

TAX LAW

On the boundaries between tax regulation and the transactional behavior of market participants – the substantive tax principle

Jiang Yajuan^{**} and Zhang Hua^{****}

Introduction

The iterative development of the economy constantly affects the markets. Market business models, transaction forms and market operations are constantly giving rise to new forms of business. In adjusting the transaction behaviour of market entities, China's tax law and the relevant norms of civil law and economic law have reflected each other in the collision of values and goals and the fusion of systems, forming a representative case and institutional system. In recent years, there have been many cases of tax evasion by entertainment stars in China. If the tax authorities and taxpayers do not have a common understanding of a tax-planning scheme, how should the tax base be determined? Especially when the taxpayer's and others' valid transactions are based on the principle of autonomy and compliance with civil law, can the tax authority intervene and reassess the determination of the tax law? What happens if the tax authority and the taxpayer disagree on the tax base? If the dispute arises due to unclear provisions of tax law, who will make an interpretation? These issues are very common in market transactions and the cases are complicated and need to be clarified.

Fiscal intervention in market transaction behaviour

The income of the celebrities involved in the cases was eventually recognised as tax evasion, despite meticulous tax planning. The “Viya tax evasion” case is a typical example. On 20 December 2021, the Inspection Bureau of Hangzhou Taxation Bureau, Zhejiang Province, China, found that live streamer Huang Wei, known as Viya, an internet celebrity with tens of millions of followers and who has used her platform to sell a variety of products,¹ evaded taxes by hiding her personal income as well as other financial offences between 2019 and 2020. Huang Wei was decided on tax administrative processing penalties, tax recovery, adding late payment fees, and imposed fines totalling 1.341 billion yuan according to law.² The multi-channel network (MCN) company to which Viya belongs is called Qianxun (Hangzhou) Culture and Media Company Limited (hereinafter referred to as Qianxun Culture). According to the official website of Qianxun Culture, the company was founded in 2017 and is the TOP1 new content e-commerce live broadcasting organisation. There are more than 50 anchors under its banner, including Taobao's No. 1 anchor Viya, and more than 50 other anchors. The actual controller of Qianxun Culture is Dong Haifeng, Viya's husband. However, Qianxun Culture is not a husband-and-wife business of Viya, but has carried out equity incentives and established two well-known funds, namely Junlian Capital under Lenovo and Yunfeng Fund under Ma Yun. According to Qianxun Culture's official website, it plans to apply for a stock exchange listing in 2025. Compared to the wages and salaries Viya received as an employee of Qianxun Culture, Viya would save about 180 million yuan in taxes by signing a labour contract with Qianxun Culture and thus receive income from compensation for labour. However, with a tax burden of 720 million yuan, Viya still felt burdened, which later led to more aggressive personal income tax planning and tax administrative penalties.

* Professor in Law, Vice Dean, Economic Law School, Southwest University of Political Science and Law, China. Email: jiangyajuan@swupl.edu.cn.

** Vice Professor in law, International Law School, Southwest University of Political Science and Law, China. Email: zhanghuachn@gmail.com.

¹ Kerry Allen. Viya: *Top Chinese live-streamer fined \$210m for tax evasion*, 20 December 2021. <https://www.bbc.com/news/world-asia-china-59732499> accessed 15 March 2024.

² Cheng Mengke: *The Boundary between Remuneration for Labor and Income from Business--Taking the Via Case as an Entry Point*, Journal of Southeast University (Philosophy and Social Science), 2022, Vol.25, 101.

The main avenues of tax evasion in the Viya case were fictitious business, conversion of the nature of income, and concealment of personal income. The specific practices are as follows. First, set up a shell company in a low-tax region. Since 2019, several individual sole proprietorships and partnerships have been set up one after another, such as Shanghai Viya Enterprise Management Consulting Centre and Shanghai Dusu Enterprise Management Consulting Partnership, etc. Fictitious Business (hereinafter referred to as the “Shell”), and through the “Shell” it entered into an agreement with the Qianxun Culture. By signing the agreement with Qianxun Culture, the nature of the income is changed, and the personal income is transformed into the income of the enterprise, which is subject to a lower tax rate and enjoys tax incentives. Second, apply for approval from the tax bureau. The “shell” (including sole proprietorships and partnerships) applies to the relevant tax bureau for payment of personal income tax in the form of “authorised taxation”. Once Viya has paid the personal income tax, the funds are withdrawn from the “shell” account.³ Third, concealment of income. From 2019 to 2020, Huang Wei concealed her commission income from the live platform and converted the commissions, pit fees and other remuneration income from the live broadcast of goods for services into business income.⁴ As a result of the above practices, Huang Wei’s personal income tax liability was reduced by 650 million yuan.

Unlike other public figures whose tax evasion cases have been exposed by news reports, the tax authorities detected Viya’s tax evasion case by using big data and information technology.⁵ It is common for taxpayers to avoid taxes through fictitious market transactions or by circumventing the provisions of the tax law and the tax evasion behaviour of taxpayers will not only lead to a large loss of tax, but also affect the fairness of the tax. However, market behaviour is not a vacuum for tax law intervention.

The principle of tax intervention in market behaviour – the substantive tax principle

The origin of substantive taxation and the fight against tax avoidance

For tax law to intervene in market behaviour, the principle of substantive taxation is indispensable. The principle of substantive taxation originated in Germany. After the First World War, the German economy was in disarray. However, some taxpayers used loopholes in the tax code to avoid paying taxes, putting a strain on German public finances. To revive the German economy, the German legal profession proposed the principle of substantive taxation for this type of tax avoidance behaviour. After the First World War, the German Imperial Tax Code stipulated that taxpayers should not abuse the form of civil law transactions to avoid the tax burden, but should be taxed according to the substance of the economic behaviour behind the legal relationship. In recent times, the substantive tax principle has been widely transplanted and adopted in both civil law and common law jurisdictions, while a consensus has been reached on the application of the substantive tax principle. The principle of substantive taxation means that a certain situation cannot be based solely on its appearance and form to determine whether it should be taxed, but on its actual situation. In particular, in order to achieve a fair, reasonable and effective tax, it should pay attention to its economic purpose and economic substance to determine whether it is in line with the elements of taxation.⁶ In judging whether a particular person or event satisfies the elements of taxation and should be subject to tax obligations, the substance should be explored in depth through the appearance of legal and economic facts, and when the substantive conditions satisfy the elements of taxation, the tax obligations should be recognized in accordance with the direction of the substantive conditions, thus realising the substantive justice of the tax law.⁷

³ Li Peizhi, *Research on the Implementation of Tax Collection and Management Policies for the Online Live Broadcast Industry in S Province*, Master’s Thesis, Shandong University, December 10, 2022, 29.

⁴ Zhao Shujing, Lin Yuwei: *Viya fined for tax evasion, Live broadcasting ends savage growth*, Beijing Business Today, December 21, 2021.

⁵ Jiang Fei: *Changes in tax collection from Viya’s tax evasion penalty*, China Reform, Vol.2, 2022, 65

⁶ Guo Changsheng: *Theoretical Interpretation of the Principle of Substantive Taxation*, Journal of Chongqing University (Social Science Edition), 2023(1), Vol. 29, 206.

⁷ Ma Weiwei: *Test Analysis of The Composition of The Conditions of Sale for The Payment of Royalties to Third Parties*, Journal of Customs and Trade, Vol.37, 2016(6), p.104.

Economic substance and the avoidance of tax evasion

Tax avoidance is hard to define. Tax avoidance is not only a legal form of innovation, but also a necessary part of any business transaction. Tax considerations are always part of the transaction. In fact, tax avoidance is the exploitation of loopholes and shortcomings in existing rules for the benefit of an individual or a company. There is a difference between “tax avoidance” and “tax evasion”. Tax avoidance is the use of ambiguities or omissions in existing laws and regulations to reduce or evade taxes to obtain benefits without directly violating the provisions of the tax law. Tax evasion refers to all types of behaviour in which the taxpayer evades the established tax obligations by using a series of means to reduce or eliminate the tax burden.⁸

Legitimate tax avoidance does not entail a loss of tax revenue or a divergence between form and substance. The reason why tax authorities look at economic substance is that the National Treasury revenue is harmed by the abuse of transaction form as a means of self-defence against the tax law. The judge will consider mainly whether the main purpose is to avoid tax or to save some tax incidental to the transaction to achieve business. If the purpose of all parties to the transaction is to make money out of the tax system or to engage in institutional arbitrage without business reason and purpose, it is necessary to penetrate from the transaction form to the economic substance of the case to make a tax law judgment.

Not all tax avoidance practices require tax approval. For example, Article 47 of the Enterprise Income Tax Law sets out the specific cases for tax approval by the tax authorities.⁹ Where “an enterprise engages in other arrangements that do not have a reasonable commercial purpose and reduce its taxable income or taxable profit”, the tax authorities have the right to adjust an enterprise’s taxable amount in a reasonable manner in accordance with the principle of substantive taxation. If an individual or enterprise conducts a transaction based on a reasonable commercial arrangement, the purpose of which is not to obtain tax benefits, and does not violate the provisions of the tax laws, the conduct does not involve the abuse of the provisions of the tax laws or the abuse of the form of transaction provided by law, and is not, thus, subject to the principle of substantive taxation, which does not give rise to tax approval.

The consequence of the principle of substantive taxation is that, if a transaction has no economic substance, but only aims to achieve the purpose of tax evasion, the judge and the tax authority will deny the legal effect of the act and an anti-avoidance regulation will be applied to the transaction. As tax avoidance directly affects the interests of the national income treasury, the lack of regulation of tax avoidance behaviour will cause tax horizontal equity and vertical equity; therefore, tax avoidance behaviour must be included in the scope of law adjustment. Substantive taxation is regulated in China’s Enterprise Income Tax Law, Tax Administration Law, and Individual Income Tax Law, for example, tax adjustments for related enterprises, special tax adjustments and general anti-avoidance clauses for cases of abuse of tax incentives, abuse of the form of enterprise organization, tax avoidance using tax havens and other arrangements that have no reasonable commercial purpose. Where the existing legal provisions are unclear, they are often regulated and corrected in various ways, such as improvement of the tax law system, legal interpretation, legal application, and judicial review.

The judicial practice of substantive taxation in China - the case of the Guangzhou Defa

Economic substance is easy to define but difficult to identify. In addition to the subjective situation of tax avoidance, there is the objective problem of legal application. As the first tax administrative case to be heard by the Supreme People’s Court of the People’s Republic of China (SPC) and one of the ten typical administrative cases heard by SPC, the case of Guangzhou Defa Real Estate Construction Co. (hereinafter referred to as the “Defa Case”) is a representative case of the application of the principle of economic substance taxation. In the case, there were disputes over “the conflict between the right to tax

⁸ Zhang Shouwen: *Tax evasion and its regulation*, Taxation Research, Vol.201, 2002 (2), 38.

⁹ *Enterprise Income Tax Law*. Signed in Beijing on 23 April 1996 and came into force on 1 February 2002. Article. 3.

approval and the principle of freedom of contract in civil law”, “whether the relevant transactions could be tax approved” and “how to approve the disputes”. The conclusions of SPC’s review judgment in the case of the conflict between the right to tax approval and the principle of freedom of contract in civil law, whether the relevant transaction can be tax approved, how to approve the dispute, and other disputes, have caused widespread concern in society and affected relevant tax practices.

Background to the “Defa Case”

In 2004, Guangzhou Defa Real Estate Construction Co. (hereinafter referred to as “Guangzhou Defa”) held a public auction for its own property, the Bank of America Centre, which had a total area of more than 60,000 square metres and was internally valued by Guangzhou Defa at 563 million yuan. However, on 19 December 2004, a company called Sheng Feng Industrial from Hong Kong, the only bidder for the property, won it at a low price of 138 million. Subsequently, Guangzhou Defa declared and paid the relevant taxes on the transfer of the property at the transaction price of 138 million yuan and obtained the tax clearance certificate issued by the tax bureau. However, in 2006, the First Inspection Bureau of the Guangdong Local Taxation Bureau conducted an inspection of the tax situation of Guangzhou Defa during the period from 2004 to 2005, which included the above auction property transaction. The inspectors concluded that the actual transaction price of the property was much lower than the price of similar properties during the same period.¹⁰ It was not until September 2009 that the Inspection Bureau finally decided on the treatment of Guangzhou Defa. The Inspection Bureau considered that Guangzhou Defa’s auction price of the property was obviously low and had to be adjusted, and the approved taxable price after adjustment was 312 million yuan and it was calculated that Guangzhou Defa should pay 8.67 million yuan in back taxes based on the adjusted price, and at the same time add an overdue fine of 2.8 million yuan.

Guangzhou Defa appealed the above decision and applied for administrative review, but the original decision was upheld. Guangzhou Defa then filed an administrative lawsuit, and the first instance court did not support Guangzhou Defa’s claim, and the second instance court upheld the original decision. However, Guangzhou Defa still refused to accept the above verdict and filed an application for retrial with SPC in 2013, and on 29 June 2015, the Supreme Court held a public hearing on the case. The case was decided by the SPC on 7 April 2017 with the following results: 1. It overturned the administrative rulings of the first and second instance; 2. It overturned the decision of the Audit Bureau to impose an overdue sales tax fine and an overdue slope protection fee fine on Defa; 3. it ordered the First Guangzhou Municipal Inspection Bureau to return the above overdue fine and pay the corresponding interest.

The “Defa Case”: contentious issues

First, it is often debated whether inspectorates have the same qualifications as tax bureaus as subjects of law enforcement at all levels. According to the Tax Collection and Administration Act, tax authorities include tax inspection bureaus under the tax authorities, and further clarification on tax inspection bureaus can be found in the provisions of the Tax Collection and Administration Act. The legal status of the tax inspection bureau is clearly stipulated in the Tax Collection and Administration Law and its implementation regulations. In this case, the Guangzhou Tax Inspection Bureau has the qualification of a tax enforcement subject.

The second issue is whether the tax authorities can re-approve the taxable amount when the auction price is already available. SPC certainly confirms the power of the tax inspection department to approve the tax, and held that although there is no clear legal basis in the laws and regulations of the State Administration of Taxation on whether the tax inspection department has the power to approve the taxable amount as stipulated in the Tax Administration Law, if the tax inspection department encounters special circumstances as stipulated in the Tax Administration Law in the course of investigating and

¹⁰ Wang Xia: *The application of the judicial standard of proof for tax authorization from the “Defa case”*, Science of Law (Journal of Northwest University of Political Science and Law), Vol.37, 2019 (4), 193.

handling the tax-related cases, such as the tax base is low, and if the tax inspection department does not have the power to approve the taxable amount, it will certainly cause difficulties in the inspection work and also reduce the quality of the investigated cases.

The third argument is whether the valid behaviour regulated by civil law excludes the approval right of the tax authorities. In this case, the auction company carried out the auction activities where only one company bid, especially where the Guangzhou Defa's property auction transaction price is obviously lower than the valuation of the property. In this case, people believe that the bidding in such an auction is not sufficient. However, under certain circumstances, the Tax Inspection Bureau may also re-approve the amount of tax payable by the taxpayer and overrule the calculation of tax payment according to the auction transaction price, which is conducive to avoiding the loss of government tax revenue. In addition, in SPC's judgment of "tax base is low and there is no justifiable reason for the judgment" generally has a strong discretionary power, SPC's reasons for the judgment shows that for the tax authorities in the statutory investigation procedures based on the professional determination, the people's court should be supported and respected,¹¹ unless the determination made by the tax authorities is manifestly unreasonable or manifestly an abuse of power.

Jurisprudential analysis of the judgment in the "Defa Case"

Authorized levy power and tax inspection

In the division of administrative powers, the power to authorize the collection of taxes is regarded as a type of taxing power of the tax authorities, and it is generally believed that it should be the exclusive power of the tax collection department. Thus, it seems that the exercise of the power to authorize the amount of tax payable by the tax inspection bureaus is indeed controversial in terms of overstepping the limits of their powers. According to the current practice and the business scope of the inspection bureaus at all levels, the inspection bureaus, in addition to the general work content, should also assume the responsibility of assisting and cooperating with the work of the tax collection and management departments. At this level, the Guangzhou Inspection Bureau's approval of the taxable amount of the company in this case is in accordance with the relevant provisions of the law, and SPC has also recognized this view. For the standardization and control of tax authorization, the standard of tax authorization discretion should be formulated to limit the abuse of administrative discretion by tax administrative law enforcement authorities, and then protect the legitimate rights and interests of taxpayers. Discretionary standards for tax authorization should be improved, stipulating the conditions, procedures, authority, and time limits for tax authorization. Matters of tax approval should be made public and justified, and the decision on tax approval should be discussed collectively during the tax approval process. Where there is an error in tax authorization, the relevant subjects should be held legally accountable for the action taken and publicized.¹²

Auction price and tax basis

The view of academic research generally recognises that the phrase "the tax basis is obviously low" refers to tax basis being lower than the seventy percent of the market price of similar goods. The property involved in this case was sold at auction price is 44.52 per cent of the price of similar properties in the comparable market, and thus it is reasonable to consider such as obviously low. However, an auction is a statutory mechanism for fair price formation. In this case, if the Inspectorate has doubts about the authenticity of the auction price of Defa, it should bear the burden of proof on its collusion to avoid tax.¹³ In other words, the conflict between the transaction price and the tax basis in the "Defa Case" reflects the contradiction between the interests of private law and the interests of public law. It is

¹¹ Zhang Xuegan, Jia Xiaodong: *Legal Analysis of the Supreme People's Court's Judgment on the Arraignment of Defa*, Taxation Research, Vol.401, 2018(6), 62-63.

¹² Li Dengxi; Li Daqing: On the Discretionary Attributes and Legal Control of Tax Approval Power - A Study Based on the "Defa Case" and Article 35 of the Tax Levy Control Law, Tax and Economic Research, Vol.112, 2018(6), 87-88.

¹³ Wang Xia: The application of judicial proof standard for tax approval from "Defa case", Science of Law (Journal of Northwest University of Political Science and Law), vol.37 2019(4), 193.

important to balance the interest's conflict between private law and public law, which in this case is the conflict between transaction price and tax basis. The price of private law transactions is taken into account because the transaction parties recognize the transaction price and their rights have been respected by law, and the rationality of their private transactions should be respected. However, the tax law/tax basis has public transaction rationality, which aimed at balancing the rationality of the state taxing rights and private property rights.¹⁴ The realization of the state's interests must be based on the realization of private interests. In this case, the state's interests cannot override private interests. The company selling the property cheaply in private law is rational behavior, when there is an absence of sufficient evidence to prove that the company have sold the property cheaply for an improper purpose, the state tax right should maintain rationality, and the tax authorities should recognize the transaction price as the tax basis for calculation.

It is often a difficult point in practice to judge the terms "tax basis is obviously low and without justifiable reasons" in the process of tax approval. Legal service providers tend to interpret the existing legislation, while academics tend to analyze different cases theoretically to promote the innovation of law.¹⁵ In terms of the practice of tax collection and management, it is not practical to require tax authorities to conduct a complete handling of all tax-related illegal cases in strict accordance with the audit procedure. This will greatly increase the cost of the tax collection and management process. What can be considered is that the tax authorities may try to adopt the method of tax assessment when dealing with tax-related illegal cases for which they do not yet have strong evidence. The lesson from this case is that tax audits require a high degree of certainty about tax-related violations and there should be a serious crackdown on them when the procedures are legal, and the evidence is sufficient. The tax collection and management mainly focus on controlling the cost of tax collection by the relevant tax authorities, and in fact pays more attention to the improvement of administrative efficiency and economic efficiency. A clear distinction should be made between the right of tax collection and management and the right of tax inspection. In addition, it is necessary to improve the system of late payment of tax based on the conditions of application of late payment of tax, the collection rate, and the starting and ending time of calculation.

Harmonizing the contradiction between civil law norms and tax administrative law norms

When civil legal norms and tax administrative legal norms are in conflict, the principle of civil legal norms will be applied in general, and tax administrative legal norms will be applied if necessary or when there are special circumstances. In the case of Defa, after the auction company conducted the auction of the entrusted property, there was no statutory subject to issue any explanation or notification on the validity of the auction. The tax authority should apply the principle of civil legal norms, recognizing that the auction price is legal as the basis for tax calculation. Only when it is necessary to safeguard the interests of the state can the tax authority, in accordance with the purpose of the law on tax administration, measure the transaction price by the strict basis for tax calculation, Without considering this case, if the tax authorities are required to determine the tax basis in accordance with the auction price, it is likely that autonomy under civil law will invalidate tax authority, and it is also likely to lead to the damage of the state's tax interests. Therefore, although the auction was found to be valid, the tax authority's power to approve the amount of tax payable cannot be completely denied, and at the same time, the tax authority's exercise of the power to approve the collection of taxes should be strictly limited.

SPC adopted the position of "fitness for purpose" that the auction is valid and legal and affirm the significance of private law to make contracts and establish prices in the "Defa Case". However, in cases where "the tax basis is obviously low and there is no justifiable reason for it", to protect the national

¹⁴ Li Dengxi; Li Daqing: On the Discretionary Attributes and Legal Control of Tax Approval Power - A Study Based on the "Defa Case" and Article 35 of the Tax Collection and Management Law, *Tax and Economic Research*, Vol.112, 2018(6) 87.

¹⁵ Zhang Xuegan, Jia Xiaodong: *Legal analysis of the Supreme People's Court's judgement on the arraignment of the case of Defa*, *Taxation Research*, Vol.401, 2018(6), 61.

tax interests, the tax authorities may check the substance of the transaction and authorize the taxable price.

Boundaries of the application of the substantive taxation principle

Collision and balance between the application of tax law and civil law

The tax code, whether civil or common law, is statutory law and only the legislator can write what is in the code. However, many concepts in tax law are defined by other laws, such as company law, property law, and contract law. From this point of view, tax law is dependent on other laws that are involved mainly in regulating the behavior of the market. Market operation is through piecemeal transactions, such as labour, loans, and intellectual property rights into products that form the tax base. Taking income tax as an example, the definition of income comes from transactions, while the transactions are regulated by the law of the market, and the market law in turn influent the income tax law. Therefore, the principle of freedom in civil law and the principle of equality in tax law are not contradictory, but just have different missions and they are in fact compatible with each other. For example, in the “Defa Case”, there are multiple concepts in collision between both the civil law and tax law systems, such as the party’s autonomy and the discretion of the tax authorities, the auction price and the market price, the auction price and the taxable price, and the legal transaction and the tax authorities of the approved power. It is an example of the conflict and integration between different legal systems in a specific transaction behavior. In other words, the case of dubious forms of transactions, it is necessary to look at the appearance of the transaction through the legal form to find the economic substance.

Civil law regulates the most basic social relations. The subject of market transaction is the subject of both civil law and tax law, and the behavior of market transaction belongs to both civil transaction behavior and tax object. Therefore, the synergy of civil law and tax law can not only make the subject of market transactions more clearly the effect of behaviour, but also more conducive to the establishment of a harmonious and stable market order.¹⁶ In fact, the tax law norms and civil law norms of synergistic intermingling has long existed. The realization of tax law norms depends on civil law norms, such as ownership, contract, etc.; the implementation of tax law depends on civil law to establish the rights and obligations of the subject relationship. The intermingling of tax law norms with civil law norms has also resulted in tax concepts, such as tax guarantees and tax subrogation.

In general, the determination of the nature of civil transactions is based on the principle of autonomy, while the characterization of tax law transactions needs to consider the economic substance. When the form of transaction is consistent with the economic substance, tax law can directly recognize the civil law on the determination of the nature of civil transactions. However, where there is a mismatch between the form of the transaction and its economic substance, and where the party to the transaction is abusing the law or violating the principle of good faith, it is time to apply the principle of substantive taxation to protect the value of tax law. In general, tax law will not interfere with the civil transaction behavior of taxpayers, and only in the case that the subject of the transaction may abuse the right of transaction, violate the principle of honesty and credit and lack of reasonable business purposes (based on the protection of national tax interests) will the tax be approved according to the principle of substantive taxation. Therefore, it is necessary to establish a balancing mechanism between respecting the free will of taxpayers and safeguarding the interests of taxation to prevent the abuse of taxpayers’ rights as well as the abuse of power of tax authorities.¹⁷

¹⁶ Xiong Wei, Liu Shan: *Harmonization and Convergence: The Impact of the Implementation of the Civil Code on Tax Law*, Taxation Research, 2021(1), 20.

¹⁷ Xiong Wei, Liu Shan: *Harmonization and convergence: the impact of the implementation of the Civil Code on tax law*, Taxation Research, 2021(1), 22.

“Substance” of substantive taxation

Whether a taxpayer satisfies the tax elements must be assessed on a case-by-case basis, depending on the taxpayer’s method of tax avoidance and the nature of the transaction.¹⁸ For example, a taxpayer avoids tax by signing two or more contracts with different contents on the same subject matter for the sale of a house, stating a price of \$200,000 in one contract instead of the true transaction price of \$800,000 to the State Administration of Taxation (SAT). Will it be taxed at \$200,000 or \$800,000? Neither. SAT will determine a taxable price according to the approved method of taxation, the same lot, and the same time of transaction. For example, if a taxpayer reduces its taxable income through transfer pricing from a related entity, the taxpayer should be taxed at the price determined by the tax bureau. Therefore, the tax authorities have the right to reassess the taxable price and calculate the taxable amount, accordingly, based on the principle of substantive taxation.¹⁹ The significance of the substantive taxation principle lies in judging the factual relationship and determining its purpose and economic significance to prevent tax avoidance and evasion by taxpayers, or to fill the legal loopholes or impose purposive restrictions.

The introduction and implementation of the Civil Code of the People’s Republic of China,²⁰ is a major event to be remembered in the process of the rule of law in taxation and will certainly open a new chapter in tax governance. Civil law is the private law that regulates the relationship of rights and obligations between equal civil subjects and is characterised by its emphasis on equality, equivalence, and compensation. In civil law, the rights and freedoms of the individual are paramount, as is the pursuit of fairness and justice. In most cases, concepts in tax law relate directly to concepts in civil law, such as the relationship between sale and purchase. However, some taxpayers will use some means to avoid the tax relationship under tax law, for example, by “borrowing” money from the target company to receive disguised “dividends”. This difference determines that the application of tax law should not ignore the fundamental role of civil law, with attention attached to the balance and coordination between tax law and civil law.

Tax authorisation powers of the tax authorities

The principle of substantive taxation not only provides a better response to the problem of tax avoidance by taxpayers, but also compensates to some extent for the problems in the application and interpretation of the tax law arising from the overly rigid, abstract, or even vague provisions of the law. However, under China’s current tax administration system, the checks and balances of power, and supervision mechanisms are not in place, and the possibility of tax authorities abusing the principle of substantive taxation is relatively high. In the “Defa Case”, the SPC believed that it was risky for the tax authorities to make interpretations if they could. At present, interpretations are also mainly made by SAT. Excessive discretion would negate the form of the law and the transaction. All powers, including the power to approve taxes, tend to be expansive, and the exercise of administrative power is aimed at realising the public interest, which is uncertain. Thus, administrative power is the most expansive of all public rights. Substantive taxation in individual cases relies mainly on the judgement and examination of tax officials, and there is a conflict between the purpose of individual cases, the applicable rules and the general application of the law. Taxpayers are reluctant to file lawsuits due to the influence of the administrative relationship between the tax authorities and taxpayers. Further, the risk of the tax authorities being held accountable is relatively low, and their supervisory power is weak. It is therefore necessary to define the limits of the principle of substantive taxation. Where are the limits of civil autonomy, freedom of contract, protection of taxpayers’ rights and protection of the public interest? Who interprets legal rules? What forms of law are acceptable or unacceptable? It is not only the excessive application of substantive taxation that is likely to affect the market, but the restrictions on transactions can also affect the tax base and innovation.

¹⁸ He Xiaolu: *Substantive Taxation Principle - The Unification of Efficiency and Equity*, Southern Discourse, 2007 (6), 28.

¹⁹ Liu Yiwen: *Difference Analysis of the Provisions on Revenue Recognition in Accounting and Tax Law*, International Taxation in China, 2002 (11), 61.

²⁰ *Civil Code of the People’s Republic of China*. Signed in Beijing on 28 May 2020 and came into force on 1 January 2021.

Tax authorisation shall be based on the following conditions. First, the inability to make a true determination of the tax facts in certain specific cases requires a reservation in the law, thereby giving the tax authorities administrative discretion. Second, tax authorities should protect the taxpayer's right to the presumption of honesty in tax enforcement and in dealing with specific cases. Third, tax authorities should respect civil legal relationships and civil matters governed by civil law. Fourth, the provisions of tax law should be applied in determining taxable facts. The principle of substantive taxation is not a general principle, but a specific one in tax administration law. The application of the principle of substantive taxation must be based on the principle of statutory taxation and applied in a prudent and objective manner. In the practice of tax collection and administration, different tax authorities have the right to apply the principle in a flexible manner; therefore, different law enforcement agencies, and even courts, may have different understandings and interpretations of tax law provisions and different judgments on similar cases. Therefore, only by unifying the application of the principle of substantive taxation in accordance with the principle of lawful taxation and principles of fairness of taxation, can the use of public power be limited, and the legitimate rights and interests of taxpayers.

While the SPC clarified that the tax authorities have the right to apply the principle of "substantive taxation" and to keep the right within the cage of the institution, it also explained that there are necessary conditions for the application of this principle. This means that the tax authorities should respect the autonomy of private rights and that the principle of substantive taxation must be applied subject to conditions. The tax authorities must bear the burden of proof to establish the substantive relationship, and the evidence should be precise without affecting the stability of civil transactions or posing a significant threat to the rights and interests of the parties.

Conclusions

The purpose of the substance over form principle is to prevent tax avoidance and evasion by taxpayers and to promote fairness in the application of tax laws. The effect of economic substance is a matter of legal interpretation. Substantive taxation reflects the degree of integration between different legal systems in each transactional behaviour. Tax law and civil law are eclectic from the perspective of the tax law ecosystem. Tax authorities should respect the autonomy of the private rights of market participants to encourage them to participate more in competition and innovation. According to the working procedures of the National People's Congress and the Standing Committee of the National People's Congress, it is unlikely that timely interpretations or legislation can be made in a timely manner to deal with the numerous cases that have arisen in practice. While taxpayers do not have the right to interpret the law, neither do the tax authorities as law enforcement agencies and litigants. At the same time, international tax and accounting rules are converging, and all parties to international trade expect China to provide clear explanations on key issues that commonly arise in market trading activities.

These objective conditions have prompted Chinese judges to respond to the case, and judges have had to face this practical challenge and take on the task of interpreting tax law. This is also the reason why the judge in the "Defa Case" undertook to interpret the law. While China has been carrying out compliance risk management, the interaction between tax law and civil law will run through the whole process of tax legislation, tax law interpretation, and tax law enforcement and adjudication. This in turn will also expand tax law theories and practices, such as the transaction characterization theory, the substantive taxation principle, and the anti-avoidance principle.