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Tax Transplants and the Critical Role of Processes: A Case Study of China

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Abstract:

This paper seeks to explore the above question by drawing insights from existing literature. The existing body of literature is rich in documenting the phenomenon of legal transplants, theorising why legal transplants take place and presenting the debate on the relevance of local culture to the adaptation of the transplants. In terms of tax transplants, there is an emerging strand of literature that examines the unique characteristics of tax transplants, the common core of tax law, and the global tax convergence. However, there is a lack of analysis focusing on the critical role of processes in legal and tax transplants. Through a case study of the Chinese tax transplants, this paper seeks to test the theories of legal transplants and to demonstrate the importance of process in successful transplants. It examines two types of processes: tax processes and transplantation processes. Tax processes include the political process, administrative and compliance process, and dispute resolution process. Tax transplantation processes include the process of selection, translation, adoption and adaptation.

The central claim of this paper is that processes matter in tax transplants. Taxation science is capable of being borrowed and duplicated. Tax processes in a country are defined by its general political, legal and institutional culture, and thus vary from country to country. Many tax rules or principles are the outcomes of tax processes in the country of origin and their implementation depends on a certain set of administrative processes. The transplantation of a tax rule or principle is likely to fail if it is done without the necessary processes, or at least, without a full appreciation and accommodation of the differences in processes.

Keywords:

Tax Transplant, Tax Law, Chinese Tax Transplants

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Tax Transplants and the Critical Role of Processes: A Case Study of China

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1. Introduction

- Daughter: Daddy, my friends and I will get a gift basket tomorrow for our fundraising efforts at school.
- Father: Good. Make sure you let your friends choose first and you take whatever is left.
- Daughter: No. We will take turns in picking what each of us wants, one at a time, until we divide up all the gifts.
- Father: That sounds good, too.

The conversation above is between my daughter and her dad. Although both agree that sharing the gifts is important, they have a different approach to sharing. The daughter has a process that is fair to both her and her friends. The father's idea of sharing requires his daughter to be virtuous and to put her friends' interests first. Having grown up in Canada, the daughter is accustomed to using rules and processes, whereas the father holds traditional Chinese values dearly and emphasises personal virtues.

How does this dialogue relate to tax transplantation? It makes me contemplate the importance of process in transplanting good tax ideas or 'scientific' tax rules from the West to China. China and Western countries share the same general objectives of taxation: to generate revenue to finance public expenditures, to redistribute social income, and to regulate private economic and social activities. China and the West also face similar tax problems, such as how to tax high income earners and multinational corporations. Yet China and the West have different ways of achieving these objectives and dealing with these common problems. To begin with, the political and legal systems of China and the West are different. The relationship between individuals and the state and the approach to problem solving are also viewed from different angles. When China implements a tax rule from the West to solve an apparently similar tax problem, to what extent do processes matter? In other words, if

the outcome of a process in the West is transplanted to China, can it work well in China without similar processes?

This paper seeks to explore the above question by drawing insights from existing literature. The existing body of literature is rich in documenting the phenomenon of legal transplants, theorising why legal transplants take place and presenting the debate on the relevance of local culture to the adaptation of the transplants. In terms of tax transplants, there is an emerging strand of literature that examines the unique characteristics of tax transplants, the common core of tax law, and the global tax convergence. However, there is a lack of analysis focusing on the critical role of processes in legal and tax transplants. Through a case study of the Chinese tax transplants, this paper seeks to test the theories of legal transplants and to demonstrate the importance of process in successful transplants. It examines two types of processes: tax processes and transplantation processes. Tax processes include the political process, administrative and compliance process, and dispute resolution process. Tax transplantation processes include the process of selection, translation, adoption and adaptation.

The central claim of this paper is that processes matter in tax transplants. Taxation science is capable of being borrowed and duplicated. Tax processes in a country are defined by its general political, legal and institutional culture, and thus vary from country to country. Many tax rules or principles are the outcomes of tax processes in the country of origin and their implementation depends on a certain set of administrative processes. The transplantation of a tax rule or principle is likely to fail if it is done without the necessary processes, or at least, without a full appreciation and accommodation of the differences in processes.

The rest of this paper proceeds as follows. Part 2 provides a brief review of the existing literature on legal transplants and the emerging literature on tax transplants. It notes the debate about tax common core and culture-specific tax transplants and the

phenomenon of tax transplants in China. Part 3 discusses tax processes and argues why tax processes should be considered in tax transplants from one culture to another. Tax law is the result of a political and legal process. Taxation is more like science than art. Like other scientific disciplines, such as medicine, taxation is about both knowledge and process. Part 4 presents a case study of the Chinese tax transplants and the importance of selecting and adapting transplants. It shows that the transplantation of the arm's length principle is more successful than the transplantation of the progressive tax principle, largely because China introduced the necessary tax processes in respect of the former, but not the latter. Part 5 concludes the paper with some observations and comments.

2. Legal (Tax) transplants

2.1 Evidence of Legal and Tax transplants

'Legal transplants' is a term coined by Alan Watson that refers to the 'moving of a rule or a system of law from one country to another, or from one people to another'.¹ There is a rich body of literature documenting the evidence of legal transplants as the 'most fertile source of legal change in the world'.²

2.1.1 Global Tax Convergence

As an observable fact, tax law appears to be convergent at a global level in terms of the choice of taxes (income, property, sales or consumption), the underlying principles (fairness, efficiency and simplicity) and the levels of tax burdens.³ When faced with essentially the same tax problems, countries tend to adopt similar laws to solve these

¹ A Watson, *Legal Transplants: An Approach to Comparative Law* (1974), at 95.

² *Ibid*; O Kahn-Freund, 'On Uses and Misuses of Comparative Law' in O Kahn-Freund, *Selected Writings* (Stevens Publishing, London, 1978).

³ M Livingston, 'Tax Culture, Tax History and the Limits of Convergence: A Comment on Professor Likhovski's Article' (2010) 11(2) *Theoretical Inquiries in Law* 18.

problems, which results in convergence. In the area of VAT, there is a remarkable degree of similarity in the over 100 countries that have adopted VAT.⁴ To a lesser degree, corporate income tax has recently enjoyed a greater degree of convergence, thanks to a greater mobility of capital and to globalisation.⁵

Convergence in tax policy amongst members of the European Union and the Organization for Economic Co-Operation and Development (OECD) is perhaps the most comprehensive.⁶ Some tax rules and norms are virtually universal; for example, the arm's length principle is found in virtually every one of 3000 or so bilateral tax treaties and the domestic law of most countries.⁷ The convergence of tax laws has reached such a stage that it is unthinkable for any country to adopt a new consumption tax that is vastly different from the VAT. It is equally unthinkable for any country to create an income tax system for the first time that deviates from the accepted international norms. Global tax issues, such as base erosion, profit shifting and stateless income tax planning (that is, moving income from the production and market countries to low-tax jurisdictions),⁸ are expected to lead to further convergence in tax laws governing the taxation of multinational corporations.

⁴ R Bird and P Gendron, *The VAT in Developing and Transitional Countries* (Cambridge University Press, 2007); K James, 'An Examination of Convergence and Resistance in Global Tax Reform Trends' (2010) 11 *Theoretical Inquiries in Law* 475.

⁵ J Slemrod, *Are Corporate Tax Rates, Or Countries Converging?* (2001) <<http://www.bus.umich.edu/OTPR/WP2001-12paper.pdf>>; C Garbarino, 'An Evolutionary and Structural Approach to Comparative Taxation: Methods and Agenda for Research' (2009) 57 *American Journal of Comparative Law* 677; R S Avi-Yonah, *International Tax As International Law: An Analysis of the International Tax Regime* (Cambridge Tax Law Series, Cambridge University Press, 2007); R S Avi-Yonah, N Sartori and O Marian, *Global Perspectives on Income Taxation Law* (Oxford University Press, 2011); R S Avi-Yonah, 'Tax Convergence and Globalization' (July 8, 2010). U of Michigan Law & Econ, Empirical Legal Studies Center Paper No. 10-019; U of Michigan Public Law Working Paper No. 214. Available at SSRN: <http://ssrn.com/abstract=1636299> or <http://dx.doi.org/10.2139/ssrn.1636299>.

⁶ For further discussion, see F J Delgado and M J Preseno, *Tax Policy Convergence in EU: An Empirical Analysis* (2008) <<http://www.ugr.es/~montero/XVIeep/93.pdf>>; G Vintila, *Fiscal Pressure and Tax Mix Convergence in the European Union* (2012) <<http://www.ibimapublishing.com/journals/JEERBE/2012/295339/295339.pdf>>; Ken Messere, Flip de Kam and Christopher Heady, *Tax Policy: Theory and Practice in OECD Countries* (Oxford University Press, 2003), and V Tanzi, *Tax Systems in the OECD: Recent Evolution, Competition and Convergence* (2010) <<http://aysps.gsu.edu/isp/files/ispwp1012.pdf>>.

⁷ Avi-Yonah, above n 5; Garbarino, above n 5.

⁸ H J Ault, 'Some Reflections On the OECD and the Sources of International Tax Principles' (2013) 70(12) *Tax Notes International* 1195, 1195–201; OECD Report For The G8 Summit, 'A Step Change In Tax Transparency: Delivering a Standardised, Secure and Cost Effective Model of Bilateral Automatic Exchange for the Multilateral

2.2.2 Tax Transplants in China

The modern evolution of Chinese law is largely a process of legal transplants in the name of modernisation.⁹ Chinese tax law is a clear example. Transplanting foreign tax laws into China is a recent phenomenon. China's traditional tax system originated in 2023 BC when the first state was created. It was home-grown until the Opium War in 1842.¹⁰ Traditional taxes included land taxes and excises on salt, tea, liquor and other goods. After the Opium War, Western influences became a factor and China introduced toll charges (*li jin* 厘金), stamp duties and customs duties.¹¹ Income tax was drafted by the Nationalist Government in 1928 but was never enacted.¹² All of these taxes were abolished and replaced with a new system soon after the establishment of the People's Republic.¹³ The function of taxation diminished when the socialist economic structure was entrenched and private ownership of property and entrepreneurship were limited. Taxation revived during the late 1970s, when China embarked on the path of economic reforms-and non-public actors were allowed to operate in the economy and some individuals were allowed to become rich first. The

Context' (June 2013) <<http://www.oecd.org/newsroom/oecd-reports-to-g8-on-global-system-of-automatic-exchange-of-tax-information.htm>>; E D Kleinbard, 'Through a Latte, Darkly: Starbucks' Window into Stateless Income Tax Planning', Center in Law, Economics and Organization, Research Papers Series No. C13-9; Legal Studies Research Paper Series No.13-10, available at <http://ssrn.com/abstract=2264384>; J G Gravelle, *Tax Havens: International Tax Avoidance and Evasion*, CRS Report for Congress, (23 January 2013) <www.crs.gov>, R40623; and H Grubert and R Altshuler, 'Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax' (1 April 2013) <<http://www.wrn.com/abstract=2245128>>.

⁹ J. Chen, 'Modernisation, Westernisation and Globalisation: Legal Transplant in China' in J Oliveira and P Cardinal (eds), *One Country, Two Systems, Three Legal Orders: Perspectives of Evolution* (Springer, 2009) 91.

¹⁰ For an excellent account of the history of taxation in China and its relationship to culture, see Weng Lihua, *Comprehensive Analysis of Chinese Fiscal and Tax Culture* (China Finance and Economics Press, 2nd ed, Beijing, 2011) (in Chinese).

¹¹ Ibid at 68–9.

¹² Ibid at 70.

¹³ The Administrative Council promulgated 'Rules for the Implementation of National Tax Policies' in January 1950, which created a new tax system for China. For more discussion of the evolution of the Chinese tax system, see J Li, *Taxation in the People's Republic of China* (1991) *New York: Praeger*. [Publisher and edition details if available]

notion of income tax was introduced in Article 8 of the 1979 Chinese-Foreign Equity Joint Venture Law.¹⁴

The first pieces of modern income tax legislation are the Chinese-Foreign Equity Joint Venture Income Tax Law and the Individual Income Tax Law.¹⁵ These two tax laws include features found in income tax laws of other countries, but are not a carbon copy of any specific country's law. The structure of the law and many key concepts reflect the so-called international tax norm. For example, tax liability is based on personal and territorial nexus with China, the tax base is net income, and foreign taxes are creditable.¹⁶ American tax scholars, such as Harvey Dale, Oliver Oldman, Stanley Surrey, Richard Pomp and Jerome Cohen, were among the early international experts who provided training to Chinese officials.¹⁷ Evidence of their teachings can be found in these two laws. The 1981 Foreign Enterprise Income Tax Law¹⁸ has 19 articles and provides for Chinese source-based taxation of foreign enterprises. Subsequent income tax laws, especially the 2007 Enterprise Income Tax Law,¹⁹ continue to include foreign tax principles, norms, concepts and rules. As such, the current income tax system in China is a hybrid of home-grown and transplanted laws.

¹⁴ It states: 'From the gross profit earned by an equity joint venture, after payment of the venture's income tax in accordance with the provisions of the tax laws of the People's Republic of China ... and the net profit shall be distributed to the parties to the venture in proportion to their respective contributions to the registered capital'.

¹⁵ The Income Tax Law of the People's Republic of China Concerning Joint Ventures with Chinese and Foreign Investment adopted by National People's Congress and promulgated on 10 September 1980. The Income Tax Law applicable to Foreign Enterprises, adopted by the National People's Congress in 1981. Both were abolished with the promulgation of Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises, promulgated by the National People's Congress on 9 April 1991. For an overview of the history of the Chinese tax system, see A Easson and J Li, 'Taxation of Foreign Business and Investment in the People's Republic of China' (1985–1986) *New Jersey International Law & Business* 666.

¹⁶ Ibid Easson and Li.

¹⁷ R D Pomp and S S Surrey, 'The Structure of Taxation in the People's Republic of China' (1979) 20 *Virginia J of Int'l L* 1.

¹⁸ The Law of People's Republic of China on Foreign Enterprise Income Tax, promulgated on 8 December 1981 by the 4th Session of the National People's Congress.

¹⁹ Enterprise Income Tax of the People's Republic of China Art 58 (promulgated at the 5th session of the 10th National People's Congress of China on 16 March 2007 and issued by Order of President No 63 on 16 March 2007) (the 'EIT Law'); Implementation Regulations for the Enterprise Income Tax Law of the People's Republic of China, National Legislation IBFD was promulgated by State Council on 28 November 2007 and issued by the Order of the State Council No 512 on 6 December 2007 (the 'EIT Regulations'). See J Li, 'Fundamental Enterprise Income Tax Reform in China: Motivations and Major Changes' (2007) 61 *Bulletin for Intl Taxation* 12; and J Li and H Huang, 'Transformation of the Enterprise Income Tax: Internationalization and Chinese Innovations' (2008) 62 *Bulletin for Intl Taxation* 275.

The Chinese Value-added Tax (VAT) was also a transplant. It was first introduced in 1980 to apply, on a trial basis, to companies manufacturing machinery, agricultural equipment and domestic appliances.²⁰ VAT then expanded to apply to all domestic enterprises in 1984²¹ and to foreign-investment enterprises and foreign enterprises in 1994.²² The scope of the VAT does not cover services (with the exception of processing, repair and maintenance), which are subject to a single-stage Business Tax. In 2011-2012, VAT was expanded to some services in selected pilot jurisdictions, such as Shanghai, Tianjin and Beijing.²³ The VAT system is a transplant, with major modifications to suit China's needs. One major modification is the denial of input credits for capital expenditures and another is the limitation of the tax base to goods.²⁴

Evidence of tax transplantation and tax convergence goes beyond formal laws. The interpretation of domestic laws by reference to international tax norms and best practices is often adopted. One example is the “Measures for the Implementation of Special Tax Adjustment (Trial)” issued by the State Administration of Taxation (SAT) in 2009. This document reflects the international tax norms on transfer pricing.²⁵ China's extensive tax treaty network also encourages the convergence of Chinese tax

²⁰ Ministry of Finance, *Notice on the Levy of VAT on a Trial Basis on Industrial Companies and Reform Industrial and Commercial Tax Collection Methods* (11 July 1980).

²¹ Regulations of the People's Republic of China on VAT (Draft), promulgated by the State Council on 18 September 1984.

²² Interim Regulations of the People's Republic of China on Value-Added Tax, promulgated by State Council on 13 December 1993. On 22 February 1994, the Standing Committee of the National People's Congress issued The Decision to Subject Foreign Investment Enterprises and Foreign Enterprises to VAT, Consumption Tax, Business Tax and other Taxes, effective on 1 January 1994.

²³ China Daily, 'China Expands Value-added Tax Reform', 2 October 2012 <http://www.chinadaily.com.cn/business/2012-10/02/content_15795129.htm>.

²⁴ For further discussion of Chinese VAT, see Y Xu, 'Putting the "Value Added" in China's VAT' (2010) 58(6) *Tax Notes International* 487.

²⁵ State Administration of Taxation, (2009) *Guo Shui Fa* No 2, 8 January 2009, effective on 1 January 2008. Administrative circulars issued prior to 2008 were revoked. The SAT has issued several sets of measures related to transfer pricing, such as 'How to Deal With the Enterprise Income Tax on the Service Charges Paid to a Parent Company by a Subsidiary Company' (2008) *Guo Shui Fa* No 86; 'Related Tax Policy Issues on the Pre-tax Deduction Standard of the Interest Expenses Paid to Related Parties' (2008) *Guo Shui Fa* No121; 'Trial Measures on the Application for Mutual Agreement Procedures (MAP) by Chinese Residents and Citizens'; SAT circular, (2005) *Guo Shui Fa* No 115.

laws with those of other countries.²⁶ Such convergence is part of the trend of global tax convergence.

2.2 Literature on legal transplants

2.2.1 Theories on why legal transplants take place

“The act of borrowing is usually simple. To build up a theory of borrowing on the other hand, seems to be an extremely complex matter”.²⁷ Comparative law scholars have traditionally been more interested in observing the occurrence of legal transplants than in offering a theoretical explanation of why legal transplants happen.²⁸ At the moment, the main theories are grounded in prestige, efficiency (or law and economics), law and development, and globalisation.

According to the theory of prestige, foreign law enjoys certain prestige over domestic law, especially when the foreign country is perceived as more advanced.²⁹ The prestige theory is related to the theory of formants, which focuses on law as a social activity and argues that legal process is seen as a competitive arena with different groups of elites (or formants), such as lawmakers, judges, lawyers, and legal scholars, including foreign advisors.³⁰ The incentives for these actors in legal transplantation are

²⁶ See J Li, ‘The Rise and Fall of Chinese Tax Incentives and Implications for International Tax Debates’ 8 *Florida Tax Rev* 670 (also available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1087382); [LINK TITLE DOES NOT MATCH] and W Cui, ‘The China-United Kingdom Tax Treaty’ (2013) 67(6) *Bulletin for International Taxation* 271.

²⁷ A Watson, ‘Aspects of Reception of Law’ (1996) 44(2) *American Journal of Comparative Law* 335, at 335. See also A Watson, ‘Legal Transplants and European Private Law’ (2000) 4.4 *Electronic Journal of Comparative Law* <<http://www.ejcl.org/ejcl/44/44-2.html>>.

²⁸ U Mattei, ‘Three Patterns of Law: Taxonomy and Change in the World’s Legal Systems’ (1997) 45(1) *American Journal of Comparative Law* 5; J Smits, ‘The Harmonization of Private Law in Europe: Some Insights from Evolutionary Theory’ (2002) 31 *Georgia Journal of International and Comparative Law* 79; E Özücü, ‘A Theoretical Framework for Trans-Frontier Mobility of Law’ in R Jagtenberg, E Özücü and A J De Roo (eds), *Transfrontier Mobility of Law* (Kluwer Law International, 1995) 14.

²⁹ R Sacco, ‘Legal Formants: A Dynamic Approach to Comparative Law’ (1991) 39(1) *American Journal of Comparative Law* 343; A Gianmaria, ‘By Chance and Prestige: Legal Transplants in Russia and Eastern Europe’ (1995) 43(1) *American Journal of Comparative Law* 93.

³⁰ *Ibid* Sacco; H Spamann, ‘Contemporary Legal Transplants — Legal Families and the Diffusion of (Corporate) Law’ (2009) *Brigham Young University Law Review* 1813; J Ohnesorge, ‘Beijing Consensus Anyone?’ (Symposium: The Future of Law and Development, Part V) (2010) 104 *Northwestern University Law Review Colloquy* 257; D M Trubek and A Santos, *The New Law and Economic Development: A Critical Appraisal* (2006).

significant factors in determining what to transplant and how well the transplants work.³¹ Judges and lawyers play a unique role in transplanting foreign laws.³²

The efficiency theory is advocated by some comparative law and economics scholars.³³ It suggests that economic efficiency is the main reason for legal transplants. If a doctrine enjoys a wide success in the competitive arena of international legal thinking and practice, it means that this doctrine is more efficient than its alternatives. Borrowing legal rules may also reduce the cost of developing indigenous rules. Where ideological concerns are less strong, efficient convergences are more likely to occur. Laws that regulate economic transactions in one country can be more readily transplanted to another country.³⁴

The law and development movement includes transplanting the Western rule of law, institutions and legal doctrines to less developed countries.³⁵ The Western legal system is advocated by local policy makers as enhancing economic development. The logic seems quite straightforward: Western economies are more developed and such development is predicated on the legal system. International institutions, such as the World Bank and the International Monetary Fund, have tied financial assistance packages to countries with legal reforms.

³¹ F Schauer, 'The Politics and Incentives of Legal Transplantation' in Joseph S Nye (ed), *Governance In A Globalizing World* (Brookings Institution Press, 2000).

³² N Garoupa and A Ogus, 'A Strategic Interpretation of Legal Transplants' (2006) 35(2) *Journal of Legal Studies* 339.

³³ W Ewald, 'Comparative Jurisprudence (1): What Was It Like to Try A Rat?' (1995) 143 *Penn L Rev* 1889; Mattei, above n 28; A Ogus, 'Competition Between National Legal Systems: A Contribution of Economic Analysis to Comparative Law' (1999) 48 *The International and Comparative Law Quarterly* 405.

³⁴ E Buscaglia and W E Ratliff, *Law and Economics in Developing Countries* (2000).

³⁵ See, for example, D Berkowitz, K Pistor and J F Richard, 'The Transplant Effect' (2003) 51(1) *American Journal of Comparative Law* 163; A Gelpern, *Law & Development Narrow and Law & Development Broad*, In *Symposium: The Future of Law and Development, Part I* (2009) 104 *Northwestern University Law Review Colloquy* 164; F Schauer, 'The Politics and Incentives of Legal Transplantation' (2000) Working Papers at Centre of International Development at Harvard University, <http://www.hks.harvard.edu/var/ezp_site/storage/fckeditor/file/pdfs/centers-programs/centers/cid/publications/faculty/wp/044.pdf>; R Peerenboom, 'What Have We Learned About Law and Development? Describing, Predicting and Assessing Legal Reforms in China' (2006) 27 *Michigan Journal of International Law* 823.

In the age of globalisation, competitive pressures force many less developed countries to harmonise their legal systems with those of capital-exporting countries by incorporating foreign legal frameworks that firms in advanced economies think will enhance their security and productive efficiency. Even among developed countries, there is a growing ‘Americanization’ of laws in the European Union and amongst members of the OECD.³⁶ Yet, the transplantation of American laws has not led to a complete harmonisation due to well-entrenched social and political differences among countries.³⁷

All of the above theories seem to help explain the phenomenon of legal transplantation to China. China rationalises the borrowing of Western laws governing economic transactions on the ground that they are rational and advanced.³⁸ China’s desire to attract foreign direct investment during the early years of its economic reform made it imperative for China to adopt laws that appear similar to foreign investors, including tax laws, corporate and commercial laws, and intellectual property laws. China’s accession to the World Trade Organisation also deepens the transplantation process. China borrowed Western laws even in areas of public law, such as criminal procedures.

2.2.2 Determinants of Successful Legal Transplants

There is little agreement among scholars on what makes a transplant work and how to measure success.³⁹ However, literature suggests that, in general, whether or not a transplant can adapt and survive depends on both internal and external factors. Internal

³⁶ L A Mistelis, ‘Regulatory Aspects: Globalization, Harmonization, Legal Transplants, and Law Reform — Some Fundamental Observations’ (2000) 34 *International Lawyer* 1055.

³⁷ R A Kagan, ‘Globalization and Legal Change: The “Americanization” of European Law?’ (2007) 1 *Regulation & Governance* 99; J Mertus and E Breier-Sharlow, ‘Power, Legal Transplants and Harmonization’ (2003–4) *University of Detroit Mercy Law Review* 81; T C Halliday and P Osinsky, ‘Globalization of Law’ (2006) 32 *Annual Review of Sociology* 447–70.

³⁸ J F Chen, *Chinese Law: Context and Transformation* (Martinus Nijhoff Publishers, 2008) 70.

³⁹ H Kanda and C Milhaupt, ‘Re-examining Legal Transplants: The Director’s Fiduciary Duty in Japanese Corporate Law’ (2003) 51(4) *American Journal of Comparative Law* 887.

factors would be the quality of the rule itself (in organisms these would be the genes or the DNA). External factors include local legal culture, social norm, political conditions and economic conditions, which is collectively referred to as environmental factors.⁴⁰

A legal system or rule has a greater chance of success in transplantation if it is of good quality. Quality can be measured by factors such as: whether it is regarded as ‘good’ in the home jurisdiction, whether it has been transplanted into a different country and taken root in that country, whether it has been codified into an international treaty, whether it is controversial at home or abroad, and whether it is based on a sound theory. For example, the system of rule of law has been tested in Western democracies and embraced by many developing countries, and its genetic quality is arguably good.

The type of transplants also matters. Some laws and rules are more ‘mechanical’ or ‘technical’ and thus are easier to transplant. Examples include laws regulating economic relations and market transactions. The ‘invisible hand’ that regulates market behaviour is arguably ‘global’. On the other hand, some laws and rules are more ‘personal’ or ‘social’ and are therefore more sensitive to the social environment. Examples include laws regulating social relationships and the relationships between the state and its citizens (such as constitutional law, criminal law, and family law). As such, public law is harder to transplant than private law. For example, Kahn-Freund distinguishes between various ‘mechanical’ and ‘organic’ transplants and argues that transplants of the ‘organic’ type depend mainly on their interlocking with specific power structures of the societies involved.⁴¹

The relevance of environmental factors, such as social, legal and political culture and economic conditions, to the success of legal transplants is controversial. One school of

⁴⁰ J L Nolan, *Legal Accents, Legal Borrowing: The International Problem-Solving Court Movement* (2009); G Teubner, ‘Legal Irritants: How Unifying Law Ends up in New Divergences’ in P A Hall and D Soskice (eds), *Varieties of Capitalism* (Oxford University Press, 2001).

⁴¹ Kahn-Freund, above n 2, 303.

thought maintains that the process of legal transplantation is indicative of the autonomy of law. The representative of this school is Alan Watson, the ‘father’ of legal transplants. Laws are instruments to solving common problems in different societies. Legal evolution takes place rather insulated from social changes. The success of legal transplants can be explained by a highly developed autonomy of the modern legal profession.⁴² The recent export of Western laws and institutions to developing and transition countries seems to be influenced by this thinking.

Another school of thought argues that law is embedded in society and that legal institutions and norms transferred from one system to another can only survive if there is a fit between the two systems and the environment of the borrowing country. This is the culturalists’ position which is also consistent with the evolutionary theory of law that sees adaptation of a rule to the local culture as critical for its survival because ‘law is deeply ensconced in a particular cultural context’.⁴³ The culturalists maintain that a legal transplant is like a kidney transplant.⁴⁴ The key question to ask is: ‘Can it be adjusted to the new body or will the new body reject it?’ The culturalists recognise that while legal rules have their inherent ‘logic’, they are also inextricably tied to culture.⁴⁵ Teubner also asserts that the dialectical nature of the relationship between the transplant and local culture is a process of ‘co-evolution’: “Legal irritants” cannot be domesticated; they are not transformed from something alien into something familiar, not adapted to a new cultural context, rather they will unleash an evolutionary dynamic in which the external rule’s meaning will be reconstructed and the internal context will undergo fundamental change.’⁴⁶

⁴² A Watson, ‘From Legal Transplants to Legal Formants’ (1995) 43(3) *American Journal of Comparative Law* 469.

⁴³ Nolan, above n 40, 28.

⁴⁴ Kahn-Freund, above n 2.

⁴⁵ Nolan, above n 40; Teubner, above n 40.

⁴⁶ Teubner, above n 40, 12. F A Hayek, ‘Notes on the Evolution of Systems of Rules of Conduct’ in F A Hayek (ed), *Studies in Philosophy, Politics and Economics* (Routledge, 1967) 66.

Others maintain that '[b]ecause law is a product and a carrier of culture, when it moves from one place to another, it not only functions differently in the importing country (i.e. adapts), but it will skew the receiving culture in profound ways.'⁴⁷ They further argue that because law is deeply embedded in culture, legal transplants are exposed to the insurmountable differences of cultural organisms; they cannot survive the surgical operation. Legal transplants are thus literally 'meaningless' because 'as it crosses boundaries, the original rule necessarily undergoes a change that affects it *qua* rule.'⁴⁸

2.3 Emerging Literature on Tax Transplants

2.3.1 'Touchy' issues about tax law

During the past two decades or so, the body of literature on comparative tax law has been growing.⁴⁹ However, because of language barriers and the complexity of tax laws, comparative tax law research is 'torturous'⁵⁰ and has a minoritarian position in the global tax discourse.⁵¹ The transplantation of tax laws is a 'touchy' issue.⁵²

⁴⁷ Nolan, above n 40, citing Jack Hiller, 439.

⁴⁸ P Legrand, 'The Impossibility of 'Legal Transplants'' (1997) 4 *Maastricht Journal of European Comparative Law* 111; P Legrand, 'The Return of the Repressed: Moving Comparative Legal Studies Beyond Pleasure' (2001) 75 *Tulane Law Review* 1033; P Legrand, 'What 'Legal Transplants''?' in D Nelken and J Feest (eds), *Adapting Legal Cultures* (Hart, 2001); P Legrand, 'The Same and the Different' in P Legrand and R Munday (eds), *Comparative Legal Studies: Traditions and Transitions* (Cambridge University Press, 2003) 240 and P Legrand, 'Paradoxically, Derrida: For a Comparative Legal Studies' (2005) 27 *Cardozo Law Review* 631.

⁴⁹ D Ring, 'The Promise of International Tax Scholarship and Its Implications for Research Design, Theory and Methodology' (2010) 55(1) *St Louis University Law Journal* 307; O Marian, 'The Discursive Failure in Comparative Tax Law' (2010) 58(2) *American Journal of Comparative Law* 415; Avi-Yonah et al, above n5[above n 5?], H Ault & B J Arnold, *Comparative Income Taxation: A Structural Analysis* (Kluwer Law International, 3rd ed, 2010); V Thuronyi, 'What Can We Learn from Comparative Tax Law?' (2004) 103 *Tax Notes* 459; M A Livingston, 'Law, Culture, and Anthropology: On the Hopes and Limits of Comparative Tax' (2005) 18(1) *Canadian Journal of Law and Jurisprudence* 119; M A Livingston, 'From Milan to Mumbai, Changing in Tel Aviv: Reflections on Progressive Taxation and "Progressive" Politics in a Globalized but Still Local World' (2006) 54(3) *American Journal of Comparative Law* 555; M A Livingston, 'From Mumbai to Shanghai, with a Side Trip to Washington: China, India, and the Future of Progressive Taxation in an Asian-Led World' (2010) 11(2) *Theoretical Inquiries in Law* 539; and Livingston, above n 3.

⁵⁰ Ibid Ault and Arnold.

⁵¹ Marian, above n 49; Avi-Yonah et al, above n 5. [Does this also refer to n 5?]

⁵² Livingston, above n 3.

Transplanting ‘universal tax norms’ such as the arm’s length principle, appears easy. International institutions, such as the International Monetary Fund, have ‘transplanted’ Western tax laws and norms to developing and transition countries.⁵³ OECD member countries have been borrowing tax laws from each other in reforming their domestic tax laws, especially those related to corporations and international transactions.⁵⁴ Transplanting progressive income tax either by imposition (as in the case of colonisation) or by voluntary borrowing reflects the belief that it is a ‘good’ tax. However, the problem lies in implementation. For example, Likhovski demonstrates that the law on the books, which was transplanted from Britain to Mandatory Palestine, did not differ much from that in other British dominions, but the law in action did because of local cultural and institutional factors.⁵⁵ Infanti argues that the risk of the rejection of tax transplant is multiplied if the tax rules are being ‘cloned’.⁵⁶ If local conditions are ignored, the transplants may cause harm to the receiving country.⁵⁷ On the other hand, since the level of taxation reflects social and democratic values, it is suggested that tax transplants can promote democratic policy and human development.⁵⁸

Comparative tax scholarship is primarily descriptive and doctrinal, aimed at advancing the understanding of alternative solutions to common problems and providing practical guidelines to policy makers and their international tax advisors.⁵⁹ This type of scholarship is considered important because of the special features of tax law, such as the inherently global nature of this field, the complexity of tax laws, the importance of

⁵³ Thuronyi, above n 49; M Stewart, ‘Global Trajectories of Tax Reform: Mapping Tax Reform in Developing and Transition Countries’ (2003) 44 *Harvard International Law Journal* 140.

⁵⁴ Ault and Arnold, above n 49; Garbarino, above n 5.

⁵⁵ A Likhovski, ‘Is Tax Law Culturally Specific? Lessons from the History of Income Tax Law in Mandatory Palestine’ (2010) 11(2) *Theoretical Inquiries in Law* 725.

⁵⁶ A C Infanti, ‘Spontaneous Tax Coordination: On Adopting a Comparative Approach to Reforming the US International Tax Regime’ (2002) 35 *Vanderbilt Journal of Transnational Law* 1105; A C Infanti, ‘The Ethics of Tax Cloning’ (2003) 6(3) *Florida Tax Review* 251.

⁵⁷ Stewart, above n 53.

⁵⁸ W B Barker, ‘Expanding the Study of Comparative Tax Law to Promote Democratic Policy: The Example of the Move to Capital Gains Taxation in Post-Apartheid South Africa’ (2005) 109(3) *Penn State Law Review* 703.

⁵⁹ Ault and Arnold, above n 49; Thuronyi, above n 49.

detailed knowledge of both the international tax systems and the likely planning techniques, and the influence of norms and ‘soft law’.⁶⁰ There is a premium on developing an understanding of the complex ways in which tax policies form on a global scale — how norms are established and how countries influence each other’s policy choices.⁶¹

In terms of general characteristics, tax laws are in the nature of public law with profound social and economic implications for the private sector. Among the types of taxes, some are more value-based and organic, while others tend to be more ‘technical’. For example, personal income tax expresses the societal sense of distributive justice and fairness, and is thus deeply rooted in the social, economic and political environment. VAT tends to be more ‘technical’ and is used to maximise revenue while minimising tax distortions. Its dependence on the environment is mostly in the area of administration and compliance. Corporate income tax is most vulnerable to global influences due to the mobility of capital and the pressures of international tax competition, and thus it is more susceptible to transplantation. A common feature of all tax laws, however, is their complexity and high level of technicality. As such, expertise is required in drafting, implementing and complying with tax laws.

2.3.2 Common Core

The general debates about the autonomy of law (hence legal transplantation) and the relevance of culture (adaptation and modification of transplants) extend to the transplantation of tax laws. Evidence on Chinese tax transplant is abundant in supporting both schools. Chinese tax transplantation occurs at different levels of the hierarchy of taxation. Starting from the top is the mix of taxes, tax policies, tax

⁶⁰M Livingston, ‘Reinventing Tax Scholarship: Lawyers, Economists, and the Role of the Legal Academy’ (1998) 266, *Cornell Law Review* 83[There aren’t any 1998 Livingston publications at 49?]; A Christians, ‘Critical Issues in Comparative & International Taxation: Case Study Research and International Tax Theory’ (2010) 55(1) *St Louis University Law Journal* 331; D Ring, above n 49.

⁶¹ Avi-Yonah, 2007, above n 5.

structures, tax concepts, and tax rules. The higher level a transplant is in the hierarchy, the more autonomous the law is because it reflects the ‘common core’⁶² of modern taxation. Another way of looking at the common core is from the perspectives of the functions of taxation and the design of tax laws. The need for taxation as a revenue source and as a policy instrument is common, and hence tax laws perform the same functions in different countries. The tax design features that address common problems are generally adopted by many jurisdictions.

During the past three decades, the Chinese tax system has evolved from a primarily turnover tax system to a system of mixed income taxes and VAT/turnover taxes. The types of taxes that China could introduce to facilitate the transition from a centrally-planned economy to a market-based economy were limited to those commonly used in other countries. Taxation was regarded as a field of ‘science’.⁶³ As such, the scientific theories and proofs developed in other countries were applicable to China. For example, income taxes which were non-existent until 1980 have become increasingly important in China in generating revenue. Income tax revenue accounted for 15 per cent of total tax revenue in 1994 and 24 per cent in 2010.⁶⁴ As discussed below, however, the design and implementation of income taxes and VAT in China differ significantly from the ‘common core’ of these taxes in OECD countries.

From the design perspective, some general principles or ideas of taxation are common. One example is the principle of progressive taxation. The Chinese Individual Income Tax has progressive rates for employment income and business income.⁶⁵ Other examples include the principle of deferring to financial accounting in determining corporate income and the principle of recognising the legal form of transactions.

⁶² The notion of ‘common core’ of tax rules is used in Avi-Yonah, Sartori and Marian, above n 49, at 6–7; Ault and Arnold, above n 49.

⁶³ See, for example, Jin Xin, *Collection of Papers by Jin Xin* (China Tax Press, 2008) (in Chinese).

⁶⁴ See tax revenue statistics on the SAT website at www.chinatax.gov.cn; Gongliang Tang (ed), *Annual China Tax Report- Forecasting China Tax Reform in the 12th Five-Year Plan Period* (2011) 17 (in Chinese).

⁶⁵ For a study of the Chinese Individual Income Tax and its comparison with personal income tax in other countries, see L Liu, *Progressivity of Income Tax and Income Redistribution* (2011) (in Chinese).

The basic structural design of Chinese income taxes and VAT is consistent with the common core by including: who is taxable, what is taxable, how much is taxable, when is tax payable, and how are taxes paid and disputes resolved. The basic structure of international taxation includes the taxation of residents — with respect to their foreign-source income, the taxation of non-residents in relation to their domestic income and rules to protect the integrity of these two elements (i.e., anti-avoidance rules). The structure of a tax is perhaps the most scientific or mechanical element of any tax law.

The basic concepts in Chinese income tax laws and VAT law also share some commonality with those in Western countries. For example, income from employment, which accounts for the biggest portion of the tax base for personal income tax, is taxable, generally on a gross basis, and is subject to withholding at source.⁶⁶ A corporation is taxed as a separate person and special rules of consolidation are needed to overrule this fundamental principle.⁶⁷ ‘Residence’ determines the scope of a person’s tax liability in a jurisdiction. ‘Place of consumption’ and ‘export tax refund’ mean that VAT is levied on consumers not producers.

Specific tax rules tend to be more divergent, depending on local environment, including drafting conventions and tax culture. However, a common core is still discernible in some areas. For example, the transfer pricing rule in China looks similar to that in other countries. The transplantation of the tax common core does not mean that the transplanted tax, policy, principle, concept or rule remain unchanged in China. Even if the transplants remain unchanged in form, they inevitably acquire some ‘Chinese characteristics’ in reality.

⁶⁶ Ault and Arnold, above n 49.

⁶⁷ Ibid; G Cooper, ‘Policy Forum: A Few Observations on Managing the Taxation of Corporate Groups – The Australian Experience’ (2011) 59(2) *Canadian Tax Journal* 265; A Ting, ‘The Unthinkable Policy Option? Key Design Issues Under A System of Full Consolidation’ (2011) 59(3) *Canadian Tax Journal* 421.

2.3.2 Culture-specific

Tax ideas or rules are generally more difficult to transfer if they are embedded in local socio-economic culture. In general, rules affecting individuals and governing domestic transactions are more culture-specific than those affecting capital and corporations and governing international transactions respectively. The transplantation of the tax ‘common core’ does not mean complete tax convergence because the convergence of tax laws does not necessarily lead to convergence in the institutions or processes for tax law in general. This means that transplanted tax laws are formulated and administered by institutions through processes that are as divergent as before. There is also little evidence on the convergence of tax culture or tax environment.⁶⁸ As such, the gap between tax laws on the book and tax laws in action is, presumably, quite significant in different countries. The progressivity of income tax will be used as an example.

Progressive income taxation was first introduced in Prussia (Germany) in the late 19th century, which led to a rise in tax rate from 0.67 to 4 per cent. Though some other Continental countries soon followed Prussia, it took nearly twenty years for the movement to reach the Anglo-Saxon powers. In 1910 and 1913, Great Britain and the United States adopted graduated income taxes rising to 8.25 and 7 per cent, respectively. During World War I and the post-war years, the top rate subsequently reached 97 and 91 per cent. Other Western democracies and developing countries followed suit.⁶⁹ Even though the recent adoption of ‘flat tax’ in some Eastern European countries⁷⁰ erodes the idea of progressivity as a universal idea, progressive

⁶⁸ Livingston, above n 3.

⁶⁹ For an excellent discussion of the history of the debate about equity and efficiency and the idea of progressive taxation, see D J Ventry Jr, ‘Equity Versus Efficiency and the U S Tax System in Historical Perspective’ in J J Thorndike and D J Ventry, Jr (eds), *Tax Justice: The Ongoing Debate* (2002) 25; and W J Blum and H Kalven Jr, *The Uneasy Case for Progressive Taxation* (1963). For a discussion about progressive taxation and democracy, see [S Steinmo](#), *Taxation and Democracy: Swedish, British and American Approaches to Financing the Modern State* (Yale University Press, 1996).

⁷⁰ Examples are Russia, Romania and the Czech Republic.

taxation remains a powerful symbol of a society's notion of fairness, equity and tax justice. High-income countries and low-income countries tend to have similar top marginal personal income tax rates.⁷¹

The superficial level of global convergence on progressive taxation cannot be confused with the great variations in the practice of progressive taxation across countries. Personal income tax accounts for about 25 per cent of total tax revenue in OECD countries (and higher ratio in the United States and Common-law countries) and less than 10 per cent in low-income countries. In China, the ratio is about 6 percent, meaning that progressive taxation has a greater impact on tax fairness and justice in higher-income countries than in lower-income countries.⁷² The variation is attributable to differences in political factors, economic factors, societal attitudes, institutional factors, and effectiveness in tax administration.

Research finds that political will is the 'sine qua non of any successful tax reform' and a country's tax system, especially, personal income tax system, reflects its political institutions.⁷³ 'The main reason many developing countries do not tax themselves more may be that increasing tax is not in the interest of those who dominate the political institutions of such countries'.⁷⁴ In Latin America, for example, the difficulty in implementing progressive taxation is due to a lack of 'an (implicit) social contract between governments and the general populace of the kind that is embedded in taxation and fiscal principles and practices in politically more stable parts of the world'.⁷⁵ In the United States, on the other hand, there is a political process for finding

⁷¹ See K Sabirianova and S Buttrick, 'Global Reform of Personal Income Taxation: 1981–2005: Evidence from 189 Countries' (2010) 63 *National Tax Journal* 447.

⁷² R Bird and E Zolt, "Redistribution Via Taxation: The Limited Role of the Personal Income Tax in Developing Countries" (2005) 52(6) *UCLA Law Review* 1.

⁷³ R Bird, 'Managing Tax Reform' (2004) 58 *Bulletin for International Fiscal Documentation* 42.

⁷⁴ R Bird, J Martinez-Vazquez and B Torgler, 'Tax Efforts in Developing Countries and High Income Countries: The Impact of Corruption, Voice and Accountability' (2008) 38 *Economic Analysis & Policy* 55.

⁷⁵ V A Schneider and M Moore, *Pro-Poor Tax Reform in Latin America: A Critical Survey and Policy Recommendations*, IDS, Sussex, (March 2003).

the right balance between competing demands of social equity, economic incentives and the need to pay for an expanding government.⁷⁶

The level of economic development tends to coincide with the actual level of progressive taxation. The tax system in OECD countries is more progressive than that in lower-income countries. In the latter, because per capita income is low, the number of taxpayers is also low. The existence of a large informal sector in developing countries makes it difficult to observe and assess personal income tax.⁷⁷ Moreover, corruption has a larger negative impact on income taxes compared with consumption taxes,⁷⁸ and corruption-resistant features are often missing in the design of taxes in developing countries.⁷⁹

‘Tax administration matters – a lot!’⁸⁰ The best tax policy on paper means nothing if it cannot be effectively administered. A large body of literature has examined tax administration difficulties — faced by developing countries. The main challenges include the size of the agricultural and informal sector, the use of the financial sector (in relation to the economic environment in which tax administrators operate), the organisational change and the political will to reduce corruption, rent seeking and improvement in the accountability of tax administration, and the use of technology in tax administration.⁸¹

Local culture also plays a role in the divergence of progressivity. Livingston demonstrates that institutional and attitudinal differences in China, India, Israel, Italy

⁷⁶ S R Weisman, *The Great Tax Wars* (Simon and Schuster, 2002).

⁷⁷ S Mahdavi, ‘The Level and Composition of Tax Revenue in Developing Countries: Evidence from Unbalanced Panel Data’ (2008) 17 *International Review of Economics and Finance* 607.

⁷⁸ V Tanzi and H R Davoodi, ‘Corruption, Growth, and Public Finance’ (IMF Working Paper WP/00/182, 2000).

⁷⁹ M Emran, and Joseph E Stiglitz, ‘Development Oriented Tax Policy’ (Columbia University and GWU Working Papers, 2006).

⁸⁰ R Bird, ‘Taxation and Development’ (2010) The World Bank <<http://siteresources.worldbank.org/INTPREMNET/Resources/EP34.pdf>>, no 34, 4. [Kindly note the link doesn’t work].

⁸¹ See Bird, above n 73; J Alm, J Martínez–Vazquez and S Wallace (eds), *Taxing the Hard-to-Tax: Lessons from Theory and Practice* (Elsevier Science Ltd, 2005).

and the United States have some effect on progressive taxation, even though the precise effect is difficult to discern.⁸² He also notes that attitudinal differences (tax anthropology) are less important than institutional factors (tax sociology). Steinmo found that the different models of democratic culture in the United States, Sweden and the United Kingdom helped explain the different level of progressivity in these countries.⁸³

3. Tax Processes

The existing literature does not specifically address the relevance of process to legal or tax transplants.⁸⁴ This part of the paper discusses why processes are important and what the major differences are in tax processes between China and Canada (which is used as a representative of Western countries).

3.1 *Importance of Tax Processes in Tax Transplants*

Processes are important in studying tax transplants for several reasons. First, taxation is more of a science than an art. Second, taxation is about sharing and thus how to share is often as important as what is shared. Third, the desired effect of tax transplants is ‘practical’ and ‘real’ in the sense of generating revenue with minimal adverse impact on market efficiency and private choices, which means that the law in action is generally more relevant than the law on paper.

‘Taxation is a field of science’.⁸⁵ Science is both a body of knowledge and process. Science is ongoing, continually refining and expanding our knowledge. Scientific processes lead to new questions for future investigation. Science is a global human

⁸² Livingston, above n 3; Livingston (2006), above n 49.

⁸³ Steinmo, above n 69.

⁸⁴ For example, G Mousourakis, ‘Transplanting Legal Models Across Culturally Diverse Societies: A Comparative Law Perspective’ (2010) 57 *Osaka University Law Review* 87.

⁸⁵ Jin, above n 63.

endeavour. Taxation science can be learned and tax knowledge can be shared. Because of the necessity of raising money by taxes, the ‘most perfect knowledge of the science is required’.⁸⁶ How to raise the desired amount of taxes with minimal interference is one of the key scientific questions for tax researchers and policymakers. Experiences in one country can be learned by another country. The phenomenon of tax transplants illustrates the scientific aspect of taxation. Both the knowledge of taxation and the process of taxation can be learned, refined and expanded, and used to solve problems in different countries. The learning and borrowing of knowledge itself is never complete. Without scientific processes, knowledge may not be useful or be improved. As explained above, however, processes are embedded in culture. Incorporating scientific taxation processes into the local culture requires scientific transplantation processes, such as the process of selection, the process of translation, and the process of adaptation. More importantly, the transplantation of substantive tax rules or laws without transplanting the relevant tax processes will likely impede the chance of successful adaptation of the transplants.

Taxation is not just about raising the desired amount of money. It is also an act of laying a tax, i.e. the process by which the state, through its law-making body, raises revenue to defray the necessary expenses of the government. Much of the debate about taxation and tax policy surrounds the ‘how’ question, rather than the ‘how much’ question. Because the process of taxation is superimposed on the economic process (or market allocation of resources) and interacts with social relationships, its impact on the society is immense. That is why the standard policy criteria for assessing taxation are equity and fairness, neutrality and efficiency in administration. The equity and

⁸⁶ ‘If it were not for the necessity of taxation’, wrote Richardo in 1819, ‘the business of government regarding Agriculture, Commerce and Manufactures would be very easy indeed, --- all that would be required of them would be to avoid all interference, neither to encourage one source of production nor to depress another, but the necessity of raising money by taxes renders some interference necessary. The aim of the legislature should nevertheless be to press on all equally, so as to interfere as little as possible with the natural equilibrium which would have prevailed if no disturbance whatever had been given’. See C S Shoup, *Ricardo and Taxation (FinanzArchiv / Public Finance Analysis, New Series, Bd. 18, H. 1 (1957/58), 13–24* .

fairness criterion evaluates the spread of the tax burden among taxpayers. The neutrality criterion looks at the interaction between taxation and the market. The administrative efficiency criterion looks at the overall cost and efficiency of tax compliance and administration.⁸⁷

Taxation is about the political process of a country. There can be different models for making political decisions. Irrespective of the model, taxpayers are key players in the process. They can vote with their hand (election), their feet (emigration) or their arms (rebellion). They can ‘voluntarily’ comply with tax laws or resist taxation through lawful or unlawful means. The doctrine of no taxation without representation is embraced in the United States and other Western democracies. At the end of the day, taxation is not just about the end, but also the means. Taxation is the process of maintaining public trust in government. Because taxation affects almost every citizen as either taxpayers or as beneficiaries of public programs financed by tax revenue, the manner in which the government administers tax laws and deals with the public significantly affect public opinion about the government. In the absence of public trust, it is difficult, if possible at all, to operate a modern tax system.

The general objective of taxation is to raise revenue. The primary goal of tax transplants is to borrow foreign laws and incorporate them into the local system so that the system is more efficient in raising revenue while meeting other policy objectives. Ideally, the gap between the ‘law on paper’ and the ‘law in action’ should be as small as possible. The size of the gap, to a great extent, depends upon the similarity of the processes of making, interpreting and enforcing the laws. Owing to social, political

⁸⁷ It might be interesting to note that in spite of the significant reductions in tax rates during the past four decades, the average tax burden measured by the tax/GDP ratio has changed in the opposite direction! According to the OECD report, *Tax Reform Trends in OECD Countries* (2011) <<http://www.oecd.org/ctp/48193734.pdf>>, in the mid 1980s, the top personal income tax rate in OECD countries exceeded 65 per cent, and corporate income tax rate was rarely less than 45 per cent; in 2011, these rates were dropped to 41.5 per cent and 26 per cent respectively. Meanwhile, the average tax/GDP ratio actually increased from 30.5 per cent to 35 per cent. One might ask: whose tax burden was increased or decreased? How? Why? What processes led to such outcome?

and economic reasons, such processes are often different between countries, especially countries belonging to different legal families. The types of taxes and the level of taxation generally reflect the outcomes of the social choices or political decisions of a country. As such, tax processes are expected to be more divergent than tax policies or tax rules across countries. That presents challenges to successful tax transplants. The level of sensitivity of tax transplants to local culture and local processes may depend on the type of tax transplants. As mentioned earlier, VAT is arguably less sensitive than income taxes; corporate income tax is less sensitive than personal income tax; international tax rules are less sensitive than domestic tax rules; tax rules related to market transactions are less sensitive than those related to personal or social transactions; administrative tax rules are less sensitive than judicial procedures; policy-based rules (such as tax incentives and anti-avoidance rules) are less sensitive than basic charging rules. In terms of tax policy, equity-and fairness-oriented policies are more sensitive to local culture than efficiency-and growth-oriented policies. Cultural orientation towards fairness and equity is more evident in tax policy whereas efficiency and economic growth are influenced more by market forces and globalisation.

3.2 *Differences between China and the West*

It is beyond the scope of this paper to delve into the differences in the Western way of thinking and the Chinese way of thinking about processes. It suffices to note below some differences that may be relevant in thinking about taxation and tax transplants. Canada is used as an example of the West in the following discussions, but it is important to note that there are significant differences among Western countries.

3.2.1 Less Emphasis on Processes in China

Generally speaking, the Chinese way of thinking emphasises less on processes and more on results. There can be several explanations for this.

First, Chinese tend to think holistically, whereas Westerners tend to think analytically. Researchers find that ‘East Asians tend to be holistic, attending to the entire field and assigning causality to it, making relatively little use of categories and formal logic, and relying on “dialectical” reasoning, whereas Westerners are more analytic, paying attention primarily to the object and the categories to which it belongs and using rules, including formal logic, to understand its behaviour’.⁸⁸

Second, Chinese tend to adopt a compromise approach in dealing with seeming contradictions — retaining basic elements of opposing perspectives by seeking a ‘middle way’, whereas Westerners tend to follow a differentiation model that polarises contradictory perspectives in an effort to determine which fact or position is correct. Chinese prefer dialectical resolutions to social conflicts⁸⁹ and favour dialectical arguments over classical Western logical argumentation.⁹⁰ Westerners are keen on finding out who is right in an argument. On the other hand, it has been argued that the tendency to find the middle way has hampered Chinese’s efforts to seek out scientific truth through aggressive argumentation, the classic Western method for forging a linear path through contradictory information, which results in identifying right and wrong answers.⁹¹

Third, Chinese culture values collective interest, hierarchy and social harmony, whereas Western culture values individualism, recognises self-interest, and develops a common core through processes. Rules and processes are presumably more important

⁸⁸ R E Nisbett, I Choi, K Peng and A Norenzayan, ‘Culture and Systems of Thought: Holistic Versus Analytic Cognition’ (2001) 108 *Psychological Review* 291, 291.

⁸⁹ The Chinese apply dialectical thinking to social relationships, not to the physical material world or science. For example, the Chinese do not apply dialectical thinking to astronomy and geography to come to the conclusion that the sun can rise in both the East and the West. [Can you kindly clarify?]

⁹⁰ K Peng and R Nisbett, ‘Culture, Dialectics, and Reasoning about Contradiction’ <<http://www-personal.umich.edu/~nisbett/cultdialectics.pdf>>.

⁹¹ K Peng was quoted in ‘Americans and Chinese have Different Ways of Discovering Truth, Finds UC Berkeley Expert on Chinese Psychology’ <http://berkeley.edu/news/media/releases/98legacy/06_09_1998.html>. For further discussion, see K Peng, J Spencer-Rodgers and N Zhong, ‘Naive Dialecticism and the Tao of Chinese Thought’ in U Kim, K S Yang and G Huang (eds), *The Handbook of Indigenous and Cultural Psychology* (2005), 247–62; F E Blackwell, J Hagaman, J Grice and K Peng, *From Leadership to Parenthood: The Applicability of Leadership Styles to Parenting Styles. Group Dynamics: Theory, Research and Practice* (2006), 43–56.

in balancing competing interests among ‘equals’ than prescribing duties and obligations of the ‘subordinates’. In any society, people are both individual beings and social beings and most people look after their self-interest. In the West, individual rights and private property are recognised and respected and relationships (private-private and private-public) are regulated through law. The Chinese thinking is primarily top-down, whereas the Western thinking is more bottom-up, starting from the basic unit.

3.2.2 Approach to Problem Solving

Approaches to solving problems are different in the Chinese culture and Western culture. The Chinese approach tends to be more pragmatic, result-oriented, experts-led, and non-confrontational, whereas the Western approach tends to be more principled, process-driven, evidence-based, and encourages open debates. At the risk of oversimplification, the Chinese approach is represented by the two famous sayings: ‘crossing the river by feeling the stones’, and ‘A cat is a good cat no matter it is white or black’. In the West, a problem solving process typically consists of defining the problem, analysing the problem, generating possible solutions, analysing the solutions, selecting the best solution(s) and reassessing the solutions. The different approaches to problem-solving can be illustrated by the approach to tax reforms in Canada and in China.

One of the most thorough reform processes in Canada occurred in the 1960s. The problems to be addressed by the Commission arose from the ad hoc nature of the existing tax system. The federal income tax was introduced in 1917 in the frenzied atmosphere of a grave national emergency during World War I. Ad hoc changes were made during World War II and the Korean War. It was noted that:

The [Canadian] federal taxation was hastily thrown together at its origin, was subject to its greatest changes during periods of national

stress, that the alterations made in these conditions were on a purely pragmatic basis and tended to persist once the crisis had passed, and that never yet has there been thorough examination of its underlying objectives and philosophy. For half a century we have gone along on a hand-to-mouth basis that has produced each year more problems than it has ever solved. ... It was folly to continue it.⁹²

A Royal Commission on Taxation was appointed in September 1962 with a sweeping mandate to examine the federal tax laws of Canada and to make recommendations for their improvement. The order-in-council establishing the Commission was signed by Robert Bryce, then the Deputy Minister of Finance. Mr. Kenneth Carter, a chartered accountant in private practice, was the Chair of the Commission while Mr. Douglas Hartle, a young professor at the University of Toronto, was the Research Director. The Commission was persuaded that ‘only by establishing some basic underlying principles on which to build a solid structure is there any escape from ultimate complete frustration’.⁹³ The Commission spent four years studying the tax system in-depth. It engaged a large group of research staff (which included about 75 professionals) and held public hearings across the country. It eventually published 30 separate research studies and received over 300 briefs. The Commission delivered the final report to the Government in December 1966 and released it in February 1967. The final report contains 2,575 double-spaced, typed pages in six volumes. It was known as the Carter Report after its chairman and was described as ‘one of the most far-reaching, explosive, revolutionary sets of proposals ever put before the Canadian people.’⁹⁴ The Carter Report ‘is not a series of unrelated ideas and recommendations:

⁹² J H Perry, ‘Anatomy of a Tax System’ in *Twentieth Tax Conference* (1967) 7–30, 12.

⁹³ *Ibid.*

⁹⁴ N Brooks (ed), *The Quest for Tax Reform: The Royal Commission of Taxation Twenty Years Later* (Carswell, 1988), 4. [Note: Should this be ‘The Quest for Tax Reform: The Royal Commission of Taxation Twenty Years Later’]

it tells a story, and it tells the story with conciseness, clarity and passion. The story is premised on a clear vision of an equitable society'.⁹⁵

Public reaction to the Carter Report was mixed. The business community collectively opposed the recommendations, which emphasised tax equity and fairness. In 1969, the Government tabled a White Paper on Tax Reform, which was a watered-down version of the Carter Report. The Finance Minister at the time explained that the reasons for the initial abandonment of many of the recommendations 'were more political and administrative than philosophical'. The White Paper was publicly debated. In 1971, draft legislation was tabled in the House of Commons and the final legislation was passed and became effective in 1972, of which the structure and principles remain today. The whole process was open, consultative, evidence-based, principled, and led by experts who are not politically motivated.

China has undertaken several major tax reforms since the inception of the modern tax system in the early 1980s. The Chinese tax system was introduced during the period of economic transition, largely on an *ad hoc* basis. It contains legacies of the socialist system as well as transplanted foreign ideas and norms. It is certainly due for a thorough review, but a public process similar to that of the Carter Commission seems unlikely. The direction for reform comes from the top. For example, the 12th Five-Year Plan (2011-2015) by the Central Government calls for strengthening the regulatory effects on high-income earners,⁹⁶ 'making the sharing of the tax burden more fair', 'gradually establishing an individual income tax system that combines comprehension and scheduler features, and perfecting the system of collection and administration of individual income tax'.⁹⁷ Chapter 46 of the 12th Five-Year Plan states — that experts and public input must be sought in policy-making and

⁹⁵ Ibid 6.

⁹⁶ The 12th Five Year Plan was approved by the National People's Congress on 14 March 2011. It sets forth the objectives, strategies and measures of economic and social development. See Chapter 32, section 3.

⁹⁷ Ibid Chapter 47, section 3.

administrative accountability should be widely implemented in order to improve public confidence.⁹⁸ The role of public input is, in practice, limited to commentary on specific issues as opposed to ideas and principles or the structure of the tax.

3.3 Political processes

3.3.1 Taxation with(out) Representation

In Canada and other Western democracies, the issue of taxation is highly political. The modern notion of taxation is a system of compulsory contributions levied by government on individuals, corporations, and properties, primarily as a source of revenue for the government. The power of taxation proceeds upon the theory that the existence of government is a necessity. The basis of taxation is found in the reciprocal duties of protection and support between the state and the taxpayers or the idea of a social contract between citizens and the government. The relationship between the government and the people is governed by the rule of law. Tax laws are passed by the legislatures and the law-makers are elected by citizens. There is a political process for ‘consulting’ taxpayers about their choices. The government is accountable to the people about the use of tax revenues through budgeting processes and reporting.

In modern China, the political process is fundamentally different from that of Western countries. ‘Members of the National People’s Congress (NPC) are not directly elected by the people and most are members of the Chinese Communist Party (CCP). Key policy decisions are made by the CCP. Article 1 of the Constitution states that ‘The People’s Republic of China is a socialist state under the people’s democratic dictatorship led by the working class and based on the alliance of workers and peasants’. Many provisions of the Constitution spell out what the state promises to do for the people. Article 56 states: ‘It is the duty of citizens of the People’s Republic of

⁹⁸ Ibid Chapter 46.

China to pay taxes in accordance with the law'. In the true sense of 'socialism', there is no need for taxation because taxation is the means of mandatory transfer of wealth from the private sector to the government in order to finance public expenditures. In reality, it is acknowledged that China's 'socialism' is at an earlier stage and market is allowed as the main mechanism for regulating economic activities. As such, taxation is relevant.

The current Chinese system is rooted in the Chinese tradition that emphasises morality, duties, and vertical relationships. For example, the relationship between the state and taxpayers is framed in terms of a 'duty' to support the state.⁹⁹ The Chinese term for 'state' is 'guo jia' or 'nation family'. The government is analogised to the 'head of the family'. As the head of the family, the government regards the people as subjects or children, exercising a top-down model of governance. When the Xia Dynasty (BC 2233) levied agriculture tax, it named the levy 'gong' or 'tribute'.¹⁰⁰ The payment of taxes to the emperor was analogised to supporting one's parent.¹⁰¹ The taxpayers/children's duty to support the emperor/parent was 'unconditional' and it was regarded as a moral obligation.¹⁰² Emperors did not need to consult with, or account to, taxpayers about the level of taxation and the use of tax revenue. Imperial governments did not see themselves as providers of services to taxpayers. Without the

⁹⁹ Jing Fang, 'Zhongxi Fang Shuishou Falu Wenhua Bijiao Yanjiu' ('A Comparative Study on Chinese and Western Tax Cultures') (2003) 16 Journal of Yantai University (Philosophy & Social Science) 43; Li Linping, 'Zhong Xi Fang Shui Shou Wen Hua Zhi Bijiao' ('Comparison of Chinese and Western Tax Cultures') (2005) 8 Li Lun Daokan (Journal on Theory) 77, 77–8; Liu Rong & Du Jian, 'Na Shui Ren Quan Li Bao Hu Yu Wo Guo Shui Shou Si Fa Gai Ge' ('The Protection of Taxpayers' Rights and Chinese Taxation Judicial Reform') (2007) 1 Taxation Research 51; You Xiaofeng & Wang Zhifang, 'Shui Shou Qi Yue Yu Na Shui Ren Quan Li Zhi Bao Hu' ['Taxation Agreement and the Protection of Taxpayers' Rights'] (2008) 2 Taxation Research 69 (in Chinese). (Note: As the journal titles are originally in Chinese, can you kindly spell out the abbreviations? Thanks)

¹⁰⁰ Weng, above n 10, 4.

¹⁰¹ Fang, above n 99; Li, above n 99; Yang Bin, 'Zhong Xi Fang Wen Hua Chaiyi Yu Shui Zhi Gai Ge' ('Differences Between Chinese and Western Cultures and Tax Reform — A Case Study of VAT and Personal Income Tax') (2005) 5 Shui Wu Yan Jiu [Tax Research] 14; Yu Daqing & Peng Jiming, 'Zhong Ying Chuantong Shuishou Wenhua Bijiao' ['Comparison Between Chinese and English Traditional Tax Cultures'] (2003) 16 Journal of Xi'an Institute of Finance and Economics 14 (in Chinese). [Please spell out journal title in full]

¹⁰² Li Qian and Han Yu, 'Qi Ye Suo De Shui Fa, Yi Ban Fan Bi Shui Tiao Kuan Ping Xi' ('Some Comments on General Anti-Avoidance Provisions in the Enterprise Income Tax Law of the People's Republic of China') (2008) 8 International Taxation in China 68; Wang Jianping, 'Na Shui Ren Quan Li Li Nian Yu Zheng Fu — Na Shui Ren Guan Xi De Zhuan Xing' ['The Concept of Taxpayers' Right and the Relationship Between the Government and Taxpayers'] (2008) 4 International Taxation in China 57 (in Chinese). [Please spell out journal title in full]

possibility of participating in tax-law making or having an impartial arbiter in resolving tax disputes, taxpayers resorted to tax evasion and tax resentment.¹⁰³

3.3.2 Rule of Law

Modern taxation was created in Western countries where the rule of law, market and social contract co-existed and operated in tandem. For example, the Canadian tax system is based on the principle of rule of law. The principle signifies that ‘all elements of Canadian society — public and private, individual and institutional — are subject to and governed by known legal rules’.¹⁰⁴ Competing and conflicting interests and values are managed through an open, political process and the majority or compromised view is expressed through legislation. Political leaders and government agencies are accountable to the people and the elected legislative respectively. Economic relations are regulated by free markets that demand fair dealing, transparency, equal exchange, resulting in a win-win outcome. Private property and individual rights are protected and regulated by law. There is an implicit social contract between taxpayers and the state: the state uses tax revenue to pay its expenses on public services whereas taxpayers receive the benefits and protection from the government, which attempts to level the playing field and to provide a fair opportunity to all of its citizens to realise their potential. These processes are generally open, transparent and have built-in checks and balances.

In a tax context, the rule of law means that taxes must be imposed through a proper parliamentary process rather than through administrative or judicial discretion. The government as well as the taxpayers must comply with tax laws. The rule of law also implies that tax laws must be reasonably capable of discovery and that taxpayers should be able to reasonably predict, in advance and with a sufficient degree of

¹⁰³ Liu, above n 65, 224.

¹⁰⁴ Beverley McLachlin, Chief Justice of Canada, Forward to G L Gall, *The Canadian Legal System* (5th ed, 2004).

certainty, the tax consequences of their actions. It also implies the separation of powers and the independence of the judiciary, so that taxpayers can rely on the courts to resolve their disputes with the government.

The Chinese legal system is different; it is not based on the Western notion of the rule of law that restrains state power. In ancient China, the ruler was accountable to no one and was above the law. The law functioned as an instrument of control. The political process required no participation of the people. Regime changes were driven by bloody conflicts. The administrative process was highly sophisticated and top officials were selected through the *keju* system. ‘Administrative bureaucracies in China have long dominated the process of governance, to the extent that administrative decision making virtually eclipsed the law-making authority of the [law maker].’¹⁰⁵ Under that system, bureaucrats not only enforced laws, but also adjudicated disputes. There was no independent judiciary. In modern China, some of these traditions remain. ‘Law is not a limit on state power, rather, it is a mechanism by which state power is exercised, as the legal forms and institutions that comprise the Chinese legal system are established and operate to protect the Party/state’s political power.’¹⁰⁶ Deputies to the NPC are becoming more active in proposing legislation, ‘although broader data suggests that the Party and state bureaucracies continue to dominate most legislative proposals’.¹⁰⁷ The judiciary is subordinate to the NPC.

In the Chinese tax context, tax ‘laws’ are promulgated by the NPC, implementation regulations are promulgated by the State Council, and specific tax measures are introduced by the SAT or the Ministry of Finance. The power to interpret tax laws, regulations and measures lies with the body that has the power to enact them, that is, the NPC, the State Council and the SAT or the Ministry of Finance. Courts have no

¹⁰⁵ P B Potter, *The Chinese Legal System: Globalization and Local Legal Culture* (2001), 20–1.

¹⁰⁶ *Ibid* 10.

¹⁰⁷ *Ibid* 17.

general power to interpret tax legislation. Interpretations and decisions of the SAT are not generally subject to judicial review. For the first time in Chinese history, starting in 1989, certain bureaucratic actions (primarily enforcement actions and penalty decisions) became reviewable by the court in accordance with the Administrative Litigation Law.¹⁰⁸ This law was intended to hold decisions by administrative agencies more accountable and to provide remedies for administrative misconduct.¹⁰⁹

3.4 Tax Policy Process

The process of making tax policy is dictated by the institutional structure and processes of each country. In Canada, the Department of Finance is responsible for tax policy, which includes formulating amendments to existing statutes, such as the Income Tax Act (the ‘Act’), or introducing a new tax:

- Many amendments are announced in the Minister’s annual budget. The Minister of Finance presents a budget to Parliament each year, usually in February or March. The budget provides an estimate of the government’s revenues and expenditures for the next financial year, which starts on April 1. Because of the significance of income taxes for the revenue side, the budget usually proposes a set of changes to the Income Tax Act.
- The Department of Finance is responsible for starting the legislative process in amending the Act. It often prepares a ‘notice of ways and means motion to amend the *Income Tax Act*,’ which lists and describes all the amendments to the Act that have been proposed. The notice of ways and means motion is followed by legislation in draft form. Since 1983, the Department of Finance has followed the practice of issuing explanatory notes (or technical notes) to

¹⁰⁸ Administrative Procedure Law of the People’s Republic of China, Adopted at the Second Session of the Seventh National People’s Congress on April 4, 1989, promulgated by Order No 16 of the President of the People’s Republic of China on April 4, 1989, and effective as of October 1, 1990). For further discussion, see W Cui, ‘The Rule of Law in Chinese Tax Administration’ in C Evans et al, (eds), *The Delicate Balance: Tax, Discretion and the Rule of Law* (2011) 362–3.

¹⁰⁹ The impact of this law can be limited. Potter, above n 105, notes at 24: ‘Since Chinese regulations are drafted to give officials maximum discretionary authority and so are often intentionally vague and ambiguous, it is difficult, if not impossible, to establish that any but the most egregious conduct was actually in violation of existing regulations. And since the courts have expressly been denied power to pass judgment on the propriety of administrative decisions that are not in violation of specific laws and regulations, administrative decisions that represent abuses of discretion but are technically within the law may not be overturned under the [Administrative Litigation Law]’.

accompany the draft legislation. This material is helpful in explaining the purpose of amendments, which are often exceedingly difficult (even for tax professionals) to understand on their own. The purpose of issuing the legislation in draft form initially is to provide an opportunity for the tax community to comment on the legislation. In fact, commentary is received and sometimes does lead to changes in the legislation.

- Eventually, a bill amending the Act is introduced into the House of Commons by the Minister of Finance. That bill then follows the normal legislative process, which includes scrutiny by standing committees of both the House of Commons and the Senate, and is enacted into law in due course.¹¹⁰

Tax policies in China generally originate from either the SAT or the Ministry of Finance. The process of tax policy making in China has become more transparent over the past three decades. Public input was sometimes sought and given. An example is the 2011 amendment of the Individual Income Tax. In the case of the unprecedented process for public input in amending the Individual Income Tax, the process seems to be as follows:

- The Ministry of Finance started the process by involving the relevant department of SAT and created a first draft. This draft was submitted to the Legal Affairs Office of the State Council, which consulted with relevant ministries and departments of government and then generated the second draft.
- On 1 March 2011, the executive meeting of the State Council approved the ‘Draft Amendment to the Individual Income Tax Law’. The State Council submitted the Draft Amendment to the Standing Committee of the 11th NPC.
- On 20 April 2011, the Standing Committee of NPC considered the draft Amendment,¹¹¹ and officials from the Ministry of Finance and SAT answered questions about the proposed amendment in public.¹¹²

¹¹⁰ For further discussion, see B J Arnold and H Kerr, ‘The Canadian Tax Policy Process’ in Kerr, McKenzie and Mintz, *Tax Policy in Canada* (2012), Ch 3; and S D Pollack, ‘Arenas of Federal Tax Policy’ (2012) *Tax Notes* 1499–514.

¹¹¹ In accordance with the Chinese Law Making Law, upon the receipt of a draft legislation, the Standing Committee of the National People’s Congress can ask a committee to examine the draft and prepare a report and then include the draft legislation on the agenda of the meetings of the Standing Committee. In the case of the proposed Individual Income Tax Amendment, the Finance and Economics Committee reviewed the draft and suggested changes.

¹¹² See Officials from the Minister of Finance and State Administration of Taxation Answering Questions from the Media, at <<http://www.gov.cn>>, 20 April 2011 (in Chinese).

- On 25 April 2011, the Office of the Standing Committee of the NPC published the Proposed Amendment to the Individual Income Tax Law of the People's Republic of China (Draft) and sought public input.
- From 25 April 2011 to 31 May 2011, 82,707 'netizens' (Internet Users) provided input, 181 people wrote letters, and 11 experts and 16 members of the public were invited to attend a hearing and give comments on the proposed draft amendment.¹¹³
- On June 30, 2011, the Standing Committee of the NPC promulgated the decision

The draft was presumably made public by the State Council when published on its website on 2 March 2011.¹¹⁴ As a result of the amendment, 60 million individuals were removed from the tax net.¹¹⁵ In general, however, the law-making process in China is more opaque: public input is not often allowed and policy debates are not made in public.

3.5 Tax Administrative Process

3.5.1 The Agency

In Canada, federal tax laws are administered by the Canada Revenue Agency (CRA). According to the *Canada Revenue Agency Act* (S.C. 1999, c. 17),¹¹⁶ the CRA is responsible for, among others, supporting the administration and enforcement of tax legislation. The CRA's website¹¹⁷ states that 'the CRA is the model for trusted tax and benefit administration, providing unparalleled service and value to its clients, and offering its employees outstanding career opportunities'. The CRA undertakes to

¹¹³ Liao Wengen, 'Netizens Actively Suggest Amendments to the Individual Income Tax Law: 82707 People Made 237684 Suggestions' <http://www.npc.gov.cn/huiyi/lfzt/grsdsfxz/2011-06/16/content_1659110.htm>. (in Chinese).

¹¹⁴ Office of State Council, 2 March 2011, State Council Discussed and Passed the Draft Amendment to the Individual Income Tax Law, at <<http://www.gov.cn>>.

¹¹⁵ Wu Yan, '60 Million Individuals Are Exempted From Paying Individual Income Tax and Experts Worry About Difficulties in Sharing Public Resources', *People's Daily*, 29 July 2011 (in Chinese) <<http://www.chinanews.com/cj/2011/07-29/3218426.shtml>>.

¹¹⁶ For the text of this legislation, see <<http://laws-lois.justice.gc.ca/eng/acts/C-10.11/page-2.html>>.

¹¹⁷ See <http://www.cra-arc.gc.ca/gncy/prgrms_srvcs/mssn-eng.html>.

contribute to the well-being of Canadians and to the efficiency of government by delivering world-class tax and benefit administration that is responsive, effective and trusted. It regards integrity as the foundation of its administration and aspires to treat people fairly and to apply the law fairly. Professionalism, respect of clients and co-operation are its key values. The CRA regards taxpayers as its clients and aims to provide ‘unparalleled service and value’ to its clients.

The SAT administers tax laws in China. In comparison to the CRA, the SAT has a much broader mandate. Providing services to taxpayers is among its main responsibilities, but not listed as the top one. Its main functions include drafting tax laws and regulations, providing tax policy recommendations, enforcing tax laws and regulations, interpreting tax law and policy, participating in research on macro-economic policy and making recommendations on central-local tax sharing, planning and organising a system of taxpayer services, protecting taxpayer’s lawful interests, formulating and implementing rules to regulate registered tax practitioners, and exercising vertical, exclusive control and administration of the national tax system and dual control over the local tax administration system. The SAT website makes no mention of its values and principles.

3.5.2 Rules and Procedures

In Canada, rules and procedures governing the main aspects of tax administration are provided in legislation. These rules and procedures are designed to ensure the operation of a self-assessment tax system. There are extensive provisions specifying the obligations of taxpayers and third parties (including banks, financial institutions, employers, etc.) to provide information to the CRA, the powers of the CRA to demand information from taxpayers, to audit and assess taxpayers, the duty of the CRA to

protect taxpayer information, as well as the duties of tax advisers to the tax system.¹¹⁸ The administrative process limits the scope of discretion of CRA officials and all parties are bound by the same law. The thrust of these rules is that taxpayers are presumed honest in reporting their tax obligations and the CRA's job is to assist taxpayers comply with the law and go after those who do not. Transparency is the key. Tax avoidance and tax evasion are dealt with differently: the latter is a crime and is punishable by imprisonment, whereas the former is lawful, and even if the avoidance scheme is found unsuccessful, there is no penalty imposed. The difference between tax avoidance and tax evasion lies in deceit: the latter involve fraud and intentional misrepresentation of facts, whereas the former involves taking advantage of legislative loopholes, but nothing is hidden from the CRA.

The Chinese Law on Tax Collection and Administration¹¹⁹ provides for many general rules that are similar to those in Canada, such as filing tax returns, withholding obligations, audit and investigation, and penalties. These rules appear to be 'heavy handed' in favour of the government as opposed to 'guides' for taxpayers to comply with the law. These seem to lack a sense of treating taxation as a 'social' enterprise, that is, banks, financial institutions, other third parties, as well as tax advisers all play a role in operating the tax system.

3.6 Tax Disputes Resolution Process

3.6.1 Judicial and/or Administrative Processes

Disputes between taxpayers and the tax administration are resolved through administrative reviews and judicial appeals. In Canada, the majority of tax disputes are

¹¹⁸ See Hogg, Magee and Li, *Principles of Canadian Income Tax Law* (8th ed, 2013), Chapter 18.

¹¹⁹ Law of the People's Republic of China Concerning the Administration of Tax Collection (hereinafter '*the Tax Administration Law*'), adopted at the 27th meeting of the Standing Committee of the Seventh National People's Congress on 4 September 1992; amended in 1995, 2001; Implementation Regulations for the Tax Administration Law, effective as of 15 October 2002.

settled administratively, while a small percentage of disputes end up in court. In China, judicial review is rare and administrative review is the norm.

The system of the rule of law requires an independent judiciary that has exclusive jurisdiction over statutory interpretation, including the Constitution and tax statutes. In Canada, the courts' role is to interpret and apply the tax legislation as it was adopted by Parliament. Judges are not accountable to the government or Parliament. Judges regard themselves as 'arbiters' of the tax battlefield between the government and taxpayers: 'The role of the court is as arbitrator between the Minister and the taxpayer. We are the protectors of neither the public nor the private purse'.¹²⁰ Courts generally interpret tax statutes on the basis of the textual meaning and construct the facts in accordance with their legal form (as opposed to their economic substance). Only in GAAR cases, judges take on the 'unusual duty' of going behind the words of the legislation to determine the object, spirit or purpose of the provision or provisions relied on by the taxpayer.¹²¹ The origin of the Canadian judicial approach towards tax avoidance goes back to the *Duke of Westminster* (1935) case.¹²² This case established the principle that a taxpayer is entitled to arrange his or her affairs to minimise tax. This principle is derived from the strict or literal approach to statutory interpretation

¹²⁰ In tax cases, the government and the taxpayer are equal parties before the court.

¹²¹ In *Copthorne v R* (2011), Justice Rothstein further clarifies that: '[I]f the Court is confined to a consideration of the language of the provisions in question, without regard to their underlying rationale, it would seem inevitable that the GAAR would be rendered meaningless' : at [66].

¹²² *Commissioners of Inland Revenue v The Duke of Westminster* [1936] AC 1 (House of Lords): 'The facts in *Duke of Westminster* were straightforward. The Duke of Westminster had a number of household servants. The then British Income Tax Act did not allow a deduction of wages of household servants, but allowed a deduction of annual payments made in pursuance of a legal obligation other than remuneration of servants. The Duke accordingly entered into deeds of covenant with each of his servants under which he undertook to pay each of them annual sums for a period of seven years. The payments were to be made irrespective of whether any services were performed by the promisee, and were without prejudice to the promisee's entitlement to remuneration if he or she did perform any services to the promisor. However, it was established by evidence that the understanding between the Duke and his servants was that they would rest content with the provision made for them by deed, and would not assert any right to remuneration. In this way, the Duke converted his non-deductible wages obligation into a deductible annuity obligation. The deeds were legally effective in that all legal formalities had been carried out. Nor were the deeds shams: the Duke had covenanted to pay the annuities for seven years, and had thereby assumed the risk of having to continue to pay an annuitant who had stopped working for him or who had insisted upon additional remuneration for working for him. Of course, the understanding that the faithful retainers would continue to work for him, and would do so without extra charge, virtually eliminated this risk. But the risk was genuinely assumed, and none of their lordships regarded the deeds as shams. The legal form of the transactions was found controlling and the Duke was entitled to deduct the payments.'

and the characterisation of transactions based on legal form.¹²³ When the government loses a case in court, it can only reverse the decision prospectively through legislative amendment.

The Tax Court of Canada is a specialised court. Although based in Ottawa, the court hears cases in different locations across the country. There are two sets of procedures for the Tax Court. The informal procedures apply to cases involving a small amount and taxpayers do not need to have legal representation. The general procedures apply to other cases and require taxpayers be represented by a lawyer. The decision of the Tax Court is final unless the losing party appeals the decision to the Federal Court of Appeal. The Court of Appeal may overturn or uphold the decision of the Tax Court and its decision cannot be automatically appealed to the Supreme Court of Canada. A leave for appeal must be granted by the Supreme Court before a formal appeal is filed. The Supreme Court hears tax cases only when there is an issue of national importance.

In China, courts do not have the final power of statutory interpretation. The lawmaker is also the ‘legitimate’ interpreter. For example, the Constitution provides that the NPC has the power of interpretation regarding ‘laws’ and the State Council has the power to interpret ‘regulations’. Chinese courts adjudicate a small number of tax disputes that may shed some light on the meaning of tax legislation. Case law is not a source of law in China. In reality, the SAT has the actual power of interpretation that binds taxpayers. Courts generally hear administrative cases that involve taxpayers suing tax officials for their ‘misconduct’.¹²⁴ These cases are generally concerned with

¹²³ According to strict interpretation, tax could only be imposed if a taxpayer’s situation was literally covered by the words of a charging provision; and a taxpayer’s situation was determined by reference to the legal rights and obligations created by the taxpayer, not the economic substance. If, therefore, a taxpayer arranged the legal rights and obligations so that the statute did not literally apply, tax was avoided despite the fact that the arrangement, especially if construed in accordance with its economic substance, might have been within the spirit of the statute.

¹²⁴ The Administrative Procedure Law of the People’s Republic of China (adopted on 4 April 1989 at the Second Session of the Seventh National People’s Congress, effective 1 October 1990.) The SAT has issued guidelines to help local tax offices prepare for the defence, make arguments in court, file appeals and enforce court decisions. See Operational Guidelines on Responding to Tax Administrative Appeals (effective 1 January 1995), available at the SAT website.

actions in assessing penalties, enforcing collections, or other aspects of tax administration.¹²⁵

3.6.2 Role of Tax Professionals

Lawyers and accountants play an important role in the tax system. In Canada, lawyers may represent a client in a controversy with the CRA at the stage of audit, administrative appeal within the CRA, or in courts. In this context, the lawyer serves as an advocate. Among the duties and obligations, candour towards the tribunal and the duty of confidentiality to the client are particularly important. In tax litigation, as in other litigation, the lawyer's duties of honesty and candour require that the lawyer be scrupulous to never mislead his or her opponent or the court by misstating the facts or the law, or by failing to inform the court of a relevant authority. The failure to inform the court of a relevant authority is a breach of legal ethics, even if the authority is adverse to the client and has been overlooked by the opponent's lawyer. This is an example where the lawyer's obligation to the system trumps or mitigates his/her duty of loyalty to the client. Within these constraints, a lawyer is free to urge on behalf of the client any position that is fairly arguable, even if the lawyer regard that position as unmeritorious. In the role of an advocate (as opposed to an adviser), the lawyer is not asserting his or her opinion as to the correct legal position, but is simply submitting arguments on behalf of the client. The lawyer leaves the task of evaluating the strengths of competing arguments and of determining the correct legal position to the court. Traditionally, the ethical obligations of tax lawyers do not differ much from the ethical obligations of other lawyers. The same rules of professional conduct apply to the practice of tax law. In recent years, however, there has been a trend in Canada and

¹²⁵ For an empirical study of tax administrative cases in China, see Ji Li, 'Dare You Sue the Tax Collector! An Empirical Study of Administrative Lawsuits Against Tax Agencies in China' at <<http://ssrn.com/abstract=2256021>>.

elsewhere to impose additional obligations on tax practitioners, who by virtue of their expertise, are viewed as gatekeepers for the tax system.

In China, tax disputes are resolved primarily through administrative reviews as the courts play an insignificant role. Tax practitioners are primarily accountants and tax agents.¹²⁶ Lawyers are involved in tax practice in a more limited manner. Tax agents are required to ‘abide tax laws and regulations, to be independent and honest in their work, to safeguard state interest, and protect the lawful rights and interests of clients’.¹²⁷ Their duty to the state and duty to the client are parallel, although the former is expected to trump the latter in case of any conflict between the two. It is interesting to observe that a large tax agency firm, UniTax, states on its website in Chinese that its ‘enterprise tenet’ is to ‘serve for national tax, serve for taxpayer’, but the order was in their English translated website changed — to ‘serve for taxpayer, serve for national tax’.

3.7 Horizontal versus vertical relationships

Overall, the tax processes in Canada and other Western countries are more ‘collaborative’ and the Chinese processes tend to be top-down, dominated by the SAT. For example, in Canada, each of the tax institutions (legislature, judiciary, the CRA, and tax professionals) plays a role in developing tax law:

- The legislature formally enacts tax legislation and is the supreme body of law-making.
- The judiciary contributes to tax law development in at least three ways. First, courts clarify the meaning of statutory provisions through the exercise of

¹²⁶ SAT issued Interim Regulations on Tax Agents in September 1994; Interim Regulations on the Qualifications of Registered Tax Agents on 22 November 1996 (together with the Human Resources Ministry); and Interim Regulations on the Administration of Registered Tax Agency Firms, effective 1 February 2006. Registered tax agents and tax firms are emerging. Some tax firms, such as UniTax (<http://www.uni-tax.com>), are employing over 1,000 people and rendering tax services to some prominent clients. One of its founders, Mr Zhizhong Liu, has recently been appointed as a member of the Tax Appeals Review Committee of the SAT.

¹²⁷ Ibid. Art 19 of the Interim Regulations on the Administration of Registered Tax Agency Firms.

statutory interpretation. For example, the concept of ‘income’ has been interpreted by Canadian courts to exclude gambling winnings or gifts. Second, court decisions that are deemed incorrect are overruled through legislative amendment. Finally, some tax principles are well entrenched in the tax culture but not codified into tax statutes. These principles include: the right of taxpayers to arrange their affairs in any manner possible to minimise taxation, the characterisation of facts in accordance with the legal form, and that any ambiguity in a statutory provision should be interpreted in favour of the taxpayer.

- The CRA contributes to the development of tax law by participating in tax policy formulation, tax law drafting, and enforcing tax rules, especially the general anti-avoidance rule (GAAR).
- Tax professionals, especially tax planners and tax litigation lawyers, often push the limit of tax law by taking advantage of the ‘loopholes’ or advancing innovative positions on statutory interpretation. In court proceedings, lawyers representing the taxpayer provide the court with legal arguments to support their client’s case in a manner that is grounded in law and reasoning. In an adversarial system, the two parties battle to win the case, each acting as the adversary of the other. It provides a procedure for the parties to present and resolve their case, in as fairly a manner as possible. The court is thus presented with two sets of arguments and its decision is thus better informed than otherwise.

Before the law, taxpayers and the CRA are equal. Tax compliance and tax planning can be analogised to a card game. The CRA’s cards are all on the table, faced up; the taxpayer does not need to show his or her cards until the end of the game. In case of any disputes, the referee (i.e., the court) decides the winner. If the CRA does not like the cards or the decision of the referee, it must go back to the legislature for new cards or new rules of the game. The taxpayer and his or her tax advisors have opportunities to say if the new cards or new rules are fair. The game then continues.

4. Case Study of China’s Tax Transplants

The phenomenon of tax transplants in China discussed earlier confirms the validity of the theory that legal borrowing is a main source of legal change. This Part of the paper discusses some challenges in transplanting foreign tax laws into China and the

experiences drawn from the transplantation of two tax principles: progressive income tax and arm's length principle.

4.1 Processes of Transplantation

4.1.1 Selection

China has not transplanted an entire tax system or tax law from the West. It has always selected appropriate tax concepts, rules or principles that solve a specific tax problem and suit China's needs. Throughout Chinese history, there has been no Western religion, language, medicine or law that could displace the indigenous Chinese counterpart. For example, Western medicine co-exists with traditional Chinese medicine. Thus, foreign transplants must meet China's needs.

Potential candidates for transplants can be identified through various means, including research using print or online sources, in-country presentations by foreign experts, short-term study visits to foreign countries, officials studying in a foreign country for an extended period of time (including LLM in tax programs), and attending international tax conferences. Since it is often easier to find a specific rule or legislative provision (law on paper) than to find the rationale for such provision (the political or policy process) and how it is actually applied (administrative process and judicial process), what tends to be transplanted is the substantive rule.

4.1.2 Life Cycle

Whether a transplant meets China's needs depends on many factors. One of the factors is the 'life cycle' of the transplant. A tax system or tax idea may have a 'life cycle'. For example, it was suggested that progressive taxation becomes a concern at the early state of national economic development and becomes less pressing when a country

reaches a more mature phase.¹²⁸ A tax system undergoes changes at different stages of maturity. A tax norm that suits the need of a mature economic system may not be appropriate for an emerging economy.

China has transplanted tax norms from mature tax systems, whose specific context for introducing the norm and the stage of the ‘life cycle’ of the tax system differ significantly from that of China. For example, the general anti-avoidance rule (GAAR) was recently introduced in Australia (1981), Canada (1988), and the United States (2010), almost a century after the introduction of income tax, in order to counter aggressive tax planning structures that were held acceptable by the courts.¹²⁹ China introduced the GAAR as part of its consolidated Enterprise Income Tax Law (2007). Its motivations were different from, for example, that of Canada. To begin with, introduction of the GAAR was not in reaction to any adverse court decision. The main purpose of the GAAR is to combat ‘hidden’ or ‘unforeseeable’ tax avoidance transactions. ‘No matter how airtight the tax law system is, loopholes always exist’.¹³⁰ GAAR seems to mainly target cross-border transactions. Another possible motivation is ‘scientific’ drafting so that the law on paper looks comprehensive. Compared with the Canadian GAAR, the Chinese GAAR is primarily meant to be proactive, empowering the SAT to attack emerging aggressive tax planning transactions.

¹²⁸ Livingston, 2010, above n 3, 38.

¹²⁹ In Canada, the triggering court case is *Stuart Investments Ltd. v. The Queen* [1984] 1 S.C.R. 536. In that case, the taxpayer transferred the business losses of one subsidiary to another subsidiary for tax purposes through a series of transactions on paper. The Income Tax Act treats each corporation as a separate entity and does not generally allow a consolidation of losses between related companies. The taxpayer achieved consolidation by selling the profit-making business to the loss company and then appointing the profit-making company to manage the business as an agent. There are specific anti-avoidance rules, but the Supreme Court of Canada found these rules inapplicable. Furthermore, the Court relied on the number and variety of these specific anti-avoidance measures that were in existence at the time to buttress its conclusion that the Court of its own motion should not create a business purpose test that had not been enacted by Parliament. Since none of the specific anti-avoidance measures caught the situation in that case, the Court reasoned that it should not assume the power to disregard genuine legal arrangements simply because of their tax avoidance motivation. The lesson that the Department of Finance drew from the reasoning in *Stuart* was that the Income Tax Act ought to include a general anti-avoidance rule, which would cover such a broad range of tax avoidance activity that an unforeseen device such as that employed in *Stuart* would not fall through the cracks again. The GAAR was enacted as a “defensive” measure and as the last resort.

¹³⁰ SAT, Guidelines for Public Education of the Spirit of the New Enterprise Income Tax Law, Circular No 59, 5 Feb 2008, available at the SAT website: <[http:// www.chinatax.gov.cn](http://www.chinatax.gov.cn)>

The GAAR is used in mature tax systems to ‘invite’ the courts to play a more active role in protecting the tax base, but such use is currently not an issue in China — the life cycle of the GAAR is comparable, the life cycle of the tax system is not. As a result, the operation of the GAAR is bound to be different in China. An appreciation of the different processes that led to the enactment of the GAAR in Canada, US and Australia may shed more light on the application of the GAAR in China, especially with respect to multinational companies based in these countries.

4.1.3 Translation

One of the first steps of tax transplantation is to translate a foreign rule into Chinese.¹³¹ Anyone who speaks more than one language and has attempted translation can attest to the fact that it can be truly difficult, if possible at all, to achieve perfect translation. The criteria for ‘good’ translation include: a faithful reproduction of the information given in the source language text, correct, taking implicit factors and complementary information into account.¹³² Literal translation is generally not good enough. Faithful and correct translation requires more than linguistic skills.

Translation of foreign tax laws into Chinese imposes an additional layer of complexity because of the technical aspects. The translator should ideally have linguistic skills as well as tax knowledge. To do a good translation, the translator should ideally understand the context in which the tax norm is used. In other words, it is not just words that are translated, but the concepts or even the way of thinking. It cannot be denied that some concepts are not easy for translation. For example, both ‘tax equity’ and ‘tax fairness’ are translated into ‘*shui shou gong ping*’ (税收公平). The Chinese words ‘*gong*’ and ‘*ping*’ together imply justice and proportionality and not much of

¹³¹ Ibid.

¹³² See P Newmark, *About Translation* (Multilingual Matters Limited, 2nd ed, 1993), 162; S W Chan, *A Dictionary of Translation Technology* (Chinese University Press, 2004), 90; J Munday, *Introducing Translation Studies: Theories and Applications* (Routledge, 1st ed, 2001). [Please provide publisher details too. Thanks.]

procedural fairness as it was embedded in the English concept. Another term is ‘arm’s length’. The literal meaning of ‘arm’s length’ is to ‘the length of one’s arm’. ‘Arm’s length principle’ is translated into ‘独立交易原则’ (‘principle of independent transactions’) in Enterprise Income Tax Law, Article 41.

The translator may misread the source country or misunderstand its own country. Legal doctrines or institutions evolve and develop over time, often not in response to a particular objectively defined social need, but as a result of a complex interplay of social forces with different agendas.¹³³ Understanding the cultural context in its home country (often the United States) is important to the accuracy of the translation and the fate of the transplant in China. Because taxation is an important public policy instrument, it is by nature a field of contestation for different groups with radically differing goals. The final tax law reflects a compromise of various competing interests or an outcome of processes that may be unique to the source country. The lack of proper understanding of the different processes in China and the West may result in superficial translation.¹³⁴

4.1.4 Adaptation

The process of adopting foreign tax rules into domestic law and the process of ensuring the borrowed rules adapt to the local environment are related and critical to the success of tax transplants. Several considerations may be relevant. Presumably, adopting a foreign rule that has a good ‘genetic’ quality and fits well in more than one country, especially one that has some similarities with the Chinese environment, would have a better chance of adaptation in China. In the area of personal income tax, an example might be the jurisdictional principles that look at a person’s residence or the territorial source of income. Moreover, adopting a scheme of taxation as opposed

¹³³ D C Clark, ‘Lost in Translation? Corporate Legal Transplants in China’ (Public Law Research Paper No 213, George Washington University Law School, 10 July 2006) <<http://ssrn.com/abstract=913784>>.

¹³⁴ Ibid.

to a specific rule out of context would have a better chance of adaptation. Similarly, transplanting the necessary tax processes along with the substantive tax rules would facilitate the adaptation of the transplants.

The gap between law on paper and law in action is often determined by administrative conditions and institutional capacity. Tax rules that are sound in tax policy and work well in a developed country may not function well in China. One key condition is the compatibility of a transplanted rule with Chinese tax processes. For example, the progressive tax principle is most sensitive to local political and administrative processes, whereas the arm's length principle is less sensitive to political process, but very sensitive to administrative processes. On paper and in reality, China is successful in transplanting the arm's length principle, but not the progressive tax principle.

4.2 Progressive tax Principle

Progressive taxation is a fundamental Western principle of personal income taxation. Personal income tax is particularly adaptable to the graduated rates that makes it progressive. This is because taxpayers typically cannot shift the tax to others. It can be designed to take account of the personal circumstances of each taxpayer, and in particular the total amount of the taxpayer's income, his or her family circumstances, and other factors which bear on the taxpayer's ability to pay. That is why personal income tax is the only progressive tax in Western countries.

The idea is that tax burdens should be proportionate to the taxpayer's ability to pay reflects a society's sense of fairness.¹³⁵ Fairness is sometimes considered the glue of a democratic society.¹³⁶ It is a key issue to consider when designing a tax regime. Once

¹³⁵ 'The search for fairness is one of the most enduring of the shared goals of a civilized society': Brooks, above n 94, 6 (citing Douglas Hartle's remarks about the Royal Commission on Taxation created in 1962 to study tax reform in Canada).

¹³⁶ R M Bird and J S Wilke, 'Chapter 2: Tax Policy Objectives' in *Tax Policy in Canada*, above n 110, at 2:3.

a certain level of government spending and taxation is accepted, how the tax burden is shared among the taxpayers becomes the tax policy question. The benefit principle and the ability to pay principle provide some insights into thinking about the fairness question.

The benefit principle suggests that taxpayers contribute in proportion to the benefit they derive from the government. It assumes that taxes are the purchase of governmental services by taxpayers. In Canada, a person's ability to earn income depends to a substantial extent on a number of factors, such as the existence of a vibrant civil society, good legal system, health care, educational and public safety systems, and opportunities produced by a dynamic economy, which, in turn, depend on a sound legal system that defines and protects property rights and regulates the function of the markets.

The ability to pay principle suggests that contributions to the expenses of government should be apportioned so that each person 'shall feel neither more nor less inconvenience from his share of the payment than any other person experiences from his'.¹³⁷ This principle demands that persons with greater ability to pay tax do so at a higher rate. A person with a low income needs all or most of the income simply to survive. A person with a high income can provide for necessities and have a substantial amount left over. The taxpayer's ability to pay taxes is determined by the amount of income available for discretionary use. In general, the greater the total income, the higher the fraction of that income is available for discretionary use. The ability to pay principle dictates not merely that upper-income taxpayers should pay more dollars in tax than lower-income taxpayers, but that upper-income taxpayers should pay a greater proportion of their income in tax than lower-income taxpayers. This conclusion necessitates a progressive rate schedule.

¹³⁷ Mill, *Principles of Political Economy* (Longmans, Green, 1923), Bk 5, Ch 2, sec 2. (Note: Any publisher details available?)

The Western notion of fairness based on ability to pay or benefit theory does not have a natural fit in the Chinese culture. The Chinese tradition is derived from the Confucianism and from its assumptions about authority and hierarchy in social organisation.¹³⁸ The Confucian concept of *li* (propriety or virtue) dominated the regulation of social relationships and held that these were inherently unequal. The hierarchical social structures resulted from the *li* were deemed essential to the orderly existence of society. On the other hand, the inherent inequality of social relations was accepted as it proceeded from an assumption of the basic natural equality of men and that man was born with equal natural abilities and characteristics, and any achievement of status was deemed to be the result of superiority in acquired virtue.¹³⁹ In other words, higher social status can be earned through hard work, education and exam writing skills. During imperial China, the bureaucracy was open to men who passed the highly demanding examinations (*ke ju kao shi*) and higher-level positions were offered to higher scorers. Those who aspired to a career in the imperial service had to submit to three stages of gruelling tests conducted in specially built exam centres. It was the most able and most driven candidates who passed the examination.¹⁴⁰ In ancient times, the exams were virtually the only path to a privileged life for common people and that made the national *keju* competition extremely fierce. Once successful, power and perks accompany the position obtained. A old Chinese saying goes ‘*yi ren de dao, ji quan sheng tian*’ (When a man becomes an official, even his chickens and dogs receive privileges.) The society accepted the inequalities in social standing, economic wealth, and/or political power as natural and as merely the

¹³⁸ Potter, above n 105, 7.

¹³⁹ Ibid 8–9. See also D J Munro, *The Concept of Man in Contemporary China* (University of Michigan Press, Ann Arbor, 1977), 1-22.

¹⁴⁰ But with its strong emphasis on the Four Books and Five Classics of Confucianism, with their bewildering 431,286 characters to be memorised, and the rigidly stylised eight-legged essay introduced in 1487, it was an exam that rewarded conformity and caution. It was fiercely competitive, no doubt, but it was not the kind of competition that promotes innovation, much less the appetite for change. See N Ferguson, *Civilization: The West and the Rest* (The Penguin Press HC, 2011), at 43.

result of varying degrees of attained virtue.¹⁴¹ There was no popular demand for redistribution.

In contemporary China, the attitude towards tax equity and fairness has evolved. Until the economic reforms, income inequality was not a major concern. Income disparity started to grow after the adoption of the policy to ‘let some people become rich first’.¹⁴² Some people became rich through entrepreneurship, investment and speculative adventures. Some amassed wealth through rent seeking or profited from each wave of reforming/privatising state-owned enterprises or assets. Overall, it can be said that the main reason for the growing disparity is that income was earned through monopoly and illegal activities.¹⁴³ There has been a growing public resentment of such disparity. And yet, the official policy of allowing some people to become rich first is at odds with progressive taxation. The Chinese Individual Income Tax is progressive only with respect to wages, salaries and income from private businesses. It does not capture grey income arising from rent seeking, illegal income or income from the informal sector. There is no clear consensus or a political process for developing such consensus on the ways of improving equity and fairness.

Progressive tax rates were part of the new Individual Income Tax Law introduced in 1980. The political process that resulted in progressive taxation in the West was not transplanted, for obvious reasons. The administrative processes to ensure reporting and paying progressive taxes by individuals were not transplanted. Instead of self-assessment, reinforced by third-party information reporting of income and source withholding of taxes, the Chinese Individual Income Tax relies on final withholding of taxes on a payment-by-payment basis, which makes it impossible to impose tax based on the ability to pay. There is also strong social support for the collection of this tax as

¹⁴¹ Potter, above n 105, 9.

¹⁴² Attributable to Deng Xiaoping, the leader of China who started the economic reforms in the late 1970s.

¹⁴³ Liu, above n 65, 138.

banks, institutions and payers [this is right and understandable by our readers]of investment income (such as corporations) are not legally required to assist the government in collecting the tax. As a result, although it has been part of the Chinese tax system since the inception of the modern tax system, the progressive tax principle has not taken root in China.¹⁴⁴

4.3 *Arm's Length Principle*

The arm's length principle is a widely adopted principle that deals with the problem of transfer pricing. Transfer pricing refers to practices of multinational corporations to price their intra-group transactions prices in order to minimise their global tax liability.¹⁴⁵ The arm's length principle is found in the tax laws of OECD countries and many developing countries. The OECD Transfer Pricing Guidelines are regarded as standard guidelines. These Guidelines provide detailed commentaries and guidance on the meaning of the arm's length principle, the methodologies for determining the arm's length price, and processes for diagnosing transfer pricing problems, procedures for documenting and reporting information by taxpayers, processes for negotiating advance pricing agreements, and the process of resolving tax disputes. The CRA has incorporated these guidelines into its administrative policies in administering section 247 of the *Income Tax Act*.¹⁴⁶

The arm's length principle was not introduced in China until 1988, even though the first corporate income tax was introduced in 1980.¹⁴⁷ It was codified into law in

¹⁴⁴ For further discussion, see R Krever and H Zhang, 'Progressive Income Taxation and Urban Individual Income Inequality' (2011) *Asia-Pacific Tax Bulletin* 192; Jinyan Li, 'China's Individual Income Tax: A 26-Year-Old Infant' (2006) *Tax Notes International* 297; Liu, above n 65.

¹⁴⁵ Organisation for Economic Cooperation and Development (OECD), *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010) (the 'OECD Guidelines') <<http://www.oecd.org/ctp/transfer-pricing/transfer-pricing-guidelines.htm>>.

¹⁴⁶ Canadian Revenue Agency, *Information Circular, IC87-2R International Transfer Pricing* (27 September 1999) <<http://www.cra-arc.gc.ca/E/pub/tp/ic87-2r/>>.

¹⁴⁷ *Supra* note 15. [Which reference in footnote 15? Please clarify] – there is only one A Easson and J Li, 'Taxation of Foreign Business and Investment in the People's Republic of China' (1985–1986) *New Jersey International Law & Business* 666

1991.¹⁴⁸ Almost simultaneously, the SAT issued interpretation circulars to provide more details on the implementation of the arm's length principle.¹⁴⁹ Following several years of experience with transfer pricing, the SAT revised the transfer pricing circular in 1998 — 'Tax Administration Rules and Procedures for Transactions between Associated Enterprises' (Trial).¹⁵⁰ The revised circular marked the beginning of China's transfer pricing administration system.¹⁵¹ It incorporated much of the OECD Transfer Pricing Guidelines and reflected some of the best practices in other countries. In 2004, the SAT further revised the transfer pricing circular¹⁵² and released a new circular on APAs — 'Implementation Rules for Advance Pricing Agreements Governing Transactions between Related Enterprises (Trial)'.¹⁵³ The year 2004 was known in China as the year of anti-avoidance.¹⁵⁴ In 2005, the SAT established a national anti-avoidance case monitoring and management system.¹⁵⁵ The arm's length principle was included in the current Enterprise Income Tax Law (EIT Law) and the Implementation Regulations, promulgated in 2007.¹⁵⁶ The SAT issued a revised, more detailed circular specifying the methodologies and processes for implementing the

¹⁴⁸ *Law of the People's Republic of China Concerning the Administration of Tax Collection*, adopted at the 27th meeting of the Standing Committee of the Seventh National People's Congress on 4 September 1992; amended in 1995, 2001; Implementation Regulations for the Tax Administration Law, effective as of 15 October 2002.

¹⁴⁹ In 1992, the tax authorities published a circular entitled 'The Implementation Measures for the Tax Administration of Transactions between Associated Enterprises' (*Guo Shui Fa* No 237 (1992)), to explain the standards for the identification of associated enterprises, annual information to be reported and other fundamental issues.

¹⁵⁰ *Guo Shui Fa* No 59 (1998) (hereinafter 'the 1998 Transfer Pricing Circular'). This circular was comprised of 52 articles which are organized in 12 chapters. In October 2002, the State Council introduced Implementation Rules for Tax Collection and Administration Law, Articles 51 to 56 of which provide detailed rules for transfer pricing, which incorporated many provisions in the 1998 Transfer Pricing Circular.

¹⁵¹ For a rather detailed account of the history of the Chinese transfer pricing system, see *Transfer Pricing Tax System and Its Development in China*, which was purportedly prepared by the State Administration of Taxation, online: <<http://www.rrojasdatabank.info/chinatprice02.pdf>> (hereinafter '*the Unofficial SAT Document on Transfer Pricing*').

¹⁵² SAT Circular, *Guo Shui Fa* No 143 (2004).

¹⁵³ SAT Circular, *Guo Shui Fa* No 118 (2004).

¹⁵⁴ *China Tax News* (2 September 2009).

¹⁵⁵ *Ibid.* By the end of 2007, 174 taxpayers had been subjected to transfer pricing audits, 152 of which had been reassessed, resulting in over RMB1.2 billion.

¹⁵⁶ EIT Law, above n 19.

arm's length principle — 'Measures for the Implementation of Special Tax Adjustment (Trial)' (2009). These Measures largely track the OECD Guidelines.¹⁵⁷

Judging by the volume of rules and procedures introduced by the SAT and the near complete 'transplantation' of the OECD Guidelines, the Chinese transplantation of the arm's length principle is a huge success. In fact, the Chinese SAT has become very sophisticated in implementing the arm's length principle and recently begun to play a role in further refinement of principle through the work of the United Nations.¹⁵⁸ As such, judging by the gap between the transplanted law on paper and the law in reaction, the Chinese transplantation of the arm's length principle is also successful.

Unlike the transplantation of the progressive tax principle, the transplantation of the arm's length principle is less dependent on the political process. Securing a fair share of the profit of multinational corporations for Chinese tax purposes serves China's national interest. In order to secure China's 'fair' share of global profit, China needs to follow the international norms that are defined by the OECD and followed by other countries. Chinese traditional values and culture are less relevant to the transplantation of the arm's length principle and its associated processes because the problem of transfer pricing is new and solutions could not be home-grown. Moreover, because the arm's length principle relies on effective administrative processes for implementation, it 'fits' with the strong bureaucratic tradition in China. It is the transplantation of the processes that ensures the successful transplantation of the arm's length principle.

5. Conclusions

This paper teases out some arguments about the importance of process in tax transplants. Because processes are arguably sensitive to local political, socio-legal and

¹⁵⁷ See Explanation of the EIT Regulations published on SAT's website: <<http://www.chinatax.gov.cn>>.

¹⁵⁸ United Nations, *Transfer Pricing Manual* — China (2012)
<http://www.un.org/esa/ffd/documents/UN_Manual_TransferPricing.pdf>.

economic conditions of a country, it is imperative that they are taken into consideration in the process of tax transplants. To the extent possible, the transplantation of substantive rules, principles or norms should be accompanied by transplanting the necessary processes. Alternatively, the recipient country should beware of the demands for processes of the transplanted tax law and strive to create the necessary processes to ensure its adaptation. The correct selection and translation of Western tax laws is a precondition to successful transplants.

In terms of contribution to literature, this paper singles out tax processes as a key factor that affects the success of tax transplants. The case study of the Chinese tax transplants builds on existing literature on the theories of legal transplants and on the unique features of tax transplants. This paper adds to existing literature by demonstrating that the apparent convergence in tax law (e.g., progressive tax principle and arm's length principle) in Canada and China does not mean convergence in reality, owing to different tax processes. The paper also contributes to literature by demonstrating that tax processes are the product of local political, socio-legal culture. If a transplanted tax principle or rule is accompanied with a transplant of the associated processes, it has a greater chance of success in the recipient country.

Research for this paper has several limitations. One limitation is the lack of any standard to measure the success of the Chinese transplantation of progressive tax principle or the arm's length principle. The paper relies, instead, on presumptive evidence, such as the extent of legislative and administrative rules. The other limitation is the lack of empirical evidence that links the effectiveness of tax transplants to tax processes. Hopefully, these drawbacks can be remedied by further research.