CHINA’S FOREIGN-INVESTED HOLDING COMPANY: 
TAXATION AND TAX PLANNING

A REVIEW WITH REFERENCE TO AUSTRIAN TAX LAW

Ph.D-Thesis written by Daniel Bimler

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PREFACE

The faculty of Business Administration of the Vienna University of Business Administration and Economics accepted this work as a doctoral thesis in Business Administration in the winter semester 2007/2008. At the time of printing, literature and legislation considered within this work is of the status as of June 2007.

Throughout my studies of business and economics, until the completion of this doctoral thesis, I have been lucky to receive generous support from various people and parties.

Firstly, I have to thank my principal consultant Prof. Dr. Mag. Eva Eberhartinger, LL.M, for accepting the responsibility to accompany this research project. Throughout the conception and realization of this research, she supported me with valuable practical advice and encouragements. From the first day on, Professor Eberhartinger generously provided me with all the support and freedom needed to complete this work and, thus, hugely contributed to its realization. Secondly, I would like to thank Prof. Dr. Mag. Romuald Bertl for his kind acceptance of becoming the secondary consultant, as well as for his supportive and constructive critique. Special gratitude I also owe to the Max-Planck Society for Intellectual Property Law and International Tax Law, Munich, Germany and its friendly staff for its restless support.

However, most grateful I am for the patience, the support, and understanding I received from the people close to me, my dear friends, my wonderful girlfriend Susanne, and my family. I wish to dedicate this work to my loved and admired sister Aileen and to my honoured and loved parents, Dr. Hans-Hinrich Bimler and Margit Bimler.

Munich, October 2007

Daniel K. H. Bimler
ABSTRACT

The present work researches the taxation and tax planning of foreign-invested holding companies in the People’s Republic of China. The scientific field of the work is the science of Tax Management. The research is undertaken with the goal to deliver a profound presentation of the corporate taxation of such foreign-invested holding companies established in the PRC. Based on such presentation, internationally known tax planning methods are examined to find clues for valid tax-planning means and methods for such holding companies. The scientific approach is to be seen as content-analytical with a strong reference to the basics of corporate holding taxation as exercised in Austria. The author describes the legal nature of holding companies, as they exist in Austrian and Chinese law setting the focus on incorporated holding companies. The legal conditions of establishing a foreign-invested holding company in the PRC are explained and clues for the tax examination are presented. Based on the finding that the Austrian “Gruppenbesteuerung” offers a tax consolidation model, which allows the setting off tax results amongst qualifying members, the author researches the Chinese tax laws for a similar group-relief system. However, as the research shows Chinese law does not contain any form of tax group-relief regime for foreign-invested holding companies. Therefore, the work continues to research further tax facts and tax events of Chinese tax legislation for means that allow foreign corporate investors to efficiently structure their investments from a tax point of view. In order to conduct such a search of alternative tax planning clues the research, basically, follows the systematic of the balance sheet of corporations determining the taxation of the individual balance sheet items. Finally, the work hints to the coming introduction of a new Chinese enterprise tax law which may change the situation of the taxation and tax planning of foreign-invested holding companies in the PRC altogether.
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<table>
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<tr>
<th>Abbreviation</th>
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<tr>
<td>aAktG</td>
<td>Austrian “Aktiengesetz”</td>
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<td>ACDTT</td>
<td>Austrian Chinese Double Tax Treaty</td>
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<td>ADT-Decree</td>
<td>Avoidance of Double Taxation Decree</td>
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<td>aEStG</td>
<td>Austrian “Einkommensteuergesetz”</td>
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<td>AG</td>
<td>Aktiengesellschaft</td>
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<td>aHGB</td>
<td>Austrian “Handelsgesetzbuch“</td>
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<td>aKStG</td>
<td>Austrian “Körperschaftsteuergesetz”</td>
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<td>Art.</td>
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<tr>
<td>ASBE</td>
<td>Accounting System for Business Enterprises</td>
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<td>ASBE-BC</td>
<td>Accounting Standard for Business Enterprises concerning Borrowing Costs</td>
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<td>ASBE-I</td>
<td>Accounting Standard for Business Enterprises concerning Investments</td>
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<td>BT</td>
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<td>BT-Rules</td>
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<td>Capital Ratio Tentative Provisions</td>
<td>Sino-foreign Equity Joint Ventures Ratio of Registered Capital to Total Investment Tentative Provisions</td>
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<td>CHHC</td>
<td>China-Holding Holding Company</td>
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<td>CJV</td>
<td>Contractual (or Co-operative) Joint Venture</td>
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# China’s Foreign-Invested Holding Company: Taxation and Tax Planning

- A Review with Reference to Austrian Tax Law

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<td>CLP</td>
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<td>CLS</td>
<td>Company Limited by Shares</td>
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<td>CSRC</td>
<td>China Securities Regulatory Commission</td>
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<td>domestic enterprise</td>
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<td>FDI</td>
<td>foreign direct investment</td>
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<td>LLC</td>
<td>Limited Liability Company</td>
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<td>UNCTAD</td>
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<td>World Trade Organization</td>
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A. INTRODUCTION

I. RATIONALE AND SIGNIFICANCE

The primary objective of this study is to investigate the taxation of holding companies, more precise, the taxation of foreign-invested holding companies in the People’s Republic of China (hereinafter “PRC”). Austrian tax law, especially, the recently introduced group taxation regime (“Gruppenbesteuerung”)\(^1\) and other particular holding-relevant provisions serve as a basis of reference. A survey of commonly known and scientifically discussed international tax planning strategies follow. The examination of the Chinese foreign-invested holding company and the discussion of the internationally known tax planning strategies shall deliver clues for the actual tax planning of foreign-invested holding companies in the PRC. Such suggested tax-planning initiatives will be supported by quantitative examples expressing potential tax advantages or disadvantages of the respectively discussed strategy. The derivation and study of such tax planning strategies is to be seen as the subsidiary research purpose.

The beginning of any scientific research is characterized by questioning the rationale and the significance of the research object in focus. Since its gradual economical and political opening, beginning with the so-called “Open Door Policy”\(^2\) of the late 1970s, the PRC has become one of the fastest growing economies on the globe. The average rise in gross domestic product in China between 1996 and 2004 was 8.4% compared to, 2.3% in both Austria and the European Union.\(^3\) A Country, with a surface of 3,696,100 square miles and a population of approximately 1.3 billion, making it the third largest country with respect to size and the largest country with respect to population in the world\(^4\), is designed to be one of the major markets in the world. Thus, in the globalization strategies\(^5\) of mainly, but not

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2 An introductive view on China’s “Open Door Policy” can be found with Ho/Hueneman, China’s Open Door Policy, 1984.
3 Compare National Bureau of Statistics of China, 2006; Oesterreichische Nationalbank, 2006; European Statistical Data Support, 2006. The figure computed for the European Union is based on the former 15 member states Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Portugal, Spain, Sweden, The Netherlands, and The UK.
4 Compare Xueming, Auslandsinvestitionen, 2003, pp. 42 et seq.; The New Encyclopaedia Britannica, China, 2003, pp. 36 et seq.
5 Ad the role of MNCs in globalization compare, e.g., Kleinert, Globalization, 2004. In his book Kleinert takes up a definition of globalization from Siebert/Klodt, Global Competition, 1999: “…globalization can be defined as the process of converting separate national economies into an integrated world economy.”
exclusively\textsuperscript{6}, multinational corporations (hereinafter “MNC”) the Chinese market demands special attention in two respects. Firstly, China as a market itself, currently still changing from a socialist planned economy to a market economy, bears an almost unaccountable market potential for the future and is meant to offer significant sales prospects for products and services. Secondly, capital and, to a large degree, production factors have become highly flexible. China, with its relatively low factor costs, an incentive-creating legislation, and a growing domestic industry, driven by the transformation process, that is eager to expand its activities to the world stage, seems to offer to foreign companies irresistible opportunities to locate production and research and development in the PRC.\textsuperscript{7} The Chinese government has indicated that it welcomes the engagement and support of foreign investors in its striving for economic transition and the transformation of state-owned enterprises into private enterprises that will be able to respond to, as well as survive and grow in a market economy.\textsuperscript{8} The scope of foreign investment, especially foreign direct investment (hereinafter “FDI”)\textsuperscript{9} rose from US$ 2.244 billion in 1986 to US$ 63.630 billion in 2003 aggregating to US$ 556.045 billion, making the PRC the largest capital importer over this period of the world, second only to the USA.\textsuperscript{10} However, since the beginning of 2005, the investment climate in the PRC has been experiencing a slight decline, despite the ongoing surge in the Chinese economy with current growth rates of gross domestic product of approximately 10.7%.\textsuperscript{11} The profits of MNCs are stalling and imports to the PRC are decreasing.\textsuperscript{12} The consequences are tighter profit margins, growing trade tensions with Chinese companies that are turning into competitors, and other factors, fueling the need for the restructuring of investments.

\textsuperscript{6} This thesis will only cover holding companies set up by MNCs, as the capital requirements to form a Chinese holding company are very stringent and, thus, nearly automatically eliminate the accessibility of this company form for small- and mid-sized companies.

\textsuperscript{7} Compare UNCTAD, World Investment Report, 2005, p. 166; Yuping/Lall, Impact, 2005, p. 43. A present summary on the political and economical development in the PRC is provided in issue no. 8470 of The Economist.


\textsuperscript{9} “Foreign Investment” is any act of acquiring of assets outside one’s home country. It includes financial assets, such as bonds, bank deposits, and equity shares, as well as foreign direct investments that additionally involves the ownership of means of production; compare hereto: Grubel, Foreign Investment, 1987, pp. 403 et seq.; Xueming, Auslandsinvestitionen, 2003, pp. 42 et seq.


\textsuperscript{11} Compare N.n., Bild, 2006, p. 6, N.n., Wirtschaft, 2006, p. 3.

\textsuperscript{12} Compare Anderson, The End, 2005, pp. 21 et seq.; Enright, Rethinking, 2005, pp. 16 et seq.
Investing enterprises have to examine all economic, legal, social, cultural, and other parameters potentially influencing an investment decision and the outcome of an investment very cautiously. These multi-faceted parameters cover a wide field, such as the need to maximize sales and/or profits, the ongoing globalization, the urge to increase innovation and flexibility, the steady search for new markets and entrance to such markets, as well as the necessity to adjust to continuously changing economic and legal backgrounds and jurisdictions. The latter, the legal background, includes, e.g., civil and tax law. The MNC is confronted with the task to determine the legal form of any new investment, as well as of assessing the legal form of already existing investments. The question of choice for a legal form of an investment arises in two cases, firstly, when initially planning and setting up an investment and secondly, when restructuring an existing investment. This choice determines which civil and tax law rules are to be applied. Additionally, it is common understanding, that civil law determines which tax law consequences are triggered.

Scholes et al. indicate that tax rules affect profitability and return on assets. Hence, the impact of tax rules on investments is evident. Nominally, the success of an investment is measured in profit. Taxes directly influence the scope of profit. Therefore, taxes take on a crucial role in the evaluation of an investment project. Consequently, differences in the tax treatment of a certain tax fact, as well as differences in tax rates, result in an immediate impact on the earnings capacity of an investment. As a logical consequence, investment decisions are subject to tax and tax-planning considerations of the people in charge of an investment. The organizational structure of enterprises, especially of MNCs, and its changes are always under close surveillance. The aim is to find ways to adjust the risk structure and profile, in order to minimize the risk exposure and simultaneously maximize the returns. These ever-new organizational corporate restructurings and new alignments of corporate

13 Landmark scientific economical findings concerning investments, the theory of investment and investment decisions were amongst others published by Fisher, Interest, 1930; Keynes, Treatise 1, 1930; Markowitz, Portfolio Selection, 1970.

14 Most of the listed reasons, forcing firms to always adapt to new circumstances, have been (are) at the core of the scientific economic discussion. An introduction and a broad overview on these classical economic theories, such as among others “The Theory of the Firm”, “The Profit Theory”, “The Theory of Institutional Economics” and “The Theory of Transaction Costs” as well as comprehensive bibliographies to each of these theoretical frameworks can, e.g., be found in Archibald, The Theory of the Firm, 1987, pp. 357 et seq.; Bouckaert/de Geest, Encyclopedia I, 2001; Meghnad, Profit and Profit Theory, 1987, pp. 1014 et seq.; Picot/Kaulmann, Theorie der Unternehmung, 1988, pp. 1940-1947.

15 Note that the term “investment” in this context shall cover all sorts of entrepreneurial engagement in a foreign country, in accordance with the definition provided under supranote 9.


organizations and strategies have come along with an increasing involvement of holdings or holding companies. They are used as structural and strategic means in order to support such reorganizations. Holding companies are entered into existing corporate structures or are initially set up, in order to manage, monitor, diversify, and finance investments in domestic and foreign markets. Another rationale for holdings is to satisfy general strategic and economic necessities, personal intentions, tax-relevant and financial considerations. The terms “holding” and “holding company” have become widely known for its frequent use in connection with tax issues and tax-planning strategies.

Understanding the tax regulations of a target-country, therefore, gains crucial economical importance. A China-specific aspect, which supports the foundation of holdings in the PRC, is the current transformation from a state-owned planned economy to a social market-economy. During transformation processes, the establishment of holdings has always been an important means in enhancing the privatization of a state-owned economy. In the course of these reforms, the PRC has introduced several legal investment vehicles for foreign investors to organize their investments and equity interests. These investment vehicles include the so-called “Foreign-invested Investment Companies”, a term the Chinese lawmaker developed to refer to the organizational structure, which internationally is discussed under the terms “holding” or “holding company”. Both the importance of holdings as a means to optimize organizational and business processes on the one hand and of the PRC as maybe “the” market of the future on the other hand is continuously growing. In theory, law should regulate both, holdings and the Chinese market. Thus, this study focuses on the combination of the ever-relevant issue of how a particular company form is regulated by law, narrowing it down to the tax law and the tax planning aspects.

Hence, in particular this thesis intends to contribute to, so far limited, existing research in the field of the taxation of holdings in the PRC and shall serve as a starting point for further detailed research in the extensive continuously changing “jungle” of holding taxation. To examine the extensive and broadly shattered field of Chinese tax legislation, for specific

19 Ad the distinction between and the use of the terms “holding” and “holding company” compare chapter B.I. If not explicitly stated otherwise, the term “holding” is used throughout this thesis.
21 Compare Grotherr, Besteuerungsfragen I, 1995, pp. 1510 et seq.
22 This could also be witnessed during the transformation process of the former USSR, or during the transformation of the Indian economy, and in Germany after its reunification in 1990, with, e.g., the establishment of the “Treuhandanstalt”.
regulations that might rule holding-relevant tax facts and events “blindly”, might be of limited use. Thus, the approach presented within this study is to extract holding-relevant tax facts and subject matters from a well-known, well-documented, and progressive tax regime. For this reason, the author chose Austrian tax law. This choice can be supported through various arguments. First, Austrian source and literature material, being the backbone of this study, are readily and easily accessible without the implicit danger of misunderstandings due to translations and lack of original source material. Moreover, the Austrian tax law offers itself as the ideal basis of reference, because of its similarities to the German tax law, which offers additional source and explanation material. Yet, compared to German tax law, Austrian tax law can be considered to be more in accordance with present tendencies of corporate tax reforms as presented by the EC or other private scientific bodies. With the introduction of the “Gruppenbesteuerung” and the new § 9 aKStG, Austria is one of the very few countries which undertook to incorporate a modern group-relief regime into its tax laws. The author assumes that the combination of such a new group-relief regime and a traditionally grown well manifested and documented overall tax system as applied in Austria is an adequate starting point for the research and review of the taxation of holdings and holding companies in the PRC. Given that the “Gruppenbesteuerung” is solely applicable for incorporated bodies,23 covering corporations, the further research shall have its primary focus on corporations!

Taking a different country’s legislation as a basis of reference, leads the way to be able to take advantage of theoretical findings from comparisons of legal systems and their individual treatment of certain legal facts and issues. This approach intends to broaden the perspective for individual national legislative regulations and views on certain legal facts. Furthermore, this doctoral thesis shall gain practical relevance from its explanation of civil and tax law requirements to be fulfilled, when establishing a holding in the PRC, as well as from displaying particular tax imponderablenesses a holding might face. With the attempt to deliver well-founded recommendations for the implementation of adequate tax planning strategies, the practical relevance is emphasized. Addressees of this research project, hence, are scholars, studying the field of corporate taxation and company law, managers, practitioners in counseling and consulting professions, and the lawmaker as such. The latter may gain useful information for future legislative undertakings, while other may be drawn to the practical relevance of the topic.

23 See §9 I, II aKStG.
II. **The Research Question**

Taxation is a major concern in choosing an appropriate investment vehicle. Internationally operating corporations have to tackle several tax issues when setting up a holding in any targeted investment country. Even more, a profound assessment becomes due, when planning for investments in an emerging country, such as the PRC, where different tax treatments for different business vehicles may apply. To support the decision-making, it is important for foreign investors to understand the relevant tax issues. A sustainable analysis of all potential tax aspects concerning the envisaged business activities becomes essential. The problems with regard to taxation issues faced by a foreign company, wishing to establish a holding in the PRC, are extensive and multi-layered. Additionally, the Chinese legislation on taxation in general and on the taxation of foreign-invested holdings in particular is highly fragmented. Furthermore, the provisions, the law offers, from a company law point of view, in several respects appear to be burdensome. Another issue often complained about, is the lack in legal certainty, a phenomenon that can be watched globally. However, the PRC offers some specialties. Due to its still socialist political system, it is manifested that the Communist Party is the superior power in the country. Therefore, legal practice generally has only ruling power in the given individual case, but its conclusions may not serve as a case precedent with general interpretative validity. This leads to a status where valuable interpretations of certain tax facts and events can only be obtained by the government and its respective government bodies and agencies. Promulgated laws and regulations often serve to mystify as much, as encourage foreign investors. Like so many of the PRC’s laws and regulations, also the foreign-investment related ones remain unclear in many respects.\(^2\)\(^4\) The lack of legal certainty paired with high compliance costs, born by companies in the PRC increase the risks inherent with business activities in the PRC.

Task of this thesis will be to limit the range of theoretical problems with respect to the establishment, taxation, and ongoing tax planning of a holding company in the PRC. Such a task covers the thorough research of general aspects of company law, being the prerequisite to sort and judge tax facts\(^2\)\(^5\), the interpretation of the respective tax laws and regulations, and the implementation of reliable interpretations of these findings into the conclusion of tax planning strategies. Correspondingly, the research question is twofold. Firstly, it covers the analysis of the holding-relevant Chinese tax legislation based on the reference provided via Austrian tax


\(^{25}\) Compare Crezelius, Steuerrecht, 1994, pp. 6 et seq.
China’s Foreign-Invested Holding Company: Taxation and Tax Planning

A Review with Reference to Austrian Tax Law

law, especially the Austrian “Gruppenbesteuerung”, and secondly, the study and discussion of
tax planning strategies and possible quantitative impacts for foreign-invested holding
companies operating in the PRC. The overall guiding research questions consequently are:

1) How is the foreign-invested holding company taxed in the PRC, presuming Austrian tax
   law as a basis of reference?

2) Which exemplary tax planning strategies are available at what possible quantitative
effects?

III. Method and Theory

The methodical approach to discuss the research questions is content-analytical. Following a
general introduction and an approach to define the term “holding”, as it is used in the two
jurisdictions, covered by this study, the author presents the Austrian “Gruppenbesteuerung”
as a tax regime that incorporates a progressive handling of holding-typical tax facts and
events. The study in its entirety shall serve as an examination catalogue. The basis of
reference shall hint the author to relevant tax facts. The relevant tax facts are analyzed,
interpreted, and summarized within the context of Chinese tax law. Besides the mere tax facts
and events, such content analysis always includes necessary assessments of those civil law
implications that influence taxation. The discussion of the Austrian tax law will support the
author to keep the central thread during the examination of the Chinese tax law. Based on the
results of the assessment of the Chinese tax law, the possible application of several tax
planning strategies and possible quantitative effects of their application will be discussed.
Identifying such tax-planning measures and their quantitative effects shall support a more tax-
efficient management, i.e. support the efficiency of entrepreneurial decisions, of holding
companies and their investments in the PRC.

The “meta”-topic “holding-taxation” has both a legal, as well as an economic angle that are
linked to each other. The fact that the study involves two separate legal systems, the Austrian
and the Chinese, could lead to the assumption that its aim was to produce a comprehensive
legal comparison. Yet, as the background is to be seen in the context of the scientific field of
Tax Management, certainly one with close legal ties, nevertheless an economic discipline, this
assumption has to be negated. However, it is eminent to have an understanding of the basics
of the theory of legal comparison, in order to be able to draw well-founded conclusions. The
science of Comparative Law targets to measure and understand analogies and differences
between alternative legal patterns. 26 There are different paradigms on how Comparative Law can be approached. While, e.g., in the theory of “Comparative Law and Economics”, there is a distinction made between a “static” and a “dynamic” approach, whereas, “Comparative Law” distinguishes “macro- from micro-law-comparison”. 27

The static approach of “Comparative Law and Economics” compares a set of “legal formants” at a given time, trying to identify differences and analogies and to understand their contribution to framing a working rule. Contrary thereto, the dynamic approach, which takes into consideration mutual interactions between the observed legal systems, is focusing on historical and present legal changes. 28 One of the major findings of “Comparative Law” scientific research projects is that changes in legal systems are often due to legal transplants, that being the result of moving one legal rule from one country to another. 29 The moving of legal rules or systems of law tends to increase efficiency. This is especially relevant within scenarios, where the aim of the research is to combine legal with economical aspects, either to formulate a set of hypotheses for further research, or to conclude theoretical results with the support of “Comparative Law”. Subject to the present thesis, understanding the essentials of the legal background is mandatory to any judgments of taxation related operative facts. The law-comparative analysis distinguishes between what is called the “working rule”, the rule applied in a given case, and the particular legal justification given for the application of this rule. Each legal rule itself is determined by different formative elements, elements that are called “legal formants” 30 in the respective literature. 31

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26 Compare Mattei/Antoniolli/Rossato, Economics, 2001, pp. 505 et seq.
28 Results of legal comparisons pursued with the dynamic approach show either a convergence, or a divergence regarding its legal solutions. “Convergence: legal systems starting from different points tend to coverage toward similar solutions; divergence: legal systems moving from similar starting points tend, in the course of time, to reach different legal solutions”; see Mattei/Antoniolli/Rossato, Economics, 2001, p. 508.
29 Compare Watson, Legal Transplants, 1974, p. 20.
30 Ad “Legal Formants” compare Schlesinger et al., Comparative Law, 1994, p. 78. Schlesinger and his colleagues conclude that in a given legal system barely a single rule of law exists on a particular point. Yet, depending on the source consulted, there may be a series of different formulations with respect to that given particular point. A formant of law might, therefore, “be a group, type of personnel, or a community, institutionally involved in the activity of creating law... all interacting and competing legal formants”. See Monateri/Sacco, Legal Formants, 1998, p. 531. Supporting Mattei/Antoniolli/Rossato, “Legal Formants” also are any “…legal proposition that affects the solution of a legal problem”; see Mattei/Antoniolli/Rossato, Economics, 2001, p. 511.
31 Compare Mattei/Antoniolli/Rossato, Economics, 2001, pp. 505 et seq.; Sacco, Legal Formants I & II, 1991, pp.1 et seq. & pp. 343 et seq. Sacco generally provides a brief, yet comprehensive introduction to what he calls “A Dynamic Approach To Comparative Law”, including an overview of the aims of Comparative Law, aspects to be considered with regard to the general “Comparability of Different Legal Systems”, an explanation of the concept of “Legal Formants” as well as advices to different forms of “Application”. The Dynamic Approach often is also called the “Legal Formants Approach”.

8
Following Zweigert/Kötz the scientific framework of international Comparative Law distinguishes a “macro-law-comparison” from a “micro-law-comparison”. Whilst macro-law-comparison is dedicated to the comparison of general methods of the introduction and application of the law, micro-law-comparison covers specific legal institutions or legal issues. The taxation of holding companies is a certain legal issue, i.e. tax legal issue. Notwithstanding the attempt of the international harmonization of corporate tax systems, individual legislations cover certain tax facts and events in their own specific way. Thus, the present approach resembles more the approach of micro-law-comparison, than of macro-law-comparison. Nonetheless, the borders between macro- and micro-law-comparison are fluent and support each other’s arguments. The comparison of legislations and their treatment of certain legal issues serve to broaden the scientific findings and to deliver solutions to growing social, legal, and economic problems. To be able to produce a sound level of scientific findings and to suggest solutions, it is necessary to include all possible legal sources that influence the researched tax issues into the study. The interpretation and systematization of laws and regulations needs to be carried out by taking the position of a critical independent, respectively distanced role to exclude subjectivity from the scientific research as much as possible.

As stated above, this study is based on the scientific background of Tax Management. Critical for Tax Management, as an application-oriented science, are entrepreneurial decisions. Tax Management examines the influence of taxes, as a forced fiscal means, on entrepreneurial decisions. Tax Management covers two major fields of research, the effects of taxation and the planning of tax facts, i.e. tax planning. The science of the effects of taxation is deemed to conclude hypotheses, concerning the effect taxes have on entrepreneurial decisions. Contrary, the science of tax planning, which tries to develop theoretical recommendations for entrepreneurial decisions in order to minimize an enterprise’s tax burden, starting from the analysis and interpretation of a given tax framework. With the discussion of the Chinese tax rules concerning holding companies and the subsequent conclusion of tax planning strategies for such PRC holding companies, the focus of this study is on tax planning. In order to be able

32 Compare Zweigert/Kötz, Rechtsvergleichung, 1996, pp. 4 et seq., 32.
33 Compare Zweigert/Kötz, Rechtsvergleichung, 1996, pp. 14, 33 et seq. Zweigert/Kötz define „legal sources“, as used in the context of law comparison, as everything that shapes and influences legal life and order.
34 Legal interpretation can be distinguished in verbal, logic, systematic, and teleological interpretation-approaches. Compare hereto, e.g. Bertl et al., Handbuch I, 2004, p. 9.
to make statements on the effects gained from implementing certain tax planning strategies, standards of comparison are necessary. Exemplatory computations, designed as casuistic assessment simulations ("kasuistische Veranlagungssimulation"), will supply such a standard of comparison based on a particular index figure. These computations offer the opportunity to compare quantitative effects of various tax-planning alternatives. Yet, the question, which index figure would be appropriate in the given context to express, not only the differences, but could also generate viable recommendations, is critical.

It is intended to present an index figure that expresses the cash effect of the taxation in the PRC and then subsequently of the application of tax planning strategies in the PRC in a simplistic way. Additionally, the chosen index figure shall express the volume of net income available to the foreign-invested holding company’s parent company. The index figure chosen shall be a figure called “net distributable income” (hereinafter “NDI”). Such NDI shall determine the amount of net disposable income available at the level of the MNC top-entity’s shareholder level, i.e. the maximum amount of income the MNC top-entity could dispose over to distribute to its shareholders. The computation of this figure, therefore, needs to consider all intermediary levels, its basic underlying systematic and path of derivation is displayed in Figure 1 below.

![Figure 1: Net Distributable Income](image)

<table>
<thead>
<tr>
<th>Chinese Subsidiary Pre-tax Income</th>
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<tbody>
<tr>
<td>( \text{/. Chinese Enterprise Income Tax} )</td>
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<tr>
<td>( \text{/. Chinese Withholding Tax} )</td>
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<tr>
<td>( \text{/. Other Chinese Taxes} )</td>
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<tr>
<td>( = ) Chinese Subsidiary Distributable Profit</td>
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<table>
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<tr>
<th>China-Holding Holding Company Income</th>
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<tbody>
<tr>
<td>( \text{/. Chinese Enterprise Income Tax} )</td>
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<tr>
<td>( \text{/. Chinese Withholding Tax} )</td>
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<tr>
<td>( \text{/. Other Chinese Taxes} )</td>
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<tr>
<td>( = ) Distributable China-Holding Holding Company Profits</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Taxable Income of MNC Top-Entity in Austria</th>
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</thead>
<tbody>
<tr>
<td>( \text{/. Austrian Corporate Income Tax} )</td>
</tr>
<tr>
<td>(+) Creditable Chinese Withholding Tax</td>
</tr>
<tr>
<td>(+) / Double Taxation Treaty Effect</td>
</tr>
<tr>
<td>( = ) Net Distributable Income of Austrian MNC</td>
</tr>
</tbody>
</table>

Figure 1: “Net Distributable Income”

36 Self-prepared figure.
The derivation of the NDI begins at the level of the market income generated by the subsidiaries of the Chinese holding company. Assumingly, these subsidiaries are subject to tax to some extent. Consequently, the subsidiaries can only distribute to the Chinese holding company their gross income less any taxes payable on such gross income. Such distributable profit equals the taxable income of the Chinese holding company. Again, at the holding company level taxes are due. Ultimately, the holding company will distribute to the MNC top-entity its after-tax income. However, before arriving at the MNC top-entity level, effects caused by double tax treaties or other means to avoid double taxation have to be considered. In the framework of this study, it is assumed that the double taxation treaties, the PRC has entered into with other countries are identical, i.e. individual provisions single treaties may provide are not taken into account. Nonetheless, in order to being able to include precise potential tax implications into the computation and, at the same time, to stay in frame with the overall framework of this thesis, the author chooses the Austrian-Chinese double taxation treaty\(^{37}\) (hereinafter “ACDTT”) as a reference.\(^{38}\) Ultimately, the MNC top-entity’s national tax laws provide for the taxation of income generated by the MNC top-entity. Thus, Austrian tax rates and tax law need to be considered when ultimately measuring the tax consequences influencing the income receivable by the MNC. At this level, the research project does not continue to factor in possible tax effects. Hence, the NDI does not take into account the taxation of such a quantity at the level of the MNC top-entity’s shareholders, irrespective of its legal personality and possibly resulting differences in taxation.

The index figure shall support the author to formulate tax-planning recommendations. In the context of this thesis, it, therefore, is not intended to conclude a particular mathematically comprehensive index-figure, e.g., the tax present value.\(^{39}\) The assumptions of the computation-model needed to be simple in form and easy to derive theoretically, as well as understandable and expressive. It is intended to show that the results depend on the kind of tax planning strategy applied, but also at what level and at what point in time they are applied.


\(^{38}\) As this thesis covers the Austrian and the Chinese jurisdictions, it appeared to be obvious to consider the two countries’ tax provisions within the computation. However, the computation model is constructed in a way that particular provisions of other double taxation treaties and national tax provisions could be inserted, instead of the Austrian provisions. This is one of the reasons to keep the computation model simple so that the national tax provisions of the China-Holding’s parent company can easily be replaced, in order to receive valuable data for the tax planning strategies in any given MNC-home country. For the Austria-China treaty see International Bureau of Fiscal Documentation, Tax Treaties, 2005.

\(^{39}\) However, the derivation of a comprehensive time-sensitive index-figure for this context could become the research-object of future research undertakings.
IV. **The Course of Work**

For a better understanding of the conditions and circumstances in the PRC, chapter B aims at displaying the necessary civil law background by providing definitions of the terms “holding” and “holding company”, as well as their organizational particularities. This is necessary, to be able to carry out a profound research of the taxation of holding companies in the PRC. Chapter B commences with an explanation, why such a definition and demarcation is essential. Both, the public and the economic and legal sciences use different terms to describe the same organizational phenomenon. The terms “holding”, “holding company”, or “foreign-invested investment company”, the latter being the term that is used by the Chinese lawmaker, have different origins and underlying meanings. Yet, additionally, interpreting the terms, one could conclude, e.g., that when examining tax issues in connection with the term “holding”, a broader range of tax facts might have to be considered, than when examining tax issues in connection with the term “holding company”. Thus, this chapter will separate the terms used, simultaneously, providing an explanation for the need of a clear notional definition.

In order to produce a profound basis for the definition of the holding-term used within this study it is essential to understand the very origin of the concept of enterprises holding shares in other enterprises and performing several services for such other enterprises and for the entire group of enterprises as such. One will be able to gain an overview on the development of such organizational entities until the present day and be able to understand its growing importance better. Once, the need for a definition and the historical background are established, chapter B.III. sets forth the essential civil law framework governing foreign investment vehicles in the PRC.

The PRC, still being a socialistic organized state, with its long and intensive history and tradition, has developed a very individual approach to the concept and rule of law. Chapter B.III. opens with a brief historical overview and introduction to the basics and principles of the Chinese legal system in general, supporting the following analysis and interpretation of the relevant Chinese tax laws and regulations. The Chinese lawmaker has provided several pieces of legislation governing foreign investment in the PRC. It is intended to deliver a systematic overview on this legislation and to conclude the holding-relevant civil law facts and events. One will learn that the Chinese legal system shows a wide degree of dispersion with regard to single pieces of legislation, but also with regard to the competences of governmental bodies. With the presentation of the investment alternatives available to foreign investors, the focus is narrowed down to specific regulations governing the foreign-invested
Chinese holding. At this stage, the work presents detailed company law specifications related to foreign-invested holding companies in the PRC. Chapter B.IV. gives an overview on the main civil law issues and definitions related to the holding or holding company in the German speaking jurisdictions. Chapter B will ultimately close with a combined conclusion of the underlying meaning that the term holding is given in the context of this study.

Chapter C serves to establish the Austrian’s tax law and especially the “Gruppenbesteuerung”, as what has been called “the basis of reference” before. Chapter C will open with a systematically indispensable introduction to the particularities of the Austrian tax law in general and of the “Gruppenbesteuerung” in particular, including important issues such as the allocation and computation of income and the tax treatment of investments and respective valuation issues.

Based on the reference, derived from Chapters B and C, Chapter D discusses the primary research object, the taxation of the foreign-invested holding company in the PRC as per the legal status as of June 2007. However, it needs to be indicated that the 10th National People’s Congress reviewed and enacted a new “Enterprise Income Tax Law”\(^{40}\), which is to go into effect on January 1, 2008 with a transition period of five years, yet this work concentrates on the presently applicable laws and regulations. Following the order of Chapter C, the author closely reviews, examines, analyzes, and undertakes to interpret the tax facts and tax events relevant to the taxation of foreign-invested holdings in the PRC. The study of the holding-relevant Chinese tax law presupposes the identification of a corresponding legal framework and the knowledge about existing taxes and tax rates. This thesis is focussed on the presently applicable enterprise income tax aspects. Therefore, in Chapter D.II., the holding-related enterprise income tax issues are discussed, including such important aspects as the identification of the taxable entity and the computation of taxable income, the allocation of income to subsidiaries and their parent company. Furthermore, the taxation of the different sources of income and expenses, as well as the tax treatment of investments and corresponding issues, such as valuation issues, are examined. The individual structure of Chinese tax laws covers a very basic generally applicable enterprise income tax law, which is accompanied and complemented by various legal provisions and strongly refers to existing accounting provisions. Therefore, the examination order of the Chinese tax law alters from that provided by the basis of reference, wherever deemed necessary. Important examples that supplement the basic tax rules are integrated into this work.

\(^{40}\) Compare 10th NPC, promulgated March 16, 2007.
Chapter E is dedicated to the discussion of tax planning strategies and possible quantitative effects. The general theoretical foundations of tax planning, as well as the derivation of particular internationally known tax planning strategies are set forth in the beginning of this chapter. To be able to construct a framework of applicable strategies, it is important to know the “toolbox” of tax planning and its limits and targets. Chapter F.I. explains the scientific foundations of the term “tax planning” and hints to the targets, enterprises envisage, when applying particular tax-planning alternatives. This view on general quantitative and qualitative tax-planning targets is followed by a comprehensive study of specific clues available for tax planning to foreign-invested holding companies active in the PRC. It is being discussed, whether and to what extent the commonly used distinction between “repatriation” and ”allocation strategies” and their respective single forms could be applied in a reasonable way by holding companies in the PRC. Ensuing to these general implications on tax planning, the author concludes a set of particular tax planning strategies available to foreign-invested Chinese holdings. The specific clues for the conclusion of these strategies are derived from the previous discussion of the taxation of the foreign-invested holding company in the PRC. The effects such strategies unfold, are expressed with the support of an index-figure, the “NDI” available at the level of the foreign-invested Chinese holding company’s parent company.

Ultimately, Chapter F closes this work with a conclusive and comprehensive summary of the findings of this work, likely future tendencies, and shall hint to further research options.
B. CIVIL LAW AND DEFINITIONS

I. THE NEED FOR A DEFINITION

There hardly is any term in the legal and economic world that is used as randomly as that of “holding” or “holding company”. However, why at all, make a difference between these terms? The term “holding” describes a structural organization pattern, where several associated enterprises are bracketed under the umbrella of one particular top entity. Yet, contrary thereto, the term “holding company” specifies exactly that very entity at the hierarchical top of a “holding”. Figure 2 below shall display the difference in a simplified way. Although the existing literature acknowledges the difference between the terms, there hardly is a distinction made or a distinction deemed necessary.\(^4\) Hence, it can be concluded that a holding always implies the existence of a holding company. Meaning, the association of several enterprises to form a holding is only possible with one legally identifiable entity that “holds” the equity interests in associated enterprises in part or in whole. Therefore, the author uses the term “holding”, when referring to aspects that concern both the organizational entity as such, as well as the top-entity alone. The term “holding company” is used, when the actual legal facts or the respective circumstances of discussion explicitly refer to the particular legal form of such a top entity.

Still, we find these terms being frequently used in everyday newspapers, magazines, scientific publications, and in television programs, when it comes to the documentation and news-coverage of a globalizing corporate world. National borders are no more real obstacles to allocate and distribute production factors and capital freely around the globe. However, seldom, the recipients of such news get a precise definition, of what lies beneath these terms. For most of the public, the terms “holding” or “holding company” stand for ever more complex corporate structures, implemented to prevent the influence of national governments and of the lawmaker from its operations, be it, e.g., to circumvent employment laws or to shelter income from tax authorities. Assumingly, the general opinion on the essence and purpose of a holding has a negative taste. Knowledge on the positive functions a holding

might take in a corporate structure is sparsely spread in the public. The embodiment of holdings or holding companies may increase the flexibility of corporate operations and corporate structures leading to an increase in efficiency, meaning a more efficient allocation of production factors and capital, which, in an ideal world, would lead to an increase in shareholder and stakeholder value and the creation of new jobs. Unfortunately, often-observed actual side effects of such risings in efficiency are negative social effects, resulting in layoffs and shrinking governmental tax-incomes. While a welcome and flexible strategic device for MNCs, holdings arouse the suspicion of governments and a not-knowing public.

With respect to holdings, the tasks of applied legal and economic sciences can be seen as threefold. The first task would be, to support the public in broadening its understanding for the concepts of use of holdings. Secondly, sciences need to support governments to be able to pass laws and regulations that on the one hand offer a tool to control corporate organizations and on the other hand offer as much economical and entrepreneurial freedom as possible. Thirdly, sciences should support corporations using holdings in a legitimate way, by discussing and presenting the legal and economic frameworks. Within the holding, in its entirety, consequently, more tax facts are realized, than by the holding company, seen as a standalone tax subject.

42 Self-prepared figure.
This study focuses on the fields of application a holding might have in corporate organizations with regard to taxation and tax planning. To be able to identify and, subsequently, examine the relevant aspects, it is essential to delimit the research object in question, giving it a profound and sound definition. The scientific body, especially the sciences of law, economics, and business administration, has developed several different approaches to define the term “holding”. As stated above, the existence of a holding presupposes the existence of a holding company. Once established and embodied, it is the holding company and its interactions with its environment, the combination of which forms the holding, that realize relevant legal and tax law facts and events.

II. THE HISTORICAL DEVELOPMENT

Following the end of the French Revolution in 1793 and of the American War of Independence in 1783, not only the political and social lives changed, but also the economical. With the introduction of the concepts of “competition” and “laissez-faire” as new pillars of economical politics and sciences, the role of the enterprise and of capital evolved. The inverse connection between the increase in profits and the reduction of risk became a keynote of this economical evolution. An economical realization of these thoughts could be manifested in the concentration tendencies that followed with the beginning use of machine manufacture and steam power during the industrialization period, especially in countries like the USA (after the end of the Civil War), England, Wales, and Germany. The consolidation of industrial activities was pursued in order to reduce costs, enlarge market shares, and under optimal circumstances, achieve a monopolistic market position. These ambitions were supported by rapidly developing techniques, allowing firms to improve their production processes and to achieve, what was then called “economies of scale”. However, especially the US-entrepreneurs of the late nineteenth century and the beginning twentieth century, quickly learnt, that without sufficient capitalization and a risk-aware (risk-adverse) structure of their ventures, their growth would be limited. This awareness led to major capital coalitions in the

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43 Even though 1789 is commonly known as “the” year of the French Revolution, the end of the Revolution was in July 1793 when all feudal claims and rights were abolished; compare Treue, Wirtschaftsgeschichte I, 1973, p. 143.
44 Compare Smith, Wealth, 1976; Faulkner, History, 1943, pp. 430 et seq.
47 E.g., Rockefeller, Dupont, Carnegie, Vanderbilt, and J. P. Morgan.
form of so-called “pools”\textsuperscript{48} and “trusts”\textsuperscript{49} that were developing in the USA with the beginning of the 1870s and 1880s.\textsuperscript{50} These pools and trusts followed monopolistic goals and tried to manipulate or even eradicate competition.\textsuperscript{51} The abusive conduct of such corporate forms, operating mainly in the railroad, petroleum, sugar, cotton, and steel industries, motivated the US-government to pass its first antitrust laws\textsuperscript{52} to brake up existing pools and trusts and to prevent the creation of such organizational forms and monopolistic market structures. Nevertheless, not all states followed the new federal antitrust legislation. Beginning with New Jersey, several federal states\textsuperscript{53} introduced state laws that vested the right of residency to enterprises that only held shares in other enterprises. This was the first time, the holding of shares in other enterprises, as a sole object of business, was expressed by a piece of legislation. Although having been in use before, the holding company was now legally born, without further legal specification.\textsuperscript{54}

In his doctoral thesis Zitzmann concludes the definition of a holding company, in accordance with the remarks made by Bamler\textsuperscript{55} and Liefmann\textsuperscript{56}, as well as with the wording of the respective US-literature and US-legislation\textsuperscript{57}, as follows: \textit{``The object of a holding company is}

\textsuperscript{48} A “Pool” as understood in this context, is a “…organization of business units whose members seek to control prices by apportioning the available business in some way.” See Faulkner, History, 1943, p. 436.

\textsuperscript{49} A rather figurative definition of “Trust” is given by Cook, in Cook, Trusts, 1888, where he writes, “A ‘Trust’ is a combination of many competing concerns under one management, which thereby reduces the cost, regulates the amount of production, and increases the price for which the article is sold. It is either a monopoly or an endeavor to establish a monopoly. Its purpose is to make larger profits by decreasing cost, limiting production, and increasing the price to the consumer. This it accomplishes by presenting to competitors the alternative of joining the ‘Trust’ or being crushed out. Its organization is intricate, secret, and subtle. It is a masterpiece of modern ingenuity and fertility of resource. It is a product of the highest order of business talent and executive ability. It is at once a monument to American genius and a symbol of American rapacity.”

\textsuperscript{50} This development, starting with the beginning of the nineteenth century, also saw the creation of a corporate banking and stock exchange system, as well as of “Limited Liability”, a legal concept supporting the legal form of the “corporation” as a means for the organization of labor and capital. Compare Bamler, Trusts, 1929, pp. 11 et seq.; Blumberg, Corporate Groups, 1983, p. 2; Gilbert/Williamson, Antitrust Policy, 1998, pp. 82 et seq.; Jenks, Trusts, pp. 3 et seq.; Lander, History, 1967, pp. 203 et seq.; Lauchener, Die Holding Company, 1924, p. 8; Treue, Wirtschaftsgeschichte I, 1973, pp. 613 et seq.

\textsuperscript{51} Cook, e.g., cites George Stephenson, “…where combination is possible, competition is impossible”; see Cook, Trusts, 1888, p. 1. Compare also Faulkner, History, 1943, pp. 444 et seq.; Liefmann, Kartelle, 1930, pp. 344 et seq.; Liefmann, Cartells, 1977, pp. 283 et seq.


\textsuperscript{53} I.e. Delaware, West-Virginia, Maine, and New York.

\textsuperscript{54} Compare Balmer, Trusts, 1929, pp. 24 et seq.; Lander, History, 1967, p. 214; Zitzmann, Trusts, 1927, pp. 21 et seq., 45. § 51 of New Jersey’s Corporation Act of 1889 and 1893 ruled that “any corporation may purchase, hold, sell, assign, transfer, mortgage, pledge or otherwise dispose of the shares of the capital stock, or any bonds, securities or evidences of indebtedness created by any other corporation or corporations of this or any other state and while owner of such stock may exercise all the rights powers and privileges of ownership including the right to vote thereon.”

\textsuperscript{55} Compare Bamler, Trusts, 1929, p. 25.

\textsuperscript{56} Compare Liefmann, Kartelle, 1930, pp. 282 et seq.; Liefmann, Cartells, 1977, pp. 230 et seq., 283 et seq.

to acquire the shares of other firms and to hold these shares perpetually, in order to control the will of such submitted firms by exercising its voting rights ... It is a new independent firm with legal capacity ... as a stock company, that as a management company controls the share in the, till then competing, firms and influences them in an uniform direction... it merely financially concentrates and externally recognizable leaves the legal autonomy to the subsidiaries with regard to their accounting.”

As we will see in the following chapters these early thoughts on possible definitions of holdings and holding companies already included several fundamental concepts. These concepts are still at the core of the discussion today, e.g., the distinction of legal from economic independence of associated enterprises, a concept of uniform control, a supposed legal personality, as well as the idea of the holding being the entire entities “managing” organ.

III. THE PEOPLE’S REPUBLIC OF CHINA

1. The History of the Legal System

For the primary aim of this study to profoundly research and discuss the taxation of foreign-invested holding companies a basic understanding of the Chinese legal system is inevitable. This necessity is supported by the blatant cultural differences between China and the West. Yet, it is not intended to discuss all aspects of the Chinese legal system and its history in depth. By exploring the historical backdrop against which reforms in present day China are occurring, it is easier to understand how the rule of law in China has developed so far and could continue to develop. This becomes even more evident, as for Westerns it is difficult to imagine a rule of law embedded in a non-liberal context. Consequently, law plays a different role in society, such as, e.g., strengthening the state, rather than the protection of individual rights. As a constantly moving and changing discipline, the Chinese law, just as any other national law, is always under development. This following brief historical retrospective, however, is not undertaken for its own sake, but will directly lead to the civil law background of foreign-invested holdings in the PRC.

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58 Compare Zitzmann, Trusts, 1927, p. 22.
China’s legal system has a strong traditional basis, which reaches as far back as the 11th century BC and determined the rule of law in China until the beginning of the 20th century.\textsuperscript{60} In 1954, the Communist Party promulgated its first extensive constitution, as a basis for an extensive legal regulation of social and economic relationships and transactions. However, the Communist government did not actively begin to rule all fields of life with laws, as law was considered to bind the “hands and feet of the masses”.\textsuperscript{61} This development escalated into the “Cultural Revolution” in the mid 1960s, where the publication of laws and orders was stalled. The political doctrines and the few existing laws of the state became the basis of Chinese judiciary.\textsuperscript{62} The main characteristics of this period were the establishment of the claim to leadership by the Communist Party, a legal theory following the Marxist-Leninist principles, a term of “law” resembling punishment, the strict enforcement of discipline, and the oppression of unwelcome behavior and resistance. Furthermore, certain legal institutions, like the dominance of state property, a centrally planned economic system, the allocation of powers, a politicized criminal law, and the preference of extrajudicial dispute settlement developed.\textsuperscript{63}

With the end of the Cultural Revolution and Mao Zedong’s death, the development of the rule of law and legal principles took on speed again, as Deng Xiaoping announced, “...there must be laws, one can and must stick to, that are to be strictly enforced and violations of which are to be prosecuted.”\textsuperscript{64} The coming legal reforms were to “reflect the interplay of foreign legal norms with local context”.\textsuperscript{65} A first step to binding and limiting political power, the prevention of misusing political power, and personal rights was made. This process of development, of the Chinese political, legal, and economic system, also called “Open Door Policy”, was supported by the government’s realization of the country’s economical backwardness and by the announcement of the new concept of a “socialistic market

\textsuperscript{60} A comprehensive summary on the history of Chinese Law can be found with Heuser, Einführung, 2002; Weggel, Chinesische Rechtsgeschichte, 1980.


\textsuperscript{65} Compare Pitman, Legal System, 2001, p. 4.
This concept was later also incorporated into the 1993-amendment of the constitution of 1982, as the principle for the economic order of the PRC. The government is still seen to be able to intervene with the economy, but is only meant to act on a strategic basis, without simultaneously completely planning and controlling the economy. The entire legal development process was emphasized, once the PRC began to prepare for its membership application to the WTO.

2. Legislature and Judiciary

Given the array of different provisions issued at different government levels that rule all different forms of enterprises, it appears necessary to give a brief overview on the hierarchical order of Chinese legislature and judiciary. Understanding the hierarchical differences in legislature and judiciary is important for anyone working in the field of law; especially, as the ongoing interpretative work throughout this thesis can only be carried out systematically correct, once the relations between different laws and regulations, and their inherent hierarchical order is understood. Figure 3 and Figure 4 shall support this understanding.

67 6th NPC, promulgated December 4, 1982; Art. 15 PRC Constitution. The second sentence of the original Art. 15 was changed and now reads, “The State has put into practice a socialist market economy. The State strengthens formulating economic laws, improves macro adjustment and control and forbids according to law any units or individuals from interfering with the social economic order.”
68 See Pitman, Legal System, 2001, pp. 5 et seq., 125 et seq.
69 According to Peerenboom more than 350 laws and 6,000 lower-level regulations have been passed in the PRC during the reform era since 1978; Peerenboom, March, 2002, p. 239. Compare also Zheng, Wirtschaftsrecht, 1997, pp. 36 et seq.
The National People’s Congress (hereinafter “NPC”) constitutionally holds the legislative power. Yet, it delegates such power to hierarchically lower government levels, especially to the State Council (hereinafter “SC”). Practically, the SC drafts the laws and issues implementing rules, circulars, and other official documents and orders referring to such laws. Such documents are meant to serve the interpretation of the single provisions and of terms used therein, as well as to define additional relevant facts and events. Hence, the NPC, the NPC’s-Standing Committee, the SC, the respective ministries, commissions, and bureaus, and the local people’s congresses and governments are all in charge of the issuance of different types of legislation. Although the PRC has passed a number of laws referring to the procedures of law-making, the legislative authority in the PRC is still widely dispersed, supporting the lack of transparency and a high incidence of inconsistency between parts of lower and superior legislation.

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71 Self-prepared figure with reference to Wang/Mo, Chinese Law, 1999, pp. 40 et seq.
72 Compare Art.’s 57, 58, 62 no.’s (1), (2), (3), 64, 67 no.’s (1), (2), (3), (4), (6), (7), (8), (14), 89 no.’s (1), (9), (13), (14), (16), 99, 100, 104, 107, 116 PRC Constitution. Compare also Pfaar/Salzmann, Besteuerung, 2005, p. 1.
A great problem, also in the context of this study, remains the publication and accessibility of laws and regulations, an obstacle that is even enhanced by the rapid change in laws. Clearly, these factors cause legal instability and for investors it becomes hard to prepare feasibility studies and adhere to financial predictions. A typical example for Chinese pieces of legislation, increasing legal uncertainty are the legal “experiments” with so-called “Provisional Regulations”; e.g., almost fifty foreign-invested holding companies had already been approved by the time the Ministry of Foreign Trade and Economic Cooperation finally issued a first set of regulations authorizing them.\(^7^4\)

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\text{Figure 4: The Court System of the PRC}\,^7^5
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Unlike many other countries, the PRC lacks some of the institutional mechanisms that other countries have developed for legal interpretation and controlling administrative discretion, such as comprehensive and comprehensible systems of authoritative legal commentary. Law in the PRC is to be interpreted by the NPC and its organs or other state-organs, the administrative bureaucracies of the state. Often the NPC and the lower government bodies have been reluctant to provide legal interpretations. Occasionally, the Supreme People’s Court has stepped into the gap and has issued interpretations, although, its constitutional powers do

\(^7^5\) Compare Wang/Mo, Chinese Law, 1999, p. 55.
not cover obligatory legal interpretations. Based on a broad international consensus, a judiciary should be independent, competent, and sufficiently powerful in its competences. However, the PRC falls short on all three of such categories.\textsuperscript{76}

The failure of the PRC to present a strong, independent, and competent judiciary vests in its constitution. As per Art. 128 of the Constitution of the PRC (hereinafter “PRC Constitution”), the Supreme People’s Court is responsible to the NPC and to the NPC’s Standing Committee. Additionally, Art. 129 of the PRC Constitution reads that “the people’s procuratorates of the People’s Republic of China are state organs for legal supervision”, thus, supervising the Supreme People’s Court itself. The courts generally are not allowed to interpret law, conduct judicial review, or strike down government regulations inconsistent with superior legislation.\textsuperscript{77}

Thus, the PRC, having a constitution that displays the ambiguous relationship between the constitutional supremacy of the Communist Party and the authority of the law\textsuperscript{78}, lacks a functioning system of checks and balances. Foreign entities wishing to engage economically and financially in the PRC have to cope with significant legal uncertainty. A further important conclusion can be made with regard to the hierarchy of individual laws and regulations. Superiorly applicable are all pieces of legislation promulgated either by the NPC, the NPC’s Standing Committee, or by the SC. Such legislation, usually denominated as “law”, constitutes the general rule of law. Whereas, all pieces of legislation denominated as “regulations”, “provisions”, “circular” or else, promulgated by government bodies, hierarchically situated below the State Council, constitute the specific rule of law. In their interacting, the specific rule is valid, applicable, and prevailing as long as it is not contradicting any provisions given by any legislation that constitutes a general rule of law. However, the specific rules supplement the general rules in areas, where the general laws and regulations are silent or they may fill the vacuum temporarily left by the often broad and principle rules of general law.\textsuperscript{79}

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\textsuperscript{78} Compare the Preamble to the PRC Constitution.

3. **Civil Law and Foreign Investment**

The Chinese legal regime governing foreign investment in the PRC has evolved significantly following the Third Plenum of the 11th Central Committee of the Chinese Communist Party in 1978.\(^{80}\) Gradually, the government permitted a broader variety of foreign-invested business vehicles. These investment vehicles receive a special civil law treatment within the framework of Chinese civil law and particular within Chinese company law. To understand the company law specifications of foreign-invested holdings a view on the overall ruling of foreign investment vehicles is obligatory.

Being the primary source of law in the PRC every economic activity needs to obey to the PRC Constitution. Accordingly, the Chinese constitution makes statements with regard to domestic enterprises (hereinafter “DE”) in its Art.’s 16, and 17, and with regard to foreign enterprises and foreign-invested enterprises in Art. 18. The emergence of the socialistic market economy presupposes the existence of a market, thus, the existence of competitors. Nevertheless, who are these competitors and what legal rules constitute their existence and their economic activities? Traditionally, the PRC used to qualify its enterprises after the allocation of property, as portrayed in Figure 5.

![Figure 5: Traditional Property-based Enterprise Forms in the PRC\(^{81}\)](image)

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\(^{81}\) Self-prepared figure with reference to Wang/Mo, Chinese Law, 1999, pp. 255 et seq., 369 et seq.
The classification into “Small” and “Large Enterprises” in the “Private Economy” was made subject to the number of employees working at such an enterprise. A “Small Enterprise” was any private enterprise with not more than a maximum of eight employees. All private enterprises with at least nine employees, thus, were considered to be “Large Enterprises”. Since the late 1970s, though, this way of classifying types and forms of enterprises, yielded in favor of a classification, following the legal form of the respective enterprise. This process was determined by the introduction of new laws and regulations, of which the following are particularly important for the foregoing of this thesis:

- the Law of the PRC on Chinese-Foreign Equity Joint Ventures (hereinafter “EJV-Law”), 1979
- the PRC Constitution, 1982
- the General Principles of Civil Law, 1986
- the Law of the PRC on Wholly Foreign-owned Enterprises (hereinafter “WFOE-Law”), 1986
- the Provisional Regulations of the PRC on Private Enterprises, 1988
- the Company Law of the PRC, 1993

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82 See Heuser, Einführung, 2002, p. 384 et seq.;
83 5th NPC, promulgated on July 8, 1979.
84 6th NPC, adopted on December 4, 1982.
86 6th NPC, adopted on April 12, 1986.
87 7th NPC, promulgated on April 12, 1986.
88 7th NPC, promulgated on April 13, 1988.
90 SC (Approval)/MOFERT (Promulgation), promulgated on December 12, 1990; SC, Revision on April 12, 2001.
91 8th NPC, promulgated on December 29, 1993, effective as of July 1, 1994; Revision, promulgated on October 27, 2005, effective as of January 1, 2006. The CL quoted in this study is the 2005-revision. Whenever a distinction between the elder version and the current version should appear to be necessary this will be clearly marked.
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- Tentative Provisions on the Establishment of Companies with an Investment Nature by Foreign Investors, first promulgated in 199592
- the Implementing Rules of the Contractual Joint Venture Law (hereinafter “CJV-Rules”), 199593
- Establishment of Companies With an Investment Nature by Foreign Investors Provisions (2nd Revision) (hereinafter “Holding-Provisions”), 200494
- Catalogue for the Guidance of Foreign Investment Industries, 200495
- the Company Law of the PRC (Amended) (hereinafter “The CL”), 200596

All laws ruling the existence and activities of private enterprises in the PRC naturally have to be “en lieu” with the economic understanding of the PRC Constitution. The PRC Constitution rules important aspects, which serve as prerequisites for the engagement of foreign investors in the Chinese economy. The absolute general basis for any foreign engagement is the existence of a market. Moreover, the allowance of private property and, subsequently, the allowance to “reap the fruits” from these properties are other essential prerequisites for foreign investors.

93 SC (Approval)/MOFTEC (Promulgation), promulgated on September 4, 1995.
94 MOFCOM, promulgated on November 17, 2004.
95 MOFCOM, promulgated on November 30, 2004.
96 NPC, promulgated on October 27, 2005 and effective as of January 1, 2006.
97 MOFCOM, promulgated on May 26, 2006 and effective as of July 1, 2006.
Although, the PRC Constitution clearly favors state property, it allows in several provisions that Chinese and foreign individuals or enterprises acquire and possess private property. The general legitimacy for foreign investment in the PRC is given within Art. 18 of the PRC Constitution, that reads, “The People’s Republic of China permits foreign enterprises, other foreign economic organizations and individual foreigners to invest in China and to enter into various forms of economic co-operation with Chinese enterprises and other economic organizations in accordance with the law of the People’s Republic of China...”

Business activity in the PRC can be carried out in two different ways. First, either the active entity has natural personality, or second, is registered as a legal person taking on one of the legal forms reserved for legal persons. This study will find that foreign-invested holdings are deemed to register as legal persons, which is why a further discussion of natural personality can be neglected. The CL is the general piece of legislation governing legal persons in the PRC. However, Art. 218 The CL suggests that in cases of concrete dispute between the regulations of The CL and the specific legislation, the specific legislation shall prevail. Therefore, foreign-invested enterprises established under The CL should be eligible to the benefits of the specific legislation. Yet, this does not found an unlimited eligibility to such benefits, as it would undermine a number of basic principles laid out within the framework of The CL. Once, the specific legislation, has been promulgated after The CL, it is regarded to represent a true position of Chinese Law, and thus may prevail over The CL.

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98 Art.’s 6, 7, 12 PRC Constitution.
99 Art. 13 PRC Constitution; Amendment to Art. 11 III of the PRC Constitution, approved on April 12, 1988, by the 7th NPC. The amended Art. 11 III reads, “The State permits the private sector of the economy to exist and to develop within the limits prescribed by law. The private sector of the economy is a complement to the socialist public economy, and exercises guidance, supervision and control over the private sector of the economy.”
101 Note that within the original version of The CL, of 1993, the prevalence of the specific foreign investment regulations was set forth in Art. 18. Compare hereto also Ho, New Company Law, 1994, p. 9. A further comprehensive overview of the general perception of and the rulings provided by The CL of 1993 is given by Howson, Company Law, 1997, pp. 127-173.
102 E.g., there exists a broad difference in the definitions of “registered capital” between The CL and, e.g., the Implementing Rules to the Contractual Joint Venture Law, the Equity Joint Venture Law and the Wholly Foreign-owned Enterprise Law. The Company Law defines “registered capital” as “paid-up capital”, Art. 26 I The CL, whereas the implementing rules to special FIE-vehicle laws govern, that “registered capital” is the “capital subscribed”, implying that under these rules the foreign investor has more time to pay up the registered capital, e.g., Art. 21 WFOE-Rules. “Registered Capital” under Chinese law, creates a binding and legal obligation of the partners to the respective enterprise contract to contribute the full amount of registered capital, which may not be reduced throughout the term of operation. Compare also, Chang, Pay Up, 1988, p. 10.
China’s Foreign-Invested Holding Company: Taxation and Tax Planning

A Review with Reference to Austrian Tax Law

Besides the national government’s laws and regulations affecting foreign investment, the laws and regulations issued by the local governments and their authoritative bodies should not be neglected. The PRC Constitution provides local governments with considerable authority in making local laws and regulations, as well as in approving foreign investment proposals. A local government is given the constitutional power to adopt and pass laws, as long as they do not conflict with superior legislation. Often the local governments pass beneficiary tax laws\textsuperscript{104}, or introduce other benefits to foreign investors, in order to attract and to strengthen foreign investment in their respective governmental districts.\textsuperscript{105}

To this point of the present study, there has been no need to draw a fine distinction between the terms “foreign enterprise” (hereinafter “FE”) and “foreign-invested enterprise” (hereinafter “FIE”). Yet, this distinction is necessary, as it originates in the wording of several pieces of PRC legislation.\textsuperscript{106} The PRC government and its local subsidiaries have issued an array of legislation that covers all aspects of foreign investment in the PRC, among others the establishment of investment vehicles, their administration, potential liquidation\textsuperscript{107} or bankruptcy\textsuperscript{108}, and taxation\textsuperscript{109}, as well as the industrial areas and projects open or closed to foreign investment\textsuperscript{110}. The choice of a legal form for a given investment, hence, is not free, because such legislation often determines the legal form demanded in order to execute the envisioned investment. In particular industries the legislation demands the participation of a Chinese partner, thus only the joint venture investment forms are eligible.\textsuperscript{111}

\textsuperscript{104} Such as, e.g., the number of Special Economic Zones, Open Coastal Cities, and Special Development Areas; hereto also Annex I.

\textsuperscript{105} Mo, Foreign Investment Law, 1997, pp. 298 et seq.

\textsuperscript{106} E.g., The CL, The Income Tax Law for Enterprises with Foreign Investment and Foreign Enterprises.

\textsuperscript{107} A German language introduction to the liquidation of foreign-invested enterprises in the PRC is given by Tetz, Liquidation, 1995, pp. 557-564.

\textsuperscript{108} An early German language introduction to the bankruptcy legislation of the PRC is given by Lauffs, Konkursrechtsgesetzgebung, 1986, pp. 779-788.


\textsuperscript{110} MOFTEC, Catalogue for the Guidance of Foreign Investment Industries, promulgated on March 11, 2002; amended on November 30, 2004. The catalogue divides investment projects into four categories, according to which investment projects are either ‘encouraged’, ‘permitted’, ‘restricted’, or ‘prohibited’; compare hereto also Torbert, Investment Regulations, 1995, pp. 7 et seq. referring to an older provisional version of this catalogue, issued in 1995.

\textsuperscript{111} Compare Pfair/Salzmann, Besteuerung, 2005, p. 18. E.g. Art. 5 of the “Measures for the Administration of Strategic Investments in Listed Companies by Foreign Investors” holds such a regulating provision.
Art. 192 The CL stipulates the existence of “foreign companies” opposite to the “foreign-invested limited liability companies and companies limited by shares” referred to in Art. 218. The CL. The distinction between the two terms becomes especially important in connection with questions regarding the application of certain tax laws and tax regulations. As this thesis will find the fact that an entity is qualified as a FE or a FIE can set forth a significant difference in the respective tax consequences.

a. Foreign Enterprises

Art. 2 II of the “Income Tax Law of the PRC on Enterprises with Foreign Investments and Foreign Enterprises”\(^{112}\) (hereinafter “FEITL”) gives a clear definition of FEs: “the term ‘foreign enterprise’ refers to foreign companies, enterprises, and other economic organizations which have set up establishments or sites in the PRC engaged in production and business operations, or which have not set up establishments or sites but nevertheless derive income from sources in the PRC.”\(^{113}\) Thus, FEs are entities formed outside the PRC under a non-Chinese jurisdiction.\(^{114}\) According to Art. 3 II of the “Detailed Implementing Rules for the Income Tax Law of PRC on Enterprises with Foreign Investment and Foreign Enterprises”\(^{115}\) (hereinafter “IRFEITL) such establishments or sites can be “management establishments, business establishments, offices, factories, places of extraction of natural resources, sites for contracted projects such as construction, installation, assembly or exploration projects, sites for the furnishing of services and business agents.”\(^{116}\) Hence, FEs never form a legally independent separate Chinese person, but represent foreign legally independent legal or natural persons which have establishments or branches set up within the PRC.

\(^{112}\) 7th NPC, promulgated on April 9, 1991 (effective as of July 1, 1991).
\(^{113}\) Compare hereto also Art. 192, The CL; see also Ho, New Company Law, 1994, p. 13.
\(^{114}\) Compare Pfaar/Salzmann, Besteuerung, 2005, p. 18.
\(^{115}\) SC, promulgated on June 30, 1991 (effective as of July 1, 1991).
\(^{116}\) Compare also Zheng, Wirtschaftsrecht, 1997, p. 163.
b. Foreign-Invested Enterprises

Contrary to FEs, FIEs are enterprises that are legal entities formed in the PRC under Chinese law, having their headquarters located in the PRC. To obtain FIE-status at least 25% of the registered capital of such an enterprise must be of foreign origin. The Chinese lawmaker distinguishes three forms of FIEs, Contractual Joint Ventures, or Co-operative Joint Ventures, as they are sometimes referred to (hereinafter “CJV”), Equity Joint Ventures (hereinafter “EJV”), and Wholly Foreign-owned Enterprises (hereinafter “WFOE”).

i. Contractual Joint Ventures

A CJV is based on a contractual agreement ruled by the provisions set forth in the Contract Law of the PRC. As per Art. 2 CJV-Law, a CJV either is a loosely connected co-operation between the contracting partners, or a legal person. It is a legal person, when the contracting partners determine that a separate legal entity best suits their needs and they express this need in the co-operation agreement. Formed as a legal person, the CJV-Rules govern, that the CJV takes the form of a Limited Liability Company (hereinafter “LLC”). However, MOFTEC promulgated on January 10, 1995 a legislative document, “Several Questions Concerning the Establishment of Foreign Investment Companies Limited by Shares Tentative Provisions” (hereinafter “CLS-Provisions”), that foreign companies, enterprises, and other economic organizations or individuals may also establish companies limited by shares (hereinafter “CLS”). Consequently, it can be assumed that a CJV, just like the other FIE-forms, EJVs and WFOEs, may also take the form of a CLS.


119 Art. 14 CJV-Rules.

120 Art. 1 CLS-Provisions.
The cases of non-legal person status CJVs are particularly ruled by Art.’s 50-54 CJV-Rules. Such non-legal person CJVs neither can carry on business activities in its own name, nor are liable for any debt in their own right, but the partners to such venture would be liable for the venture’s debt to the limit of their contributions.121 The partners can make their contributions, i.e. pay in capital, either in the way of cash, or in industrial or intellectual property, or other movable or immovable property, i.e. pay in capital by way of a contribution in kind. The distribution of profits122 can follow optional contractual provisions.

Critically, the CJV-Rules do not state any limits of non-cash investment, yet it can be assumed, as the cross-reference among foreign investment related regulations appears to be a general rule123, that the non-cash investment may not exceed 20%, as stipulated by the WFOE-Rules.124 However, Art. 27 III The CL provides that the non-cash investment may be as high as 70%. However, given Art. 218 The CL, FIEs are primarily subject to the specific foreign investment legislation. As per Art. 18 III CJV-Rules, the minimum foreign investment to a legal person CJV must be 25% of the registered capital.125 The ratio of registered capital to total investment of legal-person CJVs can be derived from the “Sino-foreign Equity Joint Ventures Ratio of Registered Capital to Total Investment Tentative Provisions” (hereinafter “Capital Ratio Tentative Provisions”). The Capital Ratio Tentative Provisions unfold validity beyond the scope of EJVs to include CJVs and WFOEs.126 Art. 3, no.’s (1) to (4), of these provisions set forth the following ratios:

121 Compare Mo, Foreign Investment Law, 1997, p. 290; Wang, Besteuerung, 2006, p. 18; additionally Mo lays out that the Art.’s 50-54 CJV-Rules by no means “provide sufficient legal rules to clarify ambiguities arising from the legal status of such venture.”
122 Art. 21 I WFOE-Law; see Küssel, Handlungsoptionen, 1999, p. 363.
123 Compare Heuser, Recht, 1990, p. 543.
124 Art. 27 II WFOE-Rules.
125 The rule that at least 25% of the registered capital necessarily has to be ‘foreign’ investment in order to qualify as a FIE originates in the specific FIE-regulations. However, the opportunity of a foreign investment accounting for less than 25% of the registered capital remains and would then be ruled by the provisions of The CL.
126 SAIC, promulgated on March 1, 1987. The PRC government has issued relatively strict equity contribution regulations defining the procedure, timing, and penalties to be taken into account, when planning to make financial contributions especially to Chinese-foreign EJVs in the PRC. These rules are to be applied analogously to CJVs and WFOEs. Compare SC/MOFTEC and SAIC, Supplementary Provisions to the Several Provisions on Capital Contributions by the Parties to Chinese-Foreign Equity Joint Ventures, September 29, 1997; SC (Approval)/MOFERT and SAIC (promulgation), Certain Provisions on Contributions by the Parties to Chinese-Foreign Equity Joint Ventures, promulgated on January 1, 1988; compare hereto also Chang, Losing Control, 1997, pp. 9 et seq.; Chang, Pay Up, 1988, pp. 9 et seq.; Cohen, Law, 1989, p. 778; Folsom/Minan, Foreign Investment Law, 1989, p.748; Zheng, Wirtschaftsrecht, 1997, p. 177; Zimmerman, China Law, 2004, p. 83.
Problems occur with regard to non-legal person CJVs, as the fact that they do not qualify, as a legal person does not automatically make them qualify as a natural person, i.e. a partnership in the sense of the Chinese law. In theory, they would not be able to carry on civil law activities, i.e. enter a legal relationship in its own right, yet, despite of that, an unincorporated CJV has to be able to operate. As per Art. 50 CJV-Rules, the relevant principles of the Chinese law shall govern such entities. Accordingly, Art. 52 of the General Principles of Civil Law provides that for an economic association that conducts joint operations, but does not qualify as a legal person, either each party to the association shall bear individual liability, in proportion to its respective investment contribution, or joint liability shall be specified by law or agreement.

### ii. Equity Joint Ventures

Foreign investors and Chinese partners jointly establish EJVs as a Chinese LLC, as per Art. 4 I EJV-Law. Thus, EJVs are always legal persons, set up in the form of an LLC, and, within the limitations set forth in the previous chapter, are subject to The CL. Accordingly, they are also eligible to the CLS-company form and generally are subject to the specific legislation on foreign investment in the PRC as stipulated by Art. 218 The CL. Before its establishment, a proposal and feasibility study of the envisaged venture must be submitted with the relevant authorities. Once approved, the partners may proceed with preparing certain documents required by the authorities and supporting the operations of such an EJV.\(^{128}\) The stake of registered capital made up by foreign capital may not be less than 25%.

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127 Self-prepared table.
128 Art. 9 EJV-Rules.
As per Art. 4 III EJV-Law, profits are to be distributed proportionate to the investors’ shares in the EJV’s registered capital. Comparable to the other investment forms, investments can be made in cash or in non-cash forms, where again supposedly, the rules of the WFOE-Rules, set a cap to the non-cash investments at 20% of the registered capital.129

### iii. Wholly Foreign-Owned Enterprises

As per Art. 2 WFOE-Law, a WFOE is an enterprise invested in exclusively by foreigners, i.e. foreign registered companies and foreign individuals. According to Art. 8 WFOE-Law, WFOEs have legal personality, once they meet the conditions set forth in the respective legislation.130 A WFOE allows a foreign investor to enjoy autonomy in administering and managing the enterprise.131 Like any other enterprise in the PRC, prerequisite for the setting-up of a WFOE is an application to be filed with the relevant government bodies in accordance with Art.’s 6 and 7 WFOE-Law and Art.’s 7 to 17 WFOE-Rules.

With regard to the capital equipment of a WFOE, Art.’s 19 and 20 WFOE-Rules define the total amount of investment as the amount required to realize the investment and the registered capital as the amount that is registered with the relevant government bodies, it shall correspond to the envisaged scale of business. A specific sum, however, is not being provided. Art. 6 Capital Ratio Tentative Provisions clearly states its legal validity also for WFOEs, causing such capital ratios to apply also in cases of WFOEs.132 Art. 25 WFOE-Rules provides that the registered capital can be paid in, in three ways, firstly, in foreign currency, secondly, in renminbi (hereinafter “RMB”), the PRC’s official currency133, generated by any other investment project or enterprise in the PRC, or thirdly, in form of capitalized items such as machinery, equipment, industrial or intellectual property. Whereas, again, capitalized items may not make up for more than 20% of the registered capital and are to be evaluated in accordance with common international principles of valuation.134

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129 Like LLC-CJVs an EJV could also be established in accordance with the CL and thus being subject to The CL’s registered capital provisions. Compare chapter B.III.3.b.i.
130 Legal personality is ruled by Art. 37 Civil Law Principles. Art. 18 WFOE-Rules sets forth further details with regard to the legal person status of WFOEs. Compare also Heuser, Recht, 1986, p. 424.
132 See above.
133 The Chinese currency is the RenMinBi (RMB), generally pronounced Yuan in written form, but spoken as Kuai.
4. The China-Holding

a. Term and Statutory Framework

Foreign investors with multiple investments in the PRC may want to “hold” their investments under the bracket of one company. Ever since the allowance of foreign capital to be invested into the Chinese economy, foreign investors have been setting up organizations to manage their investments. Although Art.’s 15 and 16 The CL stipulate rules governing investments by one enterprise in another enterprise, following the prevalence of the specific foreign investment rules subject to Art. 218 The CL, the Holding-Provisions set forth the legal framework for such investments of Chinese foreign-invested holdings in other Chinese enterprises.\footnote{Before the amendment of The CL in 2005, The CL ruled in Art. 12 II that such investments were limited to an amount of 50% of the investing company’s assets, unless the investing company was an investment company or a holding company. Yet, at the time The CL was adopted in 1993, there were not any pieces of legislation ruling investment or holding companies. Foreign investors were individually allowed to apply for the establishment of such an entity even before the issuance of specific rules. Being the latest version of the Holding-Provisions this study refers to the 2nd Revision, promulgated on November 17, 2004. Compare hereto also Au/Heuer/Xuan, China-Holding, 1996, pp. 691 et seq.; Kuzmik/Burke, Holding Companies, 1993, p. 7; Pitman, Legal System, 2001, p. 120; Raiser/Wei, Gesellschaftsrecht, 1996, p. 22; Stricker, GmbH- und Aktienrecht, 1994, pp. 648-650.} Depending on the translation, the Holding-Provisions use the term “foreign-invested company with an investment nature”, “investment-oriented company”, or “investment-company” describing the organizational structure, which globally is known as “holding” or “holding company”. In order to circumvent the use of these lengthy and confusing terms, the author, with reference to Au/Heuer/Xuan\footnote{See Au/Heuer/Xuan, China-Holding, 1996.}, suggests using the term “China-Holding” as a synonym describing the entire organizational entity, unifying the top-entity and its subsidiaries. The top-entity itself shall be referred to as the “China-Holding Holding Company” (hereinafter “CHHC”). Corresponding to previous remarks, however, the term “China-Holding Holding Company” will only be used in cases, when the respective actual discussion of facts or events demands such a clear distinction between the organizational entity and its hierarchical members. Typically, this will be the case, when the discussion of a fact or event simultaneously includes the holding’s top-entity, as well as its subsidiaries.
The civil law statutory framework of the China-Holding consists of a set of gradually promulgated provisions and circulars, the first of which was published in 1995. These administrative documents cover,

- Establishment of Companies With an Investment Nature by Foreign Investors Tentative Provisions\textsuperscript{137},
- Problems Concerning the Establishment of Companies With an Investment Nature by Foreign Investors Tentative Provisions Explanation\textsuperscript{138},
- Establishment of Companies With an Investment Nature by Foreign Investors Tentative Provisions Supplementary Provisions\textsuperscript{139},
- Establishment of Companies With an Investment Nature by Foreign Investors Tentative Provisions Supplementary Provisions (2)\textsuperscript{140},
- Amending the Establishment of Companies With an Investment Nature by Foreign Investors Tentative Provisions and its Supplementary Provisions Decision\textsuperscript{141},
- Establishment of Companies With an Investment Nature by Foreign Investors Provisions\textsuperscript{142},
- Establishment of Companies With an Investment Nature by Foreign Investors Provisions (Revised)\textsuperscript{143},
- Establishment of Companies With an Investment Nature by Foreign Investors Provisions (2\textsuperscript{nd} Revision), i.e. “the Holding-Provisions”, and the
- Supplementary Provisions on the Investment in, and Establishment of Companies with an Investment Nature by Foreign Investors, i.e. “the Holding-Provisions Amendment”\textsuperscript{144}.

From a civil law point of view, this thesis refers to the Holding-Provisions and the Holding-Provisions Amendment, being the latest issued documents.

\textsuperscript{137} MOFTEC, promulgated April 4, 1995.
\textsuperscript{138} MOFTEC, promulgated February 16, 1996.
\textsuperscript{139} MOFTEC, promulgated on August 24, 1999.
\textsuperscript{140} MOFTEC, promulgated on May 31, 2001.
\textsuperscript{141} MOFTEC, promulgated on March 7, 2003.
\textsuperscript{142} MOFCOM, promulgated on June 10, 2003.
\textsuperscript{143} MOFCOM, promulgated on February 13, 2004.
\textsuperscript{144} MOFCOM, promulgated May 26, 2006 and effective as of July 1, 2006.
b. Legal Form

i. The China-Holding Holding Company

What legal form does the CHHC take and what about the hierarchy of norms with regard to the foreign-investment legislation and The CL? The primary pieces of legislation governing the legal specifications of the CHHC’s legal form and its legal organization as such are set forth in the Holding-Provisions that have recently been complemented by the Holding-Provisions Amendment. Yet, the Holding-Provisions are to be seen in the context of the entire Chinese law, especially the further specific foreign investment legislation and The CL. Repeating, the following rule can be manifested, The CL, generally accounts for all enterprises with legal person status, Chinese as well as foreign-invested enterprises. Yet, Art. 218 The CL sets forth the prevalence of the specific regulations ruling foreign investment, wherever they provide different or specific provisions. These different FIE-ruling provisions, including the Holding-Provisions, however, may not be interpreted and applied in contradiction to other laws, regulations, and rules of the PRC.145

Sentence 1 of Art. 2 Holding-Provisions rules that the CHHC takes the legal form of either an EJV or WFOE. The enterprise as such is to be established in the form of a LLC.146 Presuming that EJV and WFOE represent legal forms in the framework of Chinese law, it can be concluded, that the CHHC itself does not vest an own legal form as such.147 In sentence 2 of the same article, the provisions state that the CHHC shall take the form of a LLC. This suggests that the CHHC is considered to be both, a type of FIE, and a legal person with limited liability.148 As per Art. 36 Civil Law Principles, “a legal person shall be an organization that has capacity for civil rights and capacity for civil conduct and independently enjoys civil rights and assumes civil obligations in accordance with the law.” To receive legal person status as an enterprise, the respective entity must further fulfill the qualifications set forth in Art. 37 Civil Law Principles, including that mandatory articles of association rule its entrepreneurial purpose and organization and that the entity is being

145 E.g., Art.’s 1, 26 Holding-Provisions.
146 Art. 2 s. 2 Holding-Provisions.
registered with the relevant authorities.\textsuperscript{149} For the China-Holding these prerequisites are laid out within Art.’s 5, 6 Holding-Provisions, which in turn are in accordance with the specific regulations for FIEs\textsuperscript{150} and with The CL\textsuperscript{151}.

Taking the further gradual opening of the Chinese economy and the development of its financial markets into account, it might be of additional interest for MNCs, running holding operations in the PRC, to tap the domestic financial markets\textsuperscript{152} and to pursue the opportunity to list the CHHC or one of its subsidiaries at one of the country’s applicable stock exchanges. Prerequisite for such a step would be that the China-Holding was able to take on the legal form of a CLS. Art. 1 CLS-Provisions, reads “…foreign companies, enterprises and other economic organizations or individuals may establish foreign-funded companies limited by shares…” Having assessed that the CHHC, by taking the form of either an EJV or a WFOE, consequently qualifies as a FIE, the applicability of the CLS-form to the CHHC could be assumed. The shareholders of a CHHC, thus are able to either newly establish the CHHC together with Chinese partners in the form of an EJV-CLS or to convert a WFOE-CHHC into a CLS in accordance with the CLS-Provisions and The CL.\textsuperscript{153} Both accessible legal forms, the LLC and the CLS, share the concept of limited liability, i.e. each shareholder in such a company assumes liability to the company to the extent of the amount of shares held by him, or to the extent of monetary value represented in such an amount of shares, respectively. However, the company itself is liable for its debts to the extent of all its assets.\textsuperscript{154} Ultimately, it is to be concluded that the China-Holding generally obtains legal personality by taking the legal form of either a WFOE or EJV constituted as either a LLC or a CLS.

\textsuperscript{149} Compare for the discussion of legal personality in the PRC, e.g.: Tingmei, Legal Person, 1993, pp. 261-297; Zheng, Wirtschaftsrecht, 1997, pp. 96 et seq.

\textsuperscript{150} Art. 3 EJV-Law; Art.’s 2, 6 WFOE-Law; Art.’s 9, 10 WFOE-Rules.

\textsuperscript{151} Art. 11 The CL.

\textsuperscript{152} Officially Chinese companies and FIEs can list on the mainland stock exchanges in Shenzhen and Shanghai, as well as on foreign exchanges, including Hong Kong and New York. There are two categories of shares issued by CLS. The first category is ordinary shares, denominated and traded in RMB that may generally be held only by Chinese individuals, legal entities, or the State, but there is one exemption, the so-called “qualified foreign institutional investors” that are allowed to hold up to 10% in this share category. These shares are referred to as “A-Shares”. The second category is special shares, which are denominated in RMB but quoted and traded in foreign exchange and may be held only by foreigners. Special shares include “B-Shares”, which are traded on the Shanghai and Shenzhen stock exchanges; “H-Shares”, which are traded at the Hong Kong Stock Exchange; and “N-Shares”, which are traded at the New York Stock Exchange. Compare hereto Howson, Company Law, 1997, p. 135; Luttermann/Hartwig, Bilanzrecht, 2004, p. 506; Schobert/Schulte, Financial Markets, 2005, pp. 3-9; Zheng, Wirtschaftsrecht, 1997, pp. 231-244. Zimmerman, China Law, 2004, p. 686.


\textsuperscript{154} As defined in Art. 3 II, III The CL.
ii. Subsidiaries and Branches

The CHHC holds investments in other enterprises. The civil law connection between the CHHC and these investments constitutes the China-Holding. Subject to Art. 25 Holding-Provisions, the CHHC “and the enterprise(s) invested in and established...are legal persons.” Thus, the Holding-Provisions rule that the individual enterprises involved are legal persons, existing legally independent of each other. This provision in connection with Art. 14 Holding-Provisions stipulates that the subsidiaries, the CHHC establishes or invests in, are either LLCs or CLS. Subject to the newly introduced Holding-Provisions Amendment, the CHHC is now also permitted to hold equity interests in publicly listed enterprises\textsuperscript{155}, a possibility that Art. 14 Holding-Provisions denied before. Accordingly, the subsidiaries of a CHHC may also take the form of a CLS.

In way of interpreting Art.’s 3 no. (1), l.’s (i), (ii), 8, 19, 20 Holding-Provisions, it can be concluded that the subsidiaries are either FIEs themselves, i.e. EJV, WFOE, or legal person CJV, or legal person DEs. However, a DE - Art. 8 alternative 4 Holding-Provisions - can only become a subsidiary by way of acquiring equity interests in it. In this case a MNC, ordering its Chinese top-entity to acquire an interest in such a DE would have to carefully assess the capital ratios to guarantee a post-acquisition qualification as a FIE, in order to take advantage of the preferential treatment of FIEs.\textsuperscript{156} Besides ruling the financial affiliation criteria, Art. 12 Holding-Provisions interpretatively states that the condition to qualify as “an investee enterprise of a company with an investment nature” is the qualification as a FIE. Only once an entity qualifies as a FIE it is considered as “full” subsidiary\textsuperscript{157} and, hence, becomes eligible to the many advantages the China-Holding may provide, e.g., intra-group foreign-exchange balancing or central management and administration tasks. Concluding it can be said that subsidiaries of the CHHC are FIEs, i.e. EJV or WFOEs taking the form of either a LLC or a CLS, as it is shown in Figure 6.

\textsuperscript{155} Art. 4 Holding-Provisions Amendment.
\textsuperscript{156} Art. 20 Holding-Provisions.
\textsuperscript{157} The word “full” is emphasized as generally the holding of non-FIE shares is allowed as well and thus could from a company law point of view, also be regarded as subsidiaries. However, in this context, only such entities are entitled “subsidiary” that ultimately fulfil also the financial affiliation criteria.
Besides holding investments, the CHHC itself is allowed to establish branches in regions other than the one where its registered office is located. Moreover, Art. 10 no. (3) Holding-Provisions permits the establishment of scientific research and development centers or departments which themselves can technically be regarded as branches.

c. The Financial Affiliation

Determining the financial affiliation between subsidiary and top-entity is crucial. The relevant rule can be found in Art. 12 Holding-Provisions. As mentioned above the qualification as a subsidiary is a condition precedent for the inclusion into the holding. Art. 12 Holding-Provisions regulates two possible cases, which are exemplary also visualized in Figure 7. The first case is ruled by the connection of Art. 12 no. (1) and no. (3) Holding-Provisions covering the situation, where a CHHC establishes a subsidiary by way of initial investment either alone or in conjunction with foreign and/or Chinese partners. The provisions provide that the CHHC, its foreign investors, and third party foreign investors must account for a combined share of at least 25% in the respective entity’s registered capital.

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158 Self-prepared figure.
159 Art. 21 Holding-Provisions
160 Compare Mollard/Tiang, Explanation, 1997, p. 44; Süss, Gründung, 1996, p. 3.
Additionally, Art. 12 no. (3) Holding-Provisions introduces a minimum threshold with regard to the equity interests that have to be actually directly held by the CHHC. Thus, an investment of at least 10% of the registered capital needs to be directly attributable to the CHHC.\textsuperscript{161}

The second case covers the alternative, where the CHHC gets financially involved in an existing entity. Art. 12 no. (2) Holding-Provisions requires that the CHHC acquires in part or in whole equity interests in such an existing entity from the investors of the China-Holding, its affiliates, other third party foreign investors, and/or other Chinese investors. As a minimum threshold the acquired shares of the CHHC in addition to the further shares attributable to foreign investors, must at least account for 25% of the registered capital. Simultaneously, the CHHC’s directly attributable equity interest in such a subsidiary may not amount to less than 10% of the registered capital.\textsuperscript{162}

Figure 7 displays the “acquisition”-alternative in three steps (I-III). Step I covers the initial situation where, e.g., the CHHC’s foreign investors, third party foreign investors, and third party Chinese investors are shareholders of the subsidiary. Then in order to be integrated into the China-Holding the subsidiary needs to be partly or in whole acquired by the CHHC. For this reason, the CHHC acquires shares of the subsidiary from its original shareholders (Step II). To constitute sufficient financial affiliation the CHHC needs to acquire a minimum of 10% of the subsidiary’s registered capital directly, as long as simultaneously the combined foreign investment in the subsidiary is at least 25% (Step III).

\textsuperscript{161} Compare Mollard/Tiang, Explanation, 1997, p. 44; Süß, Gründung, 1996, p. 3.

\textsuperscript{162} Art. 12 Holding-Provisions.
d. Establishment, Registration, and Administration

Once, a foreign investor fulfills the general conditions of Art.’s 1, 2 Holding-Provisions, as well as the capitalization requirements set forth in Art. 3 Holding-Provisions it may file an application with the relevant authorities. In such an application, the foreign investor guarantees payment of the registered capital, or its stake in registered capital, and the transfer of technology belonging to the foreign investor and needed, or agreed to be necessary, in order to efficiently carry out the investment purposes in the PRC. As Art. 6 Holding-Provisions state, the establishment of a China-Holding deems necessary the presentation of certain documents such as e.g. the application forms, contracts between founding partners, articles of association, feasibility study reports, and financial documents supporting the financial strength of the founding partners. The question concerning the term of operation is one that is to be addressed during the application process, but also has to be re-assessed during the life cycle of the holding, e.g., when it comes to extending the initially indicated term of operation. This is, because any FIE must obtain a business license before commencing its business activities. Such license is issued in accordance with the term of operation, as stipulated in the application documents and is, e.g., a condition precedent to file tax returns.

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163 Self-prepared figure.
164 Art. 5 Holding-Provisions.
The term of operation of a China-Holding conforms to the provisions given by the specific FIE-regulations or by specific regulations, which provide separate regulations for different industries.

Besides the establishment of new FIEs and/or the investment in existing FIEs to spread their local representations over the country, the China-Holding may establish branches in regions other than the one of its registered office. Establishing branches additionally supports the definition of the registered office of the China-Holding as its regional headquarters. Yet, the acknowledgement of a CHHC as a regional headquarter is subject to several conditions that need to be fulfilled simultaneously. Firstly, the paid up registered capital may either not be less than US$ 100m or at least US$ 50m with the total amount of assets and profits of its subsidiaries not being less than RMB 3 billion and RMB 100m, respectively. Secondly, the CHHC complies with the rules for the use of the registered capital in accordance with Art. 8 Holding-Provisions, and thirdly, the China-Holding establishes a research and development institution. The recognition of a CHHC as a regional headquarter brings several additional benefits with regard to certain extensions in the allowed scope of business, as laid out below.

e. The Capitalization

The founding partners of a CHHC, be it only (one) foreign investor(s) or both foreign investors and (one) Chinese partner(s), have to meet certain criteria in order to file the application for setting up a China-Holding. The criteria is divided depending on, whether the CHHC is to be set up as a WFOE or as an EJV. In the former case, at least, the foreign investor, with the largest equity stake in the enterprise, shall have good creditworthiness, financial strength, a total asset value of no less than US$ 400m in the year prior to the application. The investor shall also have established FIE(s) in the PRC with actually paid in capital of more than a total of US$ 10m. Alternatively, such foreign investor, in addition to

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165 Art. 13 EJV-Law; Art.’s 100, 101 EJV-Rules; Art. 20 WFOE-Law; Art.’s 70, 71 WFOE-Rules. None of the aforementioned legislation, except the EJV-Rules mentions a specific timeframe. Art. 100 EJV-Rules states that the term of operation of an EJV can regularly be assumed to be between 10 to 30 years and very comprehensive and investment-intensive ventures can be extended to 50 or beyond years.

166 Art. 18 Holding-Provisions.

167 Art. 21 Holding-Provisions.

168 Art. 22 I no. 1 (i) Holding-Provisions.


170 Art. 22 I no. 1 (iii) Holding-Provisions.


172 Art. 3 I (1) (i) Holding-Provisions.
a good creditworthiness and financial strength, shall already have established a minimum of

ten FIEs with an aggregated capital contribution of at least US$ 30m of registered capital

actually paid in.\(^{173}\) In the latter case, where a CHHC is established as an EJV, the Chinese

partner must have good creditworthiness, financial strength, and a total asset value of not less

than RMB 100m the year prior to the application.\(^ {174}\) Besides, at least the largest foreign

partner in such an EJV-CHHC must fulfill one of the conditions laid out above.\(^{175}\)

As per Art. 3 I no. 3 Holding-Provisions the registered capital of a CHHC is required to be at

least US$ 30m. The Holding-Provisions rule that the foreign investor shall contribute capital

either in a freely convertible currency or from RMB-profits or -proceeds gained in the PRC,

while a potential Chinese partner generally may contribute capital in RMB. In any event, the

registered capital is to be paid in within two years of the issuance of the business license.\(^ {176}\)

Special consideration shall be put on the legally given timeframes regarding, when certain

parts of the registered capital are to be paid in, as defaults may cause draconian penalties, e.g.,

depriving the defaulting party of management control of the FIE.\(^ {177}\) In connection with the

payment of registered capital, a CHHC’s foreign parent-company, moreover, has to be aware

that the Chinese approval authorities demand guarantees issued by the parent company for the

payment of the CHHC’s own registered capital, as well as the registered capital of the

CHHC’s subsidiaries.\(^ {178}\) In practice the parent-companies considering to establishing a China-

Holding, tend to set up some kind of special purpose vehicle, located in a jurisdiction with

favorable liability and tax rules, in order to mitigate the risk of piercing the corporate veil.\(^ {179}\)

\(^{173}\) Art. 3 I (1) (ii) Holding-Provisions.

\(^{174}\) Art. 3 I (2) Holding-Provisions.

\(^{175}\) Given that on October 20, 2006, the exchange rate US$/RMB was: 1 US$ = 7.9026 Rmb (Source: World

Bank), it seems that the PRC-government expects the foreign partner to be financially far stronger than its

Chinese Partner. An awkward situation, considering that in an EJV the Chinese partner is given preferential

positions by the law with respect to corporate governance issues. Additionally, this provision is a fine example of

the Chinese government’s attempts to channel foreign currency into the country.

\(^{176}\) Art. 7 Holding-Provisions.

\(^{177}\) Art. 7 Holding-Provisions; SC (Approval)/MOFTEC and SAIC (promulgation), Supplementary Provisions to

the Several Provisions on Capital Contributions by the Parties to Chinese-Foreign Equity Joint Ventures,

9; Pitman, Legal System, 2001, p. 121.

\(^{178}\) Art.’s 5, 6 I no. (5) Holding-Provisions.


particular example on the individual understanding of piercing the corporate veil, as expressed by the Chinese

State, compare Art. 4 III of the 1993-version of The CL, where the law provides that “the ownership of State-

owned assets in a company shall vest in the State.” Howson comments this stipulation as “nonsense, as a
corporation’s assets should belong to the corporation…” See Howson, Company Law, 1997, p. 142.
Art. 8 Holding-Provisions stipulates the use of the registered capital. Accordingly, at least US$ 30m of the registered capital is to be used in one, or in the combination of two or more, of the following four ways. Firstly, it can be used as capital contributions to established new FIEs. The second possibility would be to use it as contribution to, or increase in the capital of FIEs already invested in and established, either by the CHHC’s parent company or its affiliate(s), where the registered capital has not yet been fully paid up. Furthermore, one could facilitate it as investments in R&D-centers, or fourthly, use it for the purchase of a third party equity interests in the PRC. Ultimately, this means that potentially the CHHC may use its entire registered capital to establish other FIEs, to meet unpaid registered capital obligations, or to increase the registered capital of FIEs.

The Holding-Provisions further provide thin-capitalization rules as also shown in Table 2. With a registered capital of not less than US$ 30m, the maximum amount of loans taken out by the respective CHHC may not exceed four times the paid up registered capital. This ratio may rise to six times its paid up registered capital in cases, where the registered capital is not less than US$ 100m. Individually, in cases of certain business requirements, higher ratios can be applied for with the Ministry of Commerce.\footnote{Art. 9 Holding-Provisions.}

<table>
<thead>
<tr>
<th>total investment (US$)</th>
<th>reg. capital/total investment</th>
<th>minimum registered capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>≥ 30m</td>
<td>¼</td>
<td>30m</td>
</tr>
<tr>
<td>≥ 100m</td>
<td>1/6</td>
<td>100m</td>
</tr>
</tbody>
</table>

\textit{Table 2: China-Holding Capitalization Ratios}\footnote{Self-prepared table.}

Given these strict capitalization rules, the establishment of a China-Holding suggests to be reserved for capital rich foreign investors, mainly MNCs.

\textbf{f. The Scope of Business}

An important issue for MNCs assessing the establishment of a China-Holding certainly represents the fact that the PRC-government has issued very strict rules governing the scope of business of a FIE, i.e. of the CHHC. The foreign parent company of a CHHC will want to make sure that its Chinese top-entity is allowed to engage in all fields of businesses deemed important to justify its establishment and to indicate the possible tax facts it may realize upon its establishment. For this reason, Art.’s 10, 13, 14, and 15 Holding-Provisions provide a

\footnote{Art. 9 Holding-Provisions.}
\footnote{Self-prepared table.}
detailed catalogue of businesses a CHHC may engage in. Worthwhile noting, e.g., is that, as per the law, a CHHC may provide certain (limited) services to its subsidiaries, including, amongst others, balancing foreign exchange among its subsidiaries\(^{182}\), and the assistance in raising loans\(^{183}\), i.e. carry out central treasury functions via group finance company subsidiaries.\(^{184}\) However, in reality the thresholds for procuring treasury functions are prohibitively high.\(^{185}\) Subject to the approval of the China Banking Regulatory Commission, it may further provide financial support\(^{186}\), act as a sponsor for FIE-CLS-subsidiaries, or hold unlisted shares of FIE-CLS-subsidiaries or of other Chinese CLS\(^{187}\). Furthermore, once the registered capital has been paid in and used the ways stipulated by Art. 8 Holding-Provisions, the CHHC may additionally, in accordance with its actual business requirements and with the relevant provisions, e.g., act as a distributor for the products produced by its subsidiaries\(^{188}\), purchase and sell-on products of its subsidiaries\(^{189}\) and sell products imported from its parent company\(^{190}\), as well as participate in contracting foreign projects of Chinese enterprises\(^{191}\).

CHHCs that have been recognized as the regional headquarters of a MNC may in addition, e.g., engage in the import and sale of products of MNCs and their controlled affiliates\(^{192}\), establish in accordance with China Banking Regulatory Commission approval finance companies to provide relevant finance services for the entire China-Holding.\(^{193}\) Moreover, they may engage in overseas project contracting, overseas investment, and establishing lease-financing companies to provide related services\(^{194}\), spanning the fields of activity for a China-Holding significantly and making it a viable option as a regional headquarter, even beyond the borders of the PRC. Although, Art. 27 Holding-Provisions marks one decisive limitation, prohibiting the CHHC’s direct engagement in production activities, it can be stated that the CHHC is, within the framework of the Chinese legislation, allowed to engage in various free

\(^{182}\) Art. 10 I no. (2) (ii) Holding-Provisions; Art. Art.’s 1, 7, 11 Holding-Provisions Amendment.

\(^{183}\) Art. 10 I no. (2) (iv) Holding-Provisions; Art. 9 Holding-Provisions Amendment.

\(^{184}\) CBRC, July 27, 2004; ad “group finance companies” compare also Harner, Group Finance Companies, 2004, pp. 35 et seq.

\(^{185}\) Compare Corne, Swansong, 2003, p. 18; Süss, Gründung, 1996, p. 5.

\(^{186}\) Art. 13 Holding-Provisions. What exactly is meant by the phrase ‘provide financial support’ and if it includes the issuance of loans from the China-Holding to a subsidiary-FIE is not clear. However, this will be a major research issue, when discussing the tax-relevant aspects of the financing of the China-Holding and will be discussed in detail in the respective chapters.

\(^{187}\) Art. 14 Holding-Provisions.

\(^{188}\) Art. 15 no. I (1) (i) Holding-Provisions.

\(^{189}\) Art. 15 I no. (3) Holding-Provisions.

\(^{190}\) Art. 15 no. (9) Holding-Provisions.

\(^{191}\) Art. 15 no. (8), Holding-Provisions.

\(^{192}\) Art. 22 I no. (2) (ii) Holding-Provisions; Art. 10 Holding-Provisions Amendment.

\(^{193}\) Art. 22 I no. (2) (vi) Holding-Provisions; Art. 11 Holding-Provisions Amendment.

\(^{194}\) Art. 22 I no. (2) (vii) Holding-Provisions.
market transactions, thus its classification would go beyond that of a classic “management-holding”, as it is defined in chapter B.V.1.a.\textsuperscript{195}

IV. \textbf{AUSTRIA – HOLDING AND GROUP OF COMPANIES}

The variety in the facets a holding may take, has simultaneously adapted to the progress of globalization, an ever faster moving economy, to ever-shorter product life cycles, and to the complexities inherent to these ongoing changes.\textsuperscript{196} The use of the holding and its organizational molding has always been adjusted to the current circumstances by the ones wishing to use it. Holding companies, therefore, are still an important tool in the wake of economic, organizational, and strategic corporate restructurings, due to different economic and legal reasons. Changes in technological standards, in production mechanisms, in the resource equipment, and in legislation can all cause corporate restructurings. Such restructurings also include reallocations of equity interests through mergers, acquisitions and even liquidations. Holdings can be established and integrated relatively quickly and their statutes usually allow for a large degree of flexibility with regard to location, capitalization, legal form and scope of business. A general problem with the term “holding”, or “holding company”, is the fact that a binding legal definition does not exist. In Austria and Germany, e.g., a holding represents a practical organizational structure, but cannot take a particular legal form. The holding company on the contrary does take a legal form, yet it is not determined which legal form it is to take.\textsuperscript{197} It can be supported that mostly holding companies will take the form of legal persons, due to the limited liability, inherent with legal personality and the easier access to capital markets, as well as certain tax advantages. However, especially in connection with family-owned enterprises, a widespread use of non-legal person holding companies or holding companies with a mixed legal personality (e.g. in the form of the “GmbH & Co. KG” in Austria and Germany) can be witnessed.\textsuperscript{198} The decision, which legal

\textsuperscript{195} Compare also Au/Heuer/Xuan, China-Holding, 1996, p. 693.
form to use for a holding company will always be subject to the overall strategy of the MNC, as well as to the composition of its circle of shareholders.

Civil law influences tax law. Accordingly, the civil law qualification of any given fact or event can have direct tax consequences. Therefore, the identification of the civil law qualifications of both the holding company and its investments are fundamental. Taxes are levied on transactions between objects, irrespective of their legal form. These transactions are governed by the rules of civil law. Which civil law rules are to be applied, depends heavily on the legal qualification of the participants and of the transactions among them. Consequently, one could conclude the hypothesis that the civil law qualification of a holding, e.g., as a group of companies, implied certain tax consequences. Indeed, Austrian and German tax laws link certain tax consequences to the civil law existence of a group of companies, whenever a group of companies opts for the particular tax regimes offered by the respective tax laws. The Austrian “Gruppenbesteuerung” may via the term “Gruppe” (=group)\textsuperscript{199} be directly linked to civil law facts related with groups of companies. In Germany, the “Organschaft” (=fiscal unity)\textsuperscript{200} even presupposes the existence of a civil law group of companies. Actually, in the

\textsuperscript{199} Ad “Gruppe” and the “Gruppenbesteuerung”-related relevant civil law facts compare Chapter B.IV.2. below.

\textsuperscript{200} Ad “Organschaft”: The “Organschaft” is a tax-consolidation-regime marked by stringent inclusion criteria. It is still practiced, e.g., in Germany. In Germany an “Organschaft” can be set up three ways, as a corporate tax “Organschaft”, as a trade tax “Organschaft”, and as a VAT “Organschaft”. Only the conditions of the corporate tax “Organschaft”, which is primarily ruled in §§ 14-19 of the German Corporate Income Tax Code (“Körperschaftsteuergesetz”) shall be briefly outlined. The provisions provide that the income or loss of a controlled subsidiary (“Organgesellschaft”) may be attributed to a parent company (“Organträger”), once a controlling enterprise directly or indirectly holds a majority of the voting rights in the dependent enterprise and the dependent enterprise is treated as though it were a branch of the controlling enterprise’s business. Moreover it is deemed conditional that the dependent enterprise concludes a control agreement with the controlling enterprise and that the dependent enterprise is integrated into the controlling enterprise in accordance with the provisions of §§ 319 to 327 of the German Corporation Code (“Aktiengesetz”). If the above requirements are met, the entire profits and losses of the dependent enterprises may be pooled for corporate income tax purposes with those of the controlling enterprise, provided, there is a profit transfer agreement between both companies for a period of at least 5 years, as per §§ 14 to 19 German Corporate Income Tax. Additionally conditional for such a tax-consolidation is the existence of a profit pooling agreement between the dependent and the controlling enterprise in accordance with § 14 I s. 1 German Corporation Code (“Aktiengesetz”). Usually, the “Organschaft” is limited to domestic companies. However, theoretically the inclusion of foreign fiscal unit member enterprises would be possible, if the provisions of the German law were satisfied. This could only be the case, if the foreign law, the foreign fiscal unit member enterprise had to obey to, would provide similar provisions for a profit pooling agreement as provided for in Germany. Moreover, § 14 I s. 1 no. 2 s. 2 German Corporate Income Tax Code, in connection with a decree of the German Ministry of Finance (hereinafter “GMF”) and the legal practice of the German Federal Tax Court, rules that a holding can only simultaneously qualify as a fiscal unit, if the top entity pursued its own trade or business. The mere ownership and holding of investments does not qualify as a business in this sense. Hence, depending on the de facto business activities of a given holding, a holding might not qualify as an “Organschaft”. See hereto German Federal Ministry of Finance, Directive IV B 7-S 2770 – 24/05; German Federal Tax Court, January 22, 2004; German Federal Tax Court, January 23, 2002; German Federal Tax Court, April 14, 1992; German Federal Tax Court, April 11, 1990; German Federal Tax Court, August 1, 1984. Compare hereto also Bertl et al., Handbuch I, 2004, pp. 530-538; Daneling, Österreichische Gruppenbesteuerung, 2005, pp. 1342 et seq.; Dötsch, Organschaft, 2005, pp. 695 et seq.; Gahleitner/Furherr, Gruppenbesteuerung, 2005, p. 130; Gassner, Europarechtswidrigkeit, 2004, pp. 841-844; Gassner/Lang/Wiesner,
cases of the Austrian “Gruppenbesteuerung” and the German “Organschaft” one could find that tax law influences civil law, too and not only vice versa, as stated above. By opting for one of these group-relief regimes the designated members might for the first time fulfill the conditions of a group of companies. However, ultimately, the tax and civil law consequences do not change.\footnote{201}{Notwithstanding the aforementioned, the commercially consolidated accounting income of the group of companies has no tax significance, as it does not become the tax base of a group of companies.\footnote{202}}

In the German speaking legal literature, there has been a comprehensive discussion, whether a holding generally fulfills the criteria of simultaneously qualifying as a group of companies.\footnote{203}{A group of companies is generally defined as the combination of two or more legally independent enterprises under the uniform control of the top entity.\footnote{204}{Eventually, the finding that a holding company, also qualifies as a group of companies can have further legal consequences for its designated members, e.g., with regard to labor law, joint-management, accounting, and auditing issues.\footnote{205}{Legally, a group of companies can be defined from a corporation law point of view, as well as from a commercial law, i.e. accounting law point of view. As this thesis focusses on the taxation of holding companies, a lengthy discussion of the various legal definitions of the term “group of companies” can be neglected. For the purposes of this work it is deemed sufficient that the organizational entity considered, the holding, would qualify for any available existing group-relief regime, i.e. in Austria the “Gruppenbesteuerung”. The fact that a group in the sense of the “Gruppenbesteuerung”, ultimately, could satisfy the conditions precedent for the existence of a group of companies proves irrelevant for the further discussion of the present topic, the taxation of holding companies.}}

\begin{itemize}
  \item See Lutter, Begriff, 2004, p. 18; apparently the legal practice in the field of group law has been more active in Germany than in Austria, which is why the statements given above mostly refer to German legal practice and literature.
\end{itemize}
V. SUMMARY OF FINDINGS

The previous remarks show that the definitions available to the term “holding company” are manifold. For the purposes of this research, however, it is essential to focus on a particular type of holding company. The review of the Austrian tax laws and its “Gruppenbesteuerung” shall guide the study of the taxation of the China-Holding and the conclusion of available and applicable tax planning strategies.

The foreign investor assessing to invest within the PRC is offered several investment alternatives. Foreign investment in the PRC can either be conducted by a FE or an FIE. A FE is an entity formed outside the PRC under non-Chinese rules of law, which carries out business activities in the PRC without forming a particular legal form as defined by Chinese law, as, e.g., the operation of mere branches or establishments. Contrary thereto, a FIE is a specific Chinese legal form. FIEs can be established either as CJVs, EJVs, or WFOEs and usually take legal personality either as a LLC or a CLS. In order to qualify as a FIE, the combined foreign investment into such an entity needs to be at least 25% of registered capital and has to be made up by at least 80% cash contributions and not more than 20% contributions in kind.206 The China-Holding’s civil law aspects are ruled by the “Holding-Provisions” and its respective amendments. As per Art. 2 Holding-Provisions the CHHC takes legal form by adopting the corporate forms of either a LLC or CLS and qualify as a FIE. Subsidiaries enclosed into the holding circle of the China-Holding are, as per Art. 25 Holding-Provisions, also understood to be legal persons. Notwithstanding the possibility that the China-Holding is allowed to set up branches, regional offices, research and development centers or may operate as a MNC’s regional headquarter. Financially, the foreign share of financial affiliation in the CHHC’s subsidiaries may not surpass 25%. However, such 25%-threshold is understood in a cumulative way, meaning that the combined equity interests of foreign investors in a subsidiary may not be less than 25% with the CHHC’s direct financial share not being less than 10%.

In general, the condition to establish a China-Holding is the extensive filing of an application to receive a business license and the sufficient capitalization of the CHHC. The foreign investor intending to set up a China-Holding needs to be of what the law describes as “good creditworthiness”. Additionally, he needs to have an asset value of not less than US$ 400m

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206 Notwithstanding the possibility that under certain applied for circumstances the contribution-in-kind-ratio may rise to 70% if such contributions in kind are particularly progressive technologies or of other particular development interest for the PRC.
and FIEs set up in the PRC already with a combined capital contribution of not less than US$ 30m. The individually registered capital required to set up a CHHC is US$ 30m and has to be paid in particular instalments. The CHHC’s foreign parent company has to guarantee to the competent authorities the payment of the registered capital of both the CHHC, as well as its subsidiaries. The registered capital of the CHHC may, e.g., be used to establish new FIEs, increase the registered capital of already existing FIEs, establish and invest in research and development centers, and to purchase new investments. The overall financing capacity of the China-Holding is bound to particular thin capitalization rules, as per which, the maximum debt-to-equity ratio for China-Holdings capitalized with less than US$ 100m in equity is four to one (4-1). Such ratio is allowed to be increased to six to one (6-1) for all China-Holdings with an equity capitalization in excess of US$ 100m.

The scope of business, a China-Holding may engage in is also ruled by the Holding-Provisions. It is assumed that the CHHC actively manages its investments in the PRC and renders services such as the assistance with financing, central treasury functions, product distribution, import and sales of products and project contracting. To maximize its scope of business the CHHC is assumed to function as a regional headquarter.

In accordance with the legal conditions and the scope of business activities permitted by the Chinese law, the author concludes that the CHHC can be defined as an incorporated management holding company. The civil-law definition as a corporation determines firstly, the kind of taxes applicable and secondly the articles and sections within the respective tax laws and provisions that need to be closely examined. Moreover, usually the subsidiaries of a holding company take the same legal form as the holding company itself, in order to grant the possibility of parallel organizational structures, the efficient realization of management strategies via uniform leadership and coordination instruments.

In accordance thereto, this research limits the type of holding companies reviewed within the framework of the Austrian tax laws to incorporated bodies, precisely corporations, too. Reading § 9 aKStG makes it even more reasonable to limit the scope of possible holding

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companies to corporations as the provision solely refers to incorporated bodies. Therefore, the Austrian holding company, like the CHHC, within this study is defined as a management holding established in the legal form of a corporation. The ongoing study, therefore, focuses exclusively on incorporated management holdings.

The civil law findings and definitions of Chapter B, as well as the fact that the examination of the CHHC is supposed to include aspects of international taxation, and that the effects of potential tax planning strategies will be supported by an index figure, as proposed in Figure 1, suggests, that this work presumes the existence of an exemplatory MNC-group-of-companies. For the ongoing and subsequent research, it is assumed that such exemplary MNC-group-of-companies exists in the form of a holding. The author suggests, that as an underlying example, the top-entity, the top holding company, maintains its registered offices in Austria. It shall form a group in the sense of § 9 aKStG with eligible subsidiaries, and has established a CHHC, as an intermediary management holding company, to manage its various Chinese investments.

209 The condition that a holding intends to fall under the provisions of the “Gruppenbesteuerung” is presumed. Notwithstanding the fact that in reality there also exist natural-person holdings. However, these are not being considered within this study.
C. HOLDING TAXATION IN AUSTRIA

Lately, Austria has introduced several new regulations, which directly affect the taxation of holding companies. These new regulations especially include the “Gruppenbesteuerung” of § 9 aKStG\textsuperscript{210}, § 11 I no. 4 aKStG\textsuperscript{211} that rules the tax deductibility of such interest that is directly attributable financing cost resulting from the acquisition of investments, and § 10 II, III, IV aKStG\textsuperscript{212} covering the international participation exemption. However, the Austrian laws do not provide a homogenous piece of legislation that governs all aspects of the taxation of a holding. The present context generally suggests the applicability of the “Gruppenbesteuerung”, i.e. the holding company does qualify as a group parent, while its subsidiaries do qualify as group members. As has been laid out above, the establishment of holdings economically goes hand in hand with the target to increase the efficiency in entrepreneurial processes and organizational structures. Additionally, this tax regime with its broadened consolidation and loss transfer possibilities as well as the inclusion of cross-border investments and losses potentially enhance the profitability of financing activities. Thus, the “homo oeconomicus” would not neglect the provisions of the “Gruppenbesteuerung” as long as the operative facts of § 9 aKStG are satisfied. Yet nonetheless, the fact that not necessarily all investments and subsidiaries qualify as group members shall not be left unnoticed and also find recognition.

I. THE STATUTORY FRAMEWORK

It has been concluded that within this thesis, both the holding company and its subsidiaries take the form of a corporation.\textsuperscript{213} The Austrian tax law does not explicitly provide specific provisions that explicitly state the terms “holding” or “holding company”, but with § 9 aKStG, the “Gruppenbesteuerung”, it includes a set of provisions that cover holding-relevant tax law facts and events. However, the “Gruppenbesteuerung”, similar to the German “Organschaft”, does not represent a fully consistent statutory framework governing all fields of the taxation of holding companies. Rather, there are several tax provisions that are governed in different tax laws or different provisions of the same tax law, the aKStG. Together they provide the basic statutory framework that needs to be considered, when one

\textsuperscript{210} See Austrian Federal Gazette, I 2004/57.
\textsuperscript{211} See Austrian Federal Gazette, I 2004/57.
\textsuperscript{213} Compare chapter B.VI.
examines the taxation of an Austrian holding. A general distinction is to be made between unilateral and bilateral provisions. Unilateral provisions are solely drafted and promulgated by the Austrian government. Whereas, bilateral provisions are drafted and promulgated together with at least one further non-Austrian sovereign government, usually, in accordance with internationally accepted model conventions.

The unilateral Austrian tax provisions governing the taxation of holding companies are manifold. Firstly, the fact that only corporations are being reviewed, suggests that the aKStG is the primary source of reference. Above all, it is § 9 aKStG that contains the provisions governing the “Gruppenbesteuerung”. Further generally important corporate-tax provisions in this context include, among others\(^\text{214}\), § 1 aKStG that covers tax liability, § 7 aKStG that explains the tax base, and § 8 aKStG governing rules for capital contributions and withdrawals, as well as the appropriation of income. § 10 aKStG, besides ruling the taxation of domestic dividends and further tax exemptions, sets forth the provisions of the international participation exemption, while §§ 11 and 12 aKStG provide the rules for deductible and non-deductible expenses.

Secondly, the aKStG refers in several provisions to the aEStG\(^\text{215}\), especially when it comes to the computation of the tax base and the particular tax treatment of certain facts and events. Important, e.g., are, § 2 aEStG that defines the different sources of income, §§ 4 and 5 aEStG, which contain provisions for the computation of profit, and §§ 6, 7, and 8 aEStG that individually cover different aspects of the valuation of assets and their respective tax considerations. §§ 9 to 14 aEStG rule several other aspects influencing the computation of profits. Finally, §§ 98 to 102 aEStG provide guidance with regard to the taxation of limited tax liable tax subjects. The levy of corporate and individual income tax is generally executed in the form of a tax assessment resulting from the respective tax returns issued by the taxpayer. However, the Austrian tax law contains a specialty with regard to withholding tax. Besides the tax on wages, that can be neglected in this context, one has to potentially consider withholding taxes in connection with capital yields realized by limited tax liable tax entities. Such capital yields might be subject to withholding tax levied in accordance with §§ 93 to 97 aEStG.\(^\text{216}\) In addition to the laws mentioned, the respective government directives

\(^{214}\) Such listings are not complete and are solely meant to deliver a brief overview on the most important provisions.

\(^{215}\) E.g., § 1 II s. 2, § 7 II, and § 9 III scale line 6 aKStG.

have to be considered, especially, the Austrian Ministry of Finance’s group directive governing the “Gruppenbesteuerung”\textsuperscript{217}. Moreover, the provisions provided by the international tax law have to be closely reviewed. Especially, such tax law norms, which cover the avoidance of the double taxation of dividends and other profit transfers from abroad, gain importance. This framework, aimed at the avoidance of double taxation, contains, next to the national provisions, multiple double taxation treaties signed by the Austrian government.\textsuperscript{218} The present study refers in particular to the Austrian-Chinese double taxation treaty (hereinafter “ACDTT”), but not without referring to the OECD Model Tax Convention (hereinafter “OECD-MC”), when necessary.

II. \textbf{THE TAXABLE ENTITY}

The determination which subject qualifies as the taxable entity implies crucial tax impacts. Thus, the identification of the taxable entity determines which tax laws and provisions have to be applied and, hence, constitute the ultimate tax consequences. These tax consequences cover such important categories as the tax rate, the determination and computation of the object of taxation, and the qualification of particular individual tax facts and events that in turn again determine the computation of the object of taxation. It has been said, that this study covers Austrian holding companies taking the form of corporations. Assumingly, they further shall satisfy the criteria to qualify as a group, in the sense of the “Gruppenbesteuerung”. More specifically, therefore, only incorporated holding companies and their incorporated subsidiaries, i.e. group parents and their group members are covered. A holding, the organizational entirety, cannot take a legal form itself. Distinguishing between corporations and non-incorporated legal forms does make a major difference with regard to the taxation of the respective subject under review.

It is an internationally accepted legal principle that corporations, contrary to partnerships, are treated as an independent subject of law. This legal independence of corporations results in a separation of the enterprise, as an own legal subject, from its shareholders; something the German legal language calls the “separation principle” (“Trennungsprinzip”). The Austrian tax law follows this principle and qualifies corporations as individual subjects of taxation, and, thus, implies that consensual relations between the corporation and its shareholders are

\textsuperscript{218} Currently Austria has signed double taxation treaties with 68 nations around the world. Compare Doralt, Doppelbesteuerungsabkommen, 2005.
principally legally acknowledged. The corporation’s income is taxed independently of that of its shareholders. Consequently, the taxation ultimately encroaches on both levels, firstly, at the level of the corporation and, secondly, once the corporation distributes profit (capital) at the level of the shareholder. Accordingly, a corporation can gain a temporary shielding function for its shareholders.

Being of legal personality, the tax liability of Austrian holding companies and their investments and subsidiaries is ruled by § 1 aKStG. § 1 aKStG distinguishes between unlimited tax liability and limited tax liability. Domestic group parents or group members are unlimited corporate tax liable, when they take the form of one of the incorporated bodies listed in § 1 II aKStG, and maintain their place of effective management or registered office in Austria. § 1 II no. 2 aKStG lists particular civil law legal persons as qualifying unlimited tax liable incorporated bodies. Hence, the tax events are satisfied and Austrian holding companies and their subsidiaries constitute unlimited tax liability in Austria according to § 1 I, II aKStG.

A corporation’s independent legal personality furthermore, could found a treaty entitlement that enables the corporation to benefit directly of double taxation avoidance provisions set forth in double taxation treaties. According to Art. 1 ACDTT that is based on the OECD-MC, “persons who are residents” are eligible to such treaty entitlement. To judge, whether Austrian corporations are eligible to such treaty entitlement, both events have to be satisfied, i.e. corporations must be resident persons in the sense of these provisions. Do the Austrian corporation forms “Gesellschaft mit beschränkter Haftung” (hereinafter “GmbH”) and “Aktiengesellschaft” (hereinafter “AG”) qualify as “resident person”?

Subject to Art. 1 and Art. 3 no. 1 l. (e) ACDTT and Art. 1 and Art. 3 no. 1 l. (a) OECD-MC the “term “person” includes an individual, a company, and any other body of person.” The Austrian forms of corporations could qualify as what the provisions call a “company”. Letters (f) or (b) of the

221 Definitions for “effective place of management” and for “registered seat” can be found at § 27 Bundesabgabenordnung. Also compare Bauer/Quantschnigg/Schellmann/Werilly, KStG 1988, §1, p. 5; Loukota, Außensteuerrecht, 2002, pp. 45 et seq.; Philipp/Loukota/Jirousek, Internationales Steuerrecht, 2005, Z00, pp. 2/3, 2/11 et seq. For a discussion of the “place of management” within the double tax treaty context compare, e.g., Loukota, Geschäftsleitungsort, 2004, pp. 261 et seq.
respective provisions further stipulate “the term company means any body corporate or any entity, which is treated as a body corporate for tax purposes.”\(^{224}\) For the interpretation of the term “company”, the treaties refer to the respective national tax laws of the treaty-applying contracting state.\(^{225}\) Hence, a legal person, from a treaty point of view, is only to be treated as such, if in the national tax law of the treaty-applying state such entity has the legal status of being a tax subject.\(^{226}\) The residency criterion for legal persons is ruled in Art. 4 III ACDTT and Art. 4 III OECD-MC, corresponding to which a “resident person” is a person, here a company, above defined as Austrian corporation, that, subject to the treaty-applying state, is tax liable in such state because it maintains its “place of effective management”\(^{227}\) there. The Austrian holding companies and their subsidiaries reviewed in this thesis are unlimited tax liable in Austria as per § 1 aKStG. This simultaneously implies that they satisfy the criteria set forth in Art. 4 ACDTT and Art. 4 OECD-MC.\(^{228}\)

Hence, as per § 1 I and § 1 II No. 1 and II s. 3 aKStG the reviewed Austrian holding company in its function as a possible group parent and its subsidiaries in their respective function as group members are qualified as unlimited tax liable corporations in Austria. Due to this qualification, they simultaneously also satisfy the criteria set forth in Art. 3 no. 1 l. (f) ACDTT and in Art. 3 I l. (b) OECD-MC and consequently are to be seen as taxable entities in view of international double taxation treaties, as well.

\(^{224}\) The term used throughout this study for what the ACDTT and the OECD-MC calls “body corporate” is “legal person”. Also compare Philipp/Loukota/Jirousek, Internationales Steuerrecht, 2005, Z3, pp. 67 et seq.

\(^{225}\) Art. 3 II ACDTT; Art. 3 II OECD-MC. Compare Philipp/Loukota/Jirousek, Internationales Steuerrecht, 2005, Z0, pp. 38/11 et seq.


\(^{227}\) The OECD-MC distinguishes between what in Art. 4 I it calls “place of management” and “place of effective management” as in Art. 4 III. For an explanation for this distinction see OECD, Model Tax Convention I, 2004, Art. 4, pp. C(4)1 et seq.; Philipp/Loukota/Jirousek, Internationales Steuerrecht, 2005, Z4, pp. 73 et seq., 80 et seq.; Wassermeyer/Lang/Schuch, Doppelbesteuerung, 2004, Art. 4, p. 270.

III. **TAXABLE INCOME**

1. **The Computation of Taxable Income**

After having concluded, which statutory framework applies to the identified subjects of taxation, this chapter provides an overview on the object of taxation and on its computation methods. The primary legal source to identify the object of taxation of corporations in Austria is § 7 aKStG. According to § 7 I aKStG corporate income tax is levied on the “income” the unlimited tax liable taxpayer has generated within a calendar year. Thus, “income” is qualified as the object of taxation. “Income” is the sum of all kinds of income, as listed in § 2 III aEStG, the taxpayer has generated in a given year after the respective income tax law and corporate tax law adjustments provided by the law have been applied. With reference to the aEStG, theoretically, a corporate taxpayer can have all kinds of income, however, in the given context, where only corporations are being reviewed, § 7 III aKStG provides an exception. According to this provision, taxpayers, that, due to their legal form, are obliged to maintain commercial accounting, generally, only receive business income. As per §§ 6, and 189 et seq. aHGB in connection with §§ 23 et seq. Austrian Limited Liability Company Code (“Gesetz über Gesellschaften mit beschränkter Haftung”) and §§ 129 et seq. Austrian Corporation Code (“Aktiengesetz”), respectively, both legal forms, the GmbH and the AG are legally obliged to maintain accounting books and records. Hence, in accordance with § 7 III aKStG, corporations generate only realize business income.

Austrian tax law generally distinguishes between “surplus-income” (“Überschußeinkünfte”) and “profit-income” (“Gewinneinkünfte”). Business income is allocated to the category of “profit-income”. Business income is determined as profit. As per § 7 II aKStG the determination of such a profit follows the rules set forth in the aEStG. The holding company and its subsidiaries, falling under the provisions of § 7 III aKStG, compute their profits by

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229 As one can see the Austrian corporate tax is levied for one calendar year. It is suggested that the taxable entities’ fiscal years resemble the calendar year (§ 7 IV aKStG). However, the law provides exemptions for tax entities that have the legal duty to keep books and records (§ 7 V aKStG) that their fiscal year may vary from the calendar year. Compare also Bertl et al., Handbuch I, 2004, p. 502.

230 § 7 II aKStG.


way of balance sheet accounting in accordance with § 5 I aEStG. An excerpt of the basic commercial financial statement classification as provided in § 224 aHGB is displayed in Figure 8.

<table>
<thead>
<tr>
<th>Financial Statement</th>
<th>EQUITY AND LIABILITIES</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ASSETS</strong></td>
<td><strong>A. Equity</strong></td>
</tr>
<tr>
<td><strong>A. Fixed assets</strong></td>
<td>I. Subscribed capital</td>
</tr>
<tr>
<td>I. Intangible assets</td>
<td>II. Capital reserves</td>
</tr>
<tr>
<td>1. Concessions, industrial property and similar rights and assets, and licenses in such rights and assets</td>
<td>III. Earnings reserves</td>
</tr>
<tr>
<td>2. Goodwill</td>
<td>IV. Unappropriated retained earnings brought forward/Cumulative losses brought forward</td>
</tr>
<tr>
<td>...</td>
<td>V. Net income for the year/Net loss for the year</td>
</tr>
<tr>
<td><strong>II. Tangible assets</strong></td>
<td>B. Untaxed reserves</td>
</tr>
<tr>
<td><strong>III. Financial assets</strong></td>
<td>C. Provisions</td>
</tr>
<tr>
<td>1. Shares in affiliated companies</td>
<td>I. Provisions for pensions and similar obligations</td>
</tr>
<tr>
<td>2. Loans to affiliated companies</td>
<td>...</td>
</tr>
<tr>
<td>3. Participating interests</td>
<td>D. Liabilities</td>
</tr>
<tr>
<td>4. Loans to participating interests</td>
<td>...</td>
</tr>
<tr>
<td><strong>B. Current assets</strong></td>
<td>...</td>
</tr>
<tr>
<td>I. Inventories</td>
<td>* Liabilities to affiliated companies</td>
</tr>
<tr>
<td>...</td>
<td>* Liabilities to companies in which the company has a participating interest</td>
</tr>
<tr>
<td>2. Receivables from affiliated companies</td>
<td>...</td>
</tr>
<tr>
<td>3. Receivables from companies in which the company has a participating interest</td>
<td>E. Deferred Income</td>
</tr>
<tr>
<td>...</td>
<td></td>
</tr>
<tr>
<td><strong>III. Securities</strong></td>
<td></td>
</tr>
<tr>
<td>1. Shares in affiliated companies</td>
<td></td>
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<tr>
<td>...</td>
<td></td>
</tr>
<tr>
<td>IV. Checks, cash on hand, central bank and postal giro balances, bank balances</td>
<td></td>
</tr>
<tr>
<td><strong>C. Prepaid expenses and deferred charges</strong></td>
<td></td>
</tr>
</tbody>
</table>

**Figure 8:** Financial Statement Scheme as per § 224 aHGB

Essentially, the determination of profit originates in commercial accounting, § 5 I s. 1 aEStG (so-called “Maßgeblichkeitsprinzip”; hereinafter “authoritative principle”). The process to compute the tax base, being the taxable income, therefore, has its origin in the commercial

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234 According to EC Decree 1606/2002 groups of companies have to file consolidated financial statements in accordance with the IAS/IFRS for business years commencing on or after January 1, 2005, if they have their seat in one of the EU member states and have securities, i.e. shares and/or notes, listed on an exchange. Groups of companies that do not have securities listed on such exchanges are free to opt to either prepare their consolidated financial statements in accordance with the IAS/IFRS or with their respective national commercial provisions. In Austria and Germany the EC Decree 1606/2002 was anticipated by the introduction of §245a aHGB and §292a German Commercial Code, respectively. As per Art. 5 EC Decree 1606/2002 it lies in the discretion of the EU member states. Austria and Germany voted for this option and individual statements are still to be prepared in accordance with the respective national commercial provisions contained in the aHGB and in the German Commercial Code, respectively. With respect to taxation such partly introduction of IAS/IFRS is irrelevant for the moment as a) the consolidated financial statements have no tax consequences and b) the IAS/IFRS are not authoritative for the computation of the tax base in Austria and Germany. Compare hereto, e.g., Bertl, Maßgeblichkeitsprinzip, 2003, pp. 122 et seq.; Grünberger, IAS/IFRS 2006, 2006, pp. 17 et seq.; Heuser/Theile, IAS Handbuch, 2003, pp. 12 et seq.

financial statement income. Subsequently, the commercial financial statement needs to be matched in accordance with several provisions set forth in the aKStG and in the aEStG, in order to derive the tax financial statement income, as a first step in computing taxable income. In order to compute taxable income, the tax financial statement income needs to be further adjusted through modifications as stipulated in the aKStG and aEStG.

These provisions, for instance, rule limitations and suppressions of the authoritative principle, tax-exempt income, non-deductible expenses, and further particular tax-relevant rulings. Taxable income, hence, equals the tax base of corporations. The tax rate is applied on the tax base to determine the actual corporate tax burden. The corporate tax rate in Austria currently is 25%. Additionally unlimited tax liable corporations have to pay a minimum tax of 5% of a quarter of the demanded minimum amount of legal registered capital. The process of computing taxable income is illustrated in a simplified manner in Figure 9.

![Figure 9: Computation and Taxation of Taxable Income](image)

The present concept of taxable income of a corporation refers to the profit of the taxable entity. As per § 7 III aKStG and § 5 I aEStG, the holding company and its subsidiaries compute their respective profits by way of balance sheet accounting.

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236 § 22 I aKStG.
237 § 24 IV aKStG.
Such balance sheet accounting is based on a particular understanding of “business expense” on the one hand and “business income” on the other. Their input on the computation of taxable income is immediate, the former decreasing taxable income and the latter increasing taxable income.\(^{239}\) The terms “business expense” and “business income” are contingent with the existence of a) a business and b) business property. The latter being the property sphere used in order to generate business income. “Business” is defined in § 23 no. 1 aEStG as “the independent, sustainable activity that is undertaken with a profit motivation and represents itself as participation in the general economic exchange.” The holding company and its subsidiaries each qualify as such a business.\(^{240}\)

Generally, in connection with the income computation as per § 5 aEStG, Austrian tax law distinguishes between two property spheres, private property, and business property. Subject to the concrete circumstances and provisions in question, business property can be further distinguished into “necessary business property” and “testamentary business property” (“gewillkürtes Betriebsvermögen”). Necessary business property covers all such assets that from an objective point of view are appropriate to generate business income and are actually used to generate business income. Testamentary business property is assets, which on the one hand are not necessary business property, but on the other hand do not qualify as private property. Contrary to business property, private property covers assets that due to their characteristics and use do not serve the generation of taxable income.\(^{241}\)

Due to the terminology of § 7 III aKStG in connection with the authoritative principle of § 5 I aEStG, necessary as well as testamentary business property are commonly treated as necessary business property. However, the commercial accounting peremptorily covers all sorts of assets owned by the respective corporation. Hence, the commercial accounting also includes possible private property that via the provision of § 5 I aEStG enters the taxable sphere. Yet, income attributable to such private sphere assets are not deemed taxable, thus, do not have quantitative tax effects. Therefore, it can be concluded that in order to be regarded taxable the income or expense category in questions must be attributable to the business property sphere.

\(^{239}\) Compare Doralt/Ruppe, Steuerrecht, 2003, pp. 120 et seq.; Konezny, Betriebseinnahmen, 2005, p. 131.

\(^{240}\) Compare Tipke/Lang, Steuerrecht, 2002, p. 270.

\(^{241}\) Compare Bauer/Quantschnigg/Schellmann/Werilly, KStG 1988, 2005, §8, pp. 13 et seq.; within the German context compare, e.g., Tipke/Lang, Steuerrecht, 2002, pp. 269 et seq., 320 et seq.
2. **Capital Contributions and Reductions**

As per § 8 I aKStG equity contributions and constructive equity contributions, performed by shareholders, i.e. contributions that are made due to a company law affiliation between a shareholder and a corporation, are not included into the computation of income. Conditional for the recognition as an equity contribution, in the sense of § 8 I aKStG, is a transfer from the shareholder’s property into the corporation’s property. The tax neutrality of the contribution is granted by the fact that the corporation’s increase in property is not caused by a taxable event, but only by the shareholder’s equity interest in the corporation’s capital. As equity contributions regularly qualify, e.g., contributions to the initial nominal capital or to increases in nominal capital, as well as contributions in kind, which are paid in to receive equity interests in the corporation in return.

Contrary to the open contribution of equity against the receipt of equity interests, there exist constructive equity contributions. Constructive equity contributions are grants that are given by the shareholder subject to the company law affiliation, but do not qualify as open contributions of equity and would not have been provided in the same way by an independent third party. Such grants may cover cash-grants or tangible and intangible assets contributed to the respective enterprise without clear consideration. From a tax point of view, taxable income has to be adjusted by way of an out-of-balance-sheet calculation. An amount equal to the monetary advantage gained by the corporations through the constructive contribution is reported as an adequate consideration, i.e. expense. In accordance thereto, the accounting of an expense by the enterprise causes an increase in the investment value on the side of the shareholder. Such rise in investment value shall equal the consideration for the grant of the respective item.

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243 Contributions in kind are regularly considered as an acquisition by way of exchange as long as they do not fall within the framework of the Reorganization Tax Code. The tax neutrality is ruled as per §6 no. 14 aEStG, according to which the contribution in kind and the corresponding issued shares are both to be valued either at the fair market value of the asset underlying the contribution in kind or at such issued shares’ fair market value. Compare hereto Bauer/Quantschnigg/Schellmann/Werilly, KStG 1988, 2005, §8, pp. 5 et seq.; Doralt, KStG-RK, 2005, §8, pp. 179 et seq.


The reduction of share capital is to be viewed as the legal counterpart to an equity contribution. In cases of the reduction of share capital, a corporation retransfers property to its shareholders. However, such retransfer is not based on a tax-effective distribution of income, but on the company law affiliation between the corporation and its shareholder. Hence, §4 XII aEStG sets forth that reductions in the share capital of corporations are tax neutral. At the level of the corporation, the disposal of liquidity is neutralized by a reduction of the reported equity. Whereas, the reduction of share capital from the shareholder’s point of view is to be regarded as a sale of an investment, which causes a simultaneous increase and decrease on the asset side of the shareholder’s financial statement. Yet, such tax neutrality is lost, once the payment for the reduction of share capital increases the carrying amount of such share capital. In such a case, the shareholder consequently realizes a taxable capital gain.246

3. The Utilization of Income

Income can be utilized in several ways. This thesis is based on the assumption that both, the holding company, as well as its subsidiaries are corporations computing taxable income in accordance with § 7 III aKStG and § 5 aEStG. Hence, the utilization of income is subject to commercial, company law and tax law provisions.

For the computation of income, the utilization of such income is irrelevant. A distribution of income due to a corporation’s articles of association, such as the open distribution of profits, i.e. dividends, or by way of constructive dividends does not influence taxable income.247 Open distribution of income such as the allocation of dividends by domestic corporations to other domestic corporations are tax exempt, provided that the event of § 10 I aKStG is fulfilled.248 Notwithstanding, their tax neutrality as per § 8 II aKStG, the open distribution of income is to be distinguished from constructive dividends. Legal practice and literature has defined constructive dividends to be all kinds of monetary-equal grants from a corporation to its shareholder(s) that a) are not open income distributions, b) are subject to the company law affiliation between them, c) reduce the corporation’s income, and d) would not have been equally granted to someone not company law affiliated with the corporation.249 Thus, constructive dividends suppose the deliberate grant of a benefit to the shareholder or someone

247 See §§ I, II aKStG.
248 Compare Chapter C.V.1.b.
249 Compare Austrian Administrative Court, October 15, 1954.
close to the shareholder, as well as the actual decrease in the corporation’s assets. Typically, the decrease in a corporation’s assets is either caused by exaggerated business expenses or too little income.\textsuperscript{250} Whether such a monetary-equal grant is based upon the company law affiliation between a corporation and its shareholder and is appropriate or inappropriate is determined either at hand of an arm’s length test, or at hand of a comparison with the suggested behavior of a prudent and conscientious business manager.\textsuperscript{251} As § 8 II aKStG rules, constructive dividends are not supposed to influence the computation of income. Hence, the scope of such constructive dividends has to be tax neutralized. Exaggerated business expenses, as well as withheld income are re-allocated to the entity’s income by way of an out-of-balance-sheet computation.\textsuperscript{252} On the side of the shareholder such constructive dividends are tax-effective, if they constitute taxable income in the sense of the aEStG, but the shareholders envisaged within this thesis are themselves corporations and thus constructive dividends are subject to the tax exemption ruled in § 10 I aKStG.\textsuperscript{253}

IV. \textit{General Holding-Relevant Tax Law Provisions}

The Austrian corporate tax law has a specific regime ruling the taxation of holdings, the “\textit{Gruppenbesteuerung}” of § 9 aKStG. However, the taxpayer is free to opt for the application of the provisions of § 9 aKStG, as the filing of a group application is voluntary. Therefore, § 9 aKStG sets forth provisions ruling events that owe their tax relevance exclusively to the existence of a group as it is understood under the law. Hence, the “\textit{Gruppenbesteuerung}” defines the events that need to be fulfilled for the existence of a group and such events that are uniquely applicable to a group, e.g., the tax-effective transfer of results or the allowance for goodwill amortizations.\textsuperscript{254} § 9 aKStG operates as a “\textit{lex specialis}”. Once the option to form a group is drawn, the general provisions of the Austrian tax law, especially of the Austrian Corporate Income and Income Tax laws, step back subsidiary behind the provisions of § 9 aKStG and its particular consequences.\textsuperscript{255}

\textsuperscript{251} Compare Bauer/Quantschnigg/Schellmann/Werilly, KStG 1988, 2005, §8, pp. 42 et seq.  
\textsuperscript{252} Compare Bauer/Quantschnigg/Schellmann/Werilly, KStG 1988, 2005, §8, pp. 50 et seq.  
\textsuperscript{253} Compare Bauer/Quantschnigg/Schellmann/Werilly, KStG 1988, 2005, §8, p. 53.  
\textsuperscript{254} Compare hereto the previous chapter.  
\textsuperscript{255} Compare Stefaner/Weninger, Änderungen, 2004, p. 889.
However, the economic life of a holding includes far more business activities, expressed through tax facts and events, that reach beyond those ruled by § 9 aKStG. Therefore, an Austrian holding as an entirety must not necessarily take the form of a group, or only certain entities belonging to the holding could be integrated into or formed as a group. Ultimately, the tax events that apply to the real economic life of a holding are manifold, all triggering tax consequences that have an immediate tax and economic impact on the entire holding. The range of such operative facts covers multiple issues relating, among others, yet most importantly, general tax aspects associated with income, expenses, and, for instance, matters related to the valuation of assets. Additionally, parallel to the globalization of the world economy, enterprises and groups of companies are forced to operate more and more internationally. Such cross-border business activities imply particular tax issues that have to be closely reviewed and taken into account as well.

The holding company can have several sources of income. The holding company may, e.g., operate as a service provider to its subsidiaries and in turn receive service fees, or it may grant licenses against the payment of royalties. In such cases, it is assumed that the holding company has an individual genuine business that generates operating income. However, the very nature of a holding, representing an array of several subsidiaries, i.e. investments, under the umbrella of a top-entity, suggests a further important source of income, income from investments, especially dividends and interest. Moreover, the holding of investments, naturally includes divestments including the realization of capital gains and built-in gains. Corresponding, to the income side, the tax effect of the expense side is to be considered, as well. Typically, in connection with holdings, tax facts concerning expenses that are incurred in connection with the financing and the financial structure of the holding are of great importance. If, as assumed above, the holding company maintains a genuine operational business, then also questions of depreciations and amortizations, as forms of capital expenditures, gain significant importance. In connection with its operational business, but also with its affiliation to its investments, the holding company will have to consider closely, whether tax events are realized that demand the forming of reserves or provisions. The valuation of investments and resulting tax consequences remain a core issue for the holding company, too. The taxation of general income, the treatment of expenses, and the valuation of such investments and other assets follow the general implications provided by Austrian tax laws.
1. Business Income

The Austrian holding company and its subsidiaries compute their taxable income in accordance with § 7 III aKStG. Hence, they only have a single source of income, business income.256 Conditional for the recognition as business income is its attribution to business property and its causation by the business. Hence, business income is understood to be all inflows of money or of monetary value that are caused by the business.257 It can be assumed that the business activities and transfers of goods and services within the holding are structured in a way to achieve a maximum of efficiency and synergies in order to maximize the profits each entity and the holding as an entirety can produce. Such striving for maximum profits supposes a close assessment of the financing structure of each single entity and of the holding as such. The responsible people have to determine, how the finances within the holding are meant to be efficiently structured in order to allow for an economically, financially, legally, and tax reasonable business activity and allocation of resources.258

A holding company generates “operating” income through individual genuine business operations. Operating income, however, does not equal income from investments such as dividends, interest, or capital gains. A holding company may generate operating income as compensation for actively carrying out services or selling or transferring goods either to holding members or to third parties on the free market. Generally, such income can be generated through any act that is taxable as per § 7 III aKStG in connection with the respective provisions of the aEStG. The performance of services depends on the actual economic structure of the given holding and the allocation of competences and resources within it. Hence, such services can cover, e.g., financing services, marketing services, consulting services, logistic services, further organizational services, purchasing, and selling services. Being an individual tax subject the holding company has to account for its taxable income following the general commercial law and tax law rules. While the receipt of income from services provided to third parties or from the sale of goods to third parties is subject to regular market transactions, tax law assumes a problem in cases, where such services are rendered and paid for in non-independent settings. A “non-independent-setting” would for

257 Compare Chapter C.III.1. §4 IV s. 1 aEStG delivers a definition of business expenses, which, according to the literature, is to be read analogously with regard to business income, compare hereto, e.g. Austrian Administrative Court, October 17, 1991; Austrian Administrative Court, January 18, 1983; Bertl et al., Handbuch I, 2004, pp. 191 et seq.; Doralt, ESIG-RK, 2005, §4, p. 242; Doralt/Ruppe, Steuerrecht, 2003, p. 120.
258 As the model-holding in this thesis consists only of corporations the tax effects affecting the holding company can be seen as deputy for any other given member of the holding.
instance be the exchange of performance and consideration within a holding or a group of companies. Tax law presumes that in such a non-independent-setting the finding of an adequate market price is not taking place. The law opposes such dependent price-setting by introducing, what it calls an arm’s length principle, according to which prices for transactions between affiliated entities have to be set as if the respective transaction was concluded between independent parties.

As per this thesis, the focus of the holding company is to hold and manage its investments and to support the efficiency of the entire organizational structure. Jesse opens his article “Dividend and Add-back Taxation” stating “...dividend income usually forms a holding company’s most important source of income, as long as it is not a mixed holding company⁵⁵⁹, thereby expressing the general importance of dividend income for holding companies, but also stresses that holding companies may very well have other sources of income. The term “dividend” refers to the legal right of the shareholder of a corporation to participate financially in such a corporation’s profit.²⁶⁰ Factual dividend distributions become tax effective at the level of the distributing and the receiving enterprise.

By the presumptions taken earlier in this thesis, the scope of possible tax subjects has been reduced to corporations. The provision ruling the taxation of domestic inter-corporate dividends is manifested in § 10 I no. 1 aKStG. The provisions of § 10 I no.’s 2-4 aKStG are not taken into account within this thesis. § 10 I no. 1 aKStG rules the tax exemption of “profit shares of any kind based on an investment in domestic corporations...” This tax exemption rule tries to anticipate that profits on the level of corporations should only be taxed once, given that the distributing, as well as the receiving entity both are corporations in the sense of the aKStG. § 10 I aKStG does not include a particular scope of investment, i.e. no financial affiliation criterion needs to be fulfilled. Hence, conditional is the mere existence of one share certificate that justifies a claim in the profit attributable to such share certificate. Moreover,

²⁵⁹ See Jesse, Dividenden- und Hinzurechnungsbesteuerung, 2002, p. 109. However, the author does not agree with Jesse’s expressed general limitation that in cases of mixed holding companies, e.g. integrated holding companies, the importance of dividend income was subsidiary. A holding company can be understood as a company law tool to hold an array of investments. It acts with the intention to maximize profits. Even if it performs services it is compensated for, such services are to serve the realization of synergies and the maximization of efficiency within the group, and thus ultimately follow the overall target of profit maximization, of not only the holding company itself but of all holding members. If Jesse understands “mixed holding companies” not as the top entity of an array of investments but as a functional business entity, e.g., in the form of a financial holding company, then the importance of dividends may indeed be subsidiary. It can probably be said that as long as the holding company is to form the top entity of such a financial affiliation of investments, its most important source of income are dividends, as assumingly the holding has only been established to realize income from such investments.

²⁶⁰ The details of such dividend-claims can be found in the respective laws covering the GmbH and the AG, i.e. §82 aGmbHG and §52 aAktG.
the existence of the transparency principle in connection with an economic interpretation of § 10 I aKStG suggests that profit shares resulting from equity interests held indirectly via partnerships allow for the tax exemption, too.261

The provisions further speaks of “profit shares of any kind”. As per legal commentary “profit shares of any kind”262 cover: official dividends, profit shares from disclosed and undisclosed reserves, undistributed profit shares from profit carry-forwards, profit shares from profit reserves of subsidiaries, profit shares resulting from contributions made by the parent company to the subsidiary, as long as they do not qualify as a reduction in capital as per § 4 XII aEStG, profit shares resulting from profit shares of investments of subsidiaries that themselves have been subject to the tax exemption as per § 10 aKStG, constructive dividends, and guaranteed dividends that, for instance, are payable by the holding company to minority shareholders of subsidiaries.263 As long as such guaranteed dividends are deemed tax-exempt on the side of the recipient, correspondingly, they cannot qualify as business expenses on the distributor’s side, notwithstanding the fact that within a group § 10 I aKStG is not applicable.264 However, excluded from the tax exemption as per § 10 I aKStG are payments made subject to a subsidiary’s reduction in capital as per § 4 XII aEStG, gains from the sale of investments, and liquidation gains resulting from the balance between the carrying amount and possibly higher liquidation proceeds.265 Irrelevant of the tax exemption of § 10 I aKStG, the distributing subsidiary has to withhold tax on capital yields, as per § 94 no. 2 aEStG, as long as the financial affiliation is less than 25%. Such withholding tax, levied at a rate of 25%,266 on capital yields is credited against the corporate income actually payable by the parent company. Hence, it ultimately reduces the corporate income tax payable or in cases, where it is higher than the amount of corporate income tax payable the resulting balance is refunded.267

263 For reference to the different categories, also compare chapter C.III.3. about general aspects of the utilization of income.
265 Compare Bauer/Quantschnigg/Schellmann/Werilly, KStG 1988, §10, pp. 13 et seq.
266 Compare §95 I aESiG.
Within holdings and groups of companies, the financing structure may require that one entity borrows funds to another. The holding company is to be regarded the lender and, hence, is the recipient of interest income. Generally, interest one would subsume under the category of investment income, which is taxable and the realization of which increases taxable income. In a leading civil law essay, Canaris, 1978, defined “interest” to be “the price payable, in terms of money or other justifiable things, for a particular term, for the possibility to use capital, independent of profit or revenue aspects.” A specification of such civil law definition of interest is deemed necessary to exclude certain interest-related expenses, which following the German language judiciary do not qualify as interest from a civil law point of view. Differentiation problems usually occur in connection with payments that are not directly made for the use of money and are term independent, such as, e.g., commissions, brokerages, charges, and premiums. Contrary to the narrow civil law definition of interest, the income tax definition of interest is broader as it needs to consider an economic view. Hence, interest covers all term-independent payments for capital lending that do not serve the debt redemption, e.g., incidental debt financing costs such as particular commissions, brokerages, charges, and premiums, or capital stock hedging.

Within the framework of the aEStG, investment income forms a separate source of the seven taxable sources of income. Interest income allocated to the taxable income category “investment income” is subject to a withholding taxation as per §§ 93 et seq. aEStG. Therefore, a given condition for the application of such withholding taxation is the possibility to allocate interest income to investment income as per §§ 2 III no. 5, 27 aEStG. Yet, this is considered possible, only if the taxable entity, i.e. the holding company, could have private property as opposed to business property. Even, if one assumed that incorporated bodies, including corporations, could have both property spheres, an assessment, to which

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268 One could change the conditions making the holding company the borrower and the subsidiary the lender and the tax consequences would be the same just with changed conditions, as both are equal tax subjects.
269 See hereto the definition manifested by Canaris, Zinsbegriff, 1978, p. 1982. Such definition was then adopted by the legislature and the legal practice in Austria, e.g., Doralt, EStG-RK, 2005, §27, p. 1036 and Germany, e.g., German Federal Civil Court, November 16, 1978.
270 Compare, German Federal Civil Court, November 9, 1978; Tissot, Abzugsfähigkeit, 2004, p. 1499.
271 Compare Austrian Administrative Court, November 26, 2002 (I); Austrian Administrative Court, November 26, 2002 (II); Austrian Administrative Court, November 25, 2002; German Federal Tax Court, November 7, 1989; German Federal Tax Court, October 13, 1987; German Federal Tax Court, January 19, 1978; German Federal Tax Court, April 19, 1977; German Federal Tax Court, July 6, 1973. Also compare hereto Bauer/Quantschnigg/Schellmann/Werilly, KStG 1988, 2005, §12, p. 302; Tissot, Abzugsfähigkeit, 2004, pp. 1499 et seq.
272 Compare hereto §§2 III no. 5, 27 aEStG.
274 Compare hereto, e.g., Achatz, Endbesteuerung, 1995, pp. 83 et seq.
property, the investment, actually triggering the interest in question, was to be allocated to, is necessary. Undoubtedly, investments held by a holding company are allocated to its business property. Additionally, as has been laid out above, the holding company computes its taxable income in accordance with § 7 III aKStG and, therefore, its entire income is qualified as business income and, thus, investment income as such cannot constitute a separate source of income.275 Concluding, in the context of corporations falling under § 7 III aKStG, interest income received is to be regarded as regular business income, generated with business property. It increases the recipient’s taxable income276 and is subject to the general provisions of the aKStG and the aEStG, including the general 25% corporate income tax rate.

The management of holdings includes the continuous assessment, whether existing investments should be sold or new investments should be acquired, in order to optimize the investment structure. To optimize an investment structure does certainly include divesting investments that no longer fit the investment portfolio or which can be sold at an attractive price leading to a profit or “gain”.277 If one talks of an economic or financial “gain”, such gain simultaneously implies the comparison of at least two figures. The second figure in connection with a capital gain would be the sale-price, the selling entity is able to achieve for any given good sold. Ultimately, a gain results when the second figure is larger than the first, or in other words the balance between such figures is positive. Initially, when such investment is acquired, it enters the financial statement as a financial asset valued at acquisition cost. The capitalized acquisition costs cover the acquisition price, as well as incidental acquisition costs.278 In the following years such capitalized acquisition costs are being valued in accordance with commercial law and tax law provisions, i.e. are subject to impairment tests. If in the moment of the sale of an investment, the capitalized and commercially, as well as tax adjusted acquisition costs of such an investment less received tax-exempt dividends (§ 10 I aKStG) aggregate to less than the realized sale-price, the selling entity realizes a taxable capital gain. Given what has been laid out above in connection with income generated from investments, i.e. dividends as per § 10 I aKStG, it could be assumed that such provision would include the taxation of capital gains, too.279 However, § 10 I aKStG does not cover a

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276 For the tax treatment of interest payable from the point of view of the borrower see below, Chapter C.V.2.b.
278 Compare Wiesner et al., EStG 1988, 2005, §6, pp. 24 et seq. Incidental acquisition costs cover, e.g., the interest due from the financing of the acquisition of an investment.
279 As, e.g., covered by § 8b II German Corporate Income Tax Code.
tax exemption of capital gains. Capital gains are subject to the general corporate income tax provisions. They form a general part of a corporation’s income and, thus, are taxable in connection with § 7 III aKStG and §§ 5 I, 23 aEStG.

2. Business Expenses

Qualified expenses may reduce taxable income. Expenses eligible to reduce taxable income must qualify as business expenses. According to § 4 IV s. 1 aEStG, “business expenses are such expenses that are caused by the business” and are considered to have been incurred within the direct economic context of the attempt to produce taxable income. Business expenses are to be seen in an objective connection with the business or operating unit and they subjectively are meant to serve the business or operating unit. Business expenses suppose a definite disposal of value, however, do not necessarily have to be connected to a monetary payment. Furthermore, business expenses are attributed to such business or operating unit, which actually causes them and, hence, is obligated to fulfill them. Notwithstanding the aforementioned and the general validity of the rules of the aEStG, in its §§ 11 and 12 the aKStG provides two provisions that specify deductible as well as non-deductible business expenses.

“Operating expenses” as a term is meant to cover all such expenses that an enterprise usually incurs in course of the generation of income and the maintenance of its genuine business. Typically, they fall under the provisions of § 7 III aKStG and §§ 5 I, 4 IV aEStG, being all sorts of expenses that are caused by running and maintaining the business. Under the given circumstances, exemplary expense categories, falling under such a term, would be wages, rents, fees, travel expenses, and all other sorts of business overheads. Beyond the general

280 Compare Austrian Administrative Court, February 24, 1999; Bauer/Quantschnigg/Schellmann/Werilly, KStG 1988, 2005, §10, pp. 4, 18; Doralt/Ruppe, Steuerrecht, 2003, p. 360. As capital gains are not tax-exempt the Austrian provisions actually do not prevent a double taxation in cases where investments that in periods previous to the sale have retained earnings, are being sold. Critically, hereto, e.g., Bauer/Quantschnigg/Schellmann/Werilly, KStG 1988, 2005, §10, p. 18; Mitterlehner, Steuerfreiheit, 2000, p. 392.
282 Compare § 11 II aKStG.
283 Compare hereto the definitions formed by the German Federal Tax Court that interpretatively also count in Austria. German Federal Tax Court, March 4, 1986; German Federal Tax Court, March 23, 1984; German Federal Tax Court, November 21, 1983; German Federal Tax Court, March 19, 1982; German Federal Tax Court, May 15, 1981; German Federal Tax Court, November 28, 1980; German Federal Tax Court, November 20, 1979; German Federal Tax Court, November 28, 1978.
284 Compare Doralt, EStG-RK, 2005, §4, pp. 250 et seq.
understanding of operating expenses in connection with § 4 IV aEStG, § 11 I aKStG introduces several further expense categories as deductible business expenses.\textsuperscript{286}

An issue of major importance, with regard to the taxation of holding companies, is the tax treatment of the financing of its investments. As has been concluded in the previous chapters, the domestic investments held by the holding company are qualifying as such provided for in § 10 I aKStG. Dividends, domestic corporations receive from such investments are tax-exempt, but what about the expenses incurred in connection with the acquisition or holding of such investments? According to the general rule of § 12 II aKStG, expenses that are considered to be in direct economic context with non-taxable income or increases in net worth are not deductible from taxable income. Given the direct economic context between the expense deduction disallowance and the tax exemption of dividends as per § 10 I aKStG or § 10 II aKStG, the corresponding financing cost, i.e. interest, paid in course of the financing or re-financing of the acquisition of the dividend-distributing investment, would, as it seems, be not deductible.\textsuperscript{287} However, within certain limitations this principle is ruled ineffective by the special rule of § 11 I no. 4 aKStG.\textsuperscript{288} Interest originating from the debt financing of investments that belong to the business property of corporations is considered to be deductible from income.\textsuperscript{289}

Given that the examined holding company computes its taxable income in accordance with § 7 III aKStG and the economic nature of the business of a holding, the reviewed investments are deemed to be attributable to the holding company’s business property. Thus, making the provision of § 11 I no. 4 aKStG generally eligible to the holding company and the entire holding. Questionable, however, remains what precisely is covered by the term “interest”, as used in the provision of § 11 I no. 4 aKStG opposed to the term “financing cost”. Assumingly, the Austrian lawmaker decided to use the term “interest” instead of “financing cost”, as the latter was expected to be interpreted in a broader sense and, thus, would have given more room for possible abusive structures. Nonetheless, reviewing the economic context of the issuance of debt capital, the additional incurrence of financing cost components is obvious. Particular components of such incidental financing costs are directly attributable to an interest and, correspondingly, should be tax relevant, i.e. deductible.\textsuperscript{290} Referring to the observations


\textsuperscript{287} Compare Bauer/Quantschnigg/Schellmann/Werilly, KStG 1988, 2005, §12, p. 301; Briem/ Helbich, Austria, 1994, pp. 73 et seq.

\textsuperscript{288} Austrian Federal Gazette I, 57/2004.

\textsuperscript{289} Compare Hanusch, Steuerrecht I, 2005, no. 14, pp. 29 et seq.

\textsuperscript{290} Compare Briem/Helbich, Austria, 1994, pp. 70 et seq.; Tissot, Abzugsfähigkeit, 2004, p. 1497.
made in Chapter C.IV.1., § 11 I no. 4 aKStG covers such interest, as defined in the narrow civil law definition, but also particular incidental components. As per the economic context, financing cost components like charges and commissions paid to the debt capital lender, or to third parties that perform services that are directly attributable to the issuance of debt capital, e.g., attorneys, brokers, or notaries, need to be included. Excluded, from the expense deduction allowance, following Tissot, however, remain such financing cost components that serve the redemption of the debt per se, the hedging of the capital stock, and, e.g., foreign currency losses.

3. Valuation, Depreciation, and Amortization

Business expenses do not necessarily have to occur in the form of monetary payments. The tax consequences resulting from valuation, depreciation, and amortization are the common examples for such non-payment related business expenses. The authoritative principle, ruled in § 5 I in connection with § 4 aEStG, provides that respective taxable entities have to account for their taxable income in accordance with the generally accepted accounting principles. Hence, based on the commercial financial statement, the tax financial statement and the taxable income are derived. The financial statement treatment of assets and liabilities, therefore, is very important. The accounting of a holding company and its incorporated subsidiaries follows the general accounting principles. As per § 224 aHGB, the financial statement classification of the financial statement’s asset side distinguishes between fixed and current assets. “Fixed assets” cover intangible, tangible, and financial assets, while inventories, receivables and other assets, and securities are sub-categories of “current assets”. A distinction between fixed and current assets is further important with regard to the separate applicable valuation rules and the possible accounting of intangible assets. Furthermore, as per § 224 aHGB, fixed and current assets have to be reported separately within the financial statement. Whether an asset is allocated to fixed assets or to current assets is determined by the function, the respective asset is deemed to serve within a given

294 Compare Chapters C.II. and C.III.1.
business. An asset is allocated to fixed assets, when it is deemed to serve the business on a permanent basis. Whereas, assets are allocated to current assets, when they are neither deemed to serve the business permanently nor are allocated to the fixed assets, or to the deferred expenses.  

a. Investments

Considered an assortment of various investments under the management roof of one top entity, questions of the valuation of investments within a holding are apparent. During a business-year, new investments join the holding, while others exit. Existing investments need to be impaired in accordance with commercial and tax law provisions. The events of respective provisions can trigger certain tax consequences. Tax consequences in connection with existing investments usually refer to fair value write-downs or tax amortizations of goodwill. The inclusion of new investments into the holding is accompanied by the need to set an adequate value with which such entering investment is to be considered in the holding company’s financial statements, possibly including goodwill. Accordingly, once an investment is exiting the holding the existing valuation of such investment in the holding’s financial statement has to be brought in line with the price the holding receives for the divestment of such a divestment, including the consideration of built-in gains and the realization of capital losses or capital gains. Equity interests in a corporation are regarded as an investment in this context, when they serve the business of the acquiring entity on an ongoing basis and, as per §228 I aHGB, exceed 20% of the respective acquired corporation’s capital.

The focus of the following observations vests in investments that form a part of the fixed asset’s financial assets. The Austrian income tax law provides provisions for the valuation of assets within § 6 aEStG that, subject to § 7 III aKStG, are also applicable to corporations. In particular the valuation of investments, qualifying as non-life-limited fixed assets, is

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297 Goodwill is created in two ways, either it is acquired, or it is self-generated; this study focuses the acquired goodwill as only the acquired goodwill may be reported in the financial statements and thus is tax-relevant. Ad self-generated goodwill compare, e.g., IAS 38.48. Ad goodwill in general compare also §203 V aHGB and Doralt, Einkommensteuergesetz I, 2005, §8, pp. 18 et seq.; IDW, WP, 2006, pp. 380 et seq.; Wiesner et al., EStG 1988, 2005, §8, pp. 17 et seq.


299 The tax definition of the term investment equals the commercial definition, i.e. the striking operative facts are “lasting affiliation” and “serve own business”. Compare hereto Doralt, Einkommensteuergesetz I, 2005, §6, p. 104; Doralt, EStG-RK, 2005, §6, p. 410.
ruled by § 6 no. 2a aEStG.\textsuperscript{301} In accordance with the authoritative principle and the commercial law provisions of §§ 203, 204 aHGB, § 6 no. 2a s. 1 aEStG rules that investments have to be valued at acquisition cost and decreases in value have to be considered through a fair value write-down. The income tax provision refers to the commercial definition of "acquisition cost", hence, acquisition costs cover the direct acquisition price, as well as incidental and belated acquisition costs.\textsuperscript{302} § 6 no. 2a s. 2 aEStG stipulates a general option to reverse such fair value write-down, once the reasons for them no longer exist. Hence, if a given investment belonged to the accounting entity’s business property in the preceding economic year, the fair value\textsuperscript{303} may also be reported, if it is higher than the last accounted value, as long as such fair value is lower than the historic acquisition cost.\textsuperscript{304} However, this option is not eligible in cases, where the respective investment qualifies as a commercial investment as per § 228 I aHGB, i.e. the holding company holds in excess of 20% in the considered investment’s nominal capital. As per § 6 no. 13 s. 2 aEStG, in such cases the write-down reversal option turns into a requirement to reverse such fair value write-downs, wherever the reasons for them no longer exist.\textsuperscript{305}

Yet, for corporations, § 12 III aKStG provides two limitations. As per § 12 III aKStG, income distribution induced fair value write-downs and income distribution induced losses, referring to investments in the sense of § 10 aKStG, are not deductible as business expenses. Such income distribution induced fair value write-downs, as well as income distribution induced losses, incurred as a result to the departure of an investment from the financial statements, hence, reduce the tax carrying amount, but do not qualify as deductible business expenses.\textsuperscript{306} Despite such expense deduction disallowance, § 12 III aKStG allows the deduction of other fair value write-downs and other departure induced losses. As per § 12 III no. 2 aKStG such

\textsuperscript{300} Whether an asset is qualified as life-limited or non-life-limited is ruled by §198 II aHGB and is subject to the anticipated period of ownership.

\textsuperscript{301} As §6 no. 2a aEStG also covers the tax valuation of current assets the observation given above with regard to the non-life-limited fixed assets apply to current assets accordingly.


\textsuperscript{303} Such fair value is regularly computed in accordance to the sale-price of comparable shares in the same company or alternatively following the methods used within the evaluation of companies.

\textsuperscript{304} Compare Bertl et al., Handbuch, 2004, p. 218; Doralt, Einkommensteuergesetz I, 2005, §6, p. 106; Wiesner, Beteiligungen, 1994, pp. 119 et seq.


write-downs and losses maybe claimed as tax-relevant expenses at the scope of one seventh of
the claimed write-down or loss per annum.\textsuperscript{307}

Goodwill can occur in two forms. First, goodwill can be acquired and second, goodwill can be
homegrown. In terms of the financial statement, acquired goodwill falls under the category of
intangible assets, yet, receives a separate individual accounting treatment. Contrary thereto,
homegrown goodwill is not being considered. Austrian commercial law provides an
amortization option for acquired goodwill in § 203 V aHGB. Hence, acquired goodwill is
capitalized by the amount the acquisition price of a business exceeds the reported sum of all
assets less the sum of all debt. According to the provision’s second sentence, such goodwill is
amortized over a period equal to the business years during which such goodwill is presumably
used, without setting forth a fixed amortization period.\textsuperscript{308}

Contrary thereto, Austrian individual income tax law provides in § 8 III aEStG for the
mandatory straight-line amortization of acquired goodwill over a period of 15 years. Via the
connecting provision of § 7 III aKStG, the amortization of acquired goodwill is also
attributable to the holding company and its investments as considered within this thesis.\textsuperscript{309} In
addition to a general amortization, the goodwill can also be subject to a fair value write-down
in the sense of § 6 no. 1 s. 2, 3 aEStG, if on the balance sheet date the carrying amount of
acquired goodwill and homegrown goodwill exceeds the respective fair value.\textsuperscript{310}

b. Other Assets

Most probably, investments, including respective goodwills, represent the asset class most
regarded in connection with the survey of a holding company’s financial statement. Still such
financial statement bears all other existing assets attributable to the holding company, too.
The holding company could be the owner of a building and of a set of license rights or patents
that it makes available for use to its investments against the charge of fees or royalties and/or
that it has receivables outstanding against one or more of its investments. Generally, the
economic ownership of the respective asset is a precondition for the applicability of any
depreciation or amortization rule. As has been said in connection with the discussion of

\textsuperscript{307} Compare Doralt, EStG-RK, 2005, §12, pp. 445; Gassner/Lahodny-Karner/Urtz, §205, 2000, p. 283; Wiesner,
Beteiligungen, 1994, pp. 122 et seq.

\textsuperscript{308} In Germany opposite to Austria, §255 IV German Commercial Code grants an amortization option,
according to which goodwill can be amortized either over a five-year period, immediately in its first year, or
over the period of its anticipated economic use, compare hereto, e.g., Baumbach/Hopt, §255, 2003, p. 882.

\textsuperscript{309} Compare Wiesner et al., EStG 1988, 2005, §8, pp. 17 et seq.

\textsuperscript{310} Compare Wiesner et al., EStG 1988, 2005, §8, p. 20.
investments, assets are categorized in either fixed or current assets. While, buildings, as a tangible asset, and license rights and patents are allocated to fixed assets, outstanding receivables would qualify as current assets. Not different to the valuation of investments, all other assets, i.e. fixed and current assets, are valued at either their acquisition or at their production cost.\(^{311}\) The subsequent valuation of fixed assets follows the distinction between life-limited and non-life-limited fixed assets.\(^{312}\) Within the tax computation of income, value adaptations expressed through amortizations, depreciations, and/or write-downs, are ruled by §§ 7 and 8 aEStG. As per § 7 I aEStG independently valuable life-limited assets are to be depreciated proportionately to the respective asset’s useful life. An asset’s useful life is ruled to be the period, during which it can be used in its designated purpose, judged at hand of objective characteristics.\(^{313}\) The asset is depreciated by using the straight-line method.

According to the financial statement classification as per § 224 aHGB\(^{314}\), license rights and patents belong to the category of intangible assets. Intangible assets are either self-produced or acquired. Following legal practice as per § 7 I aEStG, intangible assets are subject to a tax amortization, if they are life-limited. Yet, contrary to the commercial provisions of §§ 196, 204 I aHGB, the Austrian individual income tax law provides for the obligatory use of the straight-line method, hence a potential divergence between the commercial financial statements and the tax financial statement can occur.\(^{315}\) The provision rules that the acquisition cost is to be allocated to the useful life of the respective intangible asset. Such useful life is determined in accordance to the objective possibilities of use of such assets. Having reduced the considered intangible assets within this chapter to all sorts of concessions and other sorts of economically useable rights, the useful life of such intangible rights is predominantly determined through its legal life. However, in case of a shorter economical useful life, the period of such economical useful life is the predominant clue.\(^{316}\)

Corresponding to the commercial provision of § 197 II aHGB, which prohibits the capitalization of self-produced intangible assets, § 4 I s. 5 aEStG provides that self-produced intangible assets are not to be included into the computation of the taxpayer’s taxable income.

\(^{311}\) See §§203, 206 aHGB. Compare hereto also Gassner/Lahodny-Karner/Urtz, §203, 2000, p. 252.

\(^{312}\) For a more detailed discussion of the individual operative facts compare, e.g., Gassner/Lahodny-Karner/Urtz, §204, 2000, pp. 275 et seq.; Scheffler, Rechnungslegung, 2004, pp. 543 et seq.

\(^{313}\) Compare Austrian Administrative Court, September 7, 1993; Austrian Administrative Court, March 5, 1963 and also German Federal Tax Court, November 19, 1997; German Federal Tax Court, July 26, 1991.

\(^{314}\) Compare also Figure 12.


The production cost of self-produced intangible assets represents immediately deductible business expenses.317


As one of the lawmakers intentions, receivables and liabilities from or to affiliated enterprises and from or to investments have to be reported separately, as per § 224 II, III aHGB. It has previously been concluded that “equity interests in affiliated enterprises” can be subsumed under the term “investments”. Existing receivables or liabilities from investments have to be primarily reported under these specific financial statement items. While receivables are capitalized on the asset side of the financial statement, liabilities are accounted for as debt on the liabilities side of the financial statement.318

While receivables that result from loan agreements are allocated to the holding company’s fixed assets, receivables resulting from, e.g., dividend claims against its subsidiaries are allocated to current assets. As has been said, fixed assets, as well as current assets, are, in accordance with § 203 I and § 206 I aHGB and § 6 no. 1, 2a aEStG, valued at acquisition or production cost. In the tax context the judgment, whether receivables are allocated to fixed assets or current assets is of importance with regard to depreciations, fair value write-downs, and reversal of write-downs. Receivables are initially valued at acquisition cost, which is their nominal value.319 The subsequent tax valuation of fixed asset receivables follows § 6 no. 1 aEStG, while current asset receivables are valued in accordance with § 6 no. 2a aEStG. Thus, changes in circumstances affecting the valuation of such receivables are considered through the adjustment of the fair value. The fair value of receivables depends on the maturity, the possibility to charge interest, and the collection probability of the receivable. Depending on objectively lasting changes in either a single or more of these criteria, the receivables can be subject to a fair value write-down in accordance with § 6 no. 1 s. 3 aEStG following the (strict320) lower-of-cost-or-market principle (“Niederswertprinzip”). Such re-valuations, however, have to be carried out by way of a specific provision.321 The capitalization of

318 Compare Hofians, §§224, 225, 2000, pp. 447 et seq., 461, 469 et seq.
319 Compare Austrian Administrative Court, February 7, 1958; German Federal Tax Court, January 31, 1980; German Federal Tax Court, April 23, 1975; German Federal Tax Court, November 23, 1967; Doralt, Einkommensteuergesetz I, 2005, §6, p. 110.
320 The strict lower-of-cost-or-market principle applies to receivables that allocated to the current assets only. Compare hereto §207 I aHGB and Doralt, EStG-RK, 2005, §6, p. 429.
dividend claims as current asset receivables usually supposes the existence of the dividend-distributing entity’s resolution for the distribution of profits.\textsuperscript{322} Yet, where the holding company acts as the sole shareholder and distributes a particular share of such distributing entity’s profits, subject to its sole discretion as a shareholder, the holding company can capitalize the full amount of the expected distributed dividend as a receivable.\textsuperscript{323}

Different from receivables, liabilities are reported for on the liabilities side of the financial statement. Of special interest for a holding company are liabilities to affiliated enterprises and to investments. Such liabilities cover business-caused debt and obligations that are determined as to their amount and causation. Practically, the holding company, e.g., would have to report liabilities resulting from loans, it has received from a functional finance-subsidiary in order, e.g., to acquire new investments, or the outstanding debt due to the issuance of notes (e.g. a bond) on a capital market. Liabilities are considered “negative” assets and their valuation analogously follows the principles of valuation set out with regard to assets. The moment they have to be first carried as a liability is independent of their maturity date.\textsuperscript{324} As per § 6 no. 3 aEStG, liabilities are reported at acquisition cost, which is their repayment amount or nominal value.\textsuperscript{325} In cases, where the repayment amount varies from the disposition amount due to some kind of discount or financing cost, the resulting balance is to be capitalized and written down over the term of the respective liability in accordance with § 6 no. 3 aEStG. Over time, liabilities remain valued at their repayment amount as long as the underlying obligation of repayment has not increased, decreased, or vanished. Any resulting higher fair value of liabilities has to be reported. Changes in the fair value of liabilities are only reported in cases of increases, whereas decreases in the fair value below the repayment amount remain irrelevant, i.e. the repayment amount of liabilities always serves as a floor for the reportable amount.\textsuperscript{326}

\textsuperscript{322} Compare Austrian Administrative Court, January 18, 1994.
\textsuperscript{323} Compare European Court of Justice, June 6, 1996; Austrian Administrative Court, March 23, 2000; Austrian Administrative Court, January 18, 1994; German Federal Tax Court, August 7, 2000.
\textsuperscript{325} Compare German Federal Tax Court, July 15, 1998; German Federal Tax Court, January 31, 1980; German Federal Tax Court, March 4, 1976.
Provisions are liability items formed in order to allocate expenses, whose existence or amount is not secure on the balance sheet date, but lead to a potential disbursement in a later period than the period of their causation.\textsuperscript{327} From a tax point of view, a general accounting requirement is only excluded, if the listing in § 9 aEStG expressively provides for such an exclusion. Consequently, § 9 I aEStG lists tax-relevant mandatory forms of provisions, reversions of dispatches, pensions\textsuperscript{328}, deferred pensions, other insecure liabilities, or contingent losses from pending transactions.\textsuperscript{329} The principles of the formation of tax provisions follow the rules for the commercial formation of provisions. Hence tax provisions may only be reported for indefinite liabilities, where a payment obligation towards a third party is deemed probable or secure as per the balance sheet date, yet is considered indefinite with regard to its amount and the precise date of realization.\textsuperscript{330} The expenses associated with such provisions need to qualify as \textit{“expenses as incurred”} and may not be regarded as anticipated acquisition or production cost.\textsuperscript{331} Concerning the amount reported, the tax law follows the rule stipulated in § 211 aHGB according to which a prudent commercial judgment determines such reported amount. However, provisions are valued in analogy to the valuation of liabilities.\textsuperscript{332} Accordingly, provisions are reported at the amount, that given the circumstances on the balance sheet date is deemed necessary in order to fulfill the underlying anticipated payment obligation\textsuperscript{333}, hence, the yearly amount is subject to adjustments.\textsuperscript{334} For provisions for other insecure liabilities and contingent losses, however, § 9 V aEStG provides a valuation cap at 80\% of the respective provision’s fair value. Provisions whose anticipated term at the balance sheet date is less than 12 months are not subject to that 80\%-cap.\textsuperscript{335} In any event, provisions can only be formed in the year of causation of the underlying obligation. Due to the assessment principle, they have to be accounted for in each subsequent year for which such underlying obligation continues to exist. Missing the formation of a provision in


\textsuperscript{328} Accruals for pensions and deferred pensions are in detailed ruled in §14 aEStG, which is not covered within this thesis. For further information on accruals for pensions and deferred pensions also compare AMF, Directive Z 06 0557/2-IV/6/92, 1992.


\textsuperscript{330} Compare Austrian Administrative Court, October 10, 1996.

\textsuperscript{331} Compare Doralt, Einkommensteuergesetz I, 2005, §9, p. 8; Wiesner et al., EStG 1988, 2005, §9, p. 7.

\textsuperscript{332} Compare also see Doralt, EStG-RK, 2005, §§9, 14, p. 552.

\textsuperscript{333} Compare Austrian Administrative Court, July 15, 1998; Austrian Administrative Court, December 16, 1997; Austrian Administrative Court, June 15, 1983.

\textsuperscript{334} Compare Doralt, EStG-RK, 2005, §§9, 14, p. 552; Wiesner et al., EStG 1988, 2005, §9, p. 5.

\textsuperscript{335} Compare Doralt, Einkommensteuergesetz I, 2005, §9, pp. 1 et seq.; Doralt, EStG-RK, 2005, §§9, 14, pp. 552 et seq.; Wiesner et al., EStG 1988, 2005, §9, pp. 27 et seq.
the year of the underlying obligation’s causation, ultimately, results in debit and credit memoranda, as missed provisions cannot be recaptured. In the moment the insecure elements of the underlying obligation are realized, the provisions have to be transformed into liabilities or, contrary thereto, if such expense is not realized and the obligation vanishes unrealized, the relating provisions have to be dissolved, thereby increasing taxable income.

4. Thin Capitalization

The question of thin capitalization of corporations is discussed regularly in the international tax literature. While, e.g., Germany’s tax law provides for detailed thin capitalization regulations, the Austrian tax law is free of such provisions. Although the Austrian tax law does not know explicit thin-capitalization rules, the condition for the tax recognition of interest as legitimate business expenses of affiliated companies is that the contractual basis has to be in accordance with the arm’s length principle. The Austrian lawmaker and judicature assume that, generally, the taxpayer is supposed to be free in his choice of capital. Yet, simultaneously, they set forth that in extreme cases, when the grant of debt capital objectively serves the economical purpose to replace equity and, from an economic point of view, the contribution of equity was economically necessary, the re-qualification of such granted debt capital into equity, i.e. constructive equity contributions, takes place. Consequently, interest would be re-qualified into means of income distribution and, thus, is no longer eligible for a business expense deduction. Equally, the tax administration and the judicature consider economic facts of thin capitalization in connection with possible constructive dividends. Hence, a shareholder loan agreement that contains a non-market standard interest agreement could cause the same legal consequences as known in connection with constructive dividends. The balance between a standard market interest rate and the

336 Compare Austrian Administrative Court, February 25, 1998; Austrian Administrative Court, October 10, 1996; Austrian Administrative Court, July 16, 1996; Austrian Administrative Court, September 16, 1986; also Doralt, EStG-RK, 2005, §§9, 14, pp. 552, 555; Wiesner et al., EStG 1988, 2005, §9, p. 5.
338 Compare Gassner, Austria, 1996, p. 315, pp. 323 et seq.
340 Compare Briem/ Helbich, Austria, 1994, p. 76.
interest rate, as per the respective agreement, would not be treated as deductible business expenses, but as a means of taxable income distribution, i.e. as dividends.\textsuperscript{341}

V. \textit{The “Gruppenbesteuerung”}

1. Terms and Definitions of the “Gruppenbesteuerung”

Given the geographical location in the heart of Europe, at the crossroads between the “\textit{old}” Western Europe and the emerging countries in Central and Eastern Europe, Austria more and more is becoming a preferred location for MNCs to locate holding companies.\textsuperscript{342} Austria combines an overall stable legal system and its favorable geographical position with relatively flexible labor laws and progressively competitive modern tax laws.

The location of holdings was supported by the 2003-introduction of the “\textit{Budgetbegleitgesetz}”\textsuperscript{343} providing new provisions for the ruling of the international participation exemption. Subsequently, in 2004 the Austrian National Council passed the Tax Reform Act 2005\textsuperscript{344} introducing the “\textit{Gruppenbesteuerung}”. The “\textit{Gruppenbesteuerung}” is a new progressive group-relief regime governing the taxation of holdings and groups of companies. The regime intends to anticipate present currents in the lively discussion of European law, especially corporate income tax law. A couple of groundbreaking cases ruled by the European Court of Justice are supporting this discussion. The latest legal practice of the European Court of Justice and the harmonization directives of the European Council are aimed at encouraging the member states to adapt their tax legislation to allow for the inclusion of cross-border tax results of foreign subsidiaries and permanent establishments into the computation of the taxable income of a holding or a group of companies.\textsuperscript{345} Only a few

\textsuperscript{341} Compare Briem/Helbich, Austria, 1994, p. 77; Gassner, Austria, 1996, p. 315.
\textsuperscript{343} Austrian National Council, April 29, 2003.
\textsuperscript{344} Austrian Federal Gazette I, 57/2004.
\textsuperscript{345} European Court of Justice, C-446/03; European Court of Justice, C-319/02; European Court of Justice, C-168/01; European Court of Justice, C-167/01; European Court of Justice, C-324/00; European Court of Justice, C-208/03; European Court of Justice, C-397/98; European Court of Justice, C-35/98; European Court of Justice, C-307/97. Directive 2005/19; EC, Directive 2003/123; EC, Directive 2003/49; EC, Directive 90/435; EC, Directive 90/434. Compare hereto e.g. Dautzenberg, Richtlinie, 2005, pp. 254 et seq.; Eicker, Marks & Spencer, 2005, pp. 197 et seq.; Gassner, Europarechtswidrigkeit, 2004, pp. 841 et seq.; Ghislain, Holding Companies, 1992, pp. 1 et seq.; Hahn, Bosal, 2003, pp. 1245 et seq.; Häuselmann/Ludemann, Besteuerung, 2005, pp. 123 et seq.; Hirschler/Schindler, Gruppenbesteuerung, 2004, p. 506; Kußmaul/Tcherveniacki, Marks & Spencer, 2005, pp. 626 et seq.; Lang, Marks & Spencer, 2005, pp. 255 et seq.; Ruding, EU-Corporate Tax, 2005, pp. 2 et seq.
countries in the European Union have so far allowed the setting-off of foreign losses. However, most jurisdictions still prohibit the tax-import of losses generated by subsidiaries or permanent establishment abroad. The “Gruppenbesteuerung” generally provides that positive and negative incomes of domestic group members and potentially negative incomes of foreign group members are allocated to the next higher-ranked domestic group member or to the group parent (so called “upstream allocation”), where they are consolidated for tax reasons.

As to the organization of the group, § 9 I 1 aKStG provides that “financially affiliated legal persons” can form a group. The “Gruppenbesteuerung”, therefore, presupposes that “financially affiliated” legal persons form a group, thus, making the “Gruppenbesteuerung” eligible for all sorts of holdings, even if they do not simultaneously qualify as a group of companies. Notwithstanding the fact that of course the “Gruppenbesteuerung” is also eligible to groups of companies. Stipulating that only legal persons can form a group goes hand in hand with the assumption made that this thesis exclusively covers legal persons. Despite of that, it remains to be examined what is covered by the legal events “financial affiliation” and “group” in the very context of the “Gruppenbesteuerung” as per § 9 aKStG. The latter of these legal events, “group”, needs to be broken down further into such elements which ultimately form a “group”, i.e. the “group members” and the “group parent”.

a. Group Members

§ 9 II aKStG delivers a catalogue of different legal persons that qualify as a group member. In particular the law covers, unlimited tax liable corporations, purchasing and industrial cooperatives, limited tax liable foreign legal persons, and such legal persons that from a civil law point of view are comparable to Austrian legal persons. For the purposes of this research, group members shall be either unlimited tax liable corporations, limited tax liable legal persons, or foreign legal persons in their corporate form that from a civil law point of view are comparable to Austrian legal persons.


347 The upstream allocation follows the “allocation theory” (“Zurechnungstheorie”). Austrian Federal Ministry of Finance, Directive Z 06 5004/11-IV/6/01 (“Körperschaftsteuerrichtlinien 2001”), margin numbers 364, 365; German Federal Tax Court, January 22, 2004; German Federal Tax Court, January 23, 2002; German Federal Tax Court, April 14, 1992; German Federal Tax Court, September 9, 1986.

348 Unlimited tax liability is ruled in § 1 II aKStG.
persons, or such civil law comparable foreign legal persons. The unlimited tax liability of corporations in Austria is ruled in § 1 aKStG. As per § 1 II no. 1 aKStG, civil law legal persons such as the GmbH or the AG qualify as such unlimited tax liable Austrian corporations.

With regard to the scope of includable levels of foreign entities § 9 VI no. 6 s. 1 aKStG, moreover, requires that only first-tier foreign subsidiaries are to be included into the group. However, what constitutes such a first-tie level? A first-tie level is given, when, as just described, the equity interests in the foreign entity are directly held by a domestic unlimited tax liable group member, or by the group parent, respectively. Alternatively, thereto, such shares could be indirectly held, either via a restricted tax liable foreign legal person, or by a foreign partnership. However, in these cases the Austrian Federal Ministry of Finance sees the limit in mediated shareholdings at a maximum of 50%. Otherwise, the criteria “financial affiliation” would be fulfilled already at the stage of the foreign mediating entity and consequently the group criteria could not be fulfilled at all. Additionally, it is demanded that the domestic entity holds at least a minimal share in the mediated foreign entity directly to create a financial affiliation greater than 50%.349

In the context of the present survey, one particular aspect strikes the eye. The presupposed constellation for the computation of the index-figure “NDI”350 is that an Austrian MNC top-entity is the parent company of its subsidiary, the CHHC. Once, the MNC top-entity receives income from the CHHC, the question, whether the CHHC could be included into the group as a group member emerges. As laid out above, to be included into the group, the CHHC must qualify as a group member in the sense of § 9 II scale line 2 aKStG. The CHHC would have to be either limited tax liable in Austria or civil law comparable to Austrian legal persons and financially affiliated solely to unlimited tax liable group members or to the unlimited tax liable group parent. Assuming that the CHHC is not limited tax liable in Austria and financially affiliated to the Austrian MNC top-entity, the decisive question remains, whether the CHHC’s legal form resembles or is comparable to a domestic corporation, i.e. to the legal forms “GmbH” or “AG”? The interpretation of the legal event “comparability” is measured at hand of the underlying provisions of the income and corporate income tax laws and company

350 Compare hereto chapter A.III. and Figure 1.
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law. Accordingly, it has to be judged, whether the foreign corporation is comparable in its entirety, taking its economical position and its legal structure into account.

The CHHC, erectable in both forms, as an EJV or as a WFOE, regularly gains own legal personality as provided for in the Chinese law, by taking the form of either a LLC, or a CLS. 351 Thus, the bottom-line question is, if the Chinese legal forms “LLC” and “CLS” are comparable to the Austrian legal forms “GmbH” and “AG”, respectively. The conclusion of an extensive answer to this question would go beyond the scope of this study and needs to be reserved for further scientific research. However, the previous findings of this study suggest that such comparability, especially, with regard to, among others, legal personality, limited liability, registered capital, articles of association, and convertibility of shares in capital can be confirmed. Consequently, the CHHC would satisfy the group member criteria of § 9 II scale line 2 aKStG, making it eligible for the inclusion into the group. 352 The CHHC takes the form of either an EJV or a WFOE. These forms on their part take the form of either a LLC or CLS, too. Therefore, the EJV or WFOE, and the CJV once established as a legal person, can become group members, supposing the comparability of legal forms. An Austrian enterprise operating as a group member or a group parent, thus, can include its regular first-tier Chinese subsidiary-FIE, be it the CHHC or an operating Chinese subsidiary-FIE, into the group. 353

b. Group Parents

The term and event “group parent” is ruled and defined in § 9 III aKStG. Correspondingly, a group parent can be unlimited tax liable corporations, unlimited tax liable purchasing and industrial cooperatives, unlimited tax liable mutual insurance companies, and unlimited tax liable lending institutions. Yet, group parents can also be limited tax liable corporations, but only if such limited tax liable corporations are listed in the presently valid version of Annex 2 to § 94a aEStG or in Annex 2 of the EC-Parent-Subsidiary-Directive. 354 In case the entity applying for group parentship is not listed in one of these annexes, it needed to be a legal person that is company-law comparable to Austrian corporations. In addition it needed to maintain either its registered office or place of effective management in a member state of the

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351 Compare chapter B.III.4.b.
European Economic Area. Moreover, such a foreign entity must have a domestic “link”. Such a “link” can be in the form of either a registered branch\textsuperscript{355}, or a share in an actively operating domestic partnership, which potentially establishes a registered branch itself. Yet, the eligibility criteria goes further as the equity interests held in the group members need to be attributable to the regular business property of the registered branch or the partnership, respectively. From a tax-law point of view, such a registered branch needs to qualify as a permanent establishment\textsuperscript{356}, in order to qualify for group parentship.\textsuperscript{357} Another option is given through a dual-resident foreign legal person that can become a group parent, too, if it has registered a branch in Austria, and the equity interests held in Austrian group members are attributable to such a registered branch. Furthermore, the applicant needed to maintain its registered office\textsuperscript{358} in a country with which Austria has signed a double tax treaty. However, the given treaty needed to contain provisions prohibiting reciprocal discrimination with regard to the qualification of permanent establishments and would overrule § 9 aKStG.\textsuperscript{359}

Another alternative form of a possible group parent could be what the law calls “participation pools” (“Beteiligungsgemeinschaft”). Participation pools as stipulated in

\textsuperscript{355} As per the European Court of Justice a “registered branch” is any establishment of a EU-foreign company outside the country of this company’s registered office. Compare European Court of Justice, C-167/01; European Court of Justice, C-208/00; European Court of Justice, C-212/97. A more detailed definition is given by the Austrian Commercial Code (“Handelsgesetzbuch”; hereinafter “aHGB”) in § 13 aHGB and the German Commercial Code (“Handelsgesetzbuch”) in § 13 German Commercial Code, according to which a “registered branch” is a civil-law dependent, but spatially, organizationally and economically independent part of an enterprise, which is being established for a certain period of time and in which business is done comparable to that of the registered office. Also compare hereto German Federal Tax Court, July 20, 1988 and see Trenkwalder, §9 Abs 3 KStG, 2005, pp. 46 et seq.

\textsuperscript{356} “Permanent establishment” is a fixed tax term. Nationally, in Austria and Germany a “permanent establishment” is defined as “a dependent part of an entire enterprise and as such generally not to be qualified as a legal subject and as an independent subject of taxation. Nevertheless, does the tax law resume to the term “permanent establishment” in order to demarcate taxing powers, especially in the international context of tax treaties; it becomes relevant when it comes to the local allocation of income and assets. See § 29 Austrian Federal General Fiscal Code (“Bundesabgabenordnung”) and § 12 German General Fiscal Code (“Abgabenordnung”); also see, e.g., German Federal Ministry of Finance, Directive IV B 4 – S 1300 – 111/99; German Federal Tax Court, February 3, 1993; German Federal Tax Court, August 29, 1984. For further reference compare also Bendlinger/Remberg/Wiechers, Betriebsstättenbegriff, 2004, pp. 578 et seq.; Edgar/Holland, Source Taxation, 2005, pp. 525 et seq.; Jann/Schuch/Toifl, Austria, 2005, pp. 25 et seq.; Kroppen, Betriebsstättenewinnermittlung, 2005, p. 74; Möller, Begriff, 2005, pp. 350 et seq.; Wiesner/Mayr, Zweifelsfragen, 2005, p. 569.


\textsuperscript{358} Regarding the question of the location of the registered office of internationally acting holdings compare Ebert, Geschäftsleitung, 2005, pp. 534 et seq.

§ 9 III scale line 8 aKStG can be formed when no single entity fulfills the sufficient financial affiliation-criteria. Through this tool, multiple incorporated bodies, each of them individually satisfying the civil law criteria stipulated by Austrian law and legal practice, may create a “multi-parent-group”. Such a participation pool regularly will take the form of either a partnership or a comparable contractual syndication. Members of participation pools can simultaneously be either the group parent or a group member of a separate group. A participation pool can be established either as an individual group parent of any given group, but also at a group’s mid-level, if members, who simultaneously are group members of a different group, decide to establish it. A mid-level participation pool can only exist of Austrian unlimited tax liable legal persons, analogously to § 9 II scale line 2 aKStG, whereas group parent participation pools may include all forms of incorporated bodies as they are listed in and fulfill the conditions set forth in § 9 III aKStG.

Generally, unlimited tax liable incorporated bodies can only be group members or group parents in one single group; multiple group membership or parentship is not possible. Moreover, the group parent of one group may not be a group member of another group. However, limited tax liable foreign incorporated bodies may be members of their possibly existing national group-relief regimes, without contradicting a membership in an Austrian group. Ultimately, within this thesis only corporations as a special form of incorporated bodies are reviewed. Domestically, in Austria, therefore, group members and group parents either take the form of a GmbH or an AG. In cases, where foreign group members or group parents become part of this study they shall also be corporations that abiding the Austrian law are comparable to Austrian corporations.


361 § 9 III scale line 8 s. 2 aKStG. Compare Figures 7 and 8.


364 Existing differences in the legal structures of these forms of companies are not focussed and can be neglected, as is the Societas Europaea.

c. **The Financial Affiliation**

The discussion of the conditions necessary to fulfill the events “group member” and “group parent” has shown which enterprise forms are eligible to become either group members or group parents. Yet, a group is only formed if an affiliation between group member and group parent is created. This event is realized through a “financial affiliation”. The mandatory event “financial affiliation” is defined in § 9 IV aKStG. The law provides two conditions that constitute “financial affiliation”. Firstly, the group parent or respectively higher-ranked group member must reach a minimum 50%-threshold in the potential group member’s registered capital, and secondly, simultaneously, at least 50% of the voting rights in such a potential group member must be attributable to the group parent or to the respectively higher-ranked group member.

The combination of both conditions is reasonable taking the balance of power in a shareholder meeting, as well as the investment risk into account. The voting-rights rule is to be interpreted quantitatively, demanding that an absolute majority in the voting rights of more than 50% needs to be allocated to the group parent or respectively higher-ranked group member. Individually drafted and applied variances in the construction of the voting rights, e.g., in non-voting preference stock or treasury stock are not taken into account. In cases, where the equity interest and the share in voting rights differ, the equity interest is deemed to be the knock-out criterion.\(^{366}\) As Figures 10 and 11 show the financial affiliation can be established either via direct or via indirect financial affiliations, as well as via combinations thereof. Indirect financial affiliations can be constituted through partnerships, other group members, or a participation pool.

Figure 10: Domestic Austrian Group Constellations

However, if indirect shareholdings via partnerships are being included into the constitution of a group, the group parent needs to hold more than 50% in such a partnership directly. If the group parent’s equity interest in such a partnership is less than 50%, the corresponding indirect shareholdings are excluded from the computation of sufficient financial affiliation.

While cases of direct financial affiliation, apparently, do not cause problems, cases of indirect financial affiliation may occasionally result in structural challenges. One structural alternative provided by law is the abovementioned participation pool. A participation pool can constitute a group, if the individual shareholders individually do not hold a sufficient equity interest and share in voting rights of the enterprise they wish to include into the group separately.

369 See above!
In § 9 IV scale line 4 aKStG, the law rules that in cases of such participation pools, at least one majority shareholder of the pool must hold a 40% equity interest in the entity that is to be included into the group and every other shareholder of the pool must at least hold 15% in such entity’s capital. A participation pool can also be established, if one entity already is sufficiently financially affiliated to the respective group member and could actually form a group on its own.370

As per § 9 V s. 1 aKStG, the financial affiliation must exist for the entire fiscal year of the respective group member that is to be included into the group. Therefore, entities that, e.g., are acquired during their fiscal year may not be included into the group. With acquisitions, it may sometimes be difficult to determine the precise date when such acquisition became effective and, correspondingly, when the acquired entity could be included into the group. The Group-Directive suggests that this should regularly be documented by the date set forth in the acquisition agreement.372

The financial affiliation is computed by adding direct shareholdings and by multiplying indirect shareholdings. Figure 12 provides an example that includes both direct and indirect shareholdings, as well as a participation pool in connection with a cross-border scenario.

Formally, a group is established by written formal application for a minimum period of three fiscal years. The application is filed by the group parent or in cases of a participation pool by the majority shareholder of the pool, at its competent corporate income tax office.\(^{374}\)

\(^{373}\) Self-prepared figure.

\(^{374}\) § 9 VIII scale line 5 aKStG. Compare also Austrian Federal Ministry of Finance, Directive, 010216/0031-IV/6/2005, 2005, pp. 50-55; Achatz/Postl, §9 Abs 8 KStG, 2005, pp. 205 et seq.; Bruckner et al., Gruppenbesteuerung, 2005, pp. 198 et seq.; Danelsing, Österreichische Gruppenbesteuerung, 2005, p. 1345; Gahleitner/Ratzinger, Group Taxation, 2005, p. 512; Wiesner/Mayr, Gruppenbesteuerung, 2004, p. 635. Tax effects, e.g., of the breach of the minimum period or of the withdrawal of a foreign group member, as well as the overall tax aspects of the “Gruppenbesteuerung”, are illustrated in Chapter C.
2. The Allocation of Income

The central idea of the “Gruppenbesteuerung” is the possibility to pool the “authoritative tax results” of the group members at the level of the group parent.\(^{375}\) In spite of that, each group member maintains its own independent tax-subject-status and individually computes its own tax financial statement income and taxable income in accordance with the general tax accounting provisions. The wording of § 9 I s. 2 aKStG provides that the quantity that is being allocated at the different levels of the group and ultimately pooled at the level of the group parent is what the law calls “the authoritative tax result”. With the term “authoritative tax result”, the law introduces a new quantity, deciding not to use, for instance, the tax concepts of terms like “income” or “taxable income”. Given the systematic of § 9 aKStG, especially of § 9 VI no. 6 aKStG, the lawmaker was forced to find a term that would also include the authoritative tax results of unlimited tax liable group members, as well as such of foreign group members.\(^{376}\)

a. Domestic Group Members

i. The Computation and Allocation of Domestic Tax Results

The Allocation of the authoritative tax results of domestic unlimited tax liable group members equals the allocation of the positive or negative taxable income of the respective unlimited tax liable group members\(^{377}\) to the sufficiently financially affiliated\(^{378}\) group member, or directly to the group parent, respectively. The reference to the taxable income, as defined in § 7 I, II, and III aKStG, is derived from § 9 VI no.’s 1 and 2 aKStG.\(^{379}\) The provisions for the allocation of the authoritative tax result of unlimited tax liable group members are set forth in § 9 VI no.’s 1 until 3 aKStG.


\(^{376}\) See §9 VI no. 6 aKStG; Austrian Federal Ministry of Finance, Directive 010216/0031-IV/6/2005, 2005, pp. 22 et seq.

\(^{377}\) For a definition of unlimited tax liable group members see chapter C.II.

\(^{378}\) See §9 IV aKStG.

After filing the taxable group income, such income is tax-assessed at the level of the group parent. The actual allocation is executed by way of an out-of-balance-sheet tax computation. Accordingly, a true tax consolidation is not taking place, as intra-group transactions and results are not eliminated, but rather remain taxable under the provisions of the “Gruppenbesteuerung”. Each single unlimited tax liable group member pools its own accounted profit or loss with the authoritative tax results of its respective subsidiaries. Thus, on each level of result-aggregation, a profit and loss set-off is achieved. Such pooled result, subsequently, is gradually allocated up to the hierarchically next higher group member or to the group parent. Ultimately, the group parent computes its regular taxable income and adds the allocated results, both from domestic as well as from foreign group members. This add-back computation, however, takes place irrespective of the formal income computation of the group parent. The group parent adjusts the aggregated result according to the provisions of the tax laws, § 7 II aKStG, in order to derive the entire group’s taxable income. As per § 8 IV aKStG, resulting group losses can be carried forward and claimed as a loss deduction that is deducted from respective future income as a special deduction, subject to the limiting provisions set forth in § 2 Ila and IIb aEStG and in § 9 IV no. 4 aKStG.

When computing the incomes of the group members and the group parents, the legal transactions underlying all exchanges of services, service relationships, and transfer of assets within the group, i.e. between the group parent and its members, or between group members, have to follow an arm’s length principle. Such legal transactions have to be executed, as if they were realized between third parties in a free market place, actually following internationally accepted transfer pricing principles. Otherwise, the computed results have to be corrected either by way of an out-of balance sheet add-back computation or by way of a deduction.

382 The allocation follows the allocation theory, compare supranote 202 and Bruckner et al., Gruppenbesteuerung, 2005, p. 139.
385 Compare Tumpel/Aigner, §9 Abs 6 KStG, 2005, pp. 151 et seq.
ii. The Scope of Allocated Domestic Tax Results

With regard to the scope of the allocated results of unlimited tax liable group members, the general rule states that the income is to be allocated in full, i.e. at a 100%.

Such full allocation happens independently of the scope of the actual financial affiliation, meaning that the results are not allocated in proportion to the actual shareholding quotas, yet always in full. Thus, the question of how such financial affiliation has been established, can be neglected.

Direct, but also indirect financial affiliations, e.g., via partnerships, are included into the computation of the financial affiliation threshold. Once such financial affiliation, aggregated direct and indirect shareholdings, passes the “sufficiency-criterion”, set at more than 50%, the full amount of authoritative tax result is allocated to the next higher entity within the group that realizes the event of a sufficient financial affiliation.

Alternative 3 of the following Figure 13, e.g., displays a case, where the financial affiliation is realized only by the group parent facilitated through the multiplicative consideration of its equity interests in group members 1, 2, and 3 that mediate the financial affiliation to the group parent.

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The rule of full allocation of results is ignored by two exceptions.\textsuperscript{389} The first exception are cases, where the sufficient financial affiliation is constituted by the establishment of a participation pool as per § 9 III scale line 8 aKStG. The second exception refers to the involvement of the authoritative tax results of foreign group members, as provided for in § 9 VI no. 6 aKStG. A discussion of the latter case follows in the next chapter.

In cases of a participation pool, where a single corporate group parent is not identifiable, each member of the group parent participation pool receives a share in the group member’s results proportionate to their respective equity interest in the participation pool. However, the participation pool itself is to be seen as the group parent and, thus, receives 100% of the respective group members’ results. The same systematic is to be applied in cases of a mid-level participation pool. The pool, as such, receives the full results. However, the next higher entity, be it a group member, here functioning as a parent company to one of the pool’s members, or the group parent of such a pool’s member, only receives the particular member’s individual share in the result that has been allocated to the pool.\textsuperscript{390} To support the understanding of the result-allocation in connection with a participation pool, a basic example is given by Figure 14.\textsuperscript{391}

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{ParticipationPoolDiagram.png}
\caption{The Participation Pool}
\end{figure}

\textsuperscript{389} Compare Wiesner/Kirchmayr/Mayr, Gruppenbesteuerung, 2005, pp. 15 et seq.
\textsuperscript{391} See previous supranote.
b. Foreign Group Members

i. The Computation and Allocation of Foreign Tax Results

Foreign group members in this context are understood to be non-Austrian corporations that from a civil law point of view are comparable to Austrian corporations. The allocation of the authoritative tax results of foreign group members varies significantly from that of unlimited tax liable group members. The general rule for the inclusion of foreign results into the group is manifested in § 9 VI no. 6 aKStG. It rules that only losses that have been accounted for in accordance with § 5 I aEStG and the further provisions of the aEStG and of the aKStG are allocated to the directly financially affiliated group member or group parent, respectively. These losses are allocated proportionate to the sum of equity interests of all directly financially affiliated group members, including a financially affiliated group parent. Lacking a domestic right to tax, positive income cannot be included into the group. The main questions with regard to the inclusion of the authoritative tax results of foreign group members, hence, cover aspects such as the scope of losses, the method of computation, the treatment of the results of domestic permanent establishments maintained by foreign group members, and the tax consequences triggered once the foreign group member exits the group.

Once the group parent, i.e. the holding company, has taken the management decision to include a foreign subsidiary into the group as a group member, such entity’s results have to be allocated into the group obligatorily. § 9 VI no. 6 s. 1 aKStG provides that the computation of the includable amount of loss has to follow § 5 I aEStG and other tax accounting principles set forth by the Austrian tax law, including all special provisions ruling the derivation of the tax financial statement income and the taxable income. This provision has to be applied irrespective of any results such foreign group member has actually reported in accordance with the laws and regulations of its domestic jurisdiction. Thus, a tax result naturally accounted for in accordance with foreign tax accounting rules, has to be transformed into tax results as if derived following Austrian tax provisions. Only if the computation following

392 With regard to the comparability of corporations see chapter B.IV.2.


the Austrian provisions results in a negative tax result, i.e. a loss, such a result can be allocated into the group.

The actual allocation of such foreign losses essentially follows the provisions set forth in connection with the consideration of losses of foreign permanent establishments as ruled in §2 VIII aEStG. The starting point for the computation of a possible utilizable foreign loss is the commercial financial statement of the foreign group member that has been prepared in due course. It is being assumed that based on such commercial financial statement the foreign tax results have been computed. Based on the commercial financial statement an “Austrian” tax result is derived, by applying the respective Austrian tax rules. The aforementioned, however, only applies in cases, where the legal framework on which the derivation of the foreign commercial financial statement is based can either be compared to the aHGB, IFRS or US-GAAP. In other cases the Group-Directive rules that it is the respective group member’s or group parent’s obligation to provide such a proper commercial accounting basis to which the Austrian tax rules can be applied in order to derive the applicable foreign tax result. Generally, a foreign loss can only be claimed in Austria, when it has not been utilized, i.e. been set-off, in its country of origin, e.g., by way of loss-carryback or set-off against any other income within foreign group-relief regimes.

Yet, the aforementioned leaves open cases in which foreign group members realize income in Austria and thus realize a limited tax liability in Austria. Such income could be realized, e.g., by operating a permanent establishment, by realizing other domestic income, or by holding a subsidiary in Austria. The results, positive as well as negative, realized by an Austrian permanent establishment operated by a foreign group member are fully allocated to the Austrian entity (group member or group parent) that is sufficiently financially affiliated to the foreign group member. Whereas, other income realized by the foreign group member is excluded from the “Gruppenbesteuerung” and follows the general rules for the limited tax liability as per §§ 21 I, 24 aKStG in connection with § 98 I aEStG. Such other income is subject to the general rules of limited tax liability.

The inclusion of domestic subsidiaries of foreign group members into the group depends on the existence of the mandatory financial affiliations. In case the financial-affiliation-criteria are satisfied, the result of such a domestic subsidiary is directly allocated to that domestic group member or to the group parent that is financially affiliated to the foreign group member. Ultimately, in the latter case the domestic subsidiary of the foreign group member qualifies as a domestic group member itself.

ii. **The Scope of Allocated Foreign Tax Results**

The derived loss is allocated to the directly financially affiliated group member or group parent, respectively. §9 VI no. 6 s. 1 aKStG stipulates that foreign losses can only be included into the group at a scope equal to the aggregated proportions of equity interests held by domestic group members and the group parent in first-tier foreign group members. Although the law provides that the equity interests have to be “held directly”, it can be interpreted, that both indirectly and directly held equity interests ultimately constitute the scope of includable foreign losses. The decisive criterion remains the “sufficient financial affiliation”.

Due to the different tax treatment of legal persons opposite natural persons active in some form of partnership, the allocation remains possible in spite of the abovementioned. Based on the “transparency principle”, such natural persons are merely a “subject of income assessment”, but not an individual tax subject. Income generated by such natural persons, hence, is allocated to their shareholders, who in turn are the subject of taxation for the income received by the natural person. In the cases reviewed within this thesis, such shareholders would typically be corporations that are subject to corporate income tax and eligible for the provisions of the “Gruppenbesteuerung”. However, an Austrian partnership can mediate a sufficient financial affiliation in a foreign subsidiary to make it become a group member and, hence, to grant the allocation of the foreign losses into the group. The scope of such mediated losses equals the quote resulting from the multiplication of the ratio of equity interests held in
the partnership with the ratio of equity interests held by the partnership in the foreign group member.\(^{403}\)

In case neither a single group member nor the group parent is directly financially affiliated to the foreign group member, direct and indirect equity interests can be combined to establish such direct financial affiliation at the level of a group member or of the group parent. Foreign losses would be allocated to the directly financially affiliated entity by applying the allocation theory. Losses resulting from direct shareholding are allocated at a quote equaling the direct shareholding quote. Contrary thereto, losses resulting from indirect shareholdings are allocated at a quote that equals the results from multiplying the respective indirect and direct shareholdings with each other. Additionally, only direct shareholdings are eligible to be included into the computation of the scope of actually attributable losses. Therefore, it has to be noted that, while the financial affiliation threshold can be established via direct and indirect shareholdings, the scope of includable foreign losses is dependent on direct shareholdings only.\(^{404}\) It can be said that the actually existing scope of the financial affiliations between and among the group members and their group parent may, but must not necessarily equal the actual scope of the allocation of authoritative tax results, as shown in Figure 15.\(^{405}\)


The actual existence of a foreign group including the foreign subsidiaries, i.e. foreign group members, as such does not have any tax impact on the allocation of their individual operating losses to either domestic group members or to the domestic group parent. Each foreign entity that is to be included into the domestic group computes its authoritative tax results on an individual basis and only such individually computed results, not a possible foreign (consolidated) group result, are allocated. However, the existence of a foreign group must be considered closely in connection with the recapture taxation as ruled in § 9 VI no. 6 s. 2 and 3 aKStG.\(^{407}\)


iii. Facts of Recapture Taxation

As the previous chapter states, foreign losses can only be included into the group after loss-carryforwards and -backs have been considered at the level of the foreign group member in accordance with such group member’s national tax laws. However, once a domestically claimed foreign loss becomes eligible for a set-off or any other form of tax-effective utilization in the foreign group member’s residence country, e.g. through mergers, reorganizations or de-mergers, then § 9 VI no. 6 s. 2 aKStG provides for recapture taxation.\(^{408}\) The actual recapture taxation in connection with § 9 VI no. 6 s. 2 aKStG follows the rules provided for recapture taxation in § 2 VIII aEStG and by legal practice, respectively.\(^{409}\) Bruckner et al. furthermore, conclude that the actual amount that is subject to recapture taxation is capped in two ways. First, the amount may not be higher than the amount of loss that can be tax utilized according to the respective foreign tax laws and second, such amount may not be higher than that which has actually been allocated in Austria following Austrian tax law.\(^{410}\)

§ 9 VI no. 6 s. 3 aKStG rules for another form of recapture taxation in cases the foreign group member exits the group after the minimum holding period of three years, e.g. by way of sale, transfer, liquidation, or insolvency. In the exit year, an amount equaling the amount of all such entity’s losses have to be claimed as a profit at the level of the group entity that previously was the recipient of the foreign entity’s allocated losses. However, this applies only to losses that have not yet been set-off against previous income or been tax utilized at the level of the respective foreign group member, which previously allocated the foreign entity’s results to its results, in another way.\(^{411}\) Given that in the cross-border context the scope of the allocated foreign results depends on the scope of financial affiliation, a reduction in the scope of financial affiliation consequently triggers a taxable event. Such reduction in financial affiliation, hence, is subject to recapture taxation to an extent proportionate to such reduction. However, the aforementioned is always subject to the financial-affiliation criteria as per § 9 IV aKStG, meaning that the domestic group member or group parent needs to maintain its


\(^{410}\) Compare Bruckner et al., Gruppenbesteuerung, 2005, p. 147; supporting Tumpel/Aigner, §9 Abs 6 KStG, 2005, pp. 164 et seq.

sufficient financial affiliation to the foreign entity. In case a utilization of foreign losses does ultimately not become eligible in the respective group member’s seat country, accordingly no recapture taxation will take place in Austria. However, this is subject to a strict assessment and the transfer of losses to a separate legal entity, e.g. by way of corporate reorganizations, is considered a utilization of such losses and the events of recapture taxation would be realized.\textsuperscript{412} In connection with cases of liquidation or insolvency of the foreign group member, the aggregated amount of allocated foreign losses is subject to an adjustment. In accordance with § 9 VI no. 6 s. 4 aKStG, the amount that is subject to recapture taxation equals the balance of the aggregated amount of allocated foreign losses less tax-effective fair value write-downs that were taken out on the underlying investment.\textsuperscript{413}

c. Pre-Group and Out-Of-Group Losses

§9 VI no. 4 aKStG manifests a special rule with regard to pre-group and out-of-group losses incurred by group members. “Pre-group losses”, are losses that were incurred and subsequently carried forward by a group member. Such losses result from a time before the establishment of the group. “Out-of-group losses”, are losses that a group member incurs as a result from takeovers of “out-of-group” entities. In course of such re-organizational measures, the acquiring group member, thus, might “inherit” loss carryforwards that were originally incurred by the acquired entity. Both kinds of losses cannot be included into the group and be allocated to the next higher-leveled group member or to the group parent. Such losses can only be set-off directly against the operative income of the given entity realizing such a special loss. However, the amount that can be set-off shall not exceed the amount of operative income.\textsuperscript{414}

\textsuperscript{412} Compare Tumpel/Aigner, §9 Abs 6 KStG, 2005, pp. 166 et seq.
Contrary thereto, pre-group and out-of-group losses realized by the group parent may be included into the group and allocated to the results the group parent is allocated from its group members. The rules described above, also do not apply in cases, where losses are incurred because of re-organizational measures taken out within the group. Loss-carryforwards resulting thereof may be claimed as a regular loss in the subsequent years and, thus, are group-relevant.415

3. The Tax Levy within the Group

§ 9 VIII scale line 3 aKStG rules that the financially affiliated domestic corporations have to provide a tax levy agreement. The tax levy agreement is based on civil law and company law principles, a statement of the existence of which is to be attached to the group application. Tax levy agreements are only mandatory between the group parent and the domestic group members as the allocation of foreign losses to the group parent does not influence the possibility of the foreign group member to claim a national loss-carryforward and, thus, does not influence the asset situation of the foreign group member.416

Given the fact that legal entities, i.e. the group members, allocate their income to another legal entity, i.e. ultimately to the group parent, raises the question, either how the participating entities are being compensated for waiving losses that ultimately reduce the group’s tax burden or for paying taxes for received profits on behalf of the group members. Clearly, both positive income and negative income have a monetary asset dimension to them that needs to be considered by some way of tax levy. Such tax levy agreements further have to be adopted, as the group members individually remain subjectively tax liable, yet, are not objectively tax liable.417 The questions associated to how such waiving of tax results is to be treated and handled are manifold and cover legal areas beyond that of the tax law and, thus, cannot be covered extensively by this chapter.

In general, tax levies are meant to determine the allocation of the corporate income tax burden according to its initial causes between the group parent and the group members subject to an economically meaningful cost apportionment. Additionally, such allocation has to take the

416 Compare Bruckner et al., Gruppenbesteuerung, 2005, p. 203; Wiesner/Kirchmayr/Mayr, Gruppenbesteuerung, 2005, p. 303; a different view at least with regard to the necessity to company law include foreign group members into the tax levy is represented by Artmann/Lux, Konzernrecht, 2005, pp. 318 et seq.
role of potential minority shareholders of a group member into account. Entities, that themselves are not members of the group and due to the affiliation of the group member to the group cannot dispose over their proportionate stakes in such an entity’s taxable income and have to be compensated accordingly.\textsuperscript{418} Tax levies are paid two ways. In case of the “positive” tax levy, a group member’s positive income is allocated to the group parent that in due course is obliged to set off such positive income against own losses, in order to compute the group’s taxable income and ultimately pay the group’s tax burden. For taking over the tax-paying obligation on behalf of the group member, the group parent is being compensated by a tax levy paid by the group member to the group parent. Contrary thereto, in case of the “negative” tax levy, a group member’s negative income is allocated to the group parent and, therefore, contributes to the overall reduction of the corporate income tax burden of the group. However, as the group member waives the use of such loss to the benefit of the group to the group parent, and, hence, such loss will not be available to the group member in subsequent years to set-off income, such waiving needs to be compensated, too. The group parent needs to pay a compensation to the group member.\textsuperscript{419}

4. Investments and Valuation Issues

The following chapters shall introduce the provisions set forth in §9 VII aKStG of the “Gruppenbesteuerungs”-regime covering the write-downs (write ups) to fair-value and capital losses (capital gains) realized in connection with disposing group members, as well as the amortization of goodwill within a group.

a. Fair Value Write-Down and Capital Losses

Contrary of the general provisions of Austrian tax law, a tax-effective deduction of the amount of a fair value write-down is not allowed as per § 9 VII aKStG. It is suggested that such a non-allowance is justified by the fact that through the transfer of losses within the group such decreases in fair value are considered sufficiently.\textsuperscript{420} Notwithstanding the

\textsuperscript{419} Compare Artmann/Lux, Konzernrecht, 2005, pp. 303 et seq.; Mühlehner/Zöchling, Gruppenbesteuerung, 2004, pp. 63 et seq.
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aforementioned, fair value write-downs, nonetheless, may be commercially carried out in order to adjust the investment’s value subject to economic circumstances. Thereby the carrying amount of an investment is reduced, but for tax reasons the anticipated expense is re-added to the tax financial statement income by way of an out-of-balance-sheet computation, thus re-increasing taxable income. Once such investments regain in fair value such gain has to be appreciated by way of a fair value write-up, up to an amount not exceeding the previous fair value write-down. The amount of such a commercial write-up is re-added for tax purposes causing a higher carrying amount, however initiating an out-of-balance-sheet reduction.421 As the group directive lays out, capital losses resulting from sales of investments in group members are to be treated accordingly, i.e. although such losses reduce the tax financial statement income, they are re-introduced by an out-of-balance-sheet computation in order to increase taxable income. Hence, the respective opposite thereto, a capital gain, may increase the tax financial statement income, yet its tax consequences needed to be neutralized out-of-balance-sheet.422

The intention of this provision to assimilate in status operating losses on the one hand and the decrease in value on the other hand has undergone significant critique from scientific and professional bodies. It is argued that a decrease in value, due to economic circumstances, does not necessarily have to result in an actual operating loss, yet, commercially a fair value write-down is immanent. However, according to § 9 VII s. 1 aKStG such a tax-effective fair value write-down is not allowed to be effected. Consequently, the sale of such an investment would lead to the tax systematic imbalance that fair value write-downs and capital losses are tax-ineffective, whereas capital gains are taxable.423

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421 Bruckner et al., Gruppenbesteuerung, 2005, pp. 172 et seq. and Wiesner/Kirchmayr/Mayr, Gruppenbesteuerung, 2005, p. 143, among others, criticize this provision as it contradicts the wording of §208 I HGB. Generally hereto compare Heidenthaler/Preining, §9 Abs 7 KStG, 2005, pp. 182 et seq.
b. Goodwill Amortization

As defined above, “goodwill” means the balance by which the acquisition price of an enterprise surpasses the aggregated carrying amounts of the acquired entity’s assets less such entity’s debts.\(^{424}\) In international tax law, it is common practice that the purchaser adjusts such goodwill commercially and for tax purposes over the course of time. Explicitly, such adjustment covers either the amortization of positive goodwill or the write-up of negative goodwill over a certain period. Such amortizations or write-ups have direct tax-effect. They either decrease or increase taxable income.\(^ {425}\)

§ 9 VII s. 2 aKStG rules that in case of the direct acquisition of an investment in an operational managerial (“betriebsführend”) unlimited tax liable corporation\(^{426}\) by a group member or by the group parent, a goodwill amortization is to be carried out. Yet, the acquisition of investments from entities already belonging to a group of companies is excluded from such goodwill amortization. The goodwill amortization starts with the date, when such acquired investment is included into the group for the first time. With reference to the general definition of the term “goodwill”, as given in the previous paragraph, § 9 VII s. 2 scale line 1 aKStG defines “goodwill” to be the balance of the acquisition cost of such an investment less the proportionate share in commercial equity and less the proportionate share in built-in gains from non-wasting fixed assets.\(^ {427}\) However, the same provision further rules that the absolute amount of such goodwill may in no event exceed 50% of such an acquisition cost. The goodwill is to be amortized equally over a period of 15 years and only eligible for the duration of the group affiliation.\(^ {428}\)

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\(^{424}\) See §203 V aHGB; §255 IV German Commercial Code ; Doralt, Rechnungslegung, 2005, IAS 36.80 et seq & IFRS 3.51 et seq, & p. 532; Haidenthaler/Preining, §9 Abs 7 KStG, 2005, pp. 175 et seq. A detailed discussion of the separate goodwill concepts of the aEStG opposite the aKStG can be found at Hofstätter/Plansky, Firmenswert, 2004, pp. 359 et seq.


\(^{426}\) This means that the goodwill amortization as per §9 VII aKStG is only eligible in cases of the acquisition of Austrian investments, whereas foreign investments cannot become subject to a goodwill amortization; compare hereto, e.g., Tumpel/Tissot, Änderungen, 2004, p. T150; Wörndl/Kornberger, Österreich, 2004, p. 579. A structural alternative is offered by Bruckner et al., Gruppenbesteuerung, 2005, p. 180 and Stefaner/Weninger, Punkte, 2005, p. 254, where they suggest that according to the wording of the aKStG foreign entities could become eligible for the goodwill amortization if they moved their place of management to Austria before the inclusion of such entity into the group becomes effective. Supporting also Stefaner/Weninger, Konzerne, 2006, p. 38.

\(^{427}\) Several authors have criticized the inclusion of the commercial equity instead of the tax equity as a basis for the computation of the § 9 VII aKStG-goodwill. Hereto, e.g., Bruckner, Top oder Flop? II, 2005, p. 260.

Systematically, the goodwill amortization, as ruled in § 9 VII aKStG, is to be strictly differentiated from the general goodwill-amortization provision, as set forth in § 8 III aEStG, although both provisions contain a mandatory capitalization rule. While the latter only allowed for a goodwill amortization in cases of asset deals, with the introduction of § 9 aKStG, the Austrian lawmaker intended to equalize a previously existing respective disadvantage of share deals, by making the goodwill amortization eligible, once enterprises were acquired by way of a share deal. Moreover, the special goodwill-amortization provision of § 9 VII aKStG, results in the exclusion of certain other provisions that might have been eligible in case of the non-existence of a group. Correspondingly, the goodwill amortization of § 9 VII aKStG excludes the possibility to undertake, e.g. a fair value write-down on an anticipated entire group-goodwill. Additionally, as per § 9 VII s. 2 scale line 3 aKStG, the termination of the group or the exit of the respective entity, whose goodwill has previously been amortized, is equivalent to the loss of potentially remaining fifteenths that have not yet been tax-utilized either by way of amortization or write-up (§ 9 VII s. 2 scale line 4 aKStG), respectively.

A goodwill amortization, as per § 9 VII aKStG, is only eligible for investments constituted by way of direct shareholding. The amount of the actual claimable goodwill amortization is proportionate to the scope of direct shareholding, a financially affiliated group member or group parent holds in such an investment. Furthermore, such a goodwill amortization may only be claimed for full business years. Hence, for all incomplete business years that the investment is being accounted for, a fifteenth of the goodwill is lost. In such cases, where the scope of an investment is successively increased/decreased, yet the financial affiliation criterion is fulfilled for the entire respective economic year, the goodwill amortization has to be taken out in according proportions.


Excluded from the entitlement to the goodwill amortization are investments acquired and traded within a group of companies, i.e. within the group itself, as well as investments acquired from a shareholder that, according to the law, “exercises a controlling influence” in such an investment.\(^\text{432}\) Both events are primarily bound to the investment threshold set forth in § 228 aHGB, i.e. an equity interest of no less than 20% of nominal capital. However, while the existence of a group of companies is subject to a broader definition, reaching beyond a mere stake of 20% in a given investment, the second event, “controlling influence”, is meant to be satisfied, once such threshold is reached. Yet, as Bruckner understandably argues, it may very well be the case, that a single shareholder holding 20% in a given investment actually is not in a factual position to exercise a controlling influence.\(^\text{433}\) Notwithstanding this, the provision of § 9 VII aKStG and the Group Directive presuppose the events of the § 228 aHGB-threshold and do not consider possible events of a given single case.

Imaginable are, moreover, cases, where an investment is meant to be included into the group, as a group member, but prior to such inclusion a regular fair value write-down on such investment has been exercised. Accordingly, § 9 VII scale line 2 aKStG, sets forth that any given acquired goodwill needs to be reduced by the amount of previous fair value write-downs. Subsequently, the carrying amount of such investment is periodically reduced by a fifteenth of the adjusted goodwill amount and by any outstanding seventh, if any, from the pre-group fair value write-down, according to § 12 III no. 2 aKStG.\(^\text{434}\)

Contrary to the prohibition of tax-relevant fair value write-downs within the group, as per § 9 VII s. 1 aKStG, fair value write-downs might have to be commercially carried out as per § 204 II aHGB. Thus, goodwill amortizations, at one-fifteenth a year of the amount of the computed goodwill, might still coincide with a fair value write-down. Should the amount of the fair value write-down exceed that of the goodwill amortization, the resulting balance reduces the carrying amount of the respective investment in a tax-neutral manner. In subsequent periods, the goodwill amortization would be adapted to the now changed (reduced) carrying amount of the investment in focus.\(^\text{435}\) Ultimately, in

\(^{433}\) See Bruckner, Top or Flop? II, 2005, p. 261; Bruckner et al., Gruppenbesteuerung, 2005, pp. 179 et seq.; supporting Haidenthaler/Preining, §9 Abs 7 KStG, 2005, pp. 188 et seq.
§ 9 VII s. 2 scale lines 4, 5 aKStG it is ruled that the annually amortized or written-up amounts decrease or increase the tax relevant carrying amount of the investment in question and, therefore, consequently decrease or increase the taxable income.436

VI. INTERNATIONAL TAXATION

International taxation as a legal discipline covers tax facts that are not exclusively realized within the territory of a single country.437 The holding, as envisioned in this thesis, is an internationally operating unit that is economically active in multiple countries, territories, and jurisdictions. These economic activities carried out by the holding company or other holding members often realize taxable events in such territories. According to the principle of sovereignty,438 each country is autonomous with regard to the assessment and execution of its individual tax claims. The tax claim from a particular tax event attaches to certain criteria. Hence, in order to identify a tax liability, tax claims usually attach either to the person of the taxpayer, the tax object, the use of goods, transactions, and/or combinations thereof. Additionally, to conclude the scope of tax liability, the tax base has to be identified beforehand. Either the tax base is of a universal, or a territorial scope, i.e. the respective state can make a tax claim on operative facts realized universally or only from such realized territorially. If taxpayers are taxed on their universal tax base by a single country439, then such taxpayer is unlimited tax liable in that country. In case a country taxes a taxpayer, only on his territorial tax base440 that taxpayer is considered limited tax liable.441

The focus of this thesis vests on unlimited tax liable corporations. Austrian unlimited tax liable corporations compute their worldwide taxable income, the tax base, in accordance with § 7 III aKStG and §§ 2 VIII, 5 aEStG. However, given that within international transactions, the holding realizes tax-effective operative facts and events in more than one territory, raises the question, which of the affected territories has the right to tax the involved parties and transactions. For example, one can easily imagine that an Austrian unlimited tax liable holding company receives dividend income or interest payments from a Chinese subsidiary. In the given example, per se, the Austrian holding company is, as per § 1 aKStG, unlimited

439 Often referred to as the “principle of residence”.
440 Known as the “principle of source”.
tax liable in Austria, however, the dividends distributed or the interest paid by the Chinese subsidiary are simultaneously subject to local Chinese tax provisions. The simultaneous applicability of two tax jurisdictions leads to a collision. The collision of tax systems can cause two forms of double taxation. “Juridical double taxation” emerges, when the identical tax subject is subject to an identical or similar tax in several countries for the identical events and an identical time. Opposed thereto, “economic double taxation” means the double assessment of a tax object in several countries or the assessment of a tax object in several countries through different taxes.442

From an economical point of view, international double taxation implies the disadvantage of an additional financial burden. The simultaneous taxation of taxable events domestically and internationally causes a reduction of the taxpayer’s net income, resulting in a competitive disadvantage for internationally operating companies. This disadvantage tends to reduce international business and trade and, hence, expands into problems for entire economies, as it causes the reduction of the mobility of production factors, of international labor sharing, and FDI. Consequently, decisions made in the context of international transactions have to consider potential effects of double taxation and have to seek strategies and solutions within the given legal toolbox to avoid such double taxation. There exists a range of unilateral, as well as bilateral provisions aiming at the avoidance or reduction of double taxation, especially juridical double taxation. At the centre of interest for holdings and their decision makers are provisions governing the avoidance of double taxation of especially profit transfers, such as dividends, interest and capital gains from across the border into the domestic territory.443

1. Unilateral Avoidance of Double Taxation

The Austrian unilateral avoidance of double taxation concerning corporations is ruled in § 48 Bundesabgabenordnung. §§ 1, 10, 21 aKStG and §§ 1, 6 no. 6, 98-103 aEStG provide detailed rules within the income tax laws, how taxable events with cross-border affiliation are taxed. Within the framework of the Austrian corporate income and individual income tax law, the focus of the avoidance of double taxation of unlimited tax liable entities lies on the tax

exemption and the tax credit method.\textsuperscript{444} The Austrian corporate income and individual income tax laws contain unilateral provisions that have their focus on tax-relevant cross-border issues. These unilateral provisions intend to anticipate typical cross-border transactions and to implement a tax treatment that simultaneously satisfies the taxation needs and rights of the Republic of Austria, as well as to correspond to the agreed fundamentals of international taxation. Given the economic nature of an international holding, especially unilateral provisions ruling the cross-border allocation and transfer of profits, as well as the tax treatment of correspondent expenses, appear to be of major interest. Hence, the following remarks focus first on the general unilateral rule for the avoidance of double taxation, § 48 Bundesabgabenordnung, and subsequently on aspects of the international allocation of profits ruled by § 6 no. 6 aEStG, and the international participation exemption as set forth in § 10 II, III aKStG.

a. § 48 Bundesabgabenordnung

The Austrian Fiscal Code provides in its § 48 a general provision covering the domestic attempt to avoid double taxation in cases not governed by bilateral treaties. Conditional for the application of § 48 Bundesabgabenordnung is that the respective taxpayer is subject to the fiscal jurisdiction of several countries. The provision tries either to balance domestic and foreign taxation or to achieve a tax treatment in accordance with the principles of reciprocity. For the application of one of these two alternatives, the existence of a real juridical double taxation and/or potentially of an economic double taxation is conditional.\textsuperscript{445} The application procedures of § 48 Bundesabgabenordnung are supported by the Avoidance of Double Taxation Decree (hereinafter “\textit{ADT-Decree}”).\textsuperscript{446} The ADT-Decree rules which foreign income, whose taxation is not governed by a double tax treaty, are subject to the exemption method, § 1 I ADT-Decree, and which are subject to the tax credit method, § 1 II, III ADT-Decree. According to § 1 I ADT-Decree, the tax exemption method is only applicable in cases, where the foreign income is subject to a 15% average tax burden. Cases,

\textsuperscript{444} Compare § 48 Bundesabgabenordnung.
that are not subject to the explicit provisions of a double tax treaty or to the rulings of § 1 I ADT-Decree, are subject to the tax credit method as per § 1 II, III ADT-Decree.\textsuperscript{447}

Within the exemption method, the resident country waives its taxing right to the source country, i.e. the resident country excludes income generated in the source country from its tax base. However, usually the tax exemption method is combined with a progressivity provision that according to the financial authorities is to be applied on corporations. Accordingly, the resident country will include the source country income into the computation of its tax base for the sake of the determination of the applicable tax rate. The tax rate determined this way is subsequently applied on the worldwide income, yet, excluding the respective source country income. Consequently, if a unified tax rate applies, like the Austrian corporate tax rate of 25\%, such a progressivity provision has no effect.\textsuperscript{448} When it comes to the tax credit method the worldwide income is taxable in the resident country. The taxes paid in the source country (-ies) are credited against the taxes that would be due if they had to be paid on the worldwide income in the resident country. However, the credited amount is capped at a maximum amount that equals the amount of taxes that was to be paid in the resident country, if such source country income was realized in the resident country. In case the foreign taxes paid, exceed the domestic maximum amount, such balance is not considered. Moreover, Austria applies the tax credit method in connection with a per-country-limitation, which means that the maximum amount creditable is computed and applied for every country separately.\textsuperscript{449} The following Figure 16 shall provide a basic introduction into the computation models of the tax exemption method and the per-country-limited tax credit method.\textsuperscript{450}

\textsuperscript{447} Compare Endfellner, Netz, 2005, p. 292; Ellinger et al., BAO, 2005, §48, p. 3 ; Philipp/Loukota/Jirousek, Internationales Steuerrecht, 2006, Z00, pp. 14 et seq.; Schuch, Konzept, 2004, pp. 34 et seq.\textsuperscript{448} Compare Djanani, Internationales Steuerrecht, 1998, pp. 102 et seq.; Schuch, Konzept, 2004, 34 et seq.; Schuch, Verluste, 1998, pp. 31 et seq.\textsuperscript{449} Compare Djanani, Internationales Steuerrecht, 1998, pp. 109 et seq.; Schuch, Verluste, 1998, pp. 31 et seq. A general overview on the methods on the avoidance of double taxation and its various respective components see Gassner/Lang/Lechner, Methoden, 1995.\textsuperscript{450} Figure 16 was prepared in accordance with the remarks given by the authors in Gassner/Lang/Lechner, Methoden, 1995.
China’s Foreign-Invested Holding Company: Taxation and Tax Planning

- A Review with Reference to Austrian Tax Law

1. Computation of Worldwide Income according to Resident Country Tax Law
2. Computation of Tax Burden on Worldwide Income
3. Computation of the Average Tax Rate

Formula with:
\[
ATR = \frac{RCIT \times 100}{AWI}
\]

4. Exclusion of Foreign Source Income to compute Domestic Taxable Income
5. Application of ATR on Domestic Taxable Income

1. Computation of Worldwide Income according to Resident Country Tax Law
2. Computation of Maximum Tax Credit Amount

Formula with:
\[
MTCA = \frac{RCIT \times SCIT}{AWI}
\]

Figure 16: Tax Exemption and Tax Credit Method

b. International Profit Allocation

Once a tax subject generates taxable income in a certain territory, i.e. realizes a taxable event, the competent national financial authorities will want to assert their tax claim. Therefore, financial authorities will want to make sure that the tax subject does not erode the respective national tax base through unjustified profit transfers. The Austrian provision aiming at preventing such profit erosion is manifested in § 6 no. 6 aEStG, that via the reference rule of § 7 II s. 2 aKStG is applicable for the profit computation of corporate income tax subjects. According to the wording of § 6 no. 6 aEStG, the provision demands the reporting of an arm’s length price for assets traded across the border within a group of companies. In addition, the financial authorities apply this provision to cross-border services performed within a holding, such as, e.g., management and consultancy services performed by the holding company to a foreign subsidiary or the grant of a loan to a foreign subsidiary.\(^{451}\) However, the valuation of assets, transferred within a holding, with an arm’s length price causes the immediate taxation of built-in gains that actually have not yet been realized in a market transaction, a practice

critically regarded in light of European law. It is an internationally accepted rule that cross-
border transactions within one enterprise, as well as between affiliated enterprises are judged
in accordance with the arm’s length principle.\textsuperscript{452} According to the arm’s length principle,
transfer prices between such associated parties are determined as if the underlying trades and
services were concluded between unrelated parties. The concrete determination of such arm’s
length prices follows the transactional standard methods or the transactional income methods.
The typical transactional standard methods usually referred to cover:

- \textit{“the cost plus method”:} the expenses, the supplier of the goods or services
  incurred are extended by a mark up; the mark up represents a ficitional
  profit element;

- \textit{“the comparable uncontrolled price method”:} transfer prices are
determined based on actually realized comparable transactions;

- \textit{“the resale price method”:} based on a price, for which goods that were
  bought by the affiliated enterprise had been sold to third parties, an
  appropriate resale price margin and other directly associated costs are
  subtracted in order to determine the adequate transfer price; the resale price
  margin, hence, also anticipates a ficitional profit element.

Different from that with regard to the transactional income methods, one usually refers to:

- \textit{“the profit split method”:} first the splittable profit is to be determined; such
  profit may either equal the total profit ultimately resulting from the
  transactions carried out between the respective parties or the residual profit;
  residual profit is considered to be the remaining balance after the allocation
  of profits to the individually involved transactions; subsequently, the profit
  is to be split in accordance with the contribution analysis or the residual
  profit analysis; as to the contribution analysis, the mutual profit is split
  according to the value of the individually taken out functions, whose value
  in turn is assumed to be determinable or evaluable in a market; following
  the residual profit analysis, each party receives a minimum compensation
  and the remaining profit is split as if among unrelated parties;

- \textit{“the transactional net margin method”:} one refers to net margins of
  comparable transactions between unrelated parties.

\textsuperscript{452} Compare Art. 9 OECD model convention; Philipp/Loukota/Jirousek, Internationales Steuerrecht, 2006, Z00,
pp. 2/29.
c. International Participation Exemption

As long as domestically incorporated holding companies receive international inter-corporate shares in profit of any kind, e.g., dividends, they are tax-exempt as per § 10 II s. 1 aKStG. This principle, known as international participation exemption, prevents additional taxation within multilayered international groups of companies or holdings.\(^{453}\) However, the Austrian international participation exemption is dependent on a range of conditions. First, the recipient of the profit share must either be obliged to compute its profit in accordance with § 7 III aKStG or, if a foreign corporation, it must be unlimited corporate income tax liable and comparable to domestic unlimited corporate tax liable corporations that compute their profit in accordance with § 7 III aKStG. Second, the distributing entity must be comparable to a domestic corporation or, if resident in an EU-member state, needs to be listed in Annex 2 to § 94a aESStG. Third, an investment of no less than 10% of nominal capital must exist for a continuous period of at least one calendar year.\(^{454}\)

Herein the holding company is considered an unlimited tax liable corporation. As per § 1 II no. 1 aKStG and § 124 Bundesabgabenordnung unlimited tax liable Austrian corporations are obliged to prepare their accounts in accordance with the commercial provisions of §§ 6, 189 aHGB. The case of a foreign unlimited tax liable corporation being the profit share receiving entity is not examined within this research project. The issue that the profit share distributing entity is supposed to be comparable to a domestic corporation or, alternatively, if resident within the EU, must have its corporate form listed in Annex 2 to § 94a aESStG has to be considered for every single case separately. As to the third condition, the 10%-investment threshold, such investment can be made up by direct and indirect shareholdings, as long as the aggregated investment exceeds 10%.\(^{455}\) According to the corporate income tax regulations only AG-shares, GmbH-shares, mezzanine-notes, and capital-based jouissance rights can mediate such an investment.\(^{456}\)


The international exemption participation is extended through the provisions of § 10 III aKStG. According thereto, gains and losses resulting from changes in the value of international investments, as well as gains and losses from the sale of international investments, as defined in § 10 II aKStG, are not to be included into the computation of income, i.e. such investment is considered as tax neutral. Yet, the provisions of § 10 III no.’s 1-4 aKStG contain an option for the taxpayer to opt, whether or not, he wishes to consider any given international investment as tax neutral. In case the tax neutrality is not chosen, tax effects such as decreases in value or capital losses and a possibly resulting capital gain consequently become taxable. Whatever decision the taxpayer favors to make, he has to consider that it is irrevocable (§ 10 III no. 3 aKStG) and binding upon every other purchaser belonging to the same group of companies or holding (§ 10 III no. 4 aKStG) with regard to additional acquisitions of equity interests in the same investment.

The international participation exemption of § 10 II, III aKStG is effective with reservation as to § 10 IV aKStG. § 10 IV aKStG reserves the right to deny the application of the international participation exemption in order to prevent tax evasion and abusive structuring. For particular cases of abuse suspicions, the provisions provide that the tax exemption for international profit distributions and sales of investments can be denied in favor of a tax credit possibility for proved foreign prepaid taxes. A suspicion is generally raised, in cases, where foreign base companies generate harmful passive income that is not subject to a sufficient foreign tax burden. Hence, interesting are the definitions of a) “harmful passive income” and b) the “tax base” and what is deemed to qualify as sufficient foreign tax burden. The corporate income tax regulations name sources of harmful passive income of a foreign base company. These sources especially include interest income from the leasing of tangible assets, income from the transfer for use of intangible assets, such as patent and license rights, and income from selling off investments in corporations, partnerships or silent partnerships, where the interest held is less than 25%. Generally, passive income is deemed harmful, if the income receiving entity’s main business focus vests in generating exactly such income.

Before the introduction of the new § 10 II, III, IV aKStG\textsuperscript{461}, the international participation exemption was ruled by its predecessor rule and the international participation exemption decree.\textsuperscript{462} Although, the international participation exemption decree was originally introduced to support the ruling of the old § 10 II, III aKStG, its provisions are still to be applied. Especially, with regard to the question, whether a foreign base company’s focus of business vests in generating income that is qualified as harmful passive income, § 2 of the international participation exemption decree provides guidance.

As to § 10 IV scale line 2 aKStG and § 3 of the international participation exemption decree, the computation of the foreign tax base and the foreign tax burden have to be comparable to the respective Austrian provisions. Thus, as per § 3 no. 3 of the international participation exemption decree it is viewed as harmful, if the aggregated foreign tax burden on the distributed foreign income is less than 15\%, however including the exemption set forth in § 3 no. 4 of the international participation exemption decree. § 3 no. 4 of the international participation exemption decree provides for the consideration of particular foreign tax rules governing the depreciation of fixed assets or the deduction of losses. For purposes of the assessment, whether the tax burden was sufficient, the foreign income is to be computed in accordance with the provisions set forth in the Austrian corporate income tax law, i.e. § 7 III aKStG.\textsuperscript{463} Hence, crucial in this context is that applied to a tax base computed for in accordance with Austrian tax law, the aggregated\textsuperscript{464} foreign tax burden exceeds 15\%, i.e. introducing a subject-to-tax-clause\textsuperscript{465}.

Finally, the provision of § 10 IV aKStG and the international participation exemption decree aim at taxing income that was generated tax-free or tax-beneficial by base or domicile companies in low tax jurisdictions, when it is channeled back into Austria. Therefore, if the financial authorities consider the events of § 10 IV aKStG realized, a switchover of methods applies and the tax exemption method, usually applied to international participation exemptions, is replaced by the tax credit method.\textsuperscript{466}
2. Bilateral Avoidance of Double Taxation

a. The Austrian Treaty Framework

Domestic provisions as well as double tax treaties govern international transactions. Most western double tax treaties on income and capital are based on the framework of the Model Tax Convention on Income and on Capital. However, according to the topic of this thesis, the remarks made herein with regard to double tax treaties shall refer to the Austrian-Chinese double tax treaty. This treaty is based on the framework given by the OECD Model Tax Convention on Income and on Capital. Austria maintains an extensive network of double tax treaties that spans a set of treaties with currently 70 countries, most of which are based on the Model Convention. The provisions of tax treaties become directly applicable domestic law. However, tax treaties do not create new taxing rights, but limit and allocate nationally existing taxing rights to one of the signatory countries. The provision of a tax treaty applies in cases, where it offers the more favorable alternative for the taxpayer as opposed to the applicable domestic rule of law.

The primary focus of Austria-resident holdings is the avoidance of double taxation with regard to the taxation of dividends and other income transfers. The avoidance of double taxation in the tax treaty context is usually achieved via the tax exemption method or the tax credit method. The application of a certain method depends on the qualification of such dividend transfers and income transfers and whether, the recipient of such income streams is a corporation or a partnership. As within this thesis only corporations are reviewed, the qualification problem focuses exclusively on corporations. The present context presumes the unlimited tax liability of the holding company and its domestic investments and permanent establishments in Austria. Income from foreign investments and permanent establishments has to be considered as foreign sources of income. Actual importance for holding companies gain double tax treaties, if national tax provisions do not contain provisions for the respective taxable event. In the holding context, where primarily profit transfers are at focus, the renewal of § 10 II, III aKStG has diluted the importance of double tax treaties to a certain degree. Nonetheless, they maintain important for possible withholding tax reductions, given that

468 Compare Doralt, Doppelbesteuerungsabkommen, 2006; Endfellner, Netz, 2005, pp. 278 et seq.
471 Ad the term “permanent establishment” within the double tax treaty context compare, e.g., Bendlinger/Remberg/Wiechers, Betriebsstättenbegriff, 2004, pp. 578 et seq.
withholding taxes are not excluded automatically due to the parent-subsidiary directive. Whenever national provisions do not cover sources of income, double tax treaties need to be considered.

With existing double tax treaties there principally are three ways to avoid international double taxation. First, the source country limits its taxing right fully or at least partially, by reducing the sources of income taxed or by reducing the withholding tax on capital yields. In these cases, the considered foreign income is subject to the tax rules of the resident country and the sometimes-incurred withholding taxes on capital yields are tax credited domestically. Second, the foreign activity is solely taxed in the source country and correspondingly such income is tax-exempt domestically. Third, the aforementioned two alternatives are combined. If a clue for taxation exists in the source state, such source state receives the taxing right, whereas if such a clue is not given the resident country will have the taxing right.472

b. Income Taxation and the Avoidance of Double Taxation

The public opinion with regard to passive holdings and holding companies often refers to base and conduit companies, to tax havens, and to attempts of tax evasion. International tax treaties, therefore, often contain provisions that exclude such entities from the eligibility to tax treaties.473 Yet, this thesis draws the picture of an actively managed holding company. The top-entity carries out more then asset managerial tasks and is not only to be regarded as a base or a conduit company. In spite of the aforementioned, a tax treaty needs to apply to a holding company to grant the entitlement to the benefits of such a treaty. It has been concluded extensively, that the holding company qualifies as an Austrian incorporated legal person. As per Art. 1 ACDTT and Art. 1 OECD-MC, treaty protection applies to persons resident in one and/or the other contracting country. To qualify as a “person” in the sense of Art. 1 ACDTT (Art. 1 OECD-MC), the respective subject needs to be subsumable under the provisions of Art. 3 ACDTT (Art. 3 OECD-MC). The holding company would presumably qualify as such a person, if it qualified as a “company” in terms of Art. 3 no. 1 l.’s e), f) ACDTT (Art. 3 no. 1 b) OECD-MC), hence, if it was a “legal person for tax purposes” in Austria. The Austrian holding company is a legal person resident and incorporated within the territory of the Republic of Austria. According to § 1 II no. 1 aKStG, corporations, such as the holding

472 For a summary on the several ways of the avoidance of double taxation compare, e.g., Endfellner, Netz, 2005, pp. 291 et seq.; Scheffler, Besteuerung, 1995, p. 94.
company, qualify as legal person and are unlimited tax liable in Austria. Even though, as Wassermeyer\textsuperscript{474} concludes, unlimited tax liability does not necessarily have to correspond with the respective person’s residency, as per Art. 4 ACDTT (Art. 4 OECD-MC), such correspondence is assumed to be realized in the present context. Hence, the Austrian holding company is treaty-entitled according to Art. 1 ACDTT. The holding-relevant issues especially cover provisions ruling the income from immovable fixed assets, profits, dividend income, interest income, royalty income, and capital gains. Additionally, tax treaties allocate the respective taxing rights to the contracting states. The allocation of the respective taxing rights is displayed in Table 3\textsuperscript{475}. Table 3 applies to the allocation of taxing rights as stipulated by the OECD-MC.

<table>
<thead>
<tr>
<th>Income Category</th>
<th>Resident Country Taxation</th>
<th>Source Country Taxation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income from immovable fixed assets</td>
<td>Tax-exemption</td>
<td>Unlimited taxing right</td>
</tr>
<tr>
<td>Profits</td>
<td>Tax-exemption of permanent establishment profits; other business income is taxable</td>
<td>Taxation of permanent establishment profits</td>
</tr>
<tr>
<td>Dividend Income</td>
<td>Taxation either according to the tax credit method or in accordance with a withholding tax</td>
<td>Withholding tax on capital yields limited to 15%; in case of international participation exemptions limited to 5%</td>
</tr>
<tr>
<td>Interest Income</td>
<td>Taxation either according to the tax credit method or in accordance with a withholding tax</td>
<td>Withholding tax on capital yields limited to 10%</td>
</tr>
<tr>
<td>Royalty Income</td>
<td>Unlimited taxing right</td>
<td>Repeal of the taxing right</td>
</tr>
<tr>
<td>Capital Gains</td>
<td>Tax exemption of profits from the sale of immovable assets and from permanent establishment assets; other capital gains are taxable</td>
<td>Limitation of the scope of the taxing right on profits from the sale of immovable assets and from permanent establishment assets</td>
</tr>
</tbody>
</table>

\textit{Table 3: OECD Model Tax Convention - Taxing Rights}\textsuperscript{476}

Compared thereto the ACDTT offers an allocation of the taxing rights as displayed in Table 4 below.\textsuperscript{477} Moreover, this table summarizes the key provisions with regard to holding-relevant tax facts and hint to the concrete article that carries such provision.

\textsuperscript{474} Compare Wassermeyer, Art. 1 MA, 2004, p. 152.
\textsuperscript{475} Compare hereto, e.g., Endfellner, Netz, 2005, pp. 284 et seq.
\textsuperscript{476} Self-prepared table.
\textsuperscript{477} Compare hereto Austrian-Chinese double taxation treaty as, e.g., found in Doralt, Doppelbesteuerungsabkommen, 2006, pp. 107 et seq.
<table>
<thead>
<tr>
<th>Income Category</th>
<th>Treaty Provision</th>
<th>Content</th>
</tr>
</thead>
<tbody>
<tr>
<td>Immovable fixed assets</td>
<td>Art. 6</td>
<td>Withholding tax in the source country</td>
</tr>
<tr>
<td>Profits</td>
<td>Art. 7</td>
<td>Taxation in the resident country</td>
</tr>
<tr>
<td>Shipping and Air Transport</td>
<td>Art. 8</td>
<td>Taxation in the resident country</td>
</tr>
<tr>
<td>Affiliated Enterprises</td>
<td>Art. 9</td>
<td>Introduction of arm’s length principle for groups of companies and active holdings</td>
</tr>
<tr>
<td>Dividend Income</td>
<td>Art. 10</td>
<td>- general rule: taxation in the resident country of the dividend-receiving person; - but: withholding tax in the source country at the general rate, but at a rate of 7% if the beneficiary’s share in the voting rights of the dividend-distributing entity exceeds 25% and in no event at a rate exceeding 10% of the gross amount of the dividends;</td>
</tr>
<tr>
<td>Interest Income</td>
<td>Art. 11</td>
<td>- general rule: taxation in the resident country; - but also: withholding tax in the source country at no higher rate than 10% of the gross amount of interest paid;</td>
</tr>
<tr>
<td>Royalty Income</td>
<td>Art. 12</td>
<td>- general rule: taxation in the resident country; - but: withholding tax of not more than 10% of the gross royalty in the source country;</td>
</tr>
<tr>
<td>Capital Gains</td>
<td>Art. 13</td>
<td>- capital gains from sale of immovable assets are taxed in the resident country; - capital gains from sale of equity interests in companies whose assets mainly consist of immovable assets are taxed in the source state; - capital gains from sale of equity interests that constitute an investment, i.e. more than 25%, in the source country are taxed in the source country; - all other capital gains resulting from the sale of source country assets are taxed in the source country;</td>
</tr>
</tbody>
</table>
All double tax treaties provide for particular methods to eliminate potential double taxation. In Art. 24 no. 2, the ACDTT regulates the methods, how double taxation should be eliminated in Austria. Austria generally adopts the tax exemption method, according to which Austria shall exempt income or capital from tax, where an Austrian resident derives such income or owns such capital, which is taxed in the PRC. Yet, in computing the tax on the remaining income taxable in Austria, Austria exercises a progressivity proviso by adding back in the exempted income fraction for reasons to determine the tax rate that is to be applied on the non-exempted income. However, in some cases the tax exemption is waived in favor of a tax credit as provided for in Art. 24 no. 2 l. (b) ACDTT.

Art. 24 no. 2 ACDTT rules that in cases, where an Austria resident person, in the sense of the ACDTT, generates among others non-tax-exempted dividend, royalty or interest income, the

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478 Self-prepared table.
479 Compare Art. 24 no. 2 l. (a) ACDTT.
taxing rights for which are allocated to the PRC, Austria credits such tax paid in the PRC against the tax payable on the respective Austria resident person’s worldwide income. However, the amount of such credited tax is capped. The credited amount of Chinese tax shall not exceed the amount that would equal the tax payable under Austrian laws for such income. Subsequently, the ACDTT in its Art. 24 no. 2 l. c) determines that the tax rates applied in the PRC for non-tax-exempted income from dividends and interest be 10% and for royalties be 20%, hence introduces a matching credit. This means that not the actually paid tax is to be credited against the tax assessed in Austria but a fictional tax as per Art. 24 no. 2 l. c) ACDTT. However, participation exemption related dividends are subject to the tax exemption method and not the tax credit method and hence a matching credit is not applicable!480

Given the present conflict between the maximum tax credit amount as per Art. 24 no. 2 l. b) s. 2 ACDTT and the consequence of the matching credit following Art. 24 no. 2 l. c) ACDTT a distinction seems mandatory. The maximum tax credit amount is capped at the amount of the Austrian tax that would be payable on the China-sourced income. The maximum tax credit amount, as used within the per-country-limited tax credit method applicable according to the ACDTT, can be computed as follows.

\[
\text{Maximum tax credit} = \text{Domestic total tax} \times (\frac{\text{foreign income}}{\text{worldwide Income}})
\]

\textbf{Table 5: The Maximum Tax Credit}\textsuperscript{481}

The matching credit of Art. 24 no. 2 l. c) ACDTT equals a partial tax exemption. The Austrian tax authorities credit a fictional withholding tax against the tax payable on the Austrian taxpayer’s worldwide income. In the case of dividends and interest such withholding tax is assumed to be 10% and in the case of royalties 20%. Austria partially waives its taxing right on the Austrian taxpayer’s worldwide income in favour of the taxpayer and the source country of the respective underlying income sources. Table 4 above shows that in all cases, dividends, interest, and royalties, differences between the matching credit tax rate and the tax rates set within Art.’s 10, 11, 12 ACDTT are immediately obvious or at least possible. Such balances cause a tax advantage on the side of the taxpayer equal to the balance between the actually paid taxes and the credited fictional taxes as long as such fictional taxes are higher


than the actually paid taxes.\textsuperscript{482} Regarding the relation between the “maximum tax credit” and the “matching credit” it can be manifested that whatever advantageous effects the matching credit may bring for the taxpayer such effects are in any event capped by the amount of the maximum tax credit. Hence, if the matching credit would exceed the maximum tax credit any excess amount beyond the amount of the maximum tax credit cannot be credited and is lost.\textsuperscript{483}

Additionally, the ACDTT sets forth the regulations for a general international tax treaty participation exemption in Art. 24 no. 2 l. (d) ACDTT, which is to be applied irrespective of the provisions of Art. 24 no. 2 l.’s (b), (c) ACDTT. As per this participation exemption, intercorporate dividends and the value of equity interests are exempt from taxes on income and capital, respectively, if the Austrian resident company owns at least 10% of the respective Chinese company’s registered capital. In this connection the matching credit proves to be a real investment incentive-creating tool for investors, as despite the actual tax exemption of China-sourced dividends, the matching credit applies allowing them to credit a fictional 10% withholding tax.

c. The “Gruppenbesteuerung” and Double Tax Treaties

The previous chapters regarding the general aspects of Austrian international taxation lead to the question how far the provisions ruling the “Gruppenbesteuerung” and such governing the bilateral avoidance of international double taxation interact. It has been laid out that in order to be treaty-entitled, the subject of such double tax treaties need to qualify as a “person resident” as defined in Art.’s 1, 3, 4 ACDTT (Art. ‘s 1, 3, 4 OECD-MC). In the context of the present thesis it will be crucial to determine, whether the group as such or only the group parent or group members, respectively, qualify as a “company” in the sense of Art. 3 no. 1 l. f) ACDTT (Art. 3 no. 1 l. b) OECD-MC).

The individual treaty entitlement of both, the group parent and the group members, each considered being unlimited tax liable corporations in Austria, is granted.\textsuperscript{484} However, questionable remains the treaty entitlement of the group as such. The following will briefly examine, whether the group as such can qualify as a “company” and, hence, become treaty-

\textsuperscript{482} Compare Rindler, Steuer, 2002, pp. 221 et seq. Examples of quantitative effects of such matching credit can be found within the numeric examples located throughout Chapter E.III.

\textsuperscript{483} Compare Rindler, Steuer, 2002, p. 222.

\textsuperscript{484} Compare hereto the previous Chapter C.V.5.b.ii. Austrian unlimited corporate tax liable corporations are defined as companies in the sense of Art. 3 no. 1 b) Model Convention. Compare also Schuch, Abkommensrecht, 1998, pp. 175 et seq.; Trenkwalden, Abkommensrecht, 2005, pp. 411 et seq.; Wassermeyer, Anforderungen, 2005, pp. 521 et seq.
entitled. For the examination, whether a “person”, i.e. “company”, is treaty-entitled or not, international tax law attaches to the respective national tax law. The legal institution “Gruppe” (group), however, does not gain tax subjectivity as per the Austrian tax laws and, thus, is not treaty-entitled. The group as such has no legal personality and, therefore, no tax subjectivity. Notwithstanding the aforementioned, the application of double tax treaties on group parents and group members functions just as in connection with any non-group, but, affiliated treaty-entitled enterprise, given the individual tax subjectivity of each entity in the respective contracting countries.

VII. **SUMMARY OF FINDINGS**

From an Austrian tax law point of view the holding company and its subsidiaries, as reviewed herein, all take legal form and are corporations. The holding company, as the top-entity, moreover is considered to be unlimited corporate tax liable in the sense of the aKStG. Opposed thereto it has been manifested that the holding company’s subsidiaries and investments may either be unlimited corporate tax liable, too, limited corporate tax liable or not corporate tax liable in Austria. Austria imposes a corporate tax of 25% on the tax base “taxable income”, which is computed following the authoritative principal in accordance with commercial accounting provisions by way of balance sheet accounting.

The previous chapters extensively described that a holding as an organizational form does not necessarily have to take the form of a group as per § 9 aKStG or that single subsidiaries and investments may be may be excluded from a group while others are included into a group. Such a differentiation is important as § 9 aKStG serves as a lex specialis to the other provisions of the aKStG.

As per § 7 II, III aKStG in connection with the aEStG all business income is taxable. Within the holding context, especially, dividends, interest, and capital gains are of particular interest. § 10 I aKStG provides for a national participation exemption and exempts income derived as shares in profit from domestic corporations from corporate tax. Interest income is considered regular business income and taxable at 25% corporate income tax which is actually assessed by way of a capital yields tax retained at source that is credited against the corporate tax liability in order to prevent double taxation. As is interest, capital gains are also fully taxable.

486 Compare Wassermeyer, Anforderungen, 2005, pp. 522 et seq.
Expenses incurred as business expenses are deductible from taxable income, hence reduce the tax burden. However, while in general business expenses are deductible particular expenses that are not incurred in a direct context with the underlying business activity of the business are expressively ruled out from tax deductibility. Having identified the holding and management of investments as the single most important business activity of holdings, the tax treatment of expenses incurred in connection with the financing of such investments are of major interest. § 11 I no. 4 aKStG provides a regulation according to which interest resulting from the debt-financing of investments may be deducted as business expenses. Another crucial element in the context of investments is their valuation and the resulting tax consequences. In general investments enter a financial statement valued at acquisition cost. Changes in such valuations are considered by way of periodical impairment tests leading to possible adjustments of the underlying carrying amounts of such investments. Decreases in such carrying amounts are to be reported by way of fair value write-downs. The amount identified as the decrease in value may be written down using the straight-line method over a period of seven years. Another crucial item with regard to investments is goodwill. Goodwill, being the balance of the acquisition price of any given investment less the sum of all capitalized assets less debt, is considered an intangible asset and has to be capitalized within the financial statement. The law provides for a straight-line amortization of goodwill in equal instalments over a period of 15 years. Moreover, in cases where the impaired fair value of the capitalized goodwill exceeds its carrying amount, § 6 no. 1 aEStG allows for a fair value write-down.

In 2005 Austria introduced its progressive new group-relief regime, the “Gruppenbesteuerung”. This regime provides that the positive and negative taxable incomes of domestic group members and negative authoritative results of foreign first-tier group members may be consolidated either with the taxable income of the next higher ranked group member or with the group parent. The research has shown that group members within this thesis are either domestic unlimited tax liable corporations, limited tax liable foreign corporations or such legal persons that from a civil law point of view are comparable with Austrian corporations. It has been examined, whether the CHHC could be a group member in the sense of the Austrian “Gruppenbesteuerung”. It could be concluded that given the information available and without an extensive civil law examination such a group membership of the CHHC could be supported. The group parent qualifies as a domestic unlimited tax liable corporation. The matching event to define whether two particular
corporate entities can form a group is what the law calls “financial affiliation”. As per § 9 IV aKStG a “financial affiliation” is established once one entity holds a 50%-interest in the other entity’s registered capital and simultaneously holds at least 50% of such entity’s voting rights. Such financial affiliation may be constituted by direct and indirect shareholdings.

The “Gruppenbesteuerung”, however, does not waive each entity’s individual tax subject status, as each of the group members remains individually tax liable and obliged to file own tax results. Domestic taxable income as allocated from group member to group parent is allocated at a rate of 100%, irrespective of the scope of the actual investments. Contrary thereto, the results of foreign group members are only allocated at a rate that reflects the sum of the domestic group member’s or domestic group parent’s aggregated equity interest in the investment and only if they had not been set-off in the foreign group member’s home jurisdiction.

With regard to the valuation and taxation of investment, § 9 VII aKStG sets particular rules for groups. While eligible to general investments, fair value write-downs shall not be possible within the framework of the “Gruppenbesteuerung”. Similarly, capital losses from the sale of group-related investments may not be deducted. These elements are widely considered inconsistent and branded as the “Gruppenbesteuerung’s” biggest weaknesses. However, § 9 VII s. 2 aKStG allows for a goodwill amortization on acquired goodwill up to an amount not exceeding 50% of the acquisition cost of the underlying investment. Yet such goodwill amortization is not available to investments acquired or traded within the group.

When two or more jurisdictions claim the right to tax the very same facts, the danger of double taxation arises. Such double taxation can be avoided, or at least weakened, through unilateral and bilateral means. Austrian tax laws unilaterally provide for a number of particular rules which shall support the avoidance of double taxation. While in cases where no double tax treaties apply, § 48 Bundesabgabenordnung provides for the application of either the tax exemption method or the tax credit method and in cases, where unjustified profit transfers are supposed transfer prices shall help to establish an arm length scenario trying to avoid profit erosions. § 10 II aKStG manifests an international participation exemption granting tax-exempt status to shares in profit distributed to a domestic corporation from a minimum 10%-investment. Bilaterally, double taxation is typically avoided through double tax treaties. Such tax treaties, just as the ACDTT, usually make use of either the tax exemption method or the tax credit method. They allocate the respective taxing rights of respective taxable facts and events to the contracting states.
The remarks of the previous Chapter as a whole serve as the basis of reference for the following survey and discussion of the Chinese law covering the taxation of the China-Holding. The following Chapter will thoroughly examine the Chinese tax law. This examination intends to produce findings on the general rule of the taxation of holdings within the Chinese tax law. Additionally it is examined, whether there exists a similar special regime for the taxation of groups of companies and/or holdings, such as the Austrian “Gruppenbesteuerung”. Principally, the survey thereby intends to follow the same order as was applied to the discussion of the taxation of holding companies in Austria. However, particularities of the Chinese law cause several alterations in certain areas of interest, where the Chinese law either does not provide a comparable rule, provision for a particular relevant event, or simply the systematic of the Chinese law does not allow for keeping in with the same order. The author will examine the respective Chinese rules and provisions taking the peculiarities and characteristics of Chinese legal history, judiciary and political system into account. Ultimately, the results of the profound examination of the taxation of the China-Holding will in turn serve as the basis of reference for the following discussion of general and particular tax planning strategies available in connection with the China-Holding and the CHHC.
D. THE TAXATION OF THE CHINA-HOLDING

Based on the findings of the previous chapters, this chapter concludes a solid and profound framework displaying and discussing the Chinese concept of the taxation of foreign-invested holding companies. First, it is necessary to establish the statutory framework that covers the laws applicable to examine the taxation of the China-Holding and draw an overview on the taxes and tax rates applicable within the PRC. From this basis, the author will extract the concrete applicable legislation and their rules and provisions, to be able to analyze the holding-relevant tax facts and events and their corresponding tax treatment in accordance with the order that was applied to the survey of the taxation of the Austrian holding company.

A brief word shall be dedicated to the tax legislative and tax administrative system in the PRC. As presented in Chapter B.III.2., the legislative power is all but centralized. In the discipline of tax, the legislative powers, beyond those of the NPC and the SC, vest with the Ministry of Finance (hereinafter “MoF”) and the State Administration of Taxation (hereinafter “SAT”). These government bodies are responsible to draft and pass laws, administrative orders, and corresponding implementing rules. Chinese tax laws are often drafted very vaguely so that the actual tax provisions are provided through administrative orders and implementing rules.487 As Pfaar/Salzmann argue, the biggest problem of western enterprises with regard to Chinese law is the question how to access it. It has been held above, that official documents are often not published or not homogeneously published, thus, realizing a status in which only the respective government bodies may be familiar with the interpretation of a given tax fact or event. In addition, thereto, the possibility that the original Chinese texts and their translations might differ, and that the Chinese originals are authoritative, causes a great problem for foreign enterprises active in the PRC. Translations, therefore, have to be regarded cautiously and the possibility that a translation might not sufficiently cover the meaning of a specific Chinese term has to be borne in mind.488 As this thesis is also solely built on translations, due to the author’s lack of the Chinese language, such misinterpretations have to be included into the calculus. Hence, the following remarks investigate a picture of the taxation of the China-Holding and the CHHC as it is presented by the numerous accessible translations. Notwithstanding the abovementioned and the problems implicit to such translations, it has to be stated that such translations are widely used in the PRC by

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foreign enterprises and even in international law, auditing, and tax-advising firms by westerners as a first reference.

I. **CHINESE TAXES AND TAX RATES**

Foreign investors with multiple corporate entities in the PRC face the problem of coordinating administrative activities and operations. For this purpose, some MNCs are assessing to set up holding companies in the PRC. Chapter B.IV. concludes, that a foreign-invested holding company in the PRC, i.e. the “CHHC”, as well as its subsidiaries, may be set up as an EJV or as a WFOE. Hence, despite being Chinese enterprises in the form of legal persons they are granted the status of FIEs. While the CHHC, functioning as the parent company to the Chinese operations of a MNC, takes the form of a WFOE or an EJV, its subsidiaries may also be formed as a legal-person CJV. The study shows that the focus of the discussion vests on income tax aspects, whereas a detailed survey of turnover tax aspects shall not be part of this research. However, holding-relevant aspects concerning certain turnover tax issues are addressed. Therefore, the statutory framework covers such rules and provisions that rule all the relevant income tax and turnover tax facts and events a China-Holding presumably gets involved in.

Just as any other national tax law, the Chinese tax law also finds itself in a steady development owed to ongoing fiscal and monetary adaptations. The Chinese national government and its respective subsidiary local governments have, since the foundation of the People’s Republic of China in 1949, introduced numerous tax laws and tax provisions. Following the end of the Cultural Revolution, 1976, a gradual political and economical opening process of the PRC has begun. In 1979, the PRC began to introduce specific laws, especially tax laws, to attract foreign investment into the country. However, due to the political circumstances present during this time, the PRC was not taking part in a common and free exchange of scientific knowledge and capital with the western world. Therefore,

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passed laws were not following an overall legislative order, but often suffered from random introduction, which lead to a shattered and unequal enterprise tax system.\textsuperscript{491}

Until the large tax reform of 1994, the Chinese enterprise tax system included enterprise income taxes, as well as turnover taxes, despite the generally known distinction as separate species in conventional tax literature. Hence, the Chinese tax system still does not fully meet the usual distinction between direct and indirect taxes. With “turnover”, both enterprise taxes had the same tax base. Therefore, the distinction, whether or not the respective tax levied, is a direct or indirect tax depends on the characteristics of the given taxpayer. In terms of the pattern of Chinese tax revenue the turnover taxes, especially the Value Added Tax (hereinafter “\textit{VAT}”) and the Business Tax (hereinafter “\textit{BT}”), are currently significantly more important than the income taxes, such as the Individual Income Tax, the Foreign Enterprise Income Tax (hereinafter “\textit{FEIT}”), and the Domestic Enterprise Income Tax. Historically, income taxes, especially enterprise income tax, used to play a larger role and accounted for a considerable stake in the government’s tax revenue.\textsuperscript{492}

Due to the divergences in the taxation of the different investment alternatives, the Chinese government began a process of tax reform in 1991, when the NPC introduced a united tax law for all kinds of enterprises involving foreign investment, the FEITL.\textsuperscript{493} The FEITL until today represents the major source of legislation regarding the taxation of FIEs and FEs. Steadily adaptations, circulars, decrees, and other provisions and rulings have extended it. Such administrative acts generally obtain statutory character in the PRC.\textsuperscript{494} The income taxation of DEs is ruled separately, causing a dualism within the enterprise taxation between domestic and foreign enterprises in the PRC.\textsuperscript{495} Indeed, the general corporate income tax rates for FIEs and FEs on the one hand and DEs on the other hand, are nominally the same at an aggregated rate of 33%, yet, while FIEs and FEs might enjoy preferential tax treatment in the form of tax

\textsuperscript{492} In the PRC VAT is levied on every production and distribution level of producing and trading enterprises and individuals on the corresponding sale price, on billed services of processing, repairing, and maintaining enterprises and individuals, or on Imports. Explicitly excluded are particular services, the transfers of intangibles assets, as well as the sale of immovable assets, which are taxed under the Business Tax. Compare Art. 1, Provisional Regulations of the People’s Republic of China Concerning Value Added Tax, SC, promulgated on January 1, 1994; Gordon, Taxation, 2002, pp. 12 et seq.; Hongtao, Overview, 1994, p. 291; Moser/Zee, Tax Guide, 1999, pp. 3, 92 et seq.
\textsuperscript{493} See 7\textsuperscript{th} NPC, promulgated on April 9, 1991.
\textsuperscript{494} Compare Govind, Tax Approaches, 1988, p. 178.
\textsuperscript{495} Compare Yong/Reifenburg, Development, 1991, pp. 480 et seq.; Wang, Besteuerung, 2006, p. 27; in Austria and Germany, e.g., there exists a dualism within the taxation of enterprises regarding the different taxation of corporations on the hand and the taxation of partnerships on the other hand, consequently from a tax distinction of enterprises in legal and natural persons. Compare thereto, e.g., Crezelius, Steuerrecht, 1994, pp. 239 et seq.; Tipke/Lang, Steuerrecht, 2002, p. 440.
incentives or tax holidays, DEs are not granted such preferences.\textsuperscript{496} With respect to enterprise income tax, the PRC will introduce a new Enterprise Income Tax Law effective as of 2008 and applicable to both foreign-invested and domestic enterprises, hence aiming to unify the Chinese enterprise income tax law.\textsuperscript{497}

Beginning with the large tax reform of 1994, the government introduced first measures to reduce such dualism gradually. The tax reform commenced with the introduction of a homogeneous turnover tax system. The newly introduced turnover tax system covered a VAT, a consumption tax, and the BT, all taxes, that from then on were to be homogeneously levied on both FIEs and FEs, as well as DEs. In addition, thereto import and export customs duties were adjusted. All such reforms are to be seen in the PRC’s attempt to prepare itself for the entry to the WTO and to adjust its tax system to international standards.\textsuperscript{498}

Whether the PRC does actually practice such fundamental tax principles, such as the principle of equity in taxation\textsuperscript{499}, remains doubtful. According to Bahl, the following aspects can characterize the PRC’s intergovernmental fiscal system:

- “\textit{All tax rates and bases are centrally determined;}
- \textit{each local government is given a designated share of revenue collections within its boundaries;}
- \textit{tax administration is a shared responsibility between central and local government;}
- \textit{grants are distributed among local governments on an ad hoc basis.}”\textsuperscript{500}

However, the still existing inequalities in the taxation, the problems of the Chinese administration and financial authorities to implement and enforce tax laws and provisions, as well as the severely shattered fiscal jurisdiction between national and local, i.e. provincial and municipal, authorities contradict the actual enforcement of such principles.\textsuperscript{501} Yet, in theory, the income tax in the PRC is levied on the income, suggesting that the income taxation in the

\textsuperscript{496} Compare Hussain/Zhuang, Enterprise Taxation, 1998, p. 60; Yang/An, Tax Incentives, 1998, p. 71. For an overview on such available tax incentives and tax reliefs refer to Annex I.

\textsuperscript{497} See 10\textsuperscript{th} NPC, promulgated on March 16, 2007.


\textsuperscript{499} Compare Crezelius, Steuerrecht, 1994, pp. 21 et seq.; Tipke/Lang, Steuerrecht, 2002, pp. 74 et seq.


\textsuperscript{501} Ad the inequalities in Chinese taxation and the shattered fiscal jurisdiction compare, e.g., Bruggen, Importance, 2000, p. 363; Pfaar/Salzmann, Besteuerung, 2005, p. 1; Tsui, Local Tax System, 2005, pp. 175 et seq.
PRC follows the internationally accepted principle of taxable capacity. Additionally, China practices the principle of taxable capacity based on worldwide income. According to which, the worldwide income of a legal person that has its place of effective management located within the PRC is taxed in the PRC, as are natural persons who are resident in the PRC.\textsuperscript{502}

The PRC currently levies numerous separate taxes. According to Figure 17 the most important of such taxes can be distinguished in five categories classified after their given tax bases. Hence, taxes are levied on income, property and possessions, activities such as production or rendering services, and on turnover and consumption. The Individual Income Tax, the FEIT, and the domestic enterprise income tax represent the taxes the respective taxable entities have to pay on their gained (taxable) income. The taxation of property and possession, or the transfer of property and possession, or rights to use property or possession is covered by the “Land Value Added Tax”, the “Deed Tax”, the “Real Estate Tax”, and the “Vehicle and Vessel License Tax”. In cases, where legal transactions need to be legally documented “Stamp Tax” becomes due. Stamp Tax is paid as a fraction of the documented transaction amount. Turnover generally is taxed via the VAT. The turnover or the transferred sales volume from the sale, transfer, or import of particular special goods, e.g. luxury goods, is taxed by the consumption tax. Turnover that is generated through services and explicitly not subject to the VAT, as well as the transfer of intangible or immovable assets are taxed through the BT. Import and Export customs duties are levied on the respective imported or exported merchandise’s value. Wear and tear of houses and buildings is taken account of by the “Land Usage Tax”, whereas the consumption of natural resources are subject to the “Resource Tax”.

\textsuperscript{502} Compare Moser/Zee, Tax Guide, 1999, pp. 29 et seq., 54.
With reference to the above Figure 17 and the several taxes introduced, Table 6 provides an overview on the respective tax objects and applicable tax rates for the individual taxes.  

<table>
<thead>
<tr>
<th>Tax</th>
<th>Tax Object</th>
<th>Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individual Income Tax</td>
<td>taxable income</td>
<td>5-45%, 20%</td>
</tr>
<tr>
<td>Foreign Enterprise Income Tax</td>
<td>taxable business income</td>
<td>33%*</td>
</tr>
<tr>
<td>Domestic Enterprise Income Tax</td>
<td>taxable business income</td>
<td>33%</td>
</tr>
<tr>
<td>Land Appreciation Tax</td>
<td>Profit from the transfer of land use rights</td>
<td>30-60%</td>
</tr>
<tr>
<td>Deed Tax</td>
<td>Transaction price/volume</td>
<td>3-5%</td>
</tr>
<tr>
<td>Real Estate Tax</td>
<td>Residual value of the property/Rents from the property</td>
<td>1,2%, 12%</td>
</tr>
<tr>
<td>Vehicels and Vessels License Tax</td>
<td>Tonnage (transport vehicles), fixed units</td>
<td>vehicle depending rates</td>
</tr>
<tr>
<td>Stamp Tax</td>
<td>Transaction price/volume</td>
<td>0,003-0,5%</td>
</tr>
</tbody>
</table>

503 Self-prepared figure.
504 Table with reference to Tran-Nam, Tax Systems, 2002, pp. 15 et seq.
II. ENTERPRISE INCOME TAX

1. Statutory Framework

The taxation of any given entity or individual is subject to the underlying legal qualification of the respective object and subject of taxation.\(^{506}\) Within the German-speaking jurisdictions, the economic results of legally organized legal relations and transactions are taxed.\(^{507}\) A similar observation can be made within the Chinese jurisdiction. Taxes are – at least theoretically – levied depending on the precise legal constellations of economic transactions and the legal classification of the parties involved in the respective transactions. Within the context of this work, the reviewed parties taking part in such transactions are FIEs.\(^{508}\) As laid out above FIEs take legal personality in the form of a LLC or a CLS; however, the tax consequences, according to the respective Chinese tax legislation, are not necessarily connected to the FIEs’ qualification as a legal person. The taxation of enterprises in the PRC is linked to the distinction, whether they are domestic or foreign enterprises, i.e., to the question of ownership. The Chinese enterprise income tax system is divided into two parts. It covers separate regimes for domestic enterprises and for enterprises involving foreign

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\(^{505}\) Self-prepared table.

\(^{506}\) A definition and the distinction between tax object and tax subject can, e.g., be found at Crezelius, Steuerrecht, 1994, pp. 41 et seq.; Tipke/Lang, Steuerrecht, 2002, pp. 165 et seq.

\(^{507}\) Compare Crezelius, 1994, Steuerrecht, pp. 6 et seq.; Kessler, Holdinggesellschaften, 2000, pp. 188 et seq.

\(^{508}\) For an overview on the different forms of FIEs and their distinction from FEs and DEs please refer to Figure 6.
investment, i.e. FIEs and FEs. The enterprise income taxation of FIEs and FEs is fundamentally ruled by the FEITL and the IRFEITL. The FEITL contains the rules governing the taxation of all FIEs, of all foreign companies with establishments in the PRC, and foreign companies without establishments in the PRC, FEs, that derive income from Chinese sources. Two separate income tax regimes are established by the FEITL. First, it introduces an enterprise income tax on net income, applicable to FIEs and FEs that maintain establishments in the PRC and engage in business activities within the PRC. Second, the FEITL rules the withholding taxation levied on the gross receipts of particular kinds of passive income and on income, a FE generates without maintaining a domestic establishment.  

The FEITL replaced the previously applicable tax laws governing the income taxation of FIEs or FEs, i.e. “the Income Tax Law of the PRC Concerning the Joint Ventures Using Chinese and Foreign Investment” and “the Income Tax Law of the PRC Concerning Foreign Enterprises”. Hence, the introduction of the FEITL and the IRFEITL came along with a unification of the tax treatment of the FIEs and FEs. Accordingly, contrary to Austria or Germany, the Chinese legislation does not know a separate “corporate income tax”, explicitly governing the taxation of legal persons such as corporations opposed to non-legal person enterprise forms. The law does neither explicitly demand legal person status, nor exclude non-legal person enterprise forms from the applicability of the FEITL. As per the wording of Art. 2 II FEITL, “the term ‘foreign-invested enterprise’ refers to Sino-foreign EJVs, Sino-foreign CJVs, and WFOEs established in the PRC.” As it covers CJVs, without making an explicit limitation to legal-person CJVs, it as well includes non-legal person CJVs, e.g., formed as Sino-foreign partnerships. Accordingly, one cannot speak of a “corporate income tax” as, e.g., Pfaar/Salzmann suggest in their survey. Hence, a single enterprise tax is levied on all forms of foreign investments in the PRC, i.e. FIEs and FEs, irrespective of their legal personality, yet, stipulating a number of provisions that apply only to FIEs or to FEs, respectively.

Within the framework of the FEITL and the IRFEITL, it is necessary to locate such provisions that rule holding-relevant tax facts. Following the discussion of the Austrian holding taxation, it is firstly examined, whether the Chinese tax law contains a holding-

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510 5th NPC, promulgated on September 10, 1980.
511 5th NPC, promulgated on December 13, 1981.
512 Compare Pfaar/Salzmann, Besteuerung, 2005. Already in their table of contents they use the German term “Körperschaftsteuergesetz” which in English equals “Corporate Income Tax” and does only cover all forms of corporations or corporation-alike forms but no partnerships. Compare hereto, e.g., § 1 aKStG.
regime comparable to that of the Austrian “Gruppenbesteuerung”. Downright this is about answering the question, if the Chinese tax law allows for some kind of tax consolidation in connection with the taxation of the China-Holding. As has been identified, the China-Holding, as an organizational whole consists – at least in the form examined in this research project – solely of FIEs. Hence, to answer such question, the Chinese tax law, namely the FEITL and the IRFEITL, needed to provide provisions ruling a tax consolidation between FIEs.

Next to the FEITL and the IRFEITL, representing the primary applicable pieces of enterprise income tax legislation, it is necessary to review pieces of secondary legislation closely. Such secondary legislation covers the decrees and circulars periodically published by the NPC, the NPC-Standing Committee, the SC, the Ministries, Commissions, and Bureaus, as well as by local governmental bodies, such as provincial and municipal authorities. In the international context, also the contents of Chinese double tax treaties will have to be examined. In addition to the concrete tax laws and provisions, also accounting and company law may have to be reviewed in order to determine the taxation of particular facts and events. Following the hierarchy of the Chinese commercial accounting provisions the underlying law governing the commercial accounting of FIEs is the “Accounting Law of the PRC”, in accordance to which first the “Foreign-invested Enterprises Accounting System” and the “Accounting Standard for Business Enterprises” (hereinafter “Accounting Standard”) was published. The revised version of the Accounting Standard is today being complemented by the “Accounting System for Business Enterprises” (hereinafter “ASBE”) and respective guidelines dealing with the details of the accounting of individual financial statement items. Together the Accounting Standard, the ASBE, and the individual guidelines form the basis of reference with regard to the actual accounting of financial statement items of FIEs. From the company law point of view, such laws and provisions have to be included into the survey, that predominantly cover regulations concerning the distribution of profit, scope of business, capitalization, and other relevant issues. Of particular interest in this context are, among others, the Holding-Provisions, The CL, and the respective pieces of FIE-legislation, such as

513 For an overview on the legislative hierarchy in the PRC please refer to Figure 3.
515 MoF, promulgated on June 24, 1992.
516 MoF, effective as of July 1, 1993; revision promulgated on February 15, 2006 and effective as of January 1, 2007.
517 MoF, effective as of January 1, 2001.
518 Compare hereto in general Luttermann/Hartwig, Bilanzrecht, 2004, pp. 508 et seq.
EJV-Law, the EJV-Rules, the WFOE-Law, and the WFOE-Rules, as well as corresponding administrative orders.  

2. The Taxable Entity

As the title of this thesis suggests, the central research object is the taxation of the China-Holding and in particular the taxation of its top-entity, the CHHC. Having identified the FEITL and the IRFEITL as the main legislative sources for the income taxation of foreign investments in the PRC, this chapter focuses on the identification of the taxable entity as defined in the FEITL and the IRFEITL. It has been concluded and assumed that the China-Holding and all its members, i.e. parent company and subsidiaries, are granted the status of FIEs. Opposite thereto, enterprises that are tax-liable in the PRC subject to their activity, but not because they maintain legally independent entities in the PRC and are themselves resident to any other state are referred to as “FEs”.

![Diagram: A Sample of the China-Holding](image)

*Figure 18: A Sample of the China-Holding*  

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519 Please refer here to also to Chapter B.III.  
520 Self-prepared figure.
It has been extensively covered that the CHHC and its subsidiaries all take legal person status, as defined under the respective Chinese laws and qualify as China-domiciled FIEs. FEIs are not legal persons as per the Chinese law. Several laws and provisions provide specific examples as to what particular forms of business, a FEs can maintain in the PRC. Such forms especially cover representative offices, branches, business agents, sites, factories, and plants. However, as the law stipulates, it is not mandatory that a FE maintains any establishment or site within China, yet, it is still qualified as a FE, when it derives income from Chinese sources. “The term ‘establishments or sites’ refers to management establishments, business establishments, offices, factories, places of extraction of natural resources, sites for contracted projects such as construction, installation, assembly or exploration projects, sites for the furnishing of services and business agents.” The striking finding in this context is that the China-Holding, as reviewed within this thesis, exists of Chinese-domiciled legal persons, hence neither the CHHC nor its subsidiaries can be qualified as FEs. Figure 6 in Chapter B.III.4.b. might suggest that FIEs would therefore not be eligible to maintain or establish such establishments as displayed under the FE-category, but this is not the case. FIEs, as genuinely Chinese enterprises, are, within the boundaries of the respective laws and provisions, allowed to maintain all kinds of establishments deemed necessary for its business operations. Besides holding subsidiaries, the CHHC itself is allowed to establish branches in regions other than the one, where its registered office is located. Moreover, Art. 10 no. (3) Holding-Provisions permits the establishment of scientific research and development centers or departments, which themselves can technically be regarded as branches.

According to Art. 11 FEITL the tax liability attaches to a) the generation of income from production and business operations and from other income, b) to the qualification of being a FIE, and c) the FIE needs to be established in the PRC. As to a) the CHHC’s scope of business covers all listed possible sources of income. While, the CHHC itself is not allowed to carry on productive businesses as per Art. 27 Holding-Provisions, it may very well conduct numerous, in the Holding-Provisions and in the Holding-Provisions Amendment separately and particularly listed, other business operations to generate income from business

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522 Art. 3 II IRFEITL.
523 Compare hereto the Holding-Provisions, EJV-Law, EJV-Rules, WFOE-Law, WFOE-Rules, CJV-Law, CJV-Rules, and The CL.
524 Art. 21 Holding-Provisions
525 Whether Branches constitute tax-relevant permanent establishments is discussed in Chapter C.II.
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operations. The term “other income” is to be interpreted in accordance with Art. 2 II IRFEITL. “Other income” is supposed to cover income from profits, interest, rentals and assignment of property, income from provision or assignment of the right to use patents, proprietary technology, trademarks and copyrights, and non-operating income.

The question whether the CHHC qualifies as a FIE, as per b) and c) has been extensively covered, is to be answered positively and is further supported by the provisions stipulated in Art. 2 I FEITL. The article manifests that for the purposes of the FEITL, the term “FIE” refers to Chinese-foreign EJVs, Chinese-foreign CJVs, and WFOEs established in the PRC. In order to qualify as a FIE it is conditional that the given entity is established in China under the rule of Chinese law. A CHHC is established under the regulations of the Holding-Provisions and under the respective provisions set forth in The CL. Hence, the CHHC is established in the PRC under the rule of Chinese Law. Ultimately, the CHHC is an entity qualifying as a FIE as per Art. 2 FEITL generating income in the PRC as per Art. 1 FEITL.

The final events to determine the scope of the tax liability of the CHHC in the PRC are covered in Art. 3 FEITL. In order to become unlimited enterprise income tax liable in the PRC, the CHHC would need to have its “head offices” established in the PRC and derive its “income from sources” inside and outside the PRC. It is assumed that the CHHC shall be eligible to the broadest possible scope of businesses. Hence, it will establish its headquarters in the PRC, because Art. 22 Holding-Provisions expands the business scope, once the headquarter is located within the PRC. To qualify as a “head office” such headquarter needed to be “the central establishment set up in the PRC and be responsible for the operations, management, and control of, a foreign investment enterprise organized as an independent legal person under the laws of China.” The CHHC’s headquarters certainly constitute such events. As to the second event “income from sources”, Art. 6 no. 1 IRFEITL provides a positive list of different kinds of income that qualify as “income from sources” and cover such identical kinds of income that have already been identified to be “income from production or business operations or other income” as per Art. 1 FEITL and Art. 2 IRFEITL. Therefore, it can be positively concluded that the CHHC is unlimited enterprise income tax liable in the PRC.

526 With regard to the permissible business scope of foreign-invested holdings in the PRC refer to Chapter B.III.4.f.
527 Compare also Chapter D.II.3.a.
529 Compare especially Art.’s 4, 8, 10, 13, 14, 15, 22 Holding-Provisions.
530 Art. 5 I IRFEITL.
The same can be concluded with regard to the CHHC’s subsidiaries that also qualify as FIEs\(^{531}\), established under the respective pieces of Chinese legislation.\(^{532}\) One particularity, however, is to be considered regarding the scope of business and, hence, regarding the sources of income. The subsidiary-FIEs can facilitate the entire spectrum of income sources as given in Art. 1 FEITL. Their fields of activity are solely limited by the provisions set forth in the “Catalogue for the Guidance of Foreign Investments Industries” issued by the MOFCOM.\(^{533}\)

In other words, they are free to derive income from production and business operations, as well as from other income. Further, it can be assumed that such subsidiaries also maintain their head offices within the PRC, in accordance with Art. 5 I IRFEITL, making the subsidiaries unlimited enterprise tax liable in the PRC, as well.

As to the general tax administrative issues in Art.’s 1 I, 2 I, 3 s. 1 FEITL and Art.’s 2 I, 3, 5 I, 6 no. 1 IRFEITL, the CHHC, which qualifies as a FIE in accordance with Art. 2 Holding-Provisions in connection with Art. 218 The CL, is unlimited enterprise income tax liable in the PRC. However, in accordance with a government notice, the CHHC obtains a second tax personality due to its qualification as a foreign investor. Hence, investment income, i.e. income from profit distributions received from its investments is taken out of the general unlimited enterprise income tax liability. Therefore, the CHHC is required to keep two sets of accounting records, one to cover the CHHC’s income derived from its investment activities and the other to cover its income derived from its other business activities.\(^{534}\)

As per Art.’s 87, 88 IRFEITL, the establishment, liquidation, merger, and any other organizational change in an FIE has to be reported to the relevant tax authorities within 30 days prior to the going into operation or cessation of the business. The tax authorities subsequently file a tax collection notice, which encloses the foundation of the tax liability and the location and time of the registration. Such notice is the condition for the taxpayer to receive the tax return formulas necessary to file its tax return. The FEIT is levied on the Gregorian calendar year\(^{535}\) and is paid in quarterly tax prepayments.\(^{536}\) The final enterprise income tax return is to be filed by the end of the fifth month of the year following the assessed tax year.\(^{537}\) The standard enterprise income tax rate is 30% plus 3% local income tax. To attract foreign investment, China provides a set of tax incentives and tax holidays to foreign

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531 Compare to the findings of Chapter B.III.4.b.ii.
532 The EJV-Law, the EJV-Rules, the WFOE-Law, the WFOE-Rules, the CJV-Law, the CJV-Rules, and The CL.
533 Compare MOFCOM, promulgated on November 30, 2004.
535 Art. 8 I IRFEITL.
536 Art. 15 FEITL.
537 Art. 15, 16 FEITL; compare also Moser/Zee, Tax Guide, 1999, pp. 72 et seq.
3. Taxable Income

a. The Computation of Taxable Income

The statutory framework and the taxable entity have been identified in the previous chapters. The taxable entity is the CHHC, formed either as an EJV or as a WFOE, in any event qualifying as a FIE. This makes it taxable under the rules of the FEITL and the IRFEITL. The following remarks shall deliver an overview on what the FEITL qualifies as taxable income and on how income, the object of taxation, is determined.

According to Art. 1 I FEITL enterprise income tax is paid “on the income from production and business operations and on other income”. Art. 2 I IRFEITL offers an interpretation of the terms “income from production and business operations”. They refer to income generated from “production and business operations in manufacturing, mining, communications and transportation, construction and installation, agriculture, forestry, animal husbandry, fishery, water conservancy, commerce, financing, services, exploitation and development operations, and other trades.” The second half of the equation “other income” is defined in Art. 2 II IRFEITL and typically covers income originating “from profits (dividends), interest, rentals and assignment of property, income from provision or assignment of the right to use patents, proprietary technology, trademarks and copyrights, non-operating income etc.”

Thus, the CHHC mostly generates what the law calls “other income”, like, e.g., dividends, interest, and/or royalties. However, the CHHC also generates income from business operations through the considerations it receives for rendered services or other business transactions it carries out. In any event, the CHHC may not generate income from production activities, as the CHHC is strictly excluded from engaging in production activities. Generally, Pfaar/Salzmann state, that the list of productive and business income given is not to be interpreted as a limitation, i.e. excluding all other imaginable forms of productive and business income from taxability. They suggest that usually what under the term “other

“income” is described as “non-operating” income serves as a catch basin for all kinds of income that are not positively defined within the law.\textsuperscript{539}

As to the amount of taxable income Art. 4 FEITL provides the following fundamental definition: “The amount of taxable income of FIEs...engaged in production and business operations shall be their total amount of revenue for each tax year less costs, expenses, and losses.” A special peculiarity of the Chinese enterprise income tax law is its provisions to compute taxable income. According thereto, the law distinguishes the computation of taxable income in dependence of the respective taxable entity’s scope of business. Art. 10 IRFEITL provides separate formulae for the computation of taxable income for a) taxable entities active in the “manufacturing industry”, b) taxable entities active in “commerce”, c) taxable entities active in “service trades”, and d) such taxable entities active “other trades”. The respective computation-formulae are displayed in Figure 19.

<table>
<thead>
<tr>
<th>Manufacturing Industry</th>
<th>Commerce</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Taxable Income = Profit from product sales + other</td>
<td>1. Taxable income = Sales profit + other business profit</td>
</tr>
<tr>
<td>business profit + non-operating revenue (\div) non-operating expenditure</td>
<td></td>
</tr>
<tr>
<td>2. Profit from product sales = Net product sales (\div) cost of product sales (\div) tax on product sales (\div) (marketing expenses + administrative expenses + financial expenses)</td>
<td></td>
</tr>
<tr>
<td>3. Net product sales = Gross product sales (\div) (sales returns + sales allowances)</td>
<td></td>
</tr>
<tr>
<td>4. Cost of product sales = Current period product cost + beginning inventory cost (\div) ending inventory of products</td>
<td></td>
</tr>
<tr>
<td>5. Current period product cost = Current period product cost + beginning inventory of semi-finished products and products in process (\div) ending inventory of semi-finished products and products in process</td>
<td></td>
</tr>
<tr>
<td>6. Current period production cost = Direct materials consumed in production + direct wages + manufacturing expenses over the current period</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Service Trades</th>
<th>Other Trades</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Taxable income = Net business revenue + non-operating revenue (\div) non-operating expenditure</td>
<td></td>
</tr>
<tr>
<td>2. Net business revenue = Gross business revenue (\div) (tax on business revenue + operating expenditure + administrative expenses + financial expenses)</td>
<td></td>
</tr>
</tbody>
</table>

To be computed by reference to the other formulae.

Figure 19: The Computation of Taxable Income\textsuperscript{540}

In case of negative taxable income, i.e. a loss, Art. 11 s. 1 FEITL governs that such losses incurred in a tax year by a FIE engaged in production and business operations, may be carried forward to the next tax year and set off against a corresponding amount of income in that year. In case the income in the following year is insufficient to cover such losses, the setting

\textsuperscript{539} Compare Pfaff/Salzmann, Besteuerung, 2005, p. 19. 
\textsuperscript{540} Self-prepared figure with reference to Art. 10 IRFEITL.
off may be continued during subsequent years for a maximum of five years. In the event that after five years any loss carryforward could not be set off in full, any remaining balances of such loss carryforwards are ultimately lost and cannot be deducted from any income any further. \(^{541}\)

The FEITL and the IRFEITL contain a number of provisions setting forth the tax-accounting rules to be followed for the computation of taxable income. Such provisions, basically, conform with the general commercial accounting provisions applicable to FIEs, i.e. the Accounting Standard, the ASBE, and the individual guidelines. \(^{542}\) As per Art. 17 FEITL, FIEs are generally allowed to devise and implement their own financial management and accounting systems. \(^{543}\) Art. 17 II FEITL contains a provision governing FIEs to compute their income and to handle their financial affairs and accounting in accordance with tax regulations of the PRC. The Chinese tax laws do not contain an explicit authoritative principle, as known by the Austrian and German tax laws. However, indirectly it is presupposed that taxable entities in the PRC maintain their tax-accounting systems in accordance with Chinese (commercial) accounting and company law. \(^{544}\) For instance, the obligation of the CHHC to handle its financial affairs and accounting in accordance with Chinese law can be indirectly concluded, e.g., via Art. 26 Holding-Provisions, Art.’s 164, 218 The CL and Art. 69 EJV-Rules or Art. 56 WFOE-Rules. The latter, e.g., rules “WFOEs shall establish a finance and accounting system in accordance with Chinese legislation and the regulations of China’s financial authorities and shall record such system with the finance and taxation authorities...”

Concluding, the CHHC maintains its commercial accounting in accordance with the specifically applicable PRC accounting regulations. For the purposes of the computation of taxable income, the commercial financial statements are in turn adjusted in accordance with the provisions provided by the FEITL and IRFEITL, as well as by the numerous issued administrative orders covering tax-accounting regulations. \(^{545}\) In cases of disputes between the commercial accounting provisions and the tax accounting provisions regarding the tax qualification of a particular taxable fact or event, the tax provisions shall prevail. \(^{546}\)

\(^{541}\) Art. 11 s. 2 FEITL.

\(^{542}\) Compare Stucken, Besteuerung, 1995, p. 60; Tang/Chow/Cooper, Accounting, 2000, pp. 58 et seq.


\(^{544}\) The relevant Chinese law covering the commercial accounting of FIEs in the PRC is the “FIE Accounting System” [hereinafter “FIE-AS”], promulgated on June 24, 1992 by the MoF.


\(^{546}\) Art. 17 II FEITL. Compare hereto also Stucken, Besteuerung, 1995, p. 61.
The enterprise income tax relevant computation of taxable income follows Art.’s 11 et seq. IRFEITL. As a basic rule Art. 11 I IRFEITL manifests that the computation of taxable income is to be carried out at accrual basis, notwithstanding the exceptions provided by Art. 11 II IRFEITL. In general, accrual accounting attempts to record the financial effects of transactions, other events and circumstances on an entity. Such transactions, other events and circumstances do not necessarily need to have consequences for the entity in the periods in which cash is received or paid by the entity. Thus, accrual accounting is based, not only on cash transactions, but also on credit transactions, bartering, changes in prices, changes in the form of assets or liabilities, and other transactions, events and circumstances that involve no current cash transfer but will have cash consequences in the future.\textsuperscript{547} The FEITL and the IRFEITL generally allow for the deduction of all business-related costs, expenses, and losses, unless the respective item is explicitly excluded from such deduction allowance by a rule of law.\textsuperscript{548} Hence, as shown in Figure 19, the taxable income as defined by the law is the net income earned by the FIE in the given year.

Art. 21 FEITL and Art.’s 14, 15 IRFEITL manifest that the currency, taxes have to be computed and paid in is the Chinese currency RMB. Consequently, foreign currency income has to be converted into RMB. The exchange rate used for the conversion shall be the purchasing rate announced by the State Administration of Foreign Exchange. With regard to the quarterly tax prepayments, Art. 15 s. 1 IRFEITL provides that the amount of income tax payable is computed by converting the foreign currency amount into RMB using the State Administration of Foreign Exchange purchasing rate of the respective last day of the quarter. For the annual tax return, the taxpaying entity is is not required to convert the foreign currency income it has received throughout the given year again, but to convert the year’s foreign currency income at the State Administration of Foreign Exchange’s purchasing rate of the last day of the year. Accordingly, the entity’s calculation results in a foreign-currency gain or loss on which it might have to pay additional enterprise income tax, if the previous quarterly prepayments had not been sufficient.\textsuperscript{549}

\textsuperscript{547} See Delaney et al., GAAP, 2003, p. 30.
\textsuperscript{548} For a closer examination please refer to the following chapters that explicitly cover the most important aspects of the taxation of holding-relevant items, as well as chosen financial statement items!
\textsuperscript{549} Art. 15 s. 2 IRFEITL.
b. Capital Contributions

At hand of this chapter and the following two chapters, a striking characteristic of the Chinese tax law can be displayed. Chinese tax laws and their referring administrative orders, apparently, express a large degree of anxiety of the Chinese lawmaker of manifesting particular taxable facts and events and corresponding tax consequences. The law is often formulated vaguely, lacking definitions and, evenly important, valuable and legally valid interpretations. Chinese tax laws and provisions often do not contain specific rules governing the tax treatment of a given event or fact. For instance, the FEITL and the IRFEITL do not explicitly regulate the tax treatment of equity contributions, contributions in kind, constructive equity contributions, reductions of share capital, or constructive dividends. Examining the FEITL and IRFEITL searching for respective provisions one has to bear in mind that the Chinese legal dictum might not cover terms for events and facts commonly known in the German and Western legal languages. However, from the non-existence of respective regulations one cannot conclude that such events and facts do not occur in the PRC. Obviously, also the Chinese tax laws and provisions have to somehow cover events for the contribution of capital, be it open or constructive, as well as reductions in share capital or all such circumstances that in the German tax literature is referred to as a constructive dividend. However, what appears surprising is the fact that neither the FEITL nor the IRFEITL mention with a single word or formulation such economically important facts and events like contributions or reductions of capital. In order to being able to produce a valid statement with regard to the abovementioned one has to review the tax administrative orders and the relevant accounting and company law provisions issued by the respective government bodies.

Taxable under Chinese enterprise income tax law is the income from production and business operations and other income derived by FIEs established in the PRC. Therefore, equity contributions are only taxable if they qualify as a taxable activity as defined under Art. 1 FEITL. According to the fundamental Austrian and German understanding, transactions originating in the company law partnership do not qualify as a taxable activity. The contribution of capital, in cash or in kind, originates in the relevant company law provisions. Contributions of capital may take two forms, one is the initial contribution of

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550 Especially The CL covers a section dealing with increases and reductions of capital. Compare hereto Art.’s 178, 179 The CL.
551 Art. 1 FEITL.
registered capital\textsuperscript{552}, necessary to establish an incorporated entity and the other is the capital contribution made by shareholders during the term of operations, i.e. an increase in share capital.

As per Art.’s 3 no. 3, 5 Holding-Provisions the initial contribution of capital, to pay in registered capital, is clearly an activity that originates in the company law affiliation between a shareholder and a corporation set forth by the company law obligations stipulated in company law provisions and by the respective articles of association. The Chinese foreign enterprise income tax law and provisions, however, focus on the taxation of income derived from a somewhat specified market transaction that produces taxable “business revenue”\textsuperscript{553} or “other business profit”\textsuperscript{554}. Yet, the contribution of registered capital is not carried out by way of a market transaction. It originates from the company law affiliation between investor and investee. In correspondence with the Austrian provision\textsuperscript{555}, one could conclude the contribution of registered capital does not qualify as a taxable activity. In such a case it would neither qualify as taxable “business revenue” nor as “other business profit” and the contribution of registered capital would not influence the taxable income of the CHHC. The same tax neutrality could be triggered by increases in share capital taken out during the term of operations of the respective entity.\textsuperscript{556} Conditional for the recognition as a tax neutral capital contribution is the transfer of capital from the shareholder’s property into the entity’s, i.e. the CHHC’s, property. Such transfer of capital, again, is solely caused by the company law affiliation between the shareholder and the corporation. Correspondingly, increases in share capital would also have to be considered as tax neutral.

Yet, the MoF and the SAT issued an administrative order providing guidance with regard to the taxation of capital contributions.\textsuperscript{557} While the cash capital contributions do not trigger any tax effects, i.e. are tax-neutral, the contribution of appreciated property, i.e. tangible assets, to

\textsuperscript{552} Compare Art. 2 of the Administration of Registration of Company Registered Capital Provisions, promulgated by the SAIC on June 14, 2004, which defines “a company’s registered capital is the capital contribution amount paid in or subscribed to by all the shareholders or sponsors that is registered in accordance with the law with company registration authority.” Further Art. 4 of the same provisions rule that “the amount of a company’s registered capital and the method of contribution...shall comply with the relevant provisions of laws and administrative regulations.” These laws and administrative regulations cover especiallyArt.’s 3, 5, 7 Holding-Provisions, Art.’s 4, 5 EJV-Law, Art.’s 17, 18 EJV-Rules and Art.’s 19, 20, 21, 22, 25, 26, 27, 28, 29, 30, 31, 32 WFOE-Rules, respectively, as well as the “Capital Contributions by the Parties to Sino-Foreign EJVs Several Provisions Supplementary Provisions”, issued by MOFTEC/SAIC, September 29, 1997. Generally, the contribution of registered capital to legal person entities in the PRC is ruled in Art.’s 26, 27, 28, 29 The CL.

\textsuperscript{553} Art. 4 s. 2 FEITL; Art. 10 no.’s 1 l. (a), 2 l. (a), 3 l. (a) IRFEITL.

\textsuperscript{554} Art. 10 no.’s 1 l. (a), 2 l. (a), 3 l. (a) IRFEITL.

\textsuperscript{555} § 8 1 aKStG.

\textsuperscript{556} General provision for the increase in share capital of a legal person entity in the PRC are given in Art. 179 The CL.

\textsuperscript{557} MoF/SAT, January 13, 1995.
a new subsidiary-FIE causes a tax consequence. The administrative orders rule that the transfer of such appreciated property as contribution is kind has to be made at market value resulting in the realization of taxable built-in gains equal to the balance of the market value less the carrying amount of the property as recorded in the investing company’s books. Such taxable gain, however, does not have to be subject to tax at once, but can be amortized over a period of five years, given the approval of the relevant tax authorities.558

Throughout this research object, no concrete sources covering facts or events, in the German-speaking tax literature known as constructive capital contributions and constructive dividends559, could be found. With regard to these two aspects, the author therefore aims at concluding a tax handling that seems to be likely, based on the above findings and on possibly relevant provisions from the FEITL, the IRFEITL and administrative orders. As per the definition given in Chapter C.III.2., constructive capital contributions resemble grants that are given by the shareholder subject to the company law affiliation, but simultaneously do not qualify as open contributions of capital as they would not have been provided in the same way or manner by an independent third party. Given the tax neutrality of open cash capital contributions, as concluded above, it can be assumed that the lack of obtaining an “open capital contribution status” results in the fact that such constructive capital contributions somehow gain tax relevance. A constructive capital contribution is only discovered as such after the underlying event has been realized. The question is, which forms a re-qualification of the realized event can take and what tax consequences are attached thereto.

The scenario referred to within this thesis assumes the existence of a multinational group of companies that has established a CHHC to hold its various Chinese investments, i.e. subsidiaries. It could, therefore, be assumed that the combination of the CHHC and its subsidiaries qualify as “affiliates” as stipulated by Art. 13 FEITL. The definition of constructive capital contributions given above, assumes that such payments would not be made in the same way by independent third parties. Art. 13 s. 1 FEITL, however, provides that when FIEs conduct business with their affiliates, they shall charge and pay prices and expenses as in business transactions conducted at arm’s length. In case such arm’s length principle is violated and the amount of tax payable is consequently reduced, the tax authorities have the right to effect reasonable adjustments.560 In a “closed-shop” environment like a

558 Compare Howson/Li, Holding Companies, 1998, pp. 11 et seq.; International Bureau of Fiscal Documentation, China, 2003, p. 224
559 Compare Chapter D.II.3.d.
560 Art. 13 s. 2 FEITL.
holding or a group of companies, thus, constructive capital contributions are not re-qualified as open capital contributions. Their respective amount is rather re-qualified into “non-operating income” as defined in Art. 106 no. (5) ASBE. Such income, if no association with production or business income is given, represents “other income” in the sense of Art. 1 I FEITL in connection with Art. 2 II IRFEITL and, hence, increases taxable income and ultimately the tax burden of the receiving entity. Correspondingly, genuine business expenses incurred by the constructive capital contribution granting entity would resemble tax-deductible expenses.

c. Capital Reductions

Any foreign-invested enterprise only qualifies as a FIE, if at least 25% of the financial holdings in such entity are of foreign, i.e. non-Chinese, origin. Therefore, if a reduction in the foreign stake of the respective entity’s capital is considered in course of which the foreign shareholding is reduced to below the 25%-threshold, the given entity would lose its FIE-status and would consequently be treated in accordance with the tax laws, rules and provisions applicable to DEs. Such a swap in the applicable provisions can have severe tax and, ultimately, financial consequences for the given entity, as it would instantly no longer be eligible to receive the tax incentives available under the FEITL and the IRFEITL and might be obliged to pay back received tax refunds, potentially stressing financial capacities.\(^{561}\)

As has been laid out in the Austrian context reductions of share capital have to be considered as the legal counterparts of capital contributions, where capital is retransferred to a corporation’s shareholders. Hence, one could assume that such transfer is based solely on the company law affiliation between the involved parties and that it does not equal a tax-effective market transaction like, e.g., the distribution of income.\(^{562}\) Consequently, reductions of share capital needed to be tax neutral as well. However, the Chinese tax laws remain silent with regard to the taxation of capital reductions. Yet, in analogy to the taxation of capital contribution, the CHHC would account for a decrease in reported equity as the offsetting entry to the disposal of liquidity suffered by the reduction of share capital. Whereas, the CHHC’s parent company financial statement would show a decrease in the financial statement item “assets” and an increase in the financial item “checks, cash on hand, central and postal giro balances, bank balances”. The same scenario applies to the next lower level

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\(^{561}\) Art. 79 IRFEITL.

\(^{562}\) Art. 178 The CL.
in the MNC-hierarchy when the capital of a subsidiary of investment of the CHHC is reduced. Corresponding to the taxation of capital contributions made in cash, the reduction of cash-based capital contributions does not trigger any tax effect. Different from that, the reduction of capital that was originally paid in by way of a non-cash contribution, triggers tax consequences. The CHHC would have to account for non-operating income and the subsidiary whose capital is reduced would report a corresponding expense.\textsuperscript{563}

d. The Utilization of Income

The utilization of a FIE’s income, is generally ruled by the respective accounting and company law provisions and the articles of association. In its capacity of being either an EJV or a WFOE, the CHHC has to follow the applicable laws.\textsuperscript{564} As to Art. 8 EJV-Law and Art.’s 76, 77 EJV-Rules, allocations to the “\textit{reserve fund, the bonus and welfare fund for workers and staff and the expansion fund of the venture as stipulated in the articles of association}”\textsuperscript{565} have to be made before the after-tax income, i.e. the net profit, of an EJV can be distributed. However, there exist legal-form specific differences. While EJVs and CJVs have to establish all such funds, WFOEs are not legally bound to establish an expansion fund. Additionally, the amounts that have to be allocated to such funds also vary depending on the chosen legal form. WFOEs need to allocate at least 10% of the annual profit to the reserve fund until the paid in capital of such fund reaches 50% of the respective WFOE’s registered capital. On the contrary, thereto, there exists no provision governing the minimum allocations that have to be made by EJVs and CJVs.\textsuperscript{567} In addition to the mandatory fund-allocations, profits cannot be distributed unless the commercially accounted losses and loss carryforwards of the previous years have been made up, a provision, which in many cases prevents dividend distributions.\textsuperscript{568}

\textsuperscript{563} Art. 106 no. (5) ASBE; Art. 1 I FEITL; Art. 2 II IRFEITL.
\textsuperscript{564} Notwithstanding, that the Holding-Provisions serve as \textit{lex specialis} opposite the company law rules governing EJVs and WFOEs.
\textsuperscript{565} Reserve funds can be used to make up the losses of the joint venture, and with the consent of the examination and approval authority, can also be used to increase the joint venture’s capital for production expansion; see Art. 76 no. 2 EJV-Rules.
\textsuperscript{566} Art. 8 EJV-Law.
\textsuperscript{568} Art. 77 IRFEITL. Also compare Pfärr, Strukturierung, 2003, p. 694; Pfärr/Salzmann, Besteuerung, 2005, p. 132.
No evidence could be found that the Chinese tax literature knows a taxable event in the German-speaking tax literature commonly known as constructive dividends. As per the definition given in Chapter C.III.3., constructive dividends are monetary-equal grants made by a corporation to a shareholder that do not qualify as open income distribution, originate from the company law affiliation, actually reduce the corporation’s income, and would not have been granted in the same way to a third party that is not company law affiliated with the corporation. As no particular provision could be identified that contained an event ruling a circumstance similar to that of a “constructive dividend” one can presume that the catch basin phrase “other income” as defined in Art. 2 II IRFEITL covers such a phenomenon in connection with Art. 13 FEITL, which rules that affiliated entities shall charge and pay prices and expenses as in business transactions conducted at arm’s length. In case such arm’s length principle is violated and the amount of tax payable is consequently reduced, the tax authorities have the right to effect reasonable adjustments. Therefore, it can be assumed that the Chinese tax authorities will assess events that from an Austrian and German understanding equal constructive dividends, and perform adjustments as deemed reasonable.

4. The Allocation of Income

The taxation of the allocation of income is probably the single most interesting issue in connection with holdings and holding companies. When examining the taxation of income allocation in a holding-context one automatically is confronted with the question, whether the jurisdictions surveyed offer a specific group-relief regime that allows for a somehow designed offsetting of taxable results between the separate taxable entities belonging to a holding and/or group of companies. One observation, quickly made during the research for this thesis is that the PRC tax laws do not contain such a group-relief regime for FIEs.\(^{569}\) The only kind of tax consolidation eligible to FIEs refers to FIEs that operate several establishments or sites, each of these without an own legal personality.\(^{570}\) However, the ruled combined tax payment is subject to numerous limitations. According to Art.’s 89, 93 IRFEITL, a FIE may, where it has set up two or more business establishments or branches in the PRC designate one of such business establishments or branches to file returns and pay income tax on a combined basis

\(^{569}\) Compare hereto Howson/Li, Holding Companies, 1998, p. 12; Moser/Zee, Tax Guide, 1999, p. 72; Süss, Gründung, 1996, p. 6. However, the lawmaker slowly but surely begins to introduce provisions allowing for limited consolidated tax filing of DEs. The latest provision introduced was the “Circular on the Regulation of the Scope of Consolidated Enterprise Income Tax Payment” issued by the SAT on January 17, 2006.

\(^{570}\) Compare Art.’s 89, 90, 91, 92, 93 IRFEITL.
for all business establishments and/or branches. The designated business establishment or branch needs to be responsible for the supervision and administration of the business operations of all other business establishments or branches and needs to maintain the accounting for all such business establishments or branches.

In any event, the FEITL and the IRFEITL, as well as the respective administrative orders contain no provisions for tax consolidation between separate FIEs. Accordingly, the taxable results of the subsidiaries neither can be set off against each other’s results at the subsidiaries’ level, nor at the CHHC’s level.\footnote{Compare International Bureau of Fiscal Documentation, China, 2003, p. 224.} Each single entity belonging to the China-Holding, therefore, is an individual tax subject simultaneously responsible to compute its taxable income, file its quarterly and yearly tax returns, and to pay its tax liabilities. Thus, it could be said that the FEITL and the IRFEITL follow the separation\footnote{Compare Wang, Besteuerung, 2006, p. 131 et seq.} principle, separating taxable entities and separating enterprises from its shareholders. The CHHC, therefore, is confronted with the problem that it cannot directly allocate losses from its investments to a tax consolidated holding wide tax base. It remains to be examined, if the laws provide for an indirect option to allocate such losses, e.g., by way of write-downs on the value of the investments it carries in its financial statements. To the contrary, both the commercial accounting, as well as the Domestic Enterprise Income Tax Law explicitly provide for the consolidation of income of separate legal entities. According to Art. 158 ASBE, an enterprise should prepare consolidated accounting statements, if it a) holds directly more than 50% of the registered capital of an investee-enterprise, or b) holds directly 50% or less of the registered capital of an investee enterprise, but has control over the investee enterprise.

Ultimately, it can be concluded that the taxation of the China-Holding resembles the taxation of any given FIE. Yet, the survey of the taxation of the CHHC needs to consider such holding-specific administrative orders, which cover particular elements the Chinese authoritative bodies demand to be recognized and applied in connection with the taxation of the China-Holding. A tax consolidation or group-relief regime for the China-Holding and the CHHC is, despite the existence of commercial accounting provisions setting forth the commercial consolidation in particular cases and tax consolidation rules applicable to DEs, not provided by the currently applicable Chinese tax laws.\footnote{Compare Wang, Besteuerung, 2006, p. 167.}
5. **Business Income**

Given that the Chinese tax laws do not contain a separate group-relief regime, the general rules and regulations of the FEITL, the IRFEITL, and the respective administrative orders, actually are the sole source for a research on the taxation of the foreign-invested holding company in the PRC. As has been said in the Austrian context the economic life of any given holding can cover multiple different business activities. All such business activities can qualify as different enterprise income tax relevant facts and, hence, realize specific taxable events. In accordance with the previous study of the Austrian holding taxation, the following findings refer to particular chosen sources of business income, too. General operating income, obviously dividends, interest, and capital gains have been identified as such sources of business income. In addition to these categories, the study of relevant literature and legislation has shown that royalties appear to be of a particular significance in the context of business ventures in the PRC and, therefore, are included into the examination as well.

The FEIT distinguishes between two superior categories of income, “*income from production and business operations*” and “*other income*”. In order to be taxable, the respective income must qualify as one of such two categories of income. According to the legal definition of the term “*income from production and business operations*”, such income does include income generated through, among others, “commerce, financing, services...and other trades.” Whereas, such income that is covered by the term “*other income*” refers to income derived through “*profits, i.e. dividends, interest, rentals and assignment of property, proprietary technology, trademarks and copyrights, non-operating income, etc.*” Subject to the order of the following chapters one can allocate “*operating income*” to the category of “*income from production and business operations*”, while “*dividends*, “*interest*”, and “*royalties*” represent elements of the “*other-income-category*”. Not quite that evident appears to be the allocation of capital gains to one of the superior income categories, but it can be presumed that they are covered by “*other income*”, too.

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574 Art. 1 FEITL.
575 Art. 2 I IRFEITL.
576 Art. 2 II IRFEITL.
a. Operating Income

As in the Austrian context, “operating income” serves as a generic term covering all such sources of income that the CHHC and its FIE-subsidiaries derive through genuine operative business activities. According to the provisions set forth in the Holding-Provisions, that regulate the scope of business activities a CHHC is allowed to engage in and excluding the explicitly identified sources of income treated in the following chapters, numerous business activities could have tax implications. In its Art.’s 10, 13, 14, 15, and 22, the Holding-Provisions set forth an extensive catalogue of the different business activities open to a CHHC, which is further extended and partly modified through the Holding-Provisions Amendment.577

Accordingly, the income, the CHHC generates through its activities would be taxable, if they were derived from business activities in commerce, financing, the performance of services, or other trades. In reality, one can assume that the CHHC will attempt to maximize its portfolio of permitted business activities to justify its establishment. It has been shown that the establishment of a CHHC is accompanied by strict conditions and requirements, especially with regard to its capitalization and permitted scope of business activities.578 Typical business activities and services, a CHHC would want to undertake in order to increase the efficiency of the entire Chinese operations presumably cover:

- maintenance of the holding’s financial management, including
  - an intra-holding treasury system;579
  - the balancing of finances between itself and its subsidiaries and financing services by acquiring capital from holding-external capital markets, possibly by establishing “group finance companies”;580
  - the balancing of foreign exchange within the holding;581
- provision of operational leasing services or establishment of operational leasing companies;582
- rendering purchasing services for the entire holding;583

577 Art.’s 10 no. (2), 13, 15, 22 no. (2) Holding-Provisions.
578 Compare Chapter B.III.4.
579 Art’s 10 no. (2) l.’s (ii), (iv), 22 no. (2) l. (vi) Holding-Provisions.
580 Art.’s 10 no. (2) l. (iv), 22 no. (2) l. (vi) Holding-Provisions; ad “group finance companies” compare also Harner, Group Finance Companies, 2004, pp. 35 et seq.
581 Art. 10 no. (2) l. (ii) Holding-Provisions.
582 Art.’s 15 no. (6), 22 no. (2) l. (vii) Holding-Provisions.
- rendering intra-holding human resource and technical services;\(^{584}\)
- provision of general consultancy services to its subsidiaries, as well as to its shareholders;\(^{585}\)
- acting as a distributor and seller for products produced within the group;\(^{586}\)
- rendering logistics and distribution services;\(^{587}\)
- performance of technical training to holding-external business partners with regard to the products distributed by the CHHC;\(^{588}\)
- contracting of foreign projects of DEs;\(^{589}\)
- purchase, import and sale of products, raw materials, spare parts, and components of MNCs and their affiliates in the PRC;\(^{590}\)
- provision of outsourcing services;\(^{591}\)
- entrusting other enterprises in the PRC to produce/process the China-Holding’s products or products of its parent company and selling such products.\(^{592}\)

The remuneration the CHHC receives from the performance of such activities and services needed to qualify as income from production and business operations. As the CHHC is excluded from productive activities, its taxable income can be narrowed down to either “income from business operations” or “other income”, respectively.\(^{593}\) Moreover, indeed, the remunerations for the activities and services performed, as per the list given above, can be subsumed under income derived from the fields of commerce, financing, services or other trades. Consequently, the income gained by the CHHC through such activities and services

\(^{583}\) Art. 10 no. (2) I. (i) Holding-Provisions.
\(^{584}\) Art. 10 no. (2) I. (iii) Holding-Provisions.
\(^{585}\) Art. 10 no. (4) Holding-Provisions.
\(^{586}\) Art’s 15 no.’s (1) I. (i), (2), (3), (9), 22 no. (2) I. (ii) Holding-Provisions.
\(^{587}\) Art’s 15 no. (1) I. (ii), 22 no. (2) I. (v) Holding-Provisions.
\(^{588}\) Art’s 10 no. (2) I. (iii), 15 no.’s (4), (7) Holding-Provisions.
\(^{589}\) Art’s 15 no. (8), 22 no. (2) I. (vii) Holding-Provisions.
\(^{590}\) Art’s 10 no. (2) I. (i), 15 no. (5), 22 no. (2) I. (iii) Holding-Provisions.
\(^{591}\) Art’s 10 no. (5), 22 no. (2) I. (iv) Holding-Provisions.
\(^{592}\) Art. 22 no. (2) I. (viii) Holding-Provisions.
\(^{593}\) Art. 28 Holding-Provisions.
clearly marks income from business operations and hence is taxable under Art. 1 I FEITL at the standard rate of 33%, given that no tax incentives or tax holidays apply. With regard to the taxation of operating income of the CHHC’s subsidiary-FIEs the above said counts accordingly. As long as the respective source of operating income of the subsidiary can be subsumed under the terms “income from production and business operations” it will be taxable under Art. 1 I FEITL. A detailed discussion of all possible productive and operational business income, as well as of exemptions stipulated for certain industries and activities would be beyond the scope of this research and, therefore, the author refers to Table 7 for an overview on industry-specific tax exemptions.

<table>
<thead>
<tr>
<th>Article</th>
<th>Industry/Activity</th>
<th>Taxation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Art. 12 I IRFEITL</td>
<td>product-sharing CJVs</td>
<td>a joint venture party shall be deemed to derive revenue when it receives its share of products; the amount of such revenue should be computed on the basis of the price at which the products are sold to third parties or by reference to the current market price</td>
</tr>
<tr>
<td>Art. 12 II IRFEITL</td>
<td>petroleum exploitation</td>
<td>FEs shall be deemed to derive revenue when it receives its share of crude oil; the amount of revenue so derived should be computed on the basis of a price which is adjusted periodically by reference to the international market price of crude oil of the same quality</td>
</tr>
<tr>
<td>Art. 17 IRFEITL</td>
<td>foreign commercial aviation / ocean shipping</td>
<td>taxable income of enterprises active in such industries shall equal 5% of their gross revenue</td>
</tr>
</tbody>
</table>

Table 7: Individual Taxation of Particular Industries and Activities

b. Dividends

If one assumes that the FEITL distinguishes between “income from production and business operations” and “other income”, dividends, interest, and royalties are to be allocated to the latter category. As per Art.’s 1, 3, 19 FEITL and Art.’s 2 II, 6 no. (1) I. (b), 59 et seq. IRFEITL, dividends are qualified as “passive income” that is subject to a withholding taxation computed on the full amount of the revenue, yet without providing a specific definition for the term “dividend”. Tax objects falling under the provisions of such withholding taxation are

594 Compare Pfaar, Strukturierung, 2003, p. 693. Ad the applicability of tax incentives and tax holidays please refer to Annex II!
595 Self-prepared table.
596 Art. 2 II IRFEITL.
subject to a 10% tax rate levied on the gross amount of “dividend” revenue.\textsuperscript{597} However, in this context, the term “dividends” refers to any form of openly distributed and allocated shares in profit resulting from a company law affiliation between the dividend-receiving entity and the dividend-distributing entity. Hereto, Art. 60 IRFEITL defines “profits” to mean, “income derived by virtue of an investment ratio, share rights, stock or other non-creditor’s right to share of the profit.”\textsuperscript{598} In addition thereto, Art. 63 IRFEITL defines “profit derived from a FIE” as the “income from the profit earned by a FIE less the income tax or reduced income tax paid by such FIE, or from the profit earned by a FIE, which is exempt from income tax, in accordance with the Tax Law.”

With regard to such dividends, Art. 19 III l. (a) FEITL in connection with Art. 18 IRFEITL provide for the tax exemption of inter-corporate dividends. Art. 19 III l. (a) FEITL governs that “the profit derived by foreign investors from a FIE shall be exempt from income tax.” Hence, the FEITL provides for a full participation exemption with regard to dividends distributed by any FIE to its foreign-investor shareholder. The dividends received by the CHHC this way would, therefore, be tax-exempt if a) the CHHC would qualify as a foreign investor and if simultaneously b) the CHHC’s profit-distributing subsidiaries would qualify as a FIE. It has been repeatedly concluded, that the CHHC as well as its subsidiaries both qualify as FIEs. In its function as a FIE, the CHHC simultaneously qualifies as a foreign investor.\textsuperscript{599} Consequently, the profits (dividends) distributed by the CHHC’s subsidiary-FIEs to the CHHC are tax-exempt in accordance with Art. 19 III FEITL, supported by an administrative order issued by the MoF and the SAT in 1995\textsuperscript{600} and by Art. 18 IRFEITL.

As to Art. 18 IRFEITL “a FIE, which invests in another enterprise in the PRC shall not be required to include in its own taxable income the profits (dividends) derived from such other enterprise...”\textsuperscript{601} This provision further expands the tax exemption from dividends the CHHC received from FIE-subsidiaries to all kinds of dividends the CHHC might receive from

\textsuperscript{597} Usually Art. 19 I FEITL in connection with Art.’s 59, 60, 61 IRFEITL provide for withholding tax rate of 20% but the SC issued a notice on November 18, 2000 ruling that such withholding tax rate was reduced to 10%. Compare hereto, among others, Gorvind, Tax Approaches, 1988, p. 172; Moser/Zee, Tax Guide, 1999, p. 80 et seq.

\textsuperscript{598} Compare International Bureau of Fiscal Documentation, China, 2003, p. 175.

\textsuperscript{599} SAT, promulgated on July 21, 1993.


\textsuperscript{601} Compare hereto International Bureau of Fiscal Documentation, China, 2003, pp. 174 et seq.
enterprises in the PRC, such as from B-shares or other minority investments.602 The term “enterprise” in this context is understood to cover all sorts of legal form enterprises established under Chinese law. Accordingly, the tax exemption of dividends does not only cover dividends distributed by subsidiary-FIEs but all kinds of dividends distributed by legal form enterprises established in the PRC. Hence, all inter-corporate dividends received by the CHHC from a Chinese source are exempt from enterprise income tax.603

c. Interest

According to the previous chapter, interest qualifies as “passive income” that is subject to the withholding tax provisions set forth in Art. 19 FEITL and in Art.’s 59 et seq. IRFEITL. The law does not define the term “interest”, but includes interest derived from deposits, savings, loans, and various forms of debt certificates.604 Interest income, a CHHC receives from its subsidiaries, e.g. for granting loans, is to be included into the computation of taxable income. The usual 20% withholding tax rate is waived in favor of a reduced 10% tax rate, as is the case with dividends.605

However, Art. 19 III l.’s (b) and (c) FEITL provide that interest derived from particular sources is exempt from tax. Tax exempt, e.g., is interest received from loans extended to the Chinese government and Chinese State banks by international financial organizations606 and interest from loans extended at a preferential interest rate to Chinese State banks by foreign banks.607 Hence, the interest-receiving entity needed to qualify, either, as an “international financial organization”, or a “foreign bank”. As per Art. 64 IRFEITL the term “international financial organization” means “international financial organizations such as the International Monetary Fund, the World Bank, the Asian Development Bank, the International Development Association, the International Fund of Agricultural Development, etc.” Given that this thesis covers solely company law entities of the private economy as possible CHHCs, it can be concluded that the CHHC does not qualify as such an

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602 The term “minority investment” used in this context shall refer to such investments, where the share held by the CHHC amount for less than 25% of the respective entity’s registered capital and hence such entity does not qualify as a FIE but as a regular domestic Chinese company.
605 Usually Art. 19 I FEITL in connection with Art.’s 59, 60, 61 IRFEITL provide for withholding tax rate of 20% but the SC issued a notice on November 18, 2000 ruling that such withholding tax rate was reduced to 10%. Compare hereto, among others, Gorvind, Tax Approaches, 1988, p. 172; Moser/Zee, Tax Guide, 1999, p. 80 et seq.; Pfaar, Strukturierung, 2003, p. 695; Wang, Besteuerung, 2006, p. 169.
606 Art. 19 III l. (b) FEITL.
607 Art. 19 III l. (c) FEITL.
“international financial organization”. However, if the CHHC qualified as a subsidiary of a foreign bank the provision of Art. 19 III l. (c) FEITL would apply for interest, it receives from loans, which it extends to Chinese State banks. 608 The concrete scope of business is not specified further; however, as reality shows more and more international banking corporations are establishing Chinese subsidiaries. 609 Depending on the demands of the foreign parent company, such subsidiaries could be structured in the form of a China-Holding, with a CHHC at the hierarchical top taking over managerial and administrative functions.

d. Royalties

Royalties certainly are a major issue for MNCs active in the PRC. Often MNCs are only granted permission to engage in particular projects in the PRC, if they contribute their technological expertise to a venture. Besides sometimes being an entry criterion issued by the relevant Chinese authorities, the business activities of MNCs often, anyway, include the licensing of technological expertise or property against the charge of royalties. Moreover, MNCs might prefer to contribute a technology or patent as an investment to a venture, instead of a cash investment. “Royalties” as understood in the FEITL, usually include payments “obtained for the provision for use ... of patents, technical know-how, copyrights or trademarks.” 610

Royalty income includes related drawing and information fees, technical service fees, personnel training fees, and other related fees received from the supply of patent rights or proprietary technology. Such fees are considered royalties, if provided for facilitating the proper use rights to use proprietary technology, such as patents, copyrights, and designs, technical, industrial, or commercial knowledge. Whereas, other fees that are not directly involved in the transfer of use rights of proprietary technology, trademarks, and/or copyright are considered service income subject to the normal FEIT. 611

608 According to Art. 65 IRFEITL the term “Chinese State banks” refers to the People’s Bank of China, the Industrial and Commercial Bank of China, the Agricultural Bank of China, the Bank of China, the People’s Construction Bank of China, the Bank of Communications, the China Investment Bank, and other financial institutions engaged, with the approval of the SC, in credit operations with foreign entities such as foreign exchange deposits and loans.


610 Art. 6 no. (2) l. (d) IRFEITL.

According to Art. 19 III l. (d) s. 1 FEITL income from royalties is subject to 10% withholding tax. However, the FEITL provides exemption rules for such royalty-income. As per Art. 19 III l. (d) s. 2 FEITL in connection with Art. 66 IRFEITL, income from royalties paid for the use of proprietary technology provided for scientific research may be exempted from enterprise income tax, if such proprietary technology is deemed advanced or provided on preferential conditions.612

e. Capital Gains

Generally, the term “capital gains” refers to gains generated by a taxable entity in course of the sale or assignment of an asset. However, the Chinese tax laws do not know a separate concept of “capital gains”. They are neither explicitly governed by the FEITL, nor by the IRFEITL. However, given the broad scope of “taxable income” it is generally acknowledged that gains from the disposition of assets are to be included into the profit and loss statement and, hence, ultimately into the financial statements of the taxable entity. Taxable under Art. 11 FEITL is income derived from “production or business operations or other income.” Such gains do not qualify as income from production or business operations. Art. 61 IRFEITL defines “gains” to be “other income” derived “from the assignment of property in the PRC, such as buildings, structures, facilities ancillary thereto, land use rights, etc.” In addition to the aforementioned, the term “property” also covers securities,613 making gains from the sale of equity interests and investments taxable under Art. 11 FEITL. If such gains are derived by FIEs, i.e. by Chinese resident companies like the CHHC, they are taxable at the regular rate, i.e. 33%, whereas gains derived by FEs, e.g. directly by a foreign parent company614, are subject to the withholding tax provision provided in Art. 19 FEITL, with a tax rate that has been reduced to 10%.615 The taxable gain is computed as the balance between the transaction proceeds and the sum of the accounted carrying amount of the underlying property in the moment of the transaction and the corresponding transaction costs, hence, realizing built-in gains.616 This finding also corresponds to the commercial accounting provisions ruling the event of an equity investment disposal.617

612 Hereto compare also Art. 66 IRFEITL; SC, issued on November 18, 2000; Wang, Besteuerung, 2006, p. 169.
617 Art. 22 no. (7) ASBE.
According to a MoF and SAT document from 1995\textsuperscript{618}, capital gains from the assignment of non-monetary assets\textsuperscript{619} invested by a FIE in another Chinese enterprise, be it FIE or DE, represent the balance between the value of the invested asset as recognized in the investment contract, i.e. valued at the current market value\textsuperscript{620}, and the original carrying amount. If such a transaction results in a net gain, the amount is relatively large and the taxable entity encounters problems in calculating and paying overall enterprise income tax by including such a gain into the taxable income, the payable enterprise income tax may be converted into five equal installments to be proportionally taxed over a period of five years.

6. Business Expenses

The FEITL, the IRFEITL, and several administrative orders rule, whether and to which possible extent expenses are tax-deductible. Although, neither of the laws contains an exhaustive list of allowable deductions of costs and expenses, especially the IRFEITL provides a number of items that are not deductible. The general understanding expressed in Art. 4 FEITL and Art. 10 IRFEITL is that losses and expenses are deductible to the extent that they are incurred during the income generation process and that the amount to be deducted is reasonable under the given circumstances\textsuperscript{621}.

Following the classification of expenses into capital and current expenses, capital expenses cannot be deducted as immediate expenses, whereas current expenses are considered immediately deductible. Current expenses cover what within this thesis is referred to as “Business Expenses”, as opposed to capital expenses that are expenses recognized by way of depreciations, amortizations, and other forms of write-downs.

\textsuperscript{618} Compare MoF/SAT, issued on January 13, 1995.
\textsuperscript{619} Ad “non-monetary” asset compare, e.g., Delaney, GAAP, 2003, pp. 328 et seq., 501 et seq.
\textsuperscript{620} Art. 13 IRFEITL.
\textsuperscript{621} In several provisions the IRFEITL state that particular expense items may be deducted if they are deemed “reasonable”. Compare hereto, e.g., Art.’s 20, 21, 23 IRFEITL.
China’s Foreign-Invested Holding Company: Taxation and Tax Planning

A Review with Reference to Austrian Tax Law

a. Operating Expenses

In Art. 4 FEITL the Chinese tax law generally claims to follow, what in the German tax literature is referred to as the “Nettoprinzip”622, by determining taxable income as the “total amount of revenue for each tax year less costs, expenses, and losses.” Hence, only the net increase in the taxable entity’s economic power shall be taxed. The term “operating expenses” on the one hand refers to such expense items that are incurred in connection with the income generating process and for the maintenance of the business operations, but on the other hand shall also cover such specific losses incurred in business activities as provided for by the law. However, the law also manifests particular generally genuine, operating expenses that are not permitted as deductible expenses. The provision of Art. 19 IRFEITL, e.g., lists the following items as non-deductible categories of business expenses:

- 1) “expense for the purchase or construction of fixed assets”;
- 2) “expense for being assigned or developing intangible assets”;
- 3) “interest on capital”;
- 4) “any income tax payments”;
- 5) “fines for illegal operations and losses resulting from the confiscation of property”;
- 6) “late-payment fines and other fines in connection with various taxes”;
- 7) “such portion of losses from natural disaster or accidents that are indemnified”;
- 8) “donations other than for public welfare and relief purposes inside the PRC”;
- 9) “royalties paid to the head office”;
- 10) “other expense which is not related to production and business operations.”

622 According to the “Nettoprinzip” only net income, i.e. gross income less income related losses and expenses, is taxable, expressing the actual economic power of the tax subject. The “Nettoprinzip” as an outlet of the principle of economic power resembles what is known as the “net accretion theory” in the USA. Compare hereto Tipke/Lang, Steuerrecht, 2002, pp. 187 et seq., 223.
According to the stereotype business transactions a holding company gets involved with, especially the numbers 1, 2, 3, and 9 appear to be of major interest. While the tax treatment of “expenses for the purchase or construction of fixed assets” and “expenses for being assigned or developing intangible assets” is covered in Chapters D.II.7.b. and D.II.7.c., respectively, the deductibility of “interest on capital” is discussed in the following chapter “Financing Costs and Interest”.

As to number 9, the exclusion of royalties paid to the head office as deductible expenses, refers to royalties paid by a permanent establishment in the PRC to its head offices. Hence, excluded are royalties that are paid within the legal frame of either a single FIE, or from a Chinese permanent establishment to a FE. However, notwithstanding the aforementioned, the deduction of royalties as deductible operating expenses is allowable, when the underlying payments are made from one legal entity to another legal entity, i.e. from a FIE to FIE or from a FIE to its foreign parent company. Accordingly, it can be concluded that a) the CHHC’s FIE-subordinates can deduct royalties paid to the CHHC as regular operating expenses, as well as b) the CHHC can deduct royalties paid to its foreign parent company as genuine business expenses when computing taxable income.

Yet, adding to the list provided by Art. 19 IRFEITL of non-deductible operating expenses, the IRFEITL also sets forth in its Art.’s 20, 21, 22, 23, a list of operating expense categories and specific loss categories that are explicitly deductible.624 As to Art. 20 I IRFEITL management fees are generally deductible. Such fees paid to a head office by an establishment in the PRC are deductible if they are considered reasonable and are related to the production or business operations of said establishment. The deductible amount must be examined and approved by the relevant tax authorities. Yet as paragraph 1 of Art. 20 IRFEITL does not cover FIEs, but only FEs, it is not relevant for the present discussion. Contrary thereto, Art. 20 II IRFEITL could be relevant to the CHHC. The provision states “FIEs should reasonably apportion to their branches the administrative expenses and expenses related to the production and business operations of such branches.” The China-Holding consists of legally independent entities, each of which does not qualify as branches in the sense of Art. 20 II IRFEITL. Much more, the China-Holding is to be considered as a group of affiliated entities in the sense of Art.’s 52 et seq. IRFEITL. According thereto, management

624 Although covered by the law this list does not cover deductible expenses solely eligible to FEs and financing costs and interest. The latter items are subject to a special discussion in the following chapter.
fees paid by an enterprise, i.e. FIE, to its affiliate, i.e. another FIE or legally independent company established under Chinese law, may not be listed as expenses.\textsuperscript{625} This is a crucial consequence for China-Holdings, as it can be assumed that the CHHC invoices its subsidiary-FIEs for the management services, the CHHC carries out on their behalf and on behalf of the entire group.\textsuperscript{626} Hence, the subsidiary-FIEs cannot deduct the genuinely paid ratios of the CHHC’s management services when computing taxable income. This result clearly contradicts the attempt set forth in Art. 4 FEITL to tax the net increase in economical power. While the CHHC has to include the income gained for the provision of management services from its subsidiaries, the subsidiaries are not allowed to consider the payments for such management services as deductible business expenses, ultimately resulting in an indirect double taxation at the scope of the underlying amount.

According to Art. 22 IRFEITL, enterprises shall be permitted to list as expenses a limited scope of entertainment expenses, as long as they relate to their production and business operations. Enterprises engaged in industrial manufacturing, construction, commerce, and agriculture with annual net sales of up to Chinese RMB 15m may deduct such entertainment expenses up to an amount equal to 0.5% of the net sales. Enterprises, whose annual net sales exceed RMB 15m, may deduct additional entertainment expenses to the extent of 0.3% of annual net sales exceeding RMB 15m.\textsuperscript{627} For non-manufacturing enterprises, active in tourism, transportation, finance, and service industries, entertainment expenses may be deducted to the extent of 1% of the gross business revenue of RMB 5m or less per year. If the gross business revenue exceeds RMB 5m, additional entertainment expenses may be deducted to the extent of 0.5% of the gross business revenue in excess of RMB 5m.\textsuperscript{628} A further category of deductible expenses or losses is foreign currency exchange losses, resulting from production or business operations.\textsuperscript{629} Subject to an administrative order issued by the State Administration of Foreign Exchange, foreign currency gains or losses are generally amortized over a 5-year amortization period.\textsuperscript{630} As per Art. 24 IRFEITL, FIEs may list as expenses the wages and welfare benefits paid to their staff and workers, subject to the consent of the local tax authorities, but they may not include foreign social insurance premiums paid for foreign staff or workers working within the PRC. Contrary thereto, premiums for the old-age pension

\textsuperscript{625} Art. 58 IRFEITL.  
\textsuperscript{626} Compare SAT, September 28, 2002; Pfaar/Salzmann, Besteuerung, 2005, p. 175.  
\textsuperscript{627} Art. 22 no. (1) IRFEITL.  
\textsuperscript{628} Art. 22 no. (2) IRFEITL.  
\textsuperscript{629} Art. 23 IRFEITL.  
\textsuperscript{630} Compare International Bureau of Fiscal Documentation, China, 2003, pp. 168c et seq.
insurance, the medical insurance, contributions to the housing fund, the educational fund or the union paid by the employer for the employees are deductible within the norms set by the relevant state authorities. Other benefits for employees paid by the company are annually deductible up to 14% of the total approved amount the enterprise incurs as expenses for such other benefits.

An ongoing growth of the Chinese economy depends heavily on FDI. In order to support FDI, the Chinese government introduced Art.’s 25, 26, and 27 IRFEITL providing tax provisions that are meant to mitigate the risks from such investing endeavors. It is widely known that the Chinese banking sector sits on a huge portfolio of non-performing loans or other outstanding receivables. Art. 25 I IRFEITL, acknowledges this situation by stipulating that “enterprises engaged in granting credit, leasing, etc., may, on the basis of actual needs, make annual allocations to a reserve for bad debts at a rate of no more than 3% of the year-end balance of funds outstanding (not including inter-bank loans), or of the year-end balance of receivables such as accounts payable, bills receivable, etc., and deduct such allocations from the taxable income for the year concerned.” As the wording of the provision suggests this bad-debt reserve can only be formed by enterprises engaged in granting credit, leasing or similar businesses, a characteristic that has to be closely examined with regard to its fulfillment when considering the CHHC or a specialized subsidiary-group-finance-FIE. In its second paragraph Art. 25 IRFEITL determines that if the actual losses from bad debts exceed the preceding year’s allocation to the bad-debt reserve, the excess amount of such losses may be accounted for as actual loss. Analogously, any amounts by which the preceding year’s allocation to the bad-debt reserve exceeds the actual losses are to be included as a “gain” into the computation of taxable income for the current year.631 Generally, losses from bad debts are recognized as receivables from a bankrupt debtor, which cannot be collected after liquidation of the debtor’s property632, or as receivables from a descend debtor, which cannot be collected after his estate has been applied to repayment.633 Moreover, losses from bad debts are recognized as receivables from a bankrupt debtor, if the debtor has exceeded the time limit for performance of his repayment obligation by more than two years.634 Receivables that were listed as losses from bad debts, but are collected in a subsequent year, have to included as income into the taxable income in the year of the collection.635 Bad-debt reserves are annually adjusted by

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631 Art. 25 II s. 2 IRFEITL.
632 Art. 26 no. (1) IRFEITL.
633 Art. 26 no. (2) IRFEITL.
634 Art. 26 no. (3) IRFEITL.
635 Art. 27 IRFEITL.
realizing positive balances and negative balances every year. Whereby, an “actual loss” refers to the excess amount for which no reserve has been built in previous years. Bad-debt reserves may not necessarily have to be dissolved after one year, if the underlying debt remains doubtful.

b. Financing Costs and Interest

The holding and management of investments has been concluded as the primary business activity of a holding company, irrespective of where it is registered. From the Austrian context, it could be concluded, how the individual ways of financing each single investment gain critical tax importance. The financing can be obtained either from external sources, i.e. the capital markets, or from internal sources, i.e. affiliated enterprises and/or cash flow. It is common understanding that based on the economic autonomy of an enterprise the enterprise may choose how to finance itself. Irrespective, whether the enterprise decides to finance itself through equity or debt, such financing produces costs. From a tax point of view, it therefore is critical that financing costs find tax-relevant recognition. As could be seen in the Austrian context the terms “financing cost” and “interest” can but do not necessarily have to be congruent. “Financing cost” usually covers further incidental cost elements in addition to the mere interest rate payable, such as transaction costs related to the facilitating of the respective finance, e.g., directly attributable commissions, legal costs, premiums, or other charges.

As to the commercial accounting provisions, Art. 77 ASBE and the specific “Accounting Standard for Business Enterprises concerning Borrowing Costs”636 (hereinafter “ASBE-BC”) cover special provisions dealing with the accounting of “borrowing cost”. “Borrowing cost” refers to interest incurred on borrowings, amortization of discounts or premiums, ancillary costs, including handling charges incurred in connection with the arrangement of borrowings, and exchange differences arising from foreign currency borrowings, such as, e.g., the issue of bonds or convertible bonds. Art. 77 II ASBE rules that borrowing costs should be recognized as expenses in the period incurred, except they are incurred for “specific borrowings”. According to the provisions, a “specific borrowing” refers to a borrowing taken out specifically for the acquisition or construction of a fixed asset.637 Interest incurred with such a specific borrowing, as well as the amortization of discounts or premiums relating to and exchange differences arising from such specific borrowings should be capitalized as a part of

637 Art. 77 III ASBE; Art. 3 ASBE-BC.
the cost of the related asset, hence, causing an increase of the acquisition or manufacturing costs. Opposed thereto, interest incurred with the amortization of discounts or premiums relating to and exchange differences arising from other borrowings, i.e. non-specific borrowings, are treated as directly deductible business expenses.638 “Fixed asset” shall refer to the definition as provided for in Art. 30 IRFEITL. The provision defines “fixed asset” to include “buildings, structures, machines, machinery, means of transportation and other equipment, appliances, tools etc., for the purpose of production and business operations with a useful life of more than one year.” A systematic overview on the differentiation between regular borrowings and specific borrowings is provided in Figure 20 below.

Figure 20: Determination of Accountable “Borrowing Cost”639

The accounting procedures as displayed in Figure 20 above do not take a possibly necessary inclusion of discounts, premiums, and/or exchange differences on a specific borrowing into account. In case, such discounts, premiums, and/or exchange differences needed to be considered, Art. 77 no. (2) 2. IX ASBE and Art. 11 ASBE-BC set forth that the capitalization rate should be adjusted by taking the amortization amount of such discounts, premiums, and/or exchange differences into account. The respective amortization shall be carried out by using the effective interest method or the straight-line method. The capitalization of

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638 Art. 77 II ASBE; Art. 4 ASBE-BC.
639 Self-prepared figure with reference to Art. 77 ASBE.
borrowing costs shall cease in the period, when the respective fixed asset, that is being acquired or constructed, has reached its expected usable condition. Any borrowing costs incurred thereafter qualify as directly deductible business expenses.\(^{640}\)

While the commercial accounting provisions discussed above are equally tax-relevant, Art. 21 I IRFEITL additionally sets forth that “enterprises shall be permitted to list as expenses reasonable loan interest payments arising in connection with their production and business operations...” The term “reasonable loan interest” is further defined in Art. 21 III IRFEITL and refers to “interest computed at a rate not higher than the rate applicable to ordinary commercial loans.” Contrary to these provisions, “interest on capital” is excluded from the business expense deduction allowance as per Art. 19 no. (3) IRFEITL. Hence, one has to distinguish the terms “interest on capital” from “loan interest”, with the latter being deductible. Whereas “interest on capital” refers to such interest payments a foreign entity, i.e. FIE or FE, incurs, when it debt-finances its contribution to the registered capital of a EJV or WFOE, “loan interest” presumably covers interest payments an entity incurs in course of its production and business operations and that are not used to fund a new EJV or WFOE.\(^{641}\) Yet, interest may not be deductible, if the underlying loans are taken out in order to purchase or construct fixed assets or for being assigned or developing intangible assets. Interest that accrues before such assets are actually put into use must be included into the original value of such an asset to be depreciated over the respective asset’s depreciation period.\(^{642}\) Besides, the deductibility of interest as genuine business expenses of the CHHC’s subsidiaries is limited by the Capital Ratio Tentative Provisions, while the limits of interest deductibility for the CHHC are contained in Art. 9 Holding-Provisions.\(^{643}\) In addition, to the general rule of Art. 21 IRFEITL, Art. 55 IRFEITL, provides an arm’s length ruling with regard to the payment of interest between affiliates. Interest payments within the China-Holding from the subsidiaries to the CHHC or vice versa, need to equal such interest payments as assumed payable between unrelated third parties.

Ultimately, a crucial restriction with regard to the deductibility of business expenses and losses, including interest, could be provided by Art. 18 IRFEITL, which rules that enterprises “may not set off the expenses and losses arising from investments” from which it receives tax-exempt dividends. Two issues remain questionable in this context. First, it can be questioned,
whether such expenses and losses refer to those incurred by the dividend-receiving shareholder in relation to the disposition of equity investments, or to the allocated shareholder’s share of business losses of the dividend-distributing entity.\(^{644}\) Second, one could understand that the term “expenses and losses” refers to all kinds of expenses and losses, the dividend-receiving entity incurs in connection with the dividend-distributing entity. Hence, this second aspect aims mainly at the questions, whether, and if yes, to what extent, the financing cost of the acquisition of the respective investment, the CHHC considers to acquire, is deductible.\(^{645}\)

As to the first aspect, such expenses and losses could only offset gains provided such gains were taxable.\(^{646}\) If such expenses and losses refer to the allocation of expenses and losses, this would mean that, some kind of group-relief was possible. However, the FEITL and IRFEITL do not allow offsetting income from one FIE with another FIE. A FIE is only allowed to file a consolidated tax return for the entirety of its permanent establishments and sites, but is not permitted to include taxable results from other legally independent entities into its own taxable income. Hence, if the provision were to be interpreted in the latter sense CHHC’s would be excluded from the deductibility of such expenses and losses.

The second proposition, which, unlike the first, does not aim to interpret the allocation of such expenses and losses, but rather tries to dismantle the meaning of the term “expenses”, as used in this context. In particular, it aims at finding out, whether this provision prohibits the deduction of the financing cost of the acquisition of investments that eventually may distribute tax-exempt inter-corporate dividends as per Art. 19 III l. (a) FEITL in connection with Art. 18 IRFEITL. As far as this research is concerned, no evidence could be found, that the term “expense”, as used in the above-defined context, would exclude financing costs or interest expense incurred from loans taken out in order to finance the acquisition of investments in FIEs in the PRC. Concluding, it can be summarized that once the dividends the CHHC receives are considered to be tax-exempt, the CHHC may not claim related expenses,

\(^{644}\) Compare to this question International Bureau of Fiscal Documentation, China, 2003, pp. 184 et seq.; Süss, Gründung, 1996, pp. 5 et seq.

\(^{645}\) Compare hereto for the Austrian context § 11 I no. 4 aKStG that allows for the deduction of the interest payable in connection with the debt-financing of investments, as defined in § 10 aKStG, as long as they are allocated to the respective corporation’s business property (Chapter C.V.2.b.)

including financing cost and interest, as tax-deductible business expenses in the taxable income computation process.  

7. Valuation, Depreciation, and Amortization

Besides current business expenses that in their entirety are generally considered directly deductible for enterprise income tax purposes, there exist expenses that are not incurred as direct payments but acknowledge changes in the valuation of the underlying financial statement items. Accordingly, the FEITL contains provisions that set forth allowances that may be claimed with respect to the depreciation of fixed assets and with respect to the amortization of intangible assets, as well as with respect to write-downs on other financial statement items such as receivables, liabilities, and provisions.

However, despite the fact that this survey studies the taxation of foreign-invested holdings and tax laws and provisions are the primary source of research, commercial accounting laws and provisions are indispensable to deliver a wholistic picture of the taxation of particular facts and events. Despite the fact that the Chinese tax laws do not contain an explicit authoritative principle, the implicit application of commercial accounting laws and regulations to derive adequate statements of the taxation are immanent. Accordingly, for the purposes of computing taxable income, the commercial financial statement income shall be adjusted in accordance with respective Chinese tax laws and regulations.

a. Investments

i. Accounting

According to Western accounting standards, investments are considered an asset and therefore are to be accounted for and included into the financial statements. The Chinese Accounting Standard for Business Enterprises (“Accounting Standard”) defines an asset to be “a resource that is owned or controlled by an enterprise as a result of past transactions or events and is expected to generate economic benefits to the enterprise.” Accordingly, as per Art. 20 II

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648 Art. 17 II FEITL.
650 Art. 20 I Accounting Standard.
Accounting Standard “past transactions or events” refer to acquisition, production, construction or other transactions or events. Whereas the term “owned and controlled by an enterprise” shall mean the right to enjoy the ownership of a particular resource or, although the enterprise may not have the ownership, of a particular resource, it can control the resource. Finally, yet importantly, the event “expected to generate economic benefit to the enterprise” is defined as the potential to generate inflows of cash and cash equivalents to the enterprise. However, to be included into financial statements, the identified resources must not only fulfill the definition of an asset, but also needs to be recognized as such. Art. 21 Accounting Standard stipulates two conditions for the recognition of an accounted asset that have to be realized simultaneously. First, the economic benefits associated with the considered resource need to be attributable to the enterprise and second, the cost or value of such resource can be measured reliably. Whether or not investments qualify as assets is further ruled in the ASBE and in a separate Accounting Standard for Business Enterprises which particularly refers to the accounting of investments (hereinafter “ASBE-I”), both complement the Accounting Standard. The focus of the investments reviewed has already been narrowed down to exclude short-term or current investments from the examination. According to Art. 14 II ASBE, investments are generally understood to be assets obtained by an enterprise, through the transfer of another asset to another enterprise, for the accretion of wealth. Long-term investments in particular are defined to be such investments that are intended to be held for more than one year and do not qualify as a current investment, with current investment considered to be readily realizable. Further, long-term investments can be classified as either long-term debt or long-term equity investments. Long-term equity investments are at the focus of the present thesis. As per Art. 5 ASBE-I long-term equity investments follow a classification subject to the intensity of influence exercised on the investee enterprise. Accordingly, the investor enterprise, i.e. the CHHC, can have “control”, “joint control”, “significant influence”, or “no influence” over or on the investee enterprise. As to the provisions, an investment can be made in several ways. First, equity is acquired against a cash payment. Second, an investment is carried out by way of accepting non-cash assets in a debt-to-equity swap, a transaction where a portion of debt is restructured into a

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651 Art. 20 III, IV Accounting Standard.
652 Art. 21 ASBE; Art. 3 no. (1) ASBE-I.
653 Art. 3 no.'s (1), (2) ASBE-I.
654 Refer to Table 8.
655 Art. 22 no. (1) 1. ASBE.
stake in the respective entity’s equity.\textsuperscript{656} Third, the equity is transferred in a non-monetary transaction\textsuperscript{657}, i.e. a contribution in kind. Fourth, an investment can be acquired through an administrative transfer,\textsuperscript{658} an alternative that is not being considered in this thesis, as it usually refers to investment transfers that involve DEs and governmental bodies.

An investment is to be valued in accordance with the precise kind of transaction in question. Investments acquired by cash should be valued at its acquisition cost. The amount of the acquisition cost accounted, shall cover the actual price paid, including incidental expenses such as tax payments and handling charges. Furthermore, cash dividends that had been declared before the transaction but not had been paid yet, reduce the accountable acquisition cost.\textsuperscript{659} In cases of accepting non-cash assets in a debt-equity swap or in a non-monetary transaction, the investment is initially valued at the seller enterprise’s carrying amount plus relevant tax payments.\textsuperscript{660} The following remarks focus solely on cash investments. The provisions set forth that investments should be accounted for using either the cost method or the equity method.\textsuperscript{661}

As per Art. 22 no. (2) ASBE, these methods are distinguished at hand of two criteria, a) the scope of influence and/or control the investor enterprise has over the investee enterprise and b) changes of the underlying valuation. To determine, whether the cost method or the equity method should be used, the provisions refer to the scope of influence and/or control as the judging criterion. The systematic is displayed in Table 8:

<table>
<thead>
<tr>
<th>No control, joint control, or significant influence</th>
<th>Cost Method</th>
<th>Equity Method</th>
</tr>
</thead>
<tbody>
<tr>
<td>≥ 20% or &lt; 20% of voting shares, but significant influence</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>&lt; 20% or ≥ 20% of voting shares, but no significant influence</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

\textit{Table 8: Investment Accounting: Cost Method vs. Equity Method}\textsuperscript{662}

\textsuperscript{656} Art. 22 no. (1) 2. ASBE; a reference to the precise accounting treatment of non-monetary transactions is further given in Art. 7 III ASBE-I which refers to the “Accounting Standard for Business Enterprises – Non-Monetary Transactions”.

\textsuperscript{657} Art. 22 no. (1) 3. ASBE; compare hereto also Art. 7 IV ASBE-I which refers the accounting treatment of debt-restructuring investments to the “Accounting Standard for Business Enterprises – Debt Restructuring”.

\textsuperscript{658} Art. 22 no. (1) 4. ASBE.

\textsuperscript{659} Art. 22 no. (1) 1. ASBE.

\textsuperscript{660} Art. 22 no. (1) 2., 3. ASBE; Art. 7 III, IV ASBE-I.

\textsuperscript{661} Art. 22 no. (2) ASBE.

\textsuperscript{662} Self-prepared table.
With respect to the above given table, “control” refers to the power to govern the financial and operating policies of an enterprise. “Joint control” is the contractually agreed sharing of control and “significant influence” is defined as the power to participate in the financial and operating policies of an enterprise, but is not the power to govern these policies.663 Where an investor enterprise holds 20% or more of the voting shares of the investee enterprise, or where it holds less than 20% but can control, joint control, or has significant influence over the investee enterprise the equity method should be adopted.664 The cost method shall be adopted, where the investor enterprise holds less than 20% in the investee enterprise’s voting shares or more than 20%, but neither exercises control, joint control, nor significant influence.

According thereto, the cost method values the investment amount with the acquisition cost creating the carrying amount, unless additional investment is made, or cash dividends or distributed profits are re-invested into the investee enterprise, or the initial investment is recouped by the investor enterprise. In the periods following the investment, profits or cash dividends declared to be distributed by the investee enterprise should be recognized as investment income in the respective current period. However, such amount recognized is limited to the amount received from the accumulated net profits, which arise after the investee enterprise has accepted the investment from the investor. The investor enterprise should treat the precise amount distributed by the investee enterprise as “recovery of investment cost” and consequently reduce the underlying carrying amount accordingly.665

Once the equity method is used, the investor initially capitalizes the investment cost and the difference between the initial investment cost of the investor and the investor’s share in the investee enterprise’s equity. In subsequent periods, the investor enterprise shall amortize such capitalized difference evenly over the investment period. The investment period is stipulated in the investment contract. If no such investment period is specified the amortization shall be carried out over a period not exceeding 10 years.666 The investor enterprise shall further adjust the carrying amount according to its share of the investee enterprise’s net profit or loss and, hence, recognize investment income or losses for the respective period. The carrying amount is to be adjusted proportionately to the amount recognized as investment income or losses for the current period. In cases of net losses, the carrying amount shall be reduced to zero. In subsequent periods the carrying amount shall be increased again by the amount of the investor

663 Art. 5 ASBE-I.
664 Art. 22 no. (2) ASBE; Art. 18 ASBE-I.
665 Art. 22 no. (3) ASBE; Art. 17 ASBE-I.
666 Art. 22 no. (4) ASBE; Art. 8 ASBE-I.
enterprise’s share of profits exceeding its share of previously unrecognized losses.\textsuperscript{667} Moreover, Art. 22 no. (4) V ASBE, as well as Art. 19 IV ASBE-I hold a provision that allows for the adjustment of the carrying amount subject to particular circumstances, other than net profit or loss.

Art. 24 ASBE, complemented by Art. 23 ASBE-I provides for the impairment of investments. Hence, the carrying amount of investments is to be reviewed periodically on an individual item basis. Further, the provisions each stipulate that if the recoverable amount of an investment is deemed lower than the current carrying amount because of a continuing decline in market value or changes in operating conditions, the resulting balance should be recognized as an investment loss in the given period.\textsuperscript{668} As per Art. 23 II ASBE-I, "recoverable amount ... refers to the higher of net selling price of the asset and the present value of the estimated future cash flows expected to arise from the holding of the asset and from its disposal at the end of its maturity period." Thus, "recoverable amount" can be interpreted as "fair value", a term used throughout this thesis and commonly known in the German tax literature. Accounting for a fair value write-down resembles the listing of a fair value of the underlying asset that is lower than its current carrying amount. Whereas, fair value shall be the amount, a seller could receive on the sale of an asset.\textsuperscript{669}

Hence, the Chinese accounting provisions provide for regulations comparable to the fair value write-down and lower-cost-to-market principle as manifested in §§ 203, 204 aHGB. Additionally, Art. 23 III ASBE-I, sets forth that once the value of an investment, for which a "fair value write-down" had previously been carried out, recovers, such recovery should be recognized to the extent of the amount of the investment loss previously recognized.

\textbf{ii. Fair Value Write-Down and Goodwill Amortization}

In connection with the valuation of investments, the survey of the Austrian tax laws have emphasized that the taxation of the valuation of investments and of changes in the evaluation of investments is of fundamental interest. It could be found that the valuation of investments and changes therein are usually tax-effectively recognized through fair value write-downs and the amortization of goodwill. However, the general Chinese tax law, i.e. the FEITL and the corresponding IRFEITL, does not contain provisions like, e.g., § 6 no. 2a s. 2 aEStG or

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{667} Art. 22 no. (4) III ASBE; Art. 19 ASBE-I.
\item \textsuperscript{668} Art. 24 I ASBE; Art. 23 I ASBE-I.
\item \textsuperscript{669} Compare Siegel/Shim, Dictionary, 2000, p. 174.
\end{itemize}
\end{footnotesize}
§ 12 III aKStG, that explicitly provide for the tax treatment of investments. However, the
government introduced a piece of legislation that covers corporate reorganizations, the
“Income Tax Treatment of Reorganization of FIEs such as Mergers, Splits, Reorganization of
Equity, and Asset Transfer Tentative Provisions” (hereinafter “Reorganization-
Provisions”).\textsuperscript{670} The provisions set forth in this document cover the taxation of the valuation
of investments and of changes in the valuation of investments. Due to its broad applicability
range in the context of the taxation of investments, the author decided to deviate from the
order of the basis of reference resulting from the survey of the Austrian tax laws. Therefore,
the author dedicates an individual chapter, Chapter D.II.8., to corporate reorganizations\textsuperscript{671},
which includes an examination as to what extent fair value write-downs and goodwill
amortizations can be effected.

b. Fixed Assets

Other than the tax treatment of investments, the taxation of fixed assets is explicitly ruled by
the Chinese tax law in Art.'s 30 to 45 IRFEITL. What the Chinese tax law subsumes under
the term “fixed assets” is defined in Art. 30 IRFEITL, a provision that equals Art. 25 ASBE
by the content. “Fixed Asset” shall include “buildings, structures, machines, machinery,
means of transportation and other equipment, appliances, tools etc., for the purpose of
production and business operations with a useful life of more than one year.”\textsuperscript{672} According to
international tax habit, the Chinese tax laws do provide that in computing taxable income for
a current period, no deduction may be made for expenses of a capital nature. Yet, only
proportionate allowances may be claimed in respect of the depreciation of fixed assets.\textsuperscript{673}

Fixed assets are depreciated on an annual basis starting from a per item valuation at original
cost.\textsuperscript{674} “Original cost” is determined depending on, whether the respective asset is a
purchased asset, a self-manufactured asset, an asset contributed as an investment, or acquired
as a gift. The original cost of a purchased asset shall equal the purchase price plus any
incidental expenses such as, e.g., freight, installation, and handling expenses, or related tax

\textsuperscript{670} SAT, promulgated on April 28, 1997; compare also International Bureau of Fiscal Documentation, China,
2003, p. 224g.
\textsuperscript{671} Compare Chapter D.II.8.
\textsuperscript{672} Art. 30 s. 1 IRFEITL. Sentence 2 of the same article manifests that articles that are not part of the main
equipment for production and business operations and a) have a unit value of CYN 2,000 or less or b) have a
useful life of not more than two years may be listed as expenses according to the amounts actually used. Such
write-off low cost assets, however, are not being considered within this thesis.
\textsuperscript{673} Compare International Bureau of Fiscal Documentation, China, 2003, p. 168f.
\textsuperscript{674} Art. 31 I IRFEITL.
payments. The original value of self-manufactured fixed assets shall be the production cost, i.e. the actual expenses incurred in the production/manufacturing process. Fixed assets that are contributed as an investment to ventures shall be reasonably valued. The original value shall be determined, based on their age and pursuant to the investment contract, or from a value appraised based on their age and by reference to relevant market prices, plus relevant incidental expenses, incurred before the given fixed assets are put in service.

As per Art. 32 IRFEITL fixed assets are depreciated from the month following the month they are put in service. However, the (net) original value, as a base for depreciation is defined net of a residual value. The residual value should be equal to not less than 10% of the (gross) original value, yet the taxpayer may have a lower or no residual value approved by the competent tax authorities. Generally, fixed assets are depreciated following the straight-line method, but, again, upon approval by the competent tax authorities, the taxpayer may apply to use a different method. For the purposes of determining the depreciation term, fixed assets are allocated into categories as displayed in Table 9.

<table>
<thead>
<tr>
<th>Kind of fixed asset</th>
<th>Depreciation term</th>
</tr>
</thead>
<tbody>
<tr>
<td>Buildings and structures and ancillary facilities attached thereto, which are</td>
<td>≥ 20 years</td>
</tr>
<tr>
<td>integral parts of buildings and structures and are not valued individually;</td>
<td></td>
</tr>
<tr>
<td>Railway rolling stock, vessels, machines, machinery, and other production</td>
<td>≥ 10 years</td>
</tr>
<tr>
<td>equipment, and ancillary equipment not valued individually;</td>
<td></td>
</tr>
<tr>
<td>Electronic equipment, means of transportation other than railway rolling stock and</td>
<td>≥ 5 years</td>
</tr>
<tr>
<td>vessels, i.e. airplanes, automobiles, etc., as well as appliances, tools,</td>
<td></td>
</tr>
<tr>
<td>furniture, etc. related to production and business operations;</td>
<td></td>
</tr>
<tr>
<td>Assets created by enterprises engaged in the exploitation of petroleum and</td>
<td>≥ 6 years</td>
</tr>
<tr>
<td>natural gas during and after the development stage.</td>
<td></td>
</tr>
</tbody>
</table>

Table 9: Depreciation Terms of Fixed Assets

In cases, where an enterprise obtains used assets, whose remaining useful life is shorter than the depreciation terms set forth in Art. 35 IRFEITL, Art. 40 IRFEITL provides that such used fixed assets may be depreciated in accordance to the remainder of their useful life. If fixed

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675 Art. 31 II IRFEITL; Art. 8 Accounting Standard for Business Enterprises – Fixed Assets.
676 Art. 31 III IRFEITL.
677 Art. 31 IV IRFEITL.
678 Art. 33 IRFEITL.
679 Art. 34 IRFEITL.
680 Art.’s 35 no. (1), 37 IRFEITL.
681 Art.’s 35 no. (2), 38 IRFEITL.
682 Art.’s 35 no. (3), 39 IRFEITL.
683 Art. 36 IRFEITL.
684 Self-prepared table.
assets gain in value because of augmentation, replacement, rehabilitation, or technical reform during their useful life, the depreciable value of such assets should be increased by the amount of the expenses incurred for such augmentation, replacement, rehabilitation or technical reform. During their useful life, fixed assets can be assigned or disposed off. The balance of revenue resulting from such a transaction after deduction of the undepreciated net carrying amount or residual value and the expenses incurred for such assignment or disposal shall be listed as a tax-relevant capital gain or loss for the respective period. A recapture of the previous depreciation deducted is to be realized as a capital gain, if the proceeds of disposition exceed the undepreciated balance of capital cost or residual value and relevant expenses. Opposed thereto, a capital loss is to be realized, if the proceeds of disposition are less than the undepreciated capital cost or residual value plus expenses.

### c. Intangible Assets

The tax treatment of intangible assets, such as patents, proprietary technology, trademark rights, copyrights, and site-use rights is provided for in the IRFEITL. According to Art. 46 IRFEITL, they should be valued at their original value. Depending on, whether an intangible asset is assigned, self-developed, or contributed as an investment the original value is defined differently. In the first case, the original value of assigned intangible assets shall be the actual amount paid at a reasonable price. The original value of self-developed intangible assets shall be the actual expense incurred in the course of development. Whereas, the original value of intangibles assets contributed as an investment shall equal the price set forth in the underlying investment contract. A significant difference with regard to the taxation of intangible assets is the fact that the Chinese laws provide for the capitalization of the expenses for self-produced or self-developed intangible assets, while in Austria the expense of self-produced or self-developed intangible assets is directly deductible as business expenses in accordance with § 4 I s. 4 aEStG.

The amortization of an intangible asset commences from the month, in which it is put into use and ends on the date specified as the time limit for the use of the asset in the relevant contract. If no such contractual time limit is set or available, the amortization period shall not be shorter

685 Art. 42 IRFEITL.
686 Art. 44 IRFEITL.
687 Compare International Bureau of Fiscal Documentation, China, 2003, pp. 170 et seq.
688 Art. 46 II IRFEITL.
689 Art. 46 III IRFEITL.
690 Art. 46 IV IRFEITL.
than 10 years. The amortization shall be carried out using the straight-line method. The IRFEITL further specifies regulations covering the amortization of start-up expenses and expenses incurred in course of the exploration of offshore petroleum resources. Start-up expenses must be amortized over a period of at least five years, beginning the year the business commences production and business operations. Expenses incurred in course of the exploration necessary for the exploitation of petroleum and natural gas resources may be amortized against the revenue generated from petroleum or gas fields already in production. The corresponding amortization period must be at least one year.

**d. Receivables and Liabilities**

Receivables as a financial statement item represent amounts due the taxpayer from customers arising from transactions effected during the ordinary course of business. Receivables usually include accounts and notes receivable, receivables from affiliated enterprises, and officer and employee receivables. For the purposes of the present thesis, especially, accounts and notes receivable, and receivables from affiliated enterprises are considered, whereas officer and employee receivables are not being particularly examined. Once again, the Chinese tax laws do not provide concrete regulations as to the taxation of receivables, so that the Chinese accounting provisions have to serve as reference. Art. 14 I ASBE classifies “receivables” as current assets. “Current assets” refers to assets that will be realized or consumed within one year or within an operating cycle that is no longer than one year. According to Art. 17 ASBE, “receivables” arise from the ordinary course of operations of an enterprise.

As per Art. 18 no. (1) ASBE, receivables are recognized at their actual amounts. The provision further distinguishes the accounting of receivables in accordance with certain characteristics. For instance, the carrying amount of interest bearing receivables should be increased by an interest amount calculated based on the face value of the receivable at the end of the respective accounting period. In Art. 18 no. (4) ASBE receivables that are settled through a debt restructuring are dealt with. If such a receivable is settled through a cash payment lower than the carrying amount of the receivable, the resulting balance should be

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692 Art. 49 IRFEITL.
693 Art. 48 IRFEITL.
694 Compare Delaney et al., GAAP, 2003, p. 40.
695 Art. 18 no. (2) ASBE.
recognized as a non-operating expense for the current period.\textsuperscript{696} In cases of non-cash transfers, the non-cash assets received should be recognized at an amount equal to the receivable’s carrying amount. The carrying amount of the receivable is proportionately allocated to each single non-cash asset.\textsuperscript{697} If a receivable is converted into an equity interest in the debtor’s enterprise, such equity interest should be recognized at an amount equal to the underlying receivable’s carrying amount.\textsuperscript{698} Ultimately, Art. 18 no. (4) (iv.) ASBE sets forth, that, if the terms of a receivable are modified to the effect, that the carrying amount is reduced, than the resulting balance to the former, original carrying amount and the new, modified, carrying amount shall be recognized as a non-operating expense. In cases, where the modification results in an increase of the carrying amount the existing accounting entry is not to be changed at the time of the modification, but the modification is recorded in the financial statement supplements.

Categorized as a current asset, receivables follow the general impairment rules as stipulated in Art.’s 51 et seq. ASBE. Generally, enterprises shall perform a comprehensive review of all assets and should form provisions for impairment losses on assets on a reasonable basis.\textsuperscript{699} With regard to receivables, this means that an enterprise needs to analyze the recoverability of such receivables, to estimate potential bad-debt losses, and to form respective provisions. The appropriate scope of a bad-debt provision shall be determined based on relevant information such past experience, actual financial position, and cash flows of the debtor. Forming a provision for the full amount is not suitable unless there is reliable evidence that the underlying receivable cannot be recovered and a) is arising in the current year, b) is planned to be restructured, c) is from related parties, and/or d) there is no reliable evidence that the amount will be recovered.\textsuperscript{700} Thus, for the holding-context this implies that receivables recognized between holding members are subject to a particularly severe monitoring. With regard to outstanding receivables, the Chinese tax law provides that, if such receivables have not been claimed within a two-year period, they have to be included into the computation of taxable income as an income item. Therefore, especially between affiliated companies, like the China-Holding, the creditor has to document that such receivables are not considered

\textsuperscript{696} Art. 18 no. (4) (i.) ASBE.  
\textsuperscript{697} Art. 18 no. (4) (ii.) ASBE.  
\textsuperscript{698} Art. 18 no. (4) (iii.) ASBE.  
\textsuperscript{699} Art. 51 ASBE.  
\textsuperscript{700} Art. 53 ASBE.
Liabilities are present obligations arising from past business transactions or events settled through cash outflows or rendering services. Depending on, whether a particular liability is to be settled within a period of one year, one distinguishes between current and long-term liabilities. Both current liabilities and long-term liabilities should be recorded based on the actual amount incurred. In case interest expenses go along with liabilities, they should be accrued on a periodic basis based on specific interest rates and the principal amount of the liabilities of the face value of bonds, and recognized as either project cost or current periodical financial expenses.

The accounting of current liabilities restructured in debt restructurings are accounted for in accordance with Art. 70 ASBE. The provision rules, that current liabilities, settled by cash at an amount less than the carrying amount, lead to the recognition of a capital reserve in the financial statements. In cases of non-cash transfers, the debt payable should be cleared at the carrying amount. Such a balance either is forming a capital reserve or is recognized as a non-operating loss. Moreover, there exists the possibility of debt-equity swaps, i.e., a debt portion is converted into an equity interest. Art. 70 no. (3) ASBE distinguishes between whether the debtor was a CLS or another form of enterprise. In the former case, the aggregate face value of the equity a creditor becomes entitled to for waving the debt shall be recognized as capital. If such aggregate face value differs from the carrying amount of the debt, any balance shall be recognized as capital reserve. In the latter case, where the debtor was not a CLS, the received equity shall be accounted for as paid-up capital, with any balance between the former debt’s carrying amount and the new capital’s face value listed as capital reserve.

With regard to long-term liabilities, bonds and convertible bonds form classic tools for the debt financing of groups of companies and holding companies. In cases of a bond-issuance, the issuing enterprise should record a liability at the aggregate amount of the proceeds of the issue. Differences between such proceeds and the face value of the bond are to be listed as a premium or a discount. Premiums or discounts should be amortized using the effective-interest-rate method or the straight-line method over the bond’s term. Respective interest,
premiums and discounts should be accounted for using the accounting principles set forth for borrowing costs.\textsuperscript{706} For the time before a conversion is made, convertible bonds are accounted for the same way as regular bonds. When the bondholders exercise their right to convert the bond into an equity interest in the issuing enterprise’s capital, the carrying amount of the bonds is cleared and the balance between the carrying amount of the convertible bonds and the par value of the capital issued should be treated as capital reserve after deduction of any cash payments. If such convertible bonds are issued with an option of redemption, a potential interest premium should be accrued as interest payable between the dates of the bond’s issue and its redemption, using the accounting rules for borrowing cost.\textsuperscript{707}

e. Provisions

Provisions are amounts of expenses that must be recognized currently although the exact amount of the expense is uncertain at the moment of recognition.\textsuperscript{708} Provisions are to be made because of impairment. Impairment shall mean the performance of a comprehensive periodical review of all assets to assess potential losses on assets that may have occurred according to the prudence principle.\textsuperscript{709} This thesis has so far covered receivables as current assets, long-term investments, fixed assets, and intangible assets as particularly holding-relevant financial statement items. The ASBE sets forth regulations ruling the accounting of provisions for each of such financial statement items; an overview on which is illustrated in Table 10 below.

<table>
<thead>
<tr>
<th>Financial Statement Item</th>
<th>Accounting Treatment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Receivables (Art. 53 ASBE)</td>
<td>- appropriate provisions should be made for potential bad debt losses based on past experience, actual financial position, and cash flow of debtors; - provisions for full amounts only if there is reliable evidence.</td>
</tr>
<tr>
<td>Fixed Asset (Art’s 56, 59 ASBE)</td>
<td>- when recoverable amount &lt; carrying amount because of continuing decline of market price, technological obsolescence, or long-term damage or redundancy full provision should be made when: - redundant for long period of time, not to be used in future, and no resale value; - not usable due to technological progress; - production of large quantities of sub-standard product; - damage and hence no resale value; - other fixed assets unable to generate future economic benefits.</td>
</tr>
</tbody>
</table>

\textsuperscript{706} Art. 73 ASBE.  
\textsuperscript{707} Art. 74 ASBE.  
\textsuperscript{708} Compare Siegel/Shim, Dictionary, 2000, p. 351.  
\textsuperscript{709} Art. 51 I ASBE.
### China’s Foreign-Invested Holding Company: Taxation and Tax Planning

A Review with Reference to Austrian Tax Law

<table>
<thead>
<tr>
<th>Financial Statement Item</th>
<th>Accounting Treatment</th>
</tr>
</thead>
</table>
| **Intangible Assets** (Art.’s 56, 60, 61 ASBE) | - when recoverable amount < carrying amount because of continuing decline of market price, technological obsolescence, long-term damage or redundancy full provision should be made when:  
  - replaced by new technology and hence no resale value;  
  - lapsed legal protection period and no future economic benefit;  
  - other conditions proving that no use or resale value;  
  - provisions, but not full provisions should be made if:  
    - replaced by new technology that affects its ability to produce economic benefits;  
    - significant decline in market value that is not expected to recover during the remaining amortization period;  
    - lapsed legal protection period but still some value for use;  
    - other conditions proving that intangible asset has actually impaired. |
| **Long-term Investments** (Art.’s 56, 57, 58 ASBE) | - when recoverable amount < carrying amount because of continuing decline of market price, deteriorating operation of an investee enterprise, technological obsolescence;  
  - provisions for long-term investments with quoted market price if:  
    - market price < carrying amount for 2 consecutive years;  
    - trading has ceased for one year or longer;  
    - significant losses of investee in current period;  
    - investee has incurred losses for 2 consecutive years;  
    - investee under reorganization or liquidation or generally no going concern;  
  - provisions for long-term investments without quoted market price if:  
    - likely that investee will incur significant losses due to political or environmental changes;  
    - significant deterioration of the investee’s financial position due to changed market demands;  
    - significant deterioration of the investee’s financial position resulting in reorganization or liquidation or due to technological changes;  
    - other evidence sufficiently proving that investee will no longer produce economic benefits. |

| Table 10: The Accounting of Provisions<sup>710</sup> |

The accounting provisions further stipulate, where the amount of a provision made for an impairment loss exceeds the carrying amount of the provision, the difference should be recognized as an additional provision. Opposite thereto, if the amount of the provision estimated is lower than the carrying amount of the provision, previously recognized impairment losses should be reversed, however with the reversal being limited to the carrying amount of the provision. Actual asset impairment losses should be charged against the provision.<sup>711</sup> If a previously recognized asset impairment loss, that has been charged against

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<sup>710</sup> Self-prepared table.

<sup>711</sup> Art. 62 I ASBE.
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Income is subsequently recovered the relevant provision for impairment losses needs to be adjusted accordingly.

With regard to the taxation of provisions, the Chinese tax law provides explicit regulations only for one particular case, the “bad-debt reserve”. Yet, again, the tax law remains relatively silent and does not provide general principles on the taxation of provisions. As provisions result from the impairment process they express anticipated changes in the value of investments and other assets beyond those covered by the general depreciation, amortization, or fair value write-downs. For “bad-debt reserves” Art. 25 IRFEITL rules that enterprises engaged in granting credit, leasing, etc. might make annual allocations to a reserve for bad debts at a rate of no more than 3% of the year-end balance of funds or related receivables outstanding. The actual amount allocated to such reserve reduces taxable income. In case the actual losses incurred from bad debts exceed the preceding year’s allocation to the respective reserve, the excess balance may be recognized as current losses. Whereas, if actual losses are lower than the preceding year’s allocation, the excess balance increases current taxable income as do fully or partly collected receivables, that have previously been listed as a loss from bad-debts. According to Art. 26 IRFEITL, the term “losses from bad-debts” refers to a) receivables from bankrupt debtors, that cannot be collected after the liquidation of the debtor’s property, or to b) receivables from a deceased debtor, that cannot be collected after his estate has been applied to repayment, or c) to receivables from a debtor, who has exceeded the time limit for performance of his repayment by more than two years.

8. Corporate Reorganization

For a holding company, the tax consequences arising from the sale and assignment of equity interests and investments are crucial. A holding can only be established by transactions that involve the transfer of equity interests, shares, or investments from one entity to another and it can be assumed that during a holding’s operation cycle it will continue to be active in equity interest and investment transfers of some kind. In addition, the economic situation in present day China, which successively reorganizes its economy, implies an increased activity also in the restructuring of domestic business enterprises. In order to enter the Chinese market, MNCs might be attracted to acquiring shares, equity interests, or investments in Chinese enterprises, hence, realizing a corresponding transaction. The term “corporate

712 Art.'s 25, 26, 27 IRFEITL.
reorganization”, as used in this chapter’s heading, shall cover such relevant facts as mergers, splits, equity reorganizations, and asset transfers taken out between corporations.

As has been laid out in Chapter D.II.7.a.ii., which is supposed to document issues of the general taxation of investments, fair value write downs and goodwill amortizations, the general laws and regulations of the Chinese tax laws only modestly, if at all, document the actual taxation of such crucial holding-relevant facts. Therefore, the relatively profound reorganization legislation, as stipulated in the “Reorganization-Provisions”, issued by the SAT in 1997, not only rule clearly holding-relevant facts of reorganizations but also are indispensible with regard to the general understanding of the approach the Chinese law undertakes with respect to the procedures of the taxation of investment-related tax facts and events.714

According to Art. 5 Reorganization-Provisions, the qualification as a FIE is mandatory. If the ratio of Chinese to foreign equity investment of enterprises that have undergone a corporate reorganization does not conform to the ratio prescribed by the laws relating to FIEs, i.e. a minimum foreign capital interest in the respective enterprise of no less than 25%, then the FEITL, IRFEITL, and further regulations, e.g. the Reorganization-Provisions, shall no longer apply. Former FIEs would then be subject to the Domestic Enterprise Income Tax Law and its respective regulations and would consequently loose their preferential tax treatments as provided for under the FEITL and IRFEITL possibly with the financially harsh consequence of repayment of previously granted preferential tax treatments.715

a. Mergers

The Reorganization-Provisions define “mergers” to be the merger of two or more enterprises into one enterprise, either upon dissolution or by absorption. In the former case, the parties to a merger are dissolved and they jointly establish a new entity, while “merger by absorption” describes the case, where one party to the merger continues to exist while the other party(-ies) is (are) dissolved and merged with the remaining entity.716 Generally, it is assumed that for tax purposes, the pre- and post-merger business activities of the merging entities are treated as

714 SAT, promulgated on April 28, 1997; compare also International Bureau of Fiscal Documentation, China, 2003, p. 224g.
715 Compare Löwenstein, Umwandlungen, 1998, pp. 83 et seq.
those of a going concern. In accordance with previous remarks it is being assumed that the reviewed merged entities qualify as a FIE.

As per Art. II no. 1. Reorganization-Provisions all assets, liabilities, and shareholders’ equity of the post-merger entity shall be valued at historic carrying amounts of the pre-merger entities. In cases, where the original carrying amounts have been appraised within the commercial financial statement in order to effect the merger and the post-merger entity adopted such appraised fair values, such changes are not to be considered as immediately tax-effective. For tax purposes the corresponding depreciation or amortization based on such adjusted fair values has to be reversed. Two methods are available. First, the reversal can be achieved on a “year-by-year basis”, also known as “asset-by-asset basis”, according to the actual circumstances. Second, the commercial accounting results can be reversed by way of “overall adjustment”, also known as “comprehensive adjustment”. If adjustments are made on a year-by-year basis, the amount of taxable income is increased or decreased in accordance with the balance resulting from the actual change in the value of each single asset. In case of the “comprehensive adjustment”, the change in the assets’ value is adjusted on an average basis over a ten-year period and the amount of taxable income is altered correspondingly.

The Reorganization-Provisions further provide for the retention of fixed-term preferential tax reductions or exemptions enjoyed by the pre-merger entities. In particular the provisions state that, first, if the terms of such preferential tax treatment had expired the post-merger entity should not be eligible to such treatment again. Second, when such terms have not yet expired and the remaining terms from the individual pre-merger entities are of the same length, the post-merger entity shall be eligible to such treatment until they expire. Third, in cases, where the terms differ, or any of the pre-merger entities were not eligible to such treatment the post-merger entity needs to calculate the corresponding amounts of taxable income. In any event, once differentiated, the post-merger enterprise is eligible to such treatment until the respective terms expire.

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720 Art. II no. 1. (2) Reorganization-Provisions.
721 Art. II no. 2. (1) Reorganization-Provisions.
722 Art. II no. 2. (2) Reorganization-Provisions.
Particularly interesting, also with a view to the following Chapter E, is the post-merger treatment of operating losses incurred by the pre-merger entities. As per Art. 1 II no. 4 Reorganization-Provisions such losses may be offset on a continuous annual basis by the post-merger enterprise. However, such term may not exceed the aggregate 5-year maximum loss carryforward period manifested in Art. 11 s. 2 FEITL, i.e. the post-merger entity may only offset such losses for the remaining number of years. Additionally, such losses can only be set off under the same tax treatment as was applicable to the income of the pre-merger entities.\(^{724}\)

Fundamentally important in this context is the fact that the Chinese tax laws provide for a different treatment of particular sources of income, as well as of income generated by enterprises located in different regions, or active in different fields of business. Art. 1 II no. 5 Reorganization-Provisions, therefore, provides regulations on how the total amount of taxable income generated by the post-merger enterprise is to be differentiated, to apply and continue the different kinds of tax treatment, resulting from the pre-merger era. The provisions distinguish between two cases. First, the pre-merger entities continue to be separate business establishments and to engage in their pre-merger production and/or business operations after the merger. The post-merger enterprise is capable to establish separate accounts to compute the taxable income of each establishment accurately. In such a case, the post-merger enterprise may adopt the method of factual accounting. Second, the pre-merger entities either do not qualify as separate establishments, or they do, but the post-merger enterprise is not capable to produce accurate separate accounting according to the competent tax authorities. Then the total taxable income should be computed by differentiating its components according to one of the proportions or to the average as accounted for by the separate establishments to which different kinds of tax treatments are applicable. Such proportions or averages are generally calculated of annual revenue, costs and expenses, the number of staff or workers, or the amount of wages.\(^{725}\)

Mergers of FIEs in the PRC, hence, do not have an immediate tax effect as to the transfer of assets, liabilities and shareholders’ equity. They are transferred valued at their carrying amount so that neither a transfer gain, nor a transfer loss is realized. In subsequent accounting periods, however, the post-merger entity is deemed to adopt the commercial accounting


changes into its tax accounting. Depreciations and amortizations become tax-effective by adjusting the accounted values either by impairing the assets on an asset-by-asset basis, or by carrying out an overall adjustment.\textsuperscript{726}

b. Splits

The Reorganization-Provisions refer to a “split” as “the splitting of a single enterprise into two or more enterprises”, covering two variances a) the “split by new establishment” and b) the “derived split”. The “split by new establishment” occurs, when the original enterprise is dissolved and two or more new enterprises are established, whereas a “derived split” is given, when the original enterprise continues to exist, but one part of it is split off in order to establish one or more new enterprises.\textsuperscript{727} From a tax point of view, the pre- and post-split business activities of the involved enterprises are considered a going concern.\textsuperscript{728}

As in the case of mergers, the provisions set forth that the assets, the liabilities, and the shareholders’ equity are valued at the carrying amounts of the pre-split enterprise. If, however, the values were adjusted in the commercial financial statements of post-split entities such adjustments are not fully tax-relevant at once. Tax depreciations or amortizations should be reversed in accordance either with the year-by-year method or by the comprehensive adjustment method in the same way as described above in connection with mergers.\textsuperscript{729}

As per Art. 2 II no. 2 Reorganization-Provisions, the eligibility of the post-split enterprises to preferential tax rates, reductions, or exemptions enjoyed by the pre-split enterprise shall be determined based on the post-split enterprises’ individual production and business circumstances. Post-split enterprises are eligible to such preferential tax treatment, if their business scope falls within the eligibility criteria set forth by the FEITL and the IRFEITL. Yet, such preferential tax treatment is only available until the expiration of the legal terms of such treatments. If the post-split enterprise was not eligible for preferential tax treatment, but the post-split enterprises are organized in a way that they become eligible, the preference is granted for the remainder of the term of the respective preferential tax treatment as calculated

\textsuperscript{726} Compare Löwenstein, Umwandlungen, 1998, p. 77.
\textsuperscript{727} Art. 2 I Reorganization-Provisions.
\textsuperscript{728} Art. 2 II Reorganization-Provisions.
from the first profit-making year of the pre-split enterprise. Operating losses of the pre-split enterprise are allocated to the post-split enterprises in accordance with the split agreement. The respective amounts can be carried forward for the remainder of the term as specified in Art. 11 s. 2 FEITL.

As assets, liabilities, and shareholders’ equity is transferred at the carrying amount, no taxable gains or losses are realized. However, in subsequent periods the commercial accounting adjustments have to be adopted by the tax accounting leading to an adjustments corresponding to those in case of a merger which were discussed in the previous chapter.

c. Equity Reorganizations

The term “equity reorganizations” refers to all such events, which result in a change of the shareholders or in the amount or percentage of shares or equity interests held by the shareholders, without simultaneously realizing either a merger or a split as stipulated by Art.’s 1, 2 Reorganization-Provisions. In particular, they cover a) equity transfers, where a shareholder transfers all or part of the equity held by it to another party and b) increases in capital and issue of new shares, where an enterprise offers shares and issues shares to the public and new shareholders invest capital, or existing shareholders increase their investment. Both equity transfers, as well as increases in capital or issue of new shares cause a reorganization of the given enterprise’s capital structure. The first kind of equity reorganizations, equity transfers can also be interpreted to cover particular “acquisitions”. The term “acquisition” as used in this context shall mean a straight forward acquisition of an enterprise, supposedly a FIE or a DE, i.e. the target enterprise, by another enterprise, supposedly the CHHC, either by acquiring shares or equity interests in or all individual assets of the target enterprise. “Equity reorganizations” in the form of equity transfers can, therefore, represent an acquisition of shares or equity interests, a fact commonly known as “share deal”, where a parent company sells its shares or equity interest in a subsidiary, i.e. the target enterprise, to another company, which, once the acquisition is effected, will be the target enterprise’s new parent company.

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732 Art. 31 Reorganization-Provisions.
733 Art. 311, III Reorganization-Provisions.
As to the tax treatment of equity reorganizations, Art. 3 IV no. 1 I Reorganization-Provisions holds that income tax shall be paid or withheld from gains derived by FIEs from the transfer of equity or shares in accordance with the FEITL and the IRFEITL. Correspondingly, losses resulting from such transfers may be deducted from taxable income. If such equity transfers are considered acquisitions, the CHHC can be both the purchaser and the seller of the respective shares or equity interest. Accordingly, the CHHC will be taxable on income derived from such equity reorganizations and deemed to pay regular enterprise income tax. If such a transfer results in a gain or loss, such a gain or loss is determined at hand of the balance between the “equity transfer price” and the “equity cost price”. “Equity transfer price” shall refer to the “amount charged by the equity transferor for the equity transferred, including amounts in the form of cash, non-monetary assets or rights and interests.” If the respective enterprise’s financial statements contain retained earnings and taxed reserves, the newly issued equity/shares or increase in capital is charged against such retained earnings and taxed reserves. Fractions covered by the proportionate charge against retained earnings and taxed reserves shall not be included into the “equity transfer price”.734 The “equity cost price” means the capital contribution actually made to the enterprise or the equity transferor, however, excluding incidental transfer costs.735 Any capital gains (loss) resulting from an equity transfer can be determined in accordance with the following formula736:

![Equity Transfer Price](https://example.com/figure21)

**Figure 21:** Capital Gains Computation Formula737

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734 Art. 3 IV no. 1. III Reorganization-Provisions.
735 Art. 3 IV no. 1. IV Reorganization-Provisions; Pfaar/Salzmann, Besteuerung, 2005, p. 142.
737 Self-prepared figure.
However, the fact that equity reorganizations in holdings or in groups of companies should trigger taxation, i.e. built-in gains are realized and, hence, no goodwill can be acquired that subsequently could be made subject to an amortization, could be considered a fundamental obstacle when MNCs consider establishing or expanding a CHHC by ways of equity reorganization (share deal). With the awareness, that such an obstacle could withhold the Chinese attempt to reform its economy and to channel FDI into the country, the Chinese lawmaker introduced a piece of legislation especially governing the transfer of equity and assets within groups of companies and holdings, the “Handling Questions Concerning Income Tax on Transfer of Equity by FIEs and FEs Circular”. The circular states that when FIEs transfer their equity interests or shareholdings in China and this transfer is carried out during the reorganization of a group of companies and/or a holding and, simultaneously, the transferor or transferee directly or indirectly owns 100% of the other’s equity, or 100% of the equity of the transferor and the transferee is owned by the same company, carrying amounts can be maintained. Accordingly, no taxable event is triggered. No built-in gains and capital gains or losses are realized and no goodwill is acquired.

Share issue premiums, that being the balance between a share’s nominal value and its issue price, is considered to be shareholders’ equity and is not regarded as operating profit triggering income tax consequences. As one can derive from Annex I, Art. 10 FEITL and Art.’s 80, 81, 82 IRFEITL offer an attractive tax incentive, when a foreign investor directly reinvests into an enterprise its profits derived from such enterprise. However, as per Art. 3 IV no. 3. Reorganization-Provisions, such a tax incentive is not granted, if profits derived from an enterprise are utilized to purchase shares or take part in a capital increase of the same company or in another company, i.e. the reinvestment tax incentive is refused if the proceeds from the profits are used to acquire or increase an equity interest.

With regard to the valuation of assets, liabilities, and shareholders’ equity in the target enterprise’s financial statement, the Reorganization-Provisions stipulate that the carrying amounts may not be adjusted for tax reasons. If, however, the target enterprise adjusted the values in the commercial financial statements in order to effect the equity reorganization and

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738 SAT, issued April 7, 1997.
to determine its enterprise value and then took depreciation or amortization based on the adjusted values such commercial accounting changes are subject to a tax-relevant adjustment. For tax purposes, such changes shall be considered either by way of the asset-by-asset method or by way of the comprehensive adjustment method. It can be assumed that the reorganization of an enterprise’s equity does neither change the scope of its business, where such business is located, nor the identity of the tax subject. Thus, Art. 3 IV no.’s 4. (2), (3) Reorganization-Provisions provide that a) preferential tax treatment remains valid within the terms set forth in the FEITL and the IRFEITL and b) losses are continued to be treated as before the equity reorganization took place.

d. Asset Transfers

“Asset transfer” refers to the transfer of an enterprise’s assets, all or in part, to another enterprise. Such a transfer presupposes the existence of separate enterprises and suggests that it could be a part of an acquisition as defined in the previous chapter, which as opposed to a “share deal” is known as “asset deal”. “Assets” in this context means individual assets, but also business operations and operating units, as well as goodwill. Comparable to the situation with equity reorganizations the selling party to an asset transfer has to recognize built-in gains and, hence, capital gains (losses) resulting from such a transaction in the taxable income for the period concerned. However, contrary to the situation discussed in context with share deals, the parties involved in an asset deal are located on the subsidiary level. The acquiring party needs to have a subsidiary established in order to being able to absorb the assets, liabilities and shareholders’ equity acquired through the asset deal.

Art. 4 II no. 2. Reorganization-Provisions governs the calculation of the value of the transferred assets as obtained by the transferee. If such price is equal or lower to the aggregated carrying amount, the transferee recognizes the obtained assets at the carrying amounts of the transferor. Contrary thereto, two methods can be distinguished in cases, where the transfer price (acquisition price) is higher than the aggregated amount of the respective assets’ carrying amounts. The first method can be applied, when the value of the transferred assets can be calculated separately. In this scenario each of the assets obtained are to be entered into respective asset accounts of the transferee’s financial statements. The assets have

742 Art. 3 IV no. 4. (1) Reorganization-Provisions. Stucken/Ley, Behandlung, 2001, pp. 89 et seq.
743 Art. 4 I Reorganization-Provisions.
to be valued at the actual individual transfer price (current value) and become subject to a corresponding depreciation or amortization over the remainder of their respective useful lives. Applying the transfer price, instead of the carrying amount, implies the realization of built-in gains. Once a large number of assets are transferred, or goodwill, or whole business operations are attached to the transferred assets, the valuation becomes more complex. According to the second method, the transfer price is allocated to the individual assets and liabilities by recognizing them with the carrying amounts as reported in the relevant assets’ entry in the transferor’s financial statement. Any resulting balance between the aggregated carrying amounts of the transferred assets and liabilities and the transfer price shall be capitalized as goodwill. The provisions further state that such (acquired) goodwill shall be recognized as an intangible asset item in the transferee’s financial statement. Comparable to the Austrian rule of § 8 III aEStG, Art. 4 II no. 2. s. 3 Reorganization-Provisions provide for a straight-line amortization of such goodwill over a period of not less than 10 years.

With regard to possibly influencing preferential tax treatments Art. 4 II no. 3. Reorganization-Provisions rule that as long as the production and business operations are not changed preferential tax treatment can be maintained, however the transfer of assets does not allow to calculate such treatment anew, but only to continue the status quo as of the moment of the transfer. The opposite is applicable in cases, where the asset transfer causes changes in the production and business operations of the involved entities, i.e. the preferential tax treatments would vanish. Ultimately, if the transfer of assets founds the eligibility to preferential tax treatments, they should be enjoyed for the remainder of the term of the particularly applicable preferential tax treatment as calculated from the first profit-making year. In accordance with the general prohibition of loss transfers, Art. 4 II no. 4 Reorganization-Provisions also does not allow for the transfer of losses between the transferor and the transferee.

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9. Transfer Pricing

Examining the taxation of groups of companies or of holdings is directly connected to the question of how transactions carried out between the entities belonging to such a group of companies or to such a holding are taxed. In any event, taxation can only attach to a quantitative amount. In order to determine such a quantitative amount in connection with transactions carried out between two parties, a price must exist, for which one entity is willing to sell its product or render a particular service to the other party. In an open market scenario, the market forces will somehow determine such a quantitative amount, ultimately leading to a price. Contrary thereto, however, transactions carried out within a group of companies or a holding are not considered to be effectuated in an open market transaction as between independent third parties. Notwithstanding the possibility that the members of a holding, that conduct such an intra-holding transaction, might actually charge a price just the way independent third parties would, it is best practice that tax laws provide regulations to prevent tax avoiding and tax evasive structures. Not too much creativity is needed, to be able to imagine how price setting can influence the overall tax burden of a holding and how taxable income can be shifted to low-tax countries in order to minimize the tax exposure. This effect is even increased, once two or more jurisdictions are involved in international movements of goods and services, because such movements provide an opportunity to MNCs to minimize their overall tax exposure.748

The Chinese laws and provisions dealing with such transfer prices are again spread over several pieces of legislation. The basic rule is provided in Art. 13 FEITL. The provision rules that FIEs established in the PRC, engaged in production and business operations that conduct business transactions with their affiliates shall charge, and pay prices and expenses as in business transactions conducted at arm’s length. Typically, the provision carries on ruling that in cases this arm’s length principle is violated “the tax authorities have the right to effect reasonable adjustments.” This basic rule was complemented by Art.’s 52-58 IRFEITL. Ultimately, the SAT issued the relatively new “Amended Administration of Tax on Business Transactions Between Affiliated Enterprises Rules”749 (hereinafter “Transfer-Pricing-Rules”) which today form the backbone to questions regarding the taxation of business transactions between affiliated enterprises and, hence, also complement the respective regulations given by the FEITL and the IRFEITL. The rules governing transfer pricing usually focus on cross-

border transactions, however they can be equally applied in the domestic context. Hence, the following remarks account for aspects of both domestic and international taxation.750

a. Affiliated Enterprises and Business Transactions

From Art. 13 FEITL it can be concluded that affiliated enterprises have to conduct their transactions among each other at arm’s length. “At arm’s length” shall refer to business transactions carried out between non-affiliated enterprises at fair transaction prices and in accordance with common business practice.751 What consequences does this have for the China-Holding? Specific tax consequences for the China-Holding could be derived, if the members of the China-Holding qualified as “affiliated enterprises” in the sense of the Chinese laws and provisions covering transfer pricing. The term “affiliated enterprises” is further specified in Art. 52 IRFEITL. The provision states that the term “affiliate” refers to “a company, enterprise or other economic organization, which has any of the following relationships with an enterprise, a) direct or indirect ownership or control in terms of capital, business operations, sales and purchases, etc., b) direct or indirect ownership or control of both entities by a third party, or c) other affiliate relationships arising from mutual interests.”752 As this definition remains relatively vague, the Transfer-Pricing-Rules complemented it in its Art. 4 I, which lists eight circumstances, each of which supposes the existence of an affiliated enterprise. While the first three concern ownership or control with respect to capital, the last five cover control with respect to business operations,753 as can be seen from the enclosed list, according to which “affiliated enterprises” exist if:

- “one entity directly or indirectly holds a total of 25% or more of the shares of the other entity;
- 25% or more of the shares of each entity is directly or indirectly owned or controlled by a third party;
- loans between the enterprise and another enterprise account for 50% or more of the enterprise’s self-owned funds, or 10% of the enterprise’s total loans are guaranteed by another enterprise;

751 Art. 53 I IRFEITL.
752 The same definition of “affiliate enterprise” is also given in Art. 51 of the PRC Administration of the Levy and Collection of Taxes Law Implementing Rules (hereinafter “Tax-Levy-Rules”).
- more than half of the directors, or more than half of the senior management personnel such as managers etc., or one managing director, of the enterprise is appointed by another enterprise;

- the production and business operations of the enterprise can be carried out in a normal manner only with licenses (such as for industrial property rights, proprietary technology, etc.) from another enterprise;

- the raw materials, parts, components, etc. (including their prices, transaction conditions, etc.) purchased by the enterprise for production and operation purposes are controlled and supplied by another enterprise;

- the sale of the products or merchandise produced by the enterprise (including their prices, transaction conditions, etc.) is controlled by another enterprise;

- other affiliates in terms of interests that involve the actual control over the production, operation or transactions of the enterprise, and other types of interest affiliations, including relationships with family members or relatives.”

From the above displayed wide definition of what under the Transfer-Pricing-Rules is considered an “affiliate enterprise”, it can be concluded that transactions between members of holdings or groups of companies in most cases will trigger a transfer-pricing examination by the competent tax authorities. However, the legal consequences of the Transfer-Pricing-Rules are not only attached to the qualification of holding members being “affiliated enterprises”, but also to the qualification of the category and the substance of the transaction conducted between such affiliates. With regard thereto, Art. 9 Transfer-Pricing-Rules lists those kinds of transactions that are subject to the transfer-pricing examination. Included are the sales, purchase, assignment and use of tangible property, including the business of selling, purchasing, assigning, and leasing tangible property such as buildings, other structures, means of transportation, machinery, tools, and products. They further cover the assignment and use of intangible property, including the business of assigning ownership of, or providing the right to use proprietary rights such as leaseholds, copyrights, trademarks, brand names, patents, and proprietary technology and industrial property rights such as industrial product.
designs or utility models. Of particular interest in the holding context is that the Transfer-Pricing-Rules further stipulate that financing transactions, including the business of all types of long- and short-term call loans and security, sale and purchase of negotiable instruments, and all kinds of interest-bearing advances and deferred payments etc., are considered as such examinable transactions, too. Finally, the provision of services is covered, including the provision of such services as marketing surveys, marketing, management, administrative services, technical services, maintenance, designing, consultancy, agency, scientific research, legal services, and accounting services. In accordance with the stereotype business activities conducted by and within a holding as well as in accordance with the scope of businesses eligible to the CHHC, it can be assumed that the CHHC possibly conducts any of the different transaction categories as listed in Art. 9 Transfer-Pricing-Rules. However, the observation that the holding members involved in an intra-holding transaction qualify as “affiliated enterprises” and conduct a transaction as specified above is not yet sufficient for the tax authorities to judge, whether price adjustments have to be initiated. Whether or not enterprises were involved with harmful transfer-pricing structuring, is further assessed by examining the extent of transactions effected between affiliated companies, i.e. the prices set in such transactions. As per Art. 10 Transfer-Pricing-Rules, the extent of such transactions shall be a) the amounts of the prices actually paid or received for product, sales, and merchandise, b) the amounts of financing and corresponding accrued interest, c) the amounts of fees actually paid or received for the provision of services, d) the amount of fees actually paid or received for the assignment of tangible property and the provision to use tangible property, and e) the fees and amounts paid or received for the assignment of intangible property and the provision of the right to use intangible property.

The tax authorities examine, whether the status of affiliated enterprises is given, transactions qualify as such provided for by the Transfer-Pricing-Rules, and if the extent to which such transactions are conducted contradict the arm’s length principle. If the tax authorities conclude that the arm’s length principle has indeed been violated, they are authorized to adjust, the prices originally set by the involved taxpayers in accordance with particular methods and standards.

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756 Art. 9 no. (2) Transfer-Pricing-Rules.
757 Art. 9 no. (3) Transfer-Pricing-Rules.
758 Art. 9 no. (4) Transfer-Pricing-Rules.
759 The scope of businesses a CHHC may officially conduct is ruled by the Holding-Provisions. Compare also Chapter B.III.4.f.
760 Wang, Besteuerung, 2006, pp. 134 et seq.
b. Transfer Pricing Methods

According to Art. 54 IRFEITL the tax authorities may adjust the pricing of the examined transactions if the sales and purchases between affiliated enterprises are not priced at arm’s length. Such price-adjustments are effected differently, depending on which category of transaction is involved.\textsuperscript{761} As the several available methods are categorized in accordance with the specific category of transaction involved, it is deemed appropriate to display which methods are intended to be used for which transaction category at hand of the following Table 11. The legal provisions stated refer to such of the Transfer-Pricing-Rules.

<table>
<thead>
<tr>
<th>Legal Provision</th>
<th>Transaction Category</th>
<th>Transfer Price Adjustment Method</th>
</tr>
</thead>
<tbody>
<tr>
<td>Art. 28</td>
<td>Buying and selling of tangible property</td>
<td>2. Comparable uncontrolled price method:</td>
</tr>
<tr>
<td>(Art. 54</td>
<td></td>
<td>- prices for the same or similar business activity when conducted between non-affiliated enterprises;</td>
</tr>
<tr>
<td>IRFEITL)</td>
<td></td>
<td>- Comparability factors are the sales and purchase process, the sales and purchase stages, the goods</td>
</tr>
<tr>
<td></td>
<td></td>
<td>bought and sold, the sales and purchase environment.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>3. Resale price method:</td>
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<tr>
<td></td>
<td></td>
<td>- the profit margin that should be generated from the price for resale to a non-affiliated third party;</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- seller’s profit margin = buyer’s sales revenue ./ buyer’s sales expenses ./ buyer’s sales profit;</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- application reduced to simple processing or pure sale and purchase, where product is not processed</td>
</tr>
<tr>
<td></td>
<td></td>
<td>5. If none of the above methods can be applied, than another reasonable substitute method shall be used (e.g., the comparable profits method, the profit split method, or the net profit method).</td>
</tr>
</tbody>
</table>

\textsuperscript{761} Compare also Art. 27 Transfer-Pricing-Rules.
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<table>
<thead>
<tr>
<th>Legal Provision</th>
<th>Transaction Category</th>
<th>Transfer Price Adjustment Method</th>
</tr>
</thead>
</table>
| Art. 29 (Art. 55 IRFEITL) | Interest on Financing | - comparing the loans between affiliated enterprises and non-affiliated enterprises with respect to the comparability of aspects such as the amount, currency, and term, the security provided, the creditworthiness, the manner of repayment, the method of calculating interest, etc.  
- in case funds are lend on, the creditor’s costs and a reasonable profit should be taken into account. |
| Art. 30 | Service fees | - the normal charge standards for similar activities;  
- comparability at hand of nature of the business, the technical requirements, the level of specialization, the liability undertaken, the terms and manner of payment, the direct and indirect costs, etc. |
| Art. 31 | Use fees (rentals) for provision of the right to use tangible property in the form of lease | - normal fee for providing the use of the same or similar tangible property on the same or similar conditions to a non-affiliated enterprise;  
- normal use fee shall be determined by taking the lease fee or use fee actually paid by the provider plus the provider’s costs or expenses and a reasonable profit;  
- depending on the components of the lease, depreciation installments plus reasonable expenses and profits can be taken as normal use fee. |
| Art. 32 | Price or use fees for assignment of intangible property | - price in the absence of the affiliation;  
- comparability of the assignment in terms of investment in development, conditions of the assignment, degree of exclusive possession, extent and period of protection, benefits obtained, the assignee’s investment and expenses, substitutability, etc. |

*Table 11: Transfer Price Adjustment Methods*[^1]

Interestingly, the Transfer-Pricing-Rules address the application of such methods not to the taxpayer, but to the tax authorities. Only in an indirect manner, the methods are offered to the taxpayer giving guidance on how to structure transfer prices for affiliate enterprise transactions in accordance with the law.763

c. **Advanced Pricing Agreements**

In many cases, it will be in the taxpayer’s interest to secure the acceptance of an enterprise’s transaction practice and used transfer prices upfront in order to ensure a certain degree of security in its strategic and financial planning. Such a partial security can be established through advanced pricing agreements negotiated between the taxpayer and the competent tax authorities. In order to support such closing of advanced pricing agreements, the Chinese government introduced Art. 48 Transfer-Pricing-Rules and Art. 53 Tax-Levy-Rules.764 In 2004, these regulations were complemented by the “Advanced Pricing Agreement Implementing Rules”765 in order to reduce the ambiguity about the advanced pricing agreement process to conclude advanced pricing agreements between taxpayers and local tax authorities in the PRC. Accordingly, enterprises are now permitted to propose principles and calculation methods for transfer prices to the tax authorities. Once accepted the advanced pricing agreements shall be used when calculating taxable income of the enterprise from transactions with its affiliates for determining a reasonable range of sales profit rates.766

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763 Compare Pfaar/Salzmann, Besteuerung, 2005, pp. 157 et seq.
Such advanced pricing agreements can be concluded unilaterally, bilaterally, and multilaterally. Unilateral advanced pricing agreements are concluded between the competent Chinese tax authority and the domestic taxpayer, i.e. either a subsidiary FIE or the CHHC, whereas bilateral and multilateral advanced pricing agreements are concluded between the Chinese competent tax authority, the competent authority of a country with which the PRC has a double tax treaty, and the taxpayer, i.e. the CHHC’s parent company. Consequently, MNCs from countries with which the PRC has such a tax treaty can use the respective advanced pricing agreement in order to prevent potential double taxation risks related to transfer pricing.767

III. INTERNATIONAL TAXATION

Once a cross-border taxable event is realized rules of international tax law have to be considered. As has been concluded in the Austrian context768, the international tax law consists of domestic unilateral and international bilateral regulations aiming at preventing the double taxation of a particular taxable event. Whatever fragmented and confused the Chinese tax laws might appear, their systematic adopts international practice, by generally providing that the domestic laws are subsidiary to the application of double tax treaties, i.e. the bilateral means to prevent double taxation, in cases, where such treaties exist and the national regulations provide for a different handling than such international agreement.769

Like Austria, the PRC applies the “residence principle”, i.e. domestic Chinese residents, irrespective of being natural or legal persons are taxable with their worldwide-generated income in the PRC770, if they qualify as being unlimited tax liable in the sense of the applicable Chinese tax laws. Accordingly, the tax base applied in order to determine taxable income is to be viewed as a universal tax base. In addition, thereto, the PRC further acknowledges that persons, natural, as well as legal that do not qualify as being unlimited tax liable in the PRC, i.e. are limited tax liable, are only taxable on a tax base made up solely by their China-source income. For the Chinese jurisdiction, as well as for the Austrian, this thesis focuses on unlimited tax liable corporations. The Chinese enterprise income tax law manifests

768 Compare Chapter C.VI.
769 Art. 28 FEITL.
the unlimited tax liability of corporations, accessible to significant foreign ownership in Art. 3 s. 1 FEITL. The worldwide tax base of unlimited tax liable corporations is computed in accordance with Art.’s 1 I, 2, 4 FEITL and Art. 10 IRFEITL. Problems and the danger of double taxations occur once a particular tax event or fact touches two or more jurisdictions. The following chapters will examine how and to what extent the Chinese national tax laws and the Chinese double tax treaties provide unilateral and bilateral means to counter double taxation.

1. Unilateral Avoidance of Double Taxation

a. Tax Credit

If residents, i.e. the CHHC or other holding members as unlimited tax liable entities, derive income from inside and outside the PRC, Art. 12 FEITL provides that income tax paid outside the PRC may be credited against the Chinese tax payable on worldwide taxable income. Thus, the Chinese tax law provides for the use of the tax credit method. However, the credited amount may not exceed the amount of tax payable as if computed in accordance with Chinese tax law. Hence, the FEITL establishes a per-country limitation according to which the total foreign tax paid on income from all sources in one particular country is credited up to the amount of Chinese tax, that would otherwise have been payable on that income. Accurately, Art. 83 IRFEITL rules that the term “the amount of income tax paid outside the PRC” means the amount of tax payable on the income tax paid outside the PRC by a FIE on income derived from sources outside the PRC. It does not include tax payments, which the enterprise was subsequently compensated for or tax payments, which were borne by others on behalf of the enterprise. Such “foreign taxes” include direct taxes levied on foreign source income, such as taxes on business profits earned through a foreign branch and withholding

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771 The word “significant” as used in this context refers to the minimum foreign equity threshold of 25% of registered capital necessary to satisfy the FIE-criteria. Notwithstanding this, foreign parties are subject to the permission of the competent Chinese authorities of course allowed to engage in Chinese enterprises with shares in capital of less than 25%. However, in such a case the respective enterprise would not qualify as a FIE but as a DE with all consequences attached.

772 It shall be noted that the general introductory remarks given in the Austrian context also apply to the present context of the international aspects of the taxation of the China-Holding and should therefore be borne in mind and the author refrains from repeating such basic generally applicable remarks.

773 Actually, Art. 86 IRFEITL explicitly rules that the provisions of Art. 12 FEITL and Art.’s 83, 84, 85 IRFEITL apply only to FIEs.

774 Art. 12 s. 2 FEITL.

taxes on investment income. Knowing that paid foreign direct taxes can be credited against tax payments in the PRC leads to the question of how the amount of foreign tax payable is to be calculated. Generally, according to Art. 84 IRFEITL, such income derived from foreign sources is to be computed in the same way as domestic taxable income, including the allowance of deductions, expenses, and losses as incurred by the taxpayer in relation to the respective foreign-sourced income.\textsuperscript{776} The actual amount of the tax credit is either the actual amount of foreign tax paid\textsuperscript{777} or the amount of Chinese tax payable in accordance with a formula, as set forth in Art. 84 s. 2 IRFEITL. The amount applied is the smaller of such quantities. Said formula calculates the deductible amount as displayed in the following Table 12.\textsuperscript{778}

\begin{table}[h]
\begin{tabular}{|l|}
\hline
\textbf{Creditable Amount} = Total Tax Payable on Worldwide Income * (Foreign Country Income / Worldwide Income) \\
\hline
\end{tabular}
\caption{Tax Credit Computation}
\end{table}

Art. 85 s. 2 IRFEITL further rules that if the actual amount of foreign tax paid is less than the amount of Chinese tax payable, only the actual foreign tax paid can be deducted. If the foreign tax paid, exceeds the limit of the deduction as per the Chinese tax laws, such excess portion cannot be deducted as a tax payment or as an expense, but can be carried forward for five years.\textsuperscript{779}

\subsection*{b. International Participation Exemption}

Dividends qualify as “other income” in the sense of Art. 1 I FEITL. Dividends are subject to withholding taxation as per Art. 19 I FEITL. However, it has been examined that intercorporate dividends distributed by the subsidiary-FIEs to the CHHC are tax-exempt according to Art. 19 III l. (a) FEITL and Art. 18 IRFEITL. Explicitly, Art. 19 III l. (a) FEITL reads that “the profit derived by foreign investors from a FIE shall be exempt from tax.” Thus, it needed to be clarified, whether such dividends if distributed across the border, were also tax-exempt. From the wording of the clause this could be concluded if a) the CHHC as the dividend distributing entity qualified as a “FIE” and b) if the dividend recipient the CHHC’s foreign parent company qualified as a “foreign investor”. It has been extensively discussed and

\textsuperscript{776} Compare International Bureau of Fiscal Documentation, China, 2003, p. 249.
\textsuperscript{777} Art. 85 s. 1 IRFEITL.
\textsuperscript{778} Compare hereto e.g. CCH, Tax Guide, 2004, p. 312.
proven that the CHHC, in its legal form as either an EJV or a WFOE, does indeed qualify as a FIE. Moreover, the CHHC also qualifies as a foreign investor, hence, making the participation exemption become applicable to dividends distributed and received between the CHHC and its subsidiaries. The CHHC’s foreign parent company that capitalized the CHHC and holds at least 25% in its registered capital, is with reference to the provisions of the Holding-Provisions considered to qualify as a “foreign investor” in the sense of the FEITL and the IRFEITL. Consequently, the participation exemption provided in the national Chinese tax laws also cover dividends that are distributed by the CHHC to its foreign parent company.

2. Bilateral Avoidance of Double Taxation

As Moser/Zee put it, “the Chinese tax system does not exist in isolation”. Rather the PRC has entered into a number of bilateral tax treaties, which affect the PRC’s taxation of transactions across borders and involve non-Chinese residents. The tax treaties are meant to coordinate the taxation of cross-border transactions and of the parties participating in such taxable cross-border transactions. The Chinese treaty network so far includes income tax treaties with 86 countries. Even though these treaties essentially follow the Model Convention, details may vary from treaty to treaty. Art. 28 FEITL provides that, if the treaty rule offers a more favorable ruling than the domestic tax laws, such treaty rule is to be applied and legally binding. With regard to the taxation of enterprises, the Chinese tax treaties provide for the tax treatment of cross-border business profits, international shipping and air transport profits, deemed profits of associated enterprises, and gains from immovable or movable property.

The CHHC and its subsidiaries do not necessarily have to undertake all their respective business activities within the territory of the PRC. Such business activities could also involve interactions with foreign jurisdictions. Comparable to the examination of the Austrian holding company as a taxable entity, international aspects of the qualification of cross-border transactions of the CHHC and its subsidiaries have to be considered. As soon as more than one jurisdiction asserts the right to tax a given taxable event, the danger of double taxation arises. It has been laid out that the entitlement of a particular entity to double tax treaties is an

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important prerequisite to prevent such a double taxation.\(^7\) Double tax treaties are contracts made under international law. Yet, they are transformed into the respective domestic law by legislative acts and, thereby, are assimilated in status to national law. However, opposite the respective national tax laws, double tax treaties are considered as “leges speciales” taking precedence over such national law.\(^7\) According to the Chinese double taxation treaties, e.g. the ACDTT, which are based on the OECD-MC, “persons who are residents”\(^7\) are granted treaty entitlement. Hence, the CHHC and its subsidiaries need to qualify as a “person” that is “resident” in the PRC. The CHHC and its subsidiaries would then qualify as a “person”, if they were an individual, a company, or any other body of person.\(^7\) Given the legal person status of the CHHC and its subsidiaries, they could qualify as a “company” according to Art. 3 no. 1 l.’s (e) and (f) ACDTT and Art. 1 no. 1.’s (a) and (b) OECD-MC, if they were nationally, i.e. in the PRC, treated as legal persons for tax purposes. It has been sufficiently concluded that the CHHC and its subsidiaries are granted FIE-status. As such, in case of the CHHC, they take the form of legal person EJVs or WFOEs and in case of the subsidiaries or affiliates may in addition take the form of legal person-CJVs. Hence, they qualify as a “person” in the double tax treaty context. In accordance with Art. 4 III ACDTT and Art. 4 III OECD-MC, a person obtains “residency”, when it is tax liable in the given treaty-applying state, because it maintains its “place of effective management” there. As the CHHC, as well as its subsidiaries, is unlimited enterprise tax liable in the PRC, a status that presupposes domestic residency, also the second condition is satisfied and the CHHC, as well as its subsidiaries are both treaty entitled.\(^7\)

For the purposes of the present research, the ACDTT has been manifested in order to discuss the treatment of the various different sources of income. Worthwhile considering are the methods offered by the ACDTT to the PRC to eliminate double taxation. Art. 24 no. 1 l. (a) ACDTT reads that “where a resident in the PRC derives income from Austria, the amount of Austrian tax payable in respect of that income...shall be allowed as a credit against the Chinese tax imposed on that resident. The amount of credit, however, shall not exceed the amount of the Chinese tax computed as appropriate to that income in accordance with the taxation laws and regulations of the PRC.” Thus, as in its domestic tax laws, the PRC applies

\(^7\) Compare hereto Chapter C.II.
\(^7\) Compare the Chinese reference provision in Art. 28 FEITL.
\(^7\) Compare, e.g., Art. 1 ACDTT.
\(^7\) Compare Wassermeyer/Lang/Schuch, Doppelbesteuerung, 2004, Art. 1, pp. 131 et seq.; Wassermeyer/Lang/Schuch, Doppelbesteuerung, Art. 3, pp. 198, 208 et seq.
\(^7\) Compare Wang, Besteuerung, 2006, pp. 38 et seq.
the tax credit method. Moreover, the treaty provides for an international tax treaty participation exemption for distributed dividends, in cases, where a Chinese company owns not less than 10% of the shares of an Austria-resident company. However, unlike the participation exemption granted by Austria, China does not grant a participation exemption for capital gains generated from the sale of shares in an investment, in which the Chinese taxpayer owns a stake of no less than 10%.788

As this thesis concentrates on facts and events that involve transactions and income flows leaving the PRC with direction to the CHHC’s parent company the abovementioned is of minor interest. It would only be applicable, if the CHHC appears to be the recipient of income from abroad, a theoretical possibility that however is not considered within this context.

IV. VALUE ADDED TAX AND BUSINESS TAX

Even though this chapter is not meant to discuss general aspects of the VAT- and Business Tax regimes of the PRC in depth, there exist a couple of specifications that gain importance in the holding context, especially in connection with some of the tax facts and events that have been discussed so far. The VAT and the Business Tax are important cornerstones of the PRC’s tax system, as turnover taxes are the main sources of governmental tax revenues. The Chinese lawmaker introduced both taxes in the wake of the 1994-tax reform.789 The VAT is governed by the “Provisional Regulations of the PRC Concerning VAT”790 (hereinafter “VAT-Regulations”) and the “Detailed Implementing Rules for the Provisional Regulations of the PRC Concerning VAT”791 (hereinafter “VAT-Rules”). Whereas, the provisions ruling the Business Tax are set forth in the “Provisional Regulations of the PRC Concerning Business Tax”792 (hereinafter “BT-Regulations”) and in the “Detailed Implementing Rules for the Provisional Regulations of the PRC Concerning Business Tax”793 (hereinafter “BT-Rules”). Additionally, both the ruling of the VAT as well as of the Business Tax is complemented by various administrative orders.

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788 Art. 24 no. 1 l. (b) ACDTT.
790 SC, promulgated on December 13, 1993 and effective from January 1, 1994.
791 MoF, promulgated on December 25, 1993 and effective from January 1, 1994.
792 SC, promulgated on December 13, 1993 and effective from January 1, 1994.
793 MoF, promulgated on December 25, 1993 and effective from January 1, 1994.
1. Value Added Tax

In the PRC, the VAT is levied on the sale of goods, the provision of processing, repair, and replacement services, as well as on the import of goods.\textsuperscript{794} Thus, the PRC has adopted a production-based VAT that does not allow for the deduction of input VAT from purchased capital assets, as opposed to a revenue-based or consumption-based VAT. The different forms of VAT are mainly distinguished by their treatment of the deduction of input VAT or tax credits for input VAT for capital assets purchased during the current period, i.e. in respective of their specific tax base.\textsuperscript{795}

Taxable are, what Art. 1 VAT-Regulations refers to as “units” and “individuals”. While the term “individuals” is of no further interest, it could be assumed that the CHHC and the other China-Holding members qualify as “units”. According to Art. 8 VAT-Rules, the term “units” shall mean, among others, private enterprises and joint stock companies, hence, making the CHHC, in its function as a private enterprise and possibly as a joint stock company, VAT liable. The CHHC may realize VAT-liable events in multiple ways, both through transactions within the China-Holding and through transactions carried out in the market with third parties. VAT is levied on the transaction of each stage, a good or service passes, from production to distribution. Tax liable enterprises may claim an input tax relief (i.e. VAT tax credit) in particular cases.\textsuperscript{796} The VAT is levied on the sales amount attributed to the respective taxable transaction. Hence, the calculation of the VAT in the PRC follows the following set of formulas:\textsuperscript{797}

\textsuperscript{794} Art. 1 VAT-Regulations.
\textsuperscript{795} Compare Cheung/Chui, Comparison, 2004, pp. 11 et seq.; Lin, VAT, 2004, p. 67; Mui/Jia, China, 2001, pp. 45 et seq.; Ng/Chan, Value-Added Tax, 1999, pp. 23 et seq.; accordingly, in case of a revenue-based VAT the input VAT for capital assets acquired can be partially deducted in proportion to the values of the capital assets that have been expensed through depreciation in the current period, whereas in case of a consumption-based VAT, the input VAT can only be fully deducted against the output VAT when capital assets are purchased.
\textsuperscript{797} Art.’s 4, 5 VAT-Regulations.
Generally, the VAT taxable amounts in a given period should include sales to external buyers, goods and services rendered for internal use, and donations. However, for the calculation of the input VAT, capital assets purchased, goods and services for internal uses, and damaged or lost inventory are not eligible. As per Art. 2 no.’s (1), (4) VAT-Regulations the general VAT tax rate for goods sold or imported, or for processing, repair, and replacement services is 17%, unless the goods sold or imported are explicitly listed in Art. 2 no. (2) VAT-Regulations, in which case the rate is reduced to 13%, or if the goods sold or the services provided are explicitly exempted from VAT, then the rate obviously is 0%. Exported goods, however, are exempted from VAT. Furthermore, capital equipment imported by FIEs in order to transfer technology for investment projects, that fall within the “encouraged”-category and the “restricted”-category, as provided for in the “Catalogue of Foreign Investment Industrial Guidelines” and that is used within their total amount of investment are exempt from VAT and import duties, unless listed in the “Catalogue of Imported Goods not Qualified for Tax Exemption for Foreign Investment Projects.” Given this basic information, it goes without saying that the regular business transactions and the provision of services as carried out between the China-Holding’s members, basically, are subject to VAT and an in depth analysis of the VAT aspects relating to the China-Holding are not within the scope of the present research project.

798 Self-prepared figure.
799 Compare Lin, VAT, 2004, p. 68.
800 Art. 2 no. (3) VAT-Regulations.
However, especially with respect to corporate reorganizations as examined in Chapter D.II.8., VAT issues could become relevant. Restructuring a holding and its members by way of share deals should not trigger any VAT-relevant taxable events, as presumably no taxable sales that are subject to the VAT are generated, because neither services are provided, nor goods are transferred or assigned or imported. However, the tax authorities will relate the transferred equity interest back to the original registered capital contribution in determining what the actual subject of the present transfer is. Therefore, if the original capital contribution was made by way of a contribution in kind and tangible assets were invested, the tax authorities tend to view the subsequent transfer of the relating equity interest as effectively a transfer of the underlying tangible asset, which is subject to VAT. Accordingly, asset deals will always cause a VAT-liability. In the course of asset deals the target enterprise’s assets are sold and such assets could include tangible movable assets whose sale is VAT-liaible according to Art.’s 2 I, 4 no.’s (5), (6) VAT-Rules.802

2. Business Tax

Within the scope of turnover taxes, Business Tax forms a counterpart to the VAT. It is levied on all such sales of goods and provision of services that are not covered by the VAT. According to Art. 1 BT-Regulations “units and individuals that provide labor services..., assign intangible assets, or sell immovable property in the PRC shall be payers of Business Tax.” Like with the VAT, the amount of tax payable is calculated as the product of the amount of business multiplied with the tax rate.803 The “amount of business” shall be the aggregated amount of the full price paid for the goods sold or the services rendered and all additional charges collected by the taxpayer from the other party.804 The tax rate levied on transactions subject to Business Tax depends on the taxed item. The BT-Regulations conclude with an appendix that lists the tax rates as displayed in Table 13.805

803 Art. 4 I BT-Regulations.
804 Art. 5 s. 1 BT-Regulations.
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<table>
<thead>
<tr>
<th>Tax Item</th>
<th>Scope of Levy</th>
<th>Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Transport industry</td>
<td>transport by land, transport by water, transport by air,</td>
<td>3%</td>
</tr>
<tr>
<td>2. Construction industry</td>
<td>construction, installation, renovation, decoration, and</td>
<td>3%</td>
</tr>
<tr>
<td>3. Finance and insurance</td>
<td>-</td>
<td>5%</td>
</tr>
<tr>
<td>4. Post and telecommunications</td>
<td>-</td>
<td>3%</td>
</tr>
<tr>
<td>5. Culture and sports</td>
<td>-</td>
<td>3%</td>
</tr>
<tr>
<td>6. Entertainment business</td>
<td>halls providing performances by vocalists, dance halls,</td>
<td>5-20%</td>
</tr>
<tr>
<td>7. Service industry</td>
<td>agency, hotel industry, food and beverage, tourism</td>
<td>5%</td>
</tr>
<tr>
<td>8. Assignment of intangible assets</td>
<td>assignment of land use rights, patent rights, non-</td>
<td>5%</td>
</tr>
<tr>
<td>9. Sale of immovable property</td>
<td>sale of buildings and other attachments to land.</td>
<td>5%</td>
</tr>
</tbody>
</table>

Table 13: *Business Tax Rates*

Transfers of intangibles, immovable property, or the render of services below the market price, whether between affiliated parties or not, are adjusted for Business Tax purposes. The tax authorities may adjust such prices based on average prices for similar services rendered or goods sold, ultimately applying the arm’s length principle in the Business Tax context.

The Business Tax laws do not know an input tax relief (i.e. Business Tax credit). Hence, services or sales subject to Business Tax are taxed on every business level cumulatively. Given that the transfer and the assignment of intangible assets and fixed assets are subject to Business Tax, inevitably, the tax consequences of asset deals have to be considered also from a Business Tax point of view. Especially, the transfer and/or assignment of intangible assets play a major role in the business life of a China-Holding. Moreover, if the CHHC renders services to its subsidiaries, e.g., for marketing activities or logistics, such services have to be qualified as a taxable event subject to Business Tax. Conditional for a Business Tax liability is the existence of performance and consideration, i.e. the transfer or assignment of intangible assets or fixed assets or the rendering of services need to be carried out for consideration, where “consideration” shall cover currency, goods, or other benefits.

It has been stressed that especially the transfer of technology and the payment of corresponding royalties are considered to be of greater importance in the China-Holding context. Royalties are to be seen as the consideration paid for the assignment or transfer of intangible assets, usually, patents, technologies, copyrights, trademarks, as well as land use rights and goodwill. Such transfers of intangible assets are often accompanied by

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806 Self-prepared table.
808 However, the laws also provide for exceptions in particular industries.
809 Art. 4 BT-Rules.
corresponding services that are rendered with respect to the transferred intangible assets, a so-called "mixed sale". Business tax is due on such transfers, assignments, and services, if they are taken out within the PRC, covering not only one time payments for the assignment or the transfer of the respective intangible asset, but also recurring royalties paid in connection with such intangible asset. According to two administrative orders, Business Tax can be remitted upon application, in cases of the underlying intangible assets being either patents or non-patented technologies. Yet, this procedure presupposes that Business Tax exemption was only granted once the competent tax authorities have issued a certificate of exemption. This approval-based approach, however, was replaced by a record-based approach. Business Tax would now not need to be refunded, if the taxpayer had registered the technology transfer contracts with the Ministry of Commerce.

If Business Tax was to be levied on royalties it is, however, creditable against all other taxes payable on the same royalties, i.e. all other taxes would only be levied on 95% of the royalty income, assuming a 5% Business Tax rate. Another administrative order issued by the SAT on September 28, 2002 ("Issues Relevant to Taxation Treatment for Services Provided by Foreign-invested Companies with an Investment Nature to Their Subsidiaries Circular") summarized the taxation of services rendered by the CHHC to its Chinese subsidiaries. Generally, services rendered by a CHHC to its subsidiaries are subject to enterprise income tax and business tax. The provisions state that the charges and fees charged by a CHHC to its subsidiaries shall conform to amounts normally charged for arm’s length transactions. Such services should be accurately documented by contracts and income generated from such services shall be reported as taxable income. If such services are not agreed in such a contract and the fees are not charged on specific terms to each individual subsidiary, but on the actual costs incurred, the taxable revenue equals the quotient of the actual costs divided by the result of one less the business tax rate less the deemed rate of income tax. Further, the CHHC may not claim as tax-deductible business expenses, e.g., expenses incurred by the decision-making process, interest on loans taken on to fund investments, salaries and other expenses of personnel managing the investments. Moreover, if the CHHC enters, on behalf of its subsidiaries, into a contract with a third party, the CHHC may charge its subsidiaries for reimbursement of charges it incurred by paying for such services provided to the subsidiaries.

810 Art. 5 I BT-Rules.
811 SAT, issued October 8, 1999; SAT, issued October 8, 2000.
812 Compare hereto e.g. Buller, Business Tax Exemption, 2005, p. 521.
814 Compare hereto the remarks made in Chapter D.II.6.
Such reimbursements are not to be considered taxable for enterprise income tax, as well as business tax purposes.

Business Tax consequences further have to be considered, if intangible assets or fixed assets were used as contributions in kind in course of the establishment of a FIE. Notwithstanding the fact that usually the transfer of equity interests are not subject to Business Tax, the transfer of equity interests that originally have been created by making a contribution in kind with intangible assets or fixed assets may at a later transfer or assignment become Business Tax liable. However, problematic in such a case is the determination of the tax base. Hence, Business Tax may be levied on the aggregated value of such equity interest or based on the historic cost of the respective intangible assets and/or fixed assets as the form a part of the underlying equity interest. 815

V. SUMMARY OF FINDINGS

The previous chapters discussed the taxation of the China-Holding as per the laws and regulations of the PRC. Summarized, it can be said that the taxation of the China-Holding for the most part equals the taxation of FIEs and thus follows the general separation of the taxation of domestic and foreign enterprises in current law. Opposed to DEs that are exclusively taxed at a standard rate of 33%, FIEs despite being subject to the same standard enterprise income tax rate of 33% may be eligible to one of the numerous tax incentives, which regularly reduce the tax rate to between 7.5% and 24%. Such tax incentives are granted based on geographic and industrial criteria, i.e. once a particular FIE is located within a certain area or active in a particular industry it might enjoy a tax incentive.

The taxable entity of the foreign enterprise income tax is the legal person FIE. The CHHC and its subsidiaries have been identified to each qualify as both, legal persons as well as FIEs and hence they both qualify as an unlimited taxable entity within the definition of the FEITL and the IRFEITL. The CHHC and its subsidiaries generate income as it is defined by law. The FEITL and the IRFEITL define such income as “income from production and business operations and other income.”816 The CHHC is further marked by a certain particularity. It obtains two tax qualifications, one as an original legal person FIE and one as a foreign investor that is invested in other FIEs, i.e. the CHHC’s subsidiaries. As a consequence

815 SAT, April 28, 1997; compare hereto also Howson/Li, Holding Companies, 1998, p. 11; Stucken/Ley, Behandlung, 2001, p. 90; Wang, Besteuerung, 2006, pp. 192 et seq.
816 Art. 1 I FEITL; Art. 2 I IRFEITL.
thereof, the CHHC is required to keep two sets of accounting records, one for its FIE-income and the other for its income as a foreign investor.

The amount of taxable income is defined as “...the total amount of revenue...less costs, expenses, and losses”\(^{817}\) indicating that the PRC tries to follow the principle of taxable capacity by defining taxable income as a net quantity. Taxable income is generally determined in accordance with Art. 10 IRFEITL, which provides different kinds of role model computations depending on the business activity the respective taxpayer is active in. Thus, taxable income is computed differently for enterprises active in the “manufacturing industry”, in “commerce”, in “service trades”, and in “other trades”. Tax accounting generally is understood to follow the commercial accounting and only if differences occur the tax laws prevail. Losses can be set-off and carried forward for a period of five years; however, any remaining losses that could not be set-off over such period can no longer be utilized and set-off against future income.

The contribution of capital is tax neutral, as long as conducted in cash. Opposite thereto, capital contributions made by way of contributions in kind trigger tax consequences. The Chinese tax law’s frequent vagueness is also expressed in connection with constructive capital contributions and constructive dividends. Both concepts are not explicitly named in Chinese legislation. However, the catch basin of Art. 11 FEITL “other income” is believed to cover these events, too and cause them becoming taxable as “other income”. The “other income” event is further interpreted to cover cases of capital reductions that relate to a prior contribution in kind.

One of the most striking findings is that the Chinese tax laws do not provide for a group-relief regime for foreign-invested holding companies! While FIEs are entitled to consolidate the results of individual establishments, the laws do not allow for a consolidation of legally separate FIEs. Accordingly, the PRC does presently not know a group-relief regime somehow comparable to the “Gruppenbesteuerung” and the taxation of the CHHC therefore equals the taxation of any FIE. Notwithstanding the aforementioned, the Chinese have issued several regulations that rule particular tax facts and events relating to holdings.

As to the actual income generated by the CHHC dividends, interest or royalties, all qualify as “other income” and hence are subject to a withholding taxation of between 10% and 20%. However, as per Art. 19 III FEITL and Art. 18 IRFEITL inter-corporate dividends distributed

\(^{817}\) Art. 4 FEITL.
between FIEs and between FIEs and foreign investors are subject to a participation exemption and accordingly tax-exempt. Similarly, tax-exemptions may apply in the cases of interest and royalties if they are paid by particular federal institutions or for technologies that are considered advanced or provided under preferential conditions. Contrary thereto, all other business income, e.g. from services or income from capital gains is subject to the standard rate of 33%.

Business expenses are generally deductible as long as they are not particularly excluded from tax deductibility. Financing costs, “borrowing costs"818, are categorized depending on whether they are paid for the acquisition or construction of fixed assets. Once paid within the context of the acquisition or construction of fixed assets associated borrowing costs have to be capitalized and depreciated in accordance with the underlying fixed asset. If the borrowing costs are not incurred in connection with fixed assets they are generally considered directly tax deductible business expenses. However, with regard to the taxation of business expenses, Art. 18 IRFEITL provides a general rule, as to which business expenses incurred in relation to income sources of tax-exempt income may not be set-off and deducted whatsoever. Thus, the CHHC that receives tax-exempt dividend income from an investment may not deduct expenses it incurred in connection with such investment.

This thesis defines investments as long-term cash equity investments. They are valued at acquisition cost. The subsequent accounting of equity investments is either conducted by way of the “cost method" or by way of the “equity method". Both methods are differentiated based on the scope of equity interests actually held in the given investment and on the scope of control and influence the investor is able to impose in the investment. If an investor holds less than 20% or more than 20% but is not able to exercise control, joint-control or significant influence the investment is accounted in accordance with the cost method. Once the investor holds more than 20% or less than 20% but has the opportunity to exercise control, joint-control or significant influence the equity method is to be adopted. The cost method values the investment at acquisition cost, which is subsequently impaired and adjusted by amounts received as profit shares. Starting at acquisition cost, the equity method provides that such reported amount be subsequently depreciated evenly over the investment period, however not over a period exceeding 10 years. The reported carrying amount is further adjusted by related investment income or losses. If the impairment concludes that the actually recoverable amount of an investment, i.e. its market value, is lower than the current carrying amount, a

818 Compare ASBE-BC.
fair value write-down is possible. Accordingly, if the reasons for such fair value write-down reverse a fair value write-up is to be effected up to an amount not exceeding the historic carrying amount.

Other fixed assets are usually depreciated annually on a per item basis using the straight-line method. Initially they are valued at their original cost, acquisition or construction cost. However, the depreciation base has to take the remainder of a residual value not less than 10% of the original value into account. The depreciation term depends of the allocation of the underlying asset to a particular category and may range from six to more than 20 years. Contrary to the situation in Austria, China provides for the capitalization of all intangible assets, irrespective if acquired or self-produced. Intangibles are supposed to be amortized over a term as stipulated in any underlying contract or over a period of not less than 10 years.

The “Reorganization-Provisions” rule the tax treatment of mergers, splits, equity reorganizations (share deals), and asset transfers (asset deals) and their implied consequences for the taxation of investments. In case of mergers, the post-merger entity is generally treated as a going concern and its equity is value at the historic carrying amount adopted from the pre-merger entities. Only in cases, where equity appraisals took place, such appraised values have to be adjusted without, however, causing an immediate tax effect. The regulations offer two methods at hand of which such appraisals can be adjusted, the first, the “asset-by-asset-method” provides for the consideration of the changes in value of each single asset, whereas the second, the “comprehensive-adjustment-method” applies an average appraisal to each asset over a 10-year period. With regard to favorable tax treatments often available to FIEs, the post-merger entity may continue to exercise such incentives as long as they are still valid and in effect, as well as it may continue to offset still available loss carryforwards. In the case of enterprise splits, carrying amounts are continued to be used for the valuation of assets and liabilities, appraisals are adopted either through the “asset-by-asset-method” or through the “comprehensive-adjustment-method”. Post-split enterprises may also continue to use tax incentives, if they continue to conduct the business that is eligible to such incentives. Particularly interesting are share and asset deals. Equity reorganizations, or share deals, are events that result in the change of shareholders or in the scope of equity interest held by individual shareholders. Once equity interests are supposed to leave the property sphere of a shareholder they have to be valued at market value, hence, potential built-in gains are realized and become taxable as capital gains. However, for holdings the Chinese tax laws provide that for equity reorganizations conducted within the holding, under certain circumstances such
equity interest may be transferred at carrying amounts without the realization of taxable capital gains. Similarly, in case of asset transfer, or asset deals, assets exiting a financial statement are valued at their market value causing the realization of built-in gains. In cases, where the acquisition price of the assets exceeds the aggregated carrying amounts of the assets the resulting balance needs to be allocated appropriately. Such allocation may either be effected by allocating the actual new market values to every asset single handedly or by maintaining the historic carrying amounts for the assets and reporting the balance as goodwill. Such goodwill is understood to be amortized over a 10-year period using the straight-line method.

Transactions between affiliated enterprises have to be carried out at arm’s length. If such arm’s length principle is violated the authorities have the right to make adequate adjustments. The CHHC and its subsidiaries qualify as affiliated enterprises and therefore any transaction effected between them may be subject to an official examination. Examined are sales, the purchase, assignment, and use of tangible and intangible property, as well as financial transactions and particular services. The authorities may enforce changes in the prices set for such transaction by using one of the commonly known transfer pricing methods, like, e.g., the comparable uncontrolled price method, the resale price method, the cost-plus method or other methods as deemed appropriate in the given case.

Just like in the Austrian tax law, national Chinese tax law is subsidiary to international double tax treaties. The PRC also applies the “worldwide income principle” to its unlimited tax liable taxpayers. Unilaterally, the PRC applies the tax credit method with a per-country limitation. The credited amount may not exceed the amount of tax that would be payable if computed under the laws of the PRC and the actual amount of the creditable foreign tax is the smaller of either the actual amount of foreign tax paid or the amount of tax payable if computed under Chinese laws. Additionally, the participation exemption provided for in Art. 19 III FEITL also applies internationally as it explicitly names dividends distributed to foreign investors as tax-exempt. Both, the CHHC and its investments are treaty entitled. In its treaties the PRC applies the tax credit method to counter potential double taxations and in case of ACDTT it allows for a treat participation exemption according to which dividends distributed by an Austrian enterprise to a Chinese resident enterprise owning more than 10% in the Austrian enterprise would be tax-exempt.
It has been stated that the focus of this thesis vests on enterprise income and corporate income tax. Yet, some turnover tax facts shall be named that gain holding relevance. In general, the CHHC and its subsidiaries are tax liable with regard to VAT as well as Business Tax. In the holding context VAT has to be considered if within a share deal an equity interest is transferred that was originally established by way of a contribution in kind. The tax laws suppose that effectively in such a case the underlying asset is transferred and as such becomes subject to VAT as any other asset transfer or sale. Accordingly, asset deals are always subject to VAT. A similar treatment could be witnessed in connection with Business Tax. In connection with asset and share deals that involve the transfer or assignment of intangible assets and/or fixed assets, a Business Tax liability has to be considered. Additionally, Business Tax is levied on services related to such transferred or assigned assets and even on recurring royalties. In the latter case, however, the Business Tax paid is credited against the enterprise income tax payable. In general, it can be manifested that all kinds of services rendered between the CHHC and its subsidiaries or among its subsidiaries are subject to Business Tax.
E. THE CHINA-HOLDING AND TAX PLANNING

The previous Chapters B, C, and D have examined and analyzed the definitions necessary for the discussion of the research object “holding”, the specific legal framework, and the legal history one has to try to understand, when undertaking legal research in the broad field of Chinese law. The underlying Austrian holding taxation regime was discussed to establish a useful reference for the attempt to examine and analyze the taxation of foreign-invested holding companies in the PRC. In Chapter A the course of work indicates that in addition to the findings from the examination of the taxation of the China-Holding, this thesis would introduce a discussion of how internationally known tax-planning measures and strategies could be used in connection with the China-Holding. Tax planning is only possible with a profound knowledge of the underlying legislation and tax treatment of individual facts and events. Hence, the previous findings support the research of potential tax planning strategies in the PRC and enhance the meaningfulness of derived conclusions. Thus, this chapter will study, how, based on the actual taxation of the CHHC and the China-Holding, internationally known tax planning strategies could be adopted and what quantitative effect the application of chosen examplatory strategies may have.

In order to produce quantitative results, this thesis uses the figure “NDI”.\textsuperscript{819} Within a casuistic assessment simulation, it is assumed that the CHHC’s parent company is an Austrian resident corporation. Yet, it is intended to display the following findings in a basic way so that their tendencies can be transferred into any other parent company jurisdiction and, therefore, additionally allow for a more general interpretation and, possibly, application. Depending on, whether the Chinese subsidiary-FIE distributes a profit, or the scenario considered involves another form of income transfer between the Chinese-subsidiary and the CHHC and subsequently between the CHHC and its foreign parent company. The starting point of the model as it is used in the following remarks is displayed in the self-prepared Figures 23 and 24.

\textsuperscript{819} Compare Chapter A.III.
In Scenario A, the model assumes a basic Chinese subsidiary pre-tax profit of 100 monetary units. Either such profit is subject to the general Chinese enterprise income tax rate of 33%, or, if the taxable entity is eligible to one of the various tax incentives or tax holidays, to a rate of, assumably, 15%. Alternatively, if the kind of income considered is subject to withholding tax and not regular enterprise income tax, a withholding tax rate of 10% could apply. Scenario A assumes that the subsidiary-FIE distributes 100% of its distributable after-tax profits, i.e. no profits are retained. The amount of the distributable subsidiary-FIE after-tax profit, hence, equals the CHHC income. Once received by the CHHC, it has to be examined, whether the further distribution of the CHHC’s profits to the MNC’s top-entity is subject to further Chinese taxes and if internationally any double tax treaties apply. The remaining balance of distributed profits is received by the MNC’s top-entity. The MNC top-entity is subject to local taxes. The eventually remaining balance equals the NDI, which the MNC’s top-entity may retain or distribute.

820 Self-prepared figure.
The situation covered by Scenario B assumes that the CHHC receives any kind of income from its subsidiaries other than dividends and that the income distributed by the CHHC may cover all possible forms of income, including dividends. Apart from that, the assumptions remain the same as in the above-described Scenario A.

I. **THE TERM**

“What exactly does the term ‘tax planning’ refer to” could be a likely question, when first approaching this discipline. The term “planning” implies the purposeful preparation and organization of activities, i.e. measures, to reach a particular target. Hence, the term “tax planning” covers the preparation and organization of tax-effective activities in order to reach a particular tax-relevant target. Therefore, the responsible people need to develop a system focused on reaching such targets. Such system shall identify appropriate means and strategies and put them to work as efficiently as possible. Conditional for the implementation and application of such a system is that the individual targets need to be identified and put in concrete terms and, additionally, appropriate corresponding strategies need to be developed and implemented into the entire enterprise-management-system. Within the framework of an enterprise’s management system, taxes resemble an expense-factor, which needs to be

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821 Self-prepared figure.
minimized. Enterprises sometimes undertake to reduce their tax burden through measures, which no longer are covered by the respective national laws. Such ways to reduce a tax burden are considered to be, either tax evasion or tax circumvention. In order to prevent such illegal tax-evasive or tax-circumventing approaches, the Austrian tax authorities generally refer to § 22 Bundesabgabenordnung. According to § 22 I Bundesabgabenordnung, the tax liability cannot be circumvented through the abuse of civil law forms and structures. An abuse of civil law forms and structures is assumed, if the underlying structure is deemed inappropriate. A certain legal structure is deemed inappropriate, when it is actually inappropriate to realize the underlying economic target and is aimed primarily at circumventing a tax consequence, and cannot be justified through further economic or other important reasons.

The Chinese government, too, introduced provisions that are intended to prevent tax evasion and tax circumvention in the particular individual tax laws concerning the separate kinds of taxes, as well as in the tax administrative provisions, such as the “Administration of the Levy and Collection of Taxes Law” and the Tax-Levy Rules. For instance, Art. 25 s. 1 FEITL sets forth that “if any entity evades tax through concealment or deceit or fails to pay tax within the time limit...and if such entity has been reminded by the tax authorities to pay tax, but fails to do so within the specified time limit, the tax authorities shall press for payment of the amount of the tax payable by it and impose on it a fine of not more than five times the amount of tax owed.” Moreover, Art. 25 s. 2 FEITL provides that in serious cases the legal representatives and persons directly responsible shall be prosecuted in accordance with the Chinese Criminal Law. For the purposes of Art. 25 FEITL, the term “tax evasion” refers to illegal acts by taxpayers in willful violation of the tax law, such as “alteration, forgery or destruction of bills, vouchers for accounting entries or accounting books, false entry or overstatement of costs and expenses, concealment or understatement of the taxable income or revenue, and avoidance of the payment of tax or fraudulent obtaining of tax refunds.”

A general applying rule, more comparable to § 22 Bundesabgabenordnung, would be Art. 3 II of the Tax-Levy Rules, which stipulates that taxpayers shall generally perform their tax payment obligations in accordance with the tax laws and administrative regulations and that any contract or agreement signed by a taxpayer that conflicts with the tax laws or

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822 Compare Grotherr, Grundlagen, 2000, p. 5; Kessler, Holdinggesellschaften, 2000, pp. 188 et seq.; Streu, Einsatz, 2000, pp. 171 et seq.
823 Compare German Federal Tax Court, May 20, 1997.
824 Art. 107 IRFEITL.
administrative regulations shall be void. Yet, this thesis will not cover possibly illegal individual measures and strategies, but aims at focusing on measures and strategies that gain tax law acknowledgement, i.e. at tax avoidance schemes.

Tax planning is part of the entire enterprise management planning process. Tax burden, income situation, and profitability of an enterprise or an investment are influenced through entrepreneurial and management decisions. Correspondingly, if decisions influence the profitability of an enterprise or an investment, the scope of the tax burden is to be viewed as a critical factor that strongly influences the choice of single decision alternatives. Therefore, the alternative structural possibilities within the framework of tax planning become a more significant part of business planning, whenever the criteria of management decisions need to be quantified and qualified. If one assumes profit maximization to be the entrepreneurial maxim of business activities next to going concern considerations, this would lead to the conclusion that any kind of tax-related expenses, or absolute tax payments or the tax present value needed to be minimized. Accordingly, minimizing the scope of tax payments can be concluded as the superordinate target of tax planning. The German language tax literature particularly refers to the “creation of tax facts”, as well as to the exercise of accounting and tax options granted by the respective laws as the means to influence the scope of tax payments. The “creation of tax facts” refers to measures motivated by tax purposes that go beyond exercising accounting and/or tax law options, and aim at creating particular tax facts that realize predictable tax consequences. Whereas, accounting and tax law options attach to already realized tax facts and provide the taxpayer with the choice between particular legal consequences or even the possibility to avoid particular legal consequences. Further, tax planning can be distinguished with regard to whether it is taken out in the national context, i.e. within one particular jurisdiction, or in the international context, i.e. in at least two separate jurisdictions.

825 As Grotherr quotes in his essay, the German Constitutional Court and the German Federal Tax Court, for instance, generally acknowledge the taxpayer’s intention to avoid paying taxes, “No taxpayer is obliged, to construct a tax fact in a way that it results in a tax claim. Rather, he is free to avoid taxes and to choose a structure which results in a lower tax burden. A so-called “tax avoidance” is without consequences. German Constitutional Court, April 4, 1959; German Federal Tax Court, May 20, 1997; German Federal Tax Court, January 16, 1992; German Federal Tax Court, March 16, 1988; compare hereto also Grotherr, Grundlagen, 2000, p. 7.
827 Ad “German-language tax literature” compare, e.g., Gabler, Wirtschaftslexikon, p. 3601.
This thesis has built the assumption that a MNC establishes a holding company in the PRC to hold and manage its local investments. The decision for incorporating a holding company, as an intermediary holding, is usually based on a thorough business assessment often motivated by tax reasons. Holding companies often are considered to be an appropriate means to reduce the tax burden, yet, they also establish an additional level of taxation within the entire MNC’s hierarchy, which may in fact cause surplus taxation, i.e. double or multiple taxation, instead of the reduction of tax payments. The taxation level “holding” can be utilized two-ways, nationally as well internationally, first by way of “repatriation-strategies” and second, by way of “allocation-strategies”.

Eventually, the following chapters will examine and present in detail particular tax planning targets and how such targets are allocated and effected in the national and international context, respectively. Subsequently, tax planning targets and their territorial utilization will be implemented into the different repatriation- and allocation-strategies. The discussion of each strategy is accompanied by a numeric example stressing its effects.

II. TAX PLANNING TARGETS

As discussed above the tax-planning targets are derived from the overall enterprise management system. Equally, the decision to use and implement holding structures in order to maximize business and financial efficiency can be seen as a result from utilizing the enterprise management system. Consequently, the decision to implement a holding company into the overall structure of a MNC, or even to structure the entire MNC as a holding, is equally influenced by economic, legal, and tax targets. Within an international context, it is especially difficult to determine the dominance of any particular targets pursued through tax planning. Regularly, they are a part of a bundle of enterprise-management-system targets that is constantly changing due to the permanent changes in the respective prevailing circumstances.
Irrespective of the particular type of enterprise-management-system target considered, their identification and implementation implies that they can be measured qualitatively and/or quantitatively. Tax-planning targets are regularly derived from financial quantities due to their impact on income and liquidity. Taxes form a category of expenses, however, an expense-category that does not result in a consideration causing taxes to enter the enterprise management system as a negative component. Correspondingly, management aims at reducing such negative components as much as possible by deriving quantitative and qualitative tax planning targets.833

1. Quantitative Tax Planning Targets

Quantitative tax planning targets are such targets that can be expressed in monetary units, i.e. the implementation of such targets would result in objectively measurable quantities. Grotherr generally identifies especially, the avoidance of double or multiple taxation of cross-border transactions, the avoidance of the taxation of particular tax facts not realized in a market transaction, utilizing the differences in international tax rates, achieve systematic reductions in taxation, and minimize tax-related information and transaction costs, as such quantitative tax-planning targets.834 As to the last target, tax-related information and transaction costs could be minimized, e.g., through the implementation of proper cross-border information sharing and networking or through the establishment of intra-group (intra-holding) tax advising centers, yet, possibilities that will not be discussed any further within this thesis.

As to the avoidance of double or multiple taxation of cross-border transactions, the international tax literature suggests various elements that needed to be secured to achieve such a target. Double (or multiple) taxation in connection with cross-border transactions and facts becomes a question, whenever the participating jurisdictions simultaneously levy a tax claim on the same or on parts of the same tax object. Accordingly, from a tax-planning perspective it is essential that the respective eligibility criteria for a tax exemption in the residence or source state be fulfilled. Furthermore, the responsible management has to make sure that the criteria for possible tax holidays and tax incentives are realized, as well as verifying that all conditions to receive possible tax credits, or avoid excess foreign tax credits and add back taxation are fulfilled.

833 Compare Grotherr, Grundlagen, 2000, p. 10; Streu, Einsatz, 2000, pp. 171 et seq.
Given the assumption that the MNCs in mind operate in various jurisdictions with subsidiaries at different economic levels, another crucial element to avoid or minimize the danger of double taxation, is the attempt to realize a full and timely cross-border tax consolidation, i.e. profit-loss set-off, between the MNC’s levels and entities.835

Several tax-planning targets are attached to the avoidance of the taxation of facts that do not involve a market transaction. Given that, these targets focus on tax facts that are not realized in an open market transaction, but rather under the “closed-shop” circumstances present in holdings or groups of companies, they are of particular interest for this research. An important issue with respect thereto, regularly, is the transfer of assets and equity interests within the holding and the adjacent question, whether such a transaction can be carried out at cost. If such a transfer could not be carried out at cost, i.e. maintaining the carrying amount was not possible, it would trigger tax consequences through a tax-effective dissolution of built-in gains. Further issues in connection thereto, is, for instance, the attempt to avoid turnover taxes from intra-holding transactions, as well as to prevent intra-holding transfers of capital and know-how from triggering income tax by way of a withholding taxation. Another angle, where quantitative tax planning strategies become relevant, is to be seen in association with the attempt of MNCs to gain advantages from utilizing differences in international tax rates. In particular, that can be achieved by carefully assessing the jurisdictions, where to locate an entity and which legal form such an entity should take. Another aspect with respect thereto could be the structuring of the intra-holding delivery and service transactions via the setting of transfer prices and/or the adequate channeling of finance within the holding.836

Quantitative tax planning is further carried out by gaining reduced taxation from taking advantage of systematic differences in separate tax jurisdictions. The international tax law is not unified. Therefore, it offers an array of not only disadvantages, but also of opportunities to reduce tax burdens to internationally operating entities. Often particular facts receive varying tax recognition in different jurisdictions that offer the possibility, for instance, to claim depreciations twice or to set off losses twice. Systematic differences can also be positively facilitated by ways of so called “treaty shopping” and “directive shopping”, where either treaty or directive privileges are being effected by the strategic placing of intermediaries. Not to be forgotten in this context are the different tax treatments of income utilization and

distribution in different countries. The choice of location and the decision to either distribute or retain profits can make a significant difference with respect to the aim to minimize the tax burden and, thus, may make tax arbitrage opportunities become eligible.837

2. Qualitative Tax Planning Targets

Contrary to quantitative tax planning targets, qualitative tax planning targets cannot be measured numerically. However, they complement any profound tax planning strategy. Usually, they are derived from insecurities with regard to the future economic, legal, and political circumstances, as well as from the challenge to prepare the enterprise against the burden of unplanned tax payments. Accordingly, the risk reduction through the implementation of quantitative tax planning targets is achieved by applying tax planning strategies that are as flexible and adaptable as possible. Therefore, such strategies are meant to adapt varying quantitative tax planning strategies into the overall tax-planning targets.838

Flexibility can be categorized with regard to time and to quantitative elements and can be achieved in various ways. Time-related flexibility is achieved, if the strategies considered are not mandatory subject to a specific time or deadline, as often provided for by legal provisions. If the tax planning strategies chosen can be adopted independent of time, i.e. can be pushed forward into the future, more necessary information will be available to exercise the respective strategy adequately. Simultaneously, strategies are to be considered flexible and, thus, favorable, if they allow that the chosen strategy can be revoked at any point in time, without neglecting the possible consequences from revoking a particular strategy.

Quantitative flexibility can be gained, if the underlying strategies allow for a large degree of divisibility or autonomy. If a tax planning strategy is considered divisible, its tax-planning criteria can be adapted to changes in the present circumstances in a better way. The qualitative tax planning strategies are supported by divisibility in a way that such divisibility allows for adopting any quantity from a range of quantities by effecting a particular (tax) accounting valuation option. Additionally, the efficiency of tax planning strategies is supported, if the strategies chosen do not influence each other in a material or timely way.839

837 Compare Endres, Holdingstrukturen, 2003, p. 57; Grotherr, Grundlagen, 2000, p. 11; Günkel, Standortwahl, 2003, pp. 40 et seq.
Correspondingly, qualitative tax planning should closely consider the flexibility of the MNC’s legal structure, when it comes to changes in the income and expenses structure in different states. Furthermore, it is suggested that within the formulation of the tax-planning targets one has to closely assess and implement the continuity and reliability of the laws and legal provisions applicable subject to the jurisdictions chosen for the location of the MNC’s entities and the expansion possibilities with regard to the acquisition of further investments or entities into the holding.  

III. **TAX PLANNING STRATEGIES IN THE PRC**

Discussing the targets of tax planning automatically raises the question, of which particular strategies are available and applicable to realize such targets. Over the years, the international tax literature and tax law and tax management sciences have proposed several possible strategies that are regularly discussed, when it comes to the general scientific discussion of tax planning in connection with holding companies. These strategies are universally applicable as long as their mechanisms and consequences are carefully assessed under the light of the tax jurisdictions actually in question. For this reason, the PRC tax laws, like any other national tax law, also provide several clues for tax-planning considerations, aimed at optimizing the tax burden in the PRC and from cross-border transactions involving Chinese tax liable entities. The establishment of a CHHC results in an additional level of taxation within the MNC’s corporate structure. Therefore, the examination of internationally known tax-planning alternatives available to the China-Holding adopts what the literature calls “repatriation strategies” and “allocation strategies”.

The following chapters will discuss the nature of repatriation and allocation strategies, will further identify particular types of such strategies, and will examine if and how such strategies could be implemented by the MNC and the CHHC. Moreover, the discussion of such strategies is supported by simple quantitative examples.

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1. Repatriation-Strategies

Hierarchically, the CHHC is both subsidiary and parent company at the same time. From a pure Chinese perspective the CHHC forms the top entity of the China-Holding, hence, is the parent company to all its Chinese subsidiaries. However, as soon as the circle is enlarged and the picture is extended to include the entirety of the MNC, the CHHC becomes a subsidiary to either directly the MNC top entity or to any other MNC entity that is hierarchically and from a company law perspective located above the CHHC. Throughout this thesis, it has been concluded that the CHHC is permitted to pursue its own taxable activities on the market and within the holding and, thus, could turn into an income-generating subject.

Repatriation strategies do not change a MNC’s total income, but the structuring of the intra-MNC income transfers. Such changes in the income transfers deliver the clues for tax-planning considerations. Yet, repatriation strategies will only prove to be advantageous, if the inherent implementation of an additional taxation level supports the minimization of the overall tax burden. As the term, “repatriation” suggests, referring strategies aim at finding the most tax-efficient way to “repatriate” certain income from the operative subsidiaries back to the MNC top-entity. The income from the respective subsidiary needs to be made disposable to the entire MNC, i.e. it needs to be channeled back into the universal financing cycle of the MNC. In order to limit reductions in such income through tax payments, it is essential that the establishment of the CHHC supports such a strategy. Any aggregated withholding or enterprise income tax claims arising because of the implementation of the CHHC, therefore, needed to be lower than the tax claims that would arise, if the respective income were directly distributed to the MNC’s top entity. With regard to the structural possibilities, income can either just be de-routed via the CHHC, converted, i.e. the CHHC distributes a kind of income other than the kind it previously has received from a subsidiary, or periodically shielded.\(^\text{841}\)

Usually, depending on the actual tax rates of the involved countries, the tax burden can be reduced by structuring the business transactions between the parties involved in a particular way to achieve a tax-arbitrage effect. By implementing and adjusting contractual agreements, e.g., licensing- or loan-agreements, between the parties involved, it might be possible to reduce the withholding tax burden in the source country in favor of the taxable income in the MNC top-entity’s residence country.\(^\text{842}\) Assuming that repatriation strategies are about to

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\(^\text{842}\) Compare Pfaar, Strukturierung, 2003, p. 693.
identify the most efficient way to eventually repatriate funds to the MNC’s top-entity, there are various ways, where the strategies explained above cannot be regarded individually, but have to be combined in order to derive efficient strategies. Furthermore, such strategies have to be adjusted to fit in with the national particularities of any given jurisdiction. It will be shown that such repatriation strategies are often built on the assumptions, that three countries are involved, one as the seat country of the top-entity, one to locate the initially income-generating subsidiary, and the last as the matching country which hosts the holding company. Now, the basic assumption of this thesis does not include three countries, but only two. The income-generating subsidiary and the holding company are both seated in the same country, the PRC, whereas the MNC’s top-entity operates out of Austria. The combination of these conditions and the particularities of the Chinese tax law and of the ACDTT, however, allow for the facilitation of combined tax planning strategies. Strategies, that involve several elements of the role models introduced and discussed before. An important factor in this context is the applicable tax rates, provided for by the ACDTT.

<table>
<thead>
<tr>
<th>Kind of Income</th>
<th>Dividends</th>
<th>Royalties</th>
<th>Interest</th>
<th>Matching Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Article</td>
<td>Art. 10</td>
<td>Art. 11</td>
<td>Art. 12</td>
<td>Art. 24 no. 2 l. c)</td>
</tr>
<tr>
<td>Tax Rate</td>
<td>- 7% if beneficial owner is company that owns directly at least 25% of the voting shares of the dividend distributing company; - 10% in all other cases.</td>
<td>- 6% in the case of the use, or the right to use industrial, commercial, or scientific equipment; - 10% in all other cases.</td>
<td>- 7% if interest paid to banks or financial institutions; - 10% in all other cases.</td>
<td>- Dividends: 10%; - Interest: 10%; - Royalties: 20%.</td>
</tr>
</tbody>
</table>

Table 14: Tax Rates of the ACDTT

Self-prepared table.
a. Direct Conduit Strategies

Direct conduit strategies imply that income transfers that would normally be channeled directly from active subsidiaries to the MNC top entity - at least according to the model assumed herein - are de-routed via a holding company. The Chinese active subsidiary-FIEs distribute their generated income not directly to the MNC’s top entity, but to the CHHC. The direct conduit of income is considered a useful possibility to achieve the tax-exemption of dividends and capital gains from investments and other assets. Furthermore, such de-routing of income can lead to reductions in the withholding tax burden, if the countries involved in the income transfer have signed favorable double tax treaties and possible directives supporting such structures. Another known tax-planning instrument is the so-called “Credit Mix Shopping”, which aims at facilitating existing but unused excess tax credit potential, in order to reduce excess tax credits within the MNC. De-routing income via a holding could further make sense in cases, where the underlying double tax treaties would allow for a bilateral corporate imputation credit.\(^{844}\) Exemplary, the de-routing of income is displayed in Figure 25 below.

\[\text{Figure 25: Direct Conduit}^{845}\]


i. Participation and Capital Gains Exemption

Inserting a holding company into the income transfer route of a MNC, as displayed in Figure 25 above, would make sense, if such a step reduced the overall income tax and/or withholding tax burden of the MNC as opposed to a direct transfer of income from a subsidiary to the MNC’s top-entity. However, if, because of the provisions set forth in the national tax laws of the MNC’s top-entity, dividend income and capital gains was income tax-exempt anyway, then the insertion of a holding company was pointless from an income tax point of view, once one intended to transfer profits. Based on the underlying assumptions, the MNC’s top-entity as considered in this thesis is located and unlimited corporate tax liable in Austria. According to the Austrian international participation exemption, as manifested in § 10 II aKStG, dividend income and capital gains generated in connection with an international investment are tax-exempt if the Austrian enterprise holds a minimum of 10% in the foreign enterprise’s registered capital for a continuous period of at least one year. Therefore, as long as the Austrian enterprise held at least 10% in the Chinese enterprise, it could generate tax-exempt dividend income from such an investment. Given the capitalization and qualification criteria of FIEs, as per the respective Chinese laws, it can be assumed that an Austrian MNC top-entity would match such a minimum threshold. Moreover, from the Chinese point of view, dividends distributed by FIEs to foreign investors, like the MNC’s top-entity, are also tax-exempt. Given this finding, the establishment of a CHHC with the target to achieve a tax-exemption for dividend income is useless, as dividends distributed by a Chinese FIE to the MNC’s top entity would be tax-exempt anyway. Yet, the insertion of a CHHC simultaneously also does not harm the tax exemption, as the CHHC itself qualifies as a FIE, meaning that it would receive tax-exempt dividends from the Chinese subsidiary-FIEs and subsequently could pass on tax-exempt dividends to the MNC’s top entity itself.

The situation with regard to capital gains, however, is different. Whereas the Austrian tax laws provide for their tax exemption as long as the criteria of § 10 II aKStG are met, the Chinese tax laws set forth that capital gains are taxable under the provisions of the FEITL. Hence, there exist two scenarios for the taxation of capital gains in the PRC. The first scenario, which assumes that a regular Chinese legal person received the capital gains, stipulates that such income was taxable at a rate of 33%, provided no tax incentives or tax

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846 For a more detailed discussion of the Austrian participation exemption please refer to Chapter C.V.1.b.
847 According to Chinese law, a FIE does only qualify as such if it is capitalized at least to a degree of 25% (as of registered capital) by foreign investors. Refer to Chapter B.III.3.b.
848 Compare Art.’s 18, 19 III l. (a) FEITL and MoF/SAT, January 13, 1995.
holidays apply. Contrary thereto, capital gains generated by a FE, e.g., the MNC’s top-entity, directly, would only be subject to a 10%-withholding taxation. Despite the fact that the CHHC qualifies as a Chinese legal person it also qualifies as a FIE and in its particular case also as a foreign-invested “company with an investment nature”. This leads to the double tax personality as discussed in Chapter D.II.2., which causes its investment income to be taxed as if it was a FE, while it other income is taxed under the regular FIE-taxation. The FEITL does not consider capital gains to be investment income and hence the CHHC receiving capital gains from the sale of an investment in a subsidiary-FIE is subject to the general tax rate of 33% as stipulated above, as long as no tax incentives apply. Consequently, it seems that the insertion of a CHHC as a means to reduce the tax burden in connection with capital gains is counter productive. This is further supported by the fact that from a tax point of view the subsidiary-FIEs are equal to the CHHC, which itself qualifies as a FIE. Following the formula of the “NDI”, the quantitative impacts of such scenarios could be expressed as displayed in Figure 26.

For an overview on the tax incentives and tax holidays granted in the PRC refer to Annex I. Compare SC, November 18, 2000; also Chapter D.V.1.d. for a general overview on the taxation of capital gains in the PRC. Art. 19 FEITL. Compare Wang, Besteuerung, 2006, p. 218. Refer to Figure 1. Self-prepared figure.
In the case of the insertion of the CHHC one could assume a withholding tax liability on the distribution of dividends to the Austrian MNC in accordance with the provisions of the ACDTT. Yet, given the fact that both the CHHC and the Austrian MNC are corporations and that Art. 19 III l. (a) FEITL in connection with Art. 18 IRFEITL exempts inter-corporate dividends from withholding tax, no tax liability is realized and the income transfer is tax-exempt. Furthermore, no matching credit as per Art. 24 no. 2 l. c) ACDTT is eligible, because participation exemption related dividends are not subject to the tax credit method, and therefore cannot be fictionally credited. It can be concluded that with regard to the taxation of capital gains the establishment of a CHHC would prove unproductive and would, as per the present example, increase the tax burden by the considerable amount of 23 monetary units.

ii. Non-Applicable Direct Conduit Strategies

Internationally the term “treaty shopping” refers to the attempt to reduce or prevent withholding taxes by choosing countries as locations for holding companies that provide low or zero withholding tax rates opposite the MNC’s top-entity’s seat country. Usually, tax-planning structures developed under the “treaty-shopping-model” include three countries. While the first country is home to the income-generating subsidiary, the MNC’s top-entity is located in a second country, and a third country is chosen as the holding company location based on the target to optimize the income transfer route between the subsidiary and the MNC’s top holding by minimizing withholding taxes. Yet, the present context covers only two jurisdictions, the Austrian and the Chinese. Thus, it cannot be regarded as the stereotype basis for “treaty-shopping-models”. If the general perception of the “treaty-shopping-model” allows for a perception in which the direct conduit of income is effected solely by the fact that a holding company is established but no third country is affected, then it can be considered to examine such a scenario in the light of the present context. However, the word “shopping” implies that a certain double tax treaty is chosen from a particular choice of at least two double tax treaties, hence, it makes no sense to study the “treaty-shopping-model” in this context.

855 Art. 10 ACDTT.
856 Compare Wang, Besteuerung, 2006, p. 47.
858 Notwithstanding anything of the abovementioned, the “treaty-shopping-model” will certainly come into focus when discussing the offshore holding as a possible alternative to the CHHC. Compare thereto Chapter E.III.4.
Another alternative strategy is referred as “Credit-Mix Shopping”, a tax planning strategy based on the attempt to effect not yet used excess tax credits. The rationale behind such strategies is that the application of the double tax avoidance provisions set forth in double tax treaties, e.g. Art. 24 ACDTT, might cause excess tax credits. Hence, credit-mix-strategies aim at pairing dividends from high-tax countries with such from low-tax countries in an intermediary holding, which would be able to set off excess tax credits. Yet, such a strategy presupposes that the intermediary holding is located in a jurisdiction that practices the tax-exemption method for dividends. Again, such strategies usually involve the “shopping” for a third adequate jurisdiction, a condition not realized herein.859

Ultimately, so-called “imputation” strategies are based on the fact that there does not exist an internationally acknowledged unified method on how to proceed with tax credits that have been granted in connection with cross-border transactions. Generally, such strategies would make sense, if the top-entity were not granted a cross-border tax credit from an underlying double tax treaty. The de-routing of dividends may make sense, via a country, which maintains a double tax treaty with a cross-border tax credit with the country of the subsidiary, and a double tax treaty with top-entity’s seat country that allows for the tax-exempt forwarding of the benefits previously received from the tax credit. Eventually, the de facto tax burden of the subsidiary would be reduced resulting in a present value advantage.860 Again, however, as in the former shopping-strategies, the present context does not satisfy the condition that three jurisdictions needed to be included.861

b. Secondary Sheltering Strategies

While the kind of income considered, is maintained in connection with the direct conduit strategies, secondary sheltering of income presupposes that the kind of income is converted into another kind of income. The most commonly known example in this context would probably be the conversion of interest income into dividends. Such a scenario would assume that the holding company grants a loan to its subsidiary, for which it receives interest in return. However, the holding company itself would distribute its profits to the top-entity as dividends. Conditional for such a structure is that the interest income generated by the holding

861 Again reference is made to the chapter discussing the offshore holding alternative, as then a third jurisdiction will be introduced.
China’s Foreign-Invested Holding Company: Taxation and Tax Planning
- A Review with Reference to Austrian Tax Law

company is subject only to a low enterprise income tax or withholding tax, respectively. Moreover, the dividends distributed to the top-entity should be tax-exempt as far as possible. Such a model often involves the location of the holding company in a jurisdiction with favorable tax rates and supporting treaty policy.⁸⁶² Converting kinds of income into royalties or interest, when dividends can be distributed tax-exempt, lacks logic, as supported by Figure 27, but as the next examples show a reverse approach might prove to be advantageous.⁸⁶³ Additionally, the granting of loans from the CHHC to its subsidiaries is limited by the thin capitalization rules as stipulated by the Capital Ratio Tentative Provisions, while the amount of debt capital a CHHC may take on, is subject to the capitalization ratios provided in Art. 9 Holding-Provisions.⁸⁶⁴

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**Figure 27:** Secondary Sheltering: Dividends - Royalties⁸⁶⁵

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⁸⁶³ Compare Figure 30.
⁸⁶⁴ SAIC, March 1, 1987. The PRC government has issued relatively strict equity contribution regulations defining the procedure, timing, and penalties to be taken into account when planning to make financial contributions especially to Chinese-foreign EJVs in the PRC. Yet, these rules are to be applied analogously to CJVs and WFOEs. See hereto: SC (Approval)/MOFTEC and SAIC (promulgation), Supplementary Provisions to the Several Provisions on Capital Contributions by the Parties to Chinese-Foreign Equity Joint Ventures, promulgated on September 29, 1997; SC (Approval)/MOFERT and SAIC (promulgation), Certain Provisions on Contributions by the Parties to Chinese-Foreign Equity Joint Ventures, promulgated on January 1, 1988; also see Chang, Losing Control, 1997, pp. 9 et seq.; Chang, Pay Up, 1988, pp. 9 et seq.; Cohen, Law, 1989, p. 778; Folsom/Minan, Foreign Investment Law, 1989, p.748; Zheng, Wirtschaftsrecht, 1997, p. 177; Zimmerman, China Law, 2004, p. 83.
⁸⁶⁵ Self-prepared figure.
Figure 27 above clearly shows that the combination of the facts that a) dividends may be distributed to investors on a tax-exempt basis, b) that the CHHC is tax-wise treated the same way as the subsidiary-FIE, and c) that the holding company is not located in a third country does not lead to a positive tax effect for this scenario. It rather produces a significant monetary disadvantage of 15 monetary units. Hence, such a strategy of reducing the tax burden by converting dividend-income into royalty-income is not advisable.

However, changing the parameters, i.e. convert royalty income into dividend income, leads to a different result. It is shown that secondary sheltering paired with the insertion of a CHHC can also produce a financially beneficial situation. Following Figures 28 and 29 show that the opposite case to the one portrayed in Figure 27 above, can be advantageous. This advantage originates in the fact that both countries, Austria and the PRC practice an international participation exemption.

An even more advantageous result can be displayed in cases, where interest income is converted by the CHHC into dividend income. In this case the double tax treaty’s matching credit for interest income is less favorable. The NDI of the Austrian MNC is reduced by a further 10 monetary units if such interest income was transferred directly.

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866 Self-prepared figure.
China’s Foreign-Invested Holding Company: Taxation and Tax Planning
- A Review with Reference to Austrian Tax Law

Figure 29: Secondary Sheltering: Interest - Dividends\(^{867}\)

### Primary Sheltering Strategies

Primary sheltering tax planning strategies focus on the shielding of income to interrupt the income transfer route temporarily. Income generated by a subsidiary is not directly allocated to the MNC top-entity, but collected by the holding company for a certain period. Such strategies suppose that the shielding of income over time would cause tax present value advantages as opposed to a direct income allocation. The intermediary entity, i.e. the holding company, receives such income and reinvests it in accordance with the overall tax planning strategies. Such strategies are especially interesting, if the top-entity is seated in a country that practices the tax credit method as a means to avoid double taxation and, if there exist differences between the applicable tax rates. Accordingly, if the tax rates are higher in the top-entity’s residence country than in the subsidiary’s residence country, such primary sheltering of income can postpone the ultimate taxation that would be due at the higher tax rate. While contrary thereto, a lower taxation in the top-entity’s residence country would cause a definite taxation due to the excess tax credit, a situation that could be deferred by shielding the income from such consequences.\(^{868}\) The primary sheltering of income would lead to a lower tax

\(^{867}\) Self-prepared figure.

present value, if during the time the income was shielded, the amount of such income could be invested in a way that over-compensated the immediate cash-outflow that would be caused if the income was allocated to the top-entity directly and, hence, was taxed directly. Moreover, the primary sheltering of income allows the entities involved to reconsider their assessments and to adjust their respective strategies adequately. As shown in Figure 30, primary sheltering strategies are also flexible to the extent that they can be easily combined with other of the abovementioned strategies.

![Diagram of primary sheltering strategies](image)

**Figure 30: Primary Sheltering**

### 2. Allocation-Strategies

Other than in the case of repatriation strategies, allocation strategies aim at using the holding company as a genuine income-generating object, i.e. income potential is “allocated” to the CHHC on purpose. Hence, such strategies focus on influencing the MNC-external income transfer. The amount of the MNC’s total income does not change, but one can influence the scope of tax liable income. Such strategies are deemed reasonable, if the allocation of income to the holding company causes a reduction of the overall tax burden. Depending on whether such income is shifted upwards or downwards within the hierarchy of the MNC, one distinguishes between “top-down” and “bottom-up strategies”.

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a. **Top-Down Strategies**

The term “*top-down*” suggests that the realization of income is shifted from a hierarchically higher ranked entity to a hierarchically lower ranked entity. In the present context it could be assumed that the event of realizing certain income is moved from the MNC top-entity to the CHHC. Consequently, the MNC top-entity will no longer be the direct recipient of income distributed by a subsidiary-FIE, but the CHHC. Only such income parts can be made subject to top-down strategies that are economically directly attributable to the investment in the said subsidiary, i.e. tax-effective elements that influence the accounting of the investment are moved from the top-entity’s financial statement to the holding company’s financial statement, a move that includes the investment as a financial statement item itself, too. Thus, top-down strategies regularly attach to issues affecting the accounting of investments and, hence, implied tax consequences. Generally, such issues would cover the valuation and impairment of the investment, especially fair value write-downs and goodwill amortizations, the realization of capital gains or losses, as well as the allocation of investment-related expenses, as shown in Figure 31. Moreover, one has to examine, whether the movement of assets from the financial statement of the top-entity to the holding company’s financial statement produces any tax consequences, i.e. the realization of built-in gains, or if such a move can be carried out in a tax-neutral way, i.e. the underlying investment can be transferred at cost. Accordingly, what often is referred to as “*deduction shopping*” would be a typical example of a top-down strategy. The target of “*deduction shopping*” is finding an appropriate way to circumvent, e.g., the limitation of deduction allowances and the disallowance to deduct fair value write-downs or other investment-related expenses. Generally, such a strategy would only prove efficient if the holding company itself generated enough positive income to set-off any pushed down negative income tax-efficiently. In any event, the focus of such strategies is aimed at the tax consequences for the top-entity. Hence, the top-entity might want to realize in a second step the effects caused by, e.g., the write-down or loss set-off that was taken out at the level of the holding company. However, according to the findings concluded herein, the “*Gruppenbesteuerung*” rules that while losses from the CHHC can be imported, the deductibility of fair value write-downs is, if not prohibited, at least limited. An example could be modeled as displayed in Figures 32 and 33.

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871 Compare Shelton/De Petter, Holding Companies I, 1991, p. 70; Snowden, Comparison, 1994, pp. 139 et seq.
873 Compare Kessler, Holdinggesellschaften, 2000, pp. 205 et seq.
874 Compare § 9 VI no. 6, VII aKStG.
The above given example shall refer to a situation, where there is a choice of either including the Chinese subsidiary-FIE directly into the group or alternatively include the CHHC instead of the subsidiary-FIE. The “Gruppenbesteuerung” generally allows for the allocation of the losses of the first-tier foreign subsidiary for the purposes of computing the group’s taxable income. Accordingly, the Austrian top-entity is able to consider any losses produced by the Chinese subsidiary when computing its taxable income. However, according to the systematic of the “Gruppenbesteuerung” fair value write-downs on investments should not be possible.\(^{876}\) It might initially be considered that inserting a CHHC between the top-entity and the subsidiary-FIE would change the situation to the better. However, as the Chinese tax law does not know a group-relief regime allowing for any kind of tax consolidation, the genuine losses produced by the subsidiary-FIE cannot be set-off against other income at the level of the CHHC. Losses genuinely incurred by the CHHC as a result of its business operations obviously remain allocatable into an Austrian group. In addition, thereto, the Chinese tax laws just provide a limited range for tax-effective adaptations of changes in an investment’s

\(^{875}\) Self-prepared figure.
valuation. The CHHC, in accordance with the Reorganization-Provisions\(^\text{877}\), may adjust the tax-relevant values of its investments in accordance with either the “asset-by-asset method” or the “comprehensive adjustment method”. If the “asset-by-asset method” was used, the CHHC would report a write-down amount equal to the balance between the carrying amount of the former year and the present accounting period’s impaired amount of the single given asset. Given that the value of the investments appreciates in any following period a respective write-up would have to be reported tax-efficiently.\(^\text{878}\) Contrary to the asset-by-asset approach the CHHC could also effect the “comprehensive adjustment method”. In accordance with this method, the CHHC would adjust commercial write-downs through equal installments over a ten-year period.\(^\text{879}\)

<table>
<thead>
<tr>
<th>Loss Allocation from Subsidiary-FIE:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Pre-tax Income of MNC before Loss Allocation</td>
<td>100</td>
</tr>
<tr>
<td>/ Loss Allocation from Subsidiary-FIE</td>
<td>/ .35</td>
</tr>
<tr>
<td>= Taxable Income of MNC in Austria</td>
<td>65</td>
</tr>
<tr>
<td>/ Austrian Corporate Income Tax</td>
<td>/ .16.25</td>
</tr>
<tr>
<td>+/- Loss Allocation Cash Effect</td>
<td>35</td>
</tr>
<tr>
<td>= Net Distributable Income of Austrian MNC</td>
<td>83.75</td>
</tr>
</tbody>
</table>

FIGURE 32: TOP-DOWN STRATEGY - A QUANTITATIVE EXAMPLE (I)\(^\text{880}\)

From Figure 32 it can be concluded that, indeed, the scenario that excludes the CHHC appears to be financially more advantageous, as it allows for the consolidation of the subsidiary-FIE’s taxable results. Such consolidation has a direct cash advantage to the MNC, provided, that the MNC be not legally or contractually forced to set-off any losses produced by the subsidiary-FIE immediately. Once the CHHC is included into the considerations, the allocation of losses

\(^{877}\) Compare Chapter D.II.8.

\(^{878}\) Compare Art. 1 no. 1 (1) Reorganization-Provisions.

\(^{879}\) Compare Art. 1 no. 1 (2) Reorganization-Provisions.

\(^{880}\) Self-prepared figure.
falls short, because there exists no legal foundation that allows the CHHC to consolidate the subsidiary-FIE’s tax results. Not only, that the negative results produced in the PRC cannot be set-off nationally, they furthermore do not enter the cross-border income flow, as the CHHC cannot pass on a loss its was not allowed to consolidate and simultaneously the Austrian MNC top-entity is not allowed to carry out a fair value write down on its investment in the CHHC. Notwithstanding these findings, the CHHC may still report an operating loss subject to its genuine business activities, a loss that would be eligible to the rules of the “Gruppenbesteuerung” subject to the qualification of the CHHC as a group member. Moreover, the CHHC may be required to perform a tax-effective fair value write down on its Chinese investments.

From these findings, one could conclude that it might be reasonable not to include the Chinese operations into the group in the sense of the “Gruppenbesteuerung”. Assuming that the CHHC was not included into the group, but held as a non-group investment, § 6 no. 2a aEStG in connection with § 12 III aKStG hold that decreases in fair value can be annually written down at the scope of one seventh of the amount of the decrease in value. Despite the immediate cash advantage produced by such a write-down the overall NDI would still be less than in the “Gruppenbesteuerungs”-case. The allowance of the “Gruppenbesteuerung” to set off the entire loss at once produces an advantage in the given example of five monetary units.

<table>
<thead>
<tr>
<th>Pre-tax Income of CHHC</th>
<th>10</th>
</tr>
</thead>
<tbody>
<tr>
<td>/ Write-down on FIE investment</td>
<td>./. 35</td>
</tr>
<tr>
<td>= Taxable income of CHHC</td>
<td>./. 25</td>
</tr>
</tbody>
</table>

Loss Allocation from CHHC:

<table>
<thead>
<tr>
<th>Pre-tax Income of MNC before Loss Allocation</th>
<th>100</th>
</tr>
</thead>
<tbody>
<tr>
<td>/ Loss Allocation from CHH</td>
<td>./. 25</td>
</tr>
<tr>
<td>= Taxable Income of MNC in Austria</td>
<td>75</td>
</tr>
<tr>
<td>/ Austrian Corporate Income Tax</td>
<td>./. 18.75</td>
</tr>
<tr>
<td>/ / Loss Allocation Cash Effect</td>
<td>25</td>
</tr>
<tr>
<td>= Net Distributable Income of Austrian MNC</td>
<td>81.25</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Pre-tax Income of CHHC</th>
<th>10</th>
</tr>
</thead>
<tbody>
<tr>
<td>/ Write-down on FIE investment</td>
<td>./. 35</td>
</tr>
<tr>
<td>= Taxable income of CHHC</td>
<td>./. 25</td>
</tr>
</tbody>
</table>

Write-down on CHHC-investment:

<table>
<thead>
<tr>
<th>Pre-tax Income of MNC before Write-down</th>
<th>100</th>
</tr>
</thead>
<tbody>
<tr>
<td>/ Write-down on CHHC investment</td>
<td>./. 5</td>
</tr>
<tr>
<td>= Taxable Income of MNC in Austria</td>
<td>95</td>
</tr>
<tr>
<td>/ Austrian Corporate Income Tax</td>
<td>./. 23.75</td>
</tr>
<tr>
<td>/ / Write-down Cash Effect</td>
<td>5</td>
</tr>
<tr>
<td>= Net Distributable Income of Austrian MNC</td>
<td>76.25</td>
</tr>
</tbody>
</table>

Figure 35: Top-down Strategy - A Quantitative Example (II)\(^{881}\)

\(^{881}\) Self-prepared figure.
Generally, such strategies tend to make financial sense, if there are differences in income taxation between the tax law of the top-entity’s residence country and the holding company’s residence country. In the given context, therefore, a) the Chinese tax law would have to provide preferential tax provisions compared to the Austrian tax law, b) a preferential solution was not be achieved in Austria, and c) in case of the push-down of losses or write-downs to the level of the China-Holding, there had to exist a sufficient income set-off potential. However, the push-down of negative income or losses to an intermediary holding company is only reasonable, if the top-entity is subject to a far-reaching deduction disallowance and the holding company simultaneously receives positive income against which it can set-off any negative income.882

In cases, where the provisions of the “Gruppenbesteuerung” do not apply, § 6 no. 2a aESStG in connection with § 12 III aKStG rule the tax treatment of changes in the valuation of investments. As per § 6 no. 2a aESStG, investments are to be valued at their acquisition cost and decreases in value have to be taken into account by way of a fair value write-down. Yet, such a general rule might be subject to the limitations set forth by § 12 III aKStG, which rules that income distribution induced fair value write-downs and income distribution induced losses, referring to investments as defined in § 10 aKStG, may not be deducted.883 Subject to these conditions a push-down would make sense, if the Chinese tax laws allowed for a corresponding tax treatment and the allowance of a deduction of the investment’s losses, as well as a tax consolidation of such negative income with its other positive income. Chapter D.II.4. shows that the Chinese tax laws do not contain any form of tax consolidation concept and, thus, the setting-off of incomes from various subsidiary-FIEs among each other and against its own income is not possible for the CHHC. As to the Chinese tax treatment of fair value write-downs, besides being regulated vaguely884, reference can be made to the rules set forth in connection with the tax provisions governing the reorganizations of corporate structures in the PRC.885 These provisions set forth that once the original carrying amounts of investments have been appraised within the commercial financial statement, such changes are not to be considered as immediately tax-effective. For tax purposes the corresponding depreciation or amortization based on such adjusted fair values have to be reversed either on an “asset-by-asset basis” according to the actual circumstances or by way of “comprehensive

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883 Compare Chapter C.V.3.a.ii.!
884 Refer to Chapter D.II.7.a.ii.!
885 Generally, compare hereto the Reorganization-Provisions.
adjustment”. In any event, the Chinese tax laws provide for a tax-effective recognition of changes in the valuation of investments. If one could produce a connection between the facts, that a subsidiary-FIE is making losses and that such losses might be incurred due to circumstances, which simultaneously cause the CHHC to effect a write-down on the value of the given investments, the negative income from the losses actually could find entrance into the CHHC’s financial statement. Depending on the acceptance of the competent Chinese tax authorities, the CHHC may subsequently adjust such commercial write-downs in its tax financial statement. It is even possible that, if the “asset-by-asset method” was made eligible that the written down amount exceeded that of the actual loss of the given period. Therefore, one can ultimately conclude that the consideration, whether an income push-down is reasonable for tax purposes has to be closely assessed on a case-by-case basis. Hence, it may make sense to exclude the income from a subsidiary-FIE from the group, in cases, where the management anticipates that a larger write-down on a given investment has to be effected and that one can count on being eligible to tax-effectively realize such a write-down at the level of the CHHC. However, in such a scenario it has to be borne in mind that in Austria the MNC will only be able to consider such write down over the period of seven years and, hence, present value calculations have to prove, whether the immediate set-off of losses or the periodical reporting of write-downs is more advantageous in the given case.

b. Bottom-Up Strategies

The opposite of top-down strategies, bottom-up strategies are the second category of allocation strategies used in tax planning. The idea behind them is that the income-realizing event is transferred from the subsidiary to the holding company. However, such a transfer of income can only be facilitated based on a specific legal foundation. Usually, such a legal foundation is represented by the existence of particular group-relief regimes that provide for the possibility of setting-off the incomes of subsidiaries among each other and eventually with the holding company’s income.886

The examination of the taxation of the China-Holding, however, has proven that the Chinese tax laws do not provide a particular group-relief regime or any other possibilities to set off the incomes of legally independent FIEs. Contrary thereto, the Austrian corporate income tax law contains § 9 aKStG, which sets forth the “Gruppenbesteuerung” as the Austrian form of a

group-relief regime. Within the ruling of the “Gruppenbesteuerung” it is even stipulated that cross-border losses could be set off.887 Yet, the facts, as considered within this thesis, focus on the taxation of the China-Holding. If bottom-up strategies were to be considered than the “Gruppenbesteuerung” would only gain any relevant tax effect, if the subsidiary-FIEs’ income could be channeled up via the CHHC to the Austrian MNC top-entity in order to create set-off potential at the level of the top-entity. Notwithstanding the possibility that such a move might be possible from the “Gruppenbesteuerung” point of view, e.g. via cross-over cascades as suggested by Stefaner/Weninger888, the insertion of a CHHC would, nonetheless, not be supportive from a tax point of view, as its legal qualification is identical to that of the subsidiary-FIE. Hence, in order to gain access to the set-off-potential of the subsidiary-FIEs’ income, such subsidiaries could be directly made group members without initiating a complex cascade-like structure. However, it should be noted that the insertion of a CHHC might, nonetheless, be reasonable for overall economic rationales reaching beyond those of the tax perspective.

3. Clues for Tax Planning in the PRC

The discussion of the internationally known tax-planning framework and strategies have shown that in many cases the implementation of such strategies do not necessarily produce beneficial results. The reasons for such a finding originate in the particularities of the Chinese and Austrian tax laws and provisions. Obviously, it also has to be considered that the repatriation and allocation strategies introduced often only present clues for corporate decision makers to locate the areas where specified strategies could be implemented. A striking element of the finding that such known tax planning strategies altogether appear to be of limited use is the fact that the Chinese tax law does not provide for a tax consolidation mechanism at all. Therefore, the basis for tax-planning considerations does not seem to be too promising. However, given the abovementioned, several peculiarities of Chinese law in general and Chinese tax law in particular, there remain several facts and clues that demand for a closer consideration from a tax-planning point of view.

The thesis has so far discussed an array of different tax facts and events that are deemed to be of interest in a tax-planning context. Several specific areas of interest have been identified. Corporate reorganizations, e.g., affect the economic life cycle of a holding to a large degree

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887 § 9 VI no. 6 aKStG.
888 Compare Stefaner/Weninger, Cross-Over Kaskaden, 2005, pp. 133 et seq.
and the tax consequences of such reorganizations can be both severe, but also beneficial. More than once this thesis has mentioned the vast variety of tax incentives and tax holidays available to qualifying FIEs. Given the existence of such incentives and the fact that they are linked to particular conditions, suggest that there might be fields that allow for the implementation of tax planning strategies. Subject to the shattered and often confusing Chinese tax system, the proper handling of tax administrative issues is deemed fundamental, as infringements thereof may have severe financial consequences. Moreover, the application for tax incentives, as well as a solid compliance with the respective underlying laws gains tax-planning importance not only individually, but also in combination with corporate reorganization measures. It is not too far fetched, to imagine that the option to either account for a particular fact or not, or to have the option of several valuation approaches to evaluate a fact confront the taxpayer with a choice. Having a choice is considered advantageous as it increases the flexibility of tax planning.

The following chapters, therefore, will exemplatorily examine, if and to what extent, there exist clues for concrete tax planning strategies. Despite of the differentiation of the following remarks into separate chapters, the borderlines between these chapters are often fluent. Hence, it is important to understand that tax planning strategies are to be considered cumulatively and not in a strict individual context, in order to a) receive a holistic overview and b) to reach the highest flexibility possible.

a. Corporate Reorganization

i. Enterprise Income Tax

The lack of a group-relief regime and the existence of potentially significant losses can cause significant financial consequences for the CHHC and eventually also for the entire MNC. Therefore, the tax planners of the CHHC and of the MNC need to find appropriate ways that, nonetheless, allow for a tax-effective utilization of the existing losses. One could assume that the Reorganization-Provisions could hold clues for adequate strategies. Art. 1 II no. 4 Reorganization-Provisions, e.g., rules that operating losses incurred by a pre-merger entity may be offset on a continuous basis by the post-merger enterprise subject to the
provisions set forth in Art. 11 s. 2 FEITL.\textsuperscript{889} Accordingly, from a tax-planning point of view, it could be advisable to merge a loss-making entity with a profit-making entity, suggesting that the post-merger enterprise would be able to set-off the losses previously generated by the pre-merger loss-making enterprise. The profit-making entity could be either another subsidiary or even the CHHC itself.\textsuperscript{890} However, the Reorganization-Provisions do not provide for the preparation of a single consolidated income statement, but rather rule that the total amount of income is to be differentiated and allocated subject to one of two methods.\textsuperscript{891} Either the pre-merger enterprises continue to be identifiable as two separate permanent establishments operating under the legal roof of the post-merger enterprise, or no such two separate permanent establishments can be identified. In the latter case, however, the Reorganization-Provisions fake a situation, which assumes the existence of two separate permanent establishments and income is allocated to each of such artistically created permanent establishments by way of averages and proportions.\textsuperscript{892} Given that Art. 1 II no. 5 Reorganization-Provisions grants permanent establishment status to the pre-merger enterprises, their respective income can be made subject to Art.’s 89, 93 IRFEITL. According to Art.’s 89, 93 IRFEITL, a FIE, the post-merger enterprise, can, where it has set up two or more permanent establishments or branches, designate one of such permanent establishments or branches to file returns and pay enterprise income tax on a combined basis.

\textsuperscript{890} Compare Pfäar, Strukturierung, 2003, p. 697.
\textsuperscript{891} Art. 1 II no. 5 Reorganization-Provisions.
\textsuperscript{892} As to these methods refer to Chapter D.II.8.a.
According to the example provided in Figure 34, the post-merger scenario would produce a financial advantage of 16.5 monetary units. Actually, the preferable situation results from the amount saved in Chinese enterprise income tax payable because of the consolidation of the incomes of the pre-merger enterprises, which in the post-merger situation are qualified as separate permanent establishments. Strategies similar to those explained in relation to corporate mergers above can be structured in connection with corporate splits, too. One scenario, e.g., could be that in a first step a profitable permanent establishment or other profitable entity is split-off from an existing subsidiary-FIE and in a second step merged with a loss-making subsidiary-FIE, utilizing the same mechanisms as in the corporate merger context.

An additional tax-planning issue in connection with corporate reorganizations would be a continuous eligibility to tax incentives by the post-reorganization entity. According to the Reorganization-Provisions, tax incentives granted to pre-reorganization entities might still be used after completion of the corporate reorganization. Conditional for such an ongoing eligibility to tax incentives is that the eligibility criteria, that originally made the incentives available, are still in place and have not yet expired. Hence, the tax planners involved have to

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893 Self-prepared figure.
894 Art. 2 II no. 3 Reorganization-Provisions.
be alert as to the different tax incentives utilized by the pre-reorganization entities and to which extent they continue to be available after the corporate reorganization. The extreme, but simple example of Figure 35 shall briefly outline the significantly disadvantageous consequences that can result if the compliance with the rules is carried out insufficiently.

The above case shows a scenario, where two subsidiary-FIEs are merged. Before the merger, subsidiary-FIE 1 was located in a special economic zone, which made it eligible to a 15%-tax rate instead of the common tax rate of 33%. Subsidiary-FIE 2, on its part, was granted a production-related tax incentive that provided for a two-year federal tax-exemption for the first two profit-making years, resulting in a net tax burden of 3%. Yet, the production-related tax incentive was attached to, among others, the condition that the minimum term of operation would not be less than 10 years and if it fell below such term, previously granted tax incentives had to be repaid in accordance with Art. 8 I s. 3 FEITL. The post-merger enterprise does not fulfill the requirements as laid out in Art. 1 II no. 2 Reorganization-Provisions and, hence, is not entitled to a continuous use of the tax incentives as previously granted to the pre-merger subsidiary-FIEs. According to the example, the post-merger enterprise is not only suddenly subject to the regular tax rate of 33%, instead of 15%, but it is

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895 Self-prepared figure.
896 Art. 7 I FEITL in connection with Art.’s 68, 69, 71 I, 72 IRFEITL.
897 Art. 8 I FEITL in connection with Art. 74 IRFEITL.
also liable to repay the benefit previously received out of the production-related tax incentive (the example assumes that such an incentive has been granted for the two years previous to the merger). The given example, which on purpose portrays an extreme situation, would result in a financial disadvantage equal to massive 108 monetary units.

ii. Turnover Taxes

Beyond the enterprise income tax scope, corporate reorganizations might have to be closely considered from a turnover tax point of view, as particular transactions might trigger VAT and Business Tax consequences, respectively. In Chapters D.IV.1. and D.IV.2. it has been concluded that asset transfers and equity reorganizations could under certain circumstances be subject to VAT and/or Business Tax. VAT is levied in the case of asset transfers, i.e. asset deals\(^{898}\), if the transferred assets include tangible movable assets, or if a transferred equity interest relates to a previous contribution in kind.\(^{899}\) VAT would be levied on the historic acquisition cost of the tangible movable assets transferred, but not on the entire transfer price. The individually applicable VAT tax rate depends on the qualification of the transferred tangible assets, as per Art. 2 VAT-Regulations. Ultimately, however, from the selling party’s point of view its overall VAT-tax burden on such tangible movable assets would be equalized.\(^{900}\) In course of the transfer, the selling party would charge the acquiring-party a price including VAT. Hence, the selling party would be able to set-off the VAT initially paid, when such assets were first acquired, against the VAT received from the subsequent sale of the assets and the buyer would carry the VAT-tax burden. Thus, an asset transfer, involving tangible assets, implies a conflict between the selling-party and the acquiring party. The selling entity would regard an asset deal as advantageous as the sale-price would compensate for previously paid VAT. Contrary thereto, the buyer is generally interested to pay as little of an acquisition price as possible.

\(^{898}\) The enterprise income tax consequences of asset transfers are ruled by Art. 4 Reorganization-Provisions.

\(^{899}\) Compare hereto also Chapter D.IV.1.

\(^{900}\) Compare Howson/Li, Holding Companies, 1998, p. 11.
VAT certainly is to be considered a price-increasing factor. From a tax-planning point of view, the buyer, therefore, might prefer to effect the acquisition of the target entity by different means than an asset transfer, in order to circumvent possible VAT claims, e.g. pursuing an acquisition via a share deal. An example, which suggests that the assets transferred are solely tangible movable assets, the VAT tax rate is 17%, and the assets were transferred at an implied capital gain of 50, is laid out in Figure 36 below.

<table>
<thead>
<tr>
<th>Seller-side:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross transaction price</td>
<td>117</td>
</tr>
<tr>
<td>VAT payable</td>
<td>17</td>
</tr>
<tr>
<td>Assets’ aggregated carrying amounts</td>
<td>.50</td>
</tr>
<tr>
<td>= FIE 1 Taxable income (= capital gains)</td>
<td>50</td>
</tr>
<tr>
<td>Enterprise income tax (33%)</td>
<td>.16.5</td>
</tr>
<tr>
<td>+ Carrying amount cash effect</td>
<td>+ 50</td>
</tr>
<tr>
<td>+ VAT input credit</td>
<td>+ 8.5</td>
</tr>
<tr>
<td>= Net distributable Income of FIE 1</td>
<td>92</td>
</tr>
</tbody>
</table>

Buyer-side:
| Net transaction price | 100 |
| VAT on tangible movable assets (17%) | + 17 |
| = Gross transaction price payable by CHHC | 117 |

<table>
<thead>
<tr>
<th>Seller-side:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross transaction price</td>
<td>100</td>
</tr>
<tr>
<td>VAT payable (17%)</td>
<td>0</td>
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<td>Shares’ aggregated carrying amounts</td>
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<tr>
<td>= FIE 1 Taxable income (= capital gains)</td>
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</tr>
<tr>
<td>+ Carrying amount cash effect</td>
<td>+ 50</td>
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<tr>
<td>+ VAT input credit</td>
<td>+ 0</td>
</tr>
<tr>
<td>= Net distributable income of FIE 1</td>
<td>83.5</td>
</tr>
</tbody>
</table>

Buyer-side:
| Net transaction price | 100 |
| VAT on tangible movable assets (17%) | + 0 |
| = Gross transaction price payable by CHHC | 100 |

Figure 36: Corporate Reorganization and VAT

In case of an asset deal, the seller would generate a NDI of 92 monetary units and the buyer had to pay an accumulated transaction price of 117 monetary units. Contrary thereto, a share deal might produce a different result. The example given above, assumes that instead of transferring the tangible assets, equity interests could be transferred that were not initially funded through a tangible-asset based contribution in kind. The amount available to the seller would decrease by 8.5 monetary units, i.e. the reimbursement of the VAT input credit, and the price to be paid by the buyer would be, net of VAT, 100 monetary units. However, a more concrete statement would be subject to the facts and events applicable in the respective underlying case. The tax-planning conclusion, thus, depends on which side of the transfer, the

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901 Self-prepared figure.
902 The author is aware that the term “NDI” might be confusing in a context, where the sale of an item is discussed. The “NDI” shall, therefore, not equal the “profit” a seller might generate from the sale of the underlying item.
tax planner is situated and on the compilation of the respective asset base that is being transferred. It is also clear that if the equity interests transferred during a share deal were based on tangible-asset based contributions VAT would become due, nonetheless.

Corporate reorganizations may not only cause VAT-consequences, but may also found a Business Tax liability.903 Interests and investments in corporations can be established either by way of cash contributions or by way of contributions in kind. Even though the transfer or assignment of equity interests or investments usually is not subject to Business Tax, the transfer or assignment of equity interests or investments established through a contribution in kind is subject to Business Tax, if the contribution in kind was effected through the contribution of intangible assets and/or fixed assets. Comparable to the VAT-situation, the buyer would be paying the Business Tax by paying an acquisition price that included Business Tax. However, contrary to the VAT-situation, the seller would not be able to claim a Business Tax input credit so that previously paid Business Tax was refunded. Business Tax is paid cumulatively each time a taxable event is realized and the recipient of the price acts a collecting agent for the Chinese government. Hence, it is advisable to assess closely, whether the equity interests or investments transferred result from contributions in kind that might trigger a Business Tax liability. In analogy to the discussion of a possible VAT-liability, Business Tax obviously is also due in cases of asset transfers, when such transfers cover intangible assets and/or fixed assets. A simplified example is given in Figure 37. It should be noted that the Business Tax burden portrayed in connection with a share deal might only attach to that stake of the traded enterprise’s capital that was made up by contributions in kind.904 The example assumes that 20%905 of the traded entity’s capital was made up by intangibles and, hence, are subject to Business Tax.

903 The enterprise income tax consequences of equity reorganizations are ruled by Art. 3 Reorganization-Provisions.
904 Compare Howson/Li, Holding Companies, 1998, p. 11.
905 In Chapter B.III.3.b. it has been discussed that the maximum threshold for non cash contributions to FIEs is 20%. Compare hereto also Art. 27 II WFOE-Rules.
From a tax-planning point of view, the essence, with regard to quantifying the tax consequences from possible VAT- and Business Tax liabilities occurring in connection with corporate reorganizations, would be to assess the respective clue for a potential tax liability in detail. Thus, if the calculations would suggest that the VAT payable by the buyer in course of an asset deal were severe and possibly preventing from a transaction to happen, it should be considered if the results of such a transaction could not be achieved by an alternative way, too. Accordingly, a share deal may not be the ideal alternative for a corporate reorganization, if it caused a definite Business Tax tax burden.

Finally, the asset base and the situation of how equity interests were initially funded might also confront the parties with a situation, in which the asset deal scenario would cause a VAT-liability, while the share deal scenario would result in a Business Tax liability. The tax planners would then have to compute, which alternative was beneficial. However, the reality of the transaction may of course demand to effect a transaction that from a mere tax-planning point of view might not be regarded as beneficial.

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906 Self-prepared figure.
b. Tax Incentives and Tax Holidays

How tax incentives and tax holidays can be utilized for tax-planning intentions has already been shown in connection with corporate reorganization matters. Yet, as the current Chinese tax laws offer such a vast variety of tax incentives and tax holidays their importance for tax planning is undisputable. It has been concluded that tax-planning strategies need to be flexible in their application so that a combination of direct conduit, primary and secondary sheltering tax planning strategies becomes feasible.\(^{907}\) Pairing such strategies with the tax incentives offered by the Chinese tax laws could offer interesting alternatives. A comprehensive overview on the separate tax incentives and tax holidays currently effective is given in Annex I. To stress the importance of a proper tax incentive management and anticipation in connection with the preparation of tax planning strategies, the reinvestment tax refund, as stipulated by Art. 10 FEITL and Art.'s 80, 81, 82 IRFEITL, shall be invoked examplatorily. Art. 10 FEITL holds, that if the foreign investor of a FIE, i.e. the CHHC, directly reinvests the dividends received, back into such a FIE to increase such FIE’s registered capital or uses the same as capital investment for the establishment of another FIE, the foreign investor shall receive a tax refund. Such tax refund is subject to the approval by the tax authorities. As per the wording of Art. 10 FEITL, the refund equals 40% of the enterprise income tax already paid, i.e. the refund is granted to the CHHC on enterprise income tax paid by the subsidiary-FIE. Yet, as per Art. 82 IRFEITL, the tax refund amount is calculated in accordance with the following formula:

\[
\text{Tax Refund} = \left(\text{reinvested amount} \times \frac{1}{\text{The sum of the original applicable Enterprise Income Tax and local income tax rates actually applied}}\right) \times \text{the original applicable Enterprise Income Tax rate} \times \text{the refund rate}
\]

\[\text{Figure 38: Tax Refund Formula}^{908}\]

\(^{907}\) Compare Kessler, Holdinggesellschaften, 2000, p. 200.

\(^{908}\) Self-prepared figure.
The systematic of the reinvestment refund is illustrated in Figure 39. According to an administrative order from 2002 such reinvestment tax refunds can be further extended to a refund equal to 100% of the previously paid enterprise income tax, if the dividend-distributing FIE is granted the status of being “technologically advanced” by the relevant authorities.  

However, if the term of operation is shorter than five years, i.e. the reinvestment is withdrawn within five years, the refunded tax shall be paid back. The impact of the reinvestment tax refund in combination with a direct-conduit-strategy is illustrated in Tables 15a, 15b, and 15c below. Three scenarios are presented, all of which assume a six-year investment period.

In the first scenario – Table 15a – the subsidiary-FIE receives taxable market income that presumably is subject to 33% enterprise income tax. The subsidiary-FIE subsequently distributes the remaining net income as dividends to the CHHC. Such dividends shall be the CHHC’s sole income and it further distributes such dividend income as dividends to the MNC top-entity. The distribution of dividends from a Chinese FIE to a foreign investor is tax-exempt in the PRC, as well as the collection of such dividends is tax-exempt in Austria. The gross amount of the dividends distributed by the CHHC equals the “NDI” of the Austrian MNC’s top-entity. Hence, according to the linear assumptions of scenario 1, the CHHC

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910 Self-prepared figure.
annually distributes dividends worth 67 monetary units, or over the six-years period an aggregated amount of 402 monetary units.

<table>
<thead>
<tr>
<th>Scenario 1 : No reinvestment refund</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td>Sub. Taxable Income</td>
</tr>
<tr>
<td>(./.) Enterprise Income Tax</td>
</tr>
<tr>
<td>(−) Sub. Net Income</td>
</tr>
<tr>
<td>(−) Dividends distributed</td>
</tr>
<tr>
<td>(./.) Dividend Withholding Tax</td>
</tr>
<tr>
<td>(+) Reinvestment Tax Refund</td>
</tr>
<tr>
<td>(−) CHHC Net Income</td>
</tr>
<tr>
<td>Dividends Distributed</td>
</tr>
<tr>
<td>(./.) Dividend Withholding Tax</td>
</tr>
<tr>
<td>(./.) Austrian Corporate Tax</td>
</tr>
<tr>
<td>(+) Creditable Withhold. Tax</td>
</tr>
<tr>
<td>(+/./.) Double Tax Treaty Effect</td>
</tr>
<tr>
<td>(=) NDI</td>
</tr>
</tbody>
</table>

Table 15a: The Reinvestment Tax Refund - Scenario 1

As to the second scenario, the CHHC does not distribute its income received in year 1 as dividends to the MNC’s top-entity. Rather, it reinvests such amount back into the registered capital of the subsidiary and in turn receives a tax refund in year 2. The income generated in the PRC is retained within the financial cycle of the China-Holding, but is not made accessible to the MNC. Hence, from the MNC’s point of view, such a strategy would only make financial sense, if the reinvestment of income would result in an increase in future income that that then could be distributed to the MNC. However, the increase in income in future periods plus the tax-refund must over-compensate the financial disadvantage of not-distributing income in year 1. Therefore, it could be assumed that the application for such a tax refund is only filed, once the management is convinced that the reinvestment leads to increases in productivity and/or efficiency, thus ultimately to increased future income, which would justify the present non-distribution of income. The example in scenario 2 suggests an annual growth of income of 8%.

911 Self-prepared table.
### Scenario 2: Grant of 40% reinvestment refund

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Year 6</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Sub. Taxable income</strong></td>
<td>100.0</td>
<td>108.0</td>
<td>116.6</td>
<td>126.0</td>
<td>136.1</td>
<td>147.0</td>
<td>733.7</td>
</tr>
<tr>
<td>(<strong>./.</strong>) Enterprise income tax</td>
<td>33.0</td>
<td>35.6</td>
<td>38.5</td>
<td>41.6</td>
<td>44.9</td>
<td>48.5</td>
<td>242.1</td>
</tr>
<tr>
<td>(<strong>=</strong>) Sub. net income</td>
<td>67.0</td>
<td>72.4</td>
<td>78.1</td>
<td>84.4</td>
<td>91.2</td>
<td>98.5</td>
<td>491.6</td>
</tr>
<tr>
<td>(<strong>=</strong>) Dividends distributed</td>
<td>67.0</td>
<td>72.4</td>
<td>78.1</td>
<td>84.4</td>
<td>91.2</td>
<td>98.5</td>
<td>491.6</td>
</tr>
<tr>
<td>(<strong>./.</strong>) Dividend withholding tax</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>(**+) Reinvestment tax refund</td>
<td>0.0</td>
<td>8.9</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>8.9</td>
</tr>
<tr>
<td>(<strong>=</strong>) CHHC net income</td>
<td>67.0</td>
<td>81.3</td>
<td>78.1</td>
<td>84.4</td>
<td>91.2</td>
<td>98.5</td>
<td>500.5</td>
</tr>
<tr>
<td>(<strong>./.</strong>) Dividends distributed</td>
<td>0.0</td>
<td>81.3</td>
<td>78.1</td>
<td>84.4</td>
<td>91.2</td>
<td>98.5</td>
<td>433.5</td>
</tr>
<tr>
<td>(<strong>./.</strong>) Austrian corporate tax</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>(**+) Creditable withholding tax</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>(**/+./) Double tax treaty effect</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>(<strong>=</strong>) NDI</td>
<td>0.0</td>
<td>81.3</td>
<td>78.1</td>
<td>84.4</td>
<td>91.2</td>
<td>98.5</td>
<td>433.5</td>
</tr>
</tbody>
</table>

**Table 15b: The Reinvestment Tax Refund - Scenario 2**

Table 15b shows that the reinvestment of the dividends received in year 1 and the assumed 8% annual income-increase combined with the tax refund received in year 2 leads to a financial benefit of all together 31.5 monetary units opposite the scenario, where no reinvestment takes place and, hence, no refund is granted.

Table 15c below, finally, displays an example, where the subsidiary-FIE is considered to be “technologically advanced”, which makes it eligible for a 100% tax refund. However, the formula in Art. 82 IRFEITL, which ought to be used to determine the amount of the actual tax refund, does not allow for an actual refund of the total amount of enterprise income tax paid. Nonetheless, the financial advantage – all other assumptions held constant – increases by an additional 44.9 monetary units to an aggregated total of 446.9 monetary units opposite the total of 402 monetary units in the case, where no reinvestment took place, and by 13.4 monetary units opposite the total of 433.5 monetary units, from the case, where a reinvestment took place that caused an annual 8% increase in the CHHC’s net income and resulted in an actual tax refund of 8.9 monetary units.

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912 Self-prepared table.
Scenario 3: Grant of 100% reinvestment refund

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Year 6</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sub. Taxable income</td>
<td>100.0</td>
<td>108.0</td>
<td>116.6</td>
<td>126.0</td>
<td>136.1</td>
<td>147.0</td>
<td>733.7</td>
</tr>
<tr>
<td>(_) Enterprise income tax</td>
<td>33.0</td>
<td>35.6</td>
<td>38.5</td>
<td>41.6</td>
<td>44.9</td>
<td>48.5</td>
<td>242.1</td>
</tr>
<tr>
<td>(=) Sub. net income</td>
<td>67.0</td>
<td>72.4</td>
<td>78.1</td>
<td>84.4</td>
<td>91.2</td>
<td>98.5</td>
<td>491.6</td>
</tr>
<tr>
<td>(=) Dividends distributed</td>
<td>67.0</td>
<td>72.4</td>
<td>78.1</td>
<td>84.4</td>
<td>91.2</td>
<td>98.5</td>
<td>491.6</td>
</tr>
<tr>
<td>(_) Dividend withholding tax</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>(+) Reinvestment tax refund</td>
<td>0.0</td>
<td>22.3</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>22.3</td>
</tr>
<tr>
<td>(=) CHHC net income</td>
<td>67.0</td>
<td>94.7</td>
<td>78.1</td>
<td>84.4</td>
<td>91.2</td>
<td>98.5</td>
<td>446.9</td>
</tr>
<tr>
<td>Dividends distributed</td>
<td>0.0</td>
<td>94.7</td>
<td>78.1</td>
<td>84.4</td>
<td>91.2</td>
<td>98.5</td>
<td>446.9</td>
</tr>
<tr>
<td>(_) Dividend withholding tax</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>(+) Austrian corporate tax</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>(+/) Creditable withholding tax</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>(+/./) Double tax treaty effect</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>(=) NDI</td>
<td>0.0</td>
<td>94.7</td>
<td>78.1</td>
<td>84.4</td>
<td>91.2</td>
<td>98.5</td>
<td>446.9</td>
</tr>
</tbody>
</table>

Table 15c: The Reinvestment Tax Refund - Scenario 3

It is shown that a reinvestment can cause a net-cash advantage, given that such reinvestment results in productivity increases and corresponding increases in income. If, however, the reinvestment does not generate increased income or externalities cause decreases in income, the reinvested amount could be lost totally or partially. Therefore, the tax incentives, e.g., the reinvestment refund, can be used for tax-planning considerations, but their conditions and dependencies have to be very carefully assessed and integrated into the respective tax planning strategies applied. Additionally, one will have to examine, whether various tax incentives and/or tax holidays apply simultaneously.

c. Legal Compliance and Legal Options

As has been shown in the previous Chapter, a proper management of tax-administrative aspects can support the tax planners in reducing the tax burden. The Chinese tax laws and provisions provide various clues, where a close compliance with the tax laws can prove beneficial and support the reduction of the tax burden. Some examples shall support this thesis and thereby express the importance of tax-compliance. Moreover, the FEITL and the IRFEITL contain many provisions that provide for penalties issued by the tax authorities for non-compliance with the tax laws, as well as for other authoritative measures. Yet, compliance with the tax law also permits the taxpayer to apply the laws in a legal and favorable way, for instance by realizing several legal options contained within and offered by

913 Self-prepared table.
914 Compare Art. 13 s. 2, 22, 23, 24, 25, 26 FEITL and Art.’s 16, 51 II, 53 II, 54, 105, 106, 107, 108 IRFEITL.
the laws. The utilization of such legal options is an important factor of tax planning and, hence, the following chapter has embedded a choice thereof.

i. Accounting and Taxation of Receivables

One example, where close legal compliance can support tax-planning considerations shall be made in connection with the accounting and taxation of receivables. “Receivables” are amounts due the taxpayer from customers from transactions in the ordinary course of business. Within the present context, especially, receivables from affiliated companies are of interest. It has been concluded that the CHHC’s subsidiaries are considered affiliated companies of the CHHC. The previous examples often referred to royalties paid by a subsidiary-FIE to the CHHC; however, the actual payment of such royalties actually equals the realization of a corresponding receivable. Thus, before such a royalty is actually paid by the subsidiary-FIE to the CHHC, yet in the moment contractually agreed and quantified, the CHHC accounts for a receivable from royalties, at a certain point in time by the subsidiary-FIE.

In their capacity as a current asset, as per Art. 14 ASBE, receivables, follow the general impairment rules set forth by Art.’s 51 et seq. ASBE. Hence, provisions have to be built, in cases, where impairment losses are anticipated due to a questionable recoverability. Art. 53 ASBE holds that for receivables from affiliated parties that are deemed unrecoverable bad-debt provisions over the entire amount need to be formed. According to an administrative order, outstanding receivables have to be claimed within a two-year period, otherwise the underlying amount would be re-qualified and treated as income, thus, increasing taxable income. Accordingly, the tax-management of the CHHC needs to assess its outstanding receivables in order not to cause such a non-operative increase in taxable income.

ii. Accounting and Taxation of Fixed Assets

The Chinese tax laws provide various rules, that state, that the taxpayer is only entitled to a particular tax ruling, if it had previously applied for such ruling. For instance, generally, fixed assets are depreciated using the straight-line method until the remainder of a residual value. Such residual value shall equal 10% of the respective fixed asset’s gross original value.

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915 Compare, e.g., Chapter D.II.9.a.!
916 Art.’s 14 et seq. ASBE.
Accordingly, filing such an application may entitle the taxpayer to depreciate the underlying fixed asset’s original value down to zero.\textsuperscript{917} In addition thereto, the taxpayer may possibly receive the permission to use another depreciation method than the straight-line method, like the unit-of-production method, sum-of-years’-digits method, or the double-declining-balance method\textsuperscript{918} and/or to shorten the depreciation period.\textsuperscript{919}

\textbf{Figure 40: Fixed Asset Depreciation}\textsuperscript{920}

As the example of Figure 40 illustrates, a timely compliance with the tax laws can cause net cash advantages in terms of an increased NDI. The example assumes that initially the straight-line method is applied to depreciate an asset with an original value of 100 monetary units and a corresponding residual value of 10 monetary units over a period of ten years. Applying for an enhanced depreciation could lead to an excess NDI of 1.1 monetary units in the given year in the given example. The enhanced depreciation is based on a 5 years depreciation term, a straight-line depreciation method, and the possibility to depreciate the asset down to zero, i.e. no residual value has to be considered.

\textsuperscript{917} Art. 33 s. 2 IRFEITL.
\textsuperscript{918} Art. 34 IRFEITL, Art. 36 II ASBE.
\textsuperscript{919} Art. 40 IRFEITL.
\textsuperscript{920} Self-prepared figure.
iii. Accounting and Taxation of Intangible Assets

A similar procedure is indicated in Art. 47 IFEITL with regard to intangible assets, which were contributed as an investment or obtained through an assignment. The provision states that such intangible assets may be amortized over their useful life, as prescribed in the investment agreement, however, if such useful lives are not prescribed or the underlying intangible assets are self-produced the amortization period should not be shorter than ten years. Hence, when drafting such investment agreements, the term of the respective useful lives need to be accurately documented, especially, in all cases, in which they are shorter than ten years. The financial effects of non-compliance would result in reduced annual amortization amounts and longer than necessary amortization terms, suggesting similar financial effects as could be witnessed in connection with the depreciation of fixed assets laid out above.

iv. Deductibility of Investment-related Expenses

The financing and holding of investments causes costs and expenses. Chapter D.II.6.b. concluded that once a foreign investor, e.g., the CHHC, receives tax-exempt dividends, related expenses, including financing costs, may not be claimed as tax-effective, hence do not reduce taxable income. ⁹²¹ However, given that a subsidiary-FIE was not distributing tax-exempt dividends, but any form of taxable income that is subject to enterprise income tax, to the CHHC, related expenses would have to be regarded as tax deductible. ⁹²² Hence, potentially the deductibility of investment-related expenses such as, e.g., financing costs could be achieved, if the subsidiary-FIE’s distribution of dividends was altered into any other form income distribution. Therefore, by performing a secondary sheltering strategy, as defined above in Chapter E.III.2.b., by way of which dividend-income was converted into another form of income, e.g., royalties, a scenario displayed in Figure 41 below, the deductibility of investment-related expenses should be achievable.

⁹²¹ Art. 19 III FEITL and Art. 18 IRFEITL.
⁹²² Compare in accordance hereto Art. 77 ASBE, ASBE-BC, Art. 21 I IRFEITL and Art. 19 III FEITL in connection with Art. 18 IRFEITL analogously.
The scenario as displayed above, shows that the conversion of the tax-exempt dividend income into a form of income that is taxable, does entitle the CHHC to deduct its investment-related expenses, despite triggering an additional tax consequence with respect to the royalty-income. However, the eligibility to an expense deduction and its corresponding cash-effect causes a financial benefit of 1.6 monetary units in the given example. Notwithstanding the foregoing, the tax planners will have to examine at what scope of enterprise income tax liable income and investment-related expenses, such a strategy is deemed reasonable, i.e. produces a financial benefit. A scenario, where such a strategy actually produces a financial disadvantage is exemplatorily given in Figure 42.

923 Self-prepared figure.
v. Business Tax Liability

At several occasions, it has been stated that the Business Tax, as a particular form of Chinese turnover tax, can interfere with tax planning strategies. The importance of technology transfers from and to the PRC has been stressed. From a civil law point of view, the transfer of technologies resembles the assignment either of a property right or of a right to use in proprietary technologies, technological know-how, and/or patents. Such proprietary technologies, technological know-how, and/or patents qualify as intangible assets.

Art. 1 BT-Regulations manifests that the assignment of intangible assets within or into the PRC is subject to Business Tax. Such Business Tax liability also covers particular services, if they are considered to be related to the assigned intangibles. Ultimately, this leads to a “double taxation” of royalties. Royalties are on the one hand subject to enterprise income tax levied in the form of a withholding tax and on the other hand, they would be subject to Business Tax. However, upon application FIEs may file for a Business Tax exemption in connection with the assignment of proprietary technologies, technological know-how, and/or patents and corresponding services.\(^{926}\)

\(^{924}\) Self-prepared figure.

\(^{925}\) Art. 19 III FEITL.

\(^{926}\) Compare Chapter D.IV.2.
Contrary thereto, however, the assignment of trademarks or copyright cannot be exempted from Business Tax, but the Business Tax paid may be credited against other taxes payable, i.e. enterprise income tax, in connection with the assignment of such intangible assets.927

4. Alternative: Offshore Holding Company

The previous remarks have dealt with the applicability of internationally known tax planning strategies in connection with the taxation of the China-Holding. Tax planning strategies that are based on the existence of more than two jurisdictions, as, e.g., treaty-shopping- or credit-mix-shopping strategies, have not been considered. Therefore, even though, it is not at the core of this research, a hint shall be given, as to which extent the implementation of a third-country holding company instead of the CHHC, which holds and administers the Chinese investments, could be a worthwhile consideration. The title of this Chapter “Alternative: Offshore Holding Company”, hence, shall refer to an intermediary holding company established in any country other than the PRC, or the country of the MNC’s top entity’s effective place of management, as shown in Figure 43.928

927 Compare Pfaar/Salzmann, Besteuerung, 2005, pp. 95 et seq. It shall be noted that the quantitative examples performed in this thesis that cover the taxation of royalties have anticipated the Business Tax exemption and therefore do not mention any reference to the Business Tax.

928 “Offshore” shall not only cover such countries that often are referred to as “Offshore” because of their supposedly liberal legal, tax, and financial systems. Therefore, “Offshore” does not necessarily have to conform to such countries that are often known as “tax havens”. Compare hereto also Wolff, Special Purpose Vehicles, 2002, p. 457.

Given the stringent establishment and foundation criteria attached to the China-Holding, e.g., the high capitalization requirements, and the frequently appearing cultural differences between the partners in a joint-venture holding, an offshore holding company may actually prove to be more convenient to establish for a potential China-investor. Yet, the decision, whether a holding company that is meant to hold Chinese investments should rather be established in a third country, than directly in the PRC, has to follow the same catalogue of economic decision criteria as the decision to establish such a holding company in the PRC. Ultimately, it will be an assessment, which jurisdiction is able to deliver the greatest possible financial benefit at the lowest possible opportunity cost. Within this thesis, such catalogue of economic decision criteria, however, is reduced to one particular criterion, which is tax. Therefore, a third country jurisdiction would prove favorable, if the tax consequences attached to the localization of the holding company in such jurisdiction, rather than in the PRC, would produce measurable financial benefits. Given the fact that each jurisdiction provides different holding-relevant tax laws and provisions, and that such laws and provisions also vary from each other in their interaction with the Chinese laws and provisions on the one hand, and the MNC’s top-entity’s laws and provisions on the other hand, it is difficult to produce generally valid advice. It will be the responsibility of the tax planners responsible to determine on a case-by-case basis, whether an offshore holding company proves to be preferential over a CHHC.

Given the present context, with an Austrian MNC top-entity and one or more Chinese subsidiaries, the introduction of such a third country jurisdiction needed to lead to a tax situation that would result in a lower tax burden, i.e. in a lower tax present value or as it is used within this thesis a higher NDI. One of the findings of this thesis is that the PRC taxes capital gains received by a CHHC at the full enterprise income tax rate of 33%, if it is not granted any preferential tax treatment, and might additionally levy stamp tax and business tax. Therefore, tax-planning considerations could be aimed at preventing such high taxes.

Consequently, it could be imaginable that instead of a CHHC, an offshore holding company holds the investments in Chinese subsidiaries. Given that it was possible that the entire Chinese subsidiary could be sold, i.e. the offshore holding company owned 100% of the subsidiary’s capital, the Chinese capital gains tax could be circumvented by not selling the Chinese subsidiary, but the offshore holding company instead. Such a strategy would prove to be financially beneficial, if the MNC top-entity, which holds the investment in the offshore

930 Compare Wolff, Special Purpose Vehicles, 2002, pp. 458 et seq.
holding company, was located in a jurisdiction that does not levy any capital gains tax or only little capital gains tax on capital gains generated from the sale of foreign investments. Such a favorable rule is, e.g., given in § 10 II aKStG.

Another viable alternative with regard to the utilization of offshore holding companies as a tax-planning means can be found in the Chinese treaty network. According to Art. 13 ACDTT the right to tax capital gains is granted to the respective source country. Thus, if a Chinese entity’s sale results in a capital gain, the PRC is entitled to levy taxes on such capital gains. However, various Chinese double tax treaties handle such a fact differently and grant the taxation rights to the residence country. If the residence country provided for a tax exemption or lower taxation of capital gains significant tax savings could be achieved. Yet, in order to determine the ultimate tax savings potential of such a strategy, one has to consider the tax effects that would result, once the offshore holding company distributed its income to the MNC top-entity. Evidently, the financial benefit would be the greater, the lower the taxes, i.e. withholding tax in the source country and/or corporate income or income tax in the residence country, on the dividends distributed by the offshore holding company were. An example hereto is provided in Figure 44.

![Diagram of Capital Gains and the Offshore Holding Company](image)

**Figure 44: Capital Gains and the Offshore Holding Company**

931 Compare Table 5.
933 Self-prepared figure.
As the above example shows using an offshore holding company instead of a CHHC for the holding of Chinese subsidiaries can prove to be highly favorable, at least in the case, where it is intended to dispose a Chinese subsidiary. The example uses Mauritius as the offshore holding company’s jurisdiction because a) it is granted the right to tax capital gains and b) it does not levy any taxes on capital gains itself. Therefore, the Mauritian offshore holding company is able to collect the full amount of capital gains realized through the sale of the Chinese subsidiary tax-free. In a next step, the Mauritian holding company distributes its profits by way of dividends to the Austrian MNC top-entity. Such dividends are subject to a 5%-withholding tax. Moreover, it is assumed that the Mauritian offshore holding company is considered to be an “active” holding company to the effect that its tax-personality is granted from an Austrian tax law point of view. In reality, such offshore holding companies often are subject to an activity provisio, effecting CFC-legislation, according to which the existence of the offshore entity is denied from an Austrian tax law point of view, if it does not qualify as an “active” enterprise. In these cases, the underlying fact is faked by assuming that the offshore entity did not exist as an intermediary shelter and that the respective income was directly transferred from the subsidiary to the MNC top-entity sparing the offshore holding company.

IV. SUMMARY OF FINDINGS

Tax planning is to be understood as an important component of the enterprise management system. The enterprise management system consists of a bundle of different strategic target systems each comprising different strategically and economically important functions and elements. Being a part of such a bundle, tax planning itself can be differentiated further, understanding tax as a cost element and its attachment to legal facts and events. Tax planning strategies therefore attach to the individually underlying legal facts and events. Tax is levied on income. Consequently, tax planning strategies aim at forming tax facts and events in a way that is preferrable from a tax law point of view, i.e. minimize the expense-factor of taxes through adequate qualitative and quantitative tax planning strategies.

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While quantitative tax planning strategies result in objectively measurable quantities, qualitative tax planning strategies are not numeric, but intend to increase the flexibility of tax planning strategies and, hence, support the execution of quantitative tax planning strategies. Depending on how “income” as the authoritative event is treated one distinguishes “repatriation strategies” from “allocation strategies”. Repatriation strategies do not change the scope of income but intend to change the structure of holding internal income transfers in order to improve the tax efficiency of such transfers. However, such strategies usually imply that additional levels of taxation have to implemented into existing corporate structures each time adding a tax subject and hence increasing the danger of double taxation. Therefore, repatriation strategies only make sense if the aggregated tax burden can be reduced despite the fact of additional tax subject. In case of allocations strategies the scope of total income does not change, too, yet the allocation of holding-external income is altered in order to influence the scope of taxable income. In such strategies the holding company is given the status of a genuine income generating entity.

Within the scope of repatriation strategies particular strategies have been formulated. The derouting of income transfers via an additional entity has become best practice. Such “Direct-Conduit-Strategies” usually attempt to avoid or reduce withholding tax or achieve particular available tax exemptions. In this context the previous findings have shown that the insertion of a CHHC in order to achieve such withholding tax reductions or particular tax exemptions is useless, as both Austria and the PRC apply an international participation exemption allowing for the tax-exempt transfer of dividends. In cases of capital gains the insertion of a CHHC would actually produce disadvantageous results opposite the direct sale of a Chinese investemnt by the Austrian top entity. If a CHHC realized capital gains through the sale of an investment it would be liable to general enterprise income tax at rates ranging from 15% to 33%, while the capital gains resulting from a direct sale of a Chinese investment through a foreign investor that is not based within the PRC is subject to a 10% withholding tax. “Secondary sheltering” strategies intend to convert income transfers into other kinds of income on their given income transfer route between subsidiary and MNC top entity. Having found that dividends are tax-exempt it is clear that the conversion of dividends into any other income will be of no use. Yet, the examination has shown that in particular cases the insertion of a CHHC may make sense in order to convert operating income, interest or royalties into dividends.
Allocation strategies establish a holding company as a genuine income generating entity. Market income initially either generated by an entity hierarchically situated above the holding company is allocated “top-down” to the holding company, or income generated by a subsidiary hierarchically situated below the holding company is allocated “bottom-up”. Top-down strategies attach to the accounting and valuation of investments. Investments are transferred from the top entity’s financial statement to the holding company’s financial statement, a fact that might raise tax consequences through the realization of built-in gains and capital gains or the resulting opportunity to set off losses. The latter, however, has proven to be irrelevant in the present context due to the lack of a group-relief regime in the PRC. Much more, if a Chinese investment previously held by the Austrian top entity is transferred to the CHHC such subsidiary may also no longer be eligible to be included into a group as per the “Gruppenbesteuerung”. Therefore, the inclusion of a CHHC prevents the Austrian top entity to directly set off the losses of a Chinese investment. Once a CHHC is included into the group despite of the “Gruppenbesteuerungs”-aspect, the CHHC is free to conduct fair value write-downs on its investments and depending or not on whether the CHHC is a group member as per § 9 aKStG or not its resulting accounting losses could be set off at the level of the Austrian top entity. If such CHHC was not included into a group, the Austrian top entity could perform fair value write-downs on its investment in the CHHC as per § 6 no. 2a s. 1 aEStG in connection with § 12 III no. 2 aKStG. Present value calculations of the given individual case would have to show, whether over a period of time the immediate set-off possibility for losses proves to be more advantageous than the carried possibility to realize a fair value write-down. As to bottom-up strategies it could be found that they basically only apply in group-relief scenarios and hence have not produced significant findings in the Chinese context.

However, the individual tax laws and regulations of the PRC contain several clues for tax planning strategies. A major finding was that especially corporate reorganizations as they are currently frequently happening in the PRC allow for several tax planning initiatives. For instance, in cases of mergers or splits, tax incentives previously realized by the pre-reorganization entities might be eligible for a continued application if the circumstances of the underlying business activities and geographical location have not been changed during the process of the reorganization. Moreover, a merger might introduce an indirect way to effectively set off losses of one entity with the profits of another entity. With regard to turnover taxes, VAT and Business Tax, reorganization processes have to be considered
carefully, too, as share and asset deals might cause respective tax liabilities. In addition to reorganizations it could be shown that especially the various tax incentives offer direct tax planning opportunities, as does a strict legal compliance in order to prevent punitive payments.

Ultimately, the previous chapter briefly hinted into an alternative direction, the establishment of an offshore holding company instead of the CHHC. Given that many internationally known tax planning strategies fell out of the calculus, such as many direct-conduit-strategies, e.g. treaty-shopping or credit-mix-shopping, it could be shown that given the individual case it might prove to be more cash-effective to set up an offshore holding company instead of a CHHC. This alternative is also supported by the findings from the Chinese company law that provides for strict establishment criteria with regard to the establishment of a CHHC through a foreign investor.
F. CONCLUSION

In the previous chapters, this work discussed civil law and tax law facts generally associated with the organization form “holding” and its top-entity, the “holding company”. Even though such facts have international validity, the research was carried out based on two particular jurisdictions, the Austrian and the Chinese. This thesis intends to examine the taxation of the foreign-invested holding company in the PRC, based on reference derived from an order of holding-relevant facts and events as ruled for by Austrian tax laws according to legislation available until August 2007. The discussion of the taxation of the foreign-invested holding company produced the clues necessary to add a survey of the applicability of international tax planning strategies. This survey was complemented by the presentation of several particular concrete tax-planning approaches and corresponding quantitative examples, presented to extract decision-supporting advice.

I. THE RESEARCH PROJECT, CIVIL LAW, AND DEFINITIONS

The research object, the Chinese holding company, was narrowed down to cover foreign-invested holding companies in particular. The CHHC is the enterprise form accessible to foreign investors wishing to establish a holding in the PRC. Due to particularities of the Chinese legal history, political and legal system, the Chinese legislation varies from its Austrian counterparts in several respects so that the author had to alter and adjust the basis of reference, whenever the findings of the research and their underlying sources demanded for such changes. These variances in the basis of reference are especially founded by the lack of reliable legal publication, interpretation, and commentary process, as well as ever-present inconsistencies between lower and superior hierarchy levels of the Chinese legislation. Such inconsistencies often cause problems with regard to the accessibility to laws and corresponding reliable interpretation. Investors, who prepare and/or maintain investments in the PRC, are well-advised to regularly consult with the respective competent Chinese authorities over legal matters and the interpretation of particular legal facts and events. Subject to the legal uncertainty, making an investment in the PRC might become an adventure. Hence, the work followed the established basis of reference, the Austrian holding taxation, but needed to allow for the necessary flexibility during the examination of the Chinese legal system and laws.
The scientific approach of this thesis is based on the science of tax management, in particular tax planning. Tax management is an application-oriented science that aims at developing theoretical recommendations for entrepreneurial decisions. Entrepreneurial decisions are derived from enterprise management systems. The decision matrix of such an enterprise management system is constructed in a way to support the going concern and the maximization-of-profits-approach of enterprises and their management. Holding companies are usually established to hold and manage an array of investments. It is assumed that each of these investments is acquired with the intention to increase their value, i.e. maximize their profit potential. Ultimately, profit equals the balance of the sum of revenues less the sum of costs and expenses. As commonly known, taxes are a cost factor. Therefore, to maximize profits, costs and expenses have to be reduced as much as possible. Tax planning aims at finding strategies to reduce the tax burden of an enterprise or investment to support the maximization of profits. The scope of taxes and the possibility to legally influence the tax burden accordingly become considerable parameters of any enterprise management system. Correspondingly, the present research has been undertaken to produce findings that eventually support management in its decision taking process, when considering the establishment of a holding company in the PRC or when assessing how current decisions can be optimized from a tax point of view.

However, conditional for the derivation of valid and meaningful information that support management decisions with regard to tax planning is an in-depth and profound knowledge of the underlying civil law and tax law framework. Civil law influences taxation. The choice of available enterprise forms for investors will determine which tax laws and tax provisions have to be applied. The Chinese legal system, severely fragmented, basically, contains a separate unit solely covering laws and provisions dealing with all aspects of foreign investors who are economically active in the PRC. Laws and provisions are provided ruling from the accessibility to certain industries to the taxation of foreign-invested enterprises, all possible facts involving foreign elements that can be made subject to the rule of law. Accordingly, if a foreign investor intends to establish a foreign-invested holding company, he has to obey to the Chinese civil law. With regard to foreign investment forms, the PRC distinguishes between

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936 The maximization-of-profits-approach shall be undersood to refer to the fact that private enterprises are founded with the purpose of generally generating profit. The term shall be used free of any social or ethical dimensions. Currently such social and ethical dimensions are often referred to in the public in connection with management decisions actually taken apparently based on such a maximization-of-profits-approach, which may produce maximum profits, however, to the price of mass-layoffs and enterprise closings. The fact that there might exist a tradeoff between a social and ethical system of values and the maximization-of-profits-approach is evident, yet not part of the present research and discussion.
FIEs and FEs. FEs are foreign companies, enterprises, and other economic organizations which have set up establishments or sites in the PRC engaged in production and business operations, or which have not set up establishments or sites, but, nevertheless, derive income from sources in the PRC, but are not independent legal forms established in the PRC under the rule of Chinese law. Opposite thereto, FIEs are independent legal forms established under the rule of Chinese law. The CHHC qualifies as such a FIE. It is a particular kind of the investment forms offered to capital-strong foreign investors. Investors may structure their individual China-investments as an EJV, a CJV, or a WFOE. The CHHC, established to hold and manage such China-investments, is formed either as an EJV or as a WFOE. These investment forms regularly take legal personality and adopt the legal forms of either a LLC or a CLS. Hence, the CHHC, as well as its subsidiaries are FIEs and legal persons. Despite their high capitalization requirements, US$ 30m in registered capital, a CHHC, nonetheless, might be interesting for a MNC as its permitted scope of business is relatively generous and gradually expanded by the PRC government. Except productive activities, a CHHC is allowed to carry out a wide array of financing, management, service, and logistical activities to support its investments and to optimize the efficiency within the holding.

II. THE TAXATION OF THE CHINA-HOLDING

1. Enterprise Income Tax

a. Taxable Entity and Taxable Income

Even though the PRC knew tax laws governing the taxation of foreign investment vehicles, a unified foreign investment tax law was only introduced in 1991. Yet, the PRC maintained a distinction between the taxation of domestic enterprises and foreign investment forms, causing a separation of the enterprise income taxation in the PRC. Based on the qualification of the ownership of a given enterprise, it is decided, whether it is subject to the DEITL or to the FEITL. FIEs are classified as such if at least 25% of their registered capital is funded by a foreign source. Consequently, the taxation of a tax subject in the first place is primarily linked to ownership, rather than to a particular legal form. It is the qualification as a FIE that makes a respective enterprise eligible to the FEITL and not its legal form as a partnership or corporation, respectively.
As the CHHC and its subsidiaries qualify as FIEs, the FEITL, the IRFEITL, and other foreign-investment-related tax provisions have to be applied. Both, the CHHC and its subsidiaries are unlimited tax liable with their worldwide income in the PRC. They are taxed at the usual enterprise income tax rate of 33%. However, the tax rate might be significantly lower, if the taxable FIE is eligible to one of the numerous tax incentives or tax holidays offered by Chinese law to FIEs and in part FEs. In addition to its qualification as a FIE, the CHHC parallel qualifies as a foreign investor, which results in the requirement to maintain two sets of accounting books, one for its investments activities and one for its genuine business activities, excluding investment activities.

As per the laws, foreign enterprise income tax is levied on “income from production and business operations and other income.” Being not eligible to productive activities, the CHHC per definition cannot generate corresponding income. Hence, the CHHC generates income from business operations and other income. The taxable events “income from business operations” and “other income” cover all such kinds of income generated by the CHHC. While “income from business operations” refers to such kinds of income, the CHHC mainly realizes through services, management, and logistics, “other income” covers such income categories as dividends, interest, royalties, and capital gains.

Foreign enterprise income tax is levied on the amount of taxable income, which equals the total amount of revenue for each tax year less cost, expenses and losses. The concrete computation of taxable income, which has to be reported in RMB, is supposed to follow one of four formulas that determine the basic structure for the computation of taxable income depending on the taxable entity’s belonging to the manufacturing industries, to commerce, to service trades, or to other trades. The laws further stipulate that losses may be carried forward over a maximum period of five years, but no loss carryback is allowed. Even though the Chinese tax laws do not provide for the application of a strict authoritative principle, it is assumed that the accounting and computation of taxable income is to follow the general principles of commercial accounting. The general assumption is that the tax laws and individual provisions rule tax accounting aspects, whenever they deviate from the commercial accounting. If the tax laws do not individually rule particular tax facts or events, the application of the commercial accounting regulations is presumed the rule.
b. Income and Expenses

The indicated vagueness of the Chinese tax laws becomes apparent for the first time in connection with the examination of the taxation of capital contributions, constructive capital contributions, reductions of share capital, or constructive dividends. None of such important events is explicitly named in the Chinese tax laws. However, not carrying provisions for respective events, does not mean that such facts, as understood in Western tax systems, do not occur in the PRC. According to an administrative order, cash contributions made to the registered capital of enterprises are considered tax-neutral, whereas contributions in kind are tax-effective if appraised assets are contributed. When such assets are disposed from the property of one tax object to be contributed as capital, the appraised built-in gains are realized. However, such resulting capital gains can be amortized in equal installments over a period of five years. In analogy to capital contributions, reductions in share capital cause a decrease in reported equity as an offsetting entry to the disposal of liquidity. The reduction of cash-based share capital is not tax-effective, whereas the reduction of in-kind-contribution-based share capital shall trigger taxation. Equally, deemed tax-effective is the provision of constructive capital contributions, as well as the distribution of constructive dividends. In Art. 13 FEITL, the law rules that transactions between affiliated enterprises are considered as if effected between unrelated third parties in an open market transaction. Hence, what was previously a constructive capital contribution or a constructive dividend that did not trigger any tax consequences, is re-qualified into taxable “non-operating income” as per Art. 11 FEITL and Art. 2 II IRFEITL.

FIEs, i.e. the CHHC and its subsidiaries, may only distribute income after certain allocations to social funds have been made and all existing commercially accounted losses have been set off. In reality, the latter condition often prevents FIEs from making income distributions. Despite of that, the distribution and allocation of income is one of the core topics in connection with the discussion of a holding. Often holding companies are established to utilize tax beneficial group-relief regimes as offered by several national legislations. Accordingly, one of the main tasks of this thesis was to find out, whether the Chinese tax laws would also offer such a group-relief regime, as, e.g., the Austrian “Gruppenbesteuerung” that was introduced as the reference example when concluding the basis of reference. The examination of the Chinese tax laws lead to the conclusion that it does not contain a group-relief regime that allows legally independent foreign-invested entities to set off their respective incomes. Some kind of tax consolidation, however, is granted to individual FIEs.
that may tax consolidate incomes of separate permanent establishments. In any event, the non-existence of any form of group-relief regime does certainly not support the establishment of a CHHC from a tax point of view.

Presumably, the single most important income source of holding companies is dividends. Within the framework of the FEITL and the IRFEITL, dividends qualify as “other income”, which generally is subject to a withholding taxation of 10%. Yet, dividends distributed by an FIE to another FIE or to a foreign investor are, in accordance with an administrative order, ruled tax-exempt. Hence, the Chinese tax law provides for a full participation exemption on dividends distributed by a subsidiary to the CHHC, as well as on dividends distributed by the CHHC to its respective parent company. Most of the income the CHHC generates is qualified as other income, including royalties and capital gains. While royalties are usually subject to a 20% withholding tax, the tax rate can be reduced to as little as 10% or 0%, depending on the classification of the underlying intangible asset and on how technologically advanced such intangible asset is considered to be.

A main field of activity of holding companies is to buy and sell investments. Occasionally, the holding company, therefore, realizes capital gains. Capital gains are not expressively covered by one of the taxable-income events, but are subsumed under the “other-income” category. However, contrary to most of the other sources of “other income”, capital gains are not subject to a withholding tax but to the general enterprise income tax rules. Hence, they are taxed at 33%, if no tax incentives apply.

Another, prominent factor in the holding-context is interest. Interest, is a twofold parameter. First, it can represent income, e.g., generated within the holding by granting loans to subsidiaries, taxable at a withholding tax rate of 10%. Second, it has an expense dimension, when considered as the price paid for the granting of any kind of debt financing. If considered an expense, interest is subsumed under financing costs or “borrowing costs”. Chinese commercial accounting distinguishes “specific borrowings” from “other borrowings”. Interest plus any incidental financing cost incurred for a specific borrowing, i.e. the borrowing cost for debt financing taken on for the acquisition or construction of a fixed asset, have to be capitalized as a part of the respective fixed asset’s acquisition/construction cost. Contrary thereto, borrowing cost for other borrowings are considered immediate expenses. For tax purposes, the laws distinguish between “interest on capital” and “loan interest”. While “interest on capital”, e.g., interest paid for the debt financing of equity contributions, are deemed non-deductible, “loan interest”, incurred in course of the actual production and/or
business activity can be tax-effectively recognized. In any event, the deductibility of interest as a genuine business expense is limited through the capital ratios provided for FIEs and for the CHHC and through the arm’s length principle demanding interest charged between affiliated enterprises to conform to independent market standards.

In addition to these general rules on the deductibility of interest, Art. 18 FEITL sets forth that expenses incurred in connection with subsidiaries or investments that distribute tax-exempt dividends are not deductible at all. This special provision marks another critical finding in connection with the taxation of the CHHC. Generally, the CHHC is not able to deduct any expenses incurred in connection with its subsidiaries or investments, if it receives tax-exempt dividends from such entities. As to business expenses in general, they are considered deductible, if the laws do not provide for the contrary. One holding-relevant particularity is to be seen in the fact that management fees paid by a subsidiary to the CHHC are not considered tax-deductible at the level of the subsidiary, although the CHHC has to fully include income generated from the provision of management services into its taxable income.

c. **Assets, Investments, Corporate Reorganizations, and Transfer Pricing**

Besides the income effects, caused by current income streams and current expenses, taxable income is further influenced by capital expenses resulting from adjustments in the valuations of financial statement items. Investments, probably, are the most important financial statement item in a holding company’s financial statement. According to Chinese accounting provisions, investments are accounted for depending on the kind of transaction by which an investment is acquired. Investments acquired with cash enter the CHHC’s financial statement valued at acquisition cost. Contrary thereto, investments acquired in a non-cash or a non-monetary way are valued at a quantity equal to the seller’s carrying amount and transaction related tax payments. Impairment tests are performed periodically on an individual item basis. If the impairment produces declines in fair values due to a continuing market decline or changes in operating conditions, the CHHC has to recognize a fair-value write down. Given the event, the value of a previously written down investment recovers, a write-up is to be performed up to an amount not exceeding the amount previously written down.

As the FEITL and the IRFEITL contain no provisions with regard to the taxation of investments, a special piece of legislation has to be consulted. In the Reorganization-Provisions, the PRC government rules the taxation of mergers, splits, equity reorganizations,
and asset transfers, facts that, as the research showed, cover the ongoing taxation of investments. Within the ruling of the facts equity reorganizations and asset transfers, the taxation of fair value write-downs and of goodwill is covered. In case of equity reorganizations, i.e. share deals no goodwill is acquired and the acquired investments are valued at acquisition cost and in subsequent periods are impaired in accordance with one of two methods.

The first method, the “asset-by-asset-method”, recognizes changes in the valuation of each single asset in the current period, while the second method, the “comprehensive-adjustment-method”, rules for a proportionate adjustment of fair values over a ten-year period. However, the Chinese government, provides that in cases of the reorganization of holdings or groups of companies, where 100%-equity interests are transferred such a transfer can be effected by maintaining the carrying amount and, hence, no capital gains are realized. In cases of an asset transfer, i.e. asset deal, built-in gains have to be realized as well, causing the taxation of capital gains on the side of the seller, if the transaction price exceeds the aggregated amount of the transferred assets’ carrying amounts. The buyer, however, either is able to allocate the transaction price proportionately to every single asset, which results in respective depreciation or amortization amounts and periods, or the transferred assets are accounted at continued carrying amounts with the balance between such aggregated carrying amounts and the transaction price representing acquired goodwill. Any acquired goodwill is reported as an intangible asset and amortized proportionately over a period of not less than ten years. Yet, should the transaction price be lower than such aggregated carrying amounts the purchaser has to recognize the transferred assets at the transferor’s carrying amounts.

Moreover, the Reorganization-Provisions cover the taxation of mergers and splits. Both facts are treated as a going concern from a tax point of view. Despite the differences in the definition of the terms “merger” and “splits”, their tax consequences are very much alike. Assets are valued at their respective carrying amount, as taken over from the pre-merger or pre-split enterprises. In cases, where commercial appraisals are recognized in order to effect the underlying transaction, such changes are not deemed directly tax-effective. For tax purposes, adjustments have to be made in accordance with the asset-by-asset method or the comprehensive adjustment method. The Reorganization-Provisions further set forth that, if the conditions are maintained, post-transaction enterprises might be eligible to continue to use tax incentives that originally were granted to a pre-transaction enterprise. In cases of mergers the post-merger enterprise, furthermore, may be eligible to continue to utilize losses that
originally were caused by a pre-merger enterprise. Conditional, however, is the preparation of a differentiated accounting. The post-merger enterprise has to prepare accounts that reflect the pre-merger enterprises as permanent establishments of the post-merger enterprise.

However, the CHHC’s financial statement contains not only investments, but also covers all other assets of the CHHC. Fixed assets, for instance, are reported at acquisition or production cost and depreciated with the straight-line method. The depreciation base is the original value, i.e. the acquisition/production cost plus incidental expenses. However, the general rule is that fixed assets may not be written down to zero, but only to a residual value being not less than 10% of the initial depreciation base. Sales of fixed assets during the depreciation period might cause taxable gains if the sale price exceeds the current carrying amount. Intangible assets are also valued at original cost that is the acquisition cost plus incidental costs, but as the Chinese laws provide for the capitalization of self-produced intangible assets as well, the original value may also be the production cost plus according incidental costs. Intangible assets are amortized using the straight-line method in accordance with the term of use as stipulated in a corresponding agreement. If no such agreement is existent, they are amortized over a period no shorter than ten years.

Further major financial statement items reviewed, are receivables and liabilities. Receivables are recognized at the actual amount, possibly plus interest. If the impairment of receivables hints to changes in the probability of the collection of receivables, provisions can be formed. Usually, such provisions shall not exceed 80% of the underlying receivable’s actual value, but in cases of receivables against affiliated enterprises, the full amount has to be reported as a provision. Chinese tax law further rules that receivables not claimed within a period of two years are considered income and increase taxable income. Liabilities shall also be reported at the actual amount incurred and impairment is carried out in accordance with that of potential losses in the case of receivables, as is such of provisions.

Generally, transactions within a holding or group of companies trigger the attention of tax authorities. Accordingly, the PRC rules that transactions between affiliated companies are to be effected at arm’s length. It could be found that the members of the China-Holding regularly qualify as affiliated enterprises and, therefore, are subject to the transfer pricing regulations as promulgated by the PRC government. Contradicting usual practice, not the taxpayer uses the transfer pricing methods to assess the conformity of prices charged in inter-holding transactions, but the authorities. Moreover, the PRC offers the possibility to negotiate advanced pricing agreements with the Chinese authorities to provide a certain security
comfort level and to prevent the tax authorities from effecting lawful adjustments to the prices set by the taxpayers.

2. International Taxation

Beyond the above-discussed national taxation, taxable facts and events are realized across borders. Whenever taxpayers conduct business across national borders, more than one jurisdiction might raise a tax claim causing the danger of double taxation. Countries attempt to prevent double taxation through unilateral national provisions and bilateral agreements. Unilaterally, double taxation is countered usually by either exempting particular income from the national right to tax or by granting a tax credit for taxes paid on income generated in another jurisdiction. The PRC adopts the tax credit method linking it to a per-country-limitation. However, to determine the scope of the tax credit, the Chinese laws provide that the maximum permissible tax credit amount have to be derived by applying Chinese tax law. In addition to the tax credit method, the PRC further provides for an international participation exemption, ruling that inter-corporate dividends distributed to a foreign investor are tax-exempt. Bilaterally, it can be concluded that the double tax treaties applied by the PRC generally follow the OECD-MC. The CHHC and its subsidiaries are considered as “resident companies” in the sense of the reference-treaty, the ACDTT, as well as in the sense of the OECD-MC, and, hence, are treaty-entitled.

3. Other Taxes

Obviously, the CHHC does not only trigger enterprise-income-tax-relevant events, but also taxable events in other tax categories and despite the focus of this thesis on enterprise income tax, a few interesting findings with regard to VAT and Business Tax were concluded. VAT is generally levied on all stages from production to distribution, on services as well as on the sale or transfer of particular goods and assets. At each stage, where VAT is levied an input tax credit is granted, which is materialized when the good or asset is sold on or transferred again. The general VAT-rate is 17%, but may be less or exempted in particular cases. Of particular interest is a VAT liability in connection with corporate reorganizations. Accordingly, if an equity interest is transferred, which is based on a contribution in kind made of tangible assets, the Chinese authorities view the transfer of the equity interest as a factual transfer of the underlying tangible asset, which is considered a VAT-liable event. The same consequence is
triggered, once tangible assets are transferred in an asset transfer. Business Tax is levied on all services not covered by the VAT and on the sale or transfer of selected assets and goods, such as the sale or transfer of intangible assets and/or immovable property. However, in connection with the Business Tax no input tax credits are granted, resulting in a cumulative charge of Business Tax, each time a taxable event is realized. The tax rate depends on the respectively taxed item and reaches from 3% to 20% on the gross transaction amount. Corresponding to the VAT liability, a possible Business Tax liability has to be assessed in cases of equity reorganizations or assets transfers, where either intangible assets or immovable property are concerned. However, different to the VAT liability, charged Business Tax is creditable against enterprise income tax.

III. **TAX PLANNING AND FUTURE TENDENCIES**

1. **General Tax Planning Targets and Strategies**

The study of the taxation of the CHHC has produced various clues that suggest a thorough tax-planning assessment. Tax-planning theory covers two basic types of tax planning strategies, repatriation and allocation strategies. Repatriation strategies focus on identifying the most efficient way to repatriate income back to the MNC top-entity and, hence, make it available for the entire MNC and future investments. Repatriation strategies can be further distinguished into direct conduit strategies, secondary sheltering strategies, and primary sheltering strategies. In case of direct conduit strategies, a holding company is inserted into the income transfer route to de-route income via the holding company to the MNC top-entity. The establishment of an additional corporate entity within an income transfer route creates an additional level of taxation and, thus, increases the danger of double taxation. Accordingly, such a strategy is reasonable, only if the additional level of taxation helps to lower, e.g., withholding taxation or supports the utilization of imputation tax credits. In the present context, where the CHHC and its subsidiary-FIEs are located in the same country and are treated identically for tax purposes paired with the fact that both, Austria and the PRC, provide for an international participation exemption, the insertion of a CHHC is not producing added value. Even worse, however, was, if the CHHC was inserted to generate capital gains from the sale of a subsidiary that alternatively could had been directly generated by the Austrian MNC top-entity. The CHHC is taxed on the capital gains with the standard rate of 33% - if no tax incentives apply. Whereas if the capital gains where realized by the Austrian
MNC top-entity, the PRC would charge a 10% withholding tax and the capital gains would be tax-exempt in Austria because of its participation exemption in § 10 II aKStG.

Generally, direct conduit strategies cover such alternatives such as treaty shopping, credit-mix shopping, or cross-border imputation shopping, but as the term “shopping” implies the search for a best alternative from a given choice, they are not considered in the present context that assumes a given set of two single jurisdictions, the Austrian and the Chinese. Moreover, such shopping-strategies usually imply the existence of at least three jurisdictions, one as the location of the subsidiary, the next as the location of the holding company, and a third as the location of the top-entity.

Opposed to direct conduit strategies, secondary sheltering covers strategies that focus to use the additional tax level of an intermediary holding company to convert income, i.e. the holding company receives one particular kind of income but distributes a different kind of income to the top-entity. In the Chinese context, given that the target was to minimize the taxation of income, solely tax-exempt dividends would be distributed. However, in reality it might not be possible to always directly distribute income as dividends, e.g., because the subsidiary has to pay interest or royalties or the top-entity wishes to avoid a deduction disallowance as stipulated with regard to expenses related to investments, which distribute tax-exempt dividends. Nonetheless, artificially converting a kind of income that could be distributed on a tax-exempt basis into taxable income is likely to produce worse results. However, if, e.g., the Austrian top-entity originally received royalty income from the subsidiary, the insertion of a CHHC could decrease the tax burden. Originally, the royalty would be subject to 25% Austrian corporate income tax, which was reduced by a double tax treaty tax credit, resulting in a final tax burden of 15%. Yet, if the CHHC generated the royalty income deputy for the MNC top-entity, it would be subject to the local withholding tax of 10% and could subsequently be distributed to the MNC top-entity as tax-exempt dividends. Primary sheltering aims at temporarily shielding income from the taxation at the level of the MNC top-entity to gain tax present value advantages.

Allocation strategies aim at changing the identity of the income generating entity. One distinguishes top-down strategies and bottom-up strategies. Top-down strategies attach to accounting issues related to the accounting of the investment, i.e. valuation and impairment, the realization of capital gains, and the utilization of losses or investment-related expenses. However, before top-down strategies are effected the parties involved have to assess, whether the transfer of an investment from the MNC top-entity’s financial statement to the holding
company’s financial statement could be effected tax neutral, i.e. without the realization of built-in gains. An often-used example strategy in this context would be what is called, deduction shopping, where the holding company is located in a jurisdiction that provides a favorable tax framework allowing for the deduction of investment-related expense or of losses that would not be deductible in the top-entity’s country.

However, in the present context, knowing about the non-existence of a group-relief regime and deduction disallowance with regard to investment-related expenses in the PRC on the one hand, and the “Gruppenbesteuerung” and the allowance to deduct acquisition related expenses in Austria, § 11 I no. 4 aKStG, might suggest that such a top-down strategy would not prove advantageous. Given that subsidiary-FIEs qualified as group members, they could be directly included into the group and their losses could be set off, however, at the cost that no fair value write-down was available. Alternatively, one could also include the CHHC into the group and set off its operating losses. However, the CHHC cannot set off its income with the income of its Chinese subsidiaries and hence loss-potential might remain unutilized. As the CHHC is allowed to effect tax-effective fair value write-downs on its investments, if the requirements are realized, the CHHC could indirectly utilize losses from loss-making investments resulting in a loss of the CHHC itself, which could be set off within a group as per § 9 aKStG. The inclusion of the CHHC into a group, in the sense of the “Gruppenbesteuerung”, is not mandatory. Not including the CHHC into such a group would allow the top-entity to carry out fair value write-downs on its investment in the CHHC at the cost that a direct set-off of CHHC-losses was no longer possible. Valuable advice can only be given on a case-by-case basis and it would remain questionable how much reliable information was available in the moment the decision was taken, whether or not to include an entity into the group.

Eventually economic reality might prove that the inclusion into the group was disadvantageous compared to the non-exclusion. As flexibility was identified as a core target of qualitative tax planning it can be concluded that using the “Gruppenbesteuerung” reduces flexibility by binding members for a period of at least three years. The opposite of top-down strategies are bottom-up strategies. In case of bottom-up strategies, the income-generating event is transferred from the subsidiary to the holding company. Such a transfer regularly is subject to a legal foundation. Usually, such a legal foundation is represented by a group-relief regime or a profit and loss transfer agreement. Neither is available to FIEs and, hence,
CHHCs, in the PRC and, therefore, bottom-up strategies can be neglected in the CHHC-context.

2. Particular Tax Planning Strategies

The combination of the survey of the Chinese tax laws with the discussion of internationally known tax planning strategies lead to the finding of certain particular clues for the concrete application of tax-planning approaches. A major field of interest in that respect generally is corporate reorganizations and, correspondingly, the Chinese Reorganization-Provisions, which themselves provide several clues. In light of the fact that a tax consolidation of positive and negative incomes of legally independent entities is not possible, the merger of a profit-making enterprise with a loss-making enterprise might offer a considerable alternative. Even though, the resulting post-merger enterprise does not prepare a single consolidated income statement, the consolidation of the pre-merger results become possible via a detour. The post-merger enterprise has two alternatives how to achieve such a consolidation. First, the pre-merger enterprises can be actually identified as separate individual permanent establishments of the post-merger enterprise and their respective incomes can be adequately allocated. Second, the pre-merger enterprises are not maintained as separate individual permanent establishments. The post-merger enterprise is then able to fake the existence of such separate individual permanent establishments by allocating income to them in accordance with special ratios. As per the allowance set forth in Art.’s 89, 93 IRFEITL, an FIE is allowed to consolidate its permanent establishments’ income.

It has been extensively stated that the legal entities reviewed in this thesis are FIEs, hence the merger of two FIEs usually result in a new FIE. Hence, the CHHC may assess its investment portfolio and is able to produce an artificial loss-consolidation by merging two respective subsidiaries. Moreover, a subsidiary could be merged with the CHHC itself with possible direct consequences for the Austrian MNC top-entity, as resulting losses could be included via the “Gruppenbesteuerung”. Besides the opportunity to set off income, the Reorganization-Provisions further allow for the continuous use of tax incentives or tax holidays, initially granted to the pre-transaction enterprises, if the post-transaction enterprise can prove the maintenance of the eligibility criteria. In any event, it will be fundamental to secure the maintenance of such tax incentives, as the loss of such incentives can lead to severe financial consequences. Most of the tax incentive provisions rule that if the incentive-receiving entity does no longer fulfill the conditions during the term of the incentives, it has to repay the
aggregated monetary value of the incentives received until such a moment. Moreover, the
reorganization of corporate groups has to be closely assessed because of possible VAT- or
Business Tax consequences. As has been noted above, both asset deals, as well as share deals
might cause a VAT and/or Business Tax liability.

Besides the maintenance of tax incentives and tax holidays in cases of corporate
reorganizations, such incentives and holidays generally are generally important tax-planning
tools in the PRC. The management has to check, whether a certain incentive can be made
available and/or which alterations in the present business activity can be made to become
eligible. Exemplatory, the thesis discussed a reinvestment refund as offered by the Chinese
tax laws. The CHHC that reinvests funds received as tax-exempt dividends from a FIE back
into the same FIE or into other FIEs, may receive a refund of 40-100% of the enterprise
income tax initially paid by the dividend distributing FIE. Reinvesting such dividends back
into the Chinese economic cycle reduces the distribution potential of the CHHC to its parent
company. Therefore, such a reinvestment makes sense if the reinvestment causes increases in
efficiency that ultimately overcompensate the relinquishment of the distribution of income to
the CHHC parent company in a present period. Hence, the calculation, if such a reinvestment
refund is financially beneficial equals an opportunity cost assessment over time.

Making sure that the CHHC and the entire China-Holding benefits from such tax incentives
and tax holidays as much as possible is more or less a question of compliance. Generally,
complying with laws and provisions can be seen as factor that can significantly reduce
transaction costs. The Chinese laws offer several clues, where subject to proper and in-time
compliance with laws and provisions a preferential tax treatment can be achieved. It has been
stated that depreciations and amortizations usually can only be carried out until a residual
value and by using the straight-line method. However, subject to an application with the
competent authorities, other depreciation or amortization methods are also available and
sometimes no residual value has to be maintained. The granting of another method and the
waiving of the residual-value-criterion might cause significant financial benefits to the
taxpayer. As the Chinese government is very much depending on a continuous inflow of FDI,
it often grants to foreign investors particular exceptions. For instance, when applying for the
establishment of a FIE, which is meant to be equipped with proprietary technologies or
similar intangible assets, an event usually triggering Business Tax, such an assignment can be
exempted from Business Tax upon application.
This research has produced several factual clues for tax-planning considerations, obviously at no moment claiming completeness, that attach to the fact of the review of two jurisdictions only. However, as already mentioned in connection with the “shopping-strategies”, a foreign investor obviously has to weigh up, if it is advantageous to locate a holding company for the holding of Chinese investments in another jurisdiction. Briefly, this alternative has been reviewed and it could be found that it could prove to be a viable alternative for China-investors. Besides circumventing the costly establishment and maintenance of a CHHC and the legal uncertainty, an offshore holding company might actually also be advantageous from a tax point of view. A particular case considered in this thesis is the taxation of capital gains.

While the PRC taxes capital gains at 33% and most of its double tax treaties, including the ACDTT, grant the right to tax capital gains to the source country, there might be jurisdictions that provide for a preferential solution. For instance, the Chinese-Mauritian double tax treaty grants the right to tax capital gains not to the source country, but to the resident country. Hence, a holding company in Mauritius was able to collect Chinese capital gains tax-exempt and could subsequently distribute such capital gains as dividends to its parent company at a withholding tax rate as low as 5%. However, the alternative “offshore holding company” would only be advantageous, if the offshore country had a favorable double tax treaty with the PRC and with the residence country of its parent company. Moreover, it had to be secured that the offshore holding company was granted an “active” status so that it would not become subject to any CFC-legislation and add-back taxations in the parent company’s residence country.

3. Future Tendencies

The inherent cultural complexities of an engagement in the Chinese market, the high capitalization requirements and compliance costs attached to the establishment and maintenance of a CHHC, as well as the lack of a group-relief regime, and other holding-relevant tax preferences will cause any MNC to carefully perform a feasibility and profitability analysis, as to whether the establishment of CHHC is reasonable. It will have to assess, whether the economical activities permitted to a CHHC and the intangible gain in economical acceptance from Chinese business partners overcompensate the existing imponderablenesses. At a first glance, given the lack of group-relief regime, the establishment of CHHC in the PRC does not make too much sense from a tax point of view. Yet, as the discussion of the individual examples has shown, the existence of a CHHC might prove
advantageous on a case-by-case basis. Furthermore, MNCs have to closely follow the legislative process in the PRC. Tax reforms are currently under discussion in the legislative bodies of the PRC and a major overhaul has been expected for some time. One of the major objectives has been to unify the tax systems in the PRC. The 10th NPC undertook a first significant step towards unification by the promulgation of the new “Enterprise Income Tax Law of the PRC”, which is to go into effect on January 1, 2008. As per a first translation available to the author, the major intention of the new law is indeed to unify the the PRC’s system of enterprise taxation. The gap between the taxation of DE’s opposite FIE’s is meant to be abolished. Given the fact that the FIE’s actual corporate taxation under the present system has on average only been one third of such of DE’s, supports the NPC’s step to try to reach more equity in taxation.

Overall, the new Enterprise Income Tax Law unifies the tax rate for DE’s and FIE’s and the overall enterprise income tax system. As per the new law, Chinese domestic enterprises, FIE’s, FE’s, and any organization with income generated within the PRC, shall become equal taxpayers. The law further categorizes enterprises in “resident” and “non-resident enterprises”. Resident enterprises shall be enterprises registered and established under the laws of the PRC and enterprises that have their actual management bodies based in the PRC. Such resident enterprises shall assume unlimited enterprise income tax liability on their worldwide income. Contrary thereto, non-resident enterprises shall refer to enterprises established abroad, with their actual management bodies not in the PRC, but that maintain institutions and places of business within the PRC, as well as such enterprises established abroad without actual institutions or places of business within the PRC, but income originating in China. Such non-resident enterprises shall be considered of limited tax liability. While resident enterprises shall have to pay taxes on their globally generated income, non-resident enterprises shall only have to pay taxes on such income actually generated within the PRC.

The law provides for a unified enterprise income tax rate of 25% for resident enterprises, thereby decreases the tax rate for DE’s while it increases the tax rate for FIE’s. Non-resident enterprises shall be subject to a statutory withholding tax rate of 20%, which however may be lowered subject to future Implementation Rules to be issued by the SC. With regard to the

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939 Compare Art. 2 Enterprise Income Tax Law.
940 Compare Yuan, Breakthrough, 2007, p. 66.
multiple tax incentives offered by the current system, the new law shall be much more limiting. It aims at reducing tax incentives based on the geographic location of enterprises to focus tax incentives rather on particular industry sectors. Enterprises active in high-tech and/or state-supported industries shall be eligible to tax incentives, however no specified definitions are provided by the law.

In general it has to be noted that at the time of the conclusion of this thesis no Implementation Rules of the new Enterprise Income Tax Law were available, which would have allowed for a more detailed outlook on the future enterprise income taxation in the PRC. The changes will bring a new direction for the economy of the PRC. Increasing the tax burden of FIE’s will affect the decision criteria of whether or not to carry out investments in the PRC. Furthermore, despite a transition period of five years\footnote{Compare Art. 57 Enterprise Income Tax Law.} which generally applies to all presently existing codes of taxation including currently available tax incentives, already existing FIE’s and other FE’s will have to re-assess and re-formulate their investment in the PRC with regard to the potentially increasing tax burden.

However, in any event, it is too early to state, whether or not the new tax law will have a negative effect on the scope of foreign investments in the PRC and, as stated earlier herein, taxation is one of several criteria assessed when preparing an investment in a particular country, yet not the only criterion. The introduction of this law marks a significant step of the PRC’s way towards a socialist market-economy by allowing domestic as well as foreign enterprises to compete in a unified, well-regulated market environment. Yet, it will certainly be interesting to follow the future developments and to conduct respective research once first data and source material on the impact of the introduction of this new law becomes available. It will also be interesting to see, how these changes will actually affect the taxation of the China-Holding and if due to the abolishment of the separated tax law, civil law will follow suit by successively replacing split FIE-legislation and DE-legislation with a unified civil law. In addition to the introduction of a new enterprise income tax law, further changes in tax law are expected, especially, in connection with the turnover taxes, where it is assumed that the VAT is to be extended also on services, thus largely replacing the existing Business Tax system.
ANNEX

ANNEX I: TAX INCENTIVES AND TAX HOLIDAYS

Throughout this thesis, several tax incentives were repeatedly mentioned and included into the discussion. Generally, FIEs are nationally taxed at an enterprise income tax rate of 30%, which is contemplated by a 3% local enterprise income tax surcharge. Hence, the aggregated standard enterprise income tax rate is 33%. However, depending on the scope of business, the location of the effective place of management and of the establishments, the industry, the scope of investments, the export potential, or the scope of reinvestments, this tax rate can be significantly lower. The taxpayer might enjoy fundamental tax incentives in accordance with the regulations stipulated by Art.’s 6 till 10 FEITL and Art.’s 68 till 82 IRFEITL. Generally, such tax incentives are granted only to FIEs. Hence, the CHHC is eligible to tax incentives, whenever it fulfills the eligibility-criteria. Given that the CHHC may not carry out producing activities, tax preferences based on an enterprise’s productive nature are not applicable to CHHCs. Whether or not location-bound tax preferences apply has to be examined on a case-by-case basis. FEs may only enjoy such tax incentives that are granted solely due to the fact, that the Chinese establishments operated by a FE are located in one of the various special economic zones of the PRC. An overview on the several kinds of tax incentives available in the PRC is given in Table 16.

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942 Art. 5 FEITL.
943 Art. 7 FEITL.
944 The tax rates quoted in Table 6 solely refer to the national tax rate, i.e. are net of the local enterprise income tax surcharge, which is subject to the sole discretion of the relevant local tax authorities and, thus may vary from location to location.
### Tax Incentives based on location of management or establishments:

<table>
<thead>
<tr>
<th>Tax Incentives based on location of management or establishments:</th>
<th>Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Special Economic Zone (SEZ)</strong>(^{945}):</td>
<td></td>
</tr>
<tr>
<td>- Producing FIEs &amp; FEIs:</td>
<td></td>
</tr>
<tr>
<td>- General Rule:</td>
<td></td>
</tr>
<tr>
<td>- 2 years of enterprise income tax exemption, commencing with the entity’s first profitable year and;</td>
<td></td>
</tr>
<tr>
<td>- 50%-exemption for consecutive 3 years;</td>
<td></td>
</tr>
<tr>
<td>- Condition: term of operation &gt; 10 years;</td>
<td></td>
</tr>
<tr>
<td>- Exporting FIEs &amp; FEIs:</td>
<td></td>
</tr>
<tr>
<td>- 2 years of enterprise income tax exemption, commencing with the entity’s first profitable year and;</td>
<td></td>
</tr>
<tr>
<td>- 50%-exemption in each consecutive year at a tax rate of 10%;</td>
<td></td>
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<tr>
<td>- Condition: Export &gt; 70% of produced goods;</td>
<td></td>
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<tr>
<td>- Service FEIs:</td>
<td></td>
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<tr>
<td>- 1 year exemption after first profitable year;</td>
<td></td>
</tr>
<tr>
<td>- 50%-exemption for consecutive years;</td>
<td></td>
</tr>
<tr>
<td>- Conditions: investment &gt; US$ 5m &amp; term of operation &gt; 10 years;</td>
<td></td>
</tr>
<tr>
<td>- Financial institution:</td>
<td></td>
</tr>
<tr>
<td>- 1 year exemption after first profitable year;</td>
<td></td>
</tr>
<tr>
<td>- 50%-exemption for consecutive 2 years;</td>
<td></td>
</tr>
<tr>
<td>- Conditions: registered capital &gt; US$ 10m, term of operation &gt; 10 years, foreign exchange business only;</td>
<td></td>
</tr>
<tr>
<td>- Other:</td>
<td></td>
</tr>
<tr>
<td>- Depending on local administration possibly further tax incentives with regard to local enterprise income tax;</td>
<td></td>
</tr>
<tr>
<td><strong>FEs:</strong></td>
<td></td>
</tr>
<tr>
<td>Reduced Withholding Tax of 10% on passive income generated within the SEZ;</td>
<td></td>
</tr>
<tr>
<td><strong>Economic and Technological Development Zone (ETDZ)</strong>(^{946}):</td>
<td></td>
</tr>
<tr>
<td>- Producing FIEs:</td>
<td></td>
</tr>
<tr>
<td>- 2 years of enterprise income tax exemption, commencing with the entity’s first profitable year and;</td>
<td></td>
</tr>
<tr>
<td>- consecutive 3 years 50% exemption;</td>
<td></td>
</tr>
<tr>
<td>- Condition: term of operation &gt; 10 years;</td>
<td></td>
</tr>
<tr>
<td>- Other:</td>
<td></td>
</tr>
<tr>
<td>- Depending on local administration possibly further tax incentives with regard to local enterprise income tax;</td>
<td></td>
</tr>
<tr>
<td><strong>FEs:</strong> Reduced Withholding Tax of 10% on passive income generated within the ETDZ.</td>
<td></td>
</tr>
<tr>
<td><strong>Old Urban Districts (OUD) of SEZs and ETDZs and the Coastal Open Economic Zones (COEZ)</strong>(^{947}):</td>
<td></td>
</tr>
<tr>
<td>- FIEs active in technology, knowledge-intensive projects, energy, transport, harbor- and dock building, or;</td>
<td></td>
</tr>
<tr>
<td>- or other projects with an investment of more than US$ 30m and a long divestment period are subject to a 15% enterprise income tax rate;</td>
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<tr>
<td>- FIEs, not attributable to one of the categories mentioned above, are subject to 24% enterprise income tax rate;</td>
<td></td>
</tr>
<tr>
<td><strong>FEs:</strong> Reduced Withholding Tax of 10% on passive income generated within the OUD or COEZ.</td>
<td></td>
</tr>
</tbody>
</table>

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\(^{945}\) Art. 7 I FEITL in connection with Art.’s 69, 71 I, 72 IRFEITL.

\(^{946}\) Art. 7 I FEITL in connection with 69, 71 I, 72 IRFEITL.

\(^{947}\) Art. 7 II, III FEITL in connection with Art. 70, 71 II, 72, 73 IRFEITL.
<table>
<thead>
<tr>
<th>China’s Foreign-Invested Holding Company: Taxation and Tax Planning</th>
</tr>
</thead>
<tbody>
<tr>
<td>A Review with Reference to Austrian Tax Law</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>High-Tech Industry Development Zones (HTIDZ)(^{948}):</th>
<th>0%, 15%</th>
</tr>
</thead>
<tbody>
<tr>
<td>FIEs need to be officially registered as technology-intensive, then 2 years exemption commencing with the first profitable year;</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Shanghai Pudong New Area (SPNA)(^{949}):</th>
<th>0%, 7.5%, 15%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Producing FIEs:</td>
<td></td>
</tr>
<tr>
<td>- 2 years of enterprise income tax exemption, commencing with the entity’s first profitable year and;</td>
<td></td>
</tr>
<tr>
<td>- consecutive 3 years 50% exemption;</td>
<td></td>
</tr>
<tr>
<td>- Condition: term of operation &gt; 10 years;</td>
<td></td>
</tr>
<tr>
<td>FIEs active in energy, construction or transport businesses:</td>
<td></td>
</tr>
<tr>
<td>- 5 years exemption commencing with the first profitable year;</td>
<td></td>
</tr>
<tr>
<td>- 50% exemption for consecutive 5 years;</td>
<td></td>
</tr>
<tr>
<td>- Condition: term of operation &gt; 15 years;</td>
<td></td>
</tr>
<tr>
<td>Financial institutions:</td>
<td></td>
</tr>
<tr>
<td>- exemption of first profitable year;</td>
<td></td>
</tr>
<tr>
<td>- 50%-exemption for consecutive 2 years;</td>
<td></td>
</tr>
<tr>
<td>- Conditions: registered capital &gt; US$ 10m, SEZ, term of operation &gt; 10 years, foreign exchange business only;</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>FIEs:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Reduced Withholding Tax of 10% on passive income generated within the SPNA;</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Special Investment Area Beijing (SIAB)(^{950}):</th>
<th>0%, 7.5%, 10%, 15%</th>
</tr>
</thead>
<tbody>
<tr>
<td>FIEs that are active either in the research and development or production of developed new technologies (“high tech enterprises”):</td>
<td></td>
</tr>
<tr>
<td>- 3 years exemption from commencement of business activities;</td>
<td></td>
</tr>
<tr>
<td>- 50%-exemption for consecutive 3 years;</td>
<td></td>
</tr>
<tr>
<td>- if export of products &gt; 40% of all goods than reduced tax rate of 10%;</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Business Activity:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Production(^{951}):</td>
<td>0%, 15%, 30%</td>
</tr>
<tr>
<td>- 2 years of enterprise income tax exemption, commencing with the entity’s first profitable year and;</td>
<td></td>
</tr>
<tr>
<td>- 50%-exemption for consecutive 3 years;</td>
<td></td>
</tr>
<tr>
<td>- Condition: term of operation &gt; 10 years;</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Agriculture, forestry, animal husbandry(^{952}):</th>
<th>0%, 15%, 30%</th>
</tr>
</thead>
<tbody>
<tr>
<td>- 2 years of enterprise income tax exemption, commencing with the entity’s first profitable year and;</td>
<td></td>
</tr>
<tr>
<td>- 50%-exemption for consecutive 3 years;</td>
<td></td>
</tr>
<tr>
<td>- Condition: term of operation &gt; 10 years;</td>
<td></td>
</tr>
<tr>
<td>- 15-30%-exemption for consecutive 10 years;</td>
<td></td>
</tr>
<tr>
<td>- Condition: term of operation of at least a further 10 years;</td>
<td></td>
</tr>
</tbody>
</table>

| Technologically advanced and export-orientated enterprises\(^{953}\): |
|-------------------------------------------------|-------------------|
| - Technologically advanced FIE:                 | 0%, 15%, 30%      |
| - 2 years of enterprise income tax exemption, commencing with the entity’s first profitable year and; |
| - 50%-exemption for consecutive 3 years;         |

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\(^{948}\) Art. 8 II FEITL in connection with Art. 75 I Nr. 6 IRFEITL.
\(^{949}\) Art. 8 II FEITL in connection with Art. 75 I Nr. 3 IRFEITL.
\(^{951}\) Art. 8 I FEITL.
\(^{952}\) Art. 8 III FEITL.
\(^{953}\) Art. 8 II FEITL in connection with Art. 75 I no.’s. 7, 8 IRFEITL.
China’s Foreign-Invested Holding Company: Taxation and Tax Planning

- A Review with Reference to Austrian Tax Law

| Condition: term of operation > 10 years and maintenance of status as “technologically advanced”;
- Exporting FIE:
  - 2 years of enterprise income tax exemption, commencing with the entity’s first profitable year and;
  - 50%-exemption for consecutive 3 years;
  - Condition: term of operation > 10 years;
  - 50%-exemption for every single year at a tax rate of 10%;
  - Condition: Exported goods > 70% of all produced goods; |
| Port and pier construction\textsuperscript{954}:
  - Exemption of 5 years commencing with first profitable year;
  - 50%-exemption for consecutive 5 years;
  - Condition: term of operation > 15 years; |
| Financial institutions\textsuperscript{955}:
  - Exemption for first profitable year;
  - 50%-exemption for consecutive 2 years;
  - Condition: registered capital of at least US$ 10m, SEZ, term of operation > 10 years, foreign exchange business only. |
| Reinvestment: Reinvestment Tax Refund\textsuperscript{956}:
  - 40% tax refund on enterprise income tax paid if shareholder reinvest their share of after-tax profits either into the very same enterprise by way of a capital increase or into another FIE;
  - term of operation > 5 years;
  - in case the funds are reinvested into an exporting FIE or a technologically advanced FIE such refund claim can be up to 100%;
  - if reinvested capital is distributed or withdrawn within 5 years the tax refund is to be paid back; |

\textit{Table 16: Tax Incentives in the PRC\textsuperscript{957}}

\textsuperscript{954} Art. 8 II FEITL in connection with Art. 75 I no. 1 IRFEITL.
\textsuperscript{955} Art. 8 II FEITL in connection with Art. 75 I no. 5 IRFEITL.
\textsuperscript{956} Art. 10 FEITL in connection with Art.’s 80, 81, 82 IRFEITL.
\textsuperscript{957} Self-prepared table with reference to Wang, Besteuerung, 2006, pp. 26 et seq.
**ANNEX II: GLOSSARY**

<table>
<thead>
<tr>
<th>English</th>
<th>German</th>
</tr>
</thead>
<tbody>
<tr>
<td>accounting</td>
<td>Buchführung</td>
</tr>
<tr>
<td>acquired goodwill</td>
<td>derivativer Firmenwert</td>
</tr>
<tr>
<td>acquisition cost</td>
<td>Anschaffungskosten</td>
</tr>
<tr>
<td>add back taxation</td>
<td>Hinzurechnungsbesteuerung</td>
</tr>
<tr>
<td>affiliated enterprises</td>
<td>verbundene Unternehmen</td>
</tr>
<tr>
<td>amortization</td>
<td>Abschreibung von immateriellen Vermögensgegenständen</td>
</tr>
<tr>
<td>articles of incorporation (association)</td>
<td>Gesellschaftsvertrag, Satzung</td>
</tr>
<tr>
<td>assets</td>
<td>Vermögensgegenstände, Wirtschaftsgüter, Aktiva</td>
</tr>
<tr>
<td>asset side</td>
<td>Aktivseite der Bilanz</td>
</tr>
<tr>
<td>authoritative principle</td>
<td>Maßgeblichkeitsprinzip</td>
</tr>
<tr>
<td>authoritative tax result</td>
<td>steuerlich maßgebliches Ergebnis</td>
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ANNEX III: COLLECTION OF CHINESE LEGISLATION

Legislation promulgated and issued by the NPC:


China’s Foreign-Invested Holding Company: Taxation and Tax Planning

A Review with Reference to Austrian Tax Law


Legislation promulgated and issued by the SC:


China’s Foreign-Invested Holding Company: Taxation and Tax Planning

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Legislation promulgated and issued by MOFTEC/MOFCOM:


**Legislation promulgated and issued by MoF:**


China’s Foreign-Invested Holding Company: Taxation and Tax Planning

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**Legislation promulgated and issued by SAT:**


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**Legislation promulgated and issued by SAIC:**


Legislation promulgated and issued by SAFE:


Legislation promulgated and issued by the China Insurance Regulatory Commission:


Legislation promulgated and issued by CSRC:


Legislation promulgated and issued by the China Banking Regulatory Commission:


Legislation promulgated and issued by the People’s Bank of China:


Legislation promulgated and issued by the Shanghai Municipal People’s Government:

ANNEX IV: OTHER LEGISLATION

AUSTRIA:

Legislation promulgated and issued by the Austrian National Council:


Legislation promulgated and issued by the Austrian Federal Ministry of Finance:


Legislation of the Austrian Administrative Court:

Austrian Administrative Court, Case 2000/13/0176, January 19, 2005.

Austrian Administrative Court, Case 2002/14/0074, December 9, 2004.


**EUROPE:**

**Legislation promulgated and issued by the Council of the European Union:**


Legislation of the European Court of Justice:


GERMANY:

Legislation promulgated and issued by the German Federal Ministry of Finance:


German Federal Ministry of Finance, *Directive IV B 4 – S 1300 – 111/99, Grundsätze der Verwaltung für die Prüfung der Aufteilung der Einkünfte bei Betriebsstätten international tätiger Unternehmen (Betriebsstätten-Verwaltungsgrundsätze)*,
Legislation of the German Constitutional Court:

German Constitutional Court, *Case 1 BvL, 34/57*, April 14, 1959, in: Entscheidungs-
sammlung des Bundesverfassungsgerichts, vol. 9, 1959, pp. 249 et seq.

Legislation of the German Federal Civil Court:

German Federal Civil Court, *Case III ZR 47/77*, November 16, 1978, in: Neue
Juristische Wochenschrift, 1979, pp. 540 et seq.

German Federal Civil Court, *Case III ZR 21/77*, November 9, 1978, in: Neue Juristische
Wochenschrift, 1979, pp. 805 et seq.

Legislation of the German Federal Tax Court:

German Federal Tax Court, *Case III R 19/02*, January 22, 2004, in: German Federal Tax
Gazette 2004 II, pp. 515 et seq.

German Federal Tax Court, *Case I R 12/02*, September 17, 2003, in: GmbH-Rundschau
2004, pp. 595 et seq.


German Federal Tax Court, *Case GrS 2/99*, August 7, 2000, in: German Federal Tax
Gazette 2000 II, pp. 632 et seq.

German Federal Tax Court, *Case I R 24/96*, July 15, 1998, in: German Federal Tax
Gazette 1998 II, pp. 728 et seq.

German Federal Tax Court, *Case X R 78/94*, November 19, 1997, in: German Federal Tax
Gazette 1998 II, pp. 59 et seq.

Finanzrechtsprechung 1997 p. 750.

German Federal Tax Court, *Case I R 80-81/91*, February 3, 1993, in: German Federal Tax
Gazette 1993 II, pp. 462 et seq.

German Federal Tax Court, *Case VIII R 149/86*, April 14, 1992, in: German Federal Tax
Gazette 1992 II, pp. 817 et seq.
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**Legislation of the German “Reich” Tax Court:**

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