

ELIMINATING PRIVILEGES ENJOYED BY FOREIGN INVESTORS IN CHINA: RATIONALITY AND RAMIFICATIONS UNDER A UNIFIED TAX CODE

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[The enterprise income tax law in China has for a long time been characterized by the co-existence of two tax codes applied to foreign investment enterprises and indigenous enterprises respectively. Tax privileges granted to foreign investors give rise to the inequality of tax treatment among enterprises in the country. Under the newly released Enterprise Income Tax Law, a unified tax code is to be applied to all enterprises alike, and tax impetus is no longer reserved for foreign investors. This is a move towards developing a platform on which all enterprises in China can compete equally in terms of taxation. A way forward is contemplated over integrating current laws on foreign investment enterprises into the general domain of the commercial law regime, in order that those mutually exclusive legal regulations presently applied to foreign investment enterprises and their local counterparts can eventually be unified in the same way as in the field of taxation.]

I INTRODUCTION

In Paul Samuelson and William Nordhaus's *Economics*, taxation is categorized as one of the "instruments or tools that government uses to influence private economic activities".¹ While this description purports to

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¹ Paul Samuelson and William Nordhaus, *Economics* (2005) 319.

manifest the role that the government plays in a matured economy,² the proactive steering of tax rules and policies is more likely to be employed by the government in an emerging market. The tax regime in a country will significantly impact on foreign enterprises doing business there, especially when foreign investors are exclusively provided with various tax incentives, in contrast to the situation of their local counterparts that are not entitled to such privilege. In today's context of globalization, foreign investment transactions may to some extent play a highly important role in facilitating the economic growth worldwide and are used by many multinational companies as a preamble of having their presence further rooted in overseas markets.³ In order to expeditiously absorb foreign capital as far as they could, many host countries make an attempt to compete for providing foreign investors with generous tax impetus.⁴ In response to such competition, foreign capital will tend to funnel into those places where the available tax incentives look comparatively more attractive.⁵

A foreign investor normally operates in China through the vehicle of a foreign investment enterprise (hereinafter referred to as 'FIE'). The uniqueness of China's tax regime, in one distinctive aspect, lies in the existence of a favourable enterprise income tax code tailor-made for FIEs. Maintaining such a dual-track taxation system is attributable to China's early endeavours of carrying out its reform and open-door policy as of the late 1970s.⁶ The rationale behind this system does not make sense without apprehending in the first instance the form and essence of foreign investment enterprise laws. These laws started to sprout in the late 1970s and flourished in the 1980s, occupying an irreplaceable special position in contemporary Chinese jurisprudence.⁷ The creation of foreign investment enterprise laws

² See *id.* at 318-9.

³ See generally, Jonathan Perraton, 'The scope and implications of globalisation, in Jonathan Michie (ed), *The Handbook of Globalisation* (2003) 47-9.

⁴ See Gerald Epstein, 'The role and control of multinational corporations in the world economy', in Michie, *ibid.* at 158-9.

⁵ See generally, Jacques Morisset and Nedra Pirnia, 'The impact of tax policy and incentives on FDI', in Bijit Bora (ed), *Foreign Direct Investment: Research issues* (2002) 283-4.

⁶ See Yadong Luo, *International Investment Strategies in the People's Republic of China* (1998) 5-7; Kui-Wai Li, 'The Changing Economic Environment in the People's Republic of China', in Oliver H.M. Yau and Henry C. Steele (eds), *China Business: Challenges in the 21st Century* (2000) 65.

⁷ Foreign investment enterprise laws are composed of legal regulations and administrative mandates in connection with FIEs' operation in China, including those with regard to the issues of taxation. See Pitman Potter, *The Chinese Legal System:*

serves the purpose of administering FIEs. In effect, the substance of those laws bears a strong policy distinction from the perspective of attracting foreign investment while at the same time maintaining certain control upon its operation. The regime of foreign investment enterprise laws never ceases its continuous development and further upgrading. The income tax code governing FIEs is a key element in such a regime. Various incentives including tax reduction and exemption are provided to FIEs as prescribed in the laws,⁸ thus forming the basis for further construing and interpreting tax privileges enjoyed by FIEs.

The tax code applied to domestic enterprises (i.e. to the enterprises locally capitalized having no stake-holding interest from overseas) is embodied in a set of interim rules released in 1993.⁹ Its promulgation is not as early as that of the tax code applied to FIEs, i.e. the income tax law issued in 1991 governing FIEs and overseas enterprises,¹⁰ It was followed by the release in the same year of its detailed implementation rules.¹¹ These two tax codes (i.e.

Globalization and local legal culture (2001) 116-7. FIEs can be encapsulated into three types, Chinese-foreign equity joint venture (EJV), Chinese-foreign cooperative joint venture (CJV), and wholly foreign-owned enterprise (WFOE). Various laws and implementation rules have been formulated applied to EJVs, CJVs and WFOEs respectively, e.g. EJV Law of 1979 and its implementation rules of 1983, CJV Law of 1988, WFOE Law of 1986 and its implementation rules of 1990. See generally, Guiguo Wang, *Wang's Business Law of China* (2003) 198-247.

⁸ See generally, Yi Li, 'China (in Part C - Legal and Financial Framework of Promoting FDI in Capital-Importing and Capital-Exporting Countries)', in Daniel Bradlow and Alfred Escher (eds), *Legal Aspects of Foreign Direct Investment* (1999) 292-7; Guanxi Zheng, *Investing in China: Structures & Strategies* (2001) 198-209.

⁹ This set of interim rules is entitled as 'Enterprise Income Tax Interim Rules of the People's Republic of China' (hereinafter referred to as 'Domestic Enterprise Tax Law'). The term 'domestic enterprise' is of no precision but for the purpose of differentiation only. In theory, a FIE upon incorporation in China becomes a domestic entity also. Domestic Enterprise Tax Law (in Chinese and English) can be seen in Howard Gensler, Jiliang Yang and Yongfu Li, *A Guide to China's Tax and Business Laws* (1998) 103-7.

¹⁰ This tax code is entitled as 'Income Tax Law for Foreign Investment Enterprises and Enterprises from Overseas in the People's Republic of China' (hereinafter referred to as 'FIE Tax Law'). FIE Tax Law (in Chinese and English) can be seen in Gensler, Yang and Li, *ibid.* 63-70.

¹¹ The implementation rules are entitled as 'Detailed Implementation Rules of Income Tax Law for Foreign Investment Enterprises and Enterprises from Overseas in the People's Republic of China' (hereinafter referred to as 'Implementation Rules of FIE Tax Law'). Implementation Rules of FIE Tax Law (in Chinese and English) can be seen in Gensler, Yang and Li, *ibid.* at 71-102.

Domestic Enterprise Tax Law and FIE Tax Law) both have their income tax rate fixed at 33 percent.¹² However, this 33 percent rate is more of the nominal nature and seldom imposed on FIEs which may easily take advantage of their entitlement to various reduced tax rates and tax exemption under the prescribed circumstances as set forth in FIE Tax Law and Implementation Rules of FIE Tax Law.¹³

Whether tax impetus of such kind contravenes the national treatment principle in a general sense may deserve further discussion,¹⁴ China's accession into the World Trade Organisation (WTO)¹⁵ no doubt provides an opportunity to review the necessity and rationality of concurrently maintaining two tax codes which results in inequality in tax treatment among enterprises. Fulfilment of international commitments as a WTO member calls for development in China of a sound legal system which operates under the spirit of the rule of law adhering to the core values of equality, fairness, and transparency.¹⁶ Eliminating tax privileges enjoyed by foreign investors can be

¹² Domestic Enterprise Tax Law, article 3; FIE Tax Law, article 5. Under article 5 of FIE Tax Law, the 33 percent tax rate is an aggregate of a 30 percent rate at the national level plus a 3 percent rate at the local level. In light of article 9 of FIE Tax Law, the government in a lower-level, local jurisdiction may at their discretion exempt or reduce the local tax according to the circumstances. But no provision is found as to under what circumstances such discretion can be exercised.

¹³ See Wang, *supra* note 7, at 628. See also OECD, *OECD Investment Policy Review – China: Progress and Reform Challenges* (2003) 175-7.

¹⁴ It appears that the focus of the national treatment principle is on protecting foreign investors. Whether it is reciprocally against encouragement of foreign investment by favouritism is worth further discussion. See Alfred Escher, 'Foreign Direct Investment (FDI)', in Daniel Bradlow and Alfred Escher (eds), *Legal Aspects of Foreign Direct Investment* (1999) 60-1.

¹⁵ China's acquisition of a WTO membership in 2001 is an overdue outcome after the tug-of-war negotiations with major global partners for fifteen years. John Jackson, 'The impact of China's accession on the WTO', in Deborah Cass, Brett Williams and George Barker (eds), *China and the World Trading System: Entering the New Millennium* (2003) 19.

¹⁶ For seeking compliance with the WTO principles, the promulgation, revision and annulment of relevant laws and regulations have formed a theme of the legal reform in China over the recent years. See generally, Berry Hsu and Douglas Arner, 'WTO Accession, Financial Reform and the Rule of Law in China', *The China Review*, Vol. 7, No. 1 (2007) 64-70; Ming Shang, 'Enhancing Rules, Structuring Chinese Commercial Legal System in a New Era', *China Law*, No. 52 (2005) 58-61; Xin Li, 'Commitments to WTO honoured by China over past 4 years', *China Economic News*, No. 1 (2006) 7; Becky Lai, Jeremy Ngai and Susan Ju, 'The Impact of China's

perceived as a move in such a direction. And this is represented by the passage of Enterprise Income Tax Law in the legislature in March 2007, giving birth to a unified tax code that will be applied to all enterprises in China as of 2008.¹⁷

While the arrival of Enterprise Income Tax Law heralds the phase-out of foreign investors' advantageous position in taxation and the gradual building-up of a level playing field as regards tax burdens among enterprises, the legislative process of this new tax code was not a smooth one.¹⁸ Those in favour of unifying two tax codes emphasize the importance of pursuing the value of equality and believe that the practice of indiscriminate admission of overseas capital is no longer needed as it is not in conformity with China's current economic strength.¹⁹ Views to the contrary raise the concern that scrapping tax incentives enjoyed by FIEs will result in China's waning attractiveness for foreign investment, which in certain respects is to expel foreign capital from the country.²⁰ In the context of not rescinding the policy of encouraging foreign investment, any significant scale-down of foreign capital inflows will not be a benign phenomenon.²¹

This article attempts to analyse the rationality of legislating Enterprise Income Tax Law as a unified tax code aimed at constructing a level playing field for all enterprises. It also discusses the ramifications of the Enterprise

Accession to the WTO', *Asia-Pacific Journal of Taxation*, Vol. 6, No.3 (2002) 37-40.

¹⁷ See Li Li, 'Milestones Mark New Direction', *Beijing Review*, Vol. 50, No. 12 (2007) 22-4. Enterprise Income Tax Law (in Chinese) can be seen at <<http://www.chinanews.com.cn/cj/news/2007/03-19/894489.shtml>> at 19 March 2007.

¹⁸ Ascribable to the contested opinions, the legislative proposal of the new tax code had been set aside for six times. See Zhe Zhu, 'Unified 25 percent corporate tax proposed', *China Daily (Hong Kong Edition)*, 25 December 2006 1; Ping Liu, 'Merger of income tax for Chinese and foreign enterprises to be postponed', *China Economic News*, No. 11 (2006) 4.

¹⁹ They call for a new growth mode orientated towards enhancing quality and technology in the context of rational industry layouts, other than purely relying on capital investment. *Ibid.*

²⁰ Some hold the view that China is still a developing country, so continuing a favourable foreign investment policy is necessary. *Ibid.*

²¹ See Daniel Ho, 'Tax Law in Modern China: Evolution, Framework and Administration', *Hong Kong Law Journal*, Vol. 31: Part 1 (2001) 159. This could be true for the sake of maintaining implementation of a stable and consistent foreign investment policy in China. See also Jinping Zhao, 'Large Inflows of Foreign Capital: Menace or Benefit' (in Chinese), *Outlook Weekly*, Issue 14 (2005) 13-5.

Income Tax Law by focusing on how the emergence of this new tax code may prophesy the destiny of foreign investment enterprise laws and the general direction of future development for China's commercial law regime.

II ELIMINATION OF TAX PRIVILEGES – A RATIONAL MOVE?

Foreign investors' entitlement to tax privileges may to a large extent absolve FIEs from the ordinary tax burdens. This raises the concern of a widespread bias in tax treatment against indigenous enterprises. Although with the arrival of the Enterprise Income Tax Law tax incentives enjoyed by FIEs are being eliminated, the opposing voice against unifying two tax codes in parallel does not discontinue over the rationality of making such a move.

A *Tax incentives enjoyed by FIEs*

Preferential tax treatment is evinced as a theme in the tax code governing FIEs. Provision of tax incentives is determined by the factors with respect to establishing FIEs in the particularized geographical locations and those FIEs' involvement in the specific industries.

Historically, China's implementation of its foreign investment policy commenced from the experiment carried out firstly in a couple of specific places.²² The design and formation of tax impetus paced the designation and birth of a number of special places in the coastal regions. The establishment of Special Economic Zones in the 1980s could be deemed as one of the open-up efforts initiated.²³ FIEs located in Special Economic Zones are entitled to the income tax rate of 15 percent,²⁴ substantially lower than the normal rate of 33 percent.²⁵

²² See generally, Wang, *supra* note 7, at 681-96.

²³ Four places were designated in 1980 as Special Economic Zones, relating to three cities in Guangdong Province (i.e. Shenzhen, Shantou, and Zhuhai) near Hong Kong, and one city (i.e. Xiamen) within an easy reach of Taiwan; Hainan Island was designated as the fifth Special Economic Zone in 1988. See Implementation Rules of FIE Tax Law, article 69; Donald Lewis (ed), *China Investment Manual* (Hong Kong: Asia Law & Practice Publishing Ltd, 1998), 708 and 711.

²⁴ FIE Tax Law, article 7.

²⁵ See *supra* note 12.

The emergence of Coastal Economic Zones in the mid 1980s could be seen as pioneering the establishment of some export processing zones.²⁶ The development of Coastal Economic Zones was followed by the set-up of Economic and Technological Development Zones, which were originally within the realm of Coastal Economic Zones aimed at sharing the privileges but eventually became separated from Coastal Economic Zones as independent entities.²⁷ In both the Coastal Economic Zones and Economic and Technological Development Zones, FIEs are subject to the income tax rate of 24 percent.²⁸

In 1990, Pudong, an offshore extended arm of the city of Shanghai, was designated as a leading special place of this kind.²⁹ FIEs established in Pudong are subject to the income tax rate of 15 percent.³⁰

Commencing from the 21st century, the country's focus on attracting foreign investment has largely been shifted to the Western Areas.³¹ This is in response to the flourishing coastal regions after many years' open-up, and to the consequently widening disparity between those affluent places and the less developed Western Areas. In the Western Areas, FIEs are entitled to the income tax rate of 15 percent for the period from 2001 to 2010 given that they are engaged in the specific industries encouraged by the government.³²

²⁶ The initial Coastal Economic Zones were designated in 1984, relating to fourteen coastal cities along the Yangtze River Delta, the Pearl River Delta and in Fujian Province; more such designation appeared after the Liaodong Peninsula, the Shandong Peninsula, the Yangtze River Delta, the Pearl River Delta and the Triangle Areas in Fujian Province (Xiamen, Zhangzhou and Quanzhou) were named as Coastal Economic Zones in the late 1980s. See Implementation Rules of FIE Tax Law, article 70; Lewis, *supra* note 23, at 693 and 705; Yan Wang, *Chinese Legal Reform - The case of foreign investment law* (2002), 126 and 227; Qiansheng Pi, 'Stages of Developing Zones in China and Lifecycles of Export Processing Zones in the World Compared' (in Chinese), *Nankai Journal (Philosophy, Literature and Social Science Edition)*, No. 1 (2001) 21.

²⁷ See Implementation Rules of FIE Tax Law, article 69; Lewis, *id.* at 694 -5; Wang, *id.* at 126.

²⁸ FIE Tax Law, article 7.

²⁹ See Lewis, *supra* note 23, at 675; Wang, *supra* note 26, at 126.

³⁰ Implementation Rules of FIE Tax Law, article 73. See also Lewis, *id.*

³¹ The Western Areas in general cover the city of Chongqing, Provinces of Sichuan, Guizhou, Yunnan, Shanxi, Gansu and Qinghai, Autonomous Regions in Tibet, Ningxia, Xinjiang, Inner Mongolia and Guangxi. Daqi Zhu, *Tax Law* (in Chinese) (Beijing: Renmin University of China Press, 2004) 242.

³² FIEs are treated favourably in the Western Areas in terms of taxation as mandated in the relevant policies issued in 2000, 2001 and 2002, namely, 'Notice from the

Moreover, the determinant element of geographical location is closely linked to the nature of industries in which FIEs are engaged. That is to say, the eligibility of a FIE for the reduced income tax rates is on the premise that it should be concurrently engaged in a specific industry carrying out the work of “production and operation” (defined in the law as “manufacturing with income”).³³ Moreover, if the operational period of such a FIE exceeds ten years, the FIE in question can enjoy a tax holiday for the first two years from the first profit-making year and a 50 percent tax reduction for the following three years.³⁴

Also, a FIE can get a 40 percent refund of the income tax paid on the profit which has been reinvested in the enterprise for the purpose of capital increase or in other FIEs in which it holds an equity.³⁵

State Council Regarding Implementing Certain Policies of Carrying out Grand Development Scheme in the Western Areas’ (in Chinese); ‘Notice Forwarded by the Secretarial Office of the State Council from the Western Areas Development Office of the State Council Regarding Comments on Implementing Certain Policies of Carrying out Grand Development Schemes in the Western Areas’ (in Chinese); ‘Notice from the Ministry of Finance, the State Administration of Taxation, the General Administration of Customs Regarding Preferential Tax Policies of Carrying out Grand Development Scheme in the Western Areas’ (in Chinese); ‘Notice from the State Administration of Taxation Regarding Operational Details of Tax Policies for the Grand Development Scheme in the Western Areas’ (in Chinese). See *id.* at 242-3; Zuo Liu and Tieying Liu, *Chinese Foreign Tax Guide* (2004) 69.

³³ FIE Tax Law, article 7 and article 8; Implementation Rules of FIE Tax Law, article 71. Pursuant to article 72 of Implementation Rules of FIE Tax Law, there are ten categories of industry in which a FIE engaged in production and operation is eligible for favourable tax treatment: (1) industries in machinery manufacturing and electronics; (2) industries in energy (not relating to exploitation of petroleum and natural gas); (3) industries in metallurgy, chemistry, and building materials; (4) light industry, industries in textiles and packaging; (5) industries in medical appliances and pharmaceuticals; (6) industries in agriculture, forestry, animal husbandry, fisheries, and water conservancy; (7) industries in construction; (8) industries in transportation (excluding transportation in connection with passengers); (9) industries in science and technology application, geological survey, consultancy on industry information, maintenance of production equipment and precision instruments, all for the purpose of directly serving the production; and (10) other industries as endorsed by the tax authority under the State Council.

³⁴ FIE Tax Law, article 8. The 50 percent tax reduction is based on the ordinary tax rate, not on the reduced tax rate of 15 percent or 24 percent.

³⁵ This is subject to the length of the FIE’s operational period which should be no shorter than five years. See FIE Tax Law, article 10.

B *Opinionative differences*

Although efforts have been made for quite a long time towards unifying the two tax codes in parallel,³⁶ the existence of opinionative differences delays the final fulfilment of unification.

The arguments in support of rescinding the dual-track taxation system are posited on several grounds. First, establishing a level playing field is necessary, without which domestic enterprises would be forced out of competition with FIEs because of their cumbersome tax burdens exacerbated by their congenital deficiencies in commanding advanced technology and management know-how.³⁷ Second, with various tax privileges being eyed, some domestic enterprises may fraudulently manipulate the vehicle form of a FIE by employing offshore corporate bodies as a façade for gaining tax advantages.³⁸ Third, differentiated tax rules may give rise to various ways of hierarchical treatment. Tax treatment designed for FIEs appears excessively favourable compared with that for domestic enterprises. This deviates from the path of complying with the WTO principle that calls for equal treatment

³⁶ This is a target which should have been fulfilled during the implementation period of the country's 9th five-year (1996 to 2000) development plan. Daniel Cheung and Fusheng Zhang, 'Unification of China's Income Tax Laws for Foreign Enterprises and Domestic Enterprises – Its Feasibility, Principles and Problems', *Asia-Pacific Journal of Taxation*, Vol. 1, No. 2 (1997) 34.

³⁷ See *id.* at 36; Jason Yin and Yuhua An, 'Tax Reform in China and Strategic Responses for Enterprises with Different Forms of Ownership', *Journal of Asian Business*, Vol. 14, No. 4 (1998), 44-5; Kenny Lin, 'International Dimensions of Income Taxation in China: A Critique', *Asia-Pacific Journal of Taxation*, Vol. 4, No. 1 (2000) 28; Jianwen Liu, 'Enterprise Development and Enterprise Income Tax Law Reform', *China Law*, No. 54 (2005) 90; Mengzhou Xu and Xiaoting Zhang, 'My Reflections on China's Legislation for and Reform of Enterprise Income Taxation System' (in Chinese), *Journal of Shenzhen University (Humanities & Social Sciences)*, Vol. 21, Issue 6 (2004) 70; Hongfan Ma, 'Preferential Enterprise Income Tax: Assessing Merits/Demerits and Adjusting Orientation' (in Chinese), *China State Finance*, No. 476 (2005) 28.

³⁸ A domestic enterprise, by the way of forming a subsidiary in one of those offshore 'tax havens', acquires an overseas corporate identity; such subsidiary may receive capital injection from China at first instance and then arrange to send it back to the country in capacity as a FIE. See Yin and Yan, *id.*; Xu and Zhang, *id.*; Ma, *id.* at 29. See also Wang, *supra* note 26, at 130.

of all businesses in a country.³⁹ And fourth, the tax law's authoritativeness should not be impaired by a hodgepodge of administrative rules and policies, and any arbitrariness in interpreting the tax code and excessiveness of providing tax privileges to FIEs must be contained.⁴⁰ Legal authoritativeness enshrined in the tax code is genuinely in need of being ascertained and respected, as many tax incentives in fact may lack the required legality.⁴¹ A just and transparent legal framework of taxation is far more important to foreign investors than those uncertain, haphazardly granted tax advantages.⁴²

But there are opposing views against getting rid of tax privileges enjoyed by FIEs, and they have their reasons. First, foreign investment will continue to be an important contributing factor towards maintaining the growth momentum of the national economy in China.⁴³ Prematurely eliminating tax advantages enjoyed by FIEs will exert little impact on those giant foreign investors from the matured economies (e.g. those large corporations from the developed countries in Europe and/or North America), whereas small-sized FIEs (such as those export-oriented FIEs owned by Hong Kong and Taiwanese investors), which contribute more than half of the received foreign investment, will most likely be adversely affected.⁴⁴ Second, "fair competition" as an advocated notion could be challenged by the concept of "relative fairness". This conveys the idea that domestic enterprises and FIEs are not subject to the same supporting system and differentiated tax treatment

³⁹ See Xu and Zhang, *id.*; Ma, *id.*; Apisith John Sutham, *Essential Business Guide to the Law of International Trade and Commercial Transactions* (2004) 7. See also *supra* note 16.

⁴⁰ See Xu and Zhang, *id.* at 71.

⁴¹ See Wang, *supra* note 26, at 133.

⁴² See Cheung and Zhang, *supra* note 36, at 44. Pitman Potter, in his article assessing legal implications of China's accession into the WTO, strongly pronounces the importance of 'transparency', 'rule of law' and 'national treatment'. He holds the view that "[s]ubstantive law in many economic sectors, including customs, foreign exchange, taxation, intellectual property, enterprise law, bankruptcy, and pricing and other areas will need to be revised to accord with WTO requirements." This idea is of equal relevance to the discussion over unifying two tax codes in parallel. Pitman Potter, 'The Legal Implications of China's Accession to the WTO', *The China Quarterly*, No. 167 (2001) 602-3.

⁴³ The neighbouring countries (e.g. India, Korea, and Vietnam, etc.) may use tax incentives to compete for attracting foreign investment into their countries, and comparing with those neighbouring countries the production cost in China is now on the upswing. Wei Zhong, 'Impact of Two Taxes' Unification on Attracting Foreign Direct Investment into the Country' (in Chinese), *Taxation and Economy*, No. 5 (2005) 20-1.

⁴⁴ *Id.* at 22.

and gives rise to a complementary or set-off consequence.⁴⁵ The essence of the idea “relative fairness” lies in the proposition that FIEs are not necessarily more privileged than local enterprises.⁴⁶ The implication of ‘relative fairness’ has an effect of neutralizing the variation of tax treatment applied to different enterprises in terms of the nature of their ownership.⁴⁷ Unless unifying different ownership systems is implemented before eliminating tax impetus enjoyed by FIEs, the latter will not lead to the genuine fairness if not further enlarging current disparities. But the former is unrealistic and any forced consistency will not dovetail with the reality of social development in the country, thus destined to fail.⁴⁸ And third, based on the estimation that the VAT accounts for nearly 70 percent of the composite tax components with the weighting of the enterprise income tax appearing not so significant, it may arrive at a conclusion that the actual tax burdens assumed by FIEs and domestic enterprises are not different on a large scale, therefore eliminating tax privileges enjoyed by FIEs may not be so meaningful as expected.⁴⁹

C Ready for change?

The substance of the above opinionative differences can be boiled down to two points. One is to continue adopting a differentiated tax treatment approach because capital inflows from overseas are deemed to be a main engine that could propel the Chinese economy to a height that sole reliance on domestic capital is not able to attain. The other is against the way of blindly securing foreign investment with no due regard to foreign capital’s quality and effectiveness vis-à-vis taking into account an apparent improvement in recent years of the national economy. The government’s 11th five-year (2006-2010) plan on utilizing foreign investment is a good source

⁴⁵ Yu Ma, ‘Opportunity is not mature for unification’ (in Chinese), *Outlook Weekly*, Issue 7-8 (2005) 11.

⁴⁶ State-owned enterprises in China may garner certain forms of support from the government but are obliged to comply with the mandates of the government basically in all aspects; non state-owned domestic enterprises are not intervened by the government as regards their daily operation and management but may be denied market access to certain industries; FIEs are entitled to tax privileges, but may not be able to compete with their local counterparts in many other aspects. See *id.*

⁴⁷ See *id.*

⁴⁸ See *id.*

⁴⁹ See *id.* at 12; Wendy Guo, ‘China Considers Corporate Income Tax Reform, *Asia-Pacific Journal of Taxation*, Vol. 6, No. 2 (2002) 26-7.

of reference for mulling over the rationality of those arguments.⁵⁰ The plan attempts to make a realistic adjustment on the operational strategies of utilizing foreign investment.⁵¹ It is formulated in the context that China is now among the most popular places for foreign investment.⁵² The plan clings to the principle established in the five-year national development blueprint for 2006 to 2010, which purports to construct a harmonious and institutionalized society with appropriate lay-outs of industries, sustainable ecological fundamentals, good delivery of public products, and mitigated disparities in wealth between individuals and geographical regions.⁵³

Rightly steering the voyage of China's economic development requires in the first place a good judgment of how mature the economy is and what the teething problems are to be tackled at the present time. While China has achieved an amazingly high and sustained GDP growth and flourished in terms of foreign trade volumes, it is still a developing country halfway through the industrialization process if gauged by the proportion of its GDP volume against the world's totals as opposed to the developed countries as well as by its current capability of rendering creativity and innovation in science and technology.⁵⁴ The present layout of industries is characterized by an overtly speedy growth of heavy industries in chemical engineering and information technology industries, on top of many conventional export-

⁵⁰ Jian Dong, 'China aims high in utilization of foreign investment', *China Economic News*, No. 47 (2006) 1.

⁵¹ The plan highlights eight new strategies: (1) "Guiding foreign investment to optimize and upgrade industrial structure"; (2) "Promoting the construction of a resource efficient and environment friendly society"; (3) "Pushing forward opening up of the service industry"; (4) "Promoting the establishment of a more open self-reliant innovation system"; (5) "Promoting coordinated development of regional economies"; (6) "Realizing diversification in forms of using foreign investment"; (7) "Raising the quality and efficiency in utilizing foreign loans"; (8) "Strengthening macro monitoring and full-course management of external debt". Hua Zhong, 'Eight key aspects for China's utilization of foreign investment in 2006-2010', *China Economic News*, *id.* 6-8.

⁵² Dong, *supra* note 50.

⁵³ See 'Excerpt of Outline of the 11th Five-Year Programme for National Economic and Social Development', *China Economic News*, Supplement No. 5 (2006) 4-5.

⁵⁴ See Yingkui Tian, 'The 11th Five-Year Period as a Rare Starting Point for Development' (in Chinese), *Outlook Weekly*, Issue 1 (2006) 20-2. China is progressing into the acceleration stage in its industrialization process. See Wei Liu, 'Historical Change of the Reform and Fundable Transition of the Economic Growth Mode in China' (in Chinese), *Economic Research Journal*, Vol. 41, No. 1 (2006) 4.

oriented manufacturing industries.⁵⁵ Beneath the surface of such layouts is the unbalanced situation manifested by a series of proportionally insufficient service industries and plummeting agricultural industries, and by the predominant role played by traditional heavy industries of a manufacturing nature for maintaining a strong growth momentum of the economy.⁵⁶ Under the growth pattern of such kind, the value added is low on the whole and no high profit margin can be generated due to the bottleneck of lacking high-tech substances, and the continued high growth rate will be restrained by an insufficient supply of natural resources and energy.⁵⁷ The comparative advantage based on the low cost factors cannot be sustained in the long run when the inter-state dynamic comparative advantages are no longer significant in the context of the changing circumstances and more importantly if the originality required for the breakthrough in technology appears to pale.⁵⁸ Other than blindly carrying on capital input enhancement, timely upgrading of growth patterns could be extremely vital to the country.⁵⁹ The regional development disparity poses another problem. The industrialization process is not in equipoise in terms of the geographical distribution countrywide and the economic development in the coastal

⁵⁵ Fei Feng and Jianlong Yang, 'Seeking Solutions of Industrial Structures in the 11th Five-Year Programme' (in Chinese), *Outlook Weekly*, Issue 46 (2005) 28. Past experiences tell that the high growth will ineluctably carry on for quite a long time in an economy which has progressed to the acceleration stage in its industrialization process. See Liu, *id.* at 5.

⁵⁶ Feng and Yang, *id.*

⁵⁷ See *id.* at 28-9. Any attempt of accelerating the industrialization process is usually accompanied by the fast consumption of natural resources at the cost of social development. See also Liu, *id.*

⁵⁸ See Feng and Yang, *id.* at 29-30.

⁵⁹ Advocacy has been raised for switching current growth patterns from an extensive, resources-reliant mode into an intensive and environment-friendly one, from a mode that relies on importation of technology to the one established on self-controlled technology innovation, from the mode dependant on external demand from international markets to the one oriented towards meeting domestic demands, from the mode based on investments as the main carriages of economic stimuli to the one under which the growth will be mainly pulled by domestic consumption, from the mode that favours capital inflows from overseas to the one that encourages capital outflows into appropriate international markets and industrial fields, from the mode characterized by the unbalanced development glossed with special bias and inclinations to the one that attaches the strategic importance to the balanced development distinctive in equality. Jianquan Jiang, 'Development Patterns of Chinese Economy Face Seven Big Changes' (in Chinese), *Outlook Weekly*, Issue 9 (2006) 59-61.

regions far prevails over that in other places.⁶⁰ The regional differences have a causal link with the interaction of an array of elements, among which the production input and geographic locations both exert the attribution.⁶¹ The consequence of carrying out the policy that prioritizes the coastal regions in terms of the opening-up and utilizing foreign investment unavoidably widens the regional gap. In particular, with the less developed hinterland, although such widening has appeared less speedy since the implementation of the strategy for accelerating the development of the Western Areas.⁶²

The implementation of a pro-active foreign investment policy has to a large extent facilitated China's emergence now as among the most popular destinations for capital inflows from overseas.⁶³ Nevertheless, the momentum of foreign capital coming into China may be tapering.⁶⁴ Such an observation

⁶⁰ See Jiagui Chen, Qunhui Huang and Hongwu Zhong, 'The Synthetic Evaluation and Analysis on Regional Industrialization' (in Chinese), *Economic Research Journal*, Vol. 41, No. 6 (2006) 11-2. Some hold the view that the widening inter-regional gap would be exacerbated as depicted from a pyramid-type structure to an olive-type one at the time when development in the bulk of areas have progressed into the mid and the late stages of the industrialization process. See *id.*

⁶¹ See Junhua Yu and Rongxue Jin, 'The Movement and Causes of Chinese Regional Economic Difference: 1978-2004' (in Chinese), *Reform*, No. 9 (2006) 14. To learn more about regional differences in China, see generally, Barry Naughton, 'Provincial economic growth in China: causes and consequences of regional differentiation', in Mary-Francoise Renard (ed), *China and its Regions: Economic Growth and Reform in Chinese Provinces* (2002) 57-83; Sylvie Demurger, Jeffrey Sachs, Wing Thyee Woo, Shuming Bao and Gene Chang, 'The Relative Contributions of Location and Preferential Policies in China's Regional Development' in Ding Lu and William Neilson (eds), *China's West Region Development: Domestic Strategies and Global Implications* (2004) 465-86; Wenyuan Niu and David Chen, 'Geographical Background and Sustainable Development', in Y.M.Yeung and Jianfa Shen (eds), *Developing China's West: A Critical Path to Balanced National Development* (2004) 52-77.

⁶² See Yu and Jin, *id.* The impact of globalization may exacerbate the regional gap in China because the coastal regions abounding in export are susceptible to the volatility of international markets. See *id.* at 15.

⁶³ Hanyin Lu, 'China in the World Economic Structural Transformation: Economic Growth and Dynamic Efficiency' (in Chinese), *Fudan Journal (Social Sciences)*, No. 6 (2005) 86. By the end of 2006, China had for the past 16 years been consistently listed as a top recipient of foreign investment among the developing countries. Jian Dong, 'Unification of income tax – China's policy of utilizing foreign funds enters a historic period', *China Economic News*, No. 14 (2007) 1-2.

⁶⁴ Foreign investment actually used in 2006 was registered with a total amount of US\$69.468 billion, down 4.06 percent as compared with that of last year; the top ten investors in terms of actual amount invested in China were from the following

concur with what an earlier study discloses: there is a lowering portion of foreign investment in domestic fixed capital volume as vertically opposed to itself on the yearly basis as well as by comparing horizontally with other countries (including both the matured economies and the emerging markets).⁶⁵ The downward trend in quantitative terms could be attributable to the accumulation impact of foreign capital inflows over the past 10-odd years and also to the more fierce competition with other countries which equally attach great importance to the absorption of foreign capital and have worked out effective measures for such a purpose.⁶⁶

The funding seems no longer an issue that will hamper China's economic growth. This postulate can be verified by the fact that China is now the world's largest holder of foreign exchange reserves, an outcome on a big scale attributable to its export surplus.⁶⁷ Other than looking for capital inflows, the pressure is now mounting as to find some proper avenues for the stockpiling of foreign exchange liquidity, the existence of which could easily trigger off uncontrollable rounds of inflation or give rise to an unwanted currency appreciation. This prospect must be averted at least in the short term for fear of the perilous consequences it may cause to the health of the economy and to the stability of the society. This is because export gains now constitute a significant contributor to the economy and any significant currency appreciation could fatally damage those export-oriented enterprises, the competitiveness of which is in lockstep with the livelihood of millions of people who depend on the export for their survival.⁶⁸

On the other hand, although China is still in the process of industrialization, the past decade's opening-up has resulted in the achievement of a unique competitive edge in terms of market potential, upgraded technological scales and the existence of an opportunity to occupy an advantageous niche amidst

countries/regions: Hong Kong, British Virgin Islands, Japan, Korea, USA, Singapore, Taiwan, Cayman Islands, Germany, and Samoa. See Tong Shang, 'FDI in China drops in 2006', *China Economic News*, No. 7 (2007), 2-3.

⁶⁵ Xiaojuan Jiang, 'New Stage of China's Opening Up: Integrating into the Global Economy in More Balanced Approach' (in Chinese), *Economic Research Journal*, Vol. 41, No. 3 (2006) 4-7.

⁶⁶ See *id.* at 7.

⁶⁷ Gang Huang, 'Focus of China's policy of introduction of foreign capital changes', *China Economic News*, No. 37 (2006) 1.

⁶⁸ Jian Dong, 'Strategic change of foreign exchange policy', *China Economic News*, No. 49 (2006), at 1-2. At the end of March 2007, China's foreign exchange reserve was registered at US\$1,202 billion. Xin Li, 'Foreign exchange reserve exceeds US\$1,200 billion', *China Economic News*, No. 17 (2007) 8-9.

the world's layout of manufacturing industries and the division of human resources.⁶⁹ More diversified modes of using foreign capital are now somewhat reversing the conventional foreign investment policy. This can be traced to some of the new market access measures endorsed by the government, such as the entry of QFII (Qualified Foreign Institutional Investors) in the securities markets, and the admission of multinational corporations to carry out mergers and acquisitions, franchising, as well as non-equity participation in service industries, etc.⁷⁰

As opposed to foreign investment, there is a growing outflow of Chinese capital in recent years into international markets, and it is envisaged that by the year 2010 China may become an outward investment leader ranking at least among the top three developing countries in this aspect.⁷¹ In the context of China's multiple roles now as a regional hub of foreign investment, manufacturing industries, import deficit and export surplus, a big consumer of energy and a place of constant trade frictions, China could be asked to more actively act as a driving force in East Asia for the regional economy and also to develop in its own market an appropriate legal mechanism so as to provide a good environment for foreign investment utilization and continuum.⁷²

With a quick upswing of economic strength, there is a clear change in demand in China for foreign investment. While it is still debatable whether favourable tax treatment should continue to be granted to FIEs, consensus could be reached in this aspect by adopting a more rational approach of foreign capital utilization. The policy of absorbing foreign investment will be given more regard to what kinds of extra benefits, other than money, foreign capital can bring about to the country (e.g. whether, in addition to the capital in the monetary term, FIEs can also bring about any advanced technology conducive to China's industrialization process and to the expected structural upgrading of industries).⁷³ Effective implementation of Enterprise Income Tax Law will indirectly facilitate filtering away those FIEs which merely have an eye on tax privileges but are unable to make any real contribution to the Chinese economy and society.

⁶⁹ See Lu, *supra* note 63, at 88-9.

⁷⁰ See Jiang, *supra* note 65, at 10-2.

⁷¹ See Jiang, *id.* at 8-9.

⁷² See Angang Hu and Li Chang, 'China's Roles in East Asian Economy: Based on the Multi-hubs Theory' (in Chinese), *Reform*, No. 9 (2006) 73-6.

⁷³ See *id.* at 75.

The law as a super-structural constituent is very much influenced by the development of the society that is constantly undergoing minor or significant changes. In essence, pursuing the ideals like equality of treatment, legal authority and transparency as well as international compliance - as upheld by those who support the unification of two tax codes - raises the question of initiating a timely super-structural adjustment. From the perspective of maximizing short-term economic benefits, the objection to eliminating foreign investors' entitlement to tax incentives may sound reasonable to some extent, because unifying two tax codes will become far less significant if the purpose is only to create a level playing field for alleviating tax burdens shouldered by domestic enterprises. In other words, unless an adjustment over the super-structural substances in the Chinese commercial law regime are contemplated, it will hardly be justifiable to ask those dissentient voices to make a concession.

III ENTERPRISE INCOME TAX LAW: NEW FACE OR NEW SUBSTANCE?

The readiness of carrying out a super-structural adjustment over the framework of commercial law in China will very much depend on the maturity of its economic development as well as on how strongly the government is determined to make its legal mechanism become more suitable for a new role of foreign investment in the economy. Such a change is now reflected in the Enterprise Income Tax Law as a unified tax code applicable to all the enterprises in China (regardless they are FIEs or indigenous enterprises).

A *Taxpayers and tax rates*

On the whole, the content of the unified code is concise in terms of its form and substance. Taxpayers in the code are denoted as those within China including enterprises and other organisations with income, but sole proprietors and partnerships are not included.⁷⁴ In this connection, the code takes an exclusionary approach silent on how to define the term 'enterprise' and in particular whether it only refers to a corporate body.

⁷⁴ Enterprise Income Tax Law, article 1.

Based on residency, an enterprise is divided into two types – a resident enterprise and a non-resident enterprise;⁷⁵ the former is defined as the one set up in China, or established outside China under the law of an overseas jurisdiction in which it is set up but having its actual management carried out in China.⁷⁶ The latter is defined as one established outside China under the law of an overseas jurisdiction in which it is set up but having its organisation(s) in China, or having its income generated from China even though such enterprise does not set up its organisation(s) (in the physical form) in China.⁷⁷

A resident enterprise is liable to be taxed on its income from both within and outside China.⁷⁸ With regard to a resident enterprise whose income is generated from outside China, but which has been taxed overseas, that part of its taxable income which has been taxed overseas can be set off from its total calculated taxable income ascertained for the period concerned; any part of its taxable income that has been taxed overseas for this purpose which exceeds its total calculated taxable income ascertained for the period concerned can further be set off within the subsequent five years against its calculated taxable income each year.⁷⁹

A non-resident enterprise having established an organisation in China which receives its income from within China or, which receives its income from overseas, but the income generated from overseas is in actual connection with its organisation established in China, will be taxed on its income generated both from within China and from overseas.⁸⁰ Where a non-resident enterprise establishes an organisation in China, receives its income from overseas but the generation of such income is in actual connection with its China organisation, and such income from overseas has been taxed outside China, that part of its taxable income which has been taxed overseas can be set off from its total calculated taxable income ascertained for the period concerned, and any part of its taxable income which has been taxed overseas for this purpose and which exceeds its total calculated taxable income ascertained for the period concerned can be further set off within the subsequent five years against its calculated taxable income each year.⁸¹ A non-resident enterprise

⁷⁵ Enterprise Income Tax Law, article 2.

⁷⁶ *Id.*

⁷⁷ *Id.*

⁷⁸ Enterprise Income Tax Law, article 3.

⁷⁹ Enterprise Income Tax Law, article 23.

⁸⁰ Enterprise Income Tax Law, article 3.

⁸¹ Enterprise Income Tax Law, article 23.

having not established any organisation in China or having established an organisation in China but the organisation has nothing to do with its income received, will be taxed on its income generated from within China.⁸²

For a resident enterprise, the applicable income tax rate is 25 percent.⁸³ For a non-resident enterprise, having established an organisation in China which receives its income from within China or, which receives its income from overseas but the generation of such income from overseas is in actual connection with its organisation established in China, the applicable income tax rate is also 25 percent.⁸⁴ For a non-resident enterprise having not established any organisation in China or having established an organisation in China but such organisation has nothing to do with its income received, the applicable income tax rate is reduced to 20 percent.⁸⁵

In light of the provisions above, it can be deduced that a FIE incorporated in China is a resident enterprise, whereas a multinational company which is incorporated overseas but sets up its organisation(s) in China (e.g. a branch) may fall into the category of a non-resident enterprise depending on the circumstances. In general, FIEs will be prepared to pay more tax under the new tax code, while tax burdens assumed by domestic enterprises will conversely be significantly lessened. It deserves a particular attention that as of 1 January 2008 when the unified tax code starts to take effect, the previous tax code governing FIEs (including FIE Tax Law and Implementation Rules of FIE Tax Law) will accordingly be annulled.⁸⁶ Phasing out foreign investors' tax privileges will commence from then on.

Some commentators suggest that this tax rate of 25 percent fits into the average figure registered in OECD countries thus bearing the appropriate competitiveness in comparison with the equivalent rates used by the peripheral countries.⁸⁷ On the other hand, it can also be established that the 25 percent rate is not competitive enough and may lose competitiveness, even in front of Hong Kong, which as a Special Administrative Region in China applies a profit tax rate of 17.5 percent for the assessment year 2006/2007 to

⁸² Enterprise Income Tax Law, article 3.

⁸³ Enterprise Income Tax Law, article 4.

⁸⁴ *Id.*

⁸⁵ *Id.*

⁸⁶ Enterprise Income Tax Law, article 60.

⁸⁷ Min Tang, 'What Effects Will Unification of Two Tax Laws Bring About' (in Chinese), *Outlook Weekly*, Issue 7 (2007) 35. The 25 percent rate is deemed competitive after making comparison with the rates in the neighbouring countries (e.g. Singapore, Malaysia and Korea, etc.), because their rates are in general within the range of 28 percent to 35 percent. See *id.*

corporations,⁸⁸ let alone taking in account the merit of simplicity reflected in Hong Kong's tax regime. In order to encourage the establishment of more enterprises in China, the government may consider having the income tax rate further reduced.

B Reappearance of tax advantages

While the main purpose of constructing the unified tax code is to set up a level playing field by getting rid of tax advantages enjoyed by FIEs, the code itself does not entirely extinguish tax incentives, but rather offers favourable tax treatment to all the qualified enterprises.

Pursuant to the provision of the code, tax exemption or reduction can be granted to an enterprise on its income, if such income is generated from the operation of the projects in agriculture, forestry, animal husbandry, fisheries, the investment and operation in projects of public infrastructure, facilities specifically supported by the government, from the operation of the qualified projects in environmental protection and water conservancy, from qualified technology transfer, from within China due to a non-resident enterprise having not established any organisation in China or, where such an organisation is established, it has nothing to do with the income received.⁸⁹ The code does not provide any benchmark in quantitative terms as regards the circumstances pursuant to which an enterprise is entitled to tax exemption.

The code stipulates two concrete rates of tax reduction respectively applicable at two particular points. One is pertaining to "the qualified small enterprises with a slim profit margin", which are eligible for a reduced tax rate of 20 percent.⁹⁰ This stipulation is understandable because there have been petitions put forward that medium and small sized enterprises shall be given more encouragement to participate in the economy and shoulder less tax burdens so as to facilitate their growth in the keen market competition.⁹¹ The code does not indicate the required qualifications that such small enterprises shall possess in order to gain entitlement to this reduced rate. Nor

⁸⁸ See <http://www.ird.gov.hk/eng/tax/bus_pft.htm> at 28 May 2007.

⁸⁹ Enterprise Income Tax Law, article 27.

⁹⁰ Enterprise Income Tax Law, article 28.

⁹¹ See Weihua Yang and Shuping Yin, 'Adjusting Tax Policies to Promote the Development of the Small-and-medium-sized Enterprises' (in Chinese), *Journal of Sun Yatsen University (Social Science Edition)*, No. 6 (2003) 86-8.

does it exhibit any justification on the difference between this “small enterprise” rate and the normal rate. The latter point is relative to “the high-tech enterprises specifically supported by the government”, which can be taxed at the reduced rate of 15 percent.⁹² In principle, this is a measure aimed at encouraging the re-structuring of the layouts of industries in favour of the high-tech fields. However, the code does not reveal the definition of a ‘high-tech enterprise. Moreover, it is unclear whether the reduced rates of 20 percent and 15 percent have exhausted the available tax reduction as generally mentioned in the code.⁹³

The unified tax code gives a five-year grace period to an established FIE, so that it can continue to enjoy the ongoing tax privileges obtained from the previous code governing FIEs, and only when the grace period expires will it be taxed at the rate stipulated in the unified code.⁹⁴ Hence, an existing FIE will be given sufficient time to adapt to the unified code. Under such circumstances, the rates under the unified code will co-exist with tax privileges granted to FIEs under the previous code for a period of five years, during which many efforts may be required to cope with emerging difficulties. A reasonable grace period should be given, but perhaps not as lengthy as five years as currently devised.⁹⁵

In the unified code, a leeway is preserved at two particular points with respect to the reduced and exempted tax. First, the State Council can formulate interim policies for providing favourable tax treatment to “those newly established and specially assisted high-tech enterprises which are located in some special areas for fostering economic cooperation and technological exchange with foreign entities as by operation of law or endorsed by the State Council thus entitled to the special policies”.⁹⁶ It is difficult to decipher from the wording how an enterprise could be qualified for securing the entitlement and how favourable the entitlements might be.

Secondly, the code also provides that favourable tax treatment can be given to “those enterprises that are already ascertained by the government as being engaged in specifically encouraged business lines. Such enterprises are

⁹² Enterprise Income Tax Law, article 28.

⁹³ See Enterprise Income Tax Law, article 27.

⁹⁴ See Enterprise Income Tax Law, article 57. Also light of article 57, any tax privileges granted to a FIE for a fixed term less lengthy than the grace period will automatically lapse after the fixed term expires.

⁹⁵ The author proposes to reduce the grace period from five years to two years.

⁹⁶ Enterprise Income Tax Law, article 57.

entitled to the tax reduction and exemption granted by the State Council”.⁹⁷ It is again difficult to figure out the precise meaning contained in such a provision.

Although Enterprise Income Tax Law itself is the legislation, an ostensible policy slant can be detected from the provisions contained within. The practice of favourable tax treatment earmarked to those ‘special’ enterprises is in essence an imitation of the practice in the previous code of granting privileges to FIEs. A similar problem exists with respect to those “special” areas. Whatever those places are, relying on the practice of geographical preference for the purpose of ascertaining entitlement to tax privileges may lead to inequality in the same way that favouring FIEs over domestic enterprises did in the previous code. Even for those underdeveloped regions where the policy stimuli may assist, reverting to the adoption of tax incentives should be avoided and preference should be given to transfer payments made by the government. The legislation should include quantitatively definable benchmarks on how to gain entitlement to favourable tax treatment if the legislation is to treat all parties equally.

C *Status quo ante or new starting point?*

Extinguishing tax incentives to FIEs will not entirely extricate indigenous enterprises from the uneven playing field. The birth of Enterprise Income Tax Law is an initiative confined to the issues of taxation only. Construction of an all-round level playing field ought to be preceded by a successfully re-designed the legal framework for FIEs. A viable way forward is to consider integrating foreign investment enterprise laws into the general domain of the commercial law regime. Moreover, a reform on two specific law branches – economic law and commercial law, should also be contemplated.

The substance in the prototype of contemporary China’s legal system was very much influenced by the German and Japanese laws before the new China (the People’s Republic of China) was founded in 1949, and after 1949 and especially in the 1950s, by the laws of the former Soviet Union. In the 1980s Chinese jurists started to seek more enlightenment from the common law jurisdictions with a view to establishing new branches of laws and to accommodate the government’s endeavours in economic reform and open-

⁹⁷ Enterprise Income Tax Law, article 57.

up.⁹⁸ In general, the legal regime in China bears some essential characteristics of a civil law system. Perhaps, as impacted by the juristic theories of the former Soviet Union, the laws in China illustrate an explicit instrumentalist disposition in that they facilitate the fulfilment of policies and administrative mandates tailor-made for each economic development stage.⁹⁹

China's economic law is a typical example. The terminology of economic law may rarely be seen from conventional local laws in the common law jurisdictions. Economic law in China provides an important foundation for the government to carry out its macro-economic management functions. Hence, the building-up and development of economic law must closely respond to the government's responsibility to provide authoritative regulatory tenets. This will help to prevent new problems emerging from an economic experiment left unresolved due to lack of legal sources.¹⁰⁰ Economic law in China bears the distinct character of public administrative law in that it is used to deal with a wide terrain of private law issues. Tax law in China falls into the category of economic law. Foreign investment enterprise laws may also be deemed a constituent of economic law, although the subjects concerned are in closer connection with the commercial law regime. The instrumental impact of economic law, inclusive of tax law and foreign investment enterprise laws, cannot be accurately assessed without delving into the governance elements contained in both economic and commercial law. The problem lies in the development of the commercial law regime, which lags behind that economic law, having started much earlier at the initial open-up stage.¹⁰¹

⁹⁸ Guangfeng Tao, 'Globalization and the Way of the Advancement of China's Economic Law' (in Chinese), *Journal of Nanjing University (Philosophy, Humanities and Social Sciences)*, Issue 3 (2005) 40; Pitman Potter, *The Chinese Legal System – Globalization and Local Legal Culture* (2001) 4-5; Albert Chen, *An Introduction to the Legal System of the People's Republic of China* (2004) 22-9.

⁹⁹ Potter, *id.* at 10.

¹⁰⁰ Chen, *id.* at 240-2.

¹⁰¹ See Tao, *supra* note 98, at 38. China's company law was promulgated in 1993, whereas the general construction of foreign investment enterprise laws was basically completed before 1990. See *supra* note 7. For a full text of Company Law (1993) and commentaries for each of its articles, see generally, Guiguo Wang and Roman Tomasic, *China's Company Law: An Annotation* (1994). This company law was substantially amended in 2005. The version of Company Law (2005) is available starting at <<http://www.law-bridge.net/english/LAW/20064/0221042566163.html>> at 1 June 2007.

Foreign investment enterprise laws, which are tantamount to a set of private law norms in the public law denomination, are in the main employed to regulate a FIE's life from birth to death.¹⁰² As with company law, foreign investment enterprise laws constitute a separate empire composed of independent substantive laws on a range of similar corporation law issues. The vagueness of the legislative wording suggests that corporate governance law covers all the corporations in China except FIEs.¹⁰³ However, with China playing a more active role in international arenas, the two separate territories of company law and foreign investment laws may not remain immune from the general framework of corporate law. If amendments are made, foreign investment enterprise laws will be transformed from current operation-focused regulations to a concise single code, aimed at controlling foreign investment by setting up principal thresholds on foreign investor accessibility to specific industries and markets.¹⁰⁴

¹⁰² Chongli Xu, 'Change of the Foreign Investment Legislation in China' (in Chinese), *Jurists Review*, Issue 4 (2004) 153. Foreign investment enterprise laws, in the main, embrace the EJV Law of 1979 and its implementation rules of 1983, the CJV Law of 1988, and the WFOE Law of 1986 and its implementation rules of 1990. They focus on major operational issues in connection with FIEs, such as a chosen form of business entity, procedures of establishing a FIE, registered capital, capitalization and mode of capital contribution, land use rights, composition of board of directors, company management, importation of technology, sales and procurement, taxation, foreign exchange administration, accounting practices, trade union, termination and winding-up, etc. Such a framework appeared quite useful at the early stage of China's economic reform and open-up in the late 1970s and 1980s, when the required commercial law constituents (e.g. company law) were unavailable but were in urgent need of legal guidelines. See also *supra* note 7.

¹⁰³ Pursuant to article 218 of Company Law, "foreign-invested limited liability companies and joint stock companies are subject to this law; if there are laws otherwise provided in relation to foreign investment, those laws will prevail". Since foreign investment enterprise laws contain detailed provisions in regard of major operational requirements to be adhered by a FIE, they fit into the category of those "laws otherwise provided in relation to foreign investment". Hence, the incorporation and operation of FIEs are not regulated by this company law.

¹⁰⁴ Xu, *supra* note 102, at 159-60. Regulation for foreign investment in particular industries in China is now regulated under two guidelines: (1) Rules for Directing Fields of Investment for Foreign Investors, released by the State Council in 2002; and (2) Direction Catalog of Industries for Foreign Investment, jointly issued by the National Development and Reform Commission and the Ministry of Commerce in 2004 (as a revised version). These two guidelines illustrate various industries labelled respectively as "encouraged industries", "allowed industries", "restricted industries" and "prohibited industries", plus the specific geographic locations where the economy is backward and inflows of foreign capital are most needed. See *id.* The full

On the other hand, unifying foreign investment enterprise laws and corporate law is difficult. It requires a re-shuffle of various parties' vested interests in FIEs and foreign investment activities, and if not handled well may easily fall into a Scylla and Charybdis dilemma. The government must balance a supportive foreign investment policy whilst at the same time promoting an effective reform model for the current foreign investment laws. Unification cannot succeed without establishing a mature commercial law regime. This requires policy orientation and administrative organization if consistency and uniformity are to be achieved.

Commercial law, whilst ready for change, is nevertheless a long way from achieving large-scale adjustment to foreign investment enterprise laws. Further, and more fundamentally, the suggested changes can only be effectively mandated where they are unanimously embraced. The promulgation of Enterprise Income Tax Law as a unified tax code is a step in the right direction, however there is a long way to go.

IV CONCLUDING REMARKS

The effective implementation of a national policy for carrying out economic reform and open-up will be highly conducive to the aggrandizement of material wealth and a flourishing market economy. However, it will not necessarily enhance the nation's soft strength which must be decided by its capacity to adapt the superstructure to constant changes. A sound legal framework endorsing the rule of law, equality and transparency is imperative. The Chinese economy has progressed to such a stage that an expeditious reduction in the disparity between income tax treatment for FIEs and domestic enterprises is necessary. The new Enterprise Income Tax Law ensures the abolition of foreign investors entitlement to tax privileges. Whether such a move will trigger any further development in other legal fields remains to be seen. The ramifications of this unified tax code will, undoubtedly, be constructive and far-reaching. Dismantling the practice of differentiating between FIEs and indigenous enterprises may lead to greater homogeneity and uniformity in the entire commercial governance regime.

text of the former (in Chinese) is available at
<http://www.news.xinhuanet.com/zhengfu/2002-02/27/content_291499.htm> at 1
June 2007. The full text of the latter (in Chinese) is available at
<<http://www.china.com.cn/Chinese/PI-c/726125.htm>> at June 2007.

