CHINESE STATE CAPITALISM AND THE INTERNATIONAL TAX REGIME

Cameron Rotblat[*]

As signaled by its participation in the G-20/OECD Base Erosion and Profit Shifting Project, China is gaining significant influence over international tax rules. Yet, how exactly China intends to shape international tax law remains an open question, even amongst leading Chinese tax scholars. As both a major capital importer and exporter as well as a developing economy with tremendous global economic power, China does not fit neatly into the traditional dichotomies of the international tax regime. This article argues that China's international tax policy is likely to be strongly influenced by its unique system of state capitalism. Both the history of Chinese domestic tax reforms and the Communist Party's current mechanisms of control over the Chinese economy suggest that China's tax policy cannot be understood separately from its system of state capitalism. This article contends that as a result, China is likely to adopt distinctive international tax policies including maintaining a worldwide system of corporate taxation, providing tacit state support for international tax planning by major Chinese multinationals, and negotiating for broad exemptions in tax treaties for state-associated entities. If not proactively addressed by OECD countries, these policies may lead to significant fractures within the international tax regime.

[*] J.D. 2018, Yale Law School. I would like to thank Michael J. Graetz for his helpful suggestions and encouragement.

I. INTRODUCTION

In May 2017, Chinese President Xi Jinping hosted an international forum highlighting China's Belt and Road initiative—a multi-trillion-dollar infrastructure plan spanning over 60 countries and roughly one-third of the global economy.[1] Chinese leaders have labeled it "the project of the century" and state media outlets have described it as ushering in "Globalization 2.0."[2] China is already the world's largest economy (on a purchasing power parity basis), largest manufacturer, largest exporter, largest trading nation, and largest holder of foreign exchange reserves.[3] Consequently, Western observers have interpreted the initiative as a concerted effort to reshape the global economic order and rewrite the rules on international trade and investment.[4]

One month later, the international tax regime witnessed a major milestone in what has been described as the "most extensive attempt to change international tax norms since the 1920s."[5] On June 7, 2017, over 70 jurisdictions signed an innovative multilateral convention modifying the signatories' existing bilateral tax treaties.[6] The convention represents the culmination of a four-year project, known as BEPS, spearheaded by the G-20 and the OECD to combat base erosion and profit shifting.[7] This multifaceted project, which also developed recommended measures for countries' domestic tax laws, seeks to better ensure corporate profits are taxed "where substantive

[1] *See, e.g.*, Jessica Meyers, *Globalization 2.0: How China's Two-Day Summit Aims to Shape a New World Order*, L.A. TIMES, May 12, 2017, http://www.latimes.com/world/asia/la-fg-china-belt-road-2017-htmlstory.html [https://perma.cc/XX89-7GEC]; Jane Perlez & Keith Bradsher, *Xi Jinping Positions China at Center of New Economic Order*, N.Y. TIMES, May 14, 2017, https://www.nytimes.com/2017/05/14/world/asia/xi-jinping-one-belt-one-road-china.html [https://perma.cc/Z3UP-SUM9].

[2] Charles Clover, Sherry Fei Ju & Lucy Hornby, *China's Xi Hails Belt and Road as 'Project of the Century,'* FIN. TIMES, May 14, 2017, https://www.ft.com/content/88d584a2-385e-11e7-821a-6027b8a20f23 [https://perma.cc/D2DQ-3UP9]; *China's Belt and Road Initiative Ushers in 'Globalization 2.0,'* PEOPLE'S DAILY ONLINE, Apr 13, 2017, http://www.chinadaily.com.cn/business/2017-04/13/content_28909176.htm [https://perma.cc/YM9W-Z8GB]; *Belt and Road Initiative Strives to Reflect 'Globalization 2.0,'* CHINA DAILY, March 26, 2017, http://www.chinadaily.com.cn/business/2017-03/26/content_28683281.htm. [https://perma.cc/2G7M-GQXZ].

[3] *See* Wayne M. Morrison, CONG. RESEARCH SERV., RL33534, China's Economic Rise: History, Trends, Challenges, and Implications for the United States (2015); *see also* Noah Smith, *Who Has the World's No. 1 Economy? Not the U.S.*, BLOOMBERG (Oct 18, 2017), https://www.bloomberg.com/view/articles/2017-10-18/who-has-the-world-s-no-1-economy-not-the-u-s (discussing the relevance of purchasing power parity in comparing the U.S. and Chinese economies).

[4] *See* Michael Holtz, *Trumpeting 'One Belt, One Road,' China Bids to Lead 'Globalization 2.0,'* CHRISTIAN SCIENCE MONITOR (May 16, 2017), https://www.csmonitor.com/World/Asia-Pacific/2017/0516/Trumpeting-One-Belt-One-Road-China-bids-to-lead-Globalization-2.0 [https://perma.cc/9WXK-8PEW]; *see also* Meyers, *supra* note 1.

[5] Itai Grinberg, *The New International Tax Diplomacy*, 104 GEO. L.J. 1137, 1140 (2016); *see also* Itai Grinberg & Joost Pauwelyn, *The Emergence of a New International Tax Regime: The OECD's Package on Base Erosion and Profit Shifting (BEPS)*, ASIL INSIGHTS (Oct 28, 2015), https://www.asil.org/insights/volume/19/issue/24/emergence-new-international-tax-regime-oecd%E2%80%99s-package-base-erosion-and#_ednref2 [https://perma.cc/Y534-7FVN] ("A new international tax regime is emerging ….").

[6] ORG. ECON. CO-OPERATION & DEV. (OECD), *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS*, http://www.oecd.org/tax/beps/ground-breaking-multilateral-beps-convention-will-close-tax-treaty-loopholes.htm [https://perma.cc/BUJ4-ZDJ6].

[7] *See* ORG. ECON. CO-OPERATION & DEV. (OECD), *Base Erosion and Profit Shifting*, http://www.oecd.org/ctp/beps/ [https://perma.cc/RSM5-7HVF].

economic activities generating the profits are carried out and where value is created."[8] While many leading scholars are skeptical of the "patch-up" or "band-aid" nature of the project's substantive tax rules,[9] the project represents a notable change in the institutional framework for tax diplomacy.[10] The Committee on Fiscal Affairs of the OECD, a small group of mostly rich countries, has long served as the leading forum for international tax reform and more recently as "an *informal* world tax organization," often to the dismay of developing countries.[11] However, as part of BEPS, the entire G-20, including non-OECD members Brazil, Russia, India, China and South Africa, were allowed to participate "on an equal footing" with OECD members.[12]

These developments portend a major role for China in shaping future international tax rules. Over the past decade, many have predicted that China would eventually assume meaningful influence over the international tax regime.[13] Following China's participation in the BEPS project, it appears China has now made the transition "from a norm-taker to a norm-shaker."[14] In assessing its engagement, Reuven S. Avi-Yonah and Haiyan Xu concluded that China "actively participated in both developing and implementing the BEPS project."[15] Jinyan Li has similarly reasoned that China's BEPS efforts, "are likely to have significant implications for the development of international tax system."[16] Those analyzing the institutional structure of the international tax regime have likewise suggested that going forward China and the BRICS will have a "significant" impact on tax policy reform.[17] Yariv Brauner, for instance, has argued that any meaningful policy reforms will require cooperation from China and India and that these countries are positioned to

---

[8] ORG. ECON. CO-OPERATION & DEV. (OECD), *Explanatory Statement OECD/G20 Base Erosion and Profit Shifting Project*, https://www.oecd.org/ctp/beps-explanatory-statement-2015.pdf [https://perma.cc/L6VL-U2ZR].
[9] MICHAEL J. GRAETZ, FOLLOW THE MONEY 271 (2016); Yariv Brauner, *What the BEPS*, 16 FLA. TAX REV. 55 (2014); Reuven S. Avi-Yonah & Haiyan Xu, *Evaluating BEPS*, 10 ERASMUS L. REV. 3 (2017); *New Rules, Same Old Paradigm*, ECONOMIST (Oct. 15, 2015), https://www.economist.com/news/business/21672207-plan-curb-multinationals-tax-avoidance-opportunity-missed-new-rules-same-old [https://perma.cc/47XR-L4LF].
[10] *See, e.g.*, Grinberg, *supra* note 5, at 1146.
[11] Arthur J. Cockfield, *The Rise of the OECD as Informal "World Tax Organization" Through National Responses to E-Commerce Tax Challenges*, 8 YALE J.L. & TECH. 136 (2006); *see infra* Part 2.A.
[12] ORG. ECON. CO-OPERATION & DEV. (OECD), *BEPS- Frequently Asked Questions*, http://www.oecd.org/ctp/beps-frequentlyaskedquestions.htm [https://perma.cc/RR25-6TE6]; *see* Diane M. Ring, *Developing Countries in an Age of Transparency and Disclosure*, 2016 BYU L. REV 1767 (2017). Whether the inclusion of these large emerging countries in fact enhances the legitimacy of the project remains contested. *See, e.g.*, Sissie Fung, *The Questionable Legitimacy of the OECD/G20 BEPS Project*, 10 ERASMUS L. REV. 76 (2017).
[13] *See, e.g.*, Andrew P. Morriss & Lotta Moberg, *Cartelizing Taxes: Understanding the OECD's Campaign Against "Harmful Tax Competition",* 4 COLUM. J. TAX L. 1, 56 (2012-2013) ("China's role will be critical in the future … since China's interests in international finance differ significantly from OECD members' interests."); Thomas Ecker & Jieyin Tang, *Business Profits (Articles 5, 6, 7, 8, 9, and 14 OECD)*, in EUROPE-CHINA TAX TREATIES 78 (Michael Lang, Jianwen Liu & Gongliang Tang eds., 2010) ("[O]wing to its increasing importance in the world economy and the growing sophistication of the Chinese tax system, China will also likely play an important role in shaping international tax norms in the next century.").
[14] Jinyan Li, *China and BEPS: From Norm-Taker to Norm-Shaker* (Osgoode Legal Stud., Research Paper Series 126, 2016), http://digitalcommons.osgoode.yorku.ca/cgi/viewcontent.cgi?article=1121&context=olsrps [https://perma.cc/Q52A-7FGP].
[15] Reuven S. Avi-Yonah & Haiyan Xu, *China and the Future of the International Tax Regime* (Law & Economics Working Papers 140, 2017), http://repository.law.umich.edu/law_econ_current/140 [https://perma.cc/8833-8E5B].
[16] Li, *supra* note 14.
[17] *See, e.g.*, Ring, *supra* note 12, at 1793.

potentially "break the dominance of the OECD in the international tax regime."[18] In short, while many debates remain as to the future of the international tax regime, it appears that China will certainly play a significant role.

However, the existing literature on China and the international tax regime offers limited insight into the types of reforms Chinese policy-makers may seek. Extensive scholarly literature exists on the divergent international tax preferences between developed and developing countries—preferences illustrated in part by the OECD and UN model tax treaties respectively.[19] However, international tax scholars have almost completely ignored the ways in which China's unique system of state capitalism may influence its international tax policy.[20] In fact, Wei Cui and Ji Li appear to be the only English-language scholars to have considered the complex relationship between Chinese state-owned enterprises (SOEs) and Chinese international income taxation. Yet, Cui's work has focused primarily on assessing competing theoretical justifications for taxing SOEs and Li's on empirical questions regarding their tax compliance.[21] As a result, foundational matters remain unresolved, including "the objectives of international tax policy" for "countries that are home to many SOE multinationals."[22] Existing scholarship on the implications of Chinese state capitalism for U.S. law has likewise failed to consider the implications of SOEs for international income taxation.[23]

This gap in the international tax literature is particularly jarring in light of the fact that the dramatic growth in Chinese outbound investment over the past two decades has been dominated by SOEs.[24] Recent policies, including the Belt and Road Initiative and a 2017 crackdown on private-sector outbound investment, suggest the Chinese government intends for SOEs to maintain

[18] Yariv Brauner & Pasquale Pistone, *The BRICS and the Future of International Taxation*, *in* BRICS AND THE EMERGENCE OF INTERNATIONAL TAX COORDINATION, *supra* note 12, at 517; Yariv Brauner, *Treaties in the Aftermath of BEPS*, 41 BROOK. J. INT'L L. 973, 1026 (2016).

[19] *See infra* text accompanying notes 51-57; REUVEN S. AVI-YONAH, OMRI MARIAN & NICOLA SARTORI, GLOBAL PERSPECTIVES ON INCOME TAXATION LAW 166 (2010); Donald. R. Whittaker, *An Examination of the O.E.C.D. and U.N. Model Tax Treaties: History, Provisions and Application to U.S. Foreign Policy*, 8 N.C. J. INT'L L. & COM. REG. 39 (1982).

[20] *See generally* Kelle S. Tsai & Barry Naughton, *State Capitalism and the Chinese Economic Miracle*, *in* STATE CAPITALISM, INSTITUTIONAL ADAPTION AND THE CHINESE MIRACLE 11 (Barry Naughton & Kellee S. Tsai eds., 2015) (suggesting seven defining characteristics of modern Chinese state capitalism); Li-Wen Lin & Curtis J. Milhaupt, *We Are the (National) Champions: Understanding the Mechanisms of State Capitalism in China*, 65 STAN. L. REV. 697 (2013) (describing the unique "relational ecology" of Chinese state capitalism composed of deep connections between SOEs and the Party-state).

[21] Their scholarship is discussed in detail at Part 5 *infra*.

[22] Wei Cui, *Taxing State-Owned Enterprises: Understanding a Basic Institution of State Capitalism*, 52 OSGOODE HALL L.J. 775, 810 (2016).

[23] For instance, Lin and Milhaupt discuss potential implications for the Foreign Corrupt Practices Act, the Committee on Foreign Investment in the United States (CFIUS) process, the federal securities law disclosure regime, the antitrust regime, and bilateral investment treaties, but make no mention of international tax law. *See* Lin & Milhaupt, *supra* note 20, at 757-758; *see also* Curtis J. Milhaupt & Wentong Zheng, *Beyond Ownership: State Capitalism and the Chinese Firm*, 103 GEO. L.J. 665, 708-16 (2015) (discussing the implications of Chinese state capitalism for international antitrust, anticorruption, and anti-subsidy law with respect to purportedly private Chinese firms).

[24] *See infra* Part 4.B.

their leading role in China's overseas investment.[25] Scholarly critiques of the Chinese system of SOE governance and of the centrality of SOEs in Chinese outbound investments are both forceful and plentiful.[26] However, rather than engaging in debates about the overall soundness of China's system of state capitalism, this paper proceeds on the premise that SOEs will remain integral to the Chinese economy and outbound investment for the foreseeable future.[27] If so, how may the distinctive features of Chinese state capitalism shape the objectives of China's international tax policy and thereby impact the future of the international tax regime?

This paper argues that China's system of state capitalism may lead it to pursue a set of international tax policies and norms that diverge from those currently sought by OECD nations. First, due to the prominence of SOEs in its outbound investment, China may favor and successfully maintain a robust system of worldwide corporate taxation despite a general trend amongst developed countries towards territorial systems.[28] Second, due to Chinese tax administrators' strong incentive to assist Chinese SOEs in minimizing their foreign taxes paid, China may provide tacit state support for SOE tax planning, complicating the government's role in tax diplomacy.[29] Finally, Chinese international tax policy is likely to provide preferential treatment to SOEs in domestic regulations and seek to expand preferential exemptions for SOEs in bilateral treaties.[30] By pushing for a reconceptualization of sovereign immunity in taxation, China may create a new pressure point for tax competition between countries seeking to attract Chinese direct investment.

These arguments are advanced as follows. Part 2 analyzes international disagreements regarding three key fault lines in the international tax regime: 1) the allocation of taxing rights between source and residence countries, 2) OECD efforts to combat tax competition, and 3) base erosion and profit shifting. Part 3 traces the evolution of China's system of business taxation and argues that Chinese international tax policy stands at an inflection point with the existing literature providing limited insight on its future direction. Part 4 highlights the ways in which the central government maintains extensive control over the Chinese economy through its direct influence over SOEs and capital controls. Part 5 contends that these features of Chinese state capitalism may lead China to challenge the current international tax regime by pursuing a set of distinctive international tax policies and norms. Finally, Part 6 offers concluding thoughts and considers the impacts of such policies on OECD countries.

---

[25] *See, e.g.*, Lucy Hornby, *Chinese Crackdown on Dealmakers Reflects Xi Power Play*, FIN. TIMES, Aug. 9, 2017, https://www.ft.com/content/ed900da6-769b-11e7-90c0-90a9d1bc9691 [https://perma.cc/P4NM-XU5P]; Tom Mitchell & Gabriel Wildau, *China's State Council Puts Seal on Capital Controls*, FIN. TIMES, Aug. 18, 2017, https://www.ft.com/content/3a638d1c-8405-11e7-a4ce-15b2513cb3ff [https://perma.cc/AUX6-DR6K]; *see also* Wu Gong, *SOEs Lead Infrastructure Push in 1,700 'Belt and Road' Projects*, CAIXIN (May 9, 2017), https://www.caixinglobal.com/2017-05-10/101088332.html [https://perma.cc/7D88-ERY3] ("About 50 Chinese state-owned corporate giants have invested or participated in nearly 1,700 projects in countries along the new Silk Road routes over the past three years."),

[26] *See, e.g.*, Ligang Song, Jidong Yang & Yongsheng Zhang, *State-owned Enterprises' Outward Investment and the Structural Reform in China*, 19 CHINA & WORLD ECON. 38 (2011); *see also* CHENYANG XIE, THE LEGAL REGIME OF CHINESE OVERSEAS 85 (2015) ("China should restrict outward overseas investment by State-owned enterprises through legislation").

[27] *See infra* Part 4.B.

[28] *See infra* Part 5.B.

[29] *See infra* Part 5.C.

[30] *See infra* Part 5.D.

II. FAULT LINES IN THE INTERNATIONAL TAX REGIME

A. Allocation of Taxing Rights

Before considering how China's system of state capitalism may impact the objectives of its international tax policy, it is instructive to first survey three key points of disagreement between developed and developing countries regarding the current international tax regime. Only after considering the major fault lines over international tax policy does the significance of China's unique position in tax diplomacy—as an emerging economic power with significant SOE-controlled capital outflows—become clear.

The first, and arguably the most important, area of divergence is the allocation of taxing rights between source and residence countries. When a resident of country A earns income in country B, both countries may legitimately claim the right to tax these earnings. Country A, the residence country, may assert taxing jurisdiction since it is where the income recipient resides or where a corporate taxpayer has its place of incorporation or management.[31] Country B, the source country, may assert taxing jurisdiction since it is where the income is earned.[32] Thus the "essential dilemma of international taxation" is resolving the competing claims of residence and source jurisdictions.[33] Much ink has been spilled over whether residence or source countries have a "better" right to tax earnings,[34] and over the worldwide efficiency impacts of residence or source taxation.[35] Yet, self-interested countries have generally been unwilling to entirely forgo taxation of income earned by their residents abroad or by nonresidents within their borders. This can create double taxation, as earnings may be taxed twice, once by the residence country and once by the source country. While one country can unilaterally take steps to limit the burden of double taxation on its residents through the use of foreign tax credits, exemptions, or deductions, bilateral solutions are preferred.[36] Unilateral action requires a residence country to subordinate its tax claims over foreign income to source country claims, without any guarantee from the source country of reciprocity or of an upper limitation on taxes imposed. Moreover, unilateral exemptions can result in double non-taxation.[37]

As a result, a network of over 3,000 bilateral tax treaties has developed to govern the taxation of cross-border business and investment.[38] While the modern scope of bilateral tax treaties

---

[31] *See generally* Peggy B. Musgrave, *Sovereignty, Entitlement, and Cooperation in International Taxation*, 26 BROOK. J. INT'L L. 1335, 1336 (2001) (discussing justifications of resident country taxation); Omri Marian, *Jurisdiction to Tax Corporations*, 54 B.C. L. REV. 1613 (2013) (analyzing the concept of corporate residence).

[32] *See, e.g.*, Peggy B. Musgrave, *Interjurisdictional Equity in Company Taxation: Principles and Applications to the European Union*, *quoted in* MICHAEL J. GRAETZ, FOUNDATIONS OF INTERNATIONAL INCOME TAXATION 6 (2003).

[33] GRAETZ, *supra* note 9, at 11.

[34] For brief review of the literature, see VERONIKA DAURER, TAX TREATIES AND DEVELOPING COUNTRIES 12-17 (2014); GRAETZ, *supra* note 32, at 5-12.

[35] For a discussion and critique of the principles of Capital Import Neutrality and Capital Export Neutrality, see GRAETZ, *supra* note 9, at 93-98.

[36] *See, e.g.*, Allison Christians, *BEPS and the New International Tax Order*, 2016 BYU L. REV. 1603, 1610 (2016).

[37] *See id.* at 1612.

[38] *See* Reuven S. Avi-Yonah, *Double Tax Treaties: An Introduction*, *in* THE EFFECT OF TREATIES ON FOREIGN DIRECT INVESTMENT: BILATERAL INVESTMENT TREATIES, DOUBLE TAXATION TREATIES AND INVESTMENT FLOWS 99-106 (Karl P. Sauvant & Lisa E. Sachs eds., 2009) (providing an estimate of 2,500 treaties as of 2009); *see also* Brian J. Arnold, *An Introduction to Tax Treaties*, http://www.un.org/esa/ffd/wp-

has expanded, the foundational purpose of these treaties has been preventing double taxation.[39] Scholars have considered these treaties as constituting an "international tax regime," as the treaties are "meaningfully standard" and "largely similar in policy."[40] In particular, this network of treaties reflects what has been labeled the "1920s compromise." As provided for in the 1928 League of Nations model bilateral income tax treaties, the primary right to tax active business income is allocated to the source jurisdiction while the primary right to tax passive investment income is allocated to the residence jurisdiction.[41] A form of this compromise has been embedded in both the OECD and UN model treaties—which serve as the starting points for modern international tax treaty negotiations.

As the presence of two competing model treaties indicates, despite the "1920s compromise" the allocation of taxing rights still remains a pressure point in the international tax regime. In signing a bilateral tax treaty, each country reduces its source-based claims on income earned by non-residents within its borders. For the source-based claims preserved by treaty, the residence country promises to avoid double taxation by providing a tax credit or exemption to its residents for income earned in the source country.[42] Thus, the more source-based claims preserved in a bilateral treaty the greater the allocation of taxing rights to the source country; the fewer preserved, the greater the allocation to the residence country. Generally, when a set of countries has balanced bilateral investment flows, each is a source country roughly as often as it is a residence country, so both are willing to give up significant source-based claims.[43] Thus the OECD model treaty, which originated amongst a set of developed countries assumed to have relatively balanced investment flows, allocates taxing rights primarily to the state of residence. However, if one country receives more capital investment than it sends abroad, allocating tax rights primarily to the state of residence can cause the capital importing country to lose significant tax revenue. Because developed countries are generally exporters of capital, and developing countries importers of capital, the OECD model treaty—with its bias toward residence taxation—has been criticized as favoring developed countries over developing countries.[44] As a result, the UN model treaty is designed to account for non-reciprocal income flows between a developed and a developing country by preserving more source-based claims.[45]

The allocation of taxing rights is a perennial point of contention between developed and developing countries in bilateral treaties negotiations. During the 1940s, when efforts were underway to update the League of Nations model treaties, a tax conference in Mexico attended mainly by Latin American countries saw the development of a model granting source countries

---

content/uploads/2015/10/TT_Introduction_Eng.pdf [https://perma.cc/UH46-Y3SB] (providing an estimate of 3,000 as of 2015).

[39] *See* THOMAS RIXEN, THE POLITICAL ECONOMY OF INTERNATIONAL TAX GOVERNANCE 84-116 (2008).

[40] Reuven S. Avi-Yonah, *Commentary (Response to article by H. David Rosenbloom)*, 52 TAX L. REV. 167, 168-70 (2000); Brauner, *supra* note 12, at 975.

[41] *See* REUVEN S. AVI-YONAH, INTERNATIONAL TAX AS INTERNATIONAL LAW 9 (2007); GRAETZ, *supra* note 9, at 84.

[42] *See* DAURER, *supra* note 34, at 57; Christians, *supra* note 36, at 1613.

[43] *See* DAURER, *supra* note 34, at 23.

[44] *See, e.g.*, Tsilly Dagan, *The Tax Treaties Myth*, 32 N.Y.U. J. INT'L' L. & POL. 939 (2000). However, as further discussed *infra* at Part 3.B., the relationship between development status and capital flows can quite be complicated, especially for large emerging economies.

[45] *See* DAURER, *supra* note 34, at 2.

"almost exclusive taxing rights."[46]A few years later in 1946 a full international tax conference in London drafted a model more favorable to residence countries, which served as the baseline for most bilateral negotiations until 1963.[47] Although the United Nations established a committee intended to continue the model tax treaty work of the League of Nations, the committee ceased to meet after 1954.[48] As a result, the OECD became the main forum for international tax matters, releasing influential model treaties in 1963 and 1977, and consistent updates since 1992 in the form of an ambulatory model.[49] The OECD model reduces source-based claims on passive income earned by non-residents (through lowering or eliminating withholding taxes) and retains source-based claims on active income only for earnings attributable to a permanent establishment.[50] In 1967 the UN resumed its interest in international tax matters, creating a committee of experts intended to aid developing countries in bilateral tax negotiations.[51] The committee published a model treaty in 1980, which was updated in 2001 and 2011.[52] The UN model follows the same structure and terminology as the OECD model but preserves additional source-based claims by, among other things, allowing for higher withholding tax rates on passive income and providing a broader definition of permanent establishment.[53] Elements of the UN model have been used in the bilateral treaties of developing countries, including China.[54] However, the OECD model is said to "dominate the current tax treaty law."[55] Conversely, the UN model "suffers marginalization."[56] Scholars continue to critique the distributional impacts of the OECD model, and some suggest the rise of the BRICS may help foster a more equitable distribution of taxing rights in future treaties.[57]

B. Tax Competition

Another major fault line in the international tax regime is the degree to which it is appropriate for nations to implement low rates and preferential tax policies in the hope of attracting foreign investment. Distinguishing between acceptable and unacceptable tax competition continues to be a point of contention.[58] In the 1980s, the growing number of transactions taking

---

[46] *Id.* at 56.
[47] *See id.* at 56.
[48] *See* SOL PICCIOTTO, REGULATING GLOBAL CORPORATE CAPITALISM 223 (2011).
[49] *See* F. Alfredo Garcia Prats, *Impact of the Positions of the BRICS on the UN Model Convention*, *in* BRICS AND THE EMERGENCE OF INTERNATIONAL TAX COORDINATION, *supra* note 12, at 393; DAURER, *supra* note 34, at 56.
[50] ORG. ECON. CO-OPERATION & DEV. (OECD), Model Tax Convention on Income and on Capital (Dec. 18, 2017), http://www.oecd.org/ctp/treaties/model-tax-convention-on-income-and-on-capital-condensed-version-20745419.htm [https://perma.cc/A8VN-KBQF].
[51] *See* Whittaker, *supra* note 19, at 43-44; *see also* UNITED NATIONS, *Committee of Experts on International Cooperation in Tax Matters*, http://www.un.org/esa/ffd/tax/overview.htm [https://perma.cc/6VPG-PZ38] (describing the history of the Committee of Experts on International Cooperation in Tax Matters).
[52] *See* DAURER, *supra* note 34, at 59; Diane Ring, *Who is Making International Tax Policy: International Organizations as Power Players in a High Stakes World*, 33 FORDHAM INT'L L.J. 649 (2010).
[53] UNITED NATIONS, Model Double Taxation Convention between Developed and Developing Countries (Apr. 5, 2012), http://www.un.org/en/development/desa/publications/double-taxation-convention.html [https://perma.cc/V7QZ-LG99]; *see* DAURER, *supra* note 34, at 2.
[54] *See infra* text accompanying note 118 ; *see also* DAURER, *supra* note 34, at 255.
[55] Brauner, *supra* note 18, at 977; *see* Prats, *supra* note 49, at 395.
[56] Pistone & Brauner, *supra* note 18, at 12.
[57] *See, e.g.*, DAURER, *supra* note 34, at 26-27.
[58] *See* Christians, *supra* note 36, at 1630.

advantage of tax haven jurisdictions led tax policy-makers in OECD countries to recognize a need for coordinated action. Many small jurisdictions found it in their interest to offer preferential tax policies and low rates in order to attract an outsized share of global financial activities.[59] In response, the OECD published a report in 1998 entitled *Harmful Tax Competition: An Emerging Global Issue* which sought to develop criteria to identify harmful tax competition.[60] Two particularly notable elements of the report were its repeated invocations of the dangers of a "race to the bottom" amongst jurisdictions and its listing of low or zero effective tax rates as an element of harmful competition. Then, in 2000 the OECD released a "blacklist" of 35 uncooperative tax havens which were required to take measures to eliminate their harmful tax practices or risk facing coordinated coercive measures by OECD countries—such as the denial of deductions, exemptions, or credits for transactions involving the tax havens.[61] A set of scholars, practitioners, and lobbyists vehemently criticized the OECD's approach for providing unequal treatment of OECD and non-OECD countries (OECD members Switzerland and Luxembourg, for instance, were not required to make any reforms), illegitimately impinging on national sovereignty, and advancing a negative view of "competition" in conflict with free market ideals.[62] These allegations of illegitimacy and political bias coupled with the withdrawal of U.S. support, contributed to the failure of the initiative.[63] Subsequently, the OECD shifted course from focusing on tax competition to focusing on combating tax evasion through information exchange.[64]

Following the pushback to its initiative against harmful tax competition, the OECD adopted a less confrontational approach. In 2002, it released a model Tax Information Exchange Agreement (TIEA) designed to facilitate bilateral exchanges of information between countries without requiring the signing of comprehensive bilateral tax treaties.[65] This tax-transparency agenda initially witnessed limited success, with less than 25 TIEAs signed through 2007.[66] However, following the 2008 financial crisis, a more coercive approach was adopted. In 2009, the OECD, under the direction of the G-20, revealed a progress report which placed jurisdictions that had signed twelve or more TIEAs onto a white list, those that had committed to sign TIEAs onto a gray

---

[59] *See* RIXEN, *supra* note 39, at 131-42; Morriss & Moberg, *supra* note 13.
[60] ORG. ECON. CO-OPERATION & DEV. (OECD), HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE (1998).
[61] *See* Martin A. Sullivan, *Lessons from the Last War on Tax Havens*, 116 TAX NOTES 327 (2007).
[62] *See* Richard Woodward, *A Strange Revolution: Mock Compliance and the Failure of the OECD's International Tax Transparency Regime*, *in* GLOBAL TAX GOVERNANCE 109 (Peter Dietsch & Thomas Rixen eds., 2016); Allison Christians, *Sovereignty, Taxation, and Social Contract*, 18 MINN. J. INT'L L. 99 (2009).
[63] *See* Markus Meinzer, *Towards an International Yardstick for Identifying Tax Havens and Facilitating Reform*, *in* GLOBAL TAX GOVERNANCE, *supra* note at 62, at 259; *see also* Paul O'Neil, Statement on OECD Tax Havens (May 10, 2001), https://www.treasury.gov/press-center/press-releases/Pages/po366.aspx [https://perma.cc/SEC3-CNSC] ("The United States does not support efforts to dictate to any country what its own tax rates or system should be, and will not participate in any initiative to harmonize world tax systems. The United States simply has no interest in stifling the competition that forces governments—like business—to create efficiencies.").
[64] *See* Nicholas Shaxson & John Christensen, *Tax Competitiveness—A Dangerous Obsession*, *in* GLOBAL TAX FAIRNESS 287 (Thomas Poggee & Krishen Mehta eds., 2016); Timothy V. Addison, *Shooting Blanks: The War on Tax Havens*, 16 IND. J. GLOBAL LEG. STUD. 703 (2009).
[65] ORG. ECON. CO-OPERATION & DEV. (OECD), *Tax Information Exchange Agreements (TIEAs)*, http://www.oecd.org/tax/exchange-of-tax-information/taxinformationexchangeagreementstieas.htm [https://perma.cc/HC9C-BZK3].
[66] *See id.*; Richard Eccleston & Helen Smith, *The G20, BEPS, and the Future of International Tax Governance*, *in* GLOBAL TAX GOVERNANCE, *supra* note 62, at 179.

list, and those that had not taken sufficient transparency measures onto a black list.[67] Echoing the approach toward harmful tax competition, the G-20 threatened countermeasures against jurisdictions not meeting tax transparency standards.[68] The approach and the lists of noncompliant jurisdictions were not without controversy.[69] Yet, by 2010, all jurisdictions were removed from the blacklist and by 2014 over 1,600 TIEAs had been signed.[70] However, scholars suggest that the practical results have been limited, with many tax havens engaging in "mock compliance" by signing "near-useless" TIEAs amongst themselves.[71] Despite the mixed record of prior multilateral attempts to address tax competition and evasion, calls continue for further efforts to limit tax competition through U.S. or OECD-led harmonization initiatives.[72]

C. Base Erosion and Profit Shifting

The newest pressure point in the international tax regime is the G-20/OECD BEPS project. Launched in 2013, the project intends to update international tax rules to address various gaps and mismatches utilized by corporations to artificially shift profits across jurisdictions or achieve double non-taxation of income.[73] In 2015, the OECD produced 15 action plans concerning current technical challenges in international tax law.[74] Reflecting a lack of consensus regarding certain elements of the project, most plans only offer prescriptive guidance in the form of suggested best practices. Some, however, provide international minimum standards to be implemented through either the multilateral convention or domestic legislation.[75] Notably, the BEPS project lacks "even mild coercive measures," with peer review as the only enforcement mechanism.[76] Yet, despite the relatively modest aims of the project's action plans, its future remains in doubt. The United States has yet to ratify the multilateral convention and the Trump Administration has expressed little enthusiasm for the project.[77] China, on the other hand, has rapidly implemented most BEPS action

---

[67] *See* Woodward, *supra* note 62, at 111-13.
[68] *See id.*; Grinberg, *supra* note 5, at 1149-51.
[69] See *infra* text accompanying note 129.
[70] *See* Eccleston & Smith, *supra* note 66, at 179.
[71] *See, e.g.*, Meinzer, *supra* note 63, at 267, 255; Woodward, *supra* note 62, at 111-13.
[72] *See, e.g.*, Reuven S. Avi-Yonah, *The OECD Harmful Tax Competition Report: A Tenth Anniversary Retrospective*, 34 BROOK. J. INT'L L. 783, 793 (2009); Danielle Wenner & Kevin Zollman, *How to End International Tax Competition*, N.Y. TIMES, Nov. 2, 2017, https://www.nytimes.com/2017/11/02/opinion/ending-international-tax-competition.html [https://perma.cc/ZQ4Q-MKPX].
[73] *See* ORG. ECON. CO-OPERATION & DEV. (OECD), *Action Plan on Base Erosion and Profit Shifting* (2003), https://www.oecd.org/ctp/BEPSActionPlan.pdf [https://perma.cc/Q688-TRZU]. However some more critical commentators have suggested the project represents an effort to revitalize OECD initiatives against tax competition under a new and more technical guise; *See* Brauner, *supra* note 9, at 76-79; Joachim Englisch & Anzhela Yevgenyeva, *The Upgraded Strategy Against Harmful Tax Practices Under the BEPS Action Plan.* 5 BRITISH TAX REV. 620 (2013); Brian Garst, *BEPS Pivotal in Fight over Tax Competition*, CAYMAN FIN. REV. (Aug. 19, 2015), http://www.caymanfinancialreview.com/2015/08/19/beps-pivotal-in-fight-over-tax-competition/ [https://perma.cc/W3Y6-HFFH].
[74] *See* ORG. ECON. CO-OPERATION & DEV. (OECD), *BEPS Actions*, , http://www.oecd.org/tax/beps/beps-actions.htm [https://perma.cc/4ZM2-CGHP]; Christians, *supra* note 36, at 1623; Grinberg, *supra* note 5, at 1142.
[75] *See Multilateral Convention*, *supra* note 6.
[76] Grinberg, *supra* note 5, at 1168.
[77] *See, e.g.*, Torsten Fensby, *Will the BEPS Project Survive the Trump Administration?,* TAX NOTES (May 15, 2017), https://www.taxnotes.com/worldwide-tax-daily/base-erosion-and-profit-shifting-beps/will-beps-project-survive-trump-administration/2017/06/01/symv [https://perma.cc/3VA5-MCDW]; Robert Sledz, *Thomson Reuters Hosts*

plans, reflecting its significant influence over the project and its interest in becoming the vanguard in international tax policy.[78]

III. THE EVOLUTION OF CHINESE TAX POLICY

A. From Mao to the Modern Enterprise Income Tax

China has historically played a relatively minor role in international tax diplomacy, as its modern system of domestic corporate taxation is of recent origin. In fact, China's current system of corporate income taxation, the Enterprise Income Tax (EIT) dates only to 2008. A brief review of the history of Chinese business income taxation puts China's international tax policy in context and reveals why many aspects remain underdeveloped or in flux. It also illustrates the ways in which changing theories of SOE governance and administration have led to significant alterations in China's business tax policy, further elucidating the underappreciated connection between China's unique system of state capitalism and its tax policies.

China's first income tax was implemented by the Nationalist government in 1936. It applied to both business profits and employment income and was territorial in scope, exempting foreign earnings.[79] Reforms in 1943 extended taxation to rental income and capital gains and purportedly imposed taxes on Chinese citizens abroad, while offering credit for foreign taxes paid—thus following the American model. Yet, during this period China was plagued by war, its tax administration was "in chaos," and the central government had limited power.[80] As a result, there is little surviving evidence on the implementation of this early attempt to tax overseas income.[81] It was not until the mid-1990s that China would again seek to tax business income earned abroad.[82]

In the first decade following the establishment of the People's Republic in 1949, the Communist Party transformed China into a socialist state-planned economy. Initially, 14 different taxes were imposed on private businesses at various stages of transactions. These were consciously designed to discourage private business and thus facilitate the socialist transformation.[83] Thanks to the expropriation of assets held by capitalists and foreign investors, by approximately 1956, the

---

Panel on BEPS MLI and CbC Reporting at 2017 IFA Rio Congress, THOMPSON REUTERS (Oct. 3, 2017), https://tax.thomsonreuters.com/blog/thomson-reuters-hosts-panel-on-beps-mli-and-cbc-reporting-at-2017-ifa-rio-congress/ [https://perma.cc/K6GE-8NE6].

[78] *See* Chris Xing, William Zhang, Lilly Li & Conrad Turley, *China at the Forefront of Global BEPS Implementation*, INT'L TAX REV. (Dec. 3, 2015), http://www.internationaltaxreview.com/Article/3511704/China-at-the-forefront-of-global-BEPS-implementation.html [https://perma.cc/BD4R-ZL7Y].

[79] *See* Jinyan Li, TAXATION IN THE PEOPLE'S REPUBLIC OF CHINA 8-9 (1991); Wei Zhimei & Liu Jian [魏志梅 & 刘建], Zhongguo Jingwai Suodeshui Zhi de Huigu Jiejian yu Zhanwang (中国境外所得税制的回顾、借鉴与展望) (China's Overseas Income Tax System: Retrospective, Lessons, and Prospects], 7 TAX'N RES. J. 89 (2011) [税务研究].

[80] Li, *supra* note 79, at 10.

[81] *See* Wei Zhimei, *supra* note 79.

[82] *See infra* note 109.

[83] *See* Daniel H.K. Ho, *Tax Law in Modern China: Evolution, Framework and Administration*, 31 HONG KONG L.J. 141, 146-7 (2001).

private sector had vanished and SOEs had become the dominant from of commercial enterprise.[84] SOEs were themselves overseen by various government bureaucracies, the most important by central government ministries and the smallest by departments of local governments.[85]

From the mid-1950s until the start of China's reform and opening up policy in late 1978, the government would experiment with various methods of transferring funds from SOEs to the central government. Since there were essentially no foreign entities operating in China, the government's business tax policies were entirely domestic in focus.[86] At first, in the early 1950s SOEs were required to hand over nearly all profits to the central government under a system of direct state administration of income and expenses. However, across the 1950s and 1960s, SOEs were able to maintain a small portion of profits under either the "enterprise bonus system" (in which SOEs could retain any surplus over target levels set by the central government) or the "profit-contracting system" (in which SOEs would retain a pre-determined percentage of total enterprise profits). The particular system in place vacillated with the political winds.[87]

In 1978 China saw the implementation of Deng Xiaoping's reform and opening up policy, allowing for foreign investment and market reforms. In order to attract capital, China adopted income tax regimes offering preferential treatment to foreign direct investment.[88] The Chinese-Foreign Equity Joint Venture Income Tax and the Foreign Enterprise Income Tax both offered generous tax incentives including tax holidays and reinvestment refunds.[89] The first applied to equity joint ventures between a foreign investor and a Chinese partner and had the most generous incentives, while the second applied to other foreign direct investments.[90] In 1991, these two regimes were combined with the introduction of the Foreign Income Tax law providing uniform treatment for all foreign invested enterprises.[91] Across the 1990s effective tax rates for foreign invested enterprises were much lower than for domestic enterprises.[92] Scholars have generally concluded these tax incentives were effective in helping to attract much needed foreign investment.[93]

---

[84] *See* Li, *supra* note 79, at 11; Ho, *supra* note 83, at 147; Jiangyu Wang, *The Political Logic of Corporate Governance in China's State-Owned Enterprises*, 47 CORNELL INT'L L.J. 631, 644 (2014); *see also* Aron Shai, THE FATE OF BRITISH AND FRENCH FIRMS IN CHINA, 1949-54, at 99-104 (1996) (summarizing the history of direct and indirect nationalization of Western firms in China during the early 1950s).

[85] *See* Wang, *supra* note 84, at 646.

[86] *See* Ho, *supra* note 83, at 145.

[87] *See* Ho, *supra* note 83, at 149; Isabella Lam, Stella Cho & Aldous Mak, *Historical Development of Income Tax Law for Domestic and Foreign Enterprises in China*, 22 INT'L TAX J. 51, 52-55 (1996).

[88] Notably, most of these incentives applied to foreign direct investment and not to portfolio investment. Chinese regulations at the time only permitted foreign enterprises to engage in production and business activities and strictly limited their ability to hold investments outside their corporate group. *See* Jinyan Li, *The Rise and Fall of Chinese Tax Incentives an Implications for International Tax Debates*, 8 FLA. TAX REV. 669, 702 (2007). Current Chinese regulations on portfolio investments are further discussed *infra* at Part.4.C.

[89] *See id.* at 671.

[90] *See* Vlad Frants, *The Competence of the Chinese Taxation System*, 18 CURRENTS: INT'L TRADE L.J. 30, 32 (2010).

[91] *See* XIN ZHANG, LAW & PRACTICE OF INTERNATIONAL TAX TREATIES IN CHINA 22 (2003); Ho, *supra* note 83, at 152.

[92] *See, e.g.*, Li, *supra* note 88, at 677 ("As a result of these tax incentives, the effective tax rate for [Foreign Invested Enterprises] was about 10 percentage points lower than that for domestic enterprises.").

[93] *See id.* at 681-86; Qun Li, *Tax Incentive Policies for Foreign-Invested Enterprises in China and their Influence on Foreign Investment*, 18 REVENUE L.J. Art. 5, 15 (2008).

The Reform and Opening Up policy also witnessed changes in the theory of SOEs governance and a concomitant alteration in the taxation of domestic enterprises. Following the start of Reform and Opening Up in 1978, SOEs were given more authority to make independent business and personnel decisions.[94] In order to give greater financial incentives to SOEs, the government began to experiment with the reform of "from profit to tax." Starting in 1984, SOEs became subject to income and regulatory taxes.[95] Large- and medium-sized SOEs were statutorily subject to a 55 percent income tax rate, but in practice the amount of taxes paid was often "determined on a negotiated basis between the SOEs and the central government" rather than based "on taxing actual profits."[96] Small domestic private enterprises now allowed as part of market reforms were also taxed on their earnings, but under an entirely separate regime.[97]

Following Deng Xiaoping's famous 1992 Southern Tour, highlighting the success of China's initial market reforms, the central government enacted further reforms to SOE governance and taxation.[98] In 1993, the government passed a comprehensive corporate law and in the following year oversaw corporatization of 100 major SOEs as part of an effort to enhance their competitiveness.[99] Corporatization would continue across the 1990s, with large and medium-sized SOEs consolidated into government-owned corporate groups and small SOEs privatized.[100] That same year, China also promulgated new tax regulations, which applied the same tax rules and rates to all types of domestic enterprises. The new rules reduced the statutory tax rates on SOEs to 33 percent from 55 percent, but also eliminated the deductions and areas of regulatory discretion that SOEs had taken advantage of under the prior system.[101] Moreover, SOEs and other domestic enterprises were subject to the same statutory tax rate as foreign invested enterprises, although foreign enterprises were still eligible for preferential incentives and favorable deduction rules.[102]

---

[94] *See* Hongfei Zhong, *Where Is the Future: China's SOE Reform*, 1 J. WASH. INST. CHINA STUDIES 105, 105 (2006); Xun Wang, *Whither Troubled Chinese State-owned Enterprises?*, 1998 CHINA REV. 363, 366-69.
[95] *See* FULI CAO, CORPORATE INCOME TAX LAW AND PRACTICE IN THE PEOPLE'S REPUBLIC OF CHINA 9 (2011); Wang, *supra* note 94, at 367.
[96] Ho, *supra* note 83, at 153; *see* Tsang Shu-ki & Cheng Yuk-shing, *China's Tax Reforms of 1994: Breakthrough or Compromise?* 34 ASIAN SURV. 769, 782 (1994).
[97] *See* Ho, *supra* note 83, at 153.
[98] *See* Wang, *supra* note 94, at 370; *see also* THE NANXUN LEGACY AND CHINA'S DEVELOPMENT IN THE POST-DENG ERA (John Wong and Zheng Yongnian eds., 2001) (assessing the impact of the Southern Tour or *nanxun* as a political landmark in China's economic reforms).
[99] *See* Wang, *supra* note 84, at 646. *See generally* YONG ZHANG, LARGE CHINESE STATE-OWNED ENTERPRISES: CORPORATIZATION AND STRATEGIC DEVELOPMENT (2008) (providing an in-depth investigation of corporatization of large Chinese SOEs).
[100] *See* Wang, *supra* note 84, at 646; Zhong, *supra* note 94, at 106; *see also We Are the Champions*, ECONOMIST (Mar. 18, 2004), http://www.economist.com/node/2495172 [https://perma.cc/5YMK-F8RD] (describing Prime Minister Zhu Rongji's doctrine of *zhuada fangxiao* or "grasp the big, let go the small" regarding SOE restructuring).
[101] Zhonghua Renmin Gongheguo Qiye Suodeshui Zanxing Tiaoli [中华人民共和国企业所得税暂行条例] (Provisional Regulations on Enterprise Income Tax) (promulgated by the State Council., Nov. 26, 1993, effective Jan. 1, 1994), LAWINFOCHINA (last visited Jan. 1, 2017) http://www.lawinfochina.com/display.aspx?id=625&lib=law [https://perma.cc/B5JP-3X65] [*hereinafter* Domestic Enterprise Income Tax Regulations] (China); *see* Lam *supra* note 87, at 59.
[102] *See* CAO, *supra* note 95, at 11.

After 26 years of maintaining separate tax regimes for domestic and foreign enterprises, China promulgated a unified Enterprise Income Tax (EIT) in 2007.[103] This ended the tax incentive regime for foreign investment and imposes a uniform tax rate of 25 percent on all business activity.[104] Thus, for the first time, EIT provides equal tax treatment for domestic and foreign enterprises. However, it makes available a 15 percent tax rate and preferential deductions for companies that qualify as "high new technology enterprises."[105] American enterprises have accused the regulations regarding HNTE status of having "*de facto* bias against foreign companies," as they require core IP to be owned by the entity seeking HNTE tax treatment.[106]

Under the EIT, China taxes resident enterprises on their worldwide income and offers a foreign tax credit for income taxes paid in foreign countries.[107] China's system of worldwide enterprise income taxation traces its origin to the 1993 Domestic Enterprise Income Tax Regulations, which applied to income from sources both within and outside of the country.[108] In 1997 the State Administration of Taxation (SAT) published regulations that 1) reaffirmed that domestic enterprises were subject to Chinese taxation on foreign income and 2) permitted domestic enterprises to credit foreign taxes when calculating their taxable foreign income.[109] The EIT maintains this basic approach and codifies the foreign tax credit into law.[110] Under the EIT, a Chinese resident enterprise can claim a direct credit for foreign income taxes paid.[111] Additionally, on the receipt of dividends from a foreign subsidiary, it may also claim an indirect credit for income taxes paid that are attributable to the dividends received—subject to some controversial limitations.[112] While resident enterprises are generally not taxed on the profits of foreign subsidiaries until the receipt of dividends, the EIT contains a controlled foreign corporation (CFC) provision, under which a resident enterprise may be required to include its share of undistributed profits from a CFC, if the effective tax rate on the CFC is less than 12.5 percent.[113] In 2009, the State Administration of Taxation (SAT) published regulations regarding the foreign tax credit

---

103 Zhonghua Renmin Gongheguo Qiye Suodeshui Fa [中华人民共和国企业所得税法] (Enterprise Income Tax Law) (promulgated by the Nat'l People's Cong., Mar. 16, 2007, effective Jan. 1, 2008) LAWINFOCHINA (last visited Jan. 1, 2017) http://www.lawinfochina.com/display.aspx?id=5910&lib=law# [https://perma.cc/P6Q8-FRUW] [*hereinafter* Enterprise Income Tax Law] (China).

104 Enterprise Income Tax Law, chapter I, art. 4; *see*, CAO, *supra* note 95, at 11-12; Frants, *supra* note 90, at 33; Li, *supra* note 93, at 31.

105 Enterprise Income Tax Law, chapter I, art. 28; *see* CAO, *supra* note 95, at 213-22.

106 *See, e.g.*, *China's High and New-Technology Enterprise (HNTE) Program*, U.S.-CHINA BUSINESS COUNCIL (June 2013), http://uschina.org/sites/default/files/2013%20HNTE%20Backgrounder.pdf [https://perma.cc/399G-85UJ].

107 Enterprise Income Tax Law, chapter I, arts. 3, 23, 24; *see* Frants, *supra* note 90, at 35. Under the EIT, enterprises established in China under Chinese law or established abroad but with their effective place of management located in China, are considered resident enterprises. *See* Enterprise Income Tax Law, Chapter I, art. 2.

108 Domestic Enterprise Income Tax Regulations, art. 1.

109 Jingwai Suode Ji Zheng Suodeshui Zhanxing Banfa [境外所得计征所得税暂行办法] (Provisional Measures on Levying Income Tax on Overseas Income), Cai Shui Zi [1997] No.116; *see* Wei Zhimei, *supra* note 79.

110 *See generally* CAO, *supra* note 95, at 241-65 (providing an overview of the taxation of income from foreign countries and region under the EIT).

111 Enterprise Income Tax Law, chapter I, art. 23.

112 Enterprise Income Tax Law, art. 24; *see infra* text accompanying notes 136-137.

113 Enterprise Income Tax Law, art. 45.

under the EIT—addressing many fundamental issues, such as the character of creditable foreign taxes and the calculation of the indirect credit.[114]

B. China's International Tax Policy and Diplomacy at a Crossroads

The relatively recent development of China's Foreign Tax Credit and CFC rules reflects the fact that China's international tax policy currently stands at a crossroads. From the start of reforming and opening up in 1978 until quite recently, China's international tax policy closely reflected its status as a capital importer. Yet, in the decade following the 2008 global financial crisis Chinese outbound investment increased dramatically and in 2015 China became a net capital exporter.[115] As a result, Chinese international tax policy and diplomacy is gradually changing to reflect the country's new role in the global economy.

Until a decade ago, the clear objective of Chinese international tax policy and diplomacy has been to attract investment from developed countries while protecting source-based taxation claims. In the early years of reform, in addition to implementing preferential tax regimes for foreign investment, China also sought to conclude bilateral income tax treaties with developed countries.[116] China concluded its first treaty with Japan in 1983 and by 1988 it had negotiated twenty treaties, primarily with major developed countries.[117] From the Japan treaty until the mid-1990s, China sought to negotiate on the basis of the UN model and as a result, its treaties with the United States and European countries generally reflect a hybrid of the OECD and UN model treaties.[118] In particular, China insisted on a broad scope for source-based taxation claims by negotiating for broad permanent establishment definitions, source-country taxation of royalties, and source-country taxation of gains from alienation of shares.[119] Commentary on the 1984 treaty between China and the United States, for instance, noted that the United States granted China a very generous set of source-based taxation concessions in comparison to prior U.S. treaties.[120] In order to attract foreign investment, China also sought to include tax sparing clauses in its treaties

---

[114] Qiye Jingwai Suodeshui Shou Di Mian Youguan de Tongzhi [企业境外所得税收抵免有关问题的通知] (Notice on the Issues Concerning Foreign Tax Credits), Cai Shui [2009] No. 125.

[115] *See, e.g.*, Mei (Lisa) Wang, Zhen Qi & Jijing Zhang, *China Becomes a Capital Exporter*, *in* CHINA'S DOMESTIC TRANSFORMATION IN A GLOBAL CONTEXT 315, 315-17 (Ligang Song et al. eds., 2015); *China Seeks Balanced Growth as Net Capital Exporter*, XINHUA (Jan. 21, 2015), http://www.xinhuanet.com/english/china/2015-01/21/c_133935581.htm [https://perma.cc/9RT2-YBV7].

[116] *See* Cong Zhichi "Yinjin Lai" Dao Zhuli "Zuo Chuqu": Zhongguo Shuishou Xieding Gongzuo de Huigu yu Zhanwang [从支持"引进来"到助力"走出去": 中国税收协定工作的回顾与展望] (From Supporting "Attracting In" to Helping "Going Out": Review and Future Outlook of China's Tax Agreements), 9 INT'L TAX'N IN CHINA 6, 7 (2015) [国际税收] (suggesting China's international tax diplomacy can be divided into distinct historical stages each reflecting a different overarching purpose).

[117] *See* William A. Turner & Elizabeth M. Orazem, *United States-People's Republic of China Income Tax Treaty: Opening the Door to Increased Economic Cooperation*, 13 N.C.J. INT'L L. & COM. REG. 527 (1988).

[118] *See* Ecker & Tang, *supra* note 13, at 34; *id.*

[119] *See* Ecker & Tang, *supra* note 13, at 48; Hu & Li, *China Tax Treaty and Policy: Development and Updates*, *in* BRICS AND THE EMERGENCE OF INTERNATIONAL TAX COORDINATION, *supra* note 12, at 222; ZHANG, *supra* note 91, at 32.

[120] Critics of the treaty suggested that the foreign policy goal of gaining closer ties with China may have overshadowed economic considerations. *See* Turner & Orzem, *supra* note 117, at 544; Paul D. Reese, *United States Tax Treaty Policy toward Developing Countries: The China Example*, 35 UCLA L. REV. 369, 386, 388-91 (1987).

with developed countries.[121] Under a tax sparing mechanism, the residence country credits a taxpayer for foreign income taxes that would have been paid *but for* tax holidays or incentives granted by the source country. Functionally, tax sparing ensured tax incentives offered by China to foreign investors would not be nullified by reductions in residence country tax credits—thus the benefit of tax incentives would flow to foreign investors rather than residence country taxing authorities.

Over the past decade China has begun to reassess its international tax policy and diplomacy in light of its new role as significant capital exporter. For example, as noted above, new regulations have been promulgated regarding the taxation of income earned abroad by Chinese resident enterprises.[122] Moreover, Chinese tax authorities have also begun to enforce previously ignored international tax rules, most notably China's CFC rules.[123] In terms of bilateral tax treaty negotiations, scholars analyzing China's recent treaties suggest that it now strives to strike a balance between securing benefits for Chinese outbound investment and retaining "a robust position as a capital importer."[124] For instance, the OECD model appears to have now supplanted the UN model as the starting point for Chinese tax treaty negotiations.[125] In particular, recent treaties have scaled back source taxation of business profits, indicating a shift away from its prior practice of staunchly defending source taxation.[126] Moreover, since 2009, China has stopped including tax sparing mechanisms in new or amended tax treaties.[127] Many of the tax sparing provisions in older treaties are also expiring thanks to temporal limitations or Chinese domestic tax reform.[128]

China's engagement with OECD-led multilateral tax initiatives further reflects an on-going transition in Chinese international tax policy. In the past, China had a fraught relationship with the OECD's initiative on harmful tax practices. For instance, China's resistance to the inclusion of Hong Kong and Macau in a 2009 list of tax havens prepared by the OECD made international news. Reports indicated that at the G-20 Summit, the President of China wrangled with the Presidents of France and Germany over the listing of these regions and the fact the listing was

[121] *See* Ecker & Tang, *supra* note 13, at 36; Hu & Li, *supra* note 119, at 212.
[122] *See supra* note 114.
[123] *See, e.g.*, Hu & Li, *supra* note 119, at 222-25; Xing, *supra* note 78; *see also* Wang Haijun, Zhao Hongshun, & Huang Hairong [王海军, 赵洪顺 & 黄海荣], Tansuo Shijian Takuan Fan Bishui Gongzuo Xin Lingyu—Shandong Sheng Dishui Ju Liyong Shou Kong Waiguo Qiye Fan Bishui Anli Ceji [探索实践拓宽反避税工作新领域——山东省地税局利用受控外国企业反避税案例侧记] (Exploring Practices to Broaden New Fields of Anti-Tax Avoidance—Case Study of Shandong Provice Local Taxation Bureau Using CFC Anti-Avoidance) 3 CHINA TAX'N 19 (2015) [中国税务] (discussing in detail the first administrative case concerning China's CFC rules).
[124] Hu & Li, *supra* note 119, at 186.
[125] *See* Bernhard Fohls & Weizhen Guo, *Capital Gains (Article 13 OECD Model)*, *in* EUROPE-CHINA TAX TREATIES, *supra* note 13, at 141-42.
[126] Jinyan Li, *The Great Fiscal Wall of China: Tax Treaties and Their Role in Defining and Defending China's Tax Base*. 66 BULL. INT'L TAX'N 452 (2012); *see also* From Supporting "Attracting In" to Helping "Going Out," *supra* note 116, at 9 (noting that in recent tax treaty negotiations China has sought to increase the time required for construction and assembly projects to qualify for permanent establishment status, in order to benefit Chinese companies engaged in construction projects abroad).
[127] *See* Hu & Li, *supra* note 119, at 208, 213.
[128] *See* Christian Massoner, Miao Liu, & Huifang Yang, *in* EUROPE-CHINA TAX TREATIES, *supra* note 13, at 235.

controlled by the OECD rather than an organization including Chinese representation.[129] President Obama mediated a compromise whereby Hong Kong and Macau were "relegated to a footnote."[130] The relationship between China and the OECD appears to have improved under the BEPS project, as all G-20 members were reportedly "playing a full part in setting the agenda, in the discussions and the decision-making process."[131] For instance, approximately 50 Chinese tax officials participated in the project and submitted over 1,000 comments or suggestions on China's behalf.[132] China has also been reforming domestic regulations to bring them into line with the BEPS Actions Plans.[133] In short, recent developments suggest that Chinese tax officials believe that the country's international tax policy should better reflect its new status as a capital exporter and that China should take a leading role in multilateral tax diplomacy—both notable departures from prior practice.

However, with Chinese international tax policy at a turning point, existing legal scholarship provides limited insight into what Chinese international tax policy will look like going forward. Officials at SAT see an opportunity for China to shape international rules and develop a "new international tax system with Chinese characteristics."[134] Neither English nor Chinese-language scholarship has yet identified the potential distinguishing characteristics of such a system.[135] In fact, much of recent Chinese international tax scholarship has focused on administrative

---

[129] *See* Eccleston & Smith, *supra* note 66, at 190; William Vlcek, B*yways and Highways of Direct Investment: China and the Offshore World*, 39 J. CURRENT CHINESE AFF., 111, 134 (2010).
[130] *See* Meinzer, *supra* note 63, at 267.
[131] Lee Corrick, *The Taxation of Multinational Enterprises*, *in* GLOBAL TAX FAIRNESS, *supra* note 64, at 183. Some Chinese scholars however have criticized the project, suggesting that it is difficult for non-OECD members to contribute equally and that the OECD countries are using the project to make international rules to reflect their own interests. *See, e.g.*, Zhang Zeping [张泽平], BEPS Xingdong Jihua dui Woguo Guonei Shuishou Lifa de Yingxiang ji Yingdui [BEPS 行动计划对我国国内税收立法的影响及应对] (Impacts of the BEPS Action Plan on Chinese Domestic Tax Legislation and Responses], 6 INT'L TAX'N IN CHINA 28 (2015) [国际税收].
[132] *See* PricewaterhouseCoopers China, ASIA PAC. TAX NOTES 16 (2016), https://www.pwccn.com/en/aptn/aptn-2016-cn.pdf [https://perma.cc/JD3N-KAZL].
[133] *See, e.g.*, Daniel Ho, *The Development of China Tax Measures for Cross-Border Intra-Group Payments in the BEPS Era*, 41 INT'L TAX J. 47 (2015).
[134] State Admin. of Tax'n [国家税务总局], Shendu Canyu Guoji Shuishou Gaige Shuxie Daguo Shuiwu Zeren Dandang [深度参与国际税收改革书写大国税务责任担当] (Deep Participation in Drafting International Tax Reforms Assuming the Tax Responsibilities of a Great Power), (2017), http://www.chinatax.gov.cn/n810219/n810724/c2853451/content.html [https://perma.cc/PF3D-3U4G]; *see also* Chen Youxiang & Dong Qiang [陈有湘 & 董强], Guojian "Yidai Yilu" Zhanlüe xia de Guoji Shuishou Fengxian Yingdui Jizhi [构建"一带一路"战略下的国际税收风险应对机制] (Establishing an International Tax Risk Response Mechanism Under the One Belt One Road Strategy), 6 TAX'N ECON. J. 49 (2015) (税收经济研究) (arguing that China should take advantage of a period of strategic opportunity to becoming a leader in reconstructing international tax rules); Wan Jing [万静], G20 Yige dui Zhongguo Yiweizhe Shuxie Guoji Shuishou Xin Guize de Jiyu [G20, 一个对中国意味着书写国际税收新规则的机遇] (G20, A Meaningful Opportunity for China to Write New Rules for International Taxation), LEGAL DAILY [法制日报], Sept. 5, 2016 (noting the opportunity for China to rewrite international tax rules).
[135] *See* Deng Liping [邓力平], Cong "Xianshi Ban" Dao "Shengji Ban" Goujian Zhongguo Tese Guoji Shuishou de Sikao [从"现实版"到"升级版" 构建中国特色国际税收的思考] (From "Reality" to "Improvements" Thoughts on Constructing International Taxation With Chinese Characteristics), INT'L TAX'N IN CHINA 6, 9 (2014) [国际税收] (arguing that Chinese scholars should explore possibilities for a Chinese international taxation policy embodying "the strategy and style of a Great Power" and reflecting China's goal of "national rejuvenation").

difficulties and horizontal inequalities caused by the foreign tax credits limitations imposed in SAT's initial 2009 regulations. Scholars and practitioners have criticized the application of a country-by-country limitation as well as limitations on indirect foreign tax credits for subsidiaries below the third tier, arguing such limitations place undue burdens on Chinese multinationals with complex corporate structures.[136] In late 2017 SAT finally addressed these criticisms, allowing corporations to choose to use an aggregate limitation and to claim indirect foreign tax credits for additional tiers of subsidiaries.[137] Other potential reforms anticipated by scholars and practitioners are further regulations regarding China's CFC rules[138] and additional information exchange agreements with tax havens.[139] In light of recent U.S. tax reform efforts, some scholars have also argued that China should consider lowering its enterprise tax rate[140] and gradually replacing its foreign tax credit system with an exemption system.[141] Although these recent and suggested reforms are of significance, they all fall well within current international tax norms and practices. Thus, this paper instead primarily focuses on ways in which China's unique system of state capitalism may lead it to pursue distinctive international tax policies.

---

[136] *See, e.g.*, XIE, *supra* note 26, at 69; Chen Youxiang, *supra* note 134; Wang Jincheng & Sun Yahua [王金城 & 孙亚华], Wanshan Shuishou Dimian Zhidu Cuijin Qiye Duiwai Touzi [完善税收抵免制度促进企业对外投资] (Perfecting the Tax Credit System to Promote Enterprise Foreign Investment), 7 INT'L TAX'N IN CHINA (2011) [涉外税务]; Zhang Yunhua & Ren Yanhe [张云华 & 任言和], Wanshan Shuishou Di Mian Zhidu Zhu Tui Qiye "Zou Chuqu" [完善税收抵免制度助推企业"走出去] (Improving Tax Credit System and Promoting Enterprises "Going-out"), 6 INT'L TAX'N IN CHINA 72 (2015) [国际税收]. For an overview of similar debates in the United States over the appropriate mechanism for limiting the foreign tax credit under I.R.C §904(d), see, e.g., Robert J. Peroni, *A Hitchhiker's Guide to Reform of the Foreign Tax Credit Limitation*, 56 SMU L. Rev. 391 (2003).

[137] Wanshan Qiye Jingwai Suodeshui Shou Di Mian Zhengce Wenti de Tongzhi [完善企业境外所得税收抵免政策问题的通知] (Circular on Perfecting the Policy on Tax Revenue from Overseas Income of Enterprises) (promulgated by the Ministry of Finance and Taxation Administration, December 28, 2017, effective January 1, 2018), Cai Shui [2017] No. 84; *see also* Khoonming Ho & Lewis Lu, *China: Inbound and Outbound Investment Incentives Kick Off*, INT'L TAX REV. (Jan. 30, 2018), http://www.internationaltaxreview.com/Article/3784113/China-New-inbound-and-outbound-investment-incentives-to-kick-off-2018.html [https://perma.cc/HN9S-3J5L] (noting the option for corporations to apply "onshore pooling" rather than "country baskets" for calculating foreign tax credit limitations).

[138] *See, e.g.*, Mark Melnicoe, *In China, More Advance Rulings, More Cases Going to Court*, BLOOMBERG TAX MANAGEMENT TRANSFER PRICING REPORT (May 31, 2016), https://www.bna.com/china-advance-rulings-n57982073273/ [https://perma.cc/C6K9-DCGJ] ("Current CFC rules in China are murky, making it hard to assess whether an offshore company is really engaged in active business and how to prove there is a commercial need to keep its profits overseas …. But changes are likely coming…"); Dongmei Qiu, *Collecting Unpaid Tax Offshore: Caribbean Tax Havens and Foreign Direct Investment in China*, 12 BULL. INT'L TAX'N 648, 659 (2014); *see also* Zhang Wei & Huang Ying [张巍 & 黄莹], Guoji Bishuidi, CFC Fagui yu Zhongguo Jingji [国际避税地， CFC 法规与中国经济] (International Tax Havens, CFC Rules and the Chinese Economy), 9 TAX'N RES. J. 53 (2012) (税务研究) (proposing changes to Chinese CFC Regulations).

[139] *See, e.g.*, Hu & Li, *supra* note 119, at 220.

[140] *See* Gong Huiwen (龚辉文), Guoji Shuishou Jingzheng Shi Xiandai Shuizhi Gaige de Zhuyao Tuidongli (国际税收竞争是现代税制改革的主要推动力) [International Tax Competition as a Main Driving Force of Modern Tax Reform], 9 TAX'N RES. J. 14, 19 (2017) (税务研究).

[141] *See* Li Tianfei (李天飞), Mei Zuixin Shui Gai Jihua Zhong "Shudi Yuanze" Pingxi (美最新税改计划中 "属地原则"评析) [Comments on the "Territorial Principle" in the Latest U.S. Tax Reform Plan], 7 INT'L TAX'N IN CHINA 44, 45 (2017) (国际税收).

IV. Defining Features of Chinese State Capitalism

A. SASAC Governance of Chinese SOEs

Since the beginning of Chinese economic reforms in 1978, scores of Western observers have anticipated the eventual privatization of Chinese SOEs and a more complete transition to free-market capitalism.[142] After decades of halting reforms, nearly all Chinese SOEs have been corporatized and more than two-thirds of central government-controlled SOEs now have some level of foreign investment.[143] As a result, it can be natural to assume that relatively little distinguishes Chinese SOEs from private market-oriented business enterprises. Yet, as a new wave of English-language scholarship reveals, while the market forces play a significant role in most sectors, the Party-state continues to function as the leading economic actor through its extensive controls over SOEs—resulting in a unique system of Chinese state capitalism.[144]

In fact, both the significance of SOEs in the Chinese economy and degree of the Party control over major SOEs are likely to further increase under the leadership of Xi Jinping. Today, SOEs are estimated to still account for 30 to 40 percent of China's total GDP, 40 percent of industrial assets, and 20 percent of total employment.[145] Yet, Xi Jinping is actively "reversing the state's retreat from the economy."[146] He has reasserted that SOEs should be the commanding

[142] *See* Aldo Musacchio & Sergio G. Lazzarini, *Chinese Exceptionalism or New Global Varieties of State Capitalism*, *in* REGULATING THE VISIBLE HAND?: THE INSTITUTIONAL IMPLICATIONS OF CHINESE STATE CAPITALISM 403, 406-07 (Benjamin L. Liebman & Curtis J. Milhaupt eds., 2015) ("In China, every time there is a new group of Party members in power, journalists and observers in the West speculate about …whether the privatization process will be deepened, and how much the state will retreat. Yet, the outcome is always disappointing from the point of view of these observers. There is always more state intervention and more state ownership than was expected.").

[143] *See* Matthew Miller & Fang Cheng, *China Says Framework for State-Owned Enterprise Reform 'Basically Complete,'* REUTERS (Sept. 28, 2017), https://www.reuters.com/article/us-china-soe-reforms/china-says-framework-for-state-owned-enterprise-reform-basically-complete-idUSKCN1C313P [https://perma.cc/XH4F-PNHS].

[144] *See, e.g.*, CHEN LI, CHINA'S CENTRALIZED INDUSTRIAL ORDER (2015); REGULATING THE VISIBLE HAND?, *supra* note 142; Lin & Milhaupt, *supra* note 20; Ming Du, *China's State Capitalism and the World Trade Law*, 63 Int'l & Comp. L. Q. 409 (2014); Mark Wu, *The "China, Inc." Challenge to Global Trade Governance*, 57 HARV. INT'L L. J. 261 (2016); *see also* BARRY NAUGHTON, *The Transformation of the State Sector: SASAC, the Market Economy, and the New National Champions*, *in* STATE CAPITALISM, *supra* note 20, at 46, 47 (arguing Chinese central SOEs "have developed into a powerful and profitable economic force, representing the core of state capitalism in China.").

[145] *See* INT'L TRADE ADMIN., *China Country Commercial Guide* (2017) https://www.export.gov/article?id=China-State-Owned-Enterprises [https://perma.cc/9LVA-36AV]; *China's State Enterprises Are Not Retreating but Advancing*, ECONOMIST (July 20, 2017), https://www.economist.com/news/leaders/21725295-bad-china-and-world-chinas-state-enterprises-are-not-retreating-advancing [https://perma.cc/Y24N-3SG9]; *see also* Derek Scissors, *China's SOE Sector Is Bigger Than Some Would Have Us Think*, E. ASIA F. (May 17, 2016), http://www.eastasiaforum.org/2016/05/17/chinas-soe-sector-is-bigger-than-some-would-have-us-think/ [https://perma.cc/2RCZ-ERTH] (discussing the difficulty in estimating the size of the SOE sector and suggesting SOEs may account for close to 60 percent of GDP.).

[146] *China's State Enterprises Are Not Retreating but Advancing*, *supra* note 145; *see also Reform of China's Ailing State-owned Firms Is Emboldening Them*, ECONOMIST (July 22, 2017), https://www.economist.com/news/finance-and-economics/21725293-outperformed-private-firms-they-are-no-longer-shrinking-share-overall [https://perma.cc/Y24N-3SG9] (reporting that Chinese SOEs are now growing faster than Chinese private-sector investment).

heights of the economy.[147] While Chinese leadership has acknowledged the need to increase the competitiveness of SOEs, it has called for making SOEs "bigger and stronger" while maintaining them under public ownership.[148] Through both improving operations and merging major SOEs into even larger corporate giants, the government envisions the transformation of its current "national champions" into state-owned "global champions."[149] As further discussed below, China's recent industrial and foreign policy initiatives are designed to further increase their international prominence and global market clout.[150] At the same time, Xi has asserted that Communist Party leadership must remain "the root and soul" of SOEs and under his watch the Party has strengthened its influence over the business decisions of SOEs, as well as private Chinese companies.[151] The Party has always maintained extensive legal and political control over major SOEs, but recent government pronouncements have placed a particularly strong emphasis on the importance of "Party building" and "strengthening Party leadership" within SOEs.[152] Moreover, the Party is currently engaging in extensive efforts to secretly train and monitor Party cadres in overseas branches of SOEs.[153] These efforts reflect Xi's insistence that "east, west, north or south,

---

[147] *See* Michael Martina & Kevin Yao, *As China's Leaders Gather, Market Reform Hopes Fade*, REUTERS (Oct. 17, 2017), https://www.reuters.com/article/us-china-congress-reform-analysis/as-chinas-leaders-gather-market-reform-hopes-fade-idUSKBN1CM142 [https://perma.cc/TU45-VKG7].

[148] He Wei, *China to Create Bigger, Strong State-Owned Firms*, CHINA DAILY, Oct. 20, 2017, http://www.chinadaily.com.cn/business/2017-10/20/content_33477206.htm [https://perma.cc/48JJ-PFAT]; *see* Jane Cai, *Forget Privatisation, Xi Has Other Big Plans for Bloated State Firms*, S. CHINA MORNING POST, Sept. 6, 2017, http://www.scmp.com/news/china/economy/article/2109943/how-china-making-its-state-firm-dinosaurs-bigger-and-richer [https://perma.cc/5446-FAKT]; *see also* Hu Angang (胡鞍钢), Guoyou Qiye: Gonggu, Tisheng he Fazhan Guojia Nengli de Zhuli Jun [国有企业 :巩固、提升和发展国家能力的主力军] (State-Owned Enterprises: the Main Force for Consolidating, Upgrading and Developing the National Capabilities), 6 INT'L TAX'N IN CHINA 36 (2016) (国际税收) (arguing that SOEs will be the primary force for strengthening China's national economic power in the future).

[149] *See* Soyoung Kim & Paritosh Bansal, *Exclusive: China's State-Owned Firms to Face More Mergers*, REUTERS (Jan. 24, 2018), https://www.reuters.com/article/us-davos-meeting-china-companies-exclusi/exclusive-chinas-state-owned-firms-to-face-more-mergers-idUSKBN1FD0TM [https://perma.cc/NT3F-E2UR]; Gabriel Wildau, *China's State-owned Zombie Economy*, FIN. TIMES, Feb. 29, 2016, https://www.ft.com/content/253d7eb0-ca6c-11e5-84df-70594b99fc47 [https://perma.cc/P7M5-4LK6]; Huang Kaixi & Song Shiqing, *China to Accelerate SOE Consolidation in Bid to Build Corporate Giants*, CAIXIN (July 19, 2017), https://www.caixinglobal.com/2017-07-19/101118793.html [https://perma.cc/7SMD-LLKD].

[150] *See infra* Part 4.B; *see also* Luo Hu, *More Needed to Help SOEs Gain World Role*, GLOBAL TIMES, Nov. 1, 2017, http://www.globaltimes.cn/content/1073096.shtml [https://perma.cc/DX25-FFQU] (noting that Chinese SOEs are "are supposed to capitalize on the Belt and Road initiative as part of their ambition to become globally competitive").

[151] Emily Feng, *Xi Jinping Reminds China's State Companies of Who's the Boss*, N.Y. TIMES, Oct. 13, 2016, https://www.nytimes.com/2016/10/14/world/asia/china-soe-state-owned-enterprises.html [https://perma.cc/5QSV-TE4E]; *see* Lucy Hornby, *Communist Party Asserts Control over China Inc.*, FIN. TIMES, Oct. 3, 2017, https://www.ft.com/content/29ee1750-a42a-11e7-9e4f-7f5e6a7c98a2 [https://perma.cc/J4RY-UDSN]; *see also* Tsai & Naughton, *supra* note 20, at 11 (suggesting that maintaining control of SOEs is particularly important to the Party as SOEs are seen as a "source of employment and patronage").

[152] *See Communist Party Still at Heart of China's State Firm Reform Plans: Regulator*, REUTERS (Nov. 14, 2017), https://www.reuters.com/article/us-china-soe/communist-party-still-at-heart-of-chinas-state-firm-reform-plans-regulator-idUSKBN1DF0A6 [https://perma.cc/UL4C-2UEA]; Kjeld Erik Brødsgaard, *Can China Keep Controlling Its SOEs?*, DIPLOMAT (March 5, 2018), https://thediplomat.com/2018/03/can-china-keep-controlling-its-soes/ [https://perma.cc/TG4D-2K85].

[153] *See Chinese SOEs Cautiously Carry Out Party Building Activities Overseas*, GLOBAL TIMES, Jan. 1, 2018, http://www.globaltimes.cn/content/1085071.shtml [https://perma.cc/4WKA-W8YX].

the Party leads everything."[154] Thus, current trends suggest the Party's extensive systems of legal and political control over SOEs described below, are likely to be further strengthened over the foreseeable future.

The central government primarily exercises its extensive legal and political control over major SOEs through two main mechanisms: 1) the State-owned Assets Supervision and Administration Commission and 2) the Central Organization Department. The first enables the government to exercise broad power associated with roles as both majority owner and regulator. The second enables the Party-state to exert domineering influence by controlling the appointment, promotion, and removal of all high-level SOE executives.[155] As a result, China has succeeded, in words of one SOE chairman, in "weav[ing] Party leadership into corporate governance."[156]

Since its creation in 2003, the State-owned Assets Supervision and Administration Commission (SASAC) has been used by the central government to reassert its control over major SOEs.[157] In the 1990s, most Chinese SOEs were struggling financially. As a result, the state retreated from many labor-intensive and low-value added sectors, selling off nearly half of all SOEs between 1997 and 2003.[158] Yet at the same time, the government remained committed to retaining state ownership of industrial assets in monopolized sectors and those with strategic importance—including at the time "armaments, power generation and distribution, oil and petrochemicals, telecommunications, coal, aviation and shipping."[159] Assets in these sectors—often formerly managed by central government ministries or local governments—were consolidated into approximately two-hundred vertically integrated state-owned corporate groups.[160] SASAC was established to serve as the owner of these SOEs for the central government and is tasked with their supervision and management.[161] Due to their massive scale and direct

---

[154] Nectar Gan, *Xi Jinping Thought – The Communist Party's Tighter Grip on China in 16 Characters*, S. CHINA MORNING POST, Oct. 25, 2017, http://www.scmp.com/news/china/policies-politics/article/2116836/xi-jinping-thought-communist-partys-tighter-grip-china [https://perma.cc/C4J2-43RE]; Jeremy Page & Chun Han Wong, *Xi Jinping Is Alone at the Top and Collective Leadership 'Is Dead'*, WALL ST. J., Oct. 25, 2017, https://www.wsj.com/articles/chinas-xi-elevated-to-mao-status-1508825969 [https://perma.cc/7MJG-SXQP].

[155] *See* Wang, *supra* note 84, at 658-660; *see also* Lin & Milhaupt, *supra* note 20, at 711 ("[T]wo parallel structures provide for monitoring: one based on the corporate law, with SASAC as controlling shareholder, and a second, party-based structure that shadows the corporate hierarchy, especially with respect to high-level managerial appointments.").

[156] Xie Yu, *Don't Panic! Party Leadership is China's Answer to West's Corporate Governance Issues, Say SOE Bosses*, S. CHINA MORNING POST, Dec. 8, 2017, http://www.scmp.com/business/investor-relations/article/2123502/dont-panic-party-leadership-chinas-answer-wests [https://perma.cc/9EB9-56H6]; *see also* Zhou Xin, *Communist Party the Top Boss of China's State Firms, Xi Jinping Asserts in Rare Meeting*, S. CHINA MORNING POST, Oct. 12, 2016, http://www.scmp.com/news/china/economy/article/2027407/communist-party-top-boss-chinas-state-firms-xi-jinping-asserts [https://perma.cc/SQA5-A2RK] (quoting Central Party School Professor Zhang Xixian's observation that "the hallmark of state companies with Chinese characteristics is the Party's leadership.").

[157] *See* Naughton, *supra* note 144, at 46.

[158] *See id.* at 48; Wu, *supra* note 144, at 270.

[159] Zhao Huanxin, *China Names Key Industries for Absolute State Control*, CHINA DAILY, Dec. 19, 2006, http://www.chinadaily.com.cn/china/2006-12/19/content_762056.htm [https://perma.cc/3WUN-M44E]; *see* Dong Zhang & Owen Freestone, *China's Unfinished State-owned Enterprise Reforms*, 2013 ECON. ROUNDUP 79, 82; LI, *supra* note 144, at 14. (referring to these industries as "base," "lifeblood," "pillar," or "strategic").

[160] *See* LI, *supra* note 144, at 65; Lin & Milhaupt, *supra* note 20, at 711.

[161] *See* Wang, *supra* note 84, at 662-664; Zhong, *supra* note 94; Wendy Leutert, *Challenges Ahead-in China's Reform of State-Owned Enterprises*, 21 ASIA POLICY 83 (2016).

central government ownership, these major SOEs have been described by scholars as "China's national team"[162] or "China's national champions."[163] SASAC has all the powers of a controlling shareholder, including approval over all major ownership decisions, the power to consolidate and transfer control of corporations, as well as additional regulatory authority.[164] Notably, it also has "super control rights" over the transfer of SOEs and their subsidiaries that exceed those of traditional controlling shareholders under the Chinese Company Law.[165] For instance, through mergers, acquisitions, and spin-offs, it has reduced the number of central SOEs from 196 to 98, while increasing total assets under its control.[166] SASAC has announced plans for further mergers of SOEs in the near future.[167] Moreover, in its regulatory authority SASAC has also promulgated particularly detailed measures specifying the permissible overseas activities of SOEs.[168]

The structure of SASAC enables the Chinese government to control "a majority stake in virtually every leading firm in every critical industry in China" while still allowing for some degree of market competition and foreign equity in these crucial sectors.[169] For a sense of scale, of the roughly 100 SOEs administered by SASAC, 48 were ranked in the 2017 Fortune Global 500, including State Grid, PetroChina and Sinopec Corp., which were ranked 2, 3 and 4, respectively.[170] It controls China's top nuclear, aerospace and aviation, petroleum and petrochemicals, telecom, electricity, automobile firms as well as its major airlines.[171] Yet, the government allows competition in many of these sectors, by having multiple SOEs fight for market shares amongst themselves.[172] For instance, SASAC has allowed for cutthroat competition between three major state-owned airlines over pricing and domestic routes, but has vetoed past proposed mergers

---

[162] LI, *supra* note 144, at 73.

[163] Lin & Milhaupt, *supra* note 20.

[164] *See* Zhonghua Renmin Gongheguo Guoyou Qiye Zichan Fa [中华人民共和国国有企业资产法] (The Law of the People's Republic of China on the State-Owned Assets of Enterprises) (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 28, 2008, effective May 1, 2009); Leutert, *supra* note 161, at 88.

[165] Lin & Milhaupt, *supra* note 20, at 744.

[166] *See* LI, *supra* note 144, at 75; Lin & Milhaupt, *supra* note 20, at 711; *China's Centrally Administered State Firms Report Strong Profit Growth*, XINHUA (Dec. 15, 2017), http://www.xinhuanet.com/english/2017-12/15/c_136828994.htm [https://perma.cc/32KY-6TGZ].

[167] *See* Soyoung Kim & Paritosh Bansal, *supra* note 149; Gabriel Wildau, *China Prepares Fresh Round of State-Orchestrated Megamergers*, FIN. TIMES, July 9, 2017.

[168] *See New Regulations for SOEs' Overseas Deals*, GLOBAL TIMES, Jan. 18, 2017, http://www.globaltimes.cn/content/1029539.shtml [https://perma.cc/9KAL-MCAW].

[169] Lin & Milhaupt, *supra* note 20 at, 735; *see also* Wu, *supra* note 144, at 271 ("SASAC is undoubtedly one of the most powerful economic actors in the world today.").

[170] State-owned Assets Supervision and Administration Comm'n of the State Council (SASAC), 2017 "Caifu" Shijie 500 Qiang Gongbu Guowuyuan Guozi Wei Jianguan 48 Jia Yangqi Shang Bang [2017《财富》世界 500 强公布 国务院国资委监管 48 家央企上榜] (2017 Fortune Global 500 Announced--48 SASAC Supervised SOEs on the List) (July 20, 2017), http://www.sasac.gov.cn/n2588025/n2588119/c7419470/content.html [https://perma.cc/2RNM-NH6F]; Globe 500, FORTUNE, http://fortune.com/global500/2017/ [https://perma.cc/B5D5-JUWY].

[171] *See* LI, *supra* note 144, at 159.

[172] *See* Wu, *supra* note 144, at 271 ("SASAC controls China's three major telecommunications companies, its three major petrochemical corporations, its three major steelmakers, and so on.") However, there is evidence that recent SASAC orchestrated megamergers may now be limiting such competition. *See* Nicholas R. Lardy, *China's SOE Reform—The Wrong Path*, PETERSON INST. INT'L ECON. (July 28, 2016), https://piie.com/blogs/china-economic-watch/chinas-soe-reform-wrong-path [https://perma.cc/X47M-F6PT].

between the three.[173] The structure of SASAC and SOE groups has also enabled the government to raise significant funds through listing minority stakes of SOE subsidiaries on public stock markets.[174] SASAC remains the 100 percent shareholder of the core holding company (or parent corporation) of most SOE groups. This core holding company retains a majority share in one or more publicly traded subsidiaries.[175] By offering these minority stakes internationally, the government has been able to raise fresh capital for Chinese SOEs without relinquishing government control.[176] Recently, the government has also begun experimenting with offering minority stakes in SOE subsidiaries to private equity funds under the banner of "mixed-ownership."[177] Yet, private investors admit that even in SOEs with the highest levels of private investment, SASAC and the Communist Party's personnel bureau remain "the real power behind SOE decision-making."[178]

Although not part of SASAC, the largest Chinese financial institutions also remain under state ownership and control through a broadly similar mechanism. During the early 1990s, as SOEs were undergoing corporatization, China's wholly-owned and central controlled financial institutions were significantly reformed.[179] The resulting banks were categorized as either policy banks or commercial banks.[180] Policy banks remain wholly-owned and directly controlled, with each dedicated to specific lending purposes and policy goals.[181] In contrast, the major commercial banks more closely resemble SOEs—nominally operating under commercial considerations but

---

[173] *See* David Finckling, *China Eastern's Promise Fades*, BLOOMBERG (Mar. 30, 2017), https://www.bloomberg.com/gadfly/articles/2017-03-31/airline-price-war-puts-china-eastern-in-the-firing-line [https://perma.cc/NH4G-292M]; Danny Lee, *China Eastern Unites with Delta to Gain Edge at Beijing's Seven-Runway Daxing Airport*, S. CHINA MORNING POST, Nov. 25, 2017, http://www.scmp.com/news/hong-kong/economy/article/2121554/china-eastern-unites-us-airline-delta-bid-gain-edge-beijings [https://perma.cc/U5HZ-KZ4E]; Chen Huiying, Li Qiyan & Yu Ning, *Aviation's Future and the Battle for China Eastern*, CAIJING (Sept. 10, 2007), http://english.caijing.com.cn/2007-10-15/100033624.html [https://perma.cc/GH6Z-3C59].

[174] *See* LI, *supra* note 144, at 65; Lin & Milhaupt, *supra* note 20, at 711.

[175] Lin & Milhaupt, *supra* note 20, at 700; *see also* Milhaupt & Zheng, *supra* note 23, at 673 (reporting that "almost all of the thirty-four subsidiaries of China National Offshore Oil Corporation (CNOOC)" have some degree of private investment).

[176] *See* LI, *supra* note 144, at 138; Monique Taylor, *China's Oil Industry: 'Corporate Governance with Chinese Characteristics,' in* THE POLITICAL ECONOMY OF STATE-OWNED ENTERPRISE IN CHINA AND INDIA 79 (Ed. Xu Yi-chong, 2012); *see also* Yang Ge, *5 Things to Know About China's Mixed-Ownership Reform*, CAIXIN (Aug. 8, 2017), https://www.caixinglobal.com/2017-08-28/101136807.html [https://perma.cc/E466-76ER] ("Most big state-owned companies that have been listed to date remain firmly in control of the central government, which typically maintains 50% or more of the company's shares. Under that arrangement, the central government sees anyone who buys shares on the open market as purely financial investors, and typically gives them little or no say in the company's management or strategic planning.").

[177] *See* Georgina Lee, *Mixed Ownership Reform an Opportunity for Private Equity to Invest in State Enterprises*, S. CHINA MORNING POST, Dec. 5, 2017, http://www.scmp.com/business/companies/article/2123007/mixed-ownership-reform-opportunity-private-equity-invest-state [https://perma.cc/G6MP-BKCV].

[178] *See* Gabriel Wildau, *China State-Owned Telecom Privatisation Seen as Too Timid*, FIN. TIMES, Aug. 27, 2017, https://www.ft.com/content/0dd0b152-8659-11e7-bf50-e1c239b45787 [https://perma.cc/K7LZ-CC24].

[179] *See generally* JAMES STENT, CHINA'S BANKING TRANSFORMATION: THE UNTOLD STORY 75-99 (2017) (describing in detail the history of bank reform in China since Deng Xiaoping's reform and opening).

[180] *See* LI, *supra* note 144, at 127.

[181] *See id.* at 130.

remaining under extensive government control.[182] Following a series of reforms during the 1990s and early 2000s, the Central Huajin—a holding company established under China's main sovereign wealth fund (the China Investment Corporation) retains a controlling interest in the four largest commercial banks, and in combination with other state-controlled holdings gives the government majority control in each.[183] While minority shares are listed on stock exchanges and held by foreign investors, in reality, the state "has not ceded any substantial aspects of its control over these banks."[184] Moreover, the Party's Central Organization Department controls leadership appointments to each of the ten largest commercial finance institutions.[185]

The Communist Party maintains control over key SOEs through its authority over the appointment of senior executives. The powerful Central Organization Department of the Communist Party appointments nearly all state officials throughout China and regularly evaluates high-level appointees based on performance metrics.[186] The top 53 major SOEs are ranked at the vice-ministerial level or above, meaning their top executives have the same rank as Vice Provincial Governors or Party Secretaries.[187] The Central Organization Department is thus charged with appointing and evaluating the Board Chairmen, CEOs, and Party Secretaries of these SOEs. SASAC is responsible for the appointment and evaluation of deputies in these firms and the top executives in all other centrally-controlled SOEs.[188] In practice, personnel decisions are always jointly announced by SASAC and the Central Organization Department.[189] That is to say, Party organs control the appointment of all high-level SOE personnel whether or not the SOE has a board of directors in place.[190] These appointees often serve concurrent roles on both the core holding company and on listed subsidiaries.[191] Appointees are virtually all long-time Communist Party members with strong history of political loyalty to the Party.[192] They have been trained in the Party school system for midcareer cadres and often take specialized training courses at the Central Party

---

[182] *See id.*; *see also* Leong H. Liew, *State Enterprise in China's Capitalist Transformation: The Bank of China*, *in* THE POLITICAL ECONOMY OF STATE-OWNED ENTERPRISE IN CHINA AND INDIA, *supra* note 176, at 222 ("Although banks are corporatized, and even listed on international stock exchanges, the state remains the majority shareholder in the largest, commercial banks, and it is still debatable how much of their behaviors are guided solely by commercial considerations and how much are guided by official policy."); STENT, *supra* note 179, at 24 (describing the major Chinese commercial Banks as " neither wholly an agency of the state nor wholly a creature of the market.").

[183] *See* STENT, *supra* note 179, at 157.

[184] LI, *supra* note 144, at 130.

[185] *See* Liew, *supra* note 182, at 229; *see also* LI, *supra* note 144, at 144-45 (describing the political backgrounds and career trajectories of Chinese bank leaders).

[186] *See* Wang, *supra* note 84, at 658-660; Richard McGregor, *The Party Organizer*, FIN. TIMES, Sept. 30, 2009, https://www.ft.com/content/ae18c830-adf8-11de-87e7-00144feabdc0 [https://perma.cc/DLG7-BZF9]; *see also* LI, *supra* note 144, at 117 (suggesting the Department is the "mightiest human resource department" of "China Inc.").

[187] *See* Leutert, *supra* note 161, at 87.

[188] *See* Prepared Statement of Curtis J. Milhaupt, Testimony Before the U.S.-China Economic and Security Review Commission Hearing on Chinese State-Owned and State-Controlled Enterprises (Feb. 15, 2012), https://www.uscc.gov/sites/default/files/2.15.12milhaupt_testimony.pdf [https://perma.cc/WT9V-A4K3].

[189] *See* Li-Wen Lin, *Reforming China's State-owned Enterprises: From Structure to People*, 229 CHINA Q. 107, 110 (Mar. 2017); *see also* LI, *supra* note 144, at 116 ("The actions of COD and SASAC seem to have been concerted and the institutional connections between the two organs are close.").

[190] Lin & Milhaupt, *supra* note 20, at 739.

[191] *See* Taylor, *supra* note 176, at 87.

[192] *See id.* at 115-116.

School in Beijing to study Communist Party ideology.[193] Even in publicly listed SOE subsidiaries, virtually no state-appointed CEOs had worked "outside the state system."[194]

The extent of the Party's power over executive positions at central SOEs expands beyond initial appointments, as illustrated by its tradition of dramatic rotations of high-level appointees between enterprises. For instance in 2003 the Party rotated the CEOs of China's top three telecommunications companies—all publicly listed in Hong Kong of New York—without prior notice or board consultation.[195] Similarly, in 2009 it rotated the CEOs of three largest state airlines, and in 2011 rotated the CEOs of the three central petroleum enterprises.[196] By one estimate, since 2003 there have been at least 30 cases of "intra-sector" rotations of high level appointees between different SOEs in the same industry.[197] These rotations enable the Party to "reduce concentration of authority in a single individual in firms."[198] In general, senior officials are shuffled into new positions every few years and successful executives are increasingly promoted to higher-level positions in Party leadership after their stint at major SOEs.[199]

Party Committees within SOEs groups give the Party an additional system of oversight over the decisions of top executives. Under the leadership of Xi Jinping these Committees, composed of ranking Communist Party members within each enterprise, have been strengthened and granted a greater role in monitoring business decisions within SOEs.[200] For instance, the bylaws of many SOE subsidiaries now require major business to first be discussed by the company's Party Committee before managers are allowed to take action.[201] These Committees thus represent another mechanism for "supervising the implementation of [Communist Party] and national policies within the company."[202]

Thanks to Party's oversight mechanisms and its influence over appointees' career trajectories, SOE executives generally have strong incentives to obey Party directives. Both anecdotal and quantitative evidence suggest political allegiance, rather than profits or economic

---

[193] *See* LI, *supra* note 144, at 117; Lin & Milhaupt, *supra* note 20, at 738; *see also* Dan Levin *China's Top Party School*, FOREIGN POL'Y (March 6, 2012), http://foreignpolicy.com/2012/03/06/chinas-top-party-school/ [https://perma.cc/88NA-SAAU] (describing the curriculum of the Central Party School).
[194] Lin, *supra* note 189, at 125
[195] *See* Wu, *supra* note 144, at 281.
[196] *See id.*; Milhaupt, *supra* note 188, at 6; *see also* Taylor, *supra* note 176, at 76-77, 88-89 (discussing the history party personnel appointments in China's national oil companies).
[197] LI, *supra* note 144, at 120-123.
[198] Lin & Milhaupt, *supra* note 20, at 741.
[199] *See* Cheng Li, *China's Midterm Jockeying: Gearing Up for 2012 (Part 4: Top Leaders of Major State-Owned Enterprises)*, 34 CHINA LEADERSHIP MONITOR 1 (2011); Lingling Wei & Bob Davis, *For a Top Chinese Banker, Profits Hinder Political Rise*, WALL ST. J., Feb. 18, 2013, https://www.wsj.com/articles/SB10001424127887324196204578297961462046562 [https://perma.cc/K9YB-HH6C].
[200] *See* Wu, *supra* note 144, at 281; Gregor Stuart Hunter & Steven Russolillo, *Now Advising China's State Firms: The Communist Party*, WALL ST. J., Aug. 14, 2017, https://www.wsj.com/articles/now-advising-chinas-state-firms-the-communist-party-1502703005 [https://perma.cc/995D-7R9L]; Tom Mitchell, *China's Communist Party Seeks Company Control Before Reform*, FIN. TIMES, Aug. 14, 2017, https://www.ft.com/content/31407684-8101-11e7-a4ce-15b2513cb3ff.
[201] *See* Zhang Hongpei, *Organic Governance*, GLOBAL TIMES, Sept. 5, 2017, http://www.globaltimes.cn/content/1064895.shtml [https://perma.cc/Y3K9-32Z9].
[202] *Id.*

efficiency, appears to be the paramount quality in evaluating managers of China's SOEs.[203] In the words of one scholar, when conflicts arise between economic and political objectives, SOEs "often have to give priority to the political objective[s]."[204] Or as another has put it, "the goals of the state are dominant in SOE executives' decision-making processes."[205] SOE managers are willing to sacrifice economic performance in the name of achieving other goals set by the Party.[206] It is this partial subordination of profits to political concerns that raises a distinctive set of issues with regard to China's international tax policy.[207]

B. SOEs in China's "Going Out" and "Belt and Road" Initiatives

Another defining feature of Chinese state capitalism is the role of government industrial policy in shaping the Chinese economy. While China's five-year plans no longer include strict production quotas for all commodities, as they once did under the command economy of Mao Zedong, they continue to lay out the government's policy priorities and its overarching economic goals.[208] The Chinese government allows the market to play an important role in the economy but still believes the overall direction of economic development must be determined by government policy and not market forces. Through its industrial policy, the Chinese government "aims to go beyond just *riding* the waves of markets by actively *creating* the waves on which to ride."[209] China's chief economic planning authority, the National Development and Reform Commission,

---

[203] *See* Duanjie Chen, *China's State-Owned Enterprises: How Much Do We Know? From CNOOC to Its Siblings*, 6 U. CALGARY SCH. PUB. POL'Y RES. PAPERS 1, 19 (June 2013) ("Such party control of the top executives of central SOEs has ensured that those who are ambitious in climbing the government and party ladders must obey party orders more than ensuring the economic efficiency of the SOEs under their watch."); Feng Liu & Linlin Zhang, *Executive Turnover in China's State-Owned Enterprises: Government-Oriented or Market-Oriented?*, CHINA J. ACCT. RES. (2017), http://dx.doi.org/10.1016/j.cjar.2016.12.003 [https://perma.cc/FUL4-WYP5] (concluding that executive evaluations in central SOEs tend to be government-oriented and focused on political performance in comparison to evaluations in local SOEs which tend to be market-oriented); Shirley Yam, *Invisible Hand of the Market Gives Way to the Visible Hand of the Party at China's State-Owned Firms*, S. CHINA MORNING POST, July 15, 2016, http://www.scmp.com/business/companies/article/1990174/invisible-hand-market-gives-way-visible-hand-party-chinas-state [perma.cc/8HL2-MNKT] (arguing that in Chinese SOEs "politics takes precedence over economics in corporate affairs.")

[204] XIE, *supra* note 26, at 80; *see also* Naughton, *supra* note 144, at 61 (noting that "managers of state firms have very strong incentives to subordinate the interests of the individual firm to national interests").

[205] Ming Du, *When China's National Champions Go Global: Nothing to Fear but Fear Itself?*, 48 J. WORLD TRADE 1127, 1154 (2014).

[206] *See* Han Peng, *Why Can "One Belt, One Road" Happen So Fast? Credit SOEs*, CGTN.com (Oct. 25, 2017,7:50 PM), https://news.cgtn.com/news/34516a4d32597a6333566d54/share_p.html [https://perma.cc/DG2Y-RVZ6] ("State-owned enterprises don't only work for profit. Under CPC leadership, sometimes it's an obligation for us to sacrifice short-term profit in order to achieve a bigger, national goal.").

[207] *See infra* Part 5.

[208] *See* Cary Huang, *How China's Five-Year Plan, an Overhang from the Soviet Era, Has Evolved*, S. CHINA MORNING POST, Oct. 13, 2015, http://www.scmp.com/news/china/policies-politics/article/1866736/how-chinas-five-year-plan-overhang-soviet-era-has [https://perma.cc/BG56-G2TH] (arguing that the five-year plan remains an integral part of a state-controlled and centrally planned society); *Why China's Five-Year Plans Are So Important*, ECONOMIST (Oct. 26, 2015), https://www.economist.com/blogs/economist-explains/2015/10/economist-explains-24 [https://perma.cc/UZ7D-33N7] (arguing that China's five-year plans have evolved from "rigid agendas" to "rough guides to how leaders want to steer the country").

[209] Sebastian Heilmann & Lea Shih, *The Rise of Industrial Policy in China, 1978-2012*, at 21 (Harvard-Yenching Inst. Working Paper Series, Jan. 2013).

has a variety of tools at its disposal to implement its plan across the economy, such as authority over the allocation of stimulus funding and over the pricing of commodities not set by the market.[210] But more importantly, since the Commission's five-year plans represent a distillation of the Communist Party's long-term priorities, all major economic actors in the country—including central SOEs—modify their strategies and rhetoric to bring them in line with the plans.[211] Quantitative evidence suggests that China's five-year plans have significant impacts on the performance of SOEs in prioritized sectors, with SOEs in supported industries enjoying faster growth and access to additional financing.[212] The most recent plans have prioritized high-tech and emerging industries including green energy and nuclear power, biotechnology, advanced manufacturing, and new materials.[213]

Since the early 2000s, China's industrial policy has prioritized outbound investment by SOEs in furtherance of both economic and foreign policy goals. While some SOEs had been engaging in overseas activities in the 1990s with government indifference,[214] at the dawn of the new millennium the Chinese government officially launched its "going out" (or "go global") policy to actively encourage enterprises to pursue overseas investments.[215] Under this slogan the government supported investments by large SOEs, in particular in acquisitions of upstream commodity assets needed to support China's rapid economic growth.[216] The central government decrees identified recommended sectors and nations for foreign investment and the state-directed policy banks provided subsidized financing for such investments.[217] For instance, under this policy generous loans were given to state-owned oil companies to acquire stakes in foreign oil and gas production to better secure China's access to energy resources.[218] Similar support was also extended to SOEs to secure foreign mineral resources.[219] Over the decade, state officials would

---

[210] *See* Wu, *supra* note 144, at 276.

[211] *See Why China's Five-Year Plans Are So Important*, *supra* note 208.

[212] *See* Donghua Chen, Oliver Zhen Li & Fu Xin, *Five-Year Plans, China Finance and Their Consequences*, 10 CHINA J. ACCT. RES. 189 (2017) (finding that "state-owned" firms in government supported industries enjoy faster growth in initial public offerings and higher offer prices…[and] enjoy faster growth in loans granted by major national banks.").

[213] Tristan Kenderdine, *China's Industrial Policy, Strategic Emerging Industries and Space Law*, 4 ASIA & PAC. POL'Y STUD. 325, 328 (2017).

[214] *See* Xiaojie Xu, *Chinese NOCS Overseas Strategies: Background, Comparison and Remarks*, JAMES A. BAKER III INST. PUB. POL'Y 4 (March 2007), https://www.bakerinstitute.org/media/files/page/94235e0c/noc_chinesenocs_xu.pdf [https://perma.cc/T5LH-AKZ5].

[215] *See* DAVID SHAMBAUGH, CHINA GOES GLOBAL: THE PARTIAL POWER 174-76 (2013). For a discussion of the "Going Out" strategy in China's recent Five-Year Plans, see XIE, *supra* note 26, at 7.

[216] *See* Jamil Anderlini, *China to Deploy Foreign Reserves*, FIN. TIMES, July 21, 2009, https://www.ft.com/content/b576ec86-761e-11de-9e59-00144feabdc0 [https://perma.cc/7JMZ-WR2V]; *China's "Going Out" Strategy*, ECONOMIST (July 21, 2009), https://www.economist.com/blogs/freeexchange/2009/07/chinas_going_out_strategy [https://perma.cc/LLQ5-9H5E].

[217] *See* SHAMBAUGH, *supra* note 215, at 176; Du, *supra* note 205, at 1134.

[218] *See* Taylor, *supra* note 176, at 79; Peter C. Evans & Erica S. Downs, *Untangling China's Quest for Oil Through State-backed Financial Deals*, BROOKINGS (May, 1, 2006), https://www.brookings.edu/research/untangling-chinas-quest-for-oil-through-state-backed-financial-deals/ [https://perma.cc/YXQ5-FZTP]; *see also* Daniel C. O'Neil, *Risky Business: The Political Economy of Chinese Investment in Kazakhstan*, 5 J. EURASIAN STUD. 145 (2014) (discussing the types of central government financial support offered to Chinese oil and gas SOEs operating in Kazakhstan).

[219] Erica. S. Downs, *Whatever Became of China, Inc.?*, BROOKINGS (June 24, 2014), https://www.brookings.edu/articles/whatever-became-of-china-inc/ [https://perma.cc/UH8C-LVFU]("Driven by an

broaden the policy beyond natural resources and extend support to foreign projects in the transportation, telecommunications, and nuclear energy sectors.[220] As a result of these policies, from 2005 to 2013, SOEs were responsible for upwards of 90 percent of Chinese outbound direct investments.[221]

The 2013 announcement of the "One Belt, One Road" initiative sparked additional overseas investment by SOEs.[222] The initiative has been described as an "'upgraded' version of China's 'Go Global' strategy" as it seems designed, in part, to further expand the global footprint of China's SOEs.[223] Since SOEs dominate infrastructure-related industries within China, the initiative's focus on boosting transportation and energy infrastructure across Eurasia places SOEs at its center.[224] Within its first two years, the initiative had already produced new lucrative business opportunities for the ten or so central SOEs focused on civil-engineering and construction.[225] And by 2017, at least 40 Chinese SOEs had multiple projects in countries associated with the initiative.[226] At the end of 2014, SASAC published a report highlighting the impact of the initiative on the overseas operations of central SOEs. At that time, nearly all central SOEs were active overseas. Overseas operations constituted 12.7% of central SOE's total assets, 18.3% of their operational revenues, and 8.6% of their total profits.[227] Since the start of the initiative, central

---

unexpected surge in the country's commodity demand and fueled by cheap loans from state-owned policy banks, Chinese firms went on a resource buying binge from Afghanistan to Zambia."); Brad Plumer, *How China's Appetite for Raw Materials Is Transforming the World*, WASH. POST, Feb. 13, 2014, https://www.washingtonpost.com/news/wonk/wp/2014/02/13/how-chinas-hunt-for-raw-materials-is-changing-the-world/?utm_term=.d3e1bdc403ea [https://perma.cc/CLA2-CECL].

[220] *See* SHAMBAUGH, *supra* note 215, at 176; Du, *supra* note 205, at 1134; Shannon Tiezzi, *China Urges Companies to 'Go Global,'* DIPLOMAT (Dec. 25, 2014), https://thediplomat.com/2014/12/china-urges-companies-to-go-global [https://perma.cc/7C5Q-BX4M].

[221] *See* Wang et al., *supra* note 115, at 322 ("According to our calculations, between 2005 and 2013, 89.4 per cent of the US$807.5 billion of Chinese ODI and contracts were linked to SOEs."); *see also* SHAMBAUGH, *supra* note 215, at 178 (noting the "dominant position of central level SOEs" in Chinese ODI as of 2010).

[222] *See* Zhang Ye, *Central SOEs Contribute to B&R Initiative*, GLOBAL TIMES, May 8, 2017, http://www.globaltimes.cn/content/1045920.shtml [https://perma.cc/8SXU-EPVJ]; *see also* Spencer Sheehan, *The Problem With China's One Belt, One Road Strategy*, DIPLOMAT (May 24, 2017), https://thediplomat.com/2017/05/the-problem-with-chinas-one-belt-one-road-strategy/ [https://perma.cc/Z78N-7KT8](noting that projects associated with the Initiative "are often tied to political pacts through which China's state-owned enterprises get exclusive bidding rights").

[223] Yu Jie, *China's One Belt, One Road: A Reality Check*, LSE IDEAS, MEDIUM (July 24, 2017), https://medium.com/@lseideas/chinas-one-belt-one-road-a-reality-check-b28030ac6d3b [https://perma.cc/D8YU-Y7ZA].

[224] GISELA GRIEGER, ONE BELT, ONE ROAD (OBOR): CHINA'S REGIONAL INTEGRATION INITIATIVE, EUR. PARLIAMENTARY RES. SERV. 6, PE 586.608 (July 2016) ("Large state-owned enterprises (SOEs), which dominate the Chinese infrastructure-related sectors, are expected to have a major stake in OBOR's first implementation stage …."); *see also* Julan Du & Yifei Zhang, *Does One Belt One Road Initiative Promote Chinese Overseas Direct Investment?*, 47 CHINA ECON. REV. 189 (2018) (discussing the role of SOEs in One Belt, One Road initiative related overseas direct investment).

[225] *See* Willy Wo-Lap Lam, *"One Belt, One Road" Enhances Xi Jinping's Control Over the Economy*, JAMESTOWN FOUND. (May 15, 2015), https://jamestown.org/program/one-belt-one-road-enhances-xi-jinpings-control-over-the-economy/ [https://perma.cc/2T6L-FCPG].

[226] BAKER MCKENZIE, BELT & ROAD: OPPORTUNITY & RISK 13 (2017), https://www.bakermckenzie.com/-/media/files/insight/publications/2017/10/belt-road/baker_mckenzie_belt_road_report_2017.pdf?la=en.

[227] *See The Roadmap of SOE's Presence in "Belt and Road,"* PEOPLE'S DAILY ONLINE, July 16, 2015, http://en.people.cn/business/n/2015/0716/c90778-8921479.html [https://perma.cc/M4AM-TTU9].

SOEs have on average increased their overseas assets 15% annually and their overseas revenue by 4% annually.[228] One recent study suggests that thus far, nearly 70% of investment and over 95% of construction under the initiative have come from SOEs.[229] Moreover, government pronouncements suggest central SOEs will continue to be the "major force" behind the next phase of the initiative.[230]

As a result of these government policies, SOEs continue to account for an outsized percentage of Chinese outbound investment. Recent estimates suggest central SOEs continue to account for between 60% and 70% of China's outbound direct investments on a yearly basis.[231] Moreover, Chinese cumulative capital stock held overseas "remains dominated" by SOEs.[232] Chinese government statistics indicate that SOEs hold more than half (54.3%) of China's cumulative non-financial foreign investment and total overseas assets in excess of US $900 billion.[233] Some scholars have suggested even these official statistics understate the total percentage outbound foreign direct investment held by SOEs.[234]

Outbound direct investment by Chinese SOEs is not limited to developing countries as SOEs and their subsidiaries still dominate Chinese direct investment in the United States in terms of value.[235] In sum, central SOEs play a commanding role in Chinese outbound international investment, making them particularly relevant to the future of Chinese international tax policy.

C. Capital Controls and Outbound Investment Regulations

A dramatic rise and fall in the outbound investment by Chinese private enterprises and individuals in 2016 further illustrates the central government's ability to use capital controls—

---

[228] State-owned Assets Supervision and Admin. Comm'n of the State Council (SASAC), Zhongyang Qiye Canyu "Yidai Yilu" Gong Jian Qingkuang [中央企业参与"一带一路"共建情况] (Central Enterprises Participation in Building the "Belt and Road) (2017), http://www.sasac.gov.cn/n4470048/n4470081/n4582104/c4594908/content.html [https://perma.cc/9KAJ-F862].

[229] CECLIA JOY-PÉREZ & DEREK SCISSORS, AM. ENTER. INST., THE CHINESE STATE FUNDS BELT AND ROAD BUT DOES NOT HAVE TRILLIONS TO SPARE, at 12 (Mar. 28, 2018), https://www.aei.org/wp-content/uploads/2018/03/BRI.pdf [https://perma.cc/ZHR5-WCCB].

[230] Zhong Nan, *SOEs to Take Lead Role Along Belt and Road*, CHINA DAILY, May 9, 2017, http://www.chinadaily.com.cn/business/2017-05/09/content_29258516.html [perma.cc/76TK-PBNJ]. [https://perma.cc/76TK-PBNJ].

[231] *See* Central Enterprises Participation in Building the "Belt and Road," *supra* note 228; Wendy Wu, *How the Communist Party Controls China's State-Owned Industrial Titans*, S. CHINA MORNING POST, June 17, 2017, http://www.scmp.com/news/china/economy/article/2098755/how-communist-party-controls-chinas-state-owned-industrial-titans [perma.cc/9B54-3MWG]; *SOE Overseas Assets Surge*, XINHUA (June 19, 2015), http://www.xinhuanet.com/english/2015-06/19/c_134341330.htm. [https://perma.cc/X6ZW-B66S].

[232] Scissors, *supra* note 145.

[233] *See* MINISTRY OF COMMERCE OF THE PEOPLE'S REPUBLIC OF CHINA, Zhongguo Duiwai Touzi Hezuo Fazhan Baogao [中国对外投资合作发展报告] (Report on Development of China's Outward Investment and Economic Cooperation) (2017), http://fec.mofcom.gov.cn/article/tzhzcj/tzhz/upload/zgdwtzhzfzbg2017.pdf [perma.cc/3QFK-NALT]; *Overseas Assets Held by China's Centrally Owned Firms Top $900 Billion*, REUTERS (Oct. 18, 2017), https://www.reuters.com/article/us-china-congress-soes/overseas-assets-held-by-chinas-centrally-owned-firms-top-900-billion-idUSKBN1CN0UE [perma.cc/XW23-Z4R4].

[234] *See* Scissors, *supra* note 145; *see also* Du, *supra* note 205, at 1128 (suggesting a lower bound of approximately 70% on the percentage of Chinese total outbound foreign direct investment held by SOEs).

[235] *See* Ji Li, *I Came, I Saw, I... Adapted: An Empirical Study of Chinese Business Expansion in the United States and its Legal and Policy Implications*, 36 NW. J. INT'L L. & BUS. 143, 165 (2016).

another element of Chinese state capitalism—to influence the character and volume of Chinese overseas investment. In 2016, the Chinese yuan (also known as the renminbi) declined sharply against the dollar, leading many Chinese individuals and businesses to seek protection from depreciation by purchasing foreign currency or assets.[236] That year, China witnessed a boom in outbound acquisitions, largely driven by private companies such as Anbang Insurance, Dalian Wanda, Fosun and HNA.[237] For the first time, outbound investment by privately-owned Chinese enterprises surpassed that of SOEs.[238] China's outbound M&A volume broke existing annual records in just the first six months of the year and ended up surpassing U.S. outbound M&A volume for the first time.[239] Yet Chinese government officials soon suspected that many of these private corporations were overpaying for speculative foreign assets as a way of shifting assets outside of China.[240]

In response, starting in November 2016, the government tightened capital controls and regulations on outbound investment. The State Administration of Foreign Exchange (SAFE), is a central government institution that controls whether Chinese companies, both domestic and foreign-invested, may convert renminbi into foreign currency and whether they may transfer such funds overseas.[241] While it previously vetted only corporate cross-border money transfers of more than US $50 million, SAFE reportedly started requiring pre-approval for all overseas transfers of more than US $5 million.[242] Government regulators also stepped-up administrative scrutiny of

---

[236] *See* Saumya Vaishampayan & Lingling Wei, *Yuan Weakness Spurs Fresh Surge in China Outflows*, WALL ST. J., Nov. 7, 2016, https://www.wsj.com/articles/yuan-weakness-spurs-fresh-surge-in-china-outflows-1478520675.

[237] *See* Sui-Lee Wee, *China Steps up Warnings over Debt-fueled Overseas Acquisitions*, N.Y. TIMES, Aug. 18, 2017, https://www.nytimes.com/2017/08/18/business/dealbook/china-companies-deals-debt.html; Xie Yu, *China's Probes on Fosun, HNA and Others Unleash the Power of the Unsaid Word*, S. CHINA MORNING POST, July 8, 2017, https://www.scmp.com/business/banking-finance/article/2101762/chinas-probes-fosun-hna-and-others-unleash-power-unsaid [perma.cc/H83R-74FW].

[238] *See* Don Weinland, Emily Feng & Sherry Fei Ju, *State-led Companies Back on Top in China's Outbound M&A Rankings*, FIN. TIMES, Sept. 3, 2017, https://www.ft.com/content/18b1352c-8e26-11e7-a352-e46f43c5825d.

[239] *See* Denny Thomas, *China Outbound M&A Beats 2015 Record with 6 Months to Spare*, REUTERS (June 20, 2016), https://www.reuters.com/article/us-china-m-a/china-outbound-ma-beats-2015-record-with-6-months-to-spare-idUSKCN0Z60UI [perma.cc/6BEJ-JASK]; Xie Yu, *Record Year for China's Outbound M&A as It Overtakes US for the First Time*, S. CHINA MORNING POST, Dec. 21, 2016, http://www.scmp.com/business/companies/article/2056099/record-year-chinas-outbound-ma-it-overtakes-us-first-time [perma.cc/LG8C-98UQ].

[240] *See, e.g.*, Heiwei Tang & Christopher Beddor, *It's No Accident that China's Tycoons Are Bad Investors*, FOREIGN POL'Y (Oct. 17, 2017), http://foreignpolicy.com/2017/10/17/its-no-accident-that-chinas-tycoons-are-bad-investors [perma.cc/JM9L-DCAS]; Angelo Katsoras, *The Story Behind China's Crackdown on Outbound Investments*, NAT'L BANK CAN. (Oct. 4, 2017), https://www.nbc.ca/content/dam/bnc/en/rates-and-analysis/economic-analysis/GeopoliticalBriefing_4oct2017.pdf [perma.cc/5JB9-YF5K].

[241] *See* Gary Lock & Karen Ip, *Getting Your Cash Back*, 28 INT'L FIN. L. REV. 36 (2009); Friedrich Wu, Robbert-Jan Korthah & Ng Kuan Khai, *How Safe Is SAFE's Management of China's Official Foreign Exchange Reserves?*, 14 WORLD ECON. 19, 20–21 (2013).

[242] *See* James T. Areddy & Lingling Wei, *Foreign Companies Face New Clampdown for Getting Money out of China*, WALL ST. J., Dec. 1, 2016, https://www.wsj.com/articles/foreign-companies-face-new-clampdown-for-getting-money-out-of-china-1480604271; Gabriel Wildau, Don Weinland & Tom Mitchell, *China to Clamp Down on Outbound M&A in War on Capital Flight*, FIN. TIMES, Nov. 29, 2016, https://www.ft.com/content/2511fa56-b5f8-11e6-ba85-95d1533d9a62; *see also* Engen Tham & Samuel Shen, *Banks Forced to Cover Tracks of China's Forex Regulator*, Reuters (Jan. 10, 2017), https://www.reuters.com/article/uk-china-regulator-banks-exclusive-idUSKBN14V0CP [perma.cc/362X-BU95] (reporting that SAFE transmitted instructions regarding the tightening of

outbound investments with the goal of weeding out those that it deemed "irrational."[243] As a result, outbound investment declined more than 40% in the first seven months of 2017.[244] In August 2017, China's top economic planning body announced a new system of regulation for overseas investments. Restrictions were placed on investments in property, hotels, film, entertainment, and sports. On the other hand, investments related to the Belt and Road initiative, infrastructure, energy, and high-tech businesses would be given preferential state support.[245] Regulations were also put in place requiring SOEs to prove the financial viability of overseas projects before undertaking investments and mandating stricter auditing procedures, particularly for currency transactions.[246] To observers, the new regulations reaffirm the government's preference for overseas investments to be led primarily by SOEs rather than private corporations.[247]

The Chinese government's aggressive enforcement of capital controls in 2016 targeted "irrational" outbound *direct* investment, reflecting the fact that Chinese capital control regime has long been more accommodating to direct investment than portfolio investment. Cross-border investment is generally classified as foreign direct investment when the investor owns at least 10% of the stock of a foreign entity—as equity ownership above this level presumably reflects significant influence in corporate decision making. In contrast, investment below this 10% level or in debt securities is considered passive or portfolio investment.[248] Since 1991, an approval and registration process has been in place for Chinese enterprises to make direct investments in foreign projects.[249] Even after a series of significant reforms in the early 2000s, this approval process can

capital controls orally and instructed banks to keep the measures secret in order to prevent alarm); XIE, *supra* note 26, at 55–56 (describing the gradual liberalization of SAFE exchange regulations from 2008 to 2015).

[243] *See* ANDREW MCGINTY, JUN WEI & LIANG XU, HOGAN LOVELLS, CHINA'S NEW FOREIGN EXCHANGE CONTROLS CREATE FRESH CONCERNS (Jan. 2017), at 2-3, https://www.hoganlovells.com/~/media/hogan-lovells/pdf/chinas-new-foreign-exchange-controls-create-fresh-concerns-for-foreign-investors.pdf [perma.cc/JQ3N-XWGD].

[244] *See China Codifies Crackdown on 'Irrational' Outbound Investment*, BLOOMBERG (Aug. 18, 2017), https://www.bloomberg.com/news/articles/2017-08-18/china-further-limits-overseas-investment-in-push-to-reduce-risk.

[245] Jinyibu Yindao he Guifan Jingwai Touzi Fangxiang Zhidao Yijian de Tongzhi [进一步引导和规范境外投资方向指导意见的通知] (Guiding Opinion on Further Directing and Regulating the Direction of Overseas Investments)，Guo Ban Fa [2017] No.74; *see also* LATHAM & WATKINS, CHINA ISSUES FORMAL GUIDANCE FOR OUTBOUND DIRECT INVESTMENTS (Aug. 30, 2017), https://m.lw.com/thoughtLeadership/LW-China-Issues-Formal-Guidance-for-Outbound-Direct-Investments [perma.cc/J3L8-N7NB](summarizing the contents of the Guiding Opinion).

[246] Guoyou Qiye Jingwai Touzi Caiwu Guanli Banfa [国有企业境外投资财务管理办法] (Measures for the Financial Management of the Overseas Investments of SOEs), Cai Zi [2017] No. 24; Emily Feng, *China Tightens Rules on State Groups' Foreign Investments*, FIN. TIMES, Aug. 3, 2017, https://www.ft.com/content/3251987c-7806-11e7-90c0-90a9d1bc9691; *China Issues Rules to Curb State Firms' Overseas Investment* Risks, REUTERS (Aug. 2, 2017), https://www.reuters.com/article/us-china-economy-soe/china-issues-rules-to-curb-state-firms-overseas-investment-risks-idUSKBN1AI1BO [perma.cc/EV8B-YJ44].

[247] *See* Weinland, *supra* note 238; Wade Shepard, *Xi Jinping to China's Private Sector: Go Home, the New Silk Road Is Not for You*, FORBES (July 27, 2017), https://www.forbes.com/sites/wadeshepard/2017/07/25/xi-jinping-to-chinas-private-sector-go-home-the-belt-and-road-is-not-for-you/#230b364c17fb [perma.cc/3LGR-MGUU].

[248] *See* Tadeusz Galeza and James Chan, *What is Direct Investment?*, 52 FIN. & DEV. 34 (Sept. 2015); *see also* Michael J. Graetz & Itai Grinberg, *Taxing International Portfolio Investment*, 56 TAX. L. REV. 537, 539 (2003) (discussing the distinction in U.S. international tax law between foreign direct and portfolio investments).

[249] *See* Hansjörg Herr, *Capital Controls and Economic Development in China*, *in* FINANCIAL LIBERALIZATION AND ECONOMIC PERFORMANCE IN EMERGING COUNTRIES 142, 151 (P. Arestis et al. eds., 2008).

still be arduous, requiring certifications from multiple government departments.[250] Yet the regulation of outbound direct investment remains more permissive than that of outbound portfolio investment. Until the mid 2000s, Chinese capital controls prohibited individuals and companies from making portfolio investments in overseas stock markets or securities.[251] Starting in 2006, under the Qualified Domestic Institutional Investor (QDII) regime, a limited number of Chinese financial institutions were granted licenses to invest in overseas securities. Approved institutions are each granted a specific quota set by SAFE and the regime heavily restricts what foreign securities are eligible for investment.[252] These institutions may then repackage these foreign investments into financial products offered to domestic investors.[253] While the government is considering pilot programs to allow additional offshore portfolio investments, further liberalization has been repeatedly delayed.[254] As a result of these policies, Chinese foreign outward portfolio investment remains minuscule both in comparison to its outbound direct investments and to that of other countries.[255]

The same pattern holds for inbound investments, with Chinese capital controls far more permissive towards direct investment than portfolio investment by foreign investors. As previously noted, China has sought to attract inward foreign direct investment since the start of reform and

---

[250] *See* XIE, *supra* note 26, at 24–27.

[251] *See* Herr, *supra* note 249, at 153; Guonan Ma & Robert N. McCauley, *Do China's Capital Controls Still Bind? Implications for Monetary Autonomy and Capital Liberalisation* 19 (Bank for Int'l Settlements Working Paper No. 233, Aug. 2007), https://www.bis.org/repofficepubl/arpresearch200708.1.pdf [perma.cc/C7VY-EPQ3].

[252] *See* Y. Nanci Ni, *China's Capital Flow Regulations: The Qualified Foreign Institutional Investor and the Qualified Domestic Institutional Investor Programs*, 28 REV. BANKING & FIN. L. 299, 326–28 (2009); *see also* RICHARD MAZZOCHI, MINNY SIU & HAYDEN FLINN, KING & WOOD MALLESONS, QDII – AN OFFSHORE PERSPECTIVE (July 2013), http://www.kwm.com/en/hk/knowledge/downloads/kwm-connect-qdii-an-offshore-perspective-20130701 [perma.cc/3P2F-7MLY] (describing in detail the QDII Regime).

[253] *See* Ni, *supra* note 252, at 330–31; *see also* Daniel Ren, *Record Number of QDII Funds Shows Chinese Investors' Hunger for Offshore Stocks*, S. CHINA MORNING POST, Nov. 18, 2016, http://www.scmp.com/business/companies/article/2047214/record-number-qdii-funds-shows-chinese-investors-hunger-offshore [perma.cc/2547-8HGE] (noting the recent popularity of the QDII related products and funds amongst Chinese investors).

[254] *See* Ren Wei, *Yuan Scare: Why China is Putting on Hold a Major Cross-border Investment Scheme*, S. CHINA MORNING POST, Feb. 1, 2016, https://www.scmp.com/business/article/1908108/yuan-scare-why-china-putting-hold-major-cross-border-investment-scheme [perma.cc/DVP5-335L]; Don Weinland, *China Halts Overseas Investment Schemes*, FIN. TIMES, Feb. 28, 2016, https://www.ft.com/content/c64b3fc6-dc2e-11e5-a72f-1e7744c66818.

[255] *See* John Hooley, *Bringing Down the Great Wall? Global Implications of Capital Account Liberalisation in China*, BANK ENG. Q. BULL. (Dec. 20, 2013), https://www.bankofengland.co.uk/quarterly-bulletin/2013/q4/bringing-down-the-great-wall-global-implications-of-capital-account-liberalisation-in-china [perma.cc/M7F2-GVZ3] ("[T]he biggest difference between the international investment positions of China and the United States is in portfolio investment. The stock of outward portfolio investment is 3% of GDP in China, compared with 49% in the United States."); Herr, *supra* note 249, at 156 ("FDI flows clearly dominated legal capital flows in China. This is a big difference to other developing countries, which showed much higher percentages of portfolio investment and 'other investment' to aggregate cross-border flows."); Thilo Hanemann & Daniel H. Rosen, *China Invests in Europe Patterns, Impacts and Policy Implications*, RHODIUM GROUP 15 (June 2012), http://rhg.com/wp-content/uploads/2012/06/RHG_ChinaInvestsInEurope_June2012.pdf [perma.cc/D44M-3ZKG] (reporting that Chinese outward portfolio flows and stocks represent 0.3% and 0.6% of global totals respectively, while Chinese outward FDI represent 5.1% and 1.5% respectively); *see also* Graetz & Grinberg, *supra* note 248, at 538 (noting that in most years since 1990, U.S. residents' foreign portfolio investment income has exceeded their foreign direct investment income).

opening up policy.[256] While certain sectors remain off-limits to foreign investors—a point of considerable tension in U.S.-China trade relations[257]—there are no capital controls on inward foreign direct investment.[258] In contrast, China continues to strictly limit inbound portfolio investment.[259] Starting in 2002, under the Qualified Foreign Institutional Investors (QFII) regime, a limited number of qualified foreign institutional investors were first permitted to invest in the Chinese stock market, Chinese bonds, Chinese ETFs, and other securities. Potential QFII investors must apply for an investment quota from Chinese regulators and face minimum holding or lockup periods before being permitted to repatriate capital gains.[260] China has increased the QFII regime's quota limitations and reduced its lock-up periods three times since its original roll-out.[261] In 2014 and 2016 China further liberalized foreign portfolio investment with the opening of the Hong Kong-Shanghai and Hong Kong-Shenzhen Stock Connect systems, which each allow for US $3.4 billion to flow between Hong Kong and each Mainland stock market.[262] These systems allow foreign investors to trade a subset of Chinese stocks without a quota or lockup period and gives mainland investors access to the Hong Kong stock market.[263] Yet, commentators have noted that while this reform is significant, China remains "far from being a free, open stock market that investors from outside the country can access in its entirety."[264] Unsurprisingly, China's inward portfolio investment stock is also miniscule in comparison to inward direct investment and to inward portfolio investment in other countries.[265]

---

[256] *See* Ma & McCauley, *supra* note 251, at 14.

[257] *See Tit for Tat? The Shape of U.S. Restrictions on Chinese FDI*, STRATFOR (Feb. 10, 2018), https://worldview.stratfor.com/article/tit-tat-shape-us-restrictions-chinese-fdi [perma.cc/VHB4-E87D].

[258] *See* Herr, *supra* note 249, at 151.

[259] *See* Wendy Dobson & Paul R. Masson, *Will the Renminbi Become a World Currency?*, 20 CHINA ECON. REV. 124 (2009); Herr, *supra* note 249, at 153; Fred Hu, *Capital Flows, Overheating, and the Nominal Exchange Rate Regime in China*, 25 CATO J. 357, 360 (2005).

[260] *See* Herr, *supra* note 249, at 153; Hu, *supra* note 259, at 360; *see also* Bi Xiaoning, *Limits Up for QFII Investors*, CHINA DAILY, Sept. 5, 2009, https://www.chinadaily.com.cn/bizchina/2009-09/05/content_8658520.htm [perma.cc/7RDU-7BR8] (discussing the 2009 adjustments to QFII quotas and lockup periods).

[261] See *China Relaxes QFII Control*, HERBERT SMITH FREEHILLS (Feb. 22, 2016), https://www.lexology.com/library/detail.aspx?g=15ccba92-f44d-4b40-b9b5-62ebef8c0e23 [perma.cc/QGK2-XGYN].

[262] Neil Gough, *As China's Investors Rush in, Hong Kong Shares Take a Wild Ride*, N.Y. TIMES, Apr. 30, 2017, https://www.nytimes.com/2017/04/30/business/meitu-hong-kong-stock-connect-china.html [perma.cc/7ANP-36E5].

[263] Enoch Yiu, *Don't Expect QFII to Disappear Now that the Second Stock Connect Is Ready for Lift-off*, S. CHINA MORNING POST, Nov. 28, 2016, http://www.scmp.com/business/companies/article/2049765/dont-expect-qfii-disappear-now-second-stock-connect-ready-lift [perma.cc/QZS8-ECA4].

[264] Adam Shell, *China Opens Door to More Foreign Stock Investors,* USA TODAY (June 22, 2017), https://www.usatoday.com/story/money/2017/06/22/playing/415307001 [perma.cc/2Q3Y-DLXQ]; *see* Fraser Howie, *The Promise of China's Stock Connect Betrayed*, NIKKEI ASIAN REV. (Dec. 28, 2017), https://asia.nikkei.com/Viewpoints/Fraser-Howie/The-promise-of-China-s-Stock-Connect-betrayed. [perma.cc/5AMQ-PDU6].

[265] *See* Hooley, *supra* note 255 (noting that inward portfolio investment represents 4% of GDP in China and 86% of GDP in the United States).

IV. POSSIBILITIES FOR DISTINCTIVE CHINESE INTERNATIONAL TAX POLICIES AND NORMS

A. Continued Income Taxation of Chinese SOEs

As the previous Part has illustrated, the Chinese central government maintains extensive control over the shape of the Chinese economy, through its system of SOEs, industrial planning initiatives, and capital controls. Looking forward, China's international tax policy is likely to be strongly influenced by this unique system of state capitalism. This Part advances three ways in which the role of SOEs and capital controls may lead to distinctive sets of Chinese tax policies and preferences. First, China's system of state capitalism may allow it to maintain a functional system of worldwide corporate taxation despite a general international trend toward more territorial systems. Second, Chinese tax officials may help SOEs engage in foreign tax planning. Finally, Chinese tax law is likely to continue to provide differential treatment to SOEs and private enterprises engaging in investment abroad and Chinese tax diplomacy may seek to ensure other countries offer favorable tax treatment to Chinese SOEs.

As a threshold matter, enterprise income taxation will likely remain the primary concern of China's international tax policy. Admittedly, the future of corporate income taxation as a significant source of government revenue remains a topic of debate amongst Western scholars.[266] And in recent years, notable U.S. pundits on both sides of the political spectrum have called for its abolition, suggesting offsetting increases in individual income tax or other integration schemes.[267] Yet, in China, and other developing countries, relatively weak individual income tax systems coupled with an outsized role for corporate income taxes in government revenue makes the elimination of corporate income taxation appear untenable.[268] In OECD members states, corporate income taxes on average represent 8.9 percent of total tax revenue, while individual income taxes represent 24.4 percent of total tax revenue.[269] In fact, in all but two of the 35 OECD member states revenue from individual income taxes exceed that from corporate income taxes.[270] Yet in China this pattern is reversed. In 2016 the enterprise income tax accounted for 22.13 percent of total tax

---

[266] *See, e.g.*, Reuven S. Avi-Yonah, *Corporations, Society, and the State: A Defense of the Corporate Tax*, 90 VA. L. REV. 1193 (2004); Yariv Braunner, *The Non-Sense Tax: A Reply to New Corporate Income Tax Advocacy*, 2008 MICH ST. L. REV. 591 (2008).

[267] *See*, *e.g.*, Dean Baker, *A Progressive Way to End Corporate Taxes*, N.Y. TIMES, Jan. 12, 2016, www.nytimes.com/2016/01/13/opinion/a-progressive-way-to-replace-corporate-taxes.html [https://perma.cc/3Z6H-C5U8]; Matthew Yglesias, *Scrap the Corporate Income Tax,* SLATE (Apr. 9, 2013), http://www.slate.com/articles/business/moneybox/2013/04/corporate_income_tax_reform_it_s_not_possible_we_should_just_get_rid_of.html [https://perma.cc/WP8X-L6ZU]; Kevin D. Williamson, *End the Corporate Tax*, NAT'L REV. (Apr. 26, 2017), https://www.nationalreview.com/2017/04/corporate-tax-rate-reduction-zero-percent-would-be-better-15/ [https://perma.cc/27GX-QGFX].

[268] *See* Reuven S. Avi-Yonah, *Hanging Together: A Multilateral Approach to Taxing Multinationals, in* GLOBAL TAX FAIRNESS, *supra* note 64, at 114.

[269] *See* ORG. ECON. CO-OPERATION & DEV., OECD (2017), REVENUE STATISTICS 2017: TAX REVENUE TRENDS IN THE OECD, https://www.oecd.org/tax/tax-policy/revenue-statistics-highlights-brochure.pdf [https://perma.cc/4TBU-FXT4].

[270] Slovakia and Chile are the exceptions to this rule. *See id.*

revenue in China, while the individual income tax accounted for only 7.74 percent.[271] Moreover, the relative contribution of enterprise income tax revenue has increased significantly across the new millennium. More generally, China's total tax revenue collected as a percentage of GDP remains relatively low compared to both OECD and other BRIC countries and it will likely need to raise additional revenue to strengthen its social welfare programs.[272] As a result, the elimination of the corporate income tax is highly unlikely, especially in light of China's relatively underdeveloped individual income tax system.[273]

Similarly, income taxation of SOEs is likely to remain an important source of tax revenue. While the percentage of loss-making Chinese SOEs increased across the 1990s, to nearly 50 percent in 1998, following the establishment of SASAC in 2003, central SOEs saw their operations stabilize and profits soar.[274] The profits of central SOEs quadrupled from 2002 to 2007, jumping from approximately 2 percent of GDP to 3.8 percent of GDP.[275] More generally, profits of all SOEs (including state financial firms and local SOEs), increased from approximately 263 billion yuan (US $41.6 billion) in 2002 to 1.089 trillion yuan (US $170.9 billion) in 2007, an annual increase of 32.6 percent.[276] In 2017 total SOE profits stood at 2.9 trillion yuan (US $453.2 billion),

---

[271] *See* Bai Yanfeng & Cui Rui [白彦锋 & 崔芮], Guoji Shuishou Jingzheng yu Woguo Qiye Suodeshu Gaige de Lixing Xuanze [国际税收竞争与我国企业所得税改革的理性选择] (International Tax Competition and Rational Choices for Chinese Enterprise Income Tax Reform), 5 SUB NAT'L FISCAL RES. 31 (2017) [地方财政研究]; *see also* STATE ADMIN. OF TAX'N, REVENUE STATISTICS, , http://www.chinatax.gov.cn/eng/n2367736/index.html [https://perma.cc/JQA3-GSJY] (reporting in 2015 the corporate income tax similarly represented 21 percent of total tax revenues).

[272] *See* Jeffery Owens [杰弗里·欧文斯], Shuishou Zai Shixian "Zhongguo Meng" Zhong de Zuoyong [税收在实现"中国梦"中的作用] (The Role of Taxation in Realizing the "Chinese Dream"), 12 INT'L TAX'N IN CHINA 34 (2017) [国际税收]; *see also* Mingxing Cao [曹明星], BEPS Fanglue: Xin Weiquan Zhuyi Chong Gou Guoji Shuishou Zhixu de Jijie Hao? [BEPS方略:新威权主义重构国际税收秩序的集结号?] (BEPS Strategy: Is It an Assembly Signal for New Authoritarianism to Reconstruct International Tax Order?), 7 INT'L TAX'N IN CHINA 16, 20 (2014) [国际税收] (noting China's relatively low tax revenue and arguing that as China's economy continues to grow, both the government's spending on the social security and its tax revenues will be required to continue to grow); *Revenue Statistics 2017*, *supra* note at 269, at 3 (noting the OECD average of tax revenue as percentage of GDP was 34.3 percent. In China it was 21.6 percent).

[273] *See* Dou Benbin, *How China's Income Tax Became a Levy on the Poor*, SIXTH TONE (Feb. 22, 2017), http://www.sixthtone.com/news/1969/how-chinas-income-tax-became-a-levy-on-the-poor [https://perma.cc/5WGH-J5Y3]; Maggie Zhang, *China 'Not Ready' for US-style Whole Family Income Tax, Although Progressive Changes Are Underway*, S. CHINA MORNING POST, March 20, 2018, http://www.scmp.com/business/global-economy/article/2137876/china-not-ready-us-style-whole-family-income-tax-although [https://perma.cc/KRX6-GEFG].

[274] *See* Wang, *supra* note 84, at 647; Tsai & Naughton, *supra* note 20, at 2.

[275] Naughton notes that "for comparison, ExxonMobil's record profit in 2007 was equal to 0.2% of U.S. GDP." Naughton, *supra* note 144, at 51.

[276] *See* Jia Kang & Liu Wei (贾康 & 刘微), Tigao Guomin Shouru Fenpei "Liang Ge Bizhong" Ezhi Shouru Chaju Kuoda de Caishui Sikao yu Jianyi (提高国民收入分配 "两个比重" 遏制收入差距扩大的财税思考与建议) [Thoughts and Suggestions to Improve the National Income Distribution's "Two Weights" and Contain the Expanding Income Gap], 12 FISCAL RES. 2, 12 (2010) [财政研究].

with central SOE profits reaching records levels of 1.4 trillion yuan (US $217.5 billion).[277] Along with this increase in profitability, taxes on SOEs have become a significant source of government revenue. SOEs now contribute more than 10 percent of total enterprise income tax revenue and central SOEs are routinely listed as China's largest taxpayers. [278]

Moreover, income taxation is likely to remain the primary mechanism for transferring earnings from SOEs to the central government. As noted by Wei Cui, taxation of SOEs is a widespread but severely undertheorized and studied phenomena.[279] Even fundamental conceptual questions—why do countries tax the income of their SOEs and are such taxes rational—remain unsettled.[280] Scholars have recognized that for wholly government-owned SOEs (where all profit nominally belongs to the state), the government could access SOE profits by means of either a profits tax or a dividend distribution. [281] Yet, like China today, most advanced economies prior to the wave of SOE privatizations in the 1980s maintained an income tax on SOEs.[282] The Soviet Union, which is perhaps the closest, but still inexact, analogue to Chinese state capitalism, also imposed an income tax on state-owned corporations which provided the bulk of central government tax revenue.[283] In his early seminal article on SOE taxation, Robert Floyd argued that imposing the same income tax on SOEs as private enterprises can be justified in mixed-economies where SOEs have a profit motive, as such a tax is required "to prevent tax-induced distortions in the allocation of resources."[284] If SOEs are responsive to rates of return and are able to shift investments, failure to impose an income tax on SOEs could result in inefficiently high levels of SOE investment thanks to their tax-advantaged status.[285] However, this explanation has been criticized by subsequent scholarship, as imposing seemingly identical tax rules on SOEs and private enterprises will still fail to place identical tax burdens on SOEs, since SOEs have greater access to financing (and thus interest deductions) and subsidies not as readily available to private enterprises.[286] Moreover, other alternative mechanisms exist for better ensuring that the rate of

---

[277] *Chinese SOEs See Solid Profit Growth in 2017*, XINHUA (Jan. 23, 2018), http://www.xinhuanet.com/english/2018-01/23/c_136918113.htm [https://perma.cc/GG5B-RRV8]; *Chinese State Enterprises Post Record Level of Profits in 2017*, S. CHINA MORNING POST, Jan. 16, 2018), http://www.scmp.com/news/china/economy/article/2128446/chinese-state-enterprises-post-record-level-profits-2017 [https://perma.cc/VX8M-5GR4].

[278] *See* Cui, *Taxation of State-Owned Enterprises: A Review of Empirical Evidence from China*, *in* REGULATING THE VISIBLE HAND?, *supra* note 142, at 109, 118; Wang, *supra* note 84, at 647, 666.

[279] Cui, *supra* note 278, at 110.

[280] *See id.* at 111-112.

[281] *See, e.g., id.* at 111; Robert H. Floyd, *Some Aspects of Income Taxation of Public Enterprises*, 25 INT'L MONETARY FUND STAFF PAPERS 310, 312 (June 1978).

[282] *See* Floyd, *supra* note 281, at 313; Glenn P. Jenkins, *Taxation and State-owned Enterprises* 1 (Development Discussion Paper No. 225, Apr. 1986), http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.577.9665&rep=rep1&type=pdf [https://perma.cc/2PQG-2MD2]; Wei Cui, *supra* note 278, at 110; *see generally* Carles Boix, *Privatizing the Public Business Sector in the Eighties: Economic Performance, Partisan Responses and Divided Governments*, 27 BRIT. J. POL. SCI. 473 (1997) (examining the evolution of state-owned enterprises in OECD countries during the 1980s).

[283] *See* Sergei V. Aleksashenko, *Establishment of a Taxation System in the USSR*, 3 COMMUNIST ECON. & ECON. TRANSFORMATION 81 (1991); Vernon G. Setser, *The Immunities of the State and Government Economic Activities*, 24 LAW & CONTEMP. PROBS. 291, 298 (1959).

[284] Floyd, *supra* note 281, at 341.

[285] *See id.* at 340

[286] *See* Jenkins, *supra* note 282, at 2-3; *see also* Cui, *supra* note 22, at 794 (discussing and adding to these criticisms).

return on SOE investments meets that of the private sector.[287] This critique is particularly relevant in the context of China, where central SOEs are widely acknowledged to have easier access to credit and subsidies than private firms, thus "creating an unequal playing field for SOEs, private companies and foreign firms."[288] For these reason, Wei Cui argues that the best justification for corporate income taxation on Chinese SOE is as a type of forced distribution of SOE earnings, designed to avoid the corporate governance challenges associated with ensuring proper levels of SOE dividend payments.[289]

Another rationale for imposing income tax on SOEs concerns situations of mixed-ownership. Income taxation in comparison to pro rata dividends transfers a greater portion of SOE earnings to the state rather than private investors.[290] Since the state receives 100 percent of income tax payments, but less than 100 percent of dividend payments, from the perspective of central government policy-makers wishing to maximize the total amount of revenue transferred to the state from a mixed-ownership SOE, higher corporate income tax payments are preferable to larger dividend payments. As an example, take a hypothetical central SOE, ChinaCo, 70 percent owned by SASAC and 30 percent owned by qualified foreign institutional investors.[291] ChinaCo earns $100 in China before tax. On any pro rata dividend payment, the foreign investors would be subject to a 10 percent withholding tax on the dividends received.[292] As shown in Table 1 below, under either the standard enterprise tax rate of 25 percent or High and New Technology Enterprise rate of 15 percent, more revenue goes to the state than if SOE profits were untaxed. This same basic pattern holds no matter the size of the minority stake or whether it is held by foreign or Chinese investors. Thus, in the mixed-ownership context, income taxation of SOEs enables the state to claim a higher percentage of SOE earnings than it would be entitled to based solely upon its ownership stake. As a result, it is unlikely that the Chinese government will dramatically rollback or eliminate income taxation of SOEs in the near future. Notably, this also creates a strong

---

[287] *See id.* at 3.

[288] Jane Cai, *Private Players Feeling Squeezed out by Beijing's Support for State Companies*, S. CHINA MORNING POST, Oct. 4, 2017, http://www.scmp.com/news/china/economy/article/2113869/past-its-use-date-warps-chinas-antiquated-policy-picking-industry [https://perma.cc/39EG-8N96]; *see State of Grace*, ECONOMIST (Nov. 17, 2016), https://www.economist.com/news/finance-and-economics/21710291-government-their-side-chinas-state-firms-borrow-cheaply-state-grace [https://perma.cc/T8RA-NPKM]; Gabriel Wildau, *supra* note 149 ("SOEs also enjoy non-cash benefits like low-interest bank loans and discounts on land, water and electricity."); *see also*; Kai Li, Heng Yue & Longkai Zhao, *Ownership, Institutions, and Capital Structure: Evidence from China*, 37 J. COMP. ECON. 471 (2009) (showing that state ownership is positively associated with leverage and firms' access to long-term debt, while foreign ownership is negatively associated with all measures of leverage).

[289] *See* Cui, *supra* note 278, at 112, 130; Cui, *supra* note 22, at 781.

[290] Since the primary question motivating Wei Cui's theory "is how a purely state-owned firm would respond to taxation," he briefly acknowledges that mixed-ownership may provide a partial explanation for SOE taxation, but he otherwise devotes little attention to tax policy implication of mixed-ownership. *See* Cui, *supra* note 278, at 112; Cui, *supra* note 22, at 787. Yet, the Chinese government's continuing support for mixed-ownership reforms of central SOEs would suggest such ownership structures are highly relevant to tax policy considerations—even if less relevant for theory.

[291] SASAC has recently made public pronouncements explicitly inviting foreign investors to participate in mixed-ownership reforms. *See* Jing Shuiyu, *Ownership Reform Welcomes All Comers*, CHINA DAILY, Sept. 29, 2017 http://www.chinadaily.com.cn/business/2017-09/29/content_32626118.htm [https://perma.cc/848H-VTVJ].

[292] *See* CAO, *supra* note 95, at 52-53. This withholding rate might be reduced to 5 percent under a limited number of bilateral tax treaties. *See id.* at 285-289.

incentive for the central government to have managers of mixed-ownership SOEs earning only domestic income to over-pay enterprise income tax (or at minimum avoid domestic tax planning) while limiting dividend payments.[293]

Table 1

State Ownership Percentage	Foreign Ownership Percentage	Withholding Rate on Dividends
70%	30%	10%

Enterprise Income Tax Rate	Pre-Tax Earnings	Income Tax Paid	Dividends Paid to the State	Withholding on Dividends Paid to Foreign Investors	**State Total Post-Tax Revenue**	**Foreign Investor Post-Tax Revenue**
0%	100	$ -	$ 70.00	$ 3.00	**$ 73.00**	**$ 27.00**
15%	100	$ 15.00	$ 59.50	$ 2.55	**$ 77.05**	**$ 22.95**
25%	100	$ 25.00	$ 52.50	$ 2.25	**$ 79.75**	**$ 20.25**

Whatever the underlying rationale, in practice, income tax payments by Chinese SOEs greatly overshadow dividend payments. Following tax and SOE reforms of 1993-1994, under which SOEs were required to pay income taxes,[294] SOEs were no longer required to turn over dividends or excess-profits to the state and could instead reinvest all post-tax profits across their corporate group. This policy reflected the relatively poor financial status and low profits of SOEs during the 1990s as the government's interest at the time was in increasing SOEs autonomy and independence.[295] Following its establishment in 2003, SASAC sought the power to collect dividends from SOEs. Yet, this plan was delayed by an interdepartmental dispute regarding

[293] State and managerial incentives regarding SOE income earned abroad are discussed in Part 5.B, *infra*.
[294] *See supra* text accompanying notes 98-102.
[295] *See* Louis Kuijs, William Mako & Chunlin Zhang, *SOE Dividends: How Much and to Whom?* (World Bank Working Paper No. 56651, 2005), http://documents.worldbank.org/curated/en/961421468243568454/SOE-dividends-how-much-and-to-whom [https://perma.cc/YFQ5-QPR2].; Naughton, *supra* note 144, at 59-60; Lan Xinzhen, *Shaking the SOEs*, BEIJING REV. (Apr. 27, 2006), http://www.bjreview.cn/EN/06-17-e/bus-2.htm. [https://perma.cc/ZL7C-M4JS].

whether SASAC or the Ministry of Finance should have the power to allocate these receipts.[296] Eventually, a compromise payment formula was reached, and in 2007 the government announced a pilot program under which SOEs in profitable sectors were required to pay either 10 or 5 percent of profits as dividend.[297] In 2010-2011 the Ministry of Finance issued a directive increasing these requirements to 15 and 10 percent.[298] And recently, in 2014 the government again called for increasing the dividends of many SOEs in order to make them more attractive to foreign institutional investors, with a handful of the most profitable SOEs ordered to pay dividends representing 20 percent of profits.[299] Despite the recent announcement of special dividends by Shenhua Energy and China Mobile—two central SOEs—the overall value of SOE dividends has actually declined 4.4 percent from 2014 to 2016, and investors continue to view "low or non-existent dividends" of central SOEs as "a persistent bug bear."[300] Moreover, the dividend rates of Chinese SOEs remain far below the average dividend rates paid by major U.S. firms or by SOEs in other economies.[301]

---

[296] *See* Lan, *supra* note 295; Mikael Mattlin, *Whose Money?: The Tug-of-War Over Chinese State Enterprise Profits* (Finnish Inst. Int'l Aff. Briefing Paper 79 2011), https://www.files.ethz.ch/isn/128535/UPI_Briefing_Paper_79.pdf [https://perma.cc/KRJ7-VYGA].

[297] SOEs in the tobacco, petroleum, power, telecom, coal, or other monopolized sectors were required to pay 10 percent, while SOEs in the steel transportation, electronics, trade, construction, or other generally competitive sectors were required to pay 5 percent. SOEs in the defense industry were exempt from dividend payments. *See* XU YI-CHONG, SINEWS OF POWER: THE POLITICS OF THE STATE GRID CORPORATION OF CHINA 102 (2016); HOGAN LOVELLS, *Central Government to Collect Huge Capital Income from Major State-Owned Enterprises* (March 26, 2008), https://www.lexology.com/library/detail.aspx?g=b0609c70-e502-4fd7-bbe7-79773a48bd2b [https://perma.cc/U9AC-2PX5].

[298] *See* Mattlin, *supra* note 296.

[299] *See* Wei Tian, *Dividends to Increase at Central State Firms*, CHINA DAILY, May 7, 2014, http://www.chinadaily.com.cn/bizchina/2014-05/07/content_17489550.htmhttp://www.chinadaily.com.cn/bizchina/2014-05/07/content_17489550.htm [https://perma.cc/X752-AUVF].

[300] Fox Hu & Moxy Ying, *China's Dividend Superstars Mask Stinginess of State Firms*, BLOOMBERG (Aug. 29, 2017), https://www.bloomberg.com/news/articles/2017-08-28/china-s-dividend-superstars-mask-stingy-reality-for-state-firms [https://perma.cc/58MK-JWKR]; *see also* David Keohane, *For the Brave China SOE Reform Optimists Out There*, FIN. TIMES, March, 24, 2017, https://ftalphaville.ft.com/2017/03/24/2186349/for-the-brave-china-soe-reform-optimists-out-there/ (discussing the risk of extrapolating from Shenhua's special dividend); Jennifer Lo, *Chinese Government is the Biggest Beneficiary of Shenhua's Fat Dividend*, NIKKEI ASIAN REV. (March 20, 2017), https://asia.nikkei.com/Markets/Equities/Chinese-government-is-the-biggest-beneficiary-of-Shenhua-s-fat-dividend [https://perma.cc/KA39-CMH3] (noting that the Chinese government stands as the largest beneficiary of Shenhua's dividend thanks to SASAC's 73 percent ownership stake in the Shenhua Group's parent company).

[301] *See* Milhaupt & Zheng, *supra* note 23, at 679; *Effective Discipline with Adequate Autonomy: The Direction for Further Reform of China's SOE Dividend Policy*, World Bank Policy Note Number 53254 (2009), http://documents.worldbank.org/curated/en/358411468024535236/Effective-discipline-with-adequate-autonomy-the-direction-for-further-reform-of-Chinas-SOE-dividend-policy [https://perma.cc/WLF4-6YDV]; *see also* Song, Yang & Zhang, *supra* note 26, at 44 ("[B]y 2010, some sectors were handing over 15 percent of dividends to the government. In contrast, in some European countries, such as France, Germany and the UK, SOEs are required to turn over 50 percent of their profits to the treasury."); *China Plan on Wealth Gap Preserves Much of State Firms' Cash Pile*, REUTERS (Feb. 7, 2013), https://www.reuters.com/article/china-economy-inequality/china-plan-on-wealth-gap-preserves-much-of-state-firms-cash-pile-idUSL4N0B652T20130207 [https://perma.cc/7S9D-UN6P] (reporting an average dividend ratio of "33 percent ratio for 49 SOEs in 16 developed economies between 2000 and 2008" compared to ratios of 9.0, 9.4, and 7.3 percent for SASAC controlled SOEs in 2011, 2010, and 2009, respectively).

In conclusion, enterprise income taxation of both private enterprises and SOEs is likely to remain a core component of Chinese tax policy. Enterprise income taxation remains an important source of tax revenue. It enables the government to claim a higher percentage of SOE revenue from mixed-ownership enterprises than it would be entitled to based solely upon its ownership stake. And despite recent increases in SOE dividend distributions, it remains the primary mechanism for transferring SOE revenue to the state.

B. Maintenance of Worldwide Corporate Taxation

Having established that enterprise income taxation is likely to remain an important element of Chinese tax policy, this Part argues that its unique system of state capitalism may lead China to maintain a relatively well-functioning system of worldwide corporate taxation despite an international trend toward territorial taxation. In recent years a number of developed countries, including the United Kingdom and Japan have reformed their systems of international corporate taxation, shifting away from worldwide taxation and closer to territorial taxation.[302] While worldwide corporate taxation was once the OECD norm, it has become an outlier.[303] Under most modern territorial systems, active income earned abroad as well as dividends received from foreign subsidiaries are exempted from resident country taxation. In contrast under a worldwide system, this income is subject to taxation by the resident country, but a foreign tax credit may be available to offset foreign income taxes paid to source countries. Two commonly identified rationales for shifting towards a territorial system, is that it minimizes the incentive for corporate inversions and it prevents the "lockout" of earnings by foreign subsidiaries.[304] First, in order to minimize the tax burden on income earned abroad, multinationals whose corporate parent is a tax resident of a jurisdiction with a worldwide taxation system may engage in corporate inversions. Through a cross-border merger of the corporate parent with a smaller foreign corporation, the parent may transform itself into a tax resident of a jurisdiction with a territorial system, thereby reducing or eliminating any additional taxation on the earnings of its subsidiaries in low-tax jurisdictions.[305] Secondly, multinationals whose corporate parent is a resident of jurisdiction with a worldwide taxation system may also choose to keep earnings by foreign subsidiaries reinvested abroad rather than repatriating this foreign income. By keeping foreign earnings abroad, multinationals can delay

---

[302] *See* Thornton Matheson, Victoria Perry & Chandara Veung, *Territorial vs. Worldwide Corporate Taxation: Implications for Developing Countries* 4 (IMF Working Paper WP/13/205, Oct. 2013), https://www.imf.org/external/pubs/ft/wp/2013/wp13205.pdf. [https://perma.cc/D3ZG-2DE9].

[303] *See id.*; PRICEWATERHOUSECOOPERS, EVOLUTION OF TERRITORIAL TAX SYSTEMS IN THE OECD (2013), http://www.techceocouncil.org/clientuploads/reports/Report%20on%20Territorial%20Tax%20Systems_20130402b.pdf [https://perma.cc/3SML-J2QV].

[304] *See* Matheson, Perry & Veung, *supra* note302, at 5; *see also* Eric Solomon, *Corporate Inversions: A Symptom of Larger Tax System Problems*, TAX NOTES 1449 (Sept. 17, 2002), https://www.taxnotes.com/tax-notes/corporate-taxation/corporate-inversions-symptom-larger-tax-system-problems/2012/09/17/1209951 (discussing inversions, lock-out, and other problems associated with the U.S. system of worldwide corporate income taxation).

[305] *See* Orsolya Kun, *Corporate Inversions: The Interplay of Tax, Corporate, and Economic Implications*, 29 DEL. J. CORP. L. 313 (2004); Daniel N. Shaviro, *The David R. Tillinghast Lecture: The Rising Tax-Electivity of U.S. Corporate Residence* (N.Y.U. Pub. Law and Legal Theory Working Paper No. 232 2010), http://lsr.nellco.org/cgi/viewcontent.cgi?article=1233&context=nyu_plltwp, [https://perma.cc/U9UJ-H38L].

any additional taxation by the parent's country of residence, and thus benefit from tax deferral.[306] Shifting towards a territorial system reduces the incentive for resident multinationals to engage in these two tax-avoidance practices.[307] However, it may also increase their incentive to engage in other types of tax-avoidance such as transforming domestic profits into foreign profits through the use of transfer pricing or thin capitalization.[308]

Thanks in part to its mechanisms of control over SOEs and capital outflows, inversions and the lock-out effect are likely to be of much less concern to China than to other countries with more free market economies. With SOEs responsible for the majority of Chinese outbound investment, the Party-state can leverage its position as controlling shareholder and personnel manager to limit outwardly apparent avoidance of Chinese taxation. Firstly, as the controlling shareholder in central SOEs, SASAC has the power to veto any SOE merger or restructuring, such as tax-motivated corporate inversions, that would undermine public confidence in the integrity of the Chinese tax system. Similarly, under the Communist Party's personnel system, SOE executives would torpedo their future career prospects if they sought to engage in a corporate inversion of the group parent of a major Chinese SOE, especially in light of the government's identification of their economic success as a point of national pride.[309] Secondly, the state has the capability to force SOEs to repatriate foreign earnings, thus minimizing any lockout effect. As noted above, the central government has imposed dividend requirements on central SOEs.[310] Under its authority SASAC could impose a similar concomitant requirement that foreign subsidiaries of SOEs pay a minimum dividend to group parents. If either SASAC or the Central Organization Department placed a high priority on ensuring repatriation of foreign earnings, SOE executives would have little choice to comply or risk damaging their career prospects in Party leadership. In short, Party-state's extensive influence over SOE governance can ensure that SOEs do not engage in any disfavored public-facing tax-avoidance strategies to reduce Chinese income tax paid.

While the Party-state exerts less direct influence over private enterprises relative to SOEs, the current system of capital controls and required regulatory approvals for outbound investments

---

[306] *See* John R. Graham, Michelle Hanlon & Terry J. Shevlin, *Barriers to Mobility: The Lockout Effect of U.S. Taxation of Worldwide Corporate Profits*, 63 NAT'L TAX J. 1111 (Dec. 2010).

[307] *See, e.g.*, Matteo P. Arena & George W. Kutner, *Territorial Tax System Reform and Corporate Financial Policies*, 28 REV. FIN. STUD. 2250 (2015) ("We find that Japanese and U.K. multinationals accumulate less cash overall, invest less abroad, and distribute more cash to shareholders through dividends and share repurchases after the adoption of the territorial system in 2009"); Makoto Hasegawa & Kozo Kiyota, *The Effect of Moving to a Territorial Tax System on Profit Repatriation: Evidence from Japan*, 153 J. PUB. ECON. 92 (2017) ("[F]oreign affiliates that retained a large stock of retained earnings … before the tax reform significantly increased dividend payments to their parent firms in response to Japan's adoption of a territorial tax regime. This implies that the dividend exemption system helped to fulfill its primary goal of stimulating dividend repatriations from foreign affiliates that had amassed large amounts of foreign profits.").

[308] *See* Matheson, Perry & Veung, *supra* note 302; *see also* Kevin Markle, *A Comparison of the Tax-Motivated Income Shifting of Multinationals in Territorial and Worldwide Countries*, 33 CONTEMP. ACCT. RES. 7 (2015) ("[O]n average, multinationals subject to territorial tax regimes shift more income than those subject to worldwide tax regimes.").

[309] *See, e.g.*, Arnold Ngowani, *Lessons from China SOEs*, ZAMBIA DAILY MAIL LIMITED, (Oct. 23, 2017), https://www.daily-mail.co.zm/lessons-from-china-soes/ [https://perma.cc/W9A3-Z28Y] (reporting on a Chinese organized seminar on SOEs for official from developing countries and noting that Chinese SOEs "constitute the foundation of the country's economy and pride.")

[310] *See supra* text accompanying note 297.

may limit the opportunity for private Chinese multinationals to engage in tax-motivated inversions or notorious tax-avoidance strategies. According to the *Financial Times*, the dramatic tightening of Chinese capital controls in 2016 caused the cancellation of at least 30 deals between Chinese acquirers and U.S. and European targets, worth a total of almost US $76 billion, most of which involved private Chinese corporations.[311] The fact that these capital controls were imposed silently and without warning suggests that government regulators retain significant discretion as to which overseas acquisitions to allow to go forward.[312] In fact, Thilo Hanemann, an expert on Chinese FDI, suggests that in practice, the current system of investment regulations and capital controls, "allows the government to control and intervene in every single [outbound cross-border] deal."[313] As a result, even *private* Chinese multinationals would likely find it impracticable to engage in tax-motivated inversions.[314] In contrast private Chinese multinationals are likely to still find it advantageous to reinvest overseas profits offshore in order to take advantage of tax deferral. Therefore, it is not surprising that the SAT has begun employing China's CFC rules against private Chinese companies with overseas operations and is reportedly considering reforms to make these rules easier to administer.[315] Moreover, if the Party succeeds in its current efforts to have private Chinese tech companies give the state "special management shares" and a direct role in corporate decision making,[316] the state may gain the power to veto blatant attempts to avoid Chinese tax.

If the Chinese system of state capitalism helps neutralize the two most significant drawbacks to a worldwide taxation system, the question now becomes why would the Chinese government be interested in maintaining worldwide taxation? Most importantly, worldwide taxation would serve to disadvantage private outbound direct investment vis a vis SOE outbound investment, thus strengthening the role of the Party in Chinese outbound investment. Moreover, worldwide taxation would provide the central government an additional mechanism for shaping the geographic and sectoral patterns of Chinese outbound investment. In light of the government's long use of tax law as an instrument for shaping the character of direct investment into China, it is

---

[311] *See* Claire Jones, Javier Espinoza & Tom Hancock, *Overseas Chinese Acquisitions Worth $75bn Cancelled Last Year*, FIN. TIMES, Feb. 5, 2017, https://www.ft.com/content/b0ff426c-eabe-11e6-930f-061b01e23655.

[312] *See supra* text accompanying notes 242-243; *see also* Mitchell & Wildau, *supra* note 25 (noting the long delay between the emergence of Chinese investment curbs and their public recognition by state officials).

[313] Leslie Hook, *Chinese Capital Controls Hit Silicon Valley Tech Investors*, FIN. TIMES, Feb. 5, 2018, https://www.ft.com/content/0e78335e-0152-11e8-9650-9c0ad2d7c5b5.

[314] *See, e.g*, Jiang Yuesheng [姜跃生], BEPS de Jiazhi Chuangzao Lun yu Zhongguo Quanqiu Jiazhi Fenpei de Helihua [BEPS的价值创造论与中国全球价值分配的合理化] (Value Creating Theory Reflected in the BEPS Action Plan and How to Obtain Reasonable Share in the Global Value Allocation), 12 INT'L TAX'N IN CHINA 33, 38 (2014) [国际税收] (suggesting that Chinese multinationals not be allowed to move their global headquarters out of China, no matter how large their overseas sales may later become).

[315] *See* Wang Haijun, Zhao Hongshun, & Huang Hairong, *supra* note 123; Mark Melincoe, *In China, More Advance Rulings, More Cases Going to Court*, BLOOMBERG BNA (May 31, 2016), https://www.bna.com/china-advance-rulings-n57982073273/ [https://perma.cc/NUZ6-J2UT].

[316] *See* Li Yuan, *Beijing Pushes for a Direct Hand in China's Big Tech Firms*, WALL ST. J., Oct. 11, 2017, https://www.wsj.com/articles/beijing-pushes-for-a-direct-hand-in-chinas-big-tech-firms-1507758314; *China's Companies on Notice: State Preparing to Take Stakes*, BLOOMBERG (Jan. 17, 2018), https://www.bloomberg.com/news/articles/2018-01-17/china-s-communists-will-take-more-stakes-in-private-companies.

likely that Chinese policy-makers intend to have tax law play a similar role as a backstop to its regulatory policy regarding foreign outbound investment.[317]

In comparison to a worldwide taxation system, a territorial system provides resident corporations greater incentive to invest abroad. Since territorial systems do not impose additional resident country tax on foreign earnings, investments in foreign low-tax jurisdictions are generally subject to lower overall tax under a pure territorial system than under a pure worldwide system.[318] This is particularly relevant to China, as at least two-thirds of the countries along the Belt and Road initiative have statutory corporate tax rates below 20 percent, compared with China's current statutory rate of 25 percent, making them low-tax jurisdictions relative to China.[319] Recent empirical studies tend to confirm that after shifting from a worldwide to territorial system, jurisdictions see an increase in outbound foreign investment by resident corporations.[320] While the net effects on tax revenue and domestic GDP from transitioning to a territorial system remain a point of contention among scholars, this debate is centered on the impacts on domestic investment from eliminating the lock-out effect and on the substitutability of foreign and domestic investment.[321] It is *not* centered on whether territorial taxation provides an additional incentive for outbound investment.[322]

---

[317] *See supra* Part. 3.A.; *see also* He Qian [何倩], Guanyu Guli he Guifan Wogou Qiye Duiwai Touzi Shuishou Wenti de Sikao [关于鼓励和规范我国企业对外投资税收问题的思考] (Thoughts on Issues of Taxation Concerning Encouraging and Regulating Chinese Enterprises' Foreign Investments), 10 TAX'N RES. J. 90 (2007) [税务研究] (observing that the point of Chinese "going out" initiative is not primarily the economic interest of Chinese enterprises but geo-strategic issues and national competitiveness, and thus the tax departments must take active measures to help implement the strategy); Wei Cui, *"Establishment:" an Analysis of a Core Concept in Chinese Inbound Income Taxation*, 1 COLUM. J. TAX L. 46, 77 (2010) (suggesting that "the function of Chinese tax policy toward foreign investment" was as a "subordinate instrument to other regulatory policy.").

[318] *See generally* Jane G. Gravelle, *Moving to a Territorial Income Tax: Options and Challenges*, CONG. RES. SERV. (July 25, 2012), https://fas.org/sgp/crs/misc/R42624.pdf [https://perma.cc/3PRQ-7P6K], at 16-18 (summarizing the literature on the relationship between territorial taxation and the location of investment by multinationals). Admittedly, depending on the interest deduction allocation and foreign tax credits limitation rules adopted in conjunction with a worldwide system this general pattern may not hold in all cases. *See* Rosanne Altshuler & Harry Grubert, *Where Will They Go If We Go Territorial? Dividend Exemption and the Location Decisions of U.S. Multinational Corporations*, 54 NAT'L TAX J. 787 (2001).

[319] *See, e.g.*, Wang Wenjing & Lai Hongyu [王文静 & 赖泓宇], "Yidai Yilu" Zhanlüe de Guoji Shuishou Xietiao ["一带一路"战略的国际税收协调] (International Taxation Coordination Under the "Belt and Road" Initiative), 4 INT'L TAX'N IN CHINA 52, 55 (2016) [国际税收].

[320] *See, e.g.*, Lars P. Feld et al., *Effects of Territorial and Worldwide Corporation Tax Systems on Outbound M&As* (ZEW – Ctr. for Eur. Econ. Res., Discussion Paper No. 13-088, Nov. 2013), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2350755 [https://perma.cc/7FJY-ACL3]; Li Liu, *Where Does Multinational Investment Go with Territorial Taxation? Evidence from the UK* (IMF Working Paper No. 18/7, Jan. 2018), https://www.imf.org/en/Publications/WP/Issues/2018/01/12/Where-Does-Multinational-Investment-Go-with-Territorial-Taxation-Evidence-from-the-UK-45559 [https://perma.cc/A2YL-U4XZ].

[321] *Compare* Altshuler & Harry Grubert, *supra* note 318, *with* James R. Repetti, *Will U.S. Investments Go Abroad in a Territorial Tax: A Critique of the President's Advisory Panel on Tax Reform*, 8 FLA. TAX REV. 303 (2007).

[322] *See, e.g.*, Philip Dittmer, *A Global Perspective on Territorial Taxation*, TAX FOUND. (Aug. 10, 2012), https://taxfoundation.org/global-perspective-territorial-taxation/ [https://perma.cc/4NRS-VP5B] (advocating for adoption of a territorial system in the U.S. while also acknowledging territorial taxation is associated with increases in outbound foreign direct investment).

However, the choice of a worldwide or territorial taxation system is likely to have limited, or even reverse, incentive effects on the investment choices of resident SOEs. If acting as a perfect fiduciary, a manager of a wholly-owned SOE should be indifferent as to whether or not foreign earnings are subject to resident country taxation. The only difference between worldwide and territorial taxation for the SOE is *when* earnings are transferred to state coffers—after earnings are subject to source country taxation, all remaining profits belong to the state. Perhaps counter-intuitively, a perfect fiduciary manager of a mixed-ownership SOE may actually have greater incentive to engage in foreign investment under a worldwide system than under a territorial system. Under a territorial system, after foreign earnings are subject to source country taxation, SOE shareholders have a pro rata claim on all residual profits. In contrast, under a worldwide system, foreign earnings may also be subject to resident country taxation, thereby increasing the state's claim on SOE revenue relative to other shareholders.[323] Since a worldwide taxation system may thus allow a greater portion of SOE earnings to be transferred to the state vis a via private investors, a loyal manager seeking to maximize returns for the state may have greater incentive to engage in foreign investment under a worldwide system than a territorial system. In sum, the choice between a worldwide or territorial system has different incentive effects on perfectly loyal SOEs than on private enterprises.

Yet, in reality, agency problems bedevil the relationship between the Chinese government and SOE managers, raising additional questions as to the sensitivity of SOE managers to taxation. As noted by Angela Huyue Zhang, due to a combination of agency problems and the Chinese government's desire to grow national champions, managers of Chinese SOEs currently have a strong motivation to engage in empire building.[324] While the corporate managers of any type of enterprise have perverse incentives to engage in some degree of empire building,[325] managers of Chinese SOEs have additional motivation to increase the size and scope of their SOE—beyond its optimal size and at the expense of state revenue—as doing so can bolster the manager's political clout.[326] As a result, SOE managers may seek to minimize tax payments to the state through tax planning in order to retain more resources under their direct control.[327] On the other hand, since

---

[323] *See supra* text accompanying notes 293-296.

[324] *See* Angela Huyue Zhang, *Foreign Direct Investment in China: Sense and Sensibility*, 34 NW. J. INT'L L. & BUS. 395, 442 (2014); *see also* Mei Wang, Zhen Qi & Jijing Zhang, *supra* note 115, at 329 (describing Chinese SOEs as exhibiting a three tried principal–agent problem, with the nation as the principal, the SOE managers as agent, and regulators occupying a middle position).

[325] *See generally* Michael C. Jensen, A*gency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323 (1986).

[326] *See* Zhang, *supra* note 324， at 445-449.

[327] SOE managers may attempt to frame this tax-planning as a "win-win result for national interests and corporate interests" and argue that by avoiding tax payments in the short-term, they can help grow the SOE and thus increase the total amount of state tax revenue in the long run. *See, e.g.*, Cheng Li [程莉], Guoyou Qiye Ruhe Zuohao Shuishou Chouhua Gongzuo [国有企业如何做好税收筹划工作] (How State-owned Enterprises Do a Good Job in Tax Planning), 553 ACCT. AUDIT 58 (2016) [会计审计]; Lü Min [吕敏], Guoyou Qiye Shifou Ying Jinxing Shuishou Chouhua [国有企业是否应进行税收筹划] (Should State-owned Enterprise Engage in Tax Planning?), 236 MODERN BUS. (2008) [现代商业]; Song JiaoJiao [宋姣姣], Guoyou Qiye Shuishou Chouhua Zouyi [国有企业税收筹划邹议] (Discussion of State-owned Enterprise Tax Planning), 262 MONEY CHINA (2012) [财经界] (all offering a similar "win-win" justification for domestic tax planning by SOEs).

the Party's evaluation of SOE managers currently prioritizes political allegiance over profitability, managers may have a countervailing incentive to ensure an appropriate level of tax payments are made to the state.[328] The handful of empirical studies assessing domestic tax avoidance by Chinese SOEs paints a mixed picture of the principal-agent problem.[329] Most but not all studies have found Chinese SOEs to have higher effective tax rates than private enterprises, suggesting SOEs practice less domestic tax planning.[330] Yet, in a nuanced review of the existing scholarship, Wei Cui also notes that there is "at least as much evidence" indicating SOEs exhibit some tax planning and avoidance as indicating that SOEs are indifferent to taxation.[331] Thus it appears that Chinese SOEs "behave like 'real' taxpayers" to a certain degree but that they are still "less sensitive than private firms to paying the home country's income tax."[332] In other words SOE managers may not engage in as much tax-avoidance as private enterprises, but would still prefer to keep funds in corporate form rather than in state coffers.

These observations suggest that in comparison to a more territorial system, maintaining a worldwide system of taxation provides a greater disincentive to foreign investment by private enterprises than SOEs. Thus, maintaining a worldwide taxation system would help support the Chinese government's current goals of limiting private capital outflows and enabling SOEs to remain the driving force behind Chinese foreign direct investment.[333] For these reasons, it appears likely that its system of state capitalism, will enable and encourage China to successfully maintain a relatively well-functioning system of worldwide corporate taxation.

---

328 *See supra* text accompanying note 203; *see also* Mark T. Bradshaw, Guanmin Liao, & Mark (Shuai) Ma, *Ownership Structure and Tax Avoidance: Evidence from Agency Costs of State Ownership in China*, J. ACCT. & ECON. (forthcoming 2018), https://ssrn.com/abstract=2239837 [https://perma.cc/9DMG-UJZW] (suggesting that SOE managers are rewarded for paying more tax by becoming more likely to be promoted).

329 *See* Ji Li, *"Strangers in a Strange Land": Chinese Companies in the American Tax System*, 68 HASTINGS J.L. 503, 533 (2017) ("Recent empirical research on the tax behavior of SOEs has yet to produce conclusive evidence ….").

330 *See, e.g.*, Bradshaw, Liao, & Ma, *supra* note 328, at 2 (finding "SOEs exhibit significantly higher income tax rates than do non-SOEs, consistent with less tax avoidance" and concluding "the state utilizes SOE managers' career concerns to promote the minimization of tax avoidance."); Clemens Fuest & Li Liu, *Does Ownership Affect the Impact of Taxes on Firm Behavior? Evidence from China* (Oxford Univ. Ctr. for Bus. Tax'n, Working Paper No. 15/05, 2015), http://eureka.sbs.ox.ac.uk/5428/1/WP1505.pdf [perma.cc/2J5Y-7T52] (finding SOEs to be non-responsive to tax law changes and suggesting that the SOEs "do not perceive taxes as costs"); Hongbin Cai & Qiao Liu, *Competition and Corporate Tax Avoidance: Evidence from Chinese Industrial Firms*, 119 ECON. J., 764, 794 (2009) (suggesting SOEs were less likely to engage in tax avoidance activities than private enterprises); Ming Jian, Wanfu Li & Huai Zhang, *How Does State Ownership Affect Tax Avoidance? Evidence from China* (Sing. Mgmt. Univ., Working Paper No. 13-18, 2012), https://accountancy.smu.edu.sg/sites/default/files/accountancy/pdf/Papers/huaizhang_2013paper.pdf [perma.cc/6JL8-ZW37] (concluding SOEs "avoid tax to a less extent than non-SOEs" and hypothesizing "executives at SOEs have incentives to please the government through generous tax payments."); Tao Zeng, *Ownership Concentration, State Ownership, and Effective Tax Rates: Evidence from China's Listed Firms*, 9 ACCT.ACCOUNTING PERPS. 271, 286 (2011) (finding "firms whose largest shareholders are government-related have higher effective tax rates compared to firms whose largest shareholders are nongovernment related" and suggesting that "a good reputation of paying more taxes (or avoiding tax aggressiveness) benefits management.").

331 Cui, *supra* note278, at 130.

332 Cui, *supra* note 22, at 807-08.

333 *See supra* Parts 4.B and 4.C.

C. Tacit State Support for International Tax-Planning

The dominant role of SOEs in Chinese outbound foreign direct investment creates an unusually strong incentive for the Chinese government to encourage SOE managers to minimize the amount of foreign taxes paid through tax planning. This point is perhaps best illustrated through an idealized example. If through clever tax-planning, a French multinational (or any multinational that is a tax resident of a jurisdiction with a territorial system) avoids paying a dollar of tax that would otherwise be owed to a foreign jurisdiction on income earned in that foreign jurisdiction, this dollar does *not* directly benefit the French government.[334] Since a territorial system does not impose tax on the multinational's foreign income, the French government does not have a tax claim on this income. The only benefit to the French fisc comes indirectly—for instance if this additional dollar is invested in R&D that later boosts the multinationals' domestic income. If through clever tax-planning, a Mexican multinational (or any multinational that is a tax resident of a jurisdiction with a worldwide system) avoids paying a dollar of tax that it would otherwise owe to a foreign jurisdiction on income earned in that jurisdiction, this dollar may directly benefit the Mexican government, but only to a limited degree.[335] At maximum, it stands to impose its highest marginal corporate tax rate on the dollar, currently 30 cents for Mexico .[336] Yet, if through clever tax-planning a wholly-owned Chinese SOE avoids paying a dollar of tax that it would otherwise owe to a foreign jurisdiction on income earned in that foreign jurisdiction, this entire dollar benefits the Chinese government. Every dollar of foreign tax avoided by a wholly-owned Chinese SOE represents an additional dollar of income to the state. For mixed-ownership SOEs, the benefit depends in part on the state's ownership stake, but in any case, the Chinese government stands to capture a greater percentage of the dollar of tax avoided than it would from a private enterprise. As a result, China stands to reap significant benefits from foreign tax planning and avoidance by SOEs.

Yet, recent scholarship suggests that many Chinese SOEs pay relatively little attention to international tax planning. Over the past decade, numerous Chinese tax professionals have argued that the international tax planning capabilities of Chinese multinationals remain weak and underdeveloped and that they must urgently learn from the practices of mature foreign multinationals.[337] Part of this problem may be tied to the fact that tax management has never been

---

[334] *See e.g.*, SIMÉON MOQUOT BORDE & ASSOCIÉS, DOING BUSINESS IN FRANCE 13-77 (Matthew Bender ed., 1983) ("The scope of application of the French corporate income tax is determined on a territorial basis: thus, a French or foreign company is subject to corporate income tax only on its income derived from business operations carried on in France (CGI, art. 209(I)(1))."); *see also Overview of the French Tax System*, MINISTÈRE DE L'ÉCONOMIE-DIRECTION GÉNÉRALEGENERALE DES FINANCES PUBLIQUES (Dec. 31, 2016), https://www.impots.gouv.fr/portail/files/media/1_metier/5_international/french_tax_system.pdf [perma.cc/6LGX-YF4K] (providing an overview of France's taxing jurisdiction).

[335] *See* ERNST & YOUNG, WORLDWIDE CORPORATE TAX GUIDE 2017 (2017), https://www.ey.com/Publication/vwLUAssets/Worldwide_Corporate_Tax_Guide_2017/$FILE/Worldwide%20Corporate%20Tax%20Guide%202017.pdf [perma.cc/Z4WF-ER44].

[336] Depending on the multinational's situation with respect to foreign tax credit limitations, a reduction in foreign income tax paid may not necessarily result in any additional resident country tax owed. *See id.* at 994 (describing Mexico's foreign tax credit limitation calculation).

[337] *See, e.g.*, Wang Zengye, Wang Jinsong, & Zhang Hui [王增业， 王劲松, & 张辉], Shui Ji Qinshi he Run Zhuan Yidong Jihua dui Zhongguo Qiye Kuaguo Shuishou Chouhua de Yingxiang [税基侵蚀和润转移动计划对中国企业

an area of focus for most Chinese SOEs. Until recently, both tax authorities and SOE managers considered the accurate taxation of SOEs of secondary importance compared to other tax or managerial concerns, as it only impacted whether money, already belonging to the state, was "placed in the left or right pocket."[338] As a result, SOEs often lack professionals well-versed in tax planning and some do not have centralized tax teams capable of developing company-wide tax procedures or strategies.[339] Moreover, the rigid bureaucracy and hierarchy within major Chinese SOEs may hamper their ability to adopt consistent tax planning strategies across corporate groups.[340] In light of these limitations on SOEs current in-house tax planning capabilities, it is not surprising that the first empirical study of Chinese multinationals' interaction with the U.S. tax system found that the vast majority of Chinese multinationals rely on outside U.S. tax professionals for handling U.S. tax matters.[341]

Recognizing the tax-related challenges faced by Chinese multinationals investing abroad, Chinese tax scholars and practitioners have called on the government to provide tax advisory services as part of the going out and Belt and Road initiatives. One common suggestion has been the creation of a governmental international tax legal aid team able to assist Chinese multinationals facing disputes with foreign tax authorities.[342] The belief among practitioners is that Chinese multinationals investing in developing countries may face a heightened risk of capricious and aggressive tax enforcement, as local tax laws and regulations may be underdeveloped and leave great discretionary power in the hands of foreign tax authorities. Chinese government experts would be well-positioned to offer guidance in such situations, even if official government-to-government intervention is not required.[343] Others have called for a more comprehensive approach.

跨国税收筹划的影响] (The Impact of Tax Base Erosion and Profit Shifting on the Transnational Tax Planning of Chinese Enterprises), 25 INT'L PETROLEUM ECON. 79, 83 (2017) [国际油经济]; Shen Gengmin [沈庚民], Shiyou Qiye Guoji Yewu Shuishou Chouhua, [石油企业国际业务税收筹划] (Oil Companies' International Corporate Tax Planning), 15 CHINA MGMT. INFORMATIONIZATION 18 (2012) [中国管理信息化]; Duan Chunyan [段春燕], Woguo Qiye Jituan de Guoji Shuiwu Chouhua [我国企业集团的国际税务筹划] (International Tax Planning for China's Enterprise Groups), 8 CHINA BUS. 73 (2009) [经济理论研究].

338 Kong Xiangfeng [孔祥峰], Woguo Guoyou Qiye Shuishou Chouhua de Shuiwu Jianguan Wenti Yanjiu [我国国有企业税收筹划的税务监管问题研究] (Research on the Tax Supervision of Chinese State-owned Enterprises' Tax Planning), 24 TAX'N 36 (2017) [纳税].

339 *See id.*; Wang Zengye, Wang Jinsong, & Zhang Hui, *supra* note 337; Ou Jianjun [欧健军], Qiye Jituan Shuiwu Fengxian de Neikong Jizhi Tanjiu [企业集团税务风险的内控机制探究] (Research on the Internal Control Mechanism of Enterprise Group's Tax Risks), 1 CHINESE J. COM. 94 (2018) [中国商论]; Wang Kun [王琨], Guoyou Qiye Zuohao Shuiwu Chouhua Gongzuo de Yanjiu [国有企业做好税务筹划工作的研究] (Research on State-owned Enterprises Doing a Good Job in Tax Planning), 9 TIMES FIN. 639 (2016) [时代金融].

340 *See* Wang Kun, *supra* note 339.

341 *See* Ji Li *supra* note329329329, at 521; *see also* Gao Yang [高阳], Daxing Guoqi Mianlin de Dianxing Suihou Wenti [大型国企面临的典型税收问题] (The Typical Tax Issues Faced by Large State-Owned Enterprises), 6 INT'L TAX'N IN CHINA 43, 46 (2014) [国际税收] (reporting the suggestion by the CFO of one Chinese SOE that SOEs should periodically consult with international consulting companies to provide tax support to foreign subsidiaries).

342 *See, e.g.*, Li Wei [李伟], Guanyu Shishi Qiye "Zou Chuqu" Zhanlüe Wenti Yanjiu Zongshu [关于实施企业"走出去" 战略问题研究综述] (Summary of Research on the Implementation Issues of Enterprises' "Going Out" Strategy), 36 REV. ECON. RES. 45 (2017) [经济研究参考]; *see also* Gao Yang *supra* note 341.

343 *See* Gao Yang *supra* note 341; *see also* Chen Youxiang & Dong Qiang, *supra* note 134 (noting that in one recent survey, 60 percent of the problems faced by Chinese enterprises operating in Africa were related to tax issues, and

For instance, legal scholar Qi Tong has argued that SAT should provide detailed industry-specific international tax guidebooks and training sessions for smaller enterprises and should conduct in-depth tax research for major Chinese multinationals and provide them with specialized and tailored international tax advice.[344] Other scholars have suggested that SAT, SASAC, and related ministries should establish a specialized international tax management team that not only assists SOEs with foreign tax disputes but also provide guidance on overseas mergers, acquisitions, and restructurings.[345]

Within the past few years, SAT has implemented a number of new programs intended to support Chinese enterprises in tax issues related to outbound investment. For instance, in 2016 it established an International Tax Service Center and hotline intended to support Chinese enterprises engaging in foreign investment by providing tax consulting services.[346] Press releases suggest the Service Center is intended to be a new platform for "strengthening China's say on international tax matters" while also "serving the state's development strategy."[347] In October 2017, SAT released an over 250 page booklet providing guidelines to Chinese corporations on the taxation of outbound investment intended to help reduce their overseas "tax risks."[348] In general, SAT officials have prioritized maintaining accurate and updated information on the tax policies of major destinations of Chinese outbound investment and using the internet and hotline as tools for providing better advice to Chinese multinationals on foreign taxation policies.[349] Scholars have suggested that SAT should continue to build on these programs, so that its international tax experts can become a type of "think tank" for enterprises engaging in overseas investment, capable of providing tailored tax consultations.[350]

---

that in another survey 43 percent of Chinese enterprises reported having significant tax-related disputes during overseas investment).

[344] *See* Qi Tong [漆彤], "Yidai Yilu" Zhanlüe de Guoji Shuifa Sikao ["一带一路"战略的国际税法思考] (Reflections on the International Tax Law of the "One Belt and One Road" Strategy), 6 TAX'N RES. J. 31, 35 (2015) [税务研究].

[345] *See* Li Xuhong & Wang Yingqi [李旭红 & 王瑛琦], "Zou Chuqu" Guoyou Qiye Mianlin de Shuiwu Fengxian Ji Yingdui ["走出去"国有企业面临的税务风险及应对] (Tax Risks Faced by "Going Out" State-Owned Enterprises and Responses) 8 INT'L TAX'N IN CHINA 34, 36 (2013) [国际税收].

[346] *See China Opens Int'l Tax Service Hotline*, XINHUA (Nov. 19, 2016), http://www.xinhuanet.com/english/2016-11/19/c_135841256.htm [https://perma.cc/GU7V-DDTB].

[347] *China's International Taxation Service Hotline Launched in Shanghai*, XINHUA NEWS AGENCY (Nov. 18, 2016), http://www.chinatax.gov.cn/eng/n2367751/c2430750/content.html [https://perma.cc/B3AX-NPNF]; *Taxation Service Big Platform Built to Make the Voice of China*, STATE ADMIN. OF TAX'N (Nov. 21, 2016), http://www.chinatax.gov.cn/eng/n2367726/n2367766/c2430535/content.html [https://perma.cc/JW8M-MRCG] (describing the services as intended to "offer high-quality and efficient tax consulting services to provide numerous cross-border taxpayers with 'six ables' services, namely, able to listen, ask, look, inquire, appoint and handle.").

[348] *See* "Zou Chuqu" Shuishou Zhiyin ["走出去"税收指引] ("Going Out" Tax Guidelines), STATE ADMIN. OF TAX'N (Oct. 30, 2017), http://www.chinatax.gov.cn/n810219/n810744/n1671176/n2884609/c2884646/content.html [https://perma.cc/CJM6-6835].

[349] *See* Liao Tizhong [廖体忠], Shendu Canyu Guoji Shuishou Hezuo Tuidong "Fang'an" Luodi Shengxiao [深度参与国际税收合作推动《方案》落地生效] (Implementation of Plan to Promote Increasing Participating in International Tax Cooperation), 1 CHINA TAX'N 67 (2016) [中国税].

[350] Fang Fang & Chen Peihua [方芳 & 陈佩华], Woguo Qiye Jingwai Touzi de She Shui Fengxian Ji Fangfan [我国企业境外投资的涉税风险及防范] (Chinese Enterprises Overseas Investment Tax Risks and Prevention), 12 TAX'N RES. 96 (2017) [税务研究].

Judging solely from the public-facing descriptions of SAT's International Tax Service Center, it is possible that the services currently offered do not extend far beyond those provided by other tax authorities. The IRS, for instance, compiles and publishes a summary of the most pertinent provisions of U.S. tax treaties in Publication 901.[351] The website of the Indian Department of Revenue allows users to select a set of tax treaties and generate interactive comparison reports.[352] The Australian Taxation Office provides brief informational video clips describing the taxation of foreign business income.[353] Thus, SAT's services may simply provide basic Chinese international tax information in a convenient format.

However, in light of the strong incentive for Chinese revenue officials to help ensure that Chinese SOEs do not overpay foreign taxes, it is likely that SAT services may shade into tax planning. For instance, provincial and local Chinese tax bureaus are reportedly engaging in "one-on-one" counseling with Chinese multinationals headquartered in their regions providing specialized tax advice regarding anticipated foreign investments.[354] Other reports indicate that local tax departments have assisted major Chinese multinationals in both structuring foreign operations to avoid qualifying as a permanent establishment and in qualifying for other types of foreign tax emptions.[355] In short, SAT official appointed as advisors for Chinese SOEs may not only be informing managers of international tax laws, but also suggesting tax-advantaged structures and identifying other tax-planning opportunities. This would represent a new front in tax-related competition between states. Scholars have traditionally defined tax competition as efforts by jurisdictions to attract foreign investment by lowering their tax rates on income earned by foreigners.[356] Yet, providing support for SOE international tax planning, could place SAT in opposition to other tax authorities not only in shaping tax policy, but also in identifying gaps or unintended tax plan opportunities within other countries' international tax laws.

D. Differential Treatment of SOEs and Private Enterprises

Chinese international tax policy is likely to provide preferential treatment to SOEs through both domestic regulations and international agreements. Chinese domestic tax law has long provided preferential treatment to SOEs relative to private enterprises. Initially, this preferential

---

[351] *See* U.S. Tax Treaties, Pub. 901 (Rev. Sept. 2016), https://www.irs.gov/publications/p901 [perma.cc/XTE8-Z8HE].

[352] *See Treaty Comparison*, INCOME TAX DEP'T, GOV'T OF INDIA, https://www.incometaxindia.gov.in/Pages/international-taxation/treaty-comparison.aspx [perma.cc/UL3P-ST9H].

[353] *See Australians Doing Business Overseas*, AUSTRALIAN TAX'N OFF. (Feb. 16, 2016), https://www.ato.gov.au/business/international-tax-for-business/australians-doing-business-overseas/ [https://perma.cc/H7XD-XFMN].

[354] *See* Huang Shirui & Li Haiyan [黄诗睿 & 李海燕], Yangfan "Yidai Yilu" Zhuli Zhongguo "Zhi Zao" [扬帆"一带一路"助力中国"智造"] (Sailing Along "Belt and Road" to Help "Made in China"), 6 CHINA TAX'N 20, 21 (2016) [中国税务]; *see also* Zuoke Ailimu & Zhang Zhengtong [佐克·艾力木 & 张正通], Shuishou Zhuli Gu Sichou Zhi Lu Chong Fang Yicai [税收助力古丝绸之路重放异彩] (Taxation Helping to Recreate the Ancient Silk Road), 6 CHINA TAX'N 32, 33 (2017) [中国税务] (reporting that Xinjiang SAT sent a specialized point-person familiar with Kazakhstan tax law to assist a Xinjiang-based Steel company in planning for future operations in Kazakhstan).

[355] *See* Zuoke Ailimu & Zhang Zhengtong, *supra* note 354, at 33-34.

[356] *See*, *e.g.*, RIXEN, *supra* note 39, at 43; Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573, 1575-76 (2000).

treatment was explicit in the form of distinct sets of tax rules.[357] Yet, even after implementation of the unified Domestic Enterprise Income Tax in 1994, SOEs have continued to receive special tax preferences. For instance, from 1994 to 2009, a set of 120 central SOEs were allowed to compute tax liability on a consolidated basis—offsetting profits and loses across the group—despite Chinese tax law generally prohibiting consolidated returns.[358] Similarly, the three major oil and gas SOEs have been permitted to apply a preferential set of foreign tax credit rules—an aggregate rather than a country-by-country limitation—since 2011, treatment that was only expanded to all Chinese enterprises in 2017.[359] Wei Cui argues that such treatment reflects the ability of politically-connected SOE executives to successfully lobby for changes to tax regulations.[360] In light of the high priority placed on SOE participation in the Belt and Road initiative it seems likely that Chinese tax regulations will allow for differential treatment between SOEs and private enterprises in calculating foreign tax credits or in allowable deferral.

In fact, international tax preferences for SOEs may be necessary for ensuring the intended level of Chinese outbound investment. In general, SOEs should prefer paying a dollar of domestic tax rather than a dollar of foreign tax, since domestic taxes go to the state-owner while foreign taxes do not. Wei Cui explores possible implications of this fact from the perspective of countries seeking to attract inbound SOE investment.[361] Yet, this also has implications for countries—like China—seeking to encourage *outbound* SOE investment. Assuming SOEs managers are at least partially tax-sensitive,[362] SAT could provide an additional incentive for certain outbound SOE investment by over-crediting foreign taxes paid. Even if SOE managers might prefer paying domestic taxes to paying foreign tax, they are also likely to prefer keeping earnings within the SOE than transferring them to the state-owner (through tax or dividends). As a result, if foreign taxes paid by SOEs are over credited—with the SOE receiving a greater than one-dollar reduction in domestic tax liability for each dollar of foreign tax paid—SOE managers will have an additional incentive to make foreign investments. In other words, an overly generous foreign tax credit with a marginal reimbursement rate of over 100 percent would provide SOE managers greater incentive to invest abroad.[363]

Reverse engineering the various I.R.S. efforts to limit the potential adverse revenue effects to the U.S. of its foreign tax credit provides a potential blueprint for SAT in crafting a more generous foreign tax credit targeted at SOEs. To take one example, the I.R.S. has promulgated a complex set of regulations concerning what foreign levies qualify as a foreign income tax for the purpose of the foreign tax credit—regulations designed to prevent corporations from claiming other overseas business expenses (most notably oil royalty

---

[357] *See supra* Part 3.A.
[358] *See* Cui, *supra* note 278, at 119.
[359] *See id.* at 124; *supra* text accompanying note 137.
[360] *See* Cui, *supra* note 278, at 118.
[361] *See* Cui, *supra* note 22.
[362] *See supra* text accompanying notes 324-332.
[363] *See* Daniel Shaviro, *The Case Against Foreign Tax Credits*, 3 J. LEGAL ANALYSIS 65 (2011). Shaviro adopts the insightful terminology of "marginal reimbursement rate," to argue against full credibility of foreign taxes and in favor of deductibility. However, his analysis is premised on private corporations that are indifferent between paying foreign and domestic tax.

payments) as fully creditable foreign taxes.[364] Thus, by crafting an over-inclusive definition of creditable foreign taxes SAT could lighten the tax burden of Chinese enterprises investing overseas.[365] In fact, some Chinese scholars have suggested that the Chinese foreign tax credit should take into account Chinese multinationals' non-tax payments made to states with low tax transparency and low nominal tax rates, but with high compulsory non-tax levies.[366] Providing a definition of a foreign income tax that would include types of levies regularly borne by Chinese SOEs but not private enterprises, such as natural resource royalties, could provide a targeted benefit to SOEs while minimizing the additional economic distortions and negative revenue implications of a more expansive foreign tax credit. In sum, Chinese domestic tax law has in the past given preferential international tax treatment to SOEs. Going forward, one possibility for such preferential treatment is over-crediting the foreign taxes paid by SOEs so as to further China's current foreign policy goal of strengthening its economic influence in the countries along the Belt and Road initiative.

In bilateral tax treaty negotiations, China is also likely to continue to pursue—and secure—additional preferential tax treatment for SOEs. In fact, China's success in expanding the number of state-owned financial institutions granted preferential tax treatment in a number of recent bilateral tax treaties may serve as a potential model for future negotiations.

During the first-half of the twentieth century, source countries often unilaterally exempted income earned by foreign governments—even if earned in a commercial capacity—from taxation based on the international law principle of sovereign immunity.[367] For instance, starting in 1917 the United States provided a broad statutory exemption for income of foreign governments received from sources within the United States.[368] Until 1946, the exemption was often interpreted to apply to income earned from commercial activities undertaken by corporations wholly-owned by a foreign government.[369] For example, in the 1920s, income earned by a Maine corporation wholly owned by Nicaragua that operated railways and steamships was found to be exempt from U.S. taxation.[370] However, after 1946, the I.R.S. "did a complete about-face on this issue" and implemented varying tests designed to limit the exemption only to income related to governmental functions, making income related to

---

[364] Treas. Reg. § 1.901-2; *see* Bret Wells, *The Foreign Tax Credit War*, 201 BYU L. REV. 1895 (2016).

[365] *See* Glenn E. Coven, *International Comity and the Foreign Tax Credit: Crediting Nonconforming Taxes*, 4 FLA. TAX REV. 83, 84 (1999) (noting an over-inclusive description of creditable taxes may result in foreign income being taxed more lightly than domestic income).

[366] *See* Wang Wenjing & Lai Hongyu, *supra* note 319, at 57.

[367] *See generally* Matthew A. Melone, *Should the United States Tax Sovereign Wealth Funds?*, 143 B.U. INT'L L.J. 143, 176-89 (2009) (providing a history of the principle of sovereign immunity).

[368] The initial 1917 exemption applied to investments in U.S. stocks, bonds, other domestic securities, and bank deposits and was expanded the next year to include income "from any other source within the United States." *See* An Act to Provide Revenue to Defray War Expenses and for Other Purposes, Pub. L. No. 50, § 1211, 40 Stat. 300, 337 (1917); An Act to Provide Revenue and for Other Purposes, Pub. L. No. 254, § 213(b)(5), 40 Stat. 1057, 1066 (1918); *see also* Melone, *supra* note 367, at 203-07 (discussing the legislative history of current Internal Revenue Code section 892).

[369] *See* Melone, *supra* note 367, at 204.

[370] *See* Setser, *supra* note 283, at 298-99; s*ee also* O.D. 182, 1 C.B. 90 (1919); O.D. 515, 2 C.B. 96 (1920); O.D. 628, 3 C.B. 124 (1920) (all ruling that income earned by a foreign government in the U.S. from commercial operations was exempt from U.S. taxation).

commercial activities taxable.[371] This reflected a general shift by the United States to a restrictive conception of sovereign immunity across all areas of law by 1952 in response to the rise of state trading corporations in the post-war era.[372] By the 1970s this narrower conception of sovereign immunity was adopted by other developed nations.[373] As a result, under statutory law OECD countries either tax all income earned by foreign governments or exempt only passive income not associated with commercial activity.[374] A number of Western scholars have argued that the remaining exemptions should be further narrowed to ensure that passive investments by foreign Sovereign Wealth Funds are taxable.[375]

As a result, by the time that China began negotiating its first bilateral tax treaties in the early 1980s, its negotiation partners provided only limited exemptions, if any, for income earned by government entities. Even today, perhaps reflecting the standard continental European practice,[376] the text of the OECD and United Nations model treaties do not include any provision exempting interest or dividend income earned by foreign governments from taxation, and their respective commentaries were only recently updated to acknowledge an alternative practice amongst some nations.[377] Similarly, the current U.S. model treaty does not provide for

---

[371] *See* Melone, *supra* note 367, at 204-05.

[372] *See* David R. Tillinghast, *Sovereign Immunity from the Tax Collector: United States Income Taxation of Foreign Governments and International Organizations*, 10 LAW & POL'Y INT'L BUS. 495, 531 (1978); Sigmund Timberg, *Sovereign Immunity, State Trading, Socialism and Self-Deception*, 56 NW. U. L. REV. 109 (1961-1962).

[373] *See* David Gaukrodger, *Foreign State Immunity and Foreign Government Controlled Investors* 10 (OECD Working Papers on International Investment 2010/02, 2010), http://www.oecd.org/investment/investment-policy/WP-2010_2.pdf [https://perma.cc/C329-HR5R]; Sally-Ann Joseph, Michael Walpole & Robert Deutch, *Taxation of Sovereign Wealth Funds: A Suggested Approach*, 10 J. Australasian Tax Tchrs. Assoc. 2015 119, 129 (2015); *see also* Tillinghast, *supra* note 372, at 533 ("If, to take an unlikely example, the government of the U.S.S.R. decided to open a plant to distill vodka in Linden, New Jersey, next door to the Gordon's plant, the world would agree it could not claim sovereign immunity for that business. The principle of noninterference in the affairs of a sovereign pales in importance when the sovereign embarks on a profit-making enterprise within the territory of another sovereign.").

[374] *See* STAFF OF JOINT COMM. ON TAXATION, 110TH CONG., ECONOMIC AND U.S. INCOME TAX ISSUES RAISED BY SOVEREIGN WEALTH FUND INVESTMENT IN THE UNITED STATES 77 (June 17, 2008), http://www.jct.gov/x-49-08.pdf [https://perma.cc/R7UG-Z23P] [*hereinafter* JCT REPORT]; Victor Fleischer, *A Theory of Taxing Sovereign Wealth*, 84 N.Y.U. L. REV. 440, 469 (2009) ("[T]axing sovereign wealth funds as private corporations is consistent with broader international tax policy norms as reflected in the current practice of other countries. The United States is alone among its OECD peers in granting categorical, unilateral immunity from taxation for sovereign wealth funds.").

[375] *See, e.g.*, Jennifer Bird-Pollan, *The Unjustified Subsidy: Sovereign Wealth Funds and the Foreign Sovereign Tax Exemption*, 17 FORDHAM J. CORP. & FIN. L. 987 (2012); Fleischer, *supra* note 374.

[376] Under domestic law Germany, Norway, Poland, and Switzerland do not exempt foreign governments from taxation. In bilateral treaties Germany never provides an exemption to foreign governments, and most other continental European countries do exceedingly rarely. *See* JCT REPORT, *supra* note 374, at 77-78, A-3; Gaukrodger, *supra* note 373, at 33.

[377] *See* ORG. ECON. CO-OPERATION & DEV. (OECD), Model Tax Convention on Income and on Capital (Nov. 21, 2017), Commentary on Art. 10 ¶ 13.2 ("[S]ome States refrain from levying tax on dividends paid to other States and some of their wholly-owned entities, at least to the extent that such dividends are derived from activities of a governmental nature."); Commentary on Art. 11 ¶ 7.4 ("Some States refrain from levying tax on income derived by other States and some of their wholly-owned entities (e.g. a central bank established as a separate entity), at least to the extent that such income is derived from activities of a governmental nature"); s*ee also* UNITED NATIONS, Model Double Taxation Convention (2011), Commentary on Art. 10 ¶ 13 (quoting the OECD commentary); Commentary on Art. 11 ¶¶ 12-16 (quoting the OECD commentary). For a detailed discussion of the debates concerning the appropriate taxation of Sovereign Wealth Funds, which led to the adoption of these provisions in the OECD Commentary (and subsequently the UN Commentary), see Stijn Janseen, *How to Treat(y) Sovereign Wealth Funds?*

any such exemptions.[378] Admittedly, since the U.S. abolished its withholding tax on certain portfolio interest income in 1984,[379] a number of OECD states have eliminated withholding tax on interest, making a treaty exemption for government interest portfolio unnecessary in some cases.[380] However, even these countries generally retain withholding tax on dividends.[381] Moreover, most developing countries retain withholding taxes on both interest and dividends, as they are simple and easy to collect.[382] In their tax treaties, the maximum rates for interest and dividend withholding taxes are usually 10% or 15%.[383]

In negotiating bilateral tax treaties, China, like a number of other developing nations, has fought to include a non-standard provision ensuring the exemption of interest payments made to the state or certain government entities from source countries withholding taxation.[384] Since China's first bilateral tax treaty with Japan, its treaties have often included a broad provision exempting not only interest payments to the contracting parties' governments, local authorities, and central banks but also to wholly government owned financial institutions.[385] For instance, all of China's bilateral tax treaties with European countries contain this exemption in some form,

---

The Application of Tax Treaties to State-owned Entities, Including Sovereign Wealth Funds, in THE 2010 OECD UPDATES: MODEL TAX CONVENTION & TRANSFER PRICING GUIDELINES - A CRITICAL REVIEW 185 (Dennis Weber & Stef van Weeghel eds., 2011).

[378] *See* United States Model Income Tax Convention (2016), https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Treaty-US%20Model-2016.pdf [https://perma.cc/TE8M-CN8G]; *see also* Tillinghast, *supra* note 372, at 526 ("Only a handful of the income tax treaties to which the United States is a party make any special provision with respect to income received by the respective governments involved, and those that do relate only to interest payments.").

[379] *See* Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 127(a), 98 Stat. 494, 648-50 (codified as amended at I.R.C. § 871(h)).

[380] *See* Avi-Yonah, *supra* note 356, at 1581-82.

[381] *See id.*; DELOITTE, WITHHOLDING TAX RATES 2018 (2018), https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-withholding-tax-rates.pdf [https://perma.cc/TG6S-CKGD].

[382] *See* Khadija Baggerman-Noudari & René Offermanns, *Foreign Direct Investment in Developing Countries: Some Tax Considerations and Other Related Legal Matters*, BULL. INT'L TAX'N 310, 315 (June 2016); DELOITTE, WITHHOLDING TAX RATES 2018, *supra* note 381 (suggesting an average withholding).

[383] *See id.*; Ariane Pickering, *Tax Treaty Policy Framework and Country Model* (Papers on Selected Topics in Negotiation of Tax Treaties for Developing Countries, Paper No. 2-N, May 2013), http://www.un.org/esa/ffd/tax/2013TMTTAN/Paper2N_Pickering.pdf [https://perma.cc/J3HJ-SV8E]; *see also* Zhao Shubo [赵书博], Woguo yu "Yidai Yilu" Yanxian Guojia Shuishou Xieding Wenti Yanjiu [我国与"一带一路"沿线国家税收协定问题研究] (A Study on the Tax Treaties Between China and the Countries Along the "Belt and Road"), 397 TAX'N RES. J. 74 (2018) [税务研究] (noting the maximum withholding rate in China's tax treaties with countries along the Belt and Road initiative ranges between 10 and 20 percent).

[384] Developing countries may include these "government interest" provisions as they indicate strong respect for the sovereignty of another state and avoid the imposition of tax on interest payments connected to state-sponsored export promotion or development aid. *See* DAURER, *supra* note 34, at 275-76.

[385] *See* Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, China-Japan, art. 11, Sept. 6, 1983, http://www.chinatax.gov.cn/n810341/n810770/c1153042/part/1153044.pdf [https://perma.cc/6438-2JH7] ("[I]nterest arising in a Contracting State and derived by the Government of the other Contracting State, a local authority thereof, the Central Bank of that other Contracting State or any financial institution wholly owned by that Government … shall be exempt from tax in the first-mentioned Contracting State."); *see also* United States-The People's Republic of China Income Tax Convention, China-U.S., art. 10, Apr. 30, 1984, https://www.irs.gov/pub/irs-trty/china.pdf [https://perma.cc/VW2E-KE8W] (including a nearly identical provision).

and in most treaties this exemption extends to wholly owned financial institutions.[386] Similarly, 51 out of China's 56 bilateral tax treaties with 56 countries along the Belt and Road initiative contain an exemption that extends to government owned financial institutions.[387] Thus, in its international tax diplomacy, China has generally succeeded in having foreign nations accord its central bank and policy banks an exemption from taxation on interest.

While interest exemptions for wholly government owned financial institutions do not represent a major departure from common bilateral treaty practice—many African countries now include them in their bilateral treaties[388]—China's most recent treaties take a much bolder step, exempting interest income earned by certain Chinese commercial banks. As noted above, the major Chinese commercial banks were once wholly government owned institutions but are now publicly-listed corporations with minority private investment and a complicated hybrid character.[389] As a result, interest payments on foreign securities made to the major Chinese commercial banks may be subject to withholding taxation under most Chinese bilateral tax treaties. Yet, China's 2016 treaties with Cambodia and Romania ensure preferential tax treatment for China's major commercial banks by broadening the government interest exemption to include financial institutions with more than 50% government ownership.[390] A protocol to the treaty with Cambodia confirms that China's four largest commercial banks qualify for this exemption.[391] Chinese officials have stated that they hope the new stipulations regarding tax exemption "set a good example of improving fundamentals of law for tax cooperation between China and other Belt and Road countries."[392] A new protocol to the tax treaty with Pakistan that came into force in April 2017 granted an exemption on interest received by the Industrial and Commercial Bank of China derived from loans associated with energy projects that are part of a

---

[386] *See* Bernhard Canete, Bristar Mingxing Cao & Yun Huang, *Passive Income (Article 10, 11, and 12 OECD Model)*, in EUROPE-CHINA TAX TREATIES, *supra* note 13, at 121-33.
[387] *See* Zhao Zhou & Zhang Li [赵洲 & 张丽], *Lun "Yidai Yilu" Kuajing Lixi Suode de Shuishou Xietiao* [论"一带一路"跨境利息所得的税收协调] *(Tax Coordination on Cross-border Interests in Countries Along the "Belt and Road" Initiative)*, 1 INT'L TAX'N IN CHINA 51, 52 (2018) [国际税收]; *see also* Zhao Shubo, *supra* note 383, at 74 (discussing the interest income exception for wholly government owned financial institutions in China's bilateral tax treaties with Malaysia, Thailand, Vietnam, Brunei, Singapore, Oman and Turkmenistan).
[388] *See* DAURER, *supra* note 34, at 275-76.
[389] *See supra* text accompanying notes 179-185.
[390] *See* Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Cambodia-China, art. 11.3, Oct. 13, 2016 , http://www.chinatax.gov.cn/eng/n2367756/c2367970/part/2367982.pdf [https://perma.cc/E4P5-3KAZ] [hereinafter China-Cambodia Tax Treaty] ("[I]nterest arising in a Contracting State and paid to the Government or a local authority, the Central Bank or any financial institution or statutory body mainly owned by the Government of the other Contracting State, shall be exempt in the first-mentioned State. For the purposes of this paragraph, the term 'mainly owned' means the ownership exceeds 50 per cent."); *see also* Agreement for the Elimination of Double Taxation with Respect to Taxes on Income and the Prevention of Tax Evasion and Avoidance, China-Rom., art. 11.3, July 4, 2016, http://www.chinatax.gov.cn/eng/n2367756/c2367985/part/2367997.pdf [https://perma.cc/9VPV-96DN] (similar).
[391] These are the Bank of China, the Industrial and Commercial Bank of China, the China Construction Bank and the Agricultural Bank of China. *See* China-Cambodia Tax Treaty, *supra* note 390, ¶ 3.b.
[392] *See China-Romania Tax Treaty Signed by Wang Qinfeng on Behalf of China*, STATE ADMIN. OF TAX'N (Sept. 9, 2016), http://www.chinatax.gov.cn/eng/n2367726/c2369301/content.html [https://perma.cc/5KCP-SESU].

US $47 billion infrastructure plan.[393] According to news reports from Pakistan, Chinese officials were insistent in expanding the scope of the exemption despite Pakistan's reluctance.[394]

Chinese tax scholars have noted that this exemption plays a particularly important role for reducing the foreign tax burden on overseas infrastructure construction undertaken by Chinese engineering firms. Many infrastructure projects on the Belt and Road initiative are being constructed by Chinese engineering corporations and are being funded through loans made by China's policy or commercial banks.[395] In fact, by one estimate, out of all contractors participating in Chinese-funded projects, 89 percent are Chinese and only 7.6 percent are local companies.[396] Without the government interest provision, interest payments from a foreign branch or subsidiary of a Chinese construction corporation to a Chinese financial institution would generally be subject to withholding tax by the host country. Since these loans have traditionally been tax-inclusive (with withholding income tax payable on the interest borne by the borrowing company), the tax savings under this bilateral treaty provision may primarily benefit the Chinese engineering corporations.[397] Two recently settled disputes between China and foreign jurisdictions involving the imposition of withholding tax on interest payments from overseas subsidiaries of Chinese enterprises to Chinese wholly state-owned institutions, suggests that Chinese tax officials are prioritizing enforcement of these provisions.[398] Moreover, expanding the exemption to apply to Chinese commercial banks, appears to be of significant economic value to China. Estimates suggest that the protocol with Pakistan may reduce the

---

[393] *See* The Third Protocol to the Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, China-Pak, art.1, Dec. 8, 2016, http://www.chinatax.gov.cn/n810341/n810770/c1153236/part/2728748.pdf [https://perma.cc/298Y-79GY] ("For the provisions of Article 1 of the Second Protocol, the Industrial and Commercial Bank of China and the Silk Road Fund are included as "State Banks", but only for the purpose of interest income they derive from loans in Pakistan for the Energy Projects mentioned in the China-Pakistan Economic Corridor Energy Projects Cooperation Agreement signed at Beijing on November 8 , 2014."); *see also* Katherine Houreld, *China and Pakistan Launch Economic Corridor Plan Worth $46 Billion*, REUTERS (April 20, 2015), https://www.reuters.com/article/us-pakistan-china/china-and-pakistan-launch-economic-corridor-plan-worth-46-billion-idUSKBN0NA12T20150420 [https://perma.cc/QQ74-SK9] (describing the China-Pakistan Economic Corridor).

[394] *See* Shahbaz Rana, *Pakistan, China Divided over Tax Exemptions*, EXPRESS TRIBUNE (March 10, 2016), https://tribune.com.pk/story/1062662/loans-for-cpec-projects-pakistan-china-divided-over-tax-exemptions/ [https://perma.cc/VDP9-54CH].

[395] *See, e.g.*, Peng Qinqin & Denise Jia, *China State Banks Provide over $400 Bln of Credits to Belt and Road Projects*, CAIXIN (May 11, 2017), https://www.caixinglobal.com/2017-05-12/101089361.html [https://perma.cc/FKK6-U5QV]; *see also* Kane Wu & Julie Zhu, *Exclusive: China's 'Big Four' Banks Raise Billions for Belt and Road Deals – Sources*, REUTERS (Aug. 22, 2017), https://www.reuters.com/article/us-ccb-fundraising/exclusive-chinas-big-four-banks-raise-billions-for-belt-and-road-deals-sources-idUSKCN1B20ER [https://perma.cc/8W2E-VFZJ].

[396] Jonathan E. Hillman, *China's Belt and Road Initiative: Five Years Later*, CTR. STRATEGIC & IN'TL STUD. (Jan. 25, 2018), https://www.csis.org/analysis/chinas-belt-and-road-initiative-five-years-later-0 [https://perma.cc/8FLC-TTH8].

[397] *See* Zhao Shubo, *supra* note 383; s*ee also* Qi Tong, *supra* note 344 (discussing the role of bilateral tax treaties in creating tax incentives for Belt and Road infrastructure projects); *Better Reassure Enterprises Going Global*, STATE ADMIN. OF TAX'N (Oct. 13, 2016), http://www.chinatax.gov.cn/eng/n2367751/c2414677/content.html [https://perma.cc/JX8E-YPNB]) (discussing the government interest provision and noting the way it has benefited a Chinese cement company operating in Tajikistan).

[398] *See* Michael Wong et al., *A Thousand Miles Begin with a Single Step: Tax Challenges Under the BRI*, INT'L TAX REV. (Nov. 28, 2017), http://www.internationaltaxreview.com/Article/3772212/A-thousand-miles-begin-with-a-single-step-tax-challenges-under-the-BRI.html [http://perma.cc/Q4R9-ZDWN].

foreign tax burden on Chinese corporations by US $2 billion[399] and all of the expanded government interest exemptions negotiated in 2016 may reduce the foreign tax burden by roughly US $4 billion.[400] In sum, by negotiating for an exemption on withholding taxes imposed on interest payments to state-owned financial institutions, China has significantly reduced the foreign taxes owed on overseas infrastructure projects thus benefiting major SOEs. Moreover, the recent expansions of this exemption to include some of China's mixed-ownership commercial banks, illustrates China's willingness to challenge the status quo regarding the international taxation of state-owned institutions and may serve as a possible model for further expanded exemptions in the future.

Similarly, China's recent bilateral tax treaties with the Netherlands, United Kingdom, and Switzerland, suggest that it is also now seeking additional preferential tax treatment for SOEs in the form of an exemption from dividend withholding taxes. Most OECD countries retain significant withholding taxes on dividends payments to portfolio investors but apply a reduced withholding rate to dividend payments made by a subsidiary to parent corporation.[401] These three updated treaties, all of which were entered into force in 2013, contain similar provisions exempting dividend payments from withholding tax if "the beneficial owner of the dividends" is the government, a government institution, or "any other entity the capital of which is wholly owned directly or indirectly" by the government.[402] Under this provision, dividend payments from a Dutch, U.K., or Swiss resident corporation to a wholly-owned Chinese SOE are exempt from withholding tax, no matter the level of SOE investment. Commentators have noted that these exemption provisions are quite attractive for wholly-owned Chinese State-owned enterprises, as they provide tax-preferred treatment to dividends not only from their subsidiaries but from any of their portfolio holdings.[403] The willingness of these three countries to adopt a

---

[399] *See* Rana, *supra* note 394.

[400] *See* Wang Ping [王平], Fuwu "Yidai Yilu" Jianshe Shuishou Dayouzuowei [服务"一带一路"建设 税收大有作为] (Tax Has a Big Role to Play in Serving "Belt and Road" Construction), 5 INT'L TAX'N IN CHINA 6, 7 (2017) [国际税收]; *see also Better Reassure Enterprises Going Global*, *supra* note 397 (noting that interest exemptions negotiated in 2015 may have reduced foreign taxes by US $1 billion).

[401] *See* ORG. ECON. CO-OPERATION & DEV. (OECD), Model Tax Convention on Income and on Capital: Condensed Version 2017 ¶¶ 59-67, at 248-49 (Nov. 21, 2017).

[402] *See* Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Neth.-China, art. 10.3, May 31, 2013, https://www.government.nl/documents/decrees/2013/05/31/agreement-between-the-netherlands-and-the-people-s-republic-of-china-for-the-avoidance-of-double-taxation [https://perma.cc/8FBV-UVUZ]; *see also* Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains, U.K.-China, art. 10.3, Apr. 12, 2013, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/282522/8783.pdf [https://perma.cc/7BBJ-LACT] ("[D]ividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State shall be taxable only in that other Contracting State if the beneficial owner of the dividend is the Government of that other Contracting State or any of its institutions; or other entity the capital of which is wholly-owned directly or indirectly by the Government of that other Contracting State."); *see also* Agreement for the Avoidance of Double Taxation with Respect to Taxes on Income and Capital, China-Switz., art. 10.3, Sept. 25, 2013, http://www.chinatax.gov.cn/eng/n2367756/c2368077/part/2368086.pdf [https://perma.cc/VT6B-5S42] (similar).

[403] *See* ERNST & YOUNG, NEW TAX TREATY PROVISIONS BETWEEN CHINA AND THE NETHERLANDS TO PROMOTE INVESTMENT

treaty provision intended to provide preferential tax treatment for wholly-owned Chinese SOEs, proves that even developed nations may be willing to forego significant tax revenue from Chinese SOEs in the hope of increased Chinese investment leading to job creation. [404]

Thus, recent Chinese bilateral tax diplomacy, suggests that it will continue to seek to broaden exemptions from source country withholding taxation for state-owned financial institutions and SOEs. Exemptions from interest payments to state commercial banks can significantly reduce the financing costs for Chinese SOEs operating in developing countries. Exemptions from dividend payments to SOEs can reduce the tax-cost of operating subsidiaries in countries without a full treaty exemption for subsidiary-parent dividend payments and of making portfolio investment in countries with dividend withholding. Going forward, it seems likely that China will also seek to expand the dividend exemption to mixed-ownership SOEs (for instance through adoption of the 50 percent threshold, like that found in recent government interest provisions). Moreover, it is possible that in negotiations with developing countries, China may even push for exemptions for certain types of active income earned by SOEs (for instance, income associated with state-sponsored infrastructure projects), reviving earlier conceptions of state sovereign immunity with respect to tax. Lobbying for an exemption for SOEs from all foreign taxation, would in fact be in line with China's general support for broad and absolute sovereign immunity in other legal contexts.[405]

While China is likely to continue to seek preferential treatment for SOEs in bilateral treaties, some countries may choose to unilaterally exempt certain income earned by SOEs from taxation in hope of attracting Chinese investment. Currently the United States and United Kingdom generally exempt from taxation passive investment income earned by foreign sovereign wealth funds (SWFs), a close relative of SOEs.[406] SWFs are state-owned and controlled funds that make investments in foreign assets and are dedicated to achieving national

---

(2013), http://www.ey.com/Publication/vwLUAssets/New_tax_treaty_provisions_between_China_and_the_Netherlands_to_promote_investment/$File/2013G_CM3518_China%20and%20Netherlands%20new%20tax%20treaty%20provisions%20promote%20investment.pdf [https://perma.cc/E83J-AXY9]; *see also* Erik Jansen, *New Tax Treaty Between China and the Netherlands to Promote Investments*, INNOVATIVE TAX (Feb 12, 2014), http://innovativetax.com/news/new-tax-treaty-between-china-and-the-netherlands-to-promote-investments.html [https://perma.cc/9BYL-2LQH] ("If the beneficial owner of the dividends of a company is the government of the contracting state … there will not be a withholding tax proposed. It is clear that this provision is attractive for Chinese State owned enterprises ….").

404 *See, e.g.*, *New Tax Treaty Signed with China*, GOVERNMENT OF NETHERLANDS (May 30, 2013), https://www.government.nl/latest/news/2013/05/31/new-tax-treaty-signed-with-china [http://perma.cc/BY4F-S2RL] ("Many Chinese companies are active already in the Netherlands and I hope that this new treaty will be an extra incentive for even more investments in the Netherlands. It will provide employment.").

405 *See e.g.*, Ferdous Rahman, *Questioning Chinese Government's Stand for Sovereign Immunity*, 9 TRANSNAT'L CROPS. REV. 41 (2017); Matthew Miller & Michael Martina, *Chinese State Entities Argue They Have 'Sovereign Immunity' in U.S. Courts*, REUTERS (May 11, 2016), https://www.reuters.com/article/us-china-usa-companies-lawsuits/chinese-state-entities-argue-they-have-sovereign-immunity-in-u-s-courts-idUSKCN0Y2131 [http://perma.cc/5PV8-VQ49].

406 *See* JCT REPORT, *supra* note 374, at 77. Under section 892 of the Internal Revenue Code, the United States exempts passive investment income earned in the U.S. by foreign SWFs from U.S. taxation, as long as the income is not derived from conduct of commercial activity.

macroeconomic and financial objectives.[407] Australia and Canada may exempt passive income earned by SWFs provided the fund first establish its eligibility through administrative procedures and some additional countries offer such treatment through bilateral treaty provisions.[408] While the appropriate international tax treatment of SWFs remains highly controversial, scholars have demonstrated that exempting passive income earned by SWFs can incentivize additional sovereign investment under certain conditions.[409] Building on these findings, John McLaren has argued that both foreign SWFs and SOEs should be exempted from paying Australian tax on income earned from passive investments as it would benefit the country economically by signaling Australia's openness to greater foreign investment from China.[410] Wei Cui has noted more generally that there are many possibilities for host countries to offer "select incentives to foreign SOEs to make greater investments" without fear of placing private investors at a disadvantage.[411] These scholars focus their work on Western developed countries and acknowledge that in light of current geopolitics, offering tax inducements to Chinese SOEs may be politically unpalatable in Australia, the United States, and Canada.[412] However, their arguments regarding increased investment may be most relevant to developing countries—which often have higher corporate tax rates and great need for foreign investment.

These observations suggest the possibility of a type of tax competition amongst countries seeking Chinese investment. Since major overseas Chinese investments are often dictated by SOEs and state-owned commercial banks, developing countries seeking to attract Chinese investment may offer generous tax exemptions to such enterprises premised upon their state-ownership. By offering exemptions premised upon state-ownership rather than across-the-board reductions in withholding or corporate tax rates, they may be able to incentivize additional Chinese investment without significantly lowering their overall tax revenue. Moreover, Chinese government officials may be particularly supportive of this approach since it would stand to benefit the Chinese government (a reduction in the foreign tax imposed on Chinese SOEs leaves greater earnings for the state) with less risk of sparking a more generalized "race to the bottom" amongst developing countries over tax rates—which could harm China's own efforts to encourage foreign investors to continue reinvesting in China.[413] Additionally, it could put SOEs

---

[407] *See generally* ORG. ECON. CO-OPERATION & DEV. (OECD), FOREIGN GOVERNMENT-CONTROLLED INVESTORS AND RECIPIENT COUNTRY INVESTMENT POLICIES: A SCOPING PAPER 6 (2009), https://www.oecd.org/investment/investment-policy/42022469.pdf (identifying key elements that define Sovereign Wealth Funds).

[408] *See* JCT REPORT, *supra* note 374, at 77; *see also* Fleischer, *supra* note 374, at 470 (discussing international practice for taxing passive income earned by foreign governments).

[409] *See* Michael S. Knoll, *Taxation and the Competitiveness of Sovereign Wealth Funds: Do Taxes Encourage Sovereign Wealth Funds to Invest in the United States*, 82 S. CAL. L. REV. 703 (2009).

[410] *See* John McLaren, *The Taxation of Foreign Investment in Australia by Sovereign Wealth Funds: Why Has Australia Not Passed Laws Enshrining the Doctrine of Sovereign Immunity*, 17 J. AUSTL. TAX'N 53, 83 (2015).

[411] Cui, *supra* note 22, at 811.

[412] *See id.* at 811-12 ("Such policies have evoked expressions of disbelief from some commentators, who find it incredible that a country like the United States would favour "state capitalism" over "private capitalism."); *see also* McLaren, *supra* note 410 at 83-84 ("Unfortunately, public opinion is against foreign investment especially by the Chinese. . . . [A]t present, governments are reluctant to be seen to be promoting taxation benefits for foreign governments.").

[413] *See* Jingwai Touzizhe Yi Fenpei Lirun Zhijie Touzi Zan Bu Zhengshou yu Ti Suodeshui Zhengce Wenti de Tongzhi

at an economic advantage in comparison to other foreign multinationals operating in the same host country. Thus, from the perspective of Chinese tax policy makers, creating competition to pressure countries along the Belt and Road initiative to offer the most generous tax exemptions for state-owned enterprises may be an ideal tax policy: it benefits the Chinese fisc, places Chinese emperies at a competitive advantage in host countries, and does not place China at a disadvantage in terms of attracting its own foreign investment.

VI. Conclusion

With China set to assume meaningful influence over the international tax regime, its unique system of state capitalism is likely to cause its preferred international tax rules and norms to differ significantly from those of OECD countries. Maintenance of a worldwide system of taxation, state support for SOE international tax planning, and advocacy for broad tax exemptions for SOEs are only some of many possible areas of divergence. For instance, in the highly-technical field of transfer pricing China has also been challenging aspects of the OECD consensus on arm's length pricing.[414] Chinese scholars suggest that changing the transfer pricing rules related to intangible assets may help foster the development of Chinese multinationals, whose economic advantages primarily come from maintaining low production costs rather than from innovative intellectual property.[415] Of course, numerous other divergences in tax preferences may not be directly related to China's system of state capitalism, but rather to its status as a developing country. For example, China, like a number of other developing countries, has controversially attempted to impose tax on indirect transfers of taxable Chinese property by foreign shareholders, in other words, transfers of shares in offshore holding companies holding primarily Chinese assets.[416] In short, going forward China tax-policy makers are likely to push back against OECD tax norms on multiple fronts.

It is tempting for OECD countries to assume that China's involvement in BEPS and future multilateral initiatives will temper and contain most of China's potentially heterodox international tax preferences. Yariv Brauner has observed that even within the context of the BEPS projects, there are many subtle signs that the OECD nations wish to maintain greater power over international tax norms than the BRIC countries, despite their supposedly equal status within BEPS.[417] Thus, the give-and-take of multinational diplomacy may create pressures for China to

---

[境外投资者以分配利润直接投资暂不征收预提所得税政策问题的通知] (Notice Concerning the Deferral of Withholding Tax on Dividends Directly Invested by Foreign Investors) (promulgated by the General Tax Bureau of the Ministry of Finance, effective January 1, 2017), CAI SHUI, Dec. 21, 2017 (providing an recent example of Chinese tax policy designed to encourage foreign investors to reinvest in China); *see also* Chen Jia & Wang Yanfei, *Companies Reinvesting Profits Can Get Tax Break*, CHINA DAILY, Dec. 29, 2017, http://www.chinadaily.com.cn/a/201712/29/WS5a457fefa31008cf16da4134.html [http://perma.cc/KX79-KG8L] (describing the policy rationale beyond recent tax incentives targeted at foreign reinvestment).

[414] *See, e.g.*, RICHARD S. COLLIER & JOSEPH L. ANDRUS, TRANSFER PRICING AND THE ARM'S LENGTH PRINCIPLE AFTER BEPS 261 n.6 (2017).

[415] *See, e.g.*, Jiang Yuesheng, *supra* note 314, at 35-36.

[416] *See, e.g.*, Wei Cui, *Taxing Indirect Transfers: Improving an Instrument for Stemming Tax and Legal Base Erosion*, 33 VA. TAX REV. 653, 654-55 (2014).

[417] *See* Brauner, *supra* note 12, at 1025-26 (suggesting the BRICS participation in BEPS has allowed the OECD to accept some changes in international tax norms "without a significant effective concession of power by the OECD itself."); *see also* Brauner, *supra* note 9, at 78 (observing that the BEPS action item 5 on harmful tax practices

broadly adhere to prevailing OECD norms, even if it may continue to push for changes around the edges. For instance, during BEPS negotiations, Chinese tax officials proposed new transfer pricing methods that seemed to represent a major departure from the OECD consensus.[418] Yet, following the completion of BEPS, China now appears to have moved much "closer to OECD orthodoxy" in its transfer pricing regulations even if its regulations also contain a few "China-unique concepts" that are "at variance with OECD."[419] This may suggest that even if Chinese state capitalism creates a divergent set of international tax preferences, these will be neutralized through the consensus-building process of multinational negotiations.

However, China's audacious Belt and Road initiative may allow it to gradually push for new international tax norms through a regional—rather than global—approach that may sidestep the influence of OECD countries. Official state documents regarding the Belt and Road initiative emphasize that it is "open to all countries" and "not limited to the area of the ancient Silk Road."[420] However, Chinese scholars and government-associated think tanks have identified 65 or so countries associated with the initiative, the vast majority of which are non-OECD members.[421] Through the initiative, China is poised to be become the dominant economic player across Central and Southeast Asia.[422] As a result, China will likely be able to leverage its role as the primary source of foreign capital investment for most countries along the initiative to push for new international tax norms. Multiple Chinese scholars have suggested that China can use its economic influence along the Belt and Road initiative to develop new regional tax rules or even a comprehensive regional tax agreement. After first shaping new international tax rules along the Belt and Road countries, China will then be able to more strongly influence international tax law around the globe.[423] Cao Mingxing of the Central University of Economics and Finance has even suggested that China can use the Belt and Road as a basis for a new international tax reform strategy of "neo-BEPS" (Base Expansion and Profit Sharing) which would embrace more substantive changes to international tax regime than the narrow and "neo-liberal" changes of

---

awkwardly recreates an "us" and "them" dynamic between OECD and non-OECD countries and suggesting that such language "hints that the OECD still views itself primarily as the rich countries' club.").

[418] *See* Kevin A. Ball, *China Backs Down on Adopting Controversial Transfer Pricing Method*, BLOOMBERG BNA, (April 19, 2017), https://www.bna.com/china-backs-down-n57982086872/ [https://perma.cc/4DVT-5M6C].

[419] Glenn DeSouza, *China's New Transfer Pricing Platform and the Challenge for U.S. Multinationals*, BLOOMBERG BNA (May 3, 2017), https://www.bna.com/chinas-new-transfer-n73014460766/ [https://perma.cc/PSU3-72GQ].

[420] *Vision and Actions on Jointly Building Silk Road Economic Belt and 21st-Century Maritime Silk Road*, NAT'L DEV. & REFORM COMMISSION (Mar. 28, 2015), http://en.ndrc.gov.cn/newsrelease/201503/t20150330_669367.html [https://perma.cc/4MVY-UNQU].

[421] *See* Hellen Chin & Winnie He, *The Belt and Road Initiative: 65 Countries and Beyond*, FUNG BUS. INTELLIGENCE CTR. (May 2016), https://www.fbicgroup.com/sites/default/files/B%26R_Initiative_65_Countries_and_Beyond.pdf [https://perma.cc/S97W-38UD]; *see also* Wang Wenjing & Lai Hongyu, *supra* note 319 (discussing the political and economic characteristics of countries along the Belt and Road initiative).

[422] *See e.g.*, William T. Wilson, *China's Huge 'One Belt, One Road' Initiative Is Sweeping Central Asia*, HERITAGE FOUND. (Nov. 21, 2016), https://www.heritage.org/asia/commentary/chinas-huge-one-belt-one-road-initiative-sweeping-central-asia [https://perma.cc/J5FY-6DX2] ("In 2013, trade between China and the five Central Asian states…totaled $50 billion, while the five states' trade with Russia—previously the region's top economic player—amounted to only $30 billion.").

[423] *See* Qi Tong, *supra* note 344; Zhang Meihong [张美红], Wogou Qiye Haiwai Touzi She Shui Fengxian Ji Qi Yingdui [我国企业海外投资涉税风险及其应对] (Tax Risks of Chinese Enterprises' Overseas Investment and Their Countermeasures), 1 TAX'N RES. J. 79 (2017) [税务研究].

BEPS.[424] These observations indicate China's recent tax treaties with Romania and Cambodia are likely only the beginning of Chinese efforts to negotiate for new and potentially heterodox tax rules with countries along the Belt and Road initiative.

In conclusion, as China gains greater influence in shaping the international tax regime, its preferences for international tax rules are likely to be heavily shaped by its system of state capitalism. Just as Chinese domestic tax policy reforms have been driven by the central government theories of industrial planning and SOE governance, Chinese international tax policy will be designed to help China's current national champion SOEs grow into global champions. As a result, tax policy-makers in both OECD countries and those along the Belt and Road must remain cognizant of the fact that due to its unique economic system, China may pursue tax policies and norms orthogonal to the traditional battle lines between developed and developing countries. To take just one example, tax treaty provisions defining tax exempt government entities—relatively inconsequential for the vast majority of treaties between free market economies—may become the next flashpoint in international tax diplomacy. To prevent such disputes from fracturing the international tax regime, new international agreements may be required concerning the appropriate tax treatment of state-owned entities and the appropriate boundaries for assistance offered by state tax administration to domestic corporations. Policy-makers must be proactive in recognizing and addressing the challenges to the current international tax system posed by future Chinese international tax policies motivated by state capitalism.

[424] *See* Cao Mingxing [曹明星], *Neo-BEPS: Tigong "Yidai Yilu" Linian Xia de Guoji Shui Gai Fang'an* [Neo-BEPS：提供"一带一路"理念下的国际税改方案] (Neo-BEPS: Providing an International Tax Reform Program under the Belt and Road Initiative), CHINA TAX NEWS, May 10, 2017 [中国税务报].