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FOREIGN DIRECT INVESTMENT DECISIONS AND TAX PLANNING FOR CHINESE FIRMS
THOMAS KOLLRUSS

E-COMMERCE TAXATION IN CHINA
RIFAT AZAM

RESEARCH ON TAX INCENTIVES FOR CHARITABLE DONATIONS OF NON-MONETARY ASSETS BY CHINESE CORPORATIONS
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THE UNIVERSITY OF SYDNEY

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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.

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EDITORIAL

The February 2013 issue of the Journal of Chinese Tax and Policy examines a variety of tax policy trends that are emerging as China continues to modernise and market its economy.

As China experiences socio-economic development, corporate charity donations have arisen as an essential mode of resource redistribution, however the tax law is yet to be reformed in such a way as to encourage broader corporate participation. Similarly, although China has experienced rapid globalisation and technological saturation of its economy, e-commerce and cross-border transactions pose new challenges for China's income tax system that are yet to be comprehensively addressed by policy reform. Considering the idea of 'tax planning' from a tax payer viewpoint, there is a growing trend to optimise FDI in relation to a given tax liability and hence improve the competitiveness of overseas operations, however not all firms have identified and made use of this tax advantage.

The articles selected for this edition comprehensively examine these broad yet related trends in Chinese tax policy. The first article 'Research on Tax Incentives for Charitable Donations of Non-monetary Assets by Chinese Corporations' authored by Hu and Long looks at how tax incentives can be used to encourage charitable donations by firms in China — particularly non-monetary asset donations. China's current tax laws on non-monetary asset donations and their incentive effects and limitations are examined, and the roles of government and corporations in relation to charity are compared, analysing the costs and benefits of corporate donations. Hu and Long synthesise their findings and provide recommendations for reforms that would improve tax policy and encourage corporate donations.

The second article, 'E-commerce Taxation in China' authored by Rifat Azam, examines emerging challenges for tax policy that apply to e-commerce, an economic trend that has gained considerable traction both in China and internationally. E-commerce growth is analysed in relation to the relevant income tax schemes and the difficulty in defining the tax base for e-commerce transactions under the current scheme is examined. China's response to the challenges is compared with the reactions of other countries, and common difficulties are drawn out to examine whether countries can learn from each other's experiences to develop more appropriate tax regimes for e-commerce.

The final article 'Chinese Firms Foreign Direct Investment Decisions and Tax Planning' authored by Thomas Kollruss comes from a practitioner's perspective. The paper examines the role of tax planning in China's FDIs in relation to China's most popular destinations — the US and Germany — which also attract the highest tax-burden for overseas investors. Whether tax planning can optimise the after-tax profit of Chinese firms' German subsidiaries and hence improve their competitiveness in foreign markets is examined and an investment structure using intermediary locations for investment to optimise tax liability is proposed.

The culmination of these authors' work provides a comprehensive discussion of broad and varied developments in China's globalising economy, as well as a valuable contribution to the construction of an improved tax system that can accommodate these emerging economic trends.

EVA HUANG

SYDNEY, FEBRUARY 2013

Foreign Direct Investment Decisions & Tax Planning for Chinese Firms

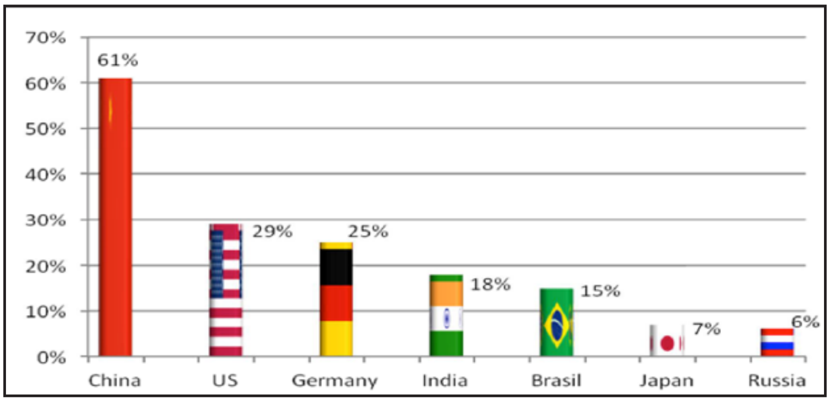
THOMAS KOLLRUSS

This article is concerned with the role of tax planning in the foreign direct investment (FDI) decisions of Chinese multinational corporations (MNCs). It can be shown that tax planning (intergroup debt financing) enables Chinese firms to locate value-added chain and direct investment (e.g. production) in high-taxed foreign countries by offsetting the relatively high tax burden. Therefore, tax planning can be regarded as an instrument to enhance the competitiveness of a foreign country as a location for Chinese firms' direct investment regarding the net after-tax profits as a key determinant of decisions. In this respect, this article shows how Chinese firms can utilise tax planning to select Germany as a target location for direct investment. Moreover, Chinese firms may use Germany as an intermediary location for tax planning, especially for structuring Chinese FDI in the USA. In this respect, thin-capitalisation and CFC rules must be considered as main restrictions for optimising the tax burden (effective tax rate/ETR).

EMPIRICAL ANALYSIS

1. Chinese Firms and Investment Location Choice

Pursuant to studies made by Ernst and Young,[1] Germany is the most attractive location for Chinese FDI in Europe. One in three investment projects run by Chinese companies in Europe were implemented in Germany. [2] Moreover, in a study in which 400 managers of Chinese firms were surveyed, Germany was named as one of the three most attractive investment locations worldwide (1.China; 2.USA; 3.Germany). [3] [4] As a consequence, Germany and the United States (USA) are considered prime targets for Chinese FDI. 28 per cent of the Chinese managers surveyed said that their firm had conducted direct investment in Germany in the last five years(for the US, this figure was 34 per cent).



Worldwide Most Attractive Investment Locations for Chinese Firms (2012)[5]

According to Chinese managers, Germany has the best basic conditions (infrastructure, academic standards, productivity, and competitiveness) for establishing regional headquarters, research and development centres, distribution centres and production plants in Europe. Therefore, 63 per cent of the 400 surveyed Chinese firms stated that they had at least one location for doing business in Germany (ranked next are France (13 per cent) and Netherlands (10 per cent).

2. Influence of the Tax Burden on Chinese FDI Decisions

The Ernst and Young study (2012) also revealed that Chinese firms regard the relatively high German business taxation rate (statutory tax rate approximately 30 per cent) as critical. Nearly30 per cent of the 400 surveyed Chinese firms held that the German tax burden was too high.[6] The same should apply if Chinese firms conducted FDI in the USA (the US statutory tax rate is 35 per cent). By comparison, the Chinese statutory CIT rate generally amounts to 25%.[7]

The FDI by US multinational corporations in Germany reveals that these investors compensate for the high tax burden of German subsidiaries by profit shifting and utilising tax planning and tax structuring techniques, especially intra-group cross-border debt financing and holding structures.[8] [9] This has enabled US investors to lower the effective tax rate (ETR) and the effective cost of capital of 'high-taxed' foreign subsidiaries significantly. [10]

Chinese firms may also use tax planning[11] as an integral part in their FDI strategy. Establishing a tax-optimised investment structure enables Chinese firms to improve the overall investment performance of their German and USsubsidiaries significantly (additional tax shield). In this respect, Chinese firms can use Germany as an intermediary location for tax planning.

CORNERSTONES FOR CHINESE TAX PLANNING REGARDING GERMAN AND US FDI

As a basic assumption regarding the following sections, Chinese FDI in Germany and USA is defined as a Chinese parent company (corporation) which invests in a wholly-owned German subsidiary and/or a US subsidiary (corporations).

1. Equity Financing of German Subsidiaries

Moreover, the applicable German withholding tax rate for a dividend distribution (German subsidiary) to a Chinese parent company (corporation) is 10 per cent of the cross dividend payment (Article 10, Para. 1,China-Germany DTT[12]). Thus, in the case of equity financing and entire profit distribution, the effective tax rate of a Chinese parent's German subsidiary is approximately 37 per cent[13] considering the Chinese standard Corporate Income Tax (CIT) rate (25 per cent) and the Chinese (indirect) tax credit method (taxation of foreign dividend income) at the level of the Chinese parent company as recipient. Due to the Chinese tax credit method, the dividend payment should not be charged with Chinese CIT.

2. Internal Debt Financing of German Subsidiaries

If the Chinese parent company finances the German subsidiary with a shareholder loan, the applicable German WHT rate — regarding the interest income — is 0 per cent. Moreover, the interest expense is deductible from the German subsidiary's German tax base within the limits of the German thin-capitalisation rule (interest barrier rule).[14] According to the German interest barrier rule, tax-effective interest deduction is limited to 30 per cent of the taxable EBITDA per fiscal year. The interest income is subject to Chinese CIT (25 per cent) at the level of the

Chinese parent company. Therefore, Chinese parent companies can lower the German tax burden by using internal debt financing instruments (shareholder loan).

3. Germany as Intermediary Tax Planning Location for Chinese US FDI

The following table shows that Chinese investors can also utilise Germany as allocation for holding and financing companies to invest in US subsidiaries (Chinese US FDI conducted via Germany). This aspect was never mentioned before in the literature. The reason is that the applicable WHT rates for dividends and interest receivables are 0 per cent for a German parent company as recipient in relation to a US subsidiary (US-Germany DTT). Whereas the applicable WHT rates for a Chinese parent corporation in relation to a US subsidiary (direct shareholding) amounts to 10 per cent for dividends and also for interest income (China-US DTT).

	Recipient			
	German corporation		**Chinese corporation**	
FDI source state US	WHT dividends (DTT)	WHT interest income (DTT)	WHT dividends (DTT)	WHT interest icome (DTT)
	0% (5%)	**0%**	10%	10%
Intermediary source state Germany (German subsidiary)			10%	10%

Therefore, a Chinese firm may utilise an intermediary German financing subsidiary or a German holding company to optimise the overall tax burden in respect of its FDI into a US subsidiary (indirect FDI).

In this respect, the restrictions of the US thin-capitalisation rules must be considered (debt-to-equity rules; safe haven 1.5:1).

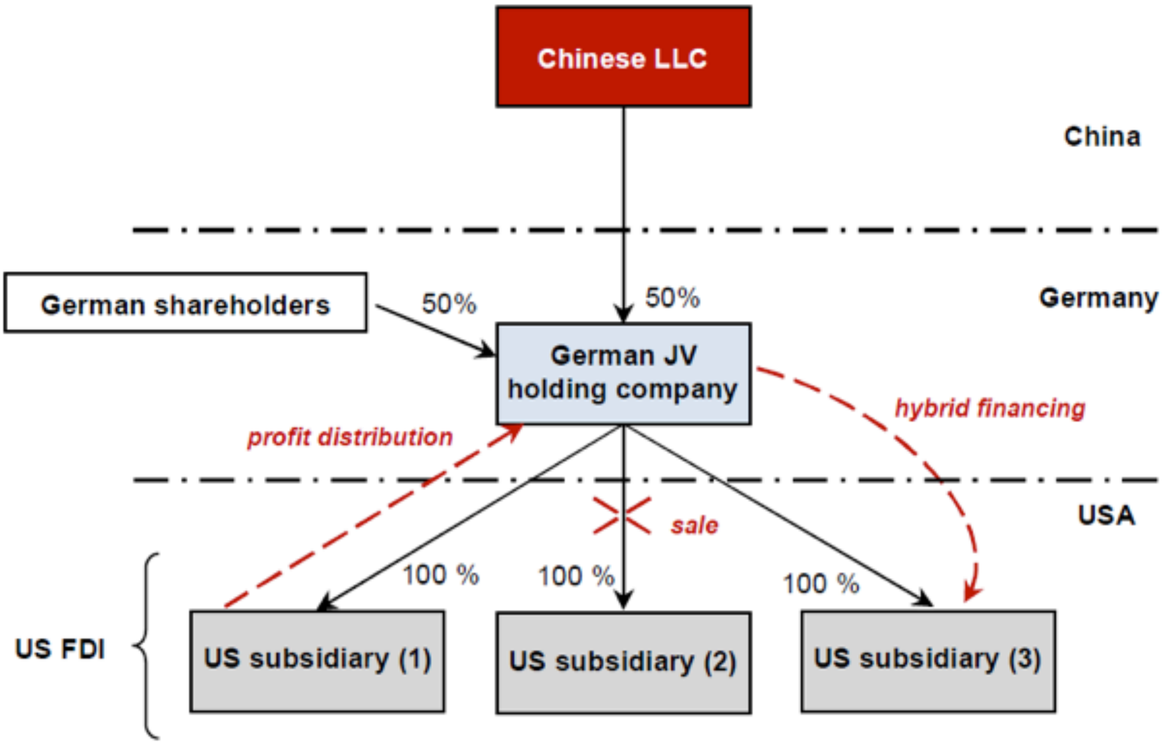
4. Tax Planning Advantages for Chinese Firms Utilising Intermediary German Corporations: Chinese CFC Taxation is Not Applicable; Favourable German Holding Taxation (Capital Gains/Dividends)

According to Article 45 of the EITL (Enterprise Income Tax Law), a Chinese shareholder may be taxed currently on its share of undistributed profits of a CFC located in a certain low tax jurisdiction. In the context of the Chinese CFC taxation, Germany is regarded as a 'white list country'. [15] [16] This means that the Chinese CFC[17] taxation is not applicable if the Chinese shareholder can prove that the foreign CFC (German subsidiary/corporation) is duly registered in Germany. [18] A CFC is registered in Germany if it has a German statutory seat, in general irrespective of whether the place of effective management is located (e.g. China, Ireland). A German statutory seat is given if the subsidiary is established/incorporated in accordance with German company law. As a consequence, a German subsidiary's Chinese shareholder is not subject to any Chinese CFC taxation (deemed dividend) in respect of the profits of the German subsidiary (CFC), irrespective of the fact that the German CFC generates low-taxed passive income (e.g. dividends, interest income, capital gains from the sale of shares in subsidiaries). Thus, a Chinese investor may utilise an intermediary German subsidiary (corporation) as a 'CFC tax shelter' (white list company) to generate (low-taxed) passive income (Guoshuihan [2009] No. 37).

Furthermore, the Chinese shareholder can participate in the favourable German holding taxation by interposing a German resident subsidiary (corporation) as an intermediary holding company. German subsidiaries are able to derive capital gains from the sale of shares in corporations and dividend payment at a tax rate in the amount of only 1.5 per cent.[19] The German holding taxation applies for shares in domestic (German) and foreign corporations, in general irrespective of a certain shareholding quota and a holding period. [20]

CHINESE US FDI TAX PLANNING UTILISING GERMANY AS INTERMEDIARY LOCATION

In the following a basic tax planning strategy for Chinese US FDI is developed using Germany as an intermediary holding location. In this context, Chinese US FDI can be described as an indirect direct investment' conducted via a German Joint-Venture)holding company. Therefore, the relevant investment structure can be depicted as follows:



Chinese Tax planning of US FDI: Germany as intermediary location

1. Tax Optimisation of Profit Repatriation
Interposing a German holding company (corporation) enables the Chinese parent company (Chinese LLC) in general to derive US dividend payment [US subsidiary(1)] without paying any US withholding taxes on the cross dividend (10 per cent) at the level of the intermediary German holding company. Pursuant to the Germany-US Double Tax Treaty (DTT) 2008(Art. 10, para. 3; Art. 28[21] Abs., Para. 2f, 4) and an active of the German JV holding company, the dividend payment is not subject to US WHT (0 per cent).Otherwise the applicable US WHT is 5 per cent (Art. 10, Para. 2, Germany-US DTT 2008). If the German holding company is wholly-owned by the Chinese LLC, the US dividend is subject to a 5 per cent US WHT. In cases where the US subsidiary is directly held by the Chinese LLC, the US WHT amounts to 10 per cent.

Since the German corporation has its statutory seat in a white list country (Guoshuihan [2009] No. 37), the Chinese CFC taxation is not applicable regarding the German subsidiary's US dividend income (passive income). According to the German holding taxation rules, the US dividend is only subject to a favourable German tax rate in the amount of 1.5 per cent (German dividend participation exemption). The received dividend income can be reinvested at the level of the German holding company also in a Chinese permanent establishment (branch).

2. Tax Exempt Capital Gains; Tax-Optimised Exit
Capital gains from the sale of shares in a US corporation [US subsidiary (2)] are subject to the 25 per cent Chinese CIT rate at the level of the Chinese LLC as vendor. If the US subsidiary is held via an intermediary German holding company, a 'tax-exempt' disposal of US shares is possible. Art. 13, para. 5 Germany-US DTT 2008 rules that a capital gain from the disposal of US shares can only be taxed in Germany. Under the terms of the German holding taxation (capital gains participation exemption) the capital gain is only subject to a 1.5per cent German business tax rate at the level of the German holding company (vendor). Furthermore, the German holding company (CFC) is not subject to Chinese CFC taxation (white list). Therefore, interposing a German holding company enables Chinese investors to create a 'tax-exempt' exit strategy vis-à-vis the shareholding in US subsidiaries.

3. Hybrid Financing; Tax Optimisation of US Subsidiaries Tax Burden
Since the statutory US CIT rate is relatively high (35 per cent), Chinese investors may use an intermediary German financing corporation to optimise the US subsidiary's tax burden. This means that a German subsidiary can also be used as a financing company. In a first step, the Chinese LLC injected the investment amount as equity contribution into a (wholly-owned) German holding company. In a second

step the German holding company forwards the received capital to a US subsidiary utilising a hybrid financing instrument. The hybrid financing instrument is a mix of an a typical silent partnership interest (minimal fraction) and a fixed-interest bearing loan. From the perspective of US tax law, the interest expense in respect of this hybrid instrument is tax-deductible at the level of the US subsidiary as debtor. Pursuant to Art 11 Para 1, Germany-US DTT, the German holding company's interest income derived from the hybrid instrument is not subject to US WHT (0 per cent). Moreover, at the level of the German holding company (recipient/creditor), the interest income is only subject to a favourable German business tax rate in the amount of 15 per cent. [22]

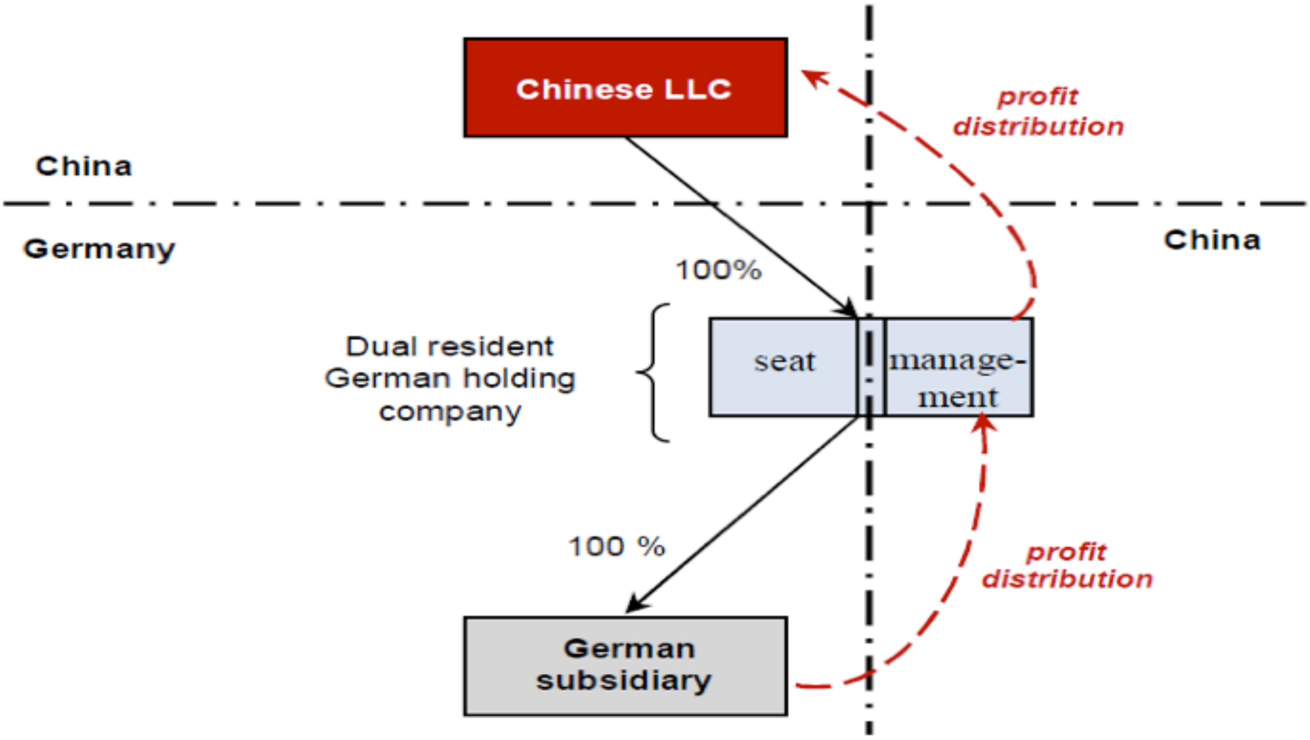
Income shifting between US subsidiaries and a German (financing) corporation by using a specific hybrid financing instrument described above enables a reduction in the applicable US tax rate by 20 basis points or by 57,14 per cent based on the shifted income (interest expense). In other words, the applicable US subsidiary's tax rate can be reduced from 35 per cent to 15 per cent within the limits of the US thin-capitalisation rules. Concerning the German corporation (passive income), the Chinese CFC Taxation is not applicable (white list). In summary, Chinese investors can optimise the effective tax rate (ETR) of their investment in US subsidiaries significantly by using a German financing company.

CHINESE FDI IN GERMAN SUBSIDIARIES AND TAX PLANNING

As mentioned above, Germany is one of the three most attractive investment locations for Chinese firms worldwide. The following sections detail tax planning strategies which enable Chinese firms to compensate for the high rates of business taxation in Germany. Tax planning may help Chinese investors to establish a tax-optimised investment structure for FDI in German subsidiaries and to lower the effective tax rate (ETR).

1. Double-Tier German Holding Structure; Zero German WHT

To avoid German WHT on a German subsidiary's dividend payment, the Chinese investor (LLC) may implement a double-tier German holding structure as described below. The first-tier of this structure consists of a German holding company (corporation) incorporated in Germany (German statutory seat) which has its place of effective management in China (dual resident German holding company). The dual resident German holding company held 100 per cent of the shares in a German subsidiary (second-tier company) which generates active income (e.g. production). The Chinese investment structure can be depicted as follows:

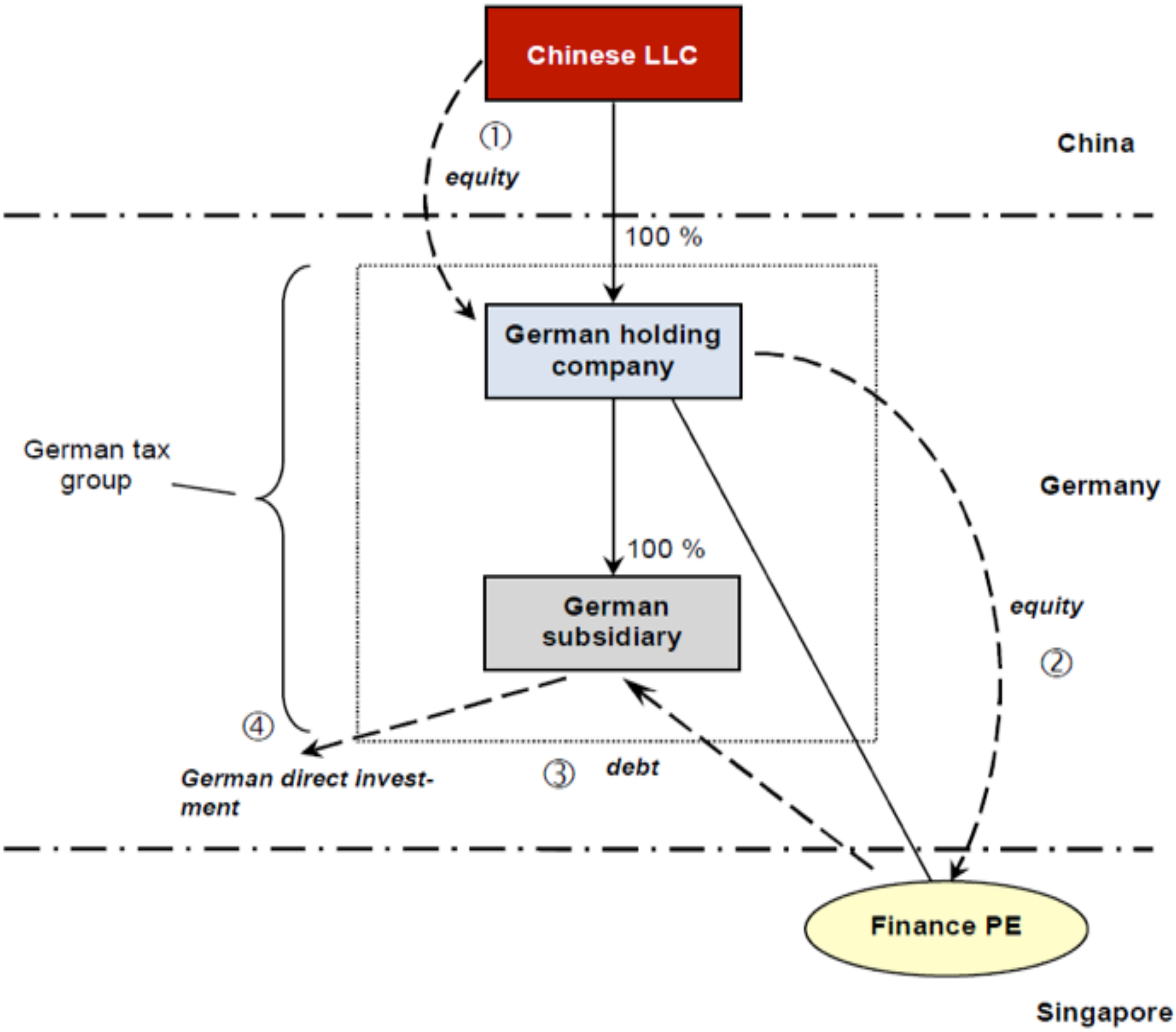


Double-tier German holding structure

In accordance with domestic German tax law, the dividend distribution from the German subsidiary to the dual-resident German holding company (recipient) is not subject to German WHT. [23] Pursuant to the prohibition on extra-territorial taxation stated in Art. 10, para. 5 of the China-Germany DTT 1985, Germany is not allowed to impose WHT on the dividend paid by the dual resident German holding company to the Chinese LLC.[24] Moreover, the German anti-treaty shopping rule (sec. 50d, Para. 3German Income Tax Act) is not applicable in respect of the dividend payment provided by the first-tier dual resident German holding company to the Chinese LLC. In summary, the double-tier German holding structure enables the Chinese investor(LLC) to derive dividend distributions from German subsidiaries without being charged with German WHT. Furthermore, in line with the Chinese indirect tax credit system (FTC),[25] the German dividend income is in general 'tax-free' at the level of the Chinese LLC (underlying German business tax).

2. German Thin-Capitalisation Rule

The German thin-cap rule (interest barrier rule) limits the tax-effective interest deduction at the level of a German subsidiary significantly (maximum 30 per cent of the taxable profit (EBITDA)). Chinese investors can implement a German tax group structure which contains a foreign finance branch (foreign CIT tax rate < 15 per cent) using inter-company debt financing to avoid the German thin-cap rule entirely (so called interest-pooling model).[26]



German tax group structure – unlimited tax effective intercompany debt financing

The German tax group structure which utilises internal debt financing[27] is generally able to reduce the German subsidiary's ETR from 30 per cent to 19.33 per cent.[28] Chinese CFC Taxation is not applicable (white list exemption).

CONCLUSION

This article has analysed the role of tax planning in Chinese firms' FDI especially in respect of the most important foreign investment locations, USA and Germany. From the background of the Chinese CIT rate (25 per cent), the tax burden in these states is relatively high and therefore regarded as critical. However, the net after-tax profit is akey factor which influences the location of direct investment globally. Tax planning enables Chinese firms to compensate for the high tax burden of US and German subsidiaries to avoid suffering from a lack of competitiveness. In this respect an important finding of this article is that Chinese firms can also utilise Germany as an intermediary location for tax planning to optimise the effective tax rate (ETR) of Chinese FDI in US subsidiaries (indirect Chinese US FDI via Germany) including tax-optimised exit strategies. For Chinese investors, German subsidiaries can shelter from the Chinese CFC Taxation (white list exemption). Moreover, tax planning enables Chinese investors to optimise the after-tax profits of German subsidiaries and the cost of capital significantly. To summarise, Chinese investors should integrate tax planning in the investment management process. Establishing tax-optimised investment structure enables Chinese firms to over-compensate the tax burden in the foreign host country and to achieve competitive advantages compared to other domestic/overseas competitors operating in the same foreign host market.

Only cross-border tax planning enables an international investor to reduce the relevant effective tax rate (ETR) under the tax burden in the foreign host country and also under the tax burden in its residence state.

NOTES

[1] Ernst & Young is a global leader in assurance, tax, transaction and advisory services.

[2] See Ernst & Young, *A Pillar of Strength in Troubled Times, 2012 Attractiveness Survey: Germany,* 12.

[3] See Ernst & Young, *Study on Germany and Europe of Chinese Investors* (June 2012) 4.

[4] 13 per cent of the 400 surveyed Chinese firms operated in the field of mechanical engineering, 13 per cent produced consumer goods, 12 per cent operated in the high-technology sector and 7 per cent in the automotive sector.

[5] See Ernst & Young, above n 3, 4. In this study, 400 Chinese firms were asked to rank investment locations worldwide; multiple answers were possible.

[6] See Ernst & Young, above n 3, 10.

[7] Tax holidays are possible for certain investments (e.g. in special economic zones).

[8] See K A Clausing, 'Multinational Firm Tax Avoidance and Tax Policy' (2009) 62 *National Tax Journal* 703 et seq.; M Overesch,'The Effects of Multinationals' Profit Shifting Activities on Real Investments' (2009) 62 *National Tax Journal* 5, T Greenaway, 'International Tax Arbitrage: A Frozen Debate Thaws' (2010) 57(4) *Tax Notes Internationa*l 1.

[9] For holding structures, see J M Mintz and A J Weichenrieder, *The Indirect Side of Direct Investment; Multinational Company Finance and Taxation* (CESifo Book Series, 2010).

[10] See F Modigliani and M H Miller, 'The Cost of Capital, Corporation Finance and the Theory of Investment' (1958) 48(3) *American Economic Review* 261; F Modigliani and M H Miller, 'Corporate Income Taxes and the Cost of Capital: A Correction' (1963) 53(3)*American Economic Review* 433.

[11] See C Finnerty, P Merks, M Petriccione and R Russo, *Fundamentals of International Tax Planning* (IBFD, 2007).

[12] DTT stands for Double Tax Treaty.

[13] 0,3 + (1-0,3) x 0,1 = 37 per cent (German subsidiary's total tax burden after applying the tax credit method at the level of the Chinese parent company).

[14] Generally, for German trade tax purposes, only 75 per cent of the interest expense is deductible (s 8 art 1(a) *German Trade Tax Act*).

[15] See Daljit Kaur and Susarla Kamesh, 'Anti-Tax Avoidance Developments in Selected Asian Jurisdictions', *Asia-Pacific Bulletin*, 2011, 261.

[16] White list countries are: USA, UK, France, Germany, Japan, Italy, Canada, Australia, India, South Africa, New Zealand and Norway.

[17] For the Chinese CFC Taxation, see Houlu Yang, 'Structuring An Overseas Investment', *Asia-Pacific Bulletin*, 2011, 343.

[18] See *Circular Guoshuihan* [2009] No. 37 dated 21 January 2009.

[19] See Sec. 8b, Para. 1,*German Corporate Income Tax Act*; Sec. 7 sent. 1 *German Trade Tax Act*.

[20] For German Trade Tax purposes, dividend income is exempt (95 per cent) at the level of a German corporation, if a 15 per cent shareholding (10 per cent shareholding in DTT cases) in the distributing corporation exists at the beginning of the year in which the profit is distributed.

[21] According to Art. 10, para. 3, the German corporation must have a shareholding of not less than 80 per cent in the voting rights of the distributing US subsidiary. Art. 28 contains a Limitation on Benefits clause (LOB).

[22] The interest income derived from the hybrid instrument is exempt from German Trade Tax (15 per cent) according to s 9 art 2 of the *German Trade Tax Act* at the level of the German corporation (creditor).

[23] See sec. 44b, para. I, sec. 44a,para. 5,*German Income Tax Act.*

[24] See Vogel/Lehner, Double Tax Treaties (DTT), Commentary (2008), 966, no. 245–254 with reference to the Hunter Douglas

Case, Federal Court — Trial Division, *Hunter Douglas Ltd. v. The Queen* 1979, DTC 5340 (Canada-Netherland DTT); HogeRaad (Netherlands) 27252 BNB 1992/379 (Netherland-Ireland DTT).

[25] See Yang, above n 17, 340–3.

[26] See T Kollruss, 'Intra-Fiscal Group Cross-border Debt Financing Via A Foreign Fiscal Group Finance Branch' (2010) 7(2) *Investment Management and Financial Innovations* 87; T Kollruss, 'International Tax Law and the Multinational Capital Structure: Evidence from US MNCs German Direct Investment' (2012) 40(3) *Intertax* 192.

[27] For tax strategies using Hong Kong and Singapore as locations, see C J Finnerty, C Pellone and N Derksen, 'Tax Strategies for Investing and Structuring into Asia-Pacific' (2011) *Asia-Pacific Tax Bulletin* 332.

[28] See Kollruss, *Intertax*, above n 26, 197.

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E-Commerce Taxation in China

RIFAT AZAM

The rapid growth of e-commerce in Chinese markets has presented great challenges to the Chinese tax system. In response, China started by applying the existing tax rules on income and value added to e-commerce but potential tax revenues were lost in this approach. Gradually, China is introducing special tax norms on e-commerce to close the gap. At the same time, there has been great progress in using technology in the administration of the tax system in different developed countries and the OECD guidelines and experience on the application of the permanent establishment rule to e-commerce provide a guiding taxation framework, both of which could potentially contribute greatly to the application of the Chinese Establishment or Site rule to e-commerce. In studying and evaluating these rules and creating its own, China could gain from the theoretical and analytical analysis of the issue and responses, as researched by the rich academic literature.

I. INTRODUCTION

On August, 15, 2012 Bloomberg Business Week reported that the Chinese government approved the transaction in which Wal-Mart Stores bought a majority stake in Yihaodian, a Shanghai company that is a leader in the country's booming online retail industry.[1] This transaction reflects the growing worldwide interest on the hot market of e-commerce in China. The e-commerce market in China grew very fast in recent years with about 50 per cent growth in the years 2008–2010 and around 20 per cent of growth in 2011[2] to reach more than 194 million shoppers online. The value of online shopping transactions in China jumped 51.6 per cent year on year, to 268.4 billion Yuan, in the second quarter of 2012. According to one study, China holds the most e-commerce potential among emerging markets.[3] In its e-commerce 12th Five-Year Plan (2011–2015) released early this year (2012), China's Ministry of Industry and Information Technology announced plans to grow the value of e-commerce to 18 trillion Yuan in 2015.[4] This huge e-commerce market presents a challenge and opportunity to the Chinese consumers, Businesses, Government and State Administration of Taxation (SAT).

The Chinese tax system has undergone substantial changes in recent years to become more modern and international.[5] The Chinese Enterprise Income Tax (EIT), which is our main focus in this article, is levied on the worldwide income of any Chinese enterprise that is incorporated or managed in China. It also applies to any income attributable to an 'Establishment' or 'Site' of a foreign enterprise in China or any income sourced in China according to the Chinese source rule. The establishment rule and the other source rules are defined in similar manner as comparable concepts in the international tax system in territorial and physical terms. As a result, it is not surprising that these concepts face several challenges in the era of e-commerce that destroys territorial and physical concepts.

So far, China didn't give a comprehensive response to the challenges of taxing e-commerce income. China started by applying the existing tax rules on income and value added to e-commerce but a lot of potential tax revenues were lost in this approach. Gradually, China is introducing special tax norms on e-commerce to close the gap. For example, online stores were required to register and disclose their actual ID to enable supervision and taxation of e-commerce by the governmental authorities.[6] In addition, new guidelines and regulations were introduced to enable and advance e-voicing as another infrastructure for taxing e-commerce. These and other changes promise an interesting discussion on e-commerce taxation in this article with expectations for new changes and crystallisation of the law in China with special influence from worldwide experience.

Following this introduction, Part II will present the data on e-commerce in China. In Part III we will describe the Chinese tax system in brief. The challenges of e-commerce taxation will be discussed in Part IV. In Parts V and VI we will discuss the Chinese and worldwide responses to the challenges respectively. We will end this article by a conclusion.

II. E-COMMERCE IN CHINA

According to the 29th Statistical Report on internet development in China,[7] the number of internet users in China is growing rapidly to 513 million. As of December 2011, this reflected an increase of about 56 million users compared to 2009. Internet users grew by 4 per cent in 2011 to constitute 38.3 per cent of the population at the end of 2011. There are 356 million mobile phone internet users in China with an increase of 52.85 million compared with that at the end of 2010. The proportion of mobile phone internet users encompasses 69.3 per cent of total internet users. Home computer broadband internet users reached 392 million, covering 98.9 per cent of home computer internet users. Internet users in the age range of 30–39 increased remarkably, up 2.3 per cent compared with those at the end of 2010, to 25.7 per cent. In 2011, the average duration for net surfing was 18.7 hours per week, with an increase of 0.4 hours compared with the end of 2010.

The 29th Report reveals that, as at end December 2011, the number of online shoppers soared to 194 million. The network shopping utilisation rate is up to 37.8 per cent. Compared with 2010, online shoppers increased by 33.44 million, a growth rate of 20.8 per cent. By end December 2011, the number of group buying users was 64.65 million, and the utilisation rate up to 12.6 per cent, increasing by 8.5 per cent compared with end 2010. The annual growth rate of group buyers was as high as 244.8 per cent. It has become the network services increasing the second fastest in a year. By the end of December 2011, users using online payment systems reached 167 million, and the utilisation rate was up to 32.5 per cent. Compared with 2010, users increased by 29.57 million, the growth rate of 21.6 per cent. By end December 2011, our country's travel booking users were up to 42.07 million, an annual growth ratio of 16.5 per cent, and user permeability grew to 8.2 per cent. Internet users will continue to utilise travel booking services widely.

The 29th Report brought a special discussion on e-commerce in China which provides a depth of insight and knowledge. I will summaries here the main findings of the special discussion. In 2011, e-commerce grew by 20.8 per cent, while in 2008–2010, it grew by 50 per cent annually for three consecutive years, as shown in the following figure:

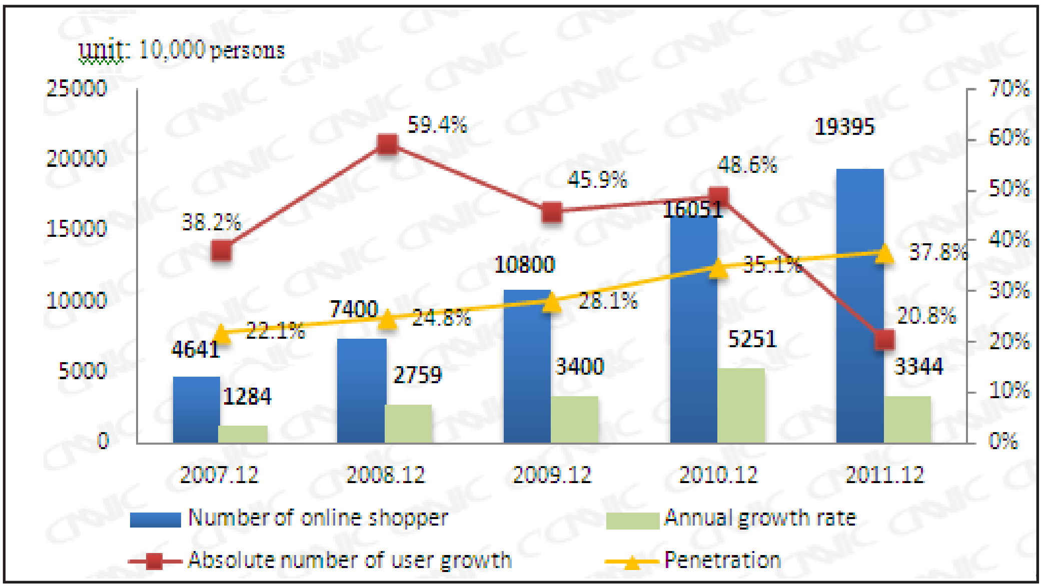


Fig. 39. Number, growth rate and penetration of online shoppers during Dec. 2007– Dec. 2011 in China

What are the reasons behind this slowdown in growth and what does this data tell about the future of e-commerce in China? According to the special discussion in the 29th report, 'decrease of total amount of new internet users and transmission fatigue of old internet users are the main causes of slowdown for online shopper growth'.[8] I am not convinced that these are really the main reasons. In my opinion, the years 2008–2010 witnessed an abnormal growth rate of 50 per cent because e-commerce was in its early stages of development, but in 2011, it became mature enough to start growing normally and more slowly. It is similar to a child who grows rapidly in the first years of life and more slowly later on.

The report concludes that 'there is huge growth space for online shoppers and the market in China in the future'.[9] This is because the Chinese e-commerce penetration rate is low in comparison to developed countries as shown by the following figure:

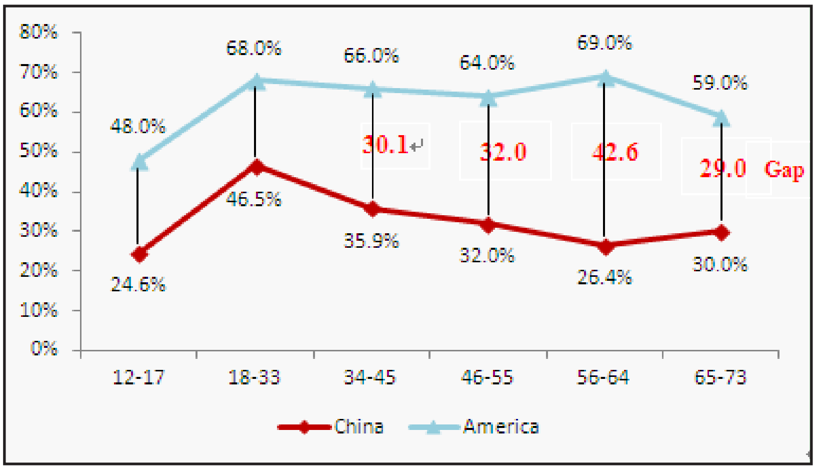
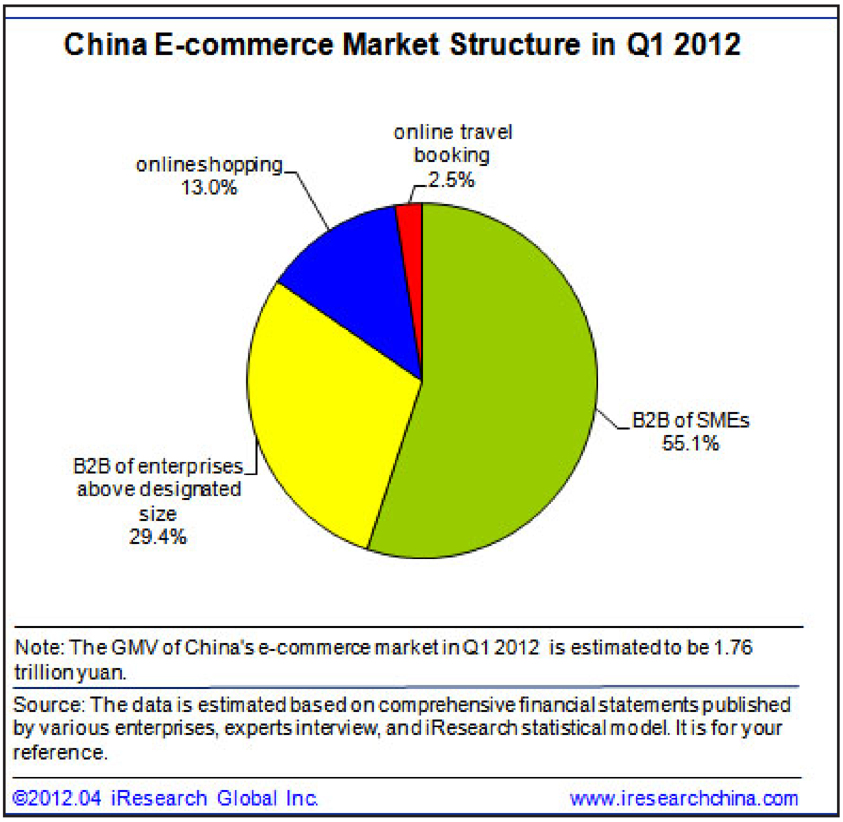


Fig. 42 Proportion of online shoppers of different ages in China and United States

This figure implies that e-commerce in China has far from peaked and leaves room for considerable, lasting growth in the future. But this growth depends on a variety of factors, including the development of delivery facilities, online security, and changes in consumer behavior, especially among the older demographic and in rural areas. But, at the end of the day, viewed from anticipation of future development, the momentum of gradually deepened internet penetration in China is irreversible. The supply and demand in online shopping continue to be active, promoting its steady growth in the future for a long time. Though the Chinese internet penetration rate has slowed, its penetration power remains strong. The popularity of low internet level is accelerated for conversion. Increasing incomes and purchasing power mean that the consumer potential of internet users will continue to be released. The momentum of development of electronic commercial enterprises is strong. As online shopping capacity continues to grow and service levels continue to deepen, these factors will effectively create room for further growth, and promote online shopping to grow steadily in the future for a long time.[10]

The statistics from iResearch show that in Q1 2012, China's e-commerce revenue reached 1.76 trillion Yuan, a growth of 25.8 per cent compared to the same period last year. The following graph[11] reveals the structure of the market in Q1 2012:



III. THE CHINESE INCOME TAX SYSTEM IN BRIEF

China, like other countries, levies several types of taxes to achieve different goals.[12] It has direct, indirect and other taxes collected through central and local governments. Over the years, the central government's share increased from 15.5 per cent in the year 1978 to 51.1 per cent in the year 2010, and the local governments' share decreased from 84.5 per cent in the year 1978 to 48.9 per cent in the year 2010.[13] The main taxes are domestic VAT which yield 28.81 per cent of the total formal taxes in 2010; Corporate Income Tax with 17.54 per cent share; Individual Income Tax with 6.6 per cent share. The following table[14] reflects the amounts collected through taxes in China during the year 2010.

8-5 MAIN ITEMS OF NATIONAL GOVERNMENT REVENUE OF THE CENTRAL AND LOCAL GOVERNMENTS (100 MILLION YUAN) (2010)

ITEM	NATIONAL GOVERNMENT REVENUE	CENTRAL GOVERNMENT	LOCAL GOVERNMENT
National Government Revenue	**83101.51**	**42488.47**	**40613.04**
Total Tax Revenue	**73210.79**	**40509.30**	**32701.49**
Domestic Value Added Tax	21093.48	15897.21	5196.27
Domestic Consumption Tax	6071.55	6071.55	
VAT and Consumption Tax from Imports	10490.64	10490.64	
VAT and Consumption Tax Rebate for Exports	-7327.31	-7327.31	
Business Tax	11157.91	153.34	11004.57
Corporate Income Tax	12843.54	7795.17	5048.37
Individual Income Tax	4837.27	2902.97	1934.30
Resource Tax	417.57		417.57
City Maintenance and Construction Tax	1887.11	150.84	1736.27
House Property Tax	894.07		894.07
Stamp Tax	1040.34	527.82	512.52

ITEM	NATIONAL GOVERNMENT REVENUE	CENTRAL GOVERNMENT	LOCAL GOVERNMENT
Stamp Tax on Security Exchange	544.16	527.82	16.34
Urban Land Use Tax	1004.01		1004.01
Land Appreciation Tax	1278.29		1278.29
Tax on Vehicles and Boat Operation	241.62		241.62
Tax on Ship Tonnage	26.63	26.63	
Vehicle Purchase Tax	1792.59	1792.59	
Tariffs	2027.83	2027.83	
Farm Land Occupation Tax	888.64		888.64
Deed Tax	2464.85		2464.85
Tobacco Leaf Tax	78.36		78.36
Other Tax Revenue	1.80	0.02	1.78
Total Non-Tax Revenue	**9890.72**	**1979.17**	**7911.55**
Special Program Receipts	2040.74	298.03	1742.71
Charge of Administrative and Institutional Units	2996.39	396.02	2600.37
Penalty Receipts	1074.64	31.79	1042.85
Other Non-Tax Receipts	3778.95	1253.33	2525.62

The Chinese Income Tax system has two main pillars: the individual income tax and the enterprise income tax.[15] The individual income tax levies income tax on any individual resident of China on a worldwide basis. The enterprise income tax is levied on Chinese and foreign enterprises. Chinese enterprises are taxed on their worldwide income while foreign enterprises are taxed on their Chinese-sourced income.[16] The enterprise income tax law defines resident enterprise for the purposes of the law as any enterprise that was incorporated in China or has a place of effective management in China. As to source rules, the EIT applies for business income a source rule of 'Establishment or Site' which is very similar to the international source rule of 'Permanent Establishment'. Any foreign enterprise that has an establishment or site in China will be taxed on all of its income attributable to this establishment. The term 'establishment' is defined in Article 5 of the EIT Regulations to be:

an establishment or site for carrying on production and business operations in China, including:

- a place of management, business, or office (or place of administration);
- a factory, farm, or a place of extraction of natural resources;
- a place for providing services. "Services" include transportation, warehousing, consulting, scientific research, technical services, education and training, restaurant and hotels, agency, travel, entertainment, and processing;
- a place of construction, installation, assembly, repair, and exploitation (including building site, ports, place of exploration);
- a place of conducting other production and business activities.

Article 7 of the EIT regulations includes the other main source rules which subject the sourced income to a 20 per cent withholding Chinese Tax. The main source rules include the following: (a) The source of income from the sale of goods is the place of the sale transaction; (b) The source of service fees is the place where service activities occur; (c) The source of dividends and bonuses is determined according to the residence of the payer; the source of interest, rents and royalties is determined according to the location of the payer; (d) The source of other types of income will be determined by the tax authorities or the Ministry of Finance.

The EIT Law and Regulations elaborate on the taxable income by defining income as any realised income from the sale of goods, provision of services, transfer of property, dividends, interest, rent, royalties, donations and other types of revenues. The income is calculated on an accrual basis according to the law rather than accounting principles. The tax is levied on net income, after the deductions of deductible costs and expenses including straight line depreciation on fixed assets for different periods in accordance with the type of the asset. The tax rate is normally 25 per cent while a lower rate of 20 per cent applies to small enterprises and a special rate of 15 per cent is given to 'key state supported, new and high tech enterprises'.[17] To eliminate double taxation, the EIT law applies a dollar for dollar tax credit on foreign tax and tax treaties, setting the withholding rates in the range between

0 per cent and 20 per cent.

To attract foreign investments and advance other state policy goals, the EIT gives several tax incentives in different forms including exemption, rate deduction, accelerated depreciation, additional deductions and tax credit. As Jinyan Li explained, 'High-tech enterprises receive several types of tax incentives, including: (a) reduced tax rate of 15 per cent (EIT Law, Art.28); (b) exemption of income from transfer of technology (EIT Law, Art. 27); 24 (c) additional deduction for research and development expenses (i.e. 150 per cent of actual expenditure is deductible as current expenses or amortised as capital expenditures) (EIT Law, Art.30 and EIT Regulations, Art.95); (d) accelerated depreciation (EIT Law, Art.32 and EIT Regulations, Art.98); and (e) special deductions for eligible investors of high-tech enterprises. If a venture capital enterprise invests in the shareholdings of a private small or medium-sized new and high-tech enterprise by stock for two years or more, 70 per cent of the amount of the investment may be deductible against the taxable income. The deductions can be carried over to the following tax year (EIT Law, Art. 31 and EIT Regulations, Art. 97)'.[18]

The EIT contains several Anti-Avoidance rules to minimise tax avoidance and maintain the Chinese Tax base. These rules include (a) a transfer pricing rule which applies the arm's length principle on transactions between related parties while the SAT Transfer Pricing Circular elaborate on the definition of related parties and the methods to set the arms length price;[19] (b) a thin capitalisation rule which prevents the deduction of interest on excessive debts owed to related parties; (c) a Controlled Foreign Corporation (CFC) rule which reads as follows: 'Where an enterprise that is established by a Chinese resident enterprise in a jurisdiction pays tax at a rate obviously lower than the tax rates as stipulated in Article 4 [of the EIT Law] and does not distribute its profits for reasons other than business needs, the amount of profit that should have been distributed to the Chinese shareholder is included in the income of the Chinese resident'[20]; (d) a general anti-avoidance rule that adopts the 'reasonable business purpose' test.

IV. THE CHALLENGES OF TAXING E-COMMERCE INCOME IN CHINA

The challenges of taxing e-commerce income in China are similar to the challenges of taxing e-commerce in other countries but China also has its unique challenges. The first challenge is determining whether the e-commerce enterprise has an 'establishment' or 'site' in China for the purposes of the EIT. This source rule relies on physical concepts and assumes that an enterprise needs such a presence to run business, but in an e-commerce environment such a physical presence is not necessary. E-commerce enterprises could sell intensively in China without any presence in the form of establishment or site. The logic of the establishment threshold is less clear in the era of e-commerce. This challenge is similar to the challenge that faces the 'permanent establishment' threshold in the international context. This challenge presents a risk for the Chinese source tax base. This risk is especially important for China as a developing country with a huge consumer market that imports products from abroad.

Similarly, the application of the other source rules which rely on physical concepts and presence faces difficulties in an e-commerce context which disregards physical limits. For example, it is not easy to apply the place of sale transaction rule in e-commerce transactions because such a transaction cannot be pinpointed to a specific place. The contract is made online and the delivery of the product is made online in digital products form and from different and easy manipulated place in the case of physical products which make it easy to escape the tax threshold. As well, the determination of where services occur in e-commerce services is not easy as such services are provided online without any specific place for services. Determining the place of online booking, for example, is very different to determining the place of booking through a travel agency. Likewise, determining the place of online banking services is very different to determining the place of branch banking services. An e-commerce context allows some flexibility in the place of incorporation for enterprises, which widens the possibilities of tax planning to reduce tax liabilities on dividends, which is determined according to the place of residence of the payer and to reduce tax liabilities on personal basis in Chinese enterprises. It is true that these tax-planning opportunities are open for e-commerce enterprises as well as for non-e-commerce enterprises but the opportunities for e-commerce enterprises are wider. This challenge has unique feature in China, as a result of the special relations and geographic proximity between China and Hong Kong, it is a low-tax jurisdiction.

The Anti-Avoidance Tax rules are difficult to apply in China, as a huge country with low tax compliance rates and especially in an e-commerce context, where tax avoidance is easier. The application of the transfer pricing rule, for example, faces the challenge of determining the arms length price in e-commerce with the existence of very different transactions and the limited experience of the Chinese Tax Administration in comparison to developed countries in transfer pricing methods and issues. The CFC rule has its own difficulties in the Chinese e-commerce context as a result of the special relationship with Hong Kong and the geographical proximity to it.

The uniqueness of China relates to its huge population and geographic dimension, and to its special stage of development in the internet and e-commerce context, as well as in the administration of a modern tax system in an era of globalisation. China is a leading trade player that joined the WTO in 2001. As a large country, it has special difficulties in administering a tax system, especially in e-commerce transactions. As an infant country in technology, it has special difficulties in handling e-commerce tax issues, particularly while this commerce is growing much more rapidly in the country than the development of government technology skills and enforcement abilities. In addition, China adopted the EIT in its current form as a modern and international tax system just a few years ago and it has limited capabilities and experience in running such a system. But the economy is growing very rapidly in a global manner, which forces the Chinese tax authorities and experts to handle the changing landscape using the insights and experience of other countries.

I would like to end the discussion of the challenges by quoting Yang Liu & Li Hongchang, Chinese Economic Scholars, who discussed the challenges and proposed some policy responses: 'The Influences of electronic commerce on the taxation system include, but are not limited to those listed below: 1) Electronic commerce shakes the foundation of the traditional taxation system for which voucher audit is the basis; 2) The computer encryption techniques make it more challenging for the taxation department to obtain the relevant information; 3) It is difficult to ensure the form of the business dealers; 4) Electronic commerce underlies the conflict of taxation jurisdiction between related countries; 5) It is hard to recognise the product qualification and the product transfer price; 6) Electronic commerce greatly influences the prevailing taxation system; 7) The international tax evasion becomes more and more serious'. [21]

V. THE CHINESE RESPONSE TO THE CHALLENGES

The Chinese Tax Administration or any other governmental agency did not issue any report or discussion paper on e-commerce taxation as did other leading countries. It seems that discussion of the issue is very limited among Chinese authorities and professionals. As one official stated in 2000, the Chinese are applying the same tax rules on e-commerce. In an interview with the news weekly Outlook,[22] Jin Renqing, director of the State Administration of Taxation (SAT), noted that some people had misunderstandings about e-commerce. 'To put it simply, e-commerce refers to business transactions conducted on the Internet. It is, in essence, the same as those made in department stores,' Jin was quoted as saying. 'Considering the neutral principle of taxation and the protection of developing China's taxation jurisdiction, our country will not pursue a tax-free policy for the fast developing e-commerce,' the official noted. Jin also revealed that the SAT has set up a special task force to focus on the study of e-commerce taxation.[23]

To my understanding, some recent change is taking place. Chinese officials have called for clearly regulating and imposing a tax on e-commerce. Zhu Yilong, member of the National Committee of the Chinese People's Political Consultative Conference (CPPCC), China's top political advisory body, made the announcement in early 2010 during the ongoing CPPCC session, that 'Online shopping has become one of the mainstream commerce models in China, but few stores on B2C and C2C websites are registered or report their incomes to the taxation departments. We must fill the taxation vacuum'.[24] According to his proposals, the National People's Congress (NPC), the country's top legislature, should move to regulate the e-commerce industry, mandate the registration of online stores and require the payment of taxes.

In late 2010, the State Administration for Industry & Commerce issued 'interim measures' that required online sellers to provide their real names and identification numbers to the shopping platforms where their online stores were hosted. Previously, some sellers registered with any name they wanted, and ID numbers were not required. Taobao.com handled more than two-thirds of China's online shopping in 2010, with 400 billion yuan in transactions. Its public relations manager, Yan Qiao, said there are two kinds of online stores on Taobao — those registered as companies and those that are not. Taxing a company 'depends on whether it is a registered company, not whether it is an online shop', Yan said. He declined to comment on whether the government should tax online stores, but said that registered companies should pay tax. Liu, the tax law specialist, thinks that the regulations are the first step toward future taxing of online sales. 'Following the provision of real personal information about online sellers, registering in the department of industry and commerce will be the next', he said.[25]

In February 2012, eight Chinese government agencies jointly announced guidelines to promote e-commerce and e-invoicing.[26] These guidelines included the setting up of a trial e-invoice system, online information platforms and online payment standards, as well as the promotion of financial integrated-circuit (IC) cards. Feng Lin, a researcher at the e-commerce research center, argued that: 'e-invoices have the benefits of being paperless and highly efficient and enabling globalisation; the use of e-invoices could reduce e-commerce's impact on traditional tax collection and management and build a foundation for future e-commerce tax collection; where the trial program increases product prices, this would be addressed through better supervision of e-invoice tax collection'. [27]

The introduction of e-invoices reflects the incorporation of some academic proposals made in China on the issue, including the proposal of Mix Xu & Luming Yang, who wrote in 2008: 'The C2C e-commerce taxation should be based on the essential content of transactions, not the form of transactions. Governments and organisations have stressed the abolition of tax barriers to promote the development of e-commerce. As part of e-commerce tax, it should also reflect the fairness of the C2C e-commerce taxation. We must give full consideration that China, as a developing country, also due to electronic transactions, should not give up territorial jurisdiction, which will lead to a significant loss of tax revenue. So we should for the purpose of national fundamental interests, adhere to the residents of the jurisdiction of both the principle of geographical jurisdiction.[28] Accordingly, they proposed to set up an electronic tax system that includes the establishment of a specialised e-business tax registration system; the invention of e-commerce taxation software; the invention of electronic invoicing and clearly its force in law.

VI. WORLDWIDE RESPONSES TO THE CHALLENGES

China could benefit a lot from the experience of the Academia, other countries and international organizations in handling e-commerce taxation challenges.[29] For this purpose, I will elaborate here about worldwide responses to e-commerce challenges as discussed in my earlier research and scholarship.[30] At the academic level, different proposals have been discussed in tax literature to cope with these challenges. I proposed to adopt an integrative adaptation model as learned from cyberspace law for the short run and a global e-commerce tax to fund global public goods for the long run. Professor Reuven Avi-Yonah proposed to levy a withholding tax on e-commerce income by the demand jurisdiction where the consumers of e-commerce reside.[31] Professor Jinyan Li proposed to fix a formula for e-commerce taxation.[32] Professor Richard Doerenberg proposed the tax base erosion approach.[33] Sweet proposed exclusive residence taxation on e-commerce income.[34]

At the national level, governments and tax authorities have studied the issue of e-commerce taxation and published a rich resource of reports and guidelines.[35] Generally speaking, governments have applied the existing tax laws on e-commerce with some adaptations, and have increased the use of technology in the administration and enforcement of the tax system.[36] In some countries, such as the United States, substantial change was effected in tax laws to cope with e-commerce challenges. Cross stated that e-commerce in the United States challenges the states' sales and use tax system. Different proposals were raised at the academic level to cope with these challenges.[37] However, ultimately, three main measures were taken in the USA to handle the issue: first, the enactment of the Internet Tax Freedom Act; second, the signing of the Streamlined Sales and Use Tax Agreement (SSUTA); and third, the introduction of 'Amazon Laws'. The Internet Tax Freedom Act was enacted in 1998 for a limited period of three years, which was later extended several times until January 11, 2014. The Act imposes a moratorium on internet taxes and forbids any tax on internet access and any multiple or discriminatory taxes on electronic commerce.[38] The Streamlined Sales and Use Tax Agreement harmonises states sales and use tax laws.[39] It harmonises the tax base (Section II), the source rules (Section III) and the tax rates. The agreement centralises the administration of the tax (Section IV) and sets the rules for joining the agreement (Section VIII). Amazon Laws were introduced recently in New York, North Carolina, California and other states to overcome the nexus rules as designed in *Quill Corp v North Dakota*[40] by using affiliated nexus construction. According to these laws, the physical presence of the affiliated partner in the state justifies levying state taxes on e-commerce and out-of-state sales. However, the constitutionality of these laws is not clear yet.[41]

At the international level, in 1998, during the Ottawa Conference ('Borderless World—Realizing the Potential of Electronic Commerce'), the OECD, its Committee of Fiscal Affairs (CFA) and participating countries concluded that 'the taxation principles that guide governments in relation to conventional commerce should also guide them in relation to e-commerce. The CFA believes that . . . existing taxation rules can implement these principles'.[42] The OECD designed broad taxation principles that should apply to electronic commerce as follows:

Neutrality
(i) Taxation should seek to be neutral and equitable between forms of electronic commerce and between conventional and electronic forms of commerce. Business decisions should be motivated by economic rather than tax considerations. Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation.

Efficiency
(ii) Compliance costs for taxpayers and administrative costs for tax authorities should be minimised as far as possible.

Certainty and Simplicity
(iii) The tax rules should be clear and simple to understand so that taxpayers can anticipate the tax consequences in advance of a transaction, including knowing when, where and how the tax is to be accounted.

Effectiveness and Fairness
(iv) Taxation should produce the right amount of tax at the right time. The potential for tax evasion and avoidance should be minimised while keeping counter-acting measures proportionate to the risks involved.

Flexibility
(v) The systems for the taxation should be flexible and dynamic to ensure that they keep pace with technological and commercial developments.[43]

Following Ottawa, five Technical Advisory Groups (TAGs) continued the research and dialogue and issued several important studies and guidelines. One important report[44] discussed the application of the 'Permanent Establishment' threshold as defined in Article 5 of the OECD Model Tax Convention to e-commerce. Based on this report, the commentary of Article 5 was changed in a manner that distinguishes between computer equipment, such as a server, which might constitute permanent establishment under certain circumstances, and computer data, such as a website, which cannot have a location and cannot be a fixed place of business as required by the PE definition. The new commentary states that:

42.4 Computer equipment at a given location may only constitute a permanent establishment if it meets the requirement of being fixed. In the case of a server, what is relevant is not the possibility of the server being moved, but whether it is in fact moved. In order to constitute a fixed place of business, a server will need to be located at a certain place for a sufficient period of time so as to become fixed within the meaning of paragraph 1.

42.5. Another issue is whether the business of an enterprise may be said to be wholly or partly carried on at a location where the enterprise has equipment such as a server at its disposal. The question of whether the business of an enterprise is wholly or partly carried on through such equipment needs to be examined on a case-by-case basis, having regard to whether it can be said that, because of such equipment, the enterprise has facilities at its disposal where business functions of the enterprise are performed.

42.6 Where an enterprise operates computer equipment at a particular location, a permanent establishment may exist even though no personnel of that enterprise is required at that location for the operation of the equipment. The presence of personnel is not necessary to consider that an enterprise wholly or partly carries on its business at a location when no personnel are in fact required to carry on business activities at that location. This conclusion applies to electronic commerce to the same extent that it applies with respect to other activities in which equipment operates automatically, e.g. automatic pumping equipment used in the exploitation of natural resources.[45]

China could learn from the different country reports and discussion papers in making its own discussion paper. In applying the current Chinese tax rules to e-commerce, China could learn from similar application made in other countries. The progress in using technology in the administration of the tax system in different developed countries could be of a great benefit to China. The OECD guidelines and experience on the application of the permanent establishment rule to e-commerce could contribute a lot to the application of the Chinese Establishment or Site rule to e-commerce.[46] In studying and evaluating these rules and making its own, China could gain a lot from the theoretical and analytical study of the issue and responses, as researched by academic literature.

VII. CONCLUSION

In conclusion, we are witnessing a real revolution in the Chinese markets by the rapid growth of e-commerce. This change presents challenges to the Chinese tax system, which responds through different means and introduces new tax rules. In introducing these new rules, China stands to benefit from international experience. At the same time, the world can also learn a lot from the Chinese responses and experience. We, the academics, can contribute to these developments. Our research into this interesting and important issue of the taxation of e-commerce may influence the public finance of governments in the future.

NOTES

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16 See Jinyan Li and He Huang, 'The Transformation of Chinese Enterprise Income Tax: Internationalization and

Chinese Innovations' (CLPE Research Paper No 41/2008, York University, Toronto, 2008).

17 Ibid 15.

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19 Ibid 22.

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Research on Tax Incentives for Charitable Donations of Non-Monetary Assets by Chinese Corporations

LONG ZHAOHUI AND HU XIAOLING

Corporate donations form a substantial part of social charitable donations in China. Corporate non-monetary asset donations are important in this regard as they bring goods and materials to areas where they are desperately needed. However, the current scope and scale of corporate donations are narrow due to a lack of tax incentives. This paper will explain the incentive effects of the current tax regime by analysing how asset donations are treated by Chinese taxation laws, from the perspective of macroeconomic policies and market demands. It focuses particularly on the relatively heavy tax burden and limited scope for tax exemptions on corporate asset donations in China. In light of this, we propose some pragmatic suggestions on incentivising policies that are more suitable for China's current situation, such as increasing the exemptions before tax and allowing exemptions to roll over to future years, developing incentive policies on indirect and property taxes, and establishing the mechanism for third-party price evaluation and equity donation regulation, etc.

I. INTRODUCTION

1.1 Background

2008 was the pivotal moment in the development of social charitable donations in China, with the rapid growth of charitable organisations and increased public awareness for this type of charity. With an increased number of natural disasters occurring in China in recent years, the demand for charity has increased and channels where disaster-stricken people express their need for help have become more varied. As public awareness increased, so too did the amount of donations. Corporate donations form a substantial part of Chinese social charitable donations, and play a significant role in the development of charitable undertakings in China. According to a questionnaire conducted by the Chinese Entrepreneur Association in 2006, over 90 per cent of Chinese corporations have made charitable donations in the past and these donations accounted for more than half of the total Chinese social charitable donations. Donations of goods, materials and other non-monetary assets were a very important part of corporate donations. In 2007, the value of donated goods and materials were worth 5.385 billion RMB, which comprised mainly medical equipment, medicine, production equipment and teaching instruments, with five corporations havingdonated more than 50 million RMB worth of such goods and materials. In 2008, goods and materials donated were worth 20.88 billion RMB, which accounted for 19.5 per cent of the total donations for the year. This was mainly due to the Wenchuan earthquake in 2008, which created alarge demand for tents, food and daily necessities in the affected regions. In 2009, the total amount of good and material donations was worth 17.5 billion RMB, of which most of them were quilts.

There are two positive effects as a result of corporations being able to conduct charitable operations. Firstly, donations will benefit people in poor and disaster-struck areas, through greater participation in charitable programs by commercial corporations, the fruits of the economy will be spread more evenly and as the third distribution, it will create a positive social atmosphere that can influence society and the economy. Secondly, corporate donations are an effective way of improving a business' corporate image, attracting more customers and expanding market influence. Appropriate donations can become part of a strategy to achieve profit maximisation.

1.2 Scope of Research and Concept Definition

This paper will discuss tax issues for corporate donations and focus on incentives for donations of non-monetary assets. Non-monetary assets are a very important part of corporate donations; however, the timely distribution of these materials is important for those areas and the people who require them. Goods and materials donated and their methods of distribution have become more varied as the capital market has and continues to become more mature and awareness of social charity has increased.

In this paper, it is important to note three important definitions. The first is 'charity', and its differences in regards to social welfare. The goal of charity is to alleviate poverty, to help the poor and care for the needy. It is the integration of love, virtue and philanthropy. The goal of social welfare is to address social needs, to enhance public benefits and to resolve social problems. In this sense, the extension of public welfare is wider than that of 'charity'. The second definition is 'charitable donations'. According to Article 51 in The Release of Regulations on the Implementation of Enterprise Income Tax Law of the People's Republic of China by the State Council, public welfare donations indicated in Article 9 are donations which enterprises have made through social welfare organisations, people's governments or other relevant administrative departments which are above the county level, with their use as stipulated in theWelfare Donations Law of the People's Republic of China. Charitable donations are part of public welfare donations and should be made through social welfare organisations and other recognised organisations. The third definition is 'non-monetary assets', which includes all assets except monetary assets, including assets such as inventory, fixed assets, intangible assets, equity and bonds not prepared to be held to maturity.

II. LITERATURE REVIEW AND RESEARCH FRAMEWORK

The notion of charity began early in Western countries, with there being many relevant theories and empirical research on tax incentives since the 1960s. However, most research has focused on individual donations. Charity in China developed rapidly despite its late start, and while there has been much research on charity in China, such research was not authoritative, as the statistical standards used were inconsistent and the relevant policies and regulations in force were incomplete. There is also foreign and local research on tax policies, incentives for corporate donations and motives for corporations to donate.

2.1 Foreign Research on Corporate Donations

R A Schwartz (1968) used aggregated data from 1931 to 1961 to conduct a regression analysis on facts including the amount of donations, tax rate, price of donation and corporations' income. He concluded that the amount of donation, the corporation's income and cash flow all have a significant impact on corporate donations. Among them, the impact of a change in cash flow was more significant than a change in the income of the corporation. His conclusion reflected that the price elasticity of donations in most industries was between -1.06 and -2.00, and the income elasticity was between 0.53 and 1.34, proving that tax deductions on donations was of great significance. James. R. Boatsman and Sanjay Gupta (1996) used panel data from 1984 to 1988 to show that corporations' donations would reduce net income, thus corporations are limited by their net income when they are making a decision on donations. The income effect of the price of donation was more important than the substitution effect. Corporate donations would decline when corporate income tax rates increase. William O Brown, Eric Helland, and Janet Kiholm Smith (2006) pointed out that the existence of agency costs played a leading role in corporate donations. Corporations with larger boards of directors tended to give more donations in cash and have their own corporate charitable foundations. In contrast, corporations with higher asset-liability ratios tended to make fewer donations and did not have their own corporate foundations.

2.2 Chinese Research on Corporate Donations

Cao Hongbin (2006) suggested that government expenditure in education, public health, social security and other areas had a positive correlation with corporate donations. The increase of government expenditure led corporate donations to increase and the two would 'merge'. Guo Jian (2008) provided a systematic analysis on the inner motives and external factors of corporate donations. He divided the inner motives into three kinds according to the degree of altruism: pure altruism, mutually beneficial, and deriving immediate benefit. From a demand and supply perspective, philanthropy demand, main donors, methods of donation, non-profit organisations and government policies were the external factors which influenced social donations. Furthermore, according to the utility maximisation model, he concluded that tax incentives had a long-term effect on corporate donations, and empirical analysis revealed that the amount of corporate donations and taxes on prices were negatively correlated. Huang Guixiang and Huang Huaqing (2008) used a cost-benefit analysis to study the effects that tax had on donors. They concluded that increasing the benefits or reducing the tax cost could effectively encourage donations. They also divided tax incentives into total tax incentives and partial tax incentives, concluding that tax-free donations would encourage more donations and partial tax-free donations would inhibit charitable behaviors of generous donors. Chen Honghui and Wang Pengfei (2010) based their research on the theory of stakeholders, taking external factors affecting donations by privately-owned corporations in Guangdong province as data for empirical analysis. They proposed that the corporation's image, charitable decision mechanism, size and life cycle stage had a significant impact on corporate donations. Privately-owned corporations should combine internal resources and the external environment to make strategic charitable donations, which would contribute to the businesses' sustainable development.

2.3 Research Frame

In contrast with other research which focuses on donations of monetary assets, this paper will focus on non-monetary asset donations by corporations. Firstly, this paper will analyse the great importance that non-monetary asset donations have on the government and on corporations. We will study the impact of the orientation of the government and the motivation behind corporations donating. Secondly, we will analyse current tax policies on non-monetary asset donations and their incentivising effects. We will divide non-monetary asset donations into four categories: products that are either produced by the corporation or externally bought, fixed assets such as factories and machinery, intangible assets such as land-use rights, and finally shares and equity. We will calculate the tax burden using an example from each category. It should be noted that this paper will discuss local corporations and non-monetary assets produced or purchased locally, without reference to foreign corporate donations and donations of imported goods. We are also ignoring creditors' donations because donations of creditors' rights are usually donated by individuals and are not clearly regulated. Finally, keeping in mind the current circumstances in China, we will suggest recommendations to optimise tax incentives for corporate non-monetary asset donations.

III. Analysis of Government and Corporations in Non-Monetary Asset Charitable Donations

3.1 Role of the Government

3.11 Government's Role from the Perspective of the Social Distribution Mechanism

The demand for charity in China is not met with adequate supply. For a long time, wealth inequality, uneven developments between regions, natural disasters and the expansion of polluted areas have posed great challenges for the government and its ability to mobilise social resources and to control the distribution mechanism for the community.

Li Yining, a leading economist, divided the present social distribution mechanism into three levels: initial distribution, redistribution and the third distribution. The market dominates the first distribution with market efficiency. However, due to market inefficiencies and defects such as market failure, externalities, transaction costs, unfair distribution of income and consumer preferences, the government carries out redistribution with a view to achieve greater fairness. This is generally done by generating government income through taxes, fees, benefits and debt, which is then used to fund social welfare systems, public services, etc., in order to redistribute income.

However, as welfare systems in China have not been fully developed, there is a large demand to relieve the poor and needy. Thus, the third distribution comes into effect. The third distribution is the mobilisation of social resources to establish systems and mechanisms which primarily serve to provide charitable relief and donations, along with volunteer services. It serves as a supplement to governmental redistribution. Among them, charitable aid is an extremely important part of the third distribution. Donations, as the main form of charitable aid, are complementary to market and government distribution, which can better promote social harmony and realise social care. Therefore, the government should use taxation polices as leverage to promote and support such donations.

3.12 Government Role from the Aspect of Government Credibility

The government should act as a coordinator and policy supporter for corporate donations. A coordinator does not interfere using administrative means, but will implement appropriate policy to establish a positive communication platform between corporations, charities and the recipients of donations. To fulfill this role, the government must create a loose policy environment and lead corporations and the public through public advertisements and other appropriate means.

Fulfilling this role helps to improve the credibility of the government and the existence of charitable donations can effectively fill the gap left by government services, increasing public satisfaction and thus maintaining social stability. Moreover, the government can lead public discussion to promote charity through a variety of activities, including a display of its approval of charitable involvement, publicising philanthropic slogans and screening philanthropic advertisements. An improved atmosphere for charitable operations due to government support will increase the public's satisfaction towards the government.

If charity-related policies are fully implemented, the credibility of the government will be improved. Under these circumstances, good relationships between the government, corporations and charities will require corporations and charitable organisations to comply with financial and taxation laws, in conjunction with the cooperation of the tax offices in interpreting and applying national policies. All of the above will help to maintain the authority of the law and, overall, assist in maintaining society's trust.

3.13 Government Role from the Perspective of Quasi-Public Goods

Most of the goods and services provided by charity are quasi-public goods. Public goods have two features according to the theory of public finance: they are non-exclusive and non-competitive. Governments will provide public goods when their provision by private entities cannot fully meet social demand, but these goods may be produced privately or publicly. On the other hand, quasi-public goods are generally provided mutually; in other words, the government and the market will both supply it. In addition, as mentioned above, tax incentives can effectively encourage corporate donation, and the loss of government income due to tax reductions or tax breaks would be far outweighed by the increase in donations due to increased incentives.

With the increased operating efficiency of the private sector, the use of tax incentives to encourage donations ensures that corporate donations, especially non-monetary asset donations, can truly help poorer areas and vulnerable groups through the cooperation of the government, corporations and charitable organisations.

3.14 Principles of Tax Incentive Policies

According to tax equity and tax efficiency theories, the government should make the principles and the effects of tax incentive programs clear when determining their roles. The principles should realise tax equity and achieve tax efficiency. On the one hand, fair taxation requires the avoidance of double taxation on charitable donations. Furthermore, the same amount of donations in different forms should have the same amount of tax applied. Only then can the government encourage corporations to actively participate in donations in a variety of ways. Otherwise, the forms and sources of donations will be very limited.

In addition, the reduction of management and compliance costs should be a consideration when developing tax incentive policies. The government can encourage corporate donation through effective measures and centralising management systems, making it easier for corporations to donate. At the same time, simplifying procedures and increasing publicity can attract more corporate donations while not allowing for the existence of loopholes for tax evasion.

3.2 Motivations of the Corporations

3.21 The Cost-Profit Analysis of Corporate Donations

As corporations aim to maximise profits, they will conduct a cost-benefit analysis when making donations.

There are two sources of costs in corporate donations: one is the direct cost which equates to the market value of the property donated, denoted by C1, and the other is the indirect cost from taxes, other fees, and the expenses from the use of human and material resources throughout the donation process, denoted by C2.

The benefit of corporate donations is threefold: the first is the realisation of the management's altruistic inclination and the corporation's benevolent goals, denoted byR1; the second one is the positive social reputation and honor granted by the government that the corporation gains through the donations, denoted by R2;and the third is the partial reduction in the expenses of donations before tax, which reduces the actual cost of donations, denoted by R3. Corporations will decide to donate only when $R1+ R2+ R3\geq C1+ C2$. Additionally, the more altruistic the management, the more honour awarded by the public and government, and the higher the amount of tax deduction available, the greater the motivation of the corporations to donate to charities.

3.22 The Analysis of the Marketing and Brand Strategies of Corporate Charitable Donations

Corporations have a greater demand for corporate donations from the perspective of marketing and branding strategies. The charitable donation of non-monetary assets is an ideal method for corporations to market their products. Corporations with higher advertising expenses are more inclined to make non-monetary asset donations, as this is one of the most important marketing techniques.

In comparison with traditional monetary asset donations, non-monetary asset donations provides the corporation with a variety of donation methods, such as donating products with the corporate brand or logo, building schools or water conservation facilities in rural areas. Thus, the corporation can influence students and the poor, which make up an overwhelmingly large proportion of the Chinese population.

Taking P&G's sponsorship support for education in China as an example, P&G places a high priority on supporting education from kindergarten to university. By having substantial sponsorship in China's education sector, they are influencing the Chinese with bright abilities, the people P&G hopes to attract to join their company. Apart from acquiring acknowledgement by the government, it is also highly beneficial in promoting their products and brand.

The corporation can receive social honor and approval through making charitable donations, and therefore obtains a series of marketing opportunities. The corporation can also refer to its altruistic behaviors in its annual reports, securities analysis reports, sales manuals, advertisements, news reports, staff communications notices and business letters to raise awareness of their acts. This attracts even more customers and nurtures a stronger sense of honor and belonging in their staff towards the company.

3.23 Liquidity Analysis of the Assets Donated by the Corporations

It is necessary for a corporation to maintain liquidity in order to survive. This is also where monetary assets and non-monetary assets differ. Monetary capital, transactional monetary assets and investments that are held up to three months are regarded as money equivalents and possess high liquidating ability. Monetary assets are clearly more liquid than non-monetary assets. By donating the corporation's highly liquid monetary assets, the corporation's liquidity will change. If the corporation's donations are done on a large scale, its liquidity will be severely affected, which is unfavorable for the corporation's operation from the view of risk management.

Non-monetary asset donations are not limited by the liquidity constraint. Moreover, an appropriate amount of non-monetary asset donations at the appropriate timing will support and assist in maintaining a proper inventory turnover ratio. For listed companies, having good operating capacity contributes positively to the corporation's image.

Corporations that require high liquidity, such as those carrying out expansion plans, companies whose products have a high circulation rate, companies that do not have high bargaining power etc., should be cautious when making charitable donations. Taking liquidity into consideration, these corporations will have lower motivation to engage in monetary asset donations. Therefore, the government should encourage more non-monetary assets charitable contribution.

In conclusion, there is a two-way demand for non-monetary asset donations by the government and corporations. Altering corporate donations from a government requirement to market motivation is an important issue discussed by the government and society. Not only are corporation donations an important source of social charity, it is also a fundamental component in the development strategy of the corporation. This is particularly true, as making non-monetary asset donations will become an increasingly popular method of corporation donation.

IV. EFFECTS OF CURRENT POLICIES AND INCENTIVES

The form of non-monetary asset donations has been changing according to the changes in demand and has become more diversified in nature. The four main forms of non-monetary asset donations that are currently used include the donation of produced or purchased products, donation of fixed assets, donation of intangible assets and donation of equity. Among them, equity donation is a new form of donation, which appeared with the development of capital markets and improvement of charitable awareness in China. This paper will review the current policies in accounting and taxation and reflect on the effectiveness of these tax incentives.

4.1 The Differences of Current Policies in Accounting and in Taxation

Under the current laws and regulations, there are different tax and accounting policies for different forms of corporation donation. This paper will analyse each in the following table. It should be noted that the following discussion does not consider urban maintenance and construction tax, and the additional tax on education funds.

According to tax regulations, the fair value mentioned above should meet the following conditions. Corporations should provide certification which states the fair value of the non-monetary assets being donated when they donate through social public welfare organisations, other non-governmental organisations and local governments above county level. If the above certification is not provided, the organisations that have received the donations cannot issue the donation invoice that corporations need to obtain tax benefits.

	Inventory	Fixed Assets	Intangible Assets	Equity
Concept	Donation of medicine, tents, drinking water, quilts and other items urgently needed. This includes goods that are produced by the corporation as well as those purchased from external sources.	Donation of vehicles, electronic equipment, plants etc. This includes new purchases or fixed assets that have been used for years but are still workable.	Donation of self-developed or purchased software, land-use right etc.	Donation of property rights, company shares, etc.
Accounting Method	Dr. Non-operating expenses (donation expenditure); Cr. Finished goods/ Raw materials (valuation at cost); Tax payable -value added tax (valuation at the product's fair value and appropriate tax rate);	1. Fixed asset disposal Dr. Fixed assets disposal (net book value); Accumulated Depreciation; Depreciation reserves of fixed assets Cr. Fixed assets (original cost); 2. Disposal cost and relevant taxes Dr. Fixed assets disposal Cr. Cash in bank (disposal expense); Payable taxes (relative taxes; if the purchase is made after 2009, value-added tax); 3. Carry forward to fixed assets net profit and loss Dr. Non-operating loss (donation expenditure); Cr. Fixed assets disposal	Dr. Non-operating expenses (donation expenditure); Depreciation reserves of intangible assets; Cr. Intangible assets	Dr. Non-operating expenses (donation expenditure); Cr. Long-term investment on company stocks
	For expenses incurred outside business operation in the income sheet, they have to be less than 12% of the financial year's accounting profits in order to be deductible, with deducting limit applied.			
Taxation Methods	1. If regarded as sales, value added tax should be paid. 2. If regarded as sales of special goods, consumer tax should be paid. 3. If regarded as sales and the amount of donations is calculated into non-operating income, for the part that is over 12 per cent, enterprise income tax should be paid.	1. If regarded as property transferring, value-added tax should be paid (The tax rate is chosen based on the method of obtaining the assets). 2. If regarded as selling and the amount of donations is calculated into non-operating income, for the part that is over 12 per cent, enterprise income tax should be paid.	1. For donations of land-use rights, normal tax payable behaviors are carried out and sales tax should be paid. 2. If regarded as selling and the amount of donations is calculated into non-operating income, for the part that is over 12 per cent, enterprise income tax should be paid.	There are currently no clear or special regulations for equity donation.

4.2 Tax Burden Comparison Under Three Different Conditions (With Examples)

From the analysis above, we can conclude that the amount of donations of inventory, fixed assets and intangible assets will not be calculated as an income in accounting, but related taxes should be paid according to tax laws and regulations. Unlike individual income tax, all donation expenditure should obey the partial deductions rules. There are no special items from which donations can be fully deducted before tax under corporate income tax calculations. In the following case, taking an inventory donation as an example, the taxes under three different situations will be discussed, using donations of the same scale or the same fair value. The tax burden of charitable non-monetary asset donations, charitable monetary asset donations and general goods and material sales is compared.

For example, A Co. Ltd. is a general tax payer of value-added tax; they have donated some self–produced computers to the schools in the underprivileged mountain region through the local Civil Affairs Bureau in May, 2010. The net value of the computers was 800,000 RMB. The tax deductible was 85,000 RMB. It is assumed that at the time of the donation, the fair value of these computers was 1 million (without tax) and the profit earned by A Co. Ltd. was 5 million this year (it is also assumed that there were no other adjustment events, the profit did not include the donation and the enterprise tax rate was 25%).

Taxes to be paid are calculated in the following three scenarios:

1) In a situation as described above.

2) In a situation where A Co. Ltd. first sold these computers and then donated the money to the schools in the poor mountain region.

3) The tax burden of selling the computers directly.

The calculations are as follows:

Categories / Items of Taxation	Non-Monetary Asset Charitable Donations (situation 1)	Monetary Asset Charitable Donations (situation 2)	Normal Sale (situation 3)
Value-Added Tax Payable	17-8.5=8.5	17-8.5=8.5	17-8.5=8.5
Enterprise Income Tax Payable	1. Taxable income (adjusted for sale)*: 100-80=20; 2. Total accounting profits: 500 – 97=403; 3. Taxable income over 12% of total profit; 97–403×12%=48.64 4. Tax payable: (20+48.64) × 25%=17.16	1. Total Accounting Profits: 500+100–80–100=420; 2. Deductible income before tax: 420×12%=50.4; 3. Taxable income over 12% of total profit: 100-50.4=49.6 4. Tax payable: 49.6×25%=12.4	Tax payable: (100 – 80)×25%=5
Total	8.5+17.16=25.66	8.5+12.4=20.9	13.5

* *income regarded as sales revenue*

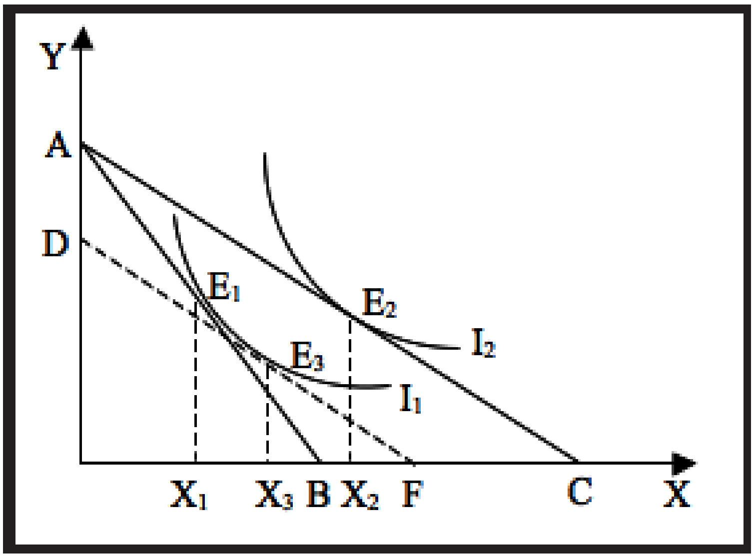
According to the calculations above, we find that non-monetary asset donations bear the highest tax burden, followed by monetary donations and the least for normal sale. Particularly, non-monetary donations bear nearly twice the taxes as that of normal sale. This reflects the onerous tax burden borne by corporate non-monetary donations, which discourages firms to donate.

4.3 Analysis of Tax Incentives in Current Policies

According to current tax law, various taxes including enterprise income tax, deed tax, land appreciation tax, stamp duty tax and many other indirect taxes (value added tax, consumer tax and business tax) will be incurred upon donation.

Donation expenditure, which is less than 12 per centof accounting profits, can be deducted when calculating enterprise income tax, which will reduce donation cost and encourage donations. In this paper, we build a simple model to analyse the effects of tax incentives on charitable donations.

FIGURE3-1. DECOMPOSITION OF THE EFFECTS OF TAX INCENTIVES ON CORPORATE DONATIONS



The X-axis is the amount of the corporate donations while the Y-axis represents the amount of wealth owned by the corporation, and AB is the budget curve of the donor. Assume that the prices of donating and owning the wealth are both 1, without tax. In this case, the quantity donated is X1. After tax incentives are applied, the price of owning the wealth changes to (1-t). The budget curve turns into AC and the indifference curve changes from I1 to I2, because the total wealth owned remains unchanged. Now, let's imagine that the donor makes more donations and the quantity increases to X2. The change from X1 to X3 comes from the substitution effect of tax incentives and the change from X3 to X2 represents the income effect. Both effects are positive, so tax incentives encourage more donations. Besides, the larger t is, the higher utility will be, and the stronger tax incentive effects are.

For the current policies of indirect taxes (value added tax, consumer tax and business tax) in China, the donations of self-produced, consigned manufacturing or purchased raw material and products, fixed assets, intangible assets and securities should be managed under two categories, namely, sale and donations, to calculate enterprise income tax. When donating, corporations are still required to pay indirect taxes even though they do not make any profit. For imported goods and materials, tariffs will be imposed except if the goods and materials are donated by foreign governments, international organisations and by those who have special regulations for tariff-free donations, which will reduce the enthusiasm of corporations.

For some donations, such as donating real estate, corporations will bear property taxes, which includes deed tax, land appreciation tax and stamp duty tax. Thus, the amount donated by the corporations will be reduced because of these taxes. Also, part of deed tax is paid by the recipient, so the amount received is different from the amount donated, which will impact negatively on corporate charitable donations.

To summarise the preceding analysis, there are several pitfalls with respect to current tax policy of non-monetary charitable donations.

1. Non-monetary charitable donations bear heavier tax burdens in that corporations need to pay indirect taxes and property taxes, while the amount deductible from income tax is lower.
2. Categories of deductibles are ambiguous.
3. While many different forms of non-monetary charitable donations are in place, relevant legislations and regulations are still lacking, which impacts negatively on corporate donation and governmental control.

V. OPTIMISATION PROPOSALS ON THE TAX INCENTIVES OF NON-MONETARY CHARITABLE DONATIONS BY CORPORATIONS

The Guideline for the Development of China's Charity (2006-2010) was made in 2005. The guideline suggests that the Chinese government should regard the improvement of the tax reduction policy on charity and the protection of the enthusiasm of the public charitable donations as the fundamental policies and measures. However, hitherto, no obvious progress was made on the reform of charity taxes except that the deductible income before tax rate has been increased from 3 per cent to 12 per cent in Enterprise Income Tax Law. Therefore, the Chinese government should make suitable tax incentive policies based on China's charity development, while learning from theexperiencesof other countries and taking China's specific circumstances into account. According to the previous analysis, we propose the following policies to optimise the handling of charitable donations both in tax law and in tax management.

5.1 To Increase Tax Deduction Limit and To Allow the Deduction Accruing to Future Years

Currently, the tax burden of corporate charitable donations of non-monetary assets in China is still high, compared with other countries or other kinds of donations. Double taxation also exists. In the United States, corporations are allowed to accrue the excess that is over the donation limit to later years and to deduct them before tax. Usually, the time limit is five years. In Germany, tax is deducted differently for charitable donations and non-charitable donations, according to two different criteria. These tax arrangement works more efficiently in meeting different needs of corporations. Learning from the experiences of the United States and Germany, the Chinese government should relax the tax deduction limits on the rescue in natural disasters, aid to poverty, assistance to the disabled and to other disadvantaged social groups,for example, donations to compulsory education in rural areas, the cultural construction in the Midwest rural areas and the employment of the disabled. The excess of the donation over the limit should be permitted to accrue to the next 3 to 5 years. Hence, some large donation expenditure can be deducted before tax, which encourages corporations to provide the timely aid when catastrophes occur.

5.2 Exemption on Indirect Taxes and Property Taxes

The deficiency in the tax preference on indirect taxes (value added tax, consumer tax and business tax) and property taxes is the shortcoming in the tax law of corporate charitable donations on non-monetary assets. This defect even prevents corporate donations. Actually, the demand for corporate non-monetary donations is very large. For example, during the Wenchuan earthquake, some corporations would donate their medical care products, tents and drinking water in stock, which were goods and materials in urgent need in areas affected by the disaster. Though tax-free policies were set for these donations, these policies did not survive for similar events. Therefore those tax-free policies are only available in special cases. In fact, the Chinese government should exempt tax for corporations that make charitable donations on non-monetary assets, such as rescue in natural disaster, aid to poverty and help for the disabled. In those circumstances, certain donation certificates should be given by state accredited agencies for exempting relevant indirect taxes and property taxes. Furthermore, these policies should be established by law.

5.3 To Establish A Third-Party Price Evaluation Mechanism

A third-party price evaluation mechanism should be established in China, and criteria of donation acceptance as well as an assets evaluation brochure should be developed. They should also be monitored in the ISO quality management system. Volunteers should be recruited for price evaluation of charitable donations. Price evaluation is vital for both for the corporation and the tax imposer, because it concerns the amount of charitable donations of non-monetary assets. Since the estimated value of the donation can affect the deduction amount before tax directly, therefore only independent and fair price evaluation mechanism can guarantee the good operation of non-monetary charitable donations, which then can satisfy the donation need of corporations, thereby increasing the amount of non-monetary asset charitable donations, as well as promoting the development of China's charity. In addition, the third-party price evaluation mechanism is beneficial in enhancing public credibility in charity, and the volunteers' work can lower the cost of the donation.

5.4 To Legislate On Equity Donation

The Chinese government should accelerate the process of legislating new forms of donation, including equity donation, and regulating equity transfer and donation, as well as regulating the operation modes of different funds. The family businesses in China are facing the taking over period. During this process, many enterprise funds probably will appear, including charitable donation funds. However,many funds in China are being affected by heavy bureaucracy, and private equity is usually in unfavorable situations. Therefore, the key to Chinese charity development is to explore suitable fund modes to provide healthy growing space for the funds. Although there is little difference between equity transfer and equity donation in terms of forms, what is transferred differs greatly; hence clear distinction should be made to prevent tax evasion. At the same time, relevant documents should be published for the right accreditation and procedure of equity donation deduction before tax, and higher level of monitoring and relevant legislations should be applied to manage the value uncertainty and tax revenue issues.

5.5 To Simplify the Procedure and to Strengthen Tax Administration

The Chinese government should simplify the application procedure of charity organisations, regulate the invoicing of charitable donations, integrate the donation system with the tax systems and share information together in possible places. In recent years, the number of charity organizations has expanded rapidly, but their coverage in China remains limited. Many not-for-profit organisations are registered in the Industrial and Commercial Bureau as companies because of the complicated application procedures. This will certainly lead to double taxation and affect the long-term development of such organisations. In addition, the administration of donation invoices is also very important, for they are the only original documents which corporations can use to for tax exemption purposes. It is also very helpful for non-profit organisations to regulate their financial management. In terms of information sharing, the local donation system should share information with the tax administration systems. Tax officials can then access relevant information when corporations make donations. This can lower the tax administration cost and tax compliance cost.

Annotation

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