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What is the 'Law' in Chinese Tax Administration?

Wei Cui*

Abstract

In December 2009, within just weeks of the issuance of several controversial (and arguably ultra vires) tax circulars by the Ministry of Finance (MOF) and by the State Administration of Taxation (SAT), the SAT promulgated a seminal regulation governing informal rulemaking activities of all tax authorities in China. This regulation took effect on 1 July 2010 and promises to significantly improve the clarity, transparency, predictability and quality of rulemaking on taxation in the PRC. Ironically, it can also be seen as a rebuke to a cynical view that is rather prevalent among Chinese tax practitioners and reinforced by the recent problematic tax circulars: namely, that because the PRC government does not care about creating order in tax administration and taxpayers are unwilling or are unable to enforce their rights, informal rules issued by the government should be given full weight even if they contradict laws created by higher authority and/or are inconsistent with each other. The new SAT regulation on informal rulemaking is just one illustration of the dynamic development of the rule of law in taxation in China. This article uses the enactment of the new regulation as an occasion for examining the question: what is the 'law' in Chinese tax administration?

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Introduction

Paradoxically, the discourse in China about the rule of law in taxation is going through both a primitive and a dynamic phase. The discourse is primitive in obvious ways. The meaning and scope of ‘law’ are not yet clear, and there is wide divergence between what the written rules say about this matter and actual practices. Many taxpayers and tax professionals do not distinguish between official prescriptions that have the force of law and those that do not, and they harbour a high tolerance for inconsistencies among informal rules which have a purported legal effect. Litigation against tax agencies is still relatively rare. On the other hand, within just the last few years, the rule of law in tax administration has also witnessed significant progress. The SAT has made surprising advances making procedural improvements in rulemaking, audit procedures, administrative appeals and other areas, heeding the State Council’s directives on ‘administration in accordance with the rule of law’.¹ Prominent public criticisms of the lack of rule of law in taxation are heard with greater frequency. Finally, China’s attempt to curb real or alleged international tax avoidance is rapidly drawing international attention and fuelling rule of law concerns.

This article aims to lay a foundation for analyses of the rule of law in Chinese taxation, by tackling the question, what is ‘law’ in China’s tax system? The answer given may be summarised as follows. The Law on Legislation² (LL) sets out a system of legal norms that only recognises State Council regulations and ministerial regulations as having the force of law, insofar as documents issued by central executive branch entities are concerned.³ The judiciary has explicitly endorsed this view. However, this view has been largely divorced from actual practice, and in the realm of tax administration, only a miniscule portion of the MOF and SAT’s tax rulemaking has taken forms that would be recognised as law by the LL. The remaining and vast majority of MOF and SAT rules have, until recently, been barely distinguishable from government internal documents. Even where tax authorities attempt to impose self-constraints on agency rulemaking, they adopt a much more expansive view of the scope of the law than do the LL and courts. There are thus at least three sharply diverging positions about what constitutes the law in tax administration:

¹ See *Guofa* [2004] No 10, Key Points in Implementing the Comprehensive Promotion of Administration in accordance with the Rule of Law (State Council, 22 March 2004).

² Law on Legislation (National People’s Congress (NPC), adopted 15 March 2000, effective 1 July 2000).

³ Statutes adopted by local legislatures and regulations issued by local heads of the executive branch also have the force of law within the relevant local jurisdictions: see Pt II.A below.

1. the position of the LL and the judiciary;
2. the approach of the MOF/SAT in practice and acquiesced to by many tax professionals; and
3. the SAT's 'reformist' view newly announced in 2010.

This divergence is partly hidden by the paucity of civil tax litigation, which also means that there has been little external constraint on tax rulemaking, despite the tax authorities' theoretical vulnerability in terms of the legal effectiveness of their pronouncements.

Part II of this article describes the system of legal norms laid out in the LL and related regulations, as well as the judicial understanding of that system for purposes of formal adjudication. Part III shows how the view of the scope of law described in Part II has had little bearing on rulemaking in Chinese taxation, and how tax administration has operated, in an important sense, almost entirely outside the scope of law. Part IV summarises the SAT's own view of the scope of tax law as expressed in a very recent regulation governing rulemaking procedures by tax agencies. This view differs significantly from that of the LL, but is nonetheless a principled view, and represents an important shift in tax administration. The conclusion analyses possible directions for future development.

II. The System of Formal Legal Rules

A. The Law on Legislation and Related Regulations

The LL is a foundational statute in the Chinese legal framework,⁴ and is important both for its explicit provisions and as a reference point for the executive and judicial branches' understanding of the law. On its face, the statute applies to the enactment, revision and nullification of national statutes (by the national legislature), 'administrative regulations' (by the State Council),⁵ local statutes (by sub-national legislatures) and certain regulations issued by ethnic autonomous regions.⁶ It also governs, in the same manner, regulations

⁴ Albert Chen, *An Introduction to the Legal System of the People's Republic of China* (3rd ed, LexisNexis, China, 2006), ch 6.

⁵ 'Administrative regulations' and 'State Council regulations' will be used interchangeably in the remainder of this article.

⁶ LL, Art 2.

issued by ministries under the State Council and certain local governments, but leaves most procedural rules regarding these two types of regulations to be formulated by the State Council.⁷ While the statute does not state anywhere that no other type of documents issued by government entities have the force of law and that the rules governed by it are the exclusive sources of law, it strongly implies so. This is because the central purpose of the LL is to bring consistency and uniformity to the Chinese legal system,⁸ and its ability to do so would be severely limited if rules with the force of law are not governed and ordered by it.

The importance of the LL in delineating the formal sources of law can be better appreciated in light of the statute's legislative history. The LL represented a major compromise between the Chinese legislative and executive branches.⁹ A view of the NPC as the supreme source of law is embodied in China's constitution.¹⁰ Despite this constitutional framework, the NPC made sweeping (and vague) delegations of authority during the 1980s to the executive branch and the judiciary, either to interpret or to make law. Beginning with the passing of the Administrative Litigation Law (ALL) in 1989,¹¹ however, the NPC began to gradually reclaim its legislative authority, and to impose limits on the executive branch's ability to make law. According to the ALL, in handling administrative cases, courts must take national and local statutes, as well as State Council regulations as the basis for making decisions.¹² By contrast, ministerial and local governmental regulations are to be taken only 'as references'

⁷ *Ibid*; see, State Council Decree No 321, Ordinance Regarding Procedures for the Formulation of Administrative Regulations (issued 16 November 2001, effective 1 January 2002) ('Administrative Regulation-Making Procedures'); State Council Decree No 322, Ordinance Regarding Procedures for the Formulation of Regulations (issued 16 November 2001, effective 1 January 2002) ('Regulation-Making Procedures').

⁸ See, for example, Gu Anran, Explanatory Remarks Regarding the Draft Law on Legislation, delivered at the NPC meeting on 9 March 2000; *Guofa* [2000] No 11, State Council Notice Regarding Implementing the Law on Legislation (issued 8 June 2000) (referring to State Council regulations and ministerial and local government regulations, but not to other normative documents, as 'constituent parts of the nation's unified legal system').

⁹ See, for example, Xu Anbiao, The Allocation of Legislative Rights under the Law on Legislation; available at: http://www.chinalawedu.com/news/16900/171/2004/10/ma0223793413101400215043_135733.htm.

¹⁰ Constitution of the People Republic of China, Arts 58, 62, and 67.

¹¹ Administrative Litigation Law (NPC, adopted 4 April 1989, effective 1 October 1990). The ALL governs judicial proceedings against government agencies.

¹² ALL, Art 52.

by courts.¹³ Subsequently, during the drafting of the LL, the NPC considered reserving the power of statutory interpretation to the legislative branch.¹⁴ This attempt did not prevail and extensive delegations of legislative authority to the State Council were codified.¹⁵ Moreover, ministerial and local governmental regulations are recognised as part of the formal legal order.¹⁶ Nonetheless, despite the political dominance of the executive branch, among documents issued by central government ministries, the LL only included State Council and ministerial regulations as part of the formal legal order. In recognition of this special status accorded to ministerial regulations by the LL, central ministries including the MOF and SAT have consistently observed the distinction between regulations and documents of lesser authority,¹⁷ although regulations represent a miniscule portion of these agencies' published rules.

The LL, along with several subsequent administrative regulations, also articulated certain features common to all rules having the force of law.

First, all rules governed by the LL cannot have a retroactive effect, with the exception of rules 'formulated specially for the purpose of better protecting the rights and interests of citizens, legal persons and other organisations'.¹⁸ This principle is affirmed in State Council ordinances regarding administrative regulations and ministerial regulations,¹⁹ and is also explicitly invoked in the SAT's own regulation regarding regulation-making procedures.²⁰ By contrast, as discussed in Part II below, at least until 2010, many circulars issued by the MOF and the SAT, whether they set out new rules or interpret existing ones, were applied retroactively.

¹³ *Ibid*, Art 53.

¹⁴ See Zhang Chunsheng, Explanatory Remarks Regarding the Draft Law on Legislation, delivered at the 12th meeting of the NPC Standing Committee on 25 October 1999 (describing a draft of the LL which would have withdrawn earlier delegations of power to interpret law).

¹⁵ LL, Arts 8-11.

¹⁶ For further discussion, see Chen (note 4 above), ch 6.

¹⁷ See *Caibanfa* [2002] No 68, Opinions of the Ministry of Finance on the Implementation of the Law in Legislation (MOF General Office, issued 4 December 2000) (laying out conditions for making MOF regulations); SAT Decree No 1, Implementation Measures for Regulation-Making by Tax Agencies (adopted 1 February 2002, effective 1 March 2002).

¹⁸ LL, Art 84.

¹⁹ Administrative Regulation-Making Procedures, Art 29; Regulation-Making Procedures, Art 32. See also *Guo Fahan* [2002] No 134, Notice Regarding Strict Implementation of Article 32 of the Ordinance Regarding Procedures for the Formulation of Regulations (State Council Legislative Affairs Office, issued 14 May 2002).

²⁰ See Implementation Measures for Regulation-Making by Tax Agencies (note 17 above), Art 3.

Second, the solicitation for public input is a requirement for formal legal rules, especially those made by the executive branch. There is no clear criterion for what constitutes sufficient solicitation, let alone a sufficient response to input received. The failure to engage in such solicitation is, in any case, not considered actionable under the ALL.²¹ Nonetheless, the recommendation for solicitation of public input is consistently applied to all administrative and ministerial regulations,²² while it is not regarded as relevant for rulings and announcements with lesser authority. Moreover, as of 2010, the State Council does require the publication of all draft State Council and ministerial regulations unless there is a legal requirement that they be kept confidential.²³

Third, formal rules of law are characterised by extensive procedures for their adoption. While the LL itself lays out such procedures for national and local statutes, the State Council has stipulated procedures for the adoption of regulations.²⁴ Two features of such procedures are perhaps most telling. The first is that for regulations even to be proposed internally, the rules they contain must already be 'mature'.²⁵ There is no mechanism for issuing temporary or trial regulations, and, in practice, trial measures tend to be issued in formats with lesser authority than regulations.²⁶ The second is that regulations must be reviewed and approved by the highest relevant body within the regulation-

²¹ See *Fa* [1991] No 19(Provisional) Opinions Regarding Certain Issues in the Implementation of the Administrative Litigation Law (Supreme People's Court, issued 11 June 1991), s 1(1) ('specific administrative actions' that are actionable must be directed at specific persons).

²² Administrative Regulation-Making Procedures, Arts 12, 19-22; Regulation-Making Procedures, Arts 14, 15, 20-23.

²³ *Guobanfa* [2010] No 3, Notice Regarding the Printing of the State Council's Legislation Work Plan for 2010 (State Council General Office, issued 1 January 2010).

²⁴ See, generally, Administrative Regulation-Making Procedures and Regulation-Making Procedures.

²⁵ See Administrative Regulation-Making Procedures Art 8; Regulation-Making Procedures, Art 19.

²⁶ Compare, for example, *Guoshuifa* [2005] No 201, Administrative Measures for Formulating Normative Documents in Taxation (for Trial Implementation) (SAT, effective 1 March 2006, repealed 1 July 2010) ('Trial Measures for Normative Documents', adopting the format of an informal rule), and the Administrative Measures for Formulating Normative Documents in Taxation Decree No 20 (SAT, effective 1 July 2010) ('New Measures for Normative Documents', a formal regulation), both of which are discussed in Pt IV below.

making agency, and signed by the head of the agency.²⁷ Just as the requirement for public comment solicitation may deter the issuance of formal regulations in other countries, in China it is this internal political process that prevents many regulations from being proposed in the first place.

Finally, all rules with the force of law may be challenged as being inconsistent with rules of higher authority through non-judicial procedures. Citizens may apply for review by the NPC Standing Committee of potentially invalid administrative regulations,²⁸ and by the State Council of potentially invalid ministerial regulations.²⁹ Although these rights have been rarely exercised, they are nonetheless conceptually important. This is because the Chinese judiciary is generally regarded as having no power to invalidate statutes and regulations.³⁰ Because these rules are generally legally binding, their validity must therefore be challengeable through other channels. Conversely, if certain rules issued by the government are not considered legally binding, there is arguably less need for non-judicial procedures for invalidating them. Courts may simply disregard such rules if they are inconsistent with higher law.

These four features of formal legal rules demonstrate that the conception of what rules have legal effect in the Chinese legal system is not arbitrary.³¹ Rather, it reflects a fundamental view about what characteristics rules deserving to be called the law must display: legal rules can be made (and repealed) only by the entities and persons with the authority to do so; they cannot be applied retroactively to the detriment of the persons subject to them and they should ideally be made pursuant to some process of public participation.

B. Judicial Views of Rules with Formal Effect of Law

As discussed above, the ALL was an important precursor of the LL in curbing the executive branch's ability to make law. The ALL does not of itself state that any effect should be given to government pronouncements of lesser status

²⁷ In the case of State Council regulations, this means the Standing Committee of the State Council and the Premier, respectively; Administrative Regulation-Making Procedures, Arts 26 and 27. For ministerial regulations, this means a ministerial committee and the minister, respectively; Regulation-Making Procedures, Arts 27 and 29.

²⁸ LL, Art 90.

²⁹ Regulation-Making Procedures, Art 35.

³⁰ Lawmaking power is, in theory, reserved to the legislative branch and executive branch entities to which such power has been delegated. See Jie Cheng, 'Constitutional Reflections on Judicial Interrogatories' (2007) 4 *Faxuejia* 122 at 129.

³¹ The publication of rules intended to have the effect of law is another notable feature common to all such rules.

than regulations. In a seminal document summarising discussions at a national judicial conference held in Shanghai in 2003 ('Shanghai Meeting Minutes'),³² the Supreme People's Court (SPC) distinguished formal regulations from 'interpretations for specific application' as well as 'other normative documents', all of which may be issued by government agencies to implement law or policy. Although 'agencies frequently rely on such interpretations ... and other normative documents as the basis for specific administrative actions', the SPC states they are not 'formal sources of law, and do not have the binding force of legal norms'.³³ Nonetheless, if a court, when adjudicating a case relating to specific administrative actions, determines that such interpretation or normative document possesses 'legal validity, effectiveness, reasonableness and appropriateness', it may give effect to such interpretation or document in determining whether the specific administrative act has a legal basis.³⁴

The message of the Shanghai Meeting Minutes seems clear: government pronouncements with lesser authority than regulations are not legally binding, and will be given effect only at a court's discretion. This message is also entirely consistent with the LL's view of what has the force of law. However, as we will see in connection with MOF and SAT rulemaking practice, the impact of the Shanghai Meeting Minutes on the behaviour of executive branch agencies has been limited. This is partly attributable to the fact that, according to the ALL, no suits may be brought to court against government agencies merely for the adoption of 'administrative regulations, regulations, or decisions and orders with general binding force'.³⁵ The SPC has interpreted such decisions and orders as encompassing 'all normative documents issued by administrative agencies repeatedly and generally applicable to more than specific parties'.³⁶ While the rule may be justifiable in connection with the adoption of formal legal rules on the ground that courts would have no power to provide a remedy (since they cannot invalidate any rules with formal legal effect), its rationale is less clear in relation to other government announcements.

³² *Fa* [2004] No 96, Meeting Minutes Regarding the Application of Legal Norms in Reviewing Administrative Cases (SPC, issued 18 May 2004), s 1, para 3.

³³ *Ibid.*, s 1.

³⁴ *Ibid.*

³⁵ ALL, Art 12.

³⁶ *Fashi* [2000] No 8, Interpretations of Certain Issues in the Implementation of the Administrative Litigation Law (SPC, published 8 March 2000 and effective 10 March 2000), Art 3. This has been widely understood as part of the ALL's position that only specific administrative acts, and not 'abstract administrative actions', such as the issuing of regulations, can be causes of action under the ALL. See ALL, Art 2 (a lawsuit may be brought against any specific administrative action by administrative agencies or personnel that infringes a person's lawful rights and interests).

III. Lawlessness in Tax Rulemaking

Unfortunately, the seemingly clear formal legal framework just described produces only dissonance and disorientation when applied to the field of Chinese taxation.³⁷ Almost all substantive tax rules in China are found in informal documents ('circulars')³⁸ issued by the MOF and/or the SAT. The classification of these circulars for bureaucratic purposes is at once intricate and obscure.³⁹ For legal purposes, however, the bottom line is that they are not ministerial regulations, even when they purport to be of general application. Of course, generally applicable rules that do not have the force of law are found in other systems of tax administration as well.⁴⁰ But their prevalence in the Chinese tax system represents an extreme case. This is because fundamental rules of tax law that are made pursuant to clear delegations of authority are regularly set forth in such informal circulars, as are most substantive tax rules that are arguably legislative in nature. Regulations play a very marginal role. Moreover, government agencies, including the MOF and the SAT, have frequently exercised their rulemaking discretion in such a way as to limit, or simply violate, taxpayers' rights established under formal rules.

A. Prescribing Fundamental Elements of Tax Law Informally

There is a fundamental institutional arrangement in Chinese tax policy making (which is itself not reflected in any formal legal rule) according to which matters of fundamental tax policy, left open by the NPC and the State Council, are to be

³⁷ This is not to say that the problems of lawlessness identified in this section are less severe in other Chinese regulatory spheres. If anything, tax agencies may have adhered more strictly to rulemaking protocols than many other agencies.

³⁸ As a result of general confusion about the legal and bureaucratic status of various types of informal documents, taxpayers and practitioners often refer to such documents in Chinese as 'Document No ___' (*haowen*) in specific contexts, the English counterpart to which is 'Circular No ___'. In more technical usage discussed in Pt V below, these are referred to as 'normative document'.

³⁹ See, for example, *Guoshuififa* [2004] No 132, Implementation Measures for the Processing of Official Documents of All Tax Agencies of China ('Official Tax Documents Rules') (SAT, issued 9 October 2004).

⁴⁰ For a summary of the use of such rules in the United States, see Kristin E Hickman, 'IRB Guidance: The No Man's Land of Tax Code Interpretation' (2009) *Mich St L Rev* 239.

governed by rules jointly issued by the MOF and the SAT.⁴¹ This arrangement is implicitly acknowledged by many specific statutes and regulations. For example, the Enterprise Income Tax Law ('EIT Law')⁴² directly delegates the authority to determine the 'specific scope and criteria of income and deductions' to the MOF and the SAT.⁴³ The Enterprise Income Tax Law Implementation Regulations (EITLIR),⁴⁴ a State Council regulation, delegates the authority to make more specific rules to the MOF and the SAT no less than 29 times. In almost all of these instances, the power delegated is clearly legislative in nature; the MOF and the SAT are expected not merely to interpret law but to prescribe rules that are missing. None of these instances of delegation for purposes of the EIT specifies whether the two agencies are to exercise their delegated authority through regulations or other means.⁴⁵ In practice, the two agencies have exercised such authority solely through the issuance of informal rules. Indeed, the only joint regulations ever issued by the MOF and the SAT appear to be for taxes for which no statutes (and only State Council regulations) have been adopted.⁴⁶ And in these cases, there is often only one joint MOF/SAT regulation for each tax. Any remaining jointly issued rules have taken non-regulation form.

The MOF and the SAT thus appear to take the stance that for fundamental tax policy matters, there is no need to advance rules in forms recognised by the LL. In doing so, the two agencies have not simply disregarded legal niceties. Informal rules without legal effect lack the core features of formal legal rules: non-retroactivity, being subject to public input, robust bureaucratic approval procedure and possibilities of non-judicial challenge. This means that informal rules can be seriously adverse to taxpayers. Three examples from the last two years in the EIT area illustrate the point.

⁴¹ The arrangement dates back to the mid-1990s. The most recent statements regarding it can be found in two State Council internal management documents. See *Guobanfa* [2008] No 65, Provisions on the Main Functions, Internal Bodies and Staffing of the Ministry of Finance (State Council General Office, issued 10 July 2009), s 5(2); *Guobanfa* [2008] No 87, Provisions on the Main Functions, Internal Bodies and Staffing of the State Administration of Taxation (State Council General Office, 10 July 2009), ss 2(1) and 5(1).

⁴² Enterprise Income Tax Law (NPC, adopted 16 March 2007, effective 1 January 2008).

⁴³ *Ibid.*, Art 20.

⁴⁴ State Council Decree No 512 (effective 1 January 2008).

⁴⁵ The LL itself is silent on how the NPC and State Council should delegate authority within the scope of statutes.

⁴⁶ Most of China's taxes are still governed by State Council regulations and not by statutes. The two exceptions are the EIT and personal income tax.

First, the EITLIR provides that asset transfers carried out in enterprise reorganisations are taxable unless otherwise provided by the MOF and the SAT, thus fully delegating to the two agencies the authority to determine which reorganisations may be eligible for deferral treatment.⁴⁷ The agencies issued rules pursuant to such a delegation at the end of April of 2009, but made them retrospective to 1 January 2008 (the effective date of the EIT Law).⁴⁸ The draft rules underwent significant changes during a long drafting process in 2008 and 2009 that was closed to the public,⁴⁹ and the product was substantially different from previously applicable rules. No taxpayer could have anticipated which reorganisations would be eligible for deferral treatment and under what conditions. The retroactivity of the finally adopted rules means that the tax treatment of reorganisations between January 2008 and April 2009 was largely an arbitrary matter, since no one knew what actions to take to achieve deferral treatment.

Second, rules on foreign tax credits (FTC) were issued at the end of 2009 but made retroactive to 1 January 2008.⁵⁰ These rules specified, for the first time and pursuant to delegated authority,⁵¹ an indirect FTC regime, the workings of which taxpayers could not have anticipated. They also limited, without any statutory basis, the ability of a Chinese enterprise to offset the losses of one foreign branch against income generated from other foreign countries. Not only has taxpayers' statutory right to deduct losses as actually incurred⁵² been restricted, it has been restricted in a retroactive fashion.

A third, and quite poignant, example of such informal but legislative, retroactive and taxpayer-adverse rulemaking relates to two MOF/SAT notices regarding non-profit organisations (NPOs), which were issued in November

⁴⁷ EITLIR, Art 75.

⁴⁸ *Caishui* [2009] No 59, Notice Regarding Several Issues in the Enterprise Income Tax Treatment of Enterprise Restructuring (MOF and SAT, issued 30 April 2009, effective 1 January 2008).

⁴⁹ See Wei Cui, 'Reflections on the Making of the Income Tax Rules for Enterprise Reorganizations' (in Chinese), in Xiong Wei (ed), *Commentaries on Tax Caselaw and Interpretation*, Vol 1 (Law Press, 2010), pp 123-37.

⁵⁰ See *Caishui* [2009] No 125, Notice on Foreign Tax Credit Issues for the Enterprise Income Tax (MOF and SAT, 25 December 2009).

⁵¹ EITLIR, Art 80 provided that the meaning of indirect control for purposes of the indirect FTC rules is to be specified by the MOF and the SAT.

⁵² EIT Law, Art 8.

2009 and again made effective on 1 January 2008.⁵³ Under the EIT Law, NPOs are taxpayers, but qualified income of NPOs may be tax-exempt.⁵⁴ The EITLIR provides that the exemption depends on the nature of both the income and the organisation. It specifies eligibility criteria for NPOs that may claim exemption on qualified income and delegates to the MOF and the SAT the authority for prescribing procedures for determining eligibility of specific NPOs.⁵⁵ Further, it provides that exempt income received by qualifying NPOs does not include income derived from for-profit activities, unless the MOF and the SAT prescribe otherwise.⁵⁶ For almost two years after the EIT Law took effect, no action was taken pursuant to these two instances of delegation, with the consequence that no NPO knew for sure whether they might be able to claim exemption and, if so, for what types of income. When the two agencies did offer such guidance, the notice that was supposed to have merely laid out procedural rules for the recognition of NPOs⁵⁷ imposed further substantive requirements. The other notice,⁵⁸ instead of laying out what income derived in for-profit activities may be exempt, limited the scope of exempt income, even for what is derived from non-profit activities.

In December 2009, nine prominent foundations publicised letters submitted to the State Council, the SAT, and the MOF, requesting each government entity to review the legality of the two notices.⁵⁹ The foundation letters alleged that the MOF and the SAT failed to consult other agencies as required by the EITLIR, with the result that some provisions are ‘impractical’ in light of present circumstances of NPOs. Moreover, the letters highlighted that all income derived in non-profit activities should be exempt under the EITLIR, contrary to the limitations set by the MOF and the SAT.⁶⁰ Subsequently, 15 other foundations also signed the petition letter to the State Council.⁶¹ So far,

⁵³ *Caishui* [2009] No 122, Notice Regarding Income Exempt from the EIT of Non-Profit Organizations (MOF and SAT, 11 November 2009) and *Caishui* [2009] No 123, Notice Regarding Administrative Issues in the Recognition of Exempt Status of Non-Profit Organizations (MOF and SAT, 11 November 2009).

⁵⁴ EIT, Law Art 26.

⁵⁵ EITLIR, Art 84.

⁵⁶ EITLIR, Art 85.

⁵⁷ *Caishui* [2009] No 123 (note 53 above).

⁵⁸ *Caishui* [2009] No 122 (note 53 above).

⁵⁹ See, for example, http://www.naradafoundation.org/sys/html/lm_1/2009-12-22/135859.htm.

⁶⁰ Further, the letters charged the agencies with failing to specify when income derived from for-profit activities should be exempt, as instructed by the EITLIR.

⁶¹ See: <http://news.cjn.cn/gn/200912/t1047449.htm>.

there has been no official response to these petitions, as nothing imposes a legal obligation on the petitioned entities to respond. Existing law only requires the State Council to review, upon request, the validity of ministerial regulations – not informal documents. Neither has the MOF or, until very recently,⁶² the SAT, instituted mechanisms for reviewing the legality of informal rules. The only way in which such informal rules can be made subject to review is through formal administrative or judicial review of specific government acts that purport to have such rules as a 'legal basis'. This shows how informal (however unmistakably legislative) documents possess some extraordinarily attractive features for officials. Besides allowing them to avoid the effort to solicit public input and strict internal bureaucratic procedures, these documents can be made retroactive at will, and they are not easily appealable.

B. The Marginal Role of Regulations

As an institutional matter, rules jointly issued by the MOF and the SAT are intended to be legislative in nature and not merely interpretative. The informal manner in which such rules are adopted and the resulting adverse consequences to taxpayers illustrate that the legal disorder in Chinese tax administration starts, at the stage of tax policymaking. In the meantime, the SAT, which is allowed to act on its own to implement tax policy, also issues countless substantive rules that are often difficult to characterise as merely interpretative. A summary examination of the SAT's practice will demonstrate that the anomaly of MOF/SAT's jointly issued rules is not isolated.

Between 2002⁶³ and August 2010, the SAT issued 22 ministerial regulations. By contrast, the agency has issued informal rules of general applicability numbering in the hundreds each year. A cursory examination of this area is sufficient to justify a conclusion that the SAT selection process governing the choice of rules to convert to a regulatory form is arbitrary. Over half of these SAT regulations govern general procedures in tax administration,⁶⁴ although many important procedural rules remain in a non-regulation form.⁶⁵

⁶² See discussion in Pt IV below.

⁶³ There were no SAT ministerial regulations before 2002 due to the fact that the legal status of ministerial regulations was not clarified until after the adoption of the LL.

⁶⁴ The bias towards procedural rules in the use of SAT regulations may reflect a preference for greater flexibility in making substantive rules.

⁶⁵ For instance, neither procedures for annual filing of personal income tax returns nor treaty benefit claim procedures have been codified in regulations.

The remaining few substantive regulations are quite specialised. For example, income tax rules for debt restructuring were the subject of one regulation in 2002, whereas such rules for all other types of reorganisations were codified in numerous SAT circulars. Regulations were used for certain VAT rules for retail gasoline stations and for the sale of electricity, whereas more basic VAT rules were scattered through myriad informal documents. The specialised nature of these regulations, combined with their paltry numbers, means that regulations play a negligible role in shaping tax law.

By far the more common formats in which SAT substantive rules were issued are SAT Issuances and SAT Correspondences.⁶⁶ Both formats are used for inter-agency communications, setting out internal bureaucratic protocols, as well as prescribing substantive rules. SAT Correspondences are issued more frequently than SAT Issuances and may exceed 1300 a year. In terms of interpreting tax law, one SAT internal manual states that SAT Issuances are to be used to provide ‘adjustments and supplements to tax policies and methods of collection, as well as clarifications and interpretations for important questions in the implementation [of such policies and methods]’, whereas Correspondences are used for ‘clarifications and interpretations of ordinary questions in the implementation of tax policies and methods of collection’.⁶⁷ Nonetheless, the two formats are often indistinguishable. For example, the recent, notorious SAT Circular 698⁶⁸ was an SAT Correspondence, as was a controversial circular giving local tax authorities discretion to apply a stringent test of beneficial ownership for treaty purposes.⁶⁹

Scrutiny of the official numbering of SAT Issuances and Correspondences suggests that many of them are not published, although many others are.⁷⁰ The criteria for publication are unclear, and whether a document is published offers

⁶⁶ Based on the database www.chinalawinfo.com, there were 158 SAT Issuances in 2009 – which is close to the number of MOF/SAT joint Issuances (167) for the same year – and 772 SAT Correspondences.

⁶⁷ Official Tax Documents Rules, Art 29.

⁶⁸ *Guoshuihan* [2009] No 698, Notice on Strengthening the Management of Enterprise Income Tax Collection on Proceeds from Equity Transfers by Non-resident Enterprises (‘Circular 698’) (SAT, 10 December 2009), retroactively effective 1 January 2008), further discussed in text (accompanying notes 76-7) below.

⁶⁹ *Guoshuihan* [2009] No 601, Notice on How to Interpret and Determine ‘Beneficial Owners’ in Tax Treaties (SAT, 27 October 2009).

⁷⁰ For instance, for the first six months of 2010, over 300 SAT Correspondences were issued, of which fewer than 60 are currently publicly available; 64 SAT Issuances were adopted but only 36 are currently publicly available.

no guide as to whether it is intended to have legal effect. There appears to be no process by which SAT informal rules developed over time are incorporated into SAT regulations. In the specific matters they govern, informal rules are not necessarily more detailed or easy to operate than regulations.⁷¹ Informal rules and SAT regulations thus do not complement each other; they are simply substitutes, with SAT regulations being the far more rarely chosen option. Finally, the record of SAT informal rules in being adverse to taxpayers, both in content (ie narrowing rights and expanding obligations relative to formal legal rules) and in the lack of procedural protections (eg in terms of retroactive applicability and the lack of non-judicial challenge procedures), is just as problematic as that of informal rules jointly issued by the MOF and the SAT. Rather than canvassing specific examples here,⁷² we now consider how the SAT, despite many Chinese tax professionals' seeming readiness to acquiesce in the state of affairs just described, has recently attempted reform.

IV. The SAT's Reformist View

It may be difficult to imagine tax authorities failing to give fundamental tax rules the force of law – even when they have clear delegated authority to do so – and prescribing rules that both lack the force of law and are inconsistent with statutes and higher regulations, if this would result in their policies being unenforceable and efforts at collecting taxes being stalled. In reality, Chinese taxpayers do not regularly rely on the legal system to contest government actions.⁷³ The reason for this is multifaceted – indeed, there may be a vicious circle where the paucity of civil tax litigation leads tax advisors to advise against such litigation. Whatever the explanation, many believe that formal legal proceedings do not pose a significant constraint on informal rulemaking by the MOF and the SAT.⁷⁴ This raises the question: given the extraordinary dominance of informal rulemaking, what relevance does the formal legal order described in Pt I have for taxation in China?

⁷¹ Indeed, few SAT informal rules have been issued to implement SAT regulations.

⁷² An example is given in text accompanying notes (76-7) below.

⁷³ For an introduction to this phenomenon, see Wei Cui, 'Two Paths for Developing Anti-Avoidance Rules in China,' (2011) Jan/Feb *Asia Pacific Tax Bulletin* 42.

⁷⁴ It should be noted, however, officials in charge of administrative reconsideration (ie legal staff at tax agencies) may hold different views, and this may explain SAT reforms such as the promulgation of the New Measures for Normative Documents.

The prevalent view among the mainstream Chinese tax profession – including international law and accounting firms – appears to be that the LL has no practical relevance in the tax context. Practitioners routinely disregard differences in the legal effectiveness of tax rules.⁷⁵ Some take pride in the wisdom that SAT circulars ‘are the law’. Recently, this view was crystallised around the widely-discussed Circular 698.⁷⁶ On its face, Circular 698, by imposing Chinese tax reporting obligations on non-residents who have no Chinese-source income, and by declaring the power on the part of the SAT to disregard offshore holding companies and levy tax against non-residents on non-Chinese-source income, goes well beyond the authority of the EIT Law.⁷⁷ Because it has no legal basis, the decision not to comply with it should attract no penalties, and under FIN 48 standards it is quite possible for foreign companies to conclude that a taxpayer is ‘more likely than not’ to prevail in court against government actions based on the circular. Even so, most Chinese tax advisors seem not to regard Circular 698’s legal invalidity as a significant concern. Instead, they now routinely recommend clients to comply with Circular 698’s reporting obligations. Moreover, they have concocted elaborate advices on which holding company structures possess ‘business purpose’ and ‘business substance’ (so that the structures would not be disregarded) for purposes of the circular, based on the imagined preferences of – or only slightly less amorphous, informal discussions with – tax officials.

So far, the best rebuttal of this purportedly pragmatic view has come from the government itself. On 15 December 2009 – just five days after Circular 698 was finalised, and only weeks after the issuance of the MOF/SAT notices regarding NPOs – the SAT’s ministerial committee met and approved the New Measures for Normative Documents (referred to below simply as the ‘New Measures’),

⁷⁵ See, for example, PricewaterhouseCoopers, ‘Treaty residents having clearer rules for claiming benefits under double tax treaties’ (Sep 2009) Issue 20 *China Tax/Business News Flash* (stating that where an SAT issuance adopted in August 2009 and an SAT decree issued in January 2009 conflict, the former prevails because it is ‘more comprehensive in terms of administrative procedures’; failing to note that the SAT decree is a ministerial regulation); available at: http://www.pwc.com/ie/en/tax/assets/benefits_under_double_tax_treaties.pdf.

⁷⁶ For a few examples from a multitude of professional articles and client alerts, see: A W Granwell and Peng Tao, ‘China Targets Offshore Firms’ Indirect Equity Transfers of Chinese Companies’ (16 Feb 2010) Vol 10, No 29 *BNA Daily Tax Report* 1; and Dongmei Qiu, ‘China’s Capital Gains Taxation of Nonresidents and the Legitimate Use of Tax Treaties’ (22 November 2010) *Tax Notes International* 593.

⁷⁷ See Lawrence Sussman *et al*, ‘China’s Controversial New Disclosure Rule’, *Tax Analysts 2009* WTD 241-1, for an example of a discussion questioning the legality of Circular 698.

which extend the norms of the LL to rulemaking activities of tax agencies. These steps show that *from the SAT's own point of view*, inconsistencies between informal rules and formal legal rules, as well as their retroactive application, are unacceptable and should be systematically eliminated.

The New Measures, which took effect on 1 July 2010, replace a previous set of rules applicable to the issuance of informal rules by tax agencies lower than the SAT,⁷⁸ and differ from these previous rules in two fundamental respects. The New Measures, but not the previous rules, take the form of a ministerial regulation, signalling that the New Measures have both the force of law (per the LL) and superior effect over the informal rules ('normative documents') that they govern. Moreover, the New Measures, but not the previous rules, govern normative documents issued by the SAT itself.⁷⁹ Since most of China's tax policy and substantive tax rules are determined nationally, the extension of the New Measures to SAT informal rulemaking gives the principles embodied in the previous rules much greater impact.

The New Measures govern 'tax normative documents', defined as 'documents that are made and promulgated by a tax agency ... that prescribe the rights and obligations of taxpayers, withholding agents and other parties against whom tax administrative actions may be taken ... and that have general binding force and are applicable repeatedly within the jurisdiction of the tax agency'.⁸⁰ The definition excludes SAT ministerial regulations, and thus captures all informal rules issued by tax agencies that 'prescribe the rights and obligations of taxpayers [etc]' generally.⁸¹ The meaning of these words is not specifically defined anywhere, and presumably is synonymous with having the effect of law.⁸² In any case, the New Measures stipulate that any tax normative document must

⁷⁸ Trial Measures for Normative Documents. Some common features between the New Measures and the previous rules – eg in adopting a principle of non-retroactivity and permitting pre-enforcement challenges regarding the legality of informal rules – demonstrate that the SAT's concerns for rule of law norms are not new.

⁷⁹ New Measures for Normative Documents, Art 2.

⁸⁰ *Ibid.*

⁸¹ *Ibid.*

⁸² In an SAT guidance issued, accompanying the New Measures, a distinction between documents laying out internal management matters and normative documents is drawn. See *Guoshuifu* [2010] No 55, Notice Regarding the Implementation of the 'Administrative Measures for the Making of Tax Normative Documents' (SAT, issued 10 February 2010, effective 1 July 2010).

be issued in Public Announcements (*gonggao*) format.⁸³ Consequently, it is now generally possible to tell whether an informal rule is intended to have the force of law simply by seeing whether it is a Public Announcement.⁸⁴

The New Measures impose three other requirements on tax normative documents that are just as significant. First, such documents cannot apply retroactively, except for special provisions adopted ‘for the purpose of better protecting the rights and interests of’ taxpayers.⁸⁵ Second, the adoption of any tax normative document must be preceded by a review procedure that specifically focuses on the legal basis of the proposed rule and its consistency with existing law.⁸⁶ Each draft document must be submitted for review by the rulemaking agency’s legal department, along with specific statements establishing its legal basis.⁸⁷ No normative document may be issued without the sign-off of the legal department.⁸⁸ Third, if taxpayers believe that a normative document is inconsistent with national or local statutes, State Council or ministerial regulations, or normative documents issued by higher agencies, they may apply for the review of such a document with the issuing agency or the tax agency at the next higher level.⁸⁹ Since this rule applies to SAT normative documents, if a taxpayer is inclined to challenge an SAT circular, he or she no longer has to wait for an enforcement action to occur.⁹⁰

⁸³ New Measures for Normative Documents, Art 27. SAT guidance accompanying the New Measures has stressed this requirement. See *Guoshuifa* [2010] No 55 (note 82 above) (‘Matters of [tax agency] internal management and matters with general binding effect on taxpayers should be addressed in separate documents. Where such separation is difficult, as long as the document relates to taxpayers’ rights and obligations, it should take the form of a public announcement. In the case of a response to a particular case involving specific matters of individual taxpayers, it need not adopt the format of a public announcement and may be labeled a “reply”; however, any such response that is to be implemented throughout the relevant jurisdiction must still adopt the form of a public announcement and cannot be given as a “reply”.’)

⁸⁴ Circulars for purposes of internal management continue to be issued without adopting the Public Announcement format. See, for example, *Guoshuihan* [2010] No 323, Notice Regarding Initiating Examinations of Contemporary Documentation (SAT, 12 July 2010).

⁸⁵ New Measures for Normative Documents, Art 13. See LL, Art 84 and discussion accompanying notes 18-20 above. A similar principle of non-retroactivity was contained in the Trial Measures for Normative Documents.

⁸⁶ *Ibid.*, Arts 16, 19, 20 and 22.

⁸⁷ *Ibid.*, Arts 19 and 20.

⁸⁸ *Ibid.*, Art 16.

⁸⁹ *Ibid.*, Art 35.

⁹⁰ The Trial Measures for Normative Documents, which did not apply to SAT documents, contained a similar mechanism for non-judicial pre-enforcement review.

In respect to retroactivity and the availability of non-judicial, pre-enforcement review mechanisms, therefore, the New Measures puts tax normative documents on par with formal legal rules recognised by the LL. By contrast, the New Measures take a fairly pragmatic approach towards rulemaking by not requiring the solicitation of public input.⁹¹ They also refrain from imposing the onerous procedures for regulation-making (including making annual regulation-making plans and having the ministerial committee approve each proposed regulation) on the issuance of normative documents.

Numerous other provisions of the New Measures⁹² also promise to introduce substantially more clarity and transparency to tax agencies' (especially the SAT's) rulemaking activities. Although the New Measures apparently do not apply to informal rules jointly issued by the MOF and the SAT,⁹³ they nonetheless represent a striking rebuke to the prevalent view discussed at the beginning of this section, that is, the view that legal order does not matter in Chinese tax administration because the government does not care about such order and taxpayers are unwilling to enforce it, and that informal rules issued by the government should be given full weight regardless of how much these rules contradict law of higher authority or are inconsistent with each other. The unproductiveness of this cynical view is now being underscored every day, with the issuance of each new tax normative document by the SAT and by local tax agencies across China pursuant to the New Measures. Simply by eschewing the worst forms of retroactivity and by being unambiguous as to its intended legal effect, each document issued testifies to the improvement of tax rulemaking already introduced by the New Measures.

V. Conclusion

The New Measures do not govern normative documents issued before 1 July 2010. It is difficult, however, not to read this abrupt contrast between the clarity of the New Measures and the amorphousness of the prior practice as implying

⁹¹ New Measures, Art 17 merely suggests that 'the drafting department should conduct in-depth investigations and research, summarise practical experiences and attend to the opinions of all relevant parties ... Opinions may be solicited in writing or online, or by holding symposiums, discussions and hearings, etc'.

⁹² New Measures for Normative Documents, Art 6, for example, clearly establishes that no internal division of a tax agency may issue normative documents.

⁹³ See Li Sanjiang (ed), *Annotations on the Administrative Measures for Formulating Normative Documents in Taxation* (China Taxation Press, Beijing, 2010), p 7.

a repudiation of the latter. Of course, the New Measures could also be read as challenging the doctrines of the LL, in suggesting that normative documents themselves may create legal rights and obligations for taxpayers. The SAT has acknowledged that normative documents may be disregarded by courts, and that such documents are inferior to regulations.⁹⁴ But its view is that this does not prevent normative documents from being part of the legal order: they simply exist in the lowest rank in it, and because the LL failed to regulate this part of the legal order, it is the task of the executive branch, including State Council ministries, to expand the norms of the LL to their own rulemaking activities.

In its own terms, this view could be as conceptually coherent as the LL itself. One might even regard it as both pragmatic and principled. After all, the LL itself does not draw a clear distinction between making and interpreting law, and is largely silent on matters of delegation of rulemaking authority to the executive branch (eg on what matters must be covered in ministerial regulations as opposed to rules of inferior status). Without even a basic framework addressing such issues, the LL's implication that its rules are the exclusive sources of law may seem hollow. This encourages executive branch agencies to take the view that, in being entrusted with the implementation of law, they not only have the power to make law (ie making 'detailed' rules) but may also do so through rules that are not ministerial regulations. What the SAT has done is to go a step further, and claim that because rulemaking below the regulation level is unavoidable in the implementation of law, such activities must be regulated in accordance with LL-like norms.

However, at the moment, the SAT's position as embodied in the New Measures is rather unique and has not been adopted by other ministries. Indeed, even the SAT itself does not follow this position when pursuing joint rulemaking with the MOF. We must therefore conclude that there are at least three starkly different views about what constitutes the tax legal order in China:

1. the view represented by the LL, according to which most Chinese tax rules lack the force of law;
2. the implicit view of many Chinese tax service providers, whereby there is no tax legal order and the inconsistencies among different rules are to be resolved by private conversation with tax officials; and
3. the view taken by the New Measures, which is progressive-minded, relative to the current circumstances of Chinese tax administration, and which has yet to be noticed, examined and embraced by taxpayers, government agencies and scholars alike.

⁹⁴ *Ibid*, p 11.