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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 interest 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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Abstract

Since the reform of tax sharing system in 1994, China has preliminarily set up a local taxation system which plays an important role in forming a public financial framework that meets the requirements of market economy. However, because of the unreasonable elements in current local tax sharing system such as local taxation lacks efficient major taxes categories and problems between state taxation and local taxation, which might bring instability to the financial fields between central and local government. Under the principal of accelerating government functions transformation and modern country governance system construction, the mode that “central government has the rights to legislate taxation laws and to cease collecting tax while local government are entitled to the rights to adjust and explain taxation laws” should be conducted in the area of tax power distribution; In the modes of taxation income distribution, we should focus on sharing tax in short term and gradually develop main tax types in local areas; In the long run, we should place importance on mature local main tax types with the feature of tax sharing so as to form the pattern that tax sharing distribution and local tax revenue have an equally important role.

Key Words local taxation, local taxation system, mode

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论中国地方税体系模式和架构的设想*

The ideas about the model and structure of China's local tax system

In 1994, China carried out a fiscal system reform and introduced a tax distribution system on the basis of which the current local tax system combines successful construction of foreign ones and our unique national conditions. After 20 years of implementation, the tax-sharing system has generally played a great role in giving full play to the initiative of central and local governments, building a mechanism of steadily increasing central and local tax revenue, advancing the optimization of resource allocation and industrial restructure, reinforcing macro-control as well as boosting the socialist market economy. However, as it is going through a major reform that it is impossible take place instantly, China's existing tax system, local tax system in particular, is far from perfection. There is a long way to go before meeting demands of governing a modern country ruled by law with a new normal economy.

I . The Definition of Local Tax and Its System

For the present, there is no agreement on the definition of local tax and its system. In terms of this conception, almost all the studies and researches home and abroad concern about whether the taxes are subject to the lawmaking authority, the collection and administration and the ownership of the local tax bureau system. Here I divide China's local taxes into pure local taxes - completely subject to the ownership of the local tax bureau system - and shared taxes by central and local governments.

II .The Existing Problems of China's Local Tax Bureau System

Despite its implementation for years, China's local tax system still has problems in terms of taxation responsibilities division, tax revenue distribution as well as collection and administration division.

(I) The Problems in Local Taxation Responsibilities Division

*This paper is an achievement included by a national social science funded key program named Develop and Research Taxation System under the rule of law in China (the project number is 14AZD087).

1. Improper delegation of local tax lawmaking authority violates the rule of law
We can see problems in distribution of taxes such as, responsibilities and highly centralized taxation powers, especially when it comes to tax lawmakers, from the operation of the local tax system. First, tax laws are low in the legislative hierarchy. At present, only three taxes of existing local taxes - enterprise income tax, individual income tax and vehicle and vessel tax - have specific laws, while the others are levied in accordance with regulations, decrees or measures. The low efficient hierarchy of tax legal system doesn't only think beneath the stability and dignity of law but also contravenes the "tax governance by law" principle and the Legislation Law. Second, local governments lack tax legislative power. Almost all the tax laws, regulations and their details are enacted and promulgated by the central government, while local governments can only adjust the rates within the fixed area and have incentives of a few local taxes. It is the central legislative and administrative authorities that enact local tax laws and policies but local governments can merely submit opinions, which reflects the general absence of beneficiaries in the lawmaking process.

2. The immoderate centralization of collection scopes damages the balance of tax collection authorities division between the central and local governments

China's collection scopes of state tax bureaus and local tax bureaus have been changed several times in violation of standardized enforcement. The taxes of several industries under the business tax which is a local tax are subject to the collection and administration of the central tax bureau system, not to mention the much more complicated enterprise income tax. Initially tax revenues were distributed in accordance to administrative division rather than tax categories. However, in terms of local enterprise income tax, the income tax to be paid by district banks and non-bank financial enterprises and even collective credit cooperative are the central government revenue; in terms of the enterprises that were newly established after 2002, the collection and administration of the enterprise income taxes shall be in the charge of the state tax bureaus; from 2009, the enterprise income taxes of the newly added enterprises which shall pay value added taxes are subject to collection and administration by the state tax bureau system. This nonstandard distribution objectively transforms the tax distribution system into "the tax selection system" or "the money distribution system".

3. The imperfections of judicial protection of local tax system dilute the seriousness of tax laws.

Due to lack of proper division of taxation judicial responsibilities between China's tax authorities and judicial organs, the former with human and material resources to conveniently deal with tax-related cases has no jurisdiction enabled by the law. Therefore, in the process of handling a case, we can see a dilemma where the latter have jurisdiction but no resources while the former in contrast. The public security organs in charge of tax-related cases usually are unfamiliar with taxation so that the cases handed over from tax authorities are always prolonged. With almost no case they can transfer, procuratorates have no case to deal with.

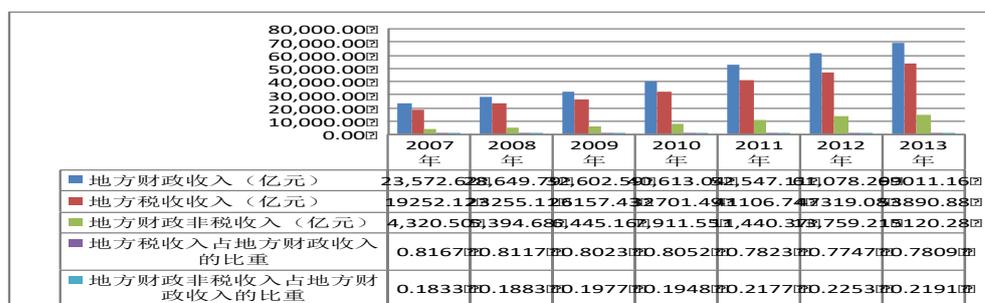
(II) The Nonstandard Distribution of Local Tax Revenues

1. The lack of local major taxes limits the fiscal collection capacity of local governments

As VAT-reform program launches in full scale, the business tax which is a local major tax will be replaced by a value added tax gradually, leaving no effective local major tax. If local spending responsibilities were unchanged, there would be no doubt that it would influence local governments in providing public goods and services as well as decrease local fiscal revenues and the taxation financial control.

2. The relatively small local tax revenues affect governance and action regulations of local governments

As is shown in P1, although it is 80% area, the percentage of local tax revenues in local fiscal revenues gradually declined from 2007 to 2012. The relatively small local tax revenues at all levels caused local fiscal difficulties. Many regions collect more fees as substitutes for taxes, directly spawning various local fees and severely disturbing local taxation order. According to statistics, China's non-tax revenue was 1375.921 billion in 2012, an increase of 3.185 times than 432.05 billion 5 years ago.



P1 The Percentage of Local Tax Revenues in Local Fiscal Revenues

Statistics of local tax revenues come from China's Taxation Statistics Yearbook in every year and

those of local fiscal revenues come from the website of National Bureau of Statistics

(III) Configuration Problems in the Collection and Administration of Local Taxes

1. Overlapping tax collection and administration by the central and local governments impairs regulations of government actions

First, the tax collection authorities of the state tax bureau system and the local tax bureau system are overlapping. Some local revenues including those of trade markets and foreign-related taxes are still levied by the State Administration of Taxation, while local governments don't have full administration of their own revenues due to overlap of the collection and administration of business tax, income tax as well as city maintenance and construction tax. Second, collection authorities lag behind the others. Some local revenues are to be collected by the State Administration of Taxation but there is a tough way to figure out how other powers such as administration, procuratorial and reconsideration authorities can be consistent with collection authorities. Third, in terms of the tax administration authorities in accordance with the current regulations, the local tax bureaus can only issue tax registration certificates to the taxpayers that shall only pay local taxes but not those shall pay both the value added tax and local taxes so that administration lags behind collection.

2. The fragmented collection and administration system blocks tax-related information sharing mechanism and reduces administrative ability

Currently because of the different and unconnected collection and administration systems of state tax bureaus and local tax bureaus, transferring massive basic data and records comes across huge barriers. Without effective tax-related information sharing mechanism, state tax bureaus and local tax bureaus can't exchange real-time information efficiently. Worse still, there is no uniform effective collection system between state tax bureaus and local tax bureaus. For the moment in terms of minor taxpayers that apply to purchase temporary invoices, the authorization for state tax bureaus to collect certain local taxes is based on the unofficial negotiation between state and local tax bureaus without a effective restrictive standardization.

3. The VAT-reform program makes the collection and administration of local tax bureaus more difficult, leading to taxation loss

Before unifying the business Tax and the value added tax, local revenues of individual income tax, land appreciation tax and city maintenance and construction

tax that are consistent with the collection and administration of business tax amounted in excess of 15% of the total local tax revenues at a same period. After the launch of the reform, almost all the temporary invoices will be issued by state tax bureaus. As the collection and administration authorities are handed over, local tax bureaus have no effective control of newly added taxpayers but tougher collection and administration of current city maintenance and construction tax as well as educational surcharge (including local education surcharge) than ever before. In terms of individual businesses in accordance to the “levying tax via invoices” principle, it’s hard to collect individual income tax, city maintenance and construction tax as well as educational surcharge (including local education surcharge).

III. Advice on how to construct a reasonable provincial taxation system

The construction of the provincial taxation system is a huge project, which cannot be done overnight. Therefore, we should gradually carry out the fiscal and taxation reform in the Third Plenary Session of the 18th Central Committee of CPC. And on the basis of VAT-reform program, we should launch step by step the lawmaking activities of the house property tax, improve a series of supporting systems, accelerate the building of tax information system and eliminate the obstacles in the tax collection and administration in order to establish a mature provincial taxation system, .

i. The pattern of provincial taxation system

The pattern of taxation authority division: The central government is in charge of the tax lawmaking and suspension, while local governments are enabled to make certain adjustment and interpretation.

Given that Chinese local governments lack strict discipline and taxation competition is serious under the imperfections of the central macro-control mechanism, the taxation authority division shall be a progressive course, adhere to the centralization of major taxes and devolution of minor taxes as well as focus on supervision to deal with the relations between the centralization and the delegation, as appropriate. In accordance to this principle, we can classify administrative authority between the central government and local governments properly. Undoubtedly, provincial tax

power is mainly centralized in provincial governments where they have certain power to regulate local governments, including the power of tax collection and administration, certain policy adjustment and explanation.

2. The pattern of tax distribution

In 1994, China introduced the tax sharing system with the value added tax as a shared tax, while the business tax and income tax were major taxes in provinces and regions. After the implementation of the reform on income tax distribution, the business tax became a local major tax, accounting for 33% of the local government tax revenue. In 2011, business tax and value added tax took up more than 47% in total. Starting from 2013, the proportion of shared taxes is expanded by the VAT reform. At that year, the revenues from shared taxes exceeded 67.85%, which supported a large-scale tax distribution system in China. Additionally, all the existing local taxes are minor, while major ones take time to develop. Under this circumstance, it is necessary to set up a large-scale tax distribution system with shared taxes as major taxes and supplemented by provincial taxes so that the local government revenues shall be diverse. In the process of establishment and development of provincial taxes, the second pattern shall take effect. That is to say, shared taxes shall be the major one in provinces and regions in the short term while we cultivate other local major taxes. And then in the long run, mature provincial taxes will become the pillar supplemented by shared taxes. Through expanding the percentage of provincial taxes in the local government revenue, the proportion of provincial taxes shall be equivalent to that of shared taxes.

(ii) The Standard on Division of Tax Authorities

1. The division of tax lawmaking authority

In accordance to the current tax power mode, the legislative power is centralized in the central government, and it enacts basic tax laws and regulations, including basic tax laws, law on the scope of tax collection and general law on the process of tax collection and payment; the central government is in charge of the lawmaking, interpretation and collection of central taxes; in terms of shared taxes, the central government shall exercise the legislative and interpretation power, while the collection shall be determined on the basis of tax sharing approaches to be in the charge of the central government or split between the central and local governments; in terms of provincial taxes, the central government shall still exercise the legislative power, while the local governments are in charge of the tax collection. Based on

actual circumstances, the tax authorities of interpretation, adjustment and so on shall be in accordance with the following rules:

(1) In terms of provincial taxes with a profound influence on national economy and volatile tax bases, the establishment and suspension of the tax collection, the adjustment of tax categories, the power to set the range of tax rates, the decision-making authorities of tax reduction, exemption and increases shall be subject to the central government, whereas the power to set tax rates within the range in regions shall vest in local governments.

(2) In terms of the provincial taxes with relatively stable tax bases and regional characteristics, the central government shall enact the basic tax laws and regulations of urban and township land use tax, house property tax, land appreciation tax, resource tax, environmental protection tax, deed tax and so on. The power to adjust detailed rules for implementation, tax categories and rates with the uniform range and scope set by the central government shall vest in people's congress of the provinces. The reduction and exemption as well as the collection and administration of these taxes can be determined by people's congress of the provinces under administrative regulations.

(3) In terms of provincial taxes that are only collected in certain regions with high cost and that are earmarked for specific activities, such as tobacco leaf tax, city maintenance and construction tax and educational tax (transform the current educational fees into an educational tax), the establishment and suspension of the tax collection shall be in the charge of the central government, while the governments at the provincial level exercise the tax policy-making power based on local actual circumstances to flexibly determine tax rates, reduction and exemption without a unified range and scope set by the central government. However, the tax collection plans shall be filed with the central government.

2. The division of the tax law enforcement

First, we should clarify the scope of law-enforcing authority of state and local tax bureaus. On the basis of the nature of taxes, symmetric powers and duties as well as parallel tax collection and administrative systems, the local law-enforcing authority shall be handed over to local tax bureaus as soon as possible. Second, in terms of problems in the overlapping tax collection and administration, a cooperative tax system shall be established to integrate the informational resources from two departments. Also, a connected taxpayer inspection system shall be introduced to

inform each other in time of the results of check on taxpayers in the charge of both systems. Major cases and check shall be dealt with in a consistent manner.

3. The division of tax judicial power

I suggest integration of the judicial power of administration of tax-related criminal cases and relevant investigation, detention, arrest and preliminary hearing of state and local departments at all levels to introduce a one-level-down joint conference system that holds coordinated discussions among different agencies. Thus, we can strengthen communication and collaboration among tax authorities, public security agencies and judicial organs to ensure sound implementation of the taxation power. Under favorable conditions, in accordance with economic division instead of local administrative division, a special tax judicial organization parallel with state and provincial tax bureaus at all levels shall be established under the leadership system of vertical administration by the central government. And a uniform, standardized system of the tax judicial safeguards shall be built up with the connection and support of taxation inspection, procuratorate and trial organs.

(iii) How to Make A Decision on Tax revenues Distribution

1. Local tax revenue shall take reasonable proportion

Provincial taxes are collected on the demand of local expenditures so the upper limit of local tax revenues in theory shall be: local tax revenues \leq local fiscal expenditures, which means all the local spending shall be covered by local tax revenues as the only source to support the local financial needs. Given to the tax distribution system and diverse sources of fiscal revenues, local tax revenues generally have no possibility to be higher than local fiscal expenditures. Of course, there are certain economically developed regions that have amplified tax sources to satisfy the demand of the local expenditures only by local tax revenues. However, under actual circumstances, the majority of regions has many other sources of fiscal revenues except for taxation. Thus the lower limit of local tax revenues shall be: local tax revenues \geq necessary expenditures + (optional spending – other fiscal revenues). If the number of necessary expenses is given, the local tax revenues is inversely proportional to other fiscal revenues in quantity. As a result, increasing local tax burdens is required to complement the loss rather than other fiscal revenues. In other words, local tax revenues generally shall exceed the minimum of local necessary spending. All in all, the country's local tax revenues shall be determined within the range in theory.

(1) The local tax revenue proportion of the volume shall be reasonable

In terms of some countries that have similar scale of land, population and national conditions as China, the local tax revenues in Japan account for 34.7% of the total tax revenues, Canada and the United States are 51.3% and 44.6% respectively. One year before the introduction of the tax distribution system in 1994, the figure in China was 13.43%, and increased dramatically after the reform. In 2002, it amounted 42.00% and then 47.03% in 2012. Compared with other countries, this percentage is not low. However, given that the proportion of local public fiscal spending in China has been in excess of 70% of the national public fiscal spending since 1994 with its peak of 85% in 2012, the local tax revenues shall take up the share of approximately 50% on the basis of a reasonable division of expenditure responsibilities to effectively reduce local governments' dependence on the central government's tax rebates and ease the burdens of transfer from the central government to local governments.

(2) The local tax revenue proportion of local financial revenue (expenditure) shall be reasonable

Between 2002 and 2012, although the local tax revenues accounted for more than 75% of the local financial revenues, it witnessed a downward trend from 86.98% in 2002 to 77.47% in 2012. The local tax revenue proportion of the local public expenditures increased from 48.47% in 2002 to 50.59% in 2005, and then declined to 44.15% in 2012. This is why the local financial revenue takes up about 50% of the national financial revenue, while the local financial expenditure accounts for over 70%. Take the figures in 2012 for example. Local fiscal revenues constituted 52.09% of the national fiscal revenues, whereas the local fiscal spending accounted for 85.10%, 33% higher than the former. In other words, local fiscal revenues and expenditures have a gap of 33% which requires the transfer from the central government with tax rebates as the major approach. The percentage was nearly 40% of the local fiscal spending in total, obviously above the average level.

Therefore, the local tax revenue proportion shall be restored to more than 85% of the local public fiscal revenues. Meanwhile, through the reasonable division of expenditure responsibilities, central responsibilities which were taken by local governments shall be in the charge of the central government again. The local fiscal spending proportion shall be slashed to increase the local tax revenue proportion of local public fiscal expenditures and lessen local governments' dependence on other

fiscal revenues, especially the non-tax revenues.

(3) The proportion of local tax revenues in GDP shall be reasonable

Theoretically, the local tax revenue proportion of GDP shall be in accordance with the economic development level of the country and relevant regions. However, it has two influential factors: the proportion of tax revenue volume in GDP and the percentage of local tax revenues in tax revenue volume. If they are reasonably defined, then the proper proportion of local tax revenues in GDP is clear.

The proportion of local tax revenues in GDP of other developing countries (below average) with similar income to China is 15.61%, or generally around 23% of board macro tax revenues including the revenues from the social security fund. In terms of those above the average, the proportion of local tax revenues in GDP in 2006 was 17.04%, or generally around 24.28% of board macro tax revenues including the revenues from the social security fund. The percentage of local tax revenues in GDP in China is by far 18% with its peak of 19.81% in 2007 and 19.39% in 2012. Therefore, the proportion of local tax revenues in GDP in China is better to remain at the current level (approximately 20%) instead of increasing. According to the rough estimate above, if the percentage of local tax revenues in tax revenue volume is 50%, the proportion of tax revenue volume in GDP shall be around 10%.

2. The standard on the division of shared taxes

(1) The division of value added tax

In order to ensure that the VAT reform can be successfully accomplished, we adopt the plan to remain the business tax revenues at previous administrative tier in the process. The revenues of VAT rather than the business tax are still local government revenues and not share with the central government. But this is just a transitional measure which cannot run in the long term. Once VAT reform is completed in full swing, it is unavoidable to adjust the tax share between central and local governments.

In order to strike a better balanced relations between the fiscal powers and expenditure responsibilities, alleviate the current difficulty of local fiscal revenues and expenditures and straighten out the fiscal distribution system, this article will give two pieces of advice on the local proportion of VAT as follows:

i The percentage shall increase to 40% by 15bp. According to the data in 2012, business tax revenue was RMB 1.574764 trillion (among which RMB 1.554291

trillion is subject to local government revenue, whereas RMB 20.473 billion subject to central government revenue), value added tax revenue was RMB 2.6415.51 trillion. The equation is local governments revenue = $15542.91 + 26415.51 \times 25\%$ = RMB 2.228007 trillion. Providing that the VAT reform is completed in full scale, if the sharing of VAT revenue between central and local government remain unchanged (the revenue from Ministry of Railways, banks and insurance companies are still subject to the central government), then the local revenue will decrease by RMB 1.165718 trillion = $15542.91 \times (1 - 25\%)$ 。 If the percentage of tax sharing in VAT changes to 40%, according to the static analysis, the equation will be local revenue = $(15542.91 + 26415.51) \times 40\%$ = RMB 1.678337 trillion, contracted by RMB 549.670 billion. Given that the VAT reform will slash taxes, it is estimated that the local revenue will plunge by RMB 750 billion, according to the dynamic analysis.

ii The percentage shall increase to 50%. The local government revenue = $(15542.91 + 26415.51) \times 50\%$ = RMB 2.097921 trillion, a decrease of RMB 130.086 billion. Given that the VAT reform will cut taxes, it is estimated that local revenue will be down by RMB 380 billion, according to the dynamic analysis.

Therefore, after the VAT reform, the figure should not exceed 50%, and I suggest 40%. The local revenue losses shall be complemented, to some extent, by adjusting the tax sharing in income tax.

iii The standard on distribution of the enterprise income tax

In order to cover the local revenue loss, the advice is that the enterprise income tax should be split in half. According to the data in 2012, the enterprise income tax at the national level was RMB 1.965453 trillion, among which RMB 757.16 billion was subject to local government revenue. Assuming that the figure is adjusted to 50%, the local revenue = $(19654.53 - 725.53) \times 50\%$ = 946.45 billion Yuan, an increase of RMB 189.29 billion.

iv The standard on distribution of the individual income tax

Similarly, individual income tax revenue shall be split in half. In 2012, individual income tax at the national level was RMB 582.028 billion, among which RMB 232.763 billion was subject to local government revenue. Provided that the figure is adjusted to 50%, the local revenue = $5820.28 \times 50\%$ = 291.014 billion, an increase of RMB 58.251 billion.

Therefore, after the ratio of VAT is adjusted to 6:4 and that of income tax becomes 5:5, the local revenue will drop by RMB 502.5 billion which will be covered through the construction of local major taxes.

(4) The setting of main local tax types

Basically, the main local tax types must meet the following three standards: Firstly, it should have wide tax base and multiple tax sources, with growth potential and great impacts on enlarging the local tax scale. Secondly, it should have a strong capability to adjust the income and industrial structure of our region. Thirdly, it should have a strict and transparent tax system which makes it easy to supervise. Therefore, the setting of main tax types must meet our economic growth and tax structure and the main local tax should be determined in phased way and be refined constantly. According to the principle of three-layer finance, we should first settle the main local tax on provincial level, followed by the municipal one. We can't determine all the main taxes on different level at one time.

1. The setting of main local tax on provincial level—the reform of consumption tax. For the time being, consumption tax is the only major tax type that is qualified to be the main local tax on provincial level. Although the initial purpose of setting up the consumption tax is to adjust taxes, the existing consumption tax has never been a pure central tax, tax revenues are relevant to tax return. Since the reform of refined oil tax, the consumption tax, which mostly comes from the road toll, needs to be largely rebated to the local government.

Vehicle purchase tax should be included in consumption tax, because it's a kind of one-off taxes on property purchase, which is similar to the purchase of properties, private jets, yachts, luxury furniture and transaction of expensive collections. So it can be integrated into consumption tax and serve as a shared tax by central and local government so as to establish a local tax system focusing on consumption tax. But according to international practices, special consumption tax on state monopoly like tobacco should be on the list of central tax.

While appropriately decreasing the VAT rate, we also need to refine the tax scope, link of paying tax in the setting of the new consumption tax system. Firstly, we should enlarge the tax scope of consumption tax, and impose consumption tax on private jets, luxury furniture, art works, calligraphy collections and paintings. Secondly, we should levy in the consumption link instead of production link.

When the new consumption tax is developed into a mature main local tax on provincial level and becomes a stable source of income of the local government, VAT is likely to see a smaller proportion shared with central government. Take the statistics of 2012 for example, the vehicle purchase tax was 222.891 billion RMB, consumption tax was 787.558 billion RMB, 300 billion RMB of consumption tax on tobacco was deducted, about 700 billion RMB can be tuned into the provincial government income. The income is likely to see a further increase if we enlarge the tax scope and adjust the tax rate.

(2)The setting of main local tax on municipal level—The development of property tax in owning link

Given the current circumstance and our development goal in the future, municipal government is the basis of the government. In terms of the setting of main tax of the municipal government, with the practice and experience of foreign counterpart and the general development climate of China's property market, we should establish a new local tax system on municipal level, with focus given to property tax, making the property tax one of the important sources of local tax income.

As property tax doesn't exist at the beginning of economic growth, and China's current property tax is least mature, it's our long-term goal to make property tax in owning link the main tax of municipal government. For the time being, we should do

the basic, accelerate the legislation, specify the goal of reform, combine the farmland occupation tax, tax on using urban land, land value increment tax for the purpose of increasing income, establish a new tax system, devise a registration system of property right on national level. In the meantime, provide guidance to establish the independent, third-party institution to assess the property value so as to lay a foundation for the setting of property tax. Allowing for the difficulty of reform, we'd better divide it into two phases, we should reform the existing property tax for the time being. And in the long term, we should combine property tax, farmland occupation tax, tax on using urban land, land value increment tax and relevant taxes and devise a new property tax.

(5) The reform of the rest of taxes

1. The reform of resource tax

There are many flaws of the existing resource tax in terms of tax scope, tax base, and the setting of tax rate. That's why we need to refine the resource tax. In terms of enlarging the tax scope, water resource, forest resource and rangeland resource which is developed and utilized in a protective way in international community should be included in the tax scope so as to make proper use of scarce resources in China. In terms of tax base, we should change taxation according to quantity into taxation according to price. In the reform of resource tax, we need to adjust the ownership of resource tax, strengthen the control of local government. We shouldn't ignore that many resources are interconnected, so we need to well handle the speed of the reform of resource tax, and bind the right time.

2. The levying of environment protection tax

The act of environmental pollution, resources damage should be on the list of tax scope of environment protection tax, we need to list the tax items respectively, and gradually enlarge the tax scope. Since environmental pollution is usually local and relevant to specific behavior, it's suitable to be the tax base in order to make the levy more convenient and allow enterprise, individual, and local government to reach

consensuses on national tax policies which aim to punish polluters and facilitate environmental protection. Besides, environment protection tax should be tied with the reform of consumption tax so as to achieve mutual complementarity and avoid double levy.

(6)The local tax structure in the future

Based on what mentioned above, the local VAT, consumption tax, income tax of enterprise and individual, resource tax and stamp tax are shard tax. VAT and income tax will be shared by central and local government according to certain proportion. Consumption tax will be shared in line with tax items. All the consumption taxes belong to provincial government except for consumption tax on tobacco. The provincial government has the right to determine the proportion of tax shared with municipal government. Resource tax belongs to the local government except for resource tax on marine oil, which belongs to central government. Stamp tax belongs to municipal government except for security transaction stamp tax, which is shared with central government with a proportion of 97/3. Construction tax, property tax in owing link, contract tax, tax on tobacco, environment protection tax is local tax, which all belong to municipal government(Table 1 includes more details).

The local tax structure in the future

Tax	Category	Division of income	More details
VAT	Shard tax	Shared by central and local government with a proportion of 6:4	If the tax belongs to provincial government, the provincial government has the right to determine the proportion of tax shared with provincial government
Consumption tax	Shard tax	Belong to local government except for tax on tobacco, which belongs to central government	vehicle purchase tax is included in consumption tax, if the tax belongs to provincial government, the provincial government has the right to determine the proportion of tax shared with provincial government
Business	Shard tax	Shared by central and	If the tax belongs to provincial

income tax		local government with a proportion of 5:5	government, the provincial government has the right to determine the proportion of tax shared with provincial government
Individual income tax	Shard tax	Shared by central and local government with a proportion of 5:5	If the tax belongs to provincial government, the provincial government has the right to determine the proportion of tax shared with provincial government
Property tax in owing link	Local tax	Belong to municipal government	The property tax is reformed for the time being. In the long term, farmland occupation tax, tax on using urban land, land value increment tax and relevant taxes will be combined into a new property tax.
Resource tax	Shard tax	belong to local government except for resource tax on marine oil	Belong to municipal government
Stamp tax	Shard tax	belong to local government except for security stamp tax which is shared by central and local government with a proportion of 97:3	Belong to municipal government
Construction tax	Local tax	belong to municipal government	
Contract tax	Local tax	Belong to municipal government	
Tax on tobacco	Local tax	Belong to municipal government	
Environment protection tax	Local tax	Belong to provincial government	The provincial government has the right to determine the proportion of tax shared with municipal government

Such a structure will ensure the source of income of provincial and municipal

government so as to regulate the government income and improve its governance.

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An Empirical Study on Corruption and Tax Compliance: Based on Time Series from 2000 to 2014 in China

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Abstract: Since 18th China Communist Party's National the new central government has adopted a "zero tolerance" policy towards corruption, aiming to keep the corruption in the cage within the system. The new policy awarded strong support from the public throughout the country. Will anti-corruption enhance the tax compliance level of taxpayers? This paper based on such a condition, by using the 2000-2014 time series data in China as samples, adopting multiple regression analysis to find out the empirical analysis of this problem. The empirical results show that government corruption is negatively correlated with the tax compliance degree of taxpayers, that is, the lower the corruption degree of a country, the higher the tax compliance level of taxpayers. This conclusion shows that government's anti-corruption is conducive to the country's fiscal revenue, and government anti-corruption should be sustained.

Keywords: Corruption, Tax compliance, Transparency

1. Introduction

As Montesquieu Wrote in the Spirit of Law: “Everyone with power is easy to abuse power, which is an immutable fact.” Since ancient times, corruption is the common enemy of people and common problems of countries. In the economic sense, corruption is defined as the act of private use by a public official in violation of the rules to exploit the rights of the individual (Shliefer and Ishny, 1993), it is driven from lack of effective supervision of the contract between the public and the government officer. In recent years, quantitative and qualitative research on corruption made by international corruption indicators has made the research more accessible, such research has been continuously pushed by international organisations. International institutes and scholars are paying more attention to the impact of corruption on various fields. The report produced by the World Bank asserted that: Corruption, with destructive consequences, is not conducive to economic and social development. On one hand, corruption will worsen the system of income distribution, leading to serious inequality in income distribution, thus affecting the stability of economy. On the other hand, corruption reduces the efficiency of the government, undermines the government’s correct decision, that costs public expenditures, thereby distorting the allocation of resources; In addition, corrupting undermines law and regulations, and leads to a serious loss of national prestige.

Since the Open Door Policy reform, Chin’s rapid economic growth achieved a brilliant record in world’s economy. The ruling ability of government officials under the leadership of the Communist Party of China (CPC) is recognised by all over the world. The Chinese model has also been highly appreciated in the world. At the same time, however, the corruption of Chinese government officials has worsened. From the central government level to the county level staff, corruption occurred in all government units involving large number of officers and huge amount of shocking. According to the Transparency International which realised the “2015 Global Refusal Index”, it is shown that China’s corruption index in the 2015 scored 37 points in the survey, ranked on No. 83 out of 168 countries, which is 51 points less than New Zealand ranked No. 1 and 5.57 points less than the average score: 42.57 points, China, in this index, was classified as the countries with relatively serious corruption. On the other hand, China’s tax revenue was lost quite serious under that situation. According to the calculation by the end of 20th century, the average tax loss rate was over 26% (Shaohua JIA, 2002, Biyun YANG, 2003).

Corruption has become a “Cancer” in the nation while corrupt officials become the “thorn” in people’s eyes. Officials of corruption have negative effects on all aspects of the country, which seriously worsened the image of the government, affecting the relationship between the people and the government. Foreign studies have shown that there is a significant positive correlation between corruption and the underground economy (Schinder, 2008). The study also shows that a country's underground economy is bigger, the more severe tax losses. So, has the current serious corruption situation in China exacerbated the taxpayer's tax non-compliance? What kind of mechanism does corruption affect taxpayers' willingness to pay? The answers to these two questions can also provide a reference for the anti-corruption road of our central government. Therefore, it is important to study the impact of corruption on the tax compliance of taxpayers.

2. Literature Review

Chinese and foreign scholars on corruption research mainly commenced from two aspects: one is the cause of corruption; the second is the impact of corruption. In term of the causes of corruption, foreign scholars believe that the factors leading to corruption are mainly the following three categories: First, a country on the macroeconomic level of openness. (Fisman, R. and Gatti, R. (2002).

The more the government controls and intervenes in the market, the more likely it is, for its officials to corrupt. Moreover, government policy distortions (such as state monopolies, high tariffs, etc.) are more likely to breed corruption than foreign competition. Alvaro Cuervo (2008) pointed out that the authoritarian dictatorship will increase the cost of investment, resulting in corruption. Second is the micro-government staff welfare benefit. People have always believed that high salaries to honesty, low salary will make civil servants have a stronger motive of corruption, this phenomenon has also been empirical proof of scholars.

Van Rijckeghem and Weder (1997) use multiple regression analysis to study the relative wage and official corruption of public servants, and the empirical results show that the lower the relative wages of public servants, the higher the degree of corruption. In addition, the World Bank in 1997, the World Development Report also pointed out the same point of view. Third is the internal and external supervision system. Since government officials are both policy-makers and policy-supervisors, the scope and intensity of internal and external supervision system will reduce the opportunity cost of corruptions of public servants, leading to a greater possibility of corruption.

Tanzi (1998) points out that, in a considerable number of countries, especially in developing countries, corruption is subject to a much greater degree of penalties than corrupt penalties prescribed by laws and regulations. This is the reason why corruption is widespread around the world. Chinese and foreign scholars who studied the impact of corruption were more concentrated, mainly focused on the relationship between corruption and economic growth. From the current research, the role of corruption on economic growth is a controversial point. Scholars on corruption and economic growth research have produced three main points: First, the "Lubricants" theory. Proponents of "Lubricants" argue that moderate corruption helps economies overcome their over-regulation of bureaucracy during economic operations, saves decision-making time, and improves the efficiency of government administration (Leff, 1964; Liu, 1985; Beck and Maher, 1986, and so on), and proposes the classical queuing model and auction model. The second is "sand" theory. On the Theory of "Sand", supporters argue that corruption can have a significant negative impact on the functioning of the macro economy, damaging the government's image, distorting government decisions, leading to irrational and inefficient allocation of resources, hampering the normal functioning of the market (Buchanan and Tullock, 1962; Bhagwati, 1982; Mauro, 1997, etc.). The third is neutral theory. Lui (1996) pointed out that corruption has dual effects on the economy, on the one hand, corruption is conducive to improving government efficiency and efficiency of resource allocation, on the other hand, corruption is not conducive to long-term economic growth. Although many scholars have made considerable achievements in the study of corruption, the research on corruption still needs to be further explored. Such as

corruption on the taxpayer's tax compliance research is not enough depth, the current literature in foreign scholars in this literature review is mainly cross-national cross-sectional data for the object, the study of corruption and the relationship between the underground economy; and Chinese scholars in this review are looking at the empirical study is almost blank. As a result, this paper focuses on aspects from theoretical and empirical of corruption on China's taxpayer tax compliance.

3. Corruption and Tax Compliance: A Theoretical Analysis

Corruption is defined as the behaviour of a public servant who uses his or her rights to seek personal gain in violation of the rules. In particular, corruption can be divided into economic crime and non-economic crime, in which economic crime is mainly manifested as corruption and bribery, non-economic crime, there are a variety of major manifestations, such as the current exposure of the extramarital sexual issues be officials, corrupt moral behaviour and dereliction of duty (Gong, 1994; He, 2000; Wederman, 2004). Tax compliance is taxpayers to comply with the tax payment behaviour by the law. The taxpayer has a correct understanding of tax payment obligations, so taxpayers are always able to fulfil their tax obligations in a conscious, accurate and timely manner. Tax non-compliance can be divided into three types: selfishness non-compliance, ignorance non-compliance and emotional non-compliance.

The reason that corruption can lead to non-compliance of taxpayers is because corruption can cause taxpayers' emotional non-compliance mood and selfishness. The specific analysis shows the following reasons: First, corruption is not conducive to economic and social development, with devastating consequences. According to the World Bank report (1996): Corrupt countries have lower private investment and slower economic growth.

Tax corruption will erode more government revenue, the government, in order to maintain the normal expenditure, will have to take measures to increase revenue, however, the adoption fiscal policy or monetary policy, will affect the economic behaviour of market players, that brings impact on economic stability and normal growth. Corruption in this case will erode the tax base, which can be called as tax-based corruption.

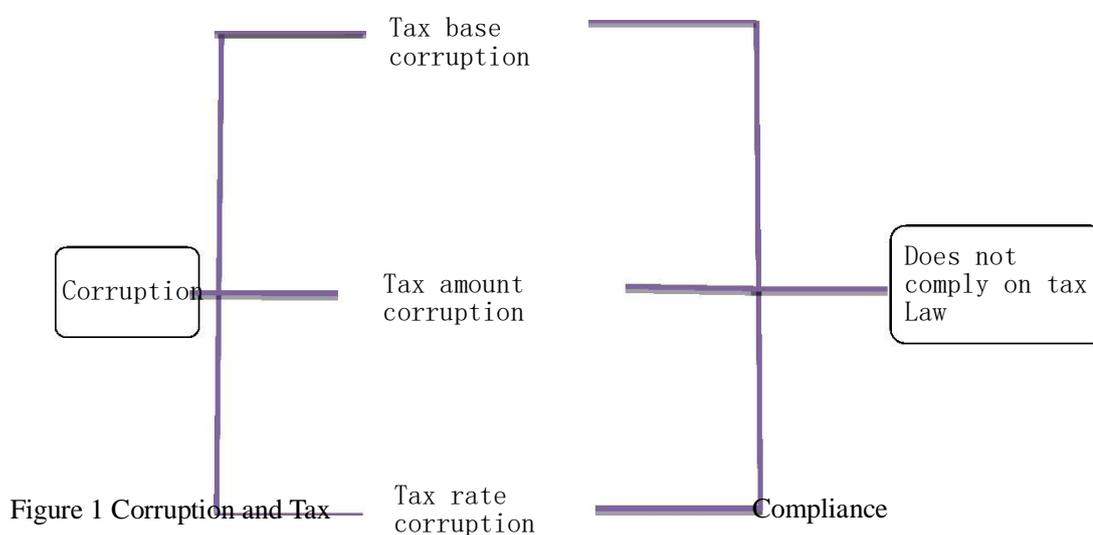
Second, corruption distorts the government's correct decision-making. Whether taxpayers bribe government officials for private gain or government officials, will directly or indirectly lead to rent-seeking and government policy distortions. This distortion will lead to the loss of government resources, abnormally making government resources transferred to the government officials and taxpayers hands. Through conspiracy, government officials and taxpayers are benefited from corruption, while the benefits are from the government ought to be the tax revenue. Corruption in this case will encroach taxes, which is called tax-type corruption. Third, corruption distorts the allocation of resources and reduces the efficiency of resource allocation. Currently, tax incentives across the country occur frequently.

For example, many companies which did not meet the standards of high-tech enterprises, but was rated as high-tech enterprises through bribery, so that their corporate tax rate is reduced, resulting

reduction in the country's Tax revenue.

Corruption in this case led to abuse of tax incentives, especially for the lower tax rate, which is called tax-type corruption. In addition, the deterioration of the income distribution of corruption, leading to serious inequality in income distribution and corruption in laws and regulations, so that a serious loss of national credibility will make taxpayers do not trust the government and to choose the emotional tax non-compliance. Based on the above analysis, this paper proposes the following Hypothesis.

The Hypothesis: The higher the degree of corruption, the lower the tax compliance of taxpayers.



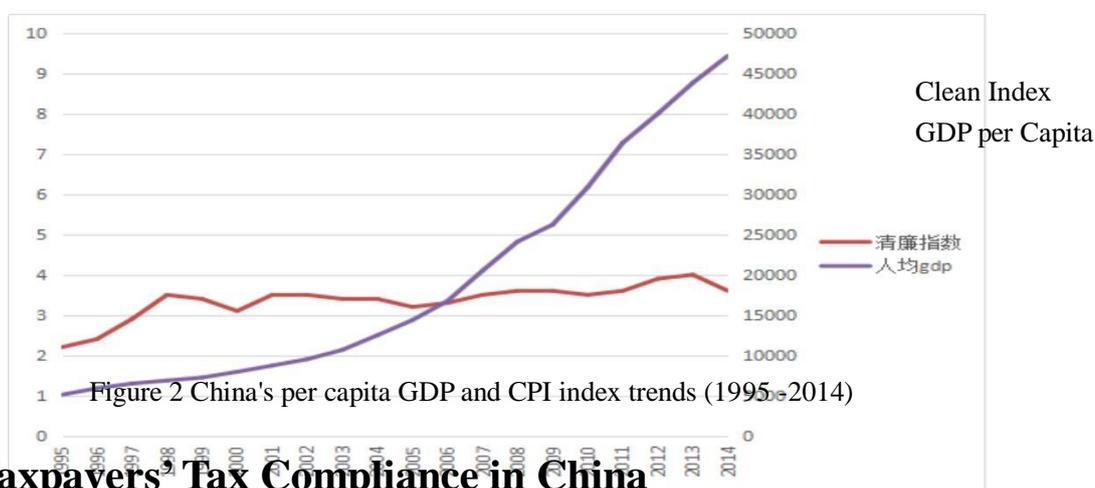
4. Corruption and Tax

Compliance in China

4.1 Corruption in China

"China is the country that appreciates the ceremonies ", since ancient times that China has the reputation of the state of ceremonies, as well as paying attention to interpersonal relationships is the performance of our etiquette, but this ritual in today's society has been changed materially. Helping relatives and friends becomes giving gifts, which evolved into a major form of corruption. Data published by the "People's Procuratorate Statistical Yearbook" shows that: Since the Open Door Policy, China's corruption has intensified. From the national point of view, in 1979 the national case amount was only 703, by 2015 the number of national registered cases rose to 33.6 million. In 36 years, the number of cases of corruption increased by 478 times. According to the anti-corruption data disclosed by the Central Commission for Discipline Inspection, in 2015, China's suspected violation of discipline in the management of cadres and the case reviewed 90 people, including 42 people who were suspected as criminals and who were transferred to the judiciary.

According to the "Global Corruption Perceptions Index" report released from 1995 by the Transparency International organisation, in the 2001-2010 decade, China's corruption index remained at around 3.5, the government rank was on No. 40 in 1995, and gradually decreased to 100 in 2014, showing it is more serious corruption in the country. Figure 2 depicts China's per capita GDP and CPI in recent years (ie, the clean index, the index is out of 10, from 2012 the index is changed and out of 100 points, as for maintaining the comparability of the data, this paper rescale the 2012 index to a 10 points system). As can be seen from the figure, China's per capita GDP in recent years is in rising, exponential growth trend; and China's CPI index has been hovering at a very low level, indicating that China's corruption has not been with the economic development and effective inhibition , The adverse effects of corruption on the community has become a chronic disease.



4.2 Taxpayers' Tax Compliance in China

China's tax compliance is not optimistic in terms of the taxpayers, according to the calculation by the end of the 20th century, the average tax losing rate was over 26% (Jia Shaohua, 2002; Yang Biyun, 2003). From the point of view individual income tax declaration, since 1 January 2007, China launches high-income individuals' personal income tax declaration system for individuals with more than 120,000 annual income. Wei Lu (2008) pointed out that high-income individuals (natural persons with annual income over 120,000 who need to declare tax) have psychological factors, such as fear of choice subjective taxpayers do not take the initiative to declare the actual number. From the point of view of enterprise tax, China's 2007-2009 annual investigation on tax cases involved more than 1 million RMB covers more than 5,000 cases. These cases contributed tax evasion for more than 17 billion (see Table 1). As can be seen from Table 1, the number of over 1 million RMB cases being investigated and dealt with in China is still rising. It is clear that China's non-compliance is quite serious in both natural taxpayers and corporate taxpayers.

Table 1 The investigated cases with the tax exceeding RMB 1 million in China (2007-2009)

Year	Number of Cases	Increase rate (%)	Tax Loss Amount (Billion RMB)	Increase rate (%)
2007	5000	-	17	-
2008	5000	0	17	0
2009	5000	0	17	0

2007	5142	/	17.73	/
2008	5227	1.65	18.01	1.58
2009	5263	0.69	22.94	27.37

5. Empirical Research

5.1 Measurement of Corruption

Because of the hidden nature of corruption and the diversity of corrupt behaviour, the measure of corruption becomes a difficult problem, which makes it difficult to select or construct a proxy variable to measure the corruption accurately. There are two main methods used to evaluate corruption: one is the use of corruption indicators issued by international organisations. These indicators, such as questionnaire surveys to obtain different groups of people subjective assessment of the status quo of corruption, the larger indicators with significant influence include the Transparency International's Corruption Perceptions Index (CPI), which reflects the global perception of corruption among businessmen, academics and risk analysts around the world; the Transparency International's Bribery Index (BPI), reflecting the multinational executives for the host country, the extent of corruption and the World Bank Corruption Control Index (CC), and the World Bank's Corruption Control Index (CCB) , which consists of a policy distortions index, a judicial predictability index, civil service wages as a percentage of wages for manufacturing workers, and a recruitment index based on individual talents.

Second, the use of objective indicators such as the number of corruption cases to measure the level of corruption, the specific measurement methods include: the number of cases per capita corruption officials to measure the degree of corruption with the People's Procuratorate on an annual investigation of corruption and bribery and the number of cases of malfeasance to measure the ratio of public servants Degree of corruption. These two methods have different shortcomings: the first index of corruption by the international organizations continue to publish a certain authority, but since the data obtained through the investigation, it also has a certain degree of subjectivity; the second is due to the observation of corruption The number of cases is not consistent with the actual number of corruption and there is insufficient. In terms of of the need for research and the convenience of data acquisition, Transparency International's Corruption Perceptions Index was used as a corruption indicator. The value of the index range between 0-10, the greater the value of the Government more honest, the smaller the value the more corruption the government.

5.2 Measurement of Tax Compliance

As the actual amount of tax evasion amount by taxpayers is difficult to accurately calculate, so taxpayers' tax compliance is also difficult to accurately measure. Currently, there is no uniform measurement standard and method in the measurement of tax compliance. Throughout the

domestic and foreign scholars' research, the following methods are proposed to estimate the tax compliance: First, tax compliance is measured from the perspective of loss in tax. This method uses the taxation capacity method in the open economy. It is estimated by the income and expenditure difference method of the underground economy caused by the economic loss. This method has been approved by many scholars, and has been widely used in the research. Second, the index system to measure the tax compliance, this approach from the following four aspects to measure:

(1) the difference between potential taxpayers and taxpayers registered to reflect the number of taxpayers not registered; (2) to record the difference between the registered taxpayer and the actual taxpayer to reflect the amount of undeclared taxpayers; (3) the amount of taxpayers reporting between the taxpayers and the potential tax payable under the tax laws and relevant laws and regulations (4) the difference between the taxpayer or the tax department to declare the actual tax and actual payment, so that to reflect the extent of tax arrears, this method is combined with the actual tax system data to calculate the tax compliance of taxpayers, but also have a high degree of credibility (Biyun YANG, Xingjian YI, 2006).

In this paper, the first method is to measure tax compliance, as the first method in the application of taxpayers often assumes that the taxpayers in the open economy, so the tax compliance measurement indicators can be simplified as: underground economy size / GDP, the smaller the ratio is, the higher level of the taxpayer's tax compliance is.

According to the basic principles of national economic accounting, the total income of residents and the total expenditure there is an equal relationship:

$$\text{Gross Household Income} = \text{Total Household Expenditure}$$

Then, we can decompose into:

$$\text{Household recorded income} + \text{Household underground Income} = \text{Household Consumption Expenditure} + \text{Household Investment Expenditure}$$

So:

$$\text{Household underground Income} = \text{Household Consumption Expenditure} + \text{Household Investment Expenditure} - \text{Household recorded income} = \text{Household Consumption Expenditure} + (\text{Household direct investment expenditure} + \text{Household financial capital investment expenditure}) - \text{Household recorded income}$$

Using the formula above, it is estimated that China's 2000-2014 underground economy will be shown in Table 2 below as:

Table 2 China's Underground Economy Scale (2000-2014)

Year	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Underground/GDP	18.23	17.13	14.92	14.51	13.45	13.02	11.95	11.36	10.8	10.76	10.69	9.82	9.48	9.22	8.73

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5.3 Empirical Analysis

(1) variable description and data sources

Based on the requirement of this study, this paper regards tax compliance as the explanatory variable, corruption as the explanatory variable and economic growth rate as the control variable. The data sources are shown in Table 3 below.

Table 3 Variables Data Sources

Variables	Tax Compliance	Corruption	Economic Growth Rate
Variable symbol	Y	X1	X2
Measurement	$\frac{\text{Underground Economy Scale}}{\text{GDP}}$	CPI index	$\frac{(\text{GDP}_t - \text{GDP}_{t-1})}{\text{GDP}_{t-1}}$
Measured data sources	Measured data, see Table 2	Transparency International "Global Corruption Perceptions Index" report	China Statistical Yearbook

(2) Descriptive statistics

Descriptive statistics of each variable sample data are shown in Table 4 below. As can be seen from Table 4, the scale of China's underground economy over GDP shows an average of 12.28%, the maximum value is 18.23%, the minimum is 8.73%, the standard deviation is 2.88, indicating that China's taxpayer tax compliance changes significantly by years. China's average CPI index is 3.51, the maximum is 4.0, the minimum is 3.1, the standard deviation is 0.23, indicating that the difference of China's government corruption across the time is relatively small.

Table 4 Descriptive statistics of each variable

Variable	Tax Compliance	Corruption	Economic Growth Rate
Measures	$\frac{\text{Underground Economy Scale}}{\text{GDP}}$	CPI index	Natural logarithm of GDP
Average	12.28	3.51	12.21
Max	18.23	4.00	18.62

Min	8.73	3.10	7.88
Standard Deviation	2.88	0.23	3.29

(3) Regression analysis

Based on the Hypothesis of this paper, we construct the following model:

$$Y_t = C + \alpha_1 X1_t + \alpha_2 X2_t + \varepsilon_t$$

In the equation, y is the degree of tax compliance, expressed as the proportion of the underground economy in GDP. X1 denotes corruption, expressed in CPI index. X2 is the economic growth rate, measured by the growth rate of GDP.

By using Eviews 8.0 regression test, the results are shown in Table 5. From Table 5, the correlation coefficient between corruption and tax compliance is -10.03 and the probability of t-statistic is 0.0009. Therefore, the coefficient between corruption and tax compliance is significantly negative at the 1% significance level. Since the corruption is represented by the CPI index, the larger the CPI, the cleaner of the government; the tax compliance is represented by the scale of the underground economy as a percentage of GDP, the higher the ratio, the lower the tax compliance; the larger negative coefficient indicates that the degree of government corruption is lower; and compliance is higher. The probability of economic growth rate's t-statistic is 0.0427, which is less than 0.05, so under the significance level $\alpha = 0.05$, the coefficient is significantly non-zero, indicating that the higher the rate of economic growth in China, the higher tax compliance, which Reflecting the economy of the economy the more the economy, the more taxpayers can pay taxes according to law. As can be seen from the above, the hypothesis of this paper holds.

Table 5 The result of regression

Explanatory Variable	Explained Variable: y
Constant: c	52.00 *** (5.87, 0.0001)
Corruption: x1	-10.03 *** (-4.38, 0.0009)
Economic growth rate: x2	-0.37** (-2.27, 0.0427)
R ²	0.627
F-statistic	10.08655

F-statistic probability	0.0027
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(Note: Values in parentheses are t-statistic and bilateral probability respectively; * Indicates variable is significant at the 10% level, ** indicates variable is significant at the 5% level, and *** indicates variable is significant at the 1% level.)

6. Conclusion and Recommendations on Policy

From the above empirical analysis, we can see that corruption and taxpayers' tax compliance has a significant negative correlation, that is, the more corruption in the government, the taxpayer's tax compliance level is lower, the more the loss of tax revenue. The policy implications of this conclusion are very concise. It shows that the government should strictly control corruption and increase the revenue of the government. Nowadays, the anti-corruption journey of our central government should be institutionalised and maintained by long-term. Taxation authority, as a main part of the government, should thoroughly combat with corruption for keeping the tax officials clean and self-love, and for establishing a good image of the government. The tax authority should go further on the journey of anti-corruption.

(1) Pay close attention to the way of working, and establish a clean sense on the authority

There are a lot of corruptions in the current tax law enforcement officers, the corruption phenomena in tax systems such as Haining and Henan tax system are good examples. Therefore, we should focus on the way of working; the government should purify the thinking of tax officers. First, to establish professional ethics training mechanism, through learning, training, to enhance the moral training of tax personnel and to form a correct view of the power. As a result officers can cultivate their diligent and honest government services for the public interest awareness and quality, consciously with inner moral power to resist the external temptation, officer can also consciously strict demands on themselves to exercise their own hands in the hands of the power to reduce the moral risk of tax corruption. Second, the incorruptness of self-discipline should be included in the tax assessment mechanism to improve the cost of corruption.

(2) Strengthen the tax system to prevent corruption

The right should be kept in the cage of the system, a good system must firstly be established. First, in the stage of tax legislation, the legislature should take into full consideration and prudent legislation to increase the penalties for illegal and criminal offenses. In particular, taxpayers should be given the right to supervise and report taxpayers while protecting their taxpayers from harm. Second, in the stage of tax enforcement, the internal organs of the tax authorities at all levels should be set up scientifically, and the decentralization should be implemented for the mutual supervision between the upper and lower levels and the mutual supervision across institutions. Taxation corruption in the tax administration is mainly manifested as the abuse of tax power as inaction or not, in dealing with the use of tax administration power, we should pay attention to the following points: First, position responsibility, that is to prevent abuse of rights beyond the scope of duties; The second is the establishment of strict power operation procedures, through the strict procedures set to regulate the free exercise of power, in particular the collection of taxes and collection of fines can only be carried out in the tax office. Third, we should establish

a united system of responsibility, rights and position. Both a rigorous internal review system and resolutely cooperate external judicial and audit review system are needed.

(3) Enhance the transparency of tax administration; improve the efficiency of tax law enforcement

It is difficult to control the tax corruption because of the asymmetry of its information, and the information asymmetry caused by collusion between taxpayers and taxpayers is more complicated than that of simple taxpayers. Therefore, to improve the efficiency of tax administration is to strengthen the disclosure of tax information so that to achieve the transparency of tax administration, by improving the quality of tax information and speed of delivery, as long as the information quality improved, psychological cost of tax corruption by taxpayers will increased as natural risk increases. The tax corruption of the parties want to conceal the possibility of economic behaviour by the black-box operation will also be reduced, inhibiting the corruption of tax opportunism.

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Intellectual Property-related Tax Avoidance Arrangements: China's New Transfer Pricing Rules & Implications for Technology-related companies operating in China

By Dr George Yijun Tian¹

Abstract

Cross-border Tax Avoidance is not a new concept. It affects every country, particularly developing countries. The United Nations Conference on Trade and Development (UNCTAD)'s *World Investment Report 2015* indicates that the amount of corporate profits shifted from developing countries is about \$450 billion USD,² and found that tax avoidance practices result in a significant leakage of development financing resources and an estimated \$100 billion USD tax revenue loss per year for developing countries.³ China, as one of the largest developing countries, also suffers a lot from tax avoidance practices by multi-national enterprises (MNEs). Chinese state media estimates that tax evasion and avoidance by foreign companies costs the world's second largest economy at least 30 billion Yuan (\$4.8 billion USD) in tax revenues each year.⁴

In recent years, particularly after G20 conference in Australia in 2013, China has taken transnational tax avoidance issue seriously. In November 2014 China levied about \$140 million in back taxes from Microsoft Corp in the first major case concerning cross-border tax evasion in the country.⁵ Furthermore, the Chinese government has increased tax scrutiny of foreign companies by the implementation of new rules designed to rein in cross-border tax avoidance, particularly transfer pricing arrangements.

This article examines the major forms of intellectual property (IP) related tax avoidance activities conducted by major technology-related MNEs, in particular, China's new anti-tax avoidance rules and policies (such as particular transfer pricing regulations). These include the *Public Notice Regarding Refining the Reporting of Related-Party Transactions and Administration of Transfer Pricing Documentation (SAT Public Notice [2016] No. 42)* ("Public Notice 42") issued by the State Administration of Taxation ("SAT") of China, and the SAT's submission to the *United Nations Practical Manual on Transfer Pricing for Developing Countries* (the Manual) in December 2016. This article explores the implications of these new rules and policies to IP related transactions. It also attempts to provide some practical suggestions for technology-related MNEs operating in China.

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² UNCTAD, *World Investment Report 2015 – Reforming International Investment Governance*, at 200 http://unctad.org/en/PublicationsLibrary/wir2015_en.pdf

³ *Ibid.*

⁴ Michael Martina, *Firms prepare for new tax rules as China vows crackdown* (Reuters Market News, Jan 31, 2015) at <http://www.reuters.com/article/china-taxavoidance-idUSL4N0V91IR20150201>

⁵ *Ibid.*

Part I: Intellectual Property and Transfer Pricing

Before examining the IP-related tax avoidance activities by MNEs in China, it is necessary to put into the context of the importance of IP and intangible assets to tax avoidance by MNEs. In the current knowledge economy environment, intellectual property rights (IPRs) and intangible asset play an increasingly important role in global economic growth and international trade. The World Intellectual Property Organization (WIPO) has noted that ‘global trade in intellectual property (IP) is valued at more than \$300 billion’, and ‘more than 50 percent of the top companies in the credit rating agency Standard and Poor’s index dependent on intangible assets’.⁶

IP carries tremendous value because it often brings or has the potential to bring enormous amounts of royalties.⁷ Further, IP does not have any physical presence, and it is intangible in nature, such as entertainment products in digital form.⁸ The IP is in digital format and easily transferable from one country to another.⁹ Therefore, an increased number of companies, particularly MNEs, have adopted sophisticated business models to use IP as a powerful instrument to avoid or minimize their income tax globally.¹⁰ For example, Duhigg and Kocieniewski made a comparison of the net profits of Apple (tech company) and Wal-Mart (non-tech company). With IP-tax avoidance tactics Apple ‘paid cash taxes of \$3.3 billion around the world on its reported profits of \$34.2 billion’ in 2011, a tax rate of 9.8 per cent. By contrast, Wal-Mart ‘paid worldwide cash taxes of \$5.9 billion on its booked profits of \$24.4 billion, a tax rate of 24 per cent, which is about average for non-tech companies’.¹¹ The main reason behind this is that Apple’s accountants have adopted IP-related ‘transfer pricing’ measures to allocate about 70 per cent of its profits (\$24 billion) to low tax countries overseas (such as Ireland and Luxemburg), rather than at the statutory rate of 35 per cent in the US.¹² It is clear that the rise and significance of transactions involving IP have arguably brought new challenges to the current tax systems, which were originally designed for commercial transaction of tangible assets ‘based on their legal ownership and physical location.’¹³

What is transfer pricing? Put simply, ‘transfer pricing’ is a term used to ‘define the price charged between associated enterprises for the transfer of goods, services and intangible property’.¹⁴ More specifically, for a company undertaking business across the world, its resources are often deployed across different taxing jurisdictions, including both high tax jurisdiction(s) and low tax jurisdiction(s). The mismatch of rate of income tax in different national taxing jurisdictions is key reason and driving force for any MNEs¹⁵ to pursue a planning strategy in order to allocate its resources and assets in the most tax efficient matter. Although such a tax efficient method may not be per se illegal, it is often looked at with suspicion by tax authorities. Allegedly ‘shifting of profits’ to relatively low-tax

⁶ WIPO, UNCITRAL Team Up On IP And Finance, 20/03/2009 by William New, *Intellectual Property Watch* at <http://www.ip-watch.org/2009/03/20/wipo-uncitral-team-up-on-ip-and-finance/>

⁷ Manish Jain, Transfer Pricing Issues in Intangibles: An Analysis, Vol. 1 Issue 1, *RGNUL Student Law Review* 12 at 10.

⁸ *Ibid.* See also Black’s Law Dictionary 811 (7th ed. 1999) (defined “Intangibles” as property lacking physical substance and existing merely on paper).

⁹ Ronald Wu, "Transfer Pricing: Current Problems and Solutions" (2010). *CMC Senior Theses*. Paper 87. http://scholarship.claremont.edu/cmc_theses/87.

¹⁰ Rachel Griffith, *Multinational firms, intellectual property and corporate income taxes*, June 2014 at https://taxpolicy.crawford.anu.edu.au/sites/default/files/events/attachments/2014-07/140701_rachel_griffith_01_july_2014.pdf (further stated: ‘Increasingly cross border nature of economic activity creates opportunities for tax avoidance’)

¹¹ Charles Duhigg and David Kocieniewski, How Apple Sidesteps Billions in Taxes (The New York Times, April 28, 2012) at <http://www.nytimes.com/2012/04/29/business/apples-tax-strategy-aims-at-low-tax-states-and-nations.html>

¹² *Ibid.*

¹³ Sarah Churton, Ellis Lambert and Ian Dennis, ‘The Impact of BEPS on intangible assets’, in *International Tax Review*, 8 March 2016, at <http://www.internationaltaxreview.com/Article/3535797/The-impact-of-BEPS-on-intangible-assets.html>

¹⁴ Raymond Wong and Tony Dong, ‘Overview of Transfer Pricing in Hong Kong and China, (KWM.com, November 26, 2015)’ at <http://www.kwm.com/en/knowledge/insights/overview-of-transfer-pricing-in-hk-and-china-20151126>

¹⁵ A multinational enterprise (MNE) is a company that is part of a “MNE Group.” An MNE Group consists of related corporations or similar entities operating in more than one country. *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* – 2010 Edition.

jurisdictions through intra-group ‘transfer pricing’, creates what is called the ‘transfer pricing’ problem.¹⁶

Transfer pricing (TP) is significant for both the taxpayers and tax authorities because it is used for cost allocations, which have a large impact on income. It ultimately determines a company’s taxable income in various tax jurisdictions.¹⁷ Therefore, it is clear that artificially shifting profits overseas in this manner could pose a ‘serious risk to tax sovereignty, tax fairness, and the integrity of corporate income tax’.¹⁸

TP issues of MNEs occupy ‘a prominent place’ in the recent *Base Erosion and Profit Shifting initiative (BEPS initiative)* of the Organisation for Economic Co-operation and Development (OECD).¹⁹ Transfer pricing is also ‘a major form of BEPS in China’,²⁰ including IP related industries. According to a recent report of the WIPO, as in previous years, China has been the main driver of growth of IP activities around the world. From already high levels, patent applications in China increased by 18.7%, and trademark applications by 27.4% in 2015. In terms of total (resident and abroad) IP filing activity by origin, China ranks the first for Patent, Trade Mark and Design.²¹ As such, not surprisingly, when investigating TP activities by MNEs, the Chinese tax authority gives a particular attention to the transactions in relation to IP and intangibles.²²

Part II: Major Forms of IP-related TP Arrangements vs Arm’s

Length Principle

Before examining how Chinese tax regulations address IP-related tax avoidance issues, it is necessary to explore the major forms of IP-related tax avoidance activities by MNEs. Although IP-related transfer pricing strategies adopted by MNEs, particularly technology-related companies, are sophisticated and various on a case-by-case basis, some popular approaches include: (1) transfer of IP ownership, (2) IP licensing arrangement, (3) IP service agreement, and (4) cost sharing agreement.²³

2.1. Transfer of IP ownership²⁴

Most high technology companies rely on IP or other intangible assets, such as software, as a source of value.²⁵ MNEs can take advantage of transfer pricing strategies by transferring ownership intangible

¹⁶ Jain, above n 7 at 10.

¹⁷ *Ibid.*

¹⁸ Orly Mazur, ‘Transfer Pricing Challenges in the Cloud’, 57 B.C. L. Rev. 643, 675 (2016) at 679.

¹⁹ See Jinyan Li, “China and BEPS: From Norm-Taker to Norm-Shaker” (2016). Osgoode Legal Studies Research Paper Series. 126 at <https://digitalcommons.osgoode.yorku.ca/olsrps/126> (sec3.5.1.)

²⁰ UN Response regarding BEPS, see *China’s reply to the BEPS Questionnaire of the UN Subcommittee*, at www.un.org/esa/ffd/wp-content/uploads/2014/10/ta-BEPS-CommentsChina.pdf [hereinafter: “UN Response re BEPS”].

²¹ WIPO, World Intellectual Property Indicators, Economics & Statistics Series 2016, at http://www.wipo.int/edocs/pubdocs/en/wipo_pub_941_2016.pdf

²² See *United Nations Practical Manual on Transfer Pricing for Developing Countries*, ST/ESA/347, (United Nations, 2013) at http://www.un.org/esa/ffd/documents/UN_Manual_TransferPricing.pdf at 380 (hereinafter ‘The UN Report 2013’)(stated: ‘intangibles are as major an issue for developing countries s they are for developed countries ’)

²³ See also Jain, above n 7 at 12 (Jain highlighted three major forms except IP service management)

²⁴ *Ibid.*

²⁵ See Mazure, above n 18 at 675.

assets abroad.²⁶ A MNE can transfer the legal ownership of its IP in a high tax country (such as the ownership of software patent in the US or China) to a related affiliate in low tax country (such as Ireland). Since the ownership of intangible assets has been shifted to a low-tax affiliate, all relevant IP royal incomes (licensing fees which both related affiliates and external companies need to pay) will be shifted to the low-tax affiliate also. In this manner, a MNE could successfully shift ‘additional income’ to a low tax country and lower its overall tax base.²⁷

Using the China as an example, in order to avoid paying the China’s 25 per cent statutory corporate income tax rate,²⁸ companies may artificially transfer the ownership of intangible assets (like patents or other IP) to related affiliates/subsidiaries that exist only on paper in tax havens or are located in low-tax countries without exercising any substantial business activities. More specifically, a Chinese technology company (parent company) might transfer its IPRs (e.g. software patent) to its subsidiary in the Cayman Islands (related affiliate), even if its underlying technology was researched and developed in China. The parent company in China would then need to pay royalties to its Caymans subsidiary to use that IP. That payment would arguably decrease the profit of the China’s parent company, which faces a high China’s tax rate, and boost the profit of its Caymans subsidiary, which faces a low tax rate.²⁹

Although this type of arrangement is not *per se* illegal, it has attracted criticism from tax authorities in many jurisdictions, including both developing and developed nations. A key concern could be sale price of the subject IP. Tax authorities may raise dispute in relation to the ‘reasonable’ sale price on the various grounds, such as the nature of developed IP, the profit potential for commercial exploitation of the subject IP, and the resultant value of the IP,³⁰ in line with ‘Arm’s Length Principle.

2.2. Low-Price Licensing of the IP

Another important method for avoiding high taxes is through IP licensing. Put simply, the licensing of any IP by a company (parent company) to its related affiliate (overseas subsidiary) typically involves a commercial arrangement whereby the licensee (affiliate) pays a royalty, usually specified as a percentage of the licensee’s sales, to the licensor (parent company) for the rights to exploit the associated intangible assets in the designated countries or regions.³¹

For instance, a parent company (a taxpayer in high tax jurisdiction) can establish an IP licensing and holding company suitably located offshore (related affiliate in low tax jurisdiction) to exploit, license or sublicense IP rights for the parent company as well as its foreign subsidiaries in other countries (including countries with high tax rate).³²

²⁶ *Ibid.*

²⁷ *Ibid.*

²⁸ See also US-China Business Council, *China’s High and New-Technology Enterprise (HNTE)* (The US-China Business Council, June 2013) at <https://www.uschina.org/sites/default/files/2013%20HNTE%20Background.pdf> (stated: ‘One of China’s core innovation tax policies, the High and New Technology Enterprise (HNTE) program, offers qualified company locations a 15 percent tax rate (versus the standard 25 percent tax rate)’)

²⁹ See also the example in Oxfam report. Oxfam America, 2016, *Broken at the Top: How America’s dysfunctional tax system costs billions in corporate tax dodging* at 3, at https://www.oxfamamerica.org/static/media/files/Broken_at_the_Top_FINAL_EMBARGOED_4.12.2016.pdf. (Oxfam report used the US as an example.)

³⁰ Jain, above n 7 at 12

³¹ *Ibid.*

³² See also Davis Tax Committee, *Addressing Base Erosion and Profit Shifting in South Africa Davis Tax Committee Interim Report – Action 8: Assure Transfer Pricing Outcomes are in line with Value Creation with regard to Intangibles*, at http://www.taxcom.org.za/docs/New_Folder/6%20DTC%20BEPS%20Interim%20Report%20on%20Action%20Plan%208%20-%20Transfer%20Pricing%20of%20Intangibles,%202014%20Deliverable.pdf at 2

Instead of transferring the ownership IP, which may incur the high-tax payment for IP sale in some countries (e.g. in the China),³³ the parent company and its foreign subsidiaries can simply issue exclusive licenses to the IP licensing and holding company offshore, and authorize the offshore company to commercialize their IP (including sub-licensing arrangements).

Like the transfer of IP ownership strategy (introduced above), profits can then be effectively shifted from the foreign subsidiary/affiliate to the offshore IP licensing and holding company. It is clear that such an arrangement may result in a deductible royalty payment in the high-tax jurisdictions and income in the low-tax jurisdiction.³⁴ Since the offshore company is set up in tax-haven country, it may end up paying little or no tax on the royalties received.³⁵

It is noteworthy that ‘inflation payment issues’ also exist in IP licensing arrangement. When licensor (parent company in the US) issues an exclusive licence to its foreign affiliate (an IP licensing and holding company in a low tax jurisdiction), it may artificially apply a low licensing price.

Any licensing agreement between a parent company (e.g. root licensor in the US) and its foreign affiliate (IP licensing and holding company – licensee in low tax jurisdiction) always contains terms for pre-existing IPRs and royalty payments in return. These royalty payments (licensing fees/prices) are taxable income in the US.³⁶ In order to avoid paying a high tax, the licensor (IP owner) often artificially reduces the licensing fees to a licensee (IP licensing and holding company offshore).

Again, like the sale of IP, the key concern in relation to the licensing of IP is how to ‘accurately value the transaction’. Without an accurate value, an appropriate ‘arm’s length payment’ or ‘royalty fees’ are difficult to support.³⁷

2.3. IP Service Agreement vs. Arm’s Length Principle

Due to the implications of the "Arm's Length Principle", the pricing of the license or transfer cannot be too low. The tax laws in many countries (such as the US³⁸ and China) require that the TP between the affiliated companies meet the "Arm's Length" principle, that is, the price of the associated parties should be the same as the price for the non-related party.³⁹

One way for MNEs to justify the low pricing for IP sale or licensing, and to avoid the Arm's Length Principle test is to sign a IP service agreement between affiliated companies, which not only covers the sale/licensing of patents (or other IP), but also covers related technical services (software/infrastructure maintenance and management).

For example, the contact between Apple and its Irish subsidiary not only covers the sale of Apple patents but also covers related technical services. It is clear that bundling the IP with related support services makes the transaction price difficult to estimate, and it becomes more difficult for a tax

³³ See also Memorandum: Offshore Profit Shifting and the U.S. Tax Code – Part 2 (Apple Inc.), (GPO, May 21, 2013) at <https://www.gpo.gov/fdsys/pkg/CHRG-113shrg81657/pdf/CHRG-113shrg81657.pdf> (hereinafter ‘Apple Memorandum’)

³⁴ Mark P. Keightley and Jeffrey M. Stupak, *Corporate Tax Base Erosion and Profit Shifting (BEPS): An Examination of the Data*, (US Congress Research Service, April 30, 2015) at <https://fas.org/spp/crs/misc/R44013.pdf> at 9.

³⁵ See C Doggart “Tax Havens and Their Uses” The Economist Publication (1990) Special Report No 1191 at 36-37, cited by Davis Tax Committee, above n 32 at 3. fees derived by the IP licensing and holding company from the exploitation of the relevant IP will be either exempt from tax or subject to a low tax rate in the tax-haven jurisdiction.³⁵

³⁶ See also example in Jain, above n 7 at

³⁷ Jain, above n 7 at 12.

³⁸ See also The Joint Committee on Taxation (JCT), Congress of the United States, Present Law And Background Related To Possible Income Shifting And Transfer Pricing (JCT, July 20, 2010), at <https://www.jct.gov/publications.html?func=startdown&id=3692>, at 23.

³⁹ See also Internal Revenue Service (IRS), LB&I International Practice Service Transaction Unit, Chapter: Section 482 Fundamentals, Part: Other Transfer Pricing Issues, Volume: Inbound Income Shifting, (IRS, September 3, 2014)

authority to review in accordance with the Arm's Length Principle.⁴⁰

It is also noteworthy that, with the development and wide application of the Internet technology (particularly cloud computing technology) the application of the service agreement for transfer pricing by technology companies becomes more common and easier. Cloud technology enables an MNE to fragment and move its core IT functions to geographic locations that are distant from the physical location of its users. For instance, an MNE can locate its technology supporting team for the IP management, the IT infrastructure maintenance and software technical support services in a low-tax jurisdiction (such as tax havens), which may differ from its market jurisdiction where its end users live (such as the US market or the Chinese market). As a consequence, the MNE's profits can be reported in the low-tax jurisdiction, even though the actual business activities related to these profits arguably occur in other countries.⁴¹

2.4. Cost-sharing Arrangement

Arrangements, such as Cost Sharing Agreement (CSA), are another important method for IP-related transfer pricing by MNEs. In a cost sharing agreement, related companies agree upon how the research and development costs for creating intangible assets/IP (such as software patent) are to be allocated between them.⁴²

Using software patents as an example, under the CSA, if a software patent was produced by the parent company in high-tax jurisdiction (such as an innovation company in the US), the related affiliate/subsidiary in low-tax jurisdiction (such as an IP licensing/holding company in tax havens) has the rights to use that patent for a portion of developmental costs it has covered.⁴³

This may result in a significantly lower licensing fee (even no royalty charge) from an offshore affiliate to the parent company. It is clear that, if the parent company is located in a higher tax jurisdiction than its offshore affiliate and the 'developmental costs' of IP are less than 'market-based royalty fees', the company can arguably decrease its global tax liability through CSA.⁴⁴

Again, using Apple as an example, Apple's CSA with its offshore affiliates in Ireland is primarily a conduit for shifting tremendous profits from the US to a low tax jurisdiction. According to the information in a 17-page testimony made by Apple in 2013, from 2009 to 2012, the CSA facilitated the shift of \$74 billion in worldwide sales income of Apple away from the US (with a tax rate of 35%) to Ireland (with a negotiated a tax rate of less than 2%).⁴⁵

Nonetheless, CSA is also subject to the Arm's Length Principle test by tax authorities. It is often alleged that MNEs are shifting cost and risks under transactions to violate the Arm's Length Principle.⁴⁶

⁴⁰ Song Haining, IP Solutions to Multinationals' Tax Avoidance Strategy, July 25, 2014 at <http://www.patentexp.com/?p=547>

⁴¹ Mazure, above n 18 at 673. See also OECD, Addressing Base Erosion and Report Shifting, (2013) at 20.

⁴² Jain, above n 7 at 12

⁴³ *Ibid.*

⁴⁴ Ronald A. Dye, "Cost-Sharing Agreement A tax-saving device of multi-nationals," "Valuation Issues for Buy-In Payments Associated with Cost-Sharing Agreements" Kellogg School of Management, 2008. http://insight.kellogg.northwestern.edu/index.php/Kellogg/article/cost_sharing_agreements. Cited by Jain, above n 7 at 12.

⁴⁵ See Connie Guglielmo, Apple, Called A U.S. Tax Dodger, Says It's Paid 'Every Single Dollar' of Taxes Owed (FORBES, 2013) at

<https://www.forbes.com/sites/connieguglielmo/2013/05/21/apple-called-a-tax-dodger-by-senate-committee-apple-says-system-needs-to-be-dramatically-simplified/#555a2f6b3384> see also Apple Memorandum, above n 33.

⁴⁶ In the industrialized world, transfer pricing is the leading international tax issue. See CYM H. Lowell et al., U.S. international transfer pricing 11.03(3) & n.186 (2005). Transfer pricing is also the most significant tax issue in many developing economies, such as China. See Khoonming Ho & Jean Li, *China*, World Tax 2005, at 116, 122 (2005).

2.5. General Challenges: Transfer Pricing, Arm's Length Principle & Difficulties of Intellectual Property Valuation

One of the key concerns in relation to IP-related TP activity is about the application of the Arm's Length Principle. A key issue related to application of principle is to 'accurately value' the relevant IP transactions. Indeed, without an accurate value, it is hard for tax authorities to apply to the Arm's Length Principle to relevant IP transactions.⁴⁷ Not surprising, IP valuation has represented an important reason for various disputes between the MNEs and tax authorities.⁴⁸

However, determination of the true value of IP is not an easy job. Even the OECD Guidelines recognize that 'it is often difficult to attribute a distinct value to each piece of IP on an ongoing basis'.⁴⁹ The economic value of IP can be affected by numerous factors, such as the economic and legal environment in which the IP is embedded (e.g. legal environment for IP enforcement), the market demand for the IP, commercial life of the IP,⁵⁰ and the existence or absence of close substitutes in relevant market.⁵¹ The valuation of IP poses difficulties for TP assessments by tax authority for at least three major reasons:⁵²

First, comparables for relevant IP assets may not always exist. Using patents as an example, since each patent has its unique functions (inventors need to pass novelty and inventive steps tests during the patent application process), it may not be easy to find comparables for the patent in the proposed transaction. Moreover, in practice, patents are rarely traded on external markets. Instead of selling their patents, MNEs usually license out some of their exclusive rights on relevant patents so that related affiliates can commercialize them in relevant market. So the sale price for a patent comparables may not always exist.

Second, IPRs are often transferred in combination with tangible assets or services.⁵³ IP buyers may want to acquire a product (product package) that relies on a combination of IP and other assets and service, such as a combination of software patent, IT infrastructure and technical support service (as introduced in section 2.3 IP service agreement). It is hard to identify an accurate 'separate' value for the relevant IP asset (e.g. the value of software patent in the proposed transaction).

Third, IP other than patents (such as trade secret, know-how) are particularly difficult to detect because they are not usually reported in MNEs' financial statements.⁵⁴ According to statistics, more than 75 per cent of all private R&D expenditures worldwide are accounted for by MNEs. However, most royalties, licenses, and management fees in relation to IP are intra-group payments flowing from foreign affiliate MNEs to the parent corporation MNE.⁵⁵ Therefore, IP is generally not recorded or disclosed in an MNE Group's financial statements or its footnotes. Even if an MNE Group measures

⁴⁷ Jain, above n 7 at 12

⁴⁸ *Ibid* at 14-15.

⁴⁹ The OECD is an international organization of thirty member countries primarily dominated by European countries. The OECD proposes government policies in various areas including transfer pricing. See About OECD, <http://www.oecd.org>.

⁵⁰ For example, Glaxo SmithKline's description of its competition recognizes that "[p]harmaceuticals may be subject to competition from other products during the period of patent protection and, once off patent, from generic versions." GSK Annual Report, cited Jain, above by Jain, above n 7 at 15.

⁵¹ Jain, above n 7 at 14-15.

⁵² *Ibid.*

⁵³ Such a combination is also known as "embedded intangibles. See generally Richard L. Doernberg, *Taxation Silos: Embedded Intangibles and Embedded Services Under U.S. Law*, 41 Tax Notes Int'l 561 (2006).

⁵⁴ See also Lorraine Eden et al., *The Production, Transfer, and Spillover of Technology: Comparing Large and Small Multinationals as Technology Producers*, in *Small and Medium Size Enterprises in the Global Economy* 121, 122 (Zoltan J. Acs & Bernard Yeung eds., 1999).

⁵⁵ *Ibid.*

its IP, very little disclosure about IP is required in the financial statement footnotes.⁵⁶ In the other words, it is very hard for the public to find the pricing information in relation to comparables of relevant IP.

As mentioned above, not surprising, IP-related valuation can be problematic under the current tax system. After all, the current tax system was originally established to tax commercial transactions of tangible assets with physical existence rather than intangible assets. The challenges summarized above are general challenges for both developing and developed nations. In China's 2013 report to the UN, China summarized some more unique challenges that developing countries have to face up.

Part III: Intellectual Property and Transfer Pricing Regulations in

China: Key Focus & Challenges

China's general tax law and TP regulations do incorporate a broad concept of IP, which may cover IP and other intangible assets, such as patent, technology know-how, trademark and copyright.⁵⁷ However, the definition may be difficult to apply to all circumstances.

3.1. The legislative framework & recent development of China's Transfer Pricing law

In China, the fundamental rules in relation to transfer pricing can found under the *Enterprise Income Tax Law* and its *Implementation Rules* (EIT Law) promulgated by the National People's Congress and the State Council in 2007.

The State Administration of Taxation ("SAT") issued the *SAT Circular on Implementation Measures for Special Tax Adjustments (Trial Implementation)*, Guoshuifa [2009] No. 2 (Circular 2) on 8 January 2009, which sets out more detailed transfer pricing rules.⁵⁸ Additional TP rules and guidelines at different governmental levels (such as provincial level⁵⁹) are also introduced in order to provide interpretation and supplements on the existing TP regime (together as, the "*Chinese Transfer Pricing Rules*").⁶⁰

The *Chinese TP Rules* cover a wide range of issues relating to TP, including:

⁵⁶ Jain, above n 7 at 16..

⁵⁷ Jeff Yuan, 'China: transfer pricing of IP and intangibles' in *Tax Planning International: Special Report – Transfer Pricing Aspects of IP and Intangibles*. March 2008, at http://www.nera.com/content/dam/nera/publications/archive1/PUB_TPI_March2008.pdf at 29-31.

⁵⁸ See Jinyan Li, 'Tax Transplants and Local Culture: A Comparative Study of the Chinese and Canadian GAAR'. *Theoretical Inquiries in Law*, (2010). 11(2)

⁵⁹ For more examples, please see *2016-2018 Administration Plan for International Tax Compliance*, Jiangsu Provincial Office, SAT, Su Guo Shui Fa [2016] No. 125 ("Su Guo Shui Fa [2016] No. 125")

⁶⁰ Wong and Dong, above n 14 at 6.

- both the *substantive rules* in relation to the definition of related parties (associated enterprises) and related-party transactions, documentation requirements,⁶¹ TP methodology,⁶² comparable analysis method;⁶³ and
- the *procedural rules* in relation to TP investigation and transfer pricing adjustment.⁶⁴

In addition, the *Chinese Transfer Pricing Rules* also cover the rules in other related areas, such as thin capitalisation⁶⁵, controlled foreign corporations and general anti-avoidance rules (GAAR).⁶⁶

3.2. Major concerns of the Chinese tax authority on Transfer Pricing

In practice, IP-related TP issue by MNEs has been one of major concerns of the Chinese tax authority.⁶⁷ According to the SAT, among various TP practices, ‘intra-group payments of service fees and royalties are of particular significance’.⁶⁸

Service fees, detected by tax authorities, account for a major share of outbound payments from China. The range of services is very broad, and certainly covers the services related to intangibles. As introduced above, both IP service agreement and the CSA adopted by related MNEs affiliates have close connection with service fee payments. For example, the IP service agreement between Apple and its Irish subsidiary covers both the sale of Apple patents and related technical services.

The potential leakage from the Chinese tax base due to outbound payments for service fees is significant.⁶⁹ In 2015, China SAT issued the *Public Notice Regarding Certain Corporate Income Tax Matters on Outbound Payments to Overseas Related Parties* (SAT Public Notice [2015] No.16,

⁶¹ For example, On July 13, 2016, China’s State Administration of Taxation (SAT) released *Announcement on the Enhancement of the Reporting of Related-Party Transactions and Administration of Contemporaneous Documentation* (Announcement 42). Most recently, following the 2016 G20 Hangzhou Summit, on July 13, 2016, China’s SAT released *Public Notice Regarding Refining the Reporting of Related-Party Transactions and Administration of Transfer Pricing Documentation* (SAT Public Notice [2016] No. 42, hereinafter referred to as “Public Notice 42”) to replace and modernize the current documentation regulations as prescribed under Circular 2 (2009). See Notice 42, ‘Chapter 2 Reporting of Related-Party Transaction, Chapter 3 Administration of Contemporaneous Documentation, Article 74 on contemporaneous documentation requirements on cost sharing agreement, and Article 89 on contemporaneous requirements on thin capitalisation of Circular 2’ and *Annual Reporting Forms for Related-Party Dealings of Enterprises of the People’s Republic of China* (Guo Shui Fa [2008] No. 114)

⁶² China’s TP regulations (i.e. Circular 59/143) do not provide specific guidance on how to determine arm’s length price for related IP transactions, only requiring that related IP transactions conform to the arm’s length principal. (2008)

⁶³ As per Article 32 of Circular 59/143, the following factors of comparability should be evaluated between the comparable transactions and the related party transaction being analysed:

- development cost,
- condition of the transfer,
- market domination,
- degree and time period of the protection under the laws of relevant country,
- benefit to the transferee,
- investment and cost incurred by the transferee, and
- possibility and degree of substitution, etc.

⁶⁴ For example, Circular 2 (2009)- SAT Circular on Implementation Measures for Special Tax Adjustments (Trial Implementation). See Chris Xing et al, ‘BEPS: China makes its mark on global tax rules and strengthens international tax enforcement’ *International Tax Review - China-Looking Ahead*, 4th edition, (KPMG, 2016) at <https://assets.kpmg.com/content/dam/kpmg/cn/pdf/en/2016/12/China-Looking-Ahead-ITR-201412.pdf> (stated: ‘The 2009 version of Circular 2 sets out the detailed administrative rules for “special tax adjustments” in relation to transfer pricing rules (including advance pricing agreements and cost sharing), CFC rules, thin capitalisation and the GAAR’) at 10. On 13 July 2016, shortly before China was to host this year’s G20 summit at Hangzhou, adjustments to the regulations of transfer prices were published by the State Administration of Taxation (SAT) [Guoshuifa [2016] No. 42].

⁶⁵ Article 89 on contemporaneous requirements on thin capitalisation of Circular 2.

⁶⁶ Moreover, Professor Li provided a fine summary of the recent development of GAAR in China. See Li, above n 58.

⁶⁷ Li, above n 19 (stated ‘Royalties and intangibles have also been a major issue.’)

⁶⁸ *Ibid.*

⁶⁹ *Ibid.*

hereinafter referred to as the “Public Notice 16” or “*Outbound Payments Notice (2015)*”⁷⁰ in order to standardize and strengthen the administration of TP in relation to outbound payments of service fees and royalties.

Again, this notice is in line with the OECD BEPS action plan. In its press release, the SAT explicitly stated this notice is ‘another BEPS measure, following the introduction of the *GAAR* and the *Offshore Indirect Transfers Measures*’⁷¹.

It is also noteworthy that, through the *Outbound Payments Notice*, China attempts to adopt an approach, which is different from the traditional Arm’s Length Principle. As Professor Li noted, ‘Instead of attempting to determine the arm’s length price for the intra-group service transactions, the *Outbound Payments Notice (2015)* denies the existence of transactions if they provide no economic benefit to the Chinese affiliate’.⁷² And it is clear that such an approach builds on the SAT previous views in relation to the Arm’s Length Principle and practices in applying the TP methods.⁷³

3.3. Key challenges of China’s TP law enforcement & its implications on IP

China’s position in relation to the IP-related TP activities can be found in its recent report to the United Nations (UN). China has been actively participated in the TP rule making under the framework of the United Nations.⁷⁴ In the *United Nations Practical Manual on Transfer Pricing for Developing Countries Pricing for Developing Countries (the Manual for Developing Countries (the UN report))*, which was first issued in 2013, the SAT contributed a section on China Country Practices.⁷⁵ In this document, China articulated what it perceives as the TP opportunities and challenges for developing countries in the post-BEPS era.⁷⁶ In October 2016 the SAT further updated this document.⁷⁷ In the report, the SAT highlighted three major challenges China (as a developing country) has.

⁷⁰ State Administration of Taxation (SAT), *Outbound Payments Notice (2015)*. Moreover, on March 18, 2015, the SAT released the Public Notice Regarding Certain Corporate Income Tax Matters on Outbound Payments to Overseas Related Parties (SAT Public Notice [2015] No.16, hereinafter referred to as the “Public Notice 16”). The SAT office released its Interpretation to the Public Notice 16 (hereinafter referred to as the “SAT’s Interpretation”) the next day, through its official website.’ See PWC, *Tax insights from transfer pricing (PWC Global, March 2015)*, at <http://www.pwc.com/gx/en/services/tax/newsletters/pricing-knowledge-network/china-outbound-payments.html>

⁷¹ Announcement of the State Administration of Taxation on Several Issues Relating to Corporate Income Tax on Gains from Indirect Transfer of Assets by Non-resident Enterprises, Gong Gao [2015] No. 7 (Announcement 7), issued by the SAT on 3 February 2015. See also SAT, *Attacking Cross-Border Tax Avoidance and Plugging Taxation Loopholes: SAT Strengthens the Administration of Transfer Pricing related to Outbound Payments of Expenses (20 Mar. 2015)*, available at www.chinatax.gov.cn/n810341/n810755/c1519231/content.html (in Chinese).

⁷² Li, above n 19.

⁷³ Ibid. SAT: (1) Notice [2014] No. 146, supra n. 27; (2) Public Announcement about Issues Related to Monitoring and Administration of Special Tax Adjustments, Gonggao [2014] No. 54; (3) Panel Review Rules for Significant Special Tax Adjustment Cases (Trial), Guoshuifa [2012] No. 16; (4) Internal Work Rules of Special Tax Adjustments (Trial), Guoshuifa [2012] No. 13; (5) Notice on Conducting Examinations of Contemporaneous Documentation, Guoshuihan [2010] No. 323; (6) Circular on Strengthening Supervision and Investigation of Cross-Border Related-Party Transactions, Guoshuihan [2009] No. 363; (7) Notice Regarding the Status of Anti-tax Avoidance Efforts in 2009, Guoshuihan [2010] No. 84; and (8) EIT Treatment Related to Payment for Provision of Services between Parent Company and Its Subsidiary Company, Guoshui Fa [2008] No. 86; and (9) Ministry of Finance & SAT, Notice on the Tax Deductibility of Interest Expense Paid to Related Parties, Caishui [2008] No. 121.

⁷⁴ Li, above n 19. (stated: ‘By the end of 2014, SAT representatives had attend 42 BEPS meetings, submitted 52 position papers to the OECD and made ‘important contribution’ to the competition of several BEPS 2014 deliverables.’)

⁷⁵ UN Report 2013, above n 22, see 10 .3 . China Country Practice at 374-387.

⁷⁶ China recognized the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the OECD Transfer Pricing Guidelines) as ‘the “gold standard” for tax administrations and taxpayers to apply the “Arm’s Length Principle Arm’s Length Principle Arm’s Length Principle” for the valuation, for tax purposes, of cross-border transactions between related parties.’ *Ibid* at 375.

⁷⁷ See Chi Cheng et al, ‘China transfer pricing – first mover on BEPS’, *International Tax Review - China Looking Ahead*, 6th edition, (2016) at <https://assets.kpmg.com/content/dam/kpmg/cn/pdf/en/2016/12/China-Looking-Ahead-ITR-201601.pdf>; Also see China’s submission to UN Subcommittee on Article 9 (Associated Enterprises)—Transfer Pricing in 2014 at <http://www.un.org/esa/ffd/tax/TransferPricing/index.htm> or <http://www.un.org/esa/ffd/tax/TransferPricing/CommentsPRC.pdf>

The **first** challenge is about a lack of appropriate/reliable comparables when applying the Arm's-Length Principle in developing countries. On the one hand, unlike developed countries that usually have a much larger number of public companies, developing countries usually only have a small number of public companies, and information on domestic private companies is lacking or inadequate. This directly limits the availability of public information on 'domestic companies' (potential 'domestic comparables'), which can be used for TP analysis.⁷⁸ As a consequence, in practice, foreign companies ('foreign comparables') are often used as an alternative to 'domestic comparables'.⁷⁹

China further pointed out that the pre-condition for using foreign comparables is 'globalisation and free capital mobility', but such a pre-condition does not really exist due to the existence of foreign exchange controls in many developing countries.⁸⁰ As such, the SAT emphasized it is necessary to perform 'comparability adjustments' when companies in developed countries are used as comparables for companies in developing countries; [4]

Second, the SAT emphasized it is important to factor in the impact of location-specific advantages (LSAs), such as the so-called "location savings" and "market premium", when performing TP analyses in developing countries. [4] In doing so, strike a sound balance of benefits between developing and developed countries in the international trade.

Third, the SAT highlighted the challenges for identification and valuation of intangibles. As introduced above, the valuation of intangibles/IP has been a difficult part for applying the Arm's Length Principle to IP-related TP analysis.

On the one hand, as Herve and Ham observed, given the uniqueness of IP, the potentially comparable uncontrolled transactions are 'in fact effectively not comparable.'⁸¹ On the other hand, it is very difficult for domestic tax authority to collect reliable information to understand to the entire business structure of the MNEs, particularly intra-group services structure. As the SAT stated in its 2014 report to the UN, in comparison with related party's buy/sale transactions, intra-group services have a 'wider variety of arrangements' and are undertaken in 'many different forms'.⁸² Because most of the parent companies or service centres of MNEs are located overseas, the local taxpayers (domestic companies) can often only provide information in relation to their own operations rather than provide 'an overall understanding of the entire intra-group services structure'.⁸³

As discussed above, many MNEs adopted IP service agreement or CSA for IP-related TP arrangements. Since intra-group services are mostly charged applying an indirect charge method (utilising various allocation keys), this arguably makes the application of the Arm's Length Principle on IP-related TP analysis become more difficult.

While most IP-related challenges are common for both developing and developed countries, China also raised same special concerns of developing countries, such as the necessity for revisiting/revaluating the pricing arrangements for 'old' intangibles developed by MNEs in developed countries in order to ensure that the transactional price for 'old' intangibles matches the current market dynamic. China also questioned on whether it is necessary to reward the local affiliates in developing countries, contributing to the improvement of the MNEs' original intangibles, with

⁷⁸ The UN Report 2013, above n 22 at 375 [10.3.2.2]

⁷⁹ *Ibid* at 376 [10.3.2.3]

⁸⁰ *Ibid*.

⁸¹ see Herve and Ham, 2012, Germany: Hypothetical arm's-length testing and intellectual property' in *International Tax Review*, 27 June 2012, in 'Application of the hypothetical arm's-length test' session

⁸² See China's submission to UN Subcommittee on Article 9 (Associated Enterprises)—Transfer Pricing in 2014 at <http://www.un.org/esa/ffd/tax/TransferPricing/index.htm> or <http://www.un.org/esa/ffd/tax/TransferPricing/CommentsPRC.pdf>

⁸³ *Ibid*.

‘addition profits’.⁸⁴ In other words, the benefits of all stakeholders (across different tax jurisdictions) in the global value chain should be taken into account.

It is clear China is playing a very active role in participating in international tax rule making.⁸⁵ On the one hand, China’s submissions did reflect unique concerns of developing countries in relation to IP-related tax avoidance activities. On the other hand, most of issues China raised are well in line with the current international debate as well as the existing international tax laws.

Part IV: Insights for Solutions & Implication for MNEs companies in

China

Instead of simply posing questions and challenging existing TP rules under the OECD framework, China made remarkable progress in relation to making new TP rules to solve these problems, and comply and implement the OECD BEPS recommendations. At the same time, China tried to make sure that the new rules suit the special economic and social circumstance in China. China’s solutions mainly include three aspects: detailed documentation rule, value chain analysis approach, and dynamic and historical approach on IP evaluation.

4.1. Disclosure of TP Model & Detailed Documentations Rules under the OECD BEPS Framework

4.1.1. Background

As introduced above, under the Arm’s Length Principle, in order to justify the pricing for intra-group transactions, such the transactions between related group companies are compared with the transactions between unrelated companies under comparable circumstances.⁸⁶

Where no ‘comparable transactions’ can be found, then an ‘alternative comparison’ may be made with unrelated companies performing similar functions, owning similar assets (including both tangible and intangible asset) and bearing similar risks to the taxpayer whose intra-group transactions are being examined, and operating under comparable circumstances.⁸⁷

As introduced above, one of the key challenges for a developing country in applying the Arm’s Length Principle is a lack of reliable information on potential ‘comparables’ (including both domestic and foreign comparables), and a lack of clear understanding of sophisticated TP strategies adopted by MNEs.

In order to solve this problem, in its submission to the United Nations in 2014, China recommended

⁸⁴ The UN Report 2013, above n 22 at 380 [10.3.4.2]

⁸⁵ Li, above n 19. (By the end of 2014, SAT representatives had attend 42 BEPS meetings, submitted 52 position papers to the OECD and made ‘important contribution’ to the competition of several BEPS 2014 deliverables.)

⁸⁶ The UN Report 2013, above n 22 at 375.

⁸⁷ *Ibid.*

that the *UN Practical Manual on Transfer Pricing* (“*UN TP Manual*”) refers to the TP documentation requirements under the *OECD Action Plan on Base Erosion and Profit Shifting* (“*BEPS*”),⁸⁸ which requires that the parent company discloses in the ‘Master File’ its TP policies for global intra-group services, its TP method and the amount of service fees it has allocated to each subsidiary.⁸⁹

Although China is not an OECD member country, the Chinese TP Rules generally follow or make reference to the *OECD Transfer Pricing Guidelines*. It was also found that the Chinese tax authorities have made reference to certain principles under the *OECD Transfer Pricing Guidelines* in an increasing number of TP investigations in recent years.⁹⁰

4.1.2. China’s recent reforms on TP Documentation regulations & implications to IP transactions by MNEs

Instead of merely making written recommendations, China has made concrete progress to apply its recommendation by amending its existing taxation laws.

Following the 2016 G20 Hangzhou Summit, on July 13, 2016, China’s SAT released the *Public Notice Regarding Refining the Reporting of Related-Party Transactions and Administration of Transfer Pricing Documentation* (SAT Public Notice [2016] No. 42, hereinafter referred to as “*Public Notice 42*”)⁹¹ to replace and modernize the current documentation regulations as prescribed under *Circular 2* (2009) and *Annual Reporting Forms for Related-Party Dealings of Enterprises of the People’s Republic of China* (Guo Shui Fa [2008] No. 114).⁹²

Unlike *Circular 2* (2009), which covered various aspects of special tax adjustments comprehensively, *Public Notice 42* only focuses on the reporting of related-party transactions and contemporaneous documentation.⁹³

Public Notice 42 has been considered as ‘the first of a series of regulations to localize OECD/G20 BEPS Project recommendations in China’.⁹⁴ The most pronounced structural change to ‘contemporaneous documentation requirements’ under *Public Notice 42* is the formal adoption of the ‘three-tiered documentation approach’ under the BEPS Action 13.⁹⁵ This supersedes the previous

⁸⁸ The action plan was endorsed by G20 finance ministers at their meeting in Lima on 8 October 2015. The BEPS plan (2013) contains 15 measures to harmonize international corporate tax regulations, and one of which is ‘a standardized documentation of transfer pricing’. See Elizabeth Shi, *China’s New Transfer Pricing Regulations*, (ECOVIS Beijing, 15 November 2016) at <http://www.ecovis-beijing.com/en/blog-en/articles/762-china-s-new-transfer-pricing-regulations>.

⁸⁹ See *China’s submission to UN Subcommittee on Article 9 (Associated Enterprises)—Transfer Pricing in 2014* at <http://www.un.org/esa/ffd/tax/TransferPricing/CommentsPRC.pdf> at 6.

⁹⁰ Wong and Dong, above n 14 at 6.

⁹¹ For the full text in Chinese, see http://www.tax.sh.gov.cn/pub/xxgk/zcfg/ssxd/201607/t20160713_425681.html

⁹² *Public Notice* will take into effect from 2016, and the applicable sections in the old regulations (Chapters 2 and 3, and Articles 74 and 89 of *Circular 2* (2009); and *Circular Guoshuifa* [2008] No. 114) will be repealed. See also PWC, ‘SAT issues new China transfer pricing compliance requirements’ *Tax Insights from Transfer Pricing* (July 27, 2016) at <http://www.pwc.com/gx/en/tax/newsletters/pricing-knowledge-network/assets/pwc-TP-China-SAT-issues-TP-compliance-requirements.pdf> at 1. The *Public Notice 42* provides new transfer pricing compliance requirements in China, including annual reporting forms for related-party transactions (RPT Forms), Country-by-Country (CbC) Reporting, and Transfer Pricing Documentation (TPD), all of which are substantial changes to the existing rules.

⁹³ A discussion draft revision to *Circular 2* (Draft *Circular 2*) was published on September 17, 2015, for public consultation. For the full text of the draft in Chinese, see <http://hd.chinatax.gov.cn/hudong/noticedetail.do?noticeid=577376>; see also <https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dtl-tax-global-transfer-pricing-alert-16-026-14-july-2016.pdf> (Many observers believed that a series of additional regulations will be issued to complete the revision of *Circular 2*).

⁹⁴ See *China Transfer Pricing Developments: Announcement 42 and New Circular 2 (Discussion Draft)* at <https://www.kpmg-institutes.com/institutes/taxwatch/events/2016/08/us-china-transfer-pricing-announcement-42.html>

⁹⁵ OECD, Action 13.

‘single report approach’ under *Circular 2 (2009)*⁹⁶. As a consequence, MNEs meeting specific reporting criteria must prepare (1) the master file, (2) the local file, and/or (3) the country-by-country (CbC) report under the new ‘three-tiered’ documentation regime in China now.⁹⁷

In addition, in order to improve the certainty of the implementation of Arm’s Length Principle, in line with the principles set out in the *Draft Circular 2 (2015)*, Public Notice 42 provided more detailed guideline in relation to ‘related-party relationships and transactions’.

Article 2 of *Public Notice 42* further clarified the factors for the determination of ‘related-party relationships’. In addition to the existing direct and indirect ownership criteria,⁹⁸ parties may be found to be related through other forms, such as (1) their financing activities;⁹⁹ (2) rights to access and use intangible assets belonging to one of the parties;¹⁰⁰ (3) through common familial relationship at the ownership level;¹⁰¹ or (4) where one party exercises substantive control over another party’s business operations.¹⁰²

It is noteworthy that the new definitions under Public Notice 42 (2016) are more specific and comprehensive in comparison with the previous *Circular 2 (2009)*.¹⁰³ In other words, the scope of related-party relationships has been expanded.

In addition to related-party relationships, the SAT has also ‘incorporated financial asset transfers’ into the scope of ‘related-party transactions’ (RPTs).¹⁰⁴ This has been seen as ‘a clear signal’ of the SAT’s growing attention to this area.¹⁰⁵ Related-party financing transactions¹⁰⁶ and related-party services transactions (including R&D service contract for intangibles¹⁰⁷) are also defined in further detail.¹⁰⁸ Therefore, the taxpayer’s general burden for disclosing information has notably increased.¹⁰⁹

4.1.3. IP-related provisions and Implication to MNEs

Through the detailed provisions, the Public Notice 42 (2016) requires MNEs to disclose more information in relation to IP-related transactions or IP-related TP activities. Article 12 explicitly requires that any enterprise that meets the criteria¹¹⁰ for preparing a master file needs to provide ‘an overview of the global business operations of the MNE group to which the ultimate holding company belongs’. The Public Notice 42 even has a specific session on intangibles. Art 12.3 explicitly requires MNE disclosing the following IP-related information in master file:

- a. A general description of the MNE’s overall strategy for the development, ownership and exploitation of intangibles, including location of principal research and development facilities,

⁹⁶ it replaced the previous single report approach under Chapters 2, 3 and Articles 74 and 89 of the *Circular 2 (2009)*

⁹⁷ The latter report must be submitted as a part of the related party transaction forms filed with the annual corporate tax return.

⁹⁸ Art 2.1 of Public Notice 42.

⁹⁹ Art 2.2 of Public Notice 42.

¹⁰⁰ Art 2.3 of Public Notice 42.

¹⁰¹ Art 2.6 of Public Notice 42.

¹⁰² Art 2.4 and Art 2.5 of Public Notice 42.

¹⁰³ Cheng et al, above note 77 at 25

¹⁰⁴ Article 4.2. of Public Notice 42.

¹⁰⁵ Cheng et al, above note 77 at 25

¹⁰⁶ Articles 4.2, 4.4 and 13 of Public Notice 42.

¹⁰⁷ Articles 4.2 and 12.3 of Public Notice 42.

¹⁰⁸ See also in Article 4.5, Art 12.3.3, and Art 14.3.2. of Public Notice 42. For the full text in Chinese, see

http://www.tax.sh.gov.cn/pub/xxgk/zcfg/ssxd/201607/t20160713_425681.html

¹⁰⁹ Article 10 of Public Notice 42. See also Chi Cheng et al, ITR at 25

¹¹⁰ Article 12 of Public Notice 42. (i) The enterprise that has conducted cross-border related party transactions during the tax year concerned, and the MNE group to which the ultimate holding company that consolidates the enterprise belongs, has prepared a master file. (ii) The annual total amount of the enterprise’s related party transactions exceeds 1 billion RMB.

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- location of research and development management, and their functions, risks, assets and personnel.
- b. A list of intangibles or groups of intangibles of the MNE group that are important for transfer pricing purposes and which entities own them.
 - c. A list of important agreements entered between constituent entities and their related parties related to intangibles, including cost sharing agreements, principal research services agreements and licence agreements.
 - d. A description of the groups' transfer pricing policies related to research and development and intangibles.
 - e. A description of any important transfers of interests in intangibles among related parties during the fiscal year concerned, including the entities, countries, and compensations involved.

These provisions not only cover the overall strategies on IP commercialization and TP policy, but also include specific documents (such as major agreements), which are important for IP management and implementation of TP policies. The new rule even requires related parties to disclose the business intention of each major transaction in relation to intangibles. These detailed information requirements would arguably significantly facilitate the IP/intangible-related TP analysis and application of the Arm's Length Principle's to transactions of intangibles.

4.2. More Alternative Transfer Pricing Method: New or Not New?

4.2.1. Background

In its report to the UN, the SAT reaffirmed that the OECD Transfer Pricing Guidelines) is the 'gold standard' for tax authority and taxpayers to apply the 'Arm's Length Principle' for the valuation of cross-border transactions between related parties for tax purposes.¹¹¹

On the other hand, China articulated its own position in relation to better alternative solutions, such as some other internationally recognised rules/methods for better applying the arm's-length principle for valuation of the transactions (including IP-related transactions).¹¹²

4.2.2. Proposed value chain apportionment (or value chain analysis) method

An important development of Chinese TP regulations, is that, in September 2015, SAT issued a *draft circular of "Implementation Measures for Special Tax Adjustments"* which aims to revise and replace Circular 2 (2009)("Draft Circular 2"). It has been regarded as SAT's response to the recommendations of in the G20/OECD BEPS Project' as well as the affirmation of its position over the past few years on 'regulating TP under intra-group arrangements involving intangible assets and services'.¹¹³

As discussed above, one of the core issues of TP is to determine an appropriate price for a transaction since two related companies may agree on a different price than two non-affiliated companies. The general rule is that the price shall be determined according to the Arm's Length Principle. Generally speaking, there are five world recognized pricing methods to calculate the arm's length price:

¹¹¹ United Nations, Department of Economic & Social Affairs, *United Nations Practical Manual on Transfer Pricing for Developing Countries*, ST/ESA/347 at http://www.un.org/esa/ffd/documents/UN_Manual_TransferPricing.pdf at 374

¹¹² [UN at; Chi Cheng et al at 28]

¹¹³ Wong and Dong, above n 14 at 7-8.

Comparable Controlled Price (CUP), Resale Price Method (RPM), Cost Plus (C+, CP) and Profit Based Methods, including Profit comparison methods (TTNMM¹¹⁴/CPM¹¹⁵), and Profit-split methods (PSM)¹¹⁶

In relation to IP, the OECD guideline has made the CUP method the major traditional transactional method for pricing IP.¹¹⁷ Although the RPM and CP method are two other traditional transactional approaches authorized by the OECD, in practice, they are rarely used for IP ‘because of the uniqueness of most IP’.¹¹⁸

While not challenging the overarching role of the arm's-length principle in TP under the OECD guideline, instead of supporting the major role of the CUP method, in the Draft Circular 2, SAT proposed to adopt the ‘value chain apportionment method’ to determine appropriate value of alleged transactions between related parties.¹¹⁹

The rationale behinds this approach is understandable. As introduced above, China identified many specific problems for developing countries applying the CUP method, particular identifying appropriate comparables.¹²⁰ On 26 December 2016, SAT released *China Advance Pricing Arrangement Annual Report (2015)* (“2015 APA Report”).¹²¹ In the report, the following table lists the TP methods used in signed APAs from 2005 to 2014 and in 2014 alone:

Transfer pricing method	2005 to 2014	2014
Comparable uncontrolled price method	5	0
Resale price method	1	0
Cost plus method	17	0
Transactional net margin method	95	9
Profit split method	3	0
Other methods	4	0

It is clear that the transactional net margin method (TNMM) is the most frequently used TP method, while the comparable CUP method, the RPM and the PSM are rarely used in China. The SAT explains that the infrequent use of the CUP method is mainly because it is difficult for the enterprises to meet the ‘high comparability standard’ required by the CUP method¹²² (As introduced above, difficult to find appropriate comparables). Thus the SAT may continue to be reluctant to accept the CUP method in future APA negotiations.¹²³

In fact, this method is largely consistent with China’s positions in its submission to the UN in 2013. In section 10.3.6 Alternative Method to the Traditional Transactional Net Margin Method (TTNMM) of

¹¹⁴ Traditional Transactional Net Margin Method

¹¹⁵ The “comparable profits measure” (CPM) determines the arm’s-length price of a controlled transaction by reference to profit level indicators such as financial ratios from transactions in the same industry. See Jain, above n 7 at 17.

¹¹⁶ Shi, above n 88. In contrast, the “profits split method” looks at the combined profit or loss from a business activity between controlled parties and allocates it between the related parties based on a preset formula. See Jain, above n 7 at 16-17.

¹¹⁷ Jain, above n 7 at 17.

¹¹⁸ See EY 2013 Global Transfer Pricing Survey AT ERNST & YOUNG, TRANSFER PRICING 2003, Supra note 7, at 18. The OECD Guidelines prefer traditional transactional methods.

¹¹⁹ Art 16.3.2. value chain analysis in *Draft Circular 2 (2015)* at <http://hd.chinatax.gov.cn/hudong/noticedetail.do?noticeid=577376>

¹²⁰ *Ibid.*

¹²¹ 2015 APA Report ‘introduce the APAs statistics concluded from 2005 to 2015, professional team building, key considerations and schedules of the APA program in China for 2015’. See KPMG, *China Tax Weekly Update*, Issue 1, January 2017 at <https://assets.kpmg.com/content/dam/kpmg/cn/pdf/en/2017/01/china-tax-weekly-update-01.pdf>

¹²² Baker & McKenzie’s China Tax Group. *China Tax Monthly*, August & September 2016 at <http://cn.swisscham.org/sites/default/files/Baker%20%26%20McKenzie%20China%20Tax%20Monthly%20Aug-Sept.pdf> at 15.

¹²³ *Ibid.*

the UN Report, China pointed out that, in certain circumstances,

‘[r]ather than a transactional¹²⁴ or profits-based approach¹²⁵, a contribution analysis approach may be more suitable.... remuneration to each party involved would be commensurate with its role and contribution to the *value chain* in the group. 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.’¹²⁶

Such a method is now further affirmed by the Public Notice 42. Article 14.3.2 of the Public Notice 42 explicitly requires taxpayers to include ‘value chain analysis’ into the TP documentation. It requires the taxpayers who meet the criteria for ‘Master File’ to disclose information in relation to ‘value chain analysis’, including:

- (1) Flows of business, goods and materials, and capitals within the group, including design, development, manufacturing, marketing, sales, delivery, billing and payment, consumption, after-sale service, recycling, other processes related to goods, services or other relevant underlying targets of the related party transactions and all the parties involved.
- (2) Annual financial statements of each of the aforementioned parties for the immediately preceding fiscal year.
- (3) Measurement and attribution of value creation contributed by location specific factors.
- (4) Allocation policies and actual allocation results of the group’s profits in the global value chain.

It is clear that this list is very comprehensive and specific in comparison with the requirements under former Circular 2 (2009). It includes most of recommendations under the Draft Circular 2.¹²⁷ The burden of MNEs to disclose/report its global transaction model has been significantly increased. This will arguably facilitate the ‘value chain analysis’ activities by tax authorities. However, it seems that Public Notice 42 has not provided a clear explanation on basic procedures for implementing this approach to TP analysis.

4.2.3. Rule shakers or Rule taker – Implications to MNEs

In relation to the potential impacts of the ‘value chain apportionment method’, some commentators believe the ‘value chain apportionment method’ (or ‘value chain analysis’) proposed by China is ‘a departure from the arm’s-length principle’ and China is developing, and even expect that it can ‘be sanctioned as a formal TP method in one of the additional TP regulations’ in soon future.¹²⁸

It seems that the impacts have been overstated. First, the ‘value chain’ method China proposed and adopted is actually not a new invention of China, and is well in line with the OECD BEPS Action plan. As some commentators observed, ‘one of the mandates of BEPS Action 10 is to clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains’.¹²⁹ Even the title of the OECD discussion paper of Action 10 is the ‘the use of profit splits in the context of

¹²⁴ ‘The ‘transactional approach’ examines transfer prices on a transaction by transaction basis does not consider the aggregate financial impact. ‘There are different methods within the transactional approach. The method referred to as the “comparable uncontrolled price” (CUP) uses a price that an outside party would charge the MNE for the item under similar circumstances. This method is the most commonly used method worldwide to support the transfer prices of IP rights, such as a licensing agreement on a patent.’ Jain, above n 7 at 16-17.

¹²⁵ ‘a) The “comparable profits measure” (CPM) determines the arm’s-length price of a controlled transaction by reference to profit level indicators such as financial ratios from transactions in the same industry.

b) In contrast, the “profits split method” looks at the combined profit or loss from a business activity between controlled parties and allocates it between the related parties based on a preset formula. CPM and PSM are collectively known as ‘valuation approach’ see Jain, above n 7 at 16-17.

¹²⁶ The UN Report 2013, above n 22 at 385.

¹²⁷ Article 16.3.2 Value Chain Analysis of Draft Circular 2 (2015)

¹²⁸ Cheng et al, above note 77.

¹²⁹ Margreet Nijof et al, Goodby TNMM, Hello Profit Split? Will the Profit Split Become Standard Fare? (Lexology, May 26, 2016) at <http://www.lexology.com/library/detail.aspx?g=b0a98ba3-e3be-4ecd-ba2e-5820d18394c4>

global value chains’.¹³⁰

Second, it does not seem that China has developed a separate new method, which departs from the traditional TP methods. As the OECD action plan has clarified, value chain analysis is simply ‘a tool in helping to delineate the actual transaction’.¹³¹ It is ‘a useful tool for all pricing methods’ and ‘it can also provide guidance on which method to apply’.¹³² It does not, of itself, indicate that the transactional profit split (or other specific method) is the most appropriate method.¹³³

As such, it seems that China is simply applying ‘value chain analysis’ in this way through new regulation. Instead of challenging the existing TP methods, China takes action in applying the recommendation of the OECD to incorporate ‘value chain analysis’ to its TP assessment regime.

While China emphasized the importance of the ‘value chain apportionment method’ (or ‘value chain analysis’) to developing countries, it does not mean China undervalues other existing methods for valuation of transitional price. In relation to this, the Chinese position has been clarified in its recent report submitted to the UN in December 2016. In the report, SAT explicitly stated: *‘No method has priority over other methods nor does the method applied need to be demonstrated as the best method.’*¹³⁴

More importantly, China’s transfer pricing rules still follow the Arm’s Length Principle (as introduced above). Therefore, as some commentators observed, ‘taxpayers should remain confident in being able to defend their related party transactions before the tax authorities’ as long as their positions are based on a ‘sound application of the Arm’s Length Principle’ and are supported by ‘high-quality comparable data’.¹³⁵

In relation to IP, China’s TP regulations do not provide specific guidance on how to determine an arm’s length price for related IP transactions, only requiring that related IP transactions conform to the arm’s length principle.¹³⁶

It is noteworthy that, in addition to reaffirm its desire to comply with the Arm’s Length Principle, China addressed its unique approach on IP-related TP arrangement from the developing country’s perspective in its submission to the UN. It suggested adopting an ‘historical’ approach to existing IP-related TP arrangements. Indeed, a licensing fee, which is appropriate for a technology patent in 2002, may not be ‘appropriate’ in 2012 any more.¹³⁷

It is clear that this approach better reflects the dynamic of IP and technology markets. It arguably may open a new niche of TP enforcement – it means that certain IP-related transactions, which have passed the Tax authority’s Arm’s Length Principle test, could be re-investigated due to the change of market

¹³⁰ BEPS Action 10: Discussion draft on the use of profit splits in the context of global value chains at <https://www.oecd.org/tax/transfer-pricing/public-comments-action-10-profit-splits-global-value-chains.pdf>

¹³¹ Base Erosion and Profit Shifting (BEPS), Comments Received on Public Discussion Draft - BEPS Action 8-10 -Revised Guidance on Profit Splits - Part I (OECD, September 8, 2016) at <http://www.oecd.org/ctp/transfer-pricing/Comments-on-discussion-draft-beps-action-8-10-revised-guidance-on-profit-splitsP1.pdf> at 15.

¹³² *Ibid*, 15

¹³³ That is to say ‘the value chain analysis itself is not sufficient to justify the profit split method’. See Baker & McKenzie’s China Tax Group, above n 122 at 4-5. See also *Fn8-OECD: BEPS Actions 8-10 Revised Guidance on Profit Splits* (public discussion draft, 4 July 2016), Para. 27.

¹³⁴ See United Nations Report 2016, D3 China Country Practice (December 2016) at http://www.un.org/esa/ffd/wp-content/uploads/2016/12/13STM_TPM_D2_China_20161120_v2_clean.pdf at 13

¹³⁵ See Baker & McKenzie’s China Tax Group, above n 122 at 4-5.

¹³⁶ For example, SAT Circular 59/143.

¹³⁷ The UN Report 2013, above n 22 at 380 (stated ‘For example, if a Chinese affiliate was charged a 3 per cent royalty for the use of a manufacturing process when the Chinese operations were established ten years ago in 2002, then it may not be reasonable for the Chinese affiliate to continue paying the same royalty in 2012 without revisiting whether the intangible has continued to provide the same value over time.’)

dynamic.

MNEs need to pay more attention to possible development of the Chinese TP regulations in this area, and re-examine current IP-pricing system, including the pricing for ‘old’ technology.

Conclusion

Following the 2013 G20 Summit in Australia and 2016 G20 Hangzhou Summit, China is playing an increasingly important role as an ‘active participant’ in the international tax reform process.¹³⁸ As some commentators observed, ‘in less than a decade, China has come a long way from having a dearth of TP regulations to now being one of the earliest adopters of the OECD’s BEPS Project on the global stage’.¹³⁹

In relation to IP-related TP rule making, it seems that China is a quick and creative international tax rule taker and maker. On the one hand, it strictly and efficiently follows the recommendations of the OECD action plan to revise and upgrade its existing TP regulations. This is evidenced by the enactments of a series of TP related regulations/bills, such as Public Notice 42 (2015), Draft Circular 2 (2015). On the other hand, when conducting the law transplant, China did take into account its special social and economic circumstances as a developing country, and incorporate the OECD recommendations to its TP rules in a creative way. This is evidenced by introducing the ‘value chain method’ to its new TP regulations to facilitate the implementation of the Arm’s Length Principles, and adopting ‘IP dynamic pricing analysis approach’ to the valuation of the transactions of intangibles.

The rapid development of TP regulations in China would arguably have profound implications for MNEs’ operations in China, including IP-related enterprises. On the one hand, the detailed provisions in the new TP regulations increase the certainty of law enforcement in China. On the other hand, they place more obligations for MNEs to comprehensively disclose its TP arrangements IP management mechanism as well as global value chain strategies in details.

Nevertheless, it is also noteworthy that some important issues China addressed in the UN *Practical Manual* (from 2013 to 2016) have not been completely converted into systematic legal solutions under the Chinese TP regulations yet. For example, the existing regulations (Public Notice 42) only provides a comprehensive list for enterprises to disclose relevant information for a value chain analysis rather than provide a detailed guideline on how value chain analysis will be conducted by tax authority. As such, it will be important to see the details in an official Circular. Given the speedy paces that China implements OECD BEPS recommendations, that development is expected shortly.

Although the effects of the China’s new TP rules (such as ‘value chain’ approach) cannot be overstated at this stage (as introduced above), generally speaking, China has made useful contribution to the implementation of the OECD BEPS recommendation and the harmonization of international TP regulation through timely domestic TP rule making/revision and through its submissions to the UN.

As Professors Richard Ainsworth and Andrew Shact have observed,

The Chinese contribution to the UN Practical Manual is significant, both for foreign businesses engaged in Chinese activities and for MNEs in general. It may well be that the Chinese approach to

¹³⁸ Cheng et al, above note 77.

¹³⁹ *Ibid.*

transfer pricing will change the way cross-border problems are analyzed globally. China's influence at the OECD may soon rival that of the US.¹⁴⁰

It is imperative for MNEs, particularly IP-related companies, to closely follow up with and participate in the new development of Chinese TP rule making process, and be well prepared for adjusting their tax planning strategies in a timely manner in the BEPS era.

¹⁴⁰ Richard Thompson Ainsworth and Andrew Shact, 'Transfer Pricing: UN Practical Manual – China' (January 6, 2014). Boston Univ. School of Law, Public Law Research Paper No. 14-1. Available at SSRN: <https://ssrn.com/abstract=2375785> at 34.

