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The Chinese Enterprise Income Tax

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Draft chapter prepared for Reuven Avi-Yonah (Ed.)
Research Handbook on Corporate Taxation

Abstract

China's Enterprise Income Tax (EIT) is the world's largest corporate income tax by revenue, contributes a significant share to China's total tax revenue, and is clearly the most substantial component of capital taxation in China. Yet scholarly research on the EIT is still limited. This overview chapter outlines the EIT's main components from a legal perspective, while referring to empirical economic and accounting research that sheds light on these components. It discusses the personal scope of the EIT, so as to identify the significance of the pass-through and the tax-exempt sectors relative to the taxable corporate sector. It then examines a range of determinants of the effective EIT burden for corporate taxpayers, including the graduated rate structure, tax exemptions and rate reductions, local tax rebates, modifications of the income tax base, and income tax accounting rules. It also considers key rules governing transactions between a corporation and its shareholders and the treatment of corporate reorganizations and groups. One theme that emerges is that because the Chinese personal income tax (PIT) remains under-developed, EIT rules are the most important area in which income tax norms are elaborated, but the crudeness of PIT rules also limits the complexity of EIT rules.

Introduction

In 2021, the Enterprise Income Tax (EIT) in China raised CNY 4.2041 trillion in revenue (equivalent to USD 651.5 billion), making it the world's largest corporate income tax.[2] The EIT has consistently contributed a significant share to total tax revenue in China during the last two decades,[3] and is surpassed currently only by general taxes on goods and services and social insurance contributions in importance (see Figure 1). Capital taxation in China has become a critical piece in the measurement of global factor income taxation,[4] and the EIT clearly constitutes the most substantial component of Chinese capital taxation.

Yet scholarly research on the EIT—whether of the legal, economic, or accounting varieties—still forms a small body of literature, and our collective understanding of the EIT's workings remains limited.

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[1] I thank Xiaoyu Ma and Qiguang (Hardy) Zhou for their comments on an earlier draft of this chapter. Copyright 2022 by Wei Cui.

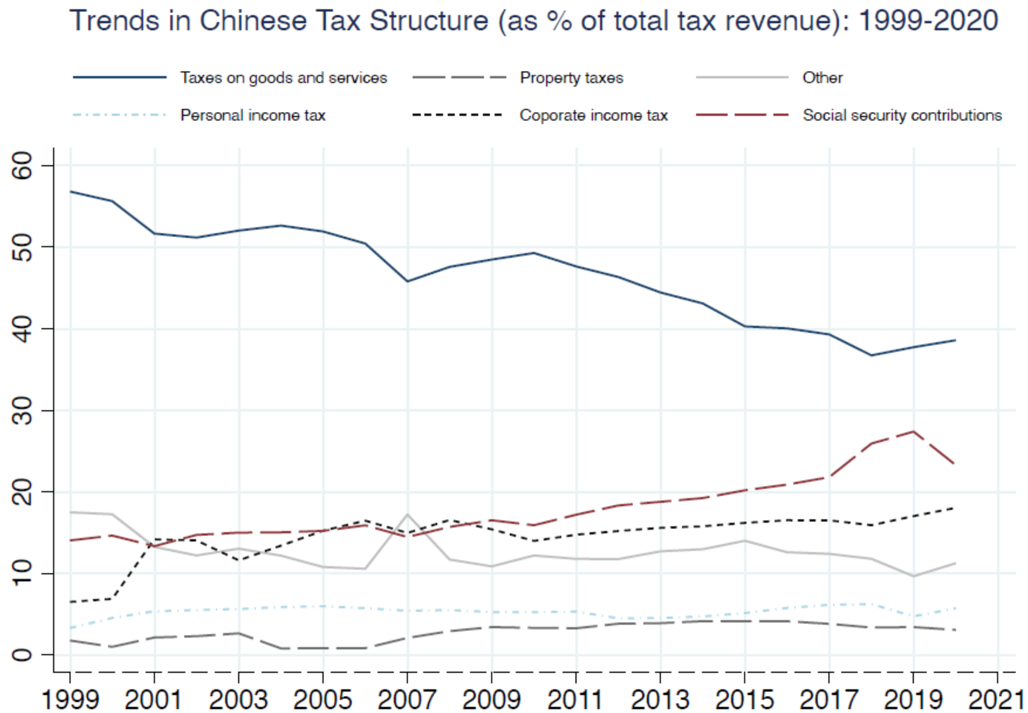
[2] USD 1 = CNY 6.453 at the average exchange rate in 2021. In comparison, U.S. federal corporate income tax revenue in 2021 was $372 billion, while total state and local corporate income tax collection in the U.S. was $75.754 billion in 2020 (the last year for which data is available).

[3] This chapter refers to the "CIT" when discussing the corporate income tax conceptually and comparatively, and to the "EIT" when discussing the CIT's particular Chinese incarnation in the Enterprise Income Tax.

[4] Rising capital taxation in China substantially contributes to rising capital taxation in developing countries. Pierre Bachas, Matthew H. Fisher-Post, Anders Jensen, and Gabriel Zucman, "Globalization and Factor Income Taxation," NBER Working Paper No. 29819 (2022), Figure 4.

There are several relevant explanations. The first is the EIT's relative youth. Most of the current corporate organizational forms used in China became available only in the early 1990s, when China's urban sector began its transition to a market economy. A general CIT regulation for domestic firms was adopted only in 1993, and it assumed legislative form only in 2008, when an Enterprise Income Tax Law (EITL) that applies to both domestic and foreign-owned firms was enacted.[5] China's rapid economic transition implies not only that scholarship about the EIT began to accumulate only recently, but also that some of the earlier scholarship quickly became obsolete.

Figure 1 Composition of Tax Revenue in China



Second, during the same early stages of evolution of the CIT in developed countries (in the first half of the 20th century), law played a crucial role in shaping its content. In countries like the U.S. and Canada, legislators debated about and crafted detailed CIT rules, and courts actively interpreted such rules.[6] In this setting, both public and scholarly understandings of the CIT rested on legal foundations. By contrast, the articulation of EIT rules through legal institutions in China is sparse. Statutory language provides limited guidance. Courts are rarely involved in the interpretation and application of EIT rules. Most guidance on the EIT's application takes the form of informal policy announcements by the Ministry of Finance (MOF) and State Taxation Administration (STA), public knowledge of which used to be patchy,

[5] Enterprise Income Tax Law (Presidential Decree [2007] No. 63, effective January 1, 2008; amended in 2017 and 2018); Enterprise Income Tax Law Implementation Regulations (State Council, Decree No. 512, 2007) ("EITLIR").

[6] This was arguably all because the income tax was collected on the basis of *self-assessment*: large populations of taxpayers had to learn, on their own or through tax advisors, what tax rules applied to them, and they filed tax returns and remitted taxes as a part of their general compliance with the law, with only limited intervention from tax authorities. See Wei Cui, *The Administrative Foundations of the Chinese Fiscal State* (Cambridge University Press, 2022), Chapter 8.

and such national guidance is in any case often lacking in detail.[7] The resulting shallowness of common knowledge about the EIT arguably also impedes scholarly research.[8]

A third explanation relates to China's political structure. China's central government claims exclusive authority in tax lawmaking. Yet it does not engage in tax administration. Instead, tax collection is handled by city-, county- or even lower-level tax bureaus, which are separated from the central government by at least one (the province) and often more bureaucratic tiers. Decentralized tax collection has resulted in large frictions in upward information transmission. Until recently, most provinces did not have centralized taxpayer databases, and consequently the MOF and STA, which rely on provinces for taxpayer information, lacked access to taxpayer data. Little EIT statistics is publicly available, and national policy discussions often generate little information regarding policy impacts. Data available for economic analyses is scant: to this date, most empirical studies of the EIT are based on highly aggregated statistics, financial disclosures of large listed companies, surveys of industrial firms conducted by statistical agencies, or, at best, taxpayer surveys (but not tax returns) of larger firms.[9]

Besides these general institutional backgrounds, a critical legal background to understanding the Chinese EIT is that the Chinese personal income tax (PIT) remains quite under-developed.[10] In addition to its relatively meagre revenue intake (Figure 1), the PIT's arrested development is manifest also in its excessive simplicity. In U.S. tax law lingo, there are few "above-the-line" deductions permitted to arrive at accurate depictions of income earned.[11] This is important for the EIT for two reasons. First, it means that EIT rules are the most important area in which income tax norms are elaborated. One cannot assume that income tax accounting applies similarly to individual and corporate taxpayers, and that, in discussing the CIT, only rules special to corporate level taxation or those governing transactions among corporations and shareholders require consideration.

Second, the tax consequences of corporate transactions with individual shareholders become much simpler. There is, for example, no such thing as "capital loss" for individual shareholders, because the PIT has no place for the deduction of losses from investments (against either capital gains or other types of income). Also, few shareholders would have ordinary (i.e. non-capital) gains or losses from shareholding, because trading activities are not treated as a type of "business" that would give rise to taxable sole proprietor business income. The income tax consequences of individuals' shareholding are

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[7] Id., Chapter 7. It is consequently important for any analysis of the EIT not to stop at the letters of the EITL and the EITLIR. This chapter will refer to informal policy announcements by their official document numbers—enough for an interested reader to determine the official basis of rules summarized, but avoiding full title citations that may be excessive for an overview chapter.

[8] The lack of such common knowledge is reflected in the under-development of tax curricula in Chinese legal and accounting education: textbooks and treatises about EIT's details are few and not commonly used.

[9] Cui, supra note 6, Chapter 6.

[10] The Chinese PIT collects a small share of total income tax revenue even compared to other countries with similar or lower levels of income per capita. Zhao Chen, Yuxuan He, Zhikuo Liu, Juan Carlos Suárez Serrato, and Daniel Yi Xu, "The Structure of Business Taxation in China," 35 Tax Policy and the Economy 131-177 (2021), at 149-50. The PIT's stagnation needs to be explained not by the lack of state capacity common to developing countries, but by specific and deliberate policy decisions made by China's political leaders. See Cui, supra note 6, pp 180-5.

[11] In 2018, China introduced several PIT deductions that favored high-income households that correspond to what U.S. tax specialists would call "below-the-line" deductions. These deductions did little to strengthen principles regarding income measurement. See, Zhan, P., S. Li, and X. Xu. 2019. "Personal Income Tax Reform in China in 2018 and Its Impact on Income Distribution." China & World Economy, 27 (3): 25–48.

therefore limited to the receipt of dividends or capital gains from the sale of shares, both of which are generally taxed at 20%.

Section I in this overview discusses the EIT's personal scope, thereby identifying the (in)significance of the pass-through and the tax-exempt sectors. Section II discusses a range of determinants of the effective tax burden for corporate taxpayers, including the graduated rate structure, tax exemptions and rate reductions, local tax rebates, policy-based modifications of the income tax base, and income tax accounting rules. Section III considers key rules governing transactions between a corporation and its shareholders, as well as rules concerning corporate reorganizations and group consolidation, topics that generate some of the greatest complexity in CIT regimes in other countries. The Conclusion finally highlights several questions the EIT poses for theories of the CIT.

While this chapter explores the Chinese EIT primarily from a legal perspective, it also refers to economic and accounting research and supplies some EIT statistics based on such research. The chapter focuses on the purely domestic dimensions of the Chinese EIT, and does not consider the EIT's application to cross border transactions.[12]

I. The Taxable Corporate Sector

The EIT's personal scope is extremely broad: subject to two explicit exceptions, it is applicable not only to all "enterprises"—i.e. entities organized to pursue profit—regardless of whether they have limited or unlimited liability, but also to government-affiliated institutions that are not government agencies (e.g. public schools, universities, hospitals), social organizations or "any other organization earning income".[13] This means, for example, that there is no general exemption from the EIT for government-owned or government-operated entities. Many such entities may still have no EIT liability, if their only sources of revenue are government budgetary appropriations, authorized fees collected from the provision of public services, charges collected on behalf of government authorities, or other types of "non-taxable income" that have specific government-designated uses.[14] But as long as such organizations receive other types of income, they are subject to the EIT.

The two explicit exceptions from the personal scope of the EIT are "partnership enterprises" and "individual proprietorship enterprises" formed pursuant to specific organizational statutes.[15] Partnership enterprises are subject to an under-developed set of rules whereby income from a partnership are taxed at the partner level, but the character of income is not necessarily preserved and losses and deductions do not flow through.[16] "Individual proprietorship enterprises" are taxed like other types of sole proprietorships under the PIT. The types of firms subject to flow-through taxation are few. The actual

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[12] Perhaps not surprisingly, scholarly publications in English on Chinese international taxation are more voluminous than such publications on the EIT's domestic aspects. For earlier treatments of Chinese international taxation, see Fuli Cao, *Corporate Income Tax Law and Practice in the People's Republic of China* (Oxford University Press, 2011); Jinyan Li, *International Taxation in China: A Contextual Analysis* (IBFD, 2016).

[13] EITLIR Art. 3.

[14] EITL Art. 7 and EITLIR Art. 26.

[15] Chinese civil law recognizes non-statutory partnerships, but such "civil law partnerships" are not explicitly carved out of the EITL's scope. Similarly, "individual proprietorship enterprises" are to be distinguished both from the vast population of sole proprietors that are not viewed as organizations (and therefore outside the scope of the EIT) and from limited liability companies with single owners and subject to the EIT.

[16] Wei Cui, "The Prospect of New Partnership Taxation in China," 46 Tax Notes Int'l 625 (May 7, 2007)

use of "partnership enterprises" and "individual proprietorship enterprises" is surprisingly even more limited. In a 2016 sample of the universe of firms from a large province used in a number of studies discussed below, out of over 2 million registered entities, less than 1% are partnerships, and only about 7% are "individual proprietorship enterprises".

Besides partnership and individual proprietorship enterprises, there are no exempt organizations *per se* under the EIT. The EITL does provide that the income of "qualified non-profit organizations" (QNPOs) may be exempt from taxation.[17] The EITL's implementational regulations (EITLIR) specify the eligibility criteria for QNPOs, and provide that exempt income received by QNPOs does not include income derived from for-profit activities, unless the MOF and STA prescribe otherwise.[18] However, the MOF and STA subsequently ruled that even for QNPOs, income exempt from the EIT only includes donations received,[19] government subsidies (not including compensation for services rendered to the government), membership dues made mandatory by government agencies, and bank deposit interest derived from these previous "income" sources.[20] No income from the provision of goods or services or from investment (even through non-profit activities) is ever exempt. QNPOs' exempt status thus currently carries little interest from the perspective of income taxation.[21]

The vast majority of EIT taxpayers are "limited liability companies" governed by the Company Law. A second corporate form governed by extensive rules in the Company Law is the joint stock company: it is a required form for listed companies, and extensively studied by Chinese corporate law scholars. But it is used by less than 0.5% of corporate taxpayers.[22]

II. Rate and Base Determinants of Effective Tax Rate

1. Graduated average rates

The EIT deploys a graduated rate structure—and to an extent that cannot be inferred from the statutory language alone. The regular and most often-cited EIT rate is 25%. But in the past decade, only a small portion of Chinese corporate taxpayers were subject to this rate, thanks to an extra-statutory regime for "small and micro-profit enterprises" (SMPEs). The EITL (Art. 28) provides that an SMPE is entitled to a reduced 20% rate. To specify the scope of the reduced rate's application, the EITLIR (Art. 92) defined SMPEs in terms of certain employee (80), asset (CNY 10 million), and annual taxable income (CNY 300,000) thresholds. However, in 2009, the MOF and STA announced that firms that satisfied the SMPE asset and employee criteria under the EITLIR and that earned less than CNY 30,000 in taxable income may include only half of such income when calculating their EIT liabilities in 2010. Eligible firms in effect faced a 10% EIT rate.

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[17] EITL art. 26.
[18] EITLIR arts. 84 and 85.
[19] Under regular EIT rules, donations/gifts represent income to the recipient: EITL Art. 6(8).
[20] Caishui [2009]122.
[21] In any case, the number of registered non-business social organizations in China appears to remain small. In the provincial taxpayer database cited above, they represent less than 1% of registered entities.
[22] However, the U.S. Treasury treats the joint stock company as the only form of *per se* corporation in China and all limited liability companies are eligible for "checking the box".

In a series of subsequent tax cuts, the MOF and STA not only extended the half-income-inclusion rule for additional years, but also gradually lifted the taxable income eligibility threshold.[23] By 2016, all businesses describable as SMPEs under the EITLIR's definition had become entitled for the half-income-inclusion rule. In other words, no Chinese firm was supposed to be paying the 20% tax rate at that point. This graduated structure (under both the statutory SMPE regime and its administrative extension) describes average, not marginal, tax rates: a firm above the taxable income threshold would be subject to a higher rate on *all* of its income.[24]

In 2017, the State Council wished to extend the SMPE tax cut to more firms. Instead of doing so by amending legislation or even its own administrative statute (the EITLIR), it authorized the MOF and STA to announce, in an informal policy circular, that "SMPEs" with annual income up to CNY 500,000 could claim a 20% tax rate and half income inclusion. This directly contradicted the EITLIR definition of SMPEs, according to which a firm with more than CNY 300,000 of taxable income could not be an SMPE. Consequently, the STA, in providing further guidance under this new policy, stated that "SMPE" meant *either* firms defined under EITLIR Art. 92 *or* those described in the 2017 informal circular.[25]

This extra-statutory SMPE regimes further expanded when the MOF and STA, again acting at the direction of the State Council, increased the "SMPE" income threshold to CNY 1 million in 2018. And in 2019, they lifted the employee and asset thresholds for applying the rate cuts: firms with fewer than 300 employees and less than RMB 50 million in assets could qualify as "SMPEs". Moreover, further rate graduation is introduced: firms with less than CNY 3 million in taxable income are entitled to half income inclusion, while firms earning less than CNY 1 million of taxable income a year only had to include *a quarter* of their income, implying a 5% tax rate.[26] The MOF claimed that this tax cut delivered benefits to 95% of all Chinese firms.[27] The "SMPE" term became completely unanchored from statutory law.

EIT rate cuts are a favored policy instrument in China, and the expanded SMPE regime continues to evolve. In 2022, the tax rate for "SMPEs" earning less than CNY 1 million of taxable was again reduced by virtue of a new 1/8 income inclusion rule, while those earning CNY 1-3 million of taxable income became eligible for 1/4 income inclusion. The new benefits are available until the end of 2024. Although all SMPE tax rates below 20% have been announced as temporary, such rates have been in place for 13 out of the 15 years in which the EITL legal regime has been in place.[28]

2. Preferential tax exemptions and rate reductions

In addition to rate differentiation by firm size, the EITL also offers sector-based preferential rates. For instance, income from much agricultural, forestry and fisheries business is exempt from the

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[23] Wei Cui, Mengying Wei, Weisi Xie and Jing Xing, "Corporate Tax Cuts for Small firms: What Do Firms Do?" CESifo Working Paper No. 9389 (2021).

[24] The resulting "notches" in rates predictably led to bunching in taxable income reporting around the income thresholds, but, interestingly, not the asset threshold. Id.

[25] For further discussions of this alternative, extra-statutory SMPE regime, see Cui, supra note 6, at 215-8.

[26] Caishui [2019] 13.

[27] Using 2011 data on primarily large- and medium-sized firms, Chen et al supra note 10 report that the most prevalent (modal) tax rate among firms with positive income was 25%. In our 2016 sample of the universe of firms from a large province, the modal rate has become 10%.

[28] Cui et al supra note 23 find suggestive evidence that at least before 2016, firms treat the SMPE tax cuts as temporary: manufacturing firms demonstrated positive investment responses depending on the size of the cash flow effect from the tax cut.

EIT, while other agricultural and fisheries activities are taxed at half the regular applicable rate.[29] Infrastructure and environmental protection projects enjoy tax holidays (3 years of exemption, 3 years of taxation at half the regular applicable rate).[30] Income from the transfer of technology is exempt to the extent of CNY 5 million and amounts in excess of CNY 5 million are taxed at half the normal rate.[31]

Perhaps the best-known EIT preferential rate (aside from the "temporary" tax cuts for SMPEs) is the 15% rate available to "high and new technology enterprises" (HNTEs).[32] China's HNTE regime has attracted extensive scholarly attention.[33] To qualify, a firm must submit extensive documentations regarding its business and technological profile and demonstrate that it satisfied a range of criteria including the proportion of personnel engaged in research and development (R&D) (no less than 10%), the proportion of revenue from the sale of high tech products and services (no less than 60%), and R&D intensity, measured by the ratio of R&D expenditures to sales.[34] The R&D intensity requirement is size-dependent and higher for firms with lower revenue. A study based on taxpayer survey data for 2008-2011 shows that firms' observed R&D intensities bunch at the size-dependent thresholds, consistent with the fact that HNTE qualification lowers the average tax rate for all income of a firm (instead of incentivizing marginal spending).[35] Moreover, firms clearly engage in "re-labelling" and report other administrative expenses as R&D, despite the relatively close scrutiny they are subject to. Using a complex economic model, the authors of the study estimate that, on average, 24% of "R&D investments" result from mis-labelling. Given firms' propensity to mis-label, however, they argue that a preferential regime offering carefully-selected firms a lower average tax rate (i.e. 15%) is superior to tax policy that offers marginal incentives for R&D spending to all firms.[36] Moreover, they argue that even though mis-labelling results in lost revenue and the notching of average tax rates distort behavior, the HNTE program may be welfare-enhancing overall, based on reasonable assumptions about the positive spillover effects of R&D on the productivity of other firms.[37]

If one only examined the EIT statute and formal regulations to identify tax exemptions and rate reductions, one would miss the vast majority of national preferential policies—and be under the serious mis-impressions that the Chinese EIT is much more uniform in its treatment of firms from different regions and industries than CIT regimes in other countries. In reality, most national preferential EIT policies are adopted by the MOF and STA without specific statutory authorization, through informal policy announcements.[38] The 15% reduced rate, for example, is available not only to HNTEs but also to

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[29] EITL Art. 27(1), EITLIR Art. 86.
[30] EITL Art. 27(2)-(3), EITLIR Arts. 87-88.
[31] EITL Art. 27(4), EITLIR Arts. 87-88.
[32] EITL Art. 28(2), EITLIR Art. 93.
[33] See, e.g. Chen, Z, Z Liu, J C Suarez Serrato, and D Y Xu (2021), "Notching R&D investment with corporate income tax cuts in China", American Economic Review 111(7): 2065-2100; Koenig M, Z Song, K Storesletten, and F Zilibotti (2022), "From imitation to innovation: Where is all that Chinese R&D going?" forthcoming in Econometrica.
[34] For the most recent version of these requirements, see *Guokefahuo* 2016 [32].
[35] Chen et al, supra note 33, 2069-2074.
[36] In reality, the EIT does offer marginal incentives to *all* firms for R&D spending, through the "super-deduction" for such expenditures discussed below.
[37] It has also been suggested that the Chinese HNTE policy is relatively unique—and effective—in requiring at least 60% of the R&D activity to be conducted within China. Annette Alstadsæter, Salvador Barrios, Gaetan Nicodeme, Agnieszka Skonieczna & Antonio Vezzani, "Patent boxes design, patents location, and local R&D," Economic Policy, 33(93), 131-177 (2018).
[38] EITL Art. 36 provides that "where the national economic and social development so requires, or the business operations of enterprises have been seriously affected by emergencies and other factors, the State Council may

"technologically advanced service firms" that export a substantial portion of their services, firms operating in encouraged industries and designated western China regions, and firms in an ever-growing set of free-trade zones and special economic zones. The list of tax exemptions, holidays, and reductions offered over the years is much longer.[39] An examination of such a list would show that rate cuts, as opposed to modifications of the tax base, represent the dominant type of tax preference.

3. Local tax rebates as rate reductions

Chinese local governments are notorious for offering tax cuts to attract business investment.[40] While there is only one EIT in China—there are no subnational income taxes *per se*—40% of EIT revenue is allocated among provincial and sub-provincial governments.[41] And local governments, especially at the county, district, and sometimes even lower (e.g. township) levels, are known for the practice of extending rebates of their share of EIT revenue to persuade businesses to locate in their jurisdictions. Because the national government disfavors such rebates, they are usually offered in secret during individual negotiations between local governments and businesses and as fiscal subsidies rather than tax cuts.[42] But such rebates effectively reduce the applicable EIT rate, and reinforce the practice of offering tax incentives through rate reductions instead of base modifications.

4. Modifications of the income tax base

The Chinese government's propensity to offer tax incentives through exemptions and rate cuts can be contrasted with the more sparing use of tax base modifications. Consider the depreciation of tangible assets. The EITL's basic depreciation rules are quite simple and provide only for straight-line depreciation and five fixed asset classes, with asset lives ranging from 3 to 20 years. The statute contemplates accelerated depreciation (AD) only to correct serious errors in the classification of assets for economic depreciation. In comparison, Chinese accounting rules allow both double declining balance (DDB) and sum-of-the-year's-digits (SYD) depreciation.

In 2014, the MOF and STA introduced AD for large populations of taxpayers for the first time. Effective from January 1, 2014, all firms could immediately expense newly purchased fixed assets with unit value under CNY 5,000, as well as newly purchased instruments and machinery with unit value under CNY 1 million used exclusively for R&D. For purchases with unit values greater than CNY 1 million

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formulate special preferential policies concerning the EIT and submit them to the Standing Committee of the National People's Congress for archival purposes."

[39] An official compilation of pre-2019 policies is found at http://www.chinatax.gov.cn/download/pdf/bszn/44.pdf.

[40] See Wei Cui, "Fiscal Federalism in Chinese Taxation," World Tax Journal 2011(3), 455-80. For spatial-econometric evidence on incomet tax competition at the city level, see Jing Xing, Wei Cui and Xi Qu, "Local Tax Incentives and Behavior of Foreign Enterprises: Evidence from a Large Developing Country," Singapore Management University School of Accountancy Research Paper No. 2018-S-71.

[41] In a tax sharing arrangement dating back to 2002, the central government claims 60% of the EIT revenue collected, while provincial governments split the remaining 40% with sub-provincial jurisdictions. Intra-provincial EIT revenue sharing arrangements vary from province to province.

[42] It is generally believed that local governments offer such tax incentives because economic growth features prominently in the performance metrics of Chinese politicians, who engage in tournament competitions for promotion. For a recent study that offers purported causal evidence, see Li, Z., Yu, A.Z. The Last Strike: Age, Career Incentives and Taxation in China. St Comp Int Dev (2022). Provincial- and city-level political leaders are less likely to liberally offer businesses tax rebates both because they face less specific pressure to promote economic growth and because they are more sensitive to national government directives, which disfavor local tax competition.

and used exclusively for R&D, firms could also claim AD, understood as a choice of either using 60% of the statutory asset life for straight-line depreciation, or using DDB or SYD depreciation. In addition, firms in six manufacturing industries could apply AD to any newly purchased fixed assets, regardless of the size and purpose of the investment.[43] In 2015, these investment incentives were extended to four additional manufacturing industries. All AD policies in 2014 and 2015 were introduced as permanent measures. In 2019, the Chinese government extended the incentives to all manufacturing industries, also on a permanent basis.

However, initial take-up of AD benefits was very low. A study based on EIT return data from one province found that during 2014-2016, firms failed to claim AD benefits on over 80% of eligible investment.[44] One explanation is that widespread losses reduce the value of AD. An additional explanation is that, due to poor policy publicity and a lack of prior exposure, many firms are unaware or fail to grasp the policy's benefits. Consistent with this idea, the study found that larger firms and HNTEs (which have more tax expertise because of HNTE qualification requirements) were more likely to claim AD. There is also evidence that greater local tax administration resources increase benefit take-up: both proximity to tax bureaus and a higher local tax-administrator-to-taxpayer ratio increase take-up.

An important question about tax incentives is whether they mainly subsidize infra-marginal investments. The study of firm response to AD finds that the largest 5% of firms both are more likely to claim AD than the rest of the sample and displayed a significant investment response. However, in the rest of the sample, proxies for awareness of the AD policy do not predict greater investment, suggesting that many better-informed firms did not increase investment because of AD, but simply claimed advantageous deductions *ex post*.

A number of other notable investment and employment incentives under the EIT modify the tax base. For all firms (i.e. not just HNTEs), there is a "super-deduction" for R&D expenses: firms can either deduct 150% of the actual expenses, or if the expenses are required to be capitalized and amortized over time, they can claim 150% of the normally available amortization deductions.[45] In 2017, the MOF and STA further enhanced the deduction to 175% for "technology-type medium and small enterprises" for three years. In 2018, the 175% super-deduction became available to all firms until the end of 2020, and this incentive has since been extended to the end of 2023.[46] In 2021 and 2022, the government separately made a 200% super-deduction permanently available for all manufacturing firms and "technology-type medium and small enterprises".[47]

In terms of employment incentives, the EITLIR provides for a 200% super-deduction for wages paid to disabled individuals a firm employs.[48] Although the EITL also authorized the State Council to

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[43] SMPEs in the six industries could immediately expense investments on instruments and machinery partially used for R&D and with unit values under 1 million CNY.

[44] W. Cui, J. Hicks & J. Xing, "Cash on the Table? Imperfect Take-up of Tax Incentives and Firm Investment Behavior," 208 Journal of Public Economics 104632 (2022)

[45] EITL Art. 30(1), EITLIR Art. 95. Firms in numerous industries (e.g. wholesale and retail, hospitality and restaurants, entertainment, real estate, and rental and commercial services) are precluded from taking R&D super-deductions (Caishui [2015] 119). Starting in 2018, expenses from R&D performed outside of China are eligible for the super-deduction, but (i) only 80% of the actual amount of such expenses are considered, and (ii) only if expenses from R&D performed outside of China do not exceed 2/3 of total R&D expenses. *Caishui* [2018] 64.

[46] *Caishui* [2018] 99 and MOF/STA Bulletin [2021] No. 6.

[47] MOF/STA Bulletin [2021] No. 13; MOF, STA and Ministry of Science and Technology Bulletin [2022] No. 16.

[48] EITL Art. 30(2) and EITLIR Art. 96.

adopt other similar wage super-deductions to encourage other types of employment, not such incentive appears to have been adopted.[49]

Investment tax credits are also available under the EIT, but are more limited compared to deductions: 10% of the cost of purchases of specialized equipment used for environmental protection, energy or water saving, or production safety can be used to offset current year EIT liabilities; unused credits can be carried forward for 5 years.[50]

5. Loss carryovers

An important limitation of the EIT is that losses can be carried forward generally only for 5 years (there is no loss carryback).[51] This not only results in the mismeasurement of firm income over time but also diminishes the attraction of the incentives offered by various deductions. A study based on a 2011 national sample of firms (biased towards large and medium firms) found that 40% of firms had non-positive profits.[52] Another study based on a sample of all firms from a large province showed that the percentage of loss-making firms each year is even higher among smaller firms (ranging from 54% to 70% during 2010-2016), and that the stock of accumulated tax losses represented on average 12%-15% of the revenue of such firms.[53] The presence of losses has been found to completely eliminate the effect of the tax cut for SMPEs, and also sharply reduce the claim of AD benefits.[54]

In 2018, the MOF and STA permanently extended the duration of permitted loss carryover from 5 to 10 years—but only for HNTEs and "technology-type medium and small enterprises".[55] Since AD and R&D super-deductions are now generally available to all manufacturing firms, the expansion of favorable loss carryover treatment still lags the expansion of tax incentives based on base modification.

6. Income Tax Accounting

As mentioned in the Introduction, the elaboration of income tax norms in China primarily takes place in the EIT context. Many features of the EIT require taxpayers to account for income or losses in ways that are substantially different from financial accounting rules. Two examples that may especially resonate with tax scholars elsewhere are the taxation of gift transactions and income from the cancellation of debt (CODI). The receipt of donations by an EIT taxpayer gives rise to taxable income,[56] but gratuitous giving in the form of sponsorships—which are distinct from contributions to recognized charities and from advertising expenses—are not deductible to the donor,[57] illustrating that rare pairing of inclusion by the donee and non-deductibility by the donor that is discussed only as a theoretical possibility in other tax systems. In terms of CODI, the EIT explicitly requires taxpayers to recognize

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[49] Limited per worker tax credits have been made available, but usually such tax credits are used first against liabilities for taxes other than the EIT (such as the value added tax).
[50] EITL Art. 34, EITLIR Art. 100. The purchased equipment must also be held and used for 5 years; the transfer or loss of such equipment within 5 years leads to the claw back of the credits.
[51] EITL Art. 18.
[52] Chen et al supra note 10.
[53] Cui et al supra note 23.
[54] Id. (loss firms show no response to SMPE tax cuts); Cui et al supra note 44 (loss firms fail to take up AD benefits).
[55] Caishui [2018] 76.
[56] EITL Art. 6(8).
[57] EITL Art. 10(6) and EITLIR Art. 54.

income when payable amounts are determined to be unpayable, and when debt liabilities are reduced as a result of debt restructuring.[58] Though the pursuit of a business is likely to be in the background for both occasions of CODI recognition, neither is required under accounting rules.

There are many other instances of EIT rules overriding accounting principles. Entertainment expenses, for example, are not fully deductible: only 60% of the amount of actual expenses are allowable as deductions, and each taxpayer's total annual entertainment expenses cannot exceed 0.5% of business revenue.[59] Advertising expenses in excess of 15% of annual sales revenue cannot be immediately deducted, but can be carried over to future years.[60] And deductions for charitable contributions each year cannot exceed 12% of total accounting profits.[61]

Indeed, the EITL explicitly provides that in the computation of taxable income, whenever accounting rules conflict with tax rules set out in statutes and regulations, tax rules prevail.[62] However, one might still be justified in taking the view that accounting rules serve a default role in the determination of EIT liabilities: on the annual EIT return, taxpayers are required to report a set of book-tax adjustments after reporting income and expenses, indicating that the initial computation of income and expenses are based on accounting principles. Still, there is no legal authority, especially in the complete absence of any EIT jurisprudence, for the inference that when tax rules are silent, taxpayers are entitled to tax consequences that flow from applicable accounting rules.

Importantly, for Chinese corporate taxpayers, there is no distinction between capital and ordinary (business) income and losses. And because this distinction is also absent from the PIT, extensive rules regarding the character of income and losses are not needed. This implies, for example, there are no rules for "recapturing income" from the disposition of depreciated property, since none of the gain from such disposition receives favorable "capital gain" treatment.

III. Transactions between Corporation and Shareholders

Under China's PIT, labor and business income faces higher marginal tax rates than the highest EIT rate of 25%: the highest marginal rate on wage is 45%, on non-wage labor compensation 36%, and on self-employed or sole-proprietor income 35%. Because the applicable EIT rate is often much lower (per Section II.1-2 above), and because the EIT allows a much larger range of deductions than the PIT, incentives for individual entrepreneurs to earn labor or business income through corporations would appear to be substantial. This is consistent with empirical evidence. In the dataset on the universe of firms from a large province cited above, companies owned by a single individual investor represented almost 40% of all companies formed in recent years.[63] Moreover, companies majority-owned by individuals represent more than 85% of all companies, whereas those majority-owned by other companies represent less than 6% (and companies that are wholly owned by another company only 3%).

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[58] EITLIR Art. 22.
[59] EITLIR Art. 43.
[60] EITLIR Art. 44.
[61] EITLIR Art. 53. Excess contributions can be carried over for 3 years. EITL Art. 9.
[62] EITL Art. 21.
[63] Wei Cui and Mengying Wei, "Registered Capital and Firm Entry," working paper. This proportion especially increased after a legislative change in 2014 that reduced the equity contribution requirement for new companies.

However, it is also worth noting that under the PIT, the investment income (e.g. dividends, interests and capital gains) of individuals are generally subject to a flat 20% rate. This relatively lower, non-progressive tax on individual investment income somewhat mitigates incentives to earn investment income through closely-held corporations. Moreover, publicly-traded equity is already lightly taxed to individual shareholders. For shares traded on the Shanghai and Shenzhen stock exchanges, the MOF and STA have exempted individual investors' capital gain from the on-exchange sale of shares from the PIT since 1997. Since 2013, the tax rate on dividends paid on shares purchased on the stock exchanges has depended on the investor's holding period: for shares held for more than a year, the rate is only 5%; for shares held for between a year and a month, the rate is 10%; only dividends on shares held for a month or less are subject to the full 20% rate.[64] The use of closely-held corporations for making financial investments therefore may be limited. [65]

1. Shareholder benefits and loans

Unsurprisingly, there are many anecdotal reports that in China's vast population of small and closely-held companies, corporate funds are often used to pay for personal expenses. The government has long taken the stand that corporate payments for shareholders' personal consumption expenses and consumption good purchases are non-deductible and moreover taxable under the PIT as dividends to shareholders.[66] Moreover, funds loaned by companies to shareholders, if not repaid within the same year the loan is made *and* not used by the shareholders for "enterprise operations", will be treated as dividends.[67]

Failures to keep personal and corporate funds separate also go the other way: shareholders may lend funds to their companies for business operations. Because the applicable EIT rate is often lower than the 20% PIT rate that interest income is subject to in the hands of an individual, interest payments on loans from shareholders would not normally serve as a tax planning device. Perhaps because of this, the MOF and STA have allowed interest payments to shareholders and other individuals to be deducted in computing corporate taxable income, even though the law (likely out of neglect) does not provide for such deductions.[68] The deductions are subject to generally applicable limitations on related parties loans regarding the interest rate and thin capitalization.[69]

2. Contributions, distributions and reorganizations

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[64] Oliver Zhen Li et al, "Individual Investors' Dividend Taxes and Corporate Payout Policies", Journal of Financial and Quantitative Analysis, 52(3), 963-990. This study reports that share repurchases by listed companies have been uncommon in the past.

[65] However, at least in theory, because investment losses can be deducted by a business entity (corporate or non-corporate) but not by an individual, an entity can facilitate the offset of investment loss against investment gain.

[66] This position, however, does not consider whether the company has sufficient profits to make dividend distributions, and whether, in the common case that the company has losses, the expenditure/distribution should be treated as a return of capital instead.

[67] Caishui [2003] 158 and Caishui [2008] 83.

[68] Guoshuihan [2009] 777. EITLIR Art. 38 only provides for deductions for interests paid to non-individual lenders.

[69] Caishui [2008] 121. Under China's thin cap rules, interest on loans from related parties that exceed 2 times the equity capital of the borrower is not deductible.

Generally, shareholder contributions of assets to corporations (whether during incorporation or subsequently) are taxable events under the EIT.[70] The making of in-kind contributions to a company thus triggers the recognition of either income or losses to the transferor.[71] For individual shareholders, the amount realized in an exchange of assets for shares is determined by subtracting the basis of the asset from the value of the assets relinquished.[72] Such valuation of assets contributed (rather than the value of shares received) will in turn determine the shareholder's basis in the shares received. Moreover, individual shareholders can pay the tax liability from gains realized on the exchange over up to 5 years.[73] Similar rules apply when the shareholder is a company, and both the transferor and transferee companies are residents in China.[74] In other cases (i.e. where the transferor or transferee is non-resident), the shareholder's basis in the shares received is determined by the shares' fair market value, which presumably means that the amount received on the exchange is also determined by the shares' fair market value and not the value of the assets contributed.[75] There is also no deferral of payment of the tax liability on gains.[76] Regardless of the nature of the contributing shareholder, the company takes fair market value basis in the assets received.[77]

Corporate liquidations are also generally realization events, including the complete liquidation of a subsidiary into a parent corporation. A liquidating company must pay EIT on its "liquidation income", computed as the difference between the cash or fair market value of the total assets available to shareholders for distribution minus the adjusted basis of the assets. All assets distributed (after the payment of EIT on liquidation income) are treated as dividends to the extent of undistributed earnings, and any remaining amount would give rise to gain or loss to the extent it exceeds (or falls short of) the cost of the shares.[78]

That asset contributions to and distributions from corporations are generally taxable invites the question of whether and when deferral (non-recognition, "rollover") treatments are available. Similarly to the United States, the tax treatment of corporation reorganizations was a prominent topic during the early evolution of the CIT in China. This was because the CIT's introduction in the early 1990s was fundamentally motivated by China's transition to a market economy, and large-scale asset sales and reorganizations involving SOEs were integral to such transition.[79] However, by 2009, when the MOF and STA put in place a new set of rules governing reorganizations, such society-wide asset reallocations originating from the state-owned sector was already over. Under the 2009 rules (as subsequently

[70] Caishui [2015] 41 (PIT treatment of individual shareholders); EITLIR Art. 25 (treatment of corporate shareholders).

[71] Neither the PIT nor EIT regime in China contains rules generally denying losses from related party transactions that are analogous to IRC Section 267.

[72] Caishui [2015] 41 (par. 2). Moreover, if the contributed assets are shares of another company, the valuation of such shares upon contribution is governed by a separate set of rules focused on preventing the under-valuation of shares. STA Bulletin [2014] No. 67.

[73] Cash considerations received from asset contributions and from the (partial) disposition of the shares received are required to be used to pay down such tax liability. STA Bulletin [2015] No. 50.

[74] Caishui [2014] 116.

[75] EITLIR Art. 71(2).

[76] STA Bulletin [2010] No. 19.

[77] EITLIR Arts. 58(5).

[78] EITL Art. 55; EITLIR Art. 11; Caishui [2009] 60.

[79] Wei Cui and Richard Krever, "The Tax Consequences of Corporate Reorganisations in China" (2011) 3 British Tax Review 340-353.

modified),[80] the following transactions are treated eligible for "special treatments" including the deferral of gain/loss recognition and carryover of basis:

- Debt-to-equity recapitalizations in the context of debt restructurings;[81]
- "Share acquisitions" where the acquiring company acquires at least 50% of all the shares of the target company, and uses its own shares or the shares of controlled subsidiaries as at least 85% of the consideration;[82]
- "Asset acquisitions" where a target company transfers at least 50% of its total assets to an acquiring company,[83] and the acquiror pays consideration no less than 85% of which comprises the shares of the acquiror or of controlled subsidiaries;
- Mergers of commonly controlled companies or mergers where the shareholders of the absorbed company receive at least 85% of total consideration in the form of the shares of the surviving corporation or of its controlled subsidiaries;
- "Divisions" where the shareholders of a company being divided receive pro rata the shares of the company spun off, where both the divided and spun-off companies continue previous operations, and where share considerations represent no less than 85% of the consideration received by shareholders of a company divided.

In addition to these formal requirements, the above reorganization transactions are eligible for special (i.e. deferral) treatment only if additional requirements regarding reasonable business purpose, continuity of business (for 12 months), and continuity of interest (major shareholders of the previous target, absorbed, or divided company must retain shares received for at least 12 months). In characterizaing transactions as eligible or ineligible reorganization, account may also be taken of transactions during the 12 month both before and after the reorganization transactions according to the principle of substance over form.

China's "special reorganization" rules were deliberately modeled on the U.S. federal income tax treatment of corporate reorganization, although resemblance is only partial. A number of other special treatments of corporate reorganizations have more native origins. For example (as discussed below), China does not have a consolidated returns regime, but an MOF-STA policy announcement in 2014 provided that among resident companies that bear 100% control relationships, transfers of assets or shares for no consideration (which are called *huazhuan* or re-allocations) that are recorded by both the transferor and the transferee at book value are treated as non-recognition transactions.[84] Because such transfers are legally defined only for SOEs, this rule appears only to accommodate SOEs that are (still) unable to accomplish the same reallocations pursuant to normal contractual practices. Another type of unusual tax treatment of reorganizations involves taxable transactions that SOEs engage in that do not qualify for deferral treatment under general rules, but where the SOEs obtain special income tax

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[80] Caishui [2009] 59; STA Bulletin [2015] No. 48.

[81] Debt restructurings are, by definition under Caishui [2009] 59, situations in which the debtor faces financial difficulties and is released from some re-payment obligations (and therefore has CODI).

[82] Initially, a share acquisition was eligible for special treatment only if 75% or more of the shares of the target is acquired. This requirement was lowered in 2014 to 50% pursuant to a State Council initiative to promote reorganizations and re-allocation of assets. Caishui [2014] 109.

[83] The 50% asset transfer requirement was also the result of a 2014 relaxation of previous requirements, under which 75% or more of all assets must be transferred by the target.

[84] Caishui [2014] 109, par. 3.

exemptions by obtaining individual rulings. While no tax is collected from the transactions, the new owners of assets or shares after the reorganizations obtain stepped-up basis.[85]

3. "De-consolidation" among Group Members and Branches

Inter-corporate dividends are exempt from EIT for the recipient company, unless the shares on which dividends are paid are listed shares held for less than 12 months.[86] Aside from this basic rule for relieving multiple layers of entity-level taxation, the EIT does almost nothing by way of special treatment of intra-group transactions. Before 2009, a select set of SOE groups were eligible for consolidation treatment, whereby losses of some group members can be used to offset income of others. This treatment was repealed in 2009 because of its revenue cost and has not been revived.[87] Intra-group transactions are generally given full effect.

While the EIT generally disregards transactions among domestic branches of the same corporate legal person, an elaborate formulary apportionment system is used to compute EIT liabilities payable by branches in different provinces.[88] The reason is that while the EIT itself is a single (nationally-imposed) tax, EIT revenue is split 60/40 between the central and provincial governments: where a corporation has operations in different provinces, it cannot pay tax just to the headquarter (HQ) jurisdiction. Instead, 50% of its tax liabilities is allocated to the HQ jurisdiction, with the remaining 50% allocated among the jurisdictions of the branches.[89] The branch allocation formula uses the factors of revenue, payroll and total assets with weights of 35%, 35%, and 30% for each. Interestingly, if different branches are entitled to different EIT rates thanks to regional tax differentials, the computation of the total EIT liability of the company depends on the allocation of income to different branches. The allocation of EIT liabilities holds for both monthly or quarterly advance payments and for the settling of tax liabilities after annual filing.[90] Tax bureaus in each jurisdiction have the authority to audit the local branches, and any outstanding tax liability discovered would be shared 50/50 between the auditing and HQ jurisdictions—but not with other branch jurisdictions.

Conclusion

Many of the off-the-shelf theories of the CIT present an awkward fit for the Chinese EIT. For example, the textbook idea of the CIT as a backstop to personal income taxation—i.e. as a *complement* to the PIT—seems highly incongruous, both because the Chinese government shows no commitment to a robust PIT, and because effective tax rates under the EIT are sufficiently low that individuals often have clear incentives to earn business income through corporations.

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[85] Wei Cui, "Taxation of State-Owned Enterprises: A Review of Empirical Evidence from China," Benjamin Liebman and Curtis Milhaupt (Eds.), *Regulating the Visible Hand? The Institutional Implications of Chinese State Capitalism* (New York: Oxford University Press, 2015), 120-22.

[86] EITL Art. 26(2) and EITLIR Art. 83.

[87] Cui, supra note 85, at 119-120.

[88] STA Bulletin [2012] No. 57.

[89] A branch for EIT allocation purposes must either be an operation that has an independent business license but over the personnel, operation and finances of which the HQ exercises direct control, or an operation that has separate financial accounting.

[90] EIT taxpayers are generally required to make monthly or quarterly pre-payments, with the frequency determined by the local tax bureau to which it is assigned.

As a self-standing tax on entities, however, the EIT is characterized by two contrasting sets of features. On the one hand, smaller firms are subject to lower tax rates, especially after the last decade of SMPE tax cuts. Together with the fact that smaller firms are also more likely to report losses, this implies that the EIT probably imposes a relatively small cost on small firm operations.[91] Aside from compliance costs, the EIT is unlikely to present a barrier to business formation. Conversely, it is unlikely to be effective as a screen against unproductive firms. Little would be lost, it seems, if many small firms already enjoying de facto exemption from the EIT are nominally made exempt as well.

On the other hand, the EIT also does not appear to be well-suited for large firms. This is seen, for example, through the relative simplicity of EIT rules, and the fact that tax incentives are given mostly through rate reductions instead of base modifications. And many aspects of the design of the EIT, e.g. the serious limitation on loss carryovers, at least *look* inefficient and poised to induce substantial distortions for the large firms affected by the EIT. Yet how much the EIT actually distorts Chinese firms' behavior remains little investigated.[92] If the EIT's main effects are not on individual savers or entrepreneurs in small businesses, but on large firms, how are these effects best described?

For scholars interested in developing positive theories of the CIT—in the sense of theories that match, explain and predict CITs in the real world—the Chinese EIT raises significant and interesting questions.

[91] This stands in contrast to the regressivity of some other taxes paid by Chinese businesses, e.g. the employer's portion of social insurance contributions. This difference between tax types may be hidden by the fact that for most taxes, the vast majority of revenue is generated from the top decile of firms.

[92] Chen et al supra note 10 report no significant sign of capital misallocation induced by the dispersion in effective EIT rates.