Finding and Applying the Optimal Benchmark to Identify Tax Expenditures in China

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DECLARATION

In accordance with *Monash University Doctorate Regulation 17 Doctor of Philosophy* the following declarations are made:

I hereby declare that this thesis contains no material which has been accepted for the award of any other degree or diploma at any university or equivalent institution and that, to the best of my knowledge and belief, this thesis contains no material previously published or written by another person, except where due reference is made in the text of the thesis.

Signed: [redacted]

Date: 10/09/2013

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ABSTRACT

The basic purpose of every tax system is to collect sufficient tax revenue to finance government expenditure. The government can also use the tax system to achieve a broad spectrum of economic, social, cultural and other policy objectives. Tax measures used to achieve such objectives are known as tax expenditures.

Tax expenditures are the technical name for spending programs run through the tax system. For government, tax expenditures lead to a loss of revenue; for a taxpayer, tax expenditures reduce tax liability. Tax expenditures are better known in many Organisations for Economic Co-operation and Development (OECD) countries as tax reliefs, tax subsidies and tax aids.

China has revised its tax laws to bring them closer in substance as well as name and form to those in more advanced economies. However, Chinese public finance still lags in the use of modern analytical tools to evaluate the operation of its tax system. One of the most important tools used market economics is tax expenditure analysis.

Tax expenditure analysis has been used as a fundamental tool of tax policy decision making in western countries for more than four decades. To date, there has been limited tax expenditures analysis by the Chinese government or Chinese academics and this thesis will provide an important contribution to the development of tax expenditures analysis in China.

The thesis compiles all the explicit and implicit deviations from a neutral benchmark company tax system in the Chinese enterprise income tax law and subjects them to tax expenditure analysis. This involves consideration of whether they amount to subsidies or disincentives for different activities or investments and whether these are appropriate given China's level of current economic and social development.

This thesis seeks to make two important contributions to the study of Chinese tax law. To begin with, it provides the first comprehensive tax expenditure analysis of Chinese tax legislation. Literature to date has identified the desirability of using tax expenditure analysis in China but so far no scholar has taken the next step and attempted an actual tax expenditure analysis of the law.

Second, this will be the first study to show how tax expenditure analysis in China has to look at tax rules beyond the enterprise income tax statute because in China the application of basic rules in the statute are found not in the law but rather in implementation regulations issued by the State Council or in circulars issued by the State Administration of Taxation (SAT, the tax administrative agency in China) or the Ministry of Finance (MOF).

This thesis will be the first to identify tax expenditures in China by using accounting principles as the basis for identifying a benchmark company tax base, sidestepping entirely the debate in many countries on the appropriate benchmark.

This thesis will also set enumerate all the company income tax expenditures in China. While there has been discussion of particular concessions from time to time, this is the first instance in which all tax expenditures have been documented in one place.

LIST OF ABBREVIATIONS

ASC	Accounting Society of China
ASBE	Accounting System for Business Enterprises
ASSBE	Accounting System for Small Business Enterprises
CAS	Chinese Accounting Standards
CPC	Communist Party of China
CPAs	Certified Public Accountants
CICPA	China Institute of Certified Public Accountants
CBO	Congressional Budget Office
EU	European Union
FEIT	Foreign Enterprises Income Tax Law
GAAP	Generally Accepted Accounting Principles
GDP	Gross Domestic Product
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
ICTS	Industrial and Commercial Tax System
JVIT	Joint Venture Income Tax
JCT	Joint Committee on Taxation
MOF	Ministry of Finance
NDRC	National Development and Reform Commission
NIDZ	National Innovation Demonstration Zone
NPC	National People's Congress

NPO	Non-Profit Organisations
NBER	National Bureau of Economic Research
OECD	Organisation for Economic Co-operation and Development
PRC	People's Republic of China
ROSC	Report on the Observance of Standards and Codes
SAT	State Administration of Taxation
SEZs	Special Economic Zones
SHS	Schanz-Haig-Simons
SOEs	State Owned Enterprises
VAT	Value Added Tax
WTO	World Trade Organization

LIST OF LEGISLATION AND REGULATIONS

State Council, 'Notice of Implementation of the Transitional Preferential Policies on Enterprise Income Tax', *Guofa [2007] No.39 (Circular 39).*

MOF and the SAT, 'Some Preferential Policies of Enterprises Income Law', Caishui *[2008] No.1 (Circular 1).*

MOF, SAT and NDRC, ' Enterprise Income Tax Incentive Catalogue for Specialised Equipment in Environment Protection, Enterprise Income Tax Incentive Catalogue for Specialised Equipment in Water Conservation or Energy Usage Reduction', *Caishui [2008] No. 115 (Circular 115)* .

MOF, SAT and NDRC, 'the Notice on the Release of the Catalogue of Enterprise Income Tax Incentives for Public Infrastructure Projects (2008Edition)', *Caishui [2008] No. 116 (Circular 116).*

SAT, 'Administrative Measures for the Deduction of Enterprises' Expenses for Research and Development (for Trial Implementation)', *Guoshuifa [2008] No. 116(Circular 116).*

MOF, SAT and NDRC, 'the Notice of the Catalogue of the Enterprise Income Tax Incentive for Comprehensive Utilisation of Resources', *Caishui [2008] No. 117(Circular 117).*

MOF, SAT and State Administration of Work Safety, 'the Enterprise Income Tax Incentive Catalogue for Specialised Equipment in Production Safety (2008 Edition) ', *Caishui [2008] No. 118(Circular 118).*

MOF and SAT, 'Scope of Preliminary Processing of Agricultural Products Entitled to Preferential Enterprise Income Tax Policies ', *Caishui [2008] No. 149(Circular 149).*

MOST, MOF and SAT, 'Circular on Administrative Measures on the Recognition of High and New Technology Enterprises', *Guokefahuo [2008] No. 172(Circular 172).*

MOST, MOF and SAT, 'Circular on Issuing Administration Guidance for Identification of High and New Enterprises', *Guokefahuo [2008] No. 362(Circular 362).*

MOF and SAT , 'the Notice on Enterprise Income Tax Policy Issues Regarding China's CDM Fund and CDM Project Developers', *Caishui [2009] No. 30(Circular 30).*

MOF and SAT , 'Several Issues concerning Tax Policy for Supporting the Development of Cultural Enterprises, *Caishui [2009] No.31(Circular 31).*

MOF and SAT, 'Certain Preferential Tax Policy for Operating Cultural Institutions Transformed to Enterprises during Reforms of Cultural System', *Caishui [2009] No.34 (Circular34).*

MOF and SAT, 'Issues Regarding Tax Policies for High Technology Service Enterprises', *Caishui [2009] No. 63 (Circular 63).*

MOF and SAT, 'Notice on Certain Issues Concerning the Implementation of Enterprise Income Tax Incentives', *Caishui [2009] No. 69 (Circular 69).*

MOF and SAT, 'Income Tax Incentives for Enterprises Employing Disabled Persons', *Caishui [2009] No. 70(circular 70).*

SAT, 'the Notice on the Implementation of State Encouraged Public Infrastructure Projects Enterprise Income Tax Incentives', *Guoshuifa [2009] No. 80 (Circular 80).*

SAT, 'Notice on Issues Relevant To Income Tax Treatment on the Accelerated Depreciation of Fixed Assets of Enterprises', *Guoshuifa [2009] No. 81(Circular 81).*

SAT, 'the Issues Concerning Implementation of the Preferential Income Tax of Venture Capital Enterprises', *Guoshuifa [2009] No. 87(Circular 87).*

MOF and SAT, 'the Circular on Enterprise Income Tax Exemption for Non-Profit Organisations', *Caishui [2009] No. 122 (Circular 122).*

MOF and SAT, 'the Circular on Management Issues Concerning Non-Profit Organisations' Eligibility of Tax Exemption', *Caishui [2009] No. 123(Circular 123).*

MOF, SAT and NDRC (Trial), 'The Notice on the Catalogue of Environmental Protection Energy and Water Saving Projects for Enterprise Income Tax Incentives' , *Caishui [2009]No.166(Circular 166).*

SAT, 'Issues Concerning the Reduction and Exemption of Enterprise Income Tax for Gains from Technology Transfers', *Guoshuihan [2009] No.212 (Circular 212).*

MOF and SAT, 'Notice Regarding about Tax Polices for Agricultural Financial Institutions', *Caishui [2010] No. 4(Circular 4).*

MOF and SAT, 'Notice Regarding Income Tax Exemption of High Technology Service Enterprise's offshore outsourcing services in Demonstration Municipalities', *Caishui [2010] No. 64 (Circular 64).*

MOF and SAT, 'Issues Regarding Enterprise Income Tax for High Technology Service Enterprises (HTSE), *Caishui [2010] No. 65 (Circular 65).*

MOF and SAT, 'The Pilot Policies Related To the Super Deduction of Research and Development Expenses for the Construction of Zhongguancun National Innovation Demonstration Zone (NIDZ)', *Caishui [2010] No. 81(Circular 81).*

MOF and the SAT, 'Concerning the Value-Added Tax, Business Tax and Enterprise Income Tax Policies for Promoting the Development of the Energy-Saving Service', *Caishui [2010] No. 110(Circular110).*

MOF and SAT, 'Enterprise Income Tax Policies for Technology Transfer of Resident Enterprises', *Caishui [2010] No.111(Circular 111).*

SAT , 'Circular on Further Confirmation of Implementation Rules of Transitional Preferential EIT Policies' , *GuoShuiHan [2010] No.157 (Circular 157).*

State Council, 'Notice on Relevant Polices for Further Encouraging Development of Software Industry and Integrated Circuit Industry', Guofa *[2011] No.4 (Circular 4).*

MOF and SAT, 'Supplemental Notice of Scope of Preliminary Processing of Agricultural Products Entitled to Preferential Enterprise Income Tax Policies', *Caishui [2011] No.26(Circular 26).*

MOF and SAT, 'Circular on the Applicable Tax Rate and the Tax Deduction and Exemption for the Offshore Income of High and New Technology Enterprises ', *Caishui [2011] No. 47 (Circular 47).*

SAT, 'the Implementation of the Enterprise Income Tax Incentives for Agriculture, Forestry, Husbandry and Fishery projects ', *SAT Announcement [2011] No.48 (Circular 48).*

MOF, SAT and General Administration of Customs, 'Issues Concerning Tax Policies for In-depth Implementation of Western Development Strategy', *Caishui [2011] No. 58 (Circular 58).*

MOF and SAT, 'Circular on VAT Policies for Software Products', *Caishui [2011] No.100 (Circular 100).*

MOF and SAT, 'Notice on the Introduction of the Pilot Scheme to Convert Business Tax to VAT' *Caishui [2011] No. 110 (Circular 110).*

MOF and SAT, 'Notice on the Introduction of Detailed Implementation of the Pilot Scheme to Convert Business Tax to VAT', *Caishui [2011] No. 111 (Circular 111).*

MOF and SAT, 'Notice on Some Tax Incentives for Small Low-Profit Enterprises', *Caishui [2011] No. 117(Circular 117).*

MOF and SAT , 'Notice regarding certain issues related to the enterprise Income Tax preferential treatment for major public infrastructure projects, environmental protection projects and energy and water conservation projects', *Caishui [2012] No. 10 (Circular 10).*

MOF and SAT, 'Further Encouraging the Development of the Software Industry and the Integrated Circuit Industry', *Caishui [2012] No. 27 (Circular 27).*

SAT, ‘The Notice Regarding the Implementation of Enterprise Income Tax Policies for the Development of the Western Regions’, *SAT Announcement [2012] No. 12 (Announcement 12).*

MOF and SAT, ‘the Notice on the Enterprise Income Tax Exemption of the Local Government’, *Caishui [2011] No. 76 (Circular 76).*

MOF and SAT, ‘Notice on Enterprise Income Tax Policies for Interests Income of Railway Construction Bonds’, *Caishui [2011] No. 99(Circular 99).*

Chapter 1 Introduction

1.1. Background and Motivation

The basic purpose of every tax system is to collect sufficient tax revenue to finance government expenditure. The government can also use the tax system to achieve a broad spectrum of economic, social, cultural and other policy objectives. Tax measures used to achieve such objectives are known as tax expenditures.

Tax expenditures are the technical name for spending programs run through the tax system. For government, tax expenditures lead to a loss of revenue; for a taxpayer, tax expenditures reduce tax liability. Tax expenditures are better known in many Organisation for Economic Co-operation and Development (OECD) countries as tax reliefs, tax subsidies and tax aids (the concept and implementation of tax expenditures are fully discussed in Chapter 5).

China has revised its tax laws to bring them closer in substance as well as name and form to those in more advanced economies. However, Chinese public finance still lags in the use of modern analytical tools to evaluate the operation of its tax system. One of the most important tools used market economics is tax expenditure analysis.

Tax expenditure analysis has been used as a fundamental tool of tax policy decision making in western countries for more than four decades. To date, there has been limited tax expenditures analysis by the Chinese government or Chinese academics and this thesis will provide an important contribution to the development of tax expenditures analysis in China.

The thesis compiles all the explicit and implicit deviations from a neutral benchmark company tax system in the Chinese enterprise income tax law and subjects them to tax expenditure analysis. This involves consideration of whether they amount to subsidies or disincentives for different activities or investments and whether these are appropriate given China's level of current economic and social development.

This thesis seeks to make two important contributions to the study of Chinese tax law.

To begin with, it provides the first comprehensive tax expenditure analysis of Chinese tax legislation. Literature to date has identified the desirability of using tax expenditure analysis in China but so far no scholar has taken the next step and attempted an actual tax expenditure analysis of the law.

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This thesis will be the first to identify tax expenditures in China by using accounting principles as the basis for identifying a benchmark company tax base, sidestepping entirely the debate in many countries on the appropriate benchmark.

This thesis will also set enumerate all the company income tax expenditures in China. While there has been discussion of particular concessions from time to time, this is the first instance in which all tax expenditures have been documented in one place.

1.2. Research Questions

Three main research questions for this thesis are as follows:

- Why Accounting Standards should be used as the benchmark to identify Chinese company income tax expenditures?
- What tax expenditures are revealed using this benchmark?
- What policy implications follow analysis of the tax expenditures?

1.3. Theoretical, Conceptual Framework& Analytical Techniques

This thesis adopts the conceptual framework used by western public finance systems and applies this theory to China's revenue system. Western governments have developed slightly different benchmark tax regimes to use as the base for identifying

tax expenditures. Rather than start from scratch to establish a benchmark system, this thesis uses the Chinese accounting standards as the benchmark. The principal advantage of using an "off the shelf" benchmark is that China can avoid the decades of theory development that western economies used to develop their benchmarks. Also, because the Chinese accounting standards are now known, all Chinese users of the thesis will be able to consider its conclusions and analysis without being distracted over debate about the benchmark. The chapter on the Chinese accounting standards shows that it yields a benchmark almost identical to that found across western economies.

The main objective of this thesis is to develop the first comprehensive tax expenditure budget for China, setting out all tax expenditures, including, as explained above, all tax expenditures deriving from non-statutory sources. The thesis will also show how the following stage of analysis, consideration of tax expenditures as spending programs, can be used.

There is no precedent for identifying tax expenditures in China. The thesis will identify tax expenditures by comparing the current law against a tax benchmark based on Chinese accounting standards. The outcome of each feature of the tax law will be compared to the outcome if accounting standards were applied to the same issue and deviations in the result will be subject to tax expenditure analysis. Each tax expenditure will be assigned a plausible rationale based on its effect when compared to the benchmark. This can be used as the basis for a later stage of tax expenditure analysis when individual measures are compared with the benefits or disadvantages of equivalent direct spending programs.

As explained in chapter 5, tax expenditures are the equivalent of a direct spending program, but carried out through the tax system. The process of tax expenditures analysis thus follows a three step process in chapter 7.

The first is to ask whether there is a case for government subsidies without regard to the form of the subsidy (that is, as a direct grant or as a tax expenditure). In a healthy market economy, the most efficient allocation of resources is presumed to follow the operation of the market -- players weighing the risks and potential returns from

alternative investments and consumers weighing up relative values before making investment or consumption choices. Governments normally intervene in the market to carry out a government function: redistribution, correcting a market failure, or supporting production or consumption that generates positive externalities (social benefits) not fully reflected in the market transaction. Redistribution may be achieved through direct assistance to lower income persons, the provision of goods or services such as education or health care to lower income persons, or tax savings directed at lower income persons. Market failures that require intervention are instances where features of the market prevent the efficient allocation of capital and the government intervenes to shift investment into the areas harmed by the market failure. For example, this could arise where the market cannot function freely because of a monopoly or because government regulation to achieve another benefit (e.g., prudential rules for banks to prevent bank failures) interferes with the market. Positive externalities are social benefits from investment that exceed the ordinary returns on investment or benefits of consumption. For example, the government might wish to support a loss-making enterprise that provides necessary training and skill-building in an area that cannot be taught except through actual involvement in production. Similarly, the government might think there are social or cultural benefits from supporting the production of cultural outputs (films, music, plays) that would attract such small minority audiences that they would be unprofitable without the subsidy.

The second step, assuming a case can be made for subsidising a type of investment or activity, is to ask whether the support can be delivered most efficiently by direct grant, by regulation, or by way of tax expenditures. There may be delivery benefits using tax expenditures to deliver subsidies -- no separate administration is needed to hand out the grants as the SAT can distribute the benefits in the course of calculating tax liabilities.

The third step, assuming a case can be made for subsidising a type of investment or activity and it is concluded the subsidy should be provided through the tax system, is to ask whether the design of the current subsidy is the most efficient. For example, if the aim of a subsidy is to assist particular start-up enterprises or loss-making enterprises, an additional deduction or an accelerated deduction or an exemption

would not be an efficient tax expenditure as it would not provide benefit to the intended beneficiaries and would provide windfall gains to enterprises that were not identified as in need of the subsidy.

1.4. The Structure and Main Body of the Thesis

This thesis is structured into 8 chapters, including chapter 1: Introduction and chapter 8: Conclusion. The main content and structure of other 6 chapters are described as follows:

(1) Chapter 2: A Short History of Tax Expenditure Research in China

This chapter reviews the progress that has been made to date in developing and promoting the tax expenditure concept in China. Developments fall into four broad periods. The first is the period from 1979 until 1993 when China opened the door to private enterprise and spun off each ministry's economic arms into state-owned corporatized entities. The adoption of income tax laws was matched by the adoption both in those laws and other laws, regulations and administrative instruments of a wide range of significant tax expenditures. Chinese scholars embarked on a steep learning curve to understand both tax principles and tax expenditure concepts and the first important literature on tax expenditures in China was published.

In the second period, from 1993 until 1999, China reformed its early tax efforts and adopted tax laws that in name, and to a lesser extent form, matched the basic tax laws of modern market economies – a personal income tax, an enterprise income tax and a value added tax. The new tax laws were replete with concessions but, ironically, as the number of tax expenditures grew, the volume of literature on the concept declined. The papers that were published in this period did help introduce more scholars and, importantly, government officials to tax expenditure budgets.

The third period from 2000 until the 2008 saw the quasi-official endorsement of tax expenditure analysis as a reform goal by the Deputy Minister of the Ministry of Finance and the closest China came to adoption of a tax expenditure budget.

This tax expenditure spring proved short lived, however, and in the final period, from 2009 to the present, the government has almost retreated from its limited interest in tax expenditure analysis as a tool of public finance and tax expenditure literature by academics and others who might potentially influence government tax policy has dried up almost completely.

(2) Chapter 3: The development of Chinese Enterprise Income Tax

The People's Republic of China (PRC) came into being on 1 October 1949. China has successively undergone three different economic systems since the establishment of the PRC, — (a) the traditional planned economy, (b) the planned commodity economy, and (c) the socialist market economy. Meanwhile, Chinese tax system was established gradually with the development of its economic system. The Chinese tax system has gone through multiple transformative stages, exhibiting different characteristics at each stage as a result of the interaction of the changing economic system of the time. Due to the differences of the economic systems at different stages, the taxpayer, tax rate tax items and effects of the tax system vary significantly at each stage.

This chapter provides an overview of the history of China's enterprise income tax from 1949 to present. This will be first started from the description of the period of income tax exemption for State Owned Enterprises (1950-1978). It then discusses the first stage: the early 1980s---concerning the foreign income tax system and the mid-1980s to late 1980s---the establishment of State Owned Enterprises income tax system. Later it outlines the second stage (1991-2007): two income tax systems. Finally, this chapter highlights the background of unification of enterprise income tax law (2008-present), summarizes and analyses its key changes of the new tax law.

(3) Chapter 4: The Evolution of Accounting Standards in Modern China

An accounting system that presents a fair and true picture of a firm's financial position is a feature essential to the success of a market economy. In the case of China, the development of accounting principles and the shift to a market economy did not occur in tandem. Adoption of a modern accounting system was delayed by

socialist officials' focus on accounting processes and failure to understand the importance of accounting principles. The understanding of modern accounting principles came only recently and in a number of respects China's accounting system remains somewhat out of synch with modern accounting regimes, though the gap is closing rapidly as Chinese accounting standards align more closely with International Financial Reporting Standards (IFRS) and more sectors of the economy are brought under Chinese Accounting Standards (CAS).

Accounting history falls into three periods which coincide with three phases of economic development in the period since the establishment of the PRC in 1949. The first, lasting from 1949 to 1978, was an orthodox socialist economic period. The second, stretching from 1978 until 1992, was a transitional period economy as the country gradually moved towards a market economy and invited foreign investment. The third period, from 1992 to date, has seen China shift formally to a "socialist market economy" based on a fully private market regulated by socialist leadership and containing significant corporatized state-owned enterprises.

(4) Chapter 5: The Tax Expenditure Concept and the importance of the "Benchmark"

While the primary purpose of a company income tax is to appropriate a portion of income derived by companies for the benefit of government expenditure, governments commonly also use the tax as an instrument of public policy to attain various economic, social, cultural and other objectives.

An income tax system whose sole purpose is to transfer a portion of income from the recipient to the state in a wholly neutral manner without influencing or biasing any aspect of the income earning process is known as a benchmark income. Deviations from the benchmark that might influence the way in which income is earned or the type of income sought by a taxpayer are known as tax expenditures.

This chapter provides a brief introduction to the concept of tax expenditures and identifies the importance of the benchmark. It begins by attempting to define tax expenditure then proceeds to discuss the development of tax expenditure reports. It includes an analysis on establishing the benchmark for the identification of tax

expenditures. It concludes by discussing key features of a tax benchmark and experiences of tax expenditure benchmarks.

(5) Chapter 6: Benchmark wars and the case for using International Accounting Standards as Tax Expenditures Benchmarks in China

Currently tax expenditures analysis is facing a challenge to improve its theoretical grounds and identification processes. One of the most striking features of tax expenditures analysis over the past 46 years is the breadth and depth of debate over the legitimacy of the concept itself. One obvious response to the criticism is to improve transparency of reporting by communicating the definitions and foundation of the analysis more openly and clearly.

Two sections are covered in this chapter:

Section 1: Forty-six Years' Debate over Tax Expenditures Baseline: Benchmark War

The most important part of the criticism is focused on the concept of a benchmark tax system .The plethora of papers that have been published since Stanley Surrey's ground breaking work in 1967 fall into three broad groups. The first comprises scholars who argue the income tax benchmark is so inherently uncertain that it can never be defined effectively, leaving no basis for identifying tax expenditures. The second group contains scholars who agree on the basic features of an income tax benchmark derived from a Schantz-Haig-Simons base but disagree on which deviations from this base are appropriate. The third group agrees a benchmark is possible but argues for completely different starting points for mapping out the benchmark.

Section 2: Other Reasons for China's Choice: Accounting Standards as Tax Expenditures

First, they measure annual net profit, which should align almost completely with a fully neutral tax base that only measures profits. It is relatively easy to identify the few instances in which accounting principles may deviate from this goal for purposes

particular to accounting. Second, they are internationally developed and are based on the best scientific thinking on the measurement of profits from around the world. Third, they have been refined into a single set of global standards, unlike the benchmarks used in tax expenditure budgets elsewhere, which vary from country to country. Fourth, they have already been developed, published and comprehensively explained. China has no tax expenditure budget and very limited expertise in the area. The process of analysing Chinese tax expenditures could be established much more quickly if China adopted an "off the shelf" model rather than attempt to develop its own benchmark from scratch.

(6) Chapter 7: Tax Expenditures Identified Using Accounting Standards as the Benchmark

This chapter summarises tax expenditures that have been identified by comparing outcomes under the Chinese Enterprise Income Tax Law with the results that follow from the application of CAS. As noted in chapter 4, CAS now aligns very closely with IFRS. While primary references are to CAS, cross references to IFRS are also included. If CAS and IFRS would yield different outcomes, the Chinese Enterprise Income Tax Law result is compared to both of the standards.

Some tax expenditures have been identified not by comparing the accounting treatment (used as the benchmark income tax) with the treatment under tax law but rather by comparing two different tax rules that apply to different types of companies or companies in different regions where the same CAS would apply to both – that is, CAS would not distinguish between enterprises on the basis of their type or location. Examples of tax expenditures that are identified in this way include lower tax rates for specified types of companies or for companies that are registered in and carry on operations in particular regions.

The tax expenditures identified comparing Chinese Enterprises Income Tax law with CAS fall into nine distinct groups.

The first group of tax expenditures comprises measures enacted to support particular types of industries. The second group of tax expenditures are intended to support

particular types of activities carried on by any companies. Tax expenditures in the third group are designed to assist disadvantaged businesses or individuals employed by companies subject to the enterprise income tax. The fourth group of tax expenditures includes concessions designed to encourage investment in particular regions of the country. Areas enjoying special concessions fall into two sets. The first are areas that were originally established to attract foreign investment to China. The second are areas that suffer from underdevelopment relative to more prosperous parts of the country.

The fifth group of tax expenditures has measures to support innovation, a goal thought to be necessary for China's future economic success. These concessions apply to all types of companies, all industries and all areas of the country. The sixth group of tax expenditures contains six concessions for interest income to subsidise borrowing costs for two types of debtors. The seventh group contains concessions to promote resident enterprises and non-resident enterprises, for those operating without a permanent establishment in China and for those operating through a branch (but not subsidiary) in China. The eighth group is non-profit organisations that satisfy the definition of an enterprise and thus fall under the Enterprise Income Tax Law. The final category is a transitional continuation of the preferential tax rate and tax exemption and deduction that applied to enterprises prior to 2008.

1.5. Sources of the Tax Law, Period and Translation

When China first adopted income tax, it distinguished between the individual income tax for income of natural persons from sources other than business and income from "enterprises". The latter group included both natural persons and legal persons carrying on business. The conventional distinction used in market economies between individuals and companies was not followed as officials were not concerned with the form of the entity carrying on business as much as the fact that someone or some entity was licenced to carry on an enterprise.

At the time of the merger in 2008 of the enterprise income tax law for wholly Chinese enterprises and the enterprise income tax law for joint ventures and enterprises with some foreign ownership, the conventional market economy

distinction was adopted and the combined enterprise income tax law only applied to enterprises carried on by legal persons. From that time, enterprises carried on by individuals were taxed under the individual income tax law.

Since 2008, therefore, the enterprise income tax is effectively a company income tax and it is common for translators to refer to the law in English as the company income tax. This thesis used the literal translation of the Chinese law, the Enterprise Income Tax Law but the references can be understood to refer to provisions that other writers might describe as sections of the company income tax law.

Source

The analysis which follows is based on four sources of tax law. The first is the Enterprise Income Tax Law and the second the Enterprise Income Tax Implementation Rules. The third are the Circulars issued by the Ministry of Finance and the State Administration of Taxation explaining the operation of the Enterprise Income Tax in particular circumstances. Commonly, circulars dealing with general issues are jointly issued by the MOF and SAT. Separately, regional offices of the SAT may issue circulars that deal with particular transactions or particular taxpayers. Both types of circulars were reviewed for this analysis. Other circulars may be jointly issued by the SAT, MOF and another ministry responsible for specific types of companies or activities that receive preferential treatment under the Enterprise Income Tax Law. For example, a circular dealing with an aspect of the tax law applied to high technology companies might be issued by the SAT, MOF and the Ministry of Science and Technology (MOST).

Finally, the study considers the effect of the transitional regulation enacted to provide direction for companies in 2008 in the course of migrating to the single Enterprise Income Tax Law from the separate laws previously applied to domestic companies and for companies with foreign ownership.

Period

The analysis is based on the Chinese Enterprise Income Tax Law in effect from 1

January 2008, as well as the accompanying Implementation Regulation and administrative practices (circulars) and interpretations as amended until 31 December, 2012.

The Enterprise Income Tax Law of the People's Republic of China (EITL) adopted at the 5th Session of the 10th National People's Congress of the People's Republic of China on March 16, 2007, was hereby promulgated and came into effect on January 1, 2008; Implementation Rules of the Enterprise Income Tax Law of the People's Republic of China (EITLIR), promulgated by Decree No.512 of the State Council of the People's Republic of China on December 6, 2007, effective on January 1, 2008.

Translations

The only official version of the Chinese law, implementing rules and circulars is the original Chinese version. The SAT provides a translation of the law and EITLIR on its website. These are provided for information purposes only and have no official status. Further translations have been made by international accounting firms and international tax information institutions such as the International Bureau for Fiscal Documentation. The translations sometimes differ significantly many versions, including the SAT versions, on occasion use literal dictionary translations of words or phrases that fail to capture accurately the meaning intended by the original Chinese text. English descriptions of these documents in this study are derived from all these sources with the final terminology chosen by the author on the basis of the most accurate reflection of the intended meaning.

1.6. The Source and Relative of the Accounting Standards

As discussed in chapter 4, CAS now aligns very closely with IFRS. While primary references are to CAS, cross references to IFRS are also included. The Chinese Accounting Standards related to the benchmark used to identify tax expenditures for the analysis in this thesis are as follows:

1.6.1. Revenue

The Basic Standard of CAS, Chapter 6: Revenue, which it is similar to the IFRS: Framework.

Under Article 30 of Basic Standard in CAS, Revenue is the gross inflow of economic benefits derived from the course of ordinary activities that result in increases in equity, other than those relating to contributions from owners.

Article 31 states that Revenue is recognised only when it is probable that economic benefits will flow to the enterprise, which will result in an increase in assets or decrease in liabilities and the amount of the inflow of economic benefits, can be measured reliably.

An item that satisfies the definition and recognition criteria of revenue shall be included in the income statement (Article 32).

1.6.2. Expenses

The Basic Standard of CAS, Chapter 7: Expenses, which it is similar to the IFRS: Framework.

Article 33 of Basic Standard in CAS confirms Expenses are the gross outflow of economic benefits resulted from the course of ordinary activities that result in decreases in owners' equity, other than those relating to appropriations of profits to owners.

Article 34 states Expenses are recognised only when it is probable there will be outflow of economic benefits from the enterprise which result in a reduction of its assets or an increase in liabilities and the amount of the outflow of economic benefits can be measured reliably.

Article 35 directly attributable costs, such as product costs, labour costs, etc. incurred by an enterprise in the process of production of goods or rendering of services shall

be recognised as cost of goods sold or services provided and are charged to profit or loss in the period in which the revenue generated from the related products or services are recognised.

Where an expenditure incurred does not generate economic benefits, or where the economic benefits derived from expenditure do not satisfy, or cease to satisfy, the recognition criteria of an asset, the expenditure shall be expensed when incurred and included in profit or loss of the current period.

Transactions or events occurred which lead to the assumption of a liability without recognition of an asset shall be expensed when incurred and included in profit or loss of the current period.

Article 36 confirms an item that satisfies the definition and recognition criteria of expenses shall be included in the income statement.

1.6.3. Intangible Assets

No.6 Intangible Assets in CAS is similar to International Accounting Standards (IAS) 38, Intangible Assets.

Under Article 3 of No.6 Intangible Assets in CAS, Intangible Assets is an identifiable non-monetary asset without physical substance owned or controlled by an enterprise. The expenditure on R&D is fallen into the category of intangible assets.

Definition and scope of R&D expenses

CAS No.6 Article 7 states that expenditure on an internal research and development project shall be classified into expenditure on the research phase and expenditure on the development phase.

Research Phase

Under Article 2(1) in Chinese Accounting Standard Implementation Guidance (CASIG) for Business Enterprises No. 6 – Intangible Assets, Research phase is of exploratory nature, and involves information research and other related activities conducted in preparation for any further development activities. Significant uncertainties exist as to whether the research activities conducted will advance into the development phase and whether any development activities will result in an intangible asset being recognised.

Examples of research activities are: activities aimed at obtaining knowledge; the search for evaluation and final selection of applications of research findings or other knowledge; the search for alternatives for materials, devices, products, processes, systems or services; the formulation, design, evaluation and final selection of possible alternatives for new technology.

Development Phase

Under Article 2(2) in CASIG, In contrast with the research phase, the development phase involves activity conducted after the research phase is completed, and to a much greater extent the basic conditions for generating a new product or technology are satisfied.

Example of development activities are: The design, construction and testing of pre-production and pre-use prototypes and models; the design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production.

Accounting treatment of R&D expenses

Articles 8 and 9 of the Standard also state that, expenditure on the research phase of an internal research and development project shall be recognised in profit or loss in the period when it is incurred. Expenditure on the development phase shall be recognised as an intangible asset only when all five conditions are satisfied. (I) it is technically feasible to complete the intangible asset so that it will be available for use

or sale (2) the enterprise has the intention to complete the intangible asset and use or sell it. (3) The enterprise can demonstrate the ways in which the intangible asset will generate economic benefits. (4) The enterprise can demonstrate the availability of adequate support of technical, financial and other resources to complete the development and the ability to use or sell the intangible asset. (5) Expenditure attributable to the intangible asset during its development phase can be reliably measured (CASIG, Article 3).

Articles 17 and 19 of the Standard also state that an intangible asset with a finite useful life shall be amortised, whereas an intangible asset with an indefinite useful life shall not be amortised (CASIG, Article 3).

Accounting treatment: an intangible asset with an indefinite useful life shall not be amortised. Tax law: no

1.6.4. Fixed Assets

No. 4 Fixed Assets in CAS is similar to IAS 16, Property, Plant and Equipment.

Under Article 3 of No. 4 Fixed Assets in CAS, Fixed assets are tangible assets that:

(1) are held for use in the production or supply of services, for rental to others, or for administrative purposes; and (2) have useful lives more than one accounting year.`
Useful life is the period over which an asset is expected to be available for use by an enterprise; or the number of units of production or service expected to be obtained from the asset by an enterprise (Article 3).

Under Article 4, fixed assets shall be recognised only when both of the following conditions are satisfied: (1) it is probable that economic benefits associated with the asset will flow to the enterprise; and (2) the cost of the asset can be measured reliably.

In Article 14, an enterprise shall provide depreciation for all its fixed assets other than fully depreciated fixed assets that are still in use and land that is separately valued and accounted for. Depreciation is the systematic allocation of the depreciable

amount of a fixed asset over its useful life using a selected depreciation method

In Article 17, an enterprise shall reasonably select the depreciation method to be applied to a fixed asset based on the pattern in which the asset's economic benefits are expected to be realized. Depreciation methods that may be applied include the straight-line method, the units of production method, the double declining balance method and the sum-of-the-digits method. Once the depreciation method is determined, it shall not be changed arbitrarily. However, a change to the depreciation method shall be made if required under Article19 of this Standard. An enterprise shall review the useful life and estimated net residual value of a fixed asset.

Under Chapter 1, No. 4 – Fixed Assets in CASIG, Depreciation of a fixed asset shall be provided for monthly. For a newly acquired fixed asset, depreciation commences in the month following the acquisition, i.e.no depreciation is provided for in the month of acquisition. For a fixed asset disposed of, deprecation is still provided for in the month of disposal and no further depreciation is provided for thereafter.

No further depreciation is provided for in respect of a fully depreciated fixed asset (whether or not it is still in use) or an early retired fixed asset. A fixed asset is "fully depreciated" when full provision has been made against its depreciable amount. Depreciable amount is the original cost of a fixed asset less its estimated net residual value and accumulated impairment losses (if provision for impairment losses has been made for the fixed asset).

1.6.5. Biological Assets

No.5 – Biological Assets in CAS is similar to IAS 41 Agriculture.
According to Article 2 and 4 of No.5 – Biological Assets in CAS, Biological assets refer to living animals and plants, agricultural production of the harvest shall apply to CAS, No. 1 – Inventories, shall apply to the agricultural production of the harvest.

In Chapter 1, Biological Assets in CASIG, Biological Assets and Agricultural produce, Agricultural activities dealt with in the Standard include crop farming, raising livestock, forestry, and aquaculture. Agricultural produce is closely

interrelated with biological assets. When agricultural produce is still attached to a biological asset, it is an integral part of the biological asset. Upon separation from the biological asset, harvested agricultural produce ceases to be living and loses ability of biological transformation, or its life process and ability of biological transformation are limited, and it should be treated as inventories. Examples of agricultural produce are lumbers from timber stands, milk from dairy cattle, wool from lambs, pork from pigs, harvested vegetables, fruits from trees, etc.

1.6.6. Employee Benefits

No.9 – Employee Benefits in CAS is similar to IAS 19 Employee Benefits.

Under Article 2 and 4 of No.9 – Employee Benefits in CAS, Employee benefits are all forms of consideration given and other relevant expenditures incurred by an enterprise in exchange for service rendered by employees. Employee benefits include:

(1) employee wages or salaries, bonuses, allowances and subsidies;
(2) staff welfare;
(3) social security contributions such as premiums or contributions on medical insurance, pensions, unemployment insurance, work injury insurance and maternity insurance;
(4) housing funds;
(5) union running costs and employee education costs;
(6) non-monetary benefits;
(7) compensation to employees for termination of employment relationship; and
(8) other expenditures incurred in exchange for service rendered by employees.

In the accounting period in which an employee has rendered service to an enterprise, the enterprise shall recognise the employee benefits for that service as a liability. Chapter 2 of No.9 – Employee Benefits in CASIG confirms that in the accounting period in which an employee has rendered service to an enterprise, the employee benefits to be recognised (including both monetary and non-monetary benefits) shall be charged to the cost of relevant assets or profit or loss for the current period according to the purpose of the employee service, and at the same time shall be

recognised as employee benefits payable, except for compensation for termination of employment relationship with employees (hereinafter referred to as "termination benefits").

1.6.7. Consolidated Financial Statements

Under No. 33 of CAS, Consolidated Financial Statements, it is similar to IAS 27, Consolidated and Separate Financial Statements.

Section 3 Consolidated Cash Flow Statements

Article 25 the consolidated cash flow statement shall be prepared in accordance with the following requirements:

(1) Cash flows resulted from investments during the period (i.e. capital contribution by cash or acquisition of additional shares) between the parent and its subsidiaries or between subsidiaries shall be eliminated.

(2) Cash receipts from intragroup investment income (between the parent and its subsidiaries or between subsidiaries) shall be eliminated against [the corresponding] cash payments in respect of dividends, distribution of profits or interest.

Chapter 2 A Short History of Tax Expenditure Research in China

2.1. Introduction

The tax expenditure concept dates back more than a century[1] and following the adoption of tax expenditure budgets in the U.S. and Germany in the late 1960s, use of tax expenditure accounting and analysis has become commonplace in most OECD countries and in many other nations, particularly for income tax laws.

Tax expenditure analysis of income tax laws compares a country's actual income tax law with a hypothetical benchmark tax that would measure profits in an economic sense. The central feature of the benchmark tax base is its neutrality, which it achieves by applying to profits without regard to how they were derived. Under tax expenditure analysis, any tax lost due to concessional measures (such as lower rates, industry and enterprise-specific tax holidays, accelerated write-offs, deferred recognition of gains, and so on) is treated as if it had been collected and then distributed back to the taxpayers who reduced tax by virtue of the concessions.

The tax forgone is labelled tax expenditure[2] and the notional outgoing is treated as the equivalent of a direct expenditure. In more recent times, tax expenditure analysis has been supplemented by the further concept of negative tax expenditures which represents measures in the tax law such as the denial of deductions for bribes or fines incurred in the course of a business that cause taxpayers to bear tax burdens greater than the tax that would have been imposed under the neutral benchmark base.[3]

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[1] Gladstone attempted to have the company income tax apply to charities in the UK in 1863, he adopted in his parliamentary address a classic tax expenditure analysis – see Neil Brooks, Book Review: S S Surrey and P R McDaniel, *Tax Expenditures* (1986) 34 *Canadian Tax Journal* 68.

[2] The terms is usually attributed to Stanley Surrey, a Harvard Law School professor who developed the first accounting of tax expenditures in the United States in 1967-68 while serving as assistant secretary of the US Treasury – see Neil Brooks, Jinyan Li, and Lisa Philipps, 'Tax Expenditure Analysis: State of the Art', in Neil Brooks, Jinyan Li and Lisa Philipps (eds), *Tax Expenditures: State of the Art* (Canadian Tax Foundation, Toronto, 2011)1:1 at 1:3. The term entered widespread use following Surrey's 1970 publication of 'Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures' (1970) 83 *Harvard Law Review* 705 and the publication three years later of his seminal treatise, *Pathways to Tax Reform: The Concept of Tax Expenditures* (Harvard University Press, Cambridge, MA, 1973).

[3] Australian tax expenditure statements use this term.

On its face, the rapid spread of tax expenditure reporting has had a limited impact on the proliferation of tax concessions. However, it would do the tax expenditure concept a disservice to suggest that tax expenditure reporting has been a failure because it has not succeeded in halting the introduction of new concessions. While governments continue to see tax concessions as equal or superior to direct expenditures as a means of subsidizing chosen sectors, taxpayers or activities, the transparency of government support resulting from tax expenditure reporting has had a sometimes significant effect on the design of tax concessions. In many instances, inequitable and inefficient concessions have been replaced by fairer and better targeted tax measures while new concessions in jurisdictions with tax expenditure analysis tend to be tightly drafted to ensure the expenditures generate the highest return of desired behaviour for the notional outgoings.

The most important economic power without any tax expenditure reporting is China. The absence of tax expenditure budgets in China is particularly significant given the country's remarkable reliance on tax expenditures as a tool for promoting economic behaviour. Following the death of Mao Zedong, the world's largest socialist state began a shift over the course of more than three decades, first to a "socialist market economy" and then a quasi-market economy dominated by corporatized and in many cases partly privatized state-owned enterprises. The corporatization of state firms and the emergence of privately owned businesses were accompanied by a shift in policy that saw the government derive its revenue not from the appropriation of state enterprise profits, but from the taxation of both privately-owned and state-owned enterprises.

From the beginning, however, the tax system was riddled with tax expenditures – indeed, concessions often outnumbered substantive revenue raising rules as China sought to use tax expenditures as an inducement to attract foreign investors who, at the time, were wary of investment in the country that only a few years earlier had promoted its cultural revolution with vigor.[4]

[4] Jinyan Li, 'The Rise and Fall of Chinese Tax Incentives and Implications for International Tax Debates' (2007) 8 *Florida Tax Review* 669. The paper suggests the Chinese government deliberately used concessions to help overcome foreign investors' fears of investing in China in the initial opening of the economy.

The absence of tax expenditure reporting in China and the consequent dearth of critical analysis of the effectiveness and cost of tax incentives and concessions is surprising given the probable magnitude of these indirect expenditures. In a remarkably short time, Chinese Ministry of Finance (MOF) officials have absorbed and applied in an increasingly sophisticated manner the fundamentals of modern public finance. Within the past decade, China has moved from a relatively rudimentary socialist accounting and bookkeeping regime to adopt accounting standards that largely align with international financial reporting standards.[5] Its income tax system is similar to that of many economies[6] and it is in the process of consolidating its indirect taxes into a modern VAT.[7] The obvious gap in the move to a more developed market economy, public finance system is the continued absence of tax expenditure reporting.

As in all jurisdictions, there are vested interests that will strongly resist the adoption of tax expenditure reporting – take for example the many ministries whose industries are subsidized through tax expenditures that must come out of the Ministry of Finance budget rather than being appropriated from their departmental budgets, as direct expenditures would entail. The large state-owned enterprises and private sector groups on the receiving end of the most costly tax expenditures will also seek to stall indefinitely the adoption of a system that would measure and expose the value of subsidies they receive through tax expenditures. Another issue – which doubly serves as an explanation for the lack of formal and even informal tax expenditure reporting in China – is the very limited role of lawyers in the tax policy debate in China and, in particular, in the push for the adoption of transparent tax expenditure accounts. The idea that tax expenditure identification and analysis should be part of a government's budget program was pushed primarily by lawyers, usually tax lawyers,

[5] World Bank, *Report on the Observance of Standards and Codes (ROSC) – Accounting and Auditing: People's Republic of China* (World Bank, Washington, DC, 2009).

[6] Jinyan Li, 'Fundamental Enterprise Income Tax Reform in China: Motivations and Major Changes' (2007) 61(12) *Bulletin for International Fiscal Documentation* 519.

[7] China currently has separate taxes on the sale of goods and services. These will be merged into a single value added tax (VAT) following a decision in 2011 of the executive committee of the State Council, the executive body that roughly aligns with a cabinet in western countries. The merger of the two taxes is being accomplished through administrative announcements rather than legislative amendment. The process commenced with two "circulars" issued by China's Ministry of Finance and the State Administration of Taxation (SAT, the revenue authority): Caishui [2011] 110 (Circular 110) - Notice on the Introduction of the Pilot Scheme to Convert Business Tax to VAT and Caishui [2011] 111 (Circular 111- detailed implementation), they releases By MOF and SAT on 16 November 2011effective from 1 January 2012.

concerned about the transparency of government spending programs and the importance of spending tax revenues in the most efficient manner.[8] In contrast, not a single item on tax expenditures in China reviewed in this paper has been drafted by a lawyer.

This article reviews the progress that has been made to date in developing and promoting the tax expenditure concept in China. Developments fall into four broad periods. The first is the period from 1979 until 1993 when China opened the door to private enterprise and spun off each ministry's economic arms into state-owned corporatized entities. The adoption of income tax laws was matched by the adoption of a wide range of tax expenditures, both in those laws and other laws, regulations and administrative instruments. Chinese scholars embarked on a steep learning curve to understand both tax principles and tax expenditure concepts, and the first important literature on tax expenditures in China was published.

In the second period, from 1993 until 1999, China reformed its early tax efforts and adopted tax laws that in name, and to a lesser extent form, matched the basic tax laws of modern market economies – a personal income tax, a company income tax and a value added tax. The new tax laws were replete with concessions but, ironically, as the number of tax expenditures grew, the volume of literature being written on the concept declined. The papers that were published in this period did help introduce more scholars and, importantly, government officials to tax expenditure budgets.

The third period from 2000 until 2008 saw the quasi-official endorsement of tax expenditure analysis as a reform goal supported by the Deputy Minister of the

[8] The US tax expenditure budget was created at the direction of Stanley Surrey, a Harvard Law School professor – see above n 2. Almost all the extensive literature on tax expenditures in the U.S. has been drafted by lawyers. The first attempt at a tax expenditure budget in Canada was prepared by an economist, but under the auspices of the Canadian Tax Foundation, a professional organisation dominated by Canada's tax lawyers – see Roger S Smith, *Tax Expenditures: An Examination of Tax Incentives and Tax Preferences in the Canadian Federal Income Tax System*, Tax Paper No 61 (Canadian Tax Foundation, Toronto, 1979). A conference of international experts organized by Neil Brooks, a tax professor at Osgoode Hall Law School, and extensive coverage in the tax policy journal edited by Professor Brooks, *Canadian Taxation*, played an important role in prompting the adoption of the first tax expenditure budget in Canada. The first tax expenditure budget in the UK was prepared by economists under the auspices of the independent Institute of Fiscal Studies – see JRM Willis and P Hardwick, *Tax Expenditures in the United Kingdom* (Heinemann, London, 1978). The first official report in Australia to characterize tax concessions as concealed subsidies that could be given overtly was a government appointed tax law review committee headed by a judge – see Taxation Review Committee (K W Asprey, chair), *Full Report* (1975)11.

Ministry of Finance, and it was the period in which China came the closest to adopting a tax expenditure budget.

This tax expenditure spring proved to be short lived, and in the final period, from 2009 to the present, the government has retreated entirely from its limited interest in tax expenditure analysis as a tool for public finance, and tax expenditure literature written by academics and others who might potentially influence government tax policy has dried up almost completely.

2.2. Early Stage: 1979 - 1993

In 1980, two years after the key meeting at which the Central Committee of the Communist Party of China resolved to build national wealth by shifting China from orthodox socialism to a 'socialist market economy', the National People's Congress adopted modern China's first personal income tax law[9] and a company income tax for enterprises involving foreign capital.[10] The following year the Ministry of Finance began to treat profit appropriations from state owned enterprises as if they were tax obligations[11] and in 1983 the Ministry of Finance adopted by way of administrative regulation a rudimentary income tax for state-owned enterprises.[12] Replacement regulations issued in 1984 consolidated the complex rules in the first regulation into a single "tax".[13] This was followed in 1985 by an income tax for collective enterprises,[14] and in 1988 by an income tax for private domestic enterprises.[15]

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[9] Individual Income Tax Law of the People's Republic of China (promulgated by the National People's Congress (NPC) 10 Sept. 1980, effective 10 Sept. 1980).

[10] Enterprise Income Tax for Sino-Foreign Joint Ventures (promulgated by the NPC 10 Sept. 1980, effective 10 Sept. 1980. While these first jointly owned enterprises were labelled 'joint ventures', they were in fact effectively separate entities akin to companies, although technically there was no company law yet in effect. The income tax law applying to foreign-owned enterprises was later translated as the Foreign Investment Enterprise Income Tax.

[11] Tinggang Lu and Jiliang Yang, 'Profit Distribution and Tax Reform in China' (1987) 13 *International Tax Journa l* 65.

[12] Experimental Provisions on Substituting Profits for Tax in State-Owned Industrial Enterprises (promulgated by the State Council, 24 April 1983, effective 1 January 1983).

[13] Regulations on State-Owned Enterprise Income Tax of the People's Republic of China (draft) (promulgated by the State Council, 18 Sept. 1984, effective 1 Oct. 1984); Experimental Provisions on the Second Step Scheme of Substituting Profits for Tax in State-Owned Industrial Enterprises (promulgated by the State Council, 18 Sept. 1984, effective 1 Oct1984); Provisions on the Collection of Adjustment Tax in State-Owned Industrial Enterprises (promulgated by the State Council, 18 Sept. effective 1 Oct. 1984).

[14] Provisional Regulations on Collective Enterprise Income Tax of the People's Republic of China (promulgated by the State Council, 11 April1985, effective 11 April 1985).

In line with inherited socialist presumptions that the state should direct investment decisions, the national government viewed taxation as being two sets of complementary rules comprising both measures to raise revenue and concessions to attract investment and influence investment decisions. Tax expenditures were thus seen by governments as an integral element of a tax system, not a departure from a neutral normative tax base. The income tax law for foreign enterprises was replete with tax concessions including generous tax holidays for enterprises that exported more than 70% of their output or that produced high technology products. Most significantly, however, was the establishment in 1980 of three "special economic zones (SEZs)" in Guangdong Province, next to Hong Kong and a fourth in Xiamen, located in Fujian Province across the Taiwan Strait, with the power to establish local economic laws that differed from national laws. Local governments in other parts of the country sought to establish similar zones, and after a few years the central government agreed to designate 14 coastal cities as the homes of "Development Zones" entitled to similar powers.[16] Seeking to boost foreign investment in these zones, particularly from Hong Kong, Macau and Taiwan, in 1984 the State Council enacted generous exemptions and reductions for companies operating in the SEZs and eligible coastal cities, concessions that were extended to Chinese-owned enterprises operating in these areas.[17]

The revenue cost of the tax expenditures was huge. Subsequent studies by academics put the figure between 10% of revenue collected under the income tax[18] and more than 100% of the amount collected.[19] As one critic noted, these estimates did not

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[15] Provisional Regulations on Private Enterprise Income Tax of the People's Republic of China (promulgated by the State Council, 25 June 1988, effective 25 June 1988).

[16] The fourteen cities were Tianjin, Shanghai, Dalian, Qinhuangdao, Yantai, Qingdao, Lianyungang, Nantong, Ningbo, Wenzhou, Fuzhou, Guangzhou, Zhanjiang, and Beihai. See Jinyan Li, 'The Rise and Fall of Chinese Tax Incentives and Implications for International Tax Debates' (2007) 8 *Florida Tax Review* 669.

[17] Provisional Regulations of the State Council of the People's Republic of China regarding the reduction of and exemption from Enterprises Income Tax and Consolidated Industrial and Commercial Tax in the Special Economic Zones and the fourteen coastal cities. (Promulgated by the State Council, 15 Nov 1984, effective 1 Dec. 1984).

[18] Jiansuo Lu, 'A Brief Discussion on the Sources of and Preventive Measures for Tax Revenue Loss' (1999) 9 *Taxation Research* 61-64.

[19] Guoqiang Ma, 'China's Current Tax Expenditure System: Issues and Policy Options 'in Hana Polockova Brixi, Christian MA Valenduc and Zhicheng Li Swift , *Tax Expenditures – Shedding Light on Government Spending through the Tax System,* (The World Bank, Washington DC, 2004) 190-202 at 196.

include the dead weight losses from additional compliance and administrative costs related to the concessions.[20]

The broad scope of concessions operating in the income tax system was noted in a paper on tax principles by Professor Daying Ma from Dongbei University of Finance and Economics; a work that became a foundation paper on tax expenditures, and that has been subsequently cited by numerous scholars.[21] Although the tax expenditure concept is mentioned only briefly in the paper, the subject of which is taxation in general, the respect and recognition accorded the paper is well-deserved. This was the first paper in China to recognize a tax concession as the equivalent of expenditure and to note how these expenditures escape scrutiny as off-budget outlays. Importantly, Professor Ma developed this sophisticated understanding of tax expenditures apparently without knowledge of the western literature on the subject. This early understanding of tax expenditures was limited to the tax rebates or direct refunds of part of enterprises' tax liability, a policy adopted by a number of provincial governments to subsidise local enterprises.

The first Chinese paper to consider western approaches to tax expenditures was published in 1986 by Tiejun Wang and Qingwang Guo.[22] The paper was based on the work of Stanley Surrey, the Assistant Secretary of the U.S. Treasury who developed the American tax expenditure reporting system in the 1960s, and adopted Surrey's definition of tax expenditures, setting out the various forms that tax expenditures could take, such as deductions, exemptions, reduced rates, and credits in addition to the direct rebates of tax discussed in the first work. They showed how tax expenditures might be used to subsidise or support particular industries, activities, or classes of persons and understood that tax expenditures were a substitute for alternative subsidies by way of direct grants, loans, or other forms of government assistance. The authors called for the comprehensive study of tax expenditures in China, as had occurred in many Western societies, and for the adoption of systems of tax expenditure reporting in order to measure the cost of tax expenditures and provide

[20] Zhiyuan Li, 'Building a Tax Expenditure System Suitable for China' (2006) 3 *Taxation Research* 40-42 at 41.
[21] Daying Ma, 'A Brief Discussion on the Nature of Tax and its Distribution Principles' (1984) 5 *Financial and Economic Issues* 52 at 59.
[22] Tiejun Wang and Qingwang Guo, 'Tax Expenditure and Controlling' (1986) 4 *Foreign Economics and Management* at 18.

the basis for controlling that cost by reduction of tax concessions. However, as is the case with much Chinese scholarship, the authors left room for the idea of limitations of tax expenditure analysis with the suggestion that any tax expenditure analysis carried out in China need be tempered by the special Chinese conditions. The phrase is a common euphemism for wriggle room to accommodate the interests of the Communist Party.

A call for tax expenditure reporting to become a budget tool followed two years later when two academic scholars Jinwu Zhang and Shouyni Qi explored the potential for tax expenditure reports as a control mechanism to limit the adoption of tax concessions and preferences.[23] The company income tax system adopted in 1983 had proved to be a somewhat inefficient revenue source. The legislation provided only a framework for the tax and most of the operative provisions came through secondary regulations and quasi-binding interpretative rulings. The wide range of concessional deductions and exemptions embedded in the subsidiary materials left to the tax base a fraction of actual profits. Looking at the wide gap between actual revenues collected and the potential revenue from a base without concessions and preferences, Zhang and Qi explained how tax expenditure analysis could be used to reinforce the tax base by controlling concessions. As with their predecessors, they were careful to adopt the standard politically-motivated proviso, indicating that any system adopted should incorporate Chinese characteristics.

These leading works were supplemented in this period by a growing library of articles, short monographs, and collected seminar papers discussing various aspects of tax expenditures. The inclusion of two tax expenditure themes in the 1989 national conference of the Chinese Taxation Institute – a research arm of the State Administration of Taxation (the national revenue authority) – brought government bodies into the debate for the first time. The conference looked at tax expenditure theory and reporting practice in western countries and whether western experience in using tax expenditure analysis to control the growth of tax concessions held any lessons for China.

[23] Jinwu Zhang and Shouyin Qi, 'A Discussion on Budget Control of Tax Preference' (1988) *1 Public Finance Research* 36-39. This journal is one of the most influential journals in China.

The prominence given to tax expenditures at the Chinese Taxation Institute conference revealed that tax expenditures (and the revenue loss they caused) had become a concern of the central government. The conference helped to stimulate a rash of publications on tax expenditure theory and the design and possible use of tax expenditure reports,[24] including two books that proved to be particularly influential, *A Brief Introduction to Tax Expenditures*[25] by Qinwang Guo, a leading academic based in Beijing, and *Theory and Practice of Tax Expenditures*, drafted by the Tax Science Research Institute of the State Administration of Taxation.[26]

The important contribution of Guo's book was the first list of tax expenditures in China, which he organized using the same budget classifications as were used for direct expenditures in the annual budget. His book mentioned two methods for measuring the impact of tax expenditures: revenue loss as a result of each concession (the standard method used in western tax expenditure accounts) and a second method he described as the "performance factor adjustment method", though what this might actually entail was obscure. Guo's book also explained how tax expenditure analysis treating each tax concession as the equivalent of a direct expenditure grant could be used to increase the efficiency of tax preferences through micro-managing their design.

The second book was a digest of translated materials on tax expenditure theory and practice in the 1980s. The materials included descriptions of tax expenditure theory, and an overview of systems used to identify tax expenditures. The translated materials revealed the fact that there was no unanimity among western governments on the normative benchmark base to be used to identify preferences. Sample tax expenditure lists based on the tax expenditure reports of six OECD countries were included as well as a Tax Expenditure Report in the appendix, prepared by the OECD

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[24] See, e.g., Zhongyi Su, 'Research on Methods to Calculate and Classify Tax Expenditures' (1992) 2 *Taxation Research* 34-38; Ziji Deng, 'Theory and Practice of Tax Expenditures'(1991) 1 *Taxation Research* 57-62; Peiyong Gao, 'Some Issues about Tax Expenditures' (1991) 1 *Taxation Research*62-66; Guibin Zhang and Yi Kai, 'Using Tax Expenditure Theory to Improve the Country's Tax Deduction System' (1992) 2 *Taxation Research*38-41; Miao Ding, 'An Analysis of the Application of Tax Expenditure Theory in China Compared with Tax Expenditure Practice in the United States' (1991) 2 *Taxation Research*14-19.

[25] Qinwang Guo, *a Brief Introduction to Tax Expenditures* (Dongbei University of Finance and Economics Press, Dalian, 1990).

[26] The Tax Science Research Institution of State Administration of Taxation, *Theory and Practice of Tax Expenditures* (*Chinese Economy & Management Publishing House*, Beijing, 1992).

Financial Affairs Council in 1984. The book proved to be an important foundation for much that was subsequently written on tax expenditures in China – indeed, a significant portion of later writing was in essence merely a reporting of aspects of the book's contents.

While papers on tax expenditures published during this period demonstrated a basic understanding of tax expenditures, the discussion was often superficial and simplistic. Papers copied the conclusions of western literature, noting tax expenditures were the equivalent of direct government expenditures used as tools to achieve social or economic objectives, but demonstrated no appreciation of the intellectual framework for tax expenditure analysis. With a limited understanding of tax policy theory, scholars were unable to apply the conceptual methodology upon which western tax expenditure analysis was built. There was confusion, for example, about the benchmark base that might be used to identify tax expenditures. This led to odd conclusions such as the assertion that some tax concessions were not tax expenditures. Ironically, in many cases the scholars' intuition was correct – the identified features were not tax expenditures but neither was they concessions.[27]

Overall, the period saw many papers advocating tax expenditure reporting as a useful tool for controlling the proliferation of tax expenditures, but none set out a program for establishing a tax expenditure budget system.

2. 3. A Period of Theoretical Development: 1993 -1999

The first decade of economic progress as China shifted to a market economy and the government became more reliant on taxation was a period of rapid learning and of growing political strains as the central government and provincial governments

[27] An example is the assertion by Jinwu Zhang that the rebate of VAT on imported goods by some businesses was a concession but not tax expenditures. A benchmark VAT system uses a system of refundable credits to remove all VAT burden from businesses so the tax will act as a tax on final consumption. At the time, China denied businesses any recovery of VAT paid on many types of acquisitions, including imports of capital equipment such as machinery. In the context of the Chinese VAT system in effect at the time, the rebate of VAT on specified imports appeared to be a concession. But, as Zhang correctly assumed, it was not tax expenditures because the true benchmark VAT would provide a rebate or credit for import VAT. Zhang did not articulate any of this, however – he simply asserted (correctly, as it turns out, but on the basis of intuition rather than any scholarly analysis) that the limited rebates of import VAT for selected industries was not tax expenditures. See Jinwu Zhang, *Construction Research on Chinese Tax Expenditure System* (People Publishing House, Beijing, 2008) 38.

sparred over the allocation of tax revenues that replaced revenue appropriations from both provincially-owned and centrally-owned enterprises. Protracted negotiations and concessions led to compromise reforms in 1993, which came into effect in 1994 that saw a complete overhaul of the tax system.

There were two limbs to the tax reform agreement entered into by the provincial and national governments. The first involved changes to the tax laws. The collection of domestic enterprise income tax laws were consolidated into a single new regulation for domestic enterprises and the personal income tax law was amended substantially. Concessions remained in the new domestic enterprise income tax and personal income tax. At the same time, the consumption tax system was overhauled with the adoption of a VAT applied to the sale of goods and a turnover tax called the "business tax" applied to the supply of services. Both laws were enacted with a wide range of concessions including a concessional low rate in the VAT for many types of supplies.

The second limb comprised a complete overhaul of the tax administration system. The central tax authority, the SAT, was dissected into two arms and parallel authorities were established in each province with the central government responsible for one office and the provincial government for the other. While all income taxes and the VAT were levied under the authority of central government law, authority for assessing different types of taxes was divided between the two governments and differing proportions of some taxes were paid over to the provincial governments. In particular, provincial tax offices were responsible for administering the business tax and income tax payable by all companies other than foreign owned enterprises and enterprises owned by the central government.

By western standards, the tax laws were very skeletal, setting out some general principles but leaving most of the detail to be filled in through subordinate regulations enacted by the central government executive and, more significantly, rulings known as "circulars" released by the national or local offices of the SAT and provincial tax authorities. A proliferation of circulars followed, along with an expansion of varied tax concessions as regions competed with one another to attract domestic and foreign investment.

The central government became increasingly concerned as the revenue leakage from concessions created by provincial governments grew until finally, in 1998, the central government executive (the State Council) issued circular forbidding provincial tax authorities from providing any relief from tax through concessions.[28] The measure contained no sanctions or enforcement mechanism, however, and the circular proved to have limited impact on the continuing widespread adoption of concessions by provincial authorities. Estimates of the revenue loss ranged from 10%[29] of GDP to 17% of GDP.[30] The government costed 100 significant tax concessions (a World Bank study suggested there may have been well over 1000 in existence[31]), but the estimates were never made public.

The proliferation of tax expenditures was not mirrored by a growth of academic papers on the subject. In fact, as the number of concessions grew in the 1990s the number of research papers on tax expenditures declined, although the quality of the papers improved remarkably as debate became more rational, systematic and thorough. The focus of research during this period was centered on the establishment of a tax expenditure reporting system in China. The leading work was authored by a researcher at the Tax Science Research Institute of the State Administration of Taxation, Xinyi Liu. The volume, The Analysis of Tax Expenditure,[32] was the product of 12 years of research and was perhaps the first work in China to explain tax expenditure theory in terms of the actual law in effect in China. Rather than merely repeating explanations of tax expenditure theory from western publications, Liu set out to catalogue key tax expenditures across all the taxes in China and provided quantitative measurements of the revenue impact of many tax expenditures. Chapters to the book included a translation of parts of the tax expenditure budget prepared by the US Treasury and, for the first time in China, a tentative, and very limited, tax expenditure report for China.

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[28] State Council, 'Notice on Strengthening Levying the Tax by Law according to the Strict Tax Administration Privileges' (Guo Fa [1998] No. 4), issued and effective on 6 April 1998.
[29] Jinwu Zhang and Shouyin Qi, 'A Discussion on Budget Control of Tax Preferences' (1988) 1 *Public Finance Research*, 36-39 at 36.
[30] Song Zhang, 'The Establishment and Improvement of Tax Expenditures Budget Management Systems' (1992) 2 *Jilin Institute of Finance and Trade Journal* at 33.
[31] Zhicheng Li Swift, 'Managing the Effects of Tax Expenditures on National Budgets' (2006) *World Bank Policy Research Working Paper* 3927 at 8.
[32] Xinyi Liu, *the Analysis of Tax Expenditure* (China Finance & Economics Publishing House, Beijing, 1996).

As valuable as the work was for the development of tax expenditure analysis in China, it suffered some shortcomings. Liu prepared a tentative list of tax expenditures based on the US precedent but provided no methodology for the identification of tax expenditures or the measurement of the substitutes for direct expenditures. Nor did the work attempt to evaluate the tax expenditures as the equivalent of direct programs to influence social and economic behavior. Liu realized that effective tax expenditure reporting required a cost–benefit analysis of individual tax expenditures, measuring both the cost of concessions and identifying the value of the economic or social outcomes the concessions were designed to achieve, and then comparing this cost-efficiency against the possible outcomes from alternative programs. He made no attempt to apply this analysis to the tax expenditures he had identified.

The same year, an academic from central China, Jinwu Zhang, using the first national research grant offered in support of tax expenditure research, produced a working paper that for the first time offered a design template for full tax expenditure analysis in China.[33] Zhang set out a persuasive argument for the use of tax expenditure reporting and analysis in China and provided a guide to the identification of tax expenditures, the measurement of their cost, and a framework for analyzing their effectiveness. An effective tax expenditure reporting and analysis system, Zhang argued, could be used to limit the number of tax expenditures and ensure that those which were adopted were most efficiently targeted with the goal of efficiently achieving outcomes at the lost revenue cost. The work was a comprehensive blueprint for the introduction of tax expenditure reporting in China.

One work published during this period that attracted considerable attention was a volume entitled *Tax Expenditure Management*, drafted by one of the fathers of public finance research in China, Ziji Deng.[34] This somewhat bizarre analysis measured the total value of tax expenditures compared to gross national product and to tax revenues across several countries in an attempt to ascertain the optimal level for tax expenditures in a wealthy society, on the suggested basis that this figure could be used as a target for Chinese tax design. While his contemporaries were developing tax

[33] Zhang's paper was widely distributed following its publication. It was not until 2008 that the paper's contents were actually published through incorporation in his book on tax expenditures, *Construction Research on Chinese Tax Expenditure System* (People Publishing House, Beijing, 2008).
[34] Ziji Deng, *Tax Expenditure Management* (Economy Publishing House, Beijing, 1999).

expenditure analysis as a way of controlling and better targeting tax expenditures, Deng appeared to view them as desirable features of a public expenditure system.

The second period of tax expenditure development closed with a work on tax expenditures published by an academic from south-west China, Rong Liu, who adopted a completely different perspective on tax expenditures that bypasses completely any measurement of the revenue cost of tax expenditures as a reduction of individual taxpayers' tax liabilities.[35] The most effective way of analyzing the impact of tax expenditures, Liu argued, was not to trace each expenditure as if it were a direct grant, but rather to model the cumulative impact of tax concessions on the entire economy as concessions modified the level of national savings and investment patterns, impacted on technological and scientific developments, modified the pattern of imports and exports, and altered the balance of regional economies within the country. She sought to measure and identify the broad economic consequences of China's tax expenditures on a macro level but failed to appreciate the need for costing and measuring the effectiveness of measures relating to specific concessions. Only the latter could be used to evaluate the merits of tax expenditures with direct expenditure or regulatory alternatives or, if tax expenditure is the preferred policy tool, to design better targeted concessions. As it turned out, the accuracy of Liu's economic analysis might be questionable. For example, in measuring the impact of tax expenditures on national savings, Liu noted the long-held view of consumption tax advocates that consumption taxation should, in theory, lead to more savings than an income tax and argued tax expenditures should have a similar effect because tax expenditures reduce the burden on income. Economic logic equally suggests that the opposite result might be true. By reducing the tax imposed on returns from investment, tax expenditures may enable taxpayers to invest less (that is, reduce their savings) to derive the same returns they would realize on far larger savings in sectors that enjoyed no tax concessions.

[35] Rong Liu, *the Economic Analysis of Tax Expenditure* (Southwest University of Finance and Economics Publishing House, Chendu, 1996).

2. 4. A Period of Administrative Development: 2000 - 2008

The beginning of the new millennium saw a dramatic development in Chinese tax policy. While China had weathered the Asian financial crisis better than many of its neighbors, the crisis had raised awareness among policymakers of the risk of economic downturns and the need to keep China's fiscal house in order. Attention turned to the large revenue cost of tax expenditures and for the first time the Ministry of Finance publicly acknowledged tax expenditures as a form of government spending. The Ministry indicated that the establishment of a tax expenditure reporting and analysis system was on its list of planned fiscal reforms, and research on tax expenditures re-emerged as a priority for tax academics.

After being prompted by the Deputy Secretary and Vice-Minister of Finance, Jiwei Lou, the Ministry of Finance, in cooperation with the World Bank, organized an international conference on tax expenditures in December 2002, gathering comparative data from eight Organisation for Economic Co-operation and Development (OECD) nations on systems used to identify, evaluate and cost tax expenditures, as well as OECD work on the subject.[36] A volume based on the proceedings and edited by Lou was published in China the following year.[37]

Despite Lou's enthusiasm for the development of a tax expenditure reporting and analysis system as a tool to control the proliferation of tax expenditures and refine the effectiveness of those in effect, there was limited internal institutional support for work and no evidence of support outside the Ministry. In 2007, Lou shifted to the position of Chairman and Chief Executive Officer of China Investment Corporation, the primary investment vehicle for the central government and no further initiatives on tax expenditures emerged from the Ministry.

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[36] The proceedings of the conference were published in English in Hana Polockova Brixi, Christian MA Valenduc and Zhicheng Li Swift , *Tax Expenditures – Shedding Light on Government Spending through the Tax System* (World Bank, Washington DC, 2004). And in Chinese in Jiwei Lou (editor), *The Theoretical Innovation and Systematic Exploring on Tax Expenditure* (China Finance & Economics Publishing House, Beijing, 2003). Jiwei Lou is the Minister of Finance now.

[37] Ibid

Work on tax expenditures continued outside the Ministry-sponsored initiative and a number of articles and books on tax expenditures were published in the period 2000-2008. However, there was little to distinguish the materials produce, with academic literature in this period clearly starting with the same basic readings and for the most part restating the points in only slightly different words.

Additionally, the attention of most research papers was directed towards public policy priorities such as establishment of the public finance system, improvement and reform of the tax system, control of tax erosion, the tax policy adjustments necessitated by membership of the WTO, reform of industry structure and local economy development. However, almost all research focused on the practical dimensions of tax benefits or tax expenditures, with limited attention directed towards the feasibility of building a tax expenditure system and the management of a tax expenditure system.

Thirdly, the research approach and the analytical tools used to examine tax expenditure broadened the theoretical horizons of the field. The book for example, *Tax Economics*, written by Guoqing Wang[38] in 2006, classified and analyzed the nature and the function of the tax expenditure system.

Another book by Wan Ying[39] in 2006 was the first book in China to discuss tax expenditure performance evaluation. Although the book examined effects of tax expenditure as its starting point, it also featured a broad array of topics including the export tax rebate, foreign enterprise income tax concessions, and tax incentives for western development, re-employment of laid-off tax benefits, welfare tax credits, tax incentives and other agriculture-related empirical performance analysis. Though the econometric model used in this book was relatively simple and crude, this book was the first to use a quantitative methodology to explore the design of tax expenditure evaluation.

The third book was written by Jinwu Zhang, the only scholar continuing in the area from 1988. His 2008 volume, *A study on Constructing a Chinese Tax Expenditure*

[38] Guoqing Wang, *Tax Economics* (Southwest University of Finance and Economics Publishing House, Chendu, 2006).
[39] Ying Wan, *the Effect Analysis and Performance Evaluation of Tax Expenditure* (Economy Publishing House, Beijing, 2006).

System [translated as *Construction Research on Chinese Tax Expenditure System* by the book's publisher],[40] systematically reviewed all elements of tax expenditure budgeting, including the adoption of a benchmark, the types of tax expenditures, alternative methods to calculate the value of tax expenditures and the objectives of tax expenditures. The work included a chapter that identified selective tax expenditures in the enterprise income tax using the Shantz-Haig-Simons comprehensive tax as a benchmark and another chapter that identified selective tax expenditures in the VAT. Zhang's contribution was significant because it addressed gaps in the research to date and laid the foundation for further research.

While the research into tax expenditures made some notable achievements over this period, many limitations remained. In many ways the discussion was superficial in the sense of raising questions but not attempting to develop answers. For example, discussion on the measurement of the cost of tax expenditures was wholly abstract in the absence of any data that could be used for actual calculations. With no reliable estimates of the cost of tax expenditures, the studies were not able to undertake any cost-benefit analysis for the growing number of tax expenditures.

There were other limitations and drawbacks in the research on tax expenditures. First, evidence demonstrating the feasibility of constructing the Chinese tax expenditure system was not yet compelling. Further, the concept of tax expenditure needed to be adjusted to more closely align with China's circumstances. Thirdly, in order to draw meaningful lessons from the experience of western countries, more analysis was needed, as well as a clear definition of the optimal measurement system. Fourthly, the research on a tax expenditure system was fragmented and incomplete, concerned with basic issues or specific parts of the institutional process, with no holistic conceptual framework.

[40] Jinwu Zhang , *Construction Research on Chinese Tax Expenditure System* (People Publishing House, Beijing, 2008).

2. 5. Retreat from Tax Expenditure Analysis: 2009 - date

Until his transfer from the Ministry of Finance to the China Investment Corporation in 2007, **Jiwei Lou** had been the driving force behind efforts to develop a tax expenditure budget in China. Support for these efforts dissipated quickly following his departure and once it became clear that tax expenditure studies no longer enjoyed the imprimatur of the Ministry, scholars rapidly lost interest in the topic. **Jin Wu Zhang**'s 2008 volume, based on his doctoral studies, proved to be the last important work on tax expenditures published in China. Only a handful of papers on the topic have been published since 2009 and the prospects of new works appearing are limited. The central government's agency for funding academic research has approved no grants to researchers working in this area, no further conferences on the subject have been held, and relevant departments in higher education institutions are unlikely to encourage doctoral students to concentrate on the topic.

Government Ministries other than the Ministry of Finance realized that tax expenditure budgeting would reveal the cost of tax concessions favouring their sectors and would quite possibly prompt calls for the elimination or reduction of these concessions. There was, as a consequence, no government support for tax expenditure analysis outside the Ministry of Finance and once the Ministry of Finance lost interest, the prospects of government action were non-existent.

2.6. Conclusion

Less than a decade and a half after the first western governments released their initial tax expenditure budgets, and well before many other western governments incorporated tax expenditure analysis into their public finance systems, local scholars were bringing the concepts and literature to China. Support from the Ministry responsible for developing the tax system followed, and until recently the possibility and perhaps even probability that China would soon adopt its own tax expenditure budget system and use tax expenditure analysis to improve the efficiency of its tax system appeared high.

That view was misplaced, however. While it was based on foreign materials, Chinese tax expenditure literature suffered from some shortcomings that severely limited its potential as a foundation for the development of effective tax expenditure analysis. Lacking a conceptual understanding of benchmark tax and public finance principles, many tax expenditure scholars, particularly in the earlier years, failed to appreciate how local political factors, not optimal tax policy, had led to the adoption of tax expenditures abroad. They similarly did not understand that foreign governments sought to use tax expenditure analysis as a tool of halting the growth of tax expenditures, nor did they understand the distorting economic biases they caused. Rather scholars, awed by the success of western economies compared to that of socialist China, saw tax expenditures as positive attributes of a successful tax system. They assumed western governments used tax expenditure analysis to identify concessions that would foster growth and suggested China, too, could develop if its tax system contained similar measures. While western scholars sought to expose features in tax law that undermined economic efficiency, some Chinese counterparts wanted to use the same tool to promote those features.

Later scholars with a better understanding of tax policy principles and the benefits of designing neutral tax laws that minimised the impact of tax on economic decision making saw how tax expenditures could be used as a reform tool to remove distorting concessions from the tax laws. They knew, too, that in western countries such as Australia and Canada it was outside-pressure from academics that eventually shifted opinion in the Ministries of Finance to adopt tax expenditure budgets. But western scholars enjoyed one benefit that was denied to their Chinese counterparts -- access to the data needed for tax expenditure analysis.

In contrast to tax statistics distributed by western tax authorities, those released by the Chinese tax authority set out net collections from different tax bases but provided no details of the effect of particular tax measures. Students of tax expenditure budgeting could reveal what appears to be tax expenditures. Without any accurate costing, it was impossible to undertake tax expenditure analysis that considered the revenue cost of concessions and then evaluated that against the possible cost of alternative and more efficient, better targeted, substitute direct expenditures. Tax expenditure

writings identified an important topic worthy of analysis but could not provide the information needed for tax expenditure analysis to be used as an effective budget tool.

The prospects for the adoption of tax expenditure budgets in China soon are dim. The retreat from tax expenditure scholarship by academics in recent years has left no independent support for tax expenditure budgeting and for the foreseeable future, tax expenditure analysis in China is at the least comatose, if not dead.

Chapter 3 the Development of Chinese Enterprise Income Tax

3.1. Introduction

Corporate income tax is a form of taxation imposed each taxable year on the taxable income of a corporation in accordance with Internal Revenue Code. [41] The name of this tax differs between countries and jurisdictions; for example, it is known as Corporate Tax in the United States. The term China adopts for corporate income tax is Enterprise Income Tax. This form of taxation is imposed on various streams of enterprises income, such as income from sales, services, interests and rental property.[42]

When China first adopted income tax, it distinguished between the individual income tax for income of natural persons from sources other than business and income from enterprises. The latter group included both natural persons and legal persons carrying on business. The conventional distinction used in market economies between individuals and companies was not followed as officials were not concerned with the form of the entity carrying on business as much as the fact that someone or some entity was licenced to carry on an enterprise.

At the time of the merger in 2008 of the enterprise income tax law for wholly Chinese enterprises and the enterprise income tax law for joint ventures and enterprises with some foreign ownership, the conventional market economy distinction was adopted and the combined enterprise income tax law only applied to enterprises carried on by legal persons. From that time, enterprises carried on by individuals were taxed under the individual income tax law. Since 2008, therefore, the enterprise income tax is effectively a company income tax and it is common for translators to refer to the law in English as the company income tax. This thesis used the literal translation of the Chinese law, the Enterprise Income Tax Law but the references can be understood to

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[41] The United States Internal Revenue Code ('IRC') §11(a).

[42] JM Li, *the Categories of Incomes under Enterprise Income Tax Law, Latest Questions and Answers Regarding Enterprise Income Tax* (Law Press, Beijing, 2009).

refer to provisions that other writers might describe as sections of the company income tax law.

This chapter provides an overview of the history of China's enterprise income tax from 1949 to present. This will be first started from the description of the period of income tax exemption for SOEs (1950-1978). It then discusses the first stage: the early 1980s---concerning the foreign income tax system and the mid-1980s to late 1980s---the establishment of SOEs income tax system. Later it outlines the second stage (1991-2007): two income tax systems. Finally, this chapter highlights the background of unification of enterprise income tax law (2008-present), summarizes and analyses its key changes of the new tax law.

3. 2. Income Tax Exemption for SOEs

When the Chinese Communist Party (CCP) came to power in 1949, it adopted an economic system and management style patterned after the Soviet model.[43] During the period of the traditional planned economy, which lasted from 1949 to 1977, China had a highly centralized planned economic system. Planed economy is an economic system in which the state directs the economy. [44]It is an economic system in which the central government controls industry such that it makes all decisions regarding the production and distribution of goods and services.[45] Its most extensive form is referred to as a command economy. In such economies, central economic planning by the state or government controls all major sectors of the economy and formulates all decisions about the use of resources and the distribution of output.[46] Planners decide what should be produced and direct lower-level enterprises to produce those goods in accordance with national and social objectives.[47]

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[43] Zhou Shulian, 'Reform of the Economic Structure' in George Totten and Zhou Shulian (eds), *China's Economic Reform -- Administering the Introduction of the Market Mechanism* (Westview Press, Colorado, 1992) at 2.
[44] Alec Nove, 'Planned Economy' (1987) 3 *The New Palgrave: A Dictionary of Economics* 879–880.
[45] Arthur Sullivan and Steven M Sheffrin , *Economics: Principles in action* (Pearson Prentice Hall, New Jersey , 2003) 27.
[46] Danny Myers, *Construction Economics* (Spon Press, Oxford, 2004) 288.
[47] Bertell Ollman, *Market Socialism: The Debate among Socialists* (Routledge, Oxford, 1997) 12.

Meantime, all enterprises were domestically owned. Chinese enterprises could be classified into two broad categories: state owned enterprises (SOEs) and other enterprises, which included collective enterprises and private enterprises. During the early period, the country had not yet stabilised from the civil war. The government was in need of funds to meet military expenditures and to rebuild the country; very little tax could be collected from the collapsing economy that was only beginning to recover. A formal tax system was not established until 1950.[48]

To meet the requirement of unifying national political policies and rapid recovery of the economy subsequent to the Chinese civil war, the Government Administration Council released the National Implementation of Tax Policies which marked the establishment of a new, nationally-unified socialist tax system in 1950. One of 14 categories in the National Implementation of Tax Policies[49] was the Industrial and Commercial Tax that consisted of four elements: sales tax, income tax, pedlar's licence tax and occasional trader's tax.

Although the Industrial and Commercial Tax was applicable to all enterprises, SOEs were exempt from the Income Tax component. Under the system of state administration of income and expenses, SOEs were required to effect transfers to certain reserves, which were mainly used for the welfare of employees, and then to hand over any surplus (including the depreciation reserve) to the government . When deficits occurred, the government was required to subsidise these enterprises.

It was until 1978 at the meeting of the Third Plenary Session of the Eleventh Central Committee, the Chinese government decided to introduce a series of economic reforms that were aimed at modernizing China's economy and raising standards of

[48] Isabella Lam, Stella Cho and Aldous Mak, 'Historical Development of Income Tax Law for Domestic and Foreign Enterprises in China'(1996) International Tax Journal 51-68 at 51.

[49] There were 14 kinds of taxes concerning industrial and commercial enterprises. namely: (1) goods tax (excise); (2) industrial and commercial tax, which was then composed of sales tax, income tax, pedlar's licence tax and occasional trader's tax; (3) salt tax; (4) customs duty; (5) income tax on wages and salaries (not implemented); (6) income tax on deposit interest; (7) stamp duty; (8) death duty (not implemented); (9) trans- action tax which was then composed of those taxes on cotton goods, cereals, hand woven cloth, medicinal herbs, and livestock; (10) slaughter tax; (11) housing property tax; (12) land property tax; (13) special consumption tax; (14) licence tax on vehicles and vessels. In 1951 the tax on marketing of cotton yarn was added. Since two of the 14 taxes were not implemented, in the early 1950s only 13 kinds of taxes comprised the industrial and commercial tax system (ICTS).

living. To facilitate economic development of the country, a Reform and Open-Door policy,[50] aimed at encouraging foreign investment, international trade and tourism was instituted in 1979. Meanwhile, the tax system entered a new period of development. Tax revenue gradually became the main source of government revenue, as well as an important tool of macroeconomic control. In more than 30 years following market-based reforms, the development of China's enterprises income tax system can be divided into three stages:

3. 3. The First Stage: 1980s

The year 1978 (two years before 1980) marks a major turning point for China. In this year, the Third Plenary Session of the Eleventh Central Committee of the CPC was convened, at which it was decided that China was to pursue the policies of economic reform and opening to the outside world.

Meantime China abandoned the political theme of "using class struggle as a principle" and decided instead to focus on economic development. It thus began to implement the Reform and Open-Door Policy"[51]. Since the adoption of this new policy, with deepened knowledge obtained through experience and implementation, the economic system underwent a number of vital changes. In 1982, the economic system was described as a "planned economy supplemented by market mechanism"; in 1984, as a "planned commodity economy based on public ownership"; in 1987, the principle was that "the socialist planned commodity economy shall be the internal unification of the planned and market mechanisms"; in 1989, it was "the establishment of an economic system and operational mechanism that combines planned economy and market mechanisms, and capable of adapting to the socialist planned commodity economy".[52]

[50] It refers to the program of economic reforms called 'Socialism with Chinese characteristics' in the PRC that were started in December 1978 by reformists within the Communist Party of China (CPC) led by Deng Xiaoping.
[51] NPC, *Resolution of the Third Session of the Eleventh Central Committee of Chinese Communist Party* (NPC, Beijing, 1978).
[52] Ibid.

3. 3.1. The Early 1980s: Concerning the Foreign Income Tax System

The immense Chinese market offers opportunities to foreign investors. Foreign investment, commencing with the 'Open- Door' policy that was introduced in the 1970s,[53] has necessitated the establishment of laws governing income tax. During this period, the foreign income tax system was established (including Sino-foreign joint venture income tax (JVIT), foreign enterprise income tax and personal income tax) as a crucial pillar of China's openness to foreign investment.

On 1 July 1979, the National People's Congress promulgated the PRC Sino-Foreign Joint Venture Law,[54] with a view that foreign investors would be able to take advantage of the cheap and abundant natural and human resources of what was then the world's third largest economy and most populous nation.

On 10 September 1980 the Third Session of the Fifth National People's Congress promulgated the Income Tax Law of the PRC for Sino-Foreign Equity Joint Venture Income Tax Law (JVIT Law). On the same day the State Council promulgated the Detailed Rules and Regulations for Implementing the JVIT Law, which was adopted by the State Council and promulgated by the Ministry of Finance on 14 December 1980.[55] The 1980 JVIT Law applied to Equity Joint Ventures.[56] In China, foreign investment enterprises or foreign direct investment has taken three forms: equity joint ventures, contractual joint ventures, and wholly foreign-owned enterprises.[57] The JVIT Law was the first foreign enterprise income tax law established in China.

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[53] Jinyan Li, *Taxation in the People's Republic of China* (Praeger Publisher, Westport, 1991).
[54] The Law adopted at the Second Session of the Fifth National People's Congress on 1 July 1 1979 and became effective on 8 July 1979.
[55] This law was effective from 10 September 1980 to 30 June 1991.
[56] Equity joint ventures take the form of limited liability corporations, in which Chinese and foreign partners jointly invest and manage the operations. There is a 25% minimum foreign participation requirement, and profits and losses are shared according to the proportion of investment contributed by each partner. Contractual joint ventures may or may not form as legal entities and there is no minimum foreign participation requirement, whereas profits and losses are shared in accordance with the terms and conditions laid down in the venture contract. Wholly foreign-owned enterprises may be established by foreign companies using their own capital, technology and management entirely. They are responsible for all the risks, gains, and losses.
[57] Samuel Tung and Stella Cho, 'The Impact of Tax Incentives on Foreign Direct Investment in China' (2000) 9(2) *Journal of International Accounting, Auditing and Taxation* 105.

On 13 December 1981, the Fourth Session of the Fifth National People's Congress promulgated the Income Tax Law of the PRC for Foreign Enterprises.[58] The 1981 Foreign Enterprises Income Tax Law (FEIT Law) applied to other entities, such as Contractual Joint Ventures and Wholly Foreign-Owned Enterprises.

In the 1980s, two different income tax laws (The 1980 JVIT Law and the 1981 FEI Tax Law) determined tax rates and incentives for the different types of foreign direct investment. Sino-foreign equity joint ventures paid taxes in accordance with one set of income tax laws, whereas Sino-foreign contractual joint ventures and wholly foreign-owned enterprises paid in accordance with another set of laws.[59]

The promulgation of these laws had an important effect on foreign investment levels by increasing the predictability of taxation rates and thus encouraging investment in China.[60]

In the 1980s, rates of foreign investment in China increased dramatically. From 1979 to 1990, China attracted foreign direct investment contracts of $US 40.615 billion and actual foreign direct investment of $US 20.692 billion.[61] In 1990, foreign direct investment accounted for 0.9 % of China's GDP and 6.3% of the total investment in fixed assets.[62]

3. 3.2. The Mid-1980s to late 1980s: The Establishment of State-Owned Enterprises Income Tax System

Prior to the introduction of market-oriented economic reforms, China only had one form of taxation. Because taxation bore no relationship to the economic activities of enterprises, this system lacked vitality. In 1981, the Chinese government began to

[58] This law was effective from 1 January 1982 to 1 July 1991.
[59] Samuel Tung and Stella Cho, 'The Impact of Tax Incentives on Foreign Direct Investment in China' Journal of International Accounting, Auditing and Taxation 9(2) (2000)105.
[60] Qun Li, 'Tax Incentive Policies for Foreign-Invested Enterprises in China and their Influence on Foreign Investment' (2008) 18 (1) *Revenue La*w Journal.
[61] National Bureau of Statistics of China, China Statistical Yearbook (2007) Table 18□14.<http://www.stats.gov.cn/tjsj/ndsj/2007/html/R1814e.htm> at July 31, 2011.
[62] National Bureau of Statistics of China, *Zhongguo Tongji Nianjian* (National Bureau of Statistics of China , Beijing, 1991) 18, 144 [trans: *China Statistical Yearbook*].

collect income tax from Sino-foreign joint ventures and foreign enterprises, taking the first step in the reform of the taxation system.

Meanwhile, the Chinese government came to the conclusion that the practice of state-owned enterprises handing over surpluses to government was undesirable as it meant that enterprises had no incentive to operate efficiently due to the limited portion of surplus retained by them. Moreover, loss-making enterprises had no incentive to operate more efficiently because subsidies could be obtained from the government. As a response to these problems, the tax-profit substitution system, which introduced the first State Owned Enterprise Income Tax law, was implemented in 1983.

In 1983 and 1984, the government introduced a policy of 'Substituting Taxes for Profits' (ligaishui) for domestic enterprises. On 18 September 1984, the NPC passed a resolution to authorise the State Council to issue the Provisional Regulations of the PRC on State-Owned Enterprise (Draft) and the Procedures on Collection of Adjusted Tax for State-Owned Enterprise. These were implemented from 1 October 1984 to 31 December 1993.

In accordance with these reforms, all large and medium-sized state enterprises gradually ceased remitting profits, and commenced paying taxes on profits, with enterprises granted greater autonomy over the disposal of residual income. This reform was introduced nationwide in two phases, with phase 1 beginning in July 1983 and phase 2 commencing on 1 January 1985. The first phase brought little substantive change in state-enterprise financial relations. A new income tax on profits with a rate of 55 percent was introduced for large and medium enterprises, which continued to remit profits under contracts that were recalculated to leave them with the same retained after-tax profits as in 1982.[63]

On 11 April 1985 the State Council issued the Provisional Regulations on Income Tax on Collective Enterprises of the PRC, which had effect from 1 January 1985 to 31 December 1993. These regulations provided that collective owned enterprises were

[63] Chistine PW Wong, 'The Economics of Shortage and Problems of Reform in Chinese Industry' (1986) 10 *Journal of Comparative Economics* 363-387.

subject to income tax at rates of between 10 percent and 55 percent.[64] At the same time, China stopped implementing the Industry and Commercial Tax (Income Tax Portion) for collectively owned enterprises.[65]

On 5 June 1988, the State Council promulgated the Provisional Regulations on Income Tax on Private Enterprises of the PRC, which had effect from 1 July 1988 to 31 December 1993.[66] This established a tax rate of 35 percent.[67]

These Regulations were formulated to encourage and guide the healthy development of private enterprises, to protect their legal rights and interests and to strengthen their supervision and administration, thus enriching the socialist planned commodity economy.[68] 'Private enterprise' was defined as the benefit-seeking economic organisation whose property was owned by individuals with more than 8 employees.[69]

3. 4. The Second Stage: Two Income Tax Systems

In 1992, China proposed the establishment of a socialist market economy[70] system, which had long been a goal of the country's reform. Generally, the basic approach underpinning the Chinese Reform and Open-Door Policy consisted of three major themes: firstly, in terms of its foreign economic policy, attracting foreign capital and expanding exports; secondly, in terms of its domestic policy in rural areas, the key to reform was the policy of "a contract system with remuneration linked to output"; thirdly, in terms of its domestic policy in urban areas, the key was to increase the independence and vitality of enterprises and to adjust the relationship between the state and enterprises (most of which were state-owned). The economic legal system at this stage was also based on the three policies above.

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[64] Article 3 of the Provisional Regulations on Income Tax on Collective Enterprises.
[65] Ibid.
[66] It was adopted at the 7th Routine Meeting of the State Council on 3 June 1988. It was issued by the 4th Order of the State Council of the People's Republic of China on 5 June 1988.
[67] General Provisions Article 3 of the Provisional Regulations on Income Tax on Private Enterprises.
[68] General Provisions Article 1 of the Provisional Regulations on Income Tax on Private Enterprises.
[69] General Provisions Article 2 of the Provisional Regulations on Income Tax on Private Enterprises.
[70] In 1993, Article 15 of the Constitution was amended. The Article had formerly stated that "the country will implement a planned economy on the basis of socialist public ownership," and this was now amended to state that "the country will implement a socialist market economy." In order to develop the socialist market economy, China comprehensively strengthened the construction of its economic legal system, which went through a significant expansion during this period.

3.3.1. Income Tax System for Foreign Enterprises

The Unified 1991 Income Tax Law of the 1980 JVI Tax Law and the 1981 FEI Tax Law

On 9 April 1991, the 1980 JVI Tax Law and the 1981 FEI Tax Law were unified and replaced by a single Income Tax Law of the PRC on Enterprises with Foreign Investment and Foreign Enterprises (hereafter the 1991 Foreign Enterprises Income Tax Law) at the Fourth Session of the Seventh National People's Congress. This law became effective on 1 July 1991 and remained in place until 31 December 2007. Additional guidance was provided by the promulgation on 30 June 1991 of the detailed rules and regulations on implementation of the 1991 Income Tax Law by the State Council (hereafter the 1991 Implementing Regulations).

The promulgation and implementation of the 1991 Income Tax Law was not simply a merger of the 1980 JVI Tax Law and the 1981 FEI Tax Law, but represented a turning point in the reconfiguration of tax policies related to foreign - investment enterprises in response to changed social, political and economic circumstances.[71]

Under the 1991 Income Tax Law, income tax was paid by enterprises with foreign investment within the territory of the People's Republic of China. Tax was payable on income derived from production, business operations and other sources. It was also paid by foreign enterprises on income derived from production, business operations and other sources within the territory of the PRC.[72]

Enterprises with foreign investment' meant Chinese-foreign equity joint ventures, Chinese-foreign contractual joint ventures and foreign-capital enterprises that are established in China.[73] 'Foreign enterprises' meant foreign companies, enterprises and other economic organizations which have establishments or places in China and engage in production or business operations, or which, though without establishments or places in China, have income from sources within China.[74]

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[71] Qun Li, 'Tax Incentive Policies for Foreign-Invested Enterprises in China and their Influence on Foreign Investment' (2008) 18(1) *Revenue Law Journal*.
[72] 1991 Income Tax Law, Article 1.
[73] 1991 Income Tax Law , Article 2
[74] See above n 72.

A main feature of the 1991 Income Tax Law was the uniform tax rate that it imposed on all foreign business activity in China. The consolidation of the 1980 JVI Tax Law and the 1981 FEI Tax Law into the 1991 Income Tax Law seen as an effective mechanism to encourage foreign investment. In 1991, foreign investment in PRC was $11.9 billion, compared to $6.20 billion in 1988, $6.30 billion in 1989 and $6.60 billion in 1990.[75]

The introduction of a unified income tax system contributed to the opening up of China's economy to foreign investment. Higher levels of foreign investment, in turn, have had a positive effect on economic development and boosted government revenue, From 1982 to 2005, China's revenue derived from foreign income tax rose from 0.1 billion yuan to 114.77 billion yuan. This amounted to an increase of 11. 476 percent over 23 years, or an average annual increase of 50.1 percent. This increase was far higher than China's overall economic growth rate and the growth rate of total tax revenue over the same period. This component of the country's total tax revenue from the proportion of total tax revenue in 1982 and gradually rose to 0.1 ‰ in 2005, 39.9 ‰, 23 years increased by 39.8 thousand points, the average annual rise of 1.7 per thousand points. [76]

3.3.2. Income Tax System for Domestic Enterprises

By 1991, an enterprise income tax law had already been instituted for foreign enterprises operating in China. Nevertheless, different forms of domestic enterprises were still taxed according to different sets of income tax rates. For example, large and medium-size SOEs paid State Owned Enterprise Income Tax at 55 percent; small SOEs and collective enterprises paid State Owned Enterprise Income Tax and Collective Enterprise Income Tax respectively at similar progressive rates; and enterprises with foreign investment and foreign enterprises paid Unified Enterprise Income Tax at 33 percent. Moreover, definitions of taxable income and allowable deductions under different sets of laws also varied.[77]

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[75] PC Lau and R Auster, 'New China tax law addresses foreign investors' (1993) 19 (3) *International Tax Journal* 43-53.

[76] Liu Zuo, 'the Development of New Chinese Enterprises Income Tax System' (2007)12(2) *Journal of Tax College of YangZhou University* 1-9.

[77] Isabella Lam, Stella Cho and Aldous Mak, 'Historical Development of Income Tax Law for Domestic and Foreign Enterprises in China'(1996) International Tax Journal 51-68 at 51.

In October 1992 the Fourteenth National Congress of the CCP proposed the establishment of the socialist market economic system. In accordance with this new economic framework, reforming the income tax system became an important strategic priority.

In order to utilise enterprise income tax as a tool of macroeconomic control, in 1993 the State Council decided that Tax Reform would commence in January 1994. The objectives of the 1994 Tax Reform process were to unify the tax laws, to spread the tax burden more equitably among taxpayers, to simplify the tax system, and to share tax levying power reasonably between state and local governments. In December 1993, the State Council promulgated the Provisional Regulations on Enterprise Income Tax of the People's Republic of China (hereafter the 1994 Enterprise Income Tax Law), which provided for the taxation of income for all domestic enterprises. On 1 January 1994, the law took effect, replacing the three old enterprise income tax laws (the State- Owned Enterprises Income Tax law, the Collective Enterprise Income Tax law, and the Private Enterprise Income Tax law.[78])

The 1994 Enterprise Income Tax Law stipulated that all enterprises within the territory of the PRC, except enterprises with foreign investment and foreign enterprises, were liable to pay enterprise income tax on their income from production, business operation and other income in accordance with the provisions of the Regulations. The income of an enterprise from production, business operation and other sources included income obtained within and outside China.[79] Taxpayers of enterprise income tax were enterprises and institutions with independent economic accounting included the following (hereafter referred as 'taxpayers'):

1. State-Owned Enterprises;
2. Collective enterprises;
3. Private enterprises;

[78] The Regulations on the Income Tax on State-Owned Enterprises of the People's Republic of China (Draft)' and the 'Procedures for the Collection of Regulation Tax on State-Owned Enterprises' promulgated by the State Council on 18 September 1984, and the 'Provisional Regulations on Income Tax on Collective Enterprises of the People's Republic of China' promulgated on 11 April 1985, and the 'Provisional Regulations on Income Tax on Private Enterprises of the People's Republic of China' promulgated on 25 June 1988, by the State Council were abrogated therefrom, and the procedure of the State Council regarding payment of enterprise income tax by state-enterprises on a contract basis ceased to be implemented as from the same day.
[79] EITL, Article 1.

4. Associated enterprises; and
5. Joint stock enterprises.[80]

The 1994 Enterprise Income Tax Law was considered highly successful in complementing the structural reforms of state-owned enterprises. A key goal of economic reform was to restructure SOEs to become more economically efficient entities. Replacing the profit-delivery mechanisms with tax payments helped SOEs and their government regulators to recognize the new relationship between enterprises and government. It also provided economic incentives for SOEs to become more profitable as they could retain after-tax profits.[81]

Overall, foreign invested enterprises and domestic enterprises were subject to different income tax regulations and tax rates in China. Although statutory tax rates for foreign and domestic enterprises were equal (the normal tax rate of 33%), foreign enterprises actually benefited from differential tax treatments in many ways. Unlike domestic enterprises, FIEs were generally entitled to a lower income tax rate and more tax deductions and exemptions, resulting in an effective tax rate much lower than 33%. This policy seemed to have contributed to the success of economic reform, at least early in the piece. However, the co-existence of divergent income tax laws for foreign and domestic enterprises remained a problem that needed to be addressed by the Chinese government in the future.

3. 5. The Third Stage: Unification of Enterprise Income Tax Law

The Enterprise Income Tax Law of the PRC, adopted at the 5th Session of the 10th NPC of the PRC on 16 March 2007 commenced on 1 January 2008. The Implementation Rules of the Corporate Income Tax Law of the People's Republic of China adopted by the State Council at the 197th executive meeting on November 28,

[80] EITL, Article 2.
[81] Jinyan Li, 'Development and Tax Policy: Case Study of China' in A Usha (eds) *Tax Laws: Global Perspectives* (Oxford University Press, London, 2007)235-76.

2007 took effect on 1 January 1 2008.[82] The new Enterprise Income Tax Law and its implementing regulations are hereafter referred to as the New Tax Law.

3. 5.1. Background to the New Tax Law

Prior to the enactment of the New Tax Law, domestic and foreign funded enterprises were governed under two different tax authorities. These different tax systems provided for different taxation rates and treatment of the taxation of enterprise profits. The New Tax Law eliminated tax disparities under the previous tax system and established a unified set of tax rules for domestic and foreign funded enterprises

China became a member of the World Trade Organization (WTO) on 11 December, 2001. It therefore had to satisfy WTO principles of 'national treatment' and 'transparency' by creating an environment for fair competition among all enterprises through a standardized and transparent fiscal environment.

Since 1994, China has been one of the world's fastest-growing economies. China's real gross domestic product (GDP) has grown at an average annual rate of 9.8%. Real GDP grew 11.4% in 2007 (the fastest annual growth since 1994). This fast-paced growth has prompted revision of China's income tax provisions to reflect rapid changes in China's economy and society. In addition, reform was necessary to eliminate current preferential policies embodied in the bifurcated Chinese tax law. These policies distorted behaviour and led to revenue loss.[83]

The New Tax Law was introduced to achieve the following objectives:

- to ensure equitable taxation of all enterprises by ending systematic and serious discrimination against Chinese-owned enterprises;
- to promote overall sustainable development of China's economy;
- to be consistent with international tax norms and practices; and
- to improve efficiency in tax administration.[84]

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[82] The Law of the People's Republic of China on the Enterprise Income Tax of Foreign-invested Enterprises and Foreign Enterprises as adopted at the 4th session of the 7th National People's Congress on 9 April 9 1991 and the 'Provisional Regulations of the People's Republic of China on Enterprise Income Tax as promulgated by the State Council on 13 December 1993 was repealed on January1

[83] Qinghua Xu, 'the New Chinese Enterprise Income Tax Law: Planning Opportunities and Traps for the Unwary' (21 August 2007) *International Tax Newsletter*.

[84] CCH, *China Master Guide 2011/12* (CCH, Beijing, 2011).

The New Tax Law sought to create a fair competitive environment among all enterprises and solve the problem of differential tax treatment between domestic enterprises and foreign investment. This was a departure from the previous policy aimed at attracting direct foreign investment by providing tax preferential treatment for FIEs.

It is hoped that the implementation of the New Tax Law will have a profound long-term impact on the Chinese economy and the business operation of enterprises in China. For example, China is currently phasing out most of the tax incentives previously granted to attract foreign manufacturers to produce products in China for export.

3. 5.2. Summary of Some Main Changes of the New Tax Law

Various changes have been made to the existing tax regime, including unification of the EIT rate, unification of deduction methods and standards, and unification of tax preferential treatment policies. The following are the major changes made by the New Tax Law:

3. 5.2.1 Resident/Non-resident Enterprises

The New Tax Law introduces the new concepts of 'resident enterprise' and 'non-resident enterprise'. 'Resident enterprise' refers to an enterprise established in accordance with the law within the territory of the PRC, or established in accordance with the law of a foreign country (region) but whose actual administration institution is located within the territory of the PRC.[85]

'Non-resident enterprise' refers to an enterprise established in accordance with the law of a foreign country (region) whose actual administration institution is located outside the territory of the PRC but with organisations or establishments within the territory of the PRC; or without organisations or establishments within the territory of the PRC but which have income derived from the territory of the PRC.[86]

[85] EITL, Article 2.
[86] Ibid.

A resident enterprise is required to pay enterprise income tax on income derived from both within and outside of China. A non-resident enterprise with organisations or establishments within China must pay enterprise income tax on income derived from within China as well as income derived from outside China but in fact related to such organisations or establishments.[87] A non-resident enterprise without any organisations or establishments within China or with organisations or establishments within China but with income not related to such organisations or establishments pays enterprise income tax on income derived from within China.[88]

3. 5.2.2. Tax Rate

The New Tax Law imposes a unified tax rate of 25 percent.[89] Non-resident enterprises deriving income stipulated in the third paragraph of Article 3 are levied tax at the rate of 20 percent. Non-resident enterprises without any establishment in China deriving income sourced in China and those having an establishment in China earning income sourced in China but are not effectively connected with that establishment pay enterprise income tax on income sourced within China.[90]

3. 5.2.3. Expense Deduction

Under the New Tax Law, expense deduction rules are identical for domestic and foreign enterprises. This is a shift from previous tax laws. For example, under the 1994 Tax Law, domestic enterprises were generally not allowed to deduct the portion of salary expenses that was in excess of stipulated limits, while foreign invested enterprises were allowed to deduct salary expenses on an actual basis. The new law allows both domestic and foreign invested enterprises to deduct salary expenses on an actual basis.

3. 5.2.4. Tax Incentives

[87] EITL, Article 3.
[88] Ibid.
[89] EITL, Article 4.
[90] EITL, Article 3.

Before the unification of the enterprise income tax laws applicable to foreign and domestic enterprises, China offered an array of tax incentives to encourage investors to invest and do business in China. Most of the tax incentives relate to foreign investment enterprise income tax. However, with the EITL promulgated on 16 March 2007 and effective on 1 January 2008, most of the tax incentives originally available to foreign investors are abolished.

Furthermore, with the issuance of Enterprise Income Tax Law Implementing Rules (EITLIR) on 6 December 2007 and a series of relevant circulars, the following new trends in the tax preferential treatments are clearer:

- shift from granting incentives only in special regions to the entire country;
- shift from a regional development orientation to an industry orientation; and
- shift from an export-oriented economy to a domestically driven economy.[91]

The new incentive that has attracted the broadest attention is a 15% tax rate that applies to an enterprise that qualifies as a high and new technology enterprise. The EITL includes a complete redesign of tax incentives, which represents a clear move from the wide ranging benefits previously available for manufacturing generally and for specific locations.

Under the New Tax Law enterprise income tax incentives are awarded to industries and projects whose development is supported and encouraged by the State.[92] The focus is on whether the investment itself is desirable (for example, desirable investment may include investment in high technology enterprises, energy and water preservation activities and environmental protection activities), rather than where the company is located (such as whether the company is located in special economic zones and coastal open economic zones) or who the investor is (for example foreign or domestic).[93]

Enterprise income tax for small-scale enterprises that meet the prescribed conditions is levied at the reduced rate of 20 percent. Enterprise income tax for State-

[91] CCH, *China Master Guide 2011/12* (CCH, Beijing, 2011).
[92] EITL, Article 25.
[93] EITL, Article 27.

encouraged high and new technology enterprises is levied at the reduced rate of 15 percent.[94] The New Tax Law revokes the previous five-year tax holiday for production-oriented foreign invested enterprises (the two-year exemption and three-year 50 percent reduction of applicable tax rate, as well as the 50 percent tax reduction for export-oriented enterprises exporting 70 percent or more of their total products).

3. 5.2.5 Supplementary Provisions

Enterprises which had been approved to be established prior to the promulgation of the New Tax Law and which enjoy preferential treatment in the form of reduced enterprise income tax rates in accordance with previous tax laws and regulations are allowed a gradual transition to new tax rates over a five year period beginning from the effective commencement date of the New Tax Law.

Enterprises currently enjoying preferential treatment in the form of enterprise income tax reduction or exemptions continue to enjoy such treatment until the end of the preferential treatment period, but enterprises which are entitled to preferential treatment but which have not yet actually received preferential treatment have the commencement of the preferential treatment period coincide with the year the New Tax Law comes into effect.

3.6. Conclusion

The PRC came into being on 1 October 1949. China has successively undergone three different economic systems since the establishment of the PRC, (a) the traditional planned economy (1949-1977), (b) the planned commodity economy (1978-1993), and (c) the socialist market economy (1994-to date).

Meanwhile, Chinese enterprise income tax system was established gradually with the development of its economic system, which has gone through multiple transformative stages, exhibiting different characteristics at each stage as a result of the interaction of the changing economic system of the time. Due to the differences of the economic

[94] EITL, Article 28.

systems at different stages, the taxpayer, tax rate tax items and effects of the enterprise income tax system vary significantly at each stage.

The enterprise income tax is not only one of the major sources of government revenue in China but also an important economic leverage and a key player for the macroeconomic control and regulation and greatly impacts on China's economic and social development. The enterprise income tax plays an increasingly important role in China’s broader taxation system.

Chapter 4 the Evolution of Accounting Standards in Modern China

4.1. Introduction

The history of accounting in China is as old as Chinese civilisation, dating back over two millennia,[95] perhaps even 3,000 years.[96] Accounting systems in China were among the most sophisticated of the early civilizations[97] and echoes from the earliest accounting practices continue to be found in Chinese accounting today.[98]

Like the Chinese economy and political system generally, Chinese accounting stagnated in the period following the Industrial Revolution in the West.[99] The limited progress in modernization made in the early decades of the 20th century after the end of the imperial dynasties came to an abrupt end with the proclamation of the PRC on October 1, 1949.

Accounting history in the period since the establishment of the PRC in 1949 falls into three periods which coincide with three phases of economic development. The first, lasting from 1949 to 1978, was an orthodox socialist economic period. The second, stretching from 1978 until 1992, was a transitional period for the economy as the country gradually moved towards a market economy and invited foreign investment. The third period, from 1992 to date, has seen China shift formally to a socialist market economy based on a fully private market regulated by socialist leadership and containing significant corporatized state-owned enterprises.

As with all facets of Chinese commercial development in the transition towards a

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[95] M Aiken and W Lu, 'Chinese Government Accounting: Historical Perspective and Current Practice' (1993) 125(2) *British Accounting Review* 109-129 at 109.

[96] C Solas and S Ayhan, 'The Historical Evolution of Accounting in China: Effects of Culture' (2007) 7 *Spanish Journal of Accounting History*146-173 at162.

[97] M Chatfield, *A History of Accounting Thought* (Robert E Krieger Publishing Co. Inc, New York, 1977); MA Van Hoepen, 'Accounting in China: a case of vanishing cultural influence' in J Blake and S Gao (eds), *Perspectives on Accounting and Finance in China*(Routledge , London,1995) 349-368.

[98] A Enthoven, 'Accounting, Auditing and Education in the People's Republic of China' in C Nobes and R.Parker (eds), *Comparative International Accounting*, 3rd edition (Prentice Hall, Sydney, 1991) 277-280.

[99] Ibid.

market economy, Chinese accounting rules reflect a combination of western influence in the private market, the socialist inclinations of the leadership, and the unique position of state-owned enterprises that operate alongside private businesses but, unlike their privately-owned competitors, are in many respects immune from ordinary market pressures. Most recently, the partial privatization of many of these enterprises has led to a convergence of the interests of the socialist state and the private market, but in many ways the Chinese accounting system remains unique, even following the notional adoption of (modified) international accounting standards.

Western accounting practice embodies two important elements: firstly, a system manual that prescribes how financial information is presented – such as through profit and loss statements, balance sheets, and so forth – and secondly, a set of principles that determine how the elements of financial data are measured. The systems side of accounting practice makes it clear that we record the expenditure of digging a hole in the ground, but the accounting principles tell us whether that hole is simply a sunk cost lost forever or a benefit with enduring value that should be recorded as an asset that offsets the outgoing. The story of accounting in modern China in the six decades since the Chinese revolution is to a large extent the story of how China has moved incrementally from an accounting practice lacking the principles needed to make the system function effectively, and has shifted towards a western model of combined practice and principles. Great progress has been made between the early years, when accounting was synonymous with socialist organization bookkeeping, and now, where the accounting system and principles, for a segment of the business world at least, seek to accurately measure assets, liabilities and cash flows to provide information to business owners, creditors and potential investors. Even today, however, the accounting regime remains fragmented with different rules applying to different sectors and a socialist legacy yields important differences between Chinese accounting standards and western standards.

4. 2. The Socialist years of Central Control and the Planned Economy: 1949-1978

At the time of founding of the PRC in 1949, almost 90 percent of the population lived in rural areas and agriculture accounted for almost the same percentage of the

economy.[100] There were, however, a number of key commercial centres and although accounting standards in China were fragmented, as was much of the economy, workable systems were in place in the commercial centres. Following the revolution, the government moved swiftly to adopt a planned economy modelled after the Soviet Union precedent and the need for a conventional accounting system for the benefit of creditors, investors and owners quickly disappeared along with private creditors, investors and owners.. Within a relatively short time, the resources of production had been transferred to the state and virtually all economic activity was carried out through state owned enterprises.

The economic planners and enterprise managers of the Soviet-style economy were not concerned with ascertaining risks or measuring returns in the conventional sense. The need was not for financial statements recording assets, liabilities and profit or loss but rather bookkeeping records to direct resources by central planners and to protect state property. The task of designing this system fell to the Ministry of Finance, which initially copied accounting regulations almost wholesale from Soviet precedents. The first accounting regulations, issued shortly after the revolution, were akin to instruction manuals for bookkeepers, with a focus on recording receipts, outgoings and assets of government departments.[101] The simplistic rules had little in common with conventional accounting principles. They mandated, for example, cash basis bookkeeping records in lieu of full accounts.

Following national conferences in 1951 and 1952 to discuss the role of accounting and the form of accounting statements in the new socialist economy, the Ministry of Finance issued multiple regulations that set out different rules for different industries and, often, different rules for different elements of single industries .[102] The Ministry were at pains to distinguish the fundamentally different nature of capitalist accounting and socialist accounting.[103] What Chinese authorities described as accounting

[100] JY Lin, F Cai and Z Li 'The lessons of China's transition to a market economy' *Cato Journal* (1996) 16 (2)201-231 at 202.

[101] The first accounting regulation promulgated by the Ministry of Finance, issued a year after the revolution, and was the *Temporary General Budget Accounting System for All Levels' People's Government.*

[102] ZH Zhou, 'Chinese Accounting Systems and Practices', *Accounting Organizations and Society* (1988) 13(2)207–224 at 209.

[103] XD Ji, *Development of Accounting and Auditing Systems in China* (Ashgate Publishing Limited, Aldershot, 2001) at 29.

regulations, western counterparts would consider something akin to inventory tracking.

In 1953, the central government launched its first "five year plan", a detailed outline of the country's economic goals for the following five years, focusing mostly on the development of heavy industry as the foundation for an industrial base. Accounting rules fragmented further in this period as the Ministry of Finance responded to requests from government departments seeking special rules for their own industries.[104] Accounting regulations veered in dramatic new directions from 1958 as the second five year plan ushered in the "Great Leap Forward" based on collectivisation of agriculture through the establishment of popular communes, control of communal administration by the party representatives and a shift to decentralised labour-intensive industrial development such as the construction of thousands of "backyard" steel mills.

The move to self-reliance and attempts at rural industrialism in the Great Leap Forward was accompanied by ideological developments that greatly impacted the development of accounting standards. In a move that foreshadowed the fanaticism of the Red Guards who would follow eight years later, the proponents of decentralised industry attacked the concept of detailed accounts as needless "scholasticism" and called for abolition of formal accounting rules in favour of limited record keeping, leading to a period of "accounting without books".[105]

Accounting ledgers and journals were eliminated and departments "simplified" their systems by withdrawing rules or merging multiple systems. The simplified rules lacked the data and conceptual analysis of the primitive rules that had been developed previously and the accounting personnel that had developed some expertise in using accounts were shifted to different responsibilities or enterprises. At this point, the

[104]For example, in 1953 and early 1954, the Ministry of Finance issued separate accounting regulations for state-owned construction enterprises, for industry enterprises, agricultural businesses, and supply and marketing agencies.

[105]MW Chan and W Rotenberg, 'Accounting, accounting education and economic reform in the People's Republic of China' (1999) 29 (3) *International Studies of Management & Organization* 37-53 at 39.

evolution of accounting principles and accounting education had stalled completely .[106]

A restoration of basic accounting processes began in 1961, following the ideological split between China and the Soviet Union. Senior figures reversed the shift to limited record keeping, affirming a position that comprehensive accounting books were essential to the operation of socialist enterprises.[107] Consistent with the policy of self-reliance adopted by Chinese authorities following the withdrawal of Soviet support, the Ministry of Finance set out to develop new systems appropriate for Chinese socialism, rather than revive the systems that had been modelled on Soviet style accounting systems. The five year period from 1962-1966 is regarded by some Chinese scholars as something of a golden era in socialist accounting and bookkeeping[108] with accounting procedures explicitly assigned a role in the national economic recovery .[109]

Accounting academics and practitioners focused on shifting from Soviet accounting theories to new, and simpler, Chinese rules. Many Chinese-authored accounting textbooks were published and a host of new accounting regulations were enacted. However, the Ministry of Finance's attempts to dominate the field were thwarted by other ministries and agencies issuing separate accounting regulations for industries falling within the spheres of their departments. Almost overnight, accounting systems shifted from superficial overviews with limited record keeping to an era of obsessively recorded detail.

This golden age of socialist accounting came to a crashing end in 1966 with the start of the Great Proletarian Cultural Revolution. Ten years of chaos followed. Accounting practice was viewed by the Red Guards as a vestige of capitalism and

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[106]E Chiapello and D Yuan, 'Searching for the Accounting Features of Capitalism: An Illustration with Economic Transition Process in China', paper presented to the Society for the Advancement of Socio-Economics conference, Budapest, 2 July 2005.
[107] For example, The Finance and Trading Office of the State Council paper, "The regulations on accounting work for state-operated businesses (Draft)".
[108] XD Ji, *Development of Accounting and Auditing Systems in China* (Ashgate Publishing Limited, Aldershot, 2001).
[109] SC Lawrence, 'Solving the Chinese Accounting Puzzle' (1997) 75 (8) *Management Accounting* 36-38 at 36.

feudalism and accounting practice largely terminated [110] while accounting education was entirely curtailed.[111] The Cultural Revolution petered out in 1976 and normality returned gradually.

4. 3. The Open Door policy period, 1978-1992

Following the death of Mao Zedong in 1976, Deng Xiaoping, a rehabilitated leader in the Party's central committee, gradually emerged as the defacto leader of China, though he was never appointed an official title as leader of the Party or State. The last remnants of the Cultural Revolution were swept away as central government re-established authority, and by 1978, the steep economic decline that had resulted from ideological distractions such as the Great Leap Forward and the Cultural Revolution had been fully reversed, with industry and agriculture outputs restored to the levels that had been reached before the damaging experiments.[112]

The stage was set for socialist China's most dramatic transition: its shift to a modern market economy. The turning point is usually traced to a key speech in 1978 by Deng to a plenary session of the Central Committee of the Communist Party of China in which he advocated China's adoption of an "open door" policy to learn from others on the path to economic development. The Central Committee supported Deng's proposal but the resolution setting the transformation in motion was short of detail on the path to be followed.[113] Policy makers' confusion over the substance of the new approach was revealed in a proliferation of inconsistent and terribly ambiguous labels adopted to describe the government's agenda.[114] Gradually, four policy limbs emerged

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[110] E Chiapello and D Yuan, 'Searching for the Accounting Features of Capitalism: An Illustration with Economic Transition Process in China', paper presented to the Society for the Advancement of Socio-Economics conference, Budapest, 2 July 2005.

[111] Solas and Ayhan claimed enterprises did not abandon accounting entirely. Rather, they say, firms ceased to apply traditional debit-credit booking and in its place used a system called the "increase-decrease" method of accounting which operated in a not dissimilar fashion. The claim is not supported in other studies. Please see C Solas and S Ayhan 'The Historical Evolution of Accounting in China: Effects of Culture' (2007) 7 *Spanish Journal of Accounting History* 146-173.

[112] VD Lippit, *the Economic Development of China* (E Sharp Inc., New York, 1987).

[113] NPC, *Resolution of the Third Session of the Eleventh Central Committee of Chinese Communist Party* (NPC, Beijing, 1978).

[114] These include: a planned economy supplemented by market mechanism (1982), a planned commodity economy based on public ownership (1984), internal unification of the planned and market mechanisms (1987), and an economic system and operational mechanism that combines planned economy and market mechanisms, and capable of adapting to the socialist planned commodity economy (1989). See H Brixi, C Valenduc and Z Li Swift, *Tax Expenditures — Shedding Light on*

as the foundation for the planned economic transformation. The first, and most important in terms of the expressed objectives of the reforms, was opening the economy to foreign investment, a step designed to attract investment capital and, more importantly, foreign expertise and examples. The expertise and experience were in many ways more important than the capital, as the other three development limbs were directly tied to upgrading and modernizing Chinese business skills and practice. These limbs were, firstly, the corporatization of state owned enterprises so that they could compete effectively in a market economy against privately owned and foreign owned firms, secondly some privatisation of state firms and, thirdly, the encouragement of new privately owned businesses.

It is difficult to imagine an accounting regime less well suited to the needs of a market economy than the one in place in China on the eve of the move to a market economy. There was no independent accounting profession providing independent advice. There were no generally accepted accounting principles. What Chinese authorities regarded as accounting rules and accounting systems were little more than simple unbalanced single entry bookkeeping records and a multitude of rules on financial practice established by different government agencies for different state-owned enterprises reporting to their government owners.[115] The rules were largely irrelevant to privately owned or foreign owned businesses and equally inappropriate for state owned enterprises about to be converted to stand alone state owned companies. There was an urgent need for reform and soon after the shift to the open economy was announced, an accounting reform program commenced.

The reform program had two limbs – the imposition of accounting obligations on state owned enterprises and private firms and the development of an accounting profession. The almost haphazard manner in which reforms were adopted revealed much about the governments disjointed policymaking processes and the failure of senior policymakers to understand fully the concepts underlying the rules they were seeking to adopt.

Government Spending through the Tax System, Lessons from Developed and Transition Economies(The World Bank, Washington DC, 2003).

[115] MW Chan and W Rotenberg, 'Accounting, accounting education and economic reform in the People's Republic of China' (1999) 29 (3) *International Studies of Management & Organization* 37-53.

4.2.1. Accounting Standards for firms with some Foreign Ownership

The trigger for the development of accounting standards in China was the establishment of companies with foreign ownership from 1979. As noted earlier, one of the primary objectives of the Chinese government in allowing foreign investment, particularly by way of investment in jointly owned enterprises, was to allow Chinese managers of state owned enterprises and potential private sector entrepreneurs to learn modern commercial techniques from foreign enterprises operating in China.

These jointly owned enterprises took two forms. Where the foreign investor had a substantial (but always under 50%) interest, the joint ownership was (and continues to be) known as a "joint venture", though these jointly owned companies bear no relationship to a contractual joint venture in the ordinary western sense of the term.[116] When the foreign investor had a much smaller share of the jointly owned company, the arrangement was called "collaboration". Joint ventures, in the western sense of the term, were possible from 1988,[117] the year in which wholly owned subsidiaries also became possible.[118]

In the initial stages, foreign investors' equity investments comprised some actual capital, along with some intellectual property and production equipment, while the Chinese investors' equity usually came in-kind, often in the form of overvalued real property and greatly overvalued and outdated production equipment. The true contribution of the Chinese partners was a readily available labour force and, more importantly, "guanxi", the unique Chinese web of personal connections that yield business benefits. Particularly important was the Chinese partners' personal connections with relevant government officials.

Until 1979, government revenue had come wholly from the appropriated income of

[116]Law of the People's Republic of China on Sino-Foreign Equity Joint Ventures, effective 7 July 1979, and the Implementing Regulations for the Law of the People's Republic of China on Sino-Foreign Equity Joint Ventures, effective 20 September 1983. The first registered joint venture was the Beijing Air Catering Co., Ltd., which commenced operations first Sino-foreign joint venture in 1980.

[117]Law of the People's Republic of China on Sino-Foreign Cooperative Joint Ventures, effective 13 April 13 1988, and the Detailed Implementing Rules for the Law of the People's Republic of China on Sino-Foreign Cooperative Joint Ventures, effective 4 September 1995.

[118]The Law of the People's Republic of China on Wholly Foreign-Owned Enterprises, effective 12 April 1986; Detailed Implementing Rules for the Law of the People's Republic of China on Wholly Foreign-Owned Enterprises, effective12 December 1990.

state-owned enterprises; a system that could not be applied to new enterprises with foreign investment. The only way to raise revenue from companies that were partially privately owned was adoption of a company income tax system, and soon after the initial foreign investors arrived, work began on developing a company income tax. Before that could be completed, however, decisions had to be made on accounting systems. An income tax is levied on profits, and the Chinese accounting systems in place, comprising little more than fragmented bookkeeping rules, were wholly inadequate for the task of measuring annual profits.

In anticipation of income taxation and probable future economic restructuring, in November 1979, the Ministry of Finance released an initial draft of proposed new accounting standards to be incorporated into general regulations on accounting procedures.[119] The following year, before any final decisions on the draft standards had been made, a company income tax law was adopted for enterprises with foreign investors,[120] along with a requirement that these firms produce audited accounts to be used as the basis for calculating their income tax liability. This left companies in the impossible position of having to produce audited accounting statements with no recognised auditors to do the task and no recognised standards to apply when preparing the statements.

The socialist era "standards" that the 1979 proposals were to replace were, as noted, little more than procedural rules with no "standards" in the modern sense of the term encompassing fundamental principles of recognition and characterisation. While the 1979 proposals consolidated the array of fragmented industry rules in place, they continued to lack the recognition and characterisation principles at the heart of modern accounting standards. The initial release of draft accounting rules in late 1979 was followed 14 months later, in February 1982, by a survey of companies seeking reactions to the initial draft.[121] Five months later, the Ministry released a second draft for comments[122] and, following consideration of the comments it received, the Ministry released two draft documents in March 1983 dealing with

[119] Entitled "Some Regulations on the Financial and Accounting for Joint Ventures".
[120] Enterprise Income Tax for Sino-Foreign Joint Ventures (promulgated by the National People's Cong., Sept. 10, 1980, effective on Sept. 10, 1980).
[121] Entitled "The Survey of the Accounting System Framework for Joint Ventures".
[122] Entitled "The Management Accounting System for Joint Ventures (Draft for Comments)".

standards and procedures.[123] In March 1985, two years later and almost six years after the process started, a final regulation with accounting rules for foreign owned and jointly owned enterprises was promulgated by the State Council– the executive body with lawmaking powers.[124] The new rules came into effect on 1 July 1985.

The accounting regulation for jointly owned enterprises drew upon what Chinese officials understood to be commonly used practice in foreign accounting systems, introducing for the first time in Chinese law or standards, internationally-recognized terminology and concepts such as amortization of the intangible assets and start-up costs.[125] It was obvious to advisors for the foreign firms, however, that the Chinese authorities had very different understandings of accounting standards compared to those of accountants in market economies. For the most part, the Chinese "standards" simply identified issues that needed to be addressed in accounts without explaining in detail how they should be addressed. Most importantly, the final regulation completely lacked guidance on recognition and characterization principles similar to those set out in generally accepted accounting principles used in market economies.

In the absence of clear Chinese accounting standards, foreign investors tended to follow the procedures set out in their national standards for their investments, making it easier to transfer data to the parents' accounts. At the same time, to satisfy the demands of local authorities they maintained a second set of books not based on any accounting standard but instead recording cash flows in the manner used for Chinese "accounting systems" (more accurately described as bookkeeping systems).

4.2.2. Accounting standards for State-owned Enterprises Ownership

The introduction of foreign capital to the Chinese market prompted a recognition that states owned enterprises would have to modernise to remain viable in the long term. To this end, state owned enterprises were converted to "companies" with the state as

[123] Entitled "The Accounting System for Joint Ventures (Draft for Test)" and "The Accounting Subjects and Financial Statements for Joint Ventures (Draft for Test)".
[124] The Chinese legislature, the National Peoples' Congress, passes legislation known as "Laws" and executive State Council passes legislation known as "Regulations". The State Council is roughly equivalent to the Cabinet in a western government but has the power to issue binding legislation in the form of Regulations.
[125] RW Scapens and Z Hao, 'Chinese Accounting Reform: Reasons and Effects' in J Blake and S Gao (eds), *Perspectives on Accounting and Finance in China* (Routledge , London,1995)261-284.

the sole shareholder so the enterprises could adopt structures, processes and accounting procedures that would allow them to compete in the longer term with international counterparts. However, the move to modern corporate management systems was partly stymied by the fact that the newly created management structures in corporatized state owned enterprises were populated by the exact same persons who had run the firms when they were branches of provincial government departments or national government ministries. The bureaucrats had new titles but carried on in much the same fashion as before. More significantly, the collapse of management standards during the Cultural Revolution had left state owned enterprises vulnerable to corruption, embezzlement and engagement in speculative investments; activities which were resulting in significant losses for the state.

An obvious avenue to address these problems would have been the adoption and mandatory use of modern accounting standards that would expose practices and performance and clear the path for remedial actions. With the decline of the Cultural Revolution in 1976, China had gradually resurrected the fragmented accounting system for state owned enterprises that had been in suspension for the previous decade,[126]and in 1980, following the shift to the open door policy, the Ministry of Finance attempted to consolidate practice by issuing overarching rules that set out basic reporting requirements for accounting statements of state owned enterprises,[127] followed by more specific rules for different types of state owned enterprises.[128]

The new rules had a limited impact on corruption and abuse, with reports emerging of management not only interfering with accounting practices, but actually abusing accounting officers and staff who had exposed corrupt activities.[129] The elementary framework for accounting practice set out in the rules lacked any conceptual framework for accurate measurements of profits and the resulting accounts told little of the true financial situation of an enterprise. The inadequacies of the procedures and the lack of guiding principles became even more obvious following the shift from a

[126] Ironically, the system was officially known as the "uniform system", though it was anything but uniform a multitude of systems developed for different industries.
[127] *Accounting system for state-owned enterprises-Accounting statements*, subsequently revised in 1985.
[128] Separate rules were issued for industrial enterprises (1980), agricultural and fishing enterprises (1986), construction enterprises (1986).
[129] ZH Zhou, 'Chinese Accounting Systems and Practices', *Accounting Organizations and Society* (1988) 13(2)207–224 at 208.

system based on appropriation of income from state owned enterprises to a company tax system for government owned firms in 1983, three years after the income tax for companies with foreign investment had been adopted.[130]

Intervention at the highest level came in 1985 when the Chinese leadership concluded the accounting system should have a foundation with more authority than ministerial rules and arranged for the NPC to enact an "Accounting Law",[131] the first legislation dealing with accounting since the establishment of the PRC in 1949. The primary objective of the law, a short piece of legislation with only 31 sections in total, was to curtail reckless and corrupt behaviour by mandating comprehensive accounts and accounting practice in all state-owned business enterprises and institutions including all public agencies, with the armed forces receiving a specific mention. The law sought to establish and protect the independence of in-house accountants while providing sanctions for managers of entities who failed to take appropriate action in response to information in the accounts,[132]which is somewhat euphemistic language for failure to address corruption or mismanagement exposed by accounts.

The Accounting Law stipulated that the Ministry of Finance would draft national accounting standards[133] but it left government departments and sub-entities with considerable discretion to develop their own variations of the national standards. The concept of "standards" remained a notion of procedures and systems rather than standards in the sense of Generally Accepted Accounting Principles (GAAP) or International Financial Report Standards (IFRS) accounting principles. No timetable was identified for the release of standards by the Ministry.

Entrenched interests in state-owned enterprises stalled the process and it was not until 1988 that the Ministry of Finance started the process of developing new standards by appointing a special study group to prepare an initial draft of the new standards.

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[130] Experimental Provisions on Substituting Tax for Profits in State-Owned Enterprises (promulgated by the State Council, 24 April 1983, with the tax implemented on 1 June 1983 with retrospective calculation of profits from 1 January 1983.

[131] Adopted at the Ninth Meeting of the Standing Committee of the Sixth National People's Congress on 21January 1985, Amended at the Fifth Session of the Standing Committee of the Eighth National People's Congress on 29 December 1993, then 1999.

[132] Article 28.

[133] Article 6 spoke of the Department establishing a "uniform accounting system" which was understood to include accounting standards.

Financial support for the project was provided by the World Bank and technical support was commissioned from international accounting firms. The process was endorsed a few months later by a special conference on accounting standards held in January 1989 during the annual meeting of the Accounting Society of China (ASC), a national accounting body established in the Ministry of Finance.

Progress was slow, however. In the absence of a clear objective basis for calculating taxable profits, tax collection was often a matter of negotiation, and while the process may have been neither efficient nor equitable, government revenues from all sources were sufficient. Most of the economy remained under state ownership and the sole shareholder did not require financial information to compare returns on investment. Nor was such information needed for the benefit of creditors. State owned banks lent to state owned companies with explicit or implicit direction from governing ministries and lenders had no need to access accurate balance sheets and profit and loss accounts. Enterprises were less interested in recording accurately changes in their economic position as reflected in a modern profit and loss statement than in measuring inventories of assets so their shareholders – ministries in the national and local governments – could know what they owned.

The jolt that shifted the seemingly glacial process of developing modern accounting standards was the re-opening of the Shanghai stock exchange and the opening of the Shenzhen exchange in 1990. From 1991, individuals and legal entities were allowed to buy shares in state owned enterprises and the central and provincial governments set about realizing the value of their new shareholdings in these enterprises through partial privatizations. The need for coherent accounting standards that would be applied consistently by public and private corporations was acute. At the same time, state enterprises were beginning to engage in international activities and business transactions and finance activities became more complex, particularly as domestic enterprises began to interact with foreign owned firms. The owners of state enterprises needed a clearer picture of the commercial status of these firms.

In early 1991, the Ministry distributed to accounting academics and professionals a

first draft of its proposed Chinese Accounting Standards for domestic enterprises.[134] The following year, in February 1992, international experts were invited to comment on the proposals at an international symposium on the proposed standards. The foreign experts noted that the standards focused for the most part on accounting processes and the content of accounting statements, not the principles that should be used to translate transactions into records.

The continued absence of generally accepted accounting principles in proposals for reform was not surprising. A little more than a decade after the opening of the economy to private sector involvement, decisions were still being made by persons educated in a socialist environment and mostly concerned with state owned enterprises. State owned enterprises were primarily interested in valuing assets (preferably on the high side) to extract maximum equity interests in joint ventures with foreign firms and foreign firms could account for their investments using their own accounting systems as required to report to their own shareholders. The full range of commercial arrangements accessed by firms in western market economies – finance leases, forward exchange contracts, prepaid service arrangements, purchased goodwill, repo contracts substituting for debt, payments contingent on production or profit levels, and so on – could not and did not feature at all in the strict confines of Chinese domestic commercial practice. For the most part, accountants did not encounter anything but the simplest of transactions and there was no need to draw on generally accepted accounting principles to determine how arrangements should be recorded for accounting purposes.

4. 4. The "Socialist Market Economy" Period, 1992-2005

4. 4.1. Background

The period of the "Open Door" policy had been one of tremendous economic change in China with rapid economic developments outpacing political developments. It was not until October 1992 that the 14th Congress of the Communist Party of China officially recognized the substantial economic achievements that had taken place since 1978, acknowledged the many tasks that lay ahead, and formally endorsed the

[134]Chinese Accounting Standards for Domestic Enterprises No. 1 - Basic Standards.

adoption of a "socialist market economy."[135] The following year, Article 15 of the Constitution was amended to replace the objective of a "planned economy on the basis of socialist public ownership" with implementation of the socialist market economy.[136] It was in this environment that development of Chinese accounting standards preceded.

4. 4.2. "Establishment of Accounting Standard" Phase: 1992- 1997

Even as domestic experts were debating some aspects of the draft accounting standards released by the Ministry of Finance in 1991, shares were being traded in publicly listed joint stock companies on the Shanghai and Shenzhen stock exchanges. The relaxed timetable for the development and adoption of general standards for the nation was far too slow for the needs of the trading market and in January 1992 the Ministry of Finance moved to leapfrog the development of general rules with a specific set of accounting standards for publicly listed companies.[137] At the same time, the 1985 system for companies with foreign ownership was revised in part to reflect the changed nature of foreign investment over the intervening period.[138] The 1992 standards for publicly listed companies set out standards of disclosure and accounting practice but once again failed to detail accounting principles on recognition and characterization akin to those found in GAAPs or IFRS. Chinese authorities' notions of accounting standards remained far from those of western investors and the profession abroad.

Meanwhile, the Ministry's study group on accounting standards continued work on general standards for domestically-owned firms other than publicly listed companies. As noted, a draft of these had been released in early 1991 and reviewed by international experts in early 1992. The model being developed comprised two major

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[135] President Jiang Zemin, Speech at the Fourteenth National People's Congress: Accelerate Opening Up Reform and the Pace of Modernization, Strive for the Success of Socialism with Chinese Characteristics (1992). See further Chen Su, 'The Establishment and Development of the Chinese Economic Legal System in the Past Sixty Years' (2009)23(7) *Columbia Journal of Asian Law*109–136.
[136] Amendment to the Constitution in 1993.
[137] Entitled "Accounting System for Experimental Joint Stock Limited Enterprises", subsequently replaced with "Accounting System for Joint Stock Limited Enterprises" once the exchanges were fully developed.
[138] The 1985 standards were set out in the Accounting system of People's Republic of China for Sino-foreign joint ventures. The 1992 revision was labelled the Accounting system for foreign investment enterprises of PRC.

components. The first, labelled basic "standards", set out the fundamental concepts underlying accounting practice such as assets, liabilities, owners' equity, revenues and expenses. The second, known as the financial principles, contained the general principles governing accounting processes for recording and reporting. Together these were to provide a foundation for the development of more detailed accounting rules for different types of transactions and arrangements but, significantly, were not in themselves standards in the conventional western sense of the term. They were, rather, a skeletal framework to which actual standards setting out the recognition rules for different types of transactions could be attached.[139]

In late 1992, the Ministry of Finance released the final versions of the "standards" and "principles" for domestically owned companies that had been released in draft form the previous year. They were made effective from 1993. The first part, labelled the "Basic Standard",[140] described all the information that should be set out in financial reports and the second, called the "General Financial Principles",[141] provided details of how the information should be set out. The Basic Standard and the General Financial Principles were subsequently supplemented by 13 sets of industry-specific accounting rules[142] and 10 sets of industry-specific financial rules.

In one sense, the 1993 measures were a milestone development in terms of being the first time that Western experience was explicitly relied upon. International accounting norms such as debit-credit bookkeeping, as well as the adoption of basic accounting concepts such as asset, liability, revenue and expenses had become part of Chinese accounting standards, as had some fundamental internationally accepted accounting principles, including the principles of prudence and capital maintenance as well as recognition for the need to capitalize into the price of inventory the direct costs of manufacturing.

However, notwithstanding the impressive array of rules, the package was as

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[139] XD Ji, W Lu and M Aiken 'How do the Chinese management accountants cope with changes from a planned economy to a market economy' (2007) 15(1) *Asian Review of accounting* 45-61 at 48.
[140] Officially known as the "Enterprises Accounting Standard".
[141] Officially titled the "General Financial Principles for Enterprises".
[142] These were: general manufacturing, agriculture, railway transportation, airline transportation, other transportation, communications, financial institutions, insurance, tourism and catering, foreign economic cooperation, merchandising, construction and real estate development.

noteworthy for its gaps as much as its inclusions. Accountants had rules to govern what went into financial accounts and rules on how to set out the accounts, but they still lacked generally accepted accounting principles needed to translate actual business operations into presentable accounts. The government concluded the development of these accounting standards would best be left to an organization with international expertise and, in 1993, with funding from the World Bank, the Ministry of Finance engaged Deloitte Touche Tohmatsu as consultants for a three year period to develop a body of practical and detailed Chinese Accounting Standards (CAS) broadly in line with accounting principles used internationally. Working with the Ministry, Deloitte Touche Tohmatsu developed over the life of its three year contract 30 detailed draft standards which were released by the Ministry as exposure drafts in the period 1994 to 1996.

Paralleling the development of the general accounting practice standards was the gradual formal establishment of the accounting profession. The formal accounting profession in China dated from the establishment of the country's first accounting firm in 1918, seven years after the fall of the last Manchu emperor.[143] The profession grew exponentially until the revolution, and quickly withered after 1949 along with the private business sector.[144] Accounts of state owned enterprises were thereafter maintained by government officials with no particular training or recognition as a profession.

The enactment of a company income tax law for enterprises with foreign investors in 1980 had been accompanied by the release of rules by the Ministry of Finance requiring enterprises subject to the new tax to attach audited financial statements to their income tax returns, with the stipulation that the auditing must be completed by a "certified practicing accountant".[145] As noted, this created something of a dilemma for the affected companies as there was neither an accounting profession in China nor any organization that might certify accountants as CPAs at the time. A week after issuing

[143] H Yee, 'The re-emergence of the public accountancy profession in China: a contextual analysis'in T Tinker T (eds) *Critical perspectives on accounting conference papers(2005),* New York: City University of New York at Baruch College1-20.
[144] ZD Xu , 'The Development of the Certified Public Accountant System in the People's Republic of China", in A Tsuji and P Garner (eds) *Studies in Accounting History* (Greenwood Press, Connecticut, 1995)57-70.
[145]The "Implementation Rules for the PRC Law on Income Taxation of China-Foreign Equity Joint Ventures".

the rules requiring companies with foreign ownership to submit audited accounts, the Ministry promulgated a second set of rules to establish an Accounting Advisory Office within the Ministry that would be responsible for supervising the development of the accounting profession.[146]

The new office had the power to "certify" an accountant as a CPA relying solely on officials' subjective views about a potential practitioner's experience and education. As there was no private profession at the time, the first CPAs were drawn from the financial officers retired from state owned enterprises or the government.

Also in 1980, the Ministry created a body within the Ministry of Finance entitled "The Accounting Society of China", charged with the task of representing the interests of all Chinese accounting academics and practitioners. The Accounting Society had no powers to regulate the profession or establish standards. Rather, its role was limited to representing the profession. In practice, as an entity within the Ministry of Finance, it was more likely to represent the Ministry's views to the profession. The following year, in 1981, the Ministry of Finance approved the establishment of the first private accounting firm since 1949.[147]

In 1986, the Ministry of Finance took the first steps to formalize an accounting profession with the promulgation of regulations to govern accounting practice.[148] Since 1980, the Accounting Advisory Office had been designating accountants as CPAs on the basis of informal assessments by bureaucrats who themselves had no formal accounting qualifications. The new regulations mandated passing a national examination as a prerequisite for practice as a certified practicing accountant and specified that all CPAs should be subject to a national registration system. However, nobody was established to set the exams or register qualifying practitioners and, notwithstanding the new regulations, the system of informal assessment remained in

[146]The "Interim Provisions on Setting up an Accounting Advisory Division", 23 Dcember 1980.
[147]The first private accounting firm soliciting business from separate organisations was established in Shanghai. At the same time, the government made it possible for state owned bodies, including government departments, to establish separate accounting firms as subsidiary bodies. It was hoped that spinning off accounting operation to separate units would facilitate a more rapid development of a separate accounting profession. See F Narayan and B Reid, *Financial Management and Governance Issues in the People's Republic of China* (Asian Development Bank, Manila, 2000).
[148] The "Regulations on Certified Public Accountants".

place.

Finally, in 1988, the Ministry established a subordinate internal agency called the Chinese Institute of Certified Accountants, conferring upon this body the power to recognize accountants. But it was not until 1991, five years after examination became compulsory, that the Ministry actually established a national examination system to replace the ad hoc system of subjective informal approval of CPAs by Ministry officials. Two years later the National People's Congress replaced the previous regulations and rules with a formal Certified Public Accountants Law, effective from January 1, 1994.The new law established a formal governing body for accountants, the China Institute of Certified Public Accountants (CICPA), established rules around the qualifications required for persons to be recognized as CPAs, set out the legal responsibilities of accountants, and provided disciplinary rules for errant accountants. Importantly, the CICPA was never envisaged as an independent body similar to its western counterparts. Like its predecessor body, it was established within the Ministry of Finance and the Ministry continues to supervise the profession.[149]

4. 4.3. "Development" phase: 1997-2005

At the end of 1996, China was on the cusp of its path to modern accounting. Accounting practice was guided by unwieldy and fragmented "basic standards", "general financial principles", 13 industry specific rules, 10 sets of industry specific financial rules and 30 drafts of accounting principles prepared by a multinational accounting firm. Almost 20 years into the shift to a market economy, no final principles were in place. The Ministry of Finance realised the practice rules and principles were both in need of reform and it set in motion parallel systems to address the two issues.

First to be addressed was the absence of binding formal accounting principles. In 1997, the Ministry of Finance moved to test the 30 detailed draft standards that had been released over the previous three years by implementing a trial program with

[149] SC Lawrence, 'Solving the Chinese Accounting Puzzle' (1997) 75(8) *Management Accounting* 36-38 at 37.

selected large state owned enterprises. From 1998, the Ministry began releasing final standards and in the period 1998 to 2000 it issued 16 final standards dealing with issues such as disclosure of related party relationships, cash flow statements, debt restructuring, construction contracts, contingencies, and transactions after the balance sheet date. While not labelled as such at the time of their release, these 16 final standards are now referred to as the "original" Chinese Accounting Standards.

Even as the standards were being released, the accounting profession, particularly the parts with foreign ties, argued that the very limited set of 16 unconnected principles developed by Deloitte were wholly inadequate for the needs of Chinese companies wishing to expand abroad, and for foreign firms investing in China. In response to these issues, the Ministry of Finance established in 1998 a new organisation, the China Accounting Standards Committee, with a mandate to fold the 16 principles into a broader set of modern accounting standards. The Standards Committee had the form of a quasi-independent body located outside the Ministry but it reported directly to an accounting regulatory department within the Ministry,

As the new Committee began to prepare a comprehensive set of accounting principles for China, work also began on the rationalisation of the accounting systems following a 1999 amendment of the Accounting Law that directed the Ministry of Finance to unify and modernize accounting reporting rules. At this point, China had three separate accounting reporting regimes – the system for publicly listed joint-stock companies released in 1992, the system for companies with foreign ownership, first released in 1985 and revised in 1992, and the generic system for state owned and domestic companies based on the 1993 basic standards, general financial principles, 13 sets of industry-specific rules 10 sets of industry-specific financial rules.

Among the catalysts for reform was China's move to join the WTO and a recognition that separate accounting systems for unlisted domestically owned firms, publicly-listed domestically owned firms, and firms with some foreign interests would be incompatible with WTO obligations. The accounting regulatory department within the Ministry of Finance was charged with responsibility for consolidating the systems into a single "unified" accounting system.

Compared to the very long gestation period for the existing accounting reporting rules, the development of the new "unified" system took place in a remarkably short period, this time without the array of conferences, drafts, and international consulting input that stretched the earlier process out for a decade. In 2000, a year after the Ministry was directed by legislation to consolidate the reporting rules, the first tranche of "unified" accounting rules was released. There were in total three limbs to the unified accounting system – one for financial institutions, another for small business, and a default regime for all other listed and unlisted domestically owned companies and companies with foreign ownership.

The general or default system, known as the "Accounting System for Business Enterprises" (the "ASBE"), was released in 2000 and was extended progressively to different types of enterprises over a three year period. The first tranche, effective in 2001, targeted publicly listed companies and replaced the 1992 rules for these companies. In 2002 the ASBE was extended to companies with foreign ownership, replacing the 1985/1992 accounting rules these enterprises had used. Finally, in 2003 the ASBE was extended to all remaining private and state owned enterprises in China other than financial institutions and small business, replacing the 1993 Basic Standards and General Financial Principles that applied to domestic companies.

Companies applying the ASBE encountered a number of questions not clearly addressed in the system rules. In response, the Ministry of Finance supplemented the system from time to time with further pronouncements, including 11 industry-specific guidelines and a number of ad hoc pronouncements. These industry specific accounting guidelines replaced the equivalent old industry-specific accounting rules issued in 1993.

The second of the three unified systems was the Accounting System for Financial Institutions, released early in 2002, with retrospective application to the beginning of that year. It was made mandatory for all listed invested banks, insurance companies, brokerages, leasing companies, and finance companies, as well as those with foreign ownership. Unlisted financial institutions were encouraged following the introduction of the new system. The accounting system for financial institutions was similar to the accounting system for general business enterprises. It contained additional principles,

however, to address issues such as the recognition of interest, the characterization of purchase-repurchase agreements, accounting for various types of securities transactions, the recognition of insurance reserves, accounting for trust accounts, and accounting for investment funds.

The last of the unified accounting systems to be adopted was the Accounting System for Small Business Enterprises (ASSBE), issued in early 2004 with effect from 2005. Small business enterprises were defined as private companies falling below three turnover tests relating to number of employees, turnover, and total assets. Different tests were used for "industrial", "construction" and "retail" enterprises.[150]

The ASSBE accounting system provided simplified rules or outright exemptions from some of the rules applicable to larger businesses. To begin with, ASSBE firms were only required to produce a profit (income and expense) statement and balance sheet. Preparation of a cash flow statement was optional and if an ASSBE firm chose to prepare a cash flow statement, this could be constructed using the direct method.

4. 5. Convergence with international standards, 2006

By 2005, China had in place a relatively comprehensive "unified system" for accounting for domestic enterprises, albeit set out in three completely separate limbs, with the default limb supplemented by a number of industry-specific guidelines and ad hoc pronouncements. It still lacked a set of comprehensive accounting principles or standards, however. Chinese companies had already, or were preparing to, list on Chinese exchanges, and others were exploring listings in Hong Kong or elsewhere. At the same time, more companies were seeking foreign investment or entering into new joint enterprises with foreign firms. The China Accounting Standards Committee faced increasing pressure to release comprehensive accounting principles for China.

In Europe and in many parts of the Asia-Pacific region, countries had been shifting

[150] The threshold for industrial companies was less than 300 employees, an annual turnover less than a little under USD $4 million and total assets of less than a little over USD $6 million. The threshold for construction companies is the same in terms of turnover and assets but the employee number threshold is raised to 600. Much lower thresholds apply to retail businesses, with no assets threshold for these businesses, an employee number threshold of 100 and turnover threshold of approximately USD $1.6 million.

from national GAAPs (generally accepted accounting systems) first to International Financial Standards and, from 2001, IFRS. The Accounting Standards Committee in the Ministry of Finance, which had been working on a set of Chinese accounting standards since 1998, realised standards based on IFRS could be adopted much more quickly and, more importantly, would be much more appropriate for an economy that was rapidly integrating into the global market. Accordingly the Committee began to work closely with the International Accounting Standards Board to ensure consistency between new Chinese rules and IFRS.

One reason western-style GAAPs had failed to gain traction in China was the absence of procedural rules in GAAPs. Western GAAPs tended to set out principles for recognising and charactering flows and assets but lacked the detailed procedural rules and presentation specifications that constituted accounting "standards" in China. After a quarter century, Chinese authorities finally understood the need for conceptual principles in accounting standards but they also wanted to see the procedural and presentation specifications that they had traditionally misunderstood to constitute accounting standards. In contrast with GAAPs, the IFRS sets out both processes and principles and this made it an attractive template for the design of Chinese CAS.

Starting with the IFRS, the Accounting Standards Committee was able to generate new rules quickly and in February 2006 the Ministry of Finance issued new Chinese Accounting Standards (CAS).[151] The new standards were made effective from 2007 for all listed companies.

The Chinese CAS closely follows the dual track of the IFRS, setting out both processes and principles. The CAS is built on one "Basic Standard" and 38 specific standards. The Basic Standard of the CAS is similar to the International Accounting Standards Board's "Preparation and Presentation of Financial Statements" framework and stipulates the objectives of financial reporting, recognition and measurement principles, underlying assumptions of accounting, and primary characteristics of accounting information, recognition, and measurement of accounting elements. Specific Standards are divided into three categories – accounting standards for general

[151] The full official name is CAS for Business Enterprises and that is often shortened to CAS.

businesses, accounting standards for specific businesses in special industries and reporting standards.

While the CAS have "substantially converged" with IFRS,[152] some significant and measurable differences remain.[153] For the most part, these are pragmatic variations adopted to reflect unique features of China's mixed economy, particularly the large and continuing role of the state in the economy through ownership of state owned enterprises and the impact of regulation on market prices. An example of the former factor may be found in the CAS rule for related party disclosures (CAS 36), which classifies state controlled entities as related parties in far fewer circumstances than its IFRS counterpart (IAS 24). With the central government or provincial governments being the ultimate controllers of most enterprises, the IFRS rule would result in most transactions being treated as related party transactions. Similarly, while the rules do not explicitly refer to state owned enterprises, the CAS rule for reporting business combinations (CAS 20) have a number of detailed rules that could only apply to companies accepting in-kind contributions from state owned enterprises as consideration for shares. These rules have no counterpart in the IFRS standard for (IFRS 3). Another example is the absence in the CAS of any rule dealing with transactions where shares are used to pay for goods – a transaction unknown in China – in contrast to specific rule in IFRS on this.[154]

The impact of China's continued regulation of market prices in many sectors is reflected in the differing priorities CAS and IFRS give to fair value accounting. Seeking to present most accurately the true economic worth of entities and their assets, international accounting standards have increasingly moved in the direction of mark-to-market and fair value accounting rather than possibly misleading historical cost. Crucial to the adoption of fair value accounting is the availability of a market that will determine fair value prices. Notwithstanding the tremendous changes in the Chinese economy over the past three decades, it is not a market economy. Regulation, and not market forces, determines the price in large parts of the economy and there are

[152] World Bank, *Report on the Observance of Standards and Codes (ROSC) – Accounting and Auditing: People's Republic of China* (World Bank, Washington, DC, 2009).
[153] X Qu and Z Guohua , 'Measuring the Convergence of National Accounting Standards with International Financial Reporting Standards: The Application of Fuzzy Clustering Analysis' (2010)45(3) *International Journal of Accounting* 334-355 at 344.
[154] Included in IFRS 2; CAS 11 is the equivalent CAS which is silent on this particular issue.

distortions and often a lack of sophistication in other segments of the economy, making it difficult to find a genuine fair value in many cases. Accordingly, the CAS allows fair value accounting in respect of many types of assets only where there is a true active market

Other differences between the CAS and IFRS are more difficult to explain as pragmatic deviations reflecting structural features of the Chinese economy. It is difficult to discount the possibility that ideology or concern over potential abuse of rules plays a role in the CAS' departures from IFRS. For example, the IFRS rule on impairment of assets (IFRS 36) allows for a reversal in later periods of an earlier impairment loss in respect of an asset (other than goodwill) while the CAS explicitly prohibits reversal of an earlier period impairment loss. Perhaps drawing on their experience with state owned enterprises, the designers of the Chinese accounting standards could not envisage in the Chinese context an enterprise ever genuinely restoring value to impaired assets.

The adoption of CAS in 2006 has modernised an important segment of the China's accounting practice, but the limited application of CAS to listed firms only left China with multiple sets of accounting standards: CAS for listed companies, the 2000 ASBE for unlisted enterprises other than small business, financial institutions and enterprises with foreign ownership, the 2002 Accounting System for Financial Institutions for unlisted financial institutions, and the 2004 ASSBE for small business enterprises. A new ASSBE was released in 2011, with effect from 1 January 2013.[155] The new ASSBE is simpler to apply and is expected to reduce accounting burdens.

Despite the recent affirmation of different rules for small businesses, there may be a gradual shift towards CAS more generally. While they are technically covered by the ASBE, from the outset of CAS firms with foreign ownership have been allowed to elect to use CAS instead and many are following this path. Shortly before the CAS became obligatory for listed companies, the prudential agencies responsible for regulation of insurance companies,[156] securities and fund management companies,[157]

[155]Ministry of Finance, Caikuai [2011] No. 17.
[156]China Insurance Regulatory Commission, BaoJianFa [2006] No. 96.
[157]China Securities Regulatory Commission, ZhengJianHuiJiZi [2006] No. 22 and 23.

national banks, and local and rural banks required unlisted institutions to also adopt CAS over defined timetables.[158] More significantly, local provincial bureaus of the Ministry of Finance have the power to mandate changes to accounting practice and some provincial offices have moved to enlarge the scope of CAS by requiring unlisted companies in selected industries or sectors to shift from ASBE to CAS. For example, in mid-2008 the Guangzhou bureau designated CAS for selected large and medium-sized state owned enterprises,[159] while Shanghai followed soon afterwards, requiring CAS for these enterprises with a two year phase-in.[160]

The Accounting Standards Committee within the Ministry of Finance realised the importance of ultimately aligning CAS more closely with IFRS and in April 2010 the Ministry issued a "roadmap" setting out its plans to align the two sets of standards by 2012.[161] The timetable has proved too optimistic and there has been little said by the Ministry about progress since an announcement in 2011 that work is progressing on the alignment of CAS with IFRS by shifting the inconsistent Chinese rules to IFRS norms.

Despite the differences between CAS and IFRS, some important international agencies that mandate IFRS for listing purposes or national accounting purposes for firms with subsidiaries abroad, including China, have accepted CAS as sufficiently similar to IFRS to satisfy requirements that firms adopt IFRS. Hong Kong accepted the equivalence of CAS and Hong Kong GAAP in 2007[162] and the European Union accepted the equivalence of CAS and IFRS for EU securities purposes in 2008.[163] These acceptances may have removed some pressure for China to accelerate the alignment of CAS with IFRS.

4.6. Conclusion

More than a quarter of a century after China commenced a shift to a market economy,

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[158]China Banking Regulatory Commission, Yin Jian Tong [2007] No. 22.
[159] Sui Cai Kuii[Circular] [2009] No. 7.
[160] Hu Cai Kuai [Circular] [2010] No. 8.
[161] Cai Kuai[Circular] [2010] No. 10, "Roadmap for Continuing and Full Convergence of the Chinese Accounting Standards for Business Enterprises (ASBE) with the IFRS".
[162] "Joint Declaration of Equivalence of Accounting Standards in Mainland China and Hong Kong, 6 December 2007. In 2010, Hong Kong approved 12 Chinese accounting firms using CAS for Chinese companies listed in Hong Kong as qualified auditors for Hong Kong securities purposes.
[163] European Securities Committee, Working document ESC-14-2008.

officials responsible for overseeing China's accounting system seemed still not to understand the difference between a system of rules setting out the processes for preparation of financial statements and a system of principles to guide the recognition of financial transactions reflected on those statements. Accounting standards in China were synonymous with procedural rules, not recognition principles.

After decades of apparent confusion, appreciation of the need for principles as well as practice came surprisingly quickly, over the course of a few short years. A number of factors contributed to the change – generational change in the Ministry of Finance, a growing understanding of market economy fundamentals and, most significantly, the close cooperation between the Ministry of Finance's Accounting Standards Committee and the International Accounting Standards Board. After decades of glacial progress, a new system emerged and was adopted almost overnight.

There is, to be sure, some distance to go before Chinese accounting will truly equate with its western counterparts. Accountants' independence might seem to be compromised so long as the profession continues to be administered by a government department rather than an independent professional organisation. So too might the standards applied by the profession, mandated by a government rather than set by an independent body. Importantly, standards are fragmented across the country as different regimes apply to different types of enterprises and different municipalities move at different rates to shift various categories of business from the ASBE to CAS. The process of reconciling the CAS itself with IFRS has not progressed as rapidly as hoped and promised.

Still, the pace of change in the past five years significantly outstrips that of the previous twenty-five and it can be asserted with confidence that China is finally on the path of reconciling its accounting standards with the rest of the world.

Chapter 5 Tax Expenditures Concept and the Importance of the "Benchmark"

5.1. Introduction

While the primary purpose of a company income tax is to appropriate a portion of income derived by companies for the benefit of government expenditure, governments commonly also use the tax as an instrument of public policy to attain various economic, social, cultural and other objectives.

An income tax system whose sole purpose is to transfer a portion of income from the recipient to the state in a wholly neutral manner without influencing or biasing any aspect of the income earning process is known as a benchmark income. Deviations from the benchmark that might influence the way in which income is earned or the type of income sought by a taxpayer are known as tax expenditures. Tax expenditures thus include all rules that exceed the framework of the existing tax rules or criteria for taxation.[164] Because of these various exemptions, some revenue does not enter into the calculation of the relevant form of taxation. Such an item constitutes tax expenditures.[165] Tax expenditures occur in many forms. These include exemptions, deductions, rebates, deferrals or credits. Importantly, tax expenditures may be bound to certain geographic locations (tax free zones) or time spans (e.g., tax holidays).[166]

This chapter provides a brief introduction to the concept of tax expenditures and identifies the importance of the benchmark. It begins by attempting to define tax expenditure then proceeds to discuss the development of tax expenditure reports. It includes an analysis on establishing the benchmark for the identification of tax

[164] OECD, *Tax Expenditures: Recent Experiences* (OECD, Paris, 1996).
[165] Vjekoslav Bratić, 'Tax expenditures' (2006) 30(2) *Financial Theory and Practice* 30 (2) 197-198 .
[166] See Zhicheng Li Swift, 'Managing the Effects of Tax Expenditures on National Budgets' World Bank Policy Research Working Paper WPS 3927(2006). Swift defined that Exemption: Revenue or transactions that are excluded from the tax base. In legal regulations, these are encountered under various headings (e.g., exemptions, tax holidays, non-taxable events, etc.). Allowances: Amounts that can be deducted from the tax base. Credits: Amounts that can be deducted from the tax liability. Rate relief: Lower tax rates than those generally applied. Deferral: Postponement or delay in the tax payment.

expenditures. It concludes by discussing key features of a tax benchmark and experiences of tax expenditure benchmarks.

5. 2. Origins of Tax Expenditure Analysis

From the time of their adoption, all income taxes have contained some concessions.[167] In many jurisdictions, the income tax bases have been further narrowed through judicial interpretations of general inclusion terms.[168] Politicians and policymakers have long recognized that governments spend through the tax system.[169] However, until the 1960s there was no comprehensive catalogue of tax preferences, nor a standard method for analysing them.[170]

As long ago as 1954, in Germany, the "equivalence between special tax deductions, credits, and other allowances and government subsidies" was recognised.[171] As Shannon writes, "the German literature generally affirms that the tax system furnishes a useful instrument for implementing economic and social policy and acknowledges that it is often used for such 'non-fiscal' purposes."[172]As early as 1959, the Federal Ministry of Finance issued a report regarding subsidies in the federal budget.[173]

The first public appeal to the concept of tax expenditure was given by Stanley Surrey, Assistant Secretary of the U.S. Treasury for Tax Policy, in a speech given on 15 November 1967. Surrey stated that "through deliberate departures from accepted concepts of net income and through various special exemptions, deductions, and credits, our tax system does operate to affect the private economy in ways that are usually accomplished by expenditures— in effect to produce an expenditure system

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[167] For the United States see Bruce Bartlett, 'The End of Tax Expenditures as We Know Them?' *Tax Notes, Special Report* (16 July 2001) 413-22 at 22.
[168] For example, in many Anglo jurisdictions outside the United States, courts read down the term "income" to exclude "capital gains" – see Richard Krever, 'Interpreting income tax laws in the common law world' in *Steuerrecht Verfassungsrecht Europarecht: Festschrift fur Hans Georg Ruppe*, (eds) Markus Achatz, Tina Ehrke-Rabel, Johannes Heinrich, Roman Leitner and Otto Taucher, (Facultas.wuv, Vienna, 2007)354-378.
[169] Neil Brooks, 'Current Tax Reading – Review of Stanley S. Surrey and Paul R. McDaniel, Tax Expenditures' (1986) 34 *Canada Tax Journal 681at 683.*
[170] Above n 167.
[171] Harry A Shannon, 'the Tax Expenditure Concept in the United States and Germany: A Comparison' *Tax Notes* (1986) 33 (201) at 203.
[172] Ibid, at 204.
[173]See Bericht des Finanzministeriums (1959) 28 (7) *Bundestag Drucksache* III/1229 at 1. Cited in ibid..

described in tax language".[174] He suggested that there should be a full accounting of tax expenditures. The first tax expenditure budget was published in the Annual Report of the Secretary of the Treasury on the State of the Finances for Fiscal Year 1968.[175]

While Germany had invented the concept—if not the name—more than a decade before the US and included tax expenditure analysis in its budget process, [176] this did not draw the same international attention as the movements occurring in the US.

Historically, before the concept of tax expenditures received wide acceptance, such measures were generally known as tax concessions, tax relief or even tax breaks. These terms often remain the more common or generic labels covering these types of tax adjustments. In the US the term "tax preferences "or "special preferences "were often used to describe preferential treatment relative to the standard taxation structure.[177]

There is no widely accepted definition of tax expenditures, although there appears to be general agreement on the concept. Common to all definitions is the identification of a benchmark income tax that accurately measures in a neutral way all net gains appropriate for taxation in the income tax. For over four decades, there has been a continuing and very often vigorous debate over the identification of the concept underlying all tax expenditure analysis: the benchmark income tax. In practice, defining tax expenditures is difficult because some tax measures may not be readily classified as part of the benchmark or an exception to it. The problem begins with defining the basic tax structure. Most experts would agree that structural elements of

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[174] See Stanley S Surrey, 'the U.S. Income Tax System—the Need for a Full Accounting.' Speech before the Money Marketers, 15 November 1967. Excerpted in U.S. Treasury Department, 1969, *Annual Report of the Secretary of the Treasury on the State of the Finances for Fiscal Year* (Government Printing Office, Washington, 1968) 322–26 and Stanley S Surrey, *Pathways to Tax Reform: The Concept of Tax Expenditures* (Harvard University Press, Cambridge , 1973).

[175] See Stanley S Surrey and William F Hellmuth, 'The Tax Expenditure Budget—Response to Professor Bittker' (1969) 22 National *Tax Journal* 528–37.

[176] Daniel Shaviro, 'Rethinking Tax Expenditures and Fiscal Language' (2004) 57(2) *Tax Law Review* 187-231.

[177] J Wanna, 'Invisible Hands? The Non-Budgeting of Tax Expenditures in Australia and Canada' paper presented to the Australasian Political Studies Association Conference, University of Tasmania, Hobart, 29 September – 1 October 2003.

a tax system should not be recorded as tax expenditures, while "programmatic" features should be.[178] Several definitions of tax expenditure are provided as follows.

Tax expenditures were defined in the Congressional Budget Act of 1974 as revenue losses attributable to provisions of the Federal tax laws which allowed a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.[179]

Surrey himself stated that the tax expenditure budget was essentially an enumeration of present tax incentives or tax subsidies, contained in our present income tax system.[180] He also defined tax expenditures as spending programs embedded in the Internal Revenue Code.[181]

Tax expenditures are defined by the Organisation for Economic Co-operation and Development (OECD)as a departure from the generally accepted (benchmark) tax structure that produces a favourable treatment for particular types of activities or taxpayers.[182] Examples of the benchmark tax structure are the rate structure, accounting conventions, the deductibility of compulsory payments, provisions to facilitate administration and those relating to international fiscal obligations.[183]

According to the Canadian Department of Finance, tax expenditures are a subset of tax concessions that are used as alternatives to direct government spending for achieving government policy objectives.[184]

The Australia 2011 Tax Expenditures Statement provides that the concept of tax expenditures is a 'provision of the tax law that provides a benefit to a specified activity or class of taxpayer that is concessional when compared to the 'standard' tax

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[178] Edward Whitehouse, 'The Tax Treatment of Funded Pensions' (1999) 20126 *World Bank Social Protection Discussion Papers*.
[179] Congressional Budget and Impoundment Control Act of 1974 (PL 93-344), sec. 3 (3).
[180] Above 174 at 7.
[181] Stanley S Surrey and Paul R McDaniel, *Tax Expenditures* (Harvard University Press, Cambridge, 1985).
[182] OECD, *Tax Expenditures: A Review of Issues and Country Practices* (OECD, Paris. 1984).
[183] OECD, Tax *Expenditures: Recent Experiences* (OECD, Paris, 1996).
[184] Department of Finance Canada, 'Tax Expenditures and Evaluations 2000'(2000) 39 Availability; http://www.treasury.gov.au/PublicationsAndMedia/Publications/2012/Tax-Expenditures-Statement-2011.[Cited 11 May12].

treatment that would apply.'[185] Tax expenditures can be provided in many forms, including tax exemptions, tax deductions, tax offsets, concessional tax rates or deferrals of tax liability.[186]

New Zealand defines tax expenditures as a tax provision significantly motivated by a policy objective other than to raise revenue that:[187]

- reduces revenue by lowering tax for a limited or select group of taxable entities;
- is able to be replaced by a direct expenditure program; and
- is neither administrative in nature or motivated by a domestic double taxation objective'

Tax expenditures are said to be a substitute for direct spending. Instead of distributing money to the beneficiary, tax liabilities are reduced.[188] Both tax expenditures and direct spending are used to achieve social and economic policies. On the other hand, tax disincentives, also known as negative tax expenditures, penalise certain groups of taxpayers or certain activities by disallowing particular expenditures, resulting in a higher taxable income.

Governments use both tax expenditures and direct spending to implement policies. Direct spending occurs when government takes taxpayer dollars and gives them to others to spend for a specific purpose. The government uses tax expenditures to accomplish the same goals as direct spending, but it redistributes money by lowering taxes for an individual or company instead of transferring them money.

Tax expenditures are the technical name for spending programs that occur through the tax system. For government, tax expenditures are the reduction in tax revenue; for a

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[185] Australia Government Treasury, 'Tax Expenditures Statement 2011'(13, January 2012) Availability; http://www.treasury.gov.au/PublicationsAndMedia/Publications/2012/Tax-Expenditures-Statement-2011.[Cited 11 May12].
[186] Ibid
[187] Craig Fookes, 'Spending through the Tax System: Tax Expenditures' (2009) 9 (1) New Zealand Treasury Policy Perspectives Paper.
[188] Kerrie Sadiq, 'the Implementation of Social and Economic Policy through the Tax Regime: A Review of Australia's Tax Expenditures Program' (2008) 23(4) *Australian Tax Forum* 339 – 357.

taxpayer, the reduction in tax liability. Tax expenditures are better known in many OECD countries as tax relief, tax subsidies and tax aids.[189]

The tax expenditure concept recognizes that there are three key factors involved in the revenue process:[190] the imputed normative tax revenue from a normative tax structure; tax expenditures; and "net tax revenue" or "tax revenue received." The relationship among those three factors can be stated as follows: "net tax revenue/tax revenue received" is the difference between the "normative tax revenue" and "tax expenditures." This relationship can be formulated as follows:

Normative Tax Revenue – Tax expenditures = Net Tax Revenue (Tax Revenue Received)

Tax expenditure analysis can help both policymakers and the public to understand the actual size of government, the uses to which government resources are put, and the tax and economic policy consequences that follow from the implicit or explicit choices made in fashioning legislation.[191]

5. 3.The Development of Tax Expenditures Reports

Tax expenditures reports were first introduced in Germany and the United States in the late 1960s. By 1983, Australia, Austria, Canada, France and Spain were also regularly identifying tax expenditures and reporting them. In 1996, almost all OECD member countries reported tax expenditures. The OECD published studies on tax expenditures in 1984 and 1996[192] and issued a special feature about tax expenditures and tax/GDP ratios in the 2003 edition of the revenue statistics. [193] The OECD Best Practices for Budget Transparency [194] contain some basic guidelines for the treatment

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[189] Allen Schick, 'Off-budget Expenditure: An Economic and Political Framework' (2007)7 (3) *OECD Journal on Budgeting*.
[190] See above n166.
[191] Joint Committee staff, 'Background Information on Tax Expenditure Analysis and Historical Survey of Tax Expenditure Estimates' (2011) *Joint Committee on Taxation JCX-15-11.*
[192] See above n 182,183.
[193] OECD, *Special Feature for the 2003 Edition of the Revenue Statistics: Note by the Secretariat* (OECD, Paris, 2003).
[194] OECD, 'OECD Best Practices for Budget Transparency' (2002) 1(2) *OECD Journal on Budgeting* 7-14.

of tax expenditures.[195] And in 2010 the OECD[196] published "Tax Expenditures in OECD Countries", indicating an increased use of this approach.

Many countries prepare a report that includes a list of their main tax expenditures and an estimate of the revenue cost of many of these provisions is named as the Tax Expenditures Report. Most developed countries have established tax reporting systems, which provide empirical information on their tax expenditures. Such tax reporting systems tend to be part of a country's overall fiscal system for strengthening government finances and contributing to fiscal transparency. Using the information available, several governments attempt to analyse the cost and economic effects of individual tax expenditures. Some governments even bring tax expenditures into the budgetary process and subject them to a level of scrutiny similar to that for direct expenditures.[197]

By 2004 some developing countries began to pay attention to the usefulness of tax expenditures' in shaping prudent and transparent fiscal policy. In adopting a market economy, developing countries commonly use tax expenditures as major fiscal policy instruments. However, with limited theoretical understanding of, and ad hoc experience with, applying tax expenditures, developing countries now confront not only revenue losses higher than they had anticipated but also the erosion of their tax bases in systems that generally have been in existence many years.[198]

5. 4. Establishing the Benchmark for the Identification of Tax Expenditures

Tax expenditures are measured as deviations against a "normal tax structure" or benchmark. Tax expenditures should be identified by use of a benchmark tax. In the literature, there is considerable discussion around what is the appropriate concept of a tax benchmark.

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[195] Dirk-Jan Kraan, 'Best Practices Guidelines—Off-Budget and Tax Expenditures' (2004) 4 (1) *OECD Journal on Budgeting*121-142 at 130.
[196] OECD, *Tax Expenditures in OECD Countries 2010* (OECD, Paris, 2010).
[197] H Brixi, C Valenduc and Z Li Swift, *Tax Expenditures — Shedding Light on Government Spending through the Tax System, Lessons from Developed and Transition Economies*(World Bank, Washington 2003).
[198] Ibid.

Nevertheless, the identification of the normative tax structure is a starting point and checkpoint during the process of classification. Some provisions are on the borderline creating difficulty in determining what provisions should be included or excluded from the normative tax structures.[199]

According to a report from the Inter-American Development Bank working group the identification of tax expenditures is a classification exercise: dividing the provisions of the tax laws into a benchmark tax and a series of deviations from that benchmark tax. [200] The identification of tax expenditures is a difficult task for many reasons. The tax code may include a number of provisions that lead to revenue losses but nonetheless promote the standard goals of a good tax system. They are integral parts of the tax system and are not judged as tax expenditures. Neither can the tax expenditure analysis rely entirely on legislative documents, since they do not always express clearly and openly the objectives of tax provisions. So, there is a need for a systematic method for identifying tax expenditures.[201]

The Australian government describes the tax expenditure benchmark as a reference point against which the nature and extent of any concession can be identified. Tax expenditures are deviations from this benchmark.[202] A more accurate description might be a tax benchmark which could be used to identify both tax expenditures and negative tax expenditures [203]. The framework for defining the benchmarks used in Australian Tax Expenditure Statement 2011 is based on two principles:[204]

The benchmark should represent the standard taxation treatment that applies to similar taxpayers or types of activity. Consequently, benchmark taxation treatment should neither favour nor disadvantage similar taxpayers or activities.

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[199] See above n 166.

[200] Luiz Villela, Andrea Lemgruber and Michael Jorratt , 'Tax Expenditure Budgets Concepts and Challenges for Implementation' IDB Working Paper No. IDB-WP-131, 2010.

[201] A report from a Nordic working group, presented at the Nordic Tax Economist meeting in Oslo, June 2009.

[202] Australia Government Treasury, 'Tax Expenditures Statement 2006' (2006) 19-32. Availability :< http://search.informit.com.au/documentSummary;dn=205403596173428;res=IELBUS> ISSN: 1031-4121. [Cited 11 Apr 11].

[203] Negative tax expenditure arises when arrangements impose an additional charge rather than a benefit.

[204] Commonwealth of Australia 2011, Tax *Expenditures Statement 2010* (Commonwealth of Australia, Canberra, 2011) at 20.

The benchmark may incorporate certain elements of the tax system which depart from a uniform treatment of taxpayers where these are fundamental structural elements of the tax system. Such elements could include integral design features; for example, the progressive income tax rate scale for individual taxpayers.

Reconciling these two criteria often involves an element of judgment. In particular, there may be different views on which structural elements to include in the benchmark. Consequently, benchmarks vary over time and across countries, and can be arbitrary.[205]

The most contentious issue raised in the debate over the nature of a normative or benchmark income tax structure is whether gains (and losses) should be recognised on an accrual or realisation basis. The starting point for many advocates of tax expenditure analysis, including Stanley Surrey, was the Schanz-Haig-Simons (SHS) definition of income (or "economic income"): an individual's consumption plus the change in her or his net worth over a given period. [206] This comprehensive definition of income[207] is commonly attributed to the German public finance economist Georg Schanz writing at the close of the 19th century[208] and Professors Robert M. Haig and Henry C. Simons writing in the in the 1920s and 1930s respectively.[209]

The SHS concept of income covers a very wide range of economic gains: imputed income from personal use of assets, gifts and windfalls, and unrealised accretions in

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[205] See above n 185 at 213.

[206] This was described by Henry Simons in these terms: "Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question." See Henry C. Simons, *Personal Income Taxation* (University of Chicago Press, Chicago, 1938) at 50. The relationship between the SHS base and the benchmark income tax used for tax expenditure analysis is discussed in S. Surrey and Paul R. McDaniel, above n 181at 186.

[207] Robert Carroll, David Joulfaian and James Mackie, 'Income versus Consumption Tax Baselines for Tax Expenditures' Chapter in National Bureau of Economic Research (NBER) book *Economic Analysis of Tax Expenditures* (National Tax Journal, Washington, 2011) 64 (2).

[208] Georg von Schanz, 'Der Einkommensbegriff und die Einkommensteuergesetze ' (1896) 13 *Finanz Archiv* 1-87.

[209] Robert M Haig, 'The Concept of Income — Economic and Legal Aspects' in Robert M Haig(eds) *The Federal Income Tax* (Columbia University Press, New York, 1921), reprinted in Richard A Musgrave and Carl Shoup(eds) *Readings in the Economics of Taxation* (Richard D Irwin, Illinois 1959) 54-76; Henry C Simons, *Personal Income Taxation* (University of Chicago Press, Chicago, 1938).

value. There is some debate over the first two aforementioned gains in the context of a benchmark for the individual income tax and over the latter gain in the context of the benchmark for both the individual and company income taxes. The benchmark income tax used in Surrey's initial measurement of tax expenditures adopted a realisation basis for recognition of gains and losses on assets; this is a deviation from the SHS concept[210] that has been followed in almost all countries' tax expenditure accounts. The rationale for using the realisation base as an income tax benchmark reflects the same reasons

Countries use the realisation base in their tax laws and the rationale for accounting standards also using this base to measure profits. The latter reasons include difficulties of valuation if an accrual base were to be used, possible liquidity problems if taxpayers were asked to pay tax on gains locked into retained assets, and the popular perception that there is no gain until it is realised. Accounting standards adopts a realisation rule for recognition of profits on the basis of the principle of certainty. Prices that reflect changing market factors may fluctuate wildly and any measurement of gains or losses on the basis of value on any particular day may lead to entirely random results. At the same time, accounting standards do use an accrual basis where gains are anticipated as is the case, for example, with deep discount (zero-coupon) debt.

Countries' tax laws differ in various aspects; so do definitions of normative or benchmark tax structures. As a result, applications of the definitions of tax expenditures (departures from normative tax structures) also differ from country to country.[211]

The most difficult task seems to be related to choosing the right tax base. Many countries use the SHS income definition for tax expenditure purposes. The main reason for this is probably that the SHS definition constitutes a tax base that neutralises the tax treatment of consumptions and savings (while a conventional

[210] See above n 181, 167. It seems clear, however, that the SHS base would measure gains on an accrual basis.
[211] See above n 166.

comprehensive income definition instead gives preferential treatment to consumption).[212]

5. 5. Key Features of a Tax Benchmark

A wide range of issues have entered the debate over the tax expenditure benchmark. Potentially contentious issues include whether a real or indexed (inflation adjusted) measurement of income should be used as the benchmark, how transactions between members of a company group should be treated and whether a classical system that taxes companies separately from shareholders, or an imputation system that provides shareholders with credits for company tax paid on distributed income, represents the benchmark. There is considerable debate over whether choices on these issues are simply political decisions that frame the normative tax base or decisions that may give rise to tax expenditures. The former proposition presumes that these issues are outside the scope of a benchmark tax base while the latter implies that the benchmark base reflects standards on all these issues.

5. 5.1 Key Features of a Benchmark Income Tax

Characteristics of the benchmark are that it is comprehensive and unique. Examples of benchmarks are: comprehensive income (the Haig-Simon concept), comprehensive consumption, value added and sales in a certain product class. If an excise is levied on a harmful product (for example, pure alcohol), no exceptions for less harmful products are necessary. In practice excises are almost never levied on the harmful ingredient per se. The normative tax base will then deviate from the benchmark.[213]

The key features of a benchmark income tax are:[214]

• the tax rate structure

• any specific accounting conventions applicable to the tax

• the deductibility of compulsory payments

• any provisions to facilitate administration

• provisions relating to any fiscal obligations.

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[212] Paul R McDaniel and Stanley S Surrey (eds), *International Aspects of Tax Expenditures: A Comparison Study* (Kluwer Law and Taxation Publishers, Deventer, 1984).
[213] See above n 195 at 133.
[214] See above n 185.

Identification of the normative tax structure (i.e., whether a measure is necessary for the benchmark income tax or is a deviation from the benchmark base) can best proceed by examining a given provision in light of the following questions:[215]

1) Is the provision necessary to determine the base of the tax, normatively defined, in accordance with the fundamental nature of the tax?

For example, a benchmark income tax allows deductions for expenditures incurred to earn gross income. Under the benchmark system, expenses are recognised in the period in which the benefit they yield is consumed. Thus, expenses for current benefits are deductible as incurred. Expenses for wasting assets are recognised via depreciation rules as the benefits waste. Expenses for non-wasting assets (e.g., land, shares, and precious metals) are recognised when the assets are sold.

2) Is the provision part of the generally applicable rate structure?

3) Is the provision necessary to define the taxable units liable for the tax?

Company income tax systems normally impose flat taxes and a flat rate is usually considered a feature of the benchmark company income tax. As a result, where a tax system has lower tax rates for smaller companies or for an initial amount of income, the reduced rate would be considered a tax expenditure.

4) Is the provision necessary to ensure that the tax is determined within the time period selected for imposition of the tax?

Generally, company tax systems measure taxable income on an annual basis, though shorter periods may be used where companies are created or cease to exist in the course of a fiscal year. Taxation periods defined by law are considered to be part of the benchmark.

5) Is the provision necessary to implement the tax in international transactions?

[215] See above n 212.

6) Is the provision necessary to administer the tax?

Behind each of the six questions is a pure tax policy decision on tax base, rate structure, taxable unit, tax period, international transactions, and tax administration; so the given provision can be identified either as a normative tax structure or a tax expenditure.

Swift and Zhicheng Li suggested the additional Principal Criteria for a Tax Benchmark represent a consistent tax treatment of similar activities or classes of taxpayers and none favour or disadvantage similarly placed activities or classes of taxpayers. Include certain tax provisions (such as exemptions, deductions, tax credits, and other tax preferences) to adjust taxable income in order to:

- comply with the ability-to-pay principle;
- enhance the economic and collection efficiency of taxation;
- simplify or make feasible tax administration with respect to a class of
- taxpayers or type of activity.
- ensure that tax expenditure report provides sufficient information for policy formulation.[216]

There is no international consensus as to how a benchmark should be defined. Attempts to categorise tax expenditures through a benchmark tax have been the subject of long-standing debate. There are three broad approaches that New Zealand could use to build or create a benchmark. The approaches draw on:

- international best practice;
- a theoretically ideal or perfect tax structure; or
- the current (status quo) tax system.[217]

5. 5.2 Other Distinctive Characteristics of the Benchmark Taxes[218]

The three aforementioned approaches are related to the tax base, which is one of the characteristics that define the benchmark taxes. However, the benchmark taxes have

[216] See above n 166.
[217] See above n 187.
[218] See above n 200.

other aspects that should also be defined. In the case of the income tax, amongst other things, it is important to decide the taxation period, and the accepted deductions. The following are some habitual practices in OECD countries:

Rate Structure

Company income tax systems normally impose flat taxes and a flat rate is usually considered a feature of the benchmark company income tax. As a result, where a tax system has lower tax rates for smaller companies or for an initial amount of income, the reduced rate would be considered a tax expenditure.

Taxation Period

Generally, company tax systems measure taxable income on an annual basis, though shorter periods may be used where companies are created or cease to exist in the course of a fiscal year. Taxation periods defined by law are considered to be part of the benchmark.

Deductions

Deductions of expenditure necessary be part of the benchmark—which is consistent with the Haig-Simons income definition—As well as the deductions of mandatory expenses

Others

In general, accounting conventions to determine income, provisions that attempt to facilitate tax administration, provisions aimed at avoiding duplicate taxation, those relating to international taxation, and the deduction of losses from previous periods are all included as part of the benchmark tax.

Rates

The common practice is to consider the generally applied legal rate as part of the benchmark. Consequently, reduced rates give rise to tax expenditures whereas

increased rates produce negative tax expenditures (even though not all countries record them). [Accounting standards does not deal with this]

5. 6. Experiences of Tax Expenditure Benchmarks

Identifying tax expenditures is a categorisation exercise that can be approached in different ways. As a result, different countries have adopted different approaches. Generally three broad approaches are widely used.[219]

The first is a conceptual approach [220] which uses a "normal" tax structure based on a theoretical concept of the Haig Simons (concept income, consumption), or "pure" VAT baseline (the pure/theoretical concept); The second approach is a reference law approach[221] which for the most part uses a country's existing tax law as a basis to define both the benchmark (for example, income subject to tax); The third approach is is the expenditure subsidy approach which seeks to cost only those concessions that are clearly analogous to an expenditure subsidy.[222]

Yet to be used in practice is a fourth approach developed by Burton and Stewart [223] which consists of a combination of external (conceptual) and internal (reference law) benchmarks approaches. This hybrid approach takes an external benchmark as a starting point but modifies that benchmark by adopting certain internal features of a tax that may be of long standing or that are otherwise considered to be entrenched systemic features.

All approaches involve judgments by the authorities. Where the Haig Simons conceptual basis is used, a number of adjustments are invariably made to take account of the practical administrative and other difficulties that would be involved in actually

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[219] Jon Craig and William Allan, 'Fiscal Transparency, Tax Expenditures, and Budget Process: An International Perspective' IMF working paper, 2004.

[220] It is defined as an 'external' or 'ideal' benchmark approach, see Mark Burton and Miranda Stewart, 'Promoting Budget Transparency Through Tax Expenditure Management: A Report on Country Experience for Civil Society Advocates '(June 13, 2011) 60*University of Melbourne Legal Studies Research Paper* No. 544. Available at SSRN: http://ssrn.com/abstract=1864324 or http://dx.doi.org/10.2139/ssrn.1864324.

[221] It is defined as an 'internal' or 'normal' benchmark, Burton, above n 220 at 61. .

[222] OECD, *Tax Policy Study No. 19: Choosing a Broad Base – Low Rate Approach to Taxation* (OECD, Paris, 2010) 39.

[223] See above n 220.

attempting to implement the concept. The reference law used in the United States is patterned on a comprehensive income tax, but it is "closer to existing law", and tax expenditures under this concept are "limited to special exemptions to the tax law that serve programmatic functions." The expenditure subsidy concept used in some countries involves direct judgments as to whether or not tax relief constitutes a substitute for a direct subsidy. As a general rule, the first approach will give the widest list of tax expenditures and the second and third approaches a narrower list[224].

Most OECD countries follow some form of conceptual baseline (e.g. Australia, Belgium, Canada, Finland, Ireland, Portugal, and Spain). Several other countries use a reference law approach (e.g. Austria, France, Korea and the Netherlands). Germany follows an expenditure subsidy approach. The UK combines a conceptual and expenditure subsidy approach, while the US uses both a conceptual and a reference law approach, and Sweden follows a conceptual approach for income taxes and a reference approach for consumption taxes.

Two countries that have recently introduced tax expenditure statements are Pakistan and Latvia. Both have adopted a reference law approach. There are more countries to apply reference law approach including, Argentina, Brazil, Colombia, Ecuador, Guatemala and Peru. However, Chile applies a conceptual approach.

Sample 1: The Canadian benchmark company income tax used to identify tax expenditures

The benchmark for the corporate income tax system is defined by considering the tax base, existing tax rates and brackets, the unit of taxation, the time frame of taxation, and the treatment of inflation for calculating income. In addition, the benchmark includes measures that reduce or eliminate double taxation, recognize expenses incurred to earn business income, and allow business losses to be claimed over a number of years. Finally, the constitutional immunity of Canada and the provinces from taxation is recognized as part of the benchmark system for income taxation.

[224] See above n 219.

A more detailed discussion of the features of the benchmark for the corporate income tax systems follows.

(1) The Tax Base

The benchmark income tax base is a variant of the Haig-Simons comprehensive income base, which requires the taxation of real current additions to purchasing power, or real increases in wealth. A strict application of the Haig-Simons base would make corporate income tax redundant since income earned at the corporate level would be taxed as it accrued to individuals. The benchmark assumes, however, that corporate net income from all sources is subject to taxation.

(2) Treatment of Inflation

The corporations report nominal income in determining their tax liability each year. Nominal income is therefore taken to be the appropriate basis for the benchmark income tax system.

(3) Tax Rates and Income Brackets

With respect to the corporate income tax system, the benchmark is the general federal corporate income tax rate (including the former general corporate surtax when applicable). Provisions that alter this tax rate for certain types of activities or corporations are regarded as tax expenditures. These include the low tax rate for small business and the low tax rate for credit unions.

(4) Tax Unit

For corporate income tax, the single corporation is generally adopted as the benchmark tax unit.

(5) Taxation Period

The benchmark taxation period for the corporate income tax system is the corporation's fiscal year. As with the personal income tax system, deferrals are considered to be tax expenditures.

A strict application of the annual taxation period would imply that measures providing for the carry-forward and carry-back of losses to other years would be tax

expenditures. However, these provisions improve the tax system by recognizing the cyclical nature of business and investment income by essentially allowing such income to be measured over a number of years. Consequently, the estimated costs associated with carry-overs of losses are presented in the Memorandum Items sections.

(6) Avoidance of Double Taxation

Measures that provide relief from double taxation are considered part of the benchmark income tax system. For example, the non-taxation of intercorporate dividends is designed to ensure that income is taxed only once at the corporate level and that the corporate income tax system is neutral across organizational structures. Consider a single corporation that currently operates as a number of divisions. Now suppose the corporation reorganizes into a holding company with wholly owned subsidiaries instead of divisions. The profits from the subsidiaries are taxed as earned and the after-tax profits flow to the holding company through intercorporate dividends. If these dividends were subject to taxation at the holding company level, double taxation would occur. Consequently, the exemption of intercorporate dividends is not considered to be tax expenditure.

Similarly, the dividend gross-up and tax credit mechanism serves to eliminate or reduce double taxation. In its absence, income earned through corporations would be taxed twice, once in the corporation when earned and again at the personal level when the after-tax income is distributed through dividends.

Finally, measures that recognize income taxes paid in foreign countries are part of the benchmark.

(7) Recognition of Expenses Incurred to Earn Income

Tax provisions that provide for the deduction of current costs incurred to earn business income are treated as part of the benchmark system. Capital costs, which contribute to earnings beyond the fiscal year in which the cost is incurred, are deductible in the benchmark system at a rate that allocates the cost over the period during which the capital contributes to earnings—generally, the useful life of the asset to which the cost relates.

(8) Government Immunity from Taxation

Section 125 of the Constitution Act, 1867, provides that "no land or property belonging to Canada or any province shall be liable to taxation." This means that neither the federal nor the provincial governments (nor their Crown agents) are liable to taxation by the other. Accordingly, constitutional immunity from taxation is recognized as part of the benchmark system for income taxation.

(9) Other Taxes in the Income Tax Act

The Income Tax Act includes certain taxing provisions that do not clearly relate to income tax, such as non-resident withholding tax. The approach taken in this publication is to treat the statutory rates of these taxes as the benchmark. [225]

Sample 2: The Australian benchmark company income tax used to identify tax expenditures

Australian Government taxes are primarily imposed on income rather than commodities. The following sections outline the general features of the benchmark for business income tax.

Tax base

The tax base for the income tax benchmark is based on the Schanz–Haig-Simons definition of income. An entity's income is defined as the increase in the entity's economic wealth (stock of assets) between two points in time, plus the entity's consumption in that period. Consumption includes all expenditures except those incurred in earning or producing income. The Schanz-Haig-Simons definition of income conforms to the principal criterion of benchmark design: all income is included in the base regardless of the income earning activity. Under the income tax benchmark, income includes: wages and salaries; allowances; and business receipts.

[225] Further discussion of this issue and other conceptual issues can be found in Chapter 3. the third edition of Tax Expenditures: Notes to the Estimates/Projections 2010 http://www.fin.gc.ca/taxexp depfisc/2010/taxexp1004-eng.asp.

Arrangements to prevent double taxation

Arrangements to reduce or eliminate double taxation are integral features of the tax system and are included in the benchmark. For example, the imputation system, which eliminates the double taxation of company profits distributed to resident shareholders, is included in the income tax benchmark.

International tax arrangements

Australian residents are taxed on their worldwide income under the income tax benchmark. Consequently, residents are taxed on their Australian source and foreign source income. The various international tax arrangements that ensure that foreign source income is subject to the appropriate level of Australian tax are included as structural elements of the income tax benchmark.

Features of the international tax arrangements that are incorporated into the benchmark are:

Resident taxpayers are allowed to claim foreign income tax offsets up to the amount of Australian tax payable on their foreign income. These arrangements ensure foreign source income is not excessively taxed. The controlled foreign company and transferor trust rules ensure Australian residents cannot escape or defer taxation of tainted income by interposing a foreign resident legal entity. Tainted income is generally income derived by investments which are mobile and whose location probably was influenced primarily by tax considerations, or certain related party transactions. It includes passive income such as interest, royalties and dividends and highly mobile forms of active income. Transfer pricing and thin capitalisation rules and interest, dividend and royalty withholding taxes aim to tax appropriately Australian sourced income and are included in the benchmark.

Foreign residents are taxed on their Australian source income only. As part of this benchmark, where foreign income (or foreign capital gains) earned by an Australian entity is subsequently distributed to a foreign resident, the distribution attracts no Australian tax. – Persons in Australia on temporary visas are taxed essentially the same as foreign residents.

Taxation treaties operate to allocate taxing rights over income between the country that is the source of income and the taxpayer's country of residence. For distributions of Australian source income to foreign residents, the basic rates of withholding tax prescribed in these treaties in respect of specified classes of income, such as interest, dividend and royalty income, are included in the benchmark as the applicable tax rates. Under this approach, the benchmark rate of interest, dividend and royalty withholding rates will vary depending on whether the country in question has a tax treaty with Australia. If a tax treaty exists, the benchmark rates of withholding tax for a class of income will be the 'basic rate', where the basic rate is the highest rate specified in the treaty for each withholding tax. Exemptions or reductions relative to the basic rates prescribed in a particular tax treaty will give rise to tax expenditures. – If a tax treaty does not apply, any exemptions or reductions from the standard domestic statutory rates will give rise to tax expenditures.

Arrangements to reduce or eliminate double taxation are integral features of the tax system and are included in the benchmark. For example, the imputation system, which eliminates the double taxation of company profits distributed to resident shareholders, is included in the income tax benchmark.

Tax rates and income brackets

The tax rate under the income tax benchmark is the legislated tax rate that applies to the relevant entity in each financial year. The personal income tax system includes the tax free threshold, the progressive personal income tax rate scale, low income tax offset and the Medicare levy. The progressive income tax rate scale is an integral and longstanding feature of the tax system. The foreign resident income tax scale is also included in the benchmark. Foreign residents are not entitled to a tax free threshold on Australian sourced income as they typically receive a tax free threshold in their home jurisdiction. They also are not entitled to the low income tax offset or liable for the Medicare levy. This treatment is also included in the benchmark.

Tax unit

Individuals and companies are subject to tax under the income tax benchmark. Sole traders, partnerships and trusts are not separate tax units. Income earned by these entities is taxable in the hands of the recipient. For the personal income tax system in Australia, the benchmark unit is the individual. For companies, the benchmark tax unit is the company (including the head entity of a consolidated group or a multiple entry consolidated group).

Taxation period

The taxation period adopted under the income tax benchmark is the financial year (1 July to 30 June). Consequently, measures that defer taxable income to another financial year, such as income averaging for primary producers (B43) or the farm management deposit scheme (B42), are reported as tax expenditures. Tax deferral arrangements will generally give rise to tax expenditures in the year income is earned, offset by a negative tax expenditure when the income is taxed. Departing from this framework, the carry forward loss provisions are an integral feature of the tax system and are included in the benchmark. These provisions allow an entity with a loss to carry the loss forward and utilise it in the future. The benchmark also includes arrangements for entities whose accounting period differs from the standard financial year (for example, companies with a substituted accounting period). 226

[226] See above n 185 Appendix A: Tax expenditure benchmarks and methodologies.

Chapter 6 Benchmark War and the Case for Using Accounting Standards as the Benchmark

6.1. Introduction

Currently tax expenditure analysis is facing a challenge to improve its theoretical grounds and identification processes. One of the most striking features of tax expenditure analysis over the past 46 years is the breadth and depth of debate over the legitimacy of the concept itself. One obvious response to the criticism is to improve transparency of reporting by communicating the definitions and foundation of the analysis more openly and clearly.

Some critics argue the concept of tax expenditure implies a sense of "exceptionalism" in approaches to tax policy – that is, a conviction that tax policy should remain surgically clean and efficient, while all messy political compromises go back to the spending side of the budget where they belong.[228]

Some argue that the tax expenditure concept's focus on tax policy issues can be seen as an abdication of its original self-avowed motivation to compare tax provisions to spending programmes with similar objectives.[229]

Moreover, several concerns about tax expenditures have existed since the concept first appeared. First, tax expenditures represent a substantial commitment of support in terms of forgone revenues on the part of the federal government. Second, tax expenditures are another form of entitlement spending since they are not examined in the annual budget process. Third, more well-off taxpayers benefit disproportionately from tax expenditures in the form of deductions or exemptions because of the progressive nature of the personal income tax system.

6. 2. Forty-six Years' Debate over Tax Expenditures Baseline: Benchmark War

[228] Kyle Logue, 'If Taxpayers can't be Fooled, Maybe Congress Can: A Public Choice Perspective on the Tax Transition Debate' (2000) 67 *University of Chicago Law Review*.
[229] See above n 176.

The aim of tax expenditure analysis is consistent with other fiscal goals such as improving the control of the use of government resources on the revenue side of the budget.[230] However, the concept of a benchmark (a normative tax base) has been mostly and heavily attacked in academic literature since the adoption of the first tax expenditure report.

The benchmark issue arises because tax expenditure analysis deals with "tax provisions that confer preferential treatment on particular income sources or taxpayer groups".[231] There is no international consensus as to how a benchmark should be defined. Attempts to categorise tax expenditures through a benchmark tax have been the subject of debate for more than 46 years.[232]

The term "tax expenditures" was originally introduced in 1967 by Stanley Surrey, who began to contribute to tax policy in 1932 and continued to do so until his death on August 27, I984.[233] Surrey used the term to refer to provisions of the Internal Revenue Code that are deliberate departures from generally accepted concepts of net income (usually by way of special exemptions, deductions, credits or exclusions) and that affect the private economy in ways that usually are accomplished by direct government spending.[234] In Surrey's view:

> "The federal income tax system consists really of two parts: one part comprises the structural provisions necessary to implement the income tax on individual and corporate net income; the second part comprises a system of tax expenditures under which Governmental financial assistance programs are carried out through special tax provisions rather than through direct Government expenditures. This second system is grafted on to the structure of the income tax proper; it has no basic relation to that structure and is not necessary to its operation. Instead, the system of tax expenditures

[230] Nordic working group , 'Tax Expenditures in the Nordic Countries' A report presented at the Nordic Tax Economist meeting in Oslo, June 2009, 9-10.
[231] J Clifton Fleming, Jr and Robert J Peroni, 'Can Tax Expenditure Analysis Be Divorced from a Normative Tax Base? A Critique of the "New Paradigm" and Its Denouement' (2010) 30 *Virginia Tax Review* 142.
[232] See above n 187.
[233] Bernard Wolfman, 'Tax Expenditures: From Idea to Ideology Reviewed on *Tax Expenditures* by Stanley S. Surrey; Paul R. McDaniel' (1985) 99 (2) *Harvard Law Review* 491-498.
[234] See Stanley S Surrey, 'The United States Income Tax System — The Need for Full Accounting', in Stanley S Surrey, *Tax Policy and Tax reform: 1961-1969* (Commerce Clearing House, 1973) 575–585 at 575.

provides a vast subsidy apparatus that uses the mechanics of the income tax as the method of paying the subsidies."[235]

In 1985 Surrey and McDaniel [236] argued that, with some concessions to practicality, the normative technical tax base should be based on the familiar SHS definition of income—the sum of the market value of the goods and services that a person consumes over the course of a year and the change in value of that person's net wealth over the same period—and that all tax measures that do not serve the purpose of assisting in defining income in this manner should be classified as tax expenditures.

According to Fleming and Peroni, critics have continuously and strongly attacked tax expenditure analysis by characterizing the SHS [237] baseline (definition of income) as "unprincipled, imprecise, and insufficiently", since the baseline is "hopelessly defective", so the critics argue, and because "Tax expenditure analysis is fatally dysfunctional and the results of its application to the various subsidy and incentive provisions in the Internal Revenue Code can be disregarded." Even some tax expenditure analysis supporters have suggested that tax expenditure analysis' effectiveness has been compromised by the intensity of the "baseline battle." [238]

The most important part of the criticism is focused on the concept of a benchmark tax system .The plethora of papers that have been published since Stanley Surrey's ground breaking work in 1967 fall into three broad groups. The first comprises scholars who argue the income tax benchmark is so inherently uncertain that it can never be defined effectively, leaving no basis for identifying tax expenditures. The second group contains scholars who agree on the basic features of an income tax benchmark derived from a SHS base but disagree on which deviations from this base are appropriate. The third group agrees that a benchmark is possible but argues for completely different starting points for mapping out the benchmark.

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[235] See above n 174.
[236] See above n 181.
[237] See above n 206. Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and the end of the period in question. In other words, it is merely the result obtained by adding consumption during the period to "wealth" at the end of the period and then subtracting "wealth" at the beginning.
[238] Michael J McIntyre, 'A Solution to the Problem of Defining a Tax Expenditure' (1980) 14 *U. C. Davis Law Review* at 102–03; see above n 176 at 217–18.

6.2.1. The First Group in the Benchmark War

The first comprises scholars who argue the income tax benchmark is so inherently uncertain that it can never be defined effectively, leaving no basis for identifying tax expenditures.

The importance of the chosen baseline and the controversy created by lack of agreement has been widely recognized since Surrey first began promoting the tax expenditure concept. In 1969 Professor Boris Bittker of Yale University was one of the first to attack the problems inherent in identifying tax expenditures.[239] Boris Bittker (1969) wrote:

> "A systematic compilation of revenue losses requires an agreed starting point, departures from which can be identified. What is needed is not an ad hoc list of tax provisions, but a generally acceptable model, or set of principles, enabling us to decide with reasonable assurance which income tax provisions are departures from the model, whose costs are to be reportable as "tax expenditures"…"[240]
>
> 'Every man can create his own set of "tax expenditures," but it will be no more than his collection of disparities between the income tax law as it is, and as he thinks it ought to be .Such compilation would be interesting. I do not know how we can select one of them for inclusion in the National Budget."[241]

Bittker pointed out the early criticism that there was no commonly accepted definition of the normal tax system as any system of taxation is an aggregation of decisions about a range of structural issues that theoretical tools such as the SHS definition of income do not purport to settle.

Bittker also questioned Surrey's way of officially connecting the normal tax system to

[239] See above n 207.
[240] Boris Bittker, 'Accounting for Federal 'Tax Subsidies' in the National Budget' (1969) 22(2) National Tax Journal 244-261 at 247.
[241] See ibid at 260.

the SHS concept while at the same time including several other elements into it without implicating the theoretical grounds. Bittker considered these additions to be subjective choices.[242]

Bittker said that in identifying tax expenditures there was no general agreement on what constitutes an ideal or correct tax structure against which to determine deviations that could be considered tax expenditures. [243]

Bittker concluded that the tax expenditure concept was inherently ambiguous, even with the SHS definition as a benchmark. He rejected the tax expenditure concept as nothing more than a list of departures from a normative tax specified by each author of a tax expenditure list. This fundamental argument against the concept draws support from the arbitrariness of any normative tax.[244]

In 1999, Vice Chairman Jim Saxton from the Joint Economic Committee United States Congress draws the conclusion that "In light of the compromise between income and consumption tax bases inherent in our current tax code, there appears to be little evidence to support the institutionalization of an expansive view of income."[245] "The tax expenditure concept relies heavily on a normative notion that shielding certain taxpayer income from taxation deprives government of its rightful revenues."

In 2001 Bartlett (previous executive director of the Joint Economic Committee of Congress, senior policy analyst in the Reagan White House, and Deputy Assistant Secretary for Economic Policy at the Treasury Department during the George H.W. Bush administration) believed that the normal tax system has a hidden agenda or target for a particular brand of tax "reform," such that, for example, an income tax benchmark would be a roadblock to the development of consumption based tax.[246]

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[242] See above n 201.
[243] See above n 167.
[244] Victor Thuronyi, 'Tax Expenditures: A Reassessment' (1988) 6 *Duke Law Journal* 1155-1206 at 1169.
[245] Jim Saxton, 'Tax Expenditures: A Review and Analysis' (1999) *Joint Economic Committee*, http://www.house.gov/jec/fiscal/tax/expend.pdf, August 1999.
[246] See above n 167.

In 2003 Professor Burman suggested that the normal tax system was not developed from first principles with sufficient rigour to serve as such a standard, resulting in errors in the identification of tax expenditures. He also believed that the differences in values among analysts are so strong that consensus on the nature of the benchmark would be impossible to achieve.[247]

Professor Kraan in 2004 stated that the definition of the normative tax base was a very political exercise.[248] For this reason, attempts in the past to define tax expenditures in terms of the normative tax base ("tax expenditures are exceptions to the normative tax base") have not been very successful. They have led to neither international nor domestic agreement about the concept of tax expenditure. Thus the definition of tax expenditure proposed above abstracts from the normative tax base. The definition instead uses the more neutral yardstick of the "benchmark tax". Tax expenditures in this sense are deviations from the benchmark tax. The benchmark has no normative significance. Deviations from it in order to arrive at the normative tax base may be perfectly appropriate. Tax expenditures may thus also be appropriate. Kraan concludes that the benchmark does not necessarily need to represent the normative tax base. The benchmark should be comprehensive and unique. [249]

Weisbach and Nussim also suggested in 2004 that the attempt to identify tax expenditures should be abandoned, and that all tax provisions should be compared with equivalent expenditure programs in order to decide how best to achieve their aims.[250]

In 2004 Professor Shaviro argued "where tax expenditure analysis went off the rails . . . was not in its aim of identifying 'special' provisions . . . but in its means of doing so, through the identification of a supposedly canonical, yet in practice under-theorized . . . definition of the 'normative income tax base.'" [251]

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[247] Leonard E Burman, 'Is the Tax Expenditure Concept Still Relevant?' (2003) 56 (3) *National Tax Journal*.
[248] See above n 195.
[249] Ibid.
[250] David A Weisbach and Jacob Nussim, 'The Integration of Tax and Spending Programs' (2004) 113(5) *Yale Law Journals 955*-1028.
[251] See above n 176.

In 2005 the Office of Management and Budget [252] stated that "the [Bush] Administration believes that the concept of 'tax expenditure' is of questionable analytic value." [253]

In 2008 the Joint Committee on Taxation argued that tax expenditure analysis can and should serve as an effective and neutral analytical tool for policymakers in their consideration of individual tax proposals or larger tax reforms. The efficacy of tax expenditure has been undercut substantially, however, by the depth and breadth of the criticisms levelled against it. Tax expenditure analysis no longer provides policymakers with credible insights into the equity, efficiency, and ease of administration issues raised by a new proposal or by present law, because the premise of the analysis (the validity of the "normal" tax base) is not universally accepted.[254]

In 2009 Professor Brooks discovered there were two problems in identifying the rules that underlie the normative tax system: first, it was not clear what principle underlies the so-called normative tax system and, second, even if that principle could be agreed upon, there was no agreement on how to define the base since enacting an administratively practicable and politically acceptable tax involved balancing a myriad of considerations.[255]

In 2009, a report from a Nordic working group pointed out [256] that the concept of benchmark does not have a sufficiently rigorous formal basis and is more or less a result of a series of subjective, pragmatic choices. As an example, it is common that the tax expenditure analysis officially refers to SHS income as a starting point when the normal structure for income tax is defined. Here the analysis follows the approach introduced by Surrey. Theoretically, comprehensive income can be defined quite precisely. However, SHS income is not an operational concept that could be measured

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[252] Since 1974, the Congressional Budget Office (CBO) and the U.S. Treasury Department have been required to prepare and publish tax expenditure estimates annually.
[253] *Budget of the United States Government Analytical Perspectives and Historical Tables Fiscal Year 2002* (United States Government Printing Office, Washington, 2002).
[254] Staff of the Joint Committee on Taxation, *a Reconsideration of Tax Expenditure Analysis JCX-37-08* (US Government Printing Office, Washington, 2008).
[255] Neil Brooks, 'The Under-Appreciated Implications of the Tax Expenditure Concept' in C Evans and R Krever (eds) *Australian Business Tax Reform in Retrospect and Prospect* (Thomson, Sydney, 2009) 233-257 at 235.
[256] See above n 201at 11.

exactly and easily enough to be used either as a basis for taxation or as a tool in tax expenditure analysis. Therefore the benchmark applied is usually a compromise between SHS income and the actual tax system or, put differently, an extension of the actual tax system towards the theoretical concept.

The Nordic report also stated that due to the vagueness of the benchmark, the classification of at least some tax expenditures has weak grounds and their status will easily become subject to discussion. If there is no hard theory behind the benchmark it is very hard to defend the identification decisions.[257]

Professor Altshuler in 2011 concluded that the definition of the normal tax, for the purposes of calculating tax expenditures, was not obvious. The normal tax was not analogous to a comprehensive income tax or the current tax system and the changes in the system over time.[258]

In 2012 Burman and Phaup agreed that the most serious challenge in measuring tax expenditures is in defining the "normal income tax", but they doubted Surrey and McDaniel's argument that it should be a comprehensive Haig-Simons measure of income with adjustments to reflect problems of administration. As vague as that guideline is, the actual choice is even more nebulous. They believe Surrey and McDaniel are agnostic about fundamental issues, such as whether the normal income tax should be indexed for inflation. Their basic view is that a fixed and relatively comprehensive baseline should be chosen and that it would serve as a useful measuring rod against which to gauge progress or lack thereof in improving the tax system.[259]

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[257] Ibid a *9-10.*

[258] Rosanne Altshuler and Robert D Dietz, 'Reconsidering Tax Expenditure Estimation'(2011) 64(2) *National Tax Journal 459–490;* See above n 187 at 17.

[259] Leonard E Burman and Marvin Phaup, 'Tax Expenditures, the Size and Efficiency of Government, and Implications for Budget Reform' in T*ax Policy and the Economy* (University of Chicago Press, Chicago, 2012) 26.

6. 2.2. The Second Group in the Benchmark War

The second group contains scholars who agree on the basic features of an income tax benchmark derived from a SHS base but disagree on which deviations from this base are appropriate.

In 1972 Professor Andrews agreed with the approach of defining tax expenditures as departures from an ideal income tax, but argued that "the ideal for this purpose must be carefully shaped and refined to reflect the intrinsic objectives of the tax." To him, a provision that departs from Haig-Simons but constitutes "a refinement in our notion of an ideal personal income tax" does not constitute tax expenditure. Andrews concluded that deductions for charitable contributions and for medical expenses comport with an ideal income tax by contributing to the accurate measurement of personal consumption, and that they therefore should not be treated as tax expenditures. He suggested, moreover, that other personal deductions (for interest and state and local taxes, for example) might be appropriate elements of an ideal income tax.[260] So he agreed with the idea of defining tax expenditures as departures from a normative tax, but disagreed with Surrey on which normative tax to choose as the baseline.[261]

In 1980 Professor Michael McIntyre suggested that a new methodology could alleviate the problem of defining tax expenditures, which rose in the absence of a consensus on the features of a normative tax.[262] McIntyre argued that the tax expenditure concept had multiple purposes, and that the definition of tax expenditures needed not be the same for each purpose. The argument is sound. The concept of tax expenditures attempts to solve a number of problems, and it could well require a different definition for its different purposes. McIntyre does not, however, offer a truly new definition that liberates tax expenditures from the search for an elusive normative tax. He suggested that a tax expenditure list could include every item that is arguably a tax expenditure under the traditional definition, or only those items defined as such by universal agreement. Although either of these approaches might work in

[260] William D Andrews, 'Personal Deductions in an Ideal Income Tax' (1972) 86(2) *Harvard Law Review* 309–385.
[261] See above n 243 at 1169.
[262] See above n 237.

some cases, neither gets to the heart of the problem. Both still rely on the idea of a normative tax, and will likely produce tax expenditure lists that are either too broad or too narrow to be useful.

In 1980, Seymour Fiekowsky, the Assistant Director of the Office of Tax Analysis in the Treasury Department reviewed the concerns that led to the development of the tax expenditures. Then he claimed it had failed to achieve its purposes of rationalizing the budgetary process. He offered a redefinition of tax expenditures. He characterized his redefinition as consistent with Surrey's aim in developing the tax expenditure budget to identify tax provisions that "affect the private economy in ways that are usually accomplished by expenditures." Fiekowsky thought that only tax "substitutes for programs financed by appropriated funds" [263]should be considered tax expenditures.
In1990 Norman Ture, former Undersecretary of the Treasury, argued that the concept of neutrality should be the essential criterion when choosing a tax base for the tax expenditure budget:

> "The neutrality criterion is essential if tax expenditures are to be identified as tax subsidies equivalent to those provided by government outlays (and other government actions and policies). The distinguishing attribute of a subsidy is that it reduces the cost or the price of the subsidized product below the level that would prevail in a market unaffected by governmental policies or activities. A subsidy, therefore, alters the relationship among costs and prices that would otherwise prevail. A neutral tax system, accordingly, would include no provisions that provided subsidies: by the same token, it would contain no provisions that raised the price or cost of any product, service, or activity relative to the prices or costs of others". [264]

In 2001 Bruce Bartlett, former executive director of the Joint Economic Committee of Congress argued that it would be very helpful to establish that a Haig-Simons income base is not the only "ideal" base that can be justified. Since the Haig-Simons base underpins tax expenditure analysis, it reinforces the supposed superiority of an income base and is a barrier to adoption of a consumption-based system. Therefore, showing the flawed intellectual underpinning of tax expenditures is desirable to

[263] Seymour Fiekowsky, 'The Relation of Tax Expenditures to the Distribution of the Fiscal Burden' (1980) 2 *Canadian Taxation* 211-219 at 215.
[264] Norman B Ture, *Tax Expenditures: A Critical Appraisal* (Institute for Research on the Economics of Taxation, Washington, 1990).

overthrowing income as the basis of taxation and establishing consumption in its place.[265]

In 2003 Professor Burman argued the US tax expenditure debate had an ideological element. Those who have favoured an income tax have supported the current method of identifying and measuring tax expenditures. On the other hand, those who have preferred consumption tax features in the tax system have proposed changes towards savings relief in the benchmark system.

It would thus be much better to have the debate about income tax versus consumption tax in the open and, once settled, attempt to make the tax system as neutral as possible. [266] The criticism also includes the hidden reform agenda on the background of tax expenditure reporting and also the objection that tax expenditure analysis implies an idea of a clean and apolitical tax policy that does not fit well with social decision making. It seems that this kind of debate and the resulting credibility problem are, to some extent, a result of unclear theoretical grounds of the identification process.

In 2008 Carroll et al compared income and consumption baselines for defining and calculating federal tax expenditures. Specifically, they discussed how the major tax expenditures reported in the Tax Expenditures chapter of the Office of Management and Budget (2007) would be classified first using a comprehensive income tax baseline and then using a comprehensive consumption tax baseline. But the authors do not try to resolve the question of whether the baseline should be consumption or income. And they do not attempt to settle the debate over whether tax expenditure is a useful concept. [267]

6. 2.3. The Third Group of Benchmark War

The third group agrees a benchmark is possible but argues for completely different starting points for mapping out the benchmark.

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[265] See above n 167.
[266] See above n 246.
[267] See above n 207.

In 1975 Professor Blum maintained that some tax expenditures could be identified without reference to a normative tax. He suggested dividing Surrey's tax expenditures into two categories. "One group consists of the preferential provisions that everyone agrees are incentive measures that cannot be defended on grounds of tax equity, tax administration, or other tax considerations. These items ...are clearly designed to accomplish a social or economic goal that is not related to the tax system." An item in this category "is correctly viewed as tax expenditure... not because of any normative judgment about the proper contours of the income tax, but because it is universally conceded to be an incentive measure that has no tax justification." Items falling outside this category, according to Blum, qualify as tax expenditures "only in terms of a normative judgment."[268]

In 1988 Victor Thuronyi who was Senior Counsel at the International Monetary Fund, developed an alternative approach by formulating a definition of "substitutable tax provisions"; a definition not based on the subjective idea of a normative tax. A substitutable tax provision is a tax law provision whose purposes may be achieved by a non-tax-based federal program at least as effectively. This definition directs policymakers to two fundamental choices: first, whether to replace certain tax provisions with programs based outside the tax system and, second, whether to reduce or eliminate the assistance provided by particular tax provisions in light of budgetary priorities.[269]

The report from the Canada Department of Finance in 2000 proposed various theoretical approaches to defining the benchmark including a labour income base, and expenditure or consumption base, and a lifetime consumption approach. All have positive and negative features, but none is seen as entirely satisfactory.[270]

In 2009 Craig Fookes, an analyst at New Zealand Treasury believed that the theoretical tax benchmarks allow the difference between a specific tax and an "ideal" tax structure to be measured. This difference, relative to a theoretical tax

[268] Walter J Blum, Book Review (1975) 'Reviewing Surry, Pathways to Tax reform' see above n 174, I *Journal of Corporation Taxation* 486-488.
[269] See above n 243.
[270] Canada Department of Finance, *Tax Expenditures: Notes to the Estimates/Projections* (Public Works and Government Services Canada, Ottawa, 2000).

structure, may vary markedly from the tax that is actually a Haig-Simons definition of income, and includes all changes in wealth including income and any capital appreciation over the period. Thus, the further the theoretical tax structure moves from the current tax structure, the less useful numbers are from a fiscal perspective. [271]

The Australian Treasury, which publicly provides a large amount of data on their benchmark, starts with a Haig-Simons definition of income, but then tailors the benchmark to sit more closely with current tax practice. [272]

6. 2.4. The Joint Committee on Taxation Critique

Since 1972 the staffs of the Joint Committee on Taxation (JCT) in the United States has prepared an annual detailed list of income tax expenditures. However, ongoing debate has led to a re-examination of JCT's approach. [273] In May 2008, a JCT report announced the most significant planned changes to its methods of presentation and measurement of tax expenditures. [274]

This 2008 JCT report questioned the utility of tax expenditure analysis as currently implemented by the JCT. It first reviewed the history of tax expenditure analysis beginning with the concept as originally introduced by Stanley Surrey in 1967. It then argues that tax expenditure analysis no longer serves as "an effective and neutral analytical tool for policymakers … because the premise of the analysis (the validity of the "normal" tax base) is not universally accepted." [275] The report argued the usefulness of tax expenditure analysis today as being undercut by the ongoing debate about what should and should not be included in the normal or baseline tax base.

The 2008 JCT report announced a new approach to identify tax expenditures: "Tax Subsidies" –"tax law provisions that are deliberately inconsistent with an identifiable general rule of present law" – and "Tax-Induced Structural Distortions" –"structural elements that materially affect economic decisions in a manner that imposes

[271] See above n 187.
[272] The Australian Treasury , *Tax Expenditure Statement 2008* (*Treasury Publication*, Canberra, 2009)
[273] See above n 187.
[274] See above n 253.
[275] Ibid at 8.

substantial economic efficiency costs".[276] It also discussed three subcategories of tax subsidies: (i) tax transfers; (ii) social spending; and (iii) business synthetic spending. It believed that this new approach was a "more principled and neutral approach to the issues" that operates "without relying on a hypothetical 'normal' tax to determine what constitutes a tax expenditure, and without holding up that 'normal' tax as an implicit criticism of present law."[277]

Moreover, the 2008 JCT report argued that even if the attacks on the tax expenditures baseline were unwarranted, they had so seriously compromised tax expenditures' effectiveness that adoption of an alternative baseline was called for.[278] Finally, the reference baseline for estimation purposes was used. This reflected an acknowledgement of the limits of defining tax expenditures relative to a normal income tax baseline.[279]

The 2008 JCT report did not however address in detail, nor did it resolve, the question of why its proposed baseline was "more principled and neutral" than a hypothetical normal tax. Whether that is in fact the case is an open question. Indeed, it is likely that there is substantial leeway for debate on when a tax provision is "deliberately inconsistent with an identifiable general rule of the present tax law," and is consequently the source of a tax expenditure. The results of applying the new approach advocated by JCT can be seen in its estimates of federal tax expenditures for fiscal years 2008–2012 (JCT (2008d)).[280]

In 2010 Professor McDaniel analysed the JCT's new approach; the reference tax standard that it adopted, however, was not the correct one. "That standard has little to support it in either tax or economic analysis and lacks any real substantive context." [281] "Indeed, identification of the relevant reference Code provision may be a more uncertain endeavour than using SHS for the individual tax base. Taking that approach,

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[276] Ibid at 9.
[277] Ibid.
[278] See above n 230.
[279] See above n 257.
[280] Thomas F Pogue, 'Tax Expenditures: Concept and Framework for Analysis' (2009) Prepared under contract with the Office of Tax Policy New Mexico Taxation and Revenue Department.
[281] Paul R McDaniel, 'The Staff of the Joint Committee on Taxation Revision of Tax Expenditure Classification Methodology: What Is To Be Made of a Change That Makes No Changes?' (2011) in *Tax Expenditures: State of the Art* above n 2 at 3:10.

the JCT staff will almost surely fail in its effort to tamp down debate about tax expenditure analysis. It certainly will not satisfy proponents of using SHS as a principal tool in the classification process. Lastly, the approach seems unlikely to satisfy those commentators who argue that there is no normative standard at all on which tax expenditure analysis can be based." [282]

McDaniel argued that the SHS normative tax base was and remains a useful tool in identifying tax expenditures. He stated that "It is to be hoped (and recommended) that in preparing future tax expenditure estimates, the JCT staff will return to the traditional normal tax structure classification system."[283] The interesting thing is that in the 2010 JCT report the JCT staff returned to basing their tax expenditure list on the SHS normative tax base.[284]

Meanwhile the OECD no longer supports the idea of a normative benchmark because defining a normative tax base is a very political issue that may be unresolvable. For this reason, the OECD suggested that a benchmark should be based on current tax practice rather than ideal tax practice. [285]

In 2010 Professor Christopher Heady , a former head of the Tax Policy and Statistics Division of the OECD's Centre for Tax Policy and Administration, notes that many countries do not use the broad SHS definition of income as the benchmark in preparing their tax expenditure accounts. Instead, they use a benchmark that much more closely resembles their actual income tax. [286] He concluded that "the need to define a benchmark raises two related problems. First, within a country, there can be disagreement about what constitutes tax expenditure. The second problem with the need to define a benchmark is the lack of international comparability in tax expenditure reports."

[282] Ibid at 3:11
[283] Ibid.
[284] Staff of the Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2009-2013, JCS-1-10* (US Government Printing Office, Washington, 2010).
[285] See above n 195.
[286] See above n 280.

Heady also noted that the OECD found most of these differences in benchmarks between countries did not relate to what economists often regard as the key elements of a tax system.[287] These included the choice between the comprehensive income tax and the expenditure tax as a benchmark, the choice of the tax unit, and the treatment of the integration of personal and corporate income tax. Heady further notes that, in particular, all countries use an income tax rather than an expenditure tax benchmark.[288]

6. 3. Analysis of the 46 years' Benchmark War

While it is true there is enormous debate over the benchmark, almost all of the debate takes place on the margins. There is acceptance of the vast majority of tax expenditures identified almost all tax expenditure budgets. Debates about whether the benchmark should be accruals or realisation for capital gains or whether income should include gifts, and so on, are irrelevant to the issues examined in tax expenditure budgets such as accelerated depreciation for ships, credits for research and development, exemptions for high tech industries, and so on.

It is common for the first section in tax expenditure budgets to attempt to justify the benchmark used in that budget, and a central focus of the academic literature since Stanley Surrey's first articulation of the concept has been on the appropriate benchmark. The level of debate on this issue reflects the historical origins of the tax expenditure concept and policy makers' concern with pragmatism. The concept was developed by a lawyer and most of the debate has been conducted by lawyers aware of various legal doctrines about the validity of accrual basis taxation or realisation basis taxation for capital gains. The pragmatic concern comes from the recognition by policy makers that an accrual basis capital gains tax is not politically viable. They see little point in starting with an unattainable benchmark.

The debate is important to the definition of the benchmark, but in practice only affects analysis at the very margins. As in all questions of law, there are difficult cases and uncertainty at the margins of a concept, but the vast majority of cases fall within the

[287] See above n 196.
[288] Christopher Heady, 'Tax Expenditures: Definitional and Policy Issues'(2011) in *Tax Expenditures: State of the Art* above n 2 at 2:17.

clear areas in the centre of the concept. All the debate at the margins is irrelevant to almost all tax expenditures resulting from tax laws, regulations and circulars.

There has been a long debate about the appropriate tax base for measuring tax expenditures (known as the base war). Much of the debate has centred on the question of whether an accrual basis base or realisation basis base should be used. Actually, the choice is between full accrual and partial accrual since everyone would recognise depreciable assets using a proxy for accruals (the correct depreciation rate) and everyone would recognise debt on an accrual basis. However, notwithstanding all the debate that has gone on, governments have mostly settled on a compromise for their tax expenditure accounts. All of them use accrual for debt and depreciable property and realisation for capital assets, exactly the same as accounting standards based on historical cost. It appears that, despite the significant debate in the literature, the issue has been settled in practice. This thesis suggests China can bypass the many decades of debate that have accompanied adoption of tax expenditure analysis in western countries and instead start with an "off the shelf" benchmark that in many ways may be superior to the often muddled benchmarks that have evolved in other countries, but which bypasses the significant literature by adopting a "ready-made as it turns out" approach, the suggested standard essentially replicates what has emerged as the practice of almost all governments. Thus, rather than adopting the de facto standard by copying another country's base or the OECD base, it goes directly to the accounting standard that parallels the base used in practice in most places.

6. 4. Other reasons for China's Choice: Accounting Standards as Tax Expenditures

The 46 years' debate is almost entirely revolves around a single question -- do we use accrual or realisation for capital gains. But in practice everyone uses realisation which is the accounting standard. So, while some might say this is a "new" benchmark, in reality it is simply the internationally known name for what every country already practices.

Everyone started with a debate about the base. But everyone ended up with something that very closely resembles accounting standards. So, for the next country, China, rather than go through the whole debate for another 46 years, China will start

with what everyone else ended up with: a benchmark that looks the same as accounting standards, and so we will use accounting standards. It is known already, it is international, and it means China can use an international standard as its starting point.

In this environment, nominating "accounting principles" as a new base might be seen as either a courageous or naïve proposal. However, accounting standard is a logical starting point for identifying a benchmark for tax expenditures in China for four reasons.

First, they measure annual net profit, which should align almost completely with a fully neutral tax base that only measures profits. It is relatively easy to identify the few instances in which accounting principles may deviate from this goal for purposes particular to accounting. One of these results from the objective of accounting statements is to provide investors with notice of known future commitments or expectations that may impact on profits in later accounting periods. Based on this accounting principle, accounting statements will record accrued leave obligations of employees. As tax law is concerned with the measurement of profits in each tax period, the tax law will commonly recognise obligations of this sort when they affect profits. Thus, it is common for tax law to delay recognition of leave entitlements until leave is taken, when the obligations are recognised as outlays (the salaries of employees who are on leave) and reduced income (if they employees are not generating outputs when they are on leave). Chinese tax law does not require different tax and accounting treatments for obligations of this sort so this is not a concern if accounting standards are used as the tax benchmark in China.

Another instance when a country adopts an imputation system to remove the double taxation of income derived through a company rather than directly by the owners of a company. This is purely a tax construction and will not be reflected at all in accounting standards. Once again, China does not have any imputation system or other system to offset the double tax consequences of a classical company and shareholder tax system and this is not a concern if accounting standards are used as the tax benchmark in China.

A third instance is where the tax law contains attribution rules or substitute value rules to prevent tax avoidance by related parties. For example, the tax system may attribute income derived from assets transferred below value in a non-arm's length transaction to the transferor. It may similarly substitute an arm's length price for the transfer price used by related entities or may attribute income derived through a controlled foreign company or foreign investment fund to the controller or investor. China does have limited rules of this sort but these can be easily identified and their effect removed from tax expenditure analysis based on an accounting standards benchmark.

A fourth instance is where the measurement of income and expenses for tax purposes is constrained by constitutional factors such as a constitutional immunity from tax of provincial governments or particular persons or entities (e.g., the constitutional head of state). While there are no explicit exemptions of this sort in Chinese tax laws, they may be implicit in the structure of government in China. These instances can be identified and easily segregated if account standards are used as the tax expenditure benchmark.

Second, they are internationally developed and are based on the best scientific thinking on the measurement of profits from around the world.

The International Accounting Standards Board (IASB) was established in 2001 to develop International Financial Reporting Standards (IFRS). A year later, European Union (EU) member states committed to requiring IFRS for all listed corporations in their jurisdictions effective year 2005 (EU 2002). The first IFRS was issued in 2003, by which time at least 19 countries required compliance with the international standards. Since then, nearly 70 countries (including EU countries) have mandated IFRS for all listed companies. Further, about 23 countries have either mandated IFRS for some listed companies or allow listed companies to voluntarily adopt IFRS. However, as of 2007, at least 40 countries continue to require domestically developed accounting standards over IFRS, and this list includes some large economies like Brazil, Canada, China, Japan, India, and the US.

Third, they have been refined into a single set of global standards, unlike the benchmarks used in tax expenditure budgets elsewhere, which vary from country to country.

Because there is no international consensus on the benchmark tax system, tax provisions that are regarded as tax expenditures in some countries may not be so regarded in others. Differences between countries include the treatment of the three items listed above (for Japan, Spain, and Sweden), and many more. However, all OECD countries regard the lower income tax rates faced by low-income taxpayers under a progressive tax system as part of the benchmark; so making the tax system redistributive in this way is not seen as constituting a tax expenditure.

As a result of these differences in benchmarks, it was not possible for the OECD to produce internationally comparable data on the extent of tax expenditures in its 1984 and 1996 reports on country practices and experiences. However, the most recent OECD publication on this topic has made an attempt to produce more nearly comparable data for a small group of countries by adjusting for as many differences between the country benchmarks as possible.[289]

Fourth, they have already been developed, published and comprehensively explained. China has no tax expenditure budget and very limited expertise in the area. The process of analysing Chinese tax expenditures could be established much more quickly if China adopted an "off the shelf" model rather than attempt to develop its own benchmark from scratch.

In the context of China, however, there are a number of factors that make adoption of an "off the shelf" benchmark sensible. The very fact that the issue has been debated so much in more developed countries lends strength to the case for a ready-made standard. The debate in some countries has extended for over 40 years. China has no tax expenditure budget, and so the most important thing is to start the process. A clear, unambiguous, well-known, internationally recognised standard is a useful starting point. China can follow the rest of the world and spend decades debating the issues around the benchmark. But for the purpose of establishing a starting point for the debate is accounting standards, which purport to be neutral and value free, is a simple and logical base.

[289] Ibid

6.5. Conclusion

For the purpose of this thesis, the accounting standard as a generally accepted rule is used that is mirrored in every tax expenditure budget. It looks as using a new standard. But in fact, the vast majority of tax expenditures set out in everyone's tax expenditure budgets would be recognised as tax expenditures in all the tax expenditure budgets and in accounting principles. Leaving aside the esoteric questions on the margin, there is an almost complete overlap on the core elements of the tax base – accelerated depreciation is tax expenditure in every system, Research and Development credits are tax expenditures in every system. So accounting standards are not a new standard – they're simply an articulation of the core principles already found in all benchmarks. This thesis will focus on tax expenditures that would be treated as tax expenditures under any existing tax expenditure budget but which, to date, have not been labelled and analysed as tax expenditures in China.

Chapter 7 Tax Expenditures Identified Using Accounting Standards as the Benchmark

7.1. Introduction

This chapter summarises tax expenditures that have been identified by comparing outcomes under the Chinese Enterprise Income Tax Law with the results that follow from the application of Chinese Accounting Standards (CAS). As noted in chapter 4, CAS now aligns very closely with International Financial Reporting Standards (IFRS). While primary references are to CAS, cross references to IFRS are also included. If CAS and IFRS would yield different outcomes, the Chinese Enterprise Income Tax Law result is compared to both of the standards.

Some tax expenditures have been identified not by comparing the accounting treatment (used as the benchmark income tax) with the treatment under tax law but rather by comparing two different tax rules that apply to different types of companies or companies in different regions where the same CAS would apply to both – that is, CAS would not distinguish between enterprises on the basis of their type or location. Examples of tax expenditures that are identified in this way include lower tax rates for specified types of companies or for companies that are registered in and carry on operations in particular regions.

The tax expenditures identified comparing Chinese Enterprises Income Tax law with CAS fall into nine distinct groups. The first group of tax expenditures comprises measures enacted to support particular types of industries. The second group of tax expenditures are intended to support particular types of activities carried on by any companies. Tax expenditures in the third group are designed to assist disadvantaged businesses or individuals employed by companies subject to the enterprise income tax.

The fourth group of tax expenditures includes concessions designed to encourage investment in particular regions of the country. Areas enjoying special concessions fall into two sets. The first are areas that were originally established to attract foreign investment to China. The second are areas that suffer from underdevelopment relative to more prosperous parts of the country. The fifth group of tax expenditures

has measures to support innovation, a goal thought to be necessary for China's future economic success. These concessions apply to all types of companies, all industries and all areas of the country. The sixth group of tax expenditures contains concessions for interest income to subsidise borrowing costs for two types of debtors.

The seventh group contains concessions to promote resident enterprises and non-resident enterprises, for those operating without a permanent establishment in China and for those operating through a branch (but not subsidiary) in China. The eighth group are non-profit organisations that satisfy the definition of an enterprise and thus fall under the Enterprise Income Tax Law. The final category is a transitional continuation of the preferential tax rate and tax exemption and deduction that applied to enterprises prior to 2008.

The tax expenditures analysed in this chapter arise as features in the tax law that deviate from accounting standards. The analysis follows four steps. The first step is the description of the rule applying to a particular type of transaction, company or region that appears to give rise to tax expenditures. The second step explains how business profits subject to the tax rule in question would be measured under accounting standards. The third step describes how tax law or practice deviates from the accounting standards benchmark, creating the tax expenditure. Finally, the fourth step provides an analysis of the tax expenditure revealed in the previous steps.

The Chinese Accounting Standards related to the benchmark used for the analysis in this chapter are as follows:

- The Basic Standard of CAS [290], Chapter 6 Revenue [291] and No. 14 – Revenue [292]
- The Basic Standard of CAS,[293] Chapter 7 Expenses [294]
- No.6– Intangible Assets of CAS [295]

[290] It is similar to the IFRS: Framework.
[291] CAS, Basic Standard, chapter 6, Revenue.
[292] CAS No. 14 – Revenue is similar to the IAS: No. 18 Revenue.
[293] It is similar to the IFRS: Framework.
[294] CAS, Basic Standards, Art 33-36.
[295] It is similar to IAS 38, Intangible Assets.

- No. 4 – Fixed Assets of CAS [296]

- No.5 – Biological Assets of CAS [297]

- No.9– Employee Benefits of CAS [298]

- No. 33 of CAS, Consolidated Financial Statements [299]

As explained in Chapter 5, tax expenditures are the equivalent of a direct spending program, but carried out through the tax system. The process of tax expenditure analysis is discussed in 1.4. of Chapter 1

7. 2. State Encouraged Industries

7. 2.1 High and New Technology Enterprises

One of the main goals of the economic reform process started in 1978 by Deng Xiaoping was to raise China's national technological capabilities. The development of China's high and new technology enterprises has played an important role in promoting the integration of technological progress and economic growth and facilitating the development of newly-emerging industries. The EITL, EITLIR and a number of circulars confirm that qualifying specified technology enterprises are entitled to a 15% income tax rate in contrast to the ordinary income tax rate of 25%.

7. 2.1.1. Accounting Treatment

Since income tax is purely a creation of government unrelated to CAS, the accounting standards establish no benchmark tax rate. CAS can nevertheless be used indirectly as a benchmark to identify tax expenditures resulting from the reduced tax rate. This has been discussed in chapter 6.

[296] It is similar to IAS 16, Property, Plant and Equipment.
[297] It is similar to IAS 41, Agriculture.
[298] It is similar to IAS 19, Employee Benefits.
[299] It is similar to IAS 27, Consolidated and Separate Financial Statements.

7. 2.1.2. Tax law and implementation rules and administrative practices

A number of tax concessions apply to a category of company defined in **Article 28** [300] of the EITL as a "State-encouraged new technology and high technology enterprises" (referred to in related Circulars as "high and new technology enterprises" or HNTEs).

The qualifying enterprise type is not defined in the law but the **EITLIR Article 93** provides a basic definition which is further refined in a **Circular 172,** [301] an administrative interpretation document issued jointly by the Ministry of Science (MOS) and Technology (MOST), the Ministry of Finance (MOF), and the State Administration of Tax (SAT),

To qualify for the reduced rate, a company must show it falls within the scope of a "State-encouraged high and new technology enterprise" as defined in **Circular 172** and meets four threshold tests set out in **EITLIR Article 93**.

Circular 172 defining "state-encouraged high and new technology enterprises" describes eight broad classes of qualifying enterprises. An accompanying "catalogue" specifies 51 different types of technology and a further 218 activities that can be used to identify the eight classes of qualifying enterprises.[302]

The three qualifying thresholds specified in **EITLIR Article 93** are:
1) the ratio of research and development expenditures to the enterprise's sales;
2) the ratio of income from sales or service of high new technology products to total revenue;

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[300] EITL, Art 28, Enterprise income tax rate shall be reduced to 15% for State-encouraged new technology and high technology enterprises.

[301] Circular (Guokefahuo) [2008] No.172 on Administrative Measures on the Recognition of High and New Technology Enterprises, issued on 14 April 2008 by the Ministry of Science and Technology (MOST), the Ministry of Finance (MOF), and the State Administration of Tax (SAT). The eight broad classes of qualifying enterprises are those carrying out high-technology services (such as website development, internet security services, information system design, or industrial design or those involved in the following areas of technology: electronics and information technology); bio-engineering and new medical technology; new materials technology; aviation and space technology; traditional industry transformation technology; new energy and energy conservation technology; and resources and environmental protection technology.

[302] Catalogue of High New Technology Industries Specifically Supported by the State, containing an initial list (to be updated from time to time).

3) the percentage of employees working in the science and technology field to the total number of employees

The relevant ratios are not found in the implementing rules, which simply describe them as the "stipulated" ratios. The actual ratios are set out in **Circular 172** jointly issued by the MOST, MOF and SAT. **Article10(4)** of the Circular sets out three qualifying ratios for research and development expenses to sales, ranging from 3% for enterprises with gross revenues below RMB 50 million to 6% for enterprises with gross revenues above RMB 200 million. **Article 10(5)** of the Circular establishes a 60% threshold for high technology sales or service revenue as a percentage of total revenue. **Article 10(3)** provides two cumulative tests that must be met to satisfy the percentage of employees' threshold. First, 30% of the employees must hold a university degree qualifying threshold and second, employees drawn from this group who are involved in research and development activities must constitute at least 10% of the total employee number.

Article 93 of the EITLIR delegates to the administering agency (the SAT) a power to establish further verification and administrative rules and procedures that must be satisfied by qualifying enterprises..

Circular 172 appeared to provide some detail of qualifying HNTEs, setting out eight broad classes of qualifying enterprises and, in its accompanying catalogue, 51different types of technology and a further 218 activities that can be can fall within one or more of the eight classes of qualifying enterprises.[303] Particular attention was paid to one of the eight difference classes of qualifying HNTEs, a group described as high-technology services enterprises (HTSEs) and a subset of this group described as high-technology outsourcing services enterprises (HTOSEs).

Notwithstanding the substantial lists providing some flesh to the eight category skeleton set out **Circular 172**, as a result of the vagueness of many descriptions in the Circular, taxpayers regarded it more as a summary of the general framework for the concession regime rather than detailed final rules on which firms qualified for the

[303] Catalogue of High New Technology Industries Specifically Supported by the State, containing an initial list (to be updated from time to time).

reduced tax rate. Especially unclear were the details of HNTE companies that were HTSEs or the HTOSE subset of HTSEs.

The MOST, MOF and SAT attempted to fill in some of the missing detail with further Circulars. First, the MOST, MOF and SAT issued **Circular 362,**[304] which provides enhanced objectives of some qualifying criteria and describes the application process to be followed by companies seeking to be recognised as qualifying HNTEs and instructions on completing the different forms required for recognition. Subsequently, the MOF and SAT jointly issued three Circulars (Circulars 63-65) that describe in some detail the tests that must be satisfied by an HTSE generally and more specifically an HTSE that is an HTOSE.

On 15 January 2009 the MOF and SAT jointly promulgated Caishui [2009] No. 63 (Circular 63) on Issues Regarding Tax Policies for High Technology Service Enterprises.

This, together with Notice Regarding Income Tax Exemption of High Technology Service Enterprise's offshore outsourcing services in Demonstration Municipalities Caishui [2010] No. 64 (Circular 64) by the MOF and SAT issued on 28 July 2010, are to a large extent a restatement of the previously promulgated Circular but provide lowered standards for HTSE qualification and an additional tax incentive.

On 5 November 2010, the MOF and SAT jointly promulgated the Caishui[2010]No. 65 (Circular 65) on Issues Regarding Enterprise Income Tax for High Technology Service Enterprises (HTSE) which provides tax incentives to recognized HTSE.

The acquisition of the status being High Technology Service Enterprise (HTSE) is another significant tax preference to all multinational corporations (MNCs) operating their businesses in China.

The Offshore Income of High and New Technology Enterprises

Prima facie, Article 28 applied to all income but there was some doubt as to whether the concession applied only to Chinese-source income derived by qualifying HNTEs

[304] Circular 362, Circular on Issuing Administration Guidance for Identification of High and New Enterprises (GuoKeFaHuo [2008] No.362), released on 8 July 2008 by MOST, MOF and the SAT.

or would also extends to their foreign-source income (offshore income, in Chinese terminology). This question was clarified in the Circular Caishui [2011] No. 47.

On 31May 2011, the MOF and SAT jointly issued the Caishui [2011] No. 47 (Circular 47).[305] "Circular on the Applicable Tax Rate and the Tax Deduction and Exemption for the Offshore Income of High and New Technology Enterprises " According to the Circular, high and new-technology enterprises refer to enterprises that have already obtained the high and new technology enterprise certification and are currently enjoying the 15 percent preferential enterprise income tax rate. For these enterprises, their offshore income is also entitled to the 15 precent preferential enterprise income tax rate.[306]

When calculating their foreign tax credit limit, the 15 percent preferential tax rate can be applied when calculating the total taxable amount both within and outside of China.

Transitional Preferential EIT Policies

The SAT issued Circular on Further Confirmation of Implementation Rules of Transitional Preferential EIT Policies (Guoshuihan [2010] No.157, Circular 157) on 21 April 2010, which came into effect on 1 January 2010.

Circular 157 stipulates that resident enterprises regarded as high and new technology enterprises, that simultaneously meet the conditions for software manufacturing enterprises and integrated circuit production enterprises entitled to preferential corporate income tax policies of regular reduction of levy by half, may choose to apply the tax rate of 15 %for high and new technology enterprises or half of the 25% tax rate. Those qualifying enterprises however, are not entitled to half of the 15 % tax rate.

7. 2.1.3. Tax Expenditure Identified

Since income tax is purely a creation of government unrelated to CAS, There are no accounting standards establishing no benchmark tax rate. CAS can nevertheless be

[305] The Circular is effective retroactively from 1 January 2010.
[306] Circular Caishui [2011] No. 47, Art (1)

used indirectly as a benchmark to identify tax expenditures resulting from the reduced tax rate. If CAS does not distinguish between companies that qualify for the reduced rate and other companies, the application of standard rate to all other companies and the imposition of a lower tax burden on specified companies is the equivalent of taxing all companies at a neutral standard rate and providing government grants to rebate back part of the tax burden to qualifying enterprises.

However, **Article 28** of EITL, Article 93 of EITLIR, Guokefahuo [2008] No. 172 (Circular 172) and the Guokefahuo [2008] No. 362 (Circular 362), Caishui [2009] No. 63 (Circular 63) , Caishui [2009] No. 64 (Circular 64), Caishui [2009] No. 65 (Circular 65) , Caishui [2011] No. 47 (Circular 47) and GuoShuiHan [2010] No.157, (Circular 157) confirm that qualifying high and new technology enterprises are entitled to a 15% income tax rate in contrast to the ordinary income tax rate of 25%.

Therefore, one tax expenditure associated with the income derived from the high and new technology enterprises – low tax rate, which could be recognised and calculated into accounting income under CAS.

7. 2.1.4. Analysis

The tax expenditures to support high and new technology enterprises follow from a view that the state has a role in shifting investment to sectors it believes are important to growth and development. Thus, while there is no evidence of market failure or other factors that would justify state intervention in the market, the rationale implicitly assumes there will be positive externalities to a larger technology sector. One objective may be to help push the Chinese economy to a higher level by accelerating some development stages. Historical development of Asian economies suggests the initial stages of modern development are often based on copying imported technology with domestic technological development happening after that earlier copying stage.

If it is accepted that there are positive externalities from subsidies to support investment in high technology, the design of a subsidy program, particularly one placed in the tax system, poses many challenges. The most effective technology development may be those that take place in existing industries – the automobile

industry, steel industry, shipping industry, train building industry, medical instruments industry, etc. and the question arises whether support should be directed at existing industries or at firms that only generate technology outputs. The current subsidies are aimed at the latter group only. A second question is how the target of the subsidy should be defined. The political designers of the subsidy wish to shift resources into "high technology" but may have limited understanding of the details of this sector and only vague ideas of which parts of the sector and which aspects of technology will generate the hoped for positive externalities. The design of effective and precise definitions would be difficult, as would the design of measures that reach the intended activities if it turns out these can be carried out in a range of environments (specialist firms or existing industries). If it were concluded that an efficiently targeted subsidy for this activity could be designed and it was accepted that there are positive externalities that justify market intervention to shift investment to these activities, the question arises as to whether the government should also pick the type of business (specialist firms) that carries out the subsidised activity or whether it should let the market decide where the activities can be most effectively carried out.

The current subsidy program has been undertaken without empirical or theoretical analysis to indicate whether there is a need for a subsidy or whether the subsidy could generate positive analysis. The design of the tax expenditure has apparently not considered where the desired activities might take place most efficiently. There is also no evidence that the design has taken into account any evidence of the types of technology that are most likely to generate the desired externalities as the current boundaries of the subsidy are vague with limited detail of what constitutes eligible activities.

If full tax expenditure budgeting were adopted in China, it is likely these subsidies would be subject to substantial redesign.

7.2.2. Venture Capital Enterprises (VCEs)

Since the 1980s, venture capital in China has grown steadily along with the robust national economy. Venture capital can be an important driving force for the development of innovative small and medium enterprises in China, small and medium enterprises, start-up enterprises, enterprises in a time of transformation and upgrading,

and high and new manufacturing enterprises can be beneficiaries of venture capital investments. However, there will also be a period of transition as the market continues to mature and as new legal structures and commercial arrangements emerge. The EITL and EITLIR provides what are described as "venture capital enterprises" with deductions for a substantial part of the cost of acquiring equity interests in designated types of small-medium high new technology enterprises.

7.2.2.1. Accounting Treatment

The accounting standard related to the accounting treatment of deduction for expenses incurred by venture capital enterprises is the Basic Standard of CAS,[307] Chapter 7 Expenses [308] (The detailed CAS are stated in Chapter 1).

Article 33 of the CAS provides a deduction on the income statement for ordinary expenses of a business. However, Article 34 prevents deductions for capital expenditure and instead requires amortisation of the cost where the assets depreciate. No Articles allow deductions for the cost of non-wasting assets such as shares. As a result, under CAS, no deduction would be allowed for the cost of acquiring equity interests in designated types of small-medium high new technology enterprises. Under CAS, a venture capital enterprise that acquired these interests would not be able to recognise the cost of acquisition until the shares were sold, at which time the cost would be subtracted from the proceeds to determine profits from the sale.

7. 2.2.2. Tax law and Implementation Rules and Administrative Practices

Tax Deduction and the unused deductions Carry Forward

Article 31 of EITL states VCEs in industries where the State has placed heavy emphasis to promote their development and growth are eligible for tax deductions toward their taxable income that are based on a specified percent set forth of the total investment amount.[309]

[307] It is similar to the IFRS: Framework.
[308] CAS, Basic Standards, Art 33-36.
[309] EITL, Art 31.

Under Article 97 of EITLIR, the tax deductions toward taxable income as cited in Article 31 of the EITL refer to where a venture capital enterprise invests in the shareholdings of small-medium high new technology enterprises for more than 2 years. In such cases, 70% of the investment amount in small-medium high new technology enterprises may be deducted toward the taxable income of the venture capital enterprise for the year when the two-year holding is completed. Where the amount of the deduction is not fully utilised in that year, the unused amount is allowed to be carried forward to the following tax years.[310]

The term "venture capital enterprises" is not defined in the EITL or EITLIR. However, the SAT in Guoshuifa [2009] No. 87 [311] (Circular 87) has provided an interpretation of venture capital enterprises that qualify for the specific rules in the EITL and EITLIR. It states that venture capital enterprises as used in the Law and Regulation refers to enterprises or other economic organisations established specifically for the purpose of engaging in venture investment activities within the territory of the People's Republic of China in accordance with the Interim Measures for the Administration of Venture Capital Enterprises issued by the National Development Reform Committee (NDRC) Order [2005] No.39 (Order 39).[312]

Circular 87 provides further limitations for qualifying venture capital enterprises that invest in small-medium high new technology enterprises with the requirement that the target small and medium-sized high technology enterprises into which the venture capital enterprises invest meet the specifications for high technology enterprises set out in Guokefahuo [2008] No. 172 (Circular 172) and the Guokefahuo [2008] No. 362 (Circular 362). That is, the target high technology enterprises must have staff numbers of 500 or less, annual sales not exceeding RMB200m and total assets not exceeding RMB200m.[313]

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[310] EITLIR, Art 97.

[311] The State Administration of Taxation released the Issues Concerning Implementation of the Preferential Income Tax of Venture Capital Enterprises on 30 April 2009 and took effect 1 January 2008.

[312] Order 39 was released on 15 November 2005 and took effect on 1 March 2006 regarding the Provisional Measures on the Administration of the VCEs of Ten Ministries and Commissions.

[313] Guoshuifa [2009] No. 87, Art 2 (3).

7. 2.2.3. Tax Expenditure Identified

Under the Basic Standard of CAS,[314] Chapter 7 Expenses [315] the investment amount from venture capital enterprise does not satisfy the definition and recognition criteria of expenses and shall not be included in the income statement. Under CAS, no deduction would be allowed for the cost of acquiring equity interests in designated types of small-medium high new technology enterprises.

However, Article 31 of EITL, Article 97 of EITLIR, Guoshuifa [2009] No. 87 [316] (Circular 87), Guokefahuo [2008] No. 172 (Circular 172) and the Guokefahuo [2008] No. 362 (Circular 362) confirm that 70% of the investment may be treated as a deductible expense and the unused deductions may be carried forward to the following tax years.

Therefore, two tax expenditures associated with the investment amount from the venture capital enterprise – tax deduction and the unused deductions carry forward, which could not be recognised and calculated into accounting expenses under CAS.

7. 2.2.4. Analysis

International experience has shown that venture capital firms play an important role in the economy in supporting new businesses, especially in the high technology area. These firms weigh the high risk of failure if a new technology does not work against the high rates of return they receive if it does when deciding which firms to invest in. China, like advanced market economies, wishes to see an effective venture capital regime in place.

Generally, countries with the most successful venture capital systems do not provide subsidies for venture capital. The market very effectively provides venture capital without any subsidies -- the investors weigh risk and return and decide where to place

[314] It is similar to the IFRS: Framework.
[315] CAS, Basic Standards, Art 33-36 .
[316] The State Administration of Taxation released the Issues Concerning Implementation of the Preferential Income Tax of Venture Capital Enterprises on 30 April 2009 and took effect 1January 2008.

investment capital. Based on international experience, there appears to be no need to subsidise this sector. The market operates efficiently.

There may be a market failure in China, however. The banking system in China is dominated by a small number of banks and all banks in China are subject to control and pressure from governments that own majorities of the banks. As a result, lending is not based on a true market system -- loan funds are often directed to enterprises supported by national or local governments and banks are not free to make loan decisions based on the risk assessments and criteria they would use in a full free lending market. This means that small venture capital firms may face higher costs for funds than would be the case if there were not this market failure and it can be argued there is a justification for government subsidy for these businesses.

If there is a justification for government subsidy for venture capital businesses, a subsidy that only assists very profitable venture capital firms seems peculiar. These are firms that do not appear to be affected by the supposed market failure. A subsidy that reduced the cost of capital such as lower interest loans or loan guarantees for reduced fees might be better targeted than a tax subsidy that helps successful venture capital firms only. These firms, by definition, did not require any subsidy.

7.2.3. Clean Development Mechanism (CDM) Fund and Clean Development Mechanism Implementing Enterprises

The ultimate objective of the U.N. Framework Convention on Climate Change (UNFCCC) is to achieve stabilization of greenhouse gas (GHG) concentrations in the atmosphere at a level that will prevent dangerous anthropogenic interference with the climate system. The Kyoto Protocol set legally binding GHG emission reduction targets for developed countries (Annex I) and countries in transition (Annex B countries).[317] China is a party to the UNFCCC and Kyoto Protocol. Tax concessions are provided for serial types of income and expenses related to the sale of greenhouse gas emission reduction credits. Collectively, there are known as “Clean Development Mechanism (CDM)”Fund and CDM Implementing Enterprises.

[317] The World Bank, the clean development mechanism in china: five years’ experience, The publication is available online at www.worldbank.eapenvironment and www.worldbank.org.cn

7. 2.3.1. Accounting Treatment

The accounting standard related to the accounting treatment of exemption and deduction for CDM Fund and CDM Implementing Enterprises are the Basic Standard of CAS,[318] Chapter 6 Revenue [319] and No. 14 – Revenue [320], Chapter 7 Expenses [321]. (The detailed CAS are stated in Chapter 1)

7. 2.3.2. Tax law and Implementation Rules and Administrative Practices

Tax Exemption and Tax Deduction

On 23 March 2009, the MOF and SAT jointly issued Caishui [2009] No. 30 (Circular 30) for the first time to clarify the enterprise income tax incentives available to projects that utilize a clean development mechanism (CDM). Circular 30 is entitled the Notice on Enterprise Income Tax Policy Issues Regarding China's CDM Fund and CDM Project Developers, applies retroactively to 1January 2007.

Tax Exemption

According to Circular 30, the following types of income related to the CDM Fund (the Fund) can be exempted from EIT:

1. The portion of the transfer revenue of greenhouse gas emission reduction turned over to the Chinese government;
2. Donations from international financial organizations;
3. Interest income associated with Clean Development Mechanism funds on deposit and treasury bonds; and
4. Donations from domestic and foreign institutions, organizations and individuals.[322]

Tax Deduction

For a Clean Development Mechanism implementing enterprise, the following portion

[318] It is similar to the IFRS: Framework.
[319] CAS, Basic Standard, chapter 6, Revenue.
[320] CAS No. 14 – Revenue is similar to the IAS: No. 18 Revenue.
[321] CAS, Basic Standards, Art 33-36
[322] Caishui [2009] No. 30, Art 1 -4.

of the transfer revenue of greenhouse gas emission reduction turned over to the Chinese government can be tax deductible:

1. 65% of transfer revenue from hydrofluorocarbon (HFC) and perflurocarbon (PFC) projects;

2. 30% of transfer revenue from nitrous oxide (N2O) projects; and

3. 2% of transfer revenue in priority areas that improve energy efficiency, develop new or renewable energy, or recycle and reuse methane or coal bed gas and forestation projects.[323]

Tax Exemption and Deduction

For the income from the above hydrofluorocarbon and perflurocarbon projects and nitrous oxide projects will be exempt from enterprises income tax for the first three years and 50 percent deduction for the second three years from the first year it obtains any transfer revenue from this project.

Circular 30 further defines "income derived from the implementation of a CDM project" as the net income that remains after subtracting the following items from the CDM project's transfer revenue:

1. The portion of the transfer Revenue remitted to the Chinese government, and

2. The costs and expenses incurred by the CDM project developer for the implementation of the CDM project. [324]

In addition, Circular 30 requires that CDM project developers separately account for the income from a CDM project and reasonably allocate all relevant expenses, or else the income will not be eligible to receive the abovementioned preferential EIT treatments.[325]

The preferential EIT treatments laid out in Circular 30 are expected to benefit CDM project developers and their investors by helping increase CDM projects' net return.

[323] Caishui [2009] No. 30, Art 2 (1).
[324] Caishui [2009] No. 30, Art 2 (2).
[325] Caishui [2009] No.30, Art 2 (2).

7. 2.3.3. Tax Expenditure Identified

Under the Basic Standard of CAS[326], Chapter 6 Revenue[327] and No. 14 – Revenue[328] CAS does not make a distinction between income derived from Clean Development Mechanism Funds or CDM implementing enterprise and income derived from other funds or other enterprise.

Under the Basic Standard of CAS,[329] Chapter 7 Expenses[330] for a Clean Development Mechanism implementing enterprise, the some portion of the transfer revenue of greenhouse gas emission reduction turned over to the Chinese government do not satisfy the definition and recognition criteria of expenses and shall not be included in the income statement. Under CAS, no deduction would be allowed for the portion of the transfer revenue of greenhouse gas emission reduction turned over to the Chinese government.

However, Caishui [2009] No. 30 (Circular 30) states 4 types of income related to the CDM Fund (the Fund) can be exempted from EIT[331] and 3 types of portion of the transfer revenue of greenhouse gas emission reduction turned over to the Chinese government can be tax deductible.[332] And the income from the above hydrofluorocarbon and perflurocarbon projects and nitrous oxide projects will be exempt and deductable.

Therefore, two tax expenditures associated with the income derived from Clean Development Mechanism implementing enterprise – tax exemption and tax deduction, which could be recognised and calculated into accounting income under CAS.

7. 2.3.4. Analysis

The market should provide the optimal level of investment in each industry. If there is a case for government intervention, it must be because there is some sort of market failure or a positive externality from the activity. There is no persuasive evidence of

[326] There is no specific accounting standard for public infrastructure projects.
[327] It is similar to the IFRS: Framework.
[328] It is similar to the IAS: No. 18 Revenue.
[329] It is similar to the IFRS: Framework.
[330] CAS, Basic Standards, Art 33-36.
[331] Caishui [2009] No. 30, Art 1 -4.
[332] Caishui [2009] No. 30, Art 2 (1).

market failure or other factors that would justify government provide tax incentives in the CDM market, the rationale implicitly assumes there will be positive externalities to a larger CDM implementing enterprise. One objective may be to help push the Chinese industries the aware of CDM implementation and cooperation is important for China to implement its obligation under the UNFCCC and Kyoto Protocol and address climate change with the international community.

However, this subsidy that only assists CDM implementing enterprise seems peculiar. These are other enterprises and individuals that do not appear to be benefited. A subsidy that reduced the cost of equipment for reducing greenhouse gas emission reduction such as lower interest loans or loan guarantees for reduced fees might be better targeted than a tax subsidy that helps a larger CDM implementing enterprise only.

7. 2.4. Culture Enterprises

According to a communique released at the sixth plenary session of the 17th Central Committee of the Communist Party of China (CPC) on 18 Oct, 2011 in Beijing.
China is facing an imperative need to boost its "cultural soft power" and enhance the global image of its culture. Culture is regarded as one of the important parts of the national comprehensive competitiveness. To promote cultural enterprises, the government has provided four types of special tax rules – low tax rates for some types of income, exemptions for some other types of income, super deductions for some types of expenses, and deductions for devalued property. Three of these appear to give rise to tax expenditures; the fourth may be consistent with accounting standards.

7. 2.4.1. Accounting Treatment

The accounting standard related to the accounting treatment of exemption and deduction for cultural enterprises are No.6– Intangible Assets of CAS [333] and CASIG the Basic Standard of CAS,[334] Chapter 6 Revenue [335] and No. 14 – Revenue [336] Chapter 7 Expenses [337] (The detailed CAS are stated in Chapter 1).

[333] It is similar to IAS 38, Intangible Assets.
[334] It is similar to the IFRS: Framework.
[335] It is similar to the IFRS: Framework.

Since income tax is purely a creation of government unrelated to CAS, the accounting standards establish no benchmark tax rate. CAS can nevertheless be used indirectly as a benchmark to identify tax expenditures resulting from the reduced tax rate. This has been discussed in Chapter 6.

7. 2.4.2. Tax law and Implementation Rules and Administrative Practices

On 27 March, 2009 the MOF and the SAT and General Administration of Customs jointly issued Caishui [2009] No.31(Circular 31) and took effect from1 January 2009 on Several Issues concerning Tax Policy for Supporting the Development of Cultural Enterprises. Cultural enterprises [338] refer to the enterprises engaged in press and publication, radio, film and television and culture and arts.

Low Tax Rate

Under Circular 31 for the period from 1 January 2009 to 31 December 2013 in the cultural-industry-supporting technology field, the enterprise income tax of the high technology enterprises recognized according to circular 172 Guokefahuo [2008] No. 172 and circular172 Guokefahui [2008] No.362 can enjoy a reduced the enterprise income tax rate of 15%.

Super Deduction of R&D Expenses

Under Circular 31 the R&D expenses of cultural enterprises incurred by development of new technologies, products and processes are allowed to be additionally deducted in calculation of taxable amounts according to provisions of state taxation laws. [339]

Deduction of Property Loss

Under Circular 31 With respect to unsalable publications of publishing and distributing enterprises, paper books stocked over 5 years (inclusive of the year of publication, the same below), audiovisual products, e-publications and projection films (inclusive of micro-products) stocked over 2 years and paper journals, wall calendars and New Year pictures stocked over 1 year may be deemed as property loss and made pre-tax deduction. For the unsalable publications which have been made

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[336] It is similar to the IAS: No. 18 Revenue.
[337] CAS, Basic Standards, Art 33-36 .
[338] Caishui [2009] No.31, Art 9.
[339] Caishui [2009] No.31, Art 5.

pretax deduction as property loss while handled in another year, the incomes from such handling shall be calculated in the taxable incomes of the year.[340]

In order to further promote the cultural restructuring and the development of cultural institutions, on 26 March 2009 the MOF and the SAT jointly issued Caishui [2009] No.34 (Circular34) on Certain Preferential Tax Policy for Operating Cultural Institutions Transformed [341] to Enterprises during Reforms of Cultural System took effect on 1 January 2009.

Tax Exemption

Under Circular34 for the period from 1 January 2009 to 31 December 2013, operating cultural institutions transformed to enterprises can enjoy enterprise income tax exemption from the date of registration as an enterprise.

7. 2.4.3. Tax Expenditure Identified

Articles 8 and 9[342] provide for recognition of no more than 100% of the cost of research and development. An outright deduction is allowed where the research and development activities generate knowhow or benefits other than actual or expected intangible property such as a patent. If the expense yields or will lead to the creation of intangible property, the expense is capitalised and recognised over the life of the expected intangible property.

Under the Basic Standard of CAS[343], Chapter 6 Revenue[344] and No. 14 – Revenue[345] CAS does not make a distinction between income derived from culture enterprise and income derived from other enterprises.

However, Caishui [2009] No.31(Circular 31) , Guokefahuo [2008] No. 172(Circular 172), Guokefahui [2008] No.362 (Circular 362) and Caishui [2009] No.34 (Circular34) confirm that qualified culture enterprises can enjoy a reduced the

[340] Caishui [2009] No.31, Art 6.
[341] Operating cultural institutions meant the public institutions engaging in press and publishing, radio, film and television as well as literature and art; and the transformation includes the overall transformation of cultural institutions into enterprises and the splitting of the business operation part of cultural institutions into enterprises, Caishui [2009] No.34, Art 4.
[342] CAS, Art, 8, 9.
[343] There is no specific accounting standard for public infrastructure projects.
[344] It is similar to the IFRS: Framework.
[345] It is similar to the IAS: No. 18 Revenue.

enterprise income tax rate of 15% , super deduction (150%)of R&D Expenses and deduction as property loss, tax exemption for the period from 1 January 2009 to 31 December 2013, operating cultural institutions transformed to enterprises can enjoy enterprise income tax exemption from the date of registration as an enterprise.

Therefore, four tax expenditures associated with the income derived from culture enterprises – low tax rate, super tax deduction, tax exemption and tax deduction which could be recognised and calculated into accounting income under CAS.

7. 2.4.4. Analysis

There is probably no need to subsidise mass market culture – television can find enough advertisers, etc. If there is a case for subsidy, it's probably for culture where the market is not big enough to support the culture on its own – for example, minority cultures. These subsidies may be inefficient ways of doing this. They only provide benefits to profitable enterprises (with exemptions, super deductions, etc.). They provide no benefits to non-profitable ones that need more funding to produce cultural outputs that are not mass-market culture. Moreover, the deduction doesn't help start-up companies.

Replacement with alternative subsidy programs such as targeted direct grants could be a more efficient way of subsidising culture. This is also true for radio, film, press and publications. If staying with tax expenditures rather than a direct grant, a refundable credit could be more efficient.

7. 2.5. Security Investment Funds

China's security investment funds began with the establishment of the Shenzhen. And Shanghai stock exchanges in the early 1990s. The first securities investment fund was formed in 1991, and the first company dedicated to fund management was established in 1992. Security investment funds have become one of the most widely used investment tools in the Chinese securities markets. The government also provides tax exemption for some types of income derived from security investment funds.

7. 2.5.1. Accounting Treatment

The accounting standard related to the accounting treatment of exemption for security investment funds for is the Basic Standard of CAS,[346] Chapter 6 Revenue [347] and No. 14 – Revenue [348] (The detailed CAS is stated in Chapter 1).

7. 2.5.2. Tax law and Implementation Rules and Administrative Practices

Tax Exemption

In order to encourage the continued growth of Chinese security investment funds the MOF and the SAT jointly issued Caishui [2008] No.1 (Circular 1) on Some Preferential Policies of Enterprises Income Law on 22 February 2008 and took effect from 1 January 2008.

Circular 1 state the following income derived from security investment funds are exempt from EIT until further notice including: The capital gain derived from the purchase and sale of stocks or bonds, dividends from stocks, interest from bonds and other revenues; [349] The revenue of investors derived from the distribution of securities investment funds;[350] The capital gain derived from the fund manager purchasing and selling stocks or bonds through the fund.[351]

7.2.5.3. Tax Expenditure Identified

Under the Basic Standard of CAS,[352] Chapter 6 Revenue[353] and No. 14 Revenue [354] CAS does not make a distinction between income derived from security investment funds and income derived from other funds. However, Caishui [2008] No.1 (Circular 1) states 3 types of income related to the security investment funds can be exempted from EIT [355] .

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[346] It is similar to the IFRS: Framework.
[347] CAS, Basic Standard, chapter 6, Revenue.
[348] CAS No. 14 – Revenue is similar to the IAS: No. 18 Revenue.
[349] Caishui [2008] No.1, Art 2 (1).
[350] Caishu*i* [2008] No.1, Art 2 (2).
[351] Caishu*i* [2008] No.1, Art 2 (3).
[352] It is similar to the IFRS: Framework.
[353] CAS, Basic Standard, chapter 6, Revenue.
[354] CAS No. 14 – Revenue is similar to the IAS: No. 18 Revenue.
[355] [2008] No.1, Art 2 (3).

Therefore, one tax expenditure associated with the income derived from security investment funds – tax exemption, which could be recognised and calculated into accounting income under CAS.

7. 2.5.4. Analysis

In a healthy successful security investment market, the most efficient allocation of resources is presumed to follow the operation of the market – investors weighing the risks and potential returns from alternative investments relative values before making investment. The market very effectively provides security investment funds without any subsidies.

There may be a market failure in China, however, Chinese authorities are willing to restructure and develop the securities markets to make them a main source in financing the Chinese economy, in contrast to bank lending which remains rather inefficient and scarce. From this perspective, they will certainly continue to promote the development of the security investment funds.

The subsidy by way of tax expenditure for the income derived from security investment funds address it inefficiently because they only limit to profitable investment. The other programs that could do it more efficiently by reducing the cost of security investment funds such as lower interest loans or loan guarantees for reduced fees might be better targeted.

7. 2.6. Software Development and Integrated Circuit Production Industries

For the last ten years, the Chinese software and integrated circuit industries mushroomed in various regions of the country, and their efforts to upgrade the industrial system towards a self-innovative one have greatly driven the domestic economy. They have helped China's progress in information technology, and promoted national economic and social development.

The software and integrated circuit industries have been included as China's "new-generation information technologies" under the category of strategic industries in the

Twelfth Five-Year Plan.[356] A number of circulars state qualified software and integrated circuit enterprises are entitled to enterprise income tax incentives in respect of tax exemption, low tax rate, exemption of Value Added Tax (VAT) refunds, and deduction of training expenses and depreciation throughout a short life of no less than 3 years.

7.2.6.1. Accounting Treatment

The accounting standard related to the accounting treatment of exemption, deduction and depreciation throughout a short life for qualified software and integrated circuit enterprises are the Basic Standard of CAS,[357] Chapter 6 Revenue [358] and No. 14 – Revenue [359], Chapter 7 Expenses [360] , and No. 4 – Fixed Assets of CAS [361] and CASIG (The detailed CAS are stated in Chapter 1).

Since income tax is purely a creation of government unrelated to CAS, the accounting standards establish no benchmark tax rate. CAS can nevertheless be used indirectly as a benchmark to identify tax expenditures resulting from the reduced tax rate. This has been discussed in chapter 6.

7.2.6.2. Tax law and Implementation Rules and Administrative Practices

On 28 January 2011 the State Council issued Guofa [2011] No.4 [362] (Circular 4) providing various incentives for the software and integrated circuit industries. It reaffirms the Chinese government's determination to develop and promote the software and integrated circuit industries.

Circular 4 set forth broad principles to support the tax incentive policies, but left it up to the MOF and SAT to formulate and issue detailed rules to implement these policies.

The MOF and SAT jointly issued Caishui [2012] No. 27 (Circular 27) on 20 April 2012, to clarify the relevant Enterprises income tax incentives , eligibility criteria and

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[356] 2011-2015
[357] It is similar to the IFRS: Framework.
[358] CAS, Basic Standard, chapter 6, Revenue.
[359] CAS No. 14 – Revenue is similar to the IAS: No. 18 Revenue.
[360] CAS, Basic Standards, Art 33-36 .
[361] It is similar to IAS 16, Property, Plant and Equipment.
[362]Guofa [2011] No.4 Notice on Relevant Polices for Further Encouraging Development of Software Industry and Integrated Circuit Industry took effect from the date of issue.

application requirements for software and integrated circuit enterprises provided under Guofa [2011] No. 4 (Circular 4).[363]

According to circular 27, qualified software and integrated circuit enterprises are entitled to enterprise income tax incentives in respect of tax holiday, low tax rate, exemption of Value Added Tax (VAT) refunds, and deduction of training expenses, depreciation.

Tax Holiday (Tax Exemption in specific time) and Low Tax Rate

Under Circular 27 in the period from 1 January 2011 to 31 December 2017, the exemption from enterprise income tax for the first two years starting from the first profit-making year[364] and the reduction of the EIT rate from 25% to 12.5% for the following three years (the "two plus three tax holiday") apply to qualified IC manufacturing enterprises [365]that are engaged in a line width of less than 0.8 microns (inclusive 0.8 microns).[366]

Under Circular 27 qualified IC manufacturing enterprises that are engaged in a line width of less than 0.25 microns (inclusive 0.25 microns) or with total investment exceeding RMB8 billion, are subject to a reduced EIT rate of 15%. Such IC manufacturing enterprises with an operating period of more than 15 years are entitled to a five-year exemption starting from the first profit-making year has to take place

[363] Caishui [2012] No. 27 took effect retroactively on 1 January 2011.
[364] It refers to the year that the taxable income is greater than zero after offsetting all tax losses brought forward.
[365] It refers to enterprises mainly engaging in the manufacturing of monolithic IC , multichip IC and hybrid IC and at the same time meeting all the following criteria: 1. Legal entities incorporated within the PRC and having obtained the relevant qualification of IC manufacturing enterprises upon recognition 2.Employees (with formal employment contracts signed) with tertiary education or above should account for no less than 40% of the monthly average workforce in the current year, among which the employees engaging in R&D should account for no less than 20% ;3. Possessing key core technology and having annual R&D expenses of not less than 5% of the turnover (including other operating income). 60% or more of annual R&D expenses should be incurred within the territory of China; 4.IC sales income is not less than 60 of total corporate income; 5. With capacity to ensure the normal operation of production and having obtained the relevant qualification; 6. With proper premises and facilities for operations.
[366] Caishui [2012] No. 27, Art 1.

prior to 31December 2017.[367] And there are followed by another five-year 12.5 EIT rate (the "five plus five tax holiday").[368]

Circular 27 aslo state newly established [369] qualified software enterprises and IC design enterprises [370] are entitled to the two plus three holiday from the first profit making year commencing prior to 31 December 2017. [371]

Qualified key software enterprises and IC design enterprises under the State's plan are entitled to a reduced EIT rate of 10% provided that no EIT exemption applies in that particular year. [372]

Exemption of Value Added Tax (VAT) refunds

Under Circular 27 Value-added Tax (VAT) refunds received by enterprises entitled to the "Same Time Levy and Rebate" treatments according to Caishui [2011] No. 100 [373](Circular 100) are excluded from the EIT taxable income provided that the VAT refunds are solely used for research and development (R&D) of software products or expansion of production capacity, and are accounted for separately. [374]

Deduction of training expenses

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[367] The reason why a time limit is imposed is that technologies in the software and IC industries advance very rapidly, and what are currently regarded as state-of the –art technologies may no longer be so within a relatively short period.
[368] Caishui [2012] No. 27, Art 2.
[369] From 1 January 2011, Circular 27 Caishui [2012] No. 27, Art 10(1).
[370] refer to the enterprises mainly engaging in IC design or software development and at the same time meeting all the following criteria: 1.Legal entities incorporated within the PRC after 1 January 2011 and having obtained qualification of IC design or software enterprises; 2.The criteria for employees is the same as that for IC manufacturing enterprises; 3.Possessing key core technology and having annual R&D expenses of no less than 6% of the total income (including other operating income). 60% or more of annual R&D expenses should be incurred within the PRC ;4.Turnover deriving from sales of IC design by IC design enterprises should be no less than 60% of the total income, of which 50% or more should be derived from proprietary IC design; 5.Turnover deriving from software development by software enterprises should be no less than 50% of the total income, of which 40% or more should be derived from proprietary software products (turnover deriving from development of embedded software products or integrated information system products by software enterprises should be no less than 40% of the total income of which 30% or more should be derived from proprietary software products); 5.Possessing proprietary intellectual property rights for the core business of the enterprises, and having obtained relevant certificates for the software products ;6.With capacity to ensure the quality of the products and maintaining proper quality management system and records; 7.With proper premises and facilities for operations.
[371] Caishui [2012] No. 27, Art3.
[372] Caishui [2012] No. 27, Art 4.
[373] The MOF and the SAT released "Circular on VAT Policies for Software Products (Caishui [2011] No.100)" released on October 13, 2011, Starting from January 1, 2011,
[374] Caishui [2012] No. 27, Art 5.

Under Circular 27 Employee training expenses actually incurred by qualified IC design enterprises and software enterprises on separately account can be fully deductible for EIT purposes. [375]

Depreciation throughout a short life

Under Circular 27 purchased software that meets the criteria of fixed or intangible assets can be depreciated or amortised throughout a short life of no less than 2 years. [376] Manufacturing equipment of IC manufacturing enterprises is allowed to be depreciated throughout a short life of no less than 3 years. [377] In addition, if a software or integrated circuit enterprise qualifies for more than one enterprises income tax incentives, it can choose the most favourable one but cannot apply for more than one.[378]

7.2.6.3. Tax Expenditure Identified

CAS is silent on tax rates.

Under the Basic Standard of CAS,[379] Chapter 6 Revenue [380] and No. 14 – Revenue [381], CAS does not make a distinction between income derived from Software Development and Integrated Circuit Production Industries and income derived from other industries.

Under the Basic Standard of CAS, [382] Chapter 7 Expenses [383] for Software Development and Integrated Circuit Production Industries do not satisfy the definition and recognition criteria of expenses and shall not be included in the income statement. Under CAS, no deduction would be allowed for Software Development and Integrated Circuit Production Industries.

[375] Caishui [2012] No. 27, Art 6.
[376] Caishui [2012] No. 27, Art 7.
[377] Caishui [2012] No. 27, Art 8.
[378] Caishui [2012] No. 27, Art 22.
[379] It is similar to the IFRS: Framework.
[380] CAS, Basic Standard, chapter 6, Revenue.
[381] CAS No. 14 – Revenue is similar to the IAS: No. 18 Revenue.
[382] It is similar to the IFRS: Framework.
[383] CAS, Basic Standards, Art 33-36

Under No. 4 – Fixed Assets of CAS and CASIG, an enterprise shall reasonably select the depreciation method to be applied to a fixed asset based on the pattern in which the asset's economic benefits are expected to be realized. Depreciation methods that may be applied include the straight-line method, the units of production method, the double declining balance method and the sum-of-the-digits method.

However, Guofa [2011] No.4 (Circular 4), Caishui [2012] No. 27 (Circular 27) and Caishui [2011] No. 100 (Circular 100) state qualified software and integrated circuit enterprises are entitled to enterprise income tax incentives in respect of tax exemption, low tax rate, exemption of Value Added Tax (VAT) refunds, and deduction of training expenses and depreciation throughout a short life of no less than 3 years.

Therefore, five tax expenditures associated with the income derived from Software Development and Integrated Circuit Production Industries – tax exemption, low tax rate, tax deduction and depreciation throughout a short life, which could be recognised and calculated into accounting income under CAS.

7. 2.6.4. Analysis

One rationale of tax expenditures to support software and integrated circuit industries implicitly assumes there will be positive externalities. The current subsidy program has been undertaken without empirical or theoretical analysis to indicate whether there is a need for a subsidy or whether the subsidy could generate positive analysis. The design of the tax expenditure has apparently not considered where the desired activities might take place most efficiently. There is also no evidence that the design has taken into account any evidence of the types of software and integrated circuit industries that are most likely to generate the desired externalities as the current boundaries of the subsidy are vague with limited detail of what constitutes eligible activities.

Other programs that could do it more efficiently by better targeting reducing the cost of software and integrated circuit industries such as lower interest loans or loan guarantees for reduced fees might be better targeted than a tax subsidy that helps successful software and integrated circuit industries only. These industries, by definition, did not require any subsidy.

7. 3. State Encouraged Projects

7. 3.1. Public Infrastructure

The Chinese government has identified a number of public infrastructure projects it wishes to support to bolster the national economy. These include construction of harbours and docks, airports, railroads, and roads, building urban public transportation and electricity generation facilities, and construction of facilities to foster better use of water resources.

To subsidise the construction of public infrastructure, the government has introduced an exemption for income from specified infrastructure construction projects for the first three years of the project and a half exemption for the following three years. The exemption is provided in a peculiar fashion. The Law states there is an exemption but the implementing Regulation provides the exemption by way of a credit for income tax payable on the income. The Circulars that explain how the provisions work treat the credit for income tax due as the equivalent of an exemption and thus refer to the period as a tax holiday period.

7. 3.1.1. Accounting Treatment

Under the Basic Standard of CAS [384], Chapter 6 Revenue [385] and No. 14 – Revenue[386]:

Revenue is the gross inflow of economic benefits derived from the course of ordinary activities that result in increases in equity, other than those relating to contributions from owners. [387]

Revenue is recognised only when it is probable that economic benefits will flow to the enterprise, which will result in an increase in assets or decrease in liabilities and the amount of the inflow of economic benefits can be measured reliably. [388]

An item that satisfies the definition and recognition criteria of revenue shall be included in the income statement. [389]

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[384] There is no specific accounting standard for public infrastructure projects.
[385] It is similar to the IFRS: Framework.
[386] It is similar to the IAS: No. 18 Revenue.
[387] CAS, Basic Standard, Art 30, CAS No. 14 – Revenue, Art 2.
[388] CAS, Basic Standard, Art 31.

7. 3.1.2. Tax law and Implementation Rules and Administrative Practices

Tax Exemptions and Deductions

Income subject to tax exemptions and deductions shall include Income earned from major State-supported public infrastructure projects [390] refer to projects as listed in Caishui [2008] No. 116 (Circular 116)[391] such as harbour and dock , airports, railroads, roads, urban public transportation, electricity projects, water resources utilisation projects, etc.

On 16 April 2009, the SAT released the Notice on the Implementation of State encouraged Public Infrastructure Projects Enterprise Income Tax Incentives, Circular 80 ,Guoshuifa [2009] No. 80 , Art 2. And it took effect from 1 January 2008. Circular 80 explains that in the case of income earned by enterprises from the aforementioned major state encouraged public infrastructure projects, with effect from the first year to which manufacturing or business operational revenue earned from the project [392] is attributable, there shall be allowed a credit for the entire enterprise income tax on that income from the first to third years and a 50% credit from the fourth to sixth years.

Under Article 87 of EITLIR, Enterprises that are subcontractors [393] for the operation or construction [394], or that undergo internal construction projects [395] for self-use shall not be eligible for enterprise income tax incentives as stipulated above [396] .

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[389] CAS, Basic Standard, Art 32.
[390] EITL, Art 27(2).
[391] Caishui [2008] No. 116, the Notice on the Release of the Catalogue of Enterprise Income Tax Incentives for Public Infrastructure Projects(2008Edition) was issued by the MOF and the SAT, and National Development and Reform Commission (NDRC) on September 8, 2008 and took effect from January 1,2008.
[392] It refers to the first revenue generated after the project is completed and put into operation (including the trial period). Circular 80, Guoshuifa [2009] No. 80 , Art 2.
[393] It refers to that operation activity through which a legal entity, independent from the legal entity that operates the project, performs the contracted operation and obtains service revenue, circular 80 Guoshuifa [2009] No. 80, Art 3.
[394] It refers to the operation activity through which a legal entity, independent from the legal entity that operates the project, obtains the construction service revenue from the project construction, circular 80 Guoshuifa [2009] No. 80, Art 4.
[395] It refers to the construction which is merely to satisfy the requirement of an enterprise's own operation as a project of the business operation. It is not the Infrastructure Projects which provide service to the public, circular 80 Guoshuifa [2009] No. 80, Art 5.
[396] EITLIR, Art 87.

Article 89 of EITLIR confirms that for projects enjoying tax exemptions or reductions in accordance with the above provisions, if they are transferred within the exemption or reduction period, the transferee may continue to enjoy the tax incentives in the remaining period starting from the date of transfer; while the transferee shall not be allowed to restart the computation of tax exemptions or reductions if the transfer is conducted after the expiration of the exemption or reduction period [397] .

On 5 January 2012, the MOF and the SAT jointly released the circular Caishui [2012] No. 10 (Circular 10) [398] clarifying enterprises engaging in the qualifying major public infrastructure projects which were approved by 31 December 2007 are eligible for a three-year tax holiday followed by a three-year 50% reduction starting from the first income generating year. However, for those whose first income generating year started before 1 January 2008, they may only enjoy their remaining tax holiday from 1 January 2008.

Moreover, for the qualifying enterprises that are eligible for the tax preferential treatments under a five-year transition period according to Guofa [2007] No. 39 (Circular 39), [399] Circular 10 emphasizes that any tax benefits overlapping are not allowed and a choice has to be made by the taxpayers.

It is note-worthy that the issuance of Circular 10 widens the scope of the tax preferential treatment by allowing the enterprises with the qualifying projects approved before 2008 to also enjoy the tax holiday of a three-year exemption followed by a three-year 50% reduction. Circular 10 does not clarify the detailed application procedures for obtaining the official approval for the tax holiday or a tax refund for the EIT paid before the promulgation of Circular 10.

[397] EITLIR, Art 89.
[398] Notice regarding certain issues related to the enterprise Income Tax preferential treatment for major public infrastructure projects, environmental protection projects and energy and water conservation projects.
[399] Notice of Implementation of the Transitional Preferential Policies on Enterprise Income Tax (Guofa [2007] No.39) issued on 26 December. 2007 by the State Council, effective from 1 January 2008.

7. 3.1.3. Tax Expenditure Identified

Under the Basic Standard of CAS [400], Chapter 6 Revenue [401] and No. 14 – Revenue [402] CAS does not distinguish between income derived by enterprises from construction of public infrastructure projects and income derived from other construction activities. However, the EITL contains a provision that allows the Ministry of Finance to exempt from tax income derived by enterprises engaged in these activities [403] and in a Caishui No. 116 issued in 2008 the Ministry provided a catalogue of activities that can generate tax-free income [404] and Caishui [2012] No. 10 (Circular 10) [405] clarifying enterprises engaging in the qualifying major public infrastructure projects which were approved by 31 December 2007 are eligible for a three-year tax holiday followed by a three-year 50% reduction starting from the first income generating year.

Therefore, two tax expenditures associated with the income derived from state encouraged public infrastructure projects – tax exemption and deduction, enterprises engaging in the qualifying major public infrastructure projects which were approved by 31 December 2007 are eligible for a three-year tax holiday followed by a three-year 50% reduction starting from the first income generating year, which could be recognised and calculated into accounting income under CAS.

7. 3.1.4. Analysis

Public infrastructure development is one of the major determinants of economic growth, particularly in developing countries. Encouraging infrastructure development as a springboard economic growth has always been at the heart of the Chinese government. Of course the government could simply pay market rate to acquire public infrastructure. The effect of the tax concession is to reduce the costs of acquiring infrastructure, assuming construction firms are seeking a particular after-tax

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[400] There is no specific accounting standard for public infrastructure projects.
[401] It is similar to the IFRS: Framework.
[402] It is similar to the IAS: No. 18 Revenue.
[403] EITL Article 27(2).
[404] Caishui [2008] No. 116 (Circular 116), "Catalogue of Enterprise Income Tax Incentives for Public Infrastructure Projects" EITL, Art 27(2).
[405] Notice regarding certain issues related to the enterprise Income Tax preferential treatment for major public infrastructure projects, environmental protection projects and energy and water conservation projects.

rate of return from their operations. Effect is to bias construction towards infrastructure rather than other types of construction.

7. 3.2. Agriculture, Forestry, Animal Husbandry, Fishery

Agriculture is an important industry in China. The economic accounts for agriculture are the basis of national economic accounts. China ranks first in worldwide farm output, primarily producing rice, wheat, potatoes, sorghum, peanuts, tea, millet, barley, cotton, oilseed, pork, and fish. A number of circulars clarify certain issues in the enterprise income tax laws and implementing rules that income derived from enterprises' operation in agriculture, forestry, husbandry and fishery projects are granted with exemption or deduction on EITL.

7. 3.2.1. Accounting Treatment

The accounting standard related to the accounting treatment of exemption, deduction for income from agriculture, forestry, husbandry and fishery projects are the No.5 – Biological Assets of CAS and CASIG, [406] and the Basic Standard of CAS, [407] Chapter 6 Revenue [408] and No. 14 – Revenue [409], (The detailed CAS are stated in Chapter 1).

7. 3.2.2. Tax Law and Implementation Rules and Administrative Practices

Tax Exemptions and Deductions

In Article 27 of EITL income earned by enterprises from their activities in agriculture, forestry, animal husbandry and fishery could be subject to tax exemptions and deductions [410]. Whether the income earned by enterprises from their activities in agriculture, forestry, animal husbandry and fishery are entitled to income tax exemption or reductions is dependent on the categories of business they are engaged in.

Income Eligible for Tax Exemption

[406] It is similar to IAS 41 Agriculture.
[407] It is similar to the IFRS: Framework.
[408] CAS, Basic Standard, chapter 6, Revenue.
[409] CAS No. 14 – Revenue is similar to the IAS: No. 18 Revenue.
[410] EITL, Art 27.

Under Article 86(1) of EITLIR income earned by enterprises from activities in the following categories shall be entitled to enterprise income tax exemption:

• growing vegetables, grains, potatoes, oil plants, beans, cotton, ramie, sugar crops, fruits and nuts;

• breeding selection of new varieties of agricultural products;

• growing Chinese medicinal herbs;

• cultivating and growing trees;

• rearing livestock and poultry;

• harvesting forestry products;

• providing services relating to agriculture, forestry, animal husbandry and fishery, such as irrigation services, preliminary processing of agricultural products, veterinary services, promotion of agricultural technologies, agricultural machinery services and repairs of agricultural machinery, etc, and

• high seas fishing.[411]

The eligible preliminary processing of agricultural products refers to processing of 14 agricultural items in relation to plantations, stockbreeding and fisheries set out in Scope of Preliminary Processing of Agricultural Products Entitled to Preferential Enterprise Income Tax Policies [412] and more details in Supplemental Notice of Scope of Preliminary Processing of Agricultural Products Entitled to Preferential Enterprise Income Tax Policies.[413]

Income eligible for tax deduction

Income earned by enterprises from activities in the following categories shall be allowed a 50% credit against the enterprise income tax[414]:

• growing flowers and crops used for beverages (such as tea, etc) and flavourings; and

• sea and inland aquaculture.

Tax exemption and reduction incentives above shall not be allowed where the income

[411] EITLIR, Art 86(1).
[412] Caishui [2008]No. 149.
[413] Caishui [2011] No.26.
[414] EITLIR, Art 86(2)

is earned by enterprises engaged in projects of industries restricted or prohibited by the State. [415]

On 13 September 2011, the SAT released Announcement [2011] No.48—Announcement of the SAT on the Implementation of the Enterprise Income Tax Incentives for Agriculture, Forestry, Husbandry and Fishery projects and took effect on 1 January 2011. Announcement 48 clarifies certain issues in the enterprise income tax laws and implementing rules that "income derived from enterprises' operation in agriculture, forestry, husbandry and fishery projects are granted with exemption or deduction on EIT". [416]

7. 3.2.3. Tax Expenditure Identified

No.5 – Biological Assets of CAS [417]and Implementation Guidance CAS and the Basic Standard of CAS,[418] Chapter 6 Revenue[419] and No. 14 – Revenue [420] do not distinguish between income earned by enterprises from their activities in agriculture, forestry, animal husbandry and fishery and income derived from other agriculture, forestry, animal husbandry and fishery activities.

However, Article 27 of EITL and Article 86(1) of EITLIR contains a provision that allows the MOF and SAT to exempt from tax income derived by enterprises engaged in these activities [421] and in 2011 SAT Announcement 48 clarifies certain issues in the

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[415] EITLIR, Art 86 (2)

[416] It includes: 1.Clarifies the scope of tax - free income obtained from breeding of new agricultural varieties, cultivation and planting of woods; 2. Clarifies taxation preferential treatment applicable on feeding of pigs and rabbits, planting of ornamental plants, waste of livestock and poultry, and feeding of animals that are not belong to livestock or poultry; 3.Clarify the scope of agricultural products initial processing: -Tax exemption are granted on processing on qualified initial processing- For those engaged in initial processing projects that enjoy halved levy preferential treatment, once complying with relevant stipulations on initial processing and conducting individual accounting on income derived from halved levy projects and initial processing projects, the initial processing part is exempted from tax;4.Clarifies the scope of tax free in pelagic fishery, which include enterprises that acquire Certificate of Pelagic Fishery Enterprises, and the certificate is still in validity; 5.Clarifies revenues generated from entrusting other enterprises or be entrusted with operating in agriculture, forestry, husbandry, and fishery projects; 6.Clarifies projects that are not subject to preferential treatments: The Selection and packing of tea procured from outside are not be treated as initial processing;- The trading of agricultural products enjoys no tax exemption.

[417] It is similar to IAS 41, Agriculture.

[418] It is similar to the IFRS: Framework.

[419] CAS, Basic Standard, chapter 6, Revenue.

[420] CAS No. 14 – Revenue is similar to the IAS: No. 18 Revenue.

[421] EITL Article 27(1).

enterprise income tax laws and implementing rules that "income derived from enterprises' operation in agriculture, forestry, husbandry and fishery projects are granted with exemption or deduction on EITL".[422]

Therefore, two tax expenditures associated with the income derived from agriculture, forestry, husbandry and fishery projects – tax exemption and deduction, income derived from enterprises' operation in agriculture, forestry, husbandry and fishery projects are granted with exemption or 50% deduction on EITL, which could be recognised and calculated into accounting income under CAS.

7. 3.2.4. Analysis

Chinese government gradually awakes of the importance of agriculture, tax policy for supporting the production of agriculture, forestry, animal husbandry and fishery has entered a fast-developing stage with key agricultural product output increased dramatically as well as agriculture, forestry, animal husbandry and fishery displaying an unprecedented development momentum. However, the market should provide the optimal level of investment in each industry. If there is a case for government intervention, it must be because there is some sort of market failure or a positive externality from the activity.

For example, the most lending comes from big banks and they only want to lend to large agricultural enterprises, there might be a market failure and a case for providing assistance to small farmers who can't access credit because of the market failure. Simply saying the government recognises agriculture is important to the economy isn't a reason to subsidise it. Agriculture is one of the biggest industries in Australia and the government sees it as important but it doesn't subsidise it.

The benefit of tax exemption and deduction for agriculture, forestry, animal husbandry and fishery only accrues to profitable businesses, that is, the ones that appear to have overcome the disadvantages of the market failure.

Other programs that could do it more efficiently by better targeting the small agriculture, forestry, animal husbandry and fishery including development of lending

[422] See above n 416

institutions or debt support arrangements directed at small agriculture, forestry, animal husbandry and fishery.

7. 3.3. Environmental protection and energy or water saving and production safety

China is facing with the enormous pressure from environmental protection, energy and water conservation after the expense of the environment, the development of roads, environmental pollution and ecological damage caused huge economic losses, and all these have threaten public health, the impact on social stability and environmental safety. To protect the ecological environment has become a basic national policy of the country. The EITL and EITLIR and Circulars state the income earned by enterprises from the aforementioned qualifying environment protection projects, and water or energy saving projects, there shall be allowed exemption , deduction and tax credit, credit carried forward.

7. 3.3.1. Accounting Treatment

The accounting standard related to the accounting treatment of exemption, deduction and tax credit, credit carried forward for qualifying environment protection projects, and water or energy saving projects are the Basic Standard of CAS,[423] Chapter 6 Revenue [424] and No. 14 – Revenue [425] and No. 4 – Fixed Assets of CAS [426] and CASIG (The detailed CAS are stated in Chapter 1).

7. 3.3.2. Tax Law and Implementation Rules and Administrative Practices

Tax Exemptions and Reductions

For environment protection and water or energy saving projects

Under 27(3) of EITL income earned from qualifying environment protection projects, water or energy saving projects could be subject to tax exemptions and reductions.[427]

In Article 88 of EITLIR qualifying environment protection projects, water or energy

[423] It is similar to the IFRS: Framework.
[424] CAS, Basic Standard, chapter 6, Revenue.
[425] CAS No. 14 – Revenue is similar to the IAS: No. 18 Revenue.
[426] It is similar to IAS 16, Property, Plant and Equipment.
[427] EITL Art 27(3).

saving projects include public waste water treatment, public refuse treatment, comprehensive exploitation and utilisation of biogas, upgrades of energy saving/pollution-discharge-reduction technologies, seawater desalination projects, etc.[428]

The detailed conditions and scope were promulgated in Caishui [2009] No.166 (Circular 166).[429] Under Circular 166 for income earned by enterprises from the aforementioned qualifying environment protection projects, and water or energy saving projects, there shall be allowed exemption for the entire enterprise income tax on that income from the first to third year and a 50% reduction from the fourth to sixth year, commencing from the first year when business operational revenue earned from the project is attributable.[430]

For Energy Management contracting projects processed by energy saving service companies

On 30 December 2010, the MOF and the SAT jointly issued Caishui [2010] No. 110(Circular110). [431] Circular 110 mainly covers the following tax incentives granted to Energy Management Contracting (EMC) projects and Energy Saving Service Companies (ESSEs):

Income earned from EMC projects by qualified energy saving service companies in compliance with the relevant provisions of EITL shall be entitled to a three-year exemption from enterprise income tax followed by a 50% reduction on statutory tax rate of 25% from the fourth to sixth year, commencing from the first year of generating the project income.[432]

Reasonable expenses actually paid by the energy consuming company to the energy saving Service Company according to the energy management contract can be deducted when computing the taxable income of the energy consuming company for

[428] EITLIR, Art 88.
[429] The Notice on the Catalogue of Environmental Protection Energy and Water Saving Projects for Enterprise Income Tax Incentives was issued by the MOF and the SAT and the NDRC (Trial), Caishui [2009]No.166 on 31 December 2009 and effective from 1 January 2008.
[430] EITLIR, Art 88
[431] Concerning the Value-Added Tax, Business Tax and Enterprise Income Tax Policies for Promoting the Development of the Energy-Saving Service, which came into effect on 1 January 2011.
[432] Caishui [2010] No. 110, Art 2(1).

the relevant period, regardless of the nature of expenditure being service fees or capital acquisition.[433]

At the end of the term of the EMC projects, if the energy saving service enterprise transfers assets to the energy consuming enterprise which are materialised in the course of executing the project, the related assets are deemed fully depreciated or amortised for enterprise income tax purposes; equally, when the energy-consuming enterprise receives the aforesaid assets from energy-saving service enterprise, the assets are also deemed fully depreciated or amortised in determining their tax basis.[434]

At the end of the term of the EMC projects, if the energy saving service enterprise transfers the titles of assets to the energy consuming enterprise, the relevant payments that have been made by the energy consuming enterprise will not be recognised as taxable income by the energy saving service enterprise.[435]

Tax Credit of Equipment Investment

In Article 34 of EITL investments by an enterprise in specialised equipment which aid in protecting the environment, conserving water or reducing energy usage, enhancing production safety, etc. are eligible for credit against income tax in accordance with a specified percentage set forth [436].

The credit against income tax refers to where enterprises purchase and actually use specialised equipment which aids in protecting the environment, conserving water or reducing energy usage, or enhancing production safety and which are listed in Enterprise Income Tax Incentive Catalogue for Specialised Equipment in Environment Protection, Enterprise Income Tax Incentive Catalogue for Specialised Equipment in Water Conservation or Energy Usage Reduction [437] or Enterprise

[433] Caishui [2010] No. 110, Art 2(2).
[434] Caishui [2010] No. 110, Art 2(2).
[435] Caishui [2010] No. 110, Art 2(2)
[436] EITL, Art 34.
[437] On 20 August 2008 the MOF, the SAT and the NDRC issued two Catalogues Caishui [2008] No. 115(Circular 115) relating the tax incentives for the use of specialized equipment: the Enterprise Income Tax Incentive Catalogue for Equipment Specialized in Environmental Protection (2008 Edition) and the Enterprise Income Tax Incentive Catalogue for Equipment Specialized in Water Conservation or Energy Saving (2008 Edition)". The first Catalogue covers 19 items in five categories, including

Income Tax Incentive Catalogue for Specialised Equipment in Production Safety[438] In such cases, 10% of the equipment investment cost may be credited against the current year's income tax payable by the enterprise. If the credit is not fully utilised, the remaining balance may be carried forward to the following five tax years. [439]

Article 100 of EITLIR explains where an enterprise enjoys the aforementioned tax credit, the enterprise must actually purchase and use the aforementioned items of equipment. Where the aforementioned equipment is transferred or leased within five years from the date of purchase, the relevant tax incentives shall terminate and the enterprise shall repay the amount of tax which has been credited [440] .

Under Circular 69 special equipment purchased and put to actual use which can protect the environment, save energy or water and ensure work safety as stipulated in Art 100 of the EITLIR includes special equipment leased by the lessee through a finance lease, the ownership of which shall pass to the lessee when the lease term expires as agreed in the financing lease contract and which meets the stipulated requirements. Where the ownership of leased equipment does not pass to the lessee upon the expiration of the lease term, the lessee shall cease to enjoy the preferential enterprise income tax deduction and shall repay the enterprise income tax already credited [441].

Circular 110 [442] confirms that the above incentive also applies to qualified environmental protection, water or energy saving projects approved before 31

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specialized equipment used for sewage treatment, special equipment for the prevention of air pollution and solid waste disposal, devices to monitor the environment and equipment for cleaner production. The second Catalogue lists five types of equipment for water conservation and 13 types of equipment for energy saving purposes; it took effect on1 January 2008.

[438] On 20 August 2008, the MOF, SAT and State Administration of Work Safety released Caishui [2008] No. 118(Circular 118) the Enterprise Income Tax Incentive Catalogue for Specialised Equipment in Production Safety (2008 Edition) covers 50 items under eight categories, including coal and other mines, dangerous chemicals, firecrackers, highway, railway, aviation and emergency rescue equipment, it took effect 0n 1 January 2008.

[439] EITLIR, Art 100.

[440] EITLIR, Art 100.

[441] Caishui [2009] No. 69 was jointly issued by the MOF and the SAT on 24 April 2009 and took effect on 1 January 2008, Notice on Certain Issues Concerning the Implementation of Enterprise Income Tax Incentives. Circular 69 clarifies that a lessee in a finance lease is entitled to such tax incentives, provided that the equipment is transferred to the lessee at the end of the lease term. The lessee will need to pay back the tax benefit if the ownership of the leased equipment is not transferred when the lease term expires.

[442] Caishui [2010] No. 110.

December 2007. However, the enterprise may only enjoy remaining tax holidays from 1 January 2008 if business operational revenue was generated on or before 31 December 2007.

In addition to the above, the energy saving service company must also meet a number of other criteria to qualify for these exemptions. For example, said company must possess a registered capital of no less than RMB 1 million. Further, the energy management contracting project implemented by the energy-saving service company must meet the criteria of items one to eight of section four, "Energy Saving Emission Reduction Technology Transformation", in the Circular on the Catalogue (Trial) for Environmental Protection, Energy and Water Conservation Projects Qualified for Corporate Income Tax Preferential Treatments, which is issued by the Ministry of Finance, State Administration of Taxation, and National Development and Reform Commission.[443]

7. 3.3.3. Tax Expenditure Identified

Under the Basic Standard of CAS,[444] Chapter 6 Revenueb[445] and No. 14 – Revenue[446] CAS does not make a distinction between income derived by environment protection and water or energy saving projects and income derived from other activities.

Under No. 4 – Fixed Assets of CAS[447] and CASIG, there is no special rule for the cost of specialised equipment which aid in protecting the environment, conserving water or reducing energy usage, enhancing production safety, etc .

However, the EITL contains a provision that allows to exempt from tax income derived by enterprises engaged in these activities[448] and in Caishui[2009] No.166 (Circular 166)[449] income earned by enterprises from the aforementioned qualifying environment protection projects, and water or energy saving projects, there shall be

[443] Caishui [2009] No. 166.
[444] It is similar to the IFRS: Framework.
[445] CAS, Basic Standard, chapter 6, Revenue.
[446] CAS No. 14 – Revenue is similar to the IAS: No. 18 Revenue.
[447] It is similar to IAS 16, Property, Plant and Equipment.
[448] EITL Article 27(3).
[449] The Notice on the Catalogue of Environmental Protection Energy and Water Saving Projects for Enterprise Income Tax Incentives was issued by the MOF and the SAT and the NDRC (Trial), Caishui [2009] No.166 on December 31, 2009 and effective from January 1,2008.

allowed exemption for the entire enterprise income tax on that income from the first to third year and a 50% reduction from the fourth to sixth year, commencing from the first year when business operational revenue earned from the project is attributable.[450]

And Caishui [2010] No. 110(Circular110) [451] mainly covers the following tax incentives granted to Energy Management Contracting (EMC) projects and Energy Saving Service Companies (ESSEs):

Income earned from EMC projects by qualified energy saving service companies in compliance with the relevant provisions of EITL shall be entitled to a three-year exemption from enterprise income tax followed by a 50% reduction on statutory tax rate of 25% from the fourth to sixth year, commencing from the first year of generating the project income.[452]

EITL and EITLIR also allow 10% of the equipment investment cost may be credited against the current year's income tax payable by the enterprise. If the credit is not fully utilised, the remaining balance may be carried forward to the following five tax years [453].

Therefore, four tax expenditures associated with the income derived from environment protection and water or energy saving projects – tax exemption and deduction, tax credit and credit carried forward, which could be recognised and calculated into accounting income under CAS.

7. 3.3.4. Analysis

Many tools available to governments seeking to promote environmental improvements – requiring certain investments or behaviour, prohibiting or punishing other types or subsidising particular activities or investments by way of direct subsidy, indirect through protectionism or other indirect means, or via tax expenditures. The Chinese government uses all these tools, though as can be seen from the discussion above, tax expenditures play a significant role in the portfolio of environmental

[450] EITLIR, Art 88
[451] Concerning the Value-Added Tax, Business Tax and Enterprise Income Tax Policies for Promoting the Development of the Energy-Saving Service, which came into effect on 1 January , 2011.
[452] Caishui [2010] No. 110, Art 2(1)
[453] EITL, Art 34, EITLIR, Art 100.

measures. An obvious limitation to the use of tax expenditures is that they can only encourage taxable persons to be environmentally responsible. They have no effect on government departments, loss-making enterprises, and other tax-exempt persons.

7. 3.4. Comprehensive Utilization of Resources

A circular economy links resources and environment, which can achieve the organic unity of economic growth, resource conservation and environmental protection. Furthermore, it is an effective way to achieve green development and the environmental measures are able to solve the bottleneck of the fundamental resource. The Chinese government attaches great importance to the development of circular economy.[454] The one of the main objectives of a circular economy is comprehensive utilisation of resources. The EITL, EITLIR and circular confirm certain portion of the revenue derived from comprehensive utilisation of resources product sales may be recognised as a deduction for enterprise income tax purposes

7.3.4.1. Accounting Treatment

The accounting standard related to the accounting treatment of deduction of income from enterprises utilise resources is the Basic Standard of CAS,[455] Chapter 6 Revenue [456] and No. 14 – Revenue.[457] (The detailed CAS is stated in Chapter 1).

7. 3.4.2. Tax Law and Implementation Rules and Administrative Practices

Deduction

In Article 33 of EITL when computing taxable income, income derived from the production of goods by an enterprise which ensures the production of goods in line with State production policies as well as a comprehensive utilisation of resources, is eligible for deductions against total revenue.[458]

Caishui [2008] No. 117(Circular 117) confirms deductions against total revenue refer

[454] Third Meeting of the Regional 3R Forum in Asia, 'Technology Transfer for promoting the 3Rs –Adapting, implementing, and scaling up appropriate technologies' Singapore, 5-7 October 2011.
[455] It is similar to the IFRS: Framework.
[456] CAS, Basic Standard, chapter 6, Revenue.
[457] CAS No. 14 – Revenue is similar to the IAS: No. 18 Revenue.
[458] EITL, Art 33.

to where enterprises utilise resources listed in Catalogue of the Enterprise Income Tax Incentive for Comprehensive Utilisation of Resources [459]as main raw materials to manufacture non-State-restricted or non-prohibited products which meet relevant national and industry standards, 10% of the revenue derived from such product sales may be recognised as a deduction for enterprise income tax purposes. [460]

7. 3.4.3. Tax Expenditure Identified

Under the Basic Standard of CAS,[461] Chapter 6 Revenue [462] and No. 14 – Revenue [463] CAS does not make a distinction between the incomes derived comprehensive utilisation of resources and income derived from other activities.

However, EITL, EITLIR and Caishui [2008] No. 117(Circular 117) confirms 10% of the revenue derived from comprehensive utilisation of resources product sales may be recognised as a deduction for enterprise income tax purposes.[464]

Therefore, one tax expenditures associated with the income derived from comprehensive utilisation of resources projects – tax deduction, which could be recognised and calculated into accounting income under CAS.

7. 3.4.4. Analysis

Although China is rich in resources and energy, the per capita amount is no more than half the average of the entire world. The environmental problems become increasingly prominent. Meanwhile the resources are used inefficiently and the renewable rate is low. The contradiction between the high-speed economic development and indigent resources is relatively sharp, which results in the serious shortage of the resource and the fragility of the environmental carrying capacity. It is now the significant task to explore ways to change the extensive development mode as "high input, high

[459] On 26 August 2008, the MOF and the SAT, and NDRC issued Caishui [2008] No. 117(Circular 117) the Notice of the Catalogue of the Enterprise Income Tax Incentive for Comprehensive Utilisation of Resources The specified raw materials, as cited in the Catalogue of the Enterprise Income Tax Incentive for Comprehensive Utilisation of Resources covers 16 items which are classified to three categories, including associated ores, sewage/exhaust gas/waste residue and recoverable resources. The specified raw materials shall be utilised in manufacturing the specified products with a proportion to the total materials consumed not lower than the standard proportion as cited in the catalogue.
[460] EITLIR, Art 99
[461] It is similar to the IFRS: Framework.
[462] CAS, Basic Standard, chapter 6, Revenue.
[463] CAS No. 14 – Revenue is similar to the IAS: No. 18 Revenue.
[464] EITL, Art 33, EITLIR, Art 99, Caishui [2008] No. 117.

consumption and high pollution", so as to achieve the sustainable development on both economy and society. Chinese government attaches tax incentive to encourage the development of comprehensive utilisation of resources.

The market should provide the optimal level of investment in each industry. If there is a case for government intervention, it must be because there is some sort of market failure or a positive externality from the activity. There is no persuasive evidence of market failure or other factors that would justify government provide tax incentives in the comprehensive utilisation of resources, the rationale implicitly assumes there will be positive externalities to a larger comprehensive utilisation of resources implementing enterprise. One objective may be to help push the Chinese industries the aware of comprehensive utilisation of resources implementation and cooperation is important for China.

However, this subsidy that only assists comprehensive utilisation of resources enterprise seems peculiar. These are other enterprises and individuals that do not appear to be benefited. A subsidy that reduced the cost of equipment for reducing the cost of comprehensive utilisation of resources such as lower interest loans or loan guarantees for reduced fees might be better targeted than a tax subsidy that helps a larger comprehensive utilisation of resources implementing enterprise only.

7.4. Protect Disadvantage Groups

7. 4.1. Small-scale Enterprises with Low Profitability

The development of small and medium-sized enterprises (SMEs) contributes over 60 percent to China's total GDP growth and is turning into a major drive of the country's economic advancement. China's SMEs, small enterprises in particular, still face considerable difficulties, and need further supports from national policy. In order to solve the capital shortage problem that resides in most SMEs, China took a series of measures such as the EITL, EITLIR and Circular confirm a small low profit enterprise will be subject to enterprise income tax on 50% of its taxable income.

7. 4.1.1. Accounting Treatment

CAS is silent in tax rate. Since income tax is purely a creation of government unrelated to CAS, the accounting standards establish no benchmark tax rate. CAS can nevertheless be used indirectly as a benchmark to identify tax expenditures resulting from the reduced tax rate. This has been discussed in Chapter 6.

7. 4.1.2. Tax Law and Implementation Rules and Administrative Practices

Low Tax Rate

Article 28 of EITL state Enterprise income tax rate shall be reduced to 20% for small-scale enterprises meeting regulatory requirements.[465]

Under Article 92 of EITLIR small-scale enterprises meeting regulatory requirements refer to enterprises in the non-restricted/prohibited industries which meet the following criteria:

• For industrial enterprises, the annual taxable income does not exceed RMB300, 000, the number of employees does not exceed 100, and the total assets do not exceed RMB30 million; [466] and

• For other enterprises, the annual taxable income does not exceed RMB300, 000, the number of staff does not exceed 80 and the total assets do not exceed RMB10 million.[467]

For the purpose of EITLIR, circular 69 Caishui No. 69 [468] clarifies how to determine the number of employees [469] and total assets of small-scale enterprises with "low

[465] EITL, Art 28.
[466] EITLIR, Art 92(1).
[467] EITLIR, Art 92(2).
[468] On 24 April 2009 the MOF and the SAT jointly issued the circular 69 Caishui [2009] No. 69 and took effect on 1 January 2008, Notice on certain issues concerning the implementation of enterprise income tax incentives.
[469] The sum of the number of employees with whom the enterprise has established a labour relationship and the number of dispatched workers accepted by the same enterprise. The number of employees and total assets shall be determined according to the monthly average over the whole year for the enterprise concerned, for which the specific calculation formula is:

Monthly average = (amount at beginning of month + amount at end of month) / 2

Monthly average for the whole year = sum of monthly averages for the whole year / 12

Where an enterprise opens for business or terminates its business activities in the middle of the year, its

profitability." The guidance also prescribes that the preferential tax rate of small-scale enterprises must not apply to enterprises using the "deemed profit" method to calculate taxable income.[470]

Moreover, the MOF and the SAT jointly issued Caishui [2011] No. 117(Circular 117) on 29 November 2011, Notice on some tax incentives for small low-profit enterprises.

According to circular 117, a small low profit enterprise will be subject to enterprise income tax on 50% of its taxable income at a reduced rate of 20% provided that the annual turnover of such enterprise is CNY60, 000 or less.[471]

7. 4.1.3. Tax Expenditure Identified

According to EITL, EITLIR and Caishui [2011] No. 117(Circular 117) a small low profit enterprise will be subject to enterprise income tax on 50% of its taxable income at a reduced rate of 20% provided that the annual turnover of such enterprise is CNY60, 000 or less,[472] versus the standard rate of 25%.

Therefore, one tax expenditure associated with a small low profit enterprise – low tax rate, which could be recognised and calculated into accounting income under CAS.

7. 4.1.4. Analysis

As in every country, small business in China competes with large business. Large business has the advantage of economies of scale but small business has the advantage of nimble and timely responses to changing market demands. These competing factors have led to the development of sustainable levels of profitable small and large businesses in market economies. However, in China most large businesses are still state owned and have the advantage of access to contracts,

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actual operating term shall be treated as a tax year for the purpose of determining the abovementioned numbers , Caishui [2009] No. 69, Art 7.

[470] Caishui [2009] No. 69, Art 8.

[471] The tax reduction will apply from 1 January 2012 to 31 December 2015. A similar incentive for small low-profit enterprises with an annual turnover up to CNY30,000 applies for 2010 and 2011.This circular extends the incentive to enterprises with an annual turnover up to CNY60,000 and the applicable period to 31 December 2015, Caishui [2011] No. 117, Art 1.

[472] The tax reduction will apply from 1 January 2012 to 31 December 2015. A similar incentive for small low-profit enterprises with an annual turnover up to CNY30,000 applies for 2010 and 2011.This circular extends the incentive to enterprises with an annual turnover up to CNY60,000 and the applicable period to 31 December 2015, Caishui [2011] No. 117, Art 1.

resources, equity funding and debt funding from state owned financial institutions, creating an imbalance in the relative advantages of each sector, leaving more small business unprofitable than in many countries . The reduced tax rate for small business can be seen as a subsidy to offset the market failure caused by the predominance of state owned enterprises in the large business sector and the predominance of state owned financial institutions that prefer to, or are pressured to, lend to other state owned companies.

The tax expenditure does not appear to be the optimal subsidy delivery vehicle if viewed as a subsidy to support small business facing this market failure. The benefit of the program only accrues to profitable businesses, that is, the ones that appear to have overcome the disadvantages of the market failure.

Other programs that could do it more efficiently by better targeting the small business including development of lending institutions or debt support arrangements directed at small business.

7. 4.2. Employment of Disabled Employees

In the modern society, labour employment is one of the most important approaches through which the disabled persons can realize their values as well as the basis for such people to obtain economic income, achieve genuine independence, and equally participate in social activities. Therefore, to make full use of the intelligence, wisdom, and potential of disabled persons and turn them into an important force that drives the economic and social development, the government has laid emphasis on the employment of disabled persons with tax incentives. However, People with disabilities remain a vulnerable group and many still encounter specific difficulties in a society whose economy is experiencing a tremendous market-oriented transition.

Over the past two decades, a series of positive legislative and administrative action has been developed for the purpose of improving the living conditions and social status of people with disabilities in the country. The EITL, EITLIR and Circular confirm 100% super deduction on the salaries expense for Disabled Persons in addition to the actual expense deduction.

7. 4.2.1. Accounting Treatment

The accounting standard related to the accounting treatment of 100% super deduction on the salaries expense for Disabled Persons in addition to the actual expense deduction is the No.9– Employee Benefits of CAS[473] and CASIG (The detailed CAS is stated in Chapter 1).

7. 4.2.2. Tax Law and Implementation Rules and Administrative Practices

Super Deduction

Under Article 30 super deductions shall be allowed for the salaries paid to disabled persons and other persons in employment that the State has encouraged enterprises to offer assistance to.[474] Article 96 of EITLIR explains the super deduction for salaries paid to disabled persons refers to a 100% super deduction on the salaries expense in addition to the actual expense deduction. [475]The scope of the disabled persons is pursuant to the Law of the People's Republic of China on Protection of the Disabled Persons[476] and relevant stipulations.

On 30 April 2009 the MOF and the SAT jointly issued Caishui [2009] No. 70(the circular 70) about Income Tax Incentives for Enterprises Employing Disabled Persons and took effect on 1 January 2008. According to circular 70, to be eligible to claim super deduction of 100% of the salaries paid to disabled employees, an enterprise should satisfy all of the conditions.[477]

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[473] It is similar to IAS 19 Employee Benefits.
[474] EITL, Art 30(2).
[475] EITLIR, Art 96.
[476] Adopted at the 17th Meeting of the Standing Committee of the Seventh National People's Congress on 28 December 1990, and revised at the 2nd Meeting of the Standing Committee of the Eleventh National People's Congress on 24 April 2008 and took effect on 1 July 2008.
[477] 1. The enterprise should sign labour contract or service agreement (at least one year contract) with the disabled persons and the disabled persons should actually work in the enterprise.2. The associated social insurance such as pension funds, medical insurance, unemployment insurance and industrial injury insurance for the employed disabled persons should be paid in accordance to the requirements of the competent government authorities and regulations on a monthly basis.3.Salary for disabled employees should be paid through bank or other financial institution in a timely manner and its level should be no lower than the minimum requirement promulgated by the provincial government authorities.4.The enterprise should have the basic facilities for disabled employees' daily work. The enterprise should submit the relevant documents, the name list of disabled employees, photocopy of the "disabled person certificate", "disabled soldier certificate (level 1–8)" and other documents required by the competent tax bureau to file with tax bureau for the 100% super-deduction of the disabled

7. 4.2.3. Tax Expenditure Identified

Under the No.9 – Employee Benefits of CAS and the Implementation Guidance for CAS No.9 – Employee Benefits they do not make a distinction between employee benefits for Disabled Persons and employee benefits for other groups. However, Article 30 of EITL, Article 96 of EITLIR and Caishui [2009] No. 70(Circular 70) confirms 100% super deduction on the salaries expense for Disabled Persons in addition to the actual expense deduction .

Therefore, one tax expenditures associated with employee benefits for Disabled Persons – super tax deduction, which only the actual expense should be charged to the cost of relevant assets or profit or loss for the current period according to the purpose of the employee service, and at the same time shall be recognised as employee benefits payable under CAS.

7. 4.2.4. Analysis

The tax expenditure for disabled persons only applies to employers that hire disable employees. It is clear, therefore, that the subsidy is not to assist disabled persons generally. Rather, it is aimed solely at those who have continuing employment. If disabled persons were as productive as non-disabled persons and required no different infrastructure or facilities, there would be no reason for the government to intervene for this type of employee over any other. There are two possible rationales for a subsidy. First, it may be in recognition of the fact that hiring disabled persons may impose additional costs on employers for infrastructure or facilities (e.g., ramps instead of stairs, grab bars in toilet facilities, etc. Alternatively, it may be compensation for the reduced productivity of disabled persons if these persons are paid the same salaries as persons able to produce more because they have no disability.

A subsidy provided in the form of a super deduction is of benefit only to profitable companies and is of no assistance to start-up companies yet to turn a profit or those

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employee's salary along with the enterprise income tax annual filing, Caishui [2009] No. 70, Art 3 (1)(2)(3)(4), Art 4.

not generating taxable profits (a consequence in some cases, perhaps, of hiring many disabled persons). A subsidy that is restricted to very profitable companies does not appear to be the most efficient subsidy. Direct grants based on the levels of disability or consequences of disability might be better targeted. Also, support provided by government departments or agencies specialising in supporting disabled persons might be more efficiently administered than tax-based support administered by the SAT, an agency with no particular expertise in the needs of disabled persons or their costs to employers.

7. 5. Special Areas

7. 5.1. Five Special Economic Zones and Shanghai Pudong New Area

Since 1980, China has established special economic zones in Shenzhen, Zhuhai and Shantou in Guangdong Province and Xiamen in Fujian Province, and designated the entire province of Hainan a special economic zone. The five special economic zones are foreign-oriented areas which integrate science and industry with trade, and benefit from preferential policies and special managerial systems; Shanghai Pudong New Area is situated in the east of Shanghai, [478] in 1990, China State Council officially announces to open a new area to strengthen the economics of Shanghai. They have summed up their rich experiences in absorbing foreign investment and developing foreign trade for China to open up to the international market. In recent years, the special economic zones and Shanghai Pudong New Area have led the country in establishing new systems, upgrading industries and opening wider to the outside world, serving as national models.

The development of Special Economic Zones and Shanghai Pudong New Area is one of the highlights of remarkable Chinese economic achievements. China's Special Economic Zones and Shanghai Pudong New Area played an instrumental role in the integration of China to the global economy and in its economic development. Their setting aims at attracting foreign investment and technology, many through the setting of joint ventures, provide employment, utilize Chinese and imported resources, and support capital formation. The law and circular confirm qualified income derived

[478] It takes the benefit of the location at the junction of middle China costal area and the mouth of Yangtze River, and face to the wide range Pacific Ocean.

from Special Economic Zones and Shanghai Pudong New Area will be exempt and deductable.

7. 5.1.1. Accounting Treatment

The accounting standard related to the accounting treatment of exemption and deduction of income from Special Economic Zones and Shanghai Pudong New Area is the Basic Standard of CAS,[479] Chapter 6 Revenue[480] and No. 14 – Revenue [481] (The detailed CAS is stated in Chapter 1).

7.5.1.2. Tax Law and Implementation Rules and Administrative Practices

Tax Exemption and Reduction

On December 26, 2007 the State Council issued the Circular of "Concerning the Implementation of Transitional Tax Preferential Treatment for High and New Technology Enterprises Newly Established in Special Economic Zones and Shanghai Pudong New Area" Guofa [2007] No. 40 (Circular 40) and took effect on January 1 2008.

According to Art 57 of EITL state encouraged new and high technology enterprises [482]located within legally established special zones for the promotion of foreign trade, economic and technological cooperation and other such zones as administered by the State Council can enjoy transitional benefits, the implementation of which would be determined by the State Council .[483]

The government will exempt qualified high new and high technology enterprises from paying income tax for the first and second year commencing from the first year the

[479] It is similar to the IFRS: Framework.
[480] CAS, Basic Standard, chapter 6, Revenue.
[481] CAS No. 14 – Revenue is similar to the IAS: No. 18 Revenue.
[482] They refer to enterprises holding independent ownership of core intellectual property, which simultaneously meet the criteria stipulated in Art 93 of the EITLIR and are verified as "High and New Technology Enterprises" in accordance with the Administration Measures for Recognition of High and new Technology Enterprises, Guofa [2007] No. 40 Art 2.
[483] They refer to Special Economic Zones of Shenzhen, Zhuhai, Shantou, Xiamen and Hainan (SEZs); other such zones as administered by the State Council refer to Shanghai Pudong New Area, Guofa [2007] No. 40, Art 1.

enterprises earn business income. The income tax rate for the third to fifth year will be 12.5%, which is only half the regular rate of 25%.[484]

For high and new technology enterprises newly established in SEZs and Shanghai Pudong New Area, which simultaneously engage in manufacturing and business operations outside SEZs and Shanghai Pudong New Area, they shall separately compute the income earned from SEZs and Shanghai Pudong New Area with expenses incurred during the period reasonably allocated. These enterprises shall not be allowed to enjoy transitional tax incentives if there is no such separate computation .[485]

Within the period that high and new technology enterprises newly established in SEZs and Shanghai Pudong New Area are enjoying the transitional tax incentives as stipulated above, if an enterprise does not pass renewal review or spot inspection and hence is disqualified as a high and new technology enterprise, the transitional tax incentives will cease from the year of disqualification; even if later the enterprise is verified as a high and new technology enterprise again, the transitional tax incentives shall not be continued or restarted.[486]

7.5.1.3. Tax Expenditure Identified

Under the Basic Standard of CAS,[487] Chapter 6 Revenue [488] and No. 14 – Revenue [489] CAS does not make a distinction between income derived from Special Economic Zones and Shanghai Pudong New Area and income derived from other areas.

However, Art 57 of EITL and Guofa [2007] No. 40 (Circular 40) confirms exempt qualified high and new technology enterprises from paying income tax for the first and second year commencing from the first year the enterprises earn business income.

[484] Guofa [2007] No. 40 Art 2.
[485] Guofa [2007] No. 40 Art 3.
[486] Guofa [2007] No. 40 Art 4.
[487] It is similar to the IFRS: Framework.
[488] CAS, Basic Standard, chapter 6, Revenue.
[489] CAS No. 14 – Revenue is similar to the IAS: No. 18 Revenue.

The income tax rate for the third to fifth year will be 12.5%, which is only half the regular rate of 25%.[490]

Therefore, two tax expenditures associated with the income derived from Special Economic Zones and Shanghai Pudong New Area – tax exemption and deduction, which could be recognised and calculated into accounting income under CAS.

7. 5.1.4. Analysis

Originally many investments (almost all) Special Economic Zones and Shanghai Pudong New Area were directed at foreign investors (foreign direct investment or FDI). There are four possible rationales for this government intervention. First is signalling effect that China now welcomes FDI and investors can discard fears of the former policy; The second is consistent with Chinese culture of welcoming ;[491] The third is needed economic bonus for foreign investors who retain lingering concerns about a government with a history of nationalisation and expropriation; higher perceived risk needs higher rate of return and tax incentives, particularly holidays, can raise the after-tax rate of return significantly; The forth is incentives distort allocation of resources in a perfect market but China in transition is not a perfect market as most of the industry was state owned when the incentives were first adopted and stated owned companies with access to funding from state owned financial institutions do not complete on a level playing field. This leads to various types of market failure and incentives to private market players can be used to address this market failure problems.

When domestic and foreign-owned enterprise income tax laws were united into one law, the incentives were retained and became available to everyone so the market failure isn't corrected (state owned companies also use them). There is no longer the same concern about nationalisation and expropriation. Signalling effects are also no longer so relevant after more than three decades of a market economy. Original rationales are not persuasive in 2013 and it is time to phase these out and let the market allocate resources without tax-induced biases and interference.

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[490] Guofa [2007] No. 40 Art 2

[491] Jinyan Li, 'The Rise and Fall of Chinese Tax Incentives and Implications for International Tax Debates' (2007) 8 *Fla. Tax Rev.* 669.

7. 5.2. Minority Autonomous Areas

China is a multi-racial nation, there are 55 minority groups living in this large country. Groups other than the majority Han Chinese are considered to be minority groups. Areas with majority ethnic populations are explicitly recognised as minority areas and this recognition carries a number of political and economic consequences, including qualification for ethnic area tax expenditures. The areas that are explicitly recognised as minority areas range from large autonomous areas to smaller counties within provinces dominated by non-ethnic populations. China has five minority autonomous regions, 30 minority autonomous prefectures within provinces, 120 minority autonomous counties within prefectures, and some other places where ethnic minorities live in concentrated communities. The EITL and EITLIR confirm government of autonomous areas may choose to reduce or exempt taxes for the portion of enterprise income tax for local distribution paid by an enterprise located in a minority autonomous region.

7. 5.2.1. Accounting Treatment

The accounting standard related to the accounting treatment of emption and deduction of income from minority autonomous regions is the Basic Standard of CAS,[492] Chapter 6 Revenue[493] and No. 14 – Revenue.[494] (The detailed CAS are stated in Chapter 1).

7. 5.2.2. Tax Law and Implementation Rules and Administrative Practices

Tax Exemption and Deduction

According to Article 29 of EITL government of autonomous areas may choose to reduce or exempt taxes for the portion of enterprise income tax for local distribution paid by an enterprise located in a minority autonomous region. Tax reductions or exemptions decided upon by autonomous prefectures and counties are subject to approval from the People's Governments of provincial and autonomous regions and

[492] It is similar to the IFRS: Framework.
[493] CAS, Basic Standard, chapter 6, Revenue.
[494] CAS No. 14 – Revenue is similar to the IAS: No. 18 Revenue.

municipalities.[495]

In accordance with the provisions of the Minority Region Autonomy Law of the People's Republic of China [496] a minority autonomous area refers to an autonomous region, prefecture or county which is governed. Article 94 of EITLIR also states that Enterprises of State-restricted or State-prohibited industries located in minority autonomous areas shall not be eligible for enterprise income tax exemptions and reductions. [497]

7. 5.2.3. Tax Expenditure Identified

Under the Basic Standard of CAS, [498] Chapter 6 Revenue [499] and No. 14 – Revenue [500] CAS does not make a distinction between income derived from minority autonomous region and income derived from other areas.

However, Article 29 of EITL and Article 94 of EITLIR confirms government of autonomous areas may choose to reduce or exempt taxes for the portion of enterprise income tax for local distribution paid by an enterprise located in a minority autonomous region.

Therefore, two tax expenditures associated with the income derived from minority autonomous region – tax exemption and deduction, which could be recognised and calculated into accounting income under CAS.

7. 5.2.4. Analysis

While the tax expenditures adopted to encourage investment in areas dominated by ethnic minorities appear to be directed at particular ethnic groups rather than persons in particular geographic or economic circumstances, there is a clear overlap between

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[495] EITL, Art 29.
[496] First promulgated by the National People's Congress in 1984 and revised in 2001. The Congress passed Regulations of the State Council on Implementing the Law of the People's Republic of China on Regional National Autonomy in 2005, amended by the Ninth National People's Congress Standing Committee of the 20th meeting of the decision of the People's Republic of China on Regional Ethnic Autonomy on 4 March 2010.
[497] EITLIR, Art 94.
[498] It is similar to the IFRS: Framework.
[499] CAS, Basic Standard, chapter 6, Revenue.
[500] CAS No. 14 – Revenue is similar to the IAS: No. 18 Revenue.

regions with lower economic development and ethnic regions. Thus, while the expenditures are described in terms of ethnic regionalism, these could be considered surrogates for regions of lower economic development. It is the case, however, that while the government wants to foster greater development in all regions with lower development, it has adopted a program that focuses on regions with ethnic minorities to achieve social as well as economic goals. There is an undeniable concern that resentment over lower economic growth in ethnic areas could fuel nationalist sentiments in these areas and lead to social disruption or more serious social problems.

Apart from the factor of ethnicity, there is no mentions in the tax expenditures of a reason these areas suffer lower economic growth. By reducing or eliminating the tax on profits in these areas, the tax expenditures can increase after-tax rates of return. However, this will only stimulate more investment in these areas if this solution overcomes the market failure that might explain why there are lower rates of economic growth in these regions. To date, the government has not conducted scientific surveys to ascertain the causes.

The ethnic areas do not have the same concentrations of population as the area that has experienced greater economic growth. One factor for lower growth in these areas might be the lack of infrastructure, raising the cost of operating businesses and increasing the cost of shipping outputs to consumers located elsewhere. If the lack of infrastructure is a cause, tax expenditures by way of reduced taxes on profits are unlikely to address effectively the problem holding back greater investment and development. Rather, it will simply deliver windfalls to businesses that would invest in these regions anyway because they are not dependant on infrastructure to generate their profits. If the lack of infrastructure it the cause of lower investment, a more effective subsidy would appear to be investment in infrastructure rather than a subsidy available only to profitable enterprises.

Another possible cause of lower economic development in ethnic areas is the higher cost of capital or reduced availability of capital. There is often a vicious cycle of reduced economic activity and lower concentrations of population and reduced availability of capital – there are fewer and less capitalised banks in the regions that have less economic activity, making it harder for enterprises in those areas to find investment capital. For the same reasons, it is more difficult for local investors to find

local equity funding for new businesses. Local business persons in ethnic areas are less likely to have the wide social and business contact networks as their counterparts in ethnically homogenous more developed regions and thus face more challenges in attracting capital from networks.

If limited access to investment capital is a cause of reduced investment, a subsidy by way of lower taxes on income of profitable enterprises does not appear to address the problem efficiently. It might be argued, however, that the lower taxes, by raising the after tax rate of return, could attract outside capital and this might be more effective than establishing programs to provide more investment funds to local businesses.

Without a better understanding of the exact causes of lower economic development in ethnic areas, it will be difficult to devise a truly efficient subsidy program that offsets the market failures or negative factors that inhibit investment and growth. This is true whether direct subsidy or tax expenditures are considered as the vehicle to provide the subsidy. Without this benchmark, there is no way of knowing whether the tax expenditure program now in place is the optimal policy or what refinements might improve its operation.

7. 5.3. Western Region

Western Region refers to the western part of China. In the definition of the Chinese government, Western China covers six provinces: Gansu, Guizhou, Qinghai, Shaanxi, Sichuan, and Yunnan; one municipality: Chongqing; and three autonomous regions: Ningxia, Tibet, and Xinjiang. [501]

Since 2000, the Chinese government launched the development of the western regions as one of the national initiatives. China's 12th Five-Year Plan, approved in March 2011, reinforces regional development and stresses the importance of large-scale development of the Western Regions. A series of tax circulars were then issued to stipulate various preferential tax policies to enterprises located in the western regions such as partial income tax exemptions and low tax rates.

[501] http://en.wikipedia.org/wiki/Western_China.

7. 5.3.1. Accounting Treatment

The accounting standard related to the accounting treatment of deduction of income from Western Regions is the Basic Standard of CAS,[502] Chapter 6 Revenue [503] and No. 14 – Revenue. [504] (The detailed CAS is stated in Chapter 1).

There is no any accounting standard related to low tax rate.

7. 5.3.2. Tax Law and Implementation Rules and Administrative Practices

Tax Deduction and Low Tax Rate

On 27 July 2011 the MOF, the SAT and General Administration of Customs jointly issued Caishui [2011] No. 58 (Circular 58) [505]which provided tax incentives for enterprises registered in the Western Regions for another 10 years, from 1 January 2011 to 31 December 2020.

Enterprises established in western region [506] and engaged in encouraged industries in accordance in the Catalogue of Encouraged Industries in Western Regions [507] and with 70% of the revenue from its main business operation are entitled to a preferential EIT rate of 15% from 1 January 2011 to 31 December 2020.

In order to further implement the enterprise income tax incentives for the development of the western regions, the SAT issued SAT Announcement No. 12

[502] It is similar to the IFRS: Framework.
[503] CAS, Basic Standard, chapter 6, Revenue.
[504] CAS No. 14 – Revenue is similar to the IAS: No. 18 Revenue.
[505] Issues Concerning Tax Policies for In-depth Implementation of Western Development Strategy. It took effect on 1 January 2011.
[506] It includes Sichuan Province, Guizhou Province, Yunnan Province, Shaanxi Province, Gansu Province, Ningxia Hui Autonomous Region, Xinjiang Uighur Autonomous Region, Inner Mongolia Autonomous Region, Tibet Autonomous Region, Guangxi Zhuang Autonomous Region, the municipality of Chongqing, and the Xinjiang Production and Construction Corps.The Tujia and Miao Autonomous Counties in western Hunan and Hubei Provinces, as well as the Yanbian Korean Autonomous Prefecture in Jilin Province, may refer to the western region taxation policy when implementing their own taxation police.
[507] NDRC issued 'Guidance Catalogue of Industrial Structure Adjustment (2011Edition)' for domestic companies on March 27, 2011, which was effective on June 1, 2011. And NDRC and Ministry of Commerce promulgated the 2012 Foreign Investment Industrial Guidance Catalogue on December 24, 2011, which took effect from January 30, 2012. The new Catalogue replaces the previous version released in 2007. And Catalogue of Competitive Industries for Foreign Investment in Central and Western Regions (2008Edition) applicable to foreign-invested enterprises.

(Announcement 12) [508] on 6 April 2012. Announcement 12 took retroactive effect on 1 January 2011 and will be valid until 31 December 2020.

From 1 January 2011 to 31 December 2020, enterprises established in the western regions, which are engaged in encouraged industries as stipulated in the Catalogue of Encouraged Industries of the Western Regions ("the Western Catalogue"), and having 70% of their total annual income [509] from the encouraged industries, are entitled to a reduced EIT rate of 15%. But approval from the tax authorities in charge is required. [510]

According to SAT Announcement 12 if an enterprise also qualifies for other tax incentives; it can enjoy both the 15% EIT rate under Announcement 12 and the other tax incentives. For instance, if an enterprise enjoys a 50% EIT reduction, its final EIT rate for the revenue from the Western regions will be 7.5%.[511]

Announcement 12 also clarifies the following issues: Application procedures, review and approval processes for enjoying the preferential EIT policies; Scope of catalogue applicable to the preferential EIT policies at this stage; Requirements for granting enterprises of the Five Major Industries [512] the EIT holiday; Principles and detailed calculation methods of the EIT for enterprises with headquarters and/or branches located in the western regions.

For enterprises that are established in the Western regions but have branches in other regions, and enterprises that are established in other regions but have branches in the Western regions, only the revenue from headquarters or branches within the Western regions are counted to determine whether that enterprise qualifies for the tax

[508] The Notice Regarding the Implementation of Enterprise Income Tax Policies for the Development of the Western Regions.
[509] Total income herein should be referenced to Article 6 of the EITL, which includes income from the sales of goods, the provision of services and the transfer of properties; dividends, profit distributions and other returns on equity investments; interest, rent, royalty, donation received and other income.
[510] SAT Announcement [2012] No. 12, Art 1.
[511] SAT Announcement [2012] No. 12, Art 5.
[512] Enterprises engaging in transportation, power, water conservancy, postal service and radio and television broadcasting that are newly established before 31 December 2010, the preferential tax treatment of "two-year exemption and three-year 50% rate reduction" shall be continued until the date of expiry., SAT Announcement [2012] No. 12, Art 4.

incentives under Announcement 12. And only the revenue from the headquarters and branches within the Western regions can enjoy the tax incentives under Announcement 12.

Circular 58, together with Announcement 12, demonstrate the central government's determination to further support the development of the Western Regions through the extension of EIT for another 10 years to the year 2020. In addition, Circular 12 refines the application and approval procedures with an aim to reduce the administrative burden for companies applying for these tax incentives.

7.5.3.3. Tax Expenditure Identified

Under the Basic Standard of CAS,[513] Chapter 6 Revenue [514] and No. 14 – Revenue [515] CAS does not make a distinction between income derived from western regions and income derived from other areas.

Caishui [2011] No. 58 (Circular 58) [516] SAT Announcement No. 12 which provided tax incentives for enterprises registered in the Western Regions with 70% of the revenue from its main business operation are entitled to a preferential EIT rate of 15% from 1 January 2011 to 31 December 2020. And if an enterprise enjoys a 50% EIT reduction, its final EIT rate for the revenue from the Western regions will be 7.5%.[517]

Therefore, two tax expenditures associated with the income derived from the Western Regions – tax deduction and low tax rate, which could be recognised and calculated into accounting income under CAS.

7. 5.3.4. Analysis

Like minority areas discussed in the previous section, the western part of China has experienced lower economic growth than the centre and east. There is some overlap between the tax expenditures to encourage investment in minority regions and tax

[513] It is similar to the IFRS: Framework
[514] CAS, Basic Standard, chapter 6, Revenue.
[515] CAS No. 14 – Revenue is similar to the IAS: No. 18 Revenue.
[516] Issues Concerning Tax Policies for In-depth Implementation of Western Development Strategy. It took effect on 1 January 2011.
[517] SAT Announcement [2012] No. 12, Art 5.

expenditures to encourage investment in the western region. Of the 10 areas included in the western region incentives, three are explicitly recognised as minority regions and there are sub-regions within six of the other areas recognised as minority regions for the purpose of the minority region tax expenditures. However, the scope of minority regions that qualify for concessions under the minority regions tax expenditure regime is wider than that applicable to western region areas as it includes minority areas such as counties where a majority of the population is from an ethnic minority located in other parts of the country, particularly in the centre of China. There are, for example, qualifying minority counties in Hunan and Hubei provinces in mid-China.

As with the concessions for minority areas, no scientific analysis has been provided to identify accurately the reason for lower investment in these areas. Once again, plausible answers include the lack of infrastructure and the reduced availability of investment capital. As with the tax expenditures discussed in the previous section, it is impossible to evaluate the effectiveness of the concessions without first knowing precisely what problem they seek to address. The starting point for a design of more effective tax expenditures or alternative direct subsidies to assist development in the western region should be the problems the subsidies are intended to overcome. This should be the first stage of a tax design review if a comprehensive tax expenditure budget is adopted in China.

7. 6. Encouraged Technology Innovation and Improvement

7. 6.1. Technology Transfer

Technology transfer is connected with bringing technologies form the source of innovation to the marketplace. Technology transfer is a critical and effective factor in social and economic development in China. It includes technological achievements, and information, the ability to transfer, transplantation, introduction, exchange and promotion. The EITL and EITLIR and Circulars provide the qualified income derived by tax resident enterprises from the transfer of technology shall be exempted and deducted.

7. 6.1.1. Accounting Treatment

The accounting standard related to the accounting treatment of exemption and deduction for qualified income derived by tax resident enterprises from the transfer of technology is the Basic Standard of CAS,[518] Chapter 6 Revenue [519] and No. 14 – Revenue.[520] (The detailed CAS is stated in Chapter 1).

7.6.1.2. Tax law and Implementation Rules and Administrative Practices

Tax Exemption and Deduction

According to Article 27(4) of EITL and Article 90 of EITLIR, the first five million yuan of qualified income derived by tax resident enterprises from the transfer of technology shall be exempted from enterprise income tax and the portion that exceeds five million yuan shall be entitled to a 50 percent reduction.

On 24 April 2009, the SAT issued Guoshuihan [2009] No.212 (Circular 212), clarifying the criteria, [521] and calculation method[522] for technology transfer income to qualify for the enterprise income tax exemption and reduction.

One of the criteria is that the technology transfer has to be within the scope prescribed by the MOF and the SAT. However, it was not until on 31 December 2010 the MOF and the SAT jointly issued Caishui [2010] No.111 (Circular 111), [523] to address this prescribed scope among other things. Circular 111 took effect retroactively from 1 January 2008.

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[518] It is similar to the IFRS: Framework.
[519] CAS, Basic Standard, chapter 6, Revenue.
[520] CAS No. 14 – Revenue is similar to the IAS: No. 18 Revenue.
[521] 1. A resident enterprise specified by Enterprise Income Tax Law; 2. The scope provided for by the Ministry of Finance and State Administration of Taxation; 3. Recognized by science departments above provincial level within China; 4. Recognized by commercial departments above the provincial level outside China;5. Other conditions provided for by the competent tax departments under the State Council. Circular Guoshuihan [2009] No.212, Art 1(1-5).
[522] Technology transfer earnings = technology transfer income - technology transfer cost – relevant taxes and fees, Circular Guoshuihan [2009] No.212, Art 2.
[523] Circular Regarding Corporate Income Tax for Resident Enterprises' Technology Transfer

Circular 111 classify the scope of qualified technology transfer [524] However it apparently limits the scope to certain types of technology transfers. The technology transfer also has to be one of ownership or global exclusive licensing right of the qualified technology for a period of five years or more, which might not be easily accomplished in reality.

Circular 111 excludes technology transfer income from related parties under the enterprises' 100 percent control (direct or indirect) from the enterprise income tax exemption and reduction.[525] This restriction aims to prevent some group companies from abusing the preferential tax treatment. However, a transfer between related parties with genuine business purpose (assuming all other criteria are met) will suffer from a higher enterprise income tax cost compared with a transfer to an unrelated third party, which could be entitled to the preferential tax treatment.

7. 6.1.3. Tax Expenditure Identified

Under the Basic Standard of CAS,[526] Chapter 6 Revenue [527] and No. 14 – Revenue [528] CAS does not make a distinction between income derived from the transfer of technology and income derived from other activities.

Article 27(4) of EITL, Article 90 of EITLIR, Guoshuihan [2009] No.212 (Circular 212) [529] and Caishui [2010] No.111 (Circular 111), [530] state that the first five million yuan of qualified income derived by tax resident enterprises from the transfer of

[524] Six types of qualified technology transfer: 1. Transfer of patented technology, which refers to legally granted exclusive ownership of invention, utility model and layout-design that is not a simple change of outlook of the product design; 2. Transfer of copyright of software; 3. Transfer of design or composition right of integrated circuit; 4. New plant variety; 5. New biological and medical variety; 6. Other transfers as prescribed by the MOF and the SAT. Technology transfer refers to the transfer of ownership or a five-year or more global exclusive licensing right of the technology listed above. Caishui [2010] No.111, 'Enterprise Income Tax Policies for Technology Transfer of Resident Enterprises', Art 1.
[525] Caishui [2010] No.111, Art 4.
[526] It is similar to the IFRS: Framework
[527] CAS, Basic Standard, chapter 6, Revenue.
[528] CAS No. 14 – Revenue is similar to the IAS: No. 18 Revenue.
[529] 1. A resident enterprise specified by Enterprise Income Tax Law; 2. The scope provided for by the Ministry of Finance and State Administration of Taxation; 3. Recognized by science departments above provincial level within China; 4. Recognized by commercial departments above the provincial level outside China; 5. Other conditions provided for by the competent tax departments under the State Council. Circular Guoshuihan [2009] No.212, Art 1(1-5)
[530] Circular Regarding Corporate Income Tax for Resident Enterprises' Technology Transfer

technology shall be exempted from enterprise income tax and the portion that exceeds five million yuan shall be entitled to a 50 percent reduction.

Therefore, two tax expenditures associated with the income derived from the transfer of technology – tax exemption and deduction, which could be recognised and calculated into accounting income under CAS.

7. 6.1.4. Analysis

From 2007 to 2010 China released tax laws, regulations, and policies with regard to technology transfer. These policies are clearly intended to support domestic reform and modernization efforts toward self-sufficiency in high-tech sectors. However, China's tax policies have not been successful in achieving their stated goals. Such as the criteria, [531]and calculation method[532] for technology transfer income to qualify for the enterprise income tax exemption and reduction are not very clearly assessed.

One objective of tax expenditures to support the transfer of technology follow from a view that the government has a role in shifting investment to the technology sectors it believes are important to growth and development. This implicitly assumes there will be positive externalities. However, the current subsidy program has been undertaken without empirical or theoretical analysis to indicate whether there is a need for a subsidy or whether the subsidy could generate positive analysis. The design of the tax expenditure has apparently not considered where the desired activities might take place most efficiently. There is also no evidence that the design has taken into account any evidence of the types of the transfer of technology that are most likely to generate the desired externalities as the current boundaries of the subsidy are vague with limited detail of what constitutes eligible activities.

[531]1. A resident enterprise specified by Enterprise Income Tax Law; 2. The scope provided for by the Ministry of Finance and State Administration of Taxation; 3. Recognized by science departments above provincial level within China; 4. Recognized by commercial departments above the provincial level outside China; 5. Other conditions provided for by the competent tax departments under the State Council. Circular Guoshuihan [2009] No.212, Art 1(1-5)

[532] Technology transfer earnings = technology transfer income - technology transfer cost – relevant taxes and fees, Circular Guoshuihan [2009] No.212, Art 2.

Other programs that could do it more efficiently by better targeting reducing the cost of the transfer of technology such as lower interest loans or loan guarantees for reduced fees might be better targeted than a tax subsidy that helps successful the transfer of technology companies only.

7. 6.2. Research and Development (R&D) Expenses

Research and development (R&D) is important for economic progress and the well-being of society in China. It also plays an increasingly vital role in the knowledge based economy. Expenditure on research and development is one of the most widely used measures of innovation inputs. The EITL, EITLIR and Circular confirm that research and development expenses are eligible for enterprise income tax purposes for a super deduction equal to 150% of the outlays.

7. 6.2.1. Accounting Treatment

The accounting standard related to the accounting treatment of super deduction for research and development expenses are No.6– Intangible Assets of CAS [533] and CASIG (The detailed CAS is stated in Chapter 1).

7. 6.2.2. Tax Law and Implementation Rules and Administrative Practices

Article 30 of EITL state research and development expenses incurred by an enterprise for the development of new technology, new products and new techniques, super deductions shall be allowed.[534]

Under Article 95 of EITLIR if the expenses are not capitalized as intangible assets but are charged to the income statement of the current period, a 50% super-deduction that is allowable in addition to the actual expense deduction; if the expenditures are

[533] It is similar to IAS 38, Intangible Assets.
[534] EITL Art 30(1)

capitalized as intangible assets, cost bases of the intangible assets equal to 150% of actual costs are allowable for amortization purposes.[535]

Guoshuifa [2008] No. 116 (Circular 116) provides the definition of R&D activities subject to the super deduction are the "continuous research and development activities with definite objectives carried out by an enterprise to acquire new knowledge of science and technology (excluding humanities and social sciences) to make innovative use of the knowledge or to substantially improve technology, production techniques or product (services)."[536]

Circular 116, however, seems to place more emphasis on the concept of "substantial improvement." There still are no specific standards to differentiate what constitutes day-to-day improvements versus substantial improvements for manufacturing enterprises. Moreover, in addition to the R&D activities of manufacturing enterprises, Circular 116 includes substantial improvements from services, which means that even some advanced or high and new technology enterprises in the service industry could apply for the R&D super deduction. [537]

Circular 116 also specifically defines the scope of R&D expenses by listing eight categories [538] of eligible expenses.

(1) Expenses for Design of new products, formulation of new technical process, technical manuals, materials and material translation fee directly related to R&D activities;

(2) Expenses for materials, fuel and power directly related to R&D activities;

(3) Direct labour cost including salaries, wages, bonuses and allowances for R&D activities;

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[535] EITIR, Art 95

[536] The SAT issued Circular 116 on 10 December 2008 that provides guidance on the super deduction for research and development (R&D) expenses under the new Enterprise Income Tax Law (Guoshuifa [2008] No. 116, "Administrative Measures for the Deduction of Enterprises' Expenses for Research and Development (for Trial Implementation)"). The circular took effect on 1 January 2008.

[537] Deloitte, Tax Analysis, NTC Tax Analysis Issue P54/2009 – 4 February 2009.

[538] Guoshuifa [2008] No.116.

(4) Depreciation expenses or lease of instrument and equipment specifically used for R&D activities;

(5) Amortization expenses of intangible assets such as software, patent rights, non-patented technologies for R&D activities;

(6) Expenses of intermediate testing and trial experiment for development and manufacturing of equipment and moulds;

(7) On-site testing expenses for exploration technology;

(8) Expenses for verification, assessment and qualification of R&D results.

On 8 October 2010 the MOF and the SAT jointly released Caishui [2010] No. 81(Circular 81).[539] The main change of Circular 81 is that it enlarges the scope of R&D expenses eligible for super deduction which are not covered by Circular 116, such as expenses of social security's[540] paid by enterprises for R&D personnel, expenses of maintenance and testing for equipment directed to use for R&D activities and expenses for clinical trial of new medicines.[541]

Circular 81 provides this generous treatment only to qualified high and new technology enterprises (HNTEs) recognized by the Beijing HNTEs recognition institution, registered in the Zhongguancun NIDZ and reporting taxation on an actual basis. This reflects Chinese government intends to encourage enterprises to establish high technology enterprises in the Demonstration Zone. [542]

7.6.2.3. Tax Expenditure Identified

Article 30 of EITL, Article 95 of EITLIR Guoshuifa [2008] No. 116 (Circular 116) Caishui [2010] No. 81(Circular 81) confirm that research and development expenses

[539] Circular 81 clarifies 'The Pilot Policies Related To The Super Deduction Of Research And Development Expenses For The Construction of Zhongguancun National Innovation Demonstration Zone (NIDZ)'.
[540] It includes Basic pension insurance, basic medical insurance, unemployment insurance, industrial injury insurance, birth insurance and housing fund, Circular 81, Art 3(3.).
[541] Circular 81, Art 3 (3) (4) (7).
[542] Ernst &Young, China Tax Center, China Tax & Investment Express, issue No. 2010042, 31 December 2010.

are eligible for enterprise income tax purposes for a super deduction equal to 150% of the outlays.

Accounting standards, in contrast, provide for recognition of no more than 100% of the cost of research and development. An outright deduction is allowed where the research and development activities generate knowhow or benefits other than actual or expected intangible property such as a patent. If the expense yields or will lead to the creation of intangible property, the expense is capitalised and recognised over the life of the expected intangible property.

Therefore, two tax expenditures associated with research and development – the grossed-up deduction for an amount 50% greater than the actual outlay and the immediate deductibility of outlays that could be capitalised and recognised over several years under CAS.

7. 6.2.4. Analysis

In order to further the growth of China's technological development Chinese government has taken several measures granting tax incentives for R&D expenses. Encouraging and nourishing R&D and innovation activities has become a national policy and is high on the agenda of "The 12th Five Year Plan"of the Chinese government.[543]

Subsidies for R&D activites are common. There are two possible rationales for this government intervention. One is an assumption by governments that there is a market failure that causes business in underinvest in R&D and the subsidies are necessary to correct this market failure. However, the market regularly shows that it has sufficient resources to generate appropriate levels of R&D, innovate and develop new products and processes without additional assistance. Ordinary market competition continuously spurs new R&D and new products and processes. Another is an assumption that there are postive externalities from R&D that provide benefits beyond

[543] China's legislature, the National People's Congress, endorsed the country's 12th Five-Year Plan2011-2015) on 14 March 2011. This far-reaching plan sets the nation's course for the next five years: the social and economic measures contained in the plan will have a deep impact on the business landscape, both within China and in countries that do business with China.

the immediate profits to the company generating the R&D. For example, medical developments might lead to a host of ancillary cures or treatments not anticipated by the persons conducting the original research.

There are a number of options open to a government that wishes to subsidise R&D. One is to provide assistance to businesses that conduct R&D either directly through grants or by way of tax subsidies. Another is to fund R&D through external organisations so the government can enjoy some return from its investment. If support is provided to businesses, all the profits generated by the government's investment flow to the business owners. If they government conducts R&D through government organisations such as universities, it can retain the intellectual property and licence it to business so it receives some of the returns from its investment.

If the government concludes there is a case for subsidising R&D and it wishes to give away all of the returns from its investment in R&D to private business owners, it must decided between direct grants provided on a competitive basis, as it does for public sector research such as university research, or tax expenditures. If it chooses tax expenditures, the question becomes which type of tax expenditure can most efficiently target the persons that the government wants to assist with R&D work.

The current law provides a super deduction for R&D activities, meaning the subsidy is only of benefit to profitable firms. As there is no limit to the amount that can be deducted, larger companies with larger R&D budgets will reap higher subsidies. On its face, this does not appear to be an efficient subsidy. Large profitable businesses have shown they can conduct R&D without assistance. The subsidy is of no benefit to start-up businesses that are likely to be engaged in R&D and new product development and new technology development. Nor does it help small unincorporated businesses that have often been the source of innovative technology -- the stories of Apple computers, Microsoft, Facebook and countless other businesses that started with developments in basements, garages or university dorms show how often this is the case.

If the government wishes to continue its subsidies for R&D, wishes to do so in a way that provides private business with all the profits from the government's investments,

and wishes to use the tax system to deliver the subsidy, consideration can be given to a more efficiently targeted tax expenditure such as a refundable tax credit similar to the system used in Australia for small business conducing R&D. Footnote here to Australian Master Tax Guide.

However, there are still some problems to remain. The scope of super deduction for R&D expenses is too narrow, the threshold is too high, which led to the lack of motivation for enterprises, especially for Small business R&D investment; Moreover , there is the lack of clearly identified criteria, resulting in both tax collectors and taxpayers are difficult to determine the suitability .

7. 6.3. Fixed Assets used in Innovation Development and Unusual Aging Factors

Innovation development in fixed assets is important for social reproduction of fixed assets. Base on construction and purchase of fixed assets, more advanced technologies and equipment are adopted in the economy. China encourages enterprises to increase investment in fixed assets. The law and Circular provide fixed assets with depreciation periods shortened or with an accelerated depreciation method applied to fixed assets affected by accelerated development of next generation products due to advancements in technology and fixed assets in constant exposure to high tremor and high corrosion

7. 6.3.1. Accounting Treatment

The accounting standard related to the accounting treatment of accelerated depreciation of fixed assets for Fixed Assets used in Innovation Development and Unusual Aging Factors are No. 4 – Fixed Assets of CAS [544] and CASIG (The detailed CAS is stated in Chapter 1).

7. 6.3.2. Tax law and Implementation Rules and Administrative Practices

Accelerated Depreciation of Fixed Assets

Article 32 of EITL states an enterprise holding fixed assets subject to advancements in technology; etc. that requires accelerating depreciation may shorten the

[544] It is similar to IAS 16, Property, Plant and Equipment.

depreciation period or apply the accelerated depreciation method.[545]

Article 98 (1-2) of EITLIR confirms fixed assets with depreciation periods shortened or with an accelerated depreciation method applied to fixed assets affected by accelerated development of next generation products due to advancements in technology and fixed assets in constant exposure to high tremor and high corrosion .[546]

Where the depreciation period is shortened, the shortest depreciation period shall not be less than 60% of the minimum depreciation period as cited in Article 60 of EITIR where an accelerated depreciation method is applied, either the double reducing balance method or the sum-of-the-years'-digits method may be used (EITIR, Art 98).

According to Article 60 of EITIR, the minimum number of years for computing depreciation of fixed assets, except to the extent, government authorities of the State Council in charge of finance and taxation stipulate otherwise, shall be:

• 20 years for houses and buildings;

• 10 years for airplanes, trains, ships, machinery, mechanical apparatuses and other equipment used in manufacturing;

• five years for apparatuses, tools, furnishings used in connection with manufacturing and business operations;

• four years for transportation vehicles other than airplanes, trains and ships; and

• three years for electronic equipment

Guoshuifa [2009] No. 81(Circular 81), was issued by SAT[547] on 16 April 2009 which clarifies the requirements for accelerated depreciation of fixed assets to be available which became effective from 1 January 2008. The requirements cover applicable situations, acceptable depreciation bases and filing arrangements. This should facilitate the plans of relevant companies to upgrade and replace their equipment.

[545] EITL, Art 32.
[546] EITIR, Art 98(1-2).
[547] Notice on issues relevant to income tax treatment on the accelerated depreciation of fixed assets of enterprises

Circular 81 applies with respect to fixed assets under the following rules:

For a new fixed asset, enterprises must show that the estimated usage period is shorter than the minimum depreciation period as provided under the corporate income tax Implementation Rules and that no fixed asset with the same or similar function has been used previously. [548]

For a replacement fixed asset, enterprises must prove that the usage period of the old fixed asset is shorter than the minimum period set out in the Implementation Rules and that the replacement fixed asset has the same or similar function as the old asset. [549]

Minimum Shortened Depreciation Period

For new fixed assets, the minimum shortened depreciation period must be not less than 60% of the minimum period set out in Article 60 of EITLIR.

For second-hand fixed assets, the minimum shortened depreciation period must not be less than 60% of the remaining period (the maximum period set out in Article 60 of EITLIR minus the current year of use).[550]

The minimum shortened deprecation period generally cannot be changed once determined.

Accelerated Depreciation Method

Double balance declining method

Sum of depreciation years method

The accelerated depreciation method generally cannot be changed once determined. [551]

Filing Requirements

[548] Guoshuifa [2009] No. 81, Art 2 (1).
[549] Guoshuifa [2009] No. 81, Art 2 (2).
[550] Guoshuifa [2009] No. 81, Art 2 (3).
[551] Guoshuifa [2009] No. 81, Art 2 (4).

To apply for the shortened depreciation period or accelerated depreciation method on fixed assets, an enterprise must file a request with the in-charge tax authority within one month of purchasing the fixed asset.[552]
During the annual corporate income tax return filing, the in-charge tax authority is to perform an on-site review of the working environment and condition of the fixed asset(s) adopting the accelerated deprecation method. For fixed assets that do not meet the requirements for the accelerated depreciation, the in-charge tax authority will request that the enterprise stop using the accelerated depreciation method.

If a branch uses a fixed asset under a shortened depreciation period or accelerated deprecation method, the headquarters is responsible for filing the request with its in-charge tax authority.[553]

Other Rules

If fixed assets adopting a shortened depreciation period have been fully depreciated but continue to be used without being disposed of (including for scrap) for more than 12 months, any replacement or upgraded fixed asset with the same or similar function will not be allowed to adopt the shortened deprecation method.[554]

7. 6.3.3. Tax Expenditure Identified

Under No. 4 – Fixed Assets of CAS and No. 4 – Fixed Assets of Implementation Guidance for CAS an enterprise shall reasonably select the depreciation method to be applied to a fixed asset based on the pattern in which the asset's economic benefits are expected to be realized. Depreciation methods that may be applied include the straight-line method, the units of production method, the double declining balancemethod and the sum-of-the-digits method.

Article 32 of EITL, Article 98 (1-2) of EITLIR, Article 60 of EITLIR Guoshuifa [2009] No. 81(Circular 81) verify fixed assets with depreciation periods shortened or

[552] Guoshuifa [2009] No. 81, Art 2 (5).
[553] circular Guoshuifa [2009] No. 81, Art 2 (8).
[554] Circular Guoshuifa [2009] No. 81, Art 2 (6)

with an accelerated depreciation method applied to fixed assets affected by accelerated development of next generation products due to advancements in technology and fixed assets in constant exposure to high tremor and high corrosion , which is not mentioned under CAS.

Therefore, one tax expenditure associated with fixed assets used in innovation development and unusual aging factors --- Accelerated Depreciation of Fixed Assets, which is not mentioned separately under CAS.

7. 6.3.4. Analysis

Accelerated depreciation for fixed assets used in innovation development and unusual aging factors is one of the EIT preferential policies, which supports advances in technology. This follows from a view that the government has a role in shifting investment to the technology and innovation sectors it believes are important to growth and development. The government also believes it can enable enterprises to speed up the elimination of backward technology and equipment, the introduction of new technologies, new processes, improve the technological content. And it also can reduce the tax burden for the taxpayer.

However, the current subsidy program has been undertaken without empirical or theoretical analysis to indicate whether there is a need for a subsidy or whether the subsidy could generate positive analysis. The design of the tax expenditure has apparently not considered where the desired activities might take place most efficiently. There is also no evidence that the design has taken into account any evidence of the types of fixed assets used in innovation development and unusual aging factors that are most likely to generate the desired externalities as the current boundaries of the subsidy are vague with limited detail of what constitutes eligible activities.

Other programs that could do it more efficiently by better targeting reducing the cost of fixed assets used in innovation development and unusual aging factors such as lower interest loans or loan guarantees for reduced fees might be better targeted than a tax subsidy that helps successful the fixed assets used in innovation development and unusual aging factors companies only.

7. 7. Interest Income to Subsidise Borrowing Costs for Two Types of Debtors

7. 7.1. The First Type of Debtor: Chinese Government

Although borrowings by the Chinese government are modest by international standards, the government does borrow money from a variety of lenders and incurs interest expenses on the loans. The EITL and EITLIR provide tax exemption for interest income from different types of government lenders such as foreign government and international financial institutions, etc. and tax deduction for interest income of Railway Construction Bond.

7. 7.1.1. Accounting Treatment

The accounting standard related to the accounting treatment of exemption and deduction for interest income from different types of government lenders are the Basic Standard of CAS,[555] Chapter 6 Revenue [556] and No. 14 – Revenue [557] (The detailed CAS is stated in Chapter 1).

7. 7.1. 2. Tax Law and Implementation Rules and Administrative Practices

7. 7.1.2.1. Tax Exemption for Interest Income from Government Bonds

Interest income from government bonds that refers to interest income derived from enterprises' holdings of government bonds issued by the government authorities of the State Council in charge of finance. [558]

7. 7.1.2.2. Tax Exemption for Interest Income from Interest income from loan lent by foreign government.

Interest Income from Interest income from loan lent by foreign government to the Chinese Government can be exempt from enterprise income tax.[559]

7. 7.1.2.3. Tax Exemption for The income from the interest of the preferential loan

[555] It is similar to the IFRS: Framework.
[556] CAS, Basic Standard, chapter 6, Revenue.
[557] CAS No. 14 – Revenue is similar to the IAS: No. 18 Revenue.
[558] EITL, Art 26 (1), EITLIR, Art 82.
[559] EITLIR, Art 91(1).

provided by international financial institutions.

The income from the interest of the preferential loan provided by international financial institutions [560] to the Chinese Government and Chinese resident enterprises; and can be exempt from enterprise income tax.[561]

7. 7.1.2.4. Other types of income approved by the State Council [562]

7. .1.2.5. Tax Exemption for the Local Government Bond Interest Income

On 26 August 2011, MOF and SAT jointly released Caishui [2011] No. 76 (Circular 76) 'Notice on the Enterprise Income Tax Exemption of the Local Government ' [563] , it stated that interest earned from purchasing local government bonds issued in 2009, 2010 and 2011 do not accrue enterprise income tax.

7. 7.1.2.6. Tax Deduction for Interest Income of Railway Construction Bond

On 10 October 2011 MOF and SAT jointly released Caishui [2011] No. 99(Circular 99), 'Notice on Enterprise Income Tax Policies for Interests Income of Railway Construction Bonds', and it took effect on the same day.

Under Circular 99, for interest income derived by enterprises from China railway construction bonds [564] issued from 2011 to 2013, it is entitled to a 50% tax rate deduction.

7. 7.1.3. Tax Expenditure Identified

Under Chinese accounting standards, the interest paid on loans to the Chinese government would be included in the revenue of the lender. The standards are silent on the tax treatment of interest, however, and thus provide no benchmark for analysing the tax rules on interest on loans to the Chinese government. In particular,

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[560] It includes the International Monetary Fund, the World Bank, the Asian Development Bank, the International Development Association, the International Fund for Agricultural Development, the European Investment Bank and other international financial organisations determined by the Ministry of Finance and the State Administration of Taxation; the term "preferential loan" shall refer to loans with an interest rate lower than the rate for loans of the same kind for the same period made by financial institutions , 'Notification on the Preferential Tax Policies Matters Approved by MOF and SAT', Caishui [2009] No.69, Art 8.

[561] EITLIR, Art 91(2).

[562] EITLIR, Art 91(3) there is residual tax expenditure in the form of a blanket authorisation for the State Council to exempt any type of income from tax but it has never been used.

[563] It took effect on the same day.

[564] It refers to bonds approved by National Development and Reform Commission which shall be issued and repaid by the Ministry of Railways. Caishui [2011] No. 99, Art 2.

they say nothing about the rate of tax that should be applied to income subject to tax under the company tax law.

The benchmark must be found in the law itself in terms of consistent and neutral treatment of all types of income subject to tax. As a general rule, all income derived by companies, including interest income, is subject to a 25% company income tax. However, there are a number of rules that provide reduced or zero rates for interest paid on loans to the Chinese government. The preferential treatment of this interest can be considered a tax expenditure using the general tax rule as a benchmark rather than accounting standards as the benchmark.

Therefore, two tax expenditures associated with the income derived from Chinese government– tax exemption and deduction, which could be recognised and calculated into accounting income under CAS.

7. 7.1.4. Analysis

While the concession falls in the first instance on the lenders to the Chinese government, the ultimate beneficiary is not the lenders but the borrower, the Chinese government. If lenders seek a particular after-tax rate of return, the interest they charge where the interest is wholly or partially tax exempt will be lower than the interest they would impose if the interest were subject to the full company income tax rate.

7. 7.2. The second type of debtor: Agricultural Financial Institutions

China faces massive challenges in the agriculture financial sector due to the primitive financial support and adjustment. There are serial problems still remaining such as capital upgrading and rationalization of the private and public financial infrastructure in the agriculture sector. It is necessary for the government to promote the dramatic improvement. The Circular confirms that the certain portion of qualified interest income or insurance premium income from agricultural financial institutions can be deductable.

7. 7.2.1. Accounting Treatment

The accounting standard related to the accounting treatment of deduction for qualified interest income or insurance premium incomes from agricultural financial institutions are the Basic Standard of CAS,[565] Chapter 6 Revenue [566] and No. 14 – Revenue [567] (The detailed CAS is stated in Chapter 1).

7. 7.2. 2. Tax law and Implementation Rules and Administrative Practices

Tax Deduction

On 13 May 2010, the MOF and SAT jointly promulgated Caishui [2010] No. 4(Circular 4) 'Notice Regarding about Tax Polices for Agricultural Financial Institutions'.

From 1 January 2009 to 31 December 2013, for financial institutions which provide small loans (up to RMB50,000) to qualified farmers or for insurance companies that offer insurance services to eligible planting or breeding industries, only 90% of their interest income or insurance premium income[568] is taxable . Financial institutions must keep a separate account of their interest income from small loans to qualified farmers.[569]

7. 7.2.3. Tax Expenditure Identified

Under the Basic Standard of CAS,[570] Chapter 6 Revenue [571] and No. 14 – Revenue [572] CAS does not make a distinction between income derived from agricultural financial institutions and income derived from other financial institutions

However, Caishui [2010] No. 4(Circular 4) confirms only 90% of their interest income or insurance premium income is taxable.

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[565] It is similar to the IFRS: Framework.
[566] CAS, Basic Standard, chapter 6, Revenue.
[567] CAS No. 14 – Revenue is similar to the IAS: No. 18 Revenue.
[568] Caishui [2010] No. 4, Art 2, 4, 5, Insurance premium income refers to the balance of original insurance premium income plus reinsurance premium income less reinsurance premium ceded.
[569] Caishui [2010] No. 4, Art 6.
[570] It is similar to the IFRS: Framework.
[571] CAS, Basic Standard, chapter 6, Revenue.
[572] CAS No. 14 – Revenue is similar to the IAS: No. 18 Revenue.

Therefore, one tax expenditure associated with the qualified interest income or insurance premium income from agricultural financial institutions – tax deduction, which could be recognised and calculated into accounting income under CAS.

7. 7.2.4. Analysis

The Chinese government has been taking various measures to boost the development of financial services in rural areas. The MOF and the SAT issued Circular 4 intending to subsidise the agriculture-related financial institutions by means of a series of EIT incentives. The extension of certain tax incentives set out in the circular will give a further boost to financial institutions' involvement in economic development of the rural areas.

7. 8. Dividend Income and other Distributions

The EITL and EITLIR provide an exemption or a reduced tax rate for some types of dividend income and other distributions received by resident enterprises or non-resident enterprises with permanent establishments in China, and non-resident enterprises with no permanent establishment in China.

7. 8.1. Accounting Treatment

Chinese accounting standards provide two alternative benchmarks that can be used for analysis of the tax rules. The basic rules, set out in the Basic Standard of CAS, [573] Chapter 6 Revenue [574] and No. 14 – Revenue [575] (the detailed CAS are stated in Chapter 1) apply where enterprises with interests in other enterprises are treated as separate entities. In this case, dividends flowing from one company to another are treated as ordinary income and are included in the gross income of the recipient company. Separately, under No. 33 of CAS Consolidated Financial Statements, which is similar to IAS 27, Consolidated and Separate Financial Statements (The detailed CAS is stated in Chapter 1), where companies are members of a group subject to common ownership, the separate companies can be treated as parts of one

[573] It is similar to the IFRS: Framework.
[574] CAS, Basic Standard, chapter 6, Revenue.
[575] CAS No. 14 – Revenue is similar to the IAS: No. 18 Revenue.

larger entity with consolidated accounting, in which case dividend distributions between the companies are ignored for account purposes.

7. 8.2. Tax law and Implementation Rules and Administrative Practices

Article 3 of EITL imposes an income tax liability on Chinese-source income derived by resident companies and non-resident companies with or without establishments in China. (Resident companies and non-resident companies deriving income through establishments are also liable for tax on foreign-source income.)[576] However, the tax law and implementation rules provide exemptions or reduced rates for dividends received by three categories of companies.

Dividends received by qualified resident enterprises

Article 26 (2) of EITL provides an exemption for dividend income and other distributions received by a qualified resident enterprise[577] from a resident company.[578] A qualified resident enterprise is a refers to an enterprise which is established within the territory of China pursuant to Chinese laws or an enterprise established within the territory of another country or other tax region pursuant to that country or that region's laws whose actual management or control is located in China [579].

Dividends received by a non-resident enterprise in connection with its establishment in China

Article 26 (3) of EITL provides an exemption for dividend income and other distributions paid by a resident company to a non-resident company in connection with its establishment in China.[580]

In the case of dividends from publicly listed companies, the exemption only applies where the shares have been held for a period of 12 months or longer [581]

Dividends received by certain non-resident enterprises

[576] EITL, Art 3.
[577] EITL, Art 26(2).
[578] EITLIR, Art 83.
[579] EITL, Art 3.
[580] EITL, Art 26 (3).
[581] EITL, Art 26 (2)(3), EITLIR, Art 83.

Article 27(5) of the EITL,[582] as confirmed by Article 91 of the EITLIR, provides a a reduced enterprise income tax rate of 10% for dividends paid by a resident enterprise to a non-resident enterprise with no establishment in China and to a non-resident enterprise with an establishment in China if the shareholding is not connected with the establishment.[583]

7.8.3. Tax Expenditure Identified

The Basic Standard of CAS,[584] Chapter 6 Revenue [585] and No. 14 – Revenue [586] CAS does not make a distinction between dividend income and types of income received by a shareholder that is a company. The exemption for dividend income received by a qualifying resident enterprise from another resident enterprise and the exemption for dividend income received by a non-resident income through an establishment in China therefore appear to be tax expenditures. As noted in chapter 6, since income tax is purely a creation of government unrelated to CAS, the accounting standards establish no benchmark tax rate but CAS can nevertheless be used indirectly as a benchmark to identify tax expenditures resulting from a reduced tax rate. The reduced rate for dividends paid by a resident enterprise to a non-resident enterprise with no establishment in China and to a non-resident enterprise with an establishment in China if the shareholding is not connected with the establishment thus gives rise to tax expenditure.

7. 8.4. Analysis

The two exemptions for inter-company dividends are apparent as tax expenditures if CAS is used to determine the benchmark income definition. However, in the case of a group of commonly owned companies, accounting standards allow the owners to treat the group as if it were a single entity and measure the income of the entire group using consolidated company accounting. Under consolidated company accounting, inter-group distributions are ignored as they are treated as transfers within a single

[582] EITL, Art 27. Income subject to tax exemptions and deductions shall include: Income described in Paragraph 3 of Article 3 hereof.
[583] EITLIR, Art 91.
[584] It is similar to the IFRS: Framework.
[585] CAS, Basic Standard, chapter 6, Revenue.
[586] CAS No. 14 – Revenue is similar to the IAS: No. 18 Revenue.

economic entity. Thus, to the extent the exemption applies to intra-group dividends, there is no tax expenditure.

The CAS treatment of inter-corporate dividends is consistent with the "classical" company and shareholder tax system that treats every legal person as if it were a separate taxpayer. An alternative economic view of companies is that they are artificial legal persons with no separate ability to pay so tax imposed on a company is in fact a surrogate tax or a withholding tax on the ultimate shareholders. Countries that fully adopt this economic analysis provide full imputation systems or other systems so the company tax is ultimately borne by natural person shareholders.

The Chinese income tax treatment of dividends paid to individuals subject to the individual income tax law, a full exemption for the dividends, suggests China has adopted the second view of company tax – it is a surrogate tax for the ultimate natural persons who own the company and there is no reason to tax companies except as a surrogate tax for the ultimate individual shareholders. In this view, there is no reason to impose tax on inter-corporate dividends (the surrogate tax has already been levied when the first company derived the income) and the income should thus be exempt from further tax.

In the context of Chinese income tax economic principles, the income tax exemption for inter-corporate dividends does not appear to be tax expenditure to correct a market failure or to promote a positive externality. Rather, it seems to be recognition that accounting standards are not consistent with the economic theory adopted by China in respect of company tax more generally. Under this view, the exemption is not tax expenditure.

The reduced tax rate applicable to dividends paid to non-resident shareholders is more difficult to analyse. If income is fully taxed at the company level and the single level of tax theory is adopted, there is no reason to impose any tax on distributions to non-residents. However, most countries do not extend the theory of single level taxation fully to non-resident shareholders. The reduced rate may be seen as a compromise position between the purest single tax theory and the approach used by other countries.

7.9. Non-Profit Organizations

The steady growth in numbers of Non-Profit Organizations in China proves that this sector is becoming a more and more important part of China's economic system. The Chinese government is aware of this fact and are actively trying to promote the development. The EITL, EITLIR and a number of circulars confirm tax exemption for qualifying income from Non-Profit Organisations.

7. 9.1. Accounting Treatment

The accounting standard related to the accounting treatment of exemption for qualifying income from Non-Profit Organisations are the Basic Standard of CAS, [587] Chapter 6 Revenue [588] and No. 14 – Revenue [589] (The detailed CAS is stated in Chapter 1).

7. 9.2. Tax law and Implementation Rules and Administrative Practices

Qualifying income received by non-profit organisations (NPO) that refer to organisations which fulfil all the criteria. [590] It shall not include income derived from profitmaking activities by NPO unless the government authorities of the State Council in charge of finance and taxation stipulate otherwise. [591]

On 11 November 2009, when MOF and SAT jointly issued Caishui [2009] No. 122 (Circular 122) [592] and Caishui [2009] No. 123 (Circular 123), [593] which clarify the

[587] It is similar to the IFRS: Framework.
[588] CAS, Basic Standard, chapter 6, Revenue.
[589] CAS No. 14 – Revenue is similar to the IAS: No. 18 Revenue.
[590] 1) Completed registration procedures for a non-profit making organisation in accordance with relevant laws and regulations; 2) Engaged in charitable or non-profit making activities; 3) Other than for reasonable expenses incurred with respect to the organisation, use derived income wholly for charitable or non-profit making activities within the registered scope or in accordance with the provisions of the Articles of Association; 4) Shall not distribute assets and associated interests of the organisation;5) Use remaining assets after de-registration within the registered scope or in accordance with the provisions of the Articles of Association for charitable or non-profit making purposes; or donate remaining assets along with public announcement to other organisations of similar nature and mission; 6) Founders shall not keep or enjoy any property rights over the asset invested into the organisation; 7) The salaries and welfare of employees shall be limited to a range as stipulated and shall not be used as a means to distribute the organisation's assets. The regulation on the qualification of the above mentioned organisation will be enacted by the government authorities of the State Council in charge of finance and taxation with the relevant departments of the State Council, EITL, Art 26 (4), EITLIR, Art 84(1-7).
[591] EITLIR, Art 85.
[592] The Circular on Enterprise Income Tax Exemption for Non-Profit Organisations.

scope of tax-exempt income and define the qualification of a NPO, Circulars 122 and 123 have retrospective effect from 1 January 2008.

Scope of Tax-Exempt Income

Under Circular 122, tax-exempt income of a NPO includes the following:

1. Donation from other entities or individuals;
2. Governmental subsidies, other than financial provisions pursuant to Article 7 of the EITL or income derived from services performed for the government;
3. Membership fees collected pursuant to rules issued by civil affairs or finance departments at provincial level or above; and
4. Bank deposit interest generated from non-taxable income and tax-exempt income.[594]

Qualification for Tax Exemption

According to Circular 123, a NPO can apply for tax exemption if it meets the following conditions:

1. The NPO is a public institution, social organization, foundation, civil non-enterprise entity, religious activity venue or other recognized organization, which is established or registered under relevant laws and regulations, and which passed annual inspection in the year prior to the application for tax exemption, except for a newly established NPO.

2. The NPO is engaged in public interest or not-for-profit activities primarily within China.

[593] The Circular on Management Issues Concerning Non-Profit Organisations' Eligibility of Tax Exemption.
[594] Caishui [2009] No. 122, Art1(1-4)

3. All income received by the NPO is used for public interest or not-for-profit purposes within the scope of its registration or charter, except covering relevant and reasonable expenses.

4. The NPO does not distribute its property and fruits, other than paying reasonable staff compensations.

5. Upon the dissolution, the remaining assets of the NPO shall be used for public interest or not-for-profit purposes, or be assigned as gifts to organizations with the same nature or purpose by the registration administration with the public notice, under the NPO's registration or charter.

6. A contributor, who is a legal person, an individual or an organization other than the government at whatever level, does not retain any legal rights to the property contributed to the NPO.

7. Staff salaries and benefits shall be within the regulated range without disguised distribution of the NPO's property, with average staff salary up to two times of average local salary level per capita in the previous year and staff benefits to be determined in accordance with relevant rules.

8. Taxable and tax-exempt income, costs, expenses and losses shall be separately accounted for. [595]

The qualification for tax-exemption is valid for five years. A NPO can renew its qualification within three month before the expiration. [596]

7.9.3. Tax Expenditure Identified

Under the Basic Standard of CAS,[597] Chapter 6 Revenue [598] and No. 14 – Revenue [599] CAS does not make a distinction between qualifying income from Non-Profit

[595] Caishui [2009] No. 123 , Art 3(1-7).
[596] Caishui [2009] No. 123, Art 4.
[597] It is similar to the IFRS: Framework.
[598] CAS, Basic Standard, chapter 6, Revenue.
[599] CAS No. 14 – Revenue is similar to the IAS: No. 18 Revenue.

Organisations and income derived from other organisations.

However, EITL, Art 26 (4), EITLIR, Art 84(1-7). EITLIR, Art 85. Caishui [2009] No. 122 (Circular 122) and Caishui [2009] No. 123 (Circular 123), confirm tax exemption for qualifying income from Non-Profit Organisations.

Therefore, one tax expenditure associated with qualifying income from Non-Profit Organisations. – Tax exemption, which could be recognised and calculated into accounting income under CAS.

7. 9.4. Analysis

Non-Profit Organisations make a significant contribution to the society in almost every sphere of activity, from sports, recreation, arts, culture, and heritage to emergency and social services, health, education, conservation and the environment. International experience shows almost all the government wants to further encourage Non-profit organisations through tax incentives are that they assist the government in furthering its own social objectives, such as increasing its support to those members of society in need and the provision of community benefits generally. Chinese government also assumes there will be positive externalities. Other more programs that could do it more efficiently by better targeting providing tax deduction for the expenses related to Non-Profit Organisations

7. 10. Transitional Concession

The EITL confirms that enterprises established prior to the promulgation of EITL [600] could continue enjoy preferential tax policy during the transition period.

7. 10.1. Accounting Treatment

There is no any accounting standard for this special transitional concession policy.

[600] 16 March 2007.

7.9.2. Tax law and Implementation Rules and Administrative Practices

Under EITL Art 57, Enterprises, which have been approved to be established prior to the promulgation of EITL and which enjoy preferential treatment in the form of reduced enterprise income tax rates in accordance with previous tax laws and regulations, in accordance with the stipulation from the State Council, are allowed for a gradual transition to tax rates stipulated in this Law over the five year period [601]beginning from the effective date of this Law; in accordance with the stipulation from the State Council;

Enterprises currently enjoying preferential treatment in the form of enterprise income tax reduction or exemption may continue to enjoy such treatment until the end of the preferential treatment period, but enterprises which are entitled to enjoy preferential treatment but have not been profitable yet to enjoy the preferential treatment would have the commencement of the preferential treatment period coincide with the year this Law comes into effect. [602]

7. 10.3. Tax Expenditure Identified

EITL Art 57 states that enterprises established prior to the promulgation of EITL could continue enjoy preferential tax policy during the transition period. However, CAS is silence for the transitional tax concession policy. Therefore, all the preferential tax treatment comes to tax expenditures, such as tax deduction and low tax rate,

7. 10.4. Analysis

The tax police for the transition period of EITL are relative to the matter of fairness. Companies invested on the expectation that they would be entitled to a lower rate. Want to assure investors that there will not be sudden policy shifts that reduce the value of their investments. This is important in the former socialist country where there may be a lingering concern about nationalisation of private property either directly, as happened in the past, or indirectly, but sudden changes in rules or tax rates.

[601] 2008-2013.
[602] EITL, Art 57.

7.11. Conclusion

Tax expenditures revealed by using accounting standards as a benchmark fall into nine broad categories. Some of these may be explained as responses to market failures but most appear to be aimed at supporting perceived positive externalities from greater investment in favoured activities or areas. The total cost of these tax expenditures is unknown and there has been no study by the government of the effectiveness of the tax-based subsidies. If the government were to accept tax expenditure analysis and providing a costing for the identified tax expenditures, a full tax expenditure analysis could be undertaken. It appears that in many cases it would be difficult to justify the tax expenditures and to the extent a case could be made for subsidies, the current designs appear to provide very poorly targeted aid in many cases.

Chapter 8 Conclusion

8.1. Summary of the Whole Thesis

Initially, transitional countries focused attention on the usefulness of tax expenditures in shaping prudent and transparent fiscal policy. In adopting a market economy, transitional countries began commonly to use tax expenditures as major fiscal policy instruments. However, with limited theoretical understanding and experience with applying tax expenditures, transitional countries now confront not only revenue losses higher than they had anticipated but also the erosion of their tax bases in systems that generally have been in existence for less than 20 years. Since 1980, analysis of tax expenditures has attracted intense public interest in the public policy literature, particularly in China.

China has revised its tax laws to bring them closer in substance, as well as name and form, to those found in more advanced economies. However, Chinese public finance still lags in the use of modern analytical tools to evaluate the operation of its tax system. One of the most important tools used market economics is tax expenditure analysis.

8.1.1. Tax Expenditure Research in China

While western academics commenced researching tax expenditure in the 1960s, academics in China have only turned their attention towards this topic since the mid-1980s. Chinese scholars were bringing the concepts and literature to China. Support from the Ministry responsible for developing the tax system followed.

The establishment of Chinese tax expenditure system by drawing on the experience of western countries has been an important element of Chinese fiscal reform. The research on tax expenditure in China has been conducted for more than 20 years and significant developments have been achieved in a variety of basic principles. However, research on tax expenditure continues to lag behind in China, and is still at the

preliminary stage in terms of understanding the western experience and fusing theoretical research with the systematic establishment.

8.1.2. Chinese Enterprise Income Tax System

The PRC was established on 1 October 1949. China has successively undergone three different economic systems since the establishment of the PRC, (a) the traditional planned economy (1949-1977), (b) the planned commodity economy (1978-1993), and (c) the socialist market economy (1994-to date).

Meanwhile, Chinese enterprise income tax system was established gradually with the development of its economic system, which has gone through multiple transformative stages, exhibiting different characteristics at each stage as a result of the interaction of the changing economic system of the time. Due to the differences of the economic systems at different stages, the taxpayer, tax rate tax items and effects of the Enterprise Income Tax system vary significantly at each stage.

8.1.3. Chinese Accounting Standards

An accounting system that presents a fair and true picture of a firm's financial position is a feature essential to the success of a market economy. In the case of China, the development of accounting principles and the shift to a market economy did not occur in tandem. Adoption of a modern accounting system was delayed by socialist officials' focus on accounting processes and failure to understand the importance of accounting principles. The understanding of modern accounting principles came only recently and in a number of respects China's accounting system remains somewhat out of synch with modern accounting regimes, though the gap is closing rapidly as Chinese accounting standards align more closely with IFRS and more sectors of the economy are brought under CAS.

8.1.5. Benchmark War and Determining the Appropriate Benchmark

Since the adoption of the first tax expenditure budget, there has been an ongoing debate in more advanced economies on the appropriate benchmark to use for identifying tax expenditures. It is common for the first section in tax expenditure budgets to attempt to justify the benchmark used in that budget and a central focus of the academic literature since Stanley Surrey's first articulation of the concept has been on the appropriate benchmark.

It is true there is enormous debate over the benchmark; almost all the debate takes place on the margins. There is acceptance of the vast majority of tax expenditures identified almost all tax expenditure budgets. Debates about whether the benchmark should be accruals or realisation for capital gains or whether income should include gifts, and so on, are irrelevant to the issues examined in tax expenditure budgets such as accelerated depreciation for ships, credits for research and development, exemptions for high technology industries, etc.

Determining the appropriate benchmark for identifying tax expenditures has proved to be the most contentious issue in tax expenditure analysis around the globe in every jurisdiction and within multilateral groups such as the OECD. In this environment, nominating a new base, "accounting standards", might be seen as a courageous or naïve proposal.

In the context of China, however, there are a number of factors that make adoption of an "off the shelf" benchmark sensible. The very fact that the issue has been debated so much in more developed countries lends strength to the case for a ready-made standard. The debate in some countries has extended for over 46 years.

China has no tax expenditure budget. The most important thing is to start the process. A clear, unambiguous, well-known, internationally-recognised standard is a useful starting point. China can follow the rest of the world and spend decades debating the issues around the benchmark but for the purpose of establishing a starting point for

the debate, accounting standards, which purport to be neutral and value free, is a simply and logical base.

Elsewhere, every country started process of developing tax expenditure reports with a debate about the benchmark tax base. But everyone ended up with something closely resembling accounting standards. Rather than reproduce 46 year base war in China and end up with a benchmark that looks very similar to accounting standards, China should jump directly to accounting standards as its starting point for tax expenditure identification.

8.1.6. Tax Expenditures identified using Accounting Standards as a Benchmark

Tax expenditure analysis involves two distinct steps. The first is the identification of tax rules that deviate from a benchmark, in this case accounting standards, and thus amount to tax expenditures. The second is an analysis of those measures as the equivalent of spending programs to influence economic behaviour and achieve consequent social or economic objectives. The analysis assumes that in ordinary circumstances resources will be optimally distributed by market forces yielding the most appropriate level of investment in each industry. A concession that creates a bias to shift investment into particular activities or investments can be justified if there is some sort of market failure inhibiting the optimal amount of investment in a field or a positive externality from the activity.

With this framework, the analysis of each of the multiple tax expenditures that fell into the nine groups identified in chapter seven sought to answer two questions:

1. Is there a reason for the government to interfere in the market (a market failure or a positive externality); and

2. If there is, does the subsidy by way of tax expenditure address it efficiently or are there other programs that could do it more efficiently by better targeting the people who need the subsidy.

The analysis identified a considerable number of tax expenditures of questionable value.

8.2. Policy Implication

Tax expenditures reporting comprising identification of tax expenditures and estimation of their revenue cost can be an important initial step to achieve improved policy analysis of China's public finance system.

At the macro level, the analysis opens the door for consideration of public finances more generally. Making subsidies provided through the tax system transparent opens them to wider scrutiny by the general public and better technical analysis by scholars and other industrial sectors. The resulting analysis may reveal whether it is appropriate for the state to be intervening in the economy to address a specific problem or achieve an identified benefit and, if so, whether tax relief is a better tool than the alternatives of direct expenditures or regulations to control behaviour.

At the micro level, if it is concluded intervention is warranted and tax expenditures are the optimal tool, analysis of tax expenditures can reveal whether they are efficiently targeting the intended beneficiaries or whether alternative designs would improve their effectiveness.

8.3. Research Limitations

Comparisons of the tax expenditure analysis developed in this thesis with the tax expenditure budgets used in market economies revealed two limitations to the findings.

There is no data available from SAT on take-up of various tax expenditures and consequent revenue cost; without the revenue cost it is difficult to complete a comprehensive cost-benefit analysis as is done for ordinary direct expenditures.

Moreover, the limited secondary materials such as legislative explanatory memoranda or government tax policy reports or commissions in China that can be used to identify the objectives behind various tax expenditures. So, have to speculate on intended goals of some tax expenditures. This contrasts with the situation in market economies where tax expenditures are justified and often costed before adoption.

8.4. Future Research

This thesis explains in some detail how accounting standards can be used as a benchmark to identify tax expenditures in the Enterprise Income Tax. However, there is a need for the development of a benchmark for VAT that can easily be applied in transitional economies and an analysis of VAT tax expenditure identified using this benchmark.

This thesis looks at tax expenditure. Tax expenditures are defined and measured as deviations from a benchmark. Only positive tax expenditure were considered – that is, concessions that come at a revenue cost. It did not seek to identify and analyse negative tax expenditures where tax rules generate higher tax burdens than those that would be applied under a tax law based on accounting principles.

For many, negative tax expenditure represents a disproportional statutory tax burden on a particular kind of income or economic activity. As an outlay equivalent, it may be thought of as a fee or transfer payment from the taxpayer to the Treasury. However, for others, negative tax expenditure is simply a tax and thus no special accounting is necessary. Indeed, the United States Budget Act does not refer to negative tax expenditures. Nonetheless, a certain respect for symmetry requires that more thought and analysis be given to negative tax expenditure reporting. [632]

Examples of such negative tax expenditures identified using accounting standards in Chinese Enterprise Income Tax include (1) Charitable donations; (2) Surcharge on late tax payments; (3) Fines, penalties, and losses incurred through confiscation of

[632] Rosanne Altshuler and Robert Dietz, 'Reconsidering Tax Expenditure Estimation: Challenges and Reforms' the 2008 working paper 20.

property;(4) Sponsorship fees; (5) Unapproved provisions; (6) Depreciation for fixed assets;(7) Regarded as sales of products;(8) Interest expenses;(9) Entertainment expenses;(10) Advertising expenses and marketing;(11) Education Expense.

Moreover, it is need to test the accounting standard benchmark as the basis for identification of tax expenditures in another developing country with a different tax system (one not based on circulars, implementation regulations and other sources outside the law).

Finally, an evaluation of the data collected for the development of tax expenditure analysis of the Enterprise Income Tax in China showed nine groups in Chapter 7 in which the research program could be expanded in the future.

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