

**FOREIGN ADMINISTRATIVE LAW AND
INTERNATIONAL TAXATION:
A CASE STUDY OF TREATY
IMPLEMENTATION IN CHINA[†]**

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INTRODUCTION

The interactions between foreign and domestic tax laws have long been a preoccupation for both the U.S. government and U.S. taxpayers doing

[†] Editors' Note: While we have faithfully endeavored to create accurate and convenient citations for Professor Cui's Article, many of the Chinese sources proved unwieldy and difficult to verify or translate. We have relied on Professor Cui and have provided as much information as possible so as to give our readers a sporting chance of locating a source of interest.

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business abroad.¹ For example, when the U.S. Internal Revenue Service (IRS) considers the grant of income tax treaty benefits to foreign persons with respect to their U.S.-source income, tax treaties require the IRS to determine whether the foreign persons are residents of the relevant treaty partner countries on the basis of the laws of such other countries.² In the United States and globally, “international tax arbitrage”—the exploitation of differences among the tax laws of different countries to reduce or even eliminate the tax burden on otherwise taxable income—has also become a central topic in international taxation.³ Traditionally, this has led the international community of tax authorities, taxpayers, and tax practitioners to take serious interest in the substantive tax laws of other jurisdictions. What is less common, however, is for either government officials or tax professionals to learn about the broader administrative law framework within which substantive tax rules are applied in foreign countries. How tax rules are made in other countries and the process for ensuring their consistent and accurate application may be viewed alternatively as too esoteric or as too basic to warrant sustained attention, especially for a transaction-focused profession.⁴

Sometimes, though, foreign administrative law issues are harder to ignore. This is certainly the case for parties facing formal disputes (or the possibility thereof) with foreign tax authorities. Beyond specific disputes,

1. See STAFF OF JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, VOLUME I: STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM 93–100 (Comm. Print 2001) (outlining the implications of interactions between U.S. tax laws and foreign tax laws, and between tax treaties and U.S. tax laws).

2. See U.S. DEP'T OF TREASURY, U.S. MODEL TECHNICAL EXPLANATION ACCOMPANYING THE U.S. MODEL INCOME TAX CONVENTION OF NOV. 15, 2006, at 1 (2006), <http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/TEMod006.pdf>. Being a tax resident of the treaty partner country is a necessary condition of treaty benefit eligibility. The United States also requires the determination of whether the treaty-benefit applicant “derives” U.S.-source income to be determined under the laws of the applicant’s resident country in cases where certain “reverse hybrid entities” are used. See I.R.C. § 894 (2006); Treas. Reg. § 1.894-1(d) (2011). The tax classification of foreign entities may also involve the analysis of foreign law. Treas. Reg. § 301.7701-3(b)(2)(ii) (2011). Many other examples may be offered.

3. See generally H. David Rosenbloom, *The David R. Tillinghast Lecture: International Tax Arbitrage and the “International Tax System,”* 53 TAX L. REV. 137 (2000) (discussing whether the level of concern over international tax arbitrage is justified); Daniel Shaviro, *Money on the Table?: Responding to Cross-Border Tax Arbitrage,* 3 CHI. J. INT’L L. 317 (2002) (considering advantages and disadvantages of international tax arbitrage); Mitchell A. Kane, *Strategy and Cooperation in National Responses to International Tax Arbitrage,* 53 EMORY L.J. 89 (2004) (emphasizing cooperation between countries to control but not eliminate international tax arbitrage).

4. But see *infra* note 9 and accompanying text, and the discussion *infra* Part V.

countries may occasionally take actions that broadly disturb the expectations of foreign investors and treaty partners, actions that must be interpreted in light of their specific legislative frameworks. The most well-known example of this is the “treaty override,” where “the domestic legislation of a State overrules provisions of either a single treaty or all treaties hitherto having had effect in that State.”⁵ But there are also more common examples of how foreign countries’ administrative law systems matter. For instance, many countries, including the United States, tax their residents on their worldwide income and grant credits for any foreign income tax paid on foreign-source income.⁶ However, to protect the domestic fisc, such countries typically require the foreign tax paid to be compulsory in nature. Noncompulsory or “voluntary” payments to other governments cannot be credited.⁷ What is a compulsory tax, however, very much depends on whether the collection of the tax has sufficiently firm grounds in the law. When the other country’s legal system is in disorder, the question can be difficult to answer. This type of issue has been highlighted in protracted and intensely contested U.S. litigation in recent years.⁸ It is likely that such disputes will occur with even greater frequency in the future.⁹

Indeed, in a significant and growing range of cases, it is no longer sufficient to ask just *what* the tax law is in a given foreign country. *How* tax law is adopted and enforced in that country has important implications both for those doing business in the country and for other countries’ tax authorities. This Article examines a particularly interesting class of such cases, relating to certain international tax rules recently adopted in China. All of the rules are promulgated by China’s State Administration of

5. Org. for Econ. Cooperation and Dev. [OECD], *Tax Treaty Override* para. 2 (Oct. 2, 1989) [hereinafter *OECD Report on Treaty Override*].

6. I.R.C. §§ 901–908.

7. Treas. Reg. § 1.901-2(e)(5). See generally Alan Fischl & Michael Harper, *What Exactly Is a ‘Voluntary Tax’?*, J. INT’L TAX’N, May 2008, at 32–48 (discussing the increasing pressures on voluntary tax rules). Germany and Canada are examples of other countries with similar rules.

8. See *Riggs Nat’l Corp. v. Comm’r (Riggs I)*, 107 T.C. 301 (1996), *rev’d*, 163 F.3d 1363 (D.C. Cir. 1999) (*Riggs II*); *Riggs Nat’l Corp. v. Comm’r (Riggs III)*, 81 T.C.M. (CCH) 1023 (2001), *rev’d*, 295 F.3d 16 (D.C. Cir. 2002) (*Riggs IV*); *Riggs Nat’l Corp. v. Comm’r (Riggs V)*, 87 T.C.M. (CCH) 1276 (2004), *aff’d sub nom. PNC Fin. Servs. Grp., Inc. v. Comm’r*, 503 F.3d 119 (D.C. Cir. 2007) (detailing the interaction between the Brazilian and U.S. tax systems). These cases are further discussed *infra* Part V.

9. See *Global Reach: U.S. Bank Gets FTC for Brazilian Tax by ‘Act of State’ Doctrine*, J. INT’L TAX’N, Mar. 1999, at 4, 5 (attributing the increasing number of international tax disputes to globalization).

Taxation (SAT)¹⁰ and are controversial in that they appear to conflict with China's obligations under income tax treaties. The application of these rules has resulted in disputes that directly or indirectly involve U.S. taxpayers¹¹ and has drawn high-level attention from the IRS.¹² The rules raise urgent questions. Should they be understood as treaty overrides on China's part? How should residents of treaty partner countries doing business in China cope with them? And what should the United States do about them?

This Article will demonstrate that these questions cannot be answered without an understanding of the Chinese administrative law system. The following features of the system are particularly relevant. Because China's legal framework for legislation and agency rulemaking is still a work in progress, important areas of rulemaking are not yet adequately regulated, such that the making and interpretation of law tend to devolve to low ranks in the government's administrative hierarchy. Indeed, devolution is so systematic in lawmaking that the domestic law procedures for giving proper legal effect to China's tax treaties are yet incomplete. Nonetheless, this has not prevented the Chinese government—including all of the legislative, executive, and judicial branches—from affirming that the treaties that it has entered into are binding on China. Nor has the government, and especially the judiciary, been prevented from both recognizing the superior effect of tax treaties over domestic tax law and from insisting that informal agency rules cannot be binding if they are inconsistent with higher, formal rules of law. It turns out that all of the controversial Chinese international tax rules discussed in this Article are informal rules of a very low rank.¹³ To the extent that they conflict with China's domestic rules of law and its treaty

10. The State Administration of Taxation (SAT) coordinates with the Chinese Ministry of Finance (MOF) in implementing tax policy and is therefore in many ways the counterpart to the U.S. Internal Revenue Service (IRS). The SAT does not itself engage in tax collection, however, and merely supervises subnational tax agencies in collection and enforcement.

11. For some recent cases see, for example, Jinji Wei, *SAT Receives Record Payment From Indirect Share Transfer*, 59 TAX NOTES INT'L 16, 16–17 (2010) (discussing a tax imposed on a U.S. company—believed to be a Carlyle affiliate—for an indirect transfer of shares in a Chinese resident company through a wholly owned Hong Kong subsidiary); Jinji Wei, *China Probes Goldman Sachs on Stock Transfers*, 59 TAX NOTES INT'L 635, 638–39 (2010) (reporting SAT's potential \$61 million capital gains tax assessment against Goldman Sachs); Dongmei Qiu, *China's Capital Gains Taxation of Nonresidents and the Legitimate Use of Tax Treaties*, 60 TAX NOTES INT'L 593, 617–19 (2010) (reviewing the case of a U.S.-owned Barbados company—believed to be an affiliate of the Texas Pacific Group—denied treaty benefits). See also *infra* Part IV.2 (discussing the PanAmSat controversy).

12. See, e.g., Lee A. Sheppard, *Don't Pay That Tax, Danilack Warns*, TAX NOTES TODAY, Apr. 7, 2011, available at LEXIS 2011 TNT 67-3 (commenting on certain positions taken by Chinese tax authorities).

13. See *infra* Part II.

obligations, therefore, Chinese courts may not give them legal effect, and they may also be challenged through administrative appeal.

This has two sets of implications. The first is that the SAT rules in question are not legally binding under Chinese domestic law where they conflict with tax treaties and may at best be viewed as “practically binding.”¹⁴ However, if a U.S. taxpayer is subject to one of these rules and deprived of a treaty benefit, but does not attempt to prevent the application of the rule by seeking administrative or judicial review, it may be difficult for the taxpayer to argue that it has sought “practical and effective remedies” against the imposition of the tax—an important standard under the Internal Revenue Code (IRC) for determining whether a tax payment is noncompulsory and eligible for the foreign tax credit. In effect, the U.S. foreign tax credit rules impose a cost on U.S. taxpayers who do not challenge the application of the Chinese rules. In addition to protecting the U.S. fisc, this part of U.S. tax law also generates a positive externality for the Chinese legal system. This previously little-discussed type of unintended consequence of the interaction between U.S. and foreign law imparts a new meaning to the U.S. regulatory requirement that whether a foreign levy is a compulsory tax payment be determined “by principles of U.S. law.”¹⁵

The second set of implications is that because the controversial Chinese tax rules are invalid under China’s domestic law, none constitute a treaty override. Even so, to respond to these controversial rules, the IRS and the tax authorities of China’s other treaty partners must no longer make the traditional leap of faith that, *somehow*, domestic law mechanisms will secure faithful performance of treaty obligations. They must engage with China’s larger legislative and administrative framework and not just with a few individuals designated as China’s “competent authority.” U.S. foreign tax credit rules already require U.S. taxpayers to do so, and it is time for the U.S. government to acknowledge a similar need in its pursuit of U.S. tax policy.

The Article will be organized as follows. Part I will introduce the set of recent SAT rules are arguably in conflict with China’s tax treaty

14. For the concept of practically binding rules, see generally Robert A. Anthony, *Which Agency Interpretations Should Bind Citizens and the Courts?*, 7 YALE J. ON REG. 1 (1990) (examining how various types of agency interpretations of statutes should be reviewed by the courts); Robert A. Anthony, “*Well, You Want the Permit, Don’t You?*” *Agency Efforts to Make Nonlegislative Documents Bind the Public*, 44 ADMIN. L. REV. 31 (1992) (arguing that nonlegislative agency rules are not legally binding); Robert A. Anthony, *Three Settings in Which Nonlegislative Rules Should Not Bind*, 53 ADMIN. L. REV. 1313 (2001) (discussing how practically binding nonlegislative agency rules should not have a binding character).

15. Treas. Reg. § 1.901-2(a)(2)(i) (2011).

obligations. Part II characterizes the place of the rules within the Chinese administrative law framework. Part III describes the relation between tax treaties and China's domestic tax law, particularly how treaties are given the effect of law under Chinese domestic law. Part IV then reviews domestic legal mechanisms for challenging tax rules that are inconsistent with tax treaties, focusing especially on Chinese courts' likely responses. These sections lead to the conclusion that the problematic SAT rules are not legally binding. Part V goes on to draw out the implication of this conclusion for U.S. taxpayers, specifically in terms of what it would mean for them to have sought "effective and practical remedies" against tax collection pursuant to the SAT rules. Finally, Part VI examines the implications of the foregoing analysis for the management of future treaty relationships with China by the United States and other governments. Some summary remarks are offered in the Conclusion.

I. RECENT CHINESE TAX RULES IN CONFLICT WITH TAX TREATIES

Treaty overrides typically refer to situations where national legislatures intentionally overrule the provisions of tax treaties.¹⁶ In China, cases of direct conflict between domestic statutes and tax treaties are very rare. Only one aspect of the current Enterprise Income Tax Law (EIT Law)¹⁷ generates such conflict. Most tax treaties contain nondiscrimination provisions, which generally prohibit less favorable treatments of the "permanent establishment" (PE) of an enterprise of a treaty partner country which carries on the same activities as an enterprise of the country where the PE is located.¹⁸ Nonetheless, under the EIT Law, enterprises resident in China can claim both direct and indirect foreign tax credits for foreign income tax paid, whereas the Chinese establishments of nonresident enterprises, while taxed on the worldwide income effectively connected with such establishments, can claim only direct foreign tax credit.¹⁹ In light of the fact that the EIT Law expressly states that where the provisions of tax treaties conflict with its own provisions, the treaty provisions shall prevail,²⁰ it is quite unclear whether this violation is intentional. And the infraction is unlikely to be significant in practice.²¹

16. See *OECD Report on Treaty Override*, *supra* note 5, paras. 2, 6.

17. Zhonghua Renmin Gongheguo Qiyue Suo de Shui Fa (中华人民共和国企业所得税法) [Enterprise Income Tax Law] (promulgated by the Nat'l People's Cong., Mar. 16, 2007, effective Jan. 1, 2008) (Lawinfochina) (China).

18. See OECD, *Articles of the Model Convention with Respect to Taxes on Income and on Capital*, art. 24(3), (July 17, 2008) [hereinafter *OECD Model Convention*].

19. Enterprise Income Tax Law arts. 23–24 (China).

20. *Id.* art. 58; see also *infra* Part III.

21. Few Chinese establishments of foreign enterprises are likely to own sufficient stakes

But more so even than in the United States, tax statutes in China form only the tip of the iceberg of the tax law. Both the EIT Law and the Individual Income Tax Law²²—which together govern Chinese income taxation and therefore overlap most with the subject of income tax treaties—are brief. Somewhat more extensive rules are contained in the implementation regulations issued by the State Council—China’s Cabinet—for these statutes,²³ yet even these State Council regulations merely lay out the framework for the income taxes and delegate authority for further rulemaking to the Ministry of Finance (MOF) and SAT. Conflicts with tax treaties in either formal regulations²⁴ adopted by the two ministries or MOF/SAT policy documents²⁵ are also extremely rare.²⁶

It is only when one delves into a more extensive body of rules, scattered among informal documents issued by the SAT over the years, that one finds more examples of inconsistencies with tax treaty provisions. A good place to start is a recent, comprehensive annotation of the China–Singapore treaty adopted by the SAT in July 2010, and released to the public in September 2010.²⁷ In issuing these Treaty Annotations, the SAT

in foreign subsidiaries to claim indirect foreign trade credits (FTC) in the first place. However, “a breach of the treaty occurs when the overriding legislation is passed by the legislature and not only when it is applied to actual cases.” *OECD Report on Treaty Override*, *supra* note 5, para. 7.

22. Zhonghua Renmin Gongheguo Ge Ren Suo de Shui Fa (中华人民共和国个人所得税法) [Individual Income Tax Law] (promulgated by the Standing Comm., Sep. 10, 1980, effective as last amended June 30, 2011) (Lawinfochina) (China).

23. See Zhonghua Renmin Gongheguo Ge Ren Suo de Shui Fa Shi Shi Tiao Li (中华人民共和国个人所得税法实施条例) [Regulation on the Implementation of the Individual Income Tax Law] (promulgated by the St. Council, Jan. 28, 1994, effective July 19, 2011) (Lawinfochina) (China); Zhonghua Renmin Gongheguo Qiye Suo de Shui Fa Shi Shi Tiao Li (中华人民共和国企业所得税法实施条例) [Regulation on the Implementation of the Enterprise Income Tax Law] (promulgated by the St. Council, Dec. 6, 2007, effective Jan. 1, 2008) (Lawinfochina) (China). For a discussion of the status and legal effect of State Council regulations, see *infra* Part III.

24. For the legal status of ministerial regulations, see *infra* notes 89–91 and accompanying text.

25. The MOF and SAT, when jointly making tax policy (including in the income tax area), have adopted an unusual and controversial practice of issuing only informal circulars instead of formal regulations. For a discussion of this practice, see Wei Cui, *What Is the ‘Law’ in Chinese Tax Administration?*, 19 ASIA PAC. L. REV. 75 (2011). The legal status of these informal circulars is rather unclear, but because the MOF and SAT are institutionally endowed with the power of joint tax policymaking, they are likely to be regarded as having equal effect as formal ministerial regulations issued by the MOF or by the SAT.

26. Regulations in effect before 2008 contained two *prima facie* instances of breach of the nondiscrimination article of tax treaties similar to the breach found in the current Enterprise Income Tax (EIT) Law, and both were repealed by the EIT Law.

27. Zhonghua Renmin Gongheguo Zheng Fu He Xin Jia Po Gong He Guo Zheng Fu

intends that (1) where the corresponding provisions of other tax treaties entered into by China are identical to what is contained in the China–Singapore treaty, the interpretations offered in the Treaty Annotations would also apply to such other identical provisions; and (2) where there is any discrepancy between the Treaty Annotations and previous documents concerning the interpretation and application of tax treaties, the former shall prevail.²⁸ The Treaty Annotations go through each article of the China–Singapore treaty and are relatively lengthy (though, as discussed below, they often merely refer to previous SAT documents for further guidance), and thus have been viewed by many Chinese tax practitioners as having the status of the official “technical explanations” of all of China’s treaties.²⁹ Whether it *can* have that status, from a legal perspective, is questionable and will be considered below.³⁰ What we note first is that the Treaty Annotations reiterate a number of controversial treaty interpretations previously published by the SAT, while introducing some new, problematic interpretations.

Examples of provisions that *prima facie* conflict with international understandings of treaty provisions include the following:

1. *The expansion of the scope of PEs beyond treaty language.* The Treaty Annotations advance the position that where a foreign enterprise establishes a fixed place in China solely to provide spare parts to Chinese clients for equipment sold, the activity is a sufficiently fundamental and significant part of services provided by the head office of the enterprise to clients that it would constitute a PE.³¹ This contradicts the clear language in the PE articles in tax treaties that “the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise” is

Guan Yu Suo de Bi Mian Shuang Chong Zheng Shui He Fang Zhi Tou Lou Shui de Xie Ding Ji Yi Ding Shu Tiao Wen Jie Shi (中华人民共和国政府和新加坡共和国政府关于对所得避免双重征税和防止偷漏税的协定及议定书条文解释) [Interpretation of the Articles of the Agreement Between the Government of the People’s Republic of China and the Government of the Republic of Singapore for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and the Protocol Thereof] (promulgated by the St. Admin. of Tax’n, July 26, 2010, effective July 26, 2010) (Lawinfochina) (China) [hereinafter Interpretation of the Articles of Agreement for the Avoidance of Double Taxation, China–Singapore (China)].

28. *Id.* Preamble para. 2.

29. *See id.* Preamble. China does not have a published model treaty, and there is no other comprehensive explanation of the provisions of the tax treaties that China has entered into.

30. *See infra* notes 59–66 and accompanying text.

31. Interpretation of the Articles of the Agreement for the Avoidance of Double Taxation, China–Singapore (China), *supra* note 27.

merely an “activity of a preparatory or auxiliary character” and therefore does not give rise to a PE.³²

2. *A twelve-month look-back rule regarding an ownership requirement for reduced rates on dividends.*³³ Some of China’s treaties (including the one with Singapore) offer special reduced withholding tax rates on dividends declared with respect to shareholders owning at least 25% of the company. Since 2009, the SAT has required this ownership requirement to have been satisfied for a continuous period of twelve months before the dividend is declared.³⁴ The Organization for Economic Cooperation and Development (OECD) specifically mentioned this “look back” rule as one that contracting states may negotiate and incorporate into the text of treaties.³⁵ China has not negotiated such a treaty provision and has merely imposed the requirement unilaterally.
3. *The characterization of service fees as royalties in any mixed contract.*³⁶ Since 2009,³⁷ the SAT has held that where any service is performed in connection with a licensing contract, fees paid for the service, even if performed outside of China and separately invoiced, are to be characterized as royalties and thereby taxable in China (whereas fees for services performed outside of China would not be taxable). This position was reaffirmed in the Treaty Annotations. It is inconsistent with the explicit and widely followed recommendations for the treatment of mixed contracts by the OECD that mixed contract amounts should be broken down and each component appropriately taxed.³⁸

32. It also contradicts the OECD’s explicitly stated view that a place for delivery of spare parts to customers for machinery supplied would constitute a permanent establishment (PE) only “where, in addition, it maintains or repairs such machinery.” *OECD Model Convention*, *supra* note 18, at 103 (commentary on Article 5).

33. Interpretation of the Articles of the Agreement for the Avoidance of Double Taxation, China–Singapore (China), *supra* note 27.

34. See Zhi Xing Shui Shou Xie Ding Gu Xi Tiao Kuan You Guan Wen Ti (国家税务总局关于执行税收协定股息条款有关问题的通知) [Issues Concerning the Application of the Dividend Clauses of Tax Agreements] (promulgated by the St. Admin. of Tax’n, Feb. 20, 2009, effective Feb. 20, 2009) (Lawinfochina) (China).

35. *OECD Model Convention*, *supra* note 18, at 190 (commentary on Article 10).

36. Interpretation of the Articles of the Agreement for the Avoidance of Double Taxation, China–Singapore (China), *supra* note 27.

37. See Execution of the Royalty Clauses of Tax Treaties (promulgated by the St. Admin. of Tax’n, Sept. 14, 2009, effective Oct. 1, 2009) art. 5 (China); Administering Tax Treaty Provisions (promulgated by the St. Admin. of Tax’n, Jan. 26, 2010, effective Jan. 16, 2010) (China).

38. *OECD Model Convention*, *supra* note 18, at 226 (commentary on Article 12); *see also id.* at 230–31.

4. *Unusual position with respect to international transportation income.* China's tax treaties generally allocate the right to tax profits from the operation of ships or aircraft in international traffic to the country where the operator resides. However, contrary to international practice and the OECD position on the matter since 1963, according to which "wet leases" (leases on charter fully equipped, crewed, and supplied) themselves constitute a form of international transportation,³⁹ the Treaty Annotations hold that income from wet leases is exempt from Chinese taxation only if such leases are ancillary to some other "main business" of international transportation. Moreover, for income from activities ancillary to international transportation to be exempt from Chinese taxation, such income cannot exceed 10% of the gross income of the shipping operator, a threshold not contemplated by the China–Singapore tax treaty or any other of China's tax treaties.⁴⁰
5. *Affirmation of the controversial "beneficial ownership" standards in Circular 601.*⁴¹ The SAT published Circular 601 in 2009, which sets forth seven factors that count against the claim of a treaty benefit applicant to be the beneficial owner of certain passive income. These factors have been widely criticized by international tax practitioners as going beyond the customary requirements of tax treaties.⁴² Nonetheless, the Treaty Annotations fully endorse

39. *Id.* at 175 (commentary on Article 8).

40. Interpretation of the Articles of the Agreement for the Avoidance of Double Taxation, China–Singapore (China), *supra* note 27. For a more detailed discussion, see Wei Cui, *China: A New (Furtive) Approach to Taxing International Transportation Income*, in TAX TREATY CASE LAW AROUND THE GLOBE 159–69 (Michael Lang ed., 2011).

41. Interpretation of the Articles of the Agreement for the Avoidance of Double Taxation, China–Singapore (China), *supra* note 27, art. 10, § 2(c); *id.* art. 11, § 2; *id.* art. 12, § 2. "Circular 601" refers to Ru He Li Jie He Que Ding Shui Shou Xie Ding Zhong "Shou Yi Suo You Ren" (如何理解和认定税收协定中受益所有人) [How to Understand and Determine the "Beneficial Owners" in Tax Agreements] (promulgated by the St. Admin. of Tax'n, Oct. 27, 2009, effective Oct. 27, 2009) (Lawinfochina) (China).

42. See, e.g., James J. Tobin, *Down the BRIC Road*, 40 TAX MGMT INT'L J. (BNA) 39, 40–41 (2011) (asserting that most factors listed under Circular 601 are irrelevant to the determination of beneficial ownership); Peter H. Blessing, *Abuse and Anti-Abuse: The Role of a Tax Professional in a Changing World*, in 2 TAX LAW AND CASE REVIEW (W. Xiong ed., 2011) (noting that the criteria exceed treaty requirements); Houlu Yang, *Report on the People's Republic of China*, 95b CAHIERS DE DROIT FISCAL INT'L (IFA) 209, 221 (2010) (highlighting that the burden of proof rests on taxpayers claiming to be "beneficial owners"). One example of Circular 601's inconsistency with international understanding is its holding that "conduit companies" can never be beneficial owners. By contrast, the OECD's position is that a conduit company will not be respected as the beneficial owner only when through "the formal owner, it has, as a practical matter, very narrow powers which render it, in

Circular 601's approach.

The above is not an exhaustive list of the aspects of the Treaty Annotations that may be viewed as inconsistent with common interpretations of tax treaties. But it should be clear that the items in the list cover diverse issues and cannot be explained in terms of a single policy concern, such as international anti-avoidance, or even through a set of coherent policy concerns other than expanding China's tax base.⁴³ Moreover, even though China is not an OECD member country, and even though the OECD Commentaries do not have the status of "legally binding international instruments,"⁴⁴ the SAT, in drafting the Treaty Annotations and elsewhere, tends to borrow very extensively from the OECD Commentaries in elaborating China's treaty policy, occasionally explicitly citing these commentaries.⁴⁵ International practice as reflected in the OECD Commentaries thus likely forms an essential background to the SAT's understanding of treaty provisions (in addition, presumably, to the understanding of many of China's treaty partners) when it negotiates them. The deviant SAT interpretations therefore cannot be attributed to a systematic, alternative set of treaty policies.

SAT documents that conflict with tax treaty provisions are not limited to those that explicitly pursue treaty interpretation. There are others that do not ostensibly address the application of tax treaties but, if implemented without modification, would arguably constitute treaty breaches. A good example of this latter type is the hugely controversial Circular 698.⁴⁶ China taxes capital gains derived from any transfer of the shares of a Chinese

relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties." *OECD Model Convention*, *supra* note 18, at 188 (commentary on Article 10).

43. For example, items 1, 3, and 4 do not implement any antiavoidance agenda, and while items 1 and 3 may simplify administration, 4 renders it more complex.

44. *OECD Model Convention*, *supra* note 18, at 14. See generally Hugh J. Ault, *The Role of the OECD Commentaries in the Interpretation of Tax Treaties*, in *ESSAYS ON INTERNATIONAL TAXATION* 61, 61–68 (Herbert H. Alpert & Kees van Raad eds., 1993).

45. See, e.g., Guan Yu Shui Shou Xie Ding Chang She Ji Gou Que Ding Deng You Guan Wen Ti (关于税收协定常设机构认定等有关问题) [Relevant Issues About the Determination of Permanent Establishments in Tax Agreements] (promulgated by the St. Admin. of Tax'n, Mar. 14, 2006, effective Mar. 14, 2006) (Lawinfochina) (China) (referring explicitly to OECD Commentaries). See generally Wei Cui, *China*, in *THE IMPACT OF THE OECD AND THE UN MODEL CONVENTIONS ON BILATERAL TAX TREATIES* (Michael Lang ed., forthcoming 2012).

46. Jia Qiang Fei Ju Min Qi Ye Gu Quan Zhuan Rang Suo de Qi Ye Suo De Shui Guan Li (加强非居民企业股权转让所得企业所得税管理) [Strengthening the Administration of Enterprise Income Tax on Non-resident Enterprises' Equity Transfer Income] (promulgated by the St. Admin. of Tax'n, Dec. 10, 2009, effective Jan. 1, 2008) (Lawinfochina) (China).

company by a foreign entity.⁴⁷ As in other countries that attempt to implement such a regime, Chinese tax authorities must confront the fact that foreigners may try to avoid the tax, when nontax considerations permit, by transferring the equity of an offshore parent (direct or indirect) and not the equity interest in a Chinese company directly. On its face, Circular 698 attempts to identify such arrangements by requiring the disclosure of indirect transfers where the holding company transferred is located in a low-tax jurisdiction. It also provides that offshore holding companies may be disregarded if their use lacks economic substance. However, the disclosure requirement has no statutory basis under Chinese domestic law because the latter does not contemplate jurisdiction over foreigners who have no Chinese-source income.⁴⁸ Moreover, where either the offshore holding company or the transferor of the shares of the offshore company is a resident of a treaty partner country, the tax treaty between China and that treaty partner country would typically preclude Chinese taxation of the capital gains from the transfer of the shares.⁴⁹ Indeed, the disregard of a holding company in contravention of treaty provisions on capital gains has been explicitly highlighted by the OECD as a form of treaty override.⁵⁰

II. THE LEGAL EFFECT OF INFORMAL ADMINISTRATIVE PRONOUNCEMENTS

Overall, the SAT rules set forth in Circular 698, the Treaty Annotations,

47. Zhonghua Renmin Gongheguo Qiyue Suo de Shui Fa (中华人民共和国企业所得税法) [Enterprise Income Tax Law] (promulgated by the Nat'l People's Cong., Mar. 16, 2007, effective Jan. 1, 2008) arts. 3–4 (Lawinfochina) (China); Zhonghua Renmin Gongheguo Qiyue Suo de Shui Fa Shi Shi Tiao Li (中华人民共和国企业所得税法实施条例) [Regulation on the Implementation of the Enterprise Income Tax Law] (promulgated by the St. Council, Dec. 6, 2007, effective Jan. 1, 2008) art. 7(3) (Lawinfochina) (China); Zhong Zhonghua Renmin Gongheguo Qiyue Suo de Shui Fa Shi Shi Tiao Li (中华人民共和国企业所得税法实施条例) [Regulation on the Implementation of the Enterprise Income Tax Law of the People's Republic of China] (promulgated by the St. Council, Dec. 6, 2007, effective Jan. 1, 2008) art. 91(1) (Lawinfochina) (China).

48. See Wei Cui, *The Unauthorized Decision to Tax Indirect Equity Transfers in China*, 2 DIRITTO E PRATICA TRIBUTARIA INTERNAZIONALE 1075, 1077 (2010).

49. This is typically due to the residual clause of the capital gains article of tax treaties, which precludes taxation of capital gains other than in transactions specifically enumerated in the article. See, e.g., *OECD Model Convention*, *supra* note 18, art. 13(5).

50. *OECD Report on Treaty Override*, *supra* note 5, paras. 31–33. Under Chinese domestic law, because the SAT fails to specify in Circular 698 (or elsewhere) what would constitute sufficient economic substance to prevent it from disregarding a holding company, while at the same time shifts the burden of proof to the private party, it is questionable whether the application of Circular 698 would be sustained in court.

and the numerous SAT documents cited and reaffirmed in the Treaty Annotations raise serious questions about China's willingness to adhere to its treaty obligations. Indeed, the bulk of international tax discussions about China in the last year has centered on these rules.⁵¹ What has been little discussed, however, is the very weak legal effect the documents setting out these rules possess.

Circulars 601 and 698, as well as a number of other circulars the positions of which the Treaty Annotations affirm, take the form of so-called "SAT correspondences" (*guoshuihan*).⁵² According to the relevant SAT internal manual, SAT correspondences may be used for "clarifications and interpretations of *ordinary questions* in the implementation of tax policies and methods of collection."⁵³ They may also be used for a wide variety of internal administrative purposes.⁵⁴ In the last decade, it was not unusual for the SAT to issue over 1,200 or 1,300 SAT correspondences a year, most of which remain unpublished because they have no general relevance for taxpayers.⁵⁵ Because of their miscellaneous administrative uses, the issuance of SAT correspondences does not require the SAT's ministry-level

51. This is not to say that conflicts between SAT rules and common treaty interpretation are new. *See infra* note 130 and accompanying text (citing two SAT documents from the 1990s).

52. *See, e.g.*, Zhi Xing Shui Shou Xie Ding Gu Xi Tiao Kuan You Guan Wen Ti (执行税收协定股息条款有关问题) [Issues Concerning the Application of the Dividend Clauses of Tax Agreements] (promulgated by the St. Admin. of Tax'n, Feb. 20, 2009, effective Feb. 20, 2009) (Lawinfochina) (China); Zhi Xing Shui Shou Xie Ding Te Xu Quan Shi Yong Fei Tiao Kuan You Guan Wen Ti (执行税收协定特许权使用费条款有关问题) [Issues Relevant to the Execution of the Royalty Clauses of Tax Treaties] (promulgated by the St. Admin. of Tax'n, Sept. 14, 2009, effective Oct. 1, 2009) (Lawinfochina) (China); Execution of the Royalty Clauses of Tax Treaties (promulgated by the St. Admin. of Tax'n, Sept. 14, 2009, effective Oct. 1, 2009) (China); Administering Tax Treaty Provisions (promulgated by the St. Admin. of Tax'n, Jan. 26, 2010, effective Jan. 16, 2010) (China); *see also* Imposition of Tax on Rental Income Derived by PanAmSat from Leasing Satellite Communication Lines to CCTV (promulgated by the St. Admin. on Tax'n, Aug. 19, 1999, effective Aug. 19, 1999) (Lawinfochina) (China).

53. Implementation Measures for the Processing of Official Documents of All Tax Agencies of China (promulgated by the St. Admin. of Tax'n, Oct. 9, 2004, effective Oct. 9, 2004) art. 29 (China) (emphasis added).

54. These include nonlegal administrative instructions to lower-level agencies, partial or temporary budgetary adjustments for tax agencies, recommendations or reprimands of staff members, and correspondence with other government agencies. *Id.*

55. For instance, for the first six months of 2010, over three hundred SAT correspondences were issued, of which fewer than sixty are currently publicly available in the legal database China Law Info. CHINA LAW INFO, <http://chinalawinfo.com> (last visited Feb. 12, 2012). Even fewer are available at the SAT's website for the publication of rules. *See* ST. ADMIN. OF TAX'N, <http://www.chinatax.gov.cn/n8136506/n8136593/n8137537/n8138502/index.html> (last visited Jan. 23, 2012).

approval and generally is not even deliberated at the level of departments within the SAT.⁵⁶ They may be drafted by only one or two SAT staff members and signed by one senior (department-level) official. Moreover, because of the SAT's internal organization, it is not unusual for an SAT correspondence in the international tax area to be issued without review by the part of the SAT in charge of tax treaties. Most SAT correspondences are also not reviewed by the Legal Department. It is also not uncommon for SAT correspondences to be quietly withdrawn. The procedures for issuing SAT correspondences, in other words, were never designed for documents that set forth new substantive tax rules of general applicability, let alone ones that break new grounds in international taxation.

If the use of SAT correspondences were to be analogized to IRS practice,⁵⁷ the small number of staff members involved in producing an SAT correspondence, their low rank, and the tentative nature of the positions in such documents all render them similar to IRS private letter rulings (PLRs), although PLRs are applicable only to particular taxpayers. Their routine use makes them similar to the miscellaneous array of IRS internal memoranda. The lack of involvement of the SAT Legal Department, however, renders them different from any document issued by the IRS Offices of Chief and Associate Chief Counsels—that is, any document that is regarded as having the value of legal guidance in the United States. In any case, the status of SAT correspondences within the SAT rulemaking system is almost certainly lower than that of revenue rulings and revenue procedures in the IRS system.

Much of the buzz over “what China is doing” within the international tax community, therefore, in reality concerns only the views of a few SAT officials, which have not been elevated to more solid legal form. Much the same can be said of the only slightly higher-level “SAT issuances” (*guoshuifa*), which in past SAT practice were used, in addition to many internal bureaucratic purposes,⁵⁸ to provide “adjustments and supplements

56. The SAT currently has thirteen departments, of which the Bureau of Policies & Legislation and the International Taxation Department are two. See Guo Jia Shui Wu Zong Ju Zhu Yao Zhi Ze Nei She Ji Gou He Ren Yuan Bian Zhi Gui Ding (国家税务总局主要职责内设机构和人员编制规定) [Provisions on the Main Functions, Internal Bodies and Staffing of the State Administration of Taxation] (promulgated by the St. Council, July 10, 2008, effective July 10, 2008) (Lawinfochina) (China). Within a department there are typically several sections: for example, the Treaty Section and the Non-Resident Section are two sections within the International Tax Department.

57. For the use of different types of regulatory documents by the U.S. Treasury and IRS, see generally Donald L. Korb, *The Four R's Revisited: Regulations, Rulings, Reliance, and Retroactivity in the 21st Century: A View from Within*, 46 DUQ L. REV. 323 (2008).

58. These include setting out general plans for tax collection, prescribing work protocols, setting annual agency budgets, issuing special awards or reprimands to staff

to tax policies and methods of collection, as well as clarifications and interpretations for important questions in the implementation” of such policies and methods.”⁵⁹ The Treaty Annotations took the form of a SAT issuance,⁶⁰ and that is why they are, in an important sense, procedurally invalid. By the end of 2009, the SAT decided the procedures for issuing substantive tax rules and interpretations through SAT issuances and correspondences were so dysfunctional that they had to be completely revamped.⁶¹ In a major new ministerial regulation, the SAT required that any “tax regulatory document” “prescrib[ing] the rights and obligations of taxpayers” must be published and compiled in a “SAT bulletin” (*gonggao*) format.⁶² To qualify as a bulletin, guidance must go through a special set of procedures. The new regulation took effect on July 1, 2010. The Treaty Annotations were adopted on July 26, 2010, and released to the public in September 2010.⁶³ Not only did the Annotations not assume the SAT bulletin format or satisfy the procedural requirements, but they were also characterized by other formal oddities.⁶⁴ In light of the very recent SAT regulation, therefore, the Treaty Annotations cannot have the effect of “prescribing the rights and obligations of taxpayers.”⁶⁵

members, making other important internal announcements, and so on. Implementation Measures for the Processing of Official Documents of All Tax Agencies of China (promulgated by the St. Admin. of Tax’n, Oct. 9, 2004, effective Oct. 9, 2004) art. 29 (China).

59. *Id.*

60. See Shui Shou Xie Ding Chang She Ji Gou Ren Ding Deng You Guan Wen Ti (税收协定常设机构认定等有关问题) [Relevant Issues About the Determination of Permanent Establishments in Tax Agreements] (promulgated by the St. Admin. of Tax’n, Mar. 14, 2006, effective Mar. 14, 2006) (Lawinfochina) (China); Implementation Measures for the Processing of Official Documents of All Tax Agencies of China (promulgated by the St. Admin. of Tax’n, Oct. 9, 2004, effective Oct. 9, 2004) art. 29 (China). Like SAT Correspondences, many SAT Issuances are not published.

61. For a glimpse of the internal discussions that led to this decision, see CHINA TAXATION PRESS, ANNOTATIONS ON ADMINISTRATIVE MEASURES FOR FORMULATING REGULATORY DOCUMENTS IN TAXATION 4–20 (Li Sanjiang ed. 2010).

62. Shui Shou Gui Fan Xing Wen Jian Zhi Ding Guan Li Ban Fa (税收规范性文件制定管理办法) [Administrative Measures for the Formulation of Tax Regulatory Documents] (promulgated by the St. Admin. of Tax’n, Feb. 10, 2010, effective July 1, 2010) art. 2 (Lawinfochina) (China).

63. Interpretation of the Articles of Agreement for the Avoidance of Double Taxation, China–Singapore (China), *supra* note 27.

64. For instance, as widely noted by Chinese tax practitioners, it did not state its own effective date.

65. In a bulletin, the SAT listed the Treaty Annotations as an effective “regulatory document,” presumably in an attempt to establish its legitimacy in binding taxpayers. Regarding the Publication of the List of Currently Effective Tax Regulatory Documents (promulgated by the St. Admin. of Tax’n, Dec. 13, 2010) (Lawinfochina) (China) However,

More fundamentally, SAT correspondences, issuances, and even bulletins all lack the binding effect of law, in accordance with the Law on Legislation and the Chinese Supreme People's Court's interpretation of the Administrative Litigation Law. This legal perspective on the formal character of SAT's policy documents will be elaborated upon in Part IV below. From an institutional perspective, SAT informal rules are the products of very devolved rulemaking—it can often be questioned whether they even represent the view of a department within the SAT, and it is almost certain that they do not represent the view of the SAT as a ministry, let alone that of the State Council or the National Legislature. Indeed, this fact about how the rules are made may explain the pattern of treaty violations noted earlier—i.e., an array of measures that expand China's taxing rights without a core policy agenda, adopted against a background of heavy reliance on international practice and norms to articulate China's treaty policy.

If agency rules so casually produced as those discussed above could constitute sources of law in China, one would have to conclude that China, for all intents and purposes, does not have an administrative law system. That conclusion is wrong because the premise is wrong. The next two Parts will offer a more systematic review of the place of tax treaties in the Chinese legal system, on the one hand, and the SAT rules surveyed above, on the other. The very clear conclusion is that while tax treaties are both internationally binding and binding under China's domestic law, the SAT informal documents, especially where they conflict with tax treaties and with domestic law, are not legally binding and may be discarded—in theory and in actual practice—upon administrative or judicial review. This illustrates how, without taking another country's legislative and administrative law framework into account, perceptions of what constitutes tax “law” in another country can be radically misleading.

III. THE PLACE OF TAX TREATIES IN THE CHINESE LEGAL SYSTEM

Understanding devolved lawmaking, it turns out, is crucial for understanding the place of tax treaties in China's legal system as well. In design and also (though to a lesser extent) in practice, the conclusion of tax treaties in China lies far above the sphere of SAT bulletins, issuances, and correspondences. According to the Chinese Constitution, the State Council has the power to conclude treaties and agreements with foreign states.⁶⁶

it is not clear that one regulatory document can restore legitimacy to another when the latter is procedurally invalid under the terms of a higher, formal regulation. The weak legal effect of regulatory documents is discussed further in Part IV, *infra*.

66. XIANFA art. 89 § 9 (1982) (China).

But the Standing Committee of the National People's Congress (NPCSC) exercises the power "to decide on the ratification or abrogation of treaties and important agreements concluded with foreign states."⁶⁷ The power to conclude and the power to ratify or abrogate treaties are enumerated in parallel with other lawmaking powers of the State Council and the NPCSC, respectively. Some Chinese scholars have argued that, consequently, treaties ratified by the NPCSC have the same effect of law as statutes adopted by that legislative body, whereas treaties merely concluded by the State Council would have the status of regulations issued by that executive body.⁶⁸ For reasons we will now detail, such a view would cast significant doubt over the legal effectiveness of most of China's (tax and nontax) treaties.

The Law on the Procedure of the Conclusion of Treaties (LPCT)⁶⁹ specifies what treaties and agreements require the NPCSC's ratification. The enumerated categories do not explicitly refer to treaties relating to taxation,⁷⁰ but one category, including treaties and agreements which contain stipulations that diverge from the (statutory) laws of the People's Republic of China (PRC),⁷¹ potentially implicates tax treaties.⁷² Since tax treaties by their nature limit the taxing power of the contracting states under domestic law, a literal reading of this provision seems to imply that all tax treaties, insofar as they modify statutory tax law, require National

67. *Id.* art. 67 § 14.

68. See, e.g., Yongwei Liu, *Important and Unimportant Treaties: A Discussion of the Importance of Tax Treaties*, 26 TRIB. POL. SCI. & L. 171, 171–78 (2008); Zhang Liang, *Revisiting the Application of the WTO Agreement in China*, available from www.chinalawinfo.com.

69. Zhonghua Renmin Gongheguo Di Jie Tiaoyue Cheng Xu Fa (中华人民共和国缔结条约程序法) [Procedure of the Conclusion of Treaties] (promulgated by the Standing Comm., Dec. 28, 1990, effective Dec. 28, 1990) art. 3 (Lawinfochina) (China).

70. The enumerated categories include: (1) treaties of friendship and cooperation, treaties of peace, and other treaties of a political nature; (2) treaties and agreements concerning territory and delimitation of boundary lines; (3) treaties and agreements relating to judicial assistance and extradition; (4) treaties and agreements which contain stipulations inconsistent with the laws of the PRC; (5) treaties and agreements which are subject to ratification as agreed by the contracting parties; and (6) other treaties and agreements subject to ratification. *Id.* art. 7.

71. In Chinese, the same term *falü* is used both for (i) law in the broad sense of rules having legal effect and (ii) laws and decisions adopted by the National People's Congress (NPC) or the Standing Committee of the National People's Congress (NPCSC). Where law in this latter sense is relevant, this Article uses the term *statute* or (*statutory*) *law*.

72. None of China's tax treaties specifically requires legislative ratification on China's part. See Procedure of the Conclusion of Treaties art. 7 § 5 (China). Category 6, the residual category, has not received any elaboration as to its meaning, and can be assumed not to apply to tax treaties. See *id.* art 7 § 6.

People's Congress (NPC) ratification.⁷³ An argument for this reading is that the executive branch should not be able to modify domestic statutory law without the agreement of the legislative branch. However, for tax treaties, the Chinese government has not followed this reading of the requirements for ratification nor has it offered any public explanation of its reasons for not doing so. Instead, in the tax area, the executive branch has adopted procedures in the LPCT that apply to the drafting and negotiation of treaties where NPC ratification is not required.

Under such procedures, the general rule is for the departments concerned under the State Council to negotiate and prepare a draft treaty and then submit it to the State Council “for examination and decision.”⁷⁴ However, later in the same statute, it states, “with respect to agreements concerning specific business affairs, with the consent of the State Council, the draft agreement of the Chinese side shall be examined and decided upon by the departments concerned under the State Council or in consultation with the Ministry of Foreign Affairs when necessary.”⁷⁵ In such latter cases, the concluded treaties merely have to be filed with the State Council, without the need of the latter's approval.⁷⁶ It is not entirely clear into which of these two categories—agreements requiring the State Council's decision, or “agreements concerning specific business affairs”—tax treaties fall. Some scholars have claimed that tax treaties are concluded by the MOF or SAT alone,⁷⁷ citing as evidence, for example, that the conclusion of new tax treaties has generally been announced by the SAT, and rarely by the State Council.⁷⁸ Others, however, have stated that the conclusion of tax treaties themselves is contingent on the State Council's examination and approval, while other international agreements reached in the treaty implementation process—such as agreements resulting from mutual agreement procedures—are handled by the SAT alone.⁷⁹

73. Some Chinese scholars have argued for such a reading. See, e.g., Xiong Wei, *Tax Treaties and China's Enterprise Income Tax Law*, 5 WUHAN U. L. REV. 2, 35 (2009).

74. Procedure of the Conclusion of Treaties art. 5 (China).

75. *Id.*

76. *Id.* art. 9 (imposing such a filing requirement).

77. See Liu, *supra* note 68; Liu Yongwei, *The Relation Between Sino-Foreign Tax Treaties and Domestic Tax Law: A Self-Criticism of Relevant Chinese Tax Law Provisions*, 6 WUHAN U. L. REV., 63, 63–68 (2006).

78. In terms of signatories, China's tax treaties have been signed by a wide variety of officials, ranging from premiers and vice premiers, to ministers and vice ministers of the SAT, the MOF, or the Ministry of Foreign Affairs (MFA), to ambassadors. All of them, however, could have been acting as authorized representatives of the State Council. See Procedure of the Conclusion of Treaties art. 6 (China) (providing the procedures for such authorization).

79. Interview with a Staff Member of the Treaty Section of the Int'l Tax Dep't of the

In any case, the most important from a legal perspective is the State Council's view that the signing of tax treaties does not require NPCSC ratification. The legislative branch itself appears to have acquiesced to this view. As early as 1981, before China had entered into any income tax treaty, the NPCSC provided in the Foreign Enterprise Income Tax Law⁸⁰ that the rules in any tax treaty between the PRC government and the governments of other countries should be given superior effect over domestic law.⁸¹ Similar provisions could be found in a successor statute,⁸² and in the Law on the Administration of Tax Collection (LATC) adopted in 1992—a statute that applies to the administration of all taxes in China.⁸³ Currently, the superior effect of tax treaties over domestic law is recognized in the EIT Law.⁸⁴ With the exception of the 1981 law, all of these statutory provisions were enacted with the knowledge that no tax treaty had gone through congressional ratification. At the very least, this suggests that the NPC and NPCSC have consented to the State Council's judgment that, substantively, tax treaties do not require congressional ratification. It may even reflect these legislative bodies' belief that, procedurally, nothing has been amiss in giving tax treaties legal effect under Chinese law.

Statutory acknowledgment that treaties supersede domestic law is by no means limited to the tax area. Other Chinese statutes have broadly provided that China's treaties have superior effect over domestic law and civil litigation matters, except where China has made explicit reservations to treaty provisions.⁸⁵ Similarly, treaties have superior effect over domestic

SAT, in Beijing (Feb. 2011) (on file with Author).

80. Income Tax Law for Foreign Enterprises (promulgated by the Standing Comm., Dec. 13, 1981, effective Jan. 1, 1982), *replaced by* Zhonghua Renmin Gongheguo Wai Shang Tou Zi Qiye He Wai Guo Qiye (中华人民共和国外商投资企业和外国企业所得税法) [Income Tax Law for Enterprises with Foreign Investment and Foreign Enterprises] (promulgated by the Standing Comm., Apr. 9, 1991, effective July 1, 1991) (Lawinfochina) (China).

81. Income Tax Law for Enterprises with Foreign Investment and Foreign Enterprises art. 17 (China).

82. *Id.* art. 28.

83. Zhonghua Renmin Gongheguo Shui Shou Zheng Shou Guan Li Fa (中华人民共和国税收征收管理法) [Law on the Administration of Tax Collection] (promulgated by the Standing Comm. Nat'l People's Cong., Sep. 4, 1992, effective as amended May 1, 2001) art. 91 (Lawinfochina) (China).

84. Zhonghua Renmin Gongheguo Qiye Suo De Shui Fa (中华人民共和国企业所得税法) [Enterprise Income Tax Law] (promulgated by the Nat'l People's Cong., Mar. 16, 2007, effective Jan. 1, 2008) art. 58 (Lawinfochina) (China).

85. Zhonghua Renmin Gongheguo Min Fa (中华人民共和国民事诉讼法通则) [General Principles of the Civil Law] (promulgated by the Nat'l People's Cong., Apr. 12, 1986, effective Jan. 1, 1987) art. 142 (Lawinfochina) (China); Zhonghua Renmin Gongheguo Min Shi Su Song Fa (中华人民共和国民事诉讼法) [Civil Procedure Law] (promulgated by the Nat'l People's Cong., Apr. 9, 1991, effective Apr. 9, 1991) art. 238 (Lawinfochina) (China).

law concerning administrative litigation procedure (absent explicit reservations made to the treaties).⁸⁶ All of these reflect a strong consensus throughout the legislative and executive branches that China is obligated to perform under its treaties regardless of the state of domestic law. As discussed in Part IV, the Chinese judiciary also holds such a view. In all, then, that treaties are binding irrespective of domestic law (other than the Constitution) is unambiguously the Chinese government's position.

Nonetheless, there is an obvious tension in this position: if a treaty concluded by the executive branch—indeed, by a part of the executive branch exercising delegated authority from the State Council and with minimal review—can bind China as a country and have superior effect over Chinese domestic law, then the executive branch can effectively override the legislative branch in lawmaking. This, under Chinese domestic law, they supposedly cannot do.

The Law on Legislation (LL),⁸⁷ adopted in 2000, highlights this tension without resolving it. The LL plays an important role in delineating both what rules have the force of law in the Chinese legal system and how conflicts among different rules are to be resolved.⁸⁸ It applies to the enactment, revision, and nullification of national statutes (by the NPC or NPCSC), “administrative regulations” (by the State Council),⁸⁹ local statutes (by legislatures of provincial and certain other subnational jurisdictions), and certain regulations issued by ethnic autonomous regions. It also governs in a similar manner regulations issued by ministries under the State Council (“ministerial regulations”) and by certain local governments. These, plus the Constitution, are the only forms of law recognized by the LL, and the creation of such rules constitutes lawmaking in the broad sense. Among these rules, the following hierarchy (in descending order of authority) is stipulated: (i) the Constitution; (ii) national statutes; (iii) State Council regulations; (iv) local statutes (with priority over local regulations but not ministerial regulations); and (v) ministerial and local regulations.⁹⁰ A rule lower in rank cannot be applied to the extent it

86. Zhonghua Renmin Gongheguo Xing Zheng Su Song Fa (中华人民共和国行政诉讼法) [Administrative Procedure Law] (promulgated by the Nat'l People's Cong., Apr. 4, 1989, effective Oct. 1, 1990) art. 72 (Lawinfochina) (China).

87. Zhonghua Renmin Gongheguo Lifa Fa (中华人民共和国立法法) [Law on Legislation] (promulgated by the Nat'l People's Cong., Mar. 15, 2000, effective July 1, 2000) (Lawinfochina) (China).

88. See ALBERT HUNG-YEE CHEN, AN INTRODUCTION TO THE LEGAL SYSTEM OF THE PEOPLE'S REPUBLIC OF CHINA 95–130 (3d ed. 2004).

89. In the following Parts, “administrative regulations” and “State Council regulations” will be used interchangeably.

90. There are numerous refinements to the hierarchy stated in the text that are not

conflicts with any rule higher in rank in the hierarchy.

However, the LL makes no mention of treaties and thus gives no explanation of where they fit within its legal order. If only treaties ratified by the NPCSC have the status of statutory law, and if treaties concluded by the State Council or its ministries without ratification possess only the status of State Council or ministerial regulations, then these latter treaties are necessarily inferior in effect to statutory law under the LL. Where they conflict with statutory law, their nonratification would seem to mean they have not been given the effect of law in China. This paradox plagues many treaties and agreements that China has signed or acceded to. The gap in lawmaking procedure has been widely recognized by Chinese scholars of international law, and proposals to amend the LPCT have been studied in recent years by the NPC and the State Council.⁹¹ However, as things stand, China's recognition of the binding nature of its treaty obligations is not always reflected in its domestic law mechanisms, and its commitment to its treaty obligations often may be said to operate *in spite of* such mechanisms.

Some may argue that the acknowledgment of the superior effect of treaties in specific statutes, such as the EIT Law and the LATC, serves to remedy the procedural flaw of nonratification of individual treaties. Moreover, it may be argued that this legislative technique provides certainty—especially to foreign investors and foreign governments—as to China's willingness to honor its treaty obligations. How plausible this argument is may be open to debate⁹² and, in any case, it does not go far enough: China's Individual Income Tax Law has never contained a similar provision regarding the superior effect of treaties. Under this technical argument, China's tax treaties have never operated to limit domestic law under the EIT, a position that few would likely accept.

Perhaps a more compelling argument is the following. The specific statutory statements regarding the superior effect of treaties evidence a

relevant here, as well as rules for resolving conflicts among rules within the same rank in the hierarchy. See Law on Legislation arts. 78–88 (China); see also CHEN, *supra* note 88, at 96–97, 112.

91. See REPORT OF THE NPC FOREIGN AFFAIRS COMMITTEE REGARDING THE CONCLUSIONS OF REVIEWING DELEGATES' LEGISLATIVE PROPOSALS SUBMITTED BY THE PRESIDUM OF THE FIRST MEETING OF THE 11TH NAT'L PEOPLE'S CONG. (Dec. 27, 2008).

92. To start, the EIT Law and Law on the Administration of Tax Collection (LATC), as statutes on specific legislative matters, cannot override the general procedures for lawmaking in the Law on Legislation (LL) and the Law on the Procedure of the Conclusion of Treaties (LPCT). Moreover, it would not be plausible to view such statutory provisions regarding the superior effect of treaties as delegating authority to the executive branch to conclude new treaties.

general recognition that treaties are binding under China's domestic law,⁹³ regardless of the actual procedures for bringing them into force. This recognition is also shared by the State Council through its acts of concluding binding international treaties and signing the Vienna Convention on the Law of Treaties, and, as will be discussed in Part IV, by the Chinese courts. In other words, the binding effect of treaties is a uniform position adopted throughout the Chinese government. Under this view, tax treaty overrides—in the customary sense of national legislatures intentionally overruling the provisions of treaties—are impossible in China. This is literally the case where statutes explicitly concede the superior effect of treaty law and conceptually the case even where such statutory provisions are missing.

Given this (what one might call the “orthodox”) view, and given the low rank within the Chinese domestic legal order of the controversial SAT regulatory documents discussed in Part I, it seems their threat to treaty partners could easily be contained within the Chinese legal system. In the next Part, we examine in detail whether this is the case. But an irony worth underscoring here is that, in a fundamental sense, it is the same system of devolved rulemaking that is responsible for both the controversial SAT circulars and the fact that the incorporation of tax treaties into domestic law is less than robust. In a more developed legal system, the treaties would be legislatively ratified, and the tax policy would be implemented through regulations with the binding force of law or at least other rules that receive careful legal review. However, given where the Chinese administrative law system stands now, treaties are legally binding even if not ratified by the NPC, whereas SAT circulars are not legally, but often practically, binding.

IV. MEANS OF CHALLENGING INVALID SAT RULES

Within the Chinese administrative law system, two well-established types of procedures exist for challenging agency rules that one believes to be substantively or procedurally invalid; several other approaches are relatively novel and untried. The two well-established procedures are administrative appeal and judicial review, either of which may be brought

93. In published annotations that the NPCSC has given to the LATC (available through www.chinalawinfo.com), for example, the NPCSC, in connection with the LATC provision acknowledging the superior effect of treaties over itself, does not state that the intent of the provision was to meet any procedural requirements, but suggests that it merely reflects the recognition that treaties are binding on the nations that enter them. *See* *Zhonghua Renmin Gongheguo Shui Shou Zheng Shou Guan Li Fa* (中华人民共和国税收征收管理法) [Law on the Administration of Tax Collection] (promulgated by the Standing Comm. Nat'l People's Cong., Apr. 28, 2001, effective May 1, 2001) art. 91 (Lawinfochina) (China).

only on the occasion of a specific agency action against a private party and purportedly based on an agency rule that one disputes. In contrast, relatively untried procedures offer the possibility of pre-enforcement review.

A. Administrative Appeal, Litigation, and Pre-Enforcement Review

An administrative appeal⁹⁴ may be brought under the Administrative Reconsideration Law⁹⁵ against a “specific administrative act[ion].”⁹⁶ The Supreme People’s Court (SPC) has interpreted this last concept, which is also used under the Administrative Litigation Law (ALL), as not encompassing the mere adoption of “administrative rules and regulations, regulations, or decisions and orders with general binding force,”⁹⁷ including “all regulatory documents issued by administrative agencies repeatedly and generally applicable to more than specific parties.”⁹⁸ However, the applicant for an administrative review has a statutory right to request that the reviewing body examine the legal validity of informal agency rules that purport to be the legal basis of a disputed action.⁹⁹ “Informal” agency rules are essentially those not recognized as having the effect of law under the Law on Legislation¹⁰⁰ and, in the case of the SAT, would include all SAT bulletins, issuances, and correspondences. In response to a request for

94. In this Article, “administrative appeal,” “administrative review,” or “administrative reconsideration” are used interchangeably and correspond to *xingzhengfuyi* in Chinese.

95. Zhonghua Renmin Gongheguo Xing Zheng Fu Yi Fa (中华人民共和国行政复议法) [Administrative Reconsideration Law] (promulgated by the Nat’l People’s Cong., Apr. 29, 1999, effective Oct. 1, 1999) (Lawinfochina) (China); see also Zhonghua Renmin Gongheguo Xing Zheng Fu Yi Fa Shi Shi Tiao Li (中华人民共和国行政复议法实施条例) [Regulation on the Implementation of the Administrative Reconsideration Law] (promulgated by the St. Council, May 29, 2007, effective Aug. 1, 2007) (Lawinfochina) (China); Shui Wu Xing Zheng Fu Yi Gui Ze (税务行政复议规则) [Rules for Tax Administration Reconsideration] (promulgated by the St. Admin. of Tax’n, Feb. 10, 2010, effective Apr. 1, 2010) (Lawinfochina) (China) (defining procedures of administrative appeals against all tax agencies).

96. Administrative Reconsideration Law art. 1 (China).

97. Zhonghua Renmin Gongheguo Xing Zheng Su Song Fa (中华人民共和国民事诉讼法) [Administrative Litigation Law] (promulgated by the Nat’l People’s Cong., Apr. 4, 1989, effective Oct. 1, 1990) art. 12(2) (Lawinfochina) (China).

98. *In re Fashi*, art. 3 (Sup. People’s Ct., Mar. 10, 2000) (Interpretations of Certain Issues in the Implementation of the Administrative Litigation Law); see also *In re Fa*, Sec. 1(1) (Sup. People’s Ct., June 11, 1991) ((Provisional) Opinions Regarding Certain Issues in the Implementation of the Administrative Litigation Law) (“specific administrative actions” that are actionable must be directed at specific persons).

99. Administrative Reconsideration Law art. 7 (China).] Unlike administrative litigation, which is further discussed below, the validity of formal agency rules, such as ministerial or local governmental regulations, may not be reviewed. See *id.*

100. *Id.*

review, the reviewing body may revoke or modify any invalid informal rules or ask a competent government authority to do so.¹⁰¹ In the case of informal tax rules adopted by the SAT itself, revocation would be processed by the SAT's Legal Department; taxpayer challenges through administrative appeals could thus offer that part of the SAT a chance to review problematic rules that it may not have had adequate opportunities to examine before promulgation.¹⁰² According to the SAT, in nearly half of the administrative appeal cases it processed between 2000 and 2006, the appellants sought the review of the agency rules underlying the disputed agency actions; in one-third of these cases, changes were made to the rules.¹⁰³

Unlike Article I judges in the United States, the reviewing bodies in Chinese administrative appeal procedures are internal to the executive branch, and typically comprised of the legal staff in the government agency that bureaucratically supervises the agency whose action is being appealed.¹⁰⁴ This institutional arrangement is not unlike those adopted by numerous countries with established traditions of the rule of law and is, at least in theory, compatible with the goals of the appeals procedure. Indeed, according to the SAT's own report, between 1994 and 2005, of all tax administrative appeals across China, agency actions were equally likely to be overturned as they were sustained. In the administrative reviews that the SAT itself processed,¹⁰⁵ agency actions were sustained in only 55% of the cases. For all administrative appeals during the same period, 62% were terminated through the withdrawal or modification of agency actions or through mediation.¹⁰⁶ The administrative appeal mechanism is thus highly effective for those taxpayers who decide to use it.¹⁰⁷ What is more, there is

101. *Id.* art. 26.

102. *See supra* text accompanying notes 53–61. In the case of informal rules made by subnational tax agencies, their higher supervising agencies generally have the authority to demand such changes.

103. Lin Hong, *Tax Administrative Cases a Growing Trend*, CHINA TAX'N NEWS, Feb. 5, 2007, at 1 [hereinafter Lin, *Tax Administration Cases*]; Lin Hong, *The SAT Uses Administrative Review to Improve Policy*, CHINA TAX'N NEWS, Feb. 5, 2007, at 2.

104. For example, a municipal tax agency may be supervised by both the provincial tax agency that has jurisdiction over the municipality and by the mayor's office. Its action may thus be reviewed by a body in either higher agency. *See* Shui Wu Xing Zheng Fu Yi Gui Ze (税务行政复议规则) [Rules for Tax Administrative Reconsideration] (promulgated by the St. Admin. of Tax'n, Feb. 10, 2000, effective Apr. 1, 2010) arts. 12–20 (Lawinfochina) (China) (listing choice of venue rules for tax administrative appeals).

105. Many reviews were completed at subnational tax agencies and never reached the national SAT level.

106. Lin, *Tax Administrative Cases*, *supra* note 103.

107. *But see infra* text accompanying notes 136–37 (discussing the infrequency with which administrative appeals are generally made).

no government charge for bringing an administrative appeal,¹⁰⁸ nor are there qualification requirements for any agents or representatives participating in an appeal proceeding.¹⁰⁹

If a taxpayer receives an unfavorable decision in an administrative appeal, he or she may appeal that decision in a regular court, where proceedings will be governed by the ALL. The ALL limits the types of government pronouncements that can be cited as the legal basis for agency actions¹¹⁰; whereas national and local statutes, as well as administrative regulations, are per se a valid basis for such actions, ministerial and local government regulations are to be taken only “as [a] reference[]” and not as the legal basis of decisions entered by courts.¹¹¹ Courts are explicitly given latitude in questioning the validity of regulations issued by ministries and local governments and in choosing whether to apply such regulations. Such latitude is even greater with respect to government pronouncements of lesser status than regulations. The ALL does not itself state that any effect should be given to these. In an important document issued in 2004 (hereinafter the “Shanghai Meeting Minutes”),¹¹² the SPC distinguished regulations, on the one hand, from “other regulatory documents,” on the other. Although “agencies frequently rely on such . . . other regulatory documents as the basis for specific administrative actions,” the SPC stated they are not “formal sources of law, and do not have the binding force of legal norms.”¹¹³ It is only when a court, in the course of adjudicating cases relating to specific administrative actions, determines that such regulatory documents possess “legal validity, effectiveness, reasonableness and appropriateness,” that it may give them effect in determining whether the specific administrative act has legal basis.¹¹⁴

108. Zhonghua Renmin Gongheguo Xing Zheng Fu Yi Fa (中华人民共和国行政复议法) [Administrative Reconsideration Law] (promulgated by the Nat'l People's Cong., Apr. 29, 1999, effective Oct. 1, 1999) art. 39 (Lawinfochina) (China).

109. *See id.* art. 10 (allowing applicants to select an agent to participate in administrative reconsideration without imposing requirements upon that agent); Rules for Tax Administrative Reconsideration art. 31 (China).

110. *See* Zhonghua Renmin Gongheguo Xing Zheng Su Song Fa (中华人民共和国行政诉讼法) [Administrative Litigation Law] (promulgated by the Nat'l People's Cong., Apr. 4, 1989, effective Oct. 1, 1990) (Lawinfochina) (China). In this respect, the Administrative Litigation Law (ALL) was historically an important precursor to the Law on Legislation in curbing the executive branch's ability to make law and is also what, one might say, gives the Law on Legislation its bite.

111. *Id.* arts. 52–53.

112. Meeting Minutes Regarding the Application of Legal Norms in Reviewing Administrative Cases, sec. 1, para. 3 (Sup. People's Ct., May 18, 2004).

113. *Id.* sec. 1.

114. *Id.* Courts may also comment on the “legal validity, effectiveness, reasonableness

As with many other civil law systems, Chinese courts generally have no power to invalidate regulations and other rules of general application.¹¹⁵ In such systems, the courts' supposed role is not to make or even interpret the law but simply to apply the law to the facts. The nullification of invalid rules and regulations is left to the legislative and executive branch entities that make them. Procedures have long existed for seeking the nonjudicial, pre-enforcement review of statutes and formal regulations recognized as law under the LL,¹¹⁶ but they have not been used often, in part because many government agencies tend to promulgate their rules in an informal format, which takes these rules outside the ambit of the LL.¹¹⁷ To address this problem, a number of recent statutes and regulations have attempted to create formal procedures for reviewing informal rules. For example, the Law on the Supervision of the Standing Committees of People's Congresses at Various Levels¹¹⁸ enables congressional bodies to revoke invalid rules issued by the executive branch, including informal "regulatory documents." Since 2005, the SAT has allowed taxpayers to apply for pre-enforcement review, conducted by higher bodies in the administrative hierarchy, of informal rules issued by subnational tax agencies,¹¹⁹ and since 2010 the SAT has provided for such review of its own informal rules.¹²⁰

It is likely, however, that these procedures will remain relatively

and appropriateness" of regulatory documents in their written decisions. *Id.*

115. Administrative Litigation Law art. 12 (China).

116. *See* Law on Legislation art. 90 (China) (allowing various political organizations to submit regulations that may contradict laws to the Standing Committee of the National People's Congress for examination); Xing Zheng Fa Gui Zhi Ding Cheng Xu Tiao Li (行政法规定程序条例) [Ordinance Concerning the Procedures for the Formulation of Administrative Regulations] (promulgated by the St. Council, Nov. 16, 2001, effective Jan. 1, 2002) art. 35 (Lawinfochina) (China).

117. For examples illustrating this obstacle to the pursuit of pre-enforcement review, see Cui, *supra* note 25, pt. II.B.

118. Zhonghua Renmin Gongheguo Ge Ji Renmin Dai Biao Da Hui Chang Wu Wei Yuan Hui Jian Du Fa (中华人民共和国各级人民代表大会常务委员会监督法) [Supervision of Standing Committees of People's Congresses at Various Levels (promulgated by the Standing Comm. Nat'l People's Cong., Aug. 27, 2006, effective Jan. 1, 2007) arts. 29–30 (Lawinfochina) (China).

119. Shui Shou Gui Fan Xin Wen Jian Zhi Ding Guan Li Ban Fa (Shi Xing) (税收规范性文件制定管理办法(试行)) [Administrative Measures for the Formulation of Regulatory Documents on Taxation (for Trial Implementation) (promulgated by the St. Admin. of Tax'n, Dec. 16, 2005, effective Mar. 1, 2006, repealed July 1, 2010) art. 33 (Lawinfochina) (China).

120. Shui Shou Gui Fan Xing Wen Jian Zhi Ding Guan Li Ban Fa (税收规范性文件制定管理办法) [Administrative Measures for the Formulation of Tax Regulatory Documents] (promulgated by the St. Admin. of Tax'n, Feb. 10, 2010, effective July 1, 2010) art. 35 (Lawinfochina) (China).

infrequently used: details of the procedures are rarely spelled out, and very often the reviewing bodies are under no obligation to respond but act only at their discretion.¹²¹ From an institutional perspective, the reviewing bodies often may also lack the clout to revoke the questionable rules. Litigation, therefore, emerges (not surprisingly) as the basic option for taxpayers who wish to prevent the application of agency rules that they believe are invalid. The ALL and the SPC's Shanghai Meeting Minutes unambiguously grant the power to courts to discard informal agency rules where they conflict with higher law. Court fees for administrative litigation are also negligible.¹²² However, most foreigners are likely to take the utmost caution in deciding to sue any government agency in their host country. A more careful assessment of the real likelihood of favorable outcomes in a lawsuit is necessary.

B. *The Likelihood of Prevailing Against Government Agencies*

As a first step in such an assessment, any casual assumption that the Chinese judicial system lacks independence is rebutted by the following statistic provided by the SAT: between 1994 and 2005, the government won in only 55% of the judicial proceedings against tax agencies.¹²³ It is difficult to gather representative samples of judicial decisions to independently assess that statistic because Chinese courts and legal professionals do not yet systematically publish and classify judicial decisions.¹²⁴ Nonetheless, the SAT itself should have no incentive to exaggerate the frequency of government losses. Moreover, available cases suggest that the Chinese judiciary is by no means unprepared to handle disputes about tax treaty claims.

One clear conclusion from published cases is that, since the 1990s, courts have steadily adhered to the position, later articulated in the SPC's 2004 Shanghai Meeting Minutes, that informal agency documents are not

121. *Id.* (requiring only that authorities "shall" handle review in a timely manner). This is also the case with the congressional review prescribed by the Law on the Exercise of Supervision by the Standing Committees of People's Congresses at Various Levels. *See supra* note 118.

122. The basic fee is between 50 and 100 yuan. *Su Song Fei Yong Jiao Na Ban Fa* (诉讼费用交纳办法) [Measures on the Payment of Litigation Costs] (promulgated by the St. Council, Dec. 19, 2006, effective Apr. 1, 2007), art. 13(5) (Lawinfochina) (China).

123. Lin, *Tax Administrative Cases*, *supra* note 103.

124. In a sample of civil tax litigation comprising roughly 200 published cases gathered by the Author, the percentage of taxpayer wins was lower (around 30%), which may, however, reflect a publication bias by the courts. The sample was created from legal databases including www.chinalawinfo.com and others, which gather court cases through paper and online publications by the courts.

binding on their decisions. Instead, informal agency rules are given effect only when they are consistent with higher laws and regulations and deemed reasonable and appropriate. The rejection of informal agency rules as legally binding can be blunt. In one tax case, the court admitted into evidence an SAT Correspondence that recommended a specific tax treatment for the plaintiff, but it gave no consideration or weight to the document in its final decision.¹²⁵ In other tax cases, the courts expressly treated informal rules as nonbinding and revoked agency actions based on them.¹²⁶ Perhaps most relevant for litigation involving tax treaty claims are a well-known pair of cases, discussed below, in which the courts treated SAT interpretations of tax treaties (made through one SAT Issuance and one SAT correspondence) as nonbinding, and instead pursued treaty interpretation *de novo*.¹²⁷ These stances are also entirely in line with judicial decisions in nontax areas.

While administrative litigation brought by foreigners is relatively rare, and as a result treaty-based litigation is also rare, Chinese courts are also known to give treaty law superior effect over Chinese domestic law.¹²⁸ The most widely discussed instance of this in the tax area is a 2001 lawsuit brought by the U.S. satellite company PanAmSat claiming a refund of taxes paid on income received for satellite transmission services rendered to China's official television station, China Central Television (CCTV). The tax bureaus claimed that the income constituted rental income (for the use of satellite equipment) under Chinese domestic law and royalty income under Article 11 of the U.S.–China tax treaty.¹²⁹ The court of first instance disregarded two SAT informal documents that had set out these claims¹³⁰

125. See *Shenzhen Energy Grp. Ltd. v. Inspection Bureau of the Qinzhou Local Tax Bureau*, Guixingzhongzi, at 30 (Guangxi Zhuang Autonomous Region Higher People's Ct. 2002) (China).

126. See, e.g., *Shenzhen Jinmanke Electric, Ltd. v. Shenzhen State Tax Bureau Xingchuzi*, at 003 (Shenzhen Interm. People's Ct. Nov. 21, 1997) (China).

127. *PanAmSat Int'l Sys., Inc. v. Second Dep't in the External Substation of the Beijing State Tax Bureau (PanAmSat II)*, Gaoxingzhongzi, at 24 (Higher People's Ct. Beijing, Dec. 20, 2002) (China); *PanAmSat Int'l Sys., Inc. v. Second Dep't in the External Substation of the Beijing State Tax Bureau (PanAmSat I)* Yizhongxingchuzi, at 168 (First Interm. People's Ct. Beijing, Dec. 20, 2001) (China).

128. For a summary discussion, see Zuo Haicong, *A Study of the Issue of Directly Applying Treaties*, *Legal Studies*, 3 CHINESE J.L. 97, 97–100 (2008).

129. Specifically, the claim was that it constituted royalty income received as “a consideration for the use of, or the right to use . . . industrial, commercial or scientific equipment.” *PanAmSat II*, Gaoxingzhongzi at 24; see also Tax Agreement with the People's Republic of China, U.S.–China, art. XI, ¶ 3, Apr. 30, 1984, S. Treaty Doc. No. 98-30.

130. Imposition of Tax on Foreign Enterprises' Incomes from Leasing Satellite Communication Lines (promulgated by the St. Admin. of Tax'n, Nov. 12, 1998, effective Nov. 12, 1998) (Lawinfochina) (China); Imposition of Tax on Rental Income Derived by

and directly applied both a domestic tax statute and the U.S.–China tax treaty. The appeals court found a conflict between the domestic statute and the U.S.–China tax treaty, and then invoked the provision in the domestic statute¹³¹ giving superior effect to the treaty to deliver a verdict on the basis of treaty provisions. In both cases, the courts' treaty interpretations were erroneous in ways that might not have been obvious at the time.¹³² As a result of these erroneous interpretations, PanAmSat lost the lawsuit. However, the courts made no mistake about what law is relevant: informal agency rules have no legal effect, and treaty provisions are to be given priority over domestic law.

All of Chinese law—statutes, regulations, and judicial opinions both generally and in specific cases—thus points to the following unambiguous conclusions: informal agency documents of the types discussed in Part I are not legally binding, they will not be given effect by courts if they are found to conflict with higher law, and tax treaties are a form of law that is regarded as having the highest legal effect. Why, then, do most taxpayers who are subject to the controversial SAT rules appear to treat these rules as binding?

This question is currently being debated among advisors on Chinese taxation, and while some answers have been proposed, none is at the same time plausible *and* sympathetic. One assertion—understandably almost never made in writing, and often offered only on occasions that are felt not to be too “sensitive”—is that China lacks an effective legal system for resolving disputes with government agencies. However, those who make this assertion do not explain how or to what extent the system is ineffective such that those asked to pay taxes that are not legally required should be absolved of any responsibility for formally seeking remedies. In the context of the deprivation of tax treaty benefits, depicting foreign investors (some of which are among the most powerful companies in the world) as helpless victims of a dysfunctional legal system seems unpersuasive, to say the least. Another explanation is that, even with controversial treaty interpretations, the tax burden borne by foreign investors is sufficiently low that confronting

PanAmSat from Leasing Satellite Communication Lines to CCTV (promulgated by the St. Admin. on Tax'n, Aug. 19, 1999, effective Aug. 19, 1999) (Lawinfochina) (China).

131. Zhonghua Renmin Gongheguo Wai Shang Tou Zi Qiye He Wai Guo Qiye (中华人民共和国外商投资企业和外国企业所得税法) [Income Tax Law for Enterprises with Foreign Investment and Foreign Enterprises] (promulgated by the Nat'l People's Cong., Apr. 9, 1991, effective July 1, 1991, annulled Jan. 1, 2008) art. 28 (Lawinfochina) (China).

132. If made today, the courts' interpretations would clearly contradict the OECD commentary on the issue. See *OECD Model Convention*, *supra* note 18, at 223–24 (commentary on Article 12) (clarifying that income from satellite transmissions does not fall under the category of royalty income in tax treaties).

Chinese tax agencies is unnecessary from a business perspective.¹³³ This is of course quite plausible in some cases but, for U.S. taxpayers and their affiliates at least, it would certainly bar the latter from claiming U.S. foreign tax credit for the erroneously paid Chinese tax, if the facts are adequately disclosed to the IRS.¹³⁴

The explanation for the ability of informal SAT rules contradicting Chinese domestic law and tax treaties to bind taxpayers that perhaps possesses the greatest combination of plausibility and exculpatory effect is that anyone pursuing a challenge would be “sticking one’s head out.”¹³⁵ Some data sheds light on the plausibility of this explanation. In 2006, there were a total of 91,667 cases of administrative appeals against agency actions throughout China and 52,792 cases of administrative litigation.¹³⁶ In more recent years, these numbers declined noticeably.¹³⁷ It can be estimated that each year between 1,000 and 1,200 cases of administrative appeals and fewer than 500 lawsuits are launched against tax agencies across China. These numbers—both for the total amount of administrative and judicial appeals and for tax disputes—are generally regarded as low, given China’s geographical and population size and its decentralized administrative structure. There is indeed a widely shared view among practitioners and scholars of Chinese law that the pursuit of formal administrative remedies is still a relatively uncommon, even if not rare, choice.

What factors cause this state of affairs is hotly debated. For example, the claim that the Chinese judiciary lacks independence has been challenged by scholars, especially with respect to areas that are not politically sensitive.¹³⁸

133. See, e.g., Jack Grocott, *Foreign Taxpayer Takes Dispute Through Chinese Courts*, INT’L TAX REV., Dec. 13, 2011, available at <http://www.internationaltaxreview.com/Article/2731834/Foreign-taxpayer-takes-dispute-through-Chinese-courts.html> (“While China has drastically increased its collections on non-resident taxpayers, the magnitude of such efforts is potentially still not great enough to force the hand of [multinational corporations] in terms of seeking greater litigation and administrative review.”). The tax rate applicable to passive income (i.e., dividends, royalties, interests, and capital gains) received by foreigners without an establishment in China is 10% before any reduction by applicable treaties. Zhonghua Renmin Gongheguo Qiyue Suo De Shui Fa Shi Shi Tiao Li (中华人民共和国企业所得税法实施条例) [Implementation Rules of Enterprise Income Tax Law] (promulgated by the Nat’l People’s Cong., Dec. 6, 2007, effective Jan. 1, 2008) art. 91 (Lawinfochina) (China).

134. See *infra* Part V.

135. If others do not pursue formal remedies, there are not only psychological but also real, practical disadvantages to resorting to such remedies. For example, it may not be easy to find competent lawyers who can handle administrative litigation if there is weak market demand for such services.

136. See Part IV: Statistics, LAW Y.B. CHINA, at 613 tbls. 2, 3 & 6 (2006).

137. By 2008 administrative appeal cases declined by 6.7% and administrative litigation cases by 16.9%. See *id.* at 634–36 tbls. 1–5.

138. For an up-to-date review of the state of judicial independence in China, see

Some Chinese tax scholars have advanced very different hypotheses. For example, some suggest that the aggregate tax rates of different taxes are so high that many Chinese taxpayers engage (or hope to engage) in negotiations with tax authorities to bring the amounts of their tax liabilities below legally-required levels. Maintaining a nonconfrontational relationship with tax agencies is believed to be necessary for preserving that option.¹³⁹ But this type of explanation has little relevance for major foreign investors in China, who do not negotiate with Chinese tax agencies on a routine basis.

However the current state of relative disuse of the Chinese system of public law remedies is explained, it tends to impart a practically binding effect to informal agency rules. Even rules that appear patently invalid still need to be taken very seriously. This does not mean, though, that they can be taken as given and remain unchallenged. In the next section, we show that for U.S. taxpayers doing business in China abandoning treaty benefits and Chinese legal remedies have costs at home, ones which they and their U.S. tax advisors have historically tried to avoid.

V. EFFECTIVE AND PRACTICAL REMEDIES: U.S. TAXPAYER OPTIONS

Under U.S. federal income tax law, a creditable foreign tax must be a payment that is compulsory and pursuant to the authority of a foreign country to levy taxes.¹⁴⁰ A payment in excess of the amount of foreign tax liability determined under foreign law is not a compulsory payment.¹⁴¹ Specifically, under U.S. Department of Treasury (Treasury) regulations, “[a]n amount paid does not exceed the amount of such liability if the amount paid is determined by the taxpayer in a manner that is consistent with a reasonable interpretation and application of the substantive and procedural provisions of foreign law (including applicable tax treaties).”¹⁴² Moreover, the taxpayer should exhaust “all effective and practical remedies, including invocation of competent authority procedures available under applicable tax treaties, to reduce . . . the taxpayer’s liability for

generally JUDICIAL INDEPENDENCE IN CHINA: LESSONS FOR GLOBAL RULE OF LAW PROMOTION (Randall Peerenboom ed., 2010), and Randall Peerenboom, Judicial Independence in China: Common Myths and Unfounded Assumptions (Sept. 1, 2008) (unpublished research paper, LaTrobe University), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1283179.

139. See Shi Zhengwen, *High Nominal Tax Burdens: Shackles on the Scientific Development of Chinese Tax Affairs*, in TAXATION RESEARCH (forthcoming).

140. Treas. Reg. § 1.901-2(a)(1)–(2)(i) (2010).

141. See *id.* § 1.901-2(e)(5)(i).

142. *Id.*

foreign tax.”¹⁴³

These basic requirements raise the following questions for U.S. taxpayers facing the application to their own and their affiliates’ transactions¹⁴⁴ of the problematic Chinese tax rules discussed in Part I. Could the payment of tax according to such rules be regarded as “consistent with a reasonable interpretation and application of the substantive and procedural provisions” of Chinese law, including applicable tax treaties? Although the relevant substantive issues may be more fully explored than they are in this Article, the answer suggested by the analysis in Parts I and IV is “No.” This is because the informal SAT rules, to the extent they conflict with treaty law,¹⁴⁵ are substantively invalid and cannot have the effect of law in China. The question then arises as to what might constitute, for U.S. taxpayers, “effective and practical remedies” against the payment of taxes pursuant to such rules, exhaustion of which entitles such taxpayers to U.S. credits for any such tax paid. Could a U.S. taxpayer simply make the following claim, perhaps relying on their Chinese tax advisors: “Practically nobody sues the government in China, and the least likely to do so are foreigners, so for all intents and purposes these rules are binding”?

The difficulty of supporting such a claim under U.S. tax law is considerable, and not only because of the facts about the frequency of tax litigation in China (infrequent, but not negligible), the likelihood of prevailing in any litigation (in fact quite high), and the past cases of litigation by foreign taxpayers discussed in the last Part. Just as important, the difficulty is on account of the consistent and high standards for compulsory tax payments, as established under U.S. law and as maintained by IRS practice. These standards are well summarized in the following statements in the Treasury regulations:

Whether a foreign levy requires a compulsory payment pursuant to a foreign country’s authority to levy taxes is determined by principles of U.S. law and not by principles of law of the foreign country. Therefore, the assertion by a

143. *Id.*; see also Fischl & Harper, *supra* note 7, at 33–34 (“IRS policy is that a foreign tax credit should be denied unless the taxpayer has taken reasonable measures to mitigate its foreign tax liability. The foreign tax credit is designed to reduce the possibility of double taxation when a taxpayer is subject to income tax in the U.S. and a foreign country, not to permit a taxpayer to be indifferent to its potential foreign income tax liability so long as the foreign tax can be offset against its U.S. tax liability.”).

144. The requirements with respect to compulsory taxes under Treas. Reg. § 1.901-2 also apply in the context of indirect foreign tax credits provided under I.R.C. § 902 and “in lieu of” credits under § 903. Treas. Reg. § 1.902-1T(a)(7) (2009); Treas. Reg. § 1.903-1(a) (2011). In the following, reference to payments by U.S. taxpayers includes payments by their affiliates for which the U.S. taxpayers may claim indirect foreign tax credit.

145. See *supra* notes 46–50 and accompanying text (noting that some of the rules, such as Circular 698, may also be invalid under Chinese domestic law).

foreign country that a levy is pursuant to the foreign country's authority to levy taxes is not determinative that, under U.S. principles, it is pursuant thereto.¹⁴⁶

More specifically, the Treasury regulations require a cost-benefit analysis of whether a remedy is "effective and practical"; only if the cost of seeking remedy (including the risk of offsetting or additional tax liability) "is reasonable in light of the amount at issue and the likelihood of success" is it required to be sought. While necessarily factually based, this analysis is also framed by certain legal and policy boundaries. Going to the heart of the matter, some U.S. tax practitioners have questioned whether taxpayers are "limited to considering the costs of litigation and potential counterclaims and offsets."¹⁴⁷ What about the desire to maintain and not to jeopardize the taxpayer's business relationship with the foreign sovereign, the loss of which could "lead to a significantly greater loss of business revenue than the foreign taxes at issue?"¹⁴⁸ "May the taxpayer make additional foreign tax payments to stave off an 'audit from hell' . . . [even] if the taxpayer has little or no foreign tax exposure as a strict legal matter?"¹⁴⁹ What about the desire to avoid negative publicity that one fears might ensue if one enters into a formal dispute with a part of the host country's government?

While these questions underscore difficult choices that taxpayers sometimes have to make, they do not expose ambiguities in the cost-benefit analysis described in the regulations. Cutting deals with foreign governments is certainly not what was contemplated in the cost-benefit analysis.¹⁵⁰ This is not just because a foreign levy is "not a tax, to the extent a person subject to the levy receives . . . directly or indirectly, a specific economic benefit . . . from the foreign country in exchange."¹⁵¹ More fundamentally, the "effective and practical remedies" test is clearly intended to balance the interest of taxpayers and the U.S. government's desire to protect revenue. It follows that preserving business relationships that are conditioned upon not exercising one's entitlement to the protection of law, avoiding a confrontational audit, or simply eschewing the risk of negative publicity are objectives insufficient to outweigh the U.S. government's legitimate claim to revenue.

146. Treas. Reg. § 1.901-2(a)(2)(i) (2011).

147. Fischl & Harper, *supra* note 7, at 42.

148. *Id.*

149. *Id.*

150. *Id.* at 40 nn. 37-38.

151. Treas. Reg. § 1.901-2(a)(2)(i). A "specific economic benefit" is one "that is not made available on substantially the same terms to substantially all persons who are subject to the income tax that is generally imposed by the foreign country." Treas. Reg. § 1.901-2(a)(2)(ii)(B).

Examples in the regulations, judicial decisions, and IRS guidance all help illustrate how the effective and practical remedies test has been applied. One example in the Treasury regulations¹⁵² suggests that (i) commencing an administrative proceeding in the foreign country and requesting for competent authority (CA) assistance are both expected (where the costs of doing so are not unreasonable), and (ii) the cost consideration is applied similarly to foreign judicial proceedings and requests for the IRS's CA assistance.¹⁵³ In the recently decided *Proctor & Gamble* case,¹⁵⁴ a U.S. company's failure to assess whether it was possible to obtain Japanese tax relief led a district court to affirm the IRS's decision to deny U.S. foreign tax credits for certain Japanese taxes paid. Both the IRS's litigating positions in this and other cases¹⁵⁵ and published IRS guidance demonstrate that the agency has taken very seriously the compulsory tax requirement. Indeed, because the IRS makes the determination of whether a payment is compulsory on a case-by-case basis,¹⁵⁶ this has very much been an area of IRS-made policy.¹⁵⁷ For example, although the regulations provide that taxpayers "may generally rely on advice obtained in good faith from competent foreign tax advisors to whom the taxpayer has disclosed the relevant facts" in interpreting foreign tax law,¹⁵⁸ the IRS does not view the advice of foreign counsel as sufficient to satisfy the taxpayer's burden of proof that it has exhausted all effective and practical remedies.¹⁵⁹

152. Treas. Reg. § 1.901-2(e)(5)(ii) (Example 3).

153. That is, the regulation does not contemplate taking into account "special business factors" in weighing the cost of foreign proceedings.

154. *Proctor & Gamble Co. v. United States*, 2010–2 T.C.M. (CCH) 85,593 (S.D. Ohio 2010).

155. In an earlier case involving another major U.S. company, the taxpayer was advised by an Italian tax expert that its only argument against the application of an Italian tax rule was "a near certain loser." *Int'l Bus. Machs. Corp. v. United States*, 38 Fed. Cl. 661, 669 (1997). The taxpayer nonetheless filed for a refund and initiated the process of litigating its claim in an Italian court. *Id.* It was in such circumstances that the court held that the taxpayer had exhausted effective and practical remedies, and it was unnecessary to wait until the litigation's unsuccessful conclusion before the taxpayer can claim foreign tax credits. *Id.* at 675; see also *infra* notes 161–63 and accompanying text (discussing the *Riggs* cases).

156. See I.R.S. Field Serv. Advisory (Mar. 5, 1998), 1998 WL 1984349 (explaining that even if reasonable, "amounts are not compulsory unless petitioner exhausted all of its effective and practical remedies to reduce its foreign tax liability").

157. For a discussion of successive reformulations of the compulsory tax requirement in the Treasury regulations, see Fischl & Harper, *supra* note 7, at 34–37.

158. Treas. Reg. § 1.901-2(e)(5)(i) (2011).

159. See I.R.S. Non Docketed Serv. Advice Review (Sept. 2, 1988), 1988 WL 1092574 ("We do not think that advice of foreign counsel will satisfy the taxpayer's burden of proof in this regard."). Moreover, this nondocketed service advice review states, "As to

Probably the most striking illustration of the IRS's approach to the compulsory tax payment issue can be found in the *Riggs* litigation.¹⁶⁰ In the *Riggs* controversy, the IRS forcefully questioned the legal validity and binding effect, under Brazilian domestic law, of a private ruling prepared by the Brazilian IRS and adopted by the Brazilian Ministry of Finance.¹⁶¹ The IRS argued that the ruling was no more than an advisory opinion and had no binding effect under Brazilian law. Further, it argued the Brazilian Ministry of Finance's "order" to withhold tax based on the ruling was also not compulsory and would be overturned if challenged in a Brazilian court. Finally, consistent with its suspicion of irregularities in the way the ruling had been issued, the IRS questioned the sufficiency of the evidence produced by the taxpayer that tax had indeed been paid to the Brazilian government. Notably, the U.S. Tax Court agreed with these IRS findings in two successive decisions.¹⁶²

The IRS's perseverance in enforcing the compulsory tax requirement throughout the last few decades has compelled "U.S. tax experts to make

administrative remedies, we think that the taxpayer and/or its foreign sub must take advantage of all administrative remedies that, under the facts, could reasonably be expected to achieve a reduction in the foreign tax liability *if the foreign tax authority is at all inclined to reduce such liability.*" *Id.* (emphasis added).

160. See *supra* note 8 and accompanying text. Although the *Riggs* controversy focused on whether certain tax payments were required under foreign law and not on the issue of "effective and practical remedies," it nonetheless illustrates the type of "principles of U.S. law" that the IRS intends to apply.

161. *Riggs Nat'l Corp. v. Comm'r (Riggs II)*, 163 F.3d 1363, 1366–67 (D.C. Cir. 1999).

162. *Riggs Nat'l Corp. v. Comm'r (Riggs I)*, 107 T.C. 301 (1996), *rev'd*, 163 F.3d 1363 (D.C. Cir. 1999) (*Riggs II*); *Riggs Nat'l Corp. v. Comm'r (Riggs III)*, 81 T.C.M. (CCH) 1023 (2001), *rev'd*, 295 F.3d 16 (D.C. Cir. 2002) (*Riggs IV*). These decisions were both overturned by the D.C. Circuit, first on the ground that the "act of state doctrine" should have precluded the Tax Court from inquiring into the legality of the Brazilian Ministry of Finance's private ruling and of the order for tax collection with respect to the U.S. lenders, *Riggs II*, 163 F.3d at 1368–69, and second on the ground that the tax receipts furnished by the borrower (the Brazilian Central Bank) were entitled to the "presumption of regularity" accorded to foreign government entities. *Riggs IV*, 295 F.3d at 20–21. The IRS indicated in a 1999 Chief Counsel Advice Memorandum that it disagreed with the first decision. Memorandum from Cynthia J. Matson, Assistant Chief Counsel (Int'l) (May 21, 1999), www.irs.gov/pub/irs-wd/9931035.pdf. As a result of these reversals, the Tax Court delivered a decision to reduce, instead of deny, Riggs Bank's FTC claim. *Riggs Nat'l Corp. v. Comm'r (Riggs V)*, 87 T.C.M. (CCH) 1276, 1287 (2004). It is unlikely for the "act of state doctrine" to prevent U.S. judicial review of whether foreign governments have pursued tax collection in violation of tax treaties, since a U.S. court can look to a treaty or other "unambiguous agreement regarding controlling legal principles" to review the legality of foreign government actions. *Banco Nacional de Cuba v. Sabbatino*, 376 U.S. 398, 428 (1964); see also *Am. Int'l Grp., Inc. v. Iran*, 493 F. Supp. 522, 525 (D.D.C. 1980) (explaining that the act of state doctrine does not apply where a treaty establishes applicable rule of law).

cost/benefit-type determinations regarding issues based on foreign law about which they do not have expertise.”¹⁶³ To a significant extent, IRS policy in this area has been internalized by U.S. taxpayers. Prima facie, it seems difficult to justify the adoption of different policies simply because in some countries formally disputing one’s tax liabilities is uncommon. Part IV, above, has shown that the monetary costs of administrative appeal and litigation in China are very low and would not in themselves justify acquiescence in the denial of treaty benefits based on invalid treaty interpretations. The chances for taxpayers to prevail in administrative and judicial proceedings, including by requesting the revocation or nonapplication of erroneous agency rules, are also by no means “remote.” Like any other legal system, the main mechanisms for resolving disagreements between Chinese government agencies and private parties depend on judicial review. The Chinese administrative law system is designed to resolve such disputes and its chief inadequacy at the present lies not in the verdicts the system delivers but in its state of relative disuse.

U.S. tax law thus likely requires U.S. taxpayers to consider pursuing, and probably to take actions to pursue, administrative or judicial remedies against the application of the controversial SAT rules discussed in Part I. Many U.S. taxpayers concerned may flinch at this conclusion¹⁶⁴: is this not too merciless an application of the compulsory tax requirement? Does it make for good tax policy? We examine this last question in the next Part, which further demonstrates the relevance of foreign administrative law to making international tax policy.

VI. STRENGTHENING TAX TREATIES BY SUPPORTING THE RULE OF LAW

The legal principle underlying the conclusion reached at the end of the last section is set forth in the Treasury regulations: “Whether a foreign levy requires a compulsory payment pursuant to a foreign country’s authority to levy taxes is determined by principles of U.S. law and not by principles of law of the foreign country.”¹⁶⁵ That is, U.S. legal principles govern the

163. Fischl & Harper, *supra* note 7, at 42. For example, during the *Marks & Spencer* litigation between 2005 and 2006, “many U.S. tax experts concluded that U.K. subsidiaries of U.S. taxpayers must file protective claims for refunds or else risk a voluntary tax challenge” in light of predictions that the European Court of Justice was going to overrule certain positions held by the U.K. tax authority. *Id.* at 41. This was done even though “U.K. Inland Revenue refused to process claims for refund based on a *Marks & Spencer*-type theory at the time.” *Id.*

164. One can imagine a cry of disbelief: “What? We are being asked by the SAT to pay Chinese tax, and by the IRS to sue the SAT to prevent the collection of such tax?”

165. Treas. Reg. § 1.901-2(a)(2)(i) (2011).

overall interpretation of the compulsory tax concept, even though specific aspects of the concept (e.g., whether a payment “is consistent with a reasonable interpretation and application of the substantive and procedural provisions of foreign law”¹⁶⁶) may be determined under foreign law. The concrete meaning of this approach has not been discussed much among U.S. tax practitioners,¹⁶⁷ but it takes on an unexpected significance in the type of cases discussed in this Article. By virtue of being part of the U.S. legal system, U.S. tax law assumes that tax authorities are constrained by the law just as taxpayers are, and that taxpayers are protected by and will exercise their legal rights. It simply does not envision U.S. taxpayers either compromising their legal rights in unprincipled fashions or taking advantage of legal loopholes.¹⁶⁸ Thus, acquiescence in legally invalid but “practically binding” rules not only does not fit into the specific regulatory cost–benefit test for the exhaustion of all effective and practical remedies, it arguably has no place in the larger foreign tax credit framework or even U.S. tax law in general. Rather, principles of U.S. law require tax to be collected according to rules that are legally valid and orders that are legally binding. Where this is not the case, the first remedies these principles look to are also legal mechanisms.

This rather fundamental feature of U.S. tax law is “exported” to other countries when potential foreign tax credit denial generates sufficient incentives for U.S. taxpayers to pursue administrative and judicial remedies in other countries. And in countries where the rule of law is weak, this “export” may constitute a positive externality. This is very likely the case in China. From the Chinese government’s point of view, the amount of tax revenue at stake under the controversial SAT rules discussed in Part I is small and will likely remain so in the foreseeable future.¹⁶⁹ By contrast,

166. *Id.* § 1.901-2(c)(5).

167. Some guidance exists, and occasionally it is to the taxpayer’s advantage. For example, in *Schering Corp. v. Commissioner*, 69 T.C. 579 (1978), *acq. in part* 1981–82 C.B. 2, the U.S. Tax Court sustained the FTC claims of a taxpayer that had not brought its issue to the competent authority, deeming such administrative steps to be “futile” and citing U.S. case law. *Id.* at 602. The IRS acquiesced in the *Schering* decision only in result. See I.R.S. Non Docketed Serv. Advice Review 8261 (Sept. 2, 1988), 1988 WL 1092574. However, it is presumably the requirement to apply U.S. legal principles that justifies the IRS position, set out in that same document, that the opinions of foreign counsel would not be conclusive as to whether effective and practical remedies have been exhausted.

168. The IRS’s position in *Riggs I*, 107 T.C. 301 (1996) and *Riggs II*, 163 F.3d 1363 (D.C. Cir. 1999) illustrates this point.

169. In 2009, total income tax revenue collected from foreign entities constituted less than 4% of total EIT revenue collected in China, which itself was less than 20% of total tax revenue (Author’s computation based on data released by the SAT’s International Tax Department and reported in *Refining Management and Improving the Level of Service in Taxation of*

although individual officials or even certain departments in tax agencies may feel vexed by appeals and detest litigation, the Chinese government overall, not to mention legal professionals and citizens in general, is supportive of such formal challenges to agency actions. This is first because the rule of law (especially in politically nonsensitive areas) is currently one of the main strategies that the government relies on to improve the accountability and therefore legitimacy of the Chinese party-state.¹⁷⁰ It is further because the use of existing mechanisms for challenging agency rulings and actions is still low, and it is widely believed that the greater use of such mechanisms could help reduce arbitrary exercises of official discretion and opportunities for rent-seeking. It would also reduce the power of legally nonbinding rules to bind practically, by making formal dispute resolution a more normal part of everyday tax compliance. For example, by creating a market demand, it may encourage the mastery of administrative procedure by tax professionals while lowering the current market premium paid to service providers whose specialty is arranging private meetings and negotiations with tax officials.

Thus, even from the Chinese government's own perspective, the attitude toward more extensive use of administrative appeals and litigation is better than neutral. From a social perspective, it is definitely positive. China also has a foreign tax credit system that in many respects resembles the U.S. system. Foreign taxes erroneously paid (e.g., in excess of what is required under tax treaties) cannot be credited.¹⁷¹ In enforcing the compulsory tax

Non-Residents, CHINA TAX'N NEWS, Oct. 19, 2009, at 1, and on the *Report of the Ministry of Finance on the Implementation of the 2009 Central and Local Budgetary Plans*, (Mar. 5, 2010), http://news.xinhuanet.com/politics/2010-03/16/content_13181369.htm. The predominant portion of such revenue collected from foreigners was likely based on uncontroversial tax rules. The portion of tax collection pursuant to controversial rules allocable to U.S. taxpayers and affiliates should be negligible from a revenue perspective.

170. See, e.g., Key Points in Implementing the Comprehensive Promotion of Administration in Accordance with the Rule of Law (promulgated by the St. Council, Mar. 22, 2004, effective Mar. 22, 2004) (a national initiative for all executive branch agencies to improve the rule of law; paragraph thirty emphasizes administrative appeals procedures in particular); Guowuyuan Guan Yu Jia Qiang Fa Zhi Zheng Fu Jian She de Yi Jian (国务院关于加强法治政府建设的意见) [Opinions of the State Council on Strengthening the Building of a Government Ruled by Law] (promulgated by the St. Council, Oct. 10, 2010, effective Oct. 10, 2010) (Lawinfochina) (China) (setting forth a recent renewal of the 2004 initiative; paragraph twenty-four emphasizes administrative appeals procedures and paragraph twenty-five emphasizes judicial independence in administrative litigation).

171. Qiye Jing Wai Suo de Shui Shou Di Mian (企业境外所得税收抵免) [Issues Concerning the Foreign Income Tax Credit of Enterprises] (promulgated by the Ministry of Finance and the St. Admin. on Tax'n, Dec. 25, 2009, effective Jan. 1, 2008) para. 4 (Lawinfochina) (China). Other provisions similar to U.S. rules include the exclusion of penalties, fines and interests, payments rebated or in exchange for direct or indirect subsidies. *Id.*; see also

requirements set forth in the Treasury regulations with respect to payments that are inconsistent with treaties, therefore, the IRS would simply be acting in a fair, reciprocal fashion.

The foregoing considerations suggest that the denial of foreign tax credits to U.S. taxpayers who do not contest the application of the controversial SAT rules discussed in Part I not only is supported by law, but may be justified as a matter of policy: it is a rule that is socially optimal when the state of Chinese administrative law is taken into account. U.S. tax law may thus help to shape the legal and governance environments in foreign countries, much as the Foreign Corrupt Practice Act¹⁷² and similar legislation do. However, once we move to the policy perspective, it is no longer sufficient just to ask whether the IRS is justified in imposing the foregoing constraints on U.S. taxpayers' actions. Clearly, the question should also be raised: what should the U.S. government do directly, as a treaty partner with China?

It is beyond the scope of this Article to examine these questions broadly in light of U.S. treaty policy. Instead, the following identifies two sets of insights on these questions that the review of Chinese tax administrative law in this Article offers.

The first set of insights has been anticipated in Part III. The challenges to foreign investors' expectations arising from the controversial SAT rules discussed in this Article should not be conceived of as treaty overrides on China's part. Instead, at least under current Chinese law, treaty overrides are not possible.¹⁷³ No Chinese government agency or official has argued that some national interests of overwhelming importance have arisen so that there is no other choice but to abandon China's treaty obligations.¹⁷⁴ Nor has anyone asserted that China can no longer perform under the relevant aspects of China's tax treaties due to some complications under domestic law.¹⁷⁵ Indeed, given the manner in which the SAT has continued to negotiate new tax treaties for China—which has not reflected any of the substantial deviations in treaty interpretation contained in the

Zhonghua Renmin Gongheguo Qiyе Suо de Shui Fa Shi Shi Tiao Li (中华人民共和国企业所得税法实施条例) [Regulation on the Implementation of the Enterprise Income Tax Law] (promulgated by the St. Council, Dec. 6, 2007, effective Jan. 1, 2008) art. 77 (Lawinfochina) (China) (limiting FTC to taxes paid in accordance with “foreign law and relevant rules”). There is no mitigating provision under current Chinese FTC rules that is analogous to the “effective and practical remedies” test: foreign taxes paid in excess of treaty requirements cannot be credited, period.

172. 15 U.S.C. § 78dd-1(a)–(g) (2006).

173. See generally *supra* Part III.

174. See *OECD Report on Treaty Override*, *supra* note 5, para. 17.

175. See *id.* para. 10.

controversial SAT circulars—there may not even have been any change in China’s treaty policy, in terms of mutual expectations that China aims to achieve an agreement on during treaty negotiation. Instead of turning its back on its treaty obligations, what has happened may be more properly characterized as a neglect of its treaty obligations.

In a way, this is good news: tax treaties are notoriously fragile. There are few easy remedies once a country decides to breach them. As the OECD Treaty Override Report observes, in the event of one country’s genuine decision to override treaties, its treaty partners essentially have only three options: protest,¹⁷⁶ terminate or suspend the operation of the treaties in whole or in part (where a violation is material),¹⁷⁷ or renegotiate the treaties.¹⁷⁸ Protests may often be ineffective. Termination “could do even more harm economically and endanger the possibility of finding an acceptable solution in the future, [while partial] suspension . . . would only leave things as they are.”¹⁷⁹ Renegotiation is not only time-consuming, but must also take into account the fact that the breaching party had already decided not to engage in treaty renegotiation before implementing its new position. In comparison, a reminder to a country that has strayed from its treaty obligations should be easier.

However, addressing the controversial SAT circulars also requires more than the traditional methods for resolving disagreements about treaty interpretation or application (e.g., engagement in communication with China’s competent authority through mutual agreement procedures).¹⁸⁰ This brings us to the second set of insights. As this Article has shown, both the adoption of tax treaties and their implementation and interpretation are handled in China through a rather devolved administrative process. This is a process that currently lacks sufficient legislative, judicial, and even executive oversight.¹⁸¹ By virtue of a strong consensus among these

176. *Id.* para. 21.

177. *Id.* para. 22.

178. *Id.* para. 33.

179. *Id.* para. 30. At the time of the report, “Member countries have so far refrained from taking retaliatory measures (which all agree would not be conducive to better understanding in the international tax field) against overriding legislation.” *Id.* para. 34.

180. *OECD Model Convention*, *supra* note 18, art. 25(3) (providing that the “competent authorities of the Contracting States shall endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention”). The U.S.–China Tax Treaty contains an identical provision in Article 24(3).

181. *See supra* notes 79–85 and accompanying text (discussing the lack of legislative oversight); *supra* Part IV.2 (regarding the rareness of treaty-based litigation); *supra* notes 57–62 and accompanying text (regarding the suspected lack of executive oversight).

different branches of government, this fact has not prevented tax treaties from being given, conceptually, proper legal effect within China's legal system. However, this conceptual consensus is in itself insufficient to guarantee tax treaties' faithful implementation. If China's treaty partners merely pursued dialogues with a few SAT officials, they would not be tapping any mechanism that could reliably resolve difficulties encountered in treaty application. This is because, as well-intentioned and technically competent as some of these officials might be, their work is not yet pursued within a properly disciplined administrative state, nor, most crucially, within an environment characterized by the rule of law. In such circumstances, it would be quite difficult for them to ensure China's treaty obligations are properly taken into account in agency rulemaking, or that other individuals in the government do not take upon themselves to pursue what *they* regard as China's national interests.

By contrast, when foreign taxpayers pursue administrative or judicial appeals in China—with or without the negative incentives imposed by their home countries—to uphold what they believe are their rights under tax treaties, they precisely tap mechanisms of executive or judicial oversight. Similarly, the governments of China's treaty partners should consider using such mechanisms (and mechanisms of legislative oversight), especially if they expect their own taxpayers to do so. That is, they should not simply act on the traditional habit of the treaty specialist and make the leap of faith that *somehow, whatever the other country's domestic law*, treaty obligations will be honored.¹⁸² Instead, they should try to engage the mechanisms that would ultimately improve treaty implementation.

This may mean, for a start, attempting to make a wider group of officials within the Chinese executive branch (whether they be in the SAT, MOF, the Ministry of Foreign Affairs, or the State Council) aware of the specific implications of treaty provisions. And it ultimately may mean engagement with China's legislative and judicial branches. While none of these possibilities are as well established as competent authority procedures, one should remember that neither are mechanisms for executive and judicial oversight that U.S. taxpayers may be asked to resort to. Just as the unfamiliarity of these latter mechanisms may induce U.S. investors to treat the controversial SAT circulars as practically binding and to neglect the pursuit of all effective and practical remedies, the habit of merely interacting with a few SAT officials on treaty matters will do little to encourage proper treaty implementation in China. Continuing such a habit would mean that the leap of faith of the treaty specialist would remain just that—an unjustified leap of faith.

182. See, e.g., *OECD Report on Treaty Override*, *supra* note 5, para. 10.

CONCLUSION

For every country that has signed tax treaties and given them effect under domestic law, the country's commitment to tax treaties is stronger than the commitment of any individual tax official charged with treaty implementation (including those officials designated as the treaty competent authority of the country). The former commitment is the ultimate cure for treaty violations. And what connects the country's commitment, on the one hand, and the commitment of individual officials, departments and agencies, on the other, is the country's system of public law governing legislation, agency rulemaking, and agency adjudication. It is in this fundamental sense that the rule of law forms the backbone of the implementation of tax treaties (and indeed of all international treaties).

Chinese tax rules that deviate from treaty obligations are interesting because, at least in principle, China has taken a clear stance that tax treaty obligations must be honored regardless of domestic law.¹⁸³ Without an understanding of how tax rules are made and enforced in China, therefore, the adoption of rules at odds with China's treaty obligations would seem inconsistent at best. Digging beneath the surface of the laws to develop a robust appreciation of the Chinese tax system allows one not only to understand this seeming contradiction but also to appreciate a surprising set of implications for China's treaty partners and their taxpayers.

Aside from tax treaties, many countries may also engage in international coordination to alleviate double taxation, for example through the collective, though legally unilateral and internationally nonbinding, adoption of rules such as the granting of foreign tax credits. Some of them do so while assuming implicitly that such coordination will be achieved within some framework of the rule of law: as we have seen in this Article, this is true of the U.S. tax law as reflected in the compulsory tax requirement under the foreign tax credit rules. This is another reason why administrative law considerations lie close to the core of international taxation.

Although this Article focused extensively on Chinese examples, the type of cases it examines could arise between any two tax treaty partners. In every country, foreign investors may face the unpalatable decision of whether to comply with rules that are not legally binding, e.g., rules that have no formal legal basis and are procedurally or substantively invalid.

183. This stance may be contrasted with that of the United States, where treaties may be overridden by later-enacted federal statutes. The U.S. government's tax treaty overrides are a familiar topic in U.S. international taxation. See, e.g., Richard E. Andersen, *Analysis of United States Income Tax Treaties*, ¶ 1.03[1] Legal Status of U.S. Income Tax Treaties, n.96 (Thomson/RIA 2011).

Although domestic taxpayers confront similar decisions, the decisions may be distinctively more difficult for foreign persons because their expectations may have been shaped by publicly available information about the country's legal system (including information about their rights under international treaties). Practically but not legally binding rules are more likely to be inconsistent with such expectations, and following rules that are known to be legally invalid may gradually lead one away from processes and interactions governed by law. Sometimes, confronting such choices may challenge some of the fundamental assumptions that one had made when deciding to do business in a foreign country. What this Article has shown is that these serious predicaments may not be matters of indifference to the foreign investors' home country governments. How these governments should react is a question that pushes considerations of foreign administrative law to the foreground.