

## **Tax Dispute Resolution, Judiciary Independence and Property Rights: the Case of China**

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### ***Abstract:***

China does not have a litigious society in which citizens regularly challenge the decisions of administrators in the courts. In this context, the promulgation of the Administrative Litigation Law in 1989 to facilitate individuals' legal actions against state players has had limited effect on appeals against administrative decisions. In advanced market economies, taxpayers rely on court appeals to protect taxpayer rights and to improve the assessment process by subjecting administrative decisions to external review. The inadequacy of an effective tax dispute resolution system has detracted from the attractiveness of investments in China for both international and domestic investors. This research aims to ascertain why resort to litigation is so rare in China, what factors may affect the outcomes of appeals, and how the limited avenues of appeal impact more generally on China's economy and society. It will examine the tax dispute resolution legal regime in China over the past decade to determine which factors currently constraining the use of appeals can be addressed to make formal legal remedies more accessible to taxpayers. The availability of an effective judicial appeal system is of growing importance in the new global era in which taxpayers have become more mobile, selective in investment locations and demanding of protection of property rights.

### **I. Introduction**

Tax is about money. It serves as a direct linkage between government and individuals. Tax is sacrifice individuals made from part of their properties to government in exchange of public goods and services. Tax is thus closely connected to individuals' property rights. Historically, the protection of property rights prompted the establishment of the rule of law and limited government. In the view of political historians, the evolution of state capacity in taxation responded to exigencies of war, which incentivized

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governments to develop institutions for supporting and maintaining trade and property rights.<sup>1</sup>

In many western jurisdictions, the reliance of taxpayers upon court appeals to protect their property rights in relation to tax assessment and payment is common and often. By contrast, taxpayers dissatisfied with administrative decisions by the tax authorities in China rarely, if not never, appeal the decisions past an initial stage of administrative review. The implementation of an administrative litigation mechanism in 1989 has raised, to a certain degree, the role of courts in providing an avenue for taxpayers to protect rights, in particular property rights provided for by various laws, through an external review of the practice and procedures of tax authorities. While there have been an increasing number of tax appeal cases at courts in recent years in China, the increase is by no means comparable to that in developed democracies such as the United States (US). The mechanisms for review of administrative decisions that taxpayers believe to be incorrect or inappropriate as a matter of law seem to have not kept pace with the rapid development of China's economy and transformation of social structures. The ever changing legal regime of taxation has been accompanied by increasing uncertainty and inconsistencies of rules, and abuse of discretionary power in tax administration and collection. The uncertainty and abuse of power have given rise to, domestically, serious conflicts between government and taxpayers, instigating social unrest, and, internationally, considerable controversies, undermining investors' confidence.

Does the rareness of court appeals regarding taxation mean Chinese taxpayers do not mind their property rights being infringed upon?<sup>2</sup> The answer is definitely not. Chinese taxpayers are no different than most other peoples. However, why are tax disputes rare in China? How, in practice, have taxpayers protected their rights? Compared to formal legal remedy system, is informal way of protection more effective? If not, why not? If yes, how, and what could be done to increase the role of court appeals in promoting the protection of property rights for taxpayers?

This paper considers these questions from the following four parts. Part II after the Introduction provides a brief account of literature review on the topic of tax dispute

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<sup>1</sup> Timothy Besley and Torsten Persson, "The Origins of State Capacity: Property Rights, Taxation, and Politics" (2007) *NBER Working Paper Series* 13028.

<sup>2</sup> Taxpayers in China include resident taxpayers and non-resident taxpayers. Resident taxpayers are normally Chinese citizens and entities, though foreign citizens and entities could also be considered resident taxpayers if they fulfill certain requirements. This paper focuses on Chinese resident taxpayers, but it also considers other types of resident taxpayers whose nationality is not Chinese or who are not registered under Chinese law.

resolution in China. Part III discusses the current Chinese legal system of tax dispute resolution, noting the distinctive features of the system that may hinder the effective use of the formal legal regime in practice. Part IV deals with the questions of why the use of formal tax dispute resolution system, in particular litigation, is scarce in China, what factors may affect the outcomes of appeals, and how the limited avenues of appeal impact on China's economy and society. This paper concludes in Part V.

## II. Literature Review<sup>3</sup>

Concomitant with the assumption of the probability of prevailing in tax cases is low, there thus far has been almost no serious and systematic research on the topic of tax dispute resolution in China. While there have been studies on administrative appeal and administrative litigation in China, these tend to focus on general theory and practice (Waldfogel, 1988; Olson, 1993; Peerenboom, 2001; Cheng, 2010) or are concerned about the tension between state power and individuals or private entities (Cheng, 2010; Cai, 2011; He, 2011; Minzer, 2011), and how, and to what extent, the courts can play a role in dispute resolution in administration in general (Pei, 1997; O'Brien and Li, 2004; Minzner, 2006; Ginsburg, 2008; He, 2009). These studies do not pay particular attention to the special feature of the formal tax dispute resolution legal system in China, even though they may be employed as a reference to describe and understand the general pictures of China's administrative appeal and litigation system.

Studies with a particular focus on tax dispute resolution either exclusively deal with the theory and implications based on certain other jurisdictions (Baistrocchi, 2012), or discuss the legal system in specific jurisdictions such as Australia, Hong Kong, India, New Zealand, the United Kingdom (UK), and the US (Berson, 2001; Chow, 2006; Howard, 2009; Lin and Qiu, 2009; Way, 2009; VanderWolk, 2010; Cowan, 2010; Maples, 2012), or talk about the norms and practices in relation to international taxation that goes beyond a single domestic jurisdiction (Burnett, 2007; Farah, 2009; Irish, 2011). These studies may, to some extent, lend theories and experiences to the study of China's tax dispute resolution system, and they can be used as a comparison for evaluating whether China's tax dispute resolution system is incompatible and inconsistent with international norms and expectations, in particular those of China's major trade partners including Hong Kong and the US. Notwithstanding the potential use of these studies, they cannot help ascertain the research questions of why resort to litigation is so rare in China, what factors may affect the outcomes of appeals, and how the limited avenues of

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<sup>3</sup> Reference style used in the part of Literature Review is different than that in the other parts of the paper. The author will adjust the style to keep it consistent throughout the paper at a later stage.

appeal impact more generally on China's economy and society. In other words, these studies cannot lead to the identification and appreciation of the exact problems and issues associated with the tax dispute resolution system and the tax system design in China that have contributed to the tax assessment disputes between authorities and taxpayers.

Previous studies have noted problems with China's tax dispute resolution system (Shi and Ding, 2002; Cui, 2011; Givens and MacDonald, 2011), and there have been a very few number of studies on the topic including the editing of tax cases happened in China in recent years (Xiong, 2010 and 2011). Nevertheless, there have been almost no serious and systematic examination and analysis of the topic among scholars either in the area of taxation or in the general areas of law, appeal, and social science based in China and overseas. A number of factors may explain the scarcity of research on the topic, notably the lack of comprehensive court records and appeal statistics of tax authorities across the levels of government, insufficient transparency of public governance and decision-making by tax authorities, and the influence of the assumption of low probability of prevailing on study agenda of law scholars. These difficulties are, however, not insurmountable. They can be solved by adopting appropriate research methodology such as surveys and interviews of tax practitioners and managers who have real experience in working on tax issues and dealing with tax authorities in China, and by identifying theories and principals that can be used to explain the problems in China.

The theories may include appeal theory, general tax law theory, the cost-benefit theory in economics, and the theories of the traditional Chinese culture and philosophy towards lawsuits and the relationship between the government and individuals. Apart from examining tax litigation statistics from appeals launched in the high courts at the provincial level of the government, the research will also scrutinize some representative cases in order to find out what types of taxpayers would like to employ formal legal systems to remedy their property rights, if any, and why.

### **III. The Existing Legal System of Tax Dispute Resolution**

The formal legal remedy system offered by law in China includes administrative appeal and appeals of tax assessment to the courts. Although the system, in particular the one for court appeal, has been in place for more than two decades, there has been no much use of it by taxpayers in resolving conflicts and disputes with tax authorities. As some scholars have argued, tax dispute resolution per se may be an unfamiliar topic for many people in China.<sup>4</sup> The very idea of resorting to formal proceedings, either administrative

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<sup>4</sup> Wei Cui, "What is the 'Law' in Chinese Tax Administration?" (2011) 19 *Asia Pacific Law Review* 1, 75-

appeal or litigation, may be extraneous. Most of Chinese tax practitioners primarily focus on tax planning and tax compliance but not tax controversy.<sup>5</sup> Before pondering why this is the case, it is necessary to examine how the current legal system of tax dispute resolution operates in China.

### 3.1 Administrative Appeal

Tax administrative appeal is governed mainly by the Law on Administrative Reconsideration (LAR),<sup>6</sup> Law on Tax Administration (LTA),<sup>7</sup> and the Provisional Rules of Tax Administrative Reconsideration (PRTAR).<sup>8</sup> Administrative reconsideration is a Chinese term equivalent to appeal in other jurisdictions.

#### 3.1.1 Scope of Appeal

In some jurisdictions such as Australia, a “taxation decision” that can be reviewed is defined broadly to include any assessment, determination, notice or decision made or issued by the tax authority against which an objection may be made. Unlike Australia, the scope of reviewable taxation decision or action under China’s LAR and PRTAR is limited.

According to Article 2 of LAR and Article 2 of PRTAR, only a specific or concrete administrative action can be brought by a citizen, legal person or any other organization to a proper administrative organ for appeal. But as to what exactly the term of “a specific administrative action” means, there has been no unanimous definition. In the Opinion on the Implementation of the Administrative Litigation Law (ALL)<sup>9</sup> issued in 1991, the Supreme People’s Court (SPC) explained that a “specific administrative action” referred to a concrete action towards specific rights and interests of a specific citizen, legal person, or any other organization, which was made by an administration agency of state and its officers, an authorized organization by law and regulations, or an organization or

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<sup>5</sup> However, it also has been found that things may have gradually been changed in China in recent years. The annual number of judicial proceedings against tax authorities is estimated to exceed 700, and the number of administrative appeal is likely twice that. The State Administration of Taxation (SAT) estimates taxpayers are able to obtain at least partial relief in half of the administrative appeals and in 45% of the litigations. Cui, *ibid*.

<sup>6</sup> LAR, promulgated by the National People’s Congress Standing Committee (NPCSC) on 29 April 1999, effective 1 October 1999, amended by the NPCSC on 27 August 2009.

<sup>7</sup> LTA, promulgated by the NPCSC on 4 September 1992, effective 1 January 1993, amended by the NPCSC on 28 February 1995 and 28 April 2001.

<sup>8</sup> PRTAR, issued by the SAT on 15 December 2009, and effective 1 April 2010. This SAT document replaced the old PRTAR that was issued on 24 February 2004 and effective 1 May 2004.

<sup>9</sup> Opinion on the Implementation of the ALL, issued by the SPC on 11 June 1991, effective 11 July 1991.

individual who had been delegated specific administrative power and function by an administrative agency.

This explanation is seriously challenged in both judicial and academic fields. One of the most criticized shortcomings of the explanation is that it limited the scope of reviewable administrative actions, and reduced the possibility that complaints can seek remedies for their legitimate rights and interests through an appeal. In 2000, the SPC replaced this Opinion with another Explanation,<sup>10</sup> which sensibly avoided offering any definition on the term of “specific administrative action”.

So far the term has not been given a clear and satisfactory definition, but it is implicitly agreed that the scope of appealable administrative actions should not be confined to a too narrow scale. An administrative action may be appealed when satisfying the following two requirements: (1) applicants consider their lawful rights and interests have been infringed upon; and (2) applicants have expressed their objections.

“Consider” in the first requirement only needs to be the applicants’ subjective perception or judgment. Even though it is later confirmed by the appeal authority that there is no damage or infringement occurred, complaints’ right of appeal is not affected. As to the expression of objection, there is no need for it to be lengthy and comprehensive and even no need to be in writing. An informal application stating that an assessment is excessive would suffice.

#### 3.1.1.1 Reviewable specific administrative actions

According to Article 14 of PRTAR, the following specific or concrete administrative acts can be accepted for review by a tax administrative appeal agency: (1) tax collection; (2) administrative licensing and administrative examination and approval; (3) invoice management acts; (4) tax preservation measures and mandatory enforcement measures; (5) administrative punishments; (6) failure to fulfill statutory duties; (7) determination of the qualification for taxpayers; (8) failure to confirm guarantee for tax payment in accordance with law; (9) specific administrative acts regarding the government information disclosure; (10) tax credit rating; (11) notifying the entry-exit departments to prevent taxpayers from leaving the country; and (12) other specific administrative acts that may infringe upon the lawful rights and interests of taxpayers.

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<sup>10</sup> Explanation on the Implementation of the All, Issued by the SPC on 24 November 1999, effective 10 March 2000 and at the same day the 1991 Opinion ceased no effect.

### 3.1.1.2 Reviewable administrative orders

Applicants may also require the administrative appeal agency to review certain types of administrative orders that form the basis of a specific administrative action when they apply for administrative appeal on the specific administrative actions.<sup>11</sup> The reviewable administrative orders include: (1) orders of the SAT and other departments under the State Council; (2) orders of the other tax authorities at all levels; and (3) orders of local people's governments at all levels and their departments. This provision shows that certain orders and normative documents of the administrative agency that are generally applied as law may be appealable.

However, the above provision does not apply to rules made by departments and commissions under the State Council, and rules issued by local people's governments.<sup>12</sup> These administrative rules have to be handled by other competent state organs according to the related laws and administrative regulations, which implies that certain delegated power is outside of the control of the judiciary power.

Under China's legal context certain separation of power has endowed the right to check the delegated power of administration with the legislature body rather than courts. The Constitution provides that the National People's Congress Standing Committee (NPCSC) has the power to annul those administrative rules and regulations, decisions or orders of the State Council that contravene the Constitution or the law.<sup>13</sup> Within the hierarchy of administrative power, it is the power and function of the State Council to "alter or annul" inappropriate orders, directives and regulations issued by the ministries or commissions of the State Council or by local governments.<sup>14</sup> Due to these concerns, laws and rules governing tax administrative appeal have to keep consistence with the other laws, leaving judgment of the legality of certain administrative rules to the corresponding state organs.

To illustrate what are reviewable administrative actions and what are not under the system, one can think about this situation – where there is an SAT circular governing personal assessment. A taxpayer can appeal his or her own assessment that is based on the SAT circular by arguing this circular is ultra-vires the law or implementation regulations. However, the taxpayer cannot appeal another person's assessment based on the same circular. Nor could the taxpayer appeal another person's private ruling that exempted him from a particular anti-avoidance regime, such as the Controlled Foreign

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<sup>11</sup> LAR, art. 7; PRTAR, art. 15.

<sup>12</sup> LAR, art. 7; PRTAR, art. 15

<sup>13</sup> Constitution, art. 67 (7).

<sup>14</sup> Constitution, art. 89 (13) and (14).

Company (CFC) regime, because of the persons' investment in a Cayman Island trust on the basis that the taxpayer's taxes and everyone else's taxes are slightly higher since the SAT allowed the person to avoid tax in a way that the taxpayer thought it was contrary to the law. In other words, reviewable actions must be applied for by the taxpayer himself who is directly the subject of an action, but not anyone else, and the taxpayer cannot apply for appeal on any other person's assessment. Moreover, the taxpayer cannot apply for appeal of the SAT circular since the circular is deemed as an abstract, not specific, action. If the taxpayer wishes to have an appeal body reviewed the circular, he cannot directly do so. He can do it only when he submits an application for reviewing his assessment that was based upon that circular. The taxpayer also could not argue that a tax concession for private schools or work units hiring disabled persons, for instance, was contrary to the Constitution because it amounted to a tax expenditure and the equivalent direct expenditure would be unconstitutional based on the provisions of the Constitution.<sup>15</sup>

### *3.1.2 Procedure of Appeal*

#### *3.1.2.1 Procedural differences in types of appeal*

Generally there are two types of appeals. One is related to tax assessment and payment, and the other non-payment disputes. The principal difference between the two types is whether there is a compulsory requirement for applicants. According to Article 88 of LAR, there is no compulsory requirement of exhaustion of all administrative remedies before taking cases to a court in situations where, for example, a taxpayer objects to an administrative penalty decision, a mandatory enforcement measure, or a tax preservation measure made by a tax authority. In these situations, the taxpayer can choose between administrative appeal and litigation for the protection of his property rights and other rights and interests.<sup>16</sup>

However, if a dispute is related to tax assessment and payment,<sup>17</sup> the taxpayer must first pay or remit the taxes and the late fee according to decisions made by tax authorities, or provide corresponding guaranty, then he may apply for an administrative appeal.<sup>18</sup> If the

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<sup>15</sup> Unlike many other jurisdictions, Constitution of the PRC is not effectively employed as a legal basis in either administrative appeals or court appeals, though it's the most important legal document in the PRC. Taxpayers or other types of complaints therefore cannot question the constitutionality of a tax circular or provisions of tax laws, regulations and circulars. However, challenging the legality of administrative documents should be allowed.

<sup>16</sup> PRTAR, art. 34.

<sup>17</sup> This includes determination of taxable persons, taxable basis, tax reduction, exemption, refund, tax credit, applicable tax rate, tax calculation basis, time limit for tax payment and tax collection methods. PRTAR, arts. 14(1), 33, 44 and 50; LTA, art. 88.

<sup>18</sup> PRTAR, art. 33.



taxpayer objects to decisions made by appeal organs, then he may bring a suit to a court according to the relevant provisions of the law.<sup>19</sup> In such case, there is indeed a compulsory requirement of exhausting administrative remedies, and more critically, satisfying the tax payment requirement, before instituting a suit in court.

### 3.1.2.2 Procedure of tax administrative reconsideration

Taxpayers must lodge an objection within 60 days from the service of the original decision, or the day when they know the specific administrative action.<sup>20</sup> Normally, an appeal body is a tax authority higher than the one making the action in question. On 26 October 2012, the SAT established the Administrative Review Committee of Appeal, which was purportedly designed to become a body of the highest level within the SAT to review appeals of taxpayers in administrative disputes on key and complex tax issues. The Committee is consisted of SAT officials, academics, and practitioners. The final opinion or ruling of the Committee on a certain tax dispute is binding on both tax administration and taxpayers. The ruling is the final stage of the administrative appeal. The establishment of the Committee was intended to improve tax administrative appeals across levels of tax authorities in China.

Usually, an appeal organ examines a dispute on the basis of documents, unless where an applicant makes a request or the appeal body deems it necessary to investigate facts from relevant organizations and individuals.<sup>21</sup> This means that the appeal body has to investigate the facts *ex officio*, and it has no need to restrict itself to facts submitted by the parties. This may help taxpayers to have an opportunity to protect their rights and interests in a direct manner.

Depending on individual cases, an appeal body can make a sustained decision if the disputed administrative action is legal, or a request decision ordering the respondent tax agency to perform duties within a fixed time limit if the respondent failed to do so, or an alteration or confirmation decision if the administrative action is illegal, or a dismissal decision if the defendant tax agency has already performed a statutory duty or does not have such a duty.<sup>22</sup> An administrative action or decision is considered illegal if the major facts are unclear or the evidence is inadequate, or the basis for making the administrative

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<sup>19</sup> PRTAR, art. 33.

<sup>20</sup> LAR, art. 9, PRTAR, art. 32.

<sup>21</sup> LAR, art. 22; PRTAR, art. 64.

<sup>22</sup> LAR, art. 28; PRTAR, arts. 75 and 78.

action is wrong, or the statutory procedures are violated, or there is an abuse of power or ultra vires action, or the disputed action is obviously inappropriate.<sup>23</sup>

In short, administrative appeal has served as a quick and inexpensive means for taxpayers to remedy their property (and personal) rights and at the same time to enhance legality and legitimacy of tax administration in China. However, there are noticeable flaws relating to this system. One of the most serious flaws is the requirement of first paying taxes and then exhausting administrative remedies in cases involving tax assessment and payment. Some jurisdictions such as Taiwan have already declared such requirement unconstitutional since this procedural requirement has hindered taxpayers from using formal legal ways to resolve disputes and protect rights. Another problem is the too limited scope of appealable administrative actions. Although the SPC no longer explicitly indicates only the so-called specific administrative action can be reviewed, in practice, administrative rules, circulars, public announcements and the like issued by the tax authorities, which are in a large amount and applied as the most important basis for making decisions for tax administration on a daily basis, cannot be challenged through the appeal procedure.

## 3.2 Litigation

### *3.2.1 Scope of Tax Administrative Litigation*

Much the same as administrative appeals, the scope of actionable tax administrative actions is limited. According to the Administrative Litigation Law (ALL),<sup>24</sup> only specific or concrete administrative actions can be sued in courts.<sup>25</sup>

According to Article 12 of ALL, courts cannot accept suits against administrative regulations and rules of the State Council and its ministries as well as administrative rules of local governments and their departments, or decisions and orders with general binding force formulated and announced by administrative agencies. Accordingly, courts cannot accept cases questioning the legality of circulars, issuances, public announcements and other types of normative documents issued by the SAT, or taxation rules of local governments and local tax bureaus.

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<sup>23</sup> PRTAR, art. 75 (3).

<sup>24</sup> ALL, promulgated by the NPC on 4 April 1989 and effective 1 October 1990.

<sup>25</sup> ALL, art. 2.

The limited scope for tax administrative litigation in China reflects the possibility of judicial protection for taxpayers' rights, in particular property rights, and the extent that judicial power can check and constrain administrative power. Unlike many jurisdictions, judicial review is not available in China. Although the ALL has provided a type of mechanism similar to judicial review for individuals and organizations to review the legality of specific administrative actions, the mechanism – administrative litigation using Chinese term – does not allow disputants to challenge the constitutionality of rules and orders with general binding force in courts. By contrast, in some jurisdictions such as Germany, its tax courts including lower tax court and the German Federal Tax Court must examine the constitutionality of any law, and, if it believes it to be unconstitutional, it must submit the issue to the Constitutional Court in Germany.

In the case of taxation, the problem with scope seems to be more acute in China as apart from a very few laws passed by the national legislature and a few administrative regulations by the State Council, an overwhelming majority of important rules in taxation comes in the form of informal circulars, issuances, and orders issued by the tax authorities. Though they are not formal legal documents and lack binding force, they are widely and frequently applied and have a direct legal impact on taxpayers' property rights. If there is no way to challenge the constitutionality or legality of these so-called abstract administrative actions, it would make taxpayers' rights protection and control over illegal administrative actions questionable.

### *3.2.2 Requirements that All Administrative Procedures be Exhausted*

Most of tax disputes are related to tax assessment and payment. Based on the ALL, an administrative litigation will not be allowed unless two requirements are met. The first is taxpayers must pay the required amount of taxes and late fees to the relevant tax authorities before applying for an administrative appeal on the payment decision. The second is only after going through the administrative appeal, can the taxpayers bring a suit to a court if they are not satisfied with the appeal decision. Without the two preceding procedures – tax payment and administrative appeal, taxpayers will not be allowed to sue before a court.

Such requirements are provided mainly for the purposes of facilitating tax collection and reducing potential burdens of courts. When the ALL was drafted, some members of the legislature worried that the introduction of the right to sue administrative actions may clog the courts and impede efficient tax administration by opening the floodgates to a spate of legal actions against the tax administration. Some also worried that tax disputes

were highly technical in nature, and thus would be better to be handled by tax agencies rather than courts.

However, using the means of limiting the right to sue in order to guarantee tax revenues and tax efficiency is contrary to the purpose of tax litigations. In many cases, tax assessment and collection are indeed illegal or unreasonable, and taxpayers concerned are not liable to the amount assessed. If taxpayers do not have the corresponding ability to pay excessive taxes or have particular difficulties in paying on time, they would probably lose the right to apply for appeal or to file a suit. In this circumstance, how can they protect their rights and how to review the legality of disputed tax administrative actions, be specific or abstract? Some commentators have argued that these requirements in effect deprive of the taxpayers' right to sue. Administration efficiency should not be made at the expense of justice.

### *3.2.3 Jurisdiction for Tax Disputes in Tax Administration*

Another problem in tax litigation relates to jurisdictions, which refers to the locality and the competence of a lower court as the court of first instance. According to Article 17 of the ALL, an administrative litigation should be under the jurisdiction of courts in the locality of the administrative agency that initially undertook the specific administrative action. An appealed case in which the agency conducting the appeal has amended the original administrative action may also be placed under the jurisdiction of the court in the locality of the appeal agency.

This provision is common in other jurisdictions. But in China, due to the fact that the distribution of courts is based on administrative zoning and courts are established according to the level of government administration, courts usually lack independence in both financial and personnel affairs. Courts cannot be immune from various interventions from local governments and local Communist Party Committee. Very often, courts have intermingled and complicated relationships with local governments and the Party. This, together with the lack of competence of the judicial system, impairs the impartiality, fairness, and neutrality of the judicial power.

In comparison, some developed jurisdictions, such as Canada and Germany, have established special tax courts that are not based on administrative zoning. This is thought to be conducive to judiciary independence, and thus beneficial to the protection of taxpayers' property rights. Many Chinese scholars have advocated reforms of the current tax administrative litigation system so as to better protect taxpayers' rights and interests.

#### **IV. Why the Use of Formal Tax Dispute Resolution System is Rare?**

It has been found that the formal legal remedy system offered by law – administrative appeal and appeals of tax assessment to the courts – has not been effective in resolving disputes between taxpayers and tax authorities in China. Only a rather small number of taxpayers, notably very large taxpayers, have been able to challenge authorities' assessments of tax allegedly payable under the law. It has been assumed that taxpayers, be large or small, who litigate against tax authorities – part of government organs, would face low chances of winning. Thus whether there are conflicts and disputes between taxpayers and tax authorities, seeking informal channels to resolve the problem such as reconciliation or settlement with the tax authorities has become a more likely desirable approach, even though formal legal mechanisms including administrative appeal and litigation have been in place.

As compared to administrative appeals, taxpayers' use of courts to appeal decisions of tax authorities in China is scarcer.<sup>26</sup> The use has been constrained by a number of factors. Taxpayers seeking redress against an administrative decision they believe to be incorrect must exhaust administrative reconsideration options and make payment before they are allowed to launch an action in court. The scope for tax appeals is rather limited as subject to a few exceptions courts will not consider the correctness of administrative interpretations set out in tax rules, circulars, notices and similar documents. Other factors inhibiting litigation include concern over real judiciary independence, agency retaliation and taxpayers' lack of expertise with tax law and litigation. Readiness to seek redress through the courts varies across different categories of taxpayers, with an overwhelming majority relying on informal resolution mechanisms.

It is worth thinking why resort to litigation is so rare in China and what factors contribute to the ineffectiveness of the current legal dispute system. If the ineffectiveness can be attributable to the ambiguity and complexity of the tax system that lead to the different interpretations between tax authorities and taxpayers, then identification of areas causing most uncertainty and giving rise to most disputes can be used as the basis for reform of the law to remove the uncertainties. It also needs to look at whether the ineffectiveness stems from the influence of traditional culture and mindset that result in the perception and reality that administrators including tax authorities hold the cards in any dispute with

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<sup>26</sup> According to a preliminary field research of the author at one of basic courts in Wuhan, there were only 2 tax cases in total 1270 administrative cases from 1987 to 2010. That is, tax cases only accounted for 0.16% in more than 2 decades.

taxpayers and actions to assert rights granted by laws are thus likely to be futile. The last question worth thinking is if the formal court appeal system is not effective to protect taxpayers' property rights, then what alternative measures could be developed to improve the protection of taxpayers' property rights and other types of rights and interests.

#### 4.1 Who would like to seek formal legal regime

The majority of applicants within a limited number of court appeals and administrative appeals are companies but not individual taxpayers. This may not be a surprising finding given two important reasons. Firstly, individual income levels have been very low since the establishment of the PRC and it is not until very recently that many ordinary individuals have paid no taxes. Individual income tax law was only introduced after the economic reform took place in late 1978.<sup>27</sup> For most ordinary taxpayers, their income source is primarily from salaries and wages, for which a withholding regime applies. Usually, there is no much controversy about the withholding tax as the system is fairly straightforward. Taxes are withdrawn at the source of income and paid by employers on behalf of individual employees to the government. Secondly, taxpayers per se may have various problems in tax payment, for example, they may have deliberately under-reported payment or concealed information regarding their income and payment from tax authorities. Thus, directly challenging tax authorities on disputed issues may not be a desirable way for them to solve disputes since tax authorities may use this opportunity to scrutinize their payment record. The situation seems to be particularly true among wealthy individuals since they have more income sources and have more methods and recourses to maneuver incomes for tax avoidance purposes. Also, formal legal system is lengthy and expensive and results are uncertain, which will hinder them from using formal legal regime to solve disputes.

In the case of companies, in particular big companies, they may seek formal system to solve disputes as they are, finically and personally, more able to deal with tax authorities than individuals. The stakes involved in the disputes may be too big and significant. Government may need to consider their complaints as tax controversies would have an impact on future investment decisions of the companies, which may affect the economic development and government revenues of the region where the disputes occurred.

#### 4.2 Traditional Cultural and Property Rights

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<sup>27</sup> Law on Individual Income Tax, issued by the NPCSC on 10 September 1980, effective the same day, amended 31 October 1993, 30 August 1999, 27 October 2005, 29 June 2007, 29 December 2007, and 30 June 2011.

Some commentators have argued that the limitedness in court appeals in China is attributable to the influence of traditional culture. People seldom challenged the government as they viewed the government as being superior to them. The assumption of the influence of traditional culture may be wrong, however. Chinese people are concerned about property rights much the same way as are other people. They may choose not to seek the formal legal system to protect property rights if they will have to face, very frequently, tax authorities in their daily life. In the other areas of government administration where individuals and companies do not need to face government often, they may choose formal ways for rights protection purposes.

Usually, taxpayers would weigh costs and benefits between formal dispute resolution system and informal resolution means. In the case of payment disputes, if the costs for administrative appeals are higher than the benefits, they will not apply for appeals. If costs are lower, they will probably apply. If they failed in administrative appeals, they may further consider costs and benefits between further litigation and comprises or any other ways for solution. Very likely, only those who have nothing or little to lose or who have powerful relationship network and bigger interests at stake would go through the formal resolution process until the last stage – court appeals.

#### 4.3 Judiciary Independency

The lack of judicial independency does seem to be a factor affecting taxpayers' decision on employing formal legal regime. As noted earlier, courts have had to rely on local governments at the same level for funding and also for personnel affairs. Though competence of judges has been improved in recent year, the lack of independence of courts in general and of judges in particular has made credibility of the judicial system questionable.

Moreover, laws and regulations in China are normally too general and abstract to apply. They provide too much discretionary power for tax authorities, but too little clear explanations and rules on how to apply discretionary power. When there is a dispute regarding application of provisions of regulations and rules, courts would be refrained from questioning the legality and legitimacy of the application of these provisions due to the ambiguity of these provisions. As to normative documents including SAT circulars and notices, although they cannot be used as a legal basis for courts to make decisions, they are still employed "as a reference". If there is no apparent conflict between these normative documents and laws and regulations of higher level, courts may still use them in making decisions but without directly citing them. This shows that unlike common law systems where judges are making laws, courts in China most of time just apply laws, while administrative authorities are making the "laws".

It should be noted the above discussion just analyses reasons taxpayers might not appeal, but not reasons the government has established a system that makes it difficult to appeal. What interest is it protecting and why is it different from other governments that have facilitated appeals? This research will look at these questions and consider the issue from the perspective of government. Without a consideration of government view, a half of the story will be missing.

## V. Conclusion

Tax dispute resolution has been an under-studied topic in China. There have been very few tax cases among courts in China. On the other hand, the ever changing legal regime of taxation has been accompanied by increasing uncertainty and inconsistencies of rules and abuse of discretionary power in tax administration. The uncertainty and abuse of power have led to serious conflicts between government and taxpayers, disincentivizing tax compliance and undermining investors' confidence. This research argues that although court appeals are rare in China, this does not follow taxpayers not care about their property rights and they have no ways of safeguarding their property rights and interests that have been affected by tax assessment and decisions. The limited use of formal system and heavy reliance on informal resolution means may be just an abnormal situation during China's economic and political transitions. The return to normalcy, however, will require significant reforms in both tax law and the overall judicial system of the country.

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