

# Tax Avoidance in Family Related Transactions and China's Anti Avoidance Measures for Purpose of Individual Income Tax

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## Abstract

In 2018, China started to implement the comprehensive income system for the first time in its new Individual Income Tax Law<sup>1</sup>, in order to reform the old scheduled income system which has been enacted since 1980 and promote tax equality. However, the tax unit of its individual income tax is only the natural person rather than the family, so the risks of tax abuse like income shifting in a family to avoid the progressive rate rise in this filed, which can be witnessed in the tax practice of many developed countries, such as United States, United Kingdom, Australia, New Zealand, Germany, etc. More importantly, this kind of tax abuse is usually manipulated by family members, causing the problem about how those family related transactions should be combated. On one hand, many tax-free provisions have ever been set for families in the system of China's individual income tax, reflecting a strong value to protect the family ethics in such a Confucian-influenced country. On the other hand, there are new but vague anti-avoidance rules added in its Individual Income Tax Law 2018, including the special rules against the transactions between related parties and the general anti-avoidance rule. With the deeper reform of direct tax in China, the concept of family plays an increasing role in its tax system. How can China coordinate between the objective of anti-abuse made by family members and the value to protect family ethics? What can China learn from the experiences of western countries' legislations to modify its current anti-avoidance rules? Is it necessary for China to introduce the joint-return system for the family now? This article will make some suggestions to respond to the above questions.

**Keywords:** Individual income tax law; Tax avoidance; Income shifting; Family.

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## 1. Introduction

The kinship and family have always been an important field of Chinese traditional culture, and the tax-related issues on family dealings often stir up the sensitive nerves of Chinese public.<sup>1</sup> For a long time, the tax-free regulations have been established for such dealings, reflecting a strong tendency for the protection to the kinship in China's tax laws. China's Individual Income Tax Law, which involves the most contexts of marriage and family relations compared with other tax laws. However, it chooses the separate-return system instead of a joint-return system which can treat the family as an independent tax unit usually paying less taxes. The current choice of tax unit

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1. See *infra* Part 2.1.

is due to the relatively slow reform of the scheduled income tax and the situation that the whole China's tax system focusing on the indirect tax, such as Value-Added Tax (hereinafter referred to as "VAT"). To a certain extent, the separate-return system has been a reasonable choice for China's IIT system before the year of 2018.

The revision of China's IIT Law in 2018 has a historic significance. With the new round of reform of China's fiscal and tax system aimed at cutting taxes and administrative fees since 2016, the revenues of indirect taxes such as VAT has declined,<sup>2</sup> and the IIT, as a typical direct tax, will be playing a more increasing role in terms of revenues collection and the realization of taxation equality. The new IIT Law has not only fundamentally changed the structure of the previous schedular income tax system, but also introduced the anti-avoidance rules such as related transaction rule, general anti-avoidance rule (hereinafter referred to as "GAAR") into this field for the first time. In this new tax system, the anti-avoidance of individual should get more attentions to be designed in detail, especially for the income shifting among the family members.

This article initially focuses on the family tax issues based on the long-standing and broad tax exemption provisions for families and the complete separate-return system. But now they also need some changes to respond to the reform of IIT Law of 2018 where the new anti-avoidance rules may not cope with the potential tax avoidance among related parties of family under the expansion of progressive tax to more income categories. This article will also compare the designs of anti-avoidance of income taxes of different countries and reflect on how to harmonize the two legal values behind China's IIT: the family ethics orientation which emanated from tax-free regulations and a commercial and market-oriented judgement standard about anti-avoidance transplanted from Enterprise Income Tax (hereinafter referred to as "EIT") Law to the new IIT Law. It is so significant for China to reconcile the contradiction between the increasingly market-oriented economy and the inheritance of traditional family ethics. Finally, the article also reflects on the current choice of tax unit in IIT and its possible improvement for the future.

Following this Introduction (part 1), part 2 mainly introduces the status quo of China's tax regulations for family members dealings, and analyzes the legal value orientation of these rules, then puts forward the potential problems about income shifting avoidance. Part 3 mainly introduces the reform of China's IIT law in 2018 and its impact on tax avoidance, and discusses the legislative logic of the new anti-avoidance rules. Part 4 analyzes how to deal with the problem of income shifting between family members with the new special anti-avoidance rules for related party transactions and GAAR, and considers the rationality to choose an optional joint-return system for core family (husband and wife) instead of the complete separate-return system. Part 5 is a brief conclusion.

## **2. Tax exemption for relatives under the schedular tax system**

### **2.1. Tax exemption and its ethical value in China's tax law**

The dealings among family members, especially the property transfers, often involve the forms of transfers at a low price or gifts. In this field, many countries levy estate and gift tax or transfer tax.<sup>3</sup> On one hand, The purpose of this kind of tax is to adjust the transfer of wealth between generations. On the other hand, it may be regarded as the supplement to the income tax. In those countries, the gift and inheritance are exempted from the income tax for the purpose of elimination of double taxation. For example, the U.S. exempts bequest and gift before death from the income tax, while

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2. From April 1, 2019, China's general VAT payers' sales activities or imports that are subject to VAT at an existing applicable rate of 16% or 10%, the applicable VAT rate is adjusted to 13% or 9% respectively. See Announcement on Policies for Deepening the VAT Reform (Announcement [2019] No. 39 of the Ministry of Finance, the State Taxation Administration and the General Administration of Customs).

3. For example, France, Germany, United States, Japan, United Kingdom all have this kind of tax.

the unified transfer tax should be paid on this part of property.<sup>4</sup> Of course, some countries, like Canada, does not levy inheritance tax, but imposes income tax on the transfer of capital property in some circumstances.<sup>5</sup>

In China, the estate and gift tax has not been levied due to the considerations of difficulties in mastering the scope of taxable property, the complexity of collection, management procedures and the capital flight, etc.<sup>6</sup> But the transfers of specific properties (equity, real estate) are subject to the individual income tax, and there are also a lot of special tax-free rules for these behaviors among family members.

The IIT Law made by National People's Congress of China (the legislator)<sup>7</sup> has no clause about taxation on gift or transfer at/with less than market value, while some administrative normative documents enacted by the State Administration of Taxation (hereinafter referred to as "SAT") of China set the taxation rules to those above dealings. For the transfer of equity, if it constitutes the condition that the transaction price is significantly low (or gift) without proper reason, the transferor should be taxed by reassessing the tax base of this transaction with a fair market value.<sup>8</sup> As for the low-price transfer of real estate, the tax shall be also levied on the transferor,<sup>9</sup> while for the donation of the real estate, the real estate shall be regarded as a kind of income of the done.<sup>10</sup>

Therefore, although China still has no estate and gift tax, taxpayers shall pay the income tax when the donation (including low-price transfer) of specific property (equity and real estate). However, if these transfers are made among the family members, the above transactions are tax-free which is stipulated as one of the legal situations of "proper reasons" in the aforementioned administrative normative documents made by SAT: if a taxpayer inherits or transfers his real estate or equity to his family members, which includes "spouse, parents, children, grandparents, grandparent, grandchildren, grandchildren, brothers and sisters, and the fosterers or dependents who have direct obligations to the transferor," all taxes shall be exempted. On top of the IIT,<sup>11</sup> in other taxes of China, family member dealings are also kept from taxation, such as Value-Added Tax, Land Value-Added Tax.<sup>12</sup> In 2011, local taxation bureaus tried to levy the deed tax on the operation that the house owner gives the house to his/her husband/wife. This taxation attracted great public response and academic discussion,<sup>13</sup> forcing the SAT issued an official document to exempt such house transac-

4. Pursuant to 26 USC 102(c), the receipt of a gift, bequest, devise, or inheritance is not included in gross income.
5. Canada Revenue Agency, Gifts and Income Tax 2019, available at <https://www.canada.ca/en/revenue-agency/services/forms-publications/publications/p113/p113-gifts-income-tax.html#eligible.>, accessed 10 May 2020.
6. See Notice of the China's Ministry of Finance on the reply to proposal No. 0107 (fiscal and financial No. 018) of the fifth session of the 12th National Committee of the CPPCC (fiscal and financial No. 197 [2017]), available at [http://szs.mof.gov.cn/jytafwgk/\\_8391/2017jytafwgk/2017zxwytawgk/201710/t20171017/\\_2726094.html](http://szs.mof.gov.cn/jytafwgk/_8391/2017jytafwgk/2017zxwytawgk/201710/t20171017/_2726094.html), accessed 10 May 2020.
7. The National People's Congress (NPC) is the supreme organ of state power in China.
8. See article 11, 12 of the Taxation on Promulgation of the Administrative Measures on Individual Income Tax on Income Derived from Equity Transfer (Trial Implementation) (State Administration of Taxation Announcement [2014] No. 67).
9. See article 1 of Issues relating to Individual Income Tax over Income from Transfer of Housing Property (State Administration of Taxation Announcement [2006] No. 108).
10. See supra note 12, article 2.
11. The individual does not pay the income tax when he / she disposes house property transfer due to divorce. See article 4 of Taxation Circular on Several Implementing Issues Regarding Individual Income Tax (State Administration of Taxation Announcement [2009] No. 121)
12. Both Value-added Tax and land Value-added Tax have exemption provisions for family dealings. See article 36 of Taxation on Full Launch of the Pilot Scheme on Levying Value-added Tax in Place of Business Tax (finance and taxation [2016] No. 36). See also article 2 of Detailed Rules for the Implementation of the Provisional Rules of the People's Republic of China on Land.
13. After the Interpretation (III) of the Supreme People's Court Interpretation of the Marriage Law of China, some couples hope to sign their names on the real estate certificate together, which constitutes the house donation behavior between spouses in civil law. In view of this situation, Wuhan, Nanjing and other local tax administrations proposed to levy deed tax on this act of adding husband/wife's name to the property certificate. Public opinion is in a uproar for this, available at <http://legal.people.com.cn/GB/15566837.html>, accessed 13 May 2020. See also Weizhen Guo, *Shui fa Zhong de shen*

tion behaviors between husband and wife.<sup>14</sup>

Therefore, it can be seen that for a long time, China's tax laws seem to provide a wide range of tax exemption for transactions between family members and it's taken for granted that the intra-family transfers, especially for interspousal transfer, is in a taxation-free field. From another point of view, the above rules seem to treat the family like an income-sharing unit in China's tax law. That is to say, when the members of this unit transfer, divide or distribute property even income, they do not bear corresponding tax obligations internally. This can also be confirmed by other rules, for example, in the EIT Law, if a stockholder and his/her family members own a company, their amounts of shares shall be consolidated.<sup>15</sup> Some Chinese scholars believe that this is a kind of "Tong Ju Gong Cai" (Living Together and Property Sharing) which is one of the traditional family characters of China, now confirmed in the tax law. Although dealings among family members are taxable according to the ability to pay principle, the above provisions provide tax benefits for purpose of "recognition and respect for the ethical value, as the cornerstone of Chinese society."<sup>16</sup> Of course, no matter whether Chinese families constitute a *de facto* income-sharing unit or not, at least, these rules reflect a strong value of family ethical protection.

## 2.2. Impacts of the separate-return system

Nevertheless, those rules with the character of "Living Together and Property Sharing" are not consistent with the legal tax unit in IIT Law, in which only the natural person instead of the family is the taxable unit. Although there have long been argued that, considering the role of traditional Chinese ethics and the family usually served as an important economic unit in China, and in order to realize the deduction of family expenses, the joint-return system reform should be implemented.<sup>17</sup> Some representatives of National People's Congress (hereinafter referred to as "NPC") have made public proposals to the NPC to call for the reform of tax unit.<sup>18</sup>

Therefore, China's tax laws permit that the relatives can transfer their property freely without tax, but in the IIT Law, only the individual is regulated as the only tax unit, rather than the family. In this system of tax unit, tax avoidance may usually happen in form of family dealings, causing some problems such as eroding the tax base of income tax, endangering tax equality, and offsetting the effect of progressive tax rate.

### 2.2.1. Possibility of tax avoidance

Generally speaking, family members who have the natural intimacy are most likely to form a related relationship and it is easier for them to come to a tax avoidance plan or scheme. In other

*fen yu zheng ce qu xiang (Identity System and policy orientation in Tax Law)*, Taxation Research, Vol. 3, 2013, 61–62. See also Ke Zhang, Fang chan, hun yin yu shui quan zhi li: ji yu "jia ming shui" feng bo (Real estate, Marriage and Tax Right Governance: Based on the Analysis of the Event of "Adding Name Tax"), Journal of Shanghai University of Political Science & Law, Vol. 29, 2014(1).

14. See Deed Tax Policies for Change from Sole Ownership of Estate or Land Title by Husband or Wife to Joint Ownership by Husband and Wife (Finance and Taxation [2011] No. 82).

15. Two or more related individuals with blood relationship, relationship in law and collateral blood relationship within three generations jointly hold a company, and their shareholding proportions shall be calculated by combining. See Implementation Measures for Special Tax Adjustment (State Administration of Taxation Announcement [2009] No. 2)

16. See Weizhen Guo, *Shui fa Zhong de shen fen yu zheng ce qu xiang (Identity System and policy orientation in Tax Law)*, Taxation Research, Vol. 3, 2013, 61–62.

17. See Zhengwen Shi, *Fen pei zheng yi yu ge ren suo de shui fa gai ge (the Justice of Distributive and the Reform of Individual Income Tax Law of China)*, China Legal Science, Vol. 5, 2011, 42. See also Hua Li, Jia ting hai shi ge ren: lun wo guo ge ren suo de shui na shui dan wei de xuan ze (Family or Individual: Research on the Choice of Tax Unit of Individual Income Tax of China), Public Finance Research, Vol. 2, 2011.

18. In 2015, Zhongchuan Dai, a deputy to the National People's Congress, suggested that IIT should be declared and deducted by family. In 2018, it was proposed by the Central Committee of the China Party for Public Interest and the Central Committee of the Chinese Peasants and Workers Democratic Party that the family should be the tax unit in IIT.

countries, for example in United States, “family” is an important concept in its Internal Revenue Code designed to reject related manipulations.<sup>19</sup> Similarly, the concept of the “related individuals” in Canada’s Income Tax Act, including consanguinity, marriage, legal cohabitation partner and upbringing relationship, is an important determinant of the non-arm’s-length relationships.<sup>20</sup> A typical loophole some fraudulent taxpayers abusively exploit is the tax rate difference between the low marginal tax rate and the high marginal tax rate in a progressive income tax system. Under the “temptation” of low marginal tax rate, taxpayers tend to transfer income from high-income individuals to low-income spouses or children, so as to minimize the application of higher marginal tax rate, and maximize the individual’s allowance and specific deduction,<sup>21</sup> reducing the overall tax liability. That makes the tax system face the problems of tax avoidance from the income transfer between family members, which is called “income shifting.”

This kind of tax avoidance is generally considered to be related to the choice of tax unit. Once a separate declaration is introduced into the income tax, the changes of law are needed to be introduced to determine the extent to which the distribution of income between spouses are allowed.<sup>22</sup> In practice, in order to realize the transfer of earned income, the taxpayers usually design a contractual arrangement making related parties obtain right to income, such as entering into employment contracts with family members, or making them become partners for the division to divide the partnership profits. For the transfer of negative income, the avoidance arrangement are usually the forms of transferring the income-generating property to the related parties and the transferor subsequently retains control of sums apparently disposed of.<sup>23</sup> Therefore, the above operations are to transfer the right to income to the related parties with lower marginal tax rate. This kind of tax avoidance not only erodes the tax base, but also undermines the income adjustment function of the progressive income tax system. In addition, it also has the effect of “stupid tax” (Dummensteuern), that is, compared with people who know the tax planning (income shifting), people who do not understand the tax law will suffer unfair.<sup>24</sup>

In China, since there is no joint-return system which can legally split income between family members, under current separate-return system, the illegal income shifting is likely to happen. Furthermore, The lack of gift tax to intra-family transfers in China makes this kind of avoidance behavior of income transfer more unimpeded,<sup>25</sup> and the tax-free rules set for transfer between relatives even

19. The U.S. income tax is far more complex and sophisticated than China, the allowance of claimed losses, the conversion of ordinary or dividend income into long-term capital gain, or the accumulation of income in holding companies are all the types of related manipulations. And the Revenue Act of 1934 was the first taxing statute to recognize “members of a family” as a definitive group for tax purposes. See Thomas J. Reilly, An Approach to the Simplification and Standardization of the Concepts, “The Family,” “Related Parties,” “Control,” and “Attribution of Ownership,” *Tax Law Review*, Vol. 15, 1960, 253–259.

20. Canada Revenue Agency, Income Tax Folio S1-F5-C1, Related Persons and Dealing at Arm’s Length, available at <https://www.canada.ca/en/revenue-agency/services/tax/technical-information/income-tax/income-tax-folios-index/series-1-individuals/series-1-individuals/income-tax-folio-s1-f5-c1-related-persons-dealing-arms-length.html>, accessed 10 May 2020.

21. See David G. Duff, *Neuman And Beyond: Income Splitting, Tax Avoidance, And Statutory Interpretation In The Supreme Court Of Canada*, *Canadian Business Law Journal*, Vol. 32, 1999, 345.

22. See Glen Loutzenhiser, *TAX AVOIDANCE, PRIVATE COMPANIES AND THE FAMILY*, *Cambridge Law Journal*, Vol. 72(1), 2013, 46.

23. See Hugh J. Ault, Brian J. Arnold, *Comparative Income Taxation: A Structural Analysis*, Wolters Kluwer, 2010, p. 326.

24. See Gezhong Ke, *Lun jia ting suo de ke shui zhi du (Research on the Family Income Tax System)*, *Public Law Review of Soochow*, Vol. 3, 2010.

25. In Canada, when the Gift Tax was first introduced in 1935, the Minister of Finance explained that the tax was being imposed “primarily to operate as a deterrent to transfers of property by gift, chiefly within family groups which would have the effect of reducing personal income to lower brackets and thus securing income tax assessment at rates lower than would otherwise be applicable.” See David G. Duff, *Neuman And Beyond: Income Splitting, Tax Avoidance, And Statutory Interpretation In The Supreme Court Of Canada*, *Canadian Business Law Journal*, Vol. 32, 1999, 345. In U.S., legislative history reveals Congress thought without gift tax, taxpayers might easily defeat the progressive rate structure of the income tax by engaging in the practice of income shifting. See also Mitchell M. Gans, Jay A. Soled, *Reforming the Gift Tax and Making it Enforceable*, *Boston University Law Review*, Vol. 87, 2007, 763.



further become a new “loophole” that can be exploited.<sup>26</sup> Therefore, under the complete separate-return system, the occurrence of income shifting among family members seems to become more possible.

### 2.2.2. Alleviation of contradictions under the schedular income system

So a contradiction actually existed between tax-free transfer among family members and the complete separate-return system. But before the reform of 2018, this kind of tax avoidance pressure for the tax authorities was actually relieved to a large extent under the previous schedular tax and withholding system.

Since 1993, when China firstly formulated the unified IIT Law,<sup>27</sup> it had implemented the schedular income tax system. In this system, the income of individual was divided into 11 legal categories.<sup>28</sup> The deductions, tax rates and the method to calculate tax of each category were different. It was impossible to combine all sources of income and apply them to an unified tax rate.<sup>29</sup> Offsetting loss in one kind of category against the income in other categories is also not feasible, for example, the loss generated from “income from transfer of property” cannot be deducted in the “income from wages and salaries.” The progressive tax rate was only applied to two kinds of income types in IIT Law, which are “income from wage and salary” with seven brackets generated from employer-employee relationship and income from individually-owned business with five brackets. The flat tax was apply to the other types of income such as remuneration, royalties, interest, dividends, bonuses, and capital gains.<sup>30</sup>

This kind of tax system design is actually related to then lack of capacity for tax collection and management of China. For individual, the reason why the progressive tax rate was only applied to the “income from wage and salary” is that “this income source is transparent and it's convenient to collect and managed,”<sup>31</sup> and withholding at source can effectively control the tax source from salaried class and ensure the distribution function of progressive tax rate. While for the income coming from independent labor services such as “income from remuneration for personal services,” “income from remuneration for personal services ,” and the capital income like dividends, interest

26. For the real estate, the taxpayer can choose the way to sale house rather than house donation, through the non-performance of the contract, so that the relative transferee can get more tax benefits deducted in the second transfer. On the other hand, due to the implementation of the preferential policy aimed at the transferor owning only one house more than 5 years, taxpayers who make the interspousal transfer of real estate, and then divorce to sell it. As for the stock equity, according to the tax policy of China, the transfer of common stock shares by individuals is tax-free, so the restricted shares (always from executives of listed companies) can be donated to their relatives by, and then converted into common shares to obtain tax-free benefits.

27. in 1980 there were three “individual income tax laws,” for the non-resident individual, resident individual and individually-owned business respectively. In 1993, they were combined into one unified individual income tax law until now.

28. See Article 2 of Individual Income Tax Law of the People's Republic of China (2011), Individual income tax shall be levied on the following categories of individual income:

- (1) Income from wages and salaries;
- (2) Income from production and business operations of individual industrial and commercial households;
- (3) Income from contracted and leasing operations of enterprises and institutions;
- (4) Income from remuneration for personal services;
- (5) Income from author's remuneration;
- (6) Income from royalties;
- (7) Income from interest, dividends and bonuses;
- (8) Income from lease of property;
- (9) Income from transfer of property;
- (10) Contingent income; and
- (11) Other taxable income determined by the finance authorities of the State Council.

29. See Zhengwen Shi, *Fen pei zheng yi yu ge ren suo de shui fa gai ge (the Justice of Distributive and the Reform of Individual Income Tax Law of China)*, China Legal Science, Vol. 5, 2011, 33.

30. The tax rate is 20%. See article 3 of Individual Income Tax Law of the People's Republic of China (2011).

31. See supra note 25.

and capital gains, they are so hidden and highly liquid that a lot of tax manipulations can be made.<sup>32</sup> They're difficult to be collected if relying on the method of withholding, and in turn a single, proportional tax rate for those income categories is a relatively feasible approach which can contribute to the tax compliance of taxpayers.

Compared with the systems in other countries with the joint-return system, where tax collection relies on the declaring instead of withholding at source, such as France, Germany, the United States, Switzerland, Luxembourg.<sup>33</sup> For purpose of collecting fiscal revenue effectively,<sup>34</sup> before 2018, China established the old scheduled income tax system to control the sources of income. In this system, the application scope of progressive tax rate applied to the income categories is limited and the tax declaration just played a subsidiary role. This is the reason why the possibility of income shifting was very limited, making the system which takes the individual as the taxable unit feasible and reasonable.

In this way, China could control the basic tax source by withholding and cut down the administrative cost, but the revenue proportion of IIT among all the taxes was very low in China,<sup>35</sup> at only 6.58% in 2019, limiting its capacity to narrow the social wealth gap, which is the price of oversimplifying tax system. Under this system China's salaried class has become the largest taxpayer group bearing IIT. From 2007 to 2014, only the "income from wage and salary" category accounted for nearly 2 / 3 of the total IIT revenue.<sup>36</sup> By contrast, the fiscal contributions of China's billionaires, the population of whom had outnumbered that of the United States in 2016,<sup>37</sup> to tax sources were not visibly proportional to their wealth.

### 3. Emergence of tax avoidance risks and anti-avoidance legislation in China's new IIT Law

#### 3.1. Reform of China's Individual Income Tax system

The revision of law often follows the changes of China's development objectives. On October 18, 2017, the Communist Party of China, as the ruling party, at its 19th national congress proposed that the principal contradiction of Chinese society "has been transformed into the contradiction between

32. See Jieyin Tang, *Na shui ren ji ben quan li de bao zhang yu shi xian ji zhi: yi ge ren suo de shui wei he xin (The Guarantee and Realization Mechanism of Taxpayers' Basic Rights: take China's Individual Income Tax as the Core)*, China Law Review, Vol. 6, 2018, 56. See also supra note 33.

33. In terms of the collection and management of individual income tax, most countries (regions) that allow families to file together, in France, Germany, the United States, Switzerland, Luxembourg, the Philippines, Thailand, Brazil, Hong Kong of China and other countries and regions, tax declaration is the main form of tax collection and management, supplemented by source withholding. Only Spain and Norway use source withholding as the main form of tax collection and management, supplemented by tax declaration. See Jieyin Tang, *Ge ren suo de shui ke shui dan wei de xuan ze: ge ren hai shi jia ting (The choice of tax unit of individual income tax: individual or family)*, Presentday Law Science, 2012(2), 117.

34. See Huiqiang Xing, *Ge ren suo de de zong he gui zhi yu fen lei gui zhi (The Comprehensive Control and Scheduled Control of China's Individual Income)*, East China University of Political Science and Law Journal, Vol. 1, 2019, 19.

35. Individual income tax is the fourth largest tax category in China. See Ministry of finance of China, Fiscal revenue and expenditure in 2019, available at [http://gks.mof.gov.cn/tongjishuju/202002/t20200210\\_3467695.htm](http://gks.mof.gov.cn/tongjishuju/202002/t20200210_3467695.htm),. Accessed 30 March 2020.

36. See Xia Cui, *Xin yi lung ge shui gai ge de xian shi yue shu yu li xing xuan ze (Realistic Restriction and Rational Choice of the New Round of Individual Income Tax Reform of China)*, On Economic Problems, Vol. 6, 2016. According to the data of China family finance survey and research center of Southwest University of Finance and Economics, the average monthly income is under 38 500 China Yuan (about 5431 U.S dollars) of the working class contributed 83.1% of individual income revenue. See Ying Lin & Weiyu Wang, *Zong he lao dong suo de ge ren suo de shui (Comprehensive Individual Earned Income Tax)*, Taxation Research, Vol.11, 2018, 38.

37. The number of billionaires (594) of China has surpassed that of U.S. (535) in 2016. Available at [http://europe.chinadaily.com.cn/epaper/2016-10/21/content\\_27126606.htm](http://europe.chinadaily.com.cn/epaper/2016-10/21/content_27126606.htm), accessed 11 May 2020.

the people's growing needs for a better life and unbalanced and inadequate development."<sup>38</sup> This is the first time since the year of 1978 that the national development goal of "economic construction as the center"<sup>39</sup> has been adjusted directionally, which means that China will pay more attentions to the current situation of uneven distribution of wealth behind its high-speed economic growth. The IIT system should play a significant role in income distribution and bridge the gap between the rich and the poor.

The new Individual Income Tax Law (implemented on January 1, 2019) makes great institutional progress compared to the previous several rounds of IIT reforms.<sup>40</sup> In this reform, the comprehensive income tax system is introduced for the first time. Four income categories including "income from wages and salaries," "income from remuneration for personal services," "income from author's remuneration" and "income from royalties" are combined into a new category called "comprehensive income," so as to uniformly apply to a progressive rate with seven brackets (3%, 10%, 20%, 25%, 30%, 35% and 45%) which was originally only applied to the "income from wages and salaries." Meanwhile, "income from lease of property," "income from transfer of property" and other negative income categories maintain a single tax rate of 20%. In essence, China's schedular income tax system has been transformed into the dual income tax system mainly with "comprehensive income," which makes the IIT have a stronger capacity to redistribute the social wealth. At the same time, China improves the amount of standard deduction and sets six new special additional living deductions, consisting of expenses towards children education, continuing education, major illness medical treatment, housing loan interest or housing rent, support for elderly<sup>41</sup> in IIT to abide by the ability to pay principle.

The reform of tax collection and management system is carried out as well. On April 27, 2017, the SAT proposed a reform to build a more "modern" tax collection and management system, taking the mode of tax declaration rather than withholding as its centre.<sup>42</sup> In 2020, China started to implement the annual individual income tax declaration and refund system, making more Chinese natural persons participate in tax declarations through the app on cell phones.<sup>43</sup>

The expansion of the application of progressive tax rate improves the redistribution capacity of IIT, but high marginal tax rates can generate significant and substantial increase of tax avoidance in IIT, especially among the upper-income taxpayers.<sup>44</sup> Furthermore, the above-mentioned independent labor income newly applied to the progressive rate is different from the "income from wages and salaries" which is easier to be withheld by the employer at source. For the self-employed individuals, they can manage to establish intermediate organizations, which usually get some tax incentives designed for small and micro enterprises by Chinese government. In this way they can

38. See Constitution of the Communist Party of China (amended on 24 October 2017), available at [http://news.cnr.cn/native/gd/20171028/t20171028\\_524003716.shtml](http://news.cnr.cn/native/gd/20171028/t20171028_524003716.shtml), accessed 11 May 2020.

39. Xiaoping Deng, the second rank leader of China, changed the line of "taking class struggle as the key point" in Zedong Mao era at the central leaders' meeting on January 16, 1980. At the same time, he proposed that the economic construction should be taken as the center, which made the Chinese rulers pay more attention to the speed of economic development (mainly GDP growth), and to some extent ignored the balance of development and the adjustment of the polarization between the rich and the poor.

40. China's current individual income tax system was determined in the IIT Law revised in 1994, and then it was revised five times in 1999, 2005, 2007, 2008 and 2011. However, these changes mainly focus on the adjustment of the standard deduction. China's IIT finally made a relatively radical modification in 2018 and made a substantial breakthrough, initially realizing the reform goal proposed in 1995: from the adjustment of the scheduled income tax system established in 1980 to the dual income tax system combining classified and comprehensive characters.

41. See article 6 of IIT Law.

42. See Opinions on Changing the way of Tax Collection and Management and Improving the Efficiency of Tax Collection and Management (State Administration of Taxation Announcement [2017] No. 45).

43. See Economic Information Daily, The individual income report and refund system has been firstly implemented in China, available at [http://dz.jjckb.cn/www/pages/webpage2009/html/2020-08/20/content/\\_66913.htm](http://dz.jjckb.cn/www/pages/webpage2009/html/2020-08/20/content/_66913.htm), accessed 3 Sept 2020. <http://www.chinatax.gov.cn/chinatax/n810219/n810780/c5155864/content.htm>

44. See James E. Long & James D. Gwartney. *Income Tax Avoidance, Evidence from Individual Tax Returns*, National Tax Journal, Vol. 40, 1987(4), 517-532.



employ the relatives or other persons with non-arm's length relationship to split the income and achieve the goal of overall tax reduction. The "royalty fees" is generated from the ownership of the intellectual property like patent, trademark, copyright or non-patent technology, which can be transferred to others with the lower marginal rate. Although the new special additional living pre-tax deductions are beneficial to the salaried and low-income class, it also becomes new loopholes for income shifting.

However, the new IIT Law still maintains the separate-return system in which one of the spouses can claim the right to deduct the family expense as an individual rather than claim this right as a family.<sup>45</sup> As the reform of comprehensive income and progressive tax rate goes deeply in China, the possibility of income shifting between family members to avoid progressive tax rate could greatly increase when the tax unit is only the individual. Therefore, the changes of the tax system and the emergence of tax avoidance risks from family members dealings make the introduction of relevant anti-avoidance measures necessary.

### 3.2. Anti-avoidance legislation and its logic

The anti-avoidance legislation was also introduced for the first time in the Article 8 of China's IIT Law of 2018. Before that, tax authorities only have legal power to combat income tax avoidance made by corporations according EIT Law. Article 8 of IIT Law defines the tax avoidances both generally and enumerately, including the GAAR and some special anti-avoidance rules against the transactions between related parties and controlled foreign corporation (hereinafter referred to as "CFC") rule.<sup>46</sup>

Different from the income tax and its anti-avoidance practice which have a long developing process in the western countries, the legislation of China's income tax and its anti-avoidance practice show a relatively short history. Even the provisions of anti-avoidance established in IIT was later than that in EIT,<sup>47</sup> due to the fact that companies have made more fiscal contributions and their situations of tax avoidance got more attention from the tax authorities of China.

The related transactions rule, CFC rule and the GAAR regulated in the IIT Law 2018 are directly transplanted from the same rules in EIT Law which were originally designed for the abuses of companies,<sup>48</sup> just expanding application scope to individuals. As for this legislation in the new IIT Law, China's Finance Minister Kun Liu explained that the new anti-avoidance rules took the

45. Either parent may claim 100% deduction in accordance with the standards, or both parents may claim 50% deduction respectively in accordance with the standards, and the chosen deduction method shall not be changed within a tax year. See Article 6 of Notice of the State Council on Promulgation of the Provisional Measures on Special Additional Deductions for Individual Income Tax (State Administration of Taxation Announcement [2018] No. 41)

46. See Article 8 of IIT Law:

*Under any of the following circumstances, the tax authorities shall have the right to make tax adjustment based on a reasonable method:*

*(1) The business dealings between an individual and his/her related parties do not comply with the arm's length principle, and the tax payable amount of the individual or his/her related parties is thereby reduced, when there is no proper reason;*

*(2) An enterprise controlled by a resident individual, or an enterprise established in a country (region) with significantly lower tax burden and jointly controlled by a resident individual and a resident enterprise, does not distribute or reduces distribution of profits which is attributable to the resident individual, when there are no reasonable business needs; or*

*(3) An individual carries out other arrangements without reasonable business purpose and obtains improper tax gains.*

*Where there is a need to levy additional tax after making tax adjustments pursuant to the provisions of the preceding paragraph, the tax authorities shall levy additional tax and collect interest thereon pursuant to the law.*

47. As early as 1992, the SAT of China issued the anti-avoidance rules specifically regulating the business transactions of related enterprises.

48. The Enterprise Income Tax Law regulated the anti-avoidance rules in 2008 for the first time.

relevant provisions of the EIT Law as the reference.<sup>49</sup> If those rules are applied to the income shifting between family members, the related transaction rule requires that dealings between related individuals, shall follow the “arm’s length principle.” Meanwhile, this operation should also meet the “reasonable business purposes” required by the GAAR otherwise it would be ignored by the tax authority.

Therefore, although the comprehensive income reform of IIT Law has increased the possibility of tax avoidance within the family members, the legislation of anti-avoidance in this law play a very key role in closing the legal loopholes which may be exploited by taxpayers.

However, the problem comes from the nearly same literal words of those rules in both laws. Transactions made by individuals also have their own characteristics distinguished from those made by enterprises: (1) Business income is earned mainly by legal persons, while high-income individuals mainly obtain capital income and most of the middle class earn the income from employment and self-employment; (2) EIT mainly applies the flat tax rate, while the IIT takes the progressive tax rate as its basic feature; (3) regarding to the nature of the taxpayers’ associations, the association of enterprises is mainly the commercial relationship,<sup>50</sup> while the relationship among natural persons contains more family bonds. They all determine the anti-avoidance mechanism designed for individuals should be different from that for enterprises. If China simply imitated the anti-avoidance rules from its EIT Law, the IIT legislation will be difficult to meet the demands to combat the avoidance of individuals.<sup>51</sup>

It is noticeable that only one obvious change in IIT Law which is different from EIT Law is the introduction of the term “proper reasons” into the related transaction rule. It was argued that this term makes the family dealings be exempted from being taxed according to related transaction rule for consideration of the family ethics.<sup>52</sup> The reason is that the same term “proper reasons” is also regulated in the administrative normative documents formulated by SAT mentioned in the Chapter 2, where we discussed it is a tax-free rule for family dealings. It seems so if they are only understood to be consistent with superficial literal words of “proper reasons” in administrative normative documents and in IIT. However, in this way, the income shifting made by family members will be exempted absolutely from the application of above anti-avoidance rules and can not be combatted.

### 3.3. “Proper reasons”: whether the family dealings are exempted in new IIT Law

It seems that the goals of respecting family ethics and anti-tax avoidance have not been coordinated in the term “proper reasons,” which may be due to the dislocation of legal power behind the authorization rules.

49. See minister of finance Kun Liu, Notes on the amendment (Draft) to the individual income tax law of the people’s Republic of China, available at [http://www.npc.gov.cn/zgrdw/npc/xinwen/2018-08/31/content\\_2060176.htm](http://www.npc.gov.cn/zgrdw/npc/xinwen/2018-08/31/content_2060176.htm)., accessed 11 May 2020.

50. See Article 109 of Implementation Regulations for the Corporate Income Tax Law of the People’s Republic of China (Revised in 2019):

*An interested party referred to in Article 41 of the Corporate Income Tax Law shall mean an enterprise, organisation or individual related to an enterprise in the following manner:*  
 (1) direct or indirect control over funds, operations, procurement and sales etc...;  
 (2) under direct or indirect control by the same third party; and  
 (3) any other interested party relationships.

51. See Zongtao Wang, *Ru he she ji fan bi shui tiao kuan: ge ren suo de shui fa xiu gai (How to Design Anti-Avoidance Clause: Modification of Individual Income Tax Law of China)*, available at <http://dwz.date/a8ev>, accessed 11 May 2020.

52. See Junming Li, Commentary on the New Anti-Tax Avoidance Clauses in the Individual Income Tax Law of Mainland China, *Angle Accounting Magazine*, Vol. 14, 2019, 124.

For those official documents enacted by SAT where the initial “proper reasons” is regulated, in theory, they should be positioned as “estimating tax bases” rule when taxpayers violate the obligation to cooperate, similar to the rule stipulated in Section 162 of The Fiscal Code of Germany.<sup>53</sup> However, in China’s taxation practice, those presumption taxation rules have not been applied correctly so that they become an administrative tool, by which tax authorities have greater discretion power to reappraise the tax base just according to the “low price” of a transaction, even if the taxpayer has provided the usable and full information of this transaction. It is also considered to be an “anti-avoidance rule” by someone in China’s tax bureau.<sup>54</sup> In the case of Defa Real Estate Ltd v Tax Bureau of Guangzhou, which is the first tax-related case ruled by Supreme Court of China, the taxpayer provide the full information of the transaction at auction where there is only one bidder though. The court stated that the minimum bid is significantly lower than the evaluated valuation of the real estate and there is no full bidding for the price, so it is reasonable for tax authority to reappraise the tax base for considerations of the national tax revenue according to this presumption taxation rule.<sup>55</sup>

It must be made clear that although one of the elements of a tax avoidance is “reduce tax paid by a person or related parties” or “obtain improper tax benefits.”<sup>56</sup> “Low price” of a transaction may reflect a possible tax benefit for taxpayer, but it is not the sufficient condition to prove the tax avoidance, whose essence is the abuse of right. Therefore, the “proper reasons” for those rules should be distinguished from the one in IIT Law. Although the wordings of both two are the same, expressing a kind of reasonable situation in which the tax should not be imposed, the “proper reasons” ruled by SAT is an absolute family tax-free regulation when the obligation to cooperate is violated and the taxable income should be estimated. While for the “proper reasons” in new IIT Law, it works in an anti-avoidance rule according to which the abusive income shifting scheme should be ignored by tax authorities, even if the submission of usable records by the taxpayer.

It is still necessary to ensure that the ethical values be protected. If there is a real family transfer or other forms whose main purpose is non-tax, such as family reasons or out of love, they can also be regarded as reasonable. But the “arm’s length principle” directly transplanted from the EIT Law can measure the “distance” between individuals (especially relatives) is questionable. The “reasonable business purpose” of the GAAR, as the very key element to apply this rule, also does not involve the considerations of personal situations, such as an outright gift between relatives.

As we can see, the original intention of the term “proper reasons” from administrative normative documents of SAT now put in the related transaction rule of IIT Law is to embody the protection of the ethical value of relatives, but the “proper reasons” now seems to be too absolute and overemphasize the ethical value among family members, which is difficult to adapt to the anti-avoidance practice after the reform of IIT tax system. While, rules and standards transplanted from EIT may collide with the real ethical value, leading to the other market-oriented extreme. All in all, there is a mismatch between the supply of anti-avoidance system transplanted by EIT Law and the special demand of anti-avoidance of IIT Law. The characters of anti-avoidance for family members seem to be ignored by Chinese legislators, which leads to an obstacle of coordination between the relevant rules and concepts.

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53. Taxpayers or participants shall be obliged to cooperate with the authorities (Mitwirkungspflicht) in establishing the facts or information of the case (Section 90), Otherwise the revenue authority shall estimate the tax base (or the transfer price).

54. See International Taxation Research Group of Suzhou Industrial Park Local Taxation Bureau, *Wo guo ge ren suo de shui fan bi shui li fa yan jiu (Research on the Legislation of Anti-Avoidance of Individual Income Tax Of China)*, International Taxation in China, Vol. 3, 2018, 71.

55. See Supreme Court of PRC, 7 Apr 2017, Defa Real Estate Ltd v Tax Bureau of Guangzhou, (2015) Xing Ti Zi No. 13, available at <https://wenshu.court.gov.cn/website/wenshu/181107ANFZ0BXS4/index.html?docId=3875e788347042248591a7580111fb2a>, accessed 2 Sept 2020.

56. See Article 8 of IIT Law.

## 4. Reflection and construction on anti-avoidance rules of IIT

### 4.1. Rationality of special income attribution rules

#### 4.1.1. Need for income attribution rules

In the current Chinese tax law, if the separate-return system is still maintained to the maximum extent, it is necessary to tailor the anti-avoidance rules against income shifting activities. The related transaction rule of the IIT Law is positioned as a special anti-avoidance rule targeted for this tax avoidance made by related parties and, but it is actually highly abstract in the literal level:

*The business dealings between an individual and his/her related parties do not comply with the arm's length principle, and the tax payable amount of the individual or his/her related parties is thereby reduced, when there is no proper reason,<sup>57</sup>*

How to explain the legal terms such as “related party,” “arm’s length principle” and “proper reason” is highly uncertain. The Implementation Regulations for the IIT Law (implemented on January 1, 2019) has yet not responded to the problems about the interpretation of this rule,<sup>58</sup> making it impossible to implement explicitly. Therefore, from the perspective of literary meaning, it seems like a too abstract and vague arm’s length principle established to require the transactions between individuals and their related parties.

However, if we explore the explanation regulations of China’s EIT Law, the related transaction rule is originally aimed at the cross-border transfer pricing activities made by multinational companies in EIT.<sup>59</sup> According to Article 110 of the Implementation Regulations for the EIT Law, the “arm’s length principle” is a standard to reappraise the tax base of transfer price, including comparable uncontrolled price method, resale price method and cost plus method, etc. Although the related transactions in both two income taxes have the common characteristic, i.e. taxpayers can transfer, divide or distribute income to related parties to lower the overall tax burdens, the rule in EIT is mainly aimed at the transfer pricing made by multinational enterprises to take advantages of the low tax rates in some countries in contrast with the income shifting in IIT mainly exploited the loophole of progressive tax rate difference, so the judgment standard and method transplanted from the transfer pricing in EIT Law are not appropriate for the income shifting in IIT Law. For the income shifting in IIT, it actually needs a method by which the appropriate tax rate can be applied to the taxpayers correctly, called the income attribution rule.

Canada has the most extensive individual income tax system, it always treats individual as a tax unit and the income attribution rules are the most strict.<sup>60</sup> In the Income Tax Act of Canada (hereinafter referred to as “ITA”), the basic income attribution rules are stipulated in the section 74.1 and 74.2, in which the fruits (dividend, interest) and capital gains transferred to relatives who have formal ownerships shall be handled in the same way: the income or loss will be re attributed to the transferor and re taxed by a higher correct tax rate.<sup>61</sup> In 1999, as a result of the phenomenon that there had been more transfers of income to minor children, the Canadian Parliament added section 120.4 to the ITA, which stipulated a special “tax on split income.” At the beginning it was called the “kiddie tax” and aimed at the behavior of distributing income to minor children by using the intermediates. Then Canada revised this rule on December 13, 2017, by further extending its application to the income shifting to adults over 18 years old, including the spouses.<sup>62</sup> This

57. See article 8, paragraph 1 of IIT Law.

58. See article 25–29 of Regulations of the Implementation of the Individual Income Tax Law (draft for comments).

59. See article 3 of Implementation Measures for Special Tax Adjustment of People’s republic of China.

60. See Hugh J. Ault, Brian J. Arnold, *supra* note 24, 320–327.

61. See section 74.1, 74.2 of Income Tax Act 1985, Canada.

62. See Technical Backgrounder on Measures to Address Income Sprinkling.

rule directly levied the highest tax rate on the transferred income with a nature of punishment.<sup>63</sup> Therefore, if the related transaction rule in China's IIT Law is projected to combat the income shifting abuse between family members, it should be further tailored into more specified income attribution rules.

In Canada, the special income attribution rules have been gradually refined into systematic special anti-avoidance rules, which adjust the income directly transferred to the minor children, spouses or third party on a non-arm's-length basis, as well as indirectly dispersed to the company or trust controlled by the related parties, in order to maintain the progressive characteristics of income tax, and constantly to improve the legislation for preventing high-income families from tax avoidance.<sup>64</sup> In New Zealand, Chapter G of the Income Tax Act of 2007 also stipulates various special rules for attribution of income into related parties.<sup>65</sup> U.S also has those rules in Section 318, Section 1563 in its Internal Revenue Code.

#### 4.1.2. Inadequacy of the arm's length principle

The conception of "non-arm's length transaction," in the explanation from the Canada Revenue Agency, is "a transaction between persons who are related to each other,"<sup>66</sup> and also includes other transactions between "unrelated persons," who do not deal with each other at arm's length at a particular time, with the comparison with an ordinary commercial dealings between parties acting in their separate interests.<sup>67</sup>

As a non-arm's length transaction referred by Canada Supreme Court,<sup>68</sup> the income shifting in section 56 (2) of ITA is stated that "(it) was made for the benefit of the taxpayer or as a benefit that the taxpayer desired to have conferred on the other person,"<sup>69</sup> in the case of *Neuman v M.N.R.*, the Supreme Court of Canada further explained the "benefit" here: if the shareholder (a spouse in this case) of the company does not make contributions while obtaining the interest, it constitutes the "benefit" of 56 (2).<sup>70</sup> That is a difference between the income shifting and ordinary business

63. See section 120.4(2) of Income Tax Act 1985, Canada.

64. The objective of the legislation was to maintain the progressivity of income taxes, improve on previous anti-avoidance rules with new results-based tests and ultimately reduce tax avoidance by higher income households. See Andrew M. Bauer, Alan Macnaughton, Anindya Sen, *Income Splitting and Anti-Avoidance Legislation: Evidence from the Canadian "Kiddie Tax"*, *International Tax and Public Finance*, Vol. 22, 2014(6), 909–931.

65. For example, "arrangements involving tax credits for families" (if an individual hires a relative and the relative receives excessive remuneration during income distribution, the tax bureau can redistribute the income according to reasonable standards), "arrangements involving trust benefit Income" (if the income is distributed benefit to a minor under the age of 16 through trust, the income will be regarded as the property of the trustee and the corresponding tax rate will be applied), and "arrangements involving partners and Owners" (to prevent partners from using the partnership or the company to share the consideration without fair market value), "attribute rule for income from personal services" (if the buyer receives the service from one party, and the service is actually provided by the other party, and the formal party providing the service forms an association relationship with the actual party, the service income shall be regarded as generated by the actual party). See Section BG 1, GC 6 (2) (a), GC 6 (2) (b), GC 6 (1), GB 23, HC 35, GB 50, GB 27 of Income Tax Act 2007, New Zealand.

66. See Canada Revenue Agency, *Definitions for capital gains*, available at <https://www.canada.ca/en/revenue-agency/services/tax/individuals/topics/about-your-tax-return/tax-return/completing-a-tax-return/personal-income/line-127-capital-gains/definitions-capital-gains.html#FairmarketvalueFMV>, accessed 13 May 2020.

67. *Ibid.*

68. See Supreme Court of Canada, *McClurg v. Canada*, [1990] 3 S.C.R. 1020.

69. "A payment or transfer of property made pursuant to the direction of, or with the concurrence of, a taxpayer to some other person for the benefit of the taxpayer or as a benefit that the taxpayer desired to have conferred on the other person..." See Section 56(2) of Income Tax Act, Canada. In the GAAR of Canada, "arm's length" is also understood as "no party thereto shall be regarded, for the purpose of this section, as having conferred a benefit on a party with whom the first-mentioned party was so dealing." See Section 245 of Income Tax Act 1985, Canada. Similar regulations can be seen in the 74.2 (1) of ITA.

70. In this case, the court thought a non-arm's length shareholder does not make a legitimate contribution to the corporation, a person who directed or concurred in the payment of a dividend to that shareholder could be assessed for taxes on the amount of the dividend under s. 56(2). See *Neuman v. M.N.R.*, [1998] 1 S.C.R. 770.



transaction. In theory, there is few questions about whether to tax taxpayers earning a particular item of income in the case of a spousal company or spousal employment contract,<sup>71</sup> because the earned income is proportionate to the contributions the participants make.

However, for the property transfer between family members, it is more difficult to distinguish whether it is an outright gift or a tax-motivated income shifting. The above Canadian approach to attribute the income to the transferor and apply a higher tax rate, following such a comparison with an ordinary business transaction, is sometimes regarded as “unattractive” and lacks of “much theoretical sense.”<sup>72</sup>

This approach does not seem to consider the particularity of the gift between spouses, such as an authenticity gift to lovers, the reasonable needs of the assets allocation in an property-sharing family. After the United Kingdom (hereinafter referred to as “UK”) moved from joint-return to separate-return system in 1990, the UK Family Expenditure Survey showed many households divided investment income with each other to take tax benefits.<sup>73</sup> In 2008, UK government made a draft to parliament, proposing that the income shifting which didn't meet the “commercial” and “arm's length” basis shall be taxed on the transferor, but finally it was withdrawn. A drawback of this draft is pointed out that the contributions made by spouse would be ignored in a situation where there are joint efforts of both husbands and wives,<sup>74</sup> and an outright gift should be excepted when deciding how far the spouses can assign their income to each other.<sup>75</sup> HM Revenue and Customs (hereinafter referred to as “HMRC”) also admitted that in the context of gifts, the appropriate counteraction with a transaction which achieves the non-commercial purpose (for example, transfers of assets to other members of a family) may be “particularly difficult.”<sup>76</sup>

In China, the “arm's length principle” originally stipulated in its EIT Law, and it also emphasizes the “normal” of a “business dealing” made by corporations.<sup>77</sup> While the marriage and blood relationships are the necessary elements to be considered in the IIT. The marriage is often seen as a contract, a term that is the subject of an ongoing negotiation process - neither entirely in accordance with the principle of arm's length, nor in a 100% community of common interest.<sup>78</sup> At least, it is usually regarded “inappropriate” to apply the market concept to deal with quasi family transactions,<sup>79</sup> and the application of the principle of “arm's length” to spouse transfer is even considered as “fallacy of individualism.”<sup>80</sup> If family members work in a family own business, they just talk about their work like colleagues, but never at home. In this way, It definitely meets the requirements of the “arm's length principle,” but it is unrealistic.<sup>81</sup> Therefore, under this principle running a family business or making division of assets between family members causes a series

71. See Lawrence Zelenak, *Marriage and the Income Tax*, CAL. L. REV., Vol. 67, 1994, 382.

72. *Ibid*, 387.

73. This analysis provides strong evidence that households did indeed take advantage of this opportunity for tax avoidance through income shifting: 10 percentage point increase in the marginal tax rate differential between spouses leads to a 2.6–3.1 percentage point increase in the share of investment income shifted to the spouse with the lower marginal tax rate. See Melvin Stephens Jr, Jennifer Ward-Batts, *The Impact of Separate Taxation on the Intra-Household Allocation of Assets: Evidence from the UK*, *Journal of Public Economics*, Vol. 88, 2004, 21.

74. See Glen Loutzenhiser, *supra* note 23, 45.

75. See John Tiley, *Tax, Marriage and the Family*, *The Cambridge Law Journal*, Vol. 65, 2006(2), 299–300.

76. See C6.3.6 of HM Revenue and Customs (HMRC) General anti-abuse rule (GAAR) guidance.

77. See Article 101 of Implementation Regulations for the Corporate Income Tax Law.

78. See Shari Motro, *A New “I Do”: Towards a Marriage-Neutral Income Tax*, *Iowa Law Review*, Vol. 91, 2006, 1539.

79. See Bruce Wolk, *Federal Tax Consequences of Wealth Transfers Between Unmarried Cohabitants*, *UCLA L. Rev.*, Vol. 27, 1980, 1240–1247.

80. See Lawrence Zelenak, *supra* note 73, 381–394.

81. See Jean Murray, *What Is an Arm's-Length Transaction*, available at <https://www.thebalancesmb.com/what-is-an-arms-length-transaction-398128>, accessed 30 March 2020. See also Patrick Chism, *Buying a Home from a Family Member: Non-Arm's Length Transactions*, available at <https://www.quickenloans.com/blog/buying-a-home-family-member>, accessed 30 March 2020.

of problems. As analyzed by some authors, the market and non-market values can't be evaluated along a simple dimension.<sup>82</sup>

In countries (regions) with the Confucian tradition, it is argued that it is impossible to totally deny all the property transfers between family members and regard all of them as tax avoidance.<sup>83</sup> Indeed, a clever example can be seen in China, in the era of high house prices, the young generation of China often rely on the funds from their parents to pay for housing or are directly received the houses from the elders. From another point of view, it is a form to maintain family bonds through material help. In Japan, which shares the similar traditional culture with China, there is also no special income attribution rule. If it is a family employment contract, the participant who makes the contributions shall pay tax, and if it is in a situation of the property transfers, gift tax shall be levied on the taxpayers.<sup>84</sup>

Therefore, if this special income attribution rule is applied, it may have the effect of "sumptuary taxation" on the family members' dealings and transfers, which is disadvantageous of personal freedom or traditional ethical protection for family members. Especially in the light of the arm's length principle an ordinary commercial dealing is to be set as a comparison to measure the spousal transfer, where the particularity of marriage and family would be neglected. Canada also clarify some situations free from taxation, such as the transfer to a spouse's Registered Retirement Savings Plan,<sup>85</sup> the property transfer caused by the written separation agreement or the breakdown of their marriage.<sup>86</sup> It is hard to harmonize the ethical protection in China's tax law and the construction of income distribution rules.

## 4.2. Application of the GAAR

### 4.2.1. An approach to respect the actual transfer of property

Although a special income attribution rule is relatively simple to operate and convenient for the tax authorities to apply, it can't effectively take into account the private factors and ethics of marriage and family, especially in a society which attaches great importance to traditional ideas. So it may interfere excessively with this field, which is contrary to marriage neutrality.<sup>87</sup>

And a more substantive way is being considered, especially for property transfer.<sup>88</sup> It is argued that the transfer of ownership of property should be generally respected, even between spouses. Therefore, it is not appropriate to tax the high-income people but the owner of property should pay tax in which this ownership should have substantial economic effect. It is the best way to keep marriage neutrality<sup>89</sup> and reduce tax intervention. In other words, if the gift is real, it should be respected. In Germany, it does not have tax attribution rules but depends on judicial judgment to a great extent.<sup>90</sup> Its judgment basis mainly comes from the "income attribution principle" in the Fiscal Code of Germany, i.e. "assets shall be attributable to their owner," which follows a more

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82. See Benjamin Means, *Nonmarket Values in Family Businesses*, Wm. & Mary L. Rev., Vol. 54, 2013(4), 1225.

83. Gezhong Ke, *supra* note 25, p. 37.

84. See Hugh J. Ault, Brian J. Arnold, *supra* note 24.

85. See Section 60 (j.2) of Income Tax Act 1985, Canada.

86. See Section 120.4(1)(b) of Income Tax Act 1985, Canada.

87. It may have little influence on the couples who don't have significant income from property, while this rule will impose rather severe marriage penalties when a non-earning woman with substantial property marries a high-earning man. See Lawrence A. Zelenak, *supra* note 73, 391.

88. Because earned income can be taxed to the earner who made the relevant contributions, that's at the core of the justification. *Ibid*, 382.

89. *Ibid*, 385.

90. There is no general assignment provision in the Income Tax Act. See Hugh J. Ault, Brian J. Arnold, *supra* note 24, 328.

economic substantive standard.<sup>91</sup> While China do not has a statutory principle concerning how to attribute income to the correct taxpayer regulated. If a substantial judgment needs to be made to the income transfer between spouses in China, the GAAR in Article 8 of the IIT Law must be relied on. In New Zealand, Australia, Canada and other countries, the GAAR can be also applied to regulate the income shifting.<sup>92</sup>

#### 4.2.2. Flaws of “reasonable business purpose”

The GAAR in the IIT Law of China is stipulated that:

*Under any of the following circumstances, the tax authorities shall have the right to make tax adjustment based on a reasonable method:*

*(3) An individual carries out other arrangements without reasonable business purpose and obtains improper tax gains.*

However, for the GAAR of China's IIT Law, there is also no corresponding explanatory rule about its application. If the GAAR was applied to the income shifting between family members, the “reasonable business purpose” as the core judgment standard is actually the mostly worthy of reflection on.

First of all, the concept of “purpose” remains significant design of GAAR in this law to be consistent with regulations of the EIT Law. It was argued that “the lack of reasonable business purpose” is the substitute for the conception of tax avoidance in the current China's GAAR.<sup>93</sup> While further confusion can be witnessed that the SAT regulates in its guideline to apply the GAAR in EIT that another component of tax avoidance is “(a transaction) does not match its economic substance.”<sup>94</sup> The reasonable business purpose is a subjective element while the economic substance is the objective one, how to apply those two elements is obscure in the GAAR: one of them can define the tax avoidance solely or the combinations of both? At least, The “purpose” component is considered to be “deeply mysterious black box” at the centre of most GAAR rules and many GAAR disputes.<sup>95</sup> A subjective element may introduce more uncertainty and unpredictability to the judgement of the anti-avoidance that may interfere with the application of tax provisions. In the example where there are some forms of income shifting with family members, it is hard to discern the purpose emanated from the assignor or recipient.<sup>96</sup>

91. See Section 39 (1), (2) of The Fiscal Code of Germany.

*(1) Assets shall be attributable to their owner.*

*(2) Notwithstanding the provisions of subsection (1) above, the following provisions shall apply:*

*1. Where a person other than the owner exercises effective control over an asset in such a way that he can, as a rule, economically exclude the owner from affecting the asset during the normal period of its useful life, the asset shall be attributable to this person.*

92. See Australian Taxation Office, Taxfacts—General Anti-avoidance Rules and How They May Apply to a Personal Services Business, available at [https://www.aph.gov.au/binaries/library/pubs/explanmem/docs/1981%20income%20tax%20laws%20amdt%20\(no%20202\).pdf](https://www.aph.gov.au/binaries/library/pubs/explanmem/docs/1981%20income%20tax%20laws%20amdt%20(no%20202).pdf), accessed 11 May 2020. See also Penny and Hooper v Commissioner of Inland Revenue [2011] NZSC 95. available at <https://www.classic.ird.govt.nz/technical-tax/case-notes/2011/cn-2011-2408-income-diversion-avoidance.html>, accessed 11 May 2020. See also Canada Revenue Agency, General Anti-Avoidance Rule - Section 245 of the I.T, available at <https://www.canada.ca/en/revenue-agency/services/forms-publications/publications/ic88-2/general-anti-avoidance-rule-section-245-income-tax-act.html>, accessed 11 May 2020.

93. See Yan He, Wo guo he li shang ye mu di fan bi shui jin lu de fan si (The Reflection on China's Anti-avoidance Approach of the Reasonable Business Purpose), Tax and Economic Research, Vol. 117, 2019 (5), 74.

94. See Article 4 of Administrative Measures on General Anti-Tax Avoidance, China.

95. See Graeme Cooper, The Role and Meaning of ‘Purpose’ in Statutory GAARs, available at <http://ssrn.com/abstract=2752276>, accessed 2 Sept 2020.

96. Ibid, 12.

On top of that, the operation without business purpose or economic substance may not necessarily constitute the tax avoidance. On one hand, there are some transactions mainly seeking the objective of saving tax but consistent with the purpose of the tax provision applied. The boundary between the tax saving and tax avoidance is so blurry that the economic substance or business purpose do not serve as a totally decisive role to judge. The European Court of Justice only regarded the economic reason as an indicator of the possible existence of tax avoidance, instead of considering it as a substantive role.<sup>97</sup> Meanwhile, no official report of OECD pointed out that the lack of effective economic reasons is the only condition of avoidance.<sup>98</sup> The Supreme Court of Canada also does not give the relevance of economic substance much weight. It stated that any economic, commercial purpose may form part of the factual context which the courts may consider in the analysis of tax avoidance, but would be insufficient by itself to establish the avoidance.<sup>99</sup>

On other hand, in the arrangement of income shifting between family members in IIT, the business purpose may not constitute the main purpose. In other words, the non-tax reason except the effective economic reason also includes the family reasons. As individuals are different from economic organizations, the pursuit of commercial interests is not the only purpose of their arrangements, and they may also transfer their property to others for moral, family<sup>100</sup> and even the emotional reasons. The “family transactions” and “family kind” are also regulated as exemptions from the applications of the GAAR of Canada<sup>101</sup> and Australia.<sup>102</sup> Of course, the applications of these exemptions are also based on that the family transaction should have the substantive family “purpose.”<sup>103</sup> The personal or family reasons are more significant for small family businesses.<sup>104</sup> Therefore, if insisting on “reasonable business purpose” as the core judgment standard for tax avoidance in the GAAR of IIT, it is undoubtedly too strict.

Considering the potential flaws of the legal elements involved in China's GAAR, the tax legislators can consider to introduce the principle of abuse of rights, which has been introduced in China's new Civil Code in 2020,<sup>105</sup> as an upper concept of tax avoidance, as some European countries did, such as Germany, France and other continental law countries. In Italy, an abuse was considered to judge whether the exercise of any right is not consistent with the social function recognized and protected by the Constitution of Italy.<sup>106</sup> In the tax law, the unnaturalness of transactions only helps distinguish tax avoidance from legal tax savings, and does not constitute an absolute standard in itself.<sup>107</sup> The central issue is the proper interpretation of the relevant provisions in

97. Ibid.

98. See Paulus Merks, *Tax Evasion, Tax Avoidance and Tax Planning*, Vol. 34, INTERTAX, 2006(5).

99. See Supreme Court of Canada, *Canada Trustco Mortgage Co. v. Canada*, [2005] 2 S.C.R. 601, para 66.

100. See Jieyin Tang, *supra* note 37, 54.

101. See Canada Revenue Agency, General Anti-Avoidance Rule - Section 245 of the I.T, available at <https://www.canada.ca/en/revenue-agency/services/forms-publications/publications/ic88-2/general-anti-avoidance-rule-section-245-income-tax-act.html>, accessed 11 May 2020.

102. Arrangements of a normal business or family kind, including those of a tax planning nature, will be beyond the scope of Australian GAAR. See the Parliament of The Commonwealth of Australia House Of Representatives, INCOME TAX LAWS AMENDMENT BILL (NO.2) 1981, available at [https://www.aph.gov.au/binaries/library/pubs/explanmem/docs1981%20income%20tax%20laws%20amdt%20\(no%202\).pdf](https://www.aph.gov.au/binaries/library/pubs/explanmem/docs1981%20income%20tax%20laws%20amdt%20(no%202).pdf), accessed 13 May 2020.

103. A transaction will not be an avoidance transaction if the taxpayer establishes that it is undertaken primarily for a bona fide business, investment or family purpose. In making this determination it is important to distinguish those transactions which may have a business, investment or family effect from those which have a business, investment or family purpose. There are many transactions that have a business, investment or family effect, which may nevertheless be avoidance transactions because the primary purpose of the transactions is to obtain a tax benefit. See Canada Revenue Agency, *supra* note 107.

104. Frans Vanistendael, *China: Taxation, Tax avoidance and Rule of Law*, Finance and Tax Law Review, Vol. 11, 2010, 14.

105. See Article 132 of PRC Civil Code.

106. See Marco Greggi, Avoidance and abus de droit: the European Approach in Tax Law, *eJournal of Tax Research*, Vol. 6, 2008(1), 7/19.

107. See Wuyao Weng, *Bi shui gai nian de fa lv fen xi* (Legal Analysis of the Conception of Tax Avoidance), Peking University

light of their context and purpose and to judge whether the exercise of a private right by taxpayers abuse or misuse this tax provision or not.

#### 4.2.3. Complexity in the process of applying the GAAR

Another inherent defect shows in the process of application of the GAAR, the complexity. Compared with the application of the special income attribution rules, to judge the authenticity of income transfer by the GAAR is more complex for the tax authorities, which must make a “careful check” on the circumstances of property transfer behavior between family members. So, for the tax authorities, it is not only time-consuming and laborious, but also may not play any role to deter the abusive tax abuse between family members eventually.<sup>108</sup>

A clever example of this was the British GAARs, which were designed only for contrived and abusive tax plans,<sup>109</sup> considered to be a narrowly-focused GAAR.<sup>110</sup> It also provided a large number of safeguards, keeping reasonable tax saving plans from being combated, and the burden of proof to apply the GAAR is borne by HMRC. So the GAAR defined in a narrow sense is difficult to adjust the income shifting avoidance behavior.<sup>111</sup>

However, situations may be the opposite in China. In the IIT Law, the “reasonable business purpose” or the effective economic reasons is taken as the core standard to judge tax avoidance, in this way it is not advantageous for taxpayers. Moreover, Chinese courts have not formed the enough restrictions on the exercise of power of tax administrations to apply the GAAR and does not play an important role in its development of tax law, which leads to the exercise of discretion power of tax authorities too arbitrary. In the case of *Defa Real Estate Ltd v Tax Bureau of Guangzhou*, the Supreme Court of China stated that the courts should generally “respect” professional determinations made by tax authorities based on statutory investigation procedures, unless such determinations are clearly unreasonable or the existence of abuse of power.<sup>112</sup> So, the application of GAAR in China has not been rationalized as a way to balance the purpose of tax revenue and protection of the tax saving rights of taxpayers, but only as a tool for the discretion of China's tax bureau, which does not rely on the interpretation and application of the court about the application of the GAAR.<sup>113</sup>

Therefore, If China's GAAR is applied to solve the problem of tax avoidance among family members and to reconcile the contradiction between the purpose of anti-avoidance and the value of ethical protection under the current situation, this application should be worried for consideration of the flawed rules itself and the judicial environment.

### 4.3. Introduction of an optional joint-return system: return to the value of ethical protection

Therefore, the application of related transaction rule imposes too many restrictions on the individuals and families. The real or bounteous intra-family transfers would be ignored under the arm's

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Law Journal, Vol. 27, 2015(3), 792.

108. See Gezhong Ke, *supra* note 25. See also See Lawrence A. Zelenak, *supra* note 73, 390.

109. See B2.1, B3.1 of HM Revenue and Customs (HMRC) General Anti-Abuse Rule (GAAR) Guidance (Approved by the GAAR Advisory Panel with effect from 28 March 2018).

110. See Glen Loutzenhiser, *supra* note 23, 47.

111. See Glen Loutzenhiser, *supra* note 24, 47.

112. See Supreme Court of PRC, 7 Apr 2017, *Defa Real Estate Ltd v Tax Bureau of Guangzhou*, (2015) Xing Ti Zi No. 13, available at <https://wenshu.court.gov.cn/website/wenshu/181107ANFZ0BXS4/index.html?docId=3875e788347042248591a7580111fb2a>, accessed 2 Sept 2020.

113. Furthermore, The lack of judicial influence in China is an important context for understanding the divergence of the GAAR in action. See Jinyan Li, *Tax Transplants and Local Culture: A Comparative Study of the Chinese and Canadian GAAR*, *Theoretical Inquiries in Law*, Vol. 11, 2010, 670–675.



length principle with a commercial basis, especially when applying the special income attribution rules. If we choose to respect the real income transfer, it seems that we can better maintain the neutrality of marriage and reduce the interference of tax law on family field. However, the “reasonable business purpose” of China’s GAAR needs to be amended and it is still inevitable that the application of this rule has a high level of complexity for both tax authorities and taxpayers. Limiting its application scope excessively does not help achieve the purpose which this rule was set for, like that in Britain. While in China, there is a lack of necessary judicial restriction on tax authority when applying the GAAR to the transfers between family members.

To follow the principle of marriage neutrality, many countries chose to shift from joint to separate-return system, but in fact, under the latter system, there are more problems about income shifting.<sup>114</sup> Especially in China, it is not the best choice to deal with those problems under no matter the special income attribution rules or the GAAR at the current stage. On the other hand, just because of the usual income distributions occurred among family members, the joint-return system had ever been established in many countries.<sup>115</sup>

So the key to solve the problem about income shifting among family members actually is to judge which legal value is more prior: for the tax equality to combat avoidance or for the ethical value? Whether to combat the income shifting is not only an issue about practice of tax avoidance, but also reflect a dilemma lying in the fact that the relationship of family members are mixed with various levels of the status of common property, love and business.<sup>116</sup> Therefore, it is a question whether tax equality or family ethics is more valuable.

In fact, in the China’s old schedular tax system, the implementation of separate-return is reasonable choice. However, with the reform of transforming it to the dual income system mainly focusing on “comprehensive income,” the time to change the tax unit has come. If China continues to insist on the current individual-return system, it is inevitable to perfect the rules of the anti-avoidance in the area of distribution of income within the family. However, if we can not make enough room for tax exemption, the design of anti-avoidance rule will inevitably lead to the problem of excessive invasion to the family’s private filed. It also goes against the value of ethics protection established in the Chinese tax law for a long time, which should be more dominant in legislation value. Therefore, China can design an optional joint-return system to split income legally in which the married taxpayers have the right to choose one of two filing statuses: filing jointly or filing separately. This system can automatically and fictionally aggregate the income of the spouses, who constitutes core family relationship and share their incomes normally, so as to greatly squeeze the space of income shifting avoidance. The husband and wife with separate property mode can also file and pay taxes separately. The income attribution rules are applicable to other members of the family, such as children, parents, uncles, aunts or other people without the non-arm’s length relationship. It has to be admitted that such an approach inevitably violates the neutrality of marriage principle. It is generally beneficial to traditional families because filing jointly is likely to result in less tax if one spouse earns most of the income and deductions will not be itemized. But the advantages are also obvious: (1) core family ethics can be protected, the value which should be respected most; (2) In fact, this joint-return system has the social effect of marriage encouragement, promoting the formation of families to deal with the aging population of Chinese society; (3) In fact, the system of optional joint-return declaration respects citizens’ freedom right to choose tax unit, not only reflecting the status of income-sharing families, but also avoiding a possibility to aggregate the incomes

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114. See Lawrence A. Zelenak, *supra* note 73, 382.

115. *Ibid.*

116. The extent of marriage bonuses or penalties depends on the degree of income splitting permitted by tax law, *Ibid.*, 340. See also Benjamin Means, *Nonmarket Values in Family Businesses*, 54 *Wm. & Mary L. Rev.* 1185 (2013). (noting that intimacy and markets are neither strictly segregated nor reducible to a common metric; rather, they are connected, fluid, and always subject to negotiation. Family businesses seek to advance collective goals, economic and noneconomic; they are contractual, but also reflect status-based family relationships.)

of family members when adopting the compulsory joint-return mode. This system will respect the free space for both family and individual.

## 5. Conclusion

With the further reform and sophistication of individual income tax system of China, tax avoidance made by individual has become an increasing challenge, especially for the income shifting behavior between the family members. The “proper reason” inherited from the presumptive taxation cannot set absolutely tax-free for family dealings when applying the anti-avoidance rule. While transplanting the conception of “arm’s length principle” and “reasonable commercial purpose” from the EIT Law to IIT Law seems to overemphasize the commercial basis for a family transfer. Consequently, It shows an awkward position: the individual income tax not only want to keep the respect for ethical value in such a traditional Confucian country, but also to realize the tax equality to combat tax avoidance to improve a more open and equal market environment, but the current legislation did not complete the mission to reach a balance between those two objects. Maybe it is necessary to amend some new conceptions, like the introduction of “abuse of right” to embed the anti-avoidance rules, but at the current stage, there are always some flaws disadvantageous for the taxpayers: the income attribution rules are strict for transferors and the GAAR gives China’s tax authority more discretion for the judgement of a tax avoidance. Therefore, it is recommended to reflect on the rationality to take the individual as the only tax unit in IIT. In this way, this system cannot ensure the harmony of those two objects. Moreover, the ethical value of the family should be in priority. Accordingly, an optional joint-return system for a core family (husband and wife) should be introduced in the future, which can also cope with the problems of the population aging and grant the freedom for family members to become an independent unit in tax laws or not.

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