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CONTENTS

- 155 The Effect of the Human Rights Act 1998 on Taxation Policy and Administration
Natalie Lee
- 183 Towards Community Ownership of the Tax System: The taxation Ombudsman's perspective
Philip Moss
- 192 Trusts and Double Taxation Agreements
John Prebble
- 210 **Tax Reform in the China Context: The corporate tax unit & Chinese enterprise**
Nolan Sharkey
- 226 Perceptions of Tax Evasion as a Crime
Stewart Karlinsky, Hughlene Burton and Cindy Blanthorne
- 241 Globalisation, Innovation and Information Sharing in Tax Systems: The Australian experience of the diffusion and adoption of electronic lodgement
Liane Turner and Christina Apelt

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

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Abstract

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

INTRODUCTION

China's income tax laws have developed rapidly over the course of the past quarter century in conjunction with the opening of China and its transition to a (socialist) market economy. During this time there have already been two major reform efforts and numerous other changes that have attempted to create an effective and efficient income tax law. At present, major income tax changes are again being debated. The reform efforts are all predicated on the shortcomings of the current income tax laws. These shortcomings include low tax yield relative to national income, lack of clarity in the law, distortionary tax effects and high levels of tax avoidance in China¹. For many commentators the problem with China's income tax laws is that they are not yet fully developed along the lines of the income tax laws in place in countries with developed market economies² that do not suffer from the serious tax problems that China does³. The solution to the problem therefore lies in further reforms aimed at developing a law that mirrors those in place in these countries. This entails, amongst other actions, the refinement of legal definitions and an increase in the detail of the laws to clearly articulate who the taxpayer is and what income they have earned during the tax period.

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

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

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

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

tax where the law needs to define “whose” income is to be calculated for the relevant period and “who” is liable to pay the tax. In most developed income taxes, the tax unit is defined as both the individual and a company/ body corporate. Most of these taxes also develop rules to deal with other forms of business such as partnerships, trusts and joint ventures. These are sometimes treated as taxpayers in their own right but are more usually treated as transparent vehicles with only the underlying individuals and companies viewed as taxpayers. The essential rationale for the individual/ company tax unit is the concept of legal person where companies are viewed as persons in their own right at law. They have the right to sue and can be sued. More importantly the property of the company is its property and not that of the shareholders. The shareholder’s property is shares in the company. The company management has the day to day power to determine the company’s activities and controls the company property. Despite the fact that shareholders are the ultimate owners of the company property they have little day to day say in how it is to be applied or enjoyed. This separation of management from ownership is why a company taxpayer is used in most income taxes alongside the individual. It recognises the inequity of taxing shareholders directly on the income of the company when they have little control of it. It is more appropriate to tax the company directly and tax the shareholders when they receive distributions from the company as this accords with the concepts of horizontal and vertical equity⁴. In the case of other entities such as partnerships, the separation of ownership from management does not exist and they are therefore not treated as taxpayers in their own right.

China’s current income tax laws⁵ do not rely upon the individual/ company taxpayer dichotomy. Instead the three tax laws distinguish between individuals and “enterprises”. The income of individuals being taxed under the Individual Income Tax while the income of enterprises is taxed under one of the two Enterprise Income Taxes depending on whether the enterprise is domestic⁶, foreign-invested or foreign⁷. The tax unit dichotomy is therefore individual/ enterprise. Enterprises are defined in Article 2 of the FIET and Article 2 of the DEIT⁸. However, these articles do not provide a strong conceptual definition of what an enterprise is. Instead they provide a list including vehicles/ operations allowed under various Chinese laws as well as companies, organisations and enterprises⁹. The specifically listed enterprises are:

- Chinese-Foreign Equity Joint Ventures
- Chinese-Foreign Contractual Joint Ventures
- Wholly Foreign Owned Enterprises¹⁰

⁴ Horizontal equity requires that those in similar positions are treated similarly while vertical equity allows for difference with different situations.

⁵ I use the term “laws” loosely to include both laws that have passed through the NPC and regulations issued by State Council. This is necessary as not all of China’s taxes are imposed by law. The Domestic Enterprise Income Tax, for example, is imposed by Regulation.

⁶ These are taxed under the Domestic Income Tax Regulations of 1993

⁷ These latter two are taxed under the Foreign Investment Enterprise and Foreign Enterprise Income Tax Law of 1991

⁸ I refer to the Income Tax Law of the People’s Republic of China for Enterprises with Foreign Investment and Foreign Enterprises (1991) as the FIET while the Provisional Regulations of the People’s Republic of China on Enterprise Income Tax are referred to as the DEIT.

⁹ Neither of these latter two are further defined.

¹⁰ The first three listed are included in the FIET

- State Owned Enterprises
- Collective Enterprises
- Private Enterprises
- Joint Venture Enterprises
- Joint Stock Enterprises¹¹

There are several noteworthy features to the above list. Firstly, all references relate to one of China's other laws allowing for commercial enterprise. Hence, the reference to "Private Enterprises" is a reference to commercial activities sanctioned and registered under China's Provisional Regulations on Private Enterprises (1988) and not to "private enterprises" in general. In a similar manner "Wholly Foreign Owned Enterprises" is a reference to those activities sanctioned and registered under the Law on Enterprises Operated Exclusively with Foreign Capital (1986) as opposed to a reference to any business with only foreign capital (for example a foreign company).

The next noteworthy feature is the length of the list. To persons only familiar with tax laws in other jurisdictions, this is a long list. This feature can only be understood in the historical context of China's post-1978 transformation and the gradual opening of the economy to new forms of enterprise (both domestic and foreign). Essentially, in the centrally planned period prior to 1978, little economic activity outside of the plan was tolerated and economic activity or enterprise was the province of State Owned Enterprises (SOEs). In the years since 1978, more and more types of enterprise have been tolerated, allowed and eventually encouraged. However, at least in the first decade and a half of reform, China's policy makers were careful to specify exactly what form of enterprise was being allowed as they were still essentially committed to state ownership and the plan. This resulted in the great variety of commercial laws seen today as a specific law or regulation was promulgated each time a new form of enterprise was sanctioned. Hence when policy makers decided to allow urban households to commence small private enterprises with no more than 7 employees in the early eighties, these were sanctioned by law¹². It was not until 1988 that larger (more than 7 employees) private enterprises were allowed through the promulgation of the Provisional Regulations on Private Enterprise (1988). Likewise all the different listed enterprise categories in the income tax laws resulted from this gradual allowance of a greater variety of enterprise activity. Only an appreciation of this gradual acceptance of private enterprise will make sense of the large number of different laws allowing commercial activities. Reference to these laws is also necessary to understand what the essential features of the various categories are.

During the 1980's China introduced a variety of income tax laws to tax the different types of enterprises that had been gradually sanctioned. This resulted by the end of the decade in a complicated situation where in addition to the variety present in the commercial laws; there was a variety of income taxes to tax these¹³. These taxes were quite different from one another. The confusion caused by this situation was one of the reasons for the tax reform that took place in China during the early nineties. The approach taken by policy makers during this reform was to adopt the "enterprise" tax

¹¹The last five listed are included in the DEIT

¹²They were incorporated in the General Principles of Civil Law (GPCL) in 1986.

¹³For an excellent review of China's taxes in the 1980's see: Ho, D. H. K. (2001). "Tax law in Modern China: Evolution, Framework and Administration." *Hong Kong Law Journal* 31(1): 141 to 159.

unit and define all the various forms of activities sanctioned by law as “enterprises” thereby creating a uniformity of income tax treatment. The only distinction that remained was that between the domestic and foreign which were covered by the two different enterprise income tax laws. However within these two laws the various business forms were branded as “enterprises” allowing for a single tax unit and uniform treatment. The foreign sector reform was completed in 1991 with the introduction of the FIET Law while the domestic sector reform was finalised in 1993 with the introduction of the DEIT Regulations. It should be noted that some forms of enterprise still fall under the Individual Income Tax¹⁴. These are the above mentioned Industrial and Commercial Households whose essential feature was the limitation of seven employees¹⁵.

The adoption of the “enterprise” tax unit in the reforms of the early nineties was, as mentioned above, driven by the need for uniformity in tax treatment. However, the simple deeming of a list of various activities/ entities established under a host of other laws as “enterprises” is the most noteworthy feature of China’s tax unit. This is because comparative reference to these various laws indicates that highly divergent and sometimes overlapping categories of both activities and entities are being treated as tax units. Most critically there is no real nexus with the concept of legal person or any other qualitative characteristic such as “business” or “entity” that determines whether you have an enterprise or a tax-transparent business vehicle. In each of the commercial laws there will be such a nexus but this varies between activity, class of activity, type of investor, business structure (i.e. enterprise) and legal person. For example a Wholly Foreign Owned Enterprise (WFOE) is an activity allowed under that law (see above). However, it is possible for a WFOE to elect to be a legal person or not. Likewise, Private Enterprises may or may not be legal persons. However, both WFOEs and Private Enterprises remain “enterprises” for tax purposes regardless of their elections. At the same time an Industrial and Commercial Household is regarded as an individual despite the fact that there may be little substantial difference between it and some Private Enterprises. Some forms of “enterprise” are always legal persons. These include SOEs, companies and Equity Joint Ventures (EJVs). However, with Contractual Joint Ventures (CJVs) there is, again, a choice on the part of the venturers. It can therefore be concluded that despite the prima-facie uniformity created by the “enterprise” tax unit, there is arguably little horizontal equity in that very different categories of operation/ entity are being treated in a similar manner¹⁶.

Having concluded that the “enterprise” tax unit used in China’s income tax law is simply a category created to catch a variety of different situations and treat them as if they were similar, it is worth considering the operation of this tax unit in situations where there is no legal personality. When there is legal personality, the adoption of the body-corporate as a tax unit operates in a conceptually similar manner to the individual tax unit. In essence the income being taxed is that earned by the person which is an increment to the private property of that person. In other words it is a question of gain by a person. However, if the tax unit is not a person (legal or real), this concept of gain in private property cannot apply as there is no private property. Therefore, a quite distinct concept is in operation when a non-person tax unit is adopted. The income *of the* “enterprise” in this case must become the income

¹⁴ A law (1999), the model for the current version initially promulgated in 1994

¹⁵ Article 2 of the IIT (1999)

¹⁶ Horizontal equity requires similar treatment in similar situations

generated by the enterprise as opposed to a gain in the private property of a person. In reality, the two concepts will often yield the same results but they are quite distinct and can lead to very different results. When a pure “enterprise” tax unit is used in China’s tax laws (in the sense of an activity as opposed to a person), the laws are operating in an internationally innovative manner. There is little doubt that this innovation is the result of an attempt to clarify taxation in relation to a great number of different commercial laws that were introduced in a firmly socialist era to allow types of economic activity as opposed to types of private property rights. At the same time it is an innovation that is worthy of consideration in any international tax reform debate. I shall return to this issue further on in this paper.

The above discussion will no doubt already give an indication as to why further reform in relation to defining the income tax unit is considered a priority in China. The current unit remains complicated despite the early nineties reforms. This is because there is no clear conceptual definition of the tax unit with many competing forms and activities all branded “enterprise”. This leads to confusion as to who the taxpayer is and therefore compliance costs, tax arbitrage opportunities and tax avoidance opportunities. Finally, as mentioned above, the current tax unit is not equitable as very different situations are being treated in a similar manner. There is therefore a need to refine the tax-unit to allow easy identification of the taxpayer and their income.

The most often proposed solution for China is the adoption of the individual/ company tax unit covered earlier. The virtues of this are clear as discussed above. Essentially, this tax unit looks to individual persons as tax payers unless there is a legal person in which case the legal person will be the taxpayer. This treatment accords with the company’s status as “person” at law. It also accords with the concept of equity given the restricted rights of the underlying shareholders vis-à-vis the company itself.

The adoption of the individual/ company tax unit also accords with the views of many commentators that the problem with China’s income tax laws is that they are not yet fully developed along the lines of the income tax laws in place in countries with developed market economies.¹⁷ These countries do not suffer from the serious tax problems that China does and therefore if China emulates their laws it will solve its tax problems. It is, of course, also accepted that China needs to develop the rest of the commercial (and other) legal framework that supports the income tax laws as they do not stand-alone. They rely upon property laws, company laws, partnership laws, trust laws and numerous other laws as well as administration to be effective. However, it is often proposed that when China fully develops a world standard legal framework, it will significantly reduce its tax problems¹⁸.

There is also another strong argument in favour of a company/ individual tax unit in China and this is that it has become the internationally used standard tax unit. The importance of this should not be underestimated. In an increasingly internationalised world, there is a need for international regulatory systems to deal with transnational activities. Harmonisation of national tax systems plays an important role in creating a consistent international tax system as opposed to a collection of conflicting national laws. This is the reason why contemporary double taxation agreements (DTAs) strive to use similar formats and terminology. Conflicting definitions at best create increased

¹⁷ including the USA, UK, Germany, Australia and Canada

¹⁸ World standard here refers to a similar framework to that in place in developed countries.

compliance costs as taxpayers and administrators strive to reconcile the differences. At worst they create holes in the system making way for arbitrage or avoidance opportunities or double taxation. This can be seen with China's current enterprise tax unit, for example, if you attempt to reconcile China's tax treatment with Australia's tax treatment of a non-legal person enterprise with foreign investors that has international activities. In this case it can be extremely difficult to identify the relevant taxpayer under the DTA. Finally, China's focus on attracting foreign investment means that this factor is going to be even more important.

The need for reform of the tax unit in China is not contested. The above discussion gives a strong rationale for such reform. However, putting aside arguments for international harmonisation, it is important to consider the perceived benefits of the company/ individual tax unit in China. These are outlined above and are anticipated in China on the basis of international experience. However, proponents of internationally successful institutions often neglect the context in which they arose and how this may conflict with the current context, in this case China.

The use of the corporate tax unit is linked to the concept of legal personality. Under the concept, a company or corporation is regarded as a person and therefore it is appropriate for it to constitute a tax unit. The development of the concept of legal personality, however, is inextricably linked to the evolution of the independent firm. Large undertakings with separation of ownership from management developed prior to the specific concept of legal personality. Courts and then legislators recognised that with such activities funded by groups of individuals, it would be more appropriate to treat the firm as a person and all the relevant property as belonging to the firm independent of the individual investors and management. This was because of the differentiated property rights of the individual shareholders and the company management where neither the investors nor managers had the full rights of control usually associated with property. Instead these rights were divided between them. This recognition became formalised through the concept of companies as legal persons and a raft of other law and institutions designed to ensure company independence. The formalisation itself then further reinforced the concept of the independent company. The independent company is therefore not only the product of law but also of Western society and ideology with its focus on independence as an ideal¹⁹. A genuine body corporate is therefore a "real" social entity and not a simple legal fiction superimposed on individuals. However, with the formalisation of incorporation procedures in Company laws, it is possible to create a company that is not a "real" independent social body. These are nevertheless recognised as persons at law as the result of judicial acceptance of the company as simply a legal fiction²⁰. Such companies amount to little more than a legal fiction.

The appropriateness of the corporate tax unit depends very much on whether the company in question is a "real" independent body or simply a legal fiction. In both cases the company is treated as independent at law but if there is not some genuine independence of management from ownership, the company will not be genuinely independent. A clear example of a company that is little more than legal fiction is a

¹⁹ Biggart, N. W. and G. G. Hamilton (1997). On the Limits of Firm-Based Theory to Explain Business Networks: The Western Bias of Neoclassical Economics. The economic organization of East Asian capitalism. Thousand Oaks, Calif., Sage Publications.: 33 - 54.

²⁰ Salomon vs Salomon & Co Ltd. [1897] AC 22

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

Serious tax problems can arise when non-independent companies that are mere legal fictions are treated as tax units. Their treatment as a separate tax-unit creates significant tax-arbitrage as well as possible evasion opportunities. The basic root of these opportunities is that a non-independent company allows a person (natural or “real” company²¹) to artificially alter their individual circumstances. As tax treatment is dependent upon a person’s circumstances (for example, total annual and type of income, location of residence, economic position etc.), an ability to change these creates arbitrage opportunities. A raft of common tax schemes from an individual using a company to obtain a lower tax rate to the use of tax havens rely upon the artificial separation granted to non-independent companies. In summary, the rationale for the corporate tax unit discussed earlier is significantly diminished, if not eliminated, when a company amounts to nothing more than a legal creation. To make use of the principle of equity again, in these cases it can be seen that the corporate tax unit allows those in a similar position to be treated differently and those in a different position to be treated the same. This is contrary to the principle. Of course, it can be argued that legal incorporation always creates rights and obligations that are different to the pre-incorporation situation. The primary example being limited liability. It may therefore be appropriate to treat any incorporated business differently to a non-incorporated equivalent. However, these minimal differences do not merit the type of different treatment that a “real” company does.

Given the above analysis, the issue that arises is why so many tax systems in Western countries have been able to successfully adopt a corporate tax unit and not suffer dire tax avoidance problems. The answer to this is essentially twofold. The primary reason is that the majority of the market in Western countries is made up of companies that are “real” and independent legal persons as well as independent natural persons. As is pointed out by comparative sociologists such as Biggart and Hamilton²² and Fei²³, independence and autonomy are deeply rooted ideals in Western society. They can be traced back to classical philosophies, Christianity and nineteenth century politics of democracy²⁴. As touched on above, these ideals prompt the introduction of laws and institutions that then reinforce the independence of companies and individuals. The assumption that the market is comprised of independent actors (companies or individuals) is a central tenet of neoclassical economics. The general accuracy of

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

²² Biggart, N. W. and G. G. Hamilton (1997). On the Limits of Firm-Based Theory to Explain Business Networks: The Western Bias of Neoclassical Economics. The economic organization of East Asian capitalism. Thousand Oaks, Calif., Sage Publications.: 33 - 54.

²³ Fei, X. (1992). From the Soil: The Foundation of Chinese Society. Berkley, University of California Press.

²⁴ Biggart, N. W. and G. G. Hamilton (1997). On the Limits of Firm-Based Theory to Explain Business Networks: The Western Bias of Neoclassical Economics. The economic organization of East Asian capitalism. Thousand Oaks, Calif., Sage Publications.: 33 - 54.

neoclassical economics in explaining Western economies and markets results from this assumption generally holding true²⁵. As this majority of companies are “real” independent bodies, the tax problems mentioned do not arise in relation to them.

The secondary reason that the major tax problems do not arise in relation to “non-real” companies in Western societies is closely related to the primary reason. The general independence of persons and the insitutionalisation of independence in these societies result in the use of contracts and records when two or more persons are not independent. These are required to ensure that rights and responsibilities are enforceable and protected given the general presumption of independence. For this reason, non-independent or non-“real” persons and their relationships to other persons can generally be identified through records. This allows the drafting and implementation of anti-avoidance rules in tax laws that can be used to identify non-independent persons and prevent them from being used for unacceptable tax purposes.

A review of the income tax law in a typical Western society such as Australia serves to illustrate these rules. Any registered company is generally treated as a tax unit. However, in a number of situations there are special rules that look through this independence. The following situations describe some of the more direct of these rules:

- When associates are dealing with one another on non-arm’s length terms, arm’s length terms are deemed
- When profits are being indirectly taken from companies by owners or associates without the declaration of a dividend, a dividend is deemed²⁶
- When a controlled foreign corporation is in use, the profits are deemed to be earned by the controller²⁷
- When a corporate group exists, it may be consolidated
- When losses or tax preferred amounts are being carried in a company and the majority underlying interests change, the losses and tax preferred amounts can be lost
- When personal services are performed in the name of a company, the company may be ignored

The law is generally effective as records²⁸ can be used to identify associates, controllers and other related persons such as partners, subsidiaries and parent companies. If records do not indicate any such relationships, the presumption is that they do not exist. As discussed above, due to the nature of the society, this presumption will be generally correct. Tax laws in Western societies do, however, recognise that when dealing with close family relationships such as spouses, parents, children and siblings, the general presumption of independence may not hold true and that there may be no records to indicate the nature of any relationship. For this reason these relationships are more closely scrutinised. However, the natural limit on the size of families means that these relationships will not result in significant tax problems. When the nature of these relationships cannot be determined, they can be ignored and

²⁵ *Ibid.*; 45

²⁶ Division 7A of the Income Tax Assessment Act (1936)

²⁷ Part X of the Income Tax Assessment Act (1936)

²⁸ These could include registries, contracts & agreements, deeds and titles

tolerated with resultant tax avoidance opportunities. Alternatively they can be treated as if tax avoidance is occurring with resultant possible inequities.

In summary, it can be said that in Western societies, the company tax unit is appropriate as most significant companies represent “real” autonomous bodies that are more than mere legal fictions superimposed on the underlying individuals. This is because of the unique situation in which none of the natural persons involved, either as investors or managers, have the full property rights and control that a person normally has over their property. The property can therefore only be regarded as the company’s. With companies that are no more than legal fictions (that is, they are not independent bodies), the serious tax problems that can arise are prevented through the correct structure of the law including anti-avoidance rules. These rules are effective because non-independent and non-“real” persons can be identified through records. These records also allow the nature of any relationship to be determined. It is likely that any person (natural or legal) will be independent and autonomous unless either a record (for example, a registry or an agreement) indicates otherwise or there is a close family relationship. This is because of the institutionalisation of independence in Western society.

Having considered the context in which the corporate tax unit has worked effectively and efficiently, the context in which it is hoped that that success will be replicated needs consideration. For the corporate tax unit to be as effective in China as it is elsewhere, the preconditions for that success need to exist in China. The nature of Chinese society, business styles and economic organisation has been the subject of much research in the social sciences. The findings of this research reveal some stark contrasts to the Western equivalents that merit close review.

At a fundamental level traditional Chinese society does not idealise the independent, autonomous person. As mentioned above, this ideal has its origins in classical philosophy, Christianity and the politics of democracy and is reinforced by social values and the legal system. Quite contrary to this, Chinese society values specified social relationships that directly challenge an individual’s independence as an ideal. The basis for this being in classical Chinese philosophies such as Confucianism reinforced by history, social values and traditional laws. According to Chinese sociologist Fei Xiaotong, one of the defining features of Chinese society is that it revolves much more significantly around networks of individuals than independent individuals, as is the case in the “West”²⁹.

The concept of Guanxi is critical in Chinese society in general and business relationships in particular. The term is loosely translated as “relationship”. However, it is more specific than that. Guanxi refers to a particular type of relationship that involves mutual obligation³⁰. These relationships are the bonds that bound together the networks referred to by Fei. The relationships between family members will amount to Guanxi as will long-term friends and friends of friends etc. Individuals work to build their Guanxi networks which are instrumental in the conduct of business. They will seek to establish relationships with those who are likely to be useful in business. This

²⁹ Fei, X. (1992). *From the Soil: The Foundation of Chinese Society*. Berkley, University of California Press.

³⁰ A detailed study of Guanxi can be found in: Yang, M. M.-h. (1994). *Gifts, Favors and Banquets: The Art of Social Relationships in China*. Ithaca, Cornell University Press.

is done socially through gift-giving, banquets etc. Through the successful pursuit of Guanxi, persons can become part of extensive networks that go well beyond the extended family and friends. The networks are employed to pool resources in the pursuit of business enterprises³¹. The essential point about these network bonds is that they have very real enforceable value in terms of mutual obligation. There is however no written contract or record to show the connection as it is socially and not legally reinforced. There is no need to rely upon legal reinforcement due to the values of Chinese society which, in themselves, provide effective sanctions against those that violate social obligations. The reason for this is the non-presumption of independence and autonomy with instead a presumption of connectivity with the appropriate persons. This has historically translated into a dislike of written contracts and law that are viewed as an indicator of poor relationships or even immorality.

Social bonds and networks provide a solution when business enterprises need to be operated effectively in weak or hostile institutional environments. The communist experience in the People's Republic of China has therefore reinforced the reliance upon Guanxi networks. Prior to 1979, private enterprise was effectively illegal in China due to communist doctrine. However, even after reform commenced, private enterprise was frowned upon and the Party's commitment to its development far from certain. There was during the 1980's a very real possibility of a return to hard-line communism. It was not until Deng Xiaoping's famous 1992 tour of the South and its symbolic approval of private enterprise that a degree of certainty of direction could be felt by private enterprise. At the same time, China's institutional infrastructure was still very weak with many problems in the legal and banking sectors (to note just two). All this reinforced the use of Guanxi networks in doing business in China as private entrepreneurs sought to both remain invisible and circumvent institutional weaknesses. In other Chinese societies in colonial and post-colonial states, hostile and weak institutional environments have also reinforced the tendency to operate through Guanxi networks. The fact that much of the foreign investment and activity in China has come from Overseas Chinese networks has again meant mutual reinforcement of business through these networks that now span the region³².

³¹ A recent study of Guanxi in China can be found in: Gold, T., D. Guthrie, et al. (2002). Social connections in China : institutions, culture, and the changing nature of Guanxi. Cambridge ; New York, Cambridge University Press.

³² There is an extensive literature on overseas Chinese networks see: EAAU (1995). Overseas Chinese business networks in Asia. Parkes Australia, East Asia Analytical Unit Dept. of Foreign Affairs and Trade, Lever-Tracy, C., D. F.-K. Ip, et al. (1996). The Chinese diaspora and mainland China : an emerging economic synergy. Houndmills, Basingstoke, Hampshire New York, Macmillan Press ;

St. Martins Press, Weidenbaum, M. L. and S. Hughes (1996). The bamboo network : how expatriate Chinese entrepreneurs are creating a new economic superpower in Asia. New York, Martin Kessler Books, Twang, P. Y. (1998). The Chinese business elite in Indonesia and the transition to independence, 1940-1950. Kuala Lumpur ; New York, Oxford University Press, Wong, B. P. (1998). Ethnicity and entrepreneurship : the new Chinese immigrants in the San Francisco Bay Area. Boston, Allyn and Bacon, Budiman, A., B. Hatley, et al. (1999). Reformasi : crisis and change in Indonesia. Clayton, Australia, Monash Asia Institute Monash University, Tseng, Y.-F., C. Bulbeck, et al. (1999). Asian migration : Pacific Rim dynamics. Taipei, Taiwan, Interdisciplinary Group for Australian Studies (IGAS) National Taiwan University, Bolt, P. J. (2000). China and Southeast Asia's ethnic Chinese : state and diaspora in contemporary Asia. Westport, Conn., Praeger, Brown, R. A. (2000). Chinese big business and the wealth of Asian nations. Basingstoke, Hampshire ; New York, Palgrave, Cartier, C. L. (2001). Globalizing South China. Oxford ; Malden, Mass., Blackwell Publishers, Gomez, E. T. and X. Xiao (2001). Chinese business in Southeast Asia : contesting cultural explanations, researching

In addition to the above factors, the commodification process during the reform period in China has further strengthened the development and use of Guanxi networks. Extensive field and theoretical work by David Wank³³ has considered the role of commodification in developing China's business modalities. The term commodification refers to the conversion of state assets into commodities in China's market economy. There are no clear property rights in relation many valuable State (or former State) assets in China. They are, however, under the control of local government. These assets include resources as critical to enterprise as land and buildings. Control of these assets and the ability to let others use them, has led to the absorption of local officials into Guanxi networks that dominate much of China's economy. In most cases successful private entrepreneurs have strong Guanxi links to local officials if they are not officials themselves. The ability to use these assets subject to "fuzzy" property rights in Guanxi based business networks incorporating local officials as well as entrepreneurs has proven effective and efficient in China. It allows assets to be moved quickly through the network to where they can be effectively used³⁴. It has been strongly argued by Hendrischke³⁵ that the success of this modality of business leads to a demand for "fuzzy" property rights in China. It is worth contrasting this with the politics of democracy in the West where there was a clear drive for clear property rights³⁶.

In summary the nature of Chinese society in combination with the formerly hostile and current weak institutional environment and the process of commodification of State assets have resulted in a situation in contemporary China where the primary actors are business networks rather than independent companies and individuals³⁷. Business is conducted by and through networks held together by strong Guanxi –

entrepreneurship. Richmond, Surrey, Curzon, McKeown, A. (2001). Chinese migrant networks and cultural change : Peru, Chicago, Hawaii, 1900-1936. Chicago, The University of Chicago Press, Koehn, P. H. and X.-h. Yin (2002). The expanding roles of Chinese Americans in U.S.-China relations : transnational networks and trans-Pacific interactions. Armonk, N.Y., M.E. Sharpe, Yan, Q. (2002). The ethnic Chinese in East and Southeast Asia : business, culture and politics. Singapore, Times Academic Press, Ma, L. J. C. and C. L. Cartier (2003). The Chinese diaspora : space, place, mobility, and identity. Lanham, Md., Rowman & Littlefield, Wu, X. A. (2003). Chinese business in the making of a Malay state, 1882-1941 : Kedah and Penang. London ; New York, RoutledgeCurzon, Gomez, E. T. and X. Xiao (2004). Chinese enterprise, transnationalism, and identity. London ; New York, RoutledgeCurzon.

³³ Wank, D. L. (1999). Commodifying communism : business, trust, and politics in a Chinese city. Cambridge England ; New York, Cambridge University Press.

³⁴ Hendrischke, H. (2002). The Role of Social Capital, Networks and Property Rights in China's Privatization Process. Chinese Enterprise Models, University of New South Wales, Sydney, UNSW Centre for Chinese Studies.

³⁵ Ibid.

³⁶ Biggart, N. W. and G. G. Hamilton (1997). On the Limits of Firm-Based Theory to Explain Business Networks: The Western Bias of Neoclassical Economics. The economic organization of East Asian capitalism. Thousand Oaks, Calif., Sage Publications.: 33 - 54.

³⁷ Hendrischke, H. (2002). The Role of Social Capital, Networks and Property Rights in China's Privatization Process. Chinese Enterprise Models, University of New South Wales, Sydney, UNSW Centre for Chinese Studies, Krug, B. and H. Hendrischke (2002). China Incorporated: Property Rights, Privatisation, and the Emergence of a Private Business Sector in China. INSEAD Euro-Asia Centre, Fontainebleau. Wank, D. L. (1999). Commodifying communism : business, trust, and politics in a Chinese city. Cambridge England ; New York, Cambridge University Press, Chan, K. B. (2000). Chinese business networks : state, economy and culture. Singapore

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Nordic Institute of Asian Studies, Gold, T., D. Guthrie, et al. (2002). Social connections in China : institutions, culture, and the changing nature of Guanxi. Cambridge ; New York, Cambridge University Press, Menkhoff, T. and S. Gerke (2002). Chinese entrepreneurship and Asian business networks. London ; New York, RoutledgeCurzon.

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

Commentators such as Biggart and Hamilton³⁸ concluded that Asian capitalism and markets are fundamentally different to those in the West as they are based on networks rather than autonomous individuals and firms. They also concluded that the differences between the structure of Asian capitalism and markets and those elsewhere in the world are so significant that they should be considered entirely different models as opposed to flawed versions of accepted ideals. They based their conclusions on sociological observations in Asia by themselves and seminal studies such as that by Fei³⁹. The additional forces at play in post-1978 China discussed above can only strengthen their conclusions as far as China is concerned.

Having considered the context in China it is clear that it is very different to Western nations in which the corporate tax unit has been proven effective and efficient. The potential dangers of a corporate tax unit have been discussed above. In broad summary, when a company is nothing more than a legal fiction, significant tax-arbitrage and avoidance opportunities arise. This has not proved a significant problem in Western countries as the majority of companies do represent “real” independent persons. When they are not their relationship to other persons can be identified through written and other records/ agreements. This allows tax laws to be drafted to prevent tax avoidance through non-“real” companies.

The context in China severely challenges the requirements for an effective corporate tax unit. The business networks can be thought of as analogous to “real” unnatural persons such as independent companies in the West. This is because many of the assets employed by the network could not be said to belong to any one of the underlying individual members of the network and are therefore owned by the network alone. However, the corporate tax unit would refer to companies incorporated under China’s Company Law (1994). These are not the same as the business networks and therefore there is a dramatic departure from the situation in the West where Company law developed to recognise and reinforce “real” companies. Companies incorporated under China’s Company law are much more likely to be mere legal fictions. There is therefore potential for the severe tax problems considered earlier. The solution to these tax problems in other jurisdictions is to develop your law to identify non-independent companies and the nature of their relationships to others. The law can then be written to prevent tax avoidance/ arbitrage. However, the ability of a tax law to do this is reliant on the records and agreements identifying relationships. These are generally available due to the reliance on contracts and law to reinforce property and other rights in a society made up of independent or presumed independent persons. This is in stark contrast to Guanxi networks in China that actively avoid the use of the law and written agreements to enforce rights preferring

³⁸ Biggart, N. W. and G. G. Hamilton (1997). On the Limits of Firm-Based Theory to Explain Business Networks: The Western Bias of Neoclassical Economics. The economic organization of East Asian capitalism. Thousand Oaks, Calif., Sage Publications.: 33 - 54.

³⁹ Fei, X. (1992). From the Soil: The Foundation of Chinese Society. Berkley, University of California Press.

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

Another critical factor to consider is the private sector’s aversion to paying income tax. Having considered the rationale for reliance on social networks rather than legal agreements in China, it can be seen that the ability to avoid taxation only adds to this. Business networks have had a new reason to remain invisible in China in the Nineties. During the Eighties they feared a Central Government backlash, now they fear that the Central Government will gather revenue from them. Governmental attempts to strengthen the institutional environment and property rights through initiatives such as the introduction of the Company Law can be counterproductive when social bonds are stronger than legal rights. This is because instead of simply being invisible, networks can make use of the new laws to create legal rights that they are able to readily circumvent. Regulators on the other hand will treat the legal rights as a correct representation of the situation. There is evidence that assets are simply placed into companies and removed at will by networks and that legal entitlements to dividends are simply ignored when profits are shared⁴⁰.

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

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

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

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

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

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