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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 2016 No 1 issue of the *Journal of Chinese Tax and Policy* features articles invited for the 2015 *International Conference of Chinese Tax and Policy*. The theme of the conference was "Tax Policy and Tax Law for China in a Time of Change –Income Tax Reform in China ".

Cassidy and Cheng's paper focused on China's fiscal and tax reforms on stock market under the guiding principles of the 13th Five-Year Plan. The reforms were aiming to strengthen the securities market. The authors also stated that China can learn from foreign experience of financial system reform that it must be supported by strong legal and taxation laws. Then the article suggested lessons that China can learn from Australia and New Zealand on taxation of capital gains after a careful comparative analysis of tax regimes.

Unitary Taxation with a Global Formulary Approach as a Realistic and Appropriate Option for Developing Nations: A Chinese Case Study by Sadiq is a contribution to the discussion on the transfer pricing regime and transfer pricing issues in China. The article proposed that unitary taxation based on formulary apportionment should be considered as a more accurate method of determining China's 'fair share' of profits to be taxed since the current jurisdiction and allocation rules do not work for multinational entities and China has clearly expressed concern about the application of the current transfer pricing rules. The author also examined the commentary provided by China in the UN Practical Manual and compared that to Brazil, India and South Africa which took into consideration practicalities of the implementation of unitary taxation for developing nations.

Sawyer's article focused on the improvement New Zealand has made towards tax simplification. This article viewed and analyzed the differential approaches of tax reforms for individual taxpayers who are not involved in business or self-employed and individuals who are in business or self-employed. For the former, tax simplification has been achieved by the removal of deductions for wage and salary earners, the removal of the need to file returns and formalizing self-assessment. For the latter, reforms were towards reducing compliance costs while retaining abilities to claim deductions. Some further reformations in respect to withholding accuracy, and online environment were also mentioned in this article.

Eva Huang

Sydney, July 2017

Reshaping the Financial Regulatory Framework in China: Improving the Individual Income Tax on Securities Trading

Professor Julie Cassidy, Dr Man Hung Alvin Cheng ☆

Abstract: China has embarked upon several financial system reforms over the past decades that are aimed at transforming the nation from a socialist economy to a market economy. On 17 March 2016, China released its 13th Five-Year Plan (Plan) which sets out the guiding principles for China's development for the five-year period from 2016 to 2020. In the midst of the volatility of the stock market, the Plan stated that China will pursue stronger fiscal and taxation system reforms and strengthen the securities market. Unlike other developed OECD countries, China's financial market is relatively new. Yet China is in a good position since it can learn from decades of overseas experience. Overseas experience suggests that financial system reform has to be supported by strong legal and taxation laws. Yet in China there are few rules governing the taxation of the sales of shares. This article looks at the taxation of capital gains (CGT) on sales of shares through a comparative analysis of the tax regimes in Australia and New Zealand. The analysis shows that there are many lessons China can learn from the CGT experiences of these two countries.

Key Words: Tax, Financial System Reform, CGT, Capital Gains Tax, Australia and New Zealand

☆ Professor Kerrie Sadiq, Queensland University of Technology Business School. The author wishes to thank the International Centre for Tax and Development (ICTD), supported by the UK Government's Department for International Development (DFID) and the Norwegian Agency for Development Cooperation (NORAD) for the funding provided to undertake this project and present the paper at the Conference of Chinese Tax and Policy 2014, Xiamen, China. The author also wishes to thank Professor Jinzhi Tong for the invitation to speak at the conference and Eva Huang for organising my visit.

1 Introduction

Capital gains tax (CGT) has attracted more public attention in recent years. Latest research from Ernst and Young shows that governments worldwide are targeting the wealthy individuals for more tax revenue and are increasingly imposing criminal sanctions in relation to tax issues[1]. One of these tax issues is the taxation of capital gains. The report finds that a growing number of countries have increased the tax rate on capital gains and have widened their tax base through the introduction of specific legislation.[2]

Although CGT has been subject to constant public criticism and subsequent amendments, no country has ever abolished their CGT since the enactment of the tax. Indeed, an overwhelming majority of the Organization for Economic Cooperation and Development[3] ('OECD') countries have had some forms of comprehensive CGT regime in place for many years. Different to most of the OECD countries, People's Republic of China has never implemented a comprehensive, realisation based CGT. Certain capital gains are taxable as income under the Individual Income Tax or the Enterprise Income Tax.

An OECD report finds that a significant feature of the tax system in China is that its overall tax revenue is highly correlated with its economic development[4]. For example, China introduced a number of taxes on transactions in relation to residential property during the booming period of the property market. The taxation of these land transactions has led to extra tax revenue when the economy was experiencing a rapid rate of growth, as more investors and households are actively buying and selling property.[5] Another important feature of the China's tax system is that its tax mix is heavily skewed towards indirect taxation such as value added tax, consumption and property taxes and focuses less on direct taxes such as individual and enterprise income taxes.[6] As shown in Table 1 below, individual income tax and enterprise income tax represent only 6% and 21% of total tax revenues in 2014.

Table 1 Tax mix

	2014	2013	2012	2011	2010	2009	2008	2007	2006	2005
Taxes(¥100 million)	19,158.05	10,530.70	00,614.28	9,738.39	3,210.79	9,521.59	4,223.79	5,621.97	4,804.35	8,778.54
Domestic Value-added Tax	30,849.78	28,810.13	26,415.51	4,266.63	1,093.48	8,481.22	7,996.94	5,470.23	2,784.81	0,792.11

[1] Ernst and Young, "Wealth under the spotlight 2015: How taxing the wealthy is changing" (2015) EYGM Limited www.ey.com/Publication/vwLUAssets/ey-wealth-under-the-spotlightv6/$FILE/ey-wealth-under-the-spotlightv6.pdf.

[2] Ernst and Young, "Wealth under the spotlight 2015: How taxing the wealthy is changing" (2015) EYGM Limited at 10.

[3] Established in 1961, the Organisation for Economic Co-operation and Development (OECD) is an international organisation of 30 member countries that are committed to democracy and a free market economy.

[4] Bert Brys, Stephen Matthews, Richard Herd, and Xiao Wang, "Tax Policy and Tax Reform in the People's Republic of China: OECD Taxation Working Papers No. 18" (2013) OECD Publishing http://dx.doi.org/10.1787/5k40l4dlmnzw-en.

[5] Bert Brys, Stephen Matthews, Richard Herd, and Xiao Wang, "Tax Policy and Tax Reform in the People's Republic of China: OECD Taxation Working Papers No. 18" (2013) OECD Publishing at 7.

[6] National Bureau of Statistics of China 国家数据, "National data: annual" 国家财政收支 (2014) National Bureau of Statistics of China <data.stats.gov.cn/english/easyquery.htm?cn=C01> (English version) and <data.stats.gov.cn/tablequery.htm?code=AD07> (Chinese version).

	2014	2013	2012	2011	2010	2009	2008	2007	2006	2005
Business Tax	17,781.62	17,233.02	15,747.64	3,679.00	1,157.91	9,013.98	7,626.39	6,582.17	5,128.71	4,232.46
Domestic Consumption Tax	8,906.82	8,231.32	7,875.58	6,936.21	6,071.55	4,761.22	2,568.27	2,206.83	1,885.69	1,633.81
Tariffs	2,843.19	2,630.61	2,783.93	2,559.12	2,027.83	1,483.81	1,769.95	1,432.57	1,141.78	1,066.17
Individual Income Tax	7,376.57	6,531.53	5,820.28	6,054.11	4,837.27	3,949.35	3,722.31	3,185.58	2,453.71	2,094.91
Corporate Income Tax	24,632.49	22,427.20	19,654.53	6,769.64	2,843.54	1,536.84	1,175.63	8,779.25	7,039.60	5,343.92

(Source: National data, National Bureau of Statistics of China, 2014)

It is noted that China has also relied heavily on other non-tax revenues raised by local governments. These revenues include local fees and fines, and income from the ownership of State-owned Enterprise[7]. Local governments frequently have to rely on gains from the disposal of land to finance expenditure in order to make up for the revenue shortages [8].

The working papers of the OECD[9] and the IMF[10] have found that the redistributive effect of taxes is relatively limited in China. The problem of income inequality is significant and the fiscal policy appears to contribute relatively little to narrow the rising inequality. This is due to the limited impact of direct taxes and the reliance on regressive, indirect taxes. To tackle the income inequality problem, the Chinese government is considering a reform of the individual income tax system[11]. The Finance Minister Lou Jiwei has indicated that the government will review the eleven individual tax payment items in the legislation and is considering the introduction of a more comprehensive individual income tax system[12].

This article provides a detailed analysis of what might be involved in terms of practical design and implementation based on features drawn from the New Zealand and Australian individual income tax system. The reasons why these two countries are used as exemplars are:

- New Zealand and Australia are nominated by the International Bank for Reconstruction and Development/ The World Bank as the top 10 countries with the most business-friendly regulations;[13]
- New Zealand was the first developed country to implement a bilateral Free Trade Agreement with China;

[7] Bin Yang and Eva Huang, "Characteristics of the Chinese tax system and its cultural underpinnings: a comparison with the West" (2011) 1 Journal of Chinese Tax & Policy 13 at 18. http://papers.ssrn.com/sol3/Delivery.cfm/SSRN_ID1963570_code1240973.pdf?abstractid=1963570&mirid=1.
[8] W. Raphael Lam and Philippe Wingender, "IMF Working Paper WP/15/66 China: How Can Revenue Reforms Contribute to Inclusive and Sustainable Growth?" (2015) International Monetary Fund https://www.imf.org/external/pubs/ft/wp/2015/wp1566.pdf.
[9] Bert Brys, Stephen Matthews, Richard Herd, and Xiao Wang, "Tax Policy and Tax Reform in the People's Republic of China: OECD Taxation Working Papers No. 18" (2013) OECD Publishing http://dx.doi.org/10.1787/5k40l4dlmnzw-en.
[10] W. Raphael Lam and Philippe Wingender, "IMF Working Paper WP/15/66 China: How Can Revenue Reforms Contribute to Inclusive and Sustainable Growth?" (2015) International Monetary Fund https://www.imf.org/external/pubs/ft/wp/2015/wp1566.pdf.
[11] Xinhua, "China considers reform on individual income tax" (28 June 2015) China Daily <http://www.chinadaily.com.cn/china/2015-06/28/content_21126869.htm>
[12] Xinhua, "China considers reform on individual income tax" (28 June 2015) China Daily.
[13] Doing business *Doing Business 2015: Going Beyond Efficiency* (12th ed International Bank for Reconstruction and Development / The World Bank, Washington DC, 2014).

- Australia is one of the major trading partners of China;
- These countries are members of the OECD;
- Australia and New Zealand are continuously seeking closer economic relationship with China and taxation is a feature of that relationship.

In particular, the article focuses on the taxation of capital gains for individuals and discusses its implication to the recent development of the financial market. China has embarked upon several financial system reforms over the past decades that aimed at transforming the nation from a socialist economy to a market economy. Unlike other developed OECD countries, China's financial market is relatively new. Yet China is in a good position since it can learn from decades of overseas experience. Overseas experience suggests that the success of a financial system reform has to be supported by strong legal and taxation laws. Yet in China there are few rules governing the taxation of the sales of shares. This article looks at the taxation of capital gains on sales of shares through a comparative analysis of the tax regimes in Australia and New Zealand. The analysis shows that there are many lessons China can learn from the CGT experiences of these two countries.

2 Global CGT tax policy and administration trends

A plain language lawyer's guide defines a CGT as "a tax on the increase in value of a capital asset realized when it is sold or transferred."[14] This concept appears to be simple. Yet the practice seems the opposite as the term "capital gain" is vaguely defined in the global context, even though a number of developed and developing countries have had CGT for many years. While the term "capital gain" is frequently used in the tax systems across the world, the "precise contours of the concept vary considerably from country to country."[15] Concepts of capital gain in the tax literature are diverse, and, therefore, there is no single definition of what are capital gains.[16] The lack of consensus as to the meaning of capital gain is further emphasised by Evans and Sandford.[17] These authors examined the taxation of capital gains in six English-speaking countries (i.e. Australia, Canada, Ireland, New Zealand, the United Kingdom and the United States) and found that the legal definitions used for capital gain were different in those countries.[18] The result showed that "it is virtually impossible to identify any unifying principle in taxing capital gains."[19]

Holmes found that the development of the legal concept of income (including capital gains) is heavily influenced by the economic theories.[20] One of the related, predominant economic concepts of income is the Haig-Simons income.[21] In simple

[14] C Rossini, *English as a legal language* (2nd ed, Kluwer Law International, London, 1998) at 155.
[15] H Ault, *Comparative income tax: A structural analysis* (Kluwer Law International, Den Haag, 1997) at 194.
[16] C Evans, "Taxing capital gains: One step forwards or two steps back?" (2002) 5(1) Journal of Australian Taxation 114 at 115.
[17] C Evans C Sandford, "Capital gains tax: The unprincipled tax" (1999) 5 British Tax Review 387.
[18] C Evans C Sandford, "Capital gains tax: The unprincipled tax" (1999) 5 British Tax Review 387 at 403.
[19] C Evans C Sandford, "Capital gains tax: The unprincipled tax" (1999) 5 British Tax Review 387 at 394.
[20] K Holmes *The concept of income- a multi-disciplinary analysis* (IBFD Publications BV, Amsterdam, 2001) at 240.
[21] See Robert M Haig, "The Concept of Income - Economic and Legal Aspects" in R A Musgrave and C S Shoup (ed) *Readings in the economics of taxation* (Homewood IL, Irwin, 1959) 54; Henry Simons, "Personal

words, income is the net increases in wealth plus consumption over the taxable year.[22] This core concept of income became commonly known as "comprehensive income"[23]. Theoretically, the Haig-Simons' comprehensive income approach recognises that capital gains, whether realised or unrealised, represent an accretion to wealth – they are merely another form of income and therefore need to be included in the income base for tax purposes. Under this concept, there will be no distinction between income on revenue account and income on capital account. In practice, the Haig-Simons' concept of income is different from the China's individual income tax base calculations as a capital gain is taxed separately from other income such as wages and salaries.

Most of the OECD countries apply the Haig-Simons' concept of income at various levels. Out of the 34 OECD member countries, only New Zealand, Greece and Switzerland do not tax capital gains on shares except in particular circumstances such as where the asset was bought for the purposes of resale[24] (discussed in the following section under the heading III New Zealand CGT). Added to this, Belgium, Korea, and Mexico do not tax gains realised on shares at the individual level. The OECD identified a number of policy considerations that are important for its member countries when considering the treatment of capital gains derived by individuals.[25] These considerations are derived from the principles of good taxation and the evaluation maxims which were identified by Adam Smith about 200 years ago[26]. In modern usage, Smith's canons of taxation are condensed into three criteria, namely, (1) equity, (2) efficiency, and (3) simplicity. The criterion of equity embraces horizontal equity and vertical equity, and is partly related to the concept of certainty. Efficiency is about the convenience and certainty of a tax to the taxpayer, and the cost of collection and compliance to the taxing unit (i.e., the administrative efficiency). Lastly, a tax system should be as simple as possible, and taxes should be easy to understand and comply with. The concept of simplicity is associated with the certainty and convenience maxims.

3 New Zealand CGT

Unlike most OECD countries, New Zealand does not have a comprehensive CGT. A number of New Zealand review committees have in the past considered whether the tax base should be broadened by introducing a CGT. While some of these,[27]

Income Taxation: the Definition of Income as a Problem of Fiscal Policy" (1938) University of Chicago Press 49.

[22] See Robert M Haig "The Concept of Income - Economic and Legal Aspects" in R A Musgrave and C S Shoup (ed) *Readings in the economics of taxation* (Homewood IL, Irwin, 1959) 54 at 67; Henry Simons "Personal Income Taxation: the Definition of Income as a Problem of Fiscal Policy" (1938) University of Chicago Press 49 at 50.

[23] K Holmes The concept of income- a multi-disciplinary analysis (IBFD Publications BV, Amsterdam, 2001) at 240.

[24] M Harding, *Taxation of Dividend, Interest, and Capital Gain Income, OECD Taxation Working Papers No. 19* (OECD Publishing, Paris, 2013) at 33.

[25] OECD, *Taxation of capital gains of individuals: Policy considerations and approaches, OECD Tax policy studies No. 14:* (OECD, Paris, 2006) at 29.

[26] Adam Smith, *An enquiry into the nature and causes of the wealth of nations* (Dent, London, 1947, Original work published in 1778) at 307 – 308.

[27] See, for example, P Bevin et al, *Income Maintenance and Taxation: Some Options for Reform* (New Zealand Planning Council, June 1978) at [10.25]; Valabh et al, *Consultative Document on the Taxation of Income from Capital* (Government Printer, Wellington, 1989) at [12.7].

and the OECD,[28] have recommended introducing a CGT, others have rejected the suggestion.[29] On 14 July 2011 the Labour Party released its key tax policies for the then upcoming 2011 election. One of these policies included broadening the New Zealand tax base by introducing a CGT, the goal being its implementation by 2013.[30] After the election, the Labour Party announced on 15 March 2012 that it would retain its plans for a CGT.[31] It continues to embrace its policy for a capital gains tax but currently lacks the political power to implement same.

Instead in New Zealand capital gains are only taxed on an *ad hoc* basis under narrow, quite specific statutory income provisions. Most of these deal with land transactions, thus it will be seen that the taxation of gains made on the sale of securities is quite limited.

Business income, which can in a given case include the proceeds of a business of share trading, are assessed under s CB1(1) *Income Tax Act 2007* ('*ÍTA*'). However, s CB(1) only taxes the normal proceeds of the business. If the proceed is not a normal incident of the business, but rather the realisation of a capital gain, it will not be assessable under s CB1(1).[32] The courts have stressed "that where the owner of an ordinary investment chooses to realise it, and obtains a greater price for it than he originally acquired it at, the enhanced price is not profit … assessable to Income Tax". [33] Thus in *CIR v National Insurance Company of New Zealand Ltd*[34] the taxpayer, a successful fire and general insurer, was not liable to pay income tax on the $67m profit on the sale of a long term share investment. The processed were not a normal incident of the business of insurance and held to be capital. This point is reinforced expressly in s CB1(2) *ITA* that provides receipts that are capital in nature are not income.

The focus of this paper is on the taxation of comparatively isolated share transactions by individuals, not businesses. As already noted there only limited, in

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[28] See, for example, Organisation for Economic Co-operation and Development, "OECD Economic Surveys: New Zealand" (2000) no 1 sup 3 OECD Economic Surveys 1 – 217 at 165; Organisation for Economic Cooperation and Development, "OECD Economic Surveys: New Zealand" (2007) no 8 OECD Economic Surveys 1 – 141 at 117-132; Organisation for Economic Co-operation and Development, "OECD Economic Surveys: New Zealand" (2009) no 4 OECD Economic Surveys 1 – 151 at 35 and 71.

[29] See, for example, LN Ross et al, *Taxation in New Zealand: Report of the Taxation Review Committee* (New Zealand Government, October 1967) at 409; M McCaw et al, *Report of the Task Force on Tax Reform* (New Zealand Government, 1982) at [10.25] and [10.36]; D Brash et al, *The Report of the Consultative Committee on Accrual Tax Treatment of Income and Expenditure* (Wellington, June 1987) at Part III; New Zealand Planning Council, *For Richer or Poorer: Income and Wealth in New Zealand – The First Report of the Income Distribution Group* (Wellington, June 1988) at 80; McLeod et al, *Tax Review 2001: Issues Paper* (Wellington, 20 June 2001) at 27 and 33; McLeod et al, *Tax Review 2001: Final Report* (Wellington, 24 October 2001) (McLeod Review) at 26–28 (Issues Paper and Final Report accessible at <www.treasury.govt.nz/publications/reviews-consultations/taxreview2001>); Tax Working Group, *A Tax System for New Zealand's Future* (Report of the Victoria University of Wellington Tax Working Group, January 2010) at 10–11.

[30] David Cunliffe, MP, "Own Our Future – Policy Launch Speech" (Westpac Stadium, Wellington, 14 July 2011). See also Phil Goff, "Labour's promise: We'll own our own future" (press release, 14 July 2011) <www.labour.org.nz/node/3897>. See further Stephanie Cadelis, "A Critique of Labour's Recent Capital Gains Tax Proposal" (2011) 43 Taxation Today 3.

[31] <www.labour.org.nz/newNZ>.

[32] *Californian Copper Syndicate (Limited and Reduced) v Harris* (1904) 5 TC 159 at 165-166; *CIR v National Distributors Ltd* (1989) NZTC 6,346 at 6,350 and 6,355.

[33] *Californian Copper Syndicate (Limited and Reduced) v Harris* (1904) 5 TC 159 at 165-166.

[34] (1989) NZTC 6,346 at 6,350 and 6,355.

fact only three, provisions that may assess such transactions, namely ss CB3, CB4 and CB5. The New Zealand courts have strongly embraced the capital / income dichotomy, with the former not constituting ordinary income. The New Zealand courts have recognised that these provisions have made inroads into the income / capital dichotomy by introducing effectively a mini CGT.[35] As a flow on from such, these provisions have been narrowly construed. Only if the prerequisites of the section have clearly been met will the courts find the proceeds are assessable. Again, as a consequence of the income/capital dichotomy, the courts have also added judicial glosses that exclude from even these statutory income provisions mere capital gains.

Section CB3 *ITA* includes in a person's income the proceeds derived from "carrying on or carrying out an undertaking or scheme entered into or devised for the purpose of making a profit …" The section does not specify the nature of the property entailed in the profit making scheme, but is broad enough to include personal property such as shares.

The jurisprudence has identified two key elements (i) purpose of making a profit and (ii) undertaking or scheme. The legislation makes it clear that the relevant purpose does not have to exist at the point of acquisition of the property. The focus is the time of the scheme or undertaking. So a pre-owned asset could be introduced into a profitmaking scheme and it is at that point that the taxpayer's intentions become important. However, the New Zealand courts have read down the provision by requiring that the profit making purpose must be the dominant purpose before the section will apply.[36] Thus a mere incidental possibility of resale at a profit will not suffice. Further, when making this assessment as to the dominant purpose the courts will not segregate the scheme property to determine if part of the property relates to a dominant purpose of profit making. The acquired asset will be treated as a whole and the dominant purpose determined in light of that whole. Thus it is the overall purpose of the broader scheme that will determine whether or not the section applies.[37]

In terms of judicial glosses, the most limiting is that in regard to the second element (ii) an undertaking or scheme. The New Zealand courts have held that s CB3 will not apply to a mere realisation of capital.[38] The section will not apply unless there is a business character to the scheme.[39] Again this comes back to the New Zealand courts requiring the facts include an 'income gain' not a 'capital gain'. The courts' reason is that there is no scheme, just a mere enterprising realisation of capital.[40]

Section CB4 *ITA* includes in a person's assessable income an amount derived from disposing of personalty that was acquired for the purpose of disposing of it at a profit. Prior to the enactment of s CB4 the sale of shares acquired with the

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[35] *CIR v National Distributors Ltd* (1989) NZTC 6,346 at 6,350 and 6,355.
[36] *CIR v Wattie & Lawrence* [1999] 1 NZLR529; *A Taxpayer v CIR* (1997) 18 NZTC 13,350.
[37] *CIR v Wattie & Lawrence* [1999] 1 NZLR529; *A Taxpayer v CIR* (1997) 18 NZTC 13,350.
[38] *Euson v CIR* [1963] NZLR 278; *Beetham v CIR* [1973] 1 NZLR 575.
[39] *Euson v CIR* [1963] NZLR 278.
[40] *Euson v CIR* [1963] NZLR 278; *Beetham v CIR* [1973] 1 NZLR 575.

intention of making a profit by resale had been held not to be taxable.[41] Thus s CB4 has been recognised as making inroads into the income/capital dichotomy[42], effecting a "limited form of capital gains tax."[43] In the context of this provision there are two key elements (i) purpose of making a profit and (ii) acquisition and disposal of the personal property. The courts have again read down the provision, significantly limiting its potential scope.

The New Zealand courts have made it clear that s CB4 will only apply if the taxpayer had the dominant purpose of resale at a profit.[44] The dominant purpose of resale at a profit must exist at the point of acquisition.[45] A subsequent profitable sale will not trigger s CB4 unless the requisite purpose existed when the property was first acquired.[46] Moreover, the dominant purpose is adjudged in light of the entire property.[47]

The courts have also distinguished the required profit making 'purpose' and an 'intention'.[48] In *Plimmer v CIR*[49] Barrowclough CJ observed that the two words are not synonymous, purpose having an added element, being the object of the transaction. This can be best explained through the facts in that case. The taxpayer sought to acquire the controlling interest in a company. To do this the taxpayer acquired a large parcel of shares consisting of both ordinary and preference shares. The ordinary shares gave the taxpayer control of the company. The taxpayer resold the preference shares, that had been acquired as a condition of the sale of the parcel of shares. The court held that while the taxpayer had always intended to sell the preference shares, that was not the purpose at the point of acquisition. The purpose was to obtain control of the company. Thus the profit from the sale of the shares was not assessable.

There must also be an acquisition and disposal of the personal property. The courts have held that s CB4 contemplates a positive act by the taxpayer in acquiring the property. Thus merely inheriting the property or accepting a gift will not suffice.[50]

The final provision dealing with the sale of personalty is s CB5 *ITA*. This includes in a taxpayer's assessable income an amount derived from disposing of personal property if their business is to deal with property of that kind. This provision builds on s CB1, discussed above, and is intended to apply where a taxpayer is not overtly conducting a business but is a 'dealer'.[51] In cases where the taxpayer is not overtly conducting a business, the issue focuses on the frequency and volume of

[41] *CIR v Walker* [1963] NZLR 339.
[42] *CIR v National Distributors Ltd* (1989) NZTC 6,346 at 6,350.
[43] *CIR v National Distributors Ltd* (1989) NZTC 6,346 at 6,355.
[44] *CIR v National Distributors Ltd* (1989) NZTC 6,346 at 6,350 and 6,355.
[45] *CIR v National Distributors Ltd* (1989) NZTC 6,346 at 6,350 and 6,355.
[46] See for example *Case T48* (1998) 18 NZTC 8,325.
[47] *CIR v National Distributors Ltd* (1989) NZTC 6,346; *Hazeldine v CIR* [1986] NZLR 747.
[48] *Plimmer v CIR* [1958] NZLR 147 at 151.
[49] *Plimmer v CIR* [1958] NZLR 147 at 151.
[50] *McClelland v FCT* (1971) 70 ATC 4,115; *AG Healing & Co Ltd v CIR* [1964] NZLR 222.
[51] *Bates v CIR* (1955) 6 AITR 283 at 290.

transactions.[52] Consequently an ad hoc sale of shares will not trigger the provisions.

Thus the capital gains from the sale of shares in New Zealand are only taxed on a limited basis. Effectively, unless they are part of a business or profit making scheme or acquired with the dominant purpose of profitmaking by resale the capital gains continue to be tax free.

4 Australian CGT

While the primary focus of the discussion below is the Australian comprehensive realisation CGT, effective from 20 September 1985, and specifically its application to the sale of securities, to provide a full picture of the taxation of such assets relevant 'íncome' provisions also need to be briefly considered.

As with the above discussion in the New Zealand context, business income can include the proceeds of a business of share trading, and are assessed as ordinary income under s 6-5 *Income Tax Assessment Act 1997* ('*ITAA 1997'*). However, again, s 6-5 only taxes the normal proceeds of the business. This involves a two step process:[53]

- the identification of the nature of the business and activities; and
- the relationship between transaction/receipt and that business.

Thus as the court in, *inter alia*, *Westfield Ltd v FCT*[54] stressed not every receipt constitutes assessable income. "Once it is clear that the activity of buying and selling which generated the profit, was not an activity in the ordinary course of business …the profit in question will only form part of the assessable income" of the taxpayer if the *Myer Emporium*[55] doctrine, briefly discussed below, applies.[56] If the proceed is not a normal incident of the business, but rather a realisation of a capital gain, it will not be assessable under s 6-5.[57] It is in such cases that the Australian CGT contained in Chap 3 *ITAA 1997* becomes important.

The focus of this paper is on the taxation of comparatively isolated share transactions by individuals, not businesses. Nevertheless in light of the above quote from *Westfield Ltd v FCT*[58] a brief comment is made as to the application of the *Myer Emporium* doctrine. Under the *Myer Emporium* doctrine certain isolated transactions may give rise to assessable business income despite the absence of the frequency and duration of activities normally indicative of a business.[59] In determining if the proceeds of an isolated activity are assessable, in essence, the

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[52] *Bates v CIR* (1955) 6 AITR 283 at 290; *CIR v Stockwell* (1992) 14 NZTC 9,190 at 9,194; *CIR v Rangatira Ltd* (1995) 17 NZTC 12,182.
[53] *London Australia Investment Co Ltd v Commissioner of Taxation* (1977) 138 CLR 106 at 165; *FCT v Merv Brown Pty Ltd* (1985) 85 ATC 4080 at 4086.
[54] *Westfield Ltd v FCT* (1991) 91 ATC 4234 at 4242.
[55] *FCT v Myer Emporium Ltd* (1987) 163 CLR 199.
[56] *Westfield Ltd v FCT* (1991) 91 ATC 4234 at 4242.
[57] *Scottish Australian Mining Co Ltd v FCT* (1950) 81 CLR 188; *Westfield Ltd v FCT* (1991) 91 ATC 4234 at 4242.
[58] *Westfield Ltd v FCT* (1991) 91 ATC 4234 at 4242.
[59] *FCT v Myer Emporium Ltd* (1987) 163 CLR 199 at 209-210; *Westfield Ltd v FCT* (1991) 91 ATC 4234 at 4242.

courts distinguish between the 'mere realisation of a capital asset' and transactions that are either incidental to the taxpayer's normal business or constitute a profitmaking scheme.[60] If the proceeds fall into the former category, they are considered capital in nature and not ordinary income. Thus even under the *Myer Emporium* doctrine, the income / capital dichotomy is maintained, and such proceeds are not assessable as ordinary income. Again, this is when the capital gains regime in Chap 3 *ITAA 1997* comes into play.

Before turning to the Australian CGT, brief mention is required in relation to three largely redundant provisions, particularly given they echo the above discussed New Zealand provisions. Section 25A(1) *Income Tax Assessment Act 1936* (Cth) ('*ITAA*') includes in the taxpayer's assessable income the net profit from the sale of property acquired for the purpose of profit-making by sale. This is the Australian equivalent to the above discussed New Zealand provisions s CB4 *ITA*. Section 25A(1) included a second limb, now embodied in s 15-15 *ITAA 1997*. This includes in the taxpayer's assessable income the net profit from the "carrying on or carrying out of any profit-making undertaking or plan". This is the Australian equivalent to the above discussed New Zealand provisions s CB3 *ITA*.

These provisions do not apply to the sale of property acquired on or after 20 September 1985: ss 25A(1A) and 15-15(2)(b). Such sales are governed by the capital gains regime discussed below. Section 15-15 continues to have a residual operation where the profitmaking undertaking or plan does not involve a capital gains event. It is possible, but rare, that a profitmaking scheme does not involve the sale of property, and thus would not be caught by CGT Event A1, the disposal of an asset, discussed below.

Section 26AAA *ITAA* applied to property disposed of within 12 months of acquisition. The provision applied to sales after 21 August 1973, but again is no longer operative. Sales after 25 May 1988 are governed by the CGT in Chap 3 *ITAA 1997.*

On 24 June 1986 the *Income Tax Assessment Amendment (Capital Gains) Act 1986* and the *Income Tax (Rates) Amendment (Capital Gains) Act 1986* received royal assent, including a new Pt IIIA (ss 160a-160zzu) in the ITAA to regulate the taxation of capital gains. As part of the Tax Law Improvement Project ('TLIP'), Pt IIIA was rewritten and incorporated in *ITAA 1997* through the introduction of Chap 3 into that Act. Generally Chap 3 only applies to the disposal of property acquired on or after 20 September 1985.[61]

While Chap 3 renders previously non-assessable capital receipts to be assessable, capital and income receipts are not treated in exactly the same fashion. There are various exempt assets, such as personal use assets (s 118-10(3)) and exempt transactions, such as the sale of the taxpayer's main residence in certain case (s 118-115 and 118-25). Further rollover relief is provided in a number of cases such as the transfer of property as a result of a matrimonial property settlement (Subdiv

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[60] *FCT v Myer Emporium Ltd* (1987) 163 CLR 199 at 209-210; *Westfield Ltd v FCT* (1991) 91 ATC 4234 at 4241-4242.

[61] See s 160L *ITAA*.

126-A) and the disposal of an asset by reason of the death of the owner (s 128-10). Thus the transfer of securities by reason of a matrimonial property settlement or an inheritance will not be taxed. The rollover relief provided by the CGT provisions means it will not be taxed until the recipient subsequently disposes of the security.

More relevant is the fact that capital gains are calculated and assessed differently to ordinary income under s 6-5. Unlike s 6-5(1) *ITAA 1997*, only the net capital gain is included in the taxpayer's assessable income: s 102-5. A net capital gain will arise if the capital gain is greater than the total capital losses for that year and any carry forward net capital losses: s 102-5(1). Most importantly the net capital gain is calculated by deducting the cost base against the capital proceeds. For example, for CGT Event A1 discussed below, a capital gain exists if the capital proceeds are more than the cost base (including any possible indexation) and a capital loss exists if the capital proceeds are less than the reduced cost base: s 104-10(4). In determining the capital gain, in addition to the actual cost, expenses such as the incidental costs of acquisition and disposal and capital expenditures incurred in enhancing the asset or establishing, preserving or defending the taxpayer's title to the asset are included in the asset's cost base, rather than being deducted under a separate deduction provision: s 110-25.[62]

As a result of changes to Chap 3 in 1999, under s 115-25(3) some taxpayers are now entitled to a 50% discount on their capital gains on certain CGT events[63] where they have held the asset for more than 12 months: s 115-25.[64] This amendment only applies to CGT events that have occurred after 11.45 am on 21 September 1999: s 115-15. Importantly in the context of this paper, it applies to CGT Event A1 discussed below. The discount is only extended to individuals, certain trusts and some superannuation funds: s 115-10. Where a taxpayer acquired an asset before 21 September 1999 they can elect to utilise either indexation, discussed immediately below, or the 50% discount.

Briefly, before these changes to Chap 3 in 1999, the Act sought to assess only 'real' capital profits by indexing the cost base of the subject asset to take into account inflationary increases. Indexation is effected by multiplying the elements of the cost base by the relevant indexation factor: s 960-270(1). The indexation factor (calculated to three decimal points) is calculated by dividing the consumer price index ('CPI') for the quarter in which the CGT event occurs (ie sale of the asset) by the CPI for the quarter in which the expenditure was incurred: s 960-275(2). The indexation factor is frozen as of 30 September 1999, which means that gains after this date are not indexed. Where the CGT event occurs after this date the CPI for September 1999 is taken as the relevant figure.

The parameters of the original CGT provisions, contained in Pt IIIA *ITAA*, were set out in former s 160L. In essence, this provided that Pt IIIA applied to a disposal of an asset that was owned by the taxpayer immediately before the disposal and that asset was acquired on or after 20 September 1985. As is evident from this outline,

[62] See further Div 110 *ITAA 1997*.
[63] If the capital gain arises out of CGT events D1, D2, D3, E9, F1, F2, F5, H2, J2, J3 or K1, the discount is not available: s 115-25(3) *ITAA 1997*.
[64] See further Div 115 *ITAA 1997*.

the operation of Pt IIIA turned upon, *inter alia*, the "acquisition" and "disposal" of an "asset". The TLIP rewrite of Pt IIIA *ITAA* considerably altered the structure, if not the content, of the CGT legislation. It is now dependent upon whether there has been a "CGT event" (s 102-20, summarised in s 104-5), rather than a "disposal". Events are denoted by a letter and a number. CGT events with the same letter indicate a grouping of related transactions. This paper considers two CGT Events particularly relevant to the disposal of securities, CGT Event A1 and CGT Event C2.

In contrast to Chap 3, Pt IIIA included general provisions to determine matters such as the timing of the disposal (see former s 160U) and how the capital gain or loss was calculated (see former Div 3). In the current provisions, the timing of the CGT event and the method of calculating the net gain or loss is separately detailed for each specific CGT event. In turn the timing of an acquisition through a CGT event is tied to the specific timing rule for that particular CGT event: s 109-5(2).

The most general CGT event, is CGT event A1 (s 104-10). This applies to a disposal of a CGT asset. Thus an element of CGT Event A1, and it will be seen CGT Event C2, is the existence of an "asset".

The current definition of a CGT asset is contained in s 108-5(1). In general terms, s 108-5(1) defines assets as "any kind of property or a legal or equitable right that is not property". Thus a CGT asset is defined as "any kind of property" but now extends the definition of asset to personal rights.[65] Proprietary assets differ from personal assets in so far as the former, but not the latter, are capable of transmission.[66] Thus, personal assets, such as a personal chose in action, while recognised in law, are not capable of being sold. They are rights that only the particular individual may exercise. Shares are capable of transmission and thus are proprietary in nature. However 'employee' shares are normally non-transmissible and are forfeited upon leaving employment. These shares would constitute personal assets. In rare cases rights might be attached to shares that can only be exercised by that particular shareholder. The founder of a company may hold an exclusive class of shares, sometimes called 'Governor' shares, that may include non-transmissible rights. Again, in such cases the shares would be personal assets.

Obviously, for CGT Event A1 to apply the taxpayer must have acquired the security that is subsequently disposed. Section 109-10 provides that an issue or allotment of shares in a company constitutes an acquisition by the person to whom they are allotted. The acquisition occurs when the contract for purchase is entered into or, if there is no such contract, when the shares are issued or allotted. The

[65] For a number of reasons, the courts held that the original definition of asset in s 160A ITAA was confined to proprietary assets: FCT v Cooling (1990) 90 ATC 4472 at 4486; Hepples v FCT (1990) 90 ATC 4497 at 4503, 5404, 4512-4514 and 4517. Perhaps the most compelling reason was that the section asserted that "'asset' means any form of property". This was taken as an exhaustive statement as to what was an asset (Hepples v FCT (1990) 90 ATC 4497 at 4512-4513) and thereby excluded from s 160A personal and popular assets: FCT v Cooling (1990) 90 ATC 4472 at 4486; Hepples v FCT (1990) 90 ATC 4497 at 4503, 4504, 4512-4514 and 4517; Reuter v FCT (1993) 93 ATC 4037 at 4049-4050; Lend Lease Custodian Pty Ltd v DFCT (2007) 2007 ATC 4041 at 4076. Moreover, as Pt IIIA was based upon a disposal of an asset, it appeared necessary that the asset be capable of transmission: *FCT v Cooling* (1990) 90 ATC 4472 at 4486; *Hepples v FCT* (1990) 90 ATC 4497 at 4504.

[66] *FCT v Orica Ltd* (1998) 98 ATC 4494 at 5415.

allotment is not, however, to be taken to be a disposal of the shares by the company. This simply echoes the general law notion that issuing shares does not involve a disposal of company property.[67] Similarly, s 109-10 provides that an issue of units in a unit trust by the trustee constitutes an acquisition by the person who receives the units. The acquisition occurs when the contract for purchase is entered into or, if there is no such contract, when the units are issued. Again this does not amount to a disposal of the units by the trustee.

Returning to CGT Event A1 itself, Event A1 (s 104-10) occurs if you dispose of a post-CGT asset: s 104-10(1) and (5)(a). A disposal is in turn identified as a change in ownership of an asset: s 104-10(2). This simply echoes the ordinary meaning of disposal.[68] Thus a sale of securities clearly falls within its parameters. Section 104-10(2) does, however, have its limits. A change in ownership will not constitute a CGT event unless, as a corollary, there is a change in the beneficial (as opposed to legal) ownership of the asset. Thus if shares are held in trust a change in trustees will not constitute a disposal of trust assets. See s 104-10(2)(b). Moreover, CGT event A1 does not occur if the change in ownership occurs as a result of providing or redeeming a security ie if shares are provided as security for a lending arrangement: s 104-10(7).

CGT event A1 occurs when the contract was entered into, or where there is no contract, when the change in ownership occurs: s 104-10(3). As a consequence, where there is a contract, this will be the time of the CGT event, not, for example, the date of settlement when the actual change in ownership occurs.[69] Thus in a share context, it is the date of contract, not the date of allotment or date of entry into the share register that is pivotal.

As noted above, a capital gain exists where the capital proceeds exceed the cost base and a capital loss arises where the capital proceeds are less than the reduced cost base: s 104-10(4).

One further CGT Event that is particularly relevant to securities in CGT Event C2 (s 104-25). Section 104-25 provides that CGT event C2 happens if your ownership of an intangible CGT asset ends as a result of the asset:

- being redeemed or cancelled (ie shares and debentures);
- being released, discharged or satisfied (ie a debt);
- expiring (ie contractual rights); or
- being abandoned, surrendered or forfeited (ie employee shares).

CGT event C2 happens when you enter into the contract that results in the asset ending or, if there is no contract, when the asset ends: s 104-25(4). Thus again the primary timing rule of CGT Event C2 revolves around the point the contract was entered into, rather than when the ownership of the intangible CGT asset ends. A capital gain is made if the capital proceeds exceed the cost base and a loss occurs when the capital proceeds are less than the reduced cost base: s 104-25(3). In terms

[67] *FCT v St Helens Farm* (ACT) Pty Ltd (1981) 81 ATC 4040 at 4042.
[68] *FCT v Cooling* (1990) 90 ATC 4472 at 4486; *Hepples v FCT* (1990) 90 ATC 4497 at 4518.
[69] *Metlife Insurance Ltd v FCT* (2008) 2008 ATC ¶20-025 at 8320.

of the capital proceeds, from 1 July 2006 where there is a surrender or cancellation of shares or units in a widely held entity, the market value substitution rule will not apply and the actual proceeds will be used to calculate any gain or loss: s 116-30(2a).

In light of the discussion below in regard to China's tax treatment of shareholdings in non-resident companies and non-resident shareholders a few brief comments need to be made in regard to Australia's application of the CGT rules. As with New Zealand, Australian residents are taxed on their world-wide income and normally non-residents are taxed on their Australian sourced income: ss 6-5(2) and (3), 6-10(4) and (5) *ITAA 1997*. However, pursuit to *Tax Laws Amendment (2006 Measures No 4) Ac 2006* the application of the CGT to non-residents was dramatically narrowed. Under the current provisions (Subdiv 855-A) the CGT only applies to non-residents where the CGT asset is "taxable Australian property." This is effectively confined to real property and the business assets of the non-resident's permanent establishment in Australia. While the indirect sale of business assets held by that permanent establishment through the sale of share in the establishment whether directly or through an interposed entity will be caught within the CGT net, ordinary sale of sales in, *inter alia*, listed companies are not taxed under the CGT regime.

Thus in contrast to New Zealand, Australia has adopted a comprehensive realisation CGT. While the Adam Smith [70] values of equity, simplicity and neutrality, discussed above, have been undermined by various concessions, the ultimate underlying principle of the Australian CGT is that capital gains are not tax exempt. Thus, despite these concessions, it is contended that the Australian CGT promotes these values of a 'good tax' more effectively than New Zealand and, it will be seen, China. China can, nevertheless, learn from the mistakes Australia has made in key design issues. Thus the complexity of the definition of "asset" and plethora for CGT events are matters China should bear in mind if it decides to adopt a comprehensive realisation CGT.

5 CGT in China

The *Individual Income Tax Law of the People's Republic of China* (2011 Amendment) [71]('*Income Tax Law'*) set out eleven categories of income[72]:

1. incomes from wages and salaries;
2. incomes of private industrial and commercial households from their productions and business operations; [73]

[70] Adam Smith, *An enquiry into the nature and causes of the wealth of nations* (Dent, London, 1947, Original work published in 1778).
[71] 《中华人民共和国个人所得税法（2011 年修订版）》
[72] *Income Tax Law* Article 2
[73] Income category 2 includes any income derived from production and business operations by individual households engaging in industry and commerce. Articles 8.2.1 to 8.2.4 of the *Implementation Regulation* state that income category 2 is not only apply to income derived from commercial business but also apply to income derived by individual from non-commercial activities such as running school, medical service, consultation and other paid services upon approval or license granted by the government.

3. incomes from contracting or leasing enterprises and institutions; [74]
4. incomes from remuneration for labour services;
5. incomes from authors' remuneration;
6. incomes from royalties; [75]
7. incomes from interest, stocks dividends and bonuses;
8. incomes from lease of property; [76]
9. incomes from transfer of property;
10. contingent incomes;[77] and
11. other incomes specified as taxable by the department of the State Council for finance.

Article 8 of the *Regulation on the Implementation of the Individual Income Tax Law of the People's Republic of China* (2011 Revision) [78] (‘*Implementation Regulation’*) further defines the scope of the eleven categories. As noted earlier, although there is no comprehensive CGT in China, certain capital gains are treated as income and are taxable under the *Income Tax Law*. For example, capital gains on the transfer of property will be taxable under income category 9. This includes any income derived from the transfer of securities, stocks, buildings, land use rights, machinery and equipment, motor vehicles and ships and other property[79]. It is noted that any compensation received from the termination of contract will be included in this category. Importantly, currently, capital gains on the disposal of certain listed companies are temporarily tax exempt. This will be discussed in the next section.

6 Tax reform of the financial system of China

As its economy is decelerating[80], China is liberalising its capital market to boost economic stability and growth. In fact, China’s accession to the global financial market has increased the urgency for financial system reform. In order to promote the role of markets in the economy, the government has introduced a number of initiatives such as the Stock-trading Link Program between Shanghai and Hong Kong[81], credit asset securitization[82] and further liberalisation of interest rates to

[74] Income category 3 is related to income from operations of contracting, leasing, subcontracting and transfer of leasing rights: *Implementation Regulation* Article 8.3

[75] Income category 6, “royalties”, is related to assignment of patent rights, copyrights, rights to use proprietary technology and other rights: *Implementation Regulation* Article 8.5 and 8.6. Any capital gains from the transfer of these intangible, intellectual property will be potentially taxable.

[76] Category 8 involves leasing of buildings, land use rights, machinery and equipment, motor vehicles and ships and other property: *Implementation Regulation* Article 8.8.

[77] Income category 10, contingent income, include most of the windfall gains such as winning prize in lotteries and other windfalls: *Implementation Regulation* Article 8.10. It is noted that the State Administration of Taxation has determined that restrictive covenant payments will be taxable as contingent income: *Income Tax Law* Article 2.11.

[78] 《中华人民共和国个人所得税法实施条例 (2011 修订)》

[79] *Implementation Regulation* Article 8.9.

[80] Mark Magnier “China’s Economic Growth in 2015 Is Slowest in 25 Years: GDP grew 6.9% in 2015; economists, Chinese officials, project a tougher year ahead” *The Wall Street Journal* (online ed., United States, 19 January 2016). http://www.wsj.com/articles/china-economic-growth-slows-to-6-9-on-year-in-2015-1453169398

[81] The Shanghai-Hong Kong stock link program 沪港通 allows the southbound and northbound investors to trade the shares in each other share market with an overall and daily investment limit. Initiatives are in progress for the launch of a similar program linking the Hong Kong market and the Shenzhen Stock Exchange.

reform the share market and the banking sector. The success of these reforms has to be supported by strong legal and taxation laws. This section will focus on the taxation of capital gains on the disposal of shares.

Capital gains derived from the sale or transfer of shares and other securities is normally taxed under income category 9 which is charged at a flat 20% rate[83]. In addition to individual income tax (CGT), it is noted that China levies a Business Tax (BT), i.e. a turnover tax, charged by the Local Tax Bureau on the transfer of shares and financial services[84]. On 24 December 2014, the State Administration of Tax introduced certain administrative measures for trial implementation in order to strengthen the tax collection on the transfer of shares[85]. Article 3 of the Measures states that the term "equity transfer" refers to the act that an individual transfers the equity he/she owns to any other individual or legal person, including the circumstances as follows:

1. sale of equity;
2. repurchase of equity by a company;
3. an issuer making an initial public offering of shares, sale of the shares held by shareholders of the Investee to the investors by way of the public offering;
4. mandatory transfer of equity by a judicial or administrative authority;
5. making foreign investments or other non-monetary transactions with equity;
6. use of equity to cover the debt; and
7. other equity transfers.

Capital gain on the transfer of share is computed by subtracting the cost of the shares and other reasonable expenses from revenue[86]. Revenue includes any cash, items in kind, negotiable securities and other forms of economic interests acquired by the taxpayer from the equity transfer[87]. Other receipts such as liquidated damages, compensation, funds, assets, and rights and interests, among others, in other forms, will also be included into the revenue from the equity transfer[88]. Added to this, if there is any subsequent income obtained by taxpayers according to contract agreements after satisfying the prescribed conditions, that receipt shall be deemed as revenue from the equity transfer[89]. Article 10 of the Measures states that revenue from an equity transfer shall be determined in accordance with the principle of fair trade.

[82] Credit assets securitisation 信贷资产证券化 involves the pooling of various assets together to restructure as marketable securities.
[83] *Income Tax Law* Article 3.5.
[84] *Interim Regulation of the People's Republic of China on Business Tax (2008 Revision)* 中华人民共和国营业税暂行条例 (2008 修订) Article 5.5.
[85] Announcement of the State Administration of Taxation [2014] No.67 - *Announcement of the State Administration of Taxation on Promulgating the Administrative Measures for Personal Income Tax on Income from Equity Transfers (for Trial Implementation)* 关于发布《股权转让所得个人所得税管理办法（试行）》的公告 - 国家税务总局公告 2014 年第 67 号('*Measures*').
[86] *Measures* Article 4.
[87] *Measures* Article 7.
[88] *Measures* Article 8.
[89] *Measures* Article 9.

The cost of the shares and reasonable expenses will be deductible for tax purposes[90]. Reasonable expenses include the relevant taxes and dues paid as prescribed during the equity transfer. In general, the cost is the sum of the price paid for the equities and the expenses if the shares were acquired by cash[91]. If the equities were acquired by means of transfer free of charge or were inherited from close relatives as stated in Article 13.2 of the Measures, the original value of the equities shall be determined in accordance with the sum of the reasonable taxes and dues directly relating to the acquisition of the equities and their original value of the original holder[92].

There are exceptions to these Measures[93]. For the transfer of shares in listed companies, the Ministry of Finance with the approval of the State Council is responsible for designing and implementing the tax policies.[94] To promote investment on domestic, listed companies, the transfers of shares listed on China stock exchanges in the secondary market are temporarily tax exempt. It is noted that individual taxpayers domiciled in China are subject to personal income tax on their worldwide income.[95] This will include capital gains derived from the transfer of shares in foreign companies except those eligible for special concession. These special concessions will be discussed in more details in the following paragraphs. For individuals who do not have their domicile in China, they will have to pay tax on their worldwide income if they have stayed in China for more than five years.[96] Non-residents are subject to tax on their China-source income only[97]. On this, foreign individuals who are investing in equity in a foreign investment enterprise such as equity joint venture in China will be subject to a 20% tax on gains derived from the sale of equity[98].

In regard to the taxation of gains from shares in a foreign jurisdiction, special concessions are given to investors who trade the shares through the Shanghai-Hong Kong Stock Link Program (‘Link Program’). On 15 November 2014, the State Administration of Taxation, the Ministry of Finance and the China Securities Regulatory Commission jointly issued several circulars after the approval from the State Council[99]. Caishui [2014] 81 (Circular 81)[100] states that individual investors are temporarily exempt from Individual Income Tax with respect to gains derived from the trading of shares on the Hong Kong Stock Exchange through the Link

[90] *Measures* Article 4.
[91] *Measures* Article 15.1.
[92] *Measures* Article 15.2 to 15.4.
[93] *Measures* Article 30.
[94] *Implementation Regulation* Article 9.
[95] *Implementation Regulation* Article 1.
[96] *Implementation Regulation* Article 6.
[97] *Implementation Regulation* Article 7.
[98] *Income Tax Law* Article 3.5.
[99] State Administration of Taxation of The People's Republic of China “Xinhuanet.com: Tax Policy Unveiled for Shanghai-Hong Kong Stock Connect, and Mainland Individual Investors Exempted from Paying Individual Income Tax on Spread Income from Trading HK-listed Shares for Three Years” (press release, 19 January 2015). http://www.chinatax.gov.cn/2013/n2925/n2953/c1465476/content.html
[100] *Notice of the Ministry of Finance, the State Administration of Taxation, and the China Securities Regulatory Commission on Taxation Policies concerning the Pilot Program of an Interconnection Mechanism for Transactions in the Shanghai and Hong Kong Stock Markets Caishui [2014] 81* 关于沪港股票市场交易互联互通机制试点有关税收政策的通知 - 财税〔2014〕81 号*(“Circular 81”)*

Program for the period from 17 November 2014 to 16 November 2017[101]. Other than capital gains, Circular 81 also states that any dividends received from shares acquired from the Link Program is taxable at 20%[102].

Special rules also apply to certain foreign investors. In the last decades, several initiatives were introduced to attract foreign investors, mostly management funds and institutions, in investing the shares in the Shanghai and Shenzhen Stock Exchanges. These programs include stock investment under the foreign currency-denominated Qualified Foreign Institutional Investors (QFII)[103] program and a similar yuan-denominated scheme between 2009 and 2014 and the recent Shanghai-Hong Kong Stock Link Program (Link Program)[104]. Special concessions are given to the individual foreign investors who trade the A-Shares[105] through these programs. The foreign, individual investors in the Hong Kong market are temporarily exempt from withholding tax and income tax with respect to gains derived from the trading of A-Shares. Dividends are subject to withholding tax at 10% with respect to dividends received from A-Shares.

7 The lessons learnt from New Zealand and Australian CGT

Similar to China, New Zealand taxes capital gains on an ad hoc basis under narrow, quite specific statutory income provisions. This ad hoc approach of what to keep and what to ignore in a tax policy setting fails to formulate a consistent set of concepts in capturing the underlying economic reality. This has resulted in a vague notion of income with "often detailed and complex legislation" in New Zealand[106]. The differential tax treatment between income and capital gain has further given rise to significant ambiguity around the capital/income distinction.

In contrast, Australia has a comprehensive CGT that covers all capital gains and is consistent with the income concept employed in most of the tax system in the OECD countries. While the computation of capital gains is different to the calculation of ordinary income, the net capital gain is included in the individual taxpayer's assessable income and taxed at a personal income tax marginal rate.

In regard to the taxation of share transactions, there is an efficiency issue with China's CGT. As discussed earlier, capital gains on the disposal of shares of listed companies are exempt. On the other hand, distributed dividends are taxable at the individual shareholder level without any imputation. This will create an incentive for the major shareholders of the listed companies to retain and reinvest the company's earnings instead of distributing them as dividends.

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[101] *Circular 81* paragraph I(1)
[102] *Circular 81* paragraph I(3)
[103] 海外投资者投资内地 A 股主要通过合格境外机构投资者
[104] *Notice of the Ministry of Finance, the State Administration of Taxation and the China Securities Regulatory Commission on Issues concerning Temporarily Exempting the Income Derived by QFII and RQFII from the Transfer of Stock or Any Other Equity Investment Asset in China from Enterprise Income Tax Caishui [2014] 79* 关于 QFII 和 RQFII 取得中国境内的股票等权益性投资资产转让所得暂免征收企业所得税问题的通知-财税〔2014〕79 号 and *Circular 81*.
[105] A-Shares are the shares of companies that are listed in the Shanghai and Shenzhen Stock Exchange.
[106] R Oliver, "Capital gains tax: the New Zealand case" in H. G. Herbert (ed) *International evidence on the effects of having no capital gains taxes* (The Fraser Institute, Vancouver, 2001) 73 at 81.

It is suggested by the OECD report[107] that the efficiency and neutrality of China's existing semi-dual income tax system, which levies different tax rates on employment income and capital gains, can be improved by imposing the same overall effective tax burden on distributed dividends, capital gains, interest and royalty payments. It is also recommended that a CGT could be introduced in the medium term to further strengthen the neutrality of the tax system with respect to sources of finance for businesses and household savings.

8 Conclusion

China's tax system is very complex as it uses separate rate schedules and computation of tax basis for the different categories of income. For example, certain income such as wages and salaries are computed and levied on a monthly basis while other types of income such as business income in category 2 is charged on an annual basis[108]. Added to this, different schedule of marginal tax rates applies for these income. For example, employment income is subject to a progressive rate schedule consisting seven levels with rates ranging 3% to 45% while business income has five levels with rates ranging 5% to 35%. The nominal tax rate of income from author's remuneration (category 5) is a flat rate of 20%, the amount of actual tax payable, however, will be reduced by 30% giving an effective tax rate of 14%[109]. Different to employment and business incomes, the other, specific incomes such as capital gains on the transfer of shares (category 9) are charged on a per transaction basis and taxed at a fixed rate of 20%. In general, it is observed that most of the incomes that are related to capital gains are taxed at a lower tax rate than employment or business income. Overseas experience suggests that most capital gains are earned by higher income earners[110]. The lower tax rate on capital gains will undermine the progressivity of the tax system in China and provide an incentive for taxpayers to restructure their transactions such that they are treated in the most favoured way.

The progressivity of the tax system is further compromised by the lack of fringe benefit tax and a high tax free general exemption. China has a relatively high marginal tax rate of 45% at the highest threshold for taxpayers earning employment income of 80,000 Yuen per month. Given that there is no separate fringe benefit tax in China, it is common for workers to receive non-cash benefits from their employers. It is also noted that China has a general monthly tax allowance of 3,500 Yuen which is relatively high, as a portion of average wage earnings, when compared to other OECD countries.[111] This means that most people in China do not have to pay income tax. Because of the regressive nature of the general

[107] Bert Brys, Stephen Matthews, Richard Herd, and Xiao Wang *Tax Policy and Tax Reform in the People's Republic of China: OECD Taxation Working Papers No. 18* (OECD Publishing, Paris, 2013) at 56. http://dx.doi.org/10.1787/5k40l4dlmnzw-en.
[108] *Income Tax Law* Article 9.
[109] *Income Tax Law* Article 6.1 and Article 6.2.
[110] OECD, *Taxation of capital gains of individuals: Policy considerations and approaches, OECD Tax policy studies No. 14:* (OECD, Paris, 2006) at 63.
[111] Bert Brys, Stephen Matthews, Richard Herd, and Xiao Wang, *Tax Policy and Tax Reform in the People's Republic of China: OECD Taxation Working Papers No. 18* (OECD Publishing, Paris, 2013) http://dx.doi.org/10.1787/5k40l4dlmnzw-en.

exemption, higher salary income earners will likely to benefit more from the general monthly allowance.

In light of these observations, returning to Adam Smith's criteria for a 'good tax', [112] it is apparent from the above analysis that the introduction of a comprehensive CGT into China, and indeed New Zealand for that matter, is crucial to creating a sustainable fiscal regime. In terms of horizontal equity it is wrong that those who make profits from the sale of shares are taxed differently from salary and wage earners. As the Carter Commission reported in its proposal for a Canadian CGT "a buck is a buck is a buck"[113]. Perhaps more telling in terms of equity is a reflection on vertical equity. Capital gains are made by wealthier taxpayers. Thus the absence of a CGT on transactions such of the sale of shares favours the wealthier citizens and undermines Adam Smith's crucial principle that the tax system should impose tax on the ability to pay tax[114]. In the absence of a CGT it is the wealthier that pay less tax contrary to vertical equity. As noted above, the key criticism of CGT is its potential complexity. It is the reason New Zealand has not taken the step forward to a comprehensive CGT. Nevertheless, lessons can be learnt from the CGT experience in other jurisdictions to ensure that any CGT legislative regime adopted in China is as simple and streamlined as possible.

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[112] Adam Smith, *An enquiry into the nature and causes of the wealth of nations* (Dent, London, 1947, Original work published in 1778) at 307 – 308.
[113] Les Macdonald, "Royal Commission on Taxation" (2 July 2006) The Canadian Encyclopedia <http://www.thecanadianencyclopedia.ca/en/article/royal-commission-on-taxation>.
[114] Adam Smith argued that tax rates should be set at a level according to one's ability to pay. i.e. "in proportion to the revenue which they respectively enjoy under the protection of the state." See Adam Smith, An enquiry into the nature and causes of the wealth of nations (Dent, London, 1947, Original work published in 1778) at V, 2, para 1.

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Unitary Taxation with a Global Formulary Approach as a Realistic and Appropriate Option for Developing Nations: A Chinese Case Study

Professor Kerrie Sadiq ☆

Abstract: China's transfer pricing regime and investigations into transfer pricing issues gained momentum in the late 1990s. Since then, China has indicated that it is of the view that because of its developing country status, with its unique economic and geographic factors, it faces a number of difficult challenges including a lack of appropriate comparables, quantification and allocation of location-specific advantages, and identification and valuation of intangibles. In the *United Nations Practical Manual on Transfer Pricing*, China highlights and expands its view on each of these challenges and of the four countries with commentary in Chapter 10, provides the most comprehensive discussion on the unique issues faced by developing and emerging economies. Interestingly, China goes so far as to mention formulary apportionment as a possible solution to the difficulties it faces in applying the arm's length principle. Consistent with the concerns expressed by China, this article proposes that unitary taxation based on formulary apportionment should be considered as a more accurate method of determining China's 'fair share' of profits to be taxed. There is already evidence that the current jurisdiction and allocation rules do not work for multinational entities and China has clearly expressed concern about the application of the current transfer pricing rules. As such, acceptance of an alternative model proposed as superior for multinational entities may not be as onerous as previously thought. To demonstrate this proposition the article establishes that a unitary taxation approach which reflects economic reality and is theoretically superior would, from a practical perspective, more easily and effectively ensure that the profits of multinational entities are taxed in the jurisdictions which give rise to those profits. In doing so, the article examines the commentary provided by China in the UN Practical Manual and compares that to Brazil, India and South Africa. It then considers the practicalities of the implementation of unitary taxation for developing nations in terms of the key components of such a regime arguing that it is a viable alternative to the current regime.

Key Words: China's transfer pricing regime, developing and emerging economies, formulary appointment, unitary taxation, 'fair share' of profits, multinational entities, economic reality, and jurisdictions.

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1 Introduction

The *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD Guidelines) are often viewed as the “gold standard” by nations around the world when looking for transfer pricing guidance and direction on the application of the arm’s length pricing principle.[115] These Guidelines represent two decades of work by the OECD on what is considered the internationally consistent transfer pricing approach. OECD membership consists of developed nations with extensive capabilities not only in dealing with complex transfer pricing issues but who also have sophisticated administrative regimes which support the implementation of, and compliance with, the OECD Guidelines. As such, the Guidelines are arguably written with these capabilities in mind. The OECD also engages with non-OECD member countries and to that extent the OECD Guidelines are often followed in the same way by both member and non-member nations. However, developing nations and emerging economies have transfer pricing regimes which are still evolving and present a unique set of challenges. The recognition of the need for further guidance on transfer pricing issues by developing countries led to the release of a document complementary to the OECD Guidelines by the United Nations in May 2013, known as the *Practical Manual on Transfer Pricing for Developing Countries* (UN Practical Manual).[116] The aim of the UN Practical Manual is to provide developing nations with “clearer guidance on the policy and administrative aspects of applying transfer pricing analysis to some of the transactions of multinational enterprises (MNEs) in particular.”[117]

At the outset, the UN Practical Manual aims to be consistent with the OECD Guidelines and recognises the reality that there is widespread support for the arm’s length standard among both developing and developed nations. As such, the UN Practical Manual does not debate the merits of the arm’s length standard, nor does it enter into the debate about alternative means of income allocation amongst jurisdictions. Put simply, it states that “the “value added” of the Manual is to be its practicality — addressing real issues for developing countries (and of course those dealing with the administrations of such countries) in a practical and problem-solving way. It therefore seeks to address the theory of transfer pricing, but in a way that reflects developing country realities in this area.”[118]

The UN Practical Manual generally provides a consensus based approach to the unique issues faced by developing nations. However, in recognition of the lack of consensus on several issues, as well as different country views, Chapter 10 of the UN Practical Manual specifically deals with the country practices of Brazil, China, India and South Africa with each of these nations contributing their own dialogue. In particular, the chapter outlines the approach to transfer pricing followed by these nations which are considered developing and emerging economies which have

[115] China specifically uses the term “gold standard” in Chapter 10 of the UN Practical Manual: United Nations “Practical Manual on Transfer Pricing for Developing Countries” (2013) https://www.un.org/esa/ffd/documents/UN_Manual_TransferPricing.pdf p374.
[116] Above n115.
[117] Above n115, iii.
[118] UN Practical Manual, vi.

become increasingly powerful in the global economy in recent years. Each of the four nations which contributed to Chapter 10 was afforded the opportunity to set out their country's viewpoints and experiences of applying the arm's length principle. China's contribution to Chapter 10 of the UN Practical Manual highlights many of the unique issues faced by developing countries which it believes have not been sufficiently or practically addressed by the OECD Guidelines.[119]

China's transfer pricing regime and investigations into transfer pricing issues gained momentum in the late 1990s. Since then, it is of the view that, because of its developing country status, with its unique economic and geographic factors, it faces a number of difficult challenges including a lack of appropriate comparables, quantification and allocation of location-specific advantages, and identification and valuation of intangibles.[120] In the UN Practical Manual China highlights and expands its view on each of these challenges and of the four countries with commentary in Chapter 10 provides the most comprehensive discussion on the unique issues faced by developing and emerging economies. Interestingly, China goes so far as to mention formulary apportionment as a possible solution[121] to the difficulties it faces in applying the arm's length principle and, using the example of global consumer electronics companies, specifically states:

> "Rather than a transactional or profits-based approach, a contribution analysis approach may be more suitable. This means that remuneration to each party involved would be commensurate with its role and contribution to the value chain in the group. In this case, the assets and the people should largely dictate where the group's profits should stay, and a global formulary approach should be a realistic and appropriate option."[122]

The purpose of this article is to demonstrate that a move towards a unitary taxation regime using global formulary apportionment for China would address many of the unique issues it raises in the UN Practical Manual as well as other well-known problems associated with the arm's length requirement of both domestic tax regimes and treaty networks. It also argues that while each of the four nation's contribution to Chapter 10 of the UN Practical Manual varies in content, common themes can be determined. In particular, the concern over a lack of comparables, along with the difficulties associated with location specific advantages such as the production arising from assets, resource endowments, government industry policies and incentives are often more pronounced in developing and emerging economies. The article then considers the findings of an earlier project funded by the International Centre for Tax and Development (ICTD)[123] on unitary taxation and formulary apportionment for developing nations and argues that if correctly implemented, unitary taxation with formulary apportionment provides a viable

[119] UN Practical Manual, p 374.
[120] UN Practical Manual, p 375.
[121] China's views, as well as its statement on formulary apportionment, were initially released as part of the draft document in 2012.
[122] UN Practical Manual, p 385.
[123] K. Sadiq "Unitary Taxation in the Finance Sector" ICTD Working Paper 25, http://www.ictd.ac/index.php/ju-download/2-working-papers/18-unitary-taxation-of-the-finance-sector.

solution to a fair and equitable allocation of profits for developing and emerging economies.

Consistent with the findings of the ICTD project and concerns expressed by China, as well as the other contributors to Chapter 10 of the UN Practical Manual, this article proposes that unitary taxation based on formulary apportionment should be considered as a more accurate method of determining China's 'fair share' of profits to be taxed. There is already evidence that the current jurisdiction and allocation rules do not work for multinational entities and China has clearly expressed concern about the application of the current transfer pricing rules in the UN Practical Manual. As such, acceptance of an alternative model proposed as superior for multinational entities may not be as onerous as previously thought. To demonstrate this proposition the article establishes that a unitary taxation approach which reflects economic reality and is theoretically superior would, from a practical perspective, more easily and effectively ensure that the profits of multinational entities are taxed in the jurisdictions which give rise to those profits. In doing so, the article examines the practicalities of the implementation of unitary taxation for developing nations in terms of the key components of such a regime.

2 Institutional Background

Prior to a consideration of the approach of China to transfer pricing issues and its contribution to Chapter 10 of the UN Practical Manual, it is necessary to outline the current transfer pricing requirements along with the application of the arm's length price as part of the existing model. The current state of play in relation to multinational entities is also worthy of investigation. As such, part two of this article provides this discussion.

2.1 The Current Transfer Pricing Requirements

Globally, a system of transfer pricing for tax purposes is adopted which generally requires an arm's length price to be attributed to transactions which occur between related parties or different parts of the one entity. This requirement, dating back to the 1920s when it was first introduced by the League of Nations and formally adopted in 1933, is embedded in both double tax treaties and domestic legislation around the world. However, these same sources do not articulate ways in which tax authorities can determine an arm's length price. Consequently, over 30 years ago, the OECD released guidelines as to how to determine an arm's length price. Their original 1979 report[124] was subsequently updated in 1984 and replaced by the 1995 Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations[125] which itself has been substantially revised, most notably in 2010.[126] Until recently, the OECD had been the only international body

[124] OECD, *Report of the OECD Committee on Fiscal Affairs on Transfer Pricing and Multinational Enterprises* (1979).

[125] OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (1995). The revised guidelines, issued on 13 July 1995, replace those contained in the OECDs 1979 report on transfer pricing.

[126] The OECD states that "In 2010, Chapters I-III were substantially revised with the addition of new guidance on the selection of the most appropriate transfer pricing method to the circumstances of the case, on how to apply transactional profit methods (the transactional net margin method and the profit split method) and on

undertaking a comprehensive investigation of this problem. However, for more than a decade academics have been warning of the caveat that must be placed on the reliance on the OECD to provide a solution to the problem of transfer price manipulation.[127] In 2001, Reuven Avi-Yonah suggested that many of the OECD solutions assume that there is no significant development or growth outside the OECD. Further concerns have often centred around the perception, real or otherwise, that the OECD favours the 'Rich countries' and "their" MNEs.

The OECD Guidelines assert that the authoritative statement of the arm's length principle is found in paragraph 1 of Article 9 of the OECD Model Tax Convention, which forms the basis of bilateral tax treaties involving OECD member countries and an increasing number of non-member countries. Article 9 provides:

> "[Where] conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."

The UN also has a model tax convention which is designed to be a suitable template for a treaty between developed and developing countries and, compared to the OECD Model Tax Convention, generally favours source countries over residence countries. However, paragraph 1 Article 9 of the UN Model Tax Convention does not vary in substance from the OECD Article. The UN Model states:

> "Where:
> (a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
> (b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of these conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly".

how to perform a comparability analysis. Furthermore, a new Chapter IX was added, dealing with the transfer pricing aspects of business restructurings."

[127] Reuven S Avi-Yonah, 'Commentary: Tax Issues Through Trade Regimes' (2001) 26 *Brooklyn Journal of International Law* 1683, 1689.

In both the OECD and UN Model Tax Convention Articles, nowhere is the phrase 'arm's length principle' used. However, as a broad concept it is a well-accepted principle of international tax law. To that end, developed nations tend to either implicitly or explicitly adopt the OECD Guidelines as the gold standard when determining how the transfer pricing provisions operate, along with the application of the arm's length price.

While the OECD guidelines are generally accepted as the 'gold standard' other bodies have highlighted the issues surrounding the application of the arm's length requirement of transfer pricing provisions. The UN has drawn attention to the issues within more general reports such as its 1988 report on *International Income Taxation and Developing Countries* [128] as well as its 1999 *United Nations Conference on Trade and Development (UNCTAD) Report* on transfer pricing.[129] However, its most recent document, released in 2013, is the *United Nations Practical Manual on Transfer Pricing* which is designed not only to highlight the unique issues facing developing countries in relation to transfer pricing but also provide 'clearer guidance on the policy and administrative aspects of applying transfer pricing analysis to some of the transactions of multinational enterprises in particular.'[130] This document is significant given its comprehensive approach to transfer pricing issues including issues surrounding the business framework, general legal environment, developing country capabilities, comparability analysis, transfer pricing methods, documentation, audits and risk assessment, and dispute avoidance and resolution. Most significant, however, for the purposes of this article is the Chapter dealing with country practices highlighting what China considers its greatest transfer pricing challenges.

2.2 Determining an Arm's Length Price

As already stated, the arm's length principle is not defined or expanded upon in the OECD or UN Model tax treaties. Rather, the OECD Transfer pricing Guidelines establish the acceptable methodologies and their application, and it is these methods which are adopted globally. The methods are discussed by China in their contribution to Chapter 10 of the UN Practical Manual and, as such, this section briefly defines what are considered acceptable methods. There are three traditional transaction methods and two transactional profit methods which are considered acceptable. They are described as follows:

Comparable Uncontrolled Price Method:

> The CUP method compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances. If there is any difference between the two prices, this may indicate that the conditions of the commercial and financial relations of the associated enterprises are not arm's length, and that the price in the uncontrolled transaction

[128] unctc.unctad.org/data/e88iia6b.pdf
[129] unctad.org/en/pages/PublicationArchive.aspx?publicationid-348
[130] UN Practical Manual, iii.

> may need to be substituted for the price in the controlled transaction.[131]

Essentially, the comparable uncontrolled price method determines an arm's length price by reference to comparable transfers between unrelated parties in comparable markets. The arm's length price is then set by reference to these comparable transfers. This is the only objective way to determine the arm's length price using a traditional method, but seldom is it possible.[132] When comparable uncontrolled transactions do not exist it is necessary to consider alternative models to determine what an unrelated entity would have charged had they engaged in the same transaction as the related multinational entity. Two further methods are considered traditional and appropriate alternatives to the comparable uncontrolled price method. These are the resale price method and the cost plus method.

Resale Price Method:

> The resale price method begins with the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise. This price (the resale price) is then reduced by an appropriate gross margin on this price (the "resale price margin") representing the amount out of which the reseller would seek to cover its selling and other operating expenses and, in the light of the functions performed (taking into account assets used and risks assumed), make an appropriate profit. What is left after subtracting the gross margin can be regarded, after adjustment for other costs associated with the purchase of the product (e.g. customs duties), as an arm's length price for the original transfer of property between the associated enterprises. This method is probably most useful where it is applied to marketing operations.[133]

Where the resale price margin is:

> The resale price margin of the reseller in the controlled transaction may be determined by reference to the resale price margin that the same reseller earns on items purchased and sold in comparable uncontrolled transactions ("internal comparable"). Also, the resale price margin earned by an independent enterprise in comparable uncontrolled transactions may serve as a guide ("external comparable"). Where the reseller is carrying on a general brokerage business, the resale price margin may be related to a brokerage fee, which is usually calculated as a percentage of the sales price of the product sold. The determination of the resale price margin in such a case should take into account whether the broker is acting as an agent or a principal.[134]

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[131] OECD Transfer Pricing Guidelines, 63.
[132] Robert A Green, 'The Future of Source-Based Taxation of the Income of Multinational Enterprises' (1993) 79 *Cornell Law Review* 18, 37.
[133] OECD Transfer Pricing Guidelines, 65.
[134] OECD Transfer Pricing Guidelines, 66.

The arm's length price under the resale price method is determined by looking backwards, that is, by deducting from the sale price of the goods, when sold to an arm's length buyer, the taxpayer's costs, and an appropriate profit margin. As with the comparable uncontrolled price method the primary limitation of the resale price method is the need for comparable independent dealings. Calculating the gross margin by reference to a percentage of the resale price where that percentage has not been determined by reference to a comparable uncontrolled dealing will not be acceptable except in extreme cases.

The resale price method is most suitable where the reseller does little in the way of value enhancement to the property and there are independent parties who undertake comparable dealings. Where the reseller further processes the goods or incorporates them with other products, thereby creating a new one, it is more difficult to determine an arm's length price. Likewise, where the reseller is the owner of intangible property which relates to the product and hence adds value the resale price method may not be suitable.

The second of the alternative traditional methods is the cost plus method.

Cost Plus Method:

> The cost plus method begins with the costs incurred by the supplier of property (or services) in a controlled transaction for property transferred or services provided to an associated purchaser. An appropriate cost plus mark-up is then added to this cost, to make an appropriate profit in light of the functions performed and the market conditions. What is arrived at after adding the cost plus mark up to the above costs may be regarded as an arm's length price of the original controlled transaction. This method probably is most useful where semi finished goods are sold between associated parties, where associated parties have concluded joint facility agreements or long-term buy-and-supply arrangements, or where the controlled transaction is the provision of services.[135]

The cost plus method arrives at an arm's length price by looking forward, that is, it determines an appropriate mark-up of profit to be added to the cost of the property to the supplier. The cost base, upon which the mark-up is added, will consist of both the direct and indirect costs associated with the production of the property, that is, absorption costing is used to determine the cost of the property to the supplier.

The appropriate profit mark-up, measured at gross profit level, is usually determined by reference to the profit margin added by the supplier in independent dealings. Where however the supplier does not engage in any independent dealings it may be necessary to determine the cost plus mark-up by reference to uncontrolled dealings of wholly independent parties. Calculating the profit mark-up by reference to a percentage of the cost price where that percentage has not been determined by reference to a comparable uncontrolled dealing will not be

[135] OECD Transfer Pricing Guidelines, 71.

acceptable except in extreme cases.

Where one of the three traditional methods is not suitable, there are two transactional profit methods which may be used. While not formulary apportionment per se, these methods move towards a formulary approach.

Transactional net margin method:

> The transactional net margin method examines the net profit relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realises from a controlled transaction. Thus, a transactional net margin method operates in a manner similar to the cost plus and resale price methods. This similarity means that in order to be applied reliably, the transactional net margin method must be applied in a manner consistent with the manner in which the resale price or cost plus method is applied. This means in particular that the net profit indicator of the taxpayer from the controlled transaction should ideally be established by reference to the net profit indicator that the same taxpayer earns in comparable uncontrolled transactions, i.e. by reference to "internal comparables". Where this is not possible, the net margin that would have been earned in comparable transactions by an independent enterprise ("external comparables") may serve as a guide. A functional analysis of the controlled and uncontrolled transactions is required to determine whether the transactions are comparable and what adjustments may be necessary to obtain reliable results.[136]

Transactional profit split method:

> The transactional profit split method seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction by determining the division of profits that independent enterprises would have expected to realise from engaging in the transaction or transactions. The transactional profit split method first identifies the profits to be split for the associated enterprises from the controlled transactions in which the associated enterprises are engaged (the "combined profits"). References to "profits" should be taken as applying equally to losses. It then splits those combined profits between the associated enterprises on an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's length.[137]

[136] OECD Transfer Pricing Guidelines, 78.
[137] OECD Transfer Pricing Guidelines, 93.

The discussion below demonstrates the unique problems that China faces in applying these traditional methodologies for determining the arm's length price.

2.3 The Institutional Setting

The UN Practical Manual comes at a time when the inadequacies of the current international tax regime are becoming increasingly obvious to the general public. Both the G20 and OECD are placing significant focus on base erosion and profit shifting. The joint work of the G20 nations in conjunction with the OECD should be commended, as should their current inclusionary approach, which is a shift for the OECD from its initial targeting of non-member countries which were regarded as tax havens. However, truly global reform requires not only a consideration of developing nations and emerging economies but also participation by representatives of all members of the international community. However, it has generally been the OECD, with its developed nations membership, which has taken the lead on international tax reform. The need to include developing nations and emerging economies is especially apparent in an era where there is rapid economic growth in these countries. Unlike a century ago when the current international tax rules were developed, it is no longer the case that the majority of international economic activity occurs between OECD nations.

A tax specific focus area of the recent BEPS initiative - ensuring that developing countries benefit from the G20's tax agenda – means that the views and approaches of developing nations to transfer pricing issues are also considered as part of the reform. In particular, many developing nations are missing out on their 'fair share' of tax revenue because the current international tax regime allows multinational entities, through the use of the current transfer pricing regime and tax treaty network, to shift the profits from those jurisdictions where the profits are earned to another location. The OECD itself recognises this stating "developing countries often have no rules or ineffective rules for dealing with BEPS issues and lack the capacity to draft effective rules. They also face significant challenges in obtaining the relevant data and information to enable them to effectively implement their rules. The other major challenge facing developing countries is building the capacity to effectively implement rules based on international standards."[138]
Base erosion is generally described as the ability of multinational entities to take advantage of the current international tax regime, with the advantage achieved by leveraging the gaps in the regime which 'provide opportunities to eliminate or significantly reduce taxation on income in a manner that is inconsistent with the policy objectives of such domestic tax rules and international standards'.[139] Profit shifting, which occurs because of several basic concepts that underpin the current

[138] OECD *Addressing Base Erosion and Profit Shifting* (Paris, 2013) OECD, Centre for Tax Policy and Administration, Base Erosion and Profit Shifting www.oecd.org/ctp/beps.htm p87.
[139] OECD *Addressing Base Erosion and Profit Shifting* (Paris, 2013) OECD, Centre for Tax Policy and Administration, Base Erosion and Profit Shifting www.oecd.org/ctp/beps.htm p5.

international tax system, is one of the most significant ways in which base erosion is occurring. Multinational entities are able to profit shift because the current international tax regime relies on the traditional concepts of residence and source, along with the notion of the permanent establishment and transfer pricing regimes imposing an arm's length standard for related party transactions. In essence, these concepts focus on physical locations and a separate entity approach which is in stark contrast to the reality of global corporations. In practical terms, profit shifting is generally achieved via transfer pricing practices, particularly with respect to the shifting of risks, shifting of intangibles, the splitting of the ownership of assets and undertaking transactions within the multinational group that would not normally occur between non-related parties.

The misuse of transfer pricing regimes is generally understood to be the reason why multinational entities are able to shift profits. And, it is the unique issues faced by developing nations that are highlighted in the UN Practical Manual. While the UN Practical Manual also adopts the approach that the arm's length principle is embodied in the UN Model Tax Convention, the Subcommittee recognised that individual countries, which are developing and emerging economies, face unique issues when applying the treaty based principles to practical situations. As such, this feedback was able to be articulated by those countries in the form of individual countries views in Chapter 10 of the UN Practical Manual.

The next section of this article sets out the concerns China, highlighting the unique issues it faces. What becomes apparent however is that those issues are not unique to China but rather developing nations and emerging economies as a whole.

3 China

China's contribution to Chapter 10 of the UN Practical Manual is much broader than the contribution made by the other BRICS nations and highlights many of the unique issues faced by developing countries which it believes have not been sufficiently or practically addressed by the OECD Guidelines.[140] The approach adopted by China to its contribution to the Chapter, rather than explain their transfer pricing regime, is to highlight in broad terms what it perceives to be the issues facing developing nations which have not been sufficiently or practically addressed by the OECD Guidelines. It then shares its practical experience in dealing with these issues.

China's transfer pricing regime and investigations into transfer pricing issues gained momentum in the late 1990s. Since then, it is of the view that, because of

[140] UN Practical Manual, p 374.

its developing country status, with its unique economic and geographic factors, it faces a number of difficult challenges including a lack of appropriate comparables, quantification and allocation of location-specific advantages, and identification and valuation of intangibles.[141] In the UN Practical Manual, China highlights and expands its view on each of these challenges and of the four countries with commentary in Chapter 10, provides the most comprehensive discussion on the unique issues faced by developing and emerging economies. Interestingly, China has not formally adopted the OECD Transfer Pricing Guidelines and goes so far as to mention formulary apportionment as a possible solution[142] to the difficulties it faces in applying the arm's length principle and, using the example of global consumer electronics companies, specifically states that "rather than a transactional or profits-based approach, a contribution analysis approach may be more suitable. This means that remuneration to each party involved would be commensurate with its role and contribution to the value chain in the group. In this case, the assets and the people should largely dictate where the group's profits should stay, and a global formulary approach should be a realistic and appropriate option."[143]

The article now turns to the three major difficulties in applying the arm's length standard as discussed by China.

3.1 A Lack of Reliable Comparables

As indicated above, the traditional arm's length methodologies rely on comparables being available, starting with transactions of the entity which are related being compared with similar transactions of the entity with unrelated parties. Where this is not possible, comparisons are then made with unrelated entities that are required to perform similar functions, own similar assets, bear similar risks and operate under comparable circumstances.[144] However, as China points out, for developing countries there is often a lack of reliable, public information on comparables because there are a limited number of public companies and information on private companies is inadequate.[145] The result for developing nations is that the data used is gathered from what are deemed suitable internationally comparable companies from developed nations. China highlights the difficulties in this approach where developing countries remain subject to foreign exchange controls. It also highlights the need for adjustments to take into account differences in geographic comparability under the profit based methods.[146]

[141] UN Practical Manual, p 375.
[142] China's views, as well as its statement on formulary apportionment, were initially released as part of the draft document in 2012.
[143] UN Practical Manual, p 385.
[144] UN Practical Manual, p 375.
[145] UN Practical Manual, p 375.
[146] UN Practical Manual, p 376.

3.2 Location-Specific Advantages

Location-specific advantages are defined as 'advantages for production arising from assets, resource endowments, government industry policies and incentives, etc, which exist in specific localities.'[147] Examples of location specific advantages include low-cost labour and production close to market, both of which tend to arise more frequently in developing nations than developed ones simply because the former tend to be low cost locations as compared to the latter. The result is that there are location savings realised through lower expenditure as well as market premiums due to the additional profits derived by operating in jurisdictions with higher sales and demand. What is particularly interesting is the fact that China makes an adjustment for location specific advantages using a formula to determine the extent to which greater profits should be allocated because of those advantages.

3.3 Identification and Valuation of Intangibles

China points out that developing nations also play a unique role in the global community in relation to intangibles. In particular, it is suggested that, while the intangibles originate in developed countries, it is developing countries which further establish the market for the intangibles. The question then becomes one of the value that the developing country has added to that intangible which, in turn, may mean that royalties should no longer be paid or, in some situations, a share of the royalty may even be due to the developing nation.

3.4 Practical Problems Recognised

China provides comprehensive commentary on what is sees as practical issues and solutions. In particular, it sees the various structures adopted by multinational entities when investing in China as having significant transfer pricing issues. Essentially, the 'operations take the form of contract or toll manufacturing, contract R&D, and limited risk distribution to leave little profit to the local country, despite the fact that many such comparative advantages contribute significant profits to the multinational group.'[148] Below are examples of the types of practical issues which arise:

- MNEs often establish numerous subsidiaries in the one developing nation which are single function entities. China takes the view that where there are multiple single function entities, they should be treated as a whole to determine the appropriate return to the group in China.

[147] UN Practical Manual, p 376.
[148] UN Practical Manual, p 381.

- Contract R&D is common in developing countries and China argues that the contribution is often underestimated because, often, it is the cost plus method which is used to determine the transfer price. China argues that a profit split method is the most appropriate in circumstances where there is R&D being conducted in the developing country.
- Contract manufacturing is very common in developing countries, particularly in relation to products which are exported. Where this is the case, China generally uses the transactional net margin method to determine the transfer price but recognises that it is difficult to determine the proper return due to a lack of comparables. Various approaches are adopted by taxpayers, including using a return on assets as a profit level indicator, but as China points out, this may still undervalue the contribution especially where the manufacturing is highly labour intensive.[149]
- Chinese distribution entities tend to be treated as limited risk distributors which, in turn, as compared to similar entities in developed nations (Japan is used as an example). However, China argues that again significantly more functions are performed in developing nations and that there are marketing differences due to the fast-growing economy of countries like China. China states that it uses more appropriate transfer pricing methods in these situations, such as the profit split method which takes into account local marketing intangibles or location specific advantages.

Of particular significance is the recognition by China that the traditional transactional net margin method may not be the most appropriate method and that the profit split method may be more appropriate. This is particularly the case where there are manufacturing and assembly operations because the majority of the workforce and assets of the MNE are located in China yet the profits of the Chinese manufacturer are 'stripped away' from China.[150] The response by China to such a situation is as follows:

> "Under this scenario, China takes the view that a risk-based approach may have insufficient regard for the fact that there are sizable assets located in China (i.e. the work force and factory plants). In many cases, the majority of the headcount of the EMS group are based in China, with only a few management personnel residing outside of China. Rather than a transactional or profits-based approach, a contribution analysis approach may be more suitable. This means that remuneration to each party involved would be commensurate with its role and contribution to the value chain in the group. In this case, the assets and the people should largely dictate where the group's profits

[149] UN Practical Manual, p 383.
[150] UN Practical Manual, p 385.

should stay, and a global formulary approach should be a realistic and appropriate option."[151]

4 Brazil

Brazil, which is known as a nation with controversial transfer pricing rules, has had a transfer pricing regime in place since 1996,[152] with significant changes introduced in 2012. The Brazilian regime specifically adopts the arm's length principle using the traditional transaction methods for determining the arm's length price but does not adopt the internationally accepted way of applying this principle. That is, the regime applies the comparable uncontrolled price method, the cost plus method, and the resale price method but applies different principles to arrive at the arm's length price. Brazil's contribution to Chapter 10 of the UN Practical Manual centres on the application of the arm's length pricing methodologies and its prescribed variations from the requirement for comparables.

Formulary apportionment is specifically rejected by Brazil as a suitable method, as are the transactional profit methods consisting of the profit split method and the transactional net margin method. However, while the Brazilian regime specifically states that it uses traditional methodologies, the application varies significantly from the traditional approach. This is because because rather than using comparable transactions to determine the gross profits under the cost plus method or the mark-up under the resale price method, it uses fixed margins for both.

The comparable uncontrolled price method, as applied in Brazil, is recognised as being consistent with OECD practices as it simply looks to an independent enterprise trading in similar goods or services to determine the price. However, where that method cannot be used, the cost plus or resale price method is then applied and this is where Brazil varies from the traditional approach.[153] Traditionally, comparable mark ups or resale prices would be determined. Rather than adopt this approach, Brazil is of the view that a methodology which relies on predetermined margins[154] for both import and export operations is superior for a number of reasons including its emphasis on practicality and simplicity. Most importantly, Brazil is of the view that the conventional use of these two methods "implies some uncertainty and juridical instability, since they are implemented by

[151] UN Practical Manual, p 385.
[152] Law n. 9430/1996 as modified by Law 9.959/2000, Law n. 10.451/2002, Law n. 11.727/2008, Provisional Measure n. 478/2009, and Law n. 12.715 of 17 September 2012.
[153] Although, the transfer pricing legislation does not apply to royalties and technical, scientific, administrative assistance or similar activities. There are also special rules for loans.
[154] It should be noted that the fixed margins are not safe harbour rules.

the taxpayer without previous consent or summary review by the tax authorities. This affects stability and expectations in economic and fiscal relations."[155]

4.1 Resale Price Method

Since 2012, the general margin applied under the resale price method is 20 percent, subject to variations for certain industry sectors. The method is applied in a similar manner to the traditional OECD approach except that the gross profit margin is simply asserted. That is, the resale price to an unrelated party is reduced by the predetermined gross profit margin with the balance considered the appropriate transfer price between the associated parties.

Current fixed margins for imports are set out below:

40 Percent	Pharmaceutical chemicals and pharmaceuticals;
	Tobacco products;
	Equipment and optical instruments, photographic and cinematographic
	Machinery, apparatus and equipment for use in dental, medical and hospital
	Petroleum, and natural gas (mining industry)
	Petroleum products (derived from oil refineries and alike)
30 percent	Chemicals (other than pharmaceutical chemicals and pharmaceuticals)
	Glass and glass products
	Pulp, paper and paper products
	Metallurgy
20 percent	Remaining sectors

(Source: UN Practical Manual, 363-364.)

Where the transactions involve exports, the margins are set at 15 percent for wholesale sales and 30 percent for retail sales.[156]

[155] UN Practical Manual, 358.
[156] UN Practical Manual, p 364.

4.2 Cost Plus Method

As with the resale price method, the cost plus method is applied in a similar manner to the traditional OECD approach except that the gross profit mark-up is simply asserted. That is, a predetermined mark-up is simply added to the cost of the product or services. The mark-up rates are 15 percent for exports and 20 percent for imports.

4.3 Strengths and Weaknesses of the Brazilian Approach

Brazil, in its contribution to the UN Practical Manual, specifically sets out what it considers to be the strengths and weaknesses of their approach. They are listed as follows:[157]

Strengths:

- It avoids the need for specific comparables;
- The use of the conventional Resale Price Method and Cost Plus Method depends on the availability of certain data, databases or reports to empirically determine the gross profit margin and gross profit mark-up. In general, these elements are usually not easy to find;
- It frees scarce human resources and can be applied without technical knowledge of specific transfer price issues;
- It stabilizes the expectations of taxpayers with respect to their Brazilian tax liability associated with inter-company transactions;
- It is a low-cost system to companies and tax administration in that it does away with one aspect of a transfer pricing analysis, the need to empirically determine gross margins;
- It has an emphasis on practicality;
- It does not distort competition among enterprises located where the methodology is applied, since they are subject to the same tax burden, and they are not benefitting from asymmetry of information;
- It allows for simple implementation by tax authorities to audit taxpayers; and
- It is simple for taxpayers to apply it.

Weaknesses:

- The approach may lead to double taxation in case there is no access to competent authorities to negotiate relief of double taxation;

[157] UN Practical Manual, p 370-371.

- The method requires clear classifications and accounting conformity with respect to the allocation of expenses between COGS and operating expenses;
- It is unavoidable that some Brazilian enterprises will be taxed at (higher or lower) profit margins not compatible with their profitability. This is because the fixed margin method applies regardless of the cost structures of taxpayers. For example, otherwise economically identical taxpayers with large COGS relative to operating costs will face higher tax burdens than taxpayers with low COGS relative to operating costs.

4.4 Brazil's Advice to "Others"

In its final two pages of contributions to Chapter 10 of the UN Practical Manual, Brazil takes the unusual step of providing advice to countries considering the use of fixed margins. Interestingly, much of the advice centres on the negotiation processes for determining the margins, much like the process for determining a formula should formulary apportionment be considered. For example, it suggests that each country should determine, according to its specific circumstances amounts involved, types of goods and services, and the specifications of margins. It also emphasises that what is being applied are ranges which mean that some taxpayers fall below the average while others are above the average. In essence, besides ignoring the profit margins of comparable unrelated parties, this results from the Brazilian regime ignoring what the OECD consider necessary under the traditional transactional methods, that is, variables such as business risks borne, functions performed and market conditions of the area of operations.

As demonstrated above, the Brazilian transfer pricing rules do deviate significantly from the generally accepted practices for determining the arm's length price. Most notably, it applies fixed statutory profit margins. However, also of significance is the inability of taxpayers to undertake a functional or risk analysis to adjust the transfer price, nor is it possible to apply a profit-based method. Finally, Brazil does not have an Advanced Pricing Agreement program in place. However, it has been suggested that the Brazilian model should be seen as a feasible alternative to the OECD's arm's length standard.[158] Marcelo Ilarraz, in his analysis of the Brazilian approach concludes that "… it provides a high level of certainty and predictability, which is desired by Multinational Enterprises, together with the possibility of making adjustments to prevent distortions. … the Brazilian pattern [also] strengthens the taxing rights of developing countries."[159]

[158] Marcelo Ilarraz, "Drawing upon an Alternative Model for the Brazilian Transfer pricing Experience: The OECD's Arm's length Standard, Pre-Fixed Profit Margins or a Third Way?" 2 (2014) *British Tax Review* 218.
[159] Marcelo Ilarraz, "Drawing upon an Alternative Model for the Brazilian Transfer pricing Experience: The OECD's Arm's length Standard, Pre-Fixed Profit Margins or a Third Way?" 2 (2014) *British Tax Review* 218 at 218.

5 India

India adopts a more conservative approach to transfer pricing than Brazil and China. It first introduced transfer pricing regulations in 2001 and has a regime based on the arm's length principle. India ultimately states that it is of the view that comparability analysis is the key to determining an arm's length price.[160] It endorses the five OECD prescribed methods for determining the arm's length price allowing for the most appropriate method to be used. It also has an administrative system which requires mandatory annual filing and has 'stringent penalty implications in the case of non-compliance'.[161] India's primary concern relates not to methodology but rather the administration of the transfer pricing regime, and like China, the concern over location specific advantages. It lists as its major administrative difficulties: challenges in the comparability analysis; issues relating to risks; the arm's length range; comparability adjustments; location savings; intangibles; intra-group services; financial transactions; and, the dispute resolution process. India's focus on the administrative aspects of transfer pricing is not surprising given that it is suggested that in 2011 India accounted for 70 percent of global transfer pricing cases and was third in terms of global transfer pricing caseload in 2012.[162] The significant points are expanded upon below.

5.1 Comparability Analysis

The first of India's concerns relates to volatility in the world market. It is of the view that commodity price volatility, large public debt, recession and other economic concerns have brought volatility to the world market which, in turn, results in fluctuations to the margins of multinational entities.[163] To resolve such volatility, India requires data to relate to the financial year in which the transactions are entered into. However, it also recognises that there may be a need to use prior year's data where it could influence the transfer price.

5.2 Risk

India is of the view that risk is a by-product of its functions performed and assets employed, rather than being independent. As such, it does not give what it considered undue influence to risk in its comparability analysis. Similar to the situation arising in China, many multinational entities are entering into contract services which they then argue are low or no risk. In these circumstances India believes that where core functions of R&D or services are performed in India then the allocation of routine and low cost plus return is insufficient.

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160 UN Practical Manual, p 389.
161 UN Practical Manual, p 388.
162 Prakash, P "India: Emerging Transfer Pricing and International Tax Issues" *International Transfer Pricing Journal* 2013 (Volume 20), No. 6 34 at 374.
163 UN Practical Manual, p 389.

5.3 Location Savings

While India endorses the use of the traditional transfer pricing methodologies and the approach of the OECD, it believes that location savings should be one of the major aspects to be considered during a comparability analysis. India articulates what it means by location savings, incorporating location-specific advantages. It states that it provides 'operational advantages to the MNEs such as labour or skill employee cost, raw material cost, transaction costs, rent, training cost, infrastructure cost, tax incentive etc.' and also, that it provides location-specific advantages such as highly specialized and skilled manpower and knowledge; access and proximity to growing local/regional markets; large customer base with increased spending capacity; superior information networks; superior distribution networks; incentives; and market premium.[164] Like China, the Indian revenue authority considers that the profits earned from location specific advantages, or location rents, can be allocated using the profit split method.

5.4 Intangibles

India recognises the common problems associated with the arm's length valuation of intangibles, most notably the fact that they are rarely traded in the external market, they are often bundled with tangible assets and they are difficult to detect.[165] More specifically, from a developing nation perspective, it sees the key issues as the 'determination of the arm's length rate of royalties, allocation of cost of development of market and brand in a new country, remuneration for development of marketing, R&D intangibles and their use, and transfer pricing of co-branding.'[166] Similar valuation issues to China are raised by India, highlighting the fact that traditionally the risk borne by the Indian subsidiaries are not being taken into account I determining the arm's length price.

6 South Africa

South Africa's transfer pricing regime came into effect in 1995, with various subsequent Practice Notes and amendments by the South African Revenue Service (SARS). South Africa concedes that, due to a lack of resources and skills challenges, it is only in the last few years that it has begun to aggressively audit transfer pricing.[167] South Africa, like other developing nations, also adopts the arm's length approach to transfer pricing. Its contribution to Chapter 10 of the UN Practical Manual is to outline how it attempts to work around what it views as the practical shortcomings of the arm's length principle. Also like other developing nations, South Africa views a lack of domestic comparables as the main challenge

[164] UN Practical Manual, p 394.
[165] UN Practical Manual, p 396.
[166] UN Practical Manual, p 396.
[167] UN Practical Manual, p 410.

it faces. South Africa also highlights the challenges it faces with the payment of management services where a single entity structure is adopted by multinational entities. Contract risk shifting with end of year adjustments is highlighted as another significant challenge faced by South Africa, with the suggestion that the practice of India and China to take into account location savings, location specific advantages and market premiums will be utilised in future audits. As with the other developing nations, South Africa also highlights the problem of intangibles and access to information. Surprisingly, given its wide range of stated challenges, South Africa concludes that "[t]he arm's length principle does not ignore basic principles such as the perspective of the prudent business man, commercial rationale and good business practice. It is with this understanding that the SARS applies the arm's length principle."[168]

7 Is Formulary Apportionment a Possible Solution?

The OECD, specifically rejects formulary apportionment as an alternative to the arm's length principle and makes it clear that formulary apportionment should not be confused with transactional profit methods or the use of a specific formula agreed upon by the relevant taxing authorities and the taxpayer as part of a mutual agreement procedure or advance pricing arrangement. It argues that the transactional profit methods are not analogous to a formulary apportionment approach because a comparison of the profits of the associated enterprises with the profits of independent enterprises is done on a case-by-case basis. It also argues that any formula reached under an agreement is not analogous to formulary apportionment because it is derived from the facts and circumstances of the case rather than being a pre-determined and mechanistic formula.[169] The OECD continues by stating that 'there would be disagreements because each country may want to emphasize or include different factors in the formula based on the activities or factors that predominate in its jurisdiction. Each country would have a strong incentive to devise formulae or formula weights that would maximise that country's own revenue.'[170] The OECD Transfer Pricing Guidelines go on to state:

> 'Global formulary apportionment would have the effect of taxing a MNE group on a consolidated basis and therefore abandons the separate entity approach. As a consequence, global formulary apportionment cannot, as a practical matter, recognize important geographical differences, separate company efficiencies, and other factors specific to one company or subgrouping within the MNE group that may legitimately play a role in determining the division of profits between enterprises in different tax jurisdictions. The arm's length principle, in contrast, recognizes that an associated enterprise may be a separate profit or loss centre with individual characteristics and economically may be earning a profit even when the rest of the MNE group is incurring

[168] UN Practical Manual, p 415.
[169] OECD Transfer Pricing Guidelines (2010), 37.
[170] OECD Transfer Pricing Guidelines (2010), 38.

a loss. Global formulary apportionment does not have the flexibility to account properly for this possibility.'[171]

The OECD position is that formulary apportionment fails to take into account many of the unique issues raised in Chapter 10 of the UN Practical Manual. Yet, the commentary suggests that it is the current transfer pricing regime, with its arm's length requirement, which in fact fails to take into account these unique features. As a practical response to these difficulties, China states:

> "China, as a developing country, has unique economic and geographic factors which contribute to the profitability of Chinese taxpayers and their foreign parent companies. These factors include, but are not limited to, readily available migrant labour, low labour and infrastructure costs, first-mover advantages in certain industries, foreign exchange controls, growing population and consumer demand for foreign and luxury products. Other developing countries have their own unique features that similarly require special attention from a transfer pricing perspective.
>
> In China's experience, MNEs have often implemented group transfer pricing policies that are sensitive to developed countries' transfer pricing regulations and nuances, but neglect to consider whether the arm's length principle has been applied properly in developing countries.
>
> China has overcome this challenge by using some practical solutions that are sensitive to unique economic and geographic factors for companies operating in China. These solutions include concepts such as location savings, market premium and alternative methods of analysis besides the traditional transactional and profit-based methods."[172]

An assessment of China's views indicates that the traditional methods of determining the arm's length price may not be satisfactory. While China applies the arm's length standard, it recognises that it is not a 'one size fits all' and that the traditional application means that often China is not being allocated the profits that they otherwise would if that allocation accurately reflected the contributions made. In a previous article I argued that formulary apportionment was a viable solution to the taxation of the multinational finance sector.[173] In the final part of this article I rely on those findings and provide a summary of the relevant results to highlight

[171] OECD Transfer Pricing Guidelines (2010), 40.
[172] UN Practical Manual, p 386-387.
[173] K Sadiq "Unitary Taxation with Formulary Apportionment in the Finance Sector – the effect on developing nations" 44 *Australian Tax Review* 75.

the issues which would arise if formulary apportionment were adopted more broadly.[174]

7.1 Formulary Apportionment Issues

If unitary taxation with formulary apportionment is to be adopted for the MNEs, the definition of the unitary business and unitary business activities needs to be established. What constitutes the unitary business group and the income to which the formula will be applied is a precursor to any apportionment. That being said, often, the MNE is obvious. However, continual growth and change means that MNEs are evolving and it is impossible to predict the type of activities that will be undertaken and entities that will undertake them in the future. As such, it is argued that a broad principles-based approach to a definition of the MNE, adopting a principles based approach, is more appropriate than a prescriptive approach.

Second, the parts of the business which fall within the scope of the MNE for unitary taxation purposes, also needs to be determined. This definition focuses on the parts of the MNE that are to be included in the unitary business (the scope of the group) and the activities of the MNE which are to be subject to unitary taxation (the scope of the business activities). It is proposed that a wide definition of both the scope of the unitary business and the unitary business activities is the most appropriate to ensure that the potential advantages of unitary taxation for developing countries are not limited. However, as previously recognised from a practical perspective this is a more difficult approach to adopt.

The scope of the unitary MNE also needs to be considered. Two issues arise; first, whether the income should include both business and non-business income, and, second, whether the income should be subject to the formulary apportionment regime on an activity-by-activity basis. It has historically been difficult to distinguish between business and non-business income, with different jurisdictions having different rules for doing so. This would be exacerbated in industries where highly complex structures and transactions entered into. As such, allowing MNEs to distinguish between business and non-business income would most likely lead to aggressive tax planning practices whereby developing nations would lose out. The ability to reclassify business income into passive income would likely be easily achieved by MNEs. As such, all income should ideally be included.

A formula may be applied to the global income of the MNE or the combined income of certain activities of the MNE, known as the activity-by-activity approach. The activity-by-activity approach would be relatively easy to implement compared to the combined income approach because often MNEs have relatively delineated retail, commercial and investment activities. However, such an approach is not ideal and, in the context of developing nations, an activity-by-activity approach may do little in the way of allocating income according to the location of the economic activity, if formulary apportionment was only applied to those parts of the MNE where the arm's length approach is difficult to apply. As

[174] It should be noted that this section relies heavily on the previous work of the author in the findings published in K Sadiq "Unitary Taxation with Formulary Apportionment in the Finance Sector – the effect on developing nations" 44 *Australian Tax Review* 75.

such, a combined income approach is one that more accurately captures all of the activities of a MNE globally.

7.2 A Formula for MNEs

The question to be addressed is whether a standard formula should be used for MNEs or a formula should be adopted which is specific to an industry. Several working examples provide insight. These models allow an evaluation of both general and industry specific formulas, the various factors to be incorporated into a formula, and the appropriate weightings.

Canada has a formulary allocation system that applies where a taxpayer has a permanent establishment in more than one province or territory. A common formula is used by the federal government to a common tax base, and then a provincial specific tax rate is applied. As a general rule, Canada applies a two-factor formula of sales and payroll with each weighted equally. The German model for allocating trade tax does not apportion the income amongst the taxing authorities, but rather apportions the tax. The formula, applied to a basic tax amount, is a single factor of salary and wages on the basis that this represents the costs that are caused by trade activities.

With twenty-six cantons applying different formulas, and different formulas applying to different industries, the Swiss tax system is complicated and allows for substantial independence of the Swiss Cantons from the federal state. Three different methods are used for apportioning the income of a company: direct, indirect and mixed. The direct method is ostensibly the same as separate accounting, while the indirect method is similar to the method used in Canada and the US, and the mixed method is a combination of the first two using a two-step process.[175]

The US domestic formulary apportionment system, despite being in existence for more than half a century, continues to be an evolving one. Historically, a range of factors have been used in US state formulas including the share of physical assets or intangible assets, the share of employment, the share of sales, manufacturing costs, purchases, expenditure for labour, accounts receivable, net cost of sales, capital assets, and stock of other companies.[176] Property, payroll and sales are now seen as the acceptable factors. Each of the states applies their own formula, however, commonalities exist. The well-known Massachusetts formula is a three-factor, equally-weighted formula consisting of tangible property, payroll expense and sales revenue. However, many states no longer use this traditional formula, instead placing greater emphasis on sales either by double-weighting the sales factor or adopting a single-sales factor formula. The EU CCCTB proposal[177] adopts a three-factor equally-weighted formula comprising labour, assets and sales.

[175] Mayer, S. (2006) *Formulary Apportionment for the Internal Market*, IBFD Doctoral Series Vo. 17, 3.4.5.1.
[176] Weiner, J. (1996) 'Using the Experience in the US States to Evaluate Issues in Implementing Formula Apportionment at the International Level', *Tax Notes International* 13: 2113-2122.
[177] European Commission (2011) *Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB)*, COM(2011) 121/4, 16 March 2011.

The labour factor varies from other models however as it is determined on the basis of payroll and the number of employees, with each item counting for half. The CCCTB proposal also includes special apportionment, or modification, rules for financial institutions. Generally, intangibles and financial assets are excluded from the formula due to their mobile nature and the risk of circumventing the system.

Any factor used in a formula must be defined. Here, the three most common factors of payroll, property and sales are revisited with the aim of defining each, as well as explaining the rationale for each and outlining the likely issues that would arise, and the impact on developing nations, if they were used in a formula for MNEs.

The payroll factor, generally defined as total employee compensation including salaries, commissions and bonuses, is included to reflect the contribution of labour to the generation of the income of the entity. There are two significant issues in relation to the payroll factor which would impact on developing nations. First, compensation is generally much lower in developing countries than it is in developed countries. A model which places equal weight on remuneration and number of staff, is also likely to be more suited to MNEs given the high salary and bonuses paid to some staff as compared to others who undertake simple retail activities. A second problem of outsourcing labour functions needs to be considered as the payroll factor does not generally include independent contractors. In the context of MNEs, payroll will be an important factor, especially given it is the most difficult to manipulate.

The property (asset) factor, is included in some formulas on the basis that capital is an important income-producing factor. However, property is also the most complex factor to define and value, especially in relation to intangibles and the allocation to the relevant jurisdictions. Intangibles may be removed from inclusion in the property factor, as is done often in the US or avoiding the property factor altogether such as in Canada. Valuation problems also arise where this factor is adopted, that is, whether historical cost or market value should be used. As I have advocated in earlier articles, it is argued in this article that the property factor should not be included in any formula. The ultimate purpose of an allocation formula is to allocate profits in a manner which accurately reflects the location of the activities which give rise to the profits of the MNE. By using labour and sales factors in the formula, this is achieved, with the property factor contributing nothing additional to the allocation model. No doubt, capital is a significant part of an MNE’s operations and it may be easy to measure. Due to the difficulties associated with the property factor, along with a move away from its use in domestic jurisdictions, it seems that the most appropriate approach would be to avoid the use of this factor in a formula for MNEs.

Literature recognises that the sales factor (by destination) is a relatively easy factor to measure. However, the ability to identify the location of the sales can be difficult. A formula for MNEs must ensure that the sales revenue is allocated to the appropriate geographic location. The sale of intangible goods and services, especially intermediary services such as those performed by some MNEs, pose the biggest problem. In the case of some MNEs, there is also the incentive to finalise contracts in low tax jurisdictions (and, more likely, tax havens). The solution to

this problem is to adopt an 'ultimate destination' test to determine where the services are ultimately used, thereby applying a tracing rule. Retail services to individuals would readily lend themselves to such an approach, however corporate clients would pose significant problems given their ability to establish subsidiaries anywhere.[178] In these cases ultimate destination tracing would be problematic and, from a practical perspective, the compliance costs and complexities associated with such an approach would lead to resistance. As Clausing and Avi-Yonah explain, 'the key advantage of a sales-based formula is that sales are far less responsive to tax differences across markets, because the customers themselves are far less mobile than are firm assets or employment. Even in a high-tax country, firms still have an incentive to sell as much as possible'.[179]

Any formula needs to be equitable and efficient as well as politically acceptable to both developed and developing nations. Unitary taxation with formulary apportionment only works to the extent that the factors of the formula allocate income based on an economically-sound basis. Fairness requires different allocation factors to be taken into account and a balanced weighting applied to those factors which results in a distribution of income according to what is viewed as sensible.[180] Generally, factors such as the location of offices, people and sales should be used in the formula with a weighting that minimises distortions. However, each nation has the incentive to place greater emphasis on the factors which maximise taxable income in its jurisdiction. It would be essential to ensure that developing countries are given equal standing in any negotiations as they may be disadvantaged where emphasis is placed on such factors as labour and capital that have lower costs in developing counties.[181] Ultimately, much of the argument will centre on country bias, dependent on whether consumption factors or destination factors produce the best result, and depending on what the majority can agree on. Developing nations will be wise to argue for greater emphasis on a destination-based sales factor on the basis that it is those nations where the market is located. To avoid distortions, minimise complexity and lessen opportunities for aggressive tax planning, all key elements of the system, apart from tax rates, should be consistent across countries.[182]

Generally, the tendency in existing regimes has been for fewer factors to be used, with a resulting combination of factor/s at origin (assets and payroll) and factor/s at destination (sales) making up the adopted formulas. The recommendations in this article are consistent with this observation as the discussion above supports the view that an equally weighted two-factor formula of labour and sales for MNEs is the most likely to be broadly accepted as well as meet the criteria of fairness and equity. An origin-based labour factor and a destination-based sales factor is the

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[178] Benshalom, I (2008) 'The Quest to Tax Financial Income in a Global Economy: Emerging to an Allocation Phase – Taxing Global Financial Institutions', *Virginia Tax Review* 28: 165-221.
[179] Clausing, K. and Avi-Yonah, R. (2007) *Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment*, The Hamilton Project Discussion Paper, Brookings Institute, 12.
[180] Weiner, J. (1996) 'Using the Experience in the US States to Evaluate Issues in Implementing Formula Apportionment at the International Level', *Tax Notes International* 13: 2113-2122.
[181] Casanegra de Jantscher, M. (2000) 'Major Tax Trends in the 21st Century', *2000 World Tax Conference Report*, Canadian Tax Foundation.
[182] McLure, C. Jr. (2002) 'Replacing Separate Entity Accounting and the Arm's Length Principle with Formulary Apportionment', *Bulletin for International Fiscal Documentation* 56(12): 586-596.

most appropriate for MNEs. The biggest difficulty will be the sales factor and, as Avi-Yonah, Clausing and Durst explain, determining the location for sale of certain services such as financial services 'will require toleration of some degree of reasonable estimation and generally will require some restraint in enforcement. In addition, owing to the wide range of situations in which sales can arise, regulations will need to be detailed, and a rulings process will be needed to provide flexibility for particularly difficult situations'.[183]

8 Conclusion

The behaviour of MNEs as taxpayers profiting from the growth of developing nations needs to be addressed. These MNEs are earning profits from transactions and clients in nations such as China but not paying appropriate taxes on those profits. Unitary taxation with formulary apportionment may provide a viable solution to ensuring that profits are taxed in the location of where they are earned. A successful formulary apportionment model makes the use of aggressive tax planning strategies worthless, as there is no longer the opportunity to have income sourced within that jurisdiction unless factors in the formula are present. Consistent with my previous recommendations, the model proposed in this article is an equally weighted two-factor formula of labour and sales where labour reflects both remuneration and numbers of staff. Ideally, this formula should be applied to all of the income of a MNE (broadly defined) on a combined income basis.[184] While only China goes so far as to suggest formulary apportionment as an alternative solution in the UN Practical Manual, Brazil has also gone against the traditional application of the methods. Only time will tell as to whether views are heard.

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[184] K Sadiq "Unitary Taxation with Formulary Apportionment in the Finance Sector – the effect on developing nations" 44 *Australian Tax Review* 75.

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Individual Income Tax Reform in China: Reflections on New Zealand's Experience

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Abstract: New Zealand (NZ) has taken a path towards tax simplification with respect to individual taxpayers who are not involved in business or self-employed, since the mid-1980s, following the election of the Fourth Labour Government in 1984. The governing principle has been to enhance efficiency and reduce complexity from the perspective of the NZ Government and Inland Revenue, while placing less weight on potential equity issues. This has seen the removal of deductions for wage and salary earners, the removal of the need to file returns (accompanied by personal tax summaries) for those with income taxed at source, and formalising self-assessment. For individuals who are in business or self-employed, the drive more recently has been to reduce their compliance costs following significant tax reform since 1984, while retaining their ability to claim deductions. This differential approach has placed greater emphasis on the employee versus self-employed distinction. Going forward, Inland Revenue, in conjunction with the NZ Government, is embarking on the largest IT-focussed project in NZ's history – the Business Transformation Programme – that is intended to take tax administration well into the 21st Century. Further simplification, greater withholding accuracy, and an online environment as the primary interface between Inland Revenue and taxpayers, are key themes. Thus like the Peoples Republic of China (PRC), NZ is undertaking significant reform of the way individuals will engage with, and meet, their tax obligations.

Keywords: New Zealand, tax simplification, tax reform.

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1 Introduction

New Zealand undertook what many perceived at the time to be a radical approach to simplifying the income tax requirements for individuals, primarily wage and salary earners and those whose income is taxed at source, either through imposing a withholding tax and/or Pay As You Earn (PAYE). This reform included removal of the ability for employees to claim certain types of work-related expenditure deductions from 1 April 1988. The major reasons for removal of the ability for employees to claim deductions were to increase certainty, prevent abuse, reduce workload for the Inland Revenue, and simplify return filing while recognising employers could reimburse employees for such expenditure. Concurrent with this change, the marginal tax rates were also reduced. Some months later in October 1989, interest and dividends became subject to a withholding tax. Furthermore, the requirement for most individual taxpayers to file annual income tax returns was abolished from 1999-2000 income year.

Notwithstanding these simplification initiatives, an individual was still permitted to claim a deduction for costs incurred in the preparation of tax returns and for premiums paid for loss of earnings/profits insurance. To claim such a deduction a tax return (IR3) must be filed; however, evidence suggests few individuals make claims for insurance premiums as relatively few hold income protection policies. Individual taxpayers face progressive marginal tax rates, commencing with the first dollar of earnings (there is no tax free threshold in NZ), although rebates are used within the PAYE system to reduce effective tax rates. Parental tax credits, in-work tax credits and guaranteed minimum family income initiatives, serve to reduce the taxes on individuals and in some cases top up incomes (creating negative income tax).

If an individual has income that is not taxed at source (such as rental income) they must still file an income tax return. The self-employed, as well as those carrying on a business as a sole-trader, also must file tax returns; they can also claim their work-related expenses as deductions. It is important to state that whether an individual receives their income from activities that are taxed at source (for example, a salary), or from being self-employed (for example, as a business

consultant), or from several activities, each source of income is added and they are taxed on a progressive rate scale on their total taxable income.

A separate form for claiming rebates for payments made to approved charitable organisations and school donations (but not school fees) can be made by individuals, including non-filing taxpayers; the credit is worth 33 percent of qualifying expenditure. These rebates are available to all individuals that make such donations provided they have sufficient taxable income.

A critical distinction for individuals is whether they are employees (and unable to claim work-related expenses) or self-employed. Inland Revenue provides guidance in its Interpretation Guideline 11/01,[185] which explains how the courts distinguish between contracts of service and contracts for services. Essentially a contract of service means there is an employer-employee relationship, while a contract for services means there is a principal-independent contractor relationship. In making this determination five tests need to be applied to the facts to determine whether a person is an employee or self-employed, namely: intention; control; independence; fundamental and integration.

Furthermore, non-filing taxpayers may still be required to complete/verify a personal tax summary (PTS - also known as an income statement[186]) that has been pre-populated with information by Inland Revenue. The PTS will usually indicate that either a refund is due or there is tax to pay. While the PTS approach has considerably simplified the tax system for most individuals, it has led to many taxpayers being "over withheld". This is principally a consequence of an antiquated PAYE system, Inland Revenue's aging computer systems, and individuals having more than one source of employment income. As a result Inland Revenue has largely left it to taxpayers to determine whether they are over

[185] *Inland Revenue, Income tax; goods and services tax - determining employment status for tax purposes (employee or independent contractor), (Inland Revenue, December 2011). The leading cases are: Bryson v Three Foot Six Ltd [2005] NZSC 34, [2005] 3 NZLR 721 (SCNZ) and TNT Worldwide Express Ltd v Cunningham [1993] 3 NZLR 681 (CA).*

[186] Taxpayers' obligations with respect to income statements are set out in Part 3A of the *Tax Administration Act* 1994 (TAA).

withheld, with many choosing to engage a tax refund agency to determine this on their behalf (for a fee), rather than deal directly with Inland Revenue.

Going forward, of particular importance is Inland Revenue's Business Transformation Programme (BTP), which over the next 3-4 years should result in new and modern tax administration information system. This new system will enable earlier and more accurate determination of taxpayers that are over withheld, with Inland Revenue able to make adjustments in real time and process refunds efficiently. Overall, as a result of the reforms over the last fifteen to twenty years, most individual taxpayers in NZ whose income is taxed at source, will have little to no direct interaction with Inland Revenue.

The remainder of this paper is organised as follows. Section 2 provides a succinct summary of history of how NZ has taxed individual taxpayers as from the mid-1980s onwards. This includes those with income taxed at source and those in business or self-employed. This is followed by an examination of the situation for non-filing taxpayers, who comprise more than half of the natural persons that reside in New Zealand who earn taxable income. The paper then moves to examine future expectations as a result of Inland Revenue's BTP, focusing on how this will affect individual taxpayers. Finally, section 5 summarises the key observations in the paper and provides a brief overview of some of the key issues facing the People's Republic of China (PRC) with respect to reforming its taxation of individuals. This section, in drawing together the prior discussion reviewing the history of the taxation of individuals in NZ, offers suggestions for consideration by the PRC.

2 A brief history of the approach to taxing individual taxpayers in New Zealand

The discussion in this section is largely a descriptive chronological analysis of the major changes to taxation for individuals, both those without business income and those with business income or self-employed. A theme that should become readily apparent is that of simplification through reducing taxpayers' obligations, to the extent that for most individuals without business income (and where their income

is taxed at source), they do not need to file a tax return and consequently have minimal interaction with Inland Revenue.

Until the mid-1980s in NZ, following the introduction of the withholding system of pay as you earn (PAYE) in 1958, individuals that earned a wage or salary had tax withheld at source during the year. However, when it came to the end of the tax year, would file a tax return (IR5) to ascertain whether sufficient tax had been withheld to meet their liability for the year. A series of periodical tax deductions were introduced for salary and wage earners, which they could claim in their tax return. This included amounts for personal superannuation deductions, and certain employment expenses, up to certain limits. Those that received interest or dividend income would be liable for tax which would be determined when the return was filed and assessed by Inland Revenue. Up to this point there was no withholding tax on these forms of passive income.

For individuals that were self-employed, in business, or had significant forms of income not taxed at source (such as rents), they would need to make provisional tax payments three time during the year (in addition to a final payment), often based on a projected estimated income for the year. Inland Revenue would still be responsible for formally assessing these individuals when they filed their tax returns.

Marginal tax rates for individuals had risen to 60 percent in 1981, and when the 10 percent surcharge was added, this took the top rate to 66 percent. This tax rate also cut in at a low threshold of $NZ22,000 (equivalent to around $NZ70,000 in 2015, which is the current top tax rate threshold[187]). The environment encouraged tax minimisation, with the growth in demand for tax avoidance schemes to take advantage of concessions and reduce effective marginal rates. By 1986 the top marginal rate had reduced to 33 percent as part of a package of reform that saw the introduction of the goods and services tax (GST) at 10 percent and financial compensation for low income earners (especially those with families), through the

[187] The exchange rate for NZ dollars to the PRC's Yuan (RMB) as at 16 October 2105 was: $NZ1 = CNY4.34. Thus $NZ22,000 would be approximately: CNY95,463, and $NZ70,000 would be CNY303,746.

tax and welfare systems. Many tax concessions were removed and the tax base was broadened extensively.[188] As Vosslamber observes:[189]

> "…. *the average tax rate fell sharply during the 1980s, and a pattern of income tax at lower average rates remained for the following two decades*. The main changes that affected an employee's tax after 1990 were the reduction of the lower rate between 1997 and 2000, the introduction of the 39 per cent top marginal rate in 2000, and adjustments to the rates and thresholds of Family Support over the years. The reductions in all marginal tax rates and changes to Family Support announced in the 2010 Budget will further reduce the average tax rates at all levels of income.
>
> As for inter-personal distinctions, *the introduction and extension of Family Support significantly reduced the amount of tax paid by low and medium-income families compared with the amount paid by those on high incomes*. Further, any distinction between couples with children and singles had disappeared by the late 1980s. Vertical equity is now a factor of income level and the presence or absence of children, but not of marital status."

In relation to the size of personal tax expenditures (employee deductions), in the 1984 Budget these were estimated to be:[190]

- principal income earner - $NZ89 million;[191]
- family - $NZ197 million;[192]
- housekeeper and dependent relative - $NZ13 million;[193]
- interest and dividend $200 tax exemption - $NZ40 million;[194]
- home ownership - $NZ30 million;[195]

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[188] For discussion on the development of income tax over the period 1985 to 2010, see Vosslamber R, 'How Much (II)?: Income Taxation on Employment 1985-2010' (2011) 17(1) *New Zealand Journal of Taxation Law and Policy* 13-32.

[189] Ibid, 30 (emphasis added).

[190] Stephens R, 'Tax Reform in New Zealand', (1987) 4 *Australian Tax Forum* 327-346, at 338. At the time the NZ population was approximately 3.3 million people. It now stands at over 4.5 million.

[191] The equivalent amount in Chinese RMB is: CNY384 million.

[192] The equivalent amount in Chinese RMB is: CNY850 million.

[193] The equivalent amount in Chinese RMB is: CNY56 million.

[194] The equivalent amount in Chinese RMB is: CNY173 million.

- life insurance tax exemption - $NZ160 million;[196]
- rates - $NZ17 million;[197] and
- first home mortgage interest - $NZ65 million.[198]

Stephens observes that these tax expenditures amounted to 9.1 percent of personal income tax revenue.[199] However, since Stephens' work, none of these exemptions remain, although the life insurance tax exemption still exists for individuals that have contracts they entered into prior to November 1984. Stephens also analyses the family assistance packages included as part of the 1986 reforms. Low income earners receive rebates as part of the PAYE system that reduces their effective tax rates. Outside of these rebates, claims for allowable charitable donations and gifts (of $5 or more) remain, as did the childcare and housekeeper rebates for payments made before 1 April 2012.

Claims for charitable donations and school donations must be filed in hard copy format with the receipts attached. This provides a 33 percent credit for each dollar donated, limited only by the net income of the individual for that income year. More recently, further charitable giving may be made by way of an employer's payroll.[200] This leads to a further reduction in net earnings for employees making these contributions, adjusted for the tax value of the charitable contributions made. Thus employees would receive the tax benefit of making charitable donations immediately, and would not need to retain and provide their receipts as this process is managed by their employer.

One may summarise the reforms of the 1984 Labour Government as representing a new approach to tax policy, the Broad Base Low Rate (BBLR) approach. BBLR in principle is a simple, understandable and coherent framework that is intended to

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[195] The equivalent amount in Chinese RMB is: CNY129 million.

[196] The equivalent amount in Chinese RMB is: CNY690 million.

[197] The equivalent amount in Chinese RMB is: CNY73 million.

[198] The equivalent amount in Chinese RMB is: CNY280 million.

[199] See Stephens, above n 6, at 338.

[200] Payroll giving was introduced from January 2010. Where it is offered by an employer (and who files their employer monthly schedule electronically), this gives an individual taxpayer the opportunity to donate to approved donee organisations direct from their wage or salary and receive immediate tax credits that reduce the amount of PAYE payable. Thus the individual does not need to wait until after the end of the income year to claim their tax credit.

lead to all areas of the economy being taxed reasonably consistently.[201] As a result it generally reduces economic distortions and keeps administrative and compliance costs lower. However, practical realities necessitate that the most efficient revenue generating taxes are not applied, such as tailoring tax rates and the like to individual taxpayer's circumstances. Overall, BBLR is seen as good as any other way of structuring a tax system that NZ has available, although it could be improved 'around the edges', such as by the introduction of a capital gains tax. It balances efficiency, fairness, compliance costs and administration costs, and has been endorsed by various tax reviews.[202] BBLR has remained operative, but with minor modifications to the tax mixes and rates, notwithstanding changes in the governments in NZ since 1984.

For work related expenses, the approach NZ has taken is to remove the ability for any such expenses to be deductible for wage and salary earners. Before 1 April 1988, a taxpayer who derived income from employment was able to claim a deduction for the greater of: 2 percent of employment income for the income year or $52, whichever was the lesser; and actual expenditure or losses incurred during the income year in earning their employment income. From 1 April 1988, the range of employment related expenses that were deductible under the former Income Tax Act 1976 (NZ), ceased to be deductible. This included: books and periodicals, club subscriptions, entertainment expenses, home office expenses, occupational clothing, self-education expenses, tools, travel expenses, union subscriptions, and miscellaneous expenses required by employment. This change came with a substantial reduction in income tax rates being made at the same time. Again, this is an instance of a package approach to tax reform.

Veal states that the reasons for the removal were:[203]

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[201] This discussion on the BBLR is based upon a presentation by a senior NZIR official: Carrigan D, 'Tax administration reform – retaining a coherent tax policy framework through change', *Tax Administration Conference* (NZIR, June 2014). See further Ryan A, 'Tax Reform in New Zealand: The Shape of Things to Come in Australia?', (1999) *Review* (March) 6-8.

[202] See for example, McLeod R et al., *Tax Review 2001*, NZ Government, 2001; and The Centre for Accounting, Governance and Taxation Research, "VUW Tax Working Group", <http://www.victoria.ac.nz/sacl/cagtr/twg>

[203] Veal J, 'Should employees be able to claim deductions?', (2012) 91(9) *Chartered Accountants Journal* 79-80, at 79.

- increasing certainty in the tax system;
- preventing abuse by people wrongly claiming deductions;
- removing undue work for Inland Revenue checking deductions claimed;
- simplifying employee return filing; and
- recognising the employer's responsibility to reimburse employee expenditure.

These factors were thought to outweigh fairness considerations. Veal argues that on the grounds of equity, the current working environment in NZ, the basic principles of deductibility, anti-discrimination reasons, and the fact that other countries allow such deductions, make a strong case for removing the prohibition. The arguments against removing the prohibition (increased certainty, simplification, lower administrative costs and employer reimbursement responsibility for such expenses), are not viewed as sufficiently strong to outweigh the arguments for allowing a deduction for such expenses. Veal concludes:[204]

> "The need for equity and changes in the work environment are compelling arguments for the reintroduction of employee deductions. The reasons why employee deductions were repealed in the first place seem invalid or irrelevant in the modern context. It is suggested that serious consideration be given to changing the law to allow employee deductions and bring New Zealand into line with other countries."

Furthermore, James et al observe:[205]

> "The removal of the deductibility of working related expenses to an extent even greater than in the UK has the benefit of greatly simplifying tax administration. Also, as in the UK, it has helped to remove the need for many taxpayers to complete a tax return. In New Zealand individuals are only required to file a tax return (IR3) if they have earned income other than salary, wages, interest, dividends, and/or taxable Māori authority distributions. This is a major difference between New Zealand and the

[204] Ibid, at 80 (emphasis added).

[205] James S, Wallschutzky I, & Alley C, 'The Henry Report and the Taxation of Work Related Expenses: Principles versus Practice', (2013) 11(2) *Journal of Finance and Management in Public Services* 46-58, at 54-55 (emphasis added).

present situation in Australia where the Australian Act basically requires everyone lodge a return. …

"To claim these deductions in NZ an IR3 Individual tax return must be completed. Few if any salary and wage earners with all income tax deducted at source by PAYE or resident withholding taxes would bother. This might again indicate that this is not an issue of great importance to many New Zealand taxpayers. In fact for many salary and wage earners in New Zealand it is a relief that they cannot claim a tax deduction as they no longer feel the need to prepare and file a tax return. For some the cost of preparing the information and of employing assistance to file the return would be greater than the tax advantage of the minimal deduction that could be claimed. There is also the feeling that the least communication with the Inland Revenue Department, the easier on the psychological outlook of the taxpayer."

As a result, in NZ individuals who earn their income from salaries and wages (employment income), are treated differently from individuals who have investment, rental or business income in regard to deductions; the former cannot claim them, while the latter can through their IR3 tax return. The prohibition on employee deductions continues today under the Income Tax Act 2007.

The provisional tax regime that applies to individuals with business or self-employment income (as well as for most entities, such as companies) was enacted in 1988; shortly thereafter it was comprehensively reviewed in late 1989. The review included introducing a withholding tax on interest and dividends, which removed many elderly and other individuals from being provisional taxpayers as their interest income was now taxed at source. The threshold of residual income was reduced from $NZ3,000 to $NZ2,500.[206]

[206] See further, David Caygill (Minister of Finance), *Consultative Document on Tax Simplification* (NZ Government, December 1989). These figures equate to CNY13,018 and CNY10,848, respectively.

In September 1990, the Tax Simplification Consultative Committee (TSCC), chaired by John Waugh, released its final report.[207] The recommendations included removing a further 233,000 taxpayers (approximately 20 percent of individuals filing returns) from paying provisional tax, simplifying tax payments and reducing the number of tax payment dates. A simplified IR5 return would be available for those with only salary and wages, dividends and small amounts of interest. Of the numerous recommendations, the vast majority were accepted by the NZ Government and subsequently acted upon. As noted by the TSCC's chair, simplifying the tax system is not a one-off exercise. There needs to be an ongoing commitment by the NZ Government and Inland Revenue to all aspects of tax simplification, as well as compliance cost reduction.

Other changes, subsequently enacted, include removing the requirement that IR5 taxpayers re-confirm PAYE tax codes annually, and increasing the non-filing income threshold from $NZ20,000 to $NZ34,200.[208] These changes were largely supported by improvements in technology, including more widespread and accurate withholding of tax at source. New Zealand's relatively flat income tax rate structure facilitated more accurate withholding. This non-filing threshold was later increased to $NZ38,000[209] (the lower boundary for the top marginal tax rate in the 1997-98 income year).

Further plans to simplify the tax system with respect to provisional tax and IR5 tax returns were released in August 1996.[210] Major changes to reduce the financial cost for provisional taxes were proposed (and implemented) to provide safe harbours and reduce the impact of use of money interest (UOMI) for late payment of taxes.[211] The non-filing income threshold was increased with effect from the

[207] Waugh J et al., *Final Report of the Tax Simplification Consultative Committee* (NZ Government, September 1990).

[208] These figures equate to CNY86,785, and CNY 148,402, respectively.

[209] This figure equates to CNY164,891.

[210] Bill Birch (Minister of Finance) and Peter Dunne (Minister of Revenue), *Tax Simplification Issues: Provisional Tax, IR5 Returns* (NZ Government, August 1996).

[211] For further details on UOMI, see <http://www.ird.govt.nz/how-to/debt/penalties/interest/interest-overview/interest-rates.html>

1998-99 income year, from $NZ38,000 to $NZ45,000,[212] for taxpayers who had elected to apply a 33 percent withholding rate (the top marginal rate) to their interest and any secondary employment income. Importantly, a further increase in the income threshold would be considered once an impact assessment of the proposed supporting measures had been undertaken subsequently. The obligation to file an IR5 return would be removed for those people who:[213]

- receive family support, or are partners of taxpayers who receive family support, and who also meet the other non-filing criteria, and/or
- have student loan repayment obligations by including the income information currently contained in the IR5 return in the family support and student loan forms.

Importantly, to prevent over withholding adversely affecting an individual taxpayer, the right to file for those affected by the non-filing requirements would remain. This would ensure that taxpayers do not pay more tax than they are required to under the law. A simplified IR5 return was proposed with less calculations and requests for information made only once. Overall compliance costs were expected to fall. The proposals indicated that the PAYE and resident withholding tax (RWT) systems deduct, on average, not less than 97.62 percent of a taxpayer's tax liability during the year.[214] It was also clear that the PAYE and RWT systems tend to be slightly more inaccurate at lower income levels. Similarly, the data suggested that there was a tendency towards under-deducting tax when income levels increase, as evidenced by the decreasing ratio of those over-deducted to those under-deducted. Thus for this group, the requirement to file an IR5 would remain.

In December 1997, a further government discussion document was released, directed at introducing further significant simplification for individual taxpayers in

[212] The new upper bound figure equates to CNY195,265.

[213] See Birch, above n 26, at para 3.16.

[214] Ibid, at para 3.10.

particular.[215] The key proposals, which were subsequently enacted, included eliminating IR5 tax returns, creating new income statements from which information sourced from employers (and other payers of sourced taxed income, such as interest and dividends), would be prepared and sent to certain taxpayers (such as those with student loans or who received family assistance). This would mean about 800,000 of the remaining 1.2 million individuals that filed an IR5 return would no longer have to file a tax return.

Donation and childcare/housekeeper rebates would be claimable by a separate return, for which receipts had to be attached. The last remaining significant expense that some individuals who filed an IR5 return could claim (namely fees paid to an agent to complete the taxpayer's return) would be removed, but taxpayers could advise Inland Revenue (and by providing the supporting documentation), their income statement would be amended to accommodate these expenses. One remaining expense that could still be claimed, where applicable, involved premiums payable for income protection insurance. Again taxpayers would also need to advise Inland Revenue and provide the supporting documentation. Several years earlier the standard deduction was removed and integrated into the tax rate structure.

Certificates with a summary of the individual's earnings for the income year can be requested. The PAYE system would be improved so as to more accurately withhold tax on salaries and wages, along with the RWT system. Again, enhanced technology, plus a desire to reduce compliance costs, was central to facilitating these reforms. For the remaining 400,000 non-business or self-employed individuals, they would need to check their income statement. These reforms were phased in over the period 1 April 1999 to 1 July 2001.[216]

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[215] Winston Peters (Deputy Prime Minister and Treasurer) and Bill Birch (Minister of Finance), *Simplifying Taxpayer Requirements* (NZ Government, December 1997).

[216] See further, Sawyer A, 'Is the End of Filing Returns Nigh for New Zealand Salary and Wage Earners?', (1998) 16 *Tax Notes International* (April 13) 1128-1129.

In August 1998, the NZ Government released its proposals to formally introduce self-assessment.[217] The proposals would ensure that the current practice of taxpayers self-assessing themselves when they file a return was reflected in the tax legislation. Coupled with this were changes introduced in prior years, including more severe penalties, a new disputes resolution process, commencement of a rewriting of the Income Tax Act, and a system of binding rulings.[218] This self-assessment project introduced further changes, including a reduction in the period for which taxpayers could request a refund (down from 8 years to 4 years). While individual taxpayers that were non-filing would not be affected, those with business income would need to take account of these changes.

The Tax Review 2001, set up in 2000 by the NZ Government of the time, encompassed an analysis of the tax bases, taxable unit, and tax rates as part of its brief.[219] None of the recommendations that directly affected resident individuals were taken up by the NZ Government.

The next major stage in tax reform benefiting individuals was proposed in June 2010 and subsequently enacted.[220] A major proposal was to reduce reliance on paper-based forms and returns through making Inland Revenue's website the major interface for individual taxpayers. Furthermore, for many individuals, PAYE would be treated as a final tax, provided the PAYE rules produced accurate outcomes. For example, where an employee held the same role(s) for 11-12 months a year, then the PAYE system would normally be sufficiently accurate. If an individual taxpayer changed their employment, or received additional income, such as rents, then they would still need to square-up their non-wage and salary income at year-end. Enhanced information exchange between government departments and ministries would be supported by way of enabling legislation.

[217] See Bill Birch (Treasurer and Minister of Finance), *Legislating for self-assessment of tax liability* (NZ Government, August 1998).

[218] These legislative changes were recommended by Rt. Hon. Sir Richardson, *Organisational Review of the Inland Revenue Department, Report to the Minister of Revenue and the Minister of Finance*, (Inland Revenue, April 1994).

[219] See McLeod et al., above n 18.

[220] Bill English (Minister of Finance) and Peter Dunne (Minister of Revenue), *Making Tax Easier* (NZ Government, 2010).

Those receiving social assistance would also need to complete a year end square up.

The income statement (PTS) would be the mechanism used for the year end square up. Where taxpayers have determined they are due a refund, they can request their PTS, and once the balance is confirmed, they would be entitled to their refund. However, as a result of the growth of the tax refund organisation industry, it was proposed that individuals would no longer be able to 'cherry pick' which years they request/confirm their PTS to be those years when they expect a refund. A PTS would need to be confirmed for each of the previous four years. This change was due to commence from the start of the 2016-17 income year. Refunds less than $NZ200 would be issued automatically, while refunds of more than $NZ200 would be issued once a taxpayer has confirmed their PTS.[221] However, the requirement to request a PTS for the prior four years has been recommended by the NZ Parliament's Finance and Expenditure Committee (FEC) not to be implemented.[222]

In summary, NZ has moved from a system of paper-based return filing for all individuals that have earned taxable income, to one where the majority do not file a return, and potentially do not need to confirm information in a PTS. Nevertheless, all individuals governed by the PTS rules[223] should check their summary of earnings, and can use Inland Revenue's online calculators to determine whether they are due a refund or have tax to pay.[224] An income statement (PTS) acts as a deemed return and assessment for affected taxpayers. Of those that still do need to file returns, namely those individuals in business or self-employed, the IR3 can be completed online with pre-populated information. IR3 taxpayers can still claim

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[221] Further details concerning PTS are available on Inland Revenue's website at: <http://www.ird.govt.nz/income-tax-individual/end-year/pts/>. The equivalent amount is: CNY868. This threshold is proposed to be increased to $NZ600 (CNY2,604) by the Taxation (Transformation: First Phase Simplification and Other Measures) Bill 2015. Furthermore, under the proposed changes, earlier tax refunds based on PTSs that meet the automatic refund threshold will have the waiting time reduced from 30 days to 15 days. Collectively approximately 400,000 people will benefit from these changes.

[222] See Officials' Report to the Finance and Expenditure Committee on Submissions on the Taxation (Annual Rates for 2015–16, Research and Development, and Remedial Matters) Bill, page 91.

[223] See Part 3A Tax Administration Act 1994 (TAA).

[224] The 2015 PTS online calculator is available at: <http://www.ird.govt.nz/calculators/tool-name/tools-p/calculator-pts-calculator-2015.html>.

their expenses and will need to either file a set of financial statements, or complete Inland Revenue's IR10 financial statement summary.[225]

3 Non-filing taxpayers – a review and look forward

While the discussion in the previous section highlights significant changes with respect to the filing and payment obligations of individuals (including those in business and/or self-employed), the most 'radical' are those for the non-filing taxpayer whose various forms of income are taxed at source. Most jurisdictions require returns to be filed by those with income not taxed fully at source, or if financial statements are required to detail how taxable income is calculated. For these taxpayers, under self-assessment, the process has placed greater obligations on them to correctly calculate their tax, although the compliance process has been streamlined with the aim of reducing taxpayers' compliance costs.[226] Greater use of technology has been important in this regard.

What the current author sees of more interest to other jurisdictions, such as the PRC, are the initiatives put in place for increasing the number of non-filing individual taxpayers. Before analysing what the future holds, it is useful to set out how the concept of a non-filing taxpayer is defined. Section YA 1 of the Income Tax Act 2007 sets out the definition:

> **non-filing taxpayer means—**
>
> (a) a person to who section 33A(1) [s 33AA] [227] of the Tax Administration Act 1994 applies and to whom 1 of the following applies:
>
> (i) they do not receive an income statement for a tax year; or

[225] See further: <http://www.ird.govt.nz/forms-guides/number/forms-001-99/ir010g-guide-ir10-2015.html>.

[226] See Gupta R & Sawyer A, 'Tax Compliance Costs for Small Businesses in New Zealand: Some Recent Findings', (2015) 30(1) *Australian Tax Forum*, 135-177. See also Inland Revenue, *SME Compliance Costs 2004 to 2013* (Inland Revenue, June 2014); available at: <http://www.ird.govt.nz/resources/b/f/bf71a8eb-a68d-40f9-9248-3826cf0b782f/sme-tax-compliance-costs-2004-2013-evaluation-report-2.pdf>.

[227] A new s 33AA TAA replaces s 33A TAA as from the 2016-2017 income year (commencing 1 April 2016 for most individual taxpayers).

(ii) the Commissioner is not required to send them an income statement for a tax year; or

(iii) the Commissioner is prohibited from sending them an income statement for a tax year; or

(b) a person whose only income having a source in New Zealand is schedular payments derived in the person's capacity as a non-resident entertainer and who chooses not to file a return for the relevant tax year; or

(c) a person who, in the relevant tax year, derives only non-resident passive income to which section RB 3 (Schedular income tax liability for filing taxpayers for non-resident passive income) applies.

The Taxation (Annual Rates, Returns Filing, and Remedial Matters) Bill (TARRFRM Bill), as introduced in 2012, contained three proposals to simplify the income tax filing requirements for individuals. These were:

- Amalgamating the two main income tax return forms for individuals: the income statement, also known as the personal tax summary (PTS) and the IR3 form. The TARRFRM Bill achieved this by removing the requirement for the Commissioner of Inland Revenue to issue PTSs to certain taxpayers;
- Requiring individuals who are not required to file a tax return, but who choose to do so anyway, to file tax returns for the previous four tax years, in addition to the year in which they have chosen to file; and
- De-coupling the requirement for individuals to file an income tax return (usually a PTS) merely because they receive Working for Families tax credits (and other forms of income support).

The TARRFRM Bill was amended prior to its enactment[228] in order to remove the proposal that would have had the effect of amalgamating the two main tax return forms for individuals. This proposal was removed to allow Inland Revenue to makes changes in a way that is less resource-reliant and system-reliant. Thus the two returns of income forms for individuals, the IR3 and the PTS, will continue to be used.

Furthermore, a new section 33AA TAA 1994 is expected to take effect from 1 April 2016, which is the start of the 2016-17 income year for most individuals. As part of drafting the amendments to give effect to the proposed amalgamation of the two main income tax return forms, section 33A TAA has been rewritten. A new section 33AA TAA has been drafted and is based on the premise that section 33 TAA requires that all taxpayers must file an income tax return. Furthermore, the new s 33AA TAA clearly identifies the individuals that are not required to file an income tax return, as well as not being issued or being required to request a PTS from Inland Revenue.

Overall, the majority of individuals in NZ do not need to file a tax return or complete a PTS if their income is taxed accurately at source. A PTS will need to be completed should there be incorrect withholding, with individuals able to request refunds. However, as from the 2016-17 income year, they will need to request a PTS for the four income years, which may give rise to amounts of tax to pay. For those that have income that is not taxed at source which is over the de minimis threshold, they will need to complete an IR3 return (preferably electronically) and file this with Inland Revenue. Those taxpayers that receive income support through the tax system will still need to complete a PTS or IR3 return for a square up/determination of their final tax liability.

A major compliance cost reduction feature for non-filing taxpayers is that they only need to keep records for 12 months after the end of the income tax year, rather than the normal seven years for other taxpayers, including individuals that must file tax

[228] See Taxation (Annual Rates, Returns Filing, and Remedial Matters) Act 2012, section 177.

returns. Records may be kept electronically provided they can be readily reproduced in hard copy format.[229]

One further issue of interest is the future of the numerous tax refund organisations that operate in NZ. The number of tax refund organisations is extensive, comprising 13 companies as at April 2014,[230] with the earliest commencing its operations in 2006, and the most recent in 2013. One important issue with these tax refund organisations is that almost all remain the agent of a taxpayer until the taxpayer advises the refund organisation or Inland Revenue otherwise. Thus taxpayers may continue to incur compliance costs by way of fees paid to their 'agent' (usually deducted from any refund due) when they request a PTS. If there is tax to pay, the refund organisation would not normally request a PTS on behalf of their 'client', although law changes (facilitated by the BTP) will see a gradual increase in the number of years that a PTS will be received for prior years. As noted earlier, taxpayers will no longer be able to 'cherry pick' the years they believe that they are due a refund and request a PTS for those years' only.

4 Inland Revenue's Business Transformation Programme (BTP) – What does the future hold?

In June 2014, Inland Revenue hosted a conference during which it set out its vision for tax administration in the 21st Century,[231] and invited comment from across the various sectors (including tax professionals, corporates, other government departments, academics, and various welfare agencies). Major changes proposed include improving the accuracy and efficiency of PAYE collection, resident withholding tax (RWT) collection and social policy, all of which would at least indirectly affect individual taxpayers. The most pertinent proposals are those directed at individual taxpayers, where the vision is to tax individuals using the following as a framework:[232]

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[229] See s 22 TAA. See also the Electronic Transactions Act 2002.

[230] Sluka K, 'Taxing Times: We can't avoid death and most of us can't avoid taxes. But should you avoid tax refund companies?', (2014) *Consumer* (Issue 545 - April) 11-13.

[231] See Inland Revenue, *Tax Administration for the 21st Century: A policy vision: An officials draft working paper*, Tax Administration for the 21st Century, Working Paper No 1 (2014).

[232] Id, at 15.

- provide a high level of certainty for taxpayers;
- provide for a low cost of contact for all parties, including Inland Revenue, individuals and third parties (for example, employers);
- be designed for a digital world, not a paper world;
- work in a way that efficiently allows for the recovery of debts, not just refunds;
- provide for one process that applies for all individual taxpayers, regardless of different information requirements; and
- be flexible enough to allow future changes.

This is dependent upon first improving the PAYE and RWT systems, and enhancing the potential of technology improvements. The policy is also premised on an electronic filing system that is pre-populated by timely and accurate withholding systems. In particular:[233]

> "In short, the focus would be on *making "filing" simpler and less onerous for individuals' tax obligations using pre-population, better technology and the use of "rolling balances"* (for example, income tax). A "rolling balance" could allow Inland Revenue to automatically adjust withholding rates to collect prior underpayments of tax."

The objective could be facilitated through individual taxpayers having a personalised webpage containing this information. The key benefits from Inland Revenue's perspective are:[234]

- greater fairness and transparency;
- simplification of withholding regimes;
- improved automation of debt collection;
- flexibility for dealing with future policy changes, and future opportunities to support all-of-government outcomes;

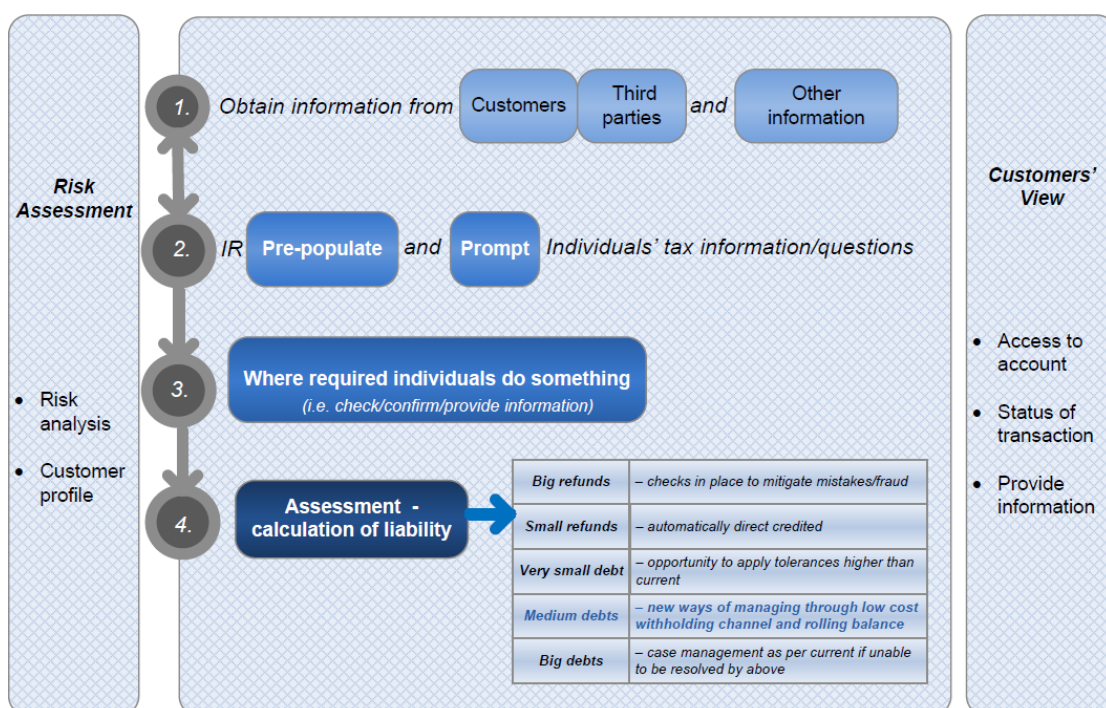
[233] Id, at 16.

[234] Id, at 17.

- administration efficiencies (for example, less "exception" processing) and lower taxpayers' compliance burden over time; and
- better use of information and data across government (both internationally and nationally).

This working paper also contains a conceptual view of the proposals, and a high level worked example, as set out in Figure 1:[235]

Figure 1: A Conceptual view of Individuals' income tax in the future



Overall, the intention is to reduce the number and cost of the square up process after year end, enhance the accuracy of withholding, and use pre-population of information in tax returns and PTSs. Furthermore, an examination of the role and costs associated with individual taxpayers interacting with Inland Revenue's systems, including the *My IR* website,[236] are critical factors in the BTP.

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[235] Id, at 18-19.

[236] See <http://www.ird.govt.nz/online-services/ir-online-services-register.html>.

Subsequent to the 2014 Tax Administration Conference four consultation documents have been released as at the time of writing. One consultative document provides an overview of the digitalisation process and is only of indirect relevance to individual taxpayers.[237] The second (a Green Paper) sets put the broad vision for the BTP over the next four to five years.[238] It represents the NZ Government's initial thinking which may be refined as the BTP takes shape. In relation to individuals, especially those not in business or self-employed, the NZ Government sees the future potentially as follows (first for employers and business, then for individuals):[239]

> *"What it could mean for employers and businesses*
>
> - Tax compliance costs would be reduced, in particular for small and medium enterprises.
> - Speed and predictability for businesses in their tax affairs, making compliance easier.
> - Making tax obligations part of the normal day-to-day business processes, making it harder to get things wrong.
> - Simplified calculations for provisional tax – based more on real-time information (for example, when using approved accounting software) – together with payment options that better reflect taxpayers' cash flows. ….
>
> *What it could mean for individuals*
>
> - You would be able to quickly and easily manage your tax obligations online.
> - Refunds would be made quickly and automatically based on better use of data.

[237] Todd McClay (Minister of Revenue), *Making Tax Simpler: Better Digital Services – A Government discussion document* (Inland Revenue, March 2015).

[238] Bill English (Minister of Finance), Todd McClay (Minister of Revenue), *Making Tax Simpler: A Government Green Paper on Tax Administration (Inland Revenue*, March 2015).

[239] Id, at 3-4 (emphasis in bold added).

- Any outstanding tax debts would be recovered automatically over time, where appropriate."

The *Green Paper* suggests that the main points made by attendees at the 2014 Conference were:[240]

- "giving people the ability to self-manage their tax affairs with more speed and predictability but with access to the right staff at the right time with the necessary skills to provide certainty to taxpayers. In other words, *Inland Revenue should use new technology to allow more focus on high-value services to taxpayers, to help them manage their tax affairs*;
- *the need to consider policy and legislative settings (and not merely current business processes) to rethink how tax administration can be improved*. It is more than just digitising existing processes and replacing an aging information technology system. Anything within the tax administration system should be up for consideration;
- the *importance of involving businesses, other customers, third parties and advisors in the design of the rules and processes that underpin tax administration*. The tax administration system has to work for all New Zealanders;
- the cost of change needs to be closely considered and managed to ensure that it is not merely shifting costs from Inland Revenue to businesses and other customers or vice versa. There has to be an overall net benefit to society through a real reduction of compliance and administrative costs; and
- ensuring that there is continued maintenance of the tax system while modernising tax administration."

On 11 November 2015, the Minister of Revenue released for public consultation two sets of policy proposals for simplifying tax administration:[241]

[240] Id, at 2 (emphasis added).

- *Making tax simpler – Towards a new Tax Administration Act*
- *Making tax simpler - Better administration of PAYE and GST.*

In addition to these two discussion papers, the Minister released a summary of public feedback received from the first round of public consultation: *Making tax simpler - Green paper and Better digital services: summary of feedback.*

These documents comprise the second round of the NZ Government's Making Tax Simpler consultation series that commenced in March 2015. The first mentioned discussion document looks at the Tax Administration Act 1994 (TAA) and how the current system might be made simpler for all and more flexible for the future. In relation to reviewing the TAA, the Minister stated:[242]

"It looks at the role of the Commissioner of Inland Revenue, how taxpayer information can be used more efficiently to provide better services for New Zealanders, and the role of taxpayers and third parties."

In relation to the second discussion paper, the focus is on how the NZ Government and Inland Revenue can make PAYE and GST systems fit with business processes rather than the current approach which expects business to adapt to Inland Revenue's systems. In particular, the proposed changes to GST relate to digital filing to reduce time and cost to businesses. The proposal is to enable businesses to complete their GST returns directly through the accounting software packages that many of them use, rather than making them file separate GST returns. In relation to PAYE, the proposal is to allow employers to carry out their PAYE obligations when they pay their employees, rather than at a separate time required by Inland Revenue.

The Taxation (Transformation: First Phase Simplification and Other Measures) Bill 2015 (the Bill), which was introduced to the NZ Parliament on 30 June 2015, passed its first reading on 13 October 2015. The Bill proposes changes as part of

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[241] McClay T, 'Second round of simplification proposals launched', (2015) Media Release (November 11); available at: <http://taxpolicy.ird.govt.nz/news/2015-11-11-second-round-simplification-proposals-launched>.

[242] Ibid.

the staged roll-out of Inland Revenue's BTP. Changes proposed in the Bill will allow modern electronic communication technologies to be used in place of current paper-based requirements for certain Inland Revenue communications with taxpayers and tax agents. Further provisions include enhanced information sharing between government departments; changes to allow earlier tax refunds for taxpayers with PTSs that meet the automatic refund threshold, are intended to refine interactions between Inland Revenue and taxpayers. The Bill is expected to be enacted in the first half of 2016.

New Zealand is not alone in significantly modernising its tax administration processes. A similar approach to Inland Revenue's BTP is underway in the United Kingdom (UK) where greater use of technology, simplification and targeting of non-compliers are key themes.[243] It would appear that the focus is narrower in the UK, with less emphasis on enhanced information exchange between government departments, but increased targeting of tax noncompliance is anticipated.

Thus the future of the return filing approach and interactions with Inland Revenue for individual taxpayers in NZ is still not sufficiently clear to enable a precise assessment to be made of how individual taxpayers will meet their tax obligations. What does seem certain is that this future will be premised on greater use of technology, less reliance on paper-based communication, greater accuracy and timeliness of information collected, and less need for taxpayers who are not in business or self-employed to undertake a square up after year end. Individual taxpayers in business will still be filing returns (normally electronically), keeping electronic copies of records, and completing financial statements in accordance with Inland Revenue's requirements.[244]

5 Concluding observations, implications for the peoples republic of china, limitations and areas for future research

This paper provides a chronological analysis of the major steps that have taken NZ from an almost closed economy with strict political controls, in 1984 to one with a

[243] HM Revenue and Customs, *Building our Future: Transforming the way HMRC serves the UK* (July 2015).

[244] See further <http://www.ird.govt.nz/yoursituation-bus/running/recordkeeping/financial-reports.html>.

very open market economy that has embraced radical tax reforms. These reforms have involved individual taxpayers, both those with income that is taxed at source and those in business or self-employed. Themes to emerge have been 'radical' reforms aimed at simplifying return filing obligations, including a gradual process of removing the need for IR5 taxpayers to file a tax return, and in time, for individuals to complete a PTS. The ability for individuals to file a return or request a PTS has remained, although requests will now require the individual to file a return or request a PTS for the previous four income years. Enhanced use of technology has seen a move away from paper-based communication to electronic platforms, including potentially at some future time under the BTP, a personalised webpage for every taxpayer. As an initiative to reduce compliance costs, non-filing taxpayers only need to retain their records for 12 months, not seven years.

Enhanced withholding accuracy and more user friendly interfaces should see a large reduction (and possibly elimination) of the various tax refund organisations that assist taxpayers in securing their refunds in return for a share of that refund (or fixed fee). Also, for individuals that are not required to file, they may still claim a rebate (tax credit) for approved charitable donations and for school donations made through filing a separate form (IR526). Currently this must be filed in hard copy format with the receipts attached.

For individuals receiving financial support through the tax system, such as parental tax credits, in work tax credits and guaranteed minimum family income (Working for Families), they are still required to complete a PTS even if otherwise they would not need to file. In this area family income is the basis for determining eligibility for Working for Families financial assistance. This is an area that is expected to be refined further as part of the BTP.

Individuals that need to file an IR3 will predominantly complete these online and provide a simplified financial statement format (IR10). Furthermore, efforts at reducing compliance costs have been ongoing, including making the process of determining one’s taxable income less complex. However, where individual taxpayers operate complex businesses, or have overseas income, their compliance

obligations remain onerous, and in most instances, require hiring a tax practitioner to assist with completing their tax returns.

The PRC, as the author currently understands it, uses a combination of global and scheduler taxation by which a number of taxes are imposed.[245] This is seen as a transitional measure but it is creating a number of significant inequities.[246] Of the eleven schedules, Numbers 1, 2 and 4 are the most relevant to this research, namely: *Wages and salaries*; *Business and production income of industrial and commercial households*; and *Personal services*. This creates a number of challenges, including horizontal and vertical inequities, as well as the risk of multiple tax liability on the same income, different rates applied to taxpayers with the same level of income, and sources of income that are not included on any schedule (and hence not taxed). New Zealand adopted a similar practice in the past for determining income that would be taxed, and still applies this concept with respect to the tax rates that apply to certain types of income (as withholding rates or final taxes on certain forms of passive income for non-residents).[247]

The PRC's personal income tax regime is characterised by relatively high marginal tax rates at the top end of the income distribution, especially for employment income, but also by a high basic allowance and broad tax brackets.[248] Overall, this means that the great majority of employees in the PRC do not pay PIT. Furthermore, the author understands that the PRC does not provide family-based standard tax reliefs. Personal income taxes are assessed on a monthly basis instead of an annual basis as is the case in NZ and most OECD countries. Collectively this increases the level of compliance and administrative costs.

[245] See Sharkey N, 'Simplicity in the Chinese Context: The categories of Differential Income Tax treatment and their Complications', in James S, Sawyer A & Budak T (eds), *The Complexity of Tax Simplification* (Palgrave MacMillan, UK, November 2015).

[246] See further, Jin D, 'Comments by Researchers from Chinese Government-Think-Tanks: The Reforms of Individual Income Tax still have a Long Way to Go', (2012) 2(1) *Journal of Chinese Tax and Policy* 21-26, at 25-26.

[247] See Income Tax Act 2007, Schedules 1 to 6.

[248] See further, Brys B, Matthews S, Herd R & Wang X, 'Tax Policy and Tax Reform in the People's Republic of China', (2013) *OECD Taxation Working Papers No 18* 30-46.

A further perceived defect with the individual tax system in the PRC is the deduction system that allows a fixed deduction against certain taxable items (currently RMB3,500[249] p.a. for local citizens). This does not take into account an individual's basic living expenses, leading to further inequity. Other defects include an inequitable allocation of the relative share of individual income tax paid between the poor and wealthy, the complexity of the progressive rate system, and application different progressive rate structures for types of income earned:

- For wage and salary earners there are seven rates (ranging from 3 to 45 percent);
- For those with income from personal services the rate is fixed (at 20 percent); and
- For those in industrial and commercial households there are five rates (ranging from 5 to 35 percent).[250]

Apart from the issue of what is an appropriate level of progressivity of marginal tax rates, these inequities could largely be overcome by applying the same rates irrespective of the nature or source of income earned by individuals in the PRC. Furthermore, promotion of individual income tax self-assessment is seen as fundamental to supporting a combined schedular and global income tax policy.[251] For the PRC going forward, Jin states:[252]

> "In other words, in the past 15 years, the individual income tax rate is becoming *increasingly flat, lower and simpler*; it has become the reform and development trend of the individual income tax in each country. *China will follow the trend of the international tax reform, lowering the tax rate and brackets as well as broadening the tax base.*"

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[249] The equivalent amount would be NZ$807.

[250] See further Zhang Y, 'Individual Income Tax Reform and Wealth Redistribution in China', (2014) 7(4) *Journal of Politics and Law* 112-119. See also, Deloitte, *Taxation and Investment in China 2015: reach, relevance and reliability* (Deloitte, DTTL-UK, 2015).

[251] See Jin, above n 62, at 26.

[252] Ibid, at 26 (emphasis added).

The PRC's leaders on 30 June 2014 endorsed a programme of reform to the country's tax system, amongst other areas of reform. The objectives for fiscal and tax reforms in the PRC's Third Plenum decisions are:[253]

> "Public finance is the foundation and a critical pillar for state governance. A scientifically designed fiscal and tax regime is the institution that guarantees resource allocation optimization, market unification, social equality, and long-lasting security and peace for a nation."

As part of ongoing reform, the PRC is trialling income tax deductions for individuals with respect to health insurance premiums, up to RMB2,400 p.a. (maximum RMB200 per month[254]). Pilot areas include Beijing, Shanghai, Tianjin and Chongqing.[255] As noted earlier in this paper, NZ previously allowed deductions for superannuation but has not permitted deductions for private healthcare insurance premiums.

Overall, the approach taken in NZ offers a unique perspective for the PRC as it contemplates how it can include more of its citizens as income tax payers, and the associated issues with regard to determining the accuracy of their tax liability. The analysis suggests that a move away from schedules may be needed, as will greater investment in technology. In this regard the BTP, as well as similar projects in other jurisdictions (such as the UK), should be closely monitored by the PRC, especially by the State Administration of Taxation (SAT).

This paper has a number of limitations, the most important being the comments reflect those of an 'outsider', rather than someone closely involved with the PRC's political activities and legislative processes. That said it is an advantage, in that being an outsider, one is more freely to offer a perspective without the limitations of secrecy and restrictions on publicly commenting on matters of national

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[253] See The World Bank (Beijing), *China's Economic Update: Special Topic – An Update of China's Fiscal and Tax Reforms* (World Bank, October 2014). The material in the World Bank's report is drawn from the Communist Party's Third Plenum of 18th Central Committee, the revised Budget Law, the State Council 2014/43 on strengthening the subnational debt management, and the State Council 2014/45 the decision on deepening the reform of budget management system.

[254] The equivalent amounts would be NZ$553, and NZ$46, respectively.

[255] See EY, 'China: Pilot Individual Income Tax Policy for commercial health insurance' (2015) *HR and Tax Alert* (June 2015).

importance associated with one's occupation, particularly as a government official or someone closely aligned with the jurisdiction.

A more significant limitation is that NZ's tax reforms with respect to the taxation filing and associated requirements of individuals, under the BTP, has to date taken only the first tentative steps. Thus this paper by no means seeks to be the final word as the issues addressed remain in a state of flux as at the time of writing. Furthermore, this paper has focussed on the income tax only, and not considered the impact of other taxes on individuals, especially GST for those individuals in business or self-employed.

Future research with regard to NZ should analyse the ongoing work of the BTP and assess its impact on individual taxpayers. This research could inform developments in the PRC with respect to individual taxation. While not within the domain of this author, researchers should continue to monitor and evaluate the efforts of the PRC to enhance its tax administration processes with respect to individual taxpayers.

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