0%), Poland (19.0%), Slovenia (17.0%), Canada (15%), and Ireland (12.5%). In tax haven countries, there is no tax at all, such as Bermuda, Cayman Islands, and British Virgin Islands.[11]

Evidently, the U.S. tax rate is the highest in the world. What is the consequence? A U.S. multinational corporation can just move to any country in the world and save a great deal of income tax by as much as 35% (35% - 0%). In fact, to date, seventy-six (76) U.S. multinational corporations have relocated to foreign countries, causing a loss of $19.5 billion in U.S. tax revenue.[12] In 2014 alone, fourteen (14) have followed suit.[13] The trend is accelerating and getting worse. This is another tax loophole and another lesson to be learned.

The above facts clearly demonstrate that the problem of corporate tax inversion today was indeed rooted in the structure of the high tax rate in the United States itself. In the past three decades, the U.S. corporate tax was never changed. It was the European countries reducing their tax rate in the past decade that caused the U.S. multinational corporations to move from the U.S. to Europe. No matter how the U.S. government imposes penalties on the action of a corporate tax inversion, it will never halt the trend unless the U.S. tax rate is reduced to a level comparable to other foreign countries.

4.3 Earnings Taxable to the Extent of Dividend Distribution

Worse yet, if the foreign earnings are indeed taxable in the U.S. after all, is it fully taxable? Strangely enough, the answer is negative. The earnings are taxable only to the extent of dividends distributed.[14] For example, IBM set up a subsidiary corporation in China earning $100,000 in profits, but distributing only $90,000 as dividends back to the U.S. headquarters. How much is taxable in the U.S.? The answer is $90,000 of dividends, not $100,000 of profits. In other words, only the dividends distributed are taxable, instead of the profits. This tax policy may breed yet another tax loophole.

If a U.S. multinational corporation earns profits abroad, but never distributes any dividends back to the U.S., it is completely tax-free. Had this U.S. multinational corporation earned the same amount of profits within the U.S., the profits would

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[11] Pomerleau, Kyle, "Corporate Income Tax Rates Around the World, 2014," *Tax Foundation*, August 20, 2014.
[12] The United States House of Representatives Ways and Means Committee, Congressional Research Service report on "New CRS Data: 47 Corporate Inversions in Last Decade," July 7, 2014.
[13] Raice, Shayndi, and Mattioli, Dana, "Inversion Deals Retain Their Allure," *The Wall Street Journal,* August 7, 2015, p. B2.
[14] IRC §862(a).

have been entirely taxable in the U.S. This tax policy is absolutely inconsistent and counter productive. It would encourage a U.S. multinational corporation to move and earn profits abroad. With the same token, it would discourage a foreign corporation from moving and earning profits in the U.S.

Even if a U.S. multinational corporation earns profits from a foreign country, this U.S. tax policy will also discourage them from distributing the profits back to the U.S. as dividends, because dividend distribution would be subject to taxation in the U.S. In other words, it would be more preferable to leave the foreign earnings in a foreign country.

The amount of untaxed earnings still sitting in foreign countries is not small. It amounted to $20 billion in 2012. This causes the U.S. Treasury Department to lose tax revenues of approximately $2 billion in the next decades.[15] It is rather appalling to realize that an unwise policy in the U.S. tax law can result in such a huge amount of losses. This is yet another lesson to be learned from the U.S for China.

4.4 Permitting Deferred Tax

The above analysis reveals the disastrous consequences of the U.S. tax policy on "worldwide income tax." And yet, it imposes a U.S. multinational corporation tax only on the dividend distribution, rather than earnings. In substance, the U.S. tax law permits a U.S. multinational corporation to defer its tax liability until the dividends are distributed. If no dividends are ever distributed, the foreign earnings will never be taxed in the U.S. It is tantamount to reducing the "worldwide income tax system" to the "territorial income tax system." It shows that the U.S. tax policy on "worldwide income tax" is self-contradictory and ineffective.

For each individual U.S. multinational corporation, the amount of untaxed profit still sitting in a foreign country is not small either. In 2012, multinationals included General Electric ($108 billion), Pfizer ($71 billion), Microsoft ($60.8 billion), Merck ($51.4 billion), Johnson & Johnson ($49 billion), AbbVie ($22 billion) and Medtronic ($18 billion).[16] When these untaxed profits are translated into the U.S. tax liability, it becomes an astronomical amount. If these U.S. multinational corporations inverted themselves to foreign countries, the U.S. Treasury Department stands to lose a tremendous amount of tax revenue. It is obviously a tax loophole, and yet another lesson to be learned from the U.S. for China.

5. Purposes and Cases of a Corporate Tax Inversion in the U.S.

If the United States tax law suffers from so many deficiencies, it will, without a doubt, give rise to the burning desire to escape the U.S. taxation. What are the purposes of a corporate inversion? At the beginning, it was intended to distribute the foreign untaxed earnings back to the U.S. without paying the U.S. tax. Not until last decade did it shift to avoiding the high tax rate in the U.S.

[15] Schoen, John W. and Flex, Esteba, "Corporate Inversions are the Latest Ploy to Upend the US Tax Code," *CNBC.com*, September 22, 2014.
[16] Thurm, Scott and Linerbaugh, Kate "More Profits Parked Offshore," *The Wall Street Journal*, March 11, 2013, Page B1.

5.1 The Desire to Distribute Foreign Earnings without Paying U.S. Tax

In the early 1960s, the U.S. multinational corporations started expanding to foreign countries. The first destination was South America and the Caribbean, where natural resources were plentiful and labor was cheap. After it was fully exploited, by the early 1980's, they began shifting to Asia. At that time, these U.S. multinational corporations accumulated a tremendous amount of profits in many foreign countries. The profits were not U.S.-sourced income, but foreign-sourced income. There is an advantage to generating foreign-sourced income. The profits are not taxable in the U.S. until dividends are distributed back to their parent corporations in the U.S. However, the U.S. parent corporations desperately need the funds for research, expansions, and other business operations. There is indeed an urgent desire to distribute the dividends. What is the best strategy to distribute these profits without paying the U.S. tax?

The problem is the fact that the U.S. parent corporation owns a controlled foreign corporation. If this ownership can be shifted from the U.S. corporation to a foreign corporation, the distribution of the earnings of a controlled foreign corporation would escape the U.S. taxation. To this end, a U.S. multinational corporation would set up another controlled foreign corporation which in turn issues stocks to the U.S. parent corporation and the old controlled foreign corporation. The new controlled foreign corporation becomes the parent corporation of the old U.S. parent corporation and the old controlled foreign corporation. The ownership of the old controlled foreign corporation would be shifted from the U.S. corporation to a new foreign corporation. Any distribution of dividends from the old controlled foreign corporation to the new foreign parent corporation would not go through the old U.S. parent corporation, and thus is nontaxable in the U.S.

Here are some actual cases of corporate inversion that has happened in the U.S. in the past three decades.[17]

(A) In 1982, McDermott, Inc. was a U.S. corporation, but it also earned profits from Panama. McDermott, Inc. registered McDermott, International in Panama and issued its stock to both McDermott, Inc. and the Panamanian subsidiary corporation. Now McDermott owns both. McDermott did not move to Panama. What was their desire? The Panamanian subsidiary corporation now can distribute dividends to the McDermott, International. It is nontaxable in the U.S. because McDermott, International is no longer a U.S. corporation.

(B) In 1992, Helen of Troy was a U.S. corporation, but it also owned many foreign subsidiary corporations. It registered a corporation in Bermuda which in turn issued its stock to not only Helen of Troy but also all foreign subsidiary corporations. Helen of Troy did not move to Bermuda. What was the purpose? Thereafter, all foreign subsidiary corporations could distribute earnings to the Bermuda corporation

[17] Wikipedia.org, Tax inversion, http://en.wikipedia.org/wiki/Tax_inversion#Notable_inversions, September 22, 2014.

without going through Helen of Troy. It is thus non-taxable in the U.S. Better yet, Bermuda is a tax haven country that has no income tax at all.

(C) In 2015, Medtronic, a U.S. Corporation in the medical technology industry, earned a huge amount of profits from around the world. There was a great desire to remit the profits back to the U.S. for further medical research, but it would entail an unbearable amount of U.S. tax. What to do? Medtronic merged with Convidient in Ireland and moved its tax domicile from the U.S. to Ireland. Medtronic's operations in the U.S. remain intact. What was the objective? Medtronic still keeps its medical research facilities in the U.S., but it is no longer a U.S. corporation. The remittance of dividends from the foreign subsidiaries to the U.S. through Medtronic is not taxable in the U.S.

There are many more cases like these. All strategies are designed to distribute the profits earned from other foreign countries without paying the heavy U.S. tax liability. More often than not, they use a controlled foreign corporation as a vehicle to accomplish this purpose.

5.2 The Desire to Avoid High Tax Rate in the U.S.

In the last decade, the purpose of a corporate inversion was shifted from avoiding U.S. tax on dividends distribution to escaping the high tax rate in the U.S. In the past, the U.S. corporate tax rate did not change. It was the European countries reducing their rates that triggered the U.S. multinational corporations to rush in to take advantage of it, as mentioned before. Notably, most of the corporate inversions were pharmaceutical corporations, because Europe offers more skilled workers and more advanced technology. Here are some actual cases that have occurred in the U.S.

(A) In 2014, Burger King was a U.S. corporation and Tim Hortons was its counterpart in Canada. They were not affiliated each other. Burger King's income from Canada was taxed at the U.S. rate of 35%. Tim Hortons's income was taxed in Canada at 15%. However, they merged to become Restaurant Brands, International, with headquarters in Canada. Burger King renounced its U.S. citizenship and moved its tax domicile from the U.S. to Canada. Both corporations' operations remain unchanged in both countries. What was their desire? Before the merger, Burger King's income from Canada was subject to the U.S. taxation; whereas, afterward, it is not. The desire was to remove Burger King's Canadian income from the jurisdiction of the U.S. government. The tax savings rate is as high as 20% (35%-15%).[18]

(B) In 2014, Horizon was a U.S. pharmaceutical corporation. It also owned Depomed in the U.S. Both sold their medical products in Europe. The U.S. tax rate is 35%, while Ireland is 12.5%. Horizon merged with Vidara in Ireland and immediately thereafter acquired

[18] Hoffman, Liz, and Mattioli, Dana, "Burger King in talks on Canada Tax Deal, *The Wall Street Journal,* August 25, 2014, p. A1.

Depomed. Horizon moved its tax domicile from the U.S. to Ireland. However, both corporations' operations in the U.S. did not change. What was the purpose? Horizon in Ireland is no longer a U.S. corporation. Income for Horizon and Depomed from Ireland is no longer subject to the U.S. taxation. The tax savings rate is as much as 22.5% (35%-12.5%).

(C) In 2015, Coca-Cola Enterprises, Inc. was a U.S. corporation. It merged with Coca-Cola Partners of Iberian of Spain, and also Coca-Cola Erfrischungsgetranke AG of Germany. However, Coca-Cola Enterprises, Inc. moved its tax domicile from the U.S. to Great Britain. What was the objective? The U.S. tax rate is 35%, while Great Britain is 21%. The income from these European countries is not subject to the U.S. taxation. The tax savings rate can be as large as 14% (35%-21%).

There are many more cases like these. For example, the Bloomberg Business database lists 76 corporations.[19] However, the common purpose is to save income tax for the difference between the U.S. tax rate and the tax rate in other foreign countries. A corporate inversion is one strategy to take advantage of these tax savings. The strategy is to change the tax domicile from the U.S. to a foreign country. Accordingly, the taxing authority of foreign-sourced income is also shifted from the U.S. government to a foreign government. This strategy can happen only when it involves international transactions. The U.S. domestic transactions cannot offer such tax savings. In this sense, an international transaction is more versatile and beneficial than a domestic counterpart.

Surprisingly enough, these corporate inversions in the past never involved Chinese corporations at all. Why it is so? The answer requires further investigation into the difference between the Chinese tax law and that of other countries, especially in the U.S. This aspect will be explored in the next section.

6. Deficiencies in the Chinese Tax Law

In retrospect of the corporate tax inversion in the U.S. in the last three decades, it was quite distressing to observe that the U.S. has lost a great number of its own multinational corporations to many other foreign countries, as well as a monumental amount of tax revenue. Now, it is time to look into the case of China. Can the debacles in the U.S. happen in China? It depends on whether the Chinese tax law falls into the same trap as the U.S. in the past. If so, can the lessons learned from the above examples serve as guidance in avoiding the same path in China? This section, in the first step, investigates some details of the Chinese tax law.

With respect to a Chinese multinational corporation operating in a foreign country, its tax rules are governed by two tax laws: The Corporate Income Tax Law of the

[19] Bloomberg, "Tracking Tax Runaways: Bloomberg Inversion Database," at http://www.bloomberg.com/infographics/2014-09-18/tax-runaways-tracking-inversions.html

People's Republic of China,[20] and China Tax Regulations on foreign-sourced Income.[21] The following aspects highlight the essence of the Chinese tax law.

6.1 Adopting the Worldwide Income Tax System

There are two alternative taxing systems for an international transaction: the "territorial income tax system," and the "worldwide income tax system," as mentioned earlier. Which system did the Chinese tax law adopt? China Tax Regulations on Foreign-sourced Income Article 9 provides that "Both the domestic-sourced income and the foreign-sourced income of a business enterprise must be combined in determining the tax liability."[22] It means that income from anywhere in the world is taxable in China. For example, if a Chinese shoe corporation goes to the U.S. to produce and sell the shoes to customers in the U.S., its income from the U.S. is subject to taxation in China. Evidently, the Chinese tax law adopts the "worldwide income tax system." Surprisingly, it is the same as the U.S. tax law.

In the past three decades, a great number of U.S. multinational corporations have inverted from the U.S. to many other foreign countries precisely for this reason. And, now the Chinese tax law follows the same disastrous footsteps as did the U.S. The lesson from the U.S. tax debacles in the past has not been learned by China. It is rather regretful and a pity to realize the ignorance of the Chinese tax law. This is the deficiency of the Chinese tax law.

6.2 Imposing a Rather High Tax Rate

The corporate tax rate in the U.S. is as high as 35 percent. What is its counterpart in China? The China Corporate Income Tax Law Article 4 provides that "The tax rate for the business enterprise is 25%."[23] Is this tax rate too high or too low? It is certainly lower than that of the U.S., but much higher than that of most of the other industrialized countries. There are more countries below the Chinese rate, but fewer countries above it.

For example, it is 21% in the United Kingdom, 15% in Canada, and as low as 12.5% in Ireland. What is the implication? The Chinese tax law certainly discourages its own corporations to invert to the U.S., but it definitely encourages them to move to the United Kingdom, Canada, or Ireland. Hence, it can be expected that more of the Chinese multinational corporations will relocate out of China than foreign corporations moving in. The net result will, for sure, not be beneficial to China.

What is the optimum tax rate? At least the rate must be in the middle of the rates in other foreign countries so that the number of Chinese corporations moving out is offset by the number of foreign countries moving in. It should end up with a neutral impact. The current Chinese tax rate at 25% certainly results in a net loss. This is another deficiency of the Chinese tax law.

[20] *The Corporate Income Tax of the People's Republic of China*, effective January 1, 2008.
[21] *China Tax Regulations on Foreign-sourced Income*, National Tax Bureau, Finance Ministry of the People's Republic of China, Tsai Suai (1997) No. 116, effective November 25, 1997.
[22] Ibid, Article 9.
[23] China Corporate Tax Law, *The Corporate Income Tax Law of the People's Republic of China*, Article 4, effective January 1, 2008.

6.3 Earnings Immediately and Fully Taxable

If foreign-sourced income is indeed taxable in China under the policy of "worldwide income tax system," to what extent is it taxable? Is it taxable to the full amount of earnings immediately, or only to the extent of dividend distribution? Although the U.S. adopts the same policy of "worldwide income tax system," as did China, there is a relief. The U.S. imposes tax only to the extent of dividends distributed. The undistributed earnings are not taxable until the time when dividends are distributed. Did China follow the same policy, as did the U.S.? Unfortunately, the answer is negative.

China Tax Regulations on Foreign-sourced Income Article 8 provides that "Foreign-sourced income is subject to taxation in China, regardless of whether the income has been repatriated back to China."[24] It means that, if a Chinese multinational corporation earns profits from a foreign country, the entire amount of profits is immediately and fully taxable in China, and not until the time of dividend distribution. It shows that China imposes tax on profits, not on dividends. In other words, no matter whether or not dividends are distributed, earnings are still taxable in China.

For example, the China Hotel Corporation acquired the Waldorf-Astoria Hotel Corporation in the U.S. The latter earned $100,000 of profits but distributed only $90,000 of dividends to the former. How much is taxable in China? The answer is $100,000, not $90,000. In a reverse situation, had this Chinese corporation been a U.S. corporation and the Waldorf-Astoria is located in China, the taxable amount in the U.S. would have been only $90,000. This marks a big difference between the Chinese tax law and its U.S. counterpart. The former provides no chance to escape the Chinese tax; whereas, the latter gives an opportunity to avoid the U.S. tax.

The Chinese tax policy certainly discourages a Chinese corporation from investing in a foreign subsidiary corporation. That is because, in the event that the foreign subsidiary corporation does not pay dividends to the Chinese parent corporation, the latter would have no financial ability to pay the Chinese tax. On the contrary, it definitely encourages the foreign corporation to invest in a subsidiary corporation in China. That is because the profits earned by a foreign corporation in China may not have to pay income tax to a foreign government. In the end, China will stand to lose more of its foreign investment by Chinese corporations to foreign countries than that of foreign investment to China by foreign corporations. This is yet another deficiency of the Chinese tax law.

In the past three decades, seventy-six U.S. corporations have inverted to foreign countries, as mentioned earlier. It was rather surprising to observe that none of them ever moved to China. The above disadvantage of the Chinese tax law may be the culprit. The above facts clearly show that the Chinese tax law is indeed deeply flawed. In this sense, China did not really learn a lesson from the U.S.

[24] *China Tax Regulations on Foreign-sourced Income*, Article 8, National Tax Bureau, Finance Ministry of the People's Republic of China, Tsai Suai (1997) No. 116, effective November 25, 1997.

6.4 No Deferred Tax Allowed

If the profits earned by a Chinese multinational corporation from a foreign country are immediately and fully taxable in China, there would be no chance to defer any of the Chinese tax liabilities.[25] That is, no income tax can be deferred in China. Under this circumstance, the Chinese multinational corporations would start seeking an opportunity to avoid the Chinese taxing authority. It means that a Chinese multinational corporation may renounce its Chinese citizenship and move its tax domicile to a foreign country where there is an opportunity to defer the tax on its foreign-sourced income.

For example, a Chinese furniture corporation earns $100,000 in profits from Canada without distributing any dividends back to China. The Chinese tax liability is $25,000 ($100,000 x 25%) and due immediately. If this Chinese furniture corporation moves to the U.S. as its tax domicile, the tax liability in the U.S. is zero, if the profits were never patriated as dividends to the U.S.

In fact, that is exactly what is happening in the U.S. now, but for different reasons. On the U.S. side, the U.S. multinational corporations are relocating to a foreign country due to the U.S. tax policy on "worldwide income tax system" and also because of its high tax rate. This is the current debacle of corporate tax inversion. On the Chinese side, the purpose of a corporate tax inversion is to escape the Chinese tax policy on the non-deferral of the Chinese tax liability. The U.S. tax law offers such an opportunity to defer the U.S. tax liability, but not the Chinese counterpart. Ultimately, China ends up with the worst combination of tax policy: worldwide income tax without tax deferral. This is still another deficiency of the Chinese tax law. This observation points out that, if the event of a corporate tax inversion is happening in the U.S. today, it will definitely occur in China soon.

If a corporate inversion indeed takes place in China, how would it work and how much is the tax savings? This question requires an example to demonstrate. Take the scenario of an inversion from China to Canada as an example. It is formulated in the next section.

7. An Example for Corporate Tax Inversion from China to Canada

China Corporation fully owns Canada Corporation. China imposes income tax at a rate of 25% on the basis of "worldwide income." Canada levies income tax at a rate of 15% on the basis of "territorial income." China Corporation has $60,000 income from China and $40,000 income from Canada. Similarly, Canada Corporation has $20,000 income from China and $80,000 income from Canada. China Corporation is considering adopting the strategy of corporate inversion by moving its tax domicile from China to Canada. What is the total tax liability for both corporations together without or with corporate inversion, respectively?

The above information and answers to the questions are summarized in TABLE 1 below. Explanations shall follow.

[25] Ibid.

Table 1 - Tax Liability

	Income	Tax *Without* Inversion	Tax *With* Inversion
<u>China Corporation</u> (25%):			
China Source	$60,000 (a)	15,000 (25%)	15,000 (25%)
Canada Source	40,000 (b)	10,000 (25%)	6,000 (15%)
<u>Canada Corporation</u> (15%):			
China Source	$20,000 (c)	5,000 (25%)	5,000 (25%)
Canada Source	80,000 (d)	12,000 (15%)	12,000 (15%)
TOTAL	200,000	42,000	38,000

It should be noted that, on the one hand, since the Chinese government adopts the "worldwide income tax" policy, it imposes tax on China Corporation on both the China-sourced income as well as the Canada-sourced income. However, the Chinese government can impose tax on Canada Corporation only on its China-sourced income, but not on its Canada-sourced income.

On the other hand, since the Canadian government adopts the "territorial income tax" policy, it levies tax on Canada Corporation only on its Canada-sourced income, but not on its China-sourced income. It levies on China Corporation on its Canada-sourced income, but not on its China-sourced income.

Furthermore, let's consider the "foreign tax credit." When China Corporation pays income tax to the Canadian government for its Canada-sourced income, the tax paid can be claimed as a "foreign tax credit" against the tax imposed by the Chinese government. However, since the Canadian government does not levy tax on any China-sourced income, the income tax paid by Canada Corporation to the Chinese government results in no benefits in claiming "foreign tax credit" against the tax levied by the Canadian government.

7.1 Without Corporate Inversion

(A) If there is no corporate inversion, China Corporation pays $15,000 ($60,000x25%) tax to the Chinese government for its $60,000 China-sourced income.

(B) It incurred \$10,000 (\$40,000x25%) tax to the Chinese government for its \$40,000 Canada-sourced income. However, it pays \$6,000 (\$40,000x15%) tax to the Canadian government for its \$40,000 Canada-sourced income. The net tax paid to the Chinese government is \$4,000 (\$10,000-6,000). Since the Chinese tax rate is higher than that of Canadian tax rate, the "foreign tax credit" from Canada does not yield any benefits. The total tax burden is still \$10,000 (\$6,000+4,000).

(C) Canada Corporation pays \$5,000 (\$20,000x25%) tax to the Chinese government for its \$20,0000 China-sourced income. It pays no income tax to the Canadian government.

(D) Canada Corporation pays no income tax to the Chinese government for its \$80,000 Canada-sourced income, but it pays \$12,000 (\$80,000x15%) tax to the Canadian government for its \$80,000 Canada-sourced income.

(E) Therefore, the total tax paid by these two corporations all together is \$42,000 (\$15,000+10,000+5,000+12,000).

7.2 With Corporate Inversion

(A) If there is a corporate inversion, China Corporation pays \$15,000 (\$60,000x25%) tax to the Chinese government for its \$60,000 China-sourced income.

(B) China Corporation pays \$6,000 (\$40,000x15%) tax to the Canadian government for its \$40,000 Canada-sourced income.

(C) Canada Corporation pays \$5,000 (\$20,000x25%) tax to the Chinese government for its \$20,000 China-sourced income.

(D) Canada Corporation pays \$12,000 (\$80,000x15%) tax to the Canadian government for its \$80,000 Canada-sourced income.

Therefore, the total tax paid by these two corporations all together is \$38,000 (\$15,000+6,000+5,000+12,000). In fact, these two corporation have combined together to become only one corporation, now based in Canada.

7.3 Comparison Between Without and With Corporate Inversion

The difference in total tax liability for these two corporations all together is \$4,000 (\$42,000-38,000). It comes from the \$40,000 China Corporation's Canada-sourced income. Without corporate inversion, it is taxed in China with a tax liability of \$10,000 (\$40,000x25%). With corporation inversion, this \$40,000 Canada-sourced income is not taxed in China, but in Canada only with a tax liability of \$6,000 (\$40,000x15%). The difference is indeed \$4,000 (\$10,000-6,000). It is the same as the difference in tax rates for the \$40,000 Canada-sourced income, i.e., \$40,000x(25%-15%) = \$40,000x10% = \$4,000. The rest of the tax liabilities do not change. This corporate inversion has such a benefit only because the Canadian tax rate is lower than the Chinese tax rate by 10% (25%-10%).

This example demonstrates that the tax savings on a corporate inversion are derived solely from China Corporation's Canada-sourced income, not from any other sources of income. In this sense, the benefit from a corporate inversion is quite limited. Those who are contemplating a corporate inversion must be aware of the source of tax savings.

7.4 Corporate Inversion from China to the U.S.

Had the above example been a corporate inversion from China to the United States, is there any tax savings? It should be noted that the U.S. income tax rate is 35%, which is higher than the 25% tax rate in China. The combined corporation would have paid $20,000 [25%x($60,000+20,000) = 25%x80,000 = $20,0000] tax to the Chinese government for their China-sourced income of $60,000 and $20,000. It would have also paid $42,000 [35%x($40,000+80,0000 = 35%x120,000 = $42,000] tax to the U.S. government for their U.S.-sourced income of $40,000 and $80,000. The total tax paid with a corporate inversion would have been $62,000 ($20,000+42,000).

In the last case of corporate inversion from China to Canada, the total tax paid with inversion was $38,000. In comparison, the corporate inversion from China to the U.S. results in a loss of $24,000 ($62,000-38,000) in favour of corporate inversion from China to Canada.

This simple comparison indicates that not any corporate inversion is beneficial. It depends on the tax rate in a foreign country. A corporate inversion from China to a lower-tax rate country would result in a gain. Whereas, an inversion from China to a higher-tax rate country would suffer a loss. Should a Chinese corporation invert? In comparing with the 25% tax rate in China, there are more countries below this rate than that of higher rate countries. It implies that there will be more Chinese corporations using inversion than not.

8. Penalties on Corporate Inversion in the U.S.

When a U.S. multinational corporation operates in a foreign country, it will invariably involve a foreign corporation. Both corporations are engaged in trade. Each corporation derives income from the other. Each pays income tax to not only its own government but also to a foreign government, because it has both U.S.-sourced income as well as foreign-sourced income. This is a normal course of business.

Now, if the U.S. multinational corporation renounces its U.S. citizenship and moves its tax domicile from the U.S. to a foreign country, its foreign-sourced income is no longer subject to the U.S. taxation. It causes losses of a tax base to the U.S. government. If this act is a normal corporate reorganization, there is nothing wrong with that. Nevertheless, if it is for the purpose of tax evasion, it becomes more serious.

Unfortunately, in the last decade, many U.S. multinational corporations moved abroad precisely for the purpose of escaping the high tax rate in the U.S. for its foreign-sourced income. The situation is deteriorating rapidly now, and it has caught the attention of the U.S. Treasury Department. As a consequence, the United States Congress enacted IRC §7874 in 2004 and the Internal Revenue Service issued Notice 2014-52 in 2014 attempting to curtail its abuse. This section investigates some details of penalties, and points out whether there is a lesson to be learned from the U.S. for China.

8.1 Does Exchange of Stock in a Corporate Inversion Result in a Taxable Gain?

In order to invert from a U.S. corporation to a foreign corporation, usually the former sets up the latter in a foreign country. Then the latter issues stock to the shareholders of the former in exchange for the stock of the former. Now the latter owns the former. Does the exchange of the stock of the former for the stock of the latter constitute the meaning of a taxable gain on the part of the U.S. shareholder?

Actually, this question was raised in the case of McDermott in 1982. At that time, McDermott, Inc. in the U.S. created McDermott, International in Panama. The latter issued stock to the shareholders of the former in exchange of the stock of the former. Was there any taxable gain in that exchange on the shareholders? In fact, the case went to the court and was ruled negative.[26] In other words, there was no taxable gain in that exchange.

Ten years later, this same question was raised again in the case of Helen of Troy in 1992.[27] At that time, Helen of Troy in the U.S. created a corporation in Bermuda. They exchanged stocks again. However, this time the U.S. Congress enacted IRC §367(a) and made this gain taxable.[28]

In essence, this exchange of stocks may constitute the meaning of corporate formation under §351(a) in which the gain is recognized only to the extent of boot received. Stock received does not constitute the meaning of boot. As a result, it should have not been taxable. Unfortunately, under IRC §367(a), the gain is now taxable. The intention was to prevent a corporate inversion from taking advantage of non-recognition of the gain in a corporate formation. A penalty is now imposed on a corporate inversion.

It implies that, if a U.S. multinational corporation goes to set up a corporation in China, nothing is taxable on the part of the shareholders in the U.S. However, if the former is inverted to China, any gain on the shareholders will become taxable in the U.S.

8.2 Should the Dividend from a Controlled Foreign Corporation be Tax-free?

It should be noted that, when a U.S. multinational corporation owns a controlled foreign corporation, earnings are taxable in the U.S. only to the extent of the amount of dividends distributed back to the U.S. parent corporation. By creating another controlled foreign corporation in a foreign country, any distribution of the above-

[26] United States Court of Appeals Sixth Circuit, *Bhada v. Commissioner Internal Revenue Service*, 892 F. 2d 39, December 19, 1989.
[27] Tax inversions. Wikipedia.org, http://en.wikipedia.org/wiki/Tax_inversion#Notable_inversions, September 22, 2014.
[28] IRC §367(a).

mentioned earnings to this foreign corporation would be tax-free, because the U.S. has no jurisdiction over a foreign corporation.

In fact, this was the case of Tyco International in 1997.[29] At that time, Tyco was a U.S. corporation, but earned a huge amount of profits from many foreign corporations in many foreign countries. Tyco moved its headquarters to Bermuda. The distribution of earnings from these controlled foreign corporations to Tyco was not taxable in the U.S., because Tyco was no longer a U.S. corporation. It avoided U.S. taxation on all untaxed earnings in foreign countries.

Is this strategy legal? The answer is absolutely positive, but it might be unpatriotic. This debacle points to the deficiency of the U.S. tax law. It desperately needs a remedy. In 2004, the U.S. Congress enacted IRC §7874 under which it provides that the stock issued to create a controlled foreign corporation for the purpose of evading U.S. taxation is void.[30] It has literally rendered the strategy of creating a controlled foreign corporation void. This is another penalty imposed on a corporate inversion.

This tax regulation indicates that, if a U.S. corporation owns a Chinese corporation, the earnings from China are not taxable in the U.S. until dividends are distributed from China back to the U.S. However, if a U.S. corporation is inverted to China, any dividend distribution of earnings from the Chinese corporation back to the U.S. is taxable in the U.S.

8.3 Should a Controlled Foreign Corporation Be Treated as a U.S. Domestic Corporation?

It should be noted that the earnings of a U.S. domestic corporation are taxable immediately in the U.S. However, the earnings of a controlled foreign corporation are not taxable in the U.S. until dividends are distributed back to the U.S. As such, a controlled foreign corporation receives preferable treatment over a domestic corporation. When a U.S. multinational corporation is merged with a foreign controlled corporation, is it really moved? More often than not, ostensibly it may be, but in substance it may be not.

If the U.S. corporation is very small relative to the controlled foreign corporation, it may signal a move. Conversely, if the U.S. corporation is so large that it overshadows the controlled foreign corporation, it may indicate that it was not really moved. As such, the combined corporation should be treated as a U.S. domestic corporation. Therefore, the size of these two corporations is important in determining whether a corporate inversion indeed took place.

In 2004, IRC §7874 provides that, if the old U.S. shareholders owns less than 60 percent of the combined corporation, it is treated as a real "foreign corporation" that can enjoy the benefits of a foreign corporation. If the old U.S. shareholders own at least 60 percent but less than 80 percent, the combined corporation is treated as a

[29] Tax inversions. Wikipedia.org, http://en.wikipedia.org/wiki/Tax_inversion#Notable_inversions, September 22, 2014.
[30] IRC §7874(c)(2)(A).

"surrogate foreign corporation,"[31] under which all restrictions of IRC §7874 and the IRS Notice 2014-52 shall apply. If the old U.S. shareholders own at least 80 percent of the combined corporation, the combined corporation is treated as a "U.S. domestic corporation."[32]

The last situation concerning the 80 percent criterion is the most devastating impact on a corporate inversion, because under which both the U.S.-sourced income and the foreign-sourced income are immediately subject to the U.S. taxation without a chance of deferring the income tax. Nonetheless, if the business activities in the country of incorporation accounts for at least 25 percent of the combined corporation, the combined corporation is treated as a foreign corporation, regardless of the ownership of the old U.S. shareholders. This is yet another penalty on a corporate inversion.

This tax regulation shows that, if a very small U.S. corporation is inverted to China, the combined corporation can enjoy the benefits of being a Chinese corporation that is taxed a rate less than that of the U.S. In a worse situation, if a very large U.S. corporation is inverted to China, the China-sourced income will be taxed in the U.S.

8.4 How Should an Intercompany Loan in a Corporate Inversion Be Treated?

After a corporate inversion, the U.S. parent corporation and the controlled foreign corporation may engage in an intercompany loan. If it is a loan from a controlled foreign corporation to the U.S. parent corporation, it is known as an "upstream loan". Similarly, if it is a loan from the U.S. parent corporation to a controlled foreign corporation, it is referred to as a "downstream loan." Why should an "intercompany loan" cause concern?

If it is an "upstream loan", the funds go from a controlled foreign corporation to the U.S. parent corporation. It is construed as a dividend distribution from a controlled foreign corporation to the U.S. corporation. As such, the loan is a taxable income in the U.S. If the funds are used by a controlled foreign corporation to purchase stock or property from the U.S. parent corporation, it is construed as a dividend distribution as well. Hence, it is taxable in the U.S.

Furthermore, the payment of interest expense to a controlled foreign corporation decreases the profits of the U.S. corporation, and creates an increase in profits to a controlled foreign corporation. It is tantamount to a transfer of profits from the U.S. parent corporation to a controlled foreign corporation. It should be noted that profits of a controlled foreign corporation are not taxable in the U.S. It results in a decrease of tax liability in the U.S. Under the IRS Notice 2014-52, this kind of "upstream intercompany loan" is void.

Conversely, in the event of a "downstream intercompany loan," it does not concern the problem of dividend distribution from a controlled foreign corporation to the U.S.

[31] Ibid §7874(a)(2)(B)(ii).
[32] Ibid §7874(b).

parent corporation. However, the payment of interest expense from a controlled foreign corporation to the U.S. parent corporation reduces the profits of a controlled foreign corporation, but increases the profits of the U.S. parent corporation. As a consequence, profits are shifted from a foreign country to the U.S. It distorts the source of income. Therefore, the IRS Notice 2014-52 also renders this "downstream intercompany loan" void.[33]

This is still another penalty on a corporate inversion. There are many more penalties. They all are concerned with the possibility of tax evasion in the U.S. These penalties are intended to curtail the abuse of corporate inversion as a tax avoidance strategy.

Are these new tax regulations in the U.S. applicable to a Chinese multinational corporation? The answer is most likely affirmative. The Chinese tax rate is lower than that of the U.S. Very likely, a U.S. corporation may be inverted to China. If so, the Chinese corporation becomes a controlled foreign corporation. Conversely, if a Chinese corporation is inverted to the U.S., the U.S. corporation becomes a controlled foreign corporation as well. That is why a Chinese multinational corporation must be aware of these new tax rules in the U.S.

9. Conclusion

This article discusses the causes of a recent tax phenomenon in the U.S. known as "corporate inversion." It points out three tax loopholes in the U.S. tax law. The U.S. imposes tax on worldwide income, while many other foreign countries impose territorial income. The U.S. has the highest tax rate in the world, which causes many U.S. corporations to move abroad. The foreign-sourced income is not taxable in the U.S. until dividends are distributed back to the U.S. The tax system encourages a U.S. multinational corporation not to distribute earnings from a foreign country. These are the roots of "corporate inversion."

This article then reveals the purpose of a corporate inversion. In the beginning, it was aimed at avoiding the heavy U.S. taxation on its earnings from a foreign country. More recently, the strategy attempts to escape the high tax rate in the U.S. It was found that the vehicle to achieve this objective is to create a controlled foreign corporation.

This article further investigates the Chinese tax law to identify whether it also suffers from the same deficiencies as did the U.S. It attempts to find out whether there is a lesson to be learned from the U.S. for China. It was quite surprising to discover that the Chinese tax law is also based on worldwide income. Worse yet, the foreign earnings are immediately and fully taxable in China. And, there is no chance of deferring any Chinese tax liability.

[33] Hoffman, Liz, and McKinnon, John D., "Curbs Don't Stop Tax-Driven Mergers," *The Wall Journal*, September 22, 2015, p. C-1.

This article also demonstrates an example to explain how the tax liability is determined without or with corporate inversion. The purpose is to find out the amount of tax savings by using a corporate inversion.

In order to curtail the abuse of corporate inversion, the United States Congress enacted IRC §7874, and the Internal Revenue Service issued Notice 2014-52. This article scrutinizes some of the details. It points out many penalties that are imposed on the use of corporate inversion as a tax-planning strategy. It serves as a lesson for the Chinese multinational corporations to learn.

This is still another penalty on a corporate inversion. There are many more penalties. They all are concerned with the possibility of tax evasion in the U.S. These penalties are intended to curtail the abuse of corporate inversion as a tax avoidance strategy.

Are these new tax regulations in the U.S. applicable to a Chinese multinational corporation? The answer is most likely affirmative. The Chinese tax rate is lower than that of the U.S. Very likely, a U.S. corporation may be inverted to China. If so, the Chinese corporation becomes a controlled foreign corporation. Conversely, if a Chinese corporation is inverted to the U.S., the U.S. corporation becomes a controlled foreign corporation as well. That is why a Chinese multinational corporation must be aware of these new tax rules in the U.S.