Is China Creating A New Business Order? Rationalizing China's Extraterritorial Attempt to Expand the Veil-Piercing Doctrine

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Is China Creating A New Business Order?
Rationalizing China’s Extraterritorial Attempt to Expand the Veil-Piercing Doctrine

Wei Shen & Casey Watters

Abstract: Countries are increasingly using tax policy as an instrument to navigate through the recent global financial difficulties, and China is no exception. In an effort to avoid the loss of tax revenue resulting from the utilization of foreign holding companies, the Chinese tax authority issued Circular 698 granting itself the authority to tax transactions between foreign entities taking place outside of China if the transactions effectively transfer interest in a domestic enterprise. The phrase ‘denying the existence of an offshore holding company which is used for tax planning purposes’ in Circular 698 appears to share similarities with the veil-piercing doctrine, a long established doctrine of corporate law existing independent of tax regulations, which disregards the separate legal personality of a company. This article addresses the legitimacy and policy objectives behind Circular 698 and its implementation, and the article compares the Chinese policy to the application of a similar policy in India. The article then examines how the expansive and extraterritorial veil-piercing scenario created by Circular 698 compares with traditional veil-piercing justifications and the three veil-piercing scenarios listed in China’s Company Law. The article interprets Circular 698 in a global context, which underscores the legitimacy of Circular 698 and suggests how foreign experiences can improve the enforcement mechanism for Circular 698. By drawing a global picture this article also enhances the proposition that there is a need to have a uniform approach to dealing with the loopholes that Circular 698 tries to fill at the global level.

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INTRODUCTION

In an effort to avoid the loss of tax revenue resulting from the utilization of foreign holding companies, the General Administration of Taxation, China’s tax authority, issued the Circular on Strengthening the Management of Enterprise Income Tax Collection of Proceeds from Equity Transfers by Non-Resident Enterprises (Circular 698) on December 10, 2009, granting itself the authority to tax transactions between foreign entities taking place outside of China if the transaction effectively transfers interest in a domestic enterprise. The phrase “denying the existence of an offshore holding company which is used for tax planning purposes” in Circular 698 appears to share similarities with the veil-piercing doctrine, a long established doctrine of corporate law existing independent of tax regulations, which disregards the separate legal personality of a company and limited liability of shareholders.

This article addresses the legitimacy and policy objectives behind Circular 698 as well as its implementation. It questions the General Administration of Taxation’s authority to issue Circular 698 and its alignment with the policy objectives underlying veil piercing. With the recent creation of Circular 698, the cases utilizing the Circular are limited, but the article examines several Chinese cases and looks to the Vodafone case in India for a comparative study of India’s application of a similar policy based on the common law veil-piercing doctrine.

Compared to the three veil-piercing scenarios listed in the Chinese Company Law, Circular 698 tries to pierce the corporate veil in a more expansive and extraterritorial manner. This raises many questions including: Does the scenario specified in Circular 698 justify veil piercing? If so, does the General Administration of Taxation have the authority to establish the new rules? What investment techniques inspired the creation of Circular 698? This article attempts to look into these questions. The rest of the article proceeds as follows.

Part 1 offers a brief introduction of key rules created by Circular 698 and tries to understand Circular 698 by looking into its connection with the conventional veil-piercing doctrine. To this end, the section includes a brief introduction to the common law veil-piercing doctrine. The analysis of the legitimacy of Circular 698 appears in Part 2, after which Part 3 looks at the Chinese adoption of the veil-piercing doctrine and examines specific instances of Circular 698’s application resulting in piercing of the corporate veil. Then Part 4 looks into possible ways of improving Circular 698 by reference to the Ramsay principle and related doctrines developed in other jurisdictions. Part 5 examines the rationality of Circular 698’s attempt at expanding the veil-piercing doctrine from a global perspective. First, the section examines the Chinese foreign investment structures and incentives that lead to a loss of Chinese tax revenue. Second, the section addresses the
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global emphasis on increased tax revenue and anti-avoidance. A conclusion follows in the end, framing the discussion in terms of the rule of law and changes resulting from the need for fair tax policies involving international investments.

I. CIRCULAR 698 AND ITS IMPLICATIONS FOR THE VEIL-PIERCING DOCTRINE

A. Circular 698: Scope and Application

The PRC Enterprise Income Tax Law provides that:

Non-resident enterprises that have set up institutions or premises in China shall pay enterprise income tax in relation to the income originating from China obtained by their institutions or establishments, and the income incurred outside China if there is an actual relationship with the institutions or establishments set up by such enterprises.

Where non-resident enterprises that have not set up institutions or establishments in China, or where institutions or establishments are set up but there is no actual relationship with the income obtained by the institutions or establishments set up by such enterprises, they shall pay enterprise income tax in relation to the income originating from China.1

On their face, these provisions indicate that the non-resident enterprises with or without establishment in China shall pay enterprise income tax for their income generated inside China. Article 7 of the Implementing Rules of the Enterprise Income Tax Law prescribes the principle of taxing the income generated from inside China.2 In terms of equity, according to


(3) With regard to income from the transfer of property, the income from the transfer of real property shall be determined according to the place where such real property is situated, while the income from the transfer of personal property shall be determined according to the place where the enterprise or institution of that transfers the property is located;

(4) the income from the transfer of equity investment assets shall be determined according to the place where the invested enterprise is located.
Item 4 of this article, if the equity transferred is in a Chinese company, then the income generated out of the transfer is regarded as the income generated from inside China, and the transferor shall pay enterprise income tax in China.\(^3\) To illustrate this rule, assume a transaction in which a US Company A transfers its owned equity of Company B in the British Virgin Islands to a German company D. If Company B is the holding company of Company A that holds equity in Company C in China, Company A can transfer the equity of the Chinese Company C by transferring the equity of Company B to Company D. This equity deal has nothing to do with China. Accordingly, A does not need to pay Chinese tax.

**Figure 1: Hypothetical Scenario Caught in Circular 698**

In the above case, consider whether the income obtained by the non-resident enterprise (Company A) from transferring equity in a Chinese resident enterprise (Company C) indirectly through the transfer of equity in an offshore holding company (Company B) should be regarded as the income originating from China and, if so, does it trigger an enterprise income tax in China? According to Circular 698, Company A needs to pay Chinese tax for its transfer of equity in the holding company to Company D, even though the transaction is a pure offshore transaction. Circular 698 effectively subjects the transfer of equity between two non-resident enterprises to Chinese tax law.

In Circular 698, the non-resident enterprise which indirectly transfers the Chinese resident enterprise is termed the “foreign investor” (actual con-

\(^3\) *Id.*
trolling party), and the holding company put in place between the foreign investor and the resident enterprise is labeled the “offshore holding company.” For the purpose of discussion, the cases in Circular 698 referred to later follow the above hypothetical example. In the above hypothetical case, Company A is the foreign investor (actual controlling party), Company B is the offshore holding company and Company C is the Chinese resident enterprise.

Article 5 of Circular 698 further provides that: when the actual tax liability in the country (region) where the overseas holding company being transferred is located is less than 12.5%, or the aforementioned country (region) does not tax foreign-sourced income, the foreign investor’s indirect transfer of the Chinese resident enterprise’s equity shall be examined by the Chinese tax authority. It also provides the materials the foreign investor needs to submit to the Chinese tax authority.

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5 The term “does not tax foreign-sourced income” may be interpreted to apply if the offshore intermediary jurisdiction does not tax foreign-sourced income. On March 28, 2011, China’s State Administration of Taxation issued the Announcement Regarding Several Issues on the Administration of Non-resident Enterprise Income Tax (Announcement No. 24) to clarify certain terms in Circular 698. Announcement No. 24 now clarifies that this term would apply only if foreign-sourced gains on the share transfer transaction are not taxed in the intermediary holding jurisdiction. It does not cover scenarios whereby the offshore intermediary jurisdiction does not impose tax on other types of foreign-sourced income such as dividends and interest. Although Announcement No. 24 is a great attempt to clarify the term, ambiguity still exists. For example, in some jurisdictions the capital gains are not taxed by virtue of reasons such as concessions or participation exemption. It is not clear whether these jurisdictions are caught by Circular 698. The purpose of Announcement No. 24 (see infra note 69) is to introduce some clarity to the application and interpretation of Circular 698, thereby streamlining administrative procedures and reducing the administrative burden of non-resident enterprises.

6 Circular 698, Article 5 reads:
In case the actual tax burden of the country (region) where one equity-transferred overseas holding company is domiciled is lower than 12.5% or no tax is levied on the income of its overseas residents while an overseas investor (actual controller) indirectly transfers the equity of a Chinese resident enterprise, it should within 30 days upon the signing of the equity transfer contract provide to the competent taxation administration where an equity-transferred Chinese resident enterprise is domiciled the following documents:

(1) Equity transfer contract or agreement;
(2) Relations of an overseas investor and its transferred overseas holding company in capital, business and purchase and sale;
(3) Statuses of production and operation, personnel, finance and properties of the overseas holding company with equity transferred by an overseas investor;
(4) Ties of the overseas holding company with equity transferred by an overseas investor and a Chinese resident enterprise in capital, business and purchase and sale;
Under Circular 698, the tax authority has the power to deny the corporate veil of the offshore holding company used for tax-planning purposes if, after reviewing the above required materials, the tax authority finds that Company A’s indirect transfer of equity in Company C constitutes an abuse of the corporate form, and certain tax liabilities are thus avoided without a reasonable business purpose. In other words, the Chinese tax authority will ignore Company B’s corporate form and regard the transaction as Company A’s direct transfer of equity in Company C to Company D, and the proceeds generated from the transfer are deemed to be “the income originating from China,” thereby achieving the purpose of levying the Chinese enterprise income tax on Company A.

B. Circular 698 and the Veil-Piercing Doctrine

The principles that the corporation has an independent personality as a legal entity and that the corporation’s stockholders only assume limited liability are the cornerstones of modern corporation law. However, each principle has exceptions. In very special circumstances, such as the fraudulent act of taking advantage of the corporation’s independent legal personality, the common law8 doctrine of piercing the corporate veil allows the court to achieve fairness by denying the legal entity’s independent personality or

(5) Explanations for reasonable commercial purpose of the establishment of an equity-transferred overseas holding company by an overseas investor; and
(6) Other related documents required by the taxation administration.

The term “actual tax burden” (or “effective tax burden”) is further clarified by Announcement No. 24, which explains that the terminology refers to the effective tax burden imposed on the gains on the share transfer transaction per se. It seems that as long as the gain is taxed at a rate of not lower than 12.5% in the intermediary holding jurisdiction, the transferor would not be required to report under Circular 698. Article 2 of Announcement No. 24 also states that the transfer of listed shares in Chinese resident enterprises bought and sold over a public securities market are not subject to Circular 698. This seems to suggest that the cases whereby a non-resident enterprise purchases and sells such listed shares in Chinese resident enterprises via over-the-counter trade sales and private placements are covered by Circular 698.

7 Circular 698, Article 6 provides that:

In case an overseas investor (actual controller) makes indirect transfer of the equity of a Chinese resident enterprise in the forms including abusing organization without reasonable commercial purpose to dodge the obligation of paying enterprise income tax, the competent taxation administration may reconfirm the quality of the equity transfer trading in accordance with the economic substance after reporting to the State Administration of Taxation for the examination and approval to negate the existence of the overseas holding company serving as taxpayer.

8 Here, common law refers to judge made law in countries using the British legal system. As discussed later in the article, the veil-piercing doctrine originated from the courts.
depriving the corporation stockholders of limited liability protection.\(^9\)

It was not until 2005 that China began formally introducing the concept of piercing the corporate veil into the Company Law of the People’s Republic of China (2005). At present, the application of the doctrine of piercing the corporate veil is limited to the following scenarios:

a) where a shareholder abuses his privileges of incorporation as a shareholder and causes loss to the company or other shareholders, he may be liable in damages;\(^10\)

b) where any of the shareholders of a company evades debts by abusing the company’s independent status as a legal person or shareholders’ limited liability, thus seriously damaging the interests of any creditor of the company, the shareholder shall be held jointly liable for the debts of the company;\(^11\)

c) in a one-shareholder limited liability company, if the assets of the company and the single shareholder are integrated and indivisible, then he and the company will be jointly liable for the debts of the company;\(^12\) or

d) where a controlling shareholder, \textit{de facto} controller, director, supervisor or senior officer uses his relationship to damage the interests of the company causing it loss, he may be liable in damages to the company.\(^13\)

However, Chinese courts have not developed clear judicial guidance in applying these principles in real cases. Compared to their counterparts in common law jurisdictions, judicial opinions in this regard are far less clear.\(^14\)

The General Administration of Taxation stepped in at the end of 2009 by issuing Circular 698, which appeared to create a new regime in which the corporate veil can be pierced outside the conventional veil-piercing framework under the Company Law. The relevant rule under Circular 698 is that where a foreign investor transfers the equity in a Chinese resident en-


\(^{11}\) \textit{Id.} at art. 20(1).

\(^{12}\) \textit{Id.} at art. 64.

\(^{13}\) \textit{Id.} at art. 21.

\(^{14}\) For a study of veil piercing cases in China see Hui Huang, \textit{Piercing the Corporate Veil in China: Where Is It Now and Where Is It Heading?} \textit{60 AM. J. COMP. L.} 743 (2012).
terprise indirectly so as to avoid paying the enterprise income tax on its income generated from China through setting up an offshore holding company, the Chinese tax authority can ignore the existence of the offshore holding company and deem it as a direct transfer of the equity in the Chinese resident enterprise by the foreign investor. As a result, a capital gain tax (in the form of the enterprise income tax under Chinese tax law) would be levied on such a transaction.

The veil-piercing doctrine originated in the leading case of *Salomon v. Salomon & Co. Ltd* decided by the House of Lords in England in 1897.¹⁵ The case laid down the cornerstone of modern company law due to its role in the establishment of the two most important principles: (i) the shareholders only assume limited liability for the company to the extent of the contributed capital; and (ii) the company is an independent legal person from its shareholders. However, the courts also foreshadowed exceptions to these two principles—the principle of lifting the veil of the corporation: whether Salomon Co. had been fraudulently used to avoid Salomon’s liability, which implied that the shareholder’s fraud may constitute an exceptional ground not to apply the two principles above.¹⁶ Later, in order to prevent the shareholders of the company from abusing the principle of independent legal personality, the court gradually drew the boundaries of various exceptional circumstances in which the principles of shareholders’ limited liability and the corporation’s independent legal personality are not applicable. The case law jurisprudence formed the so-called veil-piercing doctrine. At present, in common law countries, the circumstances justifying lifting the veil of the corporation include: avoiding legal obligations, fraud, agency, and single economic unit.¹⁷ These concepts are addressed in greater detail in the next section.

Not only does the new veil-piercing doctrine established by Circular 698 fall outside the conventional company law’s veil-piercing rule, but Circular 698 constitutes a regulatory measure based on tax law instead of company law. Circular 698’s consequences to corporate law may be the inadvertent result of an overzealous tax authority. Irrespective of the intended scope of Circular 698, its impact could be far reaching even though there are still limited cases with which to predict its application. The following subsection introduces the common law veil-piercing doctrine to provide the necessary foundation in analyzing the impact of Circular 698 and its legitimacy as a basis for disregarding limited liability protection—an issue discussed in detail in part two.

¹⁷ JULIE CASSIDY, *CORPORATIONS LAW, TEXT AND ESSENTIAL CASES* 56-64 (2d ed. 2008).
C. Overview of the Common Law Veil-Piercing Doctrine

As mentioned above, the common law veil-piercing doctrine originated in the 1898 landmark British case of *Salomon v. Salomon & Co.*, in response to the Companies Act of 1862, the law that first authorized limited liability for corporations. In examining the policies behind veil piercing, it is important to consider the doctrine’s origins and its modern variations. As veil-piercing is a common law doctrine, the analysis will include the United Kingdom, the source of the common law system, and the United States, the world’s largest economy.

1. Modern British Approach to Piercing the Corporate Veil

Although the common law doctrine of piercing the corporate veil originated in the United Kingdom, the doctrine is rarely utilized by U.K. courts. In fact, the doctrine is arguably limited to situations where fraud exists. In the opinion of the House of Lords in *Woolfson v. Strathclyde Regional Council*, Lord Keith stated a corporate veil could only be pierced “where special circumstances exist indicating that [use of the corporation] is a mere façade concealing the true facts”.

The fraud requirement was reaffirmed in 2013 when the Supreme Court addressed whether the veil-piercing doctrine is available in the United Kingdom. In *VTB Capital Plc v. Nutritek International Corp.*, the Court noted the many expressions used by British courts to describe the “façade” requirement from the House of Lords. These include “the true facts,” “sham,” “mask,” “cloak,” “device,” and “puppet.” The Court went on to note that most cases where the court pierces the corporate veil are cases where the defendant shareholder(s) could be held liable through agency or another theory. The court also makes it clear that the concept of façade should not be mistaken with the concept of ensuring the moral outcome. As such, it can be reasoned that the main goal of the veil-piercing doctrine in the United Kingdom is to avoid fraud, not merely to protect investors.

The veil-piercing theory is used more commonly in the United States and is one of the most commonly litigated issues of corporate law, making an analysis of the common approaches in the United States useful to the policy analysis.

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21 Id.
22 Id.
23 Chao Xi, *Piercing the Corporate Veil in China: How Did We Get There?* 5 J. BUS. L. 413, 413 (2011).
2. The American Approach to the Veil-Piercing Doctrine

For the purpose of examining the policies underlying the veil-piercing doctrine, this section will address the doctrine using a general approach because, in the United States, corporate law is created on the state level with laws being applied according to the state of incorporation. This system results in inconsistent application between the states. The standards for piercing the corporate veil have been broken down into three elements: (1) Domination and Control, (2) Fraud and Misuse of Corporate Form, and (3) Causation.24 This sub-section will adopt this three-pronged structure to examine the policies underlying the first two elements, which basically divides the grounds for the veil-piercing cases into two categories.25

3. Domination and Control

The issue of domination and control is essential in demonstrating that a company cannot be viewed as a separate legal entity from the parent. It is difficult to prove, and many forms of evidence can be used to establish domination. The element of domination and control can be further broken down into five factors that the court can weigh in order to determine the existence of domination and control. These factors include corporate formalities, adequate capitalization, intercompany transactions and commingling of assets, overlap in officers and directors and other miscellaneous factors.26 This is in contrast to Circular 698, which merely requires an economic gain and an abusive intention, not control.27

(a) Corporate Formalities.

In determining whether there has been domination and control of the corporation by a shareholder, the court often looks to formalities such as maintaining separate books, utilizing independent auditors and directors, and holding separate board meetings.28 The failure to adhere to corporate formalities alone is not enough to establish domination and control since the basic corporate principle still can be achieved without strict compliance with corporate formalities.29 Furthermore, corporate formalities can be met while domination and control exists. For instance, the same directors can

25 Causation is a fundamental element of most causes of action but offers little value to the policy analysis.
26 Smith, supra note 24, at 1165.
27 See Circular 698, supra note 4.
28 Smith, supra note 24, at 1173.
29 Id.
serve on the boards of a parent company and subsidiary without establishing domination and control because the directors owe separate fiduciary duties to the parent and subsidiary. While technically in compliance with corporate formalities, the dual role of the directors provides an opportunity for domination and control.

Although utilizing the same directors does not establish domination and control in the legal sense, which may require “improper control or manipulation,” it does demonstrate absolute control in the literal sense. It therefore follows logically that actual domination and control is not the issue, but the use of fraud while control exists. Analyzing the elements in this way blurs the line between the first element, control and domination, and the second, fraud or misuse. This blurring of the lines may contribute to the inconsistent application of the veil-piercing doctrine and jurisdictional variations.

(b) Adequate Capitalization

Courts often lend greater credence to the issue of adequate capitalization than other factors. In the United States, corporations do not have a registered capital requirement. This implies that limited liability protection should exist even without capitalization of the newly formed corporation. However, the courts have utilized undercapitalization as a basis for disallowing limited liability protection under special circumstances.

The amount of capitalization depends on the type of business and the degree of risk foreseeable at the time of incorporation of the company. When a plaintiff is harmed and petitions the court to pierce the veil, the court cannot simply look to actual harm in determining the adequacy of capitalization or every corporation failing to pay its debts would fail the inquiry. The Seventh Circuit noted that allocating liability whenever a corporation’s capital fell below an adequate level would harm creditors by imposing needless forced sales. To fail the capitalization requirement, the amount of capitalization must be “illusory or trifling compared with the business to be done and the risks of loss.”

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30 Id. at 1174.
31 Adequate capitalization is a factor in determining whether adequate domination and control exists to permit piercing the corporate veil. It is distinct from the “thin capitalization rule” which helps determine the deductibility of interest for corporate tax purposes.
32 Smith, supra note 24, at 1176 (citing Secon Serv. Sys., Inc. v. St. Joseph Bank & Trust Co., 855 F.2d 406, 416 (7th Cir. 1988)).
33 Id. at 1174 (citing WILLIAM MEADE FLETCHER, 1 FLETCHER CYCLOPEDIA OF THE LAW OF CORPORATIONS § 41.33 (perm. ed. 2006)).
(c) Intercompany Transactions and Commingling of Assets

Both in the cases of parent-subsidiary relationships and of shareholders with closely held corporations, transactions between the shareholder and corporation are commonplace. However, the commingling of assets implies a lack of separation between the corporation and shareholder. Without the separation, limited liability protection loses its justification because it is predicated on the corporation’s status as an independent legal person with separate finances.34

(d) Overlap in Officers and Directors

As previously discussed, the overlap of officers and directors between a parent and subsidiary is not inherently improper. However, it can be used as evidence of domination and control because utilization of the same officers or directors gives the parent an opportunity to control the subsidiary. Therefore, use of the same directors can facilitate the establishment of control, but it is neither necessarily nor sufficient. That being said, it may be extremely difficult to establish domination and control without overlap of officers or directors.35

(e) Other Miscellaneous Factors

The court may look to a variety of factors as evidence of domination and control. Although the court is free to examine any factors that may suggest domination by the shareholder or parent company, two predominant factors include joint filings of and the sharing of locations by the parent and subsidiary. Both companies consolidating their filings with the Securities and Exchange Commission or the Internal Revenue Service can provide evidence of domination. However, like the other factors, this is not dispositive because it is common and legitimate for a parent and subsidiary to consolidate their annual reports and tax filings.36 In regards to location, if the parent and subsidiary share an office it may lead the court to question the independence of the entities. However, sharing office space is not illegal and is a legitimate method to save costs. As a result, the court will weigh miscellaneous factors to determine where domination and control exists.37

In determining if there is domination and control, the court is looking

35 Smith, supra note 24 at 1178.
36 Id. at 1179.
37 See Jeffery W. Warren & Adam Lawton Alpert, Creditors’ and Debtors’ Practice in Florida, CD FL-CLE 8-1, § 8.18 (2012) which discusses the case of Dania Jai-Alai Palace, Inc. v Sykes, where the court considered location and joint tax filing in piercing the corporate veil. 425 So.2d 594, 599 (Fla. 4th DCA 1982).
to see if the shareholder exercises control over the corporation to the extent the corporation cannot be said to act as an independent legal person. However, the courts are concerned not merely with control, but with the legitimacy of the control. Thus, it seems that the policy behind the first element is to ensure the purposes of limited liability are met by guaranteeing the corporation operates as an independent legal person and ensuring that any control is not improper.

4. Fraud and Misuse of Corporate Form

Shareholder fraud or misuse must be established prior to the court lifting the corporate veil. Lack of independence alone is insufficient to establish shareholder liability. Instead, the plaintiff must prove the corporation is a “sham” used for “no other purpose than as a vehicle for fraud.” The mere “use of the corporate form to avoid liability is insufficient to warrant piercing the veil.” As such, merely seeking to avoid tax liability, as is the subject of Circular 698, is insufficient to pierce the veil. Even so, utilizing benefits of international legal structures is not tantamount to a sham. This element ensures that only shareholders abusing the corporate form to engage in fraudulent behavior lose limited liability protection, demonstrating a policy objective of avoiding fraud.

An examination of the first two factors demonstrates policy objectives of requiring a corporation to act as an independent legal person within the intended scope of corporation statutes and to prevent fraud. Therefore, the policy objectives behind veil piercing can be summarized as (1) preventing the abuse of the corporate form contrary to the intentions of corporations law, (2) preventing fraud or intentional misuse of the corporate form in order to (3) prevent harm—especially harm to involuntary creditors or third parties in tort cases. Circular 698 lacks the aforementioned “law” objectives and simply seeks to collect tax revenue without regard to the purposes behind the corporate form.

Although Circular 698 is inconsistent with the conventional veil-piercing doctrine, a complete analysis of its justifications and impact requires addressing the legitimacy of Circular 698 both in regards to the authority of the General Administration of Taxation to promulgate Circular 698 and its legitimacy as a new veil-piercing doctrine under the Chinese company law regime. To this end, the next section focuses on the legitimacy of Circular 698.

40 Smith, supra note 24, at 1180 (citing Itel Containers Intern. Corp. v. Altantrafik Exp. Serv. Ltd., 909 F.2d 698, 704 (2d Cir. 1990) rev’d on other grounds, 982 F.2d 765 (2d Cir. 1992).
II. LEGITIMACY OF CIRCULAR 698

In assessing the legitimacy of Circular 698, this section begins with an introduction to the history and importance of limited liability for a foundational understanding of the veil-piercing doctrine. It continues with a review of the established grounds for lifting the corporate veil and contrasting the objectives behind these grounds with those of Circular 698. The section concludes with a discussion of the General Administration of Taxation’s power to issue rules, such as Circular 698, that effectively bypass the sole authority of the People’s Congress to regulate fundamental economic and foreign trade systems.

A. Why Are Corporations Provided Limited Liability Protection?

The concept of the corporation dates back to the Roman Empire where professional colleges called *corpora* existed to support the existing institutions of religion, education, and government. \(^{41}\) The later Christian emperors disbanded most pagan *corpora* but tolerated some that served key economic interests. \(^{42}\) With the eventual collapse of the Roman Empire, the corporate form nearly disappeared. \(^{43}\) Most early businesses in England were sole proprietorships and other entities that lacked limited liability, which was not available until 1855 with the passage of the Limited Liability Act. The first corporations were specially chartered by the sovereign \(^{44}\) and it was not until the Companies Act of 1862 the corporate form became available to common business enterprises. \(^{45}\) Around this time, many US states adopted statutes providing for limited liability. These statutes protected shareholders from liability beyond their investment in the limited liability business entity, usually a corporation.

Originally, the corporate form was limited to large entities with multiple shareholders, but by the early 1900’s, this changed to allow increased investment as the industrial revolution came into full swing. Due to state regulation of limited liability, the process was piecemeal, with New Hampshire granting limited liability for manufacturing companies in 1816 and


\(^{42}\) Id. at 690.

\(^{43}\) Id.

\(^{44}\) Id. at 697. “[I]n 1662, an act of Parliament granted shareholders of the British Fisheries Company, the British East India Company, and the Royal African Company limited liability. This act came to embody what is now considered the beginning of the principle that the liability of members of a chartered company was unlimited unless their charter specified that it was limited (internal citations and quotation omitted).”

New York passing the Limited Partnership Act of 1822. The benefits of limited liability have resulted in a great deal of praise, with limited liability even being called the “greatest single discovery of modern times.”

The fundamental arguments supporting limited liability are economic in nature. Corporations have been described as a “nexus of contracts organizing the relationship between various actors in an enterprise,” and limited liability a corporation’s most important feature. Limited liability protection extends to all shareholders and allows them to invest whilst secure in the knowledge their other assets are safe from efforts to collect against corporate liabilities. Prior to the advent of limited liability, wealthy investors shouldered significant risk when making an investment. Not only could the investor lose their personal fortunes, but the wealthiest investors would be the target of collection attempts by the company’s creditors. This structure limited the motivation to invest and created a disincentive to diversifying investments because investing even a small amount could cause the investor to lose his great fortune. In order to protect their investments and wealth, investors need to research the company and monitor its operation to avoid risk. Those with some capital to invest but unable to afford the monitoring costs may avoid investment altogether. There would be no venture capital markets and the concept of angel investors would be non-existent without limited liability protection. The initial investigation and monitoring costs could be prohibitive to many potential wealthy investors and cut into potential returns, thereby eliminating the incentive to invest.

The established arguments in favor of limited liability include decreased monitoring costs, free transferability of shares, market efficiency, diversification of investments and incentive to invest in riskier projects. All five factors relate to an incentive to increase investments that will benefit the society as a whole through the promotion of economic growth. Decreased monitoring costs allow investment in more projects and permit the less wealthy to invest. Free transferability of shares allows for short-term investment and the involvement of new investors. Diversification allows for smaller projects to receive funding thereby encouraging entrepreneurship and innovation. Limited liability allows for the funding of important but risky projects that may not otherwise have an opportunity to raise sufficient

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46 Figueroa, supra note 41, at 703.
47 Roger E. Meiners et al., Piercing the Veil of Limited Liability, 4 DEL. J. CORP. L. 351, 356 (1979) (quoting the President of Columbia University).
48 Morrissey, supra at 537 (citing Frank H. Easterbrook & Daniel R. Fischel, Limited Liability and Corporation, 52 U. Chi. L. Rev. 89 (1985)).
49 Figueroa, supra note 41, at 705.
50 Id.
51 Id. at 706. Describes the lower monitoring cost benefit of limited liability as the “democratic argument” because it encourages individuals with less wealth to invest.
52 Id.
capital. Limited liability also supports investment and market efficiency through reducing creditor costs. When a creditor enters into a relationship with a corporation it only needs to examine the assets and debts of the corporation. Without limited liability, the creditor would need to examine the financial situations of shareholders to determine the likelihood of repayment.

The main argument against limited liability is that creditors and society shoulder the risk of non-payment of corporate liabilities. This externalization of cost places a burden on society and may harm innocent parties. The counter view is that limited liability “constitutes a subsidy aimed at fostering investment.”53 Voluntary creditors know the risk of non-payment when they enter into agreements. Besides, they are protected by the general rules of the contract law, and are always able to bargain better terms in voluntary transactions by imposing more stringent terms and conditions on the borrowing entity. Therefore, creditors can factor in the risk of nonpayment and increase the interest rates to match the risk.54 This allows limited liability to be characterized as a societal “subsidy” that promotes investment and economic growth.55 “Courts within the United States, in turn, have recognized the intimate connection between limited liability and the overall economic growth of the country, implying that the corporate limited liability form is a quintessential tool for the expansion of capitalism.”56

Bearing these general pros and cons in mind, the rest of this section looks into the legitimacy of Circular 698 mainly on two perspectives. First, is Circular 698 a specific application of the veil-piercing doctrine under the Company Law? Second, is the new rule of lifting the veil outlined by the tax authority in line with the PRC Legislation Law?

B. Is Circular 698 a Specific Application of the Veil-Piercing Doctrine Under the Company Law?

China formally introduced the veil-piercing doctrine into the Company Law in 2005.57 However, Chinese law only draws very narrow boundaries.58 Article 20(3) of the Company Law provides that: “Where any of the shareholders of a company evades debts by abusing the company’s independent status as a legal person or shareholders’ limited liability, thus seri-

53 Id. at 707.
54 Id.
55 Id.
56 Id. (citing Cathy S. Kendl & James R. Kendl, Piercing the Corporate Veil: Focusing the Inquiry, 55 Denv. L.J. 1, 8, 12–13 (1978) and JAMES D. COX ET AL., CORPORATIONS §§ 7.7, 7.11 (1995)) (internal citation omitted).
57 See PRC Company Law, supra note 10, at arts. 20(3), 64.
ously damaging the interests of any creditor of the company, it shall be held jointly liable for the debts of the company.\textsuperscript{57} Article 64 of the Company Law provides that if the assets of the company and the single shareholder are integrated and indivisible, then the shareholder and company will be jointly liable for the debts of the company. Article 18 of the second piece of judicial interpretation, that is, the Provisions of Certain Issues Concerning the Application of the Company Law, published by China’s Supreme People’s Court on May 12, 2008, effective as of May 19, 2008, covering a variety of issues related to the dissolution and liquidation of Chinese companies, provides the circumstances in which the shareholders and company are jointly liable for the debts in the bankruptcy proceeding.\textsuperscript{59}

It appears clear that the scenario related to asset integration or company liquidation is different from the transactions Circular 698 is intended to address. Then, is Circular 698 a possible result of applying the veil-piercing doctrine under the Company Law? There are some stark differences between Article 20(3) of the Company Law and Circular 698.

The Company Law does not give any specific example or define any way of abusing the corporate form. It is widely recognized that there are generally four categories of cases in which the corporate form can be deemed to be abused: a significant lack of corporate capital, confusing corporate personality, excessive control of the subsidiary by the parent company and avoidance of legal (i.e. contractual) obligations by the misuse of the company’s independent legal personality.\textsuperscript{60} Among them, avoiding legal obligations by the use of the company’s independent legal personality usually refers to the case that the controlling shareholders abuse the legal personality of the new or existing company (in most cases subsidiaries or affiliated companies) to achieve the real purpose of avoiding legal obligations. Apparently, the underlying reason to pierce the veil in this case is that the shareholders may damage social and public interests and effectiveness of the law while complying with law in an artificial way.\textsuperscript{61} What the Company Law tries to address is Chinese entities or shareholders who abuse the legal personality rule. In other words, the veil will be pierced if a Chinese parent

\textsuperscript{57} Zuigao Renmin Fayuan Guanyu Shiyong Zhonghua Renmin Gongheguo Gongsi Fa Ruogan Wenti de Guiding (ed) (最高人民法院关于适用《中华人民共和国公司法》若干问题的规定 (二) ) [Provisions of the Supreme People’s Court on Some Issues about the Application of the Company Law of the People’s Republic of China (II)] (promulgated by the Supreme People’s Court May 12, 2008, effective May 19, 2008), art. 8.

\textsuperscript{59} The four factors are often condensed or labeled differently but the underlying legal justifications remain the same. See generally, David Millon, Piercing the Corporate Veil, Financial Responsibility, and the Limits of Limited Liability (Wash. & Lee Legal Studies Paper No. 2006-08), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=932959.


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company abuses its subsidiary’s legal personality to avoid its legal obligations.

Circular 698, on the other hand, tends to prevent non-resident enterprises (which can be owned by Chinese or foreign investors) from avoiding their liability to pay Chinese enterprise income tax so as to protect the Chinese tax base. Different from the Company Law, the target of Circular 698 can be either Chinese or foreign investors. In this sense, Circular 698 creates an extraterritorial effect, which may bring impact onto the commercial transactions in a cross-border context. This extraterritorial nature will predominantly focus the impact of Circular 698 on foreign investors. The other difference between the Company Law and Circular 698 in terms of the veil-piercing rule lies in the definition of “creditor.” There is still an intense debate on the scope of the company creditors mentioned in Article 20(3) of Company Law, which may include both creditors in civil or commercial relations and special creditors in administrative relations such as the tax authority.62 The creditors in Circular 698 arguably refer to tax authorities. However, some empirical research indicates that Chinese courts have thus far not expanded the scope of creditors in the veil-piercing cases to cover special creditors like tax or other government authorities.63

Article 20(3) of the Company Law allocates liability between the shareholder and company. First, the shareholder and the company bear joint liability for the company debt. This suggests a pre-condition for the liability allocation that the company itself must have a debt so that the shareholder can bear the liability. Second, the company’s legal personality remains intact and the shareholders abusing the company’s independent personality are jointly liable for the company’s debts with the company, making the application of this provision similar to penetrating the veil. However, according to Circular 698, no matter whether the veil of the offshore holding company is lifted or not, the occurrence of the company’s debt is not a necessary condition. Rather, an offshore transfer of equity technically is a triggering event which causes the application of Circular 698. This is an expansive attempt to extend the veil-piercing doctrine to other circumstances which may not damage any third party in normal commercial transactions. Further, Article 6 of Circular 698—which denies the corporate form of the offshore holding company which is used for tax planning purposes—does not fall in the conventional categories of penetrating the corporate veil. These distinctions between Article 20(3) and Circular 698 suggest that Circular 698 is not a pure repetition of the veil-piercing doctrine established by the Company Law, and deserves closer scrutiny.

The other way to look into Circular 698 is to see whether it falls into any category of veil-piercing theory developed by cases in common law ju-

63 Huang, supra note 58, at 10.
risdictions. In the corporate group context, there appears to be a limited basis for piercing the corporate veil. This basis is articulated using several different concepts: “agency,” single economic unit, and the façade category. These concepts are used to pierce the corporate veil in cases involving the absence of any activity in the subsidiary company and the failure of a parent company to treat the entity as a separate being; to be respectful of its existence. We turn to these concepts and use them to comprehend the veil-piercing doctrine established in Circular 698.

1. Agency

Without a clear agency agreement, the court usually does not presume that the company is the agent of the shareholders and it is also hard for the plaintiff in the case to prove an agency relationship between the shareholders and company. There are some subtle differences between the veil-lifting rule in Circular 698 and agency theory here. The agency relationship is not a decisive element specified by Circular 698 in lifting the corporate veil. Rather, Circular 698 emphasizes the facts that: (i) there is a parent-subsidiary relationship; (ii) there is an offshore holding company bridging the parent and subsidiary; and (iii) the corporate structure is designed for some tax purposes. Nor does the agency relationship justify veil piercing under Circular 698. The agency relationship typically involves the explicit or implicit appointment of the company (in most cases, a wholly owned subsidiary) to act on behalf of the shareholder in relation to some activities. In piercing the veil, the court usually focuses upon whether the subsidiary has been given authority to act on behalf of and legally bind the parent company. Once the veil is pierced, the shareholder would be liable for the actions of the agent in contract or in tort provided that the agent is acting within the scope of his actual or apparent authority. The veil-piercing rule in Circular 698, however, does not follow from the relationship of agency, even though Circular 698 may generate the same legal outcome.

In the case of Smith, Stone, and Knight Ltd v. Birmingham Corporation, Judge Atkinson summed up many cases of lifting the corporate veil related to tax and pointed out that the existence of the agency relationship

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66 Smith, Stone, and Knight Ltd v. Birmingham Corporation [1939] 1 All E.R. 116, 121 (KB). However, the Court concluded that in all the cases, the question was whether the company, in this case an English company, could be taxed in respect of all the profits made by a subsidiary company which is
must meet the following six conditions simultaneously: (i) the profit of the subsidiary must be treated directly as that of the parent company; (ii) the subsidiary’s management personnel must be selected entirely by the parent company; (iii) the parent company must be the final decision maker over the subsidiary; (iv) the parent company must fully control the subsidiary including its management and capital structure; (v) the parent company must obtain profit through the control and management of the subsidiary; (vi) and the parent company must have effective and sustainable control of the subsidiary.  

It is clear that the core of these six factors is the control the parent company has over the subsidiary company. Therefore, under the agency theory, shareholders must have a high degree of control over the company so as to regard the company as the agent of the shareholders. In determining whether the subsidiary is an agent, the court’s analysis goes towards determining whether the subject company behaves as one independent entity or merely a puppet of the parent.

Circular 698, however, fails to specify this control element between the parent and subsidiary, even though it includes a parenthesis after the term of the “foreign investor” which notes the “actual controlling party.” Nor does Circular 698 clarify what the nature of the parent-subsidiary relationship must be in order to justify veil piercing. In the Circular on Several Issues relating to the Administration of EIT for Non-resident Enterprises, issued by the State Administration of Taxation in 2011 (Guo Shui Han [2011] Circular No. 24), the term “foreign investor” is defined as “all the foreign investors who indirectly transfer the equity of the Chinese resident enterprises.” This seems to suggest that Circular 698 may apply even if there is no high level of control or a complete lack of control. This subtle difference shows Circular 698’s dramatic departure from the conventional veil-piercing doctrine, indicating a more expansive approach to interpreting the key concept of “control.”

operated elsewhere. Therefore, the conclusion is somewhat different from the circumstances in Circular 698 under which income, itself, is obtained by the non-resident investors.

67 Id.; see HUI HUANG, COMPARATIVE CORPORATE LAW: INTERNATIONAL EXPERIENCES AND SUGGESTIONS FOR CHINA 117 (2011). However, the status of this case as authority is somewhat suspect. Cf. JH Rayner (Mincing Lane) Ltd v. Dept. of Trade [1989] Ch 72; Yukong Lines Ltd Of Korea v Rendsburg Investments Corporation et al; (The “Rialto”) (No. 2) [1998] 1 Lloyd’s Rep 32; Munton Brothers v. Secretary of State [1983] NI 369. The notion that control alone could result in disregarding the corporate entity would be inconsistent with Salomon v. Salomon. But “a denial of justice to the incorporator where there is no abuse factor” distinguishes Salomon v. Salomon in which such a factor was not in issue.

68 Circular 698, supra note 4, at art. 5.

69 Guanyu Fei Juming Qiye Suodeshui Guanli Ruogan Wenti de Gonggao [Circular on Several Issues relating to the Administration of EIT for Non-resident Enterprises, issued by the State Administration of Taxation on March 28, 2011 (Guo Shui Han [2011] No. 24, or “Circular 24”)], Section 6 (3).

70 A non-controlling stakeholder profiting from assets that appreciated in China would be liable for tax obligations on the gains attributable to the assets in China irrespective of their lack of control over the investment.
2. Single Economic Unit

The single economic unit theory suggests that the court may regard all the members within a corporate group as a single entity and may not consider the legal personality of each member. However, the House of Lords put a question mark on this theory in the case of Woolfson and, in the Cape Industries case, the court cited the judgment related to the single economic unit theory in the case of Bank of Tokyo to explain its stance: “[the plaintiff] holds that we are too rigid to strictly differentiate between the parent company and the subsidiary company. In his opinion, from the economic point of view, they are a whole. However, our concern is not the economy but the law. From the legal point of view, there is an unbridgeable gap between the parent company and the subsidiary, so they should be strictly distinguished.” This stance is a self-constraining one, restricting the court from expansively piercing the corporate veil and undermining the limited liability principle.

On its face, the single economic unit theory seems a sensible and relevant approach upon which companies and corporate groups can rely. Company B and C may be grouped together and characterized as a single economic unit. However, it can also be seen from the case law jurisprudence that there is no clear-cut approach to applying the single economic unit theory, which leaves the application controversial and inconsistent. And, even those who support this theory have to admit that the control of the subsidiaries by the parent company is the most critical prerequisite for the theory’s application. Only when the parent company excessively controls the subsidiary can the parent and subsidiary be regarded as a whole. The focus of Lord Denning’s analysis in the case of DHN Food Distributor, for example, appears directed at the complete control by the parent over the subsidiary. The control can be in existence in the form of an agreement, but in most cases it takes the form of direct equity holding. The notion of control brings out the other two grounds for piercing the veil: (i) the absence of activity of the subsidiary, and (ii) the complete identity of interests in a parent—

71 Vandekerckhove, supra note 16, at 72; See DHN Food Distributors v. Towler Hamlets London Borough Council [1976] 1 WLR 852 (CA) for an application of the single economic unit theory.
74 See Figure 1 above for a visual representation of the relationship between B and C.
75 Vandekerckhove, supra note 16, at 528.
76 Of course, only one element of “control” is not enough to lift the veil under the single economic unit theory, which also requires other elements such as commingling of assets, business operations, and legal personalities between corporations.
77 Lord Justice Shaw, in the case of DHN, also considered the factor of doing “justice” to the facts. In his view, strict adherence to the legal reality created by incorporation does not generate an abuse of the law but rather results in a “denial of justice.”
subsidiary relationship. In this sense, the agency relationship is a sub-category of control.

The application of Circular 698 however does not require excessive control of the Chinese Company C by Company B. According to Announcement No. 24, an “offshore investor (party with effective control)” refers to all the foreign investors that have indirectly transferred the equity interests in the Chinese resident enterprise and does not have to be the one which has actual control over the Chinese resident enterprise. This means that the tax liability is imposed even if Company B only holds 1% of equity in Company C. Following this line of logic, it appears that Circular 698 is not premised on the single economic unit theory.

3. Avoiding Legal Obligations/Fraud

The primary legal framework through which a court determines whether the corporate veil can be pierced, that the corporate veil can only be pierced “where special circumstances exist indicating that [the company] is a mere façade concealing the true facts”, is a core principle articulated in the case of Tunstall v. Steigmann. When the shareholders achieve the purpose of avoiding legal obligations or defrauding by the use of the company’s separate legal personality, the court may hold that the company is “only a façade hiding the facts”. Then, the court may make the shareholders and company liable for the obligations the shareholders try to avoid, or ignore the veil of the corporation and deny the existence of the company. In the cases of Gilford Motor and Jones v. Lipman, the defendants both attempted to establish the company to evade their existing contractual obligations, and the judges in both cases lifted the corporate veil. Here, the parties involved must try to avoid existing obligations rather than future or potential obligations.

Back to Circular 698, Company A sets up Company B which in turn

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78 See Shuiwu, supra note 69.
79 This might be more stringent than some earlier interpretations (or guesses) of the rules, whereby parties without the majority perspective would not be subject to Circular 698. Non-resident investors, which had sought to get around Circular 698 reporting requirements by contending that they do not have “effective control” over the Chinese resident enterprise, would also be obliged to comply with these requirements by virtue of Announcement No. 24.
80 [1962] 2 QB 593. It requires mentioning that the House of Lords in the UK, for instance, did not elaborate on the nature of such special circumstances or the meaning of “façade.” Nevertheless, following Adams v Cape Industries Plc, the “façade concealing the true facts” test has become the primary reference point for any lawyer investigating whether it is possible to pierce the corporate veil.
83 Vandekerckhove, supra note 16, at 71; Davis, supra note 64, at 185.
84 Gilford Motor Co Ltd v. Home [1933] Ch. 935 (CA); Jones v Lipman [1962] 1 WLR 832 (ChD).
holds Company C’s equity. It may constitute avoiding existing obligations (of Company A). However, what Company A tries to avoid is not its existing but future obligations. Therefore, it is not consistent with the veil-piercing principle, that is, avoidance of existing legal obligations. Circular 698 appears to cross the boundary and constitutes a new veil-piercing rule.

C. Is the New Veil-Lifting Rule in Line with the PRC Legislation Law?

The question of legitimacy is central to the evaluation of taxation. There is a comparative way of evaluating legitimacy. In a Western context, as taxation is a matter of raising state finance for the public good, the overriding aim of taxation is effectiveness on the basis of estimations of the patterns of compliance, non-compliance and avoidance. Legitimacy in this sense combines the interrelated issues of equity and effectiveness. The consequence of a lack of legitimacy will lead to a difficulty of political acceptability and enforcement. A system which has problems of enforceability and effectiveness will tend to lose political acceptance. Fairness in the context of taxation has two functions. First, it is to ensure that individual businesses pay their fair share of tax in relation to their commercial profits and compete on a level playing field. Fairness in this context involves a process of comparing a company’s commercial profit level with the amount of corporate tax that it is paying and then that of comparing that tax level with other, similar companies in similar transactions. The other function is to correct market failures that impose wider costs on society. Fairness is viewed as being on par with efficiency as a value shaping the corporation tax law, as a fair and efficient tax regime is the key instrument in distributive justice. Tax avoidance and anti-avoidance legislation are vivid examples to show the implications for the concept of fairness in taxation.

In the Chinese context, the question is more jurisprudential with an administrative law dimension. The legality of Circular 698 can be judged by reference to the “science of legislation.” The question is more about whether Circular 698 is a lawful regulation under the authority granted by the legislature. Since the way to “pierce the veil” under Circular 698 can-

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87 Readers unfamiliar with Chinese law may wonder why a private party has not sued the General Administration of Taxation to challenge the Circular 698. To be sure, the United States Administrative Procedures Act allows private parties to challenge administrative regulations if they are “arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law,” 5 U.S.C. § 706 (2015), which includes regulations that exceed a legislative grant of authority. See, e.g., City of Arlington, Tex. v. F.C.C., 133 S. Ct. 1863, 1868 (2013) (reiterating the principle that courts hearing challenges to agency rulemaking must always question “whether the agency has stayed within the bounds of its statutory authority”). In the United Kingdom, courts also can strike down ultra vires agency regulations at the in-
not be equated to a specific application of Article 20(3) of the Company Law, it may be considered as a new veil-piercing doctrine created by the State Administration of Taxation. The question is then whether the State Administration of Taxation has due power or authority to formulate such a veil-piercing doctrine through Circular 698 to replace or supplement the one in the Company Law.

Article 8(8) of the PRC Legislation Law provides that the “fundamental economic system and basic fiscal, tax, customs, financial and foreign trade systems” can only be formulated in law by the legislature, that is, the National People’s Congress (NPC) or its Standing Committee.\(^88\) According to the interpretation of Article 8 of the Legislation Law provided by the NPC, the Company Law is a piece of legislation regulating the “basic economic system.”\(^89\) As the company’s separate legal personality is the cornerstone of the Company Law, it lays the foundation of the modern economic system.\(^90\) Thus, the basic company law doctrines such as the veil-piercing norm must be included in law other than regulations, a fact which has been clarified in Article 8 of the Legislation Law. The nature of Circular 698 is to lift the veil of a company even though that company is incorporated in an offshore jurisdiction. As such, the rules in Circular 698 touch upon the separate legal personality and limited liability principles, the fundamental core principles of modern company law. Following this line of analysis, the rules outlined in Circular 698 should be legislated by the National People’s Congress or its Standing Committee. To implement these rules, it is the State Council that can enact administrative regulations with the delegated authority from the NPC or its Standing Committee.\(^91\) In any event, without due delegation of power from the NPC or the State Council, the State Administration of Taxation has no legislative or regulatory power to make these rules in the form of an administrative notice.

The State Administration of Taxation may argue that its power to

\(^88\) Zhonghua Renmin Gongheguo Lifa Fa (中华人民共和国立法法 [The Law on Legislation of the People’s Republic of China]) (promulgated by the Nat’l People’s Cong., Mar. 15, 2000, effective July 1, 2000), arts. 8(8) [hereinafter PRC Law on Legislation].


\(^90\) Vandekerckhove, supra note 16, at 3–4.

\(^91\) PRC Law on Legislation, supra note 88, at art. 5.
promulgate Circular 698 can originate from Article 47 of PRC Enterprise Income Tax Law, which reads: “Where an enterprise makes any other arrangement not for any reasonable business purpose, if its taxable revenue or income decreases, the tax organ has the power to make an adjustment through a reasonable method.”\footnote{PRC Enterprise Income Tax Law, supra note 1, at art. 47.} According to Article 120 of the Regulation on the Implementation of the Enterprise Income Tax Law of the People’s Republic of China, the term “without reasonable business objectives” means that “the main purpose is [the] reduction, exemption or deferral of tax payments.”\footnote{Zhonghua Renmin Gongheguo Qi Ye Suo Deshui Fa Shi Shi Tiao Li (中华人民共和国企业所得税法实施条例, 第 512 号) [Regulation on the Implementation of the Enterprise Income Tax Law of the People’s Republic of China] (Order of State Council No. 512, promulgated Nov. 28, 2007, effective Jan. 1, 2008), art. 120.} That the foreign company indirectly transfers the Chinese company’s equity through an offshore holding company to avoid the Chinese enterprise income tax may possibly constitute an “arrangement without reasonable business objectives.” This way of defining “without reasonable business objectives” is a black or white approach which may oversimplify the complexity of commercial transactions. A typical transnational company has a high degree of discretion over its corporate or financial structure so that it can devise optimal routes for internal transactions within the firm through its chains of affiliates. To form intermediary entities in convenient jurisdictions is a critically important part of this overall discretion, which is generally protected by the basic modern company law principles. To set up an intermediary entity in a tax haven jurisdiction is often specifically for the purposes of reducing tax liability and optimizing economic benefits. A transnational company has a natural right to adopt such techniques so as to take advantage of the limitations of the tax treaty system and hence reduce its cost of capital, making it gain a substantial competitive advantage. Arguably, these are important and reasonable business objectives and strategies.

The scenario caught up by Circular 698 is quite unique: it may form a concrete manifestation of making adjustments by the tax authority in accordance with authorization under Article 47 of the Enterprise Income Tax Law, but the adjustment is, on the other hand, related to the veil-lifting doctrine which in turn affects the cornerstone principle under modern company law. Additionally, the extraterritorial impact improperly steps into the realm of “foreign trade systems.” The power exercised by the State Administration of Taxation, apparently, is ultra vires, an act beyond its scope of authority or power under the PRC Legislation Law.

China’s tax authority has been given greater autonomy from the government, with targets and performance plans to meet those targets, with the overall aim of achieving “efficiency gains.” However such autonomy has
not been put in a defined remit. While administrative autonomy may lead to some improvements in collecting taxes, these improvements tend to be short term. Further, taxpayers may complain of overzealous enforcement. The challenge here is whether an autonomous tax regime itself can be generally accepted as fair and desirable in a world where the structures of social solidarity binding citizens together and to their state have become increasingly fragmented.

In summary, the State Administration of Taxation has no power to either create new rules or implement changes to the veil-piercing doctrine by denying the separate legal personality rule—particularly when the affected enterprise is an offshore company. Likely, a Chinese court may invalidate any administrative action taken by the tax authority on the basis of Circular 698 according to the Legislation Law if an offshore company challenges the legitimacy of Circular 698.

III. IS CIRCULAR 698 CREATING A NEW VEIL-PIERCING DOCTRINE?

In examining the role of Circular 698 in creating a new veil-piercing doctrine not part of the pre-existing statutory regime, it is important to examine the doctrine as established in China. The article discussed the original common law principle of veil piercing above; however, the principle only applies to China to the extent it is expressly adopted. This section first looks to the established veil-piercing doctrine as it exists in China. Next, it compares the policies behind the Circular 698 and piercing the corporate veil. After establishing the principles courts may utilize in applying Circular 698, the section concludes with examples of recent administrative enforcement of the Circular 698.

A. China’s Adoption of the Veil-Piercing Doctrine

The veil-piercing doctrine existed in China to a limited extent through judicial application prior to the enactment of China’s Company Law in 2005. In addition to the veil-piercing doctrine, two “quasi veil-piercing rules” existed. The two quasi veil-piercing rules include violation of the registered capital rules and violation of the capital maintenance rules.

95 Xi supra note 23, at 415 (describing enforcement of statutes that have the effect of holding shareholders liable for corporate debts as “quasi-veil-piercing rules”)
96 Id. at 415–16.
Through the two quasi veil-piercing rules, investors will lose their limited liability protection if the corporation failed to meet the minimum registered capital requirement or if the registered capital is improperly removed from the corporation causing the registered capital to fall below the required level.

Unlike the United States, Chinese law requires registered capital when organizing a business. The amount of registered capital varies depending on the type of business organization and the nature of the industry, with high risk industries requiring greater capital. Between 1994 and 2003, judicial interpretations made by the Supreme People’s Court determined that piercing the veil of a subsidiary is allowed if the subsidiary fails to meet the minimum registered capital requirement, or after meeting the requirement, falls below the level the corporation is required to maintain.\textsuperscript{97}

In 2003, the Supreme People’s Court (SPC) published a draft set of judicial interpretations addressing issues of corporate law including the veil-piercing rule under the heading “shareholders’ direct liability to the corporate creditors.”\textsuperscript{98} The draft judicial interpretations provided six articles addressing the scope of the veil-piercing doctrine.\textsuperscript{99} The first article (art. 48) reiterates the basic principle of limited liability and limits the court’s ability to ignore the corporate form to the situation prescribed in the following five articles. Article 49 limits the standing of plaintiffs to creditors of the corporation that wish to hold the controlling shareholder liable.\textsuperscript{100} The creditor must have suffered harm as a result of the controlling shareholder abusing their limited liability protection.\textsuperscript{101}

Article 51 lists three circumstances under which the controlling shareholders can be held liable.\textsuperscript{102} These situations include:

\begin{itemize}
  \item[a)] The company’s income is not separated from the controlling shareholders’ income;
  \item[b)] The funds of the company and shareholder are commingled and both utilize the same accounts; and
  \item[c)] The commingling of company and personal assets while the business is under the control of the controlling shareholder.
\end{itemize}

Under these standards, the court does not look for fraud or wrongdoing
but merely looks for abuse of the corporate entity.\textsuperscript{103} This is similar to the US approach of requiring domination and control and causation but without the fraud element. It should be noted that under the US standard, the first element requires misuse through domination and control, and not merely control. As a result, the Chinese standard can be seen as placing greater importance on adherence to corporate laws and regulations than to the issue of fraud.

The 2005 Company Law was drafted with contributions from several key government agencies and the article was adopted after significant political debate, which probably led to its lack of clear standards.\textsuperscript{104} Several agencies and large State Owned Enterprises (SOEs) advocated “transplanting the common law doctrine into the new Chinese company law.”\textsuperscript{105} It seemed that a specified approach to the veil-piercing doctrine would be codified until SASAC objected to the language, potentially because the veil-piercing doctrine may put SOEs at risk of losing limited liability protection—something that was not previously allowed under the company law. The Legislative Affairs Office suggested the SPC set the standards for piercing the corporate veil.\textsuperscript{106} The National People’s Congress did not adopt formal language authorizing the SPC to set the standard for veil piercing but passed the veil-piercing provision in the form of Article 20(3) in the Company Law.

The lack of clear standards under Article 20 is apparently the result of internal government controversy regarding application of the doctrine. However, the fact that clear standards were not established lends credence to several arguments. One of the strongest arguments includes the idea that the NPC intended the application of the veil-piercing doctrine to remain similar to the approach used prior to the 2005 Company Law. Another is that the NPC intended the adoption of the common law doctrine.\textsuperscript{108} Although the common law doctrine and the approach adopted in China prior to the passage of the 2005 Company Law are similar, from a policy perspective they are distinct in that only the common law approach places emphasis on the existence of fraud as a prerequisite for removing limited liability protection. As such, it is debatable whether the avoidance of fraud is a policy objective of the Chinese veil-piercing doctrine. For the purpose of analy-

\textsuperscript{103} Id.
\textsuperscript{104} Id. at 423 (The agencies include the State Administration for Industry and Commerce [SAIC], China’s company registrar, the Ministry of Commerce [MOFCOM], China’s main approval authority for the formation of FIEs, the State-owned Asset Supervision and Administration Commission [SASAC], China’s SOE watchdog, and the China Securities Regulatory Commission [CSRC], China’s securities regulator).
\textsuperscript{105} Id. at 424.
\textsuperscript{106} Xi, supra note 23, at 426.
\textsuperscript{107} Id. at 428 (“The SPC shall determine the specific circumstances under which the shareholders are held jointly liable for the debts of the company.”).
\textsuperscript{108} For more on the formation of China’s veil-piercing law, see Xi, supra note 23.
sis in this article, fraud will be included as a valid policy consideration for the veil-piercing doctrine, regardless of its utilization by Chinese courts.

B. Circular 698 and Veil-Piercing Policy Objectives

Due to Circular 698’s effect of lifting the corporate veil, one aspect of its legitimacy is the similarity of policy objectives between veil piercing, aimed at preventing abuse of the corporate form and preventing fraud, and Circular 698, aimed at tax collection. Therefore, this subsection examines the effect of Circular 698 in relation to the three major policy objectives previously identified for piercing the corporate veil and discusses tax considerations targeted by Circular 698 as a fourth policy topic. The topics include preventing abuse of the corporate form contrary to the intentions of corporate law, preventing fraud or intentional misuse of the corporate form, preventing harm to involuntary creditors and anti-tax avoidance measures respectively.

1. Preventing Abuse of the Corporate Form Contrary to the Intentions of Corporate Law

Under the circumstances outlined in Circular 698, the shareholders are not seeking to abuse the corporate form but instead failing to pay local taxes simply because the transaction was conducted outside the jurisdiction of China. The veil-piercing doctrine is an exception to the limited liability principle, and effectively acts as a remedy in specific abuses of limited liability. However, limited liability plays no role in the application of Circular 698, which is demonstrated by the fact that the tax liability under Circular 698 would be the same regardless of whether the business entity held limited liability protection. The stark differences between abusing the corporate form and failing to pay taxes demonstrate the inapplicability of this policy objective to Circular 698.

2. Preventing Fraud or Intentional Misuse of the Corporate Form

The policy objective of this element is to avoid fraud where the use of the corporate form is a mere sham. Circular 698 lacks a requirement for shareholders to intend abusing the limited liability protection of the corporation and Circular 698 does not require actual fraudulent behavior. The absence of a legitimate business purpose other than tax avoidance is not tantamount to fraud. As a result, the policy objectives of this element are not in line with the objectives of Circular 698.
3. Preventing Harm to Involuntary Creditors

In regard to the collection of tax proceeds, the government can most closely be analogized as a voluntary creditor. Although the government does not negotiate directly with the company regarding transactions and the applicable tax rate, the government does decide what transactions and business structures are authorized and the corresponding tax rates. Therefore, the government cannot be characterized as a victim if it loses money through tax planning in the same way an injury tort victim is harmed. Being characterized as a voluntary creditor, when a company structures itself in a manner consistent with the law, the government is analogous to a business creditor taking advantage of a contractual term. Therefore, the fact that the government loses potential income is not the same as a corporation abusing its form to avoid payment to a harmed creditor.

4. Anti-avoidance Measures Against the Systematization of Tax Avoidance

In the past decades, multinationals have widely used various strategies to avoid or evade tax. One of the basic methods is to change the recipient, combined with the technique of re-characterizing the nature of payments. More often, intermediary entities such as companies, trusts and partnerships are incorporated in suitable jurisdictions and used to channel assets, transactions and income. By doing so, taxation is likely to be minimized based on utilizing preferential tax structures from residence in the home country of the investor or transnational company or in the country where the business takes place. What Circular 698 tries to tackle is a scenario in which an intermediary company is formed in a jurisdiction which has a suitable tax treaty with China, a source country. The addition of the intermediary company helps reduce or eliminate source taxation. The purpose of incorporating the intermediary company is to entitle the investor to the benefit of the treaty even though the company itself is essentially a passive entity, whose function is to channel the income flow.

This “stepping stone” strategy may be legally valid but is of doubtful legitimacy from a policy perspective, largely because the underlying rationale of existing tax treaties is to assume that investors are bona fide residents and normal taxpayers. The use of an intermediary company is a form of treaty shopping, taking advantage of the fictions of legal personality and state jurisdiction. The consequence of this, as well as the popular “round-tripping” model in China (as discussed in detail below), is tantamount to outright tax evasion. The general tax avoidance or tax abuse principle in tax

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law supports the idea that these intermediary companies be regarded as a sham and can be disregarded. However, just because the use of offshore companies to evade tax liability is a sham within the context of tax policy, that does not make the corporations involved shams as the term is used in company law, which refers to the company being a mere “façade” used to take advantage of limited liability protection. Seen from this angle, Circular 698 then is a move to fill in regulatory loopholes. The source country, therefore, can claw back into its tax net the retained worldwide earnings of these intermediary firms. Against this background, Circular 698 can be regarded as a set of measures to counteract avoidance of source taxation and to deal with market inefficiency.\footnote{\textsuperscript{110} China, as the source state, effectively denies tax treaty benefits to recipients which it considers to be actually passive entities.} China, as the source state, effectively

C. Administrative Enforcement of Circular 698

Article 6 of Circular 698 states that:

Where a foreign investor (actual controlling party) indirectly transfers the equity of a Chinese resident enterprise by abusing the organizational form and other arrangements without any reasonable business purpose so as to avoid the enterprise income tax duty . . . [the tax authority can] deny the existence of the offshore holding company used for tax arrangement.\footnote{\textsuperscript{111}} How\vphantom{H}ever, neither Circular 698 nor any other subsequent regulations provide a more comprehensive definition of the principle or any guidance as to how to interpret or apply the term “without any reasonable business purpose” or “avoid the enterprise income tax duty.” Article 5 of Circular 698 merely lists the materials the tax authority requires from the transacting parties in order to examine when the equity is transferred indirectly but says nothing about the criteria the tax authority may apply to determine these terms. In this sense, Circular 698 creates a brand new veil-piercing regime separate from the existing regime codified in the Company Law. Technically, this is a much more rigid and broader regime in that it sets out a new and ambiguous economic substance criterion. Chinese tax authorities, in applying Circular 698’s test of “reasonable business purposes,” may typically

\footnote{\textsuperscript{110} Aggressive accounting and earnings management may be legal but indicate that the companies are in trouble. The companies can make some money by adopting aggressive forensic accounting practices. Now the use of forensic accounting is in a more diversified fashion. The recent years have witnessed a move from traditional indexing, based on market capitalization, to “fundamental” indexing, based on factors such as revenues, profits or dividends. Other strategies include shifts in operating items such as research and development spending and taxes, and share buybacks.}

\footnote{\textsuperscript{111} Circular 698, supra note 4, art. 6.}
evaluate the level of economic substance offshore holding companies have by reviewing such elements as staff, business premises and operating assets of individual offshore companies in comparison with the amount of income realized. This new criterion constitutes a very strong normative movement in which using a corporate form to perform a tax liability reduction function, even with the presence of other corporate purposes, would result in veil-piercing. This piercing is less about the function of the subsidiary but more about the parent’s purpose in reducing tax liability. This notion of “genuine tax purpose” (or “without reasonable business purpose”) does not capture the circumstances in which the courts conventionally have pierced the veil in a parent-subsidiary context.

The economic substance criterion has at least three shortcomings. First, it does not have a decent level of certainty, which may effectively provide the Chinese tax authority with more discretion to ignore the separate existence of an offshore holding company incorporated for the purpose of holding equity in a China-incorporated operational company on behalf of an ultimate shareholder in an offshore jurisdiction. Second, it creates additional burdens to shareholders when they design their transactional models. They may have to position some assets into a holding company. This criterion for sure will be burdensome to private equity funds which typically do not have substantive operational presence in the offshore holding companies. Third, additional transaction costs will be imposed on the transacting parties, which may now have to conduct extra due diligence to ensure the transactions are legitimate not only under corporate law but also under tax law. Given numerous significant and substantive uncertainties, transaction costs will be a great burden to both the local and international business communities.

With such general provisions, the tax authority has unlimited and imbalanced discretion. Its interpretative space is too broad and even can be considered as creating new legal principles. In other words, the law enforcer acts as the legislator. This blurring of lines makes it more difficult to articulate the level of autonomy and the scope of activity in the subsidiary that would prevent piercing. The modern company law establishes the general principle that the courts should respect the legal reality that is created upon incorporation.

In China, there are many difficulties for the plaintiffs in the administrative proceedings, resulting in a very low success rate. Even if the tax authority abuses its discretion and the argument may be viable, it is difficult in practice for the taxpayers to successfully gain relief through the administrative proceedings. In addition, because China is not a common law jurisdiction, the court is incapable of making law explicitly through precedents. Even if the court renders a ruling on a similar case, the ruling neither has universal effects nor any binding force to the administrative law enforcement of the taxation authority. The tax authority can continue to exercise its
discretion in similar cases irrespective of rulings on similar or identical cases. The above factors cause great uncertainty in the legal environment for foreign investors in China. By applying Circular 698 and piercing the corporate veil of the offshore holding company, the Chinese tax authority has created a new business order by extending its extraterritorial jurisdiction to overseas corporate groups and imposing Chinese tax liability on offshore commercial transactions. By doing so, the Chinese tax authority has effectively tightened up the regulatory space for the structure of corporate groups with offshore holding companies.

The initial precise enforcement approach the PRC tax authorities would take under Circular 698 was unclear. Progressively, it became apparent in a series of high profile cases involving several well-known private equity investors and others that the Chinese tax authorities relied on Circular 698 to deal with the perceived abusive use of offshore disposal structures.

1. Chongqing Case and Circular 698

In an effort to invest in a joint venture (JV) in China, a parent company in Singapore established a home-based special purpose vehicle (SPV). The Chongqing tax authority ignored the existence of the SPV to assess capital gain taxes realized by the parent company, effectively lifting the corporate veil. The parent company used the SPV to acquire a 31.6% interest in the Chinese JV then sold the SPV to a Chinese company for approximately US$10 million causing the local tax authority to investigate the underlying transaction. The Chongqing tax authority determined that the SPV lacked economic substance because it “had a representative amount of capital and no business activity” and was “incorporated with the sole purpose of holding a participation in the JV” to benefit from a China-Singapore Income Tax Treaty. Under the rationale of the Chinese tax authority, the parent company was required to pay the 10% capital gain tax as if the SPV did not exist.

2. Xinjiang Case and Circular 698

The Xinjiang tax authority levied a capital gain tax against a US group that utilized a SPV in Barbados to invest in a Chinese JV. The US group

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113 Id.
114 Id.
115 Id. at 54.
116 Id.
was attempting to utilize a tax treaty between China and Barbados that awards the seller’s resident state sole taxing authority with regard to capital gains. The SPV paid US$33.8 million for 33.32% equity in the JV located in Xinjiang and operated with a Chinese oil and gas extraction company. A year later, the SPV sold back its shares in the JV to the original owner for a gain of US$12.1 million.\textsuperscript{117} The local tax authority conducted an audit and determined that “the transaction was fictitious and had been undertaken with the sole purpose of avoiding tax.”\textsuperscript{118} The authority determined that the tax treaty did not apply, citing a provision under which a business is a resident of the United States if managed there.\textsuperscript{119} The SPV was owned and managed from the United States and was therefore determined not to be a resident of Barbados. Consequently, the tax authority ignored the existence to the SPV and levied a capital gain tax against the US investment group.

3. Yangzhou Case and Circular 698

Although the Chinese tax authority has not clarified the exact scope of Circular 698, the way the tax authority applies Circular 698 can be seen from the Yangzhou case. The partners of the JV, Yangzhou Chengde Steel Tube Co., Ltd. (Yangzhou Chengde) in Jiangdu, China were Jiangsu Chengde Steel Tube Co., Ltd. (Jiangsu Chengde) and Carlyle Group (Carlyle), a well-known private equity investor. Carlyle took a 49% stake in Yangzhou Chengde through a wholly owned subsidiary in Hong Kong (HK Co.). In early 2009, noting that Carlyle may transfer the equity of Yangzhou Chengde indirectly through the equity transfer in HK Co., the Jiangdu State Tax Bureau immediately reported it to the national tax authority. On December 10, 2009, the State Administration of Taxation issued Circular 698. In January 2010, Carlyle transferred the equity of the HK Co. to Carlyle Marco Asia Co., Ltd. (Carlyle Marco), a sister company in the same group. Jiangsu State Tax Bureau held that the HK Co. is a special purpose company without employees, assets or debts, investments and businesses, and then applied Circular 698 to levy the enterprise income tax in the amount of Renminbi 173 million on Carlyle.\textsuperscript{120} The transactional structure in this case is indicated in Figure 2 below.

\textsuperscript{117} Id.
\textsuperscript{118} Id.
\textsuperscript{119} Id.
\textsuperscript{120} Xuxiang Xu et al., \textit{Single Largest Tax on Non-Resident Enterprises’ Indirect Equity Transfer Income is Filed to Put into The Treasury}, China Taxation News (June 9, 2012); Shaoying Chen, \textit{Disregard of Corporate Personality and Its Application on Anti-tax-avoidance}, \textit{5 The Jurist} 79 (2011).
It seems clear from the above cases that the Chinese tax authority solely focused on a test of whether (i) the offshore holding company has “no employee, no other assets or debts, no other investments and no other businesses,” and (ii) whether the actual controlling party achieves the effect of tax avoidance through the use of the offshore holding company. In other words, the local tax bureaus in some high-profile cases indicated a tendency of focusing solely on the business substance of the intermediary holding companies other than their legal form or commercial purposes. Then the Chinese tax authority, with these elements being satisfied, seeks the additional revenue by ignoring the veil of the offshore holding company and levying taxes on the actual controlling party.

A mechanical or strict application of this “economic substance” test is problematic. Even if the offshore holding company has no employee, other assets or debts, other investments or businesses, which does not necessarily mean that the company is incorporated without any other reasonable commercial purposes. A holding company may be formed for internal restructuring, (re)investments or financing purposes or the corporate governance issues discussed above. Incorporating a holding company in a favorable ju-
risdiction may help the investors gain access to a restrictive market according to WTO agreements or a free trade agreement or provide a more favorable investment protection regime according to a bilateral investment treaty. From the financing point of view, the formation of an offshore holding company is an important step in making the domestic company go public abroad indirectly through the “round-trip investment” model. As Robert W. Hamilton pointed out, the holding company is to “hold most stocks of another company without any other business,” a function that appears to be dismissed as a non-legitimate business purpose by the tax authority.

It appears that the Chinese tax authority’s regulatory technique to apply Circular 698 is a single dimensional approach and is too narrow to be justified. Circular 698 contains ambitious direct and indirect attempts to help bring about a fairer distribution of benefits and burdens in the market. The argument may be made that “doing justice” to the facts can be a relevant factor in piercing the corporate veil here. In common law jurisdictions, there is no indication that “doing justice” alone would have been sufficient. A broader justice-based approach may provide the judiciary (or tax regulator in the Chinese context) with wider discretion to pierce the corporate veil where it is necessary to achieve justice if justice here is deemed to include allowing tax authorities to collect more tax or widen the tax base. However, prioritizations of efficiency and justice in the tax law reform may amount to nothing less than a manifestation of the role of the state in molding the public interest and the level of the tax burden to be laid on the corporate sector.

The difficulty of enforcing Circular 698 is making a clear distinction between genuine and sham arrangements. This may depend on some ulterior test of validity such as economic or commercial purpose. In this regard, Circular 698 is oversimplified leaving taxpayers and tax authorities little constructive guidance. For example, it is not clear what a potential purchaser should do if he is acquiring equity in an offshore holding company and is concerned that the vendor may be liable for Chinese tax under Circular 698. The purchaser may be at risk as the tax authority may adjust its base cost to

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123 In English law, Cummings LJ indicated in the Court of Appeal case of Re a Company that “in our view the cases . show that the court will use its powers to pierce the corporate veil if it is necessary to achieve justice irrespective of the legal efficacy of the corporate structure under consideration.” Re a Company, [1985] 1 B.C.C. 99421 (CA) 99425 (Cumming-Bruce, L.J.) (Eng.); David Kershaw, Company Law in Context: Text and Materials 75 (2d ed. 2012). However, the facts in this case suggest that the case clearly fits within the category of piercing the corporate veil to evade existing obligations. Nevertheless, UK cases have been influential in forming the contemporary Irish position that “justice” is a basis for piercing the veil. Fyffes plc v. DCC plc, [2005] IEHC 477 (unreported, High Court, 21 Dec. 2005).
recoup tax unpaid by the vendor on an onward disposal by the purchaser.\textsuperscript{124} Circular 698 fails to adopt or define the “no substantial activities” criterion, which is supposed to be the major ground to allocate the tax base by the tax authority and the major weapon against tax avoidance by Chinese residents. Nor does Circular 698 capture the impact of the corporate tax system on more conventional notions of “vertical equity” and “horizontal equity”.\textsuperscript{125} The present approach is based on treating affiliates of integrated corporate groups as separate entities and then ignoring the corporate veil of a separate entity in the group. Without some workable criteria, Circular 698 has become inordinately complex (in the sense of interpretation and enforcement), yet largely ineffective. The other defect with Circular 698 is that Chinese companies or foreign investors with offshore structures may assume a disproportionate share of the overall corporate tax burden. On the other hand, it is understandable to see Circular 698 only craft some general principles due to political concerns over tax avoidance and the existence of a large number of tax avoidance schemes,\textsuperscript{126} which will be further discussed in the next section.

An additional layer of complexity in implementing Circular 698 lies in the fact that the separate legal status of an intermediary company incorporated in another jurisdiction must be disregarded. The strengthening of residence taxation of worldwide income is often criticized as “extraterritorial.” China’s ability to pierce the veil according to Circular 698 is one way to exercise the sovereign power of the government in taxing corporate income worldwide. This ability, however, may be limited by double taxation treaties, which usually create rights for taxpayers under domestic law. Under a double taxation treaty, the Chinese tax authority (or court) should be more cautious to rely on a general anti-avoidance principle to override specific provisions in a tax treaty. Due to its “extraterritorial” effect, the functioning of anti-intermediary-company rule relies upon cooperation between the tax authorities in two jurisdictions. Viewed thus, this rule, heavily relying on the concepts of residence, source and profits, is vulnerable in a world of instantaneous, or at least very rapid, capital movement. The focus of the jurisdictional cooperation is to evaluate whether the intermediary company is a real business operation and to allow the company concerned to challenge a denial of benefits which it considers unjustified.\textsuperscript{127} Cooperation at either

\textsuperscript{124} This potentially increases transaction costs. The purchaser may insist on having a condition precedent to the closing in the transactional documents to the effect that vendors fulfill the Circular 698 reporting requirements so as to minimize any potential tax liabilities.

\textsuperscript{125} \textsc{Liam Murphy \& Thomas Nagel}, \textit{The Myth of Ownership} 13–16 (2000).

\textsuperscript{126} Courts in some countries are reluctant to adopt an over expansive approach to interpreting tax rules for a variety of reasons. One reason is the concern about the constitutional implication of usurping the role of the legislature or executive. E. Simpson, \textit{The Ramsay Principle: A Curious Incident of Judicial Reticence}, Brit. Tax Rev. 358, 358–74 (2004).

\textsuperscript{127} Devising wide anti-abuse principles in tax treaties is a possibility, but it can be costly and time
the bilateral or multilateral level also requires a widespread change to the secrecy law in tax havens. Lack of international cooperation greatly exacerbated the difficulties of effective taxation of income from capital, undermining the principles of equity underpinning income taxation to the point of threatening the legitimacy of national and international tax systems. In summary, the enforcement of Circular 698 lacks certainty and convenience, the main features Adam Smith called to be maxims of taxation.128

The enforcement of Circular 698 triggers the need for a deeper discussion and analysis of tax law and its public law nature. The fact that companies rarely operate alone, that most are members of corporate groups, and that as multinationals they cross national borders, is a practical reason that a stand-alone approach is insufficient. Instead, a more contextual approach should be taken. The “optimal tax theory” requires the tax authority to take into account certain “constraints” it may face when implementing tax rules so that it can figure out the best way of achieving tax policy objectives. Corporate tax law regulates “recursive” relations between the private party and the government.129 Given the cross-border nature of the corporate group model, the tax authority needs to link corporate tax policy and law to general public law and policy. Certain values must be well recognized in shaping tax policy. For example, efficiency mandates the tax authority to enforce tax codes without hampering economic growth and backing off foreign investment. The notion of fairness also requires the tax authority to reflect a politically appropriate tax burden for the corporate sector to bear. What is apparent in Circular 698 is a concept of fairness that is contentious and seems to place a greater emphasis on anti-avoidance than on progressivity.

The Chinese tax authority is confronting the paradox that multinational businesses are likely to increase in importance. It is the fair tax competition among nations that would allow business to exploit real commercial opportunities. While Circular 698 may remove some distortions in the marketplace, it will not eliminate regulatory failures. Nor is Circular 698 able to strike a balance between protection of the tax base and efficiency.130 Rather,
Circular 698 imposes an excess burden of compliance and enforcement. Although Circular 698 makes an attempt to address gaps in the current regulatory scheme, the attempt lacks clarity and the even-handedness required of tax structures in developed economies. In order to reconcile these difficulties the next section looks to policies in the United Kingdom and other jurisdictions in seeking a solution to reconcile the shortcomings of Circular 698.

IV. THE RAMSAY PRINCIPLE: AN EQUITABLE SOLUTION TO IMPROVE CIRCULAR 698

The concept of “reasonable business purpose” and the lack of clarity in Circular 698 create potential problems of uneven application and lack of notice to foreign enterprises investing into China. Although the result of Circular 698 is to pierce the corporate veil, the motivation underpinning the Circular is revenue enhancement. Thus, the Ramsay principle, a long-established principle of tax law, may provide a solution.

A. Circular 698 and Ramsay Principle: A Comparative Approach

1. Policies Underlying the Ramsay Principle

In determining the policies underlying the Ramsay principle it is important to examine the two cases that established the principle—Ramsay v. Inland Revenue Comrs and Inland Revenue Comrs v. Burmah Oil Co. Ltd.131

Due to the similarity in legal principles, the House of Lord combined two cases in its Ramsay decision, Ramsay v. IRC and Eilbeck v. Rawling. In the first case, W.T. Ramsay Ltd. (Ramsay) was a farming company seeking to reduce its tax obligations. Ramsay experienced a taxable profit and sought to avoid the tax by offsetting it with an allowable loss. To this end, Ramsay employed the help of a company that specialized in structuring tax avoidance schemes in order to provide a financially neutral situation that on paper would allow for the reduction of tax liability. The approach used in such schemes is to employ two assets, one which will decrease in value to allow for a loss while the other will increase in value and be sold in a manner allowing for a non-taxable gain. In this circumstance, the company utilized two loans. The loans had a clause allowing the interest rate in one loan to be decreased if the other loan was increased the same amount. After exercising the clause, one loan significantly increased in value while the other

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are largely clear-cut so that they can be enforced efficiently while the goals of having these rules can also be met.

loan decreased to the same extent. The loan that decreased in value was used as a capital loss deduction to offset Ramsay’s profits and the increase on the other loan was assumed not taxable under securities law, allowing for a net tax savings.

In *Eilbeck v. Rawling*, the taxpayer, Mr. Rawling, attempted to take advantage of trust rules to avoid tax liability. According to the provisions, interests in a trust that can be bought and sold are subject to capital gains tax, but other interests are not subject to the same taxation. Therefore, Mr. Rawling created two trusts, one of a type where a reversionary interest in the trust would be taxable and one where it would not. He then transferred assets between the trusts so as to create a loss in taxable assets and a gain in nontaxable.

In addressing *Ramsay* and *Rawling*, Lord Wilberforce stated:

> In each case two assets appear, like “particles” in a gas chamber with opposite charges, one of which is used to create the loss, the other of which gives rise to an equivalent gain that prevents the taxpayer from supporting any real loss and whose gain is intended not to be taxable. Like the particles, these assets have a very short life. Having served their purpose they cancel each other out and disappear. At the end of the series of operations, the taxpayer’s financial position is precisely as it was at the beginning, except that he has paid a fee, and certain expenses, to the promoter of the scheme.

These two cases mark a significant change in tax policy and established the beginnings of the Ramsay doctrine by requiring a legitimate purpose other than tax evasion. The facts of both cases represent extreme examples of avoiding tax obligations allowing for easier application of the doctrine than most real-world situations. Regardless of the ease of application, *Ramsay* and *Rawling* represent a change from the previous tax enforcement regime towards requiring a purpose other than avoiding tax liability.

In an expansion and application of the Ramsay principle, the House of Lords addressed the case of *IRC v. Burmah Oil Co. Ltd.* Burmah Oil Group (Burmah) experienced a loss on the sale of an investment but the loss was not tax deductible. A series of transactions were created that allowed the loss to become deductible during the liquidation of one of Burmah’s subsidiaries. The significant difference between *Burmah* and the aforementioned cases forming the Ramsay principle is that in *Burmah* the company used its own money and transferred assets within its business group, whereas in the previous cases, money was borrowed and used as part of a pre-packaged

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132 *Eilbeck v. Rawling* [1982] A.C. 300 (H.L.)
133 *Id. at* 322
In Burmah, the parent company (Burmah) held several subsidiaries including OMDR Holdings Ltd (H), Manchester Oil Refinery Holdings Ltd. (MORH) and Burmah Oil Trading Ltd (BOTL). H was inactive but held issued share capital of 700,001 GBP through a debt owed by Burmah. Burmah sold H 50,000,000 GBP of stock in British Petroleum Company Ltd. (BP) on credit for a purchase price of 380,625,000. H then sold the BP stock back to Burmah at a loss, leaving the total debt to Burmah at 159,299,999 GBP.

As part of Burmah’s scheme to avoid tax liability, MORH received funds from Burmah in the amount owed by H and provided the capital to H, which in turn used the funds to pay off its debt to Burmah. H then doubled its capital through the creation of 700,001 new ordinary shares par valued at 1 GBP per share. These shares were subsequently sold to Burmah and BOTL for 159,600,000 GBP and 228 GBP respectively – with BOTL receiving one share and Burmah obtaining the remaining balance. H repaid the loan to MORH and retained a cash balance of 296,728 GBP which was later distributed to Burmah and BOTL. Burmah claimed the amount paid for the new stock as a deduction, further asserting it was allowable through a tax provision allowing reorganization. This argument, technically complying with the letter of the law, was initially upheld by the special commissioner and the trial court. However, the House of Lords recognized the structure as a scheme lacking any purpose besides avoiding tax liability and overturned the decisions of the lower court and special commissioner. In doing so, it expanded the scope of the Ramsay principle to situations where the taxpayer uses its own recourses to structure a tax avoidance scheme.

These cases established the modern Ramsay Principle where the court looks to the substance of a transaction to determine whether an actual loss has taken place. The doctrine focuses on substantial compliance with the intent of the law rather than technical adherence. The principle is described in Burmah Oil by Lord Diplock as follows:

It would be disingenuous to suggest, and dangerous on the part of those who advise on elaborate tax-avoidance schemes to assume, that Ramsay’s case did not mark a significant change in the approach adopted by this House in its judicial role to a pre-ordained series of transaction (whether or not they include the achievement of a legitimate commercial end) into which there are inserted steps that have no commercial purpose apart from the avoidance of a liability to tax which in the absence of those particular steps would have been payable.\(^\text{135}\)
As stated above, the Ramsay principle applies when (i) the taxpayer has designed a series of transactions in advance, and (ii) the transactional arrangement has no other commercial purposes apart from the avoidance of tax; then the tax consequence of the arranged transactions should be based on the economic substance of the entire transaction rather than the legal form of the various steps—the second point being another way of describing the norm of “no substantial activities,” similar to the “reasonable commercial purpose” test described in Circular 698.

2. The Aftermath of the Ramsay Principle

UK courts have recently shown a more aggressive approach to piercing the corporate veil. In the latest landmark case, the Supreme Court ruled that company assets held by a spouse can be handed over as part of settlement claims. In that case, the Supreme Court rejected Michael Prest’s claim that he could not hand over properties controlled by his company to his former wife as part of a £17.5 million divorce settlement because he was tens of millions of pounds in debt. Michael Prest is the founder and controller of the Nigerian energy group of Petrodel Resources, incorporated in the Isle of Man. The Supreme Court ruled that the properties, put behind a corporate structure with a holding company incorporated in an offshore tax haven, were actually held in trust for the husband. Lord Justice Sumption concluded that Michael Prest had “deliberately sought to conceal [that the properties were held for him] in his evidence and failed to comply with court orders with particular regard to disclosing evidence . . . The court inferred that the reason for the companies’ failure to cooperate was to protect the properties, which suggested that proper disclosure would reveal them to [be] beneficially owned by the husband.” The significance of this verdict lies in the fact it is against the commonly held view that a company is a completely separate legal identity and should not be involved in matrimonial proceedings. This landmark case again demonstrated the vulnerability of the corporate veil in tax evasion cases.136

B. Circular 698 and the Ramsay Principle

Since “no employee, no other assets or debts, no other investments and no other businesses” can be used as the sole criterion to test the requirement of “having no reasonable commercial purposes,” what standard should the tax authority adopt while enforcing Circular 698? The Ramsay principle may be a useful approach in understanding and addressing these difficulties.

In the 1930s, the House of Lords determined that every citizen has the

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right and freedom of tax planning.\textsuperscript{137} For the tax arrangements made by citizens, it is necessary to examine their legal form rather than substance of the arrangement. However, since the 1970s, tax avoidance arrangements were adopted more often in various types of transactions. As mentioned above, in order to strike a balance between the interest of maintaining and protecting state tax revenue and the interest of taxpayers, in the Ramsay case\textsuperscript{138} in 1982, the English court changed its position from Duke of Westminster and established the Ramsay principle: (i) if the taxpayer has designed a series of transactions in advance, and (ii) the transactional arrangement has no other commercial purposes apart from the avoidance of tax; then the tax consequence of the transaction arrangement should be based on the economic substance of the entire transaction rather than the legal forms of various steps. In the Dawson case\textsuperscript{139} in 1984, the court further consolidated the application of the Ramsay principle and in the case of Craven, v White\textsuperscript{140} in 1988, the court gave some limitations on the Ramsay principle. In this case, the House of Lords pointed out that the application of the Ramsay principle must meet two points: (i) the taxpayer’s insertion must be regarded as an intermediary step in the tax arrangement by the tax authority, there is no possibility that the pre-planned series of transactions did not occur in accordance with the plan, otherwise the insertion step may be considered to have its independence and the entire transaction could not be looked at as a whole; (ii) the intermediate step of insertion has no other purpose apart from reducing the tax burden.

\textbf{C. Vodafone Case in India}

In early 2012, the Supreme Court of India heard the Vodafone case.\textsuperscript{141} Relevant to the discussion here, the court refused to apply the Ramsay principle to the case where the foreign investor indirectly transferred the resident enterprise’s equity through an offshore holding company.\textsuperscript{142}

The facts of the case are very similar to the scenario Circular 698 tries to cover and regulate. In 1992, the Hutchinson Group acquired the equity of HEL, an Indian telecoms company. The holding structure was as follows:

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\textsuperscript{138} W T Ramsay Ltd. v. Inland Revenue Commissioners [1982] AC 300 (HL).
\textsuperscript{139} Furniss (Inspector of Taxes) v. Dawson [1984] 1 AC 474 (HL).
\textsuperscript{140} Craven v. White [1989] AC 398 (HL).
\textsuperscript{141} Vodafone Int’l Holdings BV v. Union of India & Anr [SLP (C) No 26529 of 2010, dated 20 January 2012] (India).
\textsuperscript{142} The Vodafone tax dispute continues in spite of the Supreme Court’s decision. The government plans to implement retrospective tax laws affecting overseas transactions involving assets in India. The country’s finance minister said India will settle the Vodafone dispute prior to amending the law. See Prasanta Sahu et al., India Won’t Amend Tax Law Until Vodafone Issue Settled, WALL ST. J. (March 4, 2013), http://online.wsj.com/article/SB10001424127887324181789045578345154190197628.html.
the holding company HTIL, incorporated in the Cayman Islands, held the equity of the holding company incorporated in the British Virgin Islands; HTI also held the equity of the holding company CGP in the Cayman Islands; CGP held a total of 67% of the equity of HEL through eight companies in Mauritius; the remaining 33% of the shares of HEL were held by the Essar Company. In 2007, the Dutch company Vodafone NL entered into an equity transfer agreement with HTI which transferred all its shares of CGP to Vodafone NL. By this way, Vodafone NL indirectly held 67% of the equity in HEL. The transactional structure is indicated in Figure 3 below.

![Figure 3: The Equity Deal in the Vodafone Case](image)

Tax law in India is quite similar to that in China: the proceeds generated from transferring equity of an Indian company through an offshore company should be taxable. However, if an offshore company transfers equity of another offshore company, the proceeds are not taxable. The difference between Indian and Chinese tax law is that the Indian tax law imposes withholding liability on the acquirer of equity.

In the case of Vodafone, the Indian tax authority held that the actual transfer between HTI and Vodafone comprised the equity of an Indian company, that is, HEL, resulting in Indian tax liability and obligating Vodafone NL to withhold tax. Vodafone NL argued that the transfer between HTI and itself was the equity of CGP rather than HEL’s and it was under no

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144 Id. at 42–43.
obligation to withhold Indian tax. The key point in this debate was whether the court or the tax authority could ignore the corporate veil of CGP and eight holding companies incorporated in Mauritius so as to deem the transaction as between HTI and Vodafone NL.

In its ruling, the Supreme Court first reaffirmed the basic principle: the parent company and subsidiaries have their own independent legal personalities and cannot be confused. The Supreme Court nevertheless would not allow tax avoidance by the (ab)use of the corporate form. When the company is only a façade hiding the facts, the court would lift its veil.

The court reviewed the cases of *Duke of Westminster*, *Ramsay*, *Dawson* and *Craven v White* and concluded that the long-term strategic tax planning was allowed under the Ramsay principle, and the establishment of the genuine corporate structure for reasonable business purposes was protected by the law.

There may be many reasonable commercial purposes behind the establishment of a multi-layered corporate structure, such as avoiding business and political risks, ensuring liquidity of investments, improving borrowing capacity and avoiding double taxation in international investments. The Supreme Court held that when determining whether the establishment of a corporate structure had a reasonable commercial purpose, its existence period was a very important factor. It found that the holding structure of HEL, the equity of which was owned by the Hutchinson Group through CGP and eight companies in Mauritius, existed for over 10 years, making it difficult to ignore other commercial purposes apart from tax avoidance. This seemed to suggest that a longer period of incorporation may prove the absence of “avoiding an existing legal obligation,” which has been heavily adjudicated in veil-piercing cases. In other words, the longer the company has been put in place, the more difficult to challenge that the company is incorporated to avoid existing legal obligations. The period of time the company has been incorporated becomes a testing ground to show the company is incorporated to avoid future legal obligations.

The *Vodafone* case is also important because it clearly takes into account two key conditions addressing two aspects of the Ramsey principle, and one of them is the period of time for which the holding structure is in existence. This will be a useful indicator when the Chinese tax authority applies Circular 698. Condition (i) requires that when establishing an offshore holding company, the foreign investor should have a plan to indirect-

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145 Id. at 35–36, 144–145.
146 Id. at 148.
147 Id. at 40–41.
148 Id. at 189.
149 Id. at 135.
150 Id. at 198.
151 Id. at 51–52.
ly transfer equity of the Chinese resident enterprise and the plan must be implemented. If the time when the holding structure is put in place is earlier than the time of equity transfer, the period between creating of the holding structure and equity transfer will have many uncertain factors. For example, due to poor performance or heavy debts of the Chinese resident enterprise, it is possible that the foreign investor may not execute the transaction in order to exit from the investment. Condition (ii) requires that the new offshore holding company have no other purposes except tax avoidance. If the offshore holding company is formed after two parties have reached an agreement for the equity transfer, it is obvious that the foreign investor may intend to avoid its tax liability by relying upon this offshore structure. However, the pre-establishment of the holding company may imply an alternative business purpose unrelated to avoiding tax liability.

It is worth noting that avoiding tax liability through the use of a company may trigger a Ramsay principle (also known as the “reasonable business purpose” principle). The principle is not derived from avoiding existing legal obligations in the veil-piercing cases but shares the similarity with the rule of avoiding existing legal obligations. The Ramsay principle constitutes a special doctrine of avoiding existing legal obligations and may offer some insights to the rationality of Circular 698 and offer possible improvements.  

By reference to the Ramsay principle, Circular 698 may be read as follows: the taxpayer, Company A’s tax arrangement is to set up Company B in BVI and to take advantage of this company to reduce the tax burden. When (i) the foreign investor establishes the offshore holding company and this offshore holding company holds the equity of the Chinese resident enterprise, the foreign investor can transfer the equity of the Chinese resident enterprise indirectly through transferring the equity of the offshore holding company according to the plan; and (ii) when the establishment of the offshore holding company holding the equity of the Chinese resident enterprise has no other commercial purposes apart from reducing the tax burden, the tax consequence of indirectly transferring the equity in the Chinese resident enterprise by the foreign investor should be based on the economic substance of the entire transaction. Then, the tax authority can ignore the veil of the offshore holding company and Company A’s transfer of equity in Company B would be equal to Company B’s transfer of equity in Com-

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152 Many judges and scholars regard the Ramsay principle as an interpretation principle of tax law. Without such general anti-avoidance rules (as Article 47 in PRC Enterprise Income Tax Law) in the UK, the court then interpreted the objectives of the provisions of tax law through the Ramsay principle, which to some extent expanded the application of the provisions of tax law and achieved the effect of anti-tax avoidance. However, since the general anti-avoidance rule has been established in the Enterprise Income Tax Law of the People’s Republic of China, it is unnecessary to expand the application of the provisions by teleological interpretation. What can be borrowed from the Ramsay principle for reference in this article is only the method of determining reasonable business objectives.
pany C.

As previously demonstrated, the Ramsay principle can be used to remedy the lack of clarity inherent in Circular 698, thereby reconciling the shortfalls of the regulatory attempt with the reasonable goals of retaining tax revenue and preventing tax evasion. In adopting the Ramsay principle, it is important to examine the policy objectives behind the principle to ensure harmony in combining the two regulatory approaches. To this end, the next section addresses policy issues connected to the Ramsay principle and Circular 698.

D. The Ramsay Principle and Circular 698: Policy Concerns

The primary policy objective of the Ramsay principle is to prevent abuse of statutory tax provisions while allowing companies with a legitimate business purpose to structure their transactions in a manner that provides beneficial tax treatment. The tax avoidance structures in the cases establishing the doctrine are extreme examples where the transactions lack any purpose other than tax avoidance and are mere schemes. However, these schemes are an attempt to comply with the law to receive a benefit not envisioned by the legislature. This is distinctive from the objectives of veil piercing, which intends to prevent fraudulent activity.

The Ramsay principle and Circular 698 appear at first glance to have similar policy objectives; however, Circular 698 is more far reaching. Circular 698 attempts to eliminate tax obstacles by moving away from the tax treaty principle of jurisdictional allocation towards a system based on consolidated accounts. The consequence of this “unitary” approach is not only to retain national taxation and even national tax rates but also to create a de facto single market effect. The application of national taxes to income generated from international (offshore) business transactions naturally raises issues of the scope of national taxation and possibilities for international coordination or competition. According to Circular 698 (in which tax j-

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153 The tax treaty approach is labeled as a “flowed miracle.” It preserves to the maximum extent of the freedom of each state to define its own income tax system while building up sufficient coordination to facilitate economic flows between states. To achieve these dual tasks, the tax treaty approach tries to reconcile the conflicting principles of taxation based on source and residence. The real effect of the tax treaty approach is minimal, and indeed has reinforced the primacy of national jurisdiction. The reason for this flaw is that the treaty principles for allocation of rights to tax between residence and source states are essentially designed for portfolio investment. R. S. Avi-Yonah, The Structure of International Taxation: A Proposal for Simplification, 74 TEX. L. REV. 1301–59 (1996).

154 The current international tax treaty system is based on a so-called “arm’s length” doctrine, which places an emphasis on taxation of the components of subsidiaries and branches of multinational companies on the basis of separate national accounts, treating each component as if it were an independent business.

155 The unitary approach requires no commitment from a national government to an overarching multilateral framework; nor any bilateral or multilateral principles or framework for allocating the tax
risdiction is not territorially based), income tax may produce overlapping jurisdictional claims. Put differently, Chinese tax law and principle may be applied both to persons within the territory and to income earned within the territory paid to a person outside it. The efforts made in Circular 698 may raise complaints of “double taxation” and may easily attract an inevitable negative response from the business community and foreign jurisdictions which have stridently opposed any move to tax harmonization. The reinforcing of the national basis of income taxation runs counter to the international-integrationist economic logic of cross-border transactions.

As with the Ramsay principle, Article 6 of Circular 698 requires the transaction to be “without any reasonable business purpose.” This makes application of Circular 698 only appropriate when tax avoidance is the sole objective for utilizing an offshore holding company to invest in a domestic Chinese enterprise. In reality, many advantages exist for structuring ownership though a foreign holding company including the necessary reduction of formalities when changing foreign ownership in a domestic enterprise. The reduction of formalities facilitates the free transfer of shares and encourages investment—a legitimate business objective that is a key policy behind the corporate form.

The general principles of tax policy are to encourage work, savings and investment. A tax system should be well designed to maintain and promote fairness. Here, Circular 698 appears to meet the objectives of the Chinese government in terms of tightening the regulatory regime for “round-tripping investments” (discussed in detail in section 5). However, the rules in Circular 698 may generate undesirable side effects. For instance, enforcement of Circular 698 may increase taxpayers’ compliance costs, generate unfair and greater burdens and create potential implications for China’s international competitiveness. The government’s role in formulating and reforming tax policy is not only to support but to positively enhance markets in the public interest. Therefore, China’s corporate tax reform should follow some basic principles such as avoiding complexity, promoting fairness across corporate tax payers, making adaptive changes based on business conditions, maintaining stability and lowering tax rates while maintaining the tax base, thereby creating the best possible location for investment—all of which may reshape China’s economic growth. The ideas underlying these elements have been adopted by some advanced economies.

\[\text{OECD, TAXING PROFITS IN A GLOBAL ECONOMY: DOMESTIC AND INTERNATIONAL ISSUES 8 (Paris: OECD 1991).}\]
already. The emphasis on the modern business environment in formulating tax policy reflects the reality that businesses, not government, are best placed to judge how to operate and structure themselves.

The previous sections addressed Circular 698, its legitimacy and creation of a new veil-piercing doctrine through the lens of Chinese and comparative law, with this section proposing a solution borrowed from British law. Next, the article turns to a global view of the situations underpinning the need for Circular 698. First, the section addresses the “round-trip investment” model, which provides an explanation for the common convention of using offshore holding companies to invest in China—even by Chinese nationals. This phenomenon, not necessarily specific to China, created an explicit need for regulatory intervention similar to Circular 698 to prevent the loss of tax revenue. The remainder of the section discusses the global trend to tighten tax loopholes and “crack down” on tax evasion. Both domestic and international dimensions draw us a full picture so that we may better understand the “rationale” of Circular 698.

V. A NEW GLOBAL TAX ORDER? – “RATIONALIZING” CIRCULAR 698 FROM AN INTERNATIONAL DIMENSION

Although the legitimacy of Circular 698 is doubtful from the company law perspective, the underlying rationale of Circular 698 is anti-tax avoidance. With this in mind, Circular 698 may further enrich the theory and practice of the veil-lifting doctrine under Chinese laws. As Schumpeter put it long ago, “Taxes not only helped to create the state. They helped to form it”. This reminds us of the orthodox relationship between taxation and a system of public finance and macroeconomic management, which leads to a less transparent, but no less real, functional interchangeability between taxation and regulation. In terms of the insights of political economy, the economics of corporate tax can never be divorced from politics, which is evidenced by the fact that almost all the most important corporate tax issues are eminently political. Relevant to our discussion here, Circular 698 is part

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161 Peter Riddell, Commentary, in Dimensions of Tax Design: The Mirrlees Review 1304 (Stuart Adam et al., eds., 2010).
of a regulatory framework, targeting some grey transactions for macroeconomic purposes. This section tries to develop an “explanatory framework,” with a view of revealing the underlying rationale of Circular 698 in a larger regulatory context.

A. Round-Trip Investment Model

Recent years have witnessed the popularity of the “round-trip investment” model—a restructuring process offering tax and regulatory benefits to Chinese investors and companies. An offshore holding company is incorporated in a “satellite” common law jurisdiction, typically in Hong Kong, the Cayman Islands, British Virgin Islands or Bermuda. The offshore holding company, owned or controlled by Chinese shareholders, controls the onshore operating company either through direct acquisition or contractual arrangement. If through direct acquisition, the offshore holding company acquires and owns the equity capital in the onshore operating company, which retains ownership and operates existing business assets. Thus, the Chinese shareholders of the onshore operating company are moved up to the offshore level.

This is called a “round-trip investment” model for several reasons. The model involves the transfer of equity—or assets—of Chinese residents being routed to another jurisdiction, typically a tax haven. The equity is re-invested back to the parent company in China through an offshore holding company. Lastly, the ownership or control of the parent company

162 There has been an international campaign since the financial crisis against tax havens and the aggressive use of tax havens for tax evasion and avoidance purposes. Britain clinched a deal with its major offshore tax havens (including Bermuda, the British Virgin Islands, the Cayman Islands, Gibraltar, Anguilla, Montserrat, Turks, the Caicos Islands, Jersey, Guernsey and the Isle of Man) on June 15, 2013 by reaching a protocol on information sharing. Under the protocol, records can be opened up to serve the public interest (i.e., checking who could be making use of tax havens to skirt home-country taxes). The G8 wants to work out a pact on sharing banking data to allow countries to fight tax evasion. See London Clinches Deal on Tax Havens, S. CHINA MORNING POST (June 16, 2013), http://www.scmp.com/news/world/article/1261822/britain-clinches-deal-tax-havens. Tax is a key reason to tackle this at a global level. However, the positions vary from one government to the other. For example, the UK is pushing the G8 to give political backing to new global standards on corporate tax, including the automatic exchange of tax information and some kind of ownership registry for shell companies. The US has also made a strong commitment to tackle criminal and illicit actors who use shell companies to hide their true identity. Canada, however, is resisting—partly on grounds of tax confidentiality—plans to crack down on aggressive tax avoidance and evasion by requiring the disclosure of the ultimate owners of shell companies. See George Parker et al, Hopes for G8 Trade and Tax Deals Dent ed, FIN. TIMES (June 13, 2013), http://www.ft.com/intl/cms/s/0/42f678fa-d445-11e2-a464-00144feab7de.html. The German chancellor also expressed a reluctance to address the issue by saying that “the generation of profits and tax payment [has] to be linked in individual countries.” James Fontanella-Khan & Jamie Smyth, Ireland Pledges Cooperation on Global Tax Avoidance Plan, FIN. TIMES (May 22, 2013), http://www.ft.com/intl/cms/s/0/1accd5b2-e2d5-11e2-9bc8-00144feab7de.html.
remains with the Chinese shareholders.\textsuperscript{163} Figure 4 below demonstrates the corporate structure of the onshore operating company after the completion of the re-structuring process, but before the foreign investment is made into the holding company.

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{figure4.png}
\caption{“Round-trip Investment” Model}
\end{figure}

The “round-trip investment” model reflects the local business community’s preference to be “packaged” as foreign investment,\textsuperscript{164} and the concern, among others, that the government may impose exchange restrictions on residents,\textsuperscript{165} even though the Chinese government has gradually relaxed foreign exchange quotas for outbound investment since 2006.\textsuperscript{166}

The “round-trip investment” model lends economic and regulatory benefits to Chinese companies and resident shareholders. First, the idea of tax avoidance and tax-differential treatment between local and foreign investors is the main driver of the “round-trip investment” model. Until recently, the playing field was tilted in favor of foreign-invested enterprises.

\textsuperscript{163} The “round-tripping” investment also appears in other jurisdictions, and is a highly litigated or arbitrated issue. See Tokios Tokeles v. Ukraine, ICSID Case No. ARB/02/18, Decision on Jurisdiction (April 29, 2004).


(FIEs). Prior to the promulgation of the Enterprise Income Tax Law,\textsuperscript{167} the income tax rate for an FIE was 15–25%, while a tax rate of 33% is applicable to a pure domestic entity.\textsuperscript{168} By adopting a “round-trip investment” model, Chinese companies and residents may capture a tax break and enjoy more preferential tax treatment. In other words, the same business will be subject to a much lower tax rate.

Even after the enactment of the Enterprise Income Tax Law, under which both FIEs and purely Chinese enterprises are subject to the same enterprise income tax rate of 25%, the “round-trip investment” model still enables shareholders to enjoy more preferential tax treatment. By utilizing the “round-trip investment” model, the offshore holding company is only subject to a withholding tax on the distribution of dividends from the PRC-based operating company. The withholding tax rate is 10% depending on the application of a tax treaty and can be as low as 5% if the offshore company is incorporated in Hong Kong.\textsuperscript{169} Any payments of interest or dividends made by the offshore holding company, and/or capital gains derived from exiting the investment through the sale of shares in the offshore holding company, are free of PRC tax. By contrast, sales proceeds in a share transfer for a purely domestic company in China are deemed to be taxable income. Together with other taxable income received in the same fiscal year the proceeds are subject to a 25% enterprise income tax after the allowable deductions.

The tax evasion theory is another explanation for the pattern of “round-tripping.”\textsuperscript{170} China uses export tax rebates to entice domestic firms to export more.\textsuperscript{171} Exports from China to Hong Kong and other jurisdic-

\textsuperscript{167} The PRC Enterprise Income Tax Law was enacted on March 16, 2007 and came into effect on January 1, 2008.
\textsuperscript{168} In addition to a lower tax rate, China also offered a “2-year exemption and 3-year half reduction” package to FIEs. Accordingly, an FIE is exempt from the corporate income tax in the first two years of making profits and only needs to pay 50% of corporate income tax in the following three years. Unless grandfathered, FIEs are no longer entitled to such preferential tax treatment under the new PRC Enterprise Income Tax Law. FIEs located in national high-tech industrial zones were entitled to a 15% preferential tax rate.
\textsuperscript{171} The WTO’s Agreement on Subsidies and Countervailing Measures provides rules for the use of government subsidies and the application of remedies to address subsidized trade that has harmful commercial effects. A subsidy has a very particular meaning under the WTO rules (and Title VII of the US Tariff Act of 1930), and is defined as a “financial contribution” by a government which provides a benefit, and may include foregone government revenue (e.g., a tax credit). A subsidy granted by a WTO member government is prohibited if it is contingent, in law or in fact, on export performance, or on the use of domestic over imported goods. These prohibited subsidies are commonly referred to as export subsidies and import substitution subsidies, respectively. The export rebate tax, allowing for refunds,
tions, however, are systematically under-reported. This is largely because of the capital account control, which induces Chinese firms to place and control a chunk of export earnings in an offshore jurisdiction so that further currency conversion restrictions can be avoided. These exporting firms prefer to trade off the benefits of tax breaks on “round-tripping” investment against the loss of export rebates if they under report the export figure. On the import side, an importing firm, after evaluating the trade-offs of the benefits of tax breaks on “round-tripping” investments against the cost of import tariffs if it over-reports the imports figure, has a tendency to under-report imports and to mislabel more highly taxable imported goods to lower-taxed ones so as to evade import tariffs. Based on the tax evasion theory, in order to capture the tax differential, a portion of foreign direct investment (FDI) to China is thus attributable to the under-reported amount of export earnings or over-reported imports.

This also matches the empirical finding that the reported exports from China to Hong Kong are consistently lower than those Hong Kong reports, but the Chinese imports are greater than the numbers Hong Kong reports. Over-invoicing for exports from mainland China to Hong Kong has operated as an important channel guiding these financial flows into China. It is natural to see that exports to Hong Kong have surged to the highest level since 1995. The Chinese government has been trying to bring the over-invoicing under control. New banking rules in China also stipulate a reduction in the ratio of foreign currency loans to foreign currency deposits. Domestic banks are likely to buy US dollars in order to satisfy these rules. The risk is that inflows turn quickly to outflows given the fact the US dollar is to strengthen against other major currencies, which could contribute to a liquidity crisis in China’s fragile shadow banking system. Economists at Global Financial Integrity, an American research group that campaigns against illicit financial flows, have spotted huge discrepancies between (i) China’s reported exports to the world and the world’s stated imports from China; and (ii) China’s purchases from the world and the world’s exports to China. This rampant mis-invoicing indicates that China may have understated its exports and overstated its imports by a combined US$430 billion reductions, or exemptions from taxes and other payments owed to the Chinese government, available to exporters, is treated as an unfair subsidy program by China’s major trading partners. The US has repeatedly raised its concerns about these subsidies and once brought a dispute in the WTO against China though the dispute was resolved at the consultation stage. See Office of the United States Trade Representative, Fact Sheet, http://www.ustr.gov/assets/Document_Library/Fact_Sheets/2004/asset_upload_file847_6464.pdf (last visited May 11, 2012).


in 2011. These discrepancies at least confirm the difficulty of curbing the cross-border flow of capital in China, a country with such a heavy cross-border flow of goods.

For the purposes of piercing the corporate veil, it is important to differentiate between using the “round-trip investment” model as a method of avoiding complex and costly regulation and taking advantage of tax incentives and acts of fraud committed by some investors while using the investment model. The intentional improper reporting of imports and exports to avoid payment of customs duties constitutes fraud. However, merely employing the “round-trip investment” model to take advantage of the legal framework, whether or not permissible under tax law, does not rise to the level of fraud and is not a legitimate basis for piercing the corporate veil.

The “round-trip investment” model is also often used to facilitate attracting FDI into onshore operating companies through an offshore holding company. Instead of directly acquiring the equity capital in a China-incorporated company, foreign investors prefer to acquire the equity capital in an offshore holding company. In doing so, both Chinese shareholders and foreign investors can avoid the rigid regulatory regime in China. For example, if a foreign investor directly invests into a Chinese company and becomes a shareholder afterwards, any amendments to the articles of association of the company, transfer of equity capital, increase and reduction of the equity capital and liquidation and dissolution of the company are subject to unanimous consent of all the shareholders and approval of the original approval authority—a truly painful and time-consuming process. Exiting through a sale of the equity in a company will also trigger approval from the Ministry of Commerce (MOFCOM) or its local branch. Moreover, under the Equity Joint Venture Regulations other shareholders have a preemptive right to acquire the equity of the selling shareholder and have the absolute consent right to any general transfer. No transfer of an interest in the equity joint venture (EJV) or contractual joint venture (CJV)—including transfers of interests between the joint venture shareholders—can be made without an amendment to the articles of association, the other parties’ consent, unanimous consent of the board and approval of the original approval authority. The transfer of shares at the onshore level, therefore, may result in a deadlock between Chinese and foreign shareholders. In the “round-trip investment” model, however, the amendments to the articles of association of the offshore holding company, transfer of equity capital, increase and reduction of equity capital and liquidation and dissolution of the hold-

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ing company do not require unanimous consent of all shareholders or the approval of any governmental authority. This partially motivates both Chinese and foreign investors to adopt the “round-trip investment” model, which should be a permissible basis under Circular 698 because seeking to avoid costs while complying with the law is arguably a legitimate business purpose.

The “round-trip investment” model is the prevailing market practice for foreign investors to invest in a Chinese venture. As a forum shopping strategy, foreign investors land investments into China through offshore vehicles because the offshore regime is more flexible and has higher standards, thus better supports multiple rounds of debt and equity financing. The “round-trip investment” model, like a “locked-in” market norm, is the result of efficient bargaining in a series of transactional events.\(^{177}\) The advantages of this model are the possibility of avoiding the burdensome Chinese corporate law regime and, in spite of the “switching costs,” reducing transaction costs. This model, as a type of an informal sanction, has “piggy backed” on more user-friendly offshore jurisdictions in order to facilitate private placement and future overseas listings in Hong Kong, New York or elsewhere, thereby partially replacing formal legal institutions in China.

Despite it being reasonable to estimate that a portion of FDI into China is in the form of “round-trip investment,” empirically it is very difficult to quantify the amount of “round-trip investment.” Take 2008 as an example. FDI to China amounted to a total of US$92,395 million. A breakdown of these utilized inbound investments by country of origin indicates that around 44.41% and 17.27% came from Hong Kong and the British Virgin Islands respectively, which can be seen in Table 1 below. Foreign investment inflows from Hong Kong and the British Virgin Islands are far more than those from the United States and Japan, which are traditionally treated as the major investors into China. On the other hand, in the early 1990s China started outbound FDI activities that became more significant since 2001, as Table 2 indicates below.\(^{178}\) According to official figures, China’s

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\(^{177}\) This assumption is largely based on the efficiency theory that lawyers, as transaction-cost engineers, are well-compensated and sophisticated enough to structure the transaction in the most feasible and efficient way. As a result, transaction costs in negotiating a new transactional structure and changing the existing equilibrium among the parties may be high in an economic sense. See Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing* 94 YALE L.J. 239, 243 (1984); Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules* 99 YALE L.J. 87, 91–93 (1989).

\(^{178}\) The Central Committee of the Communist Party of China (CPC) first put forward the so-called “go globally” or “going abroad” strategy in 1998. The strategy was, for the first time, included in the 10th Five-Year Plan in 2001. The Central Committee of the CPC repeated its commitment to implementing this strategy in its Decision on Some Issues concerning the Improvement of the Social Economy Market, http://news.xinhuanet.com/newscenter/2003-10/21/content_1135402.htm. Since 2001, China has been steadily promoting overseas direct investment to lessen the external surplus and to secure access to natural resources. The Chinese government set a clear objective of nurturing up to 50 globally
outward direct investment exceeded $77 billion in 2012, an increase of 12.6% on the previous year, even as inflows of FDI fell for the first time since the outbreak of the financial crisis.\(^{179}\) A significant portion of Chinese outbound FDI does flow to “satellite” jurisdictions (or tax haven regimes). Table 2 demonstrates statistically that by the end of 2012 many Chinese companies’ and residents’ outbound investments had been made to offshore financial centers such as Hong Kong, the Cayman Islands and the British Virgin Islands, rather than the United States, Japan or Russia. The Heritage Foundation in Washington DC and the Economist Intelligence Unit showed, quite differently, that top destinations for China’s outward investment during the period from 2005 to 2012 were Australia, the United States, Canada, Brazil, Britain, Indonesia, Russia and Kazakhstan.\(^{180}\) Table 3 shows that the share of outbound FDI to Hong Kong, the Cayman Islands and the British Virgin Islands constitutes two-thirds of the total outbound investment, and has remained at the same level for the past five years. Bilateral FDI stocks from Hong Kong to China were the second largest (in the amount of US$241,573 million) against the eighth largest stocks from China to Hong Kong (in the amount of US$164,063) in the world in 2005 and “round-tripping” FDI accounted for a large share of these flows.\(^{181}\) The shares of small economies such as the British Virgin Islands and the Cayman Islands, which have risen over the past several years, can account for some of the “round-tripping” flows.\(^{182}\) As tax havens, incorporation regimes and offshore financial centers, at least a substantial portion of capital flows from the Cayman Islands, the British Virgin Islands or Hong Kong can presumably be from “round-tripping.”\(^{183}\) If this analysis holds, a share of one-

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\(^{180}\) Id.  
\(^{182}\) The Cayman Islands is home to more than 9,400 hedge funds, sheltering assets worth an estimated US$2.2 trillion. Thousands of hedge funds are located in the Cayman Islands due to its “tax neutrality.” The Caymans and other offshore tax havens have faced increasing calls from foreign governments for an overhaul of their tax regulations. On the other hand, the Caymans and other tax havens are also under pressure from investors on various reform initiatives. For example, a company linked to DMS Management, the largest provider of hedge fund “fiduciary services”—the hiring of independent directors to sit on fund boards—has filed a suit against the Cayman Islands Monetary Authority in order to stop the latter from “taking any decision” on a range of transparency and corporate government reforms. See Sam Jones, Great Tax Race: Hedge Fund Group Sues Over Cayman Reforms, FIN. TIMES, (April 29, 2013), http://www.ft.com/intl/cms/s/0/24f2e772-adc5-11e2-82b8-00144feabdc0.html.  
third of all inbound investment to China may be from “round-trip” investments.\textsuperscript{184} Studies of individual countries have estimated that annual capital flight as high as an average of 10.2\% of Chinese GDP.\textsuperscript{185} Although some of this amount may be reinvested through “round-tripping,” it entails a massive volume of capital outflows, outstripping in aggregate the inflows of foreign aid as well as considerable losses of public revenues.

This line of analysis also makes sense in a global context. According to figures from the Organization for Economic Co-operation and Development (OECD), the Netherlands and Luxembourg booked US$5.8 trillion of FDI by the end of 2012, which was more than the US, UK and Germany combined. The Netherlands alone attracted US$3.5 trillion by the end of 2012 with the value of cumulative capital investment of US$3.5 trillion, while only US$573 billion ended up in “real” Dutch companies. The majority of this total FDI went to SPVs, a sort of tax avoidance instrument. Similarly, Luxembourg booked US$2.28 trillion in FDI but only US$122 billion entered its real economy.\textsuperscript{186} The Netherlands, Luxembourg and Ireland are all viewed as tax havens allowing multinationals such as Starbucks and Apple to cut their tax bill worldwide.\textsuperscript{187} Tax avoidance has been a global issue which has severely affected capital flow worldwide. In a global context, US multinationals disproportionately report profits in the amount of US$768 billion in low tax countries whereas European businesses invested US$768 billion in low or no tax countries in 2010.\textsuperscript{188} While recent attention has focused on tax havens and individual multinationals, the global debate has also turned its emphasis to developed economies such as Ireland and the Netherlands which have been seen to suck up corporate investment by helping companies avoid hefty tax bills in their own jurisdictions.


\textsuperscript{\textsuperscript{187} See generally Gerald A. Epstein, FINANCIALIZATION AND THE WORLD ECONOMY (2005).}

\textsuperscript{\textsuperscript{188} Vanessa Houlder, Figures Shed Light on Tax Avoidance Haul, FIN. TIMES (April 28, 2013), http://www.ft.com/intl/cms/s/0/aad0297e-b020-11e2-8d07-00144feabd0.html.}

\textsuperscript{\textsuperscript{189} Alex Barker, EU Steps Up Brussels Broadens Probe into Tax Sweeteners for Multinationals, FIN. TIMES (Mar. 24, 2014), http://www.ft.com/intl/cms/s/0/b93d4126-b345-11e3-b09d-00144feabd0.html.}
Table 1: FDI Inflows to China from Major Originating Countries
(by share percentage)

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Data from 1994 to 2003 is from the CEIC database and data from 2004 to 2008 is from http://www.fdi.gov.cn/pub/FDI/wztj/wzrfgbdtqj/wztj20090122_101099.htm. Data for Australia during the period from 2004 to 2008 is not available and is grouped into the “others” category.
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Table 2: Top 10 Destinations of China’s Outbound Investments (2007-2012)\(^{191}\)

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Table 3: China’s Outbound Investments to Hong Kong, the Cayman Islands, and the British Virgin Islands\(^{193}\)

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The broad use of the “round-trip investment” model per se has a damaging impact on China’s tax pool, State-owned assets, foreign exchange control and regulatory efficiency. In addition, the “round-trip investment” model has been used in money-laundering activities speculating on Renminbi-denominated assets. Essentially, this model is a device used by Chinese and foreign businesses to exploit both regulatory law and practice, to resist control, and are typical examples of “creative compliance” whereby investors play the system through tax and regulatory arbitrage. This has led to variety to statutory and regulatory attempts to regulate the “round-trip investment” model.

B. Regulatory Measures to the “Round-trip Investment” Model

Chinese authorities have incrementally been tightening up regulatory loopholes in the past several years. This section addresses and summarizes a variety of the measures taken to restrict the loopholes and regulate the “round-trip investment” model. Relevant regulations are as follows:

1. Foreign Exchange Control Rules in 2005

SAFE issued two sets of rules in January and April 2005 respectively: the Circular on Relevant Issues in Perfecting Foreign Exchange Control in Mergers and Acquisitions by Foreign Investors (“Circular 11”) and the Circular on Relevant Issues in the Registration of the Offshore Investments of Individual Domestic Residents and Foreign Exchange Registration in respect of Mergers and Acquisitions by Foreign Investors (“Circular 29”). These two circulars required Chinese residents making an investment in China through an offshore SPV to carry out approval and registration formalities with SAFE or one of its local equivalents. In particular, these two circulars required residents to obtain approval from the national-level SAFE, but failed to provide any procedural guidance to applicants with which to follow. These two Circulars, therefore, made obtaining approval from SAFE a mission impossible, and de facto froze PRC investments involving offshore companies controlled by PRC residents, considerably slowing the flow of PRC-related private and foreign investments into China and red-chip listings.

The foreign investment community lobbied against both Circular 11 and Circular 29 due to the lack of procedural guidance and regulatory certainty. In October 2005, SAFE issued the Circular on Relevant Issues in the Foreign Exchange Control with respect to the Financing and Round-trip Investment through Offshore Special Purpose Companies by Residents Inside

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China (“Circular 75”) to repeal Circular 11 and Circular 29.\(^{195}\) Under Circular 75, Chinese residents \(^{197}\) need to register \(^{198}\) their “round-trip” investments\(^{199}\) with the local SAFE office: (i) before forming or taking control of a special purpose company\(^{200}\) abroad; (ii) when injecting a domestic enterprise’s assets or equity into an SPV; (iii) when conducting an equity financing exercise abroad after injecting assets or equity into an SPV; or (iv) within thirty days of a material change in the capital structure—including external guarantees—of a SPV controlled by Chinese residents.\(^{203}\)

In addition, a domestic resident must go through the approval or registration procedure for the domestic enterprise’s receipt of the “round-trip” investments or loans from a SPV’s financing proceeds like any other domestic enterprise engaging in similar foreign exchange transactions.\(^{204}\) The consequence of failing to register the “round-trip” investment with SAFE, or its local branch, or to comply with other SAFE rules is two-fold. First, the offshore parent company’s Chinese subsidiary will be prohibited from distributing “profits, dividends, liquidation proceeds, equity transfer proceeds [and] capital reduction proceeds” \(^{205}\) out of China, and will bear liabili-

\(^{195}\) Guanyu Jingnei Juming Tongguo Jingwai Teshu Mudi Gongsi Rongzi Ji Fancheng Touzi Waihui Guanli Youguan Wenti de Tongzhi (国家外汇管理局关于境内居民通过境外特殊目的公司融资及返程投资外汇管理有关问题的通知, 汇发〔2005〕75号) [Circular on Relevant Issues in the Foreign Exchange Control with respect to the Financing and Round-trip Investment through Offshore Special Purpose Companies by Residents Inside China (Circular 75)] (promulgated by the State Administration on Foreign Exchange (SAFE), Oct. 1, 2005, effective Nov. 1, 2005) [hereinafter Circular 75] (China).

\(^{196}\) According to Section 1 of Circular 75, the term “residents” covers both “domestic resident natural persons” including individuals holding a China domestic identity document and other individuals who “habitually reside in China for reasons related to their economic interests” and “domestic resident legal persons” including the enterprises, other economic organizations and the newly recognized “domestic venture investment enterprises.” See id. at § 1.

\(^{197}\) Although Circular 75 only requests the domestic residents register the transactions with SAFE, the information required to be submitted to SAFE is so substantive that registration is the same as approval or verification, where SAFE will conduct a substantive review and exerts its discretion in the registration process. Id. at § 3.

\(^{198}\) The definition of “round-trip investment” under the foreign exchange rules is great in breadth and detail to “cover purchasing or swapping for the equity of a Chinese shareholder/owner in a domestic enterprise; establishing a foreign-invested enterprise in China and through such an enterprise purchasing or reaching agreement to control domestic assets; purchasing through agreement domestic assets and using such assets to invest in and establish a foreign-invested enterprise or for increasing the capital of a domestic enterprise.” Id. at §1(2).

\(^{199}\) The definition of a “special purpose company” in Circular 75 is narrow and only covers those entities “conducting . financing abroad [with] the assets of the domestic enterprise or equity.” Id § 1. This definition seems to suggest that Circular 75 does not apply to SPVs with cash investment from the domestic resident or without the purpose of obtaining financing abroad.

\(^{200}\) Id. at § 2.

\(^{201}\) Id. at § 3.

\(^{202}\) Id.

\(^{203}\) Id. at § 7.

\(^{204}\) Id. at § 5.

\(^{205}\) Id. at § 6.
ity under Chinese law for violation of the relevant foreign exchange rules. Compared to Circulars 11 and 29, Circular 75 re-opened the door to Chinese residents who are able to make use of offshore SPVs to conduct offshore financings.

SAFE issued the Operating Procedures Regarding Issues Concerning Foreign Exchange Control on Financing and Round-trip Investment Through Offshore Special Purpose Companies by Domestic Residents (“Circular 106”) on May 29, 2007, to clarify Circular 75. Circular 106 works to implement Circular 75 by not only outlining a roadmap of the documentation and intricate registration requirements for the multiple stages of SPV financing, but also imposing new compliance burdens on Chinese residents’ use of SPVs in offshore jurisdictions. Accordingly, a domestic target company in a “round-trip” investment is required to have a three-year operating history and the registration requirement is extended to Chinese residents’ “greenfield” investments. The scope of “Chinese residents” is further expanded to any foreigner who “has permanent residence in China, owns onshore assets or interest in the Chinese company, or beneficially owns offshore assets or interests converted from his assets in the Chinese company.”


The most influential piece of legislation which had an immediate and widespread effect on the “round-trip investment” model is the Provisions on the Acquisitions of Domestic Enterprises by Foreign Investors (“M&A Rules”) in 2006. To restore a higher level of scrutiny and streamline the approval procedure, the M&A Rules require domestic companies to disclose the offshore shareholding structure to, and obtain approval from,

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206 Circular 19 eliminates most of the overlap between SAFE and MOFCOM, and simplifies the foreign currency registration of “round-trip” investments and fundraising, while increasing the pressure and urgency on investors to rectify previous non-registration. SAFE’s procedures are conditional upon the applicants having complied with MOFCOM’s requirements. See Guojie Waihui Guanli Ju Guanyu Yinfa Jingnei Jumin Tongguo Jingqai Teshu Mudi Gongzi Ji Fancheng Touzi Waihui Guanli Caozou Guicheng de Tongzi (国家外汇管理局关于印发《境内居民通过境外特殊目的公司融资及返程投资外汇管理操作规程》的通知, 汇发〔2011〕19号) [Operating Instructions on Foreign Exchange Administration for Domestic Residents Engaging in Financing and Round-tripping Investment via Overseas Special Purpose Vehicles (Circular 19)] (promulgated by the State Administration of Foreign Exchange (SAFE) on May 20, 2011, effective July 1, 2011) [hereinafter Circular 19] (China).

MOFCOM before setting up an offshore SPV. Meanwhile, no truste-

ship, holding through agency or other means, is allowed to circumvent these procedural requirements. After receiving preliminary approval from MOFCOM, a domestic company is entitled to submit application documents for the initial public offering (IPO) in an overseas stock exchange by the SPV to the China Securities Regulatory Commission (CSRC), China’s securities regulator. Following the CSRC’s approval, the domestic company is required to apply to MOFCOM for an FIE approval certificate—bearing the legend “equity held by an overseas SPV”—valid for one year from the date of issuance of the business license. The domestic company must submit both a report of its overseas IPO through an SPV and the IPO proceeds repatriation plan to MOFCOM within 30 days following the IPO. In addition, the SPV must restore the domestic firm to its initial shareholding composition if the listing does not take place within one year. The M&A Rules make the entire registration/approval regime more clumsy, burdensome, uncertain, time-consuming and costly. Under the M&A Rules, the VIE structure is, overall, unworkable and the flow of new PE-backed companies and the route of red-chip listings have been effectively closed off. As a matter of fact, MOFCOM and CSRC have not approved any related transactions and overseas IPOs since the promulgation of the M&A Rules. Almost all offshore restructurings of the VIE structure may have to stop.

3. Tax Notice 82 in 2009

The new PRC Enterprise Income Tax Law (effective as of January 1, 2008) introduced the concept of Tax Resident Enterprise (“TRE”) for the first time. In early 2009, looking to secure a sensible tax pool, the State Administration of Taxation issued Notice 82 to clarify the concept of “es-

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208 An SPV is defined as any overseas company controlled, directly or indirectly, by a domestic company or Chinese natural person inside China for overseas the listing of share interests. Id. at ch. IV.
209 Id. at art. 15.
210 Id. at arts. 45, 47.
211 Article 11 of the M&A Rules provides that, where a foreign company established or controlled by a domestic company, enterprise or natural person intends to take over its domestic affiliated company, it shall be subject to the examination and approval of MOFCOM. The parties concerned cannot get around these requirements by making investments within China through a foreign-funded enterprise or other means. Certainly, this hinges on how liberal MOFCOM will be in approving the VIE structure. Within the first year of enacting the provisions, there were no approvals for restructurings of Chinese companies into offshore holding companies.
212 While SAFE increased its focus and coordination through issuing Circular 19, MOFCOM’s uncertainties under the M&A Rules remain.
213 Guoshui fa Guanyu Jingwai Zhuce Zhong Zi Konggu Qiye Jigou Shijian Guanli Jigou Biaoshun Rending Wei Jumin Quiye Youguan Wei de Tongzhi Guiding (国税发《关于境外注册中资控股企业的实际管理机构标准认定为居民企业有关问题的通知》 规定[2009]82 号) [Notice concerning the Recognition of Chinese-controlled Overseas Incorporated Enterprises as Resident Enterprises ac-
establishment” in the “round-trip investment” structure. Under the Enterprise Income Tax law, an enterprise that is established outside the PRC but has its “place of effective management” in the PRC is regarded as a PRC tax resident enterprise. Notice 82 set out certain proposed interpretative guidance on what constitutes a place of effective management. Under Notice 82, overseas enterprises that are “controlled” by PRC enterprises may be deemed as PRC tax residents when certain conditions are satisfied. With the passing of Notice 82, the non-resident status of an offshore SPV in the “round-trip” investment structure may be difficult to maintain because the offshore SPV may be regarded as a PRC tax resident under Notice 82. As an overriding consideration, Notice 82 laid down the “substance-over-form” principle as the basis for determination of the place of effective management. Notice 82 is among the PRC tax authority’s primary instruments in its effort to tighten control over “round-trip” investments, and may push industrial and PE investors to reconsider the use of the “round-trip investment” model, or utilize other protective strategies in their China-related deals.

With the aim of further standardising the tax administration for the Chinese-capital controlled foreign companies (“CCCFCs”) which obtained Chinese TRE status (known as overseas registered Chinese-capital controlled tax resident, or “deemed overseas TREs” in short), the State Administration of Taxation released the Administrative Measures for Overseas Registered Chinese-capital Controlled TREs (Trial) on July 27, 2011. The Measures, effective from September 1, 2011, cover the major tax matters concerning deemed overseas TREs including application procedures for obtaining TRE status, documentation requirements, CIT treatments, administration and collection matters and application of double tax treaty provisions.

According to the Actual Management Entity Standard (Notice 82)] (promulgated by the State Administration of Taxation, effective April 22, 2009) [hereinafter Tax Notice 82].

214 For example, the determination criteria of Chinese TREs for Chinese-capital controlled foreign companies (“CCCFC”).

215 These conditions include, for example, where senior management are in charge of day-to-day activities and the place for senior management to execute their duties is mainly located in China; strategic management over finance and personnel decisions are made or approved by an establishment or individual in China; the enterprise’s major asset, accounting records, corporate seals and minutes of board of directors and shareholders meetings are located or maintained in China; and at least 50% of the board members with voting rights or senior management habitually reside in China. Notice 82, supra note 213, at art. 2.

216 The latest movement in the PE circle is to set up Renminbi-based funds in China which may help foreign PE investors create more inroads into China. Sundeep Tucker and Jamil Anderlini, *Carlyle to Set Up Renminbi-based Fund in Beijing*, FIN. TIMES (Jan. 13, 2010), http://www.ft.com/intl/cms/s/0/6e5e827e-ffc3-11de-ad8e-00144fca4e0.html.

For the purpose of guiding foreign investors’ mergers and acquisitions of domestic enterprises and safeguarding national security, the General Office of the State Council issued the Notice on Establishment of the Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors (“State Council Circular 6”) on February 3, 2011. The national security regime focuses on foreign investors’ mergers and acquisitions of all types of enterprises such as military industry enterprises and their ancillary enterprises, the enterprises around key and sensitive military facilities and other units which have an impact on national defense security and which may result in foreign investors’ acquisition of actual control over enterprises connected to Chinese national security.

New security review rules from MOFCOM, effective on September 1, 2011, clarify national security review procedures for foreign investments in Chinese companies and bar the use of arcane investment structures or techniques such as “multi-level reinvestment,” “nominee shareholders,” and “control by agreement” to evade China’s security review process. The relevant provision reads:

Whether a merger or acquisition of a domestic enterprise by a foreign investor falls within the scope of merger and acquisition security review shall be determined on the basis of the substance and actual impact of the transaction. No foreign investor shall substantially evade the merger and acquisition security review in any form, including but not limited to proxy, trust, multi-level reinvestment, lease, loan, variable interest entities (agreement-based control) and offshore transaction.

Although the rules are worded in a vague manner for application, they implicitly target the “round-trip investment” model and explicitly leave regulators with more discretionary powers. The term “multi-level reinvest-

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218 Id. at art. 1.
220 Id. at art. 9.
“round-trip investment” is explicitly highlighted as a form used by foreign investors to evade the security review regime. It is clear that the “round-trip investment” model will be deemed as a domestic enterprise actually controlled by a foreign investor and thus will be subject to a security review. Both the State Council Circular and MOFCOM Rules have adopted a clearly restrictive approach to applying the security review rules to foreign investment projects, and signaled the authorities’ intention to place the “round-trip investment” model under deeper and heavier regulatory scrutiny and supervision. Nevertheless, given the vagueness of rules, the exact scope of implementation remains unclear. Most likely, the “round-trip investment” model will be subject to closer scrutiny in future transactions.

A literal reading of the aforementioned rules and interpretations shows it is becoming increasingly difficult, if not entirely impossible, for Chinese residents to take advantage of SPVs to inflow “round-tripping” investments or make public or private offerings in the overseas capital markets. These regulatory changes significantly tighten the regulatory environment for offshore restructurings transactions. The motives of MOFCOM, SAFE, the Taxation Bureau and other authorities appear to include preventing China’s high-quality assets from being listed overseas, to monitor the foreign currency flows and—probably more importantly—to secure domestic listings and tax revenues.

Circular 75 and M&A Rules, together with other regulatory measures, are a revival of previous regulatory attempts to address the disguised FDI in the form of the “round-trip investment” model, either of which causes a huge loss to the national welfare. For instance, businessmen and top corrupt officials may use SPVs to transfer state-owned assets, launder corruption proceeds and avoid tax liabilities, as SPVs are easily packaged as shell companies without any substantial assets. Where the SPVs, trust and


222 Structuring pyramids of shell companies in various tax havens for aggressive tax evasion and avoidance is a common practice. In the context of the financial crisis, this common practice has been severely under attack. For instance, Google’s billions in revenue garnered every year by its sales force in the UK is not subject to local tax because of the technical closure of Google’s Dublin office. Philip Stephens, Why Google and Eric Schmidt Really Don’t Care About Tax, FIN. TIMES (May 29, 2013), http://www.ft.com/intl/cms/s/0/28b783de-c357-11e2-acc6-001446eab7de.html. Amazon, Apple and other multinationals all have elaborate tax avoidance planning by relying on the use of shell companies. Vanessa Holder, Apple Tax Probe Helps Drive to Build Consensus on Global Regime, FIN. TIMES
China’s Extraterritorial Veil-Piercing Attempt
35:469 (2015)

bearer shares are used, the ultimate shareholders of the business may be covered or disguised well through various layers of corporate veils and cannot be easily tracked down. If the “round-trip” investment truly constitutes 25% to 50% of the total FDI into China, it exaggerates China’s foreign exchange reserves. This could increase the political pressure on China to re-evaluate the exchange rate between Renminbi and the US dollar.


221 Empirically, it is very difficult to quantify the amount of “round-trip” investments in a dollar value. See supra note 184 and accompanying text.


225 The Renminbi or Yuan, the Chinese currency, has been a high profile and long-running subject of controversy between China and its trade partners, especially the United States, the European Union and Japan. China has been accused of intentionally manipulating the Renminbi’s exchange rate to the US dollar to gain a competitive advantage and keep its exports artificially cheaper. The under-valued Renminbi, as often asserted, is the key reason for China’s growth in its unparalleled foreign exchange reserves and trade surpluses, as well as for global economic imbalances. As to how much the Renminbi is misaligned, there is substantial disagreement in various research, ranging from 1% to 56% undervaluation. See W.L. Chou & Y.C. Shih, The Equilibrium Exchange Rate of the Chinese Renminbi, 26 J. COMPARATIVE ECON. 165, 174 (1998) (claiming that the Renminbi was about 10% undervalued at the beginning of the 1990s); Fred Bergsten, We Can Fight Fire with Fire on the Renminbi, FIN. TIMES (Oct. 4, 2010), http://www.ft.com/intl/cms/s/0/0070e525c-cf1d-11df-9be2-00144fcaeb49a.html (claiming that the Renminbi is still undervalued by at least 20% after its appreciation from 2005 to date); Morris Goldstein, Adjusting China’s Exchange Rate Policies 15 (Institute for Int’l Econ. Working Paper 04-1, 2004) (arguing that the Renminbi is undervalued by at least 15–25%); Ernest H. Preeg, Exchange Rate Manipulation to Gain an Unfair Competitive Advantage: The Case Against Japan and China in DOLLAR OVERVALUATION AND THE WORLD ECONOMY 267–84 (C. Fred Bergsten & John Williamson eds., 2003) (estimating that the Renminbi exchange rate undervaluation is about 40%). Also, there are proponents against the idea that China should alter its exchange rate. See Ronald McKinnon & Gunther Schnabl, China: A Stabilizing or Deflationary Influence in East Asia? The Problem of Conflicted Virtue (2003), http://web.stanford.edu/group/siepr/cgi-bin/siepr/?q=system/files/shared/pubs/papers/pdf/credpr196.pdf. US lawmakers, led by Senators Charles Schumer and Leslie Graham, threatened to sanction China by imposing a 27.5% tariff on Chinese imports in order to pressure China to raise the value of the Renminbi. See US Lawmakers Turn up Yuan Heat, STANDARD (Hong Kong) (Jun. 13, 2007), http://www.thestandard.com.hk/archive_news_detail.asp?pp_cat=5&art_id=46684&sid=14033609&con _type=1&archive_d_str=20070613. The US House of Representatives passed legislation that would punish China for undervaluing its currency and damaging the competitiveness of US manufacturers and exporters. The US administration, however, preferred to pursue a policy of engagement with China with the view of persuading China to allow the Renminbi to strengthen while enhancing its own negotiating position by mounting congressional pressure. See James Politi, House to Hit Back on Renminbi, FIN. TIMES (Sept. 30, 2010), http://big5.fchinese.com/story/001034887/en/. Meanwhile, the US administration also sought to organize a coalition within the framework of the G20. Alan Beattie, US-China Trade Ties: A Heated Exchange FIN. TIMES (Dec. 5, 2011), http://www.ft.com/intl/cms/s/0/8d773d3c-1c2a-11e1-9631-00144fcaeb0c.html. In October 2011, the U.S. Senate passed a bill that would allow the U.S. to levy retaliatory, across-the-board tariffs on Chinese imports according to estimates of currency misalignment. However, the Republican leaders opposed the move and resisted bringing a similar bill to a vote in the House of Representatives. Alan Beattie, Renminbi’s Threat to Dominant Dollar Grows, FIN. TIMES, Nov. 17, 2011, at 6. The Renminbi appreciated by 2.5% on July 21, 2005, when the Chinese government announced to re-peg Renminbi from the US dollar and allowed it to float within a band. China allowed Renminbi to appreciate to a 19-year high on October 13, 2012, against the US dollar,
An array of rules and circulars from MOFCOM, SAFE and the Taxation Bureau from 2005 to 2012, peaking with the of the State Council’s new national security review regime, are vivid examples of the tension between China’s regulatory concerns addressing high-quality domestic assets being drained overseas and the motivation of foreign investors to “vote with their feet” for an international standard regime in which the transaction can be organized in a highly automated and structured manner. It signals the regulatory body’s intention to, with a “responsive,” or “tit for tat” approach,226 integrate offshore transactions into the Chinese regulatory framework. Cir-

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cicular 698 is unique in the sense that the government substitutes public tax program for regulatory means, and extends its jurisdiction to cross-border commercial activities. In a socioeconomic order, there have been a variety of means to meet social goals or respond to perceived social problems. Each regulatory technique is likely to generate a distinct pattern of gains and losses. Various additional governmental approval requirements and procedural delays may cause a chilling effect on many legitimate transactions that actually sustain FDI flows. The regulatory intervention may ultimately deter FDI activities essential to improving the efficiency of the corporate law regime, which is in line with findings that government programs often hinder rather than help the growth of FDI activities.

A series of regulatory movements have led to a substantial drop of outbound investment to the Cayman Islands and British Virgin Islands, as indicated in Table 3 above. In 2012, outbound investment to the Cayman Islands and British Virgin Islands was only 0.9% and 2.6% of China’s total outbound investment respectively. This again confirms the correlation between regulatory design and economic activities.

Anti-tax avoidance measures can easily provoke controversy for two simple reasons. First, these measures have a tendency to increase the complexity and volume of new tax rules, which increases compliance costs in the corporate sector. Second, there is a natural outcry in the market due to political controversy over the role of the state in shaping public interest. While it can be argued that the regulatory regime generates too few benefits compared to costs, a public tax program may create a direct deterrent effect and have too few beneficiaries except the government itself. The major concern here is that the government, as the sole beneficiary of the public tax program, may have sheltered the tax regime from cost-benefit scrutiny on the grounds that tax is thought to be designed to protect the public more efficaciously.

The deeper concern is related to the relationship between the corporate sector and the government, and the mediating role of the corporate tax code in between. The normative theory is that the public law status of the corporate tax code dictates the complexity and priority of the corporate tax law. Meanwhile, it has been well recognised that the public or national interest in corporate taxation is not necessarily in line with business interests. It is also no surprise to see corporate tax law in some cases fails to respond to the commercial and financial developments sought by society. A sensible regulatory instrument is the one which can align both interests simultane-


228 See generally John Armour & Douglas Cumming, The Legislative Road to Silicon Valley, 58 OXFORD ECON. PAPERS 596 (2006).
ously. This gap needs to be conceptualized in a way that anatomises the nature of the engagement between the corporate (investment) sector and the government. An ideological consensus should be that strong economic growth is a core element of the public (national) interest. The complexity here is that the public interest in China may largely lean towards the state-owned sector rather than the private or foreign-investor sector. In this regard, the shape of the corporate tax base in China is reflective of conscious political choices.229

Although the “round-trip investment” model is unique to China, the establishment of statutes and regulations to prevent abuse of tax treaties and tax havens through the use of cross-border business structures is not. Spearheaded by the world’s largest economies, there is a global trend towards tightening loopholes and sharing information to secure revenue and prevent tax evasion. Although the implications to company law remain of questionable legitimacy, examined within the context of this new global order, Circular 698 appears more reasonable. To offer a greater understanding of the current global regulatory trend, the next section addresses anti-avoidance measures taken in other jurisdictions and the global effort to share information and “crack down” on tax avoidance.

C. Global Emphasis on Increased Tax Revenue and Anti-Avoidance

In the aftermath of the financial crisis, there has been a trend towards governments trying to deal with tax evasion and avoidance so as to collect more taxes.230 Several high-profile cases involving Google and Apple and their tax avoidance planning have not only shone a harsh spotlight on the international tax system but also injected urgency into the global effort to

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229 The tensions between the corporate sector and the government in other advanced economies have been managed in the context of successive administrations whose general ideologies place a high premium on the importance of the corporate sector in promoting the public interest. In this sense, the success of the corporate sector is a critically important component of the national success. HM TREASURY AND HMRC, CORPORATE TAX REFORM: DELIVERING A MORE COMPETITIVE SYSTEM (Nov. 2010), https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/81303/corporate_tax_reform_complete_document.pdf.

230 The latest example is a plan of 11 European countries to impose a financial transaction tax: 0.1% on stocks and bonds and 0.01% for derivatives. The tax is designed to be applied widely in cases where a buyer, seller or issuer is located in a financial transaction tax-levying state. The underlying rationale of imposing this tax is that financial trading is under-taxed relative to the rest of the economy because of the exemption of value-added tax in the financial sector. Imposing financial transaction tax will raise €34 billion per year. Financial Transaction Tax: Don’t Panic, FIN. TIMES (May 23, 2013), http://www.ft.com/intl/cms/s/0/ba8e4232-c79b-11e2-9c52-00144feab7de.html. Opponents, however, claim that the imposition of financial transaction tax would kill financial growth, rob pensioners, impoverish financial institutions, destroy transactional models involving banks, bankers and exchanges, lower investor returns, increase borrowing costs, and worsen the EU debt crisis. Avinash Persaud, Europe Should Embrace a Financial Transaction Tax, FIN. TIMES (May 28, 2013), http://www.ft.com/intl/cms/s/0/ba8e4232-c79b-11e2-9c52-00144feab7de.html.
crack down on aggressive tax avoidance. The Organization for Economic Cooperation and Development ("OECD") has drawn up a plan to reform the global tax rules and identified more than a dozen issues that need reform, which, if adopted, could lead to a drastic change in international tax standards. It has been reported that the OECD is likely to propose changes to “hybrids” or regulatory arbitrage, the structures and instruments that exploit differences between different regimes’ tax codes, and more importantly, to work out a multilateral treaty so as to revise double tax treaties. In this sense, Circular 698 can be viewed as a unilateral regulatory attempt made by the Chinese government in this global reform effort. The scenario Circular 698 is trying to tackle is similar to the paradox the US tax reform is facing. Apple, for example, as reported, has US$102 billion in foreign cash reserves, but the reserves are not subject to US tax unless they are repatriated to the United States.\(^{231}\) In other words, Apple has paid little or no tax for its earnings in the amount of tens of billions of dollars by making use of subsidiaries incorporated in Ireland and Irish tax loopholes.\(^{232}\) Similarly, Apple did not pay UK corporate tax in 2012 even though it has a number of subsidiaries in the UK, which made pre-tax profits of £68 million in the first three quarters of 2012.\(^{233}\) Google, as reported, similarly only paid £ 10.6 million in taxes even though it generated £12 billion in revenues from the UK from 2006 to 2011.\(^{234}\) A US Senate committee in May 2013 highlighted Apple’s overseas tax rate of less than 2%. The loopholes in the US tax law have allowed US multinationals to park nearly US $2 trillion of lightly taxed foreign earnings in tax havens.\(^{235}\) As a result, this has turned out to be a “non-double taxation” scenario, leaving some cross-border commercial transactions and lightly taxed “stateless” income generated out of these transactions ultimately untaxed. The paradox in relation to the US corporate

\(^{231}\) The challenging part of the US corporate tax reform is to tax global companies. US companies are taxed on their foreign profits, with a credit for taxes paid to other governments only when they repatriate these profits. The current tax system can be an additional burden on American multinationals as they suffer losses from bringing money home, but the tax may raise little revenue.

\(^{232}\) James Fontanella-Khan & Jamie Smyth, *Ireland Pledges Cooperation on Global Tax Avoidance Plan*, FIN. TIMES (May 22, 2013), http://www.ft.com/intl/cms/s/0/1acc5b2-c2d5-11e2-9bc8-00144f4eab7de.html. The economic rights to the goods Apple sold were held in Ireland. As reported in 2011, 84% of Apple’s non-US operating income was booked by Apple Sales International, an Irish subsidiary which was not a tax resident anywhere and which only paid tax at a rate of 0.05%. Vanessa Houlder, *Apple Paid No UK Corporation Tax in 2012*, FIN. TIMES (Jun. 30, 2013), http://www.ft.com/intl/cms/s/0/13273fae-e1a3-11e2-95c1-00144f4e-abdc0.html.

\(^{233}\) Tax deduction from share awards to employees helped wipe out the corporation tax liabilities of the UK subsidiaries in the year to September 2012. UK subsidiaries reported tax deductions relating to share scheme of £27.7 million. Vanessa Houlder, *Figures Shed Light on Tax Avoidance Haul*, FIN. TIMES (Apr. 28, 2013), http://www.ft.com/intl/cms/s/0/1960297e-8020-11e2-8d07-00144f4e-abdc0.html.


tax code provides a certain level of legitimacy to the Chinese tax authority’s efforts.

On the other hand, China’s regulatory move to put Circular 698 in place has also highlighted the difficulty of global cooperation on tax reform as the nations’ well-established instinct is to use the tax system to compete. Lighter fiscal regime often attracts tax payers’ reallocation of their tax residency. In reality, it is a trade war by another name—fought with income tax policies rather than tariffs. The best example is probably the UK. While the UK is expressing outrage at Apple and Google for stripping income and potential tax revenue out of the UK, it is simultaneously engaged in “beggar-thy-neighbour” policies by attracting Italy’s Fiat Industrial to move its tax residency to the UK. While some countries have had a long history of having low corporate tax rates, there is a sign that other countries are joining a global race to cut rates. Portugal recently announced plans to lower its 24% corporate tax rate whilst the US government proposed eliminating business tax breaks to reduce the 35% corporate tax rate and the UK government plans to cut the corporate tax rate to 20%, the lowest in the G20. The chief theory underpinning such regulatory competition is a free-rider problem: each state likes others to clamp down on tax avoidance without having to touch its own tax codes and tax regime.

The regulatory moves made by some other developed countries and the underlying regulatory competition theories indeed justify China’s unilateral and expansive regulatory move to catch offshore commercial activities under its realm. More relevant in this case, Circular 698 can be regarded as China’s attempt to strengthen its ability to tax Chinese investors’ profits generated from China-based assets. There is basically a lighter chance to have a more economically neutral and appropriate paradigm while all the countries are competing with each other in this game. As a result, the efforts made so far are to increase the level of transparency, which is used as a powerful weapon against tax avoidance, rather than ratifying the current international tax system. At the global level, the crackdown

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236 Houlder, supra note 233. The underlying reason that the governments in developed economies are forced into austerity regimes is probably because of budget deficits.

237 The key problem of the current international tax system is how the profits of multinational companies are allocated to individual countries. The allocation is usually made on the basis of the location of economic activities or ownership of various assets which are, however, mobile in nature. As a result, some assets can be located in regimes with lower tax rates. The reform of the international tax regime—that is, a set of anti-avoidance rules—is to prevent companies taking undue advantage. Because the less mobile element in business activities is consumers, the government can tax the profits of a multinational company to the extent that it has sales to third parties who reside in the country. Imposing such a tax seems unlikely to induce people in that country to move to a tax haven. Implementing this tax can rely on the “destination principle” (the principle is codified in the value-added tax law). The basic approach is to tax income generated from sales in a particular country and give relief for expenditure incurred in that particular country. This can be achieved by taxing imports. Focusing on the residence of the customer can avoid some complexities involved in the VAT rules. The advantages of this “destination prin-
on tax evasion has been intensified due to the US’s threat to charge a 30% witholding tax on foreign banks that did not divulge US client information under its 2010 Foreign Account Tax Compliance Act (FATCA).\textsuperscript{238} The EU is increasing efforts to clamp down on tax avoidance by wealthy investors such as private equity and hedge funds. The EU’s largest five economies including the UK, France, Germany, Italy and Spain have agreed to share confidential information on individual’s investment income and capital gains and, more substantially, to extend such rules to the rest of EU members.\textsuperscript{239} The EU is to adopt the EU version of FATCA. The G8, for example, is trying to put a country-by-country reporting scheme in place so as to benefit local tax authorities, especially those in developing countries that have limited capacity to collate tax-related information themselves. The G20 has thrown weight behind the automatic exchange of tax information.\textsuperscript{240} Globally, there have been 800 tax information exchange agreements since 2009. However, the effectiveness of these agreements is doubtful as tax evaders are, other than repatriating funds, now shifting deposits to havens not covered by a treaty with their home country. Therefore, a pressing need is an international agreement on how to link tax bases to real economic activity and limit the creation of letterbox subsidiaries whose sole purpose is to locate the most profitable portion of the businesses in low-tax (or no-tax) regimes. This again calls for a much higher level of regulatory harmonisation (compared to somewhat ill-designed double taxation treaties) for a common consolidated corporate tax base.

ciple” are multi-faceted. For instance, transfer prices charged for intra-company trade would not affect the tax base. The location of economic activity would not be affected because tax would not depend on the location or production or other factors. Competitive pressure or motivation to reduce the corporate tax rate to attract economic activity is also weakened. The US is planning to implement such a sales-centered corporate tax—the corporate tax is imposed where sales are generated. Eric Schmidt, \textit{Why We Need to Simplify Our Corporate Tax System}, FIN. TIMES (Jun. 16, 2013), http://www.ft.com/intl/cms/s/0/dfeeceae-d69e-11e2-9214-00144fca55de.html. The other option is a significant increase in corporate tax rates globally but the implementation of this option may result in less innovation, less growth and less job creation.


\textsuperscript{239} The EU tax commissioner is to issue a reform proposal that requires tax authorities to automatically exchange banking details on capital gains, dividends and royalties. Currently, EU agreements on tax sharing have applied to interest on savings and deposits, rather than more complex investment structures. James Fontanella-Khan & Alex Barker, \textit{Brussels Steps Up Efforts Over Tax Avoidance}, FIN. TIMES (May 5, 2013), http://www.ft.com/intl/cms/s/0/c0a8b6a9-b571-11e2-a51b-00144feabdc0.html.

1. European Approach to Cracking Down on Aggressive Tax Planning

Authorities in Europe have been taking increasingly tough stances on tax avoidance and financial secrecy over the past few years, forcing domestic and international investors to change their tax planning strategies. More cases have been reported recently as a result of a clampdown by Italian finance police on tax evasion while the European sovereign debt crisis roiled more countries. The widespread use of holding companies registered in Luxembourg has been a specific target of tax authorities as member states in the EU seek to boost state coffers by returning billions of euros estimated to be held in tax havens.

In one high-profile case, Italian fashion designers Domenico Dolce and Stefano Gabbana received suspended prison sentences of a year and eight months and were fined nearly half a million euros by a court in Milan for evading millions in taxes. Dolce and Gabbana are the owners of a multinational fashion group and sold their brand to Gado, a Luxembourg-based holding company, in 2004 in order to avoid declaring more than €100 million in royalties. Gado subsequently took control of the Italy-based business. Dolce and Gabbana were also fined nearly €500 million, opening up the possibility that the tax policy may allow the government to seize shares in the company and company assets. The prosecutor argued that the designers conducted a “sophisticated tax fraud and set up the Luxembourg holding company specifically to evade taxes.”

The ruling handed down by the court is a clear sign that the Italian tax authorities and judiciary are looking more aggressively than ever at evasive or abusive schemes implemented by Italian companies of all sizes. The case comes at a time that some European companies have sought to set up international structures for legitimate and legal reasons as domestic demand no longer offers growth for their local businesses. These structures, meanwhile, are used as a means of obtaining tax advantages. Nevertheless, in the context of the current financial crisis, these structures may be categorized as abusive tax avoidance schemes. Italian tax police also seized assets owned by Roman jeweler Bulgari and the Marzotto textile dynasty in recent raids on the grounds of tax avoidance.

The UK government also made an announcement in 2013 that it would crack down on aggressive tax planning. This new movement to close tax loopholes has prompted some wealthy individuals and companies to restructure their businesses in a more transparent and holistic manner. Back in 2004, the UK passed the disclosure of tax strategies legislation which

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forced taxpayers to declare any strategy or scheme that bore certain hall-
marks. Governments across the EU and the world are using similar plans to
identify and scrutinize existing tax planning schemes leading more inves-
tors to adopt more straightforward tax planning options since they fear be-
ing seen as an “untapped” resource. The changing regulatory climate is
pushing the wealthiest members of society to pay their “fair share” of tax,
which is also a popular and effective political rallying cry at a time of wide-
spread global austerity measures.

The EU announced plans to tackle the well-known tax avoidance ar-
 rangement so as to ensure a level playing field for “honest” businesses in
the single market. Due to a mismatch between different countries’ tax sys-
tems, companies can minimize their tax liability by using hybrid instru-
ments such as convertible preference shares or profit participating loans,
which may be regarded as equity in some countries but debt in others. Ac-
cording to the EU plan, countries are required to tax payments arriving from
a subsidiary in another member state where such payments had been treated
as a tax-deductible expense.242 Along with this rule, the EU Commission is
to introduce an anti-abuse rule in order to stop companies from setting up
“wholly artificial” intermediary groups to avoid tax. If these rules were put
in place, the benefits would be in the magnitude of billions of Euros. As the
plan needs unanimous consent from all the member states, it may be diffi-
cult to be passed without encountering any resistance. While these initia-
tives may constitute a contribution to the international work on tackling tax
base erosion and profit shifting, they are not immune from controversy for
at least two technical reasons. First, it is debatable whether the hybrid
schemes are abusive or not. Second, the implementation of these initiatives
may lend a competitive advantage to companies based outside the EU or to
private equity funds, which are not affected by these proposed changes. To
step up its probe into alleged illegal tax-avoidance practices, the EU Com-
mission recently expanded the investigation to cover arrangements for pa-
tent-holders by issuing an information injunction against Luxembourg and
ordering it to reveal its specific promises made in the tax rulings between
2011 and 2012 to specific companies.243

Liechtenstein has stepped up its efforts to shed its reputation as one of
the most secretive havens in the world and pressed ahead with automatic
exchange of tax information and promising to sign a global tax agree-

242 Rebecca Christie, EU Seeks to Force Firms to Pay Tax on Hybrid-Loan Payments, BLOOMBERG
pay-tax-on-hybrid-loan-payments.html; Vanessa Houlder, Europe Unveils Crackdown on Cross-border
Tax ‘Hybrid’ Schemes, FIN. TIMES (Nov. 25, 2013) http://www.ft.com/intl/cms/s/0/e45b0dc2-37c7-
11e3-8668-00144fcaeb7de.html.
243 Alex Barker, EU Steps up Probe into Tax Sweeteners for Multinationals, FIN. TIMES, Mar. 25,
2014.
This move is a positive sign of the intensifying global crackdown on tax evasion that is forcing tax havens to open up and deal with their legacy of undeclared assets and develop new business models for their secretive financial sectors. By taking this step, Liechtenstein appeared ready to combine “guaranteed tax compliance with effective tax cooperation and effective, efficient automatic information exchange based on the future OECD standard.” Liechtenstein is to build on an agreement with the UK which took the form of a partial amnesty announced in 2009 to prompt investors to declare their secret accounts. The UK has collected about £600 million from 3,000 individuals who used the Liechtenstein Disclosure Facility. The arrangement posed low penalties to individuals who owned up to undeclared offshore assets, backed up by a promise to close the accounts of customers who could not prove they had paid their taxes in their home country.

2. The United States Approach

The US corporate tax system is not problem-free. First, there is a mishmash of credits and deductions that encourages companies to contort themselves to reduce their tax bill. Second, the tax rates are too high. The statutory rate is 35%, the second highest in the world. This 35% tax rate is also applied to repatriated cash. The US has a higher corporate tax rate than any other leading economy, and imposes severe taxes on income earned outside its borders. This severely affects US-incorporated multinationals’ global competitiveness and discourages the repatriation of profits earned abroad. Third, corporate profits are extraordinarily high relative to gross domestic product but tax collection is low. The US corporate profits peaked at more than US$2 trillion in 2012. However, corporate tax receipts peaked not in 2012 but in 2007. In effect, the tax rate in 2012 was just 16% (aggregated taxes divided by aggregate pre-tax profit), down from 29% in 2000. The challenging part of the corporate tax reform is the taxation of global companies. Currently, US companies are taxed on their foreign profits, with a credit for taxes paid to other governments, only when they repatriate these profits. A rough estimation is that American businesses are holding nearly US$2 trillion in cash abroad. The current system can be a burden on

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244 Vanessa Houlder & James Shotter, Liechtenstein Moves to Shed Reputation as Secretive Tax Haven, FIN. TIMES, Nov. 15, 2013, at 6.
247 Lawrence Summers, Help American Businesses – Tax Their Profits Abroad, FIN. TIMES (July 7, 2013), http://www.ft.com/intl/cms/s/2/b9eaeec4-6e4d5-11e2-875b-00144f5ade00.html. It is reported that
American multinationals as they suffer losses from bringing money home and the tax raises little revenue. From the multinationals’ perspective, there is a strong reason to delay repatriating earnings to the US even though there is no desirability of doing so: keeping money abroad to the detriment of companies and the American fiscals. However, from shareholders’ perspective, the multinationals may have to repatriate money back to the US and may have to pay taxes on their foreign profits. The US Senate Finance Committee unveiled the proposal for a sweeping rewrite of the US tax code. Likely, the US would impose a one-time 20% tax on an estimated US$2 trillion of cash held overseas by American multinationals.\textsuperscript{248}

In a cross-border context, the US tax law also has loopholes. For instance, multinationals with big US operations may take advantage of a so-called tower structure, a hybrid scheme that complies with individual country’s tax laws while exploiting inconsistencies between them, to achieve a double tax deduction. It is a popular alternative to the more widely used strategy of routing inter-company loans through tax havens such as setting up an SPV in a tax haven to lend money to a subsidiary in a higher tax country. The scheme makes use of the 1997 US so-called check-the-box rules that allow companies to elect to disregard a subsidiary by ticking a box on a tax form. The rules, originally designed as a simplification, provided planning opportunities to foreign companies operating in the US as well as US multinationals to cut their tax bills as foreign subsidiaries can disappear into their parent companies for US tax purposes. The best example is FirstGroup’s acquisition of Laidlaw, the US yellow school bus operator. FirstGroup, the UK transport group, financed the acquisition with a US$1.8 billion intra-group loan. Interest on the loan however was paid by FirstGroup US Holdings, a new UK company used as a hybrid entity to own the target company. A check-the-box option for FirstGroup US Holdings means that any transactions would be regarded for US tax purposes as occurring in its parent, FirstGroup US Inc. The US tax authorities view the interest payments as coming from the US parent, resulting in a US tax deduction. The UK tax authorities on the other hand regard the loan as a UK company making a loan to another UK company within the same group. The interest income would be taxable in the UK but the interest paid would be tax deductible in the UK. The net result would be no taxable income in the UK. The overall group benefits as interest income is taxable once but the interest payment is tax deductible twice. The outcome is a cut in the cost

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\textsuperscript{248} James Politi, Democrats Eye Tax on Overseas Profits,\textit{FIN. TIMES}, Nov. 20, 2013, at 1 (also saying that the changes to the international tax system would be paired with the elimination of some domestic corporate tax breaks and a reduction in the overall US corporate tax rate to between 25% and 30%).
of corporate financing.\textsuperscript{249} The other way of phrasing the overall result is a double tax deduction in both the UK and the US, which is offset by a single UK tax payment on the interest received.\textsuperscript{250}

The United States, under the Obama administration, has taken a leading role in pushing for global tax reform and the sharing of information, but the majority of US efforts have focused on ensuring the US tax base from citizens and American business entities. In addition to cracking down on tax avoidance, the government sought increased income through rules unfavorable to tax payers. In 2010, the economic substance doctrine was codified with a two-part conjunctive test—the least favorable approach for tax payers. Additionally, the tax code was modified to require US citizens abroad to pay US income tax regardless of the income source (including Americans living and working abroad)\textsuperscript{251}—a move that results in double taxation or tax avoidance behaviors by US citizens. This makes the US the only country in the OECD that taxes its citizens without regard to residence.\textsuperscript{252} The new rules led to a record number of Americans, many of them millionaires living abroad, renouncing their citizenship in 2011. That year, 1,788 Americans renounced their citizenship, more than the previous three years combined.\textsuperscript{253} For the remaining Americans, the US government has a large financial incentive to receive income information and crack down on tax avoidance.

In perhaps the largest global tax avoidance effort initiated to date, the United States passed the Foreign Account Tax Compliance Act ("FATCA").\textsuperscript{254} FATCA applies worldwide to every financial firm that receives payments from the US sources, requiring disclosure from financial firms where accounts were maintained by US taxpayers to individuals or companies where a US person owned more than a 10\% interest in the firm. Much like Circular 698, FATCA has an extraterritorial effect with a primary goal of protecting domestic tax revenue. The Act uses a two-pronged approach\textsuperscript{255} requiring US citizens and permanent residents (Green card holders) to report their accounts held outside the United States and requires

\begin{itemize}
\item Similar results can be achieved in other countries by using partnerships or by using hybrid instruments such as preference shares, which are regarded as debt in one country but equity in the other.
\item Id.
\item The FATCA is a part of the Hiring Incentives to Restore Employment (HIRE) Act and created 26 USC §§ 1471–1474 and 26 USC § 6038D.
\item FATCA also closed a tax loophole that allowed taxpayers to circumvent taxes of US dividends by utilizing swap contracts.
\end{itemize}
foreign financial institutions to provide the IRS with information on American clients.\textsuperscript{256}

As with any tax provision designed to have an extraterritorial effect, the fundamental difficulty is enforcement in foreign jurisdictions. To this end, FATCA compels financial firms to disclose information on US taxpayers to the US government and requires US financial institutions and their agents to withhold 30\% on certain payments to foreign financial institutions that fail to meet the FATCA requirements and report required information.\textsuperscript{257} In this way, foreign financial intuitions are forced to either comply with the statute or cease doing business with American clients. This is in stark contrast to Circular 698 which fails to motivate foreign entities to disclose information to the Chinese tax authority—an omission that makes Circular 698 greatly ineffective. It appears that Circular 698 reporting is undertaken on a voluntary and self-reporting basis. The enforcement of Circular 698 largely depends on how actively the local tax bureaus would seek to strictly enforce Circular 698. Also borrowing from the US approach, China could seek agreements with individual governments for the disclosure of financial information used to determine tax payments. In order to facilitate compliance with FATCA and collect information on accounts held by American’s and their businesses, the US government entered into agreements with individual nations and the US Department of the Treasury created model FATCA agreements.\textsuperscript{258} The need for agreements is not


merely a result of the need for foreign cooperation, but the fact that compliance with FATCA may be illegal in foreign jurisdictions. The deputy director general of legal affairs at the People’s Bank of China said FATCA “creates unreasonable costs for foreign financial institutions and directly contravenes many countries’ privacy and data protection laws.”²⁵⁹ He further elaborated that “China’s banking and tax laws and regulations do not allow Chinese financial institutions to comply with FATCA directly.”²⁶⁰ Currently, at least nine countries have entered into FATCA agreements with the United States.²⁶¹ With the exception of Mexico, a nation that is still a member of the G20 and greatly reliant upon the United States for trade, the countries entering into FATCA agreements with the US are developed nations—many with high tax rates. Therefore, most of these countries do not benefit from US investors using their locations, tax codes, tax shelters or hiding assets within their jurisdictions. The inability of the US to gain the cooperation of tax haven jurisdictions highlights the difficulty China will have in collecting data from these tax havens to determine when a sale has taken place and enlisting the support of those nations in enforcing judgments against the selling party who may no longer hold assets within China.

However, it must be pointed out that FATCA will have a significant impact on China. Cayman Islands has already concluded an agreement with the US Treasury while the British Virgin Islands and the US have been in talks to create an intergovernmental agreement to exchange information on US taxpayers under FATCA. These moves put more pressure onto Hong Kong to comply with FATCA in order to maintain its competitive edge. Signing a similar pact would be a brand-enhancing move for China to attract more capital inflows. The pressure on financial firms in China to comply with FATCA stems from the fact that other financial firms would be loath to do business with a non-compliant firm and customers would shun non-compliant financial firms due to the withholding tax.

The economic substance doctrine is arguably the primary tax avoidance doctrine in the United States, as was codified in 2010.²⁶² Although the doctrine does not specifically target extraterritorial efforts at tax avoidance, it may be applicable and demonstrates the government’s devotion to in-

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²⁶⁰ Id.
²⁶¹ The nine countries include Denmark, Germany, Ireland, Mexico, Norway, Spain, the United Kingdom, Japan, and Switzerland. See Resource Center: FATCA-Archive, U.S. Department of the Treasury, http://www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA-Archive.aspx (last visited Sep. 18, 2013).
²⁶² 26 USC §7701(o) (clarifying of Economic Substance Doctrine).
creasing tax revenues, even through legislation extremely unfavorable to taxpayers. The philosophy behind the doctrine is similar to the business purpose doctrine in that the economic substance doctrine seeks to prevent tax benefits resulting from business transactions motivated purely by tax savings. In determining the existence of an economic benefit, the code employs a two-part conjunctive test requiring “the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer’s economic position, and the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.”263 Prior to codification, various courts used the conjunctive test while others utilized a disjunctive test, requiring the taxpayer to meet one of the two elements.264 The codification is significantly less taxpayer friendly than the disjunctive test and is therefore less evenhanded than the Ramsay principle.

In addition to its domestic efforts and extraterritorial efforts against US citizens, the US has been a leader in the global effort against tax evasion. The next subsection addresses the international efforts for global tax reform.

3. The G8, G20 and OECD – Global Tax Reform

Tax reform is not limited to domestic changes in Europe and the United States. British Prime Minister, David Cameron, introduced a 10 point plan aimed at combating tax evasion during the G8 summit June 17–18, 2013, hosted by the United Kingdom after a wave of public anger over the low tax bills paid by some large multinationals. Alongside advancing trade, the UK government listed ensuring tax compliance and promoting greater transparency (an important issue in monitoring attempts to evade taxes) as the objectives of the summit.265 Although the goals of the G8 summit demonstrate a commitment on the part of the world’s most developed countries to combat tax evasion, the proposals of the Cameron administration were too ambitious and failed to result in an agreement.266 The proposals included making beneficial ownership267 information from businesses’ registries public and sharing tax information with other nations, with develop-

264 LAMPREAVE, supra note 112.
266 Elliot, supra note 265.
267 The term “beneficial owner” refers to the party with primary control and ownership rights. Reporting beneficial owners is important in combating tax evasion to prevent the nomination of “straw men” as owners and directors in order to avoid monitoring by tax authorities, or in the case of terrorist activities, police and intelligence agencies.
ing countries being of particular concern. However, unlike China, where the sole purpose of Circular 698 is to collect tax revenue, the motivation behind the UK’s proposal includes preventing money laundering by terrorist organizations.

The recent G20 Summit hosted in Saint Petersburg by the Russian Federation was intended to focus on growth, but tax quickly dominated the agenda. The G20 member nations endorsed the creation of a global tax standard that provides for the automatic exchange of tax information by the end of 2015. This plan was originally proposed by the OECD, which is working with G20 member countries to develop the standard of automatic exchange of tax information. This effort is the culmination of several years of discussion. In 2011, G20 countries discussed the voluntary exchange of information for tax reasons. In 2012, the OECD presented a report on exchanging tax information and urged countries to share information, and the current summit begins the more comprehensive scheme of automatic information sharing. Among others, hybrid structures are on the list of loopholes to be closed in the crackdown launched in 2013 by the G20.

The OECD unveiled an action plan in July 2013 tackling tax evasion by multinationals. The plan aligns tax in a location with the economic activity in that location, preventing the artificial shifting of multinationals’ reported business to low-tax or no-tax jurisdictions like Cayman Islands, Bermuda and the British Virgin Islands. According to OECD’s plan, tax havens are required to disclose in a more transparent way the tax information of multinationals to the governments that taxed them. Other measures include neutralizing the various methods multinationals use to minimize their tax by “transfer pricing,” which is booking their profits among different tax jurisdictions. The OECD has put in place a Multilateral Convention on Mutual Administrative Assistance in Tax Matters which includes the new standard on automatic exchange of information. G20 nations are expected to be part of the initiative. China has incentives to joint this global framework so as to increase its right to tax, including by neutralizing

268 Id.; See also G8 Factsheet: Tax, GOV.UK, https://www.gov.uk/government/publications/g8-factsheet-tax/g8-factsheet-tax#g8-action (last visited Sept. 16, 2013).
269 See Russia in G20: Priorities of Russia’s G20 Presidency in 2013, THE GROUP OF 20, http://www.g20.org/docs/g20_russia/priorities.html (last visited Sept. 14, 2013). Russia set eight issues on the G20 Summit agenda, of the eight only two had a loose connection with tax—international financial architecture reform and strengthening financial regulation. The other issues focused on corruption, growth, and sustainability.
271 Id.
272 Id.
273 Id.
274 Houlder, supra note 250.
some of the tax channeled through Hong Kong where there is no real business activity, given the fact that China has a huge amount of capital outflows through tax havens. Being a capital exporting country, China has legitimate reason to be concerned about tax evasion in tax havens. In this sense, the business order created by Circular 698 is essentially part of the global initiative the world community is in a great attempt to achieve.

An update from the OECD is scheduled for the October Finance Ministers’ meeting of the G20 and the goal is to complete the framework by 2014, after which it is scheduled to be presented at the Finance Ministers and Central Bank Governors’ meeting in February 2014. An action plan on tackling tax base erosion and profit shifting is tabled to the G20 by the OECD. The OECD’s plan works on the most contentious issues including tax treatment on digital businesses and transfer pricing.

In addition to concerns over tax evasion, the G20 addressed the issues of tax avoidance through the use of shifting profits to low tax jurisdictions. The use of these “very low” or “double non-taxation” practices “undermine the fairness and integrity” of the tax system. The leaders did not come to a specific agreement addressing how to prevent the abuse of tax planning by multinational enterprises. However, implementation of tax rules and punishment for violations take place at the national level. Therefore, the automatic sharing of information will provide an opportunity for individual nations to punish individuals and entities seeking to avoid their tax obligations, but will not ensure even-handed enforcement between jurisdictions. In order to prevent companies from taking advantage of different disclosure requirements, a common template is to be created to require companies to report their global profit allocation and tax payments.

The Tax Annex to the 2013 Declaration does state that profits should be taxed “where economic activities occur and value is created.” In essence, this principle supports the Chinese tax authority’s reasoning in promulgating Circular 698. If the financial gain realized by the sale of a foreign company is attributable to the success of an enterprise or appreciation of an asset located in China, then China is arguably “where economic activities occur and value is created.” China’s Circular 698 can be better understood in the context of this evolving global tax reform.

A simple comparison shows that taxing indirect offshore disposal is still, in a global context, a novel regulatory innovation with few countries having introduced such rules or taxing approaches to date. This innova-

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275 Id.
277 Tax Annex to the Saint Petersburg G20 Leaders Declaration, supra note 270.
278 India is another country which has aggressively tightened its regulatory arms over cross-border transactions. India threatened to levy a charge and bring Nokia’s total liability to about US$1.1 billion. This may bar Nokia from transferring its Indian assets to Microsoft as part of the group’s €5.4 billion
tive and far-reaching regulatory approach, however, easily becomes a hot-button issue in cross-border mergers and acquisitions involving China elements. Difficulties can easily arise for strategic investment by multinationals. It is also unclear how Circular 698 interacts with China’s network of tax treaties, which may complicate the availability of tax credits and relief under both China’s tax treaties and domestic tax laws.

CONCLUSION

“Denying the existence of the offshore holding company” in Circular 698 constitutes a new regulatory tool for lifting the corporate veil. When the ultimate foreign shareholder indirectly transfers the equity of the Chinese resident enterprise through the transfer of equity in the offshore holding company, the Chinese tax authority may “lift” (or “ignore”) the existence of the offshore holding company as a separate legal person according to Circular 698 and regard the transaction as the foreign shareholder’s direct transfer of equity in the Chinese resident enterprise so that enterprise income tax is levied on the corporate capital gain. However, it must be pointed out that the State Administration of Taxation has no legislative power to interpret or create new rules outside of the existing veil-piercing regime provided for in China’s Company Law. Thus, the Chinese tax authority’s regulatory attempt in this regard is seemingly unlawful.

Meanwhile, it must be recognized that there is a rationality attached to Circular 698 and the underlying justification lies in the tax authority’s attempt to regulate increasingly popular “round-tripping” investments, which are adversely affecting China’s tax base. As a practical matter, while tax planning strategies that exploit loopholes are mostly legal, these strategies constitute a major risk to tax revenues, tax sovereignty and tax fairness. For years, multinationals have routed profits through low tax regimes and used other techniques to minimize their tax bills. Against this background, Circular 698 makes sense in the local context as well as given various Chinese authorities’ recent regulatory moves to tighten up the regulatory space around the “round-trip investment” model. Within this framework, Circular 698 can be viewed as a move in line with the Ramsay principle developed from English common law, a reformation of the traditional lifting circumstance of “avoiding the legal obligations.”

With generally and vaguely termed provisions in Circular 698, the Chinese tax authority enjoys unlimited discretion. Further, the Chinese tax authority takes “no employee, no other assets and debts, no other investments and no other businesses” as the criteria to characterize the offshore

phone business sale. Nokia had other tax disputes with India’s revenue department concerning a US$375 million payments made by its Indian subsidiary to its parent in Finland. James Crabtree & Richard Milne, Nokia Tax Dispute in Danger of Escalating, FIN. TIMES, Dec. 12, 2013, at 14.
holding company as a façade without any reasonable commercial purposes. While Circular 698 may be of use to further clarify or apply the veil-piercing doctrine under Chinese law, it may be more constructive if the Chinese tax authority, by utilizing the Ramsey principle, applies the Circular only in circumstances where (i) the foreign investors (i.e., ultimate shareholders) planned to indirectly transfer equity of the Chinese resident enterprise when setting up the offshore holding company and the plan will be implemented inevitably, and (ii) the formation of the offshore holding company has no other reasonable commercial purposes except avoiding tax liability. In these cases, the Ramsay principle can be applied to deny the separate legal personality status of the offshore holding company. However, if the offshore holding company is set up after the two parties of the acquisition deal have materialized their intention to transfer equity (unless the parties succeed in proving a reasonable commercial purpose), then the formation of the offshore holding company may justify veil piercing by the tax authority and accordingly a tax liability can be imposed on the offshore controlling party.

The norm of income taxation, that is, the principle of equal taxation of all varieties of income from all sources, has been under attack in the recent financial crisis. In advanced economies, tax revenues have lagged behind the demands on public expenditure, which resulted in higher levels of public debt. Governments are in a transitional period of reforming not only welfare programs, but also taxation programs to meet new challenges. The increased global interconnectedness has made it more difficult for governments to effectively govern cross-border commercial transactions and activities. For example, the wide use of “offshore” vehicles and tax havens, while enabling investors to exploit aggressive tax planning, has increased the complexity and difficulty in governance. China suffered lost tax revenues and a distorted financial system from capital flight, which is facilitated and encouraged by the offshore system. The existence and availability of offshore systems made it extremely difficult for China, as well as other countries, to tax the passive investment income of their own residents. While the Chinese government continues to offer tax incentives to attract foreign investment, it is also under increased pressure to fill in regulatory loopholes so as to not only minimize the distortive effects on capital allocation through the offshore system, but also make the entire regulatory regime effective and functioning.

The effects of tax planning of multinationals are a major source of public concern. The efforts to reform the international tax system, especially to deal with the problems of tax havens and capital flight, have been given a new impetus in the aftermath of the latest financial crisis. These issues have been taken up by the G8 and G20, and some multilateral initiatives to deal with a global systemic system have also been taken up by the OECD, the EU, G8 and G20. Nevertheless, the original plan to have a clear com-
mon transparency standard embodied in a multilateral treaty for secrecy information exchange lost its way. As a result, the current status goes back to individual states which are supposed to negotiate bilateral tax information exchange agreements. Against this background, it is not surprising to see China, among others, take some self-standing initiatives for its own interests, one of which was the adoption of Circular 698. This individual-state approach (opposite to a system-wide perspective), however, is difficult to administer and the lack of clear guidelines could have a negative impact on investment decisions. There is a clear need for a more comprehensive system for global cooperation even though the existing international taxation system leaves legitimization of taxation to each state, creating a competitive tension between states.

China is currently facing a variety of structural challenges and shifts. Among others, the most fundamental challenge is to have a functioning and modern legal infrastructure. Apart from the judiciary, an effective regulatory regime, including regulatory tools, instruments, ideology and methodologies, is key for China’s long-term growth. China’s economy is far more complicated than it was previously. It is also, so far as it draws in questions of legislative simplicity and administrative efficacy, relevant to the concerns about complexity, instability and the rule of law. The crux of the issue here is that any reform to the corporate tax system should represent a pattern of values and a harnessing of public law, molding the relations between the corporate sector and the state so as to promote a specific ideological view of the public interest. Part of the corporate tax regulatory scheme, Circular 698 could also be seen in legal terms as a form of public law due to its extensive involvement in spheres of public life.279 Accordingly, any reform to the corporation (tax) code needs to reflect a consensus around the imperative of economic growth, around the importance of fairness, and in the tax regulation’s shifting nature and constant change, a series of more or less prudential responses to the contingencies of a changing business sector. Consequently, the tax reform should return to the rule of law, i.e., reducing its complexity and ambiguity, keeping the rules as stable and comprehensive as possible and assessing more accurately the costs that businesses will have to bear for compliance, all of which reflect the conventional normativist concerns with public law280 (arguably including corporate law). All these concerns can be and should be accommodated within a neoliberal ideological framework with a prioritization of rule of law in corporate tax code reform. The reform of the corporate tax code should also be driven by commercial factors rather than by pure tax considerations.

280 Id. at 129.