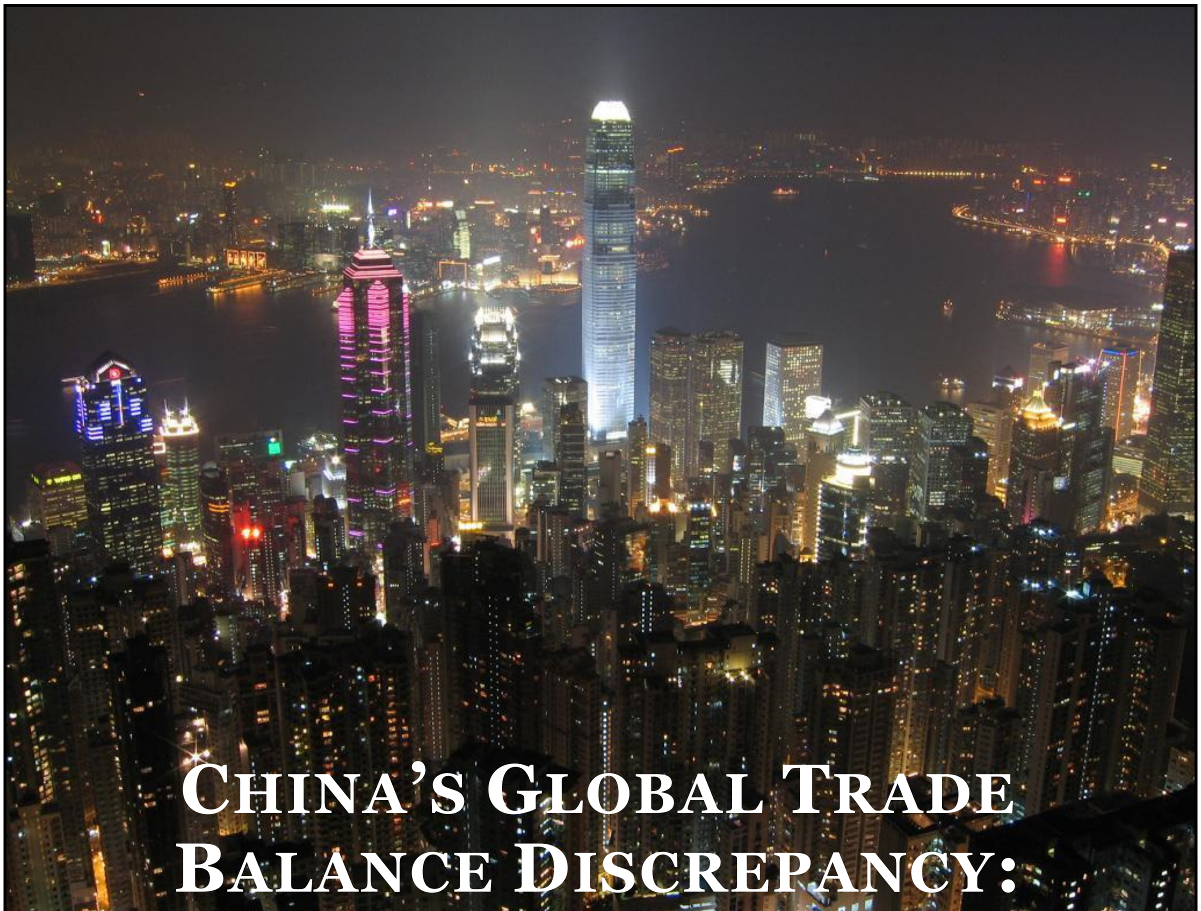

CHINA'S GLOBAL TRADE BALANCE DISCREPANCY:

HONG KONG ENTREPÔT EFFECTS AND ROUND-TRIPPING CHINESE CAPITAL

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I. EXECUTIVE SUMMARY

A. Purpose of this Study

The U.S.-China Security Review Commission and the United States Congress, commissioned the Trade Lawyers Advisory Group ("TLAG") -- specifically, members CRG Consulting Texas, Inc. ("CRG-Texas") and Georgetown Economic Services LLC ("GES") – to undertake a comprehensive study of the persistent and growing discrepancy in the trade balance data of the People's Republic of China ("China," the "Mainland," or the "PRC") and the data reported monthly by trade partner governments. The purpose of this study is to examine the role of Hong Kong in the various explanations of the statistical discrepancies that readily emerge when one compares official Chinese trade data with those of its trading partners.

Today, many international scholars and researchers are of the view that China's *entrepôt* trade through Hong Kong is to the largest factor responsible for the widening Chinese trade balance discrepancy. The distortion becomes apparent after one examines China's official trade statistics in light of the corresponding "mirror" trade data compiled by its partner nations. In other words, a comparison of *export* statistics recorded by the Chinese customs authority and the corresponding *import* data published by China's trading partner countries reveals a significant and widening inconsistency over the past several years. Chinese *export* values, as recorded by Mainland authorities, are significantly *lower* than Chinese *import* values as reported by China's trading partners. Similarly, Chinese ex*ports* values, as reported by Mainland authorities, are significantly *higher* than values of exports to China as published by China's partner countries.

Consequently, China's balance of trade (consistently in surplus), as determined by official Chinese government statistics, is substantially lower than the global trade surplus as reported by its trading partners. Specifically, based on the Global Trade Information Services database—*World Trade Atlas* ("GTIS," "GTA" or "WTA"), China's trade-in-goods surplus that was reported by 41 major trading partner countries (accounting for approximately 97 percent of total China trade) was US$554.2 billion in 2007. By contrast, Chinese trade surplus with the same 41 trading partner countries, as reported by China, was only US$234.8 billion during the same year -- a *US$319.4 billion* discrepancy. Furthermore, this discrepancy has been trending upward during the period from 1999 to 2007, increasing in eight of the past nine years. The discrepancy has ranged from a low of US$90.8 billion in 1999 to a high of US$319.4 billion in 2007, thus more than tripling over the period.

The reconciliation of this growing data discrepancy is essential for policymakers worldwide – not only to determine China's true global trade surplus, but also to understand the unique role that Hong Kong has played with regard to China's overall economic strategy. Therefore, the primary objective of this study is **(i)** to scrutinize the unique relationship between the Mainland and Hong Kong, and **(ii)** to attempt to explain the statistical discrepancies that distort China's official trade data.

The initial hypothesis that our team sought to prove or disprove was that China's *entrepôt* re-export trade through Hong Kong – that is, China's indirect export and import trade undertaken through the former British territory – constitutes the major trade factor that accounts for the statistical discrepancy and distortion summarized above. To test this hypothesis, we first analyzed various economic studies that had examined this issue during the past 25 years together with the underlying data, and determined that not all of the data discrepancies could be explained by each of those individual studies. We then carefully reviewed all of the relevant legal modifications, including international treaties and conventions that China and Hong Kong have enacted and ratified during the past decade, to try to identify additional explanations for the discrepancy.

Next, we collected our own data through an internationally-recognized source (*e.g.*, Global Trade Information Services) and conducted our own field studies with U.S., Chinese, and Hong Kong customs officials in the U.S., Hong Kong, Beijing, China, and Qinhuangdao City, China. With regard to China's *entrepôt* trade through Hong Kong, we obtained contemporaneous estimates of Hong Kong re-export "middlemen" markups and applied such markups to the most recently available data to reconcile in part China's reported trade statistics. Finally, we performed our own independent statistical analyses.

Based on these multiple criteria, our team rejected the Hong Kong re-export trade hypothesis as the only major explanation accounting for the growing trade data inconsistency highlighted above. The compelling factor supporting our conclusion is that China's indirect export and import trade through Hong Kong represented only 18 percent of China's aggregate multilateral trade with the 41 trading partner countries in 2007, a significant decrease from the 60 percent figure that prevailed approximately two decades ago. It is noteworthy that the 18 percent is calculated using China's total trade volume reported by 41 trading partner countries. Along the same calculation basis, the proportion of Hong Kong re-export trade to China's total trade with its trading partner countries had seen a gradual decrease, from 36 percent in 1999 to around 19 percent in 2006. In other words, even though the China-Hong Kong *entrepôt* effect is still responsible for a share of the statistical discrepancy at issue, that factor cannot by itself constitute an *exclusive* reason for the data discrepancies, based on contemporaneous Chinese trade flows. Furthermore, the recent appreciation of the Chinese currency, the renminbi, the rise of material costs, and increase in labor costs due to passage of the new labor law on January 1, 2008, all have serious negative impacts on Hong Kong middleman companies' business with the Mainland. For these reasons it is likely that Hong Kong's role in the Chinese trade surplus discrepancy may continue to decline in the future.

B. Round-trip Capital—An Under-emphasized Cause of Chinese Trade Balance Discrepancy

Although China's *entrepôt* trade through the former British colony has decreased substantially during the past 20 years, the statistical discrepancy explained above has been steadily increasing during this same period. As a result, our team had to search for alternative hypotheses to identify and explain the real cause or causes underlying the data problem. Based on our integrated analysis of China's current-account and capital-account transactions, we hypothesize that a phenomenon referred to as "round-tripping" is principally responsible for the bulk of the trade data incompatibilities highlighted above.

"Round-tripping" is a trade-tax-investment strategy whereby Chinese enterprises undervalue exports or artificially overvalue imports, in order to move Chinese capital across the Mainland border through current-account transactions. Specifically, Chinese enterprises export domestic capital from the Mainland to related-party enterprises situated outside China in offshore tax havens, such as Hong Kong, pursuant to non-arm's length transfer-pricing transactions that are designed to circumvent Chinese capital controls. The exported Chinese domestic capital is then recycled abroad and returns to the Mainland in the form of foreign investment, and as such, receives a lower tax rate on profits.

Three economic and legal elements should be in place to encourage round-tripping. First, investors from a tax jurisdiction such as China must have access to a foreign tax haven through which they can establish related-party companies with which to engage in non-arm's length transfer-pricing transactions. Second, the primary tax jurisdiction must have trade and investment barriers that significantly impede and discriminate against *domestic investment*. Third, the primary jurisdiction must have on the books tax or other incentives that discriminate in favor of *foreign investment*. The China-Hong Kong relationship satisfies all of these elements.

Even though Hong Kong is not a *de jure* tax haven, international practitioners universally consider the former British colony to constitute a *de facto* tax haven for the following reasons: **(i)** its relatively low corporate income-tax rate of only 17.5 percent; **(ii)** the taxation of only Hong Kong-source income; **(iii)** an extremely tax-friendly territorial principle that is flexibly applied to rather loose and relaxed residency and income-sourcing criteria; **(iv)** the notable absence of taxes on such traditional income items as capital gains, dividends, and retained earnings; and (**v**) statutory provisions that allow taxpayers to carry forward losses indefinitely. Significantly, despite the People's Republic of China's sovereignty over the island, Hong Kong does not even form part of the customs or tax territories of the PRC. Rather, Hong Kong constitutes a separate "foreign customs territory," as well as a distinct "foreign fiscal territory," situated within China's national geographic territory.

Under the "One Country, Two Systems" legal-and-economic framework, Hong Kong becomes an ideal destination for Mainland investments, governed by the series of Mainland-Hong Kong bilateral treaties. The Mainland has imposed a strict foreign currency control policy, which results in significant obstacles to the free flow of capital across the border of China. On the other hand, local governments in China have a strong incentive for soliciting foreign direct investments and have issued a set of favorable policies for these foreign investments (e.g., reduced corporate tax rate for foreign invested enterprises). It is noteworthy that effective as of January 1, 2008, the new corporate taxation law of the Mainland eliminates the gap between the domestic and foreign corporate tax rates. Therefore, the adjacent geographical location of Hong Kong, the particular institutional setting of the Mainland on foreign investment, and the Mainland's foreign currency exchange controls provide an ideal environment for round-tripping capital. One bit of evidence is the relatively high and stable proportion of Chinese FDI that originates in Hong Kong: from 1999 to 2006, Hong Kong investments had accounted for at least 33% of China's total FDI.

In the practice of round-tripping, Mainland enterprises export Chinese capital through current-account transactions that artificially inflate the value of imported components sourced from affiliated enterprises located in offshore tax havens, such as Hong Kong. As explained above, the second economic and legal element that facilitates round-tripping practices comprises trade and investment barriers that actively impede and discriminate against domestic investment in the primary tax jurisdiction. China's capital controls, inadequate protection of private property, and overall lack of domestic bank credit constitute such restrictive impediments.

Yet, to ensure that private Chinese domestic invested enterprises and foreign invested enterprises ("FIEs") operating on the Mainland receive adequate financial credit and resources to prosper and expand under such circumstances, Chinese authorities can simply direct such entrepreneurs to Hong Kong, one of the world's leading international financial centers, a ready offshore source for needed financial credit and capital. In fact, the recently-ratified Hong Kong-China bilateral free-trade agreement and bilateral tax convention mentioned above actively encourage Chinese domestic and FIE investors to obtain financing in the Chinese Special Administrative Region ("SAR"). As Beijing's seventh Special Economic Zone ("SEZ") on a *de facto* basis, Hong Kong plays the indispensable role of the Mainland's offshore international financial and banking magnet.

C. Empirical Findings and General Conclusions

By virtue of the integrated statistical reconciliation process carried out in this study that performs all pertinent trade data adjustments, including that for Chinese round-tripping activities, we are able to draw the following general conclusions concerning the China-Hong Kong *entrepôt* effect and its overall impact on the PRC's global merchandise trade surplus. In 2007, the individual causes underlying the growing statistical discrepancy that distorts official Chinese trade data break down as follows: **(i)** China-Hong Kong *entrepôt* effect – that is, Hong Kong's re-export trade and middleman markups; **(ii)** divergent customs standards used internationally to value exports and imports; **(iii)** "phantom" Chinese exports-imports; **(iv)** round-tripping of Chinese capital recycled abroad in foreign tax havens (*e.g.*, Hong Kong) that subsequently returns to the mainland disguised as foreign investment (of which Hong Kong comprised 36% of total FDI in 2006); **(v)** smuggling; and **(vi)** residual discrepancy due to other factors such as statistical errors and omissions, servicing trade, timing of imports and exports, etc.

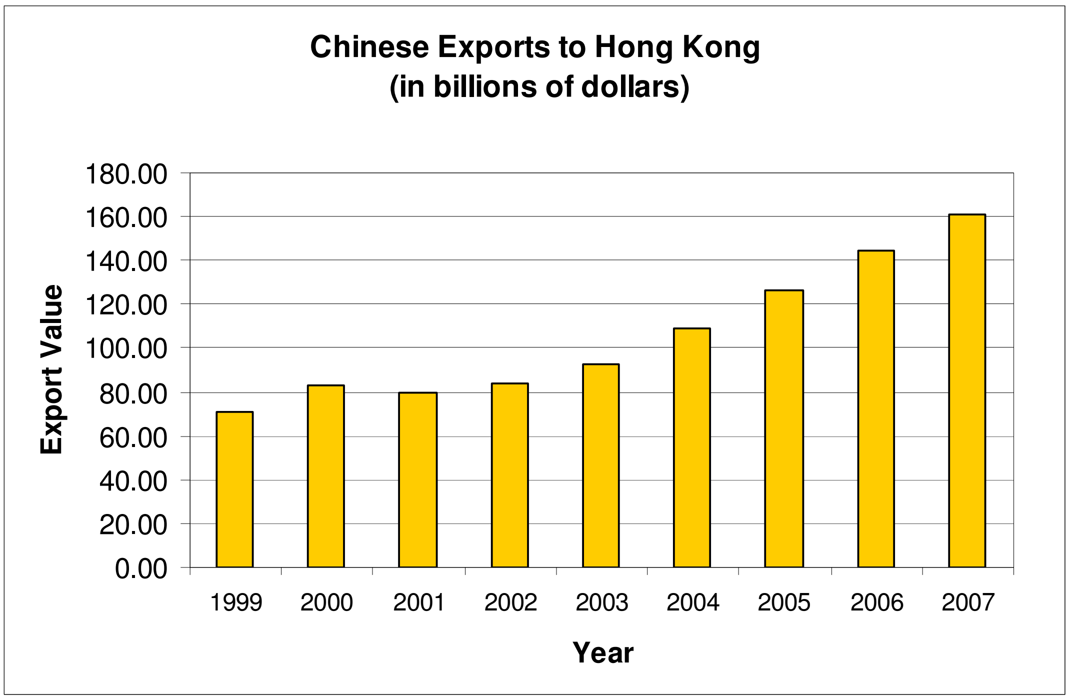
The Sino round-tripping practices and capital-flight activities carried out through Hong Kong comprise a major factor that not only contributes to divergent private savings and investment levels in the Mainland and the rest of the world, but also is a major facto in the understated current-account surplus.

The trade data and capital-flow discrepancies evaluated in this study have implications that run deeper than simple statistical errors and omissions. China's *entrepôt* trade, round-tripping practices, and capital-flight activities -- a great majority of which are carried out through Hong Kong -- have contributed to negative trade consequences in the rest of the world, including in the United States, by masking the effects of the PRC's mercantilist trade policies.

II. OVERVIEW OF THE CHINA-HONG KONG *ENTREPÔT* EFFECTS ON THE PRC'S GLOBAL TRADE SURPLUS

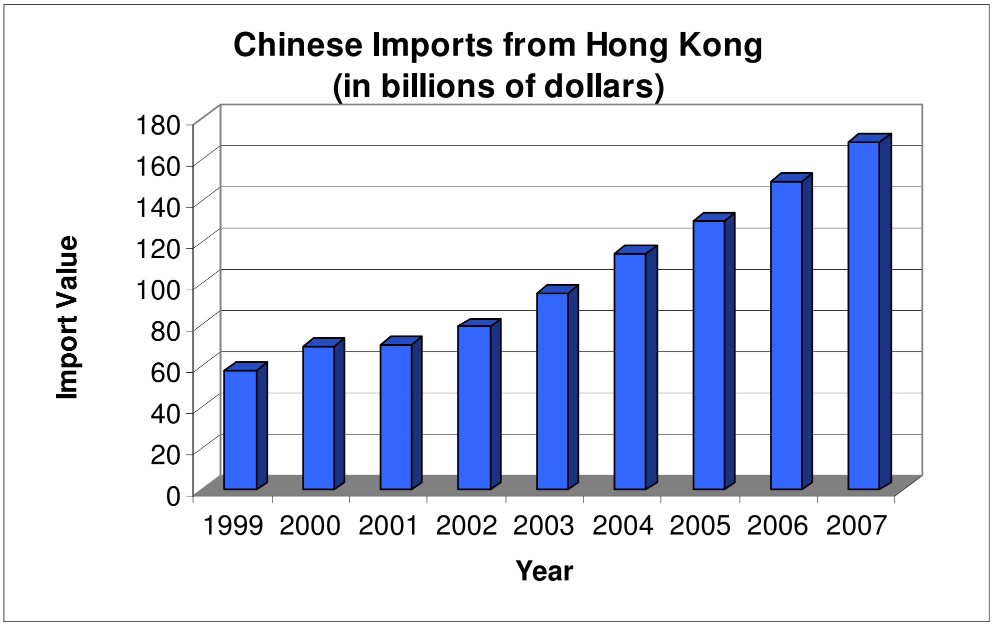
The reunification of Hong Kong with China in 1997,[1] the PRC's subsequent accession to the WTO in 2001, the ensuing implementation of the Hong Kong-China free trade agreement in 2004, and the effective ratification of the Hong Kong-Sino bilateral tax treaty in 2007 have all contributed to an unprecedented growth in trade and capital flows between the Mainland and the former British colony *(see Graph 1 and Graph 2).* As a free port not levying any import duties or customs tariffs, Hong Kong also establishes its trade-promoting taxation regime without value added taxes or general servicing tax. Other characteristics of the free port are manifested in the free inflow and outflow of international financial capital, in direct contrast to the tight foreign exchange controls of the Mainland. All these factors mentioned above jointly contribute to the proliferation of the so called entrepôt trade activities between Hong Kong and China, which have been widely recognized by academians as the major cause of the dramatic trade surplus discrepancy between China and its trading partner countries *(see Graphs 3 & 4).* As stated by Feenstra, Hai, Woo, and Yao one decade ago, "[t]he official trade statistics of the United States and China have huge discrepancies."[2] "Much of the difference is due to…the different treatment of Hong Kong's entrepôt trade by the two sides." [3]

GRAPH 1



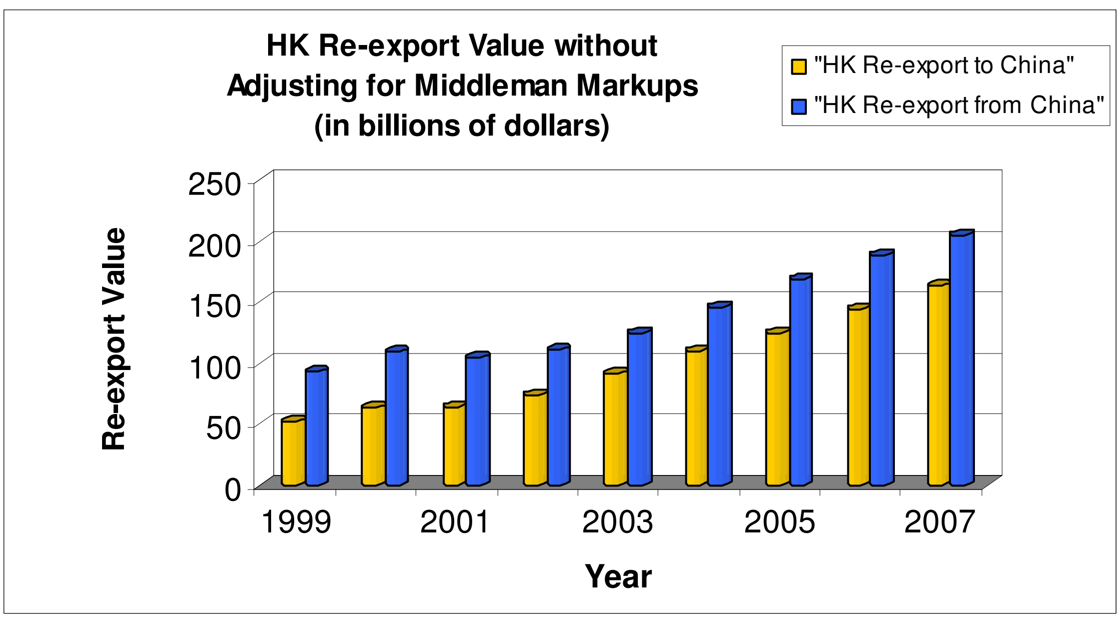
Source: GTIS, World Trade Atlas, as reported by Hong Kong

GRAPH 2



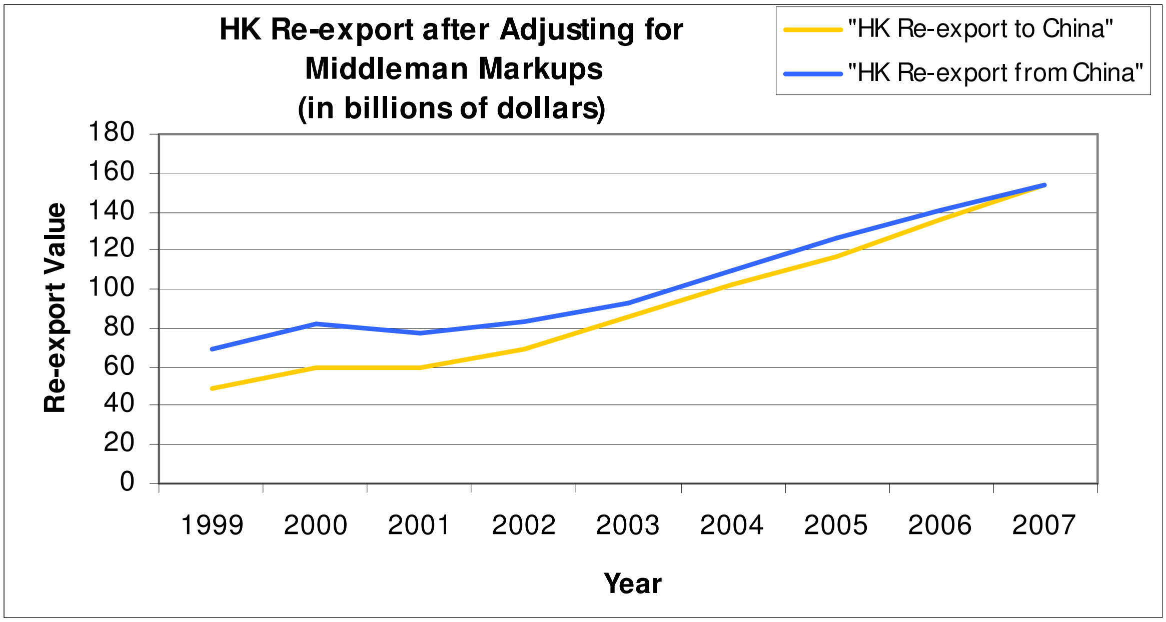
Source: GTIS, World Trade Atlas, as reported by Hong Kong

GRAPH 3



Source: World Trade Atlas, as reported by Hong Kong.

GRAPH 4



Source: World Trade Atlas, as reported by Hong Kong.

Besides the significant magnitude and scale of Hong Kong *entrepôt* trade, another feature of Hong Kong's re-export of goods from China is the related party transactions between Hong Kong companies and Mainland companies. In many cases the Hong Kong middleman companies are not independent from their suppliers in the Mainland. In fact, most related suppliers locate their manufacturing bases in Guangdong province due to its geographical adjacency to Hong Kong. The close relationship between the middleman companies and their Mainland suppliers justifies their collection of premiums (in the form of markups) for their ability to deal with the complicated institutional environment and other cultural barriers of China. As will be discussed in greater depth later in this paper, such related-party relationships also make it simple for transfer-pricing practices to occur that take advantage of Hong Kong's low corporate taxation rates.

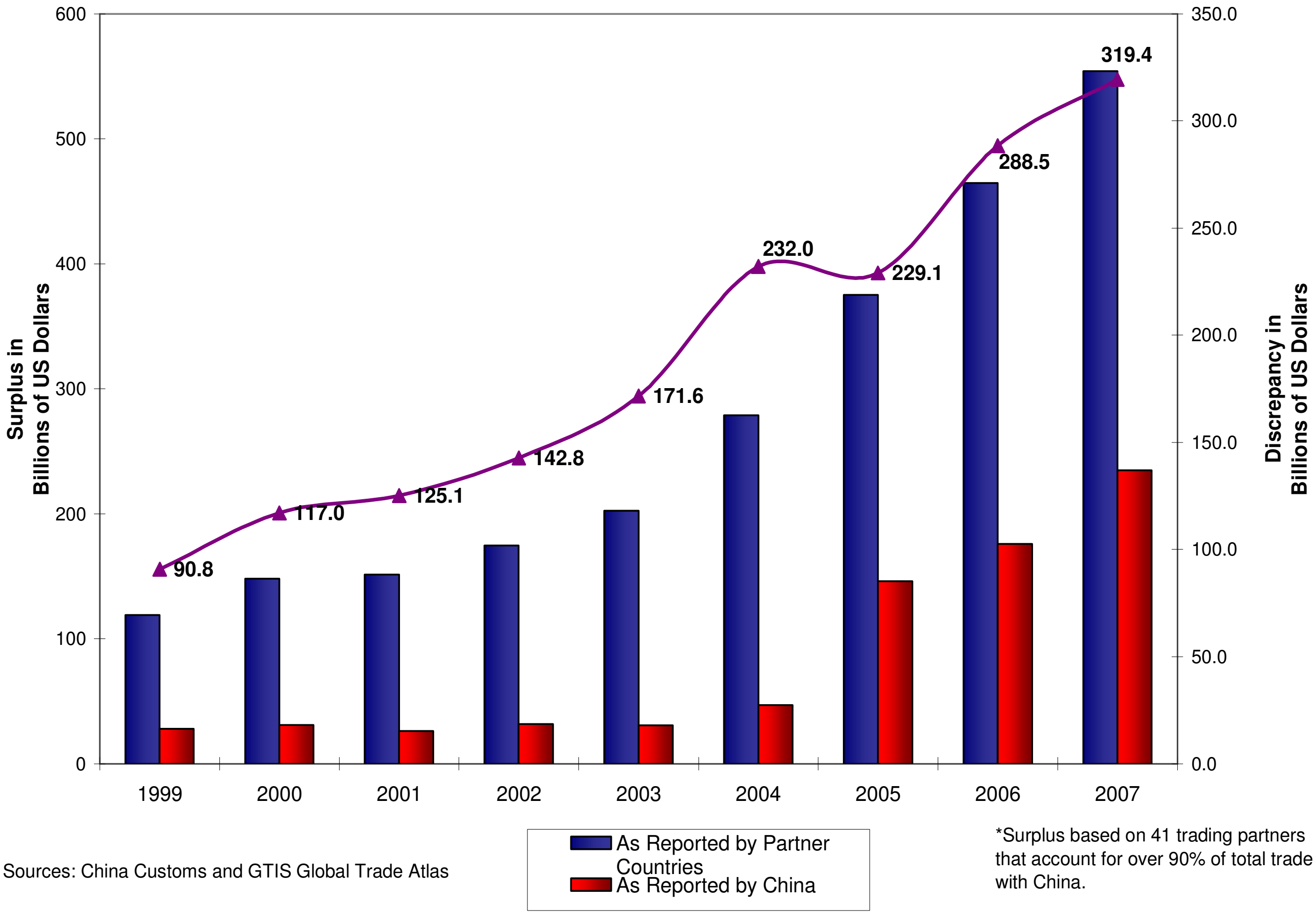
Today, "indirect trade" through an *entrepôt* is a common phenomenon.[4] By 2005, Hong Kong -- the world's largest *entrepôt* economy[5] with a population of only 6.8 million inhabitants -- had become China's fourth leading trading partner and primary foreign investor after the European Union ("EU"), the United States, and Japan,[6] and had emerged as the planet's eighth largest trading economy overall.[7] Globally, indirect trade has been increasing three times faster than world trade as a whole, rising from roughly 5 percent in the mid-1980s to approximately 17 percent today.[8] In addition to Hong Kong, roughly 30 other territories or countries are currently engaged in significant indirect *entrepôt*-trade activities, including Macau, Cyprus, Fiji, Senegal, Jordan, Armenia, Seychelles, Honduras, Benin, Montserrat, Singapore, Vietnam, and Indonesia.[9] Some authors are even of the view that *entrepôt* economies are a major source of international tariff evasion.[10]

China's well-documented *entrepôt* trade and capital flows through Hong Kong have engendered significant debate and research on account of the unique legal status of the former British territory *vis-à-vis* the Mainland. Although Hong Kong has been part of Chinese national territory since 1997, its customs and fiscal territories are legally separate and distinct from those of the PRC by strict operation of Chinese and Hong Kong law.[11] In fact, the PRC's current sovereignty over Hong Kong is exclusively limited to foreign policy and national defense matters. This "One Country, Two Systems" framework – which allows Hong Kong to act as a sovereign nation for all economic purposes -- will remain in effect until 2047.

One link between *entrepôt* trade and the statistical trade discrepancy resides in the significant markups of goods by middleman companies located in Hong Kong for provision of services such as design, re-packaging, technological innovation, etc. China's trading partner countries consider the value of goods from Hong Kong (including markup portions) as their imports from China, while no reconciliation or adjustment will be made on their trade statistics by either China or its trading partner countries for Hong Kong's share. It is noteworthy that trade statistics of Hong Kong are compiled by several Hong Kong governmental agencies among which Trade & Industry Department and Census & Statistics Department represent the two major responsible agencies. However, as commented by officials from these two agencies, the sole purpose of Hong Kong trade statistics is for purely informational use. Neither agency shoulders responsibility to verify or corroborate transfer-pricing practices of Hong Kong trading companies or other similar trade-related issues such as the aforementioned round-tripping capital phenomenon. Actually, transfer-pricing practices are not explicitly forbidden in the Hong Kong trade regulations, nor is there any arm's-length transaction consideration in trade statistics compilation by the Census & Statistics Department.

GRAPH 5

China Trade Surplus as Reported by China and Trading Partners



Sources: China Customs and GTIS Global Trade Atlas

*Surplus based on 41 trading partners that account for over 90% of total trade with China.

Both China's *entrepôt* trade and capital flows through Hong Kong are responsible for the significant Chinese trade balance discrepancy. This distortion becomes apparent after one examines official PRC trade statistics in light of the corresponding data compiled by its trading partner nations *(see Graph 5)*. A comparison of import and export statistics recorded by Mainland customs authorities and the analogous data published by China's partner countries (*i.e.*, World Trade Atlas database by Global Trade Information Services, Inc.) reveals a significant and growing discrepancy over the years *(see Tables 1, 2, 3 & Graph 6)*.

Table 1 Chinese Balance of Trade Reported by China

	*Chinese Imports**	*Chinese Exports*	*Chinese Surplus:*
1999	148,904,712,395	176,969,865,701	28,065,153,306
2000	194,243,182,887	225,166,296,661	30,923,113,774
2001	212,406,253,822	238,638,711,561	26,232,457,739
2002	258,674,549,135	290,563,563,192	31,889,014,057
2003	358,222,776,524	388,932,075,031	30,709,298,507
2004	479,510,654,448	526,386,206,320	46,875,551,872
2005	525,271,781,312	671,310,474,930	146,038,693,618
2006	659,500,473,067	835,570,759,763	176,070,286,696
2007	792,980,489,730	1,027,794,837,176	234,814,347,446

Source: GTIS, World Trade Atlas database

Table 2 - Chinese Balance of Trade Reported by 41 Partner Countries

	*Chinese Imports**	*Chinese Exports*	*Chinese Surplus:*
1999	104,517,543,045	223,409,694,886	118,892,151,841
2000	132,795,003,528	280,757,735,603	147,962,732,075
2001	143,273,888,619	294,650,582,343	151,376,693,724
2002	179,867,687,161	354,537,894,845	174,670,207,684
2003	256,917,468,233	459,234,934,795	202,317,466,563
2004	340,568,925,838	619,489,825,295	278,920,899,457
2005	402,137,392,933	777,248,188,137	375,110,795,204
2006	484,999,380,799	949,537,753,135	464,538,372,336
2007	587,237,693,828	1,141,444,693,736	554,206,999,908

Source: GTIS, World Trade Atlas database

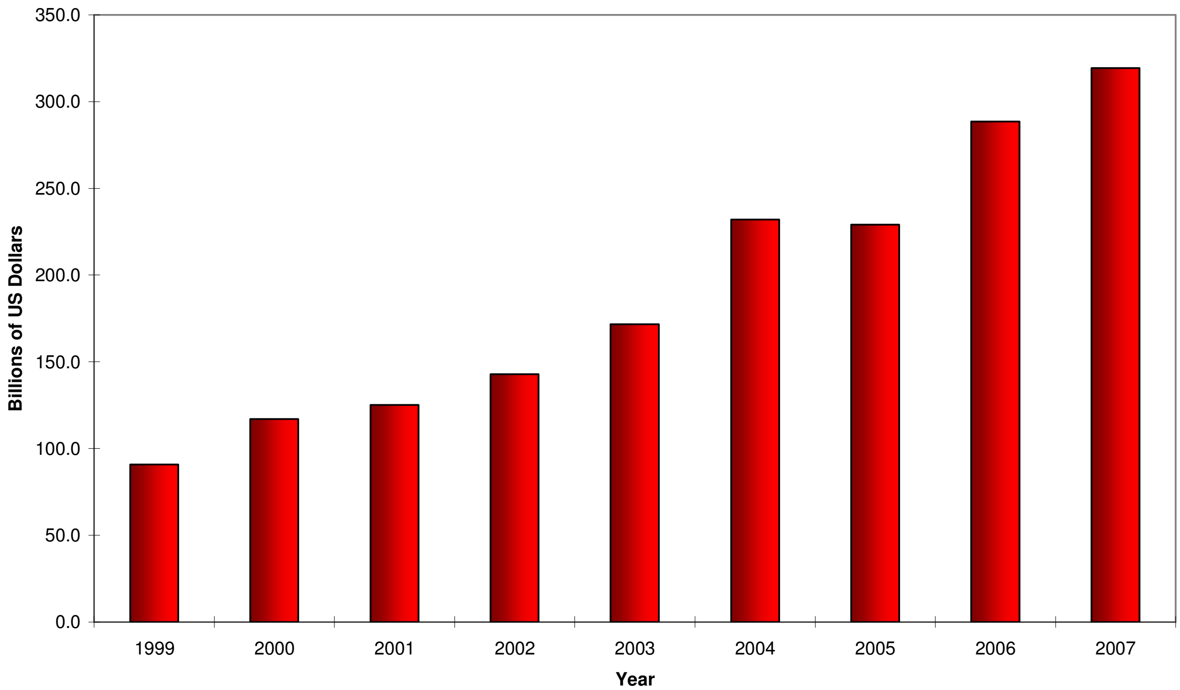
Table 3 - Chinese Balance of Trade Discrepancy

	*Chinese Imports**	*Chinese Exports*	*Chinese Surplus:*
1999	44,387,169,350	46,439,829,185	90,826,998,535
2000	61,448,179,359	55,591,438,942	117,039,618,301
2001	69,132,365,203	56,011,870,782	125,144,235,985
2002	78,806,861,974	63,974,331,653	142,781,193,627
2003	101,305,308,291	70,302,859,764	171,608,168,055
2004	138,941,728,610	93,103,618,975	232,045,347,586
2005	123,134,388,379	105,937,713,207	229,072,101,586
2006	174,501,092,268	113,966,993,372	288,468,085,640
2007	205,742,795,902	113,649,856,560	**319,392,652,462**

Source: GTIS, World Trade Atlas database

GRAPH 6

Total Discrepancy between China-reported and Trading Partner-reported Chinese Trade Surplus



Sources: China Customs and GTIS Global Trade Atlas

Chinese *export* values, as recorded by China's Customs General Administration ("Chinese Customs"), are significantly *lower* than Chinese export values as officially reported by the PRC's trading partners, including the United States, Canada, and a majority of European countries.[12] Similarly, a comparison of the import trade data published by Chinese Customs and those compiled by the customs authorities of the Mainland's partner nations establishes that China-reported *import* values are significantly *higher* than Chinese import values as officially reported by the partner countries.

Consequently, China's balance of trade appears to be substantially lower than its true global surplus. In fact, in each of the past nine years, China-reported trade data showed lower surpluses for the Mainland than the official statistics maintained by the PRC's partner nations. Specifically, based on the trade figures appearing in the WTA, China's trade-in-goods surplus to 41 trading partner countries was US$554.2 billion in 2007, after adjusting for middleman markups and CIF/FOB variances. By contrast, official PRC statistics state that the Mainland's surplus with these same countries was just US$234.8 billion for that year -- a US$319.4 billion discrepancy (*See Table 4 & 5*).

Contrary to conventional wisdom, the main source of this widening statistical inconsistency – when China's multilateral trade with the rest of the world is examined – occurs with westbound trade. In other words, the inconsistency is weighted more heavily on foreign goods that are imported into China, as opposed to eastbound trade in which Chinese goods are exported from the Mainland and imported by China's partner countries, including the United States. WTA data for 2007 show that PRC imports (as shipped from the rest of the world to the Mainland) are responsible for roughly 64 percent of the statistical discrepancy described above, while Chinese exports (as shipped from the Mainland to the rest of the world) account for approximately 36 percent of the data inconsistency. For every year since 2000 through 2007, the discrepancy between China's official trade statistics and those of its trading partners has weighed more heavily on the Chinese import side (westbound trade), rather than on the Chinese export (eastbound) side of the equation (*see Graph 7).*

TABLE 4: CHINA'S BALANCE OF TRADE BASED UPON DATA FROM VARIOUS SOURCES USING 5% CIF/FOB DEFLATOR, ADJUSTED FOR HONG KONG RE-EXPORT TRADE (1)

Annual 1999-2007
All Commodities
FOB Values in US Dollars

TABLE 4A: AS REPORTED BY CHINA FOR 41 PARTNER COUNTRIES

CHINA DATA (41 PARTNERS):	1999	2000	2001	2002	2003	2004	2005	2006	2007
Chinese Imports*	148,904,712,395	194,243,182,887	212,406,253,822	258,674,549,135	358,222,776,524	479,510,654,448	525,271,781,312	659,500,473,067	792,980,489,730
Chinese Exports	176,969,865,701	225,166,296,661	238,638,711,561	290,563,563,192	388,932,075,031	526,386,206,320	671,310,474,930	835,570,759,763	1,027,794,837,176
Chinese Surplus:	**28,065,153,306**	**30,923,113,774**	**26,232,457,739**	**31,889,014,057**	**30,709,298,507**	**46,875,551,872**	**146,038,693,618**	**176,070,286,696**	**234,814,347,446**

Source: GTIS Global Trade Atlas--Data Reported by China (See Table 5 for list of 41 partner countries).
** Imports valued at CIF less 5% to approximate FOB values.*

TABLE 4B: AS REPORTED BY 41 PARTNER COUNTRIES

41 PARTNER DATA:	1999	2000	2001	2002	2003	2004	2005	2006	2007
Chinese Imports	104,517,543,045	132,795,003,528	143,273,888,619	179,867,687,161	256,917,468,233	340,568,925,838	402,137,392,933	484,999,380,799	587,237,693,828
Chinese Exports*	223,409,694,886	280,757,735,603	294,650,582,343	354,537,894,845	459,234,934,795	619,489,825,295	777,248,188,137	949,537,753,135	1,141,444,693,736
Chinese Surplus:	**118,892,151,841**	**147,962,732,075**	**151,376,693,724**	**174,670,207,684**	**202,317,466,563**	**278,920,899,457**	**375,110,795,204**	**464,538,372,336**	**554,206,999,908**

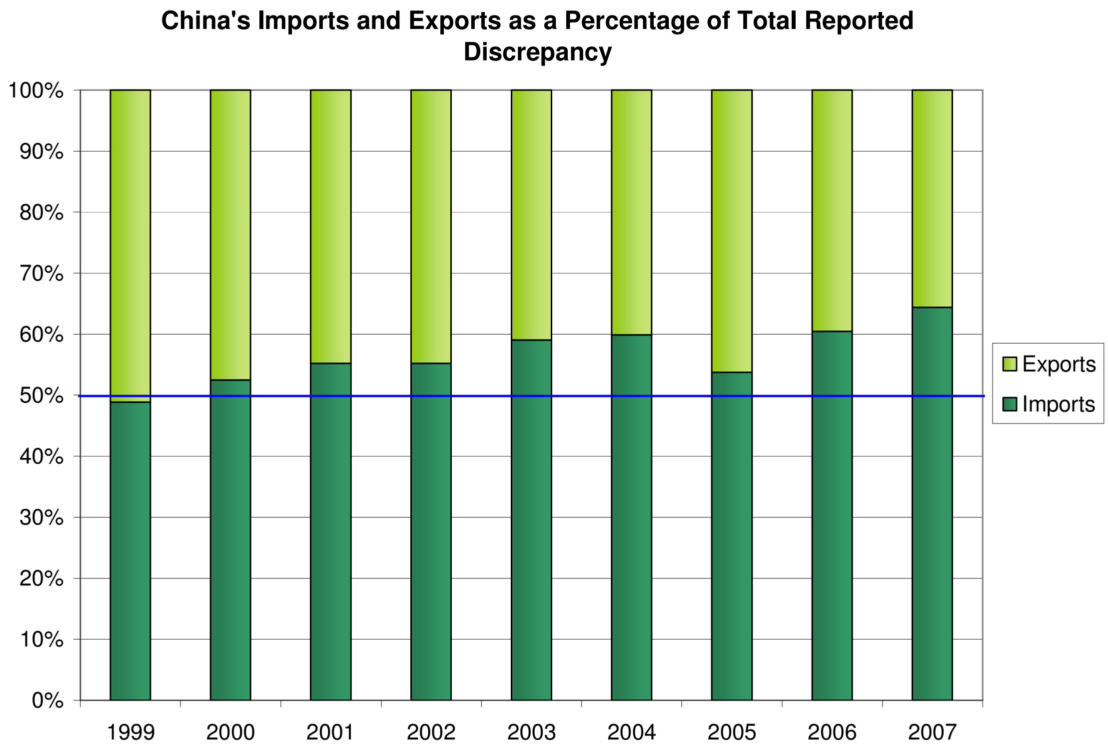
Source: GTIS Global Trade Atlas--Data Reported by Partner Countries (See Table 5 for list of 41 partner countries).
** Exports (Partner-reported imports) valued at CIF less 5% to approximate FOB values.*

NOTE: (1) The adjustment for Hong Kong re-export trade was only required for data reported by the partner countries (Table 4B).

TABLE 5: LIST OF 41 PARTNER COUNTRIES

1) Argentina
2) Australia
3) Austria
4) Belgium
5) Brazil
6) Canada
7) Chile
8) Colombia
9) Denmark
10) Finland
11) France
12) Germany
13) Greece
14) Hong Kong
15) Iceland
16) Indonesia
17) Ireland
18) Italy
19) Japan
20) Luxembourg
21) Malaysia
22) Mexico
23) Netherlands
24) New Zealand
25) Norway
26) Peru
27) Philippines
28) Portugal
29) Russia
30) Singapore
31) South Africa
32) South Korea
33) Spain
34) Sri Lanka
35) Sweden
36) Switzerland
37) Taiwan
38) Thailand
39) Turkey
40) United Kingdom
41) United States

GRAPH 7



Source: GTIS, World Trade Atlas.

III. SUMMARY OF TRADITIONAL EXPLANATIONS ON CHINA'S TRADE DISCPREPANCY

Dramatic annual discrepancies on the reported trade imbalances between the Chinese and the U.S. governments has paralleled the gradually increasing trans-border trade activities between the two countries since the mid-1980s. The scale of such a statistical discrepancy – first highlighted in the 1990s – is exhibited in both an upward trend in total volume of the bilateral trade as well as the actual gap between the trade surplus as reported by the two governments. A pair of numbers may better illustrate this story: from 1995 to 2007, the discrepancy on the reported trade surplus of China with the U.S. increased from US$24.4 billion to US$95.7 billion. Additionally, this almost fourfold jump was accompanied by an accelerating rate of increase. This topic, in the context of political economy considerations, evolves into a particularly prominent issue for policymakers from both countries. It would be undeniable that such an accelerating divergent measurement of a trade balance by two trading partners could lead to different viewpoints on the “fairness” of on-going bilateral trading practices.

Studies on the significant difference in the bilateral trade imbalance between the two governments are not few in the current literature (e.g., Feenstra, Hai, Woo & Yao, 1998; Fung & Lau, 1999; Barton, 2000, Schindler & Beckett, 2005). Factors contributing to the discrepancy on which researchers have focused include indirect trade through Hong Kong – especially the markups by Hong Kong trading companies, and variances in measurement calibration on imports and exports (e.g., Feenstra & Hanson, 2002; Fung & Lau, 2003; Ferrantino & Wang, 2007; Martin, 2007). Nonetheless, some studies (e.g., Tong, 2005; Fung, Lau & Xiong, 2006; Zhang, 2007, etc.) argued that the widening discrepancy in the trade surplus is also attributable to factors such as exclusion of servicing trade as well as intangible trade, underestimating false invoicing, transshipment, and the essence of Chinese exports as a “process and improvement” trade. The table below summarizes the main themes found in the current literature concerning the Sino-U.S. trade imbalance:

Table 6 – Thematic Cross-Table for Sources of US-China Trade Imbalance Discrepancy Among the Current Literature

	Indirect Trade through Hong Kong	Hong Kong Price Markup	Imports/Exports Measurement Discrepancies	Exclusion of Servicing Trade	Exclusion of Intangible Trade	Underestimate of False Invoicing & Transshipment	Process & Improvement Trade
Zhang (2007) in Chinese	X	X	X	X	X		X
Feenstra, Hai, Woo & Yao (1998)	X		X				
Fung & Lau (1999)	X	X	X	X		X	
Customs Service (2000)						X	
Barton (2000)						X	
Bao (2000)	X	X	X			X	X
Zhou (2006)	X	X	X				X
SCIO (1997)	X	X	X				
Schindler & Beckett (2005)	X	X					
USITC (1996)	X	X					
Martin (2007)	X		X			X	
Tong (2005)	X	X	X	X			
Ferrantino & Wang (2007)	X	X	X			X	X
Wang, Gehlhar, & Yao (2006)	X	X	X			X	
Fung, Lau, & Xiong (2006)	X	X	X	X			
Fung & Lau (2003)	X	X	X	X			
Feenstra & Hanson (2002)	X	X	X				

Some researchers have posited alternative hypotheses to reconcile the growing statistical discrepancy outlined above: **(i)** the recording of export-and-import trade using inconsistent customs standards of valuation (*e.g.,* FOB, FAS, CIF); **(ii)** so-called "phantom" Chinese goods exported to, and imported from, Hong Kong; **(iii)** transshipment (*i.e.,* false invoicing) of Chinese merchandise traded through third countries; **(iv)** smuggling; **(v)** the timing of the recording of exports and imports; **(vi)** geographic-coverage inconsistencies (*i.e.*, divergent definitions employed by China and the United States concerning the scope of the the U.S. customs territory); **(vii)** misclassification of goods; and **(viii)** exchange-rate fluctuations. None of these alternative theories adequately explains the significant and growing statistical discrepancy compiled above, however.

The literature summary table shows that nearly all of the studies reviewed attribute the statistical discrepancy between Chinese and the U.S.-reporting agencies to the indirect trade between the two countries through Hong Kong (e.g., USITC, 1996; SCIO, 1997; Fung & Lau, 1999, 2003; Zhou, 2006; Zhang, 2007). Hong Kong complicates the task of accounting for Sino-U.S. trade practices by serving a twofold role: on the one hand, the ultimate destination country of re-exports through Hong Kong are not recorded by the original exporter country, whereas the importer country usually records such re-exported goods as from the correct origin; on the other hand, the importing and exporting businesses in Hong Kong usually add on additional value to the trans-border goods and charge the importer country a significant mark-up price. For example, Feenstra et al. (1998) concluded that proper adjustment for value-added in Hong Kong on China's exports to the U.S. could on average reduce as much as 91 percent of the discrepancy between the two countries' official estimates of the balance of trade. Hong Kong's role as re-exporter was recognized as "prominent" by Schindler and Beckett (2005) on the Sino-U.S. trade statistics issue. The authors argue that without appropriate identification of the impact of re-exports from Hong Kong, the current reporting practices by both China and the U.S. may result in a misleading picture of the increasing trade deficit faced by the United States. Schindler and Beckett (2005) further contended that it is not the Chinese government's deliberate undervaluation of its trade surplus that causes the sizable trade imbalance discrepancy, and this study joins Feenstra (1998) in concluding that Hong Kong's re-exports and markups eliminate a majority of such discrepancy. Another study by Tong (2005) estimated the Hong Kong re-export markups range from 20.5% in 1991 to 28.5% in 2000. Other studies (e.g., Fung, Lau & Xiong, 2006; Zhou, 2006; Ferrantino & Wang, 2007, etc.) also included Hong Kong re-exports as a non-negligible factor in their analyses and recognize that Hong Kong plays a major role in the Sino-U.S. trade imbalance discrepancy. Furthermore, in accordance with the view of Mr. Osbert Wang and Ms. Freda Tung, Statisticians in the Trade Analysis Section of the Census and Statistics Department of Hong Kong, the Hong Kong middleman markup rate for imported goods from the Mainland is higher than that for imported goods from other regions. Specifically, the rate of the Mainland re-export margin is estimated to be as high as 20 percent, while U.S. re-exports to the Mainland, for example, only incur a markup of 2-3 percent on average, and at the most 5 percent.[13]

Most studies in the current literature also resorted to technical explanations on the sizable trade imbalance discrepancy. It has been recognized that different countries do not necessarily use the same definitions on imports and exports. For example, valuation methods vary between China and the U.S. in that the former uses "free on board" (F.O.B.) and the "cost, insurance and freight" (C.I.F) for measurement of exports and imports, respectively, whereas the U.S. adopts "free along side" (F.A.S) for export valuation and a "customs value" for import valuation (Martin, 2007). Reconciliation is necessary to reveal the more accurate, if not possibly exact, trade imbalance between China and the U.S. For instance, Fung, Lau, and Xiong (2006) adjusted their estimates by conducting both the F.A.S. — F.O.B. and the C.I.F. — F.O.B. conversions. Both conversions slightly reduce the discrepancies in the examined period (1989-2005), based on the authors' estimation. Two Chinese studies (Zhou, 2006; Zhang, 2007) also considered the statistical measurement difference as a contributing factor to the bilateral statistical discrepancy on trade imbalance. Generally, the current literature recognizes the different statistical definitions of imports and exports used by China and the U.S. as a factor, but with a relatively small impact on the total discrepancy.

Another complication to the reconciliation process involves the proper treatment and valuation of the services trade and other forms of unquantifiable trade. Typically, it is assumed that the U.S. is considered the party that has the comparative advantage in the services trade with most of its trading partners, including China (e.g., Tong, 2005). Fung and Lau (1999, 2003) argued that the services trade is an important component in bilateral trade, and as such, should not be neglected in the calculation of trade balances. However, the authors' estimate on the U.S. services trade surplus is comparatively small, ranging between $1.37 billion in 1997 to $2.3 billion in 2001. It is noteworthy that the services trade has been growing between China and the U.S. in recent years, and trade in this sector may become an increasingly important constituent of the trade balance between the two countries. A more recent estimate put the U.S. net trade surplus in commercial services at $9 billion in 2003 (Tong 2005). Tong expounded on this estimate agreeing with Fung and Lau's analysis (1999, 2003) that the China net services trade with the U.S. has been increasing since early 1990s, but Tong's study also pointed out that the services trade is far from being a significant part of the overall bilateral trade relationship. Zhang (2007) disagreed that the services trade is not yet a significant factor and summarizes that the exclusion of both the services trade, and intangible trade like "e-trade," is a major cause of the current huge statistical discrepancy in the reported bilateral trade imbalance.

In addition to the above mentioned factors, "phantom" exports and imports exacerbate the situation by distorting China's exports to and imports from the U.S. (Fung & Lau, 1999; Customs Service, 2000). False invoicing, deliberate or not, comes from Chinese exporters claiming VAT tax and customs duties rebates from the Chinese government (Fung & Lau, 1999). Bao (2000) confirmed the local smuggling of goods and values such activities at a cost of more than 8 billion RMB per year on average. He also corroborates additional varied forms of illegal trade activities including more-import-less-reporting, more-reporting-less-export, and organized large-scale smuggling operations by corporations. A rough estimate of goods smuggled from the U.S. into China is around $500 million to $700 million (Bao, 2000). The smuggling factor further gains recognition in some quantitative studies (e.g., Wang, Gehlhar, & Yao, 2006). For instance, Wang, Gehlhar, and Yao (2006) included the existence of anti-smuggling programs by both the

U.S. and Chinese governments as a dummy variable in their equation accounting for the bilateral trade imbalance discrepancy. One Chinese customs broker believes that smuggling is a much larger factor than most analysts take into account, especially in the high-tech sector.[14] Accurate estimations of the true value of smuggled goods, therefore, has a genuine impact upon the reconciliation process regarding the dramatic statistical discrepancy between the two countries.

Despite these previous investigative findings, research recently undertaken at the U.S. International Trade Commission ("ITC") definitively calls into question the validity of the China-Hong Kong *entrepôt* trade hypothesis as the most important explanation to account for the trade data inconsistency summarized above. Based on our integrated analysis of China's current-account and capital-account transactions, we determine that a phenomenon referred to as the round-tripping of Chinese capital comprises a significant portion of the data discrepancy involving official Mainland export and import statistics. As emphasized by international researcher and scholar of Chinese round-tripping FDI, Geng Xiao states, "[o]n the whole, [the] PRC's round tripping [foreign direct investment] is more of a *statistics interpretation problem* than a substantive constraint or drawback for PRC in the global economy."[15]

Simply put, "round-tripping" is a trade-tax-investment strategy whereby Chinese enterprises undervalue export or overvalue import transactions so as to move Chinese capital across the PRC border via transfer-pricing practices. Specifically, Chinese enterprises export domestic capital from the mainland to related-party foreign enterprises situated outside China in offshore tax havens, such as Hong Kong, pursuant to non-arm's length transfer-pricing techniques designed to circumvent Chinese capital controls. The exported PRC domestic capital is then recycled abroad and subsequently returns to the Mainland in the disguised form of foreign investment. In short, round-tripping is a form of tax-investment-trade arbitrage that seeks to exploit the differential tax-and-investment treatment heretofore afforded by the Government of China to domestic and foreign enterprises.

As explained by ITC researchers Ferrantino and Wang, "[o]ur results…suggest that reporting of different values to importing and exporting authorities might be a significant source of discrepancies in trade data."[16] It is therefore essential for policymakers worldwide to understand the crucial role that Chinese round-tripping practices play with regard to the PRC's overall economic performance, and its true merchandise trade surplus.

IV. SUMMARY OF THE APPLICABLE RESEARCH METHODOLOGY

Previous studies evaluating the subject trade data inconsistency for *current account* purposes failed to take into consideration and correctly quantify the effect that Chinese round-tripping practices had on the PRC's global trade surplus. Likewise, previous foreign-investment studies that focused on Sino round-tripping activities for *capital account* purposes ignored the trade-balance or *current-account* implications of such activities as well. As a result, these previous studies were not able to fully explain the emerging statistical discrepancy that materializes as a consequence of comparing official Chinese trade data with those of its partner nations.

Therefore, the primary objective of our study was to perform an integrated analysis evaluating in simultaneous fashion current-account (*e.g.*, merchandise-trade balance),[17] capital-and-financial-account (*i.e.*, foreign investment),[18] and Sino round-tripping data so as to attempt to expound upon the widening statistical discrepancy at issue. Only by conducting such an integrated analysis can researchers comprehensively explain China's trade surplus discrepancy.

We began our study by providing an overview of Hong Kong's political, legal, and economic structure that facilitates both *entrepôt* trade and the round-tripping of Chinese capital between the Mainland and the former British territory. In particular, we examined the Chinese SAR's political and economic history and policy, its favorable tax regime, and the unique Mainland-Hong Kong legal-economic relationship that today is governed by a free trade agreement and a stand-alone tax treaty that is grounded on the principles espoused by the Organization for Economic Cooperative Development ("OECD").

The following section evaluates the traditional and alternative hypotheses posited by researchers to explain the data discrepancy described above: **(i)** Hong Kong's re-export trade and "middlemen" markups; **(ii)** divergent customs standards employed internationally to value exports and imports; **(iii)** so-called "phantom" Chinese exports and imports; **(iv)** transshipment (*i.e.,* false-invoicing) activities undertaken through third countries; **(v)** smuggling; **(vi)** timing of exports and imports; **(vii)** inconsistent geographic coverage; **(viii)** misclassification of goods; and **(ix)** exchange-rate fluctuations. With regard to China's *entrepôt* trade through the former British territory, we obtained (by means of public surveys and private interviews) contemporaneous estimates of Hong Kong re-export "middlemen" markups and applied such markups to the most recently available statistics to reconcile in part China's reported trade data.

Next, we scrutinized the effect that Sino round-tripping practices have had on the calculation of China's true global trade surplus, thus, revealing a major cause of the growing statistical inconsistency between official Chinese trade data and those recorded by the PRC's partner countries. Specifically, our calculation process involves the following:

China-Hong Kong *entrepôt* effect (*i.e.*, Hong Kong's re-export trade and "middlemen" markups): the markup rate of 25% for goods from Mainland China is used in this analysis (e.g., Fung and Lau, 1999); the markup rate for goods from countries other than the Mainland, however, is 6% as reported by the Census & Statistics Department of Hong Kong for 2003. Given the rising trend of markup rate for goods from countries other than Mainland from 1999 to 2007, it is reasonable to use the 2003 markup rate as a proxy for goods to China in this analysis;

Divergent customs standards employed internationally to value exports and imports: the FOB and CIF difference rate of 5% is used (e.g., Fung and Lao, 1999);

"Phantom" Chinese exports-imports: we employed the research of the U.S. Department of Treasury study in 2005 (*see Note 105*) that found Chinese "phantom" goods were valued at about US$55 billion; the value of this "phantom" trade in other years within the examined period of this analysis (*i.e.*, 1999-2004 and 2006-2007) are consequently estimated using the average of total Chinese imports and exports as reported by both China and its 41 trading partner countries; it is noteworthy that we hereby assume that Chinese "phantom" trade volume closely followed that of China's total international trade in the examined period 1999 to 2007;

Smuggling activities: we borrowed the finding of Bao (2000) that indicates a value of US$700 million for 1999 for smuggled goods; the volume of smuggled goods for other years in the examined period are estimated using the average of China's total imports and exports as reported by both China and its 41 trading partner countries. Thus, we follow the logic of the "phantom" trade assumption in (iii) for the smuggling activities. However, the relative scale of these activities is small: not exceeding 1% of total trade in all of the years from 1999 to 2007;

Round-tripping of Chinese domestic capital recycled abroad in offshore tax havens (*e.g.,* Hong Kong) that subsequently returns to the Mainland disguised as foreign investment: we used the Chinese round-tripping FDI ratio of 50% and the ratio of returned round-tripping FDI to total Chinese capital flight of 25% per Geng Xiao's 2004 study. The assumption hereto is that all capital that flies out of the Mainland is through an overstatement of Chinese imports. Considering the conservative estimate of the 50% round-tripping ratio (Xiao, 2004), we argue that the offsetting effects from this conservative ratio can enhance the accuracy of our calculation;

Due to the unavailability of relevant data, we grouped the following factors into the residual portion of our discrepancy breakdown, which includes: transshipment (*i.e.*, false-invoicing) activities undertaken through third countries; timing of exports and imports (*i.e.*, negligible trade impact); inconsistent geographic coverage issues (*i.e.*, inconsequential trade effect); misclassification of goods (*i.e.*, negligible trade consequences); exchange-rate fluctuations; and statistical errors and omissions, as well as other factors mentioned in various literature;

Finally, we examined the multiple factors that may diminish or accelerate the incidence of Chinese round-tripping practices in the future, including the PRC's new enterprise income-tax law, China's current monetary policy and related capital-flight activities.

V. HONG KONG'S POLITICAL, LEGAL, AND ECONOMIC STRUCTURE THAT FACILITATES *ENTREPÔT* TRADE AND "ROUND-TRIPPING" PRACTICES

A. Hong Kong's Political, Legal, and Economic History and Policy

This version of so-called "Chinese federalism" [19] allows Hong Kong to act as a sovereign nation for all economic purposes. Significantly, the former British colony does not even form part of the customs or tax territories of China. Instead, Hong Kong constitutes a separate "foreign customs territory," as well as a distinct "foreign fiscal territory," situated within China's national borders. Even though Hong Kong has formed part of Chinese national territory since 1997, the customs and fiscal territories of the SAR are legally separate and distinct from those of the PRC by strict operation of Chinese and Hong Kong law. For this reason, the Mainland and Hong Kong recently negotiated, concluded, and ratified a bilateral free trade agreement and a stand-alone bilateral tax treaty. China and Hong Kong are even separate signatory members of the WTO given that each jurisdiction constitutes an independent customs territory.[20]

Consistent with this unorthodox legal structure under "Chinese federalism," Beijing's current sovereign authority over the SAR is exclusively limited to foreign policy and national defense matters.[21] Accordingly, Hong Kong maintains its own police force, central bank, and monetary system and formulates its own independent customs, tax, trade, investment, and immigration policies. [22] In essence, Hong Kong constitutes -- on a *de facto* basis -- Beijing's seventh SEZ that provides Mainland enterprises engaged in international trade with financial capital and sophisticated commercial banking services. (For a comparative analysis of international and Chinese SEZs, *see infra.,* notes 343-381 at 51-55, with accompanying text.)

Like any typical SEZ or free port internationally, Hong Kong is characterized by a free-market, capitalist economy with a policy of free trade, low taxation, and *laissez-faire* government non-intervention. Trade barriers, restrictive trade practices, and foreign-exchange controls are limited in this capitalistic enclave. Adhering to the economic philosophy established under British rule, the SAR leaves the direction of the economy to free-market forces. The free-trade oriented Heritage Foundation has cited Hong Kong, year after year, as constituting the "freest economy in the world."[23] Similarly, in its Index concerning the Protection Afforded to Investors, the World Bank deems Hong Kong the world's fourth best jurisdiction to conduct business, after New Zealand, Singapore, and Canada.[24]

Hong Kong's political-legal-economic strengths include the following:

- A duty-free port with a favorable tax regime;
- Very small degree of government involvement in business activities and overall minimal government regulation;
- Low inflation;
- Almost no barriers to foreign investment;
- A modicum of restrictions covering banking and finance activities;
- Low level of government intervention in wages and prices;

- Strong and effective protection and enforcement of private property rights, including intellectual property; and

- Only a modest level of informal market activity or corruption.[25]

Hong Kong's economy is dominated by services, which account for over 90 percent of its gross domestic product.[26] Even though traces of its past can still be found in the fishing villages scattered in the outlying islands, Hong Kong has transformed itself from a post-World War II manufacturing base to a major international financial, banking, trade, and services center featuring state-of-the-art infrastructure.[27] Hong Kong enjoys a robust and stable financial regime, exemplifying the vitality and dynamism of an economy that has the ability to prosper in an ever-changing global political economy.[28]

Thus, in addition to constituting a major international trade *entrepôt*, Hong Kong is a leading financial and banking center. Hong Kong commercial banks are experienced, and suited to engage in a full range of mainstream international financial and banking transactions, including processing letters of credit, preparing import-export documentation, and opening commercial bank accounts in which stocks and shares can be traded on the world's major stock exchanges.[29] The relatively easy access that clients have to a major international stock exchange, as well as to large multinational commercial banks for all classes and kinds of equity, debt, and derivative transactions, makes the Chinese SAR a particularly attractive financial center for both Mainland and FIEs engaged in international commerce.

B. Hong Kong's Favorable Tax Regime

Although Hong Kong does not appear on the OECD tax-haven watch list, international practitioners generally consider the Chinese SAR to constitute an "offshore" jurisdiction or, alternatively, a *de facto* tax haven. Hong Kong's extremely low corporate income tax rate of 17.5%,[30] as assessed pursuant to a tax-friendly territorial principle,[31] justifies this characterization. In accordance with the territorial principle, the Hong Kong income/profits tax applies only to corporations, companies, partnerships, joint ventures, trusts, sole proprietorships, and other business entities[32] with Hong Kong-source income; that is, only income derived from, or arising in, Hong Kong and not from any income sourced from outside the territory.[33] Income paid in Hong

Kong that relates to services rendered outside the island is generally exempt from Hong Kong tax liability as well.

Hence, the SAR is not an offshore tax jurisdiction in the traditional sense, but, instead, comprises a fiscal enclave with a non-discriminatory, low-tax regime that is governed by a tax-friendly territorial principle. The attraction of Hong Kong as a international financial center lies not in the tight secrecy and minimal corporate disclosure provisions that characterize a number of offshore common-law jurisdictions, but rather in low taxes, generous tax-deductible allowances,[34] a policy of taxing only Hong Kong-source income, and the absence of the following commonly-imposed taxes: **(i)** capital gains tax; **(ii)** dividend tax;[35] **(iii)** withholding taxes;[36] **(iv)** sales taxes; **(v)** value-added tax; **(vi)** tax on interest generated by overseas and certain other bank deposits; **(vii)** tax on profits derived by non-resident offshore funds; **(viii)** annual net worth tax; and **(ix)** accumulated earnings tax assessed on companies that retain earnings.[37]

Unlike the tax jurisdictions of almost all countries that have international financial centers, Hong Kong does not actively regulate transfer-pricing activities carried out by affiliated enterprises in cross-border trade or financial transactions.[38] Furthermore, consolidated group accounting – in accordance with which the profits of one company in an affiliated corporate group can offset losses of another related enterprise of the same group – generally does not exist in the Chinese SAR either. Nonetheless, the losses of a Hong Kong business entity can be carried forward indefinitely. This feature compares very favorably with other jurisdictions (*e.g.*, China) which allow losses to be carried forward for a fixed period of time, typically 5 years.[39]

Finally, inasmuch as there are no "debt-equity thin-capitalization" rules in Hong Kong, a foreign parent (domiciled in the Cayman Islands, for example) can constitute a subsidiary in the Chinese SAR with a minimum amount of capital and a maximum amount of debt. As a consequence, the Hong Kong subsidiary of the Cayman Islands parent can substantially reduce its taxable income arising in Hong Kong through the payment of excessive, albeit deductible, interest expenses. Nonetheless, to avoid any potential adverse tax consequences, the loan agreement executed by the Cayman parent and its Hong Kong subsidiary should stipulate that the Cayman loan proceeds are specifically made available to the borrower in the Chinese SAR, and that the corresponding interest income is deemed Hong Kong-source income.

C. Unique Mainland and Hong Kong Bilateral Trade and Tax Relationship

The reunification of Hong Kong with China in 1997, together with the PRC's subsequent WTO accession in 2001, has triggered such an unprecedented growth in undetected trade and capital flows between the Mainland and the former British territory that policymakers worldwide have been unable to measure accurately China's global economic impact. As a threshold matter, a wave of relocations from Hong Kong to China in the aftermath of reunification set the initial stage for such unchecked trade and capital flows. Specifically, relocations in the business-services sector jump-started unprecedented cross-border transactions between affiliated enterprises in the former British territory and the Mainland.[40] The Hong Kong-China Free Trade Agreement and the Hong Kong-China Bilateral Tax Treaty subsequently further stimulated these cross-border activities.

1. 2004 Hong Kong-China Free Trade Agreement

After China acceded to the WTO on December 11, 2001, the PRC almost immediately signed an innovative bilateral free trade and investment agreement ("FTA") with Hong Kong; namely, **The Mainland and Hong Kong Closer Economic Partnership Arrangement ("CEPA")**. The FTA entered into legal force and effect on January 1, 2004.[41] The primary purpose of the trade-investment pact is to increase Hong Kong's access to the Mainland market for business services, to take advantage of the trade synergies already existing between the former British colony and Guangdong Province, and to promote efficient "customs clearance facilitation" in the separate customs territories of each jurisdiction.[42]

By virtue of the innovative FTA, Hong Kong pledged to "continue to apply zero tariff[s] to all imported goods of Mainland origin."[43] Meanwhile, China obligated itself, effective January 1, 2004, to offer duty-free treatment to an initial list of Hong Kong-origin products; that is "[f]rom 1 January 2004, the Mainland [agreed to] apply zero tariff[s] to the import of those goods of Hong Kong origin listed in Table 1 of Annex 1."[44] China further pledged to provide duty-free treatment to virtually all imports of Hong Kong origin by January 1, 2006.[45]

An attractive 30-percent value-added test under the FTA rules of origin makes it relatively easy for Hong Kong entities to confer CEPA origin status to material inputs, components, and parts sourced from third countries, such as Vietnam or Singapore, before the exportation of the finished processed product to the Mainland.[46] In fact, a Hong Kong entrepreneur can include any related intellectual property expenses allocated in the SAR as part of the local value-added content to confer Hong Kong-origin status for preferential CEPA purposes.[47] Additionally, the parties sought to liberalize trade in services, including **(a)** professional services, such as law, accounting, and architecture, **(b)** commercial services, and **(c)** finance and banking.

As stated above, Beijing targeted CEPA at Guangdong Province, which consequently has been at the forefront in attracting foreign trade and investment on the Mainland.[48] Today, Guangdong Province boasts China's highest provincial GDP, accounts for more than one third of the PRC's annual foreign trade, and is the country's most attractive foreign investment destination.[49] The Chinese province is also the home of nearly 25 percent of China's FIEs, which generate more than 50 percent of Guangdong's industrial exports.[50]Guangdong Province has historically benefited economically from its geographical proximity to Hong Kong. The China-Hong Kong FTA has further solidified this natural comparative advantage by creating, in essence, a Hong Kong-Guangdong Province free trade zone that facilitates the free movement of goods, services, and people between Hong Kong and the Mainland province.[51]

In addition to creating the above trade effects, CEPA, as explained more fully below, has accelerated round-tripping practices between the Mainland and Hong Kong. Inasmuch as the FTA has eliminated or reduced Chinese import tariffs on a significant share of products sourced from Hong Kong, no real adverse customs-duty consequences attach to the strategy of artificially inflating the value of specialized components imported from related-party enterprises situated in Hong Kong.

2. 2007 Hong Kong-China Bilateral Tax Treaty

On August 21, 2006, Hong Kong and China signed a landmark bilateral tax convention; namely, the new **Arrangement for the Avoidance of Double Taxation on Income and Prevention of Fiscal Evasion Between the Mainland of China and the Hong Kong Special**

Administrative Region. This tax treaty -- which replaced an earlier tax arrangement executed by the parties in 1998 -- entered into legal force and effect in both jurisdictions on April 1, 2007.[52] Mr. Donald Tsang, the Chief Executive of the Hong Kong SAR, explained the primary objective of the Hong Kong-China tax convention in the following terms:

> The conclusion of a comprehensive double-taxation arrangement with the Mainland, together with the Mainland and Hong Kong Closer Economic Partnership Arrangement, will provide added incentives for international investors to enter the Mainland market through Hong Kong. It will also enhance cross-border financing arrangements and the transfer of technical know-how and patent rights between the two places. These will help promote Hong Kong's economy, enhance our competitiveness and overseas capital.[53]

In contrast to several bilateral tax treaties worldwide, the Hong Kong-China arrangement does not set forth any limitation-on-benefits provisions.[54] This specific tax feature can potentially foster so-called "treaty-shopping" by foreign investors.[55] The Hong Kong-China treaty employs the tax-credit mechanism as the primary instrument to avoid double taxation in both jurisdictions. As pertinent here, Chinese resident enterprises are liable for the payment of PRC income tax for any revenue generated on a worldwide basis; that is, income that is sourced both inside and outside the Mainland.[56] If, however, such a Chinese enterprise has already paid corporate income tax on any revenue attributable to Hong Kong, the amount of any Hong Kong income tax paid to SAR authorities may be credited against the income-tax liability that is due in China.[57]

In accordance with the convention, the highest Chinese withholding tax rate applicable to dividends that a resident of Hong Kong receives from its Mainland investment has declined from 20 percent to 10 percent.[58] Likewise, the corresponding PRC withholding tax for dividends that a Hong Kong business enterprise receives from its Chinese affiliate has fallen from 10 percent to 5 percent,[59] provided that the Hong Kong entity holds at least 25 percent of the capital stock of the Mainland company.[60] By way of relevant comparison, dividend tax rates in OECD-consistent treaties are usually set at 15 percent. As a result of this relatively favorable tax feature, more overseas investment earmarked for Chinese business entities should be channeled through Hong Kong going forward.[61]

Additionally, the highest PRC withholding tax rate applicable to interest income that a resident of Hong Kong derives from its Mainland investment has decreased from 20 percent to 7 percent.[62] Similarly, the corresponding withholding rate for interest income that a Hong Kong business enterprise generates from its Mainland holdings has fallen from 10 percent to 7 percent.[63] In parallel fashion, the highest PRC withholding tax rate for royalty income that a resident of Hong Kong derives from its Mainland investment has also declined from 20 percent to 7 percent, while the corresponding Chinese rate for royalty income that a Hong Kong business entity receives from its Mainland affiliate has fallen from 10 percent to 7 percent.[64] By way of comparison, interest and royalty tax rates appearing in typical OECD-based conventions are usually set at 15 percent. These generous withholding rates should attract even more overseas passive and intellectual property investment into the Mainland through Hong Kong.[65]

The Hong Kong-China bilateral tax treaty also incorporates provisions that govern capital gains realized on the Mainland. According to international practitioners, a full tax exemption in China is available on capital gains derived by a Hong Kong investor from the profitable disposal, transfer, or sale of shares of stock of a Mainland company, **(i)** provided that the sold shares comprise less than 25 percent of the stock ownership of the Mainland company, and **(ii)** provided that the assets of the Chinese company do not primarily consist of immovable property (*i.e.,* real estate) situated on the Mainland.[66] The implementation of this questionable treaty provision – specifically, paragraph 5 of Article 13 of the tax convention – is subject to the administrative interpretation of the Chinese tax authorities.[67] Given that no capital-gains tax exists in Hong Kong for such a transaction, this specific treaty provision may arguably give Hong Kong taxpayers a unilateral tax benefit through tax-free transactions.[68]

Finally, the convention provides for the exchange of information between China's State Administration of Taxation ("SAT") and Hong Kong's Inland Revenue Department. The exchange-of-information provisions, based on the 1995 OECD model convention, are designed to facilitate the implementation of the treaty.[69] Even though the pertinent provisions do allow for a certain amount of information exchange between Mainland and Hong Kong authorities to facilitate tax-collection and enforcement activities, the treaty article is much more restrictive in scope than the corresponding provision set out in the 2004 OECD model treaty.[70] Pursuant to the Hong Kong-China convention, only information that is necessary to carry out the new arrangement or implement the domestic tax laws of China or the SAR – "in particular, information for the prevention of fiscal evasion"[71] – may be exchanged.[72] Neither government is obligated to supply information that is not obtainable under the domestic tax laws of either jurisdiction or that would lead to the disclosure of any trade, business, industrial, commercial, or professional secrets or trade processes.[73]

The tax exemption for Mainland-sourced capital gains under the Hong Kong-China treaty – coupled with the relatively low Chinese withholding tax rates for dividends, interest, and royalties – not only enhances Hong Kong's natural competitiveness, but also provides added incentives to use the SAR as a conduit to do business or invest in China. In fact, the new bilateral arrangement actively encourages using a Hong Kong company as **(i)** an intermediate holding company for passive-income investments situated on the Mainland, **(ii)** a corporate vehicle to finance active business operations in China, and **(iii)** a commercial means for licensing intellectual property to PRC companies. As explained later in this study, the new tax treaty also has the potential to accelerate Sino round-tripping practices, because the convention entices Chinese business entities to establish related-party holding companies in Hong Kong, an essential pre-requisite for the round-tripping merry-go-round.

In this regard, as previously explained in note 41, the residency concept has no real practical application under Hong Kong tax law. Only Hong Kong-source income is subject to SAR tax liability in accordance with the tax-friendly territorial principle. For this reason, the former British colony is an extremely advantageous site from which to administer an offshore affiliate, without any real tax consequences, provided that the related enterprise does not conduct any business with other Hong Kong residents. This characteristic is one of the key reasons why the use of offshore Hong Kong companies has proliferated to such a great extent in recent years. Such enterprises can conveniently have SAR-based directors and a Hong Kong bank account, as well as a Hong Kong office address, without being subject to the tax net of the SAR. A Hong Kong company is not even required to state on its letterhead its registered office address or place of incorporation.[74]

VI. TRADITIONAL EXPLANATIONS TO RECONCILE THE CHINESE STATISTICAL BALANCE-OF-TRADE DISCREPANCY: CURRENT ACCOUNT ANALYSIS

A. China-Hong Kong *Entrepôt* Trade

1. Definition of Hong Kong's Re-Export Trade and its Impact on China's Merchandise Trade Balance

Today, the relatively tiny island of Hong Kong is China's leading "foreign investor" and its fourth leading trading partner as a result of its proximity to the Mainland, convenient transportation and communication systems, culture and language similarities, and the creation and efficient administration of the recently-ratified FTA and bilateral tax arrangement.[75] With regard to the Mainland's complex international-trade relationship with the former British territory and its worldwide trading partners, goods can enter or exit the PRC in one of two ways: first, they can be shipped directly to and from the Mainland; and second, they can travel through Hong Kong, the world's premier *entrepôt*.

As a result, Hong Kong has emerged as the main indirect-trade center for all of Asia, where extremely large volumes of goods are first imported and then are re-exported elsewhere. Virtually none of this re-export trade is consumed in the former U.K. territory; yet, official Hong Kong trade statistics capture all of these re-exported goods. During the nine-year period comprising 1997 through 2005, official Hong Kong trade data show that Hong Kong's re-exports of Chinese goods destined for overseas markets accounted for, on average, roughly one third (*i.e.,* 33%) of all of China's total reported exports.[76] By 2005-2006, however, the value of such Chinese-Hong Kong re-export trade, as well as that of U.S. goods re-exported to the Mainland through the former British colony, had fallen to only 14 percent of total China-US bilateral trade.[77]

The Hong Kong Census and Statistics Department defines the term "re-exports" to mean "products which have previously been imported into Hong Kong and which are re-exported without having undergone in Hong Kong a manufacturing process which has changed permanently the shape, nature, form or utility of the product."[78] In other words, the essential characteristics of the re-exported goods are not fundamentally changed or altered by means of a "substantial transformation" operation that confers Hong Kong- origin status. This same outcome prevails under CEPA even when more than 15 percent, but less than 30 percent, of the value of the finished export product is added in the former British territory.[79]

Previous researchers initially concluded that the failure to track and properly record China's *entrepôt* trade through Hong Kong was the major reason that accounted for the growing statistical discrepancy that emerges as a result of comparing official Chinese trade data with the mirror trade of the PRC's trading partner countries. Even though recent research has called into question the validity of the China-Hong Kong *entrepôt* trade hypothesis as the *most important* explanation to account for the data discrepancy, China's re-export trade through the former British colony still remains one cause that distorts China's true trade performance with the rest of the world. Indeed, despite the implementation by Chinese Customs of new procedures (including requests for Census & Statistics Department's cooperation in trade data reconciliation) in 1993, meant to identify more accurately the ultimate destination of the exportation of Chinese goods and the importation of foreign products that are re-exported through Hong Kong, and despite the reunification of Hong Kong with the Mainland in 1997, the misattribution-of-trade problem is still thought to be a major source of the trade data discrepancy.

2. Rationale that Warrants Making Data Adjustments to Reconcile Official Aggregate Chinese Export-and-Import Statistics, Official Hong Kong Government Data, and Official Aggregate Statistics of China's Trading Partners

Given that Hong Kong trade statistics are included in Chinese partner-country data used to calculate China's total merchandise-of-trade surplus with the rest of the world, that portion of Hong Kong re-export trade originating in the Mainland is sometimes double-counted (*i.e.*, misattribution of trade) as trade with China by both Hong Kong authorities and China's partner countries. An additional problem for policymakers, as already emphasized, is that the PRC partner-country statistics do not make any adjustments for the mark-ups charged by unrelated-party Hong Kong "middlemen" for their re-exporting activities and ancillary services undertaken in the SAR.[80] The difference is significant in not only the omission of Hong Kong re-export by these partner countries but also the fact that the re-export value is already higher than Chinese exports to Hong Kong due to the middleman markup.

As articulated above, Chinese Customs began implementing new procedures in 1993 to identify more accurately the ultimate destination of the exportation of Chinese products, as well as the importation of foreign goods, that are re-exported through Hong Kong.[81] Notwithstanding these new customs procedures, Fung and Lau have already established that Mainland customs authorities have not been able to eliminate completely the statistical discrepancy caused by Hong Kong re-export trade. Consequently, one must make a series of data adjustments to the official export-and-import statistics maintained by China, Hong Kong, and the PRC's partner countries in order to isolate the economic effect that such China-Hong Kong *entrepôt* trade has had on the Mainland's true global balance of trade during the past decade. One must also strip out the Hong Kong middleman mark-ups for both eastbound and westbound *entrepôt* trade transiting the free-zone enclave, because the value added by such "middlemen" is not attributable to either Chinese exporters shipping abroad or to foreign exporters trading with the Mainland. According to Fung and Lau (1999), examples of Hong Kong middleman markups are for providing services such as design, marketing, financing and sourcing.

Hong Kong customs authorities measure these middleman mark-ups annually in accordance with periodic surveys. Based on this official compilation of data, international trade researchers have estimated in a number of public studies the magnitudes of the Hong Kong re-export mark-ups charged by the unrelated-party Hong Kong "middlemen". These researchers include Sung (1991), Lardy (1994), West (1995), Fung (1996), Fung and Lau (1996), Fung and Lau (1999), Feenstra et al. (1999), Fung and Lau (2003), Schindler and Beckett (2005), and Statistics Canada (2005). Consistent with the general results of these studies,[82] our own research for calendar-year 2007 establishes that the unrelated-party Hong Kong middleman currently charge, on average, a mark-up of approximately 25 percent for Chinese goods shipped through Hong Kong before re-exportation to other foreign destinations and roughly 6 percent for foreign goods (*e.g.*, U.S. goods) shipped via Hong Kong before re-exportation to the Mainland.

B. Adjustments to Reconcile Inaccurate Chinese Trade Statistics Caused in Part by the Hong Kong Re-Export Trade Phenomenon: Misattribution of Trade; Under-Counting; Double-Counting; Middleman Mark-Ups; and Inconsistent Valuation of Exports and Imports

As demonstrated above, China's export-and-import trade activities are complex. On the one hand, China engages in direct export-and-import transactions with its trading partners, bypassing Hong Kong altogether. On the other hand, the PRC also makes substantial indirect export shipments to, and receives indirect import shipments from, its partner nations via Hong Kong. As a result, China's re-export trade through Hong Kong presents issues of misattribution of trade, under-counting, double-counting, middleman mark-ups, and inconsistent customs valuation techniques employed internationally to measure exports and imports.[83] For example, the Census & Statistics Department of Hong Kong records total value of exported goods instead of the value added portion generated in Hong Kong territory as their exports, resulting in double-counting of the portion of exported goods generated in the Mainland.

To eliminate the trade distortions caused by China's *entrepôt* trade through Hong Kong, one must make three specific data adjustments.[84] The first statistical adjustment consists of **(a)** correctly attributing all indirect Mainland exports traded through Hong Kong to the official Chinese export database and the corresponding import database maintained for the PRC's partner countries, as well as **(b)** correctly attributing all indirect Chinese imports of foreign (non-Hong Kong) origin goods re-exported through the SAR to the official Chinese import database and the corresponding export database of China's partners. The second adjustment entails stripping out the Hong Kong "middlemen" mark-ups for all indirect eastbound and westbound trade that passes through the former British colony. The third adjustment involves taking into account and neutralizing the freight and insurance costs for China's direct and indirect export and import trade.

1. Volume and Middleman Mark-up Adjustments

a. China's Trade with the Rest of the World: Inbound-Import Transactions

Like its trading-partner countries, China is usually able to identify the country of origin of imports that enter the Mainland from the rest of the world even after such merchandise has transited through Hong Kong.[85] Nevertheless, the resulting Chinese import values include the average Hong Kong middleman markup of 6 percent for such indirect trade. As a consequence, the reported value for PRC imports of foreign goods that enter into the Mainland after passing through Hong Kong typically overstates the value of such partner-country trade by approximately 6 percent per inbound shipment.[86] Accordingly, to correct the aggregate Chinese import figure, one must strip out the average Hong Kong middleman mark-up of 6 percent for each indirect import shipment that transits through Hong Kong before its final entry into China's national customs territory.[87]

From the perspective of China's partner nations, partner customs authorities *sometimes* do not know the final destination of a portion of their export goods shipped to Hong Kong.[88] As a result, China's partner countries sometimes incorrectly record such goods as exports to Hong Kong, even when some of those goods are subsequently re-exported from the SAR to the Mainland. Accordingly, to make China's partner-country export data comparable with the adjusted Chinese import statistics, one must add to the partner-countries' export database *only* the volume and value of such partner-country trade shipped to Hong Kong for subsequent re-exportation to the Mainland that the partner countries fail to record as legitimate export trade with China.[89] Such indirect exports must necessarily exclude the average Hong Kong middleman mark-up of 6 percent to achieve statistical parity.[90]

b. China's Trade with the Rest of the World: Outbound-Export Transactions

Inasmuch as Chinese Customs authorities *sometimes* do not know the final destination of a portion of Chinese goods initially exported to Hong Kong that are subsequently re-exported to third countries, Mainland authorities *sometimes* incorrectly record such shipments as Chinese exports to Hong Kong, even when such goods are re-exported from the former British territory to the rest of the world.[91] As a result, the reported volume and value figure for China's exports to its partner nations often does not fully capture those Chinese goods that are exported to the PRC's trading partners via Hong Kong.[92]

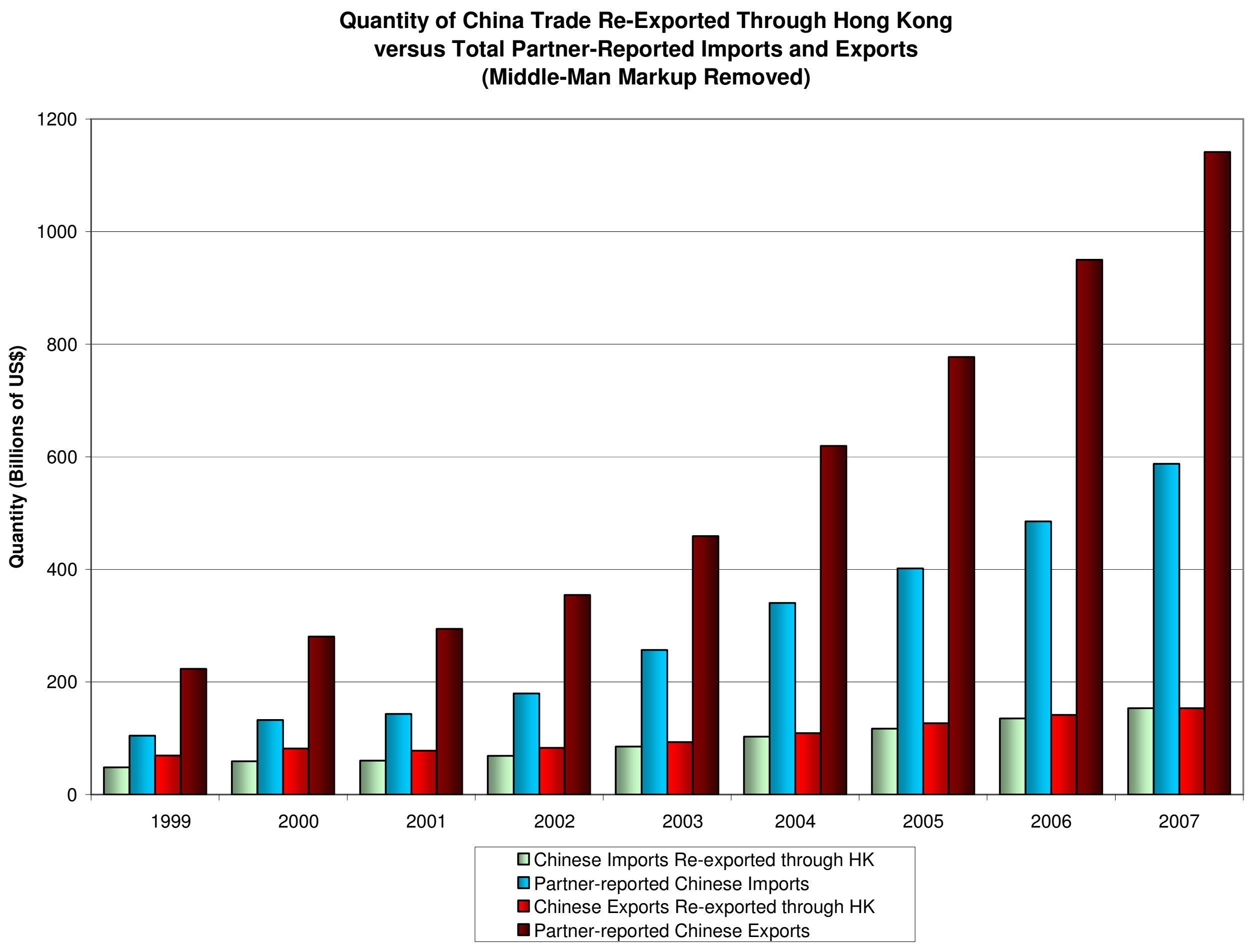
To correct China's official export volume and value in this regard, one must add to the PRC's aggregate export figure *only* the volume and value of China's indirect exports shipped through Hong Kong (for ultimate re-exportation to the rest of the world) that the Mainland authorities fail to capture as legitimate export trade with the rest of the world.[93] Such indirect exports must necessarily exclude the average Hong Kong middleman outbound markup of 25 percent to achieve statistical parity.[94] No adjustment is warranted in those cases in which Chinese Customs can correctly identify the country of ultimate destination (*e.g.*, the U.S.) for any indirect Mainland exports shipped through Hong Kong.

Adjustments are slightly different for China's partner nations.[95] Partner-country customs officials usually can identify China as the country of origin of the subject imports -- even when Chinese merchandise is re-exported through Hong Kong -- by virtue of careful document inspection.[96] However, partner countries' statistics include the average Hong-Kong middleman mark-up of 25 percent per shipment.[97] One must, therefore, subtract the average Hong Kong mark-up figure of 25 percent from the reported partner countries' import data to render aggregate trading-partner import statistics comparable with adjusted Chinese export data.[98]

c. China's Global Merchandise Trade Surplus as Adjusted for Indirect Hong Kong Re-Export Trade

After taking into account and adjusting for the Chinese eastbound and westbound re-export trade that transits through Hong Kong, as well as the Hong Kong middleman mark-ups, we calculated a revised Chinese merchandise trade surplus with the rest of the world that totaled to US$464.5 billion in 2006. After performing this same adjustment for calendar-year 2007, we calculated an adjusted Chinese global trade surplus of US$554.2 billion for that year. Nevertheless, China's indirect import and export trade through Hong Kong has decreased significantly over the past decade. The proportion of Hong Kong re-exports to China's total trade has declined from 36 percent in 1999, to only 18 percent in 2007 *(See Graph 8)*.

GRAPH 8



Source: GTIS, World Trade Atlas

While re-export trade through Hong Kong remains a factor in the growing statistical trade discrepancy, it's affect has diminished considerably. Based on this partial statistical reconciliation, we determine that the Hong Kong re-export trade phenomenon, coupled with Hong Kong middleman mark-ups, is responsible, on average, for approximately 18 percent or US$57.5 billion of the statistical discrepancy in 2007 that emerges as a result of comparing official and unadjusted Chinese trade data with those of its partner countries (i.e., 18% x US$319.4 billion = US$57.5 billion).[99]

2. Adjustments to Reconcile Inconsistent Customs Standards Employed Internationally to Value Exports and Imports

The United States measures the value of exports using the FAS [Free Alongside Ship] methodology, while China, together with almost all other countries of the world, employs the FOB [Free On Board] method to value exports. Likewise, the United States measures imports using a "customs value" definition which is a *de facto* FOB standard (*i.e.*, actual cost of goods excluding insurance and freight), while China values imports at the CIF level of trade.[100] U.S. import data are somewhat unusual in that U.S. customs authorities collect and report separate insurance and freight costs, because the United States assesses customs duties based on the *de facto* FOB value of the imported merchandise, rather than on the CIF value as is the practice in almost all other nations.[101] This inconsistent practice with regard to export and import valuation also distorts the current-account balance with regard to trade between China and the United States.

Hence, a direct comparison of the official Chinese trade balance with those of its bilateral trading partners provides somewhat inaccurate results. Chinese Customs records PRC exports on an FOB basis, while the majority of customs authorities around the world record direct and indirect imports shipped from China on a CIF basis. China's re-export trade through Hong Kong then aggravates this asymmetrical customs treatment. Accordingly, to measure Chinese direct and indirect trade more precisely under any circumstances, it is necessary to express both PRC exports shipped to its trading partners, as well as Mainland goods imported by China's partner nations, by using the same valuation technique; that is, the FOB basis of measurement.[102] The difference between FOB and CIF is generally the insurance and freight costs incurred when transporting the goods from the exporting to the importing country.

To convert the CIF value of Chinese export products, as imported by the PRC's trading partners, into an FOB value for purposes of this study, we relied on the U.S. ITC CIF/Customs Value (CV) ratios for U.S. imports for consumption from Asia. These data illustrate the U.S. ITC's estimate of the mark-up of U.S. imports reported on a CIF basis over their FOB or customs value. The average calculated mark-up from 1999-2002 was 4.46 percent. This figure is corroborated by the average differences in the FOB and CIF indices of actual shipment data as reported in numerous U.S. Department of Commerce antidumping proceedings over the years. For simplicity sake, the present analysis discounts imports reported on a CIF basis by 5 percent, a round number derived from the chart below. In fact, the consensus internationally is that the CIF import value is, on average, five percentage points (5%) higher than the corresponding FOB value:[103]

Annual Data on CIF/CV Ratios for All Import Commodities from Asia

Country	1998	1999	2000	2001	2002	2003
	In Actual Dollars					
China	105.55	107.34	107.56	106.94	106.66	107.15
Hong Kong	103.73	104.41	104.55	104.39	104.78	104.94
India	105.28	105.58	105.81	105.65	105.33	105.37
Indonesia	105.65	108.06	107.97	107.92	107.70	107.68
Japan	102.53	102.61	102.73	102.43	102.56	102.58
Korea	103.61	103.66	103.50	103.72	103.75	103.72
Malaysia	102.67	103.07	103.16	103.22	103.00	101.54
Phillipines	103.18	103.66	103.69	103.90	104.04	104.31
Singapore	101.58	101.95	101.91	101.86	102.00	101.54
Taiwan	103.68	104.44	104.30	104.15	104.09	104.50
Thailand	103.99	105.80	106.02	105.71	106.00	106.12
Total--All Asia (including not shown)	103.65	104.39	104.52	104.35	104.54	104.51
1999-2002 Average	**4.46%**					

Source: US International Trade Commission

Therefore, given the relatively small scale of the CIF/FOB adjustments in the total discrepancy, we simplify the process by assuming that 5% should be used as the percentage to adjust the total unadjusted Chinese trade balance discrepancy. In other words, all inbound and outbound trade, directly shipped or re-exported through Hong Kong, have been adjusted to correlate on an FOB basis. As a result, we find that in 2007 there was a total of US$16.0 billion of CIF/FOB adjustment.

C. “Phantom” Chinese Exports and Imports

Besides the China-Hong Kong *entrepôt* effect, the so-called Chinese “phantom” shipments may also distort the real Chinese trade surplus. Specifically, these phantom shipments refer to trade transactions that do not actually exist, but that are used for fraudulent purposes (Fung & Lawrence, 1999).[104]

Obviously, no publicly available data exist for Chinese “phantom” exports to enable us to make the necessary statistical adjustment to the official PRC database. Nevertheless, such an adjustment is should be of decreasing relevance under the current circumstances, because China’s “phantom” exports should be on the decline in light of the Mainland’s new enterprise income-tax law. The new Sino tax statute, which entered into legal force and effect on January 1, 2008, eliminates some of the Mainland export incentives that previously had encouraged PRC exporters to engage in smuggling activities for China’s outbound trade. Consistent with this observation, the major proportion of China’s “phantom“ trade is now occurring on the inbound (import) side of the equation – an outcome that artificially decreases the PRC’s merchandise trade surplus with the rest of the world by artificially increasing the value of Chinese imports relative to its exports.

The U.S. Department of Treasury stated in a 2005 study that China’s “phantom imports from China” totaled US$55 billion, a value “explained in large part by goods that are exported [from the Mainland] to Hong Kong and then re-exported back into China.”[105] As further explained by the Treasury Department: “[s]o, Hong Kong data for re-exports from China to China, adjusted with the markup for outward trade, is [sic] used to create an estimate for China’s exports [or imports] to itself.”[106] The corresponding data adjustment that reconciles these “phantom” transactions necessarily reduces the trade-balance discrepancy between China’s official export database and the corresponding import database maintained by the rest of the world for its international trade with the PRC. More important, such an adjustment increases the Mainland’s true global trade surplus, because, as explained above, Chinese “phantom” import trade <u>artificially</u> <u>increases</u> the aggregate value of Mainland <u>imports</u> (Fung & Lau, 1999).

Accordingly, after taking into account and adjusting for Chinese “phantom” trade in keeping with Treasury’s analysis, we determined that Chinese “phantom” trade is responsible, on average, for approximately 18 percent or US$ 57.5 billion of the trade data inconsistency that is the subject of this study (*i.e.,* US$57.5 billion/US$319.4 billion = 18%). Additionally, as further demonstrated below, China’s “phantom” trade is directly linked with the PRC’s growing problem of round-tripping; that is, the export of Chinese domestic capital through the Mainland’s current account that is subsequently recycled abroad in an offshore tax haven before returning to China in the disguised form of foreign direct investment.

D. Third-Country Transshipment or False Invoicing of Chinese Products

Other researchers have pointed out that the third-country transshipment (*i.e.*, false invoicing) of Chinese merchandise imported into the United States as products from other foreign nations prevents U.S. trade statistics from capturing the true value of U.S. imports from China. Transshipment of Chinese goods to the United States involves the shipping of Mainland goods to a third country, such as Vietnam, to be labeled in that country as exports of that nation for purposes of later exporting those same Chinese products to the United States as "products of Vietnam".[107] Naked and fraudulent "[m]is-attribution [of trade] takes place when [exporters] deliberately make false declarations about the origin or destination of a good."[108]

For years, U.S. customs authorities have sought to curtail the transshipment of Chinese textile-and-apparel products that evade U.S. quota restrictions. Similarly, the U.S. Department of Commerce is legally responsible for administering anti-circumvention proceedings whenever PRC exporters transship their goods through third countries to evade U.S. antidumping or countervailing duties. According to U.S. authorities, the majority of the illegally transshipped textile-and-apparel articles originate from China. In fact, U.S. customs authorities have investigated firms in Hong Kong, Taiwan, Macau, Malaysia, Singapore, Thailand, and Cambodia for re-labeled textile-and-apparel goods originally produced in China that have circumvented U.S. customs restrictions.[109]

Interestingly, the countries and provinces that have consistently reported lower Chinese import volumes based on their own official trade statistics than the corresponding PRC export volumes based on official Mainland data include the following jurisdictions: **(i)** Taiwan; **(ii)** Russia; **(iii)** Chile; **(iv)** Indonesia; **(v)** the Philippines; **(vi)** Brazil; **(vii)** Saudi Arabia; and **(viii)** South Africa.[110] This finding suggests that Mainland entities may be misinforming Chinese Customs that their export shipments are destined for one of the above customs territories, but, in reality, the PRC export goods are ultimately transshipped to another venue, such as the United States.[111] Notwithstanding the above analysis, we did not -- indeed, cannot -- make any adjustments to account for Chinese third-country transshipment activities, because no reliable data exist that correctly captures the incidence of such illicit trade entering into the United States or other trading partners' jurisdictions.

E. Smuggling

Aside from Hong Kong re-exports, middleman markups, the FOB customs standard to value exports, the CIF basis to measure imports, Chinese "phantom" trade, and transshipped PRC goods, other factors that complicate the measurement of China's (or any country's) true trade flows include smuggling.[112] Feenstra, Hai, Woo, and Yao have found that some Mainland exporters smuggle goods out of China en route to Hong Kong and, thereby, understate the PRC's export trade.[113] Hong Kong trade statistics sometimes report these rogue shipments when the Chinese products are subsequently re-exported from the former British colony to the rest of the world.[114] Likewise, some Mainland importers understate the volume and value of Chinese imports – principally, an important volume and value of clandestine trade involving foreign automobiles, cigarettes, and refined petroleum products[115]-- by virtue of smuggling activities.[116]

It is difficult, if not impossible, to estimate on an annual basis the value of goods smuggled out of and into China.[117] Some researchers contend that smuggling has been on the wane in recent years in the PRC on account of the central government's crackdown on such fraudulent activity one decade ago.[118] In one study, Fung and Lau found that "[o]n average, taking smuggling into account increases U.S. exports to China by a modest amount of less than US$0.5 billion a year, and lowers the bilateral trade imbalance in goods by the same amount."[119] "Thus, [what data that are available indicate that] smuggling does not seem to have a large impact on the U.S.-China bilateral trade balance."[120] Therefore, we estimated for all other years in the examined period that about 1% of the total discrepancy is attributable to smuggling activities. Specifically, US$3.2 billion goods were smuggled in 2007 in accordance with our estimation.

F. Timing of Exports and Imports

In some cases, a four-to-six week lag exists between the recording of an export from the exporting country and the registering of an import by the importing country. These time lags typically affect export sales shipped during the month of December of one calendar year and imported during the month of January of a subsequent year. In the case of China-US trade, a four-to-six week lag does indeed exist between the recording of an export from the Mainland and the registering of an import by the United States and vice versa. Therefore, "[g]oods in transit at the end of the year are counted as exports by China, but are not counted as imports by the United States."[121] Such lags, however, cannot by themselves account for the growing statistical discrepancy outlined above, because they are expected to be smoothed out over time. As the U.S. International Trade Commission analysts point out, "This [time lag] could be a big problem for monthly data, but for annual data the differences in the beginning and end of the year are likely to balance out."[122] Furthermore, compilation of Hong Kong trade statistics can be viewed as timely given its import and export declaration period of 14 days. Accordingly, we made no adjustments for time lags.

G. Geographic Coverage Inconsistencies

A very small amount of the statistical discrepancy that exists between the official Chinese export database and the corresponding import database of the PRC's partner countries pertains to geographic-coverage inconsistencies. For example, China and the United States maintain divergent legal definitions concerning the scope of the U.S. customs territory. The United States includes Puerto Rico and the U.S. Virgin Islands as part of its customs territory, whereas China does not.[123] To render official Mainland export statistics compatible with the corresponding U.S. import data, one must strip out any Chinese trade involving Puerto Rico and the U.S. Virgin Islands.[124] Although we made a similar adjustment on an across-the-board fashion to the import database maintained for the rest of the world, we found that such an adjustment had a statistically negligible effect.

H. Misclassification of Goods

Even when China and one of its trading partners reports the same export-import transaction at the same customs value, the Chinese exporter may classify certain goods under one tariff heading in the PRC, while the importer classifies the same products under a different tariff heading in the importing nation. Stated otherwise, "[i]t is not uncommon for one trading partner to record the transaction according to the actual type of good[s] under Chapters 1 through

97 of the Harmonized System, while another trading partner records [the products] in Chapter 98 or 99 to identify goods covered by special programs and policies."[125] In reality, misclassification of goods, as is similar with mis-invoicing practices, is common. As for either the China customs agency or Hong Kong customs agency, it is not cost effective to frequently compare their respective customs declaration forms submitted by importers and exporters.

Nevertheless, while there may be statistically significant inconsistencies pertaining to classifications of goods at a micro-level of analysis, we have maintained a much more macro view of the data. Because our analysis relies on total trade values between China, Hong Kong and China's trading partners, it is not necessary to account for potential misclassifications as all values in the various trade databases were taken into account. Also, it can be assumed that misclassifications occur on both incoming and outgoing goods, and therefore may roughly cancel each other out.

I. Exchange Rate Fluctuations

Although the Chinese yuan has appreciated incrementally against the U.S. dollar in relative terms over the past few years, previous researchers have already determined that "exchange rates are not a major factor in the discrepancy in the trade figures."[126] In other words, the Chinese yuan/dollar relationship has not been subject to volatile exchange-rate fluctuations that warrant any kind of data adjustment.[127] Furthermore, the yuan has not been subject to any volatile exchange-rate fluctuations with any other major world currencies to warrant any statistical adjustment either. For these reasons, we made no adjustment to take into account the relatively slight appreciation in nominal terms the Chinese yuan has experienced *vis-à-vis* the major global currencies over the past two years.

J. Conventional Errors and Omissions

Even the export-and-import databases compiled and maintained by the most developed countries of the world, including the United States and the EU nations, suffer from standard errors and omissions. As mentioned in the summary of methodology section, the conventional errors and omissions, together with other non-identifiable factors D, F, G, H and I discussed above, are added up together as the "residual" portion of the Chinese trade balance discrepancy.

VII. INTEGRATED CURRENT ACCOUNT AND CAPITAL ACCOUNT ANALYSIS – ROUND-TRIPPING: A COMPREHENSIVE EXPLANATION TO RECONCILE THE CHINESE STATISTICAL BALANCE-OF-TRADE DISCREPENCIES

A. Background

As explained throughout this study, previous researchers concluded that the failure to track and properly record China's *entrepôt* trade through Hong Kong was the major reason that accounted for the statistical discrepancy that emerges as a result of comparing official Chinese trade data with those of its partner nations. Other hypotheses, including phantom shipments, were also reviewed in this study. Nevertheless, none of these theories by themselves adequately explains and reconciles the statistical inconsistency outlined above. Our research findings establish that a phenomenon referred to as round-tripping is a in fact a major contributor the statistical discrepancies involving official Chinese trade data.

Round-tripping is a trade-tax-investment strategy whereby some Mainland enterprises undervalue export and/or overvalue import transactions so as to move Chinese capital across the PRC border via transfer-pricing practices with related-party enterprises.[128] Specifically, Chinese resident enterprises, including the non-Chinese FIEs, export domestic capital from the Mainland to related-party enterprises situated outside China in offshore tax havens pursuant to non-arm's length transfer-pricing techniques designed to circumvent Chinese capital controls.[129] The exported Chinese capital is then recycled abroad and thereafter returns to the Mainland in the disguised form of foreign direct investment.[130] The primary tax havens responsible for China's round-tripping activities include first and foremost Hong Kong, as well as the British Virgin Islands, and the Cayman Islands.[131] As emphasized by ITC researchers Ferrantino and Wang, "[o]ur results…suggest that reporting of different values to importing and exporting authorities might be a significant source of discrepancies in trade data."[132]

Chinese resident enterprises, including FIEs, systematically have been under-reporting the customs value of their exports shipped to Hong Kong and other destinations by virtue of transfer prices paid to related-party agents located in offshore jurisdictions.[133] Funds "harvested" from the under-reported Chinese export earnings are first retained by the related-party agent and then are later returned to the Mainland as recycled PRC capital that is disguised as foreign direct investment to take advantage of the multiple Chinese tax incentives heretofore aimed at foreign investors.[134] Likewise, Chinese resident enterprises systematically have been overvaluing the customs value of their imports sourced from Hong Kong and other foreign tax havens on a relatively large scale by means of non-arm's length transfer prices paid to related parties situated in the former British territory or other tax havens.[135]

Ferrantino and Wang (2007) at the ITC describe the intricate nature of the complex China-Hong Kong transfer-pricing network, as well as the commercial rationale underlying such non-market transactions:

> Transfer pricing refers to mis-invoicing engaged in by related parties in different countries, such as different branches of a multinational corporation. The incentives to do this are particularly strong when firms ship to themselves specialized "firm-specific" components or intermediate goods for which there is no obvious market equivalent to establish an "arm's-length" price…The role of Hong Kong, which is both a duty-free customs area and a low tax location, in U.S.-China trade suggests that the incentives for mis-invoicing and mis-attribution may be particularly high.[136]

The U.S. Department of Treasury published its own study, the findings of which are consistent with those of the ITC researchers concerning transfer-price schemes undertaken by affiliates situated in the Mainland and Hong Kong:

> Hong Kong presents an ideal location for Chinese portfolio diversification and it is possible that China-domestic Hong Kong trade is distorted by financial flows moving through the current account, which can be achieved through the under-reporting of exports or over-reporting of imports. Additionally, Chinese funds are reportedly taken out of the country and then reinvested in China as foreign funds in order to take advantage of the favorable tax treatment for foreign investors, referred to as "round tripping" of funds.[137]

Mainland FIEs constituted with foreign capital (which account for more than one half of China's exports),[138] other foreign enterprises with "permanent establishments" in China, and Chinese state-owned enterprises ("SOEs") -- with the latter group still comprising "a crucial part of the [PRC] economy"[139] – are the primary entities responsible for the cross-border round-tripping activities taking place between China and Hong Kong. Chinese FIEs (*i.e.*, "productive" FIEs, trading FIEs, service FIEs, wholesale FIEs, and retail FIEs), in turn, generally include **(i)** wholly foreign-owned enterprises ("WFOEs"), **(ii)** majority foreign-owned entities, such as equity or contractual joint ventures (*e.g.,* partnerships), and **(iii)** minority-owned FIEs with non-state partners.[140] FIEs and other foreign enterprises generally are more capable than their private Chinese domestic counterparts of importing non-Chinese origin components and inputs from abroad as a result of the know-how and relations of their foreign investors. Furthermore, unlike the Chinese private sector as a whole, FIEs and other foreign enterprises are typically not hampered by limited access to private bank credit on the Mainland as they usually look to off-shore bank financing to capitalize their on-shore Chinese operations.[141] Thus, FIEs and other foreign enterprises are generally more likely to engage in round-tripping practices than their Chinese domestic counterparts; however, as quoted above, Chinese SOEs appear to be the major entities responsible for round-tripping on the whole.

The foreign investors that control Chinese FIEs generally include **(i)** any foreign enterprise, economic entity, or individual, **(ii)** any Chinese enterprise registered outside the Mainland, and **(iii)** Hong Kong, Macau, and Taiwanese individuals or business enterprises.[142] Hong Kong is, by far, China's leading foreign investor. According to the Chinese Ministry of Commerce, more than one-half (50%) of China's foreign direct investment originates from Hong Kong, a relatively tiny island comprised of only 6.8 million inhabitants.[143] Although the United States is the leading *foreign-investor country* in China, Japan is the predominant source of Asian-based FIEs domiciled in the PRC, representing more than two thirds (66%) of all Asian-owned multinationals that have shifted production to China during the past decade.[144] Other Asian nations that have witnessed a recent proliferation of FIEs into China include Singapore, South Korea, and Malaysia.[145] The major European multinational companies that have moved production to China are headquartered in Sweden, the Netherlands, Germany, Finland, and the United Kingdom.[146]

B. Economic and Legal Incentives that Trigger Round-Tripping of Chinese Capital Through Hong Kong and Other Offshore Tax Havens

Several economic and legal elements must be in place before the phenomenon of round-tripping of domestic capital can take place. First, investors from a tax jurisdiction such as China must have access to a foreign tax haven through which they can establish related-party companies with which to engage in non-arm's length transfer-pricing transactions. Second, the primary tax jurisdiction must have enacted trade and investment barriers that impede and discriminate against *domestic investment*. Third, the primary tax jurisdiction must have on the books tax and investment incentives that discriminate in favor of *foreign investment*. The China-Hong Kong relationship satisfies all of these elements.

1. Transfer-Pricing Practices and Offshore Tax Havens

The general purpose of non-arm's length transfer-pricing practices is to shift income from a high-tax to a low-tax jurisdiction.[147] Multinational corporations are the chief players that engage in transfer-pricing activities internationally. As explained by Charles McLure Jr., at the Hoover Institute, "[t]he parent company [*e.g.,* Chinese parent company] could undercharge on the transactions between it and the [foreign] tax haven subsidiary [*e.g.,* Cayman Island subsidiary] and the subsidiary could overcharge on the related transaction between it and the subsidiary in the developing country [*e.g.,* Mexican subsidiary], so the larger profit will reside in the tax haven."[148]

Today, transfer pricing is a business practice carried out by different multinational units of the same affiliated corporate group that generally consists of *dual-invoicing strategies* that undervalue exports and/or inflate imports to evade taxes and national capital controls as well.[149] Multinational corporations can manipulate transfer prices for a variety of their related-party transactions involving finished goods, licensing of technology, input-and-component sourcing, purchase or sale of other intangible assets, loans, the provision of services and technical assistance, quality control, marketing, consulting, research and design ("R&D"), distribution, and other similar activities.[150] By carrying out such pricing practices, multinational enterprises can effectively distort their costs and, thereby, disguise the correct amount of income, as well as financial capital, attributable to a particular jurisdiction.[151] Given its current-account implications, transfer-pricing activities performed by private affiliated enterprises also distort the balance-of-trade statistics maintained by public customs authorities of the major trading countries.[152]

Furthermore, "Once transfer pricing and tax havens are combined, the benefits of manipulating transfer prices [by multinational corporations] increase dramatically."[153] In fact, round-tripping activities become virtually unchecked when multinational enterprises involved in global trade engage in transfer-pricing arrangements through a tax haven – a "creature of the twentieth century [that] began to be used extensively because of the high levels of tax which prevailed after the First World War."[154] Often described in different manners, the tax haven has been identified as an area in which "the existence of a composite tax structure [is] established deliberately to take advantage of, and exploit, a worldwide demand for opportunities to engage in tax avoidance."[155] This exactly fits into Hong Kong's case. Without transfer-pricing regulations or any governmental interference based on arm's length transaction rationale, Hong Kong successfully enhances its attraction to those round-tripping capital flow practitioners.

Freda Tung, a statistician with the Census and Statistics Department in Hong Kong, confirms that Hong Kong does not have any transfer-pricing regulation. As explained by Ms. Tung, the Census & Statistics Department has periodical programs for checking average unit values of their imports and exports, but such information is only used for trade data compilation purposes due to the absence of import duties in Hong Kong.[156]

International practitioners universally consider the Hong Kong SAR to constitute a *de facto* tax haven for the following reasons: **(i)** its relatively low corporate income-tax rate of only 17.5 percent; **(ii)** the taxation of only Hong Kong-source income; **(iii)** an extremely tax-friendly territorial principle that is flexibly applied to rather loose and relaxed residency and income-sourcing criteria; **(iv)** the notable absence of taxes on such traditional income items as capital gains, dividends, and retained earnings; and (**v**) statutory provisions that allow taxpayers to carry forward losses indefinitely.[157]

For this reason, the World Bank has found that the lion's share of recycled or round-tripped Chinese capital that re-enters the Mainland as disguised foreign investment originates from Hong Kong.[158] Hong Kong is then followed in relative importance for Sino round-tripping purposes by other well-known international tax havens – the British Virgin Islands, the Cayman Islands, Taiwan Province, Macau, Mauritius, Samoa, and Bermuda. The United States, Japan, Germany, South Korea, and Singapore comprise the remainder of the fiscal conduits through which Chinese domestic capital is recycled back into the Mainland disguised as foreign investment.[159]

2. Trade and Investment Barriers on the Mainland

The second economic and legal element that must be in place before the phenomenon of round-tripping can occur is that the primary tax jurisdiction must have enacted trade and investment barriers that hinder or discriminate against *domestic investment*. China's capital controls, inadequate protection of private property, and overall lack of domestic bank credit constitute such restrictive impediments. In countries with heavily regulated and restricted capital accounts such as the PRC, "it is common for asset holders to find ways to circumvent capital controls by using over- and under-invoicing of trade transactions to move capital across borders."[160]

As a threshold matter, Chinese exporting firms often engage in round-tripping as a mechanism to evade certain currency-conversion restrictions, as well as the maze of restrictions governing capital and investment on the Mainland. Specifically, many Chinese resident enterprises convert their arm's-length-generated export earnings into other currencies on foreign exchange markets through current-account transactions that fall outside the reach of China's stringent capital controls. To do so, such Chinese business entities simply carry out seemingly routine import-and-export transactions with affiliated entities situated principally in Hong Kong.[161] As explained in the previous section of this study, Chinese export earnings funneled offshore can later be returned to the Mainland disguised as "foreign direct investment" thanks to a related party situated in a foreign tax haven that acts as a conduit for the Mainland exporter. Even though some of the PRC export earnings return to the Mainland, some of the PRC capital remains offshore as a hedge against a sudden depreciation of the Chinese yuan, expectations of additional capital controls, and potentially adverse political changes on the Mainland. It is noteworthy that most companies that conduct round-tripping practices are state-owned enterprises.[162] These SOEs often list their stocks on the Hong Kong Stock Exchange. As pointed out by Dr. Dong He, the Head of Economic Research at the Hong Kong Monetary Authority, such SOEs are usually those that are especially profitable on the Mainland "because [SOEs are] usually monopolies with very high margins in China, such as banking, telecommunications, and real estate."[163]

China's lack of private property regulations, coupled with its relatively poor enforcement of the private property rights that do exist, constitutes yet another factor that encourages Sino round-tripping practices. Academic researcher Geng Xiao states that one reason the Chinese government and resident enterprises continue to purchase relatively large quantities of U.S. government bonds and notes is that these groups have a greater trust in the private property protections accorded by U.S. law. Specifically, Xiao writes:

> [There is a belief] that the property rights of their U.S. investments are well protected…In particular, [the] PRC has increased its purchases of USD bonds dramatically through both official and non-official channels…This can be regarded as a hedging strategy against large [foreign direct investment] inflows…It also reflects the role of cross-border capital flows into the protection of property rights…The Chinese government is protecting the property rights of foreign investors through improved business environments in [the] PRC while the U.S. government is protecting the property rights of the Chinese investors in the U.S. bond markets…Clearly [the] PRC is exporting capital to [the] U.S. to finance the U.S. trade deficits with [the] PRC while at the same time [the] PRC is receiving [a] large amount of [foreign direct investment] from the US."[164]

Finally, the relatively poor development of China's domestic financial markets – including the overall lack of available domestic bank credit to finance private-sector projects on the Mainland – constitutes another important factor that motivates businesses, especially FIEs, to redirect their financial capital outside China. To ensure that private Chinese resident enterprises operating on the Mainland receive adequate financial credit and resources to prosper, Chinese authorities can simply direct such entrepreneurs to Hong Kong, one of the world's leading international financial centers, a ready source for needed financial credit and capital.[165] In fact, the Hong Kong-China FTA and bilateral tax treaty, in tandem, actively encourage Chinese domestic and FIE investors to obtain financing in the Chinese SAR. As the state-run banking sector continues to grant an increasing volume and value of loans to Chinese SOEs on non-commercial terms, SOE managers enjoy an almost guaranteed source of unlimited funding to divert to private-sector activities to maintain the round-tripping loop.

3. Chinese Tax and Investment Incentives that Heretofore Discriminated in Favor of Foreign Direct Investment

The third economic and legal element that should be in place to facilitate the phenomenon of round-tripping is that the primary tax jurisdiction must have on the books tax and investment incentives that entice foreign investments into the target country at a higher rate than what the country's natural comparative advantage would dictate. To understand this third component, one must grasp the economic and legal factors that have been responsible for China's economic surge internationally. "The rapid [foreign direct investment] inflows into [the] PRC, following its economic opening and reform [in 1978], are essentially driven by [three] factors: **[i]** [the] PRC's large surplus labor [*i.e.,* its natural comparative advantage]; **[ii]** [the] PRC's declining barriers for [the] cross-border mobility of [foreign] capital [that enters the Mainland]…";[166] and **[iii]** China's heretofore comprehensive tax concessions aimed exclusively at foreign investors on a *de jure* basis.[167]

In this context, the "PRC allows a large amount of processing trade, which requires [a] large amount of imported components."[168] Additionally, "Large-scale processing trade is only possible for very open economies with close to zero transaction costs, tariffs and other taxes."[169] Consistent with this economic policy, China allows FIEs and other foreign enterprises to remit profits, dividends, and bonuses abroad, without requiring the prior approval of Chinese authorities.[170]

More importantly, Chinese FIEs have been entitled to extremely generous tax incentives while operating on the Mainland. During the past 16 years through December 31, 2007, FIEs in China were subject, in theory, to a 30-percent national corporate income-tax rate as supplemented by an additional 3-percent local corporate tax.[171] In practice, however, FIEs were rarely required to bear the full Chinese national-local corporate tax burden. During the relevant period, so-called "productive" FIEs operating in China for at least 10 years were granted a series of corporate income-tax concessions.[172]

Specifically, during their first 2 years of profitable operation, FIEs in certain "productive" sectors with an operating period of at least 10 years were fully exempt from all classes or kinds of Chinese corporate income tax.[173] An additional 50-percent income-tax reduction then kicked-in during the ensuing 3-year period.[174] Stated otherwise, the PRC tax incentives consisted of a national corporate tax rate of only 15 percent during the subsequent 3-year period, after the initial 2-year tax holiday, once the FIEs began registering profits. This treatment compared very favorably with the total effective tax rate of 33 percent that applied to Chinese domestic firms operating on the Mainland during the corresponding period.[175]

Additionally, the PRC government aggressively encouraged FIEs and other foreign enterprises to locate in China's SEZs, designated coastal economic development zones, free trade zones ("FTZs"), and other areas by offering these business entities other preferential income tax rates.[176] The Chinese income-tax rate for FIEs and other foreign enterprises located in such economic zones generally was set in perpetuity at a flat rate of 15 percent or 24 percent, with the final tax rate dependent on the kind of free zone regime at issue.[177] During the pertinent period, FIEs and other foreign enterprises were also entitled to value-added tax ("VAT") and customs-duty concessions for imported equipment,[178] improved land-use rights, and other economic advantages.[179] Other tax concessions were available when profits generated from an FIE or other foreign enterprise were reinvested in another PRC resident enterprise.[180] This extremely favorable tax treatment targeted exclusively at foreign investors and foreign investment has been a major driving force fueling Sino round-tripping practices, especially through Hong Kong.[181]

Accordingly, investment incentives heretofore offered by the PRC central government to foreign investors, including corporate income-tax concessions, the forgiveness of import-and-export duties, and the remission of VATs, as well as priority treatment accorded to FIEs and other foreign enterprises for infrastructure services, have provided a major catalyst that aggressively encouraged the re-routing of recycled Chinese capital via Hong Kong back to the Mainland disguised as foreign investment.

C. Data Analysis that Corroborates Chinese Round-Tripping Practices

A practical example, as illustrated by the so-called "unbundling" of company functions, fleshes out the theoretical discussion set out above. Assume that foreign investors or Chinese nationals – whether private citizens or members of the PRC central government – establish a Hong Kong holding corporation, Company A, which, in turn, acts as the parent company of a new wholly-owned Chinese FIE, Company B, situated on the Mainland.

Additionally, the Hong Kong parent company, Company A, owns all of the intangible assets of the affiliated corporate group, including all intellectual property rights that it licenses to Company B on the Mainland. Company A also arranges for the input-and-component sourcing, manufacturing, distribution, and other functions of the related corporate group. The Chinese FIE, Company B, pays a fee to its Hong Kong parent for such functions, but another subsidiary in Hong Kong, Company C, actually performs the procurement, invoicing, shipping, and other back-office operations for the business group.[182]

Assume further that Company B needs to source from Hong Kong specialized imported parts, components, and technology from Company A in order to carry out its manufacturing operations on the Mainland. Rather than charge the arm's-length, market-benchmark price of US$1,500 per unit, for example, the Hong Kong parent (Company A) charges the Chinese FIE (Company B) US$7,500 by virtue of multiple non-arm's length transfer-price transactions. In other words, Company A makes excessive profits for each related-party transaction consummated with Company B, its Mainland subsidiary. The fact that most international trade activities in China focus on processing trade indicates that import duties are usually exempted for the related company B, which significantly lowers the transaction costs for this Mainland-based company.

According to legal counsel for Company A, such transactions are not prohibited by the Hong Kong-China bilateral tax treaty. From the point of view of China Customs agency, it does not have any incentive to control the inflated price for imports due to a simple logic: highly priced goods bring more import duties to them (although in Hong Kong's case, the bilateral trade treaty waives import duties for many categories of goods between Hong Kong and China). Given that it is a Hong Kong company that is charging the transfer prices in question, and given that the treaty does not define the phrase "non-arm's length transfer-price transaction," Hong Kong domestic law must necessarily provide the governing legal standard by operation of the convention default rule.[183] Inasmuch as the Chinese SAR does not have any transfer-pricing rules on the books, and Article 9 of the treaty regulates only the under-reporting of related-party profits[184] - instead of proscribing any over-invoicing of Hong Kong components shipped by a Hong Kong entity to its

Mainland affiliate (*i.e.*, excessive related-party profits) – the transfer prices set out above are consistent with the treaty.

As a result of these non-market transfer prices, Company B effectively transfers cash for each transaction shipment an extra US$6,000 from the Mainland to Hong Kong through China's current account (*i.e.*, non-arm's length price of US$7,500 minus the arm's length price of US$1,500 = US$6,000) and, thereby, evades China's capital controls. By engaging in the non-arm's length transfer-price transactions described above, both Company B and Company A artificially increase the value of China's imports, a result that skews China's merchandise-of-trade balance. Additionally, instead of paying its related-party enterprise in Hong Kong a hypothetical rate of US$5,000 per month for sales, distribution, shipping, and invoice fees, Company B pays its affiliated Hong Kong partner US$9,500 per month. By doing so, Company B again effectively transfers an extra US$4,500 for each transaction from the Mainland to Hong Kong (*i.e.*, non-arm's length price of US$9,500 minus the arm's length price of US$5,000 = US$4,500) and again evades China's capital controls. A similar result prevails with respect to the intellectual property rights licensed by Company A to Company B on the Mainland.

Lastly, after Company A has accumulated a significant sum of money by virtue of the above transfer-pricing machinations, it decides to form another FIE subsidiary on the Mainland, Company D. To do so, Company A makes a capital contribution into Company D that totals US$10,000,000. Given that the inflow of recycled Chinese capital back to the Mainland constitutes a capital contribution into Company D, that specific business transaction is not subject to any PRC or Hong Kong tax. Inasmuch as the capital contribution constitutes a "foreign direct investment" within the meaning of Chinese law, the so-called "new investment" is entitled to all of China's tax incentives applicable to foreign direct investment.

A careful examination of the unadjusted trade databases maintained by China and the rest of the world corroborates the existence of Chinese round-tripping practices as illustrated by the preceding example. Contrary to conventional wisdom, the main source of the ever-widening statistical discrepancy that materializes as a consequence of comparing official PRC trade data with those of its partner countries – especially when China's multilateral (rather than bilateral) trade is examined – occurs with its in*bound* trade, that is, foreign goods that are *imported* into China, as opposed to its out*bound* trade in which PRC goods are *exported* from the Mainland and imported by China's partner nations (*e.g.*, United States). This view is compatible with that of the Hong Kong Monetary Authority: theoretically, Hong Kong companies may tend to overprice their exports to their related Mainland companies, though it is hard to test this practice in reality.

World Trade Atlas data for 2007 show that Chinese imports (as shipped from the rest of the world to the Mainland) are responsible for roughly 60 percent of the statistical inconsistency at issue, while PRC exports (as shipped from the Mainland to the rest of the world) account for the remaining 40 percent of the discrepancy. Stated otherwise, for every year since 2003 through 2007, the data inconsistency between the PRC's official statistics and those of its trading partners has weighed more heavily on the Chinese *import* side, rather than on the PRC *export* side, of the equation:[185]

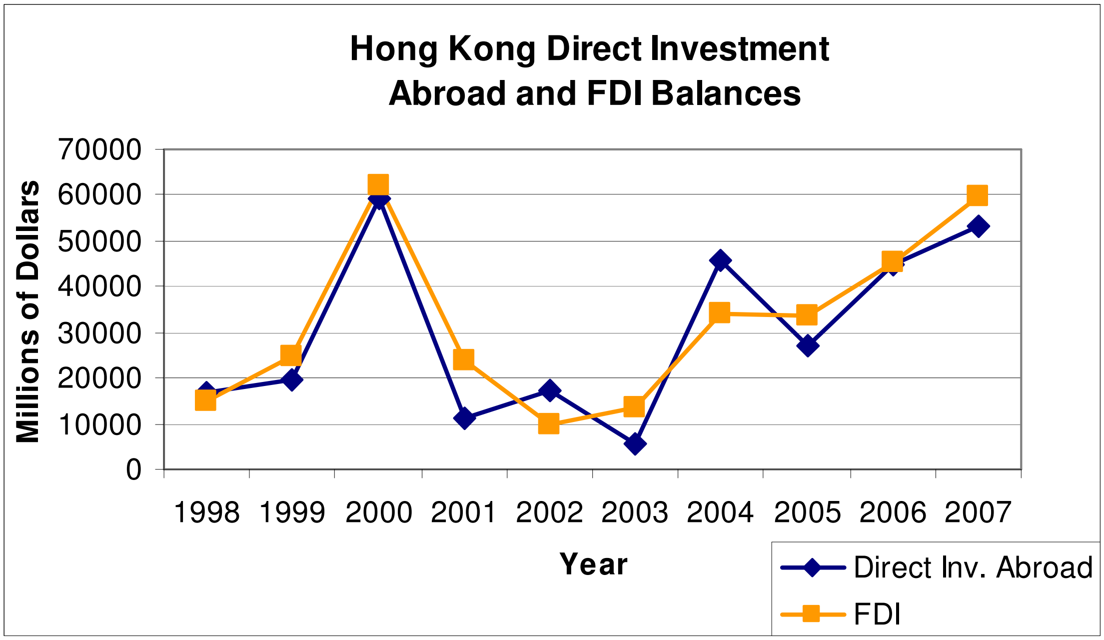
2007		
Difference in Imports	205,742,795,902	64.42%
Difference in Exports	113,649,856,560	35.58%
Total Discrepancy	319,392,652,462	100.00%
2006		
Difference in Imports	174,501,092,268	60.49%
Difference in Exports	113,966,993,372	39.51%
Total Discrepancy	288,468,085,640	100.00%
2005		
Difference in Imports	123,134,388,379	53.75%
Difference in Exports	105,937,713,207	46.25%
Total Discrepancy	229,072,101,586	100.00%
2004		
Difference in Imports	138,941,728,610	59.88%
Difference in Exports	93,103,618,975	40.12%
Total Discrepancy	232,045,347,586	100.00%
2003		
Difference in Imports	101,305,308,291	59.03%
Difference in Exports	70,302,859,764	40.97%
Total Discrepancy	171,608,168,055	100.00%

These empirical data are remarkably consistent with the theoretical model of round-tripping; essentially, that Chinese resident enterprises, including FIEs and SOEs operating on the Mainland, artificially inflate the customs value of *imported* components, inputs, intellectual property, and services sourced from affiliated parties located in offshore tax havens, such as Hong Kong. The data themselves confirm that the round-tripping of recycled Chinese capital does indeed constitute a form of tax-investment-trade arbitrage that seeks to exploit the differential tax-and-investment treatment, as well as the import, export, and tax incentives, heretofore afforded by the Government of China to PRC domestic enterprises, FIEs, and SOEs.[186]

D. Current Account Implications of China's Round-Tripping Practices

In their study published in 2006, Fung, Yau, and Zhang stated that their initial hypothesis and ultimate finding was that Chinese round-tripping practices begin in China's current account with foreign trade transactions that undervalue exports and overvalue imports.[187] These researchers then found that the principal foreign tax-haven conduits for Sino round-tripping activities are Hong Kong, Taiwan, and Macau,[188] even though other researchers have pointed to the British Virgin Islands and the Cayman Islands as well. The relatively tiny island of Hong Kong has emerged as China's leading foreign investor. In fact, Hong Kong has increasingly poured its FDI into the Mainland since the 1990s *(see Graph 9)*. Hong Kong is, by far, the major foreign source of Chinese "round-tripped" capital that is recycled offshore into "foreign investment" and then returned to the Mainland.

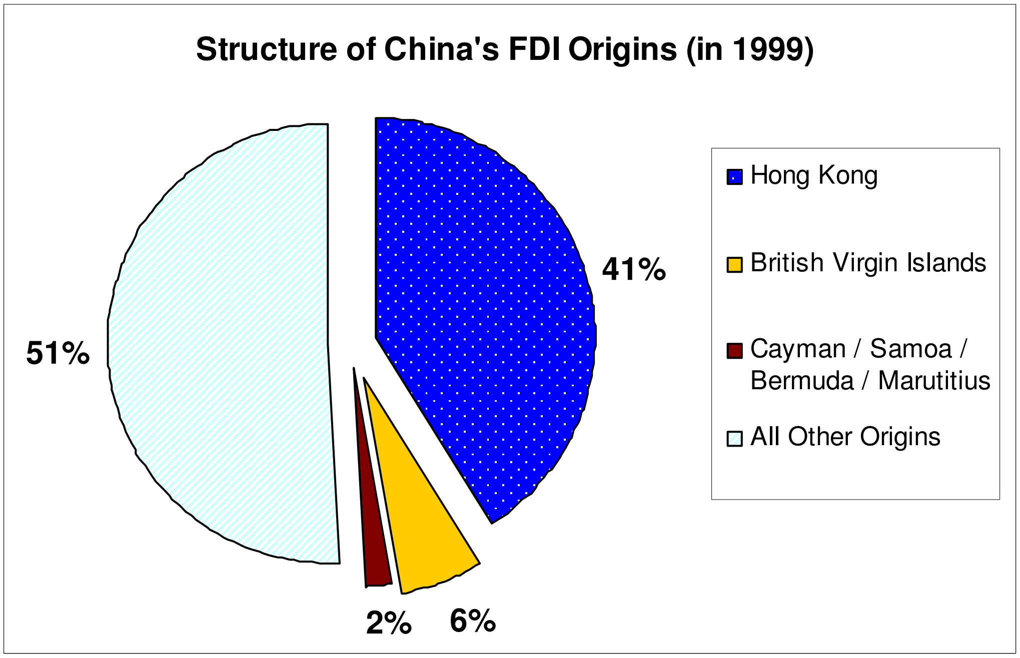
GRAPH 9



Source: IMF International Financial Statistics monthly reports.

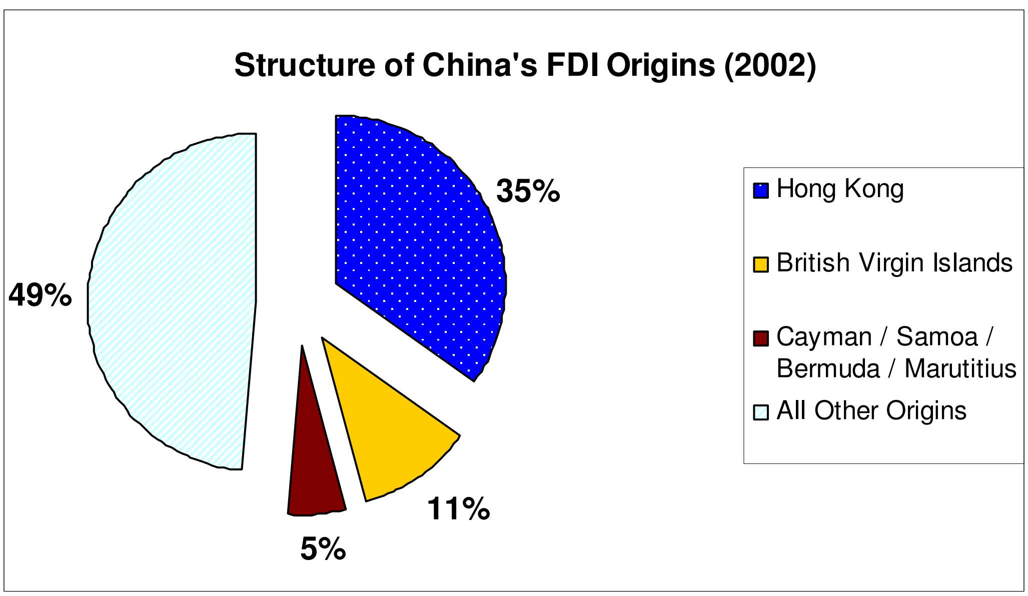
Hong Kong is only one of the representative regions that facilitates China's round-tripping FDI activities. Other regions include so called "tax havens" such as the Cayman Islands, Samoa, Bermuda, British Virgin Islands, and Mauritius. A closer examination of the annual FDI statistics as reported by China National Statistics Bureau reveals that the above-named countries or regions, although small in geographical area, account for 49%, 51%, and 58% of China's total FDI inflows in 1999, 2002, and 2006, respectively (*see Graph 10-12*).

GRAPH 10



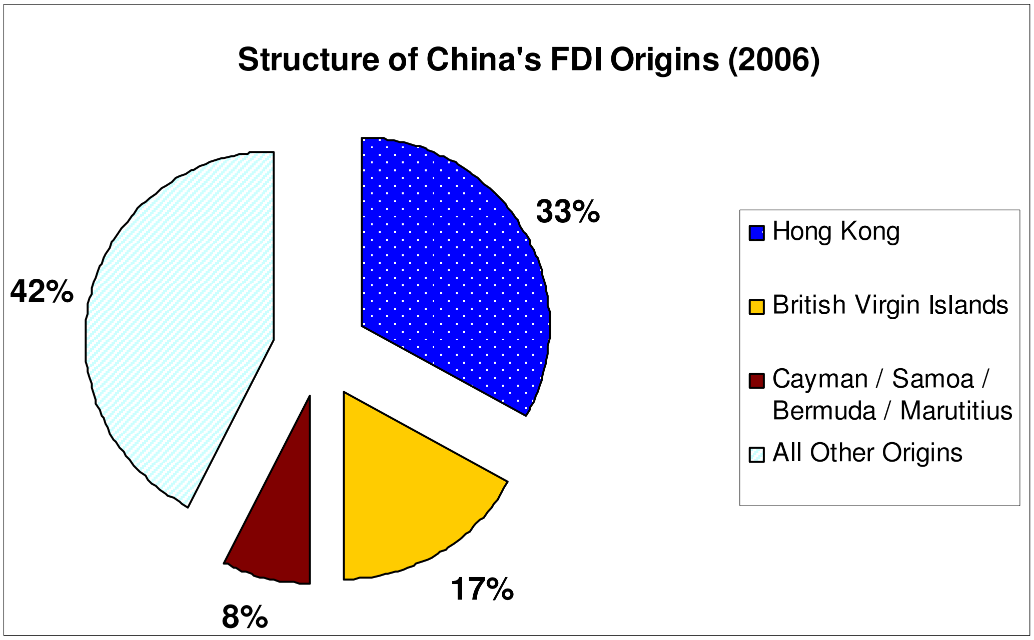
Source: China Statistics Yearbook 2000, by National Statistics Bureau, China.

GRAPH 11



Source: China Statistics Yearbook 2003, by National Statistics Bureau, China.

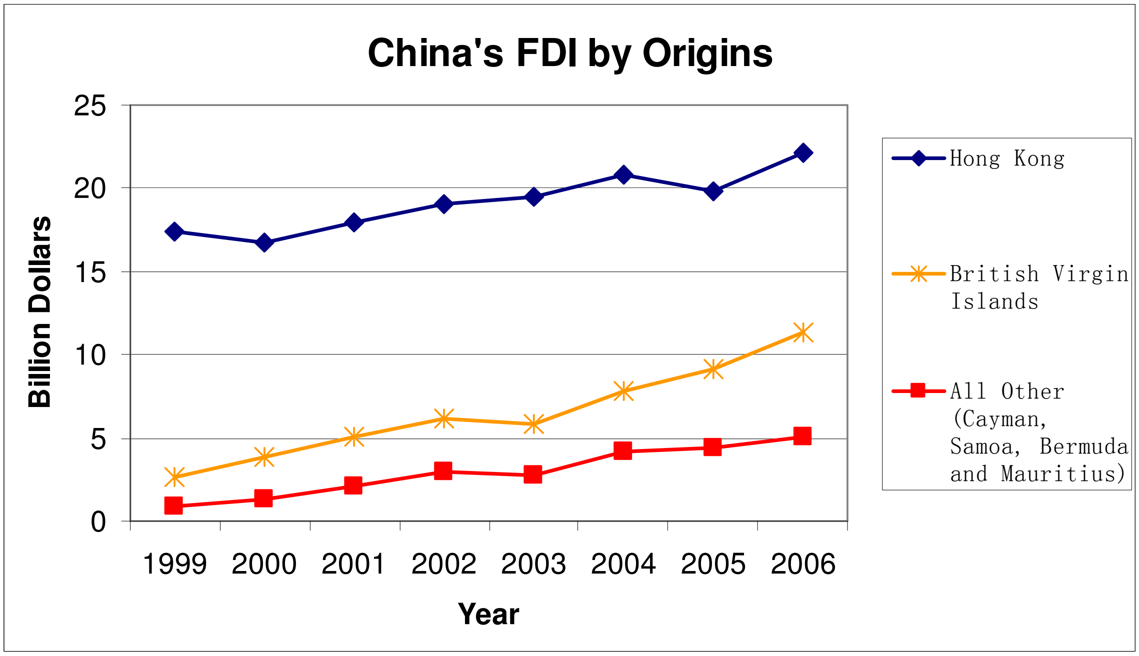
GRAPH 12



Source: China Statistics Yearbook 2007, by National Statistics Bureau, China.

Graph 13 clearly exhibits the increasing trends of China's FDI from these tax haven regions from 1999 to 2006. It is clearly shown in Graph 13 that the British Virgin Islands joins Hong Kong in providing substantial FDI flows to China, which can be interpreted directly as evidence of the existence of round-tripping FDI practices.

GRAPH 13



Source: China Statistics Yearbook 2000 to 2007, by National Statistics Bureau, China.

To adjust China's official import database for Sino round-tripping activities for purposes of our study, we relied on the overall figure of 50 percent as established by researcher Geng Xiao.[189] However, our approach results in an extremely conservative current-account adjustment, **(i)** because Sino round-tripping practices have accelerated since 2004 (as a consequence of the Hong Kong-China FTA), **(ii)** because the 50-percent ratio is based only on "rent-seeking" round-tripping practices to the exclusion of "value-seeking" round tripping, and, most importantly, **(iii)** because the 50-percent figure applies only to recycled Chinese capital that actually returns to the Mainland disguised as foreign investment, to the exclusion of any exported Chinese capital that remains outside the Mainland in offshore tax havens for extended periods. To compensate for our conservative assumption, we further assumed that total capital exiting China is as much as 4 times China's FDI inflow[190] and all the capital flight is due to overstatement of Chinese imports. This measure can at least partially offset the possible underestimation of trade distortion due to round-tripping FDI practices in China.

Nevertheless, relying on the conservative 50-percent round-tripping figure to adjust China's official import database for such practices, we calculated that Chinese round-tripping practices are responsible, on average, for approximately US$159.7 billion of the statistical discrepancy that materializes as a consequence of comparing official Mainland trade data with those of its 41 partner nations (*i.e.,* U.S. $319.4 billion x 50% = U.S. $159.7 billion).

E. China Round-Tripping Practices in the Future

1. Factors that May Diminish the Incidence of PRC Round-Tripping Activities in the Short Term

On March 16, 2007, the Chinese National People's Congress enacted a new corporate income-tax statute, the Enterprise Income Tax ("EIT") Law, to comply with the WTO national treatment principle and the Agreement on Subsidies and Countervailing Measures (the "WTO Subsidies Agreement"). China's new fiscal regime entered into effect on January 1, 2008.[191] The fundamental effect of the EIT Law was the repeal of the discriminatory tax treatment that previously had favored all Chinese FIEs and other foreign enterprises operating on the Mainland. Such foreign invested enterprises were generally entitled to a lower real effective tax rate that ranged between 15 percent and 24 percent, while their Chinese domestic counterparts operating on the Mainland were subject to an effective tax rate of 33 percent.[192]

In this regard, the new PRC legislation adopts a general unified tax rate of 25 percent that, in theory, is applicable to all Chinese resident legal entities regardless of the nationality of their owners.[193] Stated otherwise, the general unified rate of 25 percent applies to both FIEs and Chinese domestic enterprises alike.[194] Therefore, effective January 1, 2008, all newly-created FIEs and all existing Chinese domestic invested enterprises became subject in principle to the same general tax (as calculated and assessed on an accrual basis) [195] at the rate of 25 percent. According to tax lawyers at PriceWaterhouseCoopers-China, all business entities established in Chinese SEZs after December 31, 2007, similarly became subject in theory to the new unified rate as well, an outcome that represents a 10-percent marginal tax-rate increase for FIEs.[196]

Furthermore, the new Chinese EIT Law eliminates the previous tax holidays for FIE "productive," as well as export-oriented, enterprises.[197] As explained by the Chinese Finance Minister, Jin Renqing, "[s]ome preferential policies are canceled. For example, the regular tax reduction and exemption for production-orientated foreign-funded enterprises as well as the 50 percent tax reduction for export-oriented foreign-funded enterprises are abolished."[198] To achieve this end, Article 60 of the new statute repeals the 1991 Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises, as well as the 1993 PRC Provisional Regulations on Enterprise Income Tax.[199] As a result, FIEs operating in certain traditional industries, including low-end manufactured products and labor-intensive production activities, will face adverse tax consequences after the partial "grandfathering" provisions of the new EIT Law expire.[200]

Despite the new unified tax structure, FIEs established in China before January 1, 2008, including those created in Chinese SEZs before that date, are entitled to partial "grandfathering" and "gradual-transition" provisions.[201] For these business entities, the new 25-percent Chinese tax rate will be gradually phased-in over a period of 5 years commencing on the effective date of the new law.[202]

In addition to establishing a unified tax rate, the new Chinese legislation on its face **(a)** strengthens the PRC's transfer-pricing provisions for transactions between "related parties,"[203] **(b)** adopts "thin capitalization" rules (pursuant to which interest accruing from related-party loans that exceeds a prescribed debt-equity ratio can be disallowed as a tax-deductible expense),[204] and **(c)** codifies new controlled foreign corporation ("CFC") rules.[205] In accordance with these latter provisions, Chinese authorities can now tax Sino-resident shareholders on their portion of undistributed profits retained by an offshore CFC subsidiary situated in a low-tax foreign jurisdiction[206] that has an effective corporate income-tax rate that is generally below 12.5%.[207] As relevant here, Hong Kong's effective corporate income-tax rate is 17.5 percent, 5 percentage points higher than the Chinese floor.

With regard to transfer-pricing practices generally, China's SAT is required under the new law to ensure that transactions between "related parties" – that is, "associated enterprises" within the meaning of the China-Hong Kong tax treaty – be carried out in accordance with the "arm's-length principle" as articulated by OECD guidelines.[208] The term "related parties" means "enterprises, other entities and individuals, which have any of the following relationships with an enterprise: 1) direct or indirect control over such matters as finance, business operations, purchases and sales…; 2) both directly or indirectly controlled by a third party; 3) other relationship due to associated interests."[209]

A hallmark feature of the new law relates to the authority of China's SAT to impose a special tax/interest levy[210] that takes the form of a tax adjustment and an interest payment assessed for any transfer prices charged for tax-avoidance purposes.[211] PRC authorities may now impose the special tax/interest levy within a 10-year statute-of-limitations period beginning on the date of the non-market transaction.[212] Before the promulgation of the new statute, no legislative authority existed for Chinese administrators to assess any kind of monetary penalties for transfer-pricing infractions, except for collecting the correct tax after authorities had made the necessary price adjustments.[213] This deficiency in the superseded legal framework severely limited compliance incentives for taxpayers. The implementation of the special tax/interest levy should now increase the economic costs associated with such illicit transfer-pricing activities and provide the requisite disincentives to dissuade taxpayers from engaging in such behavior.[214] Notwithstanding all of these tax-compliance features, the new EIT Law recycles many of China's previous tax incentives, including fiscal exemptions, reductions, and deductions, into the current regime.

Whether the new EIT Law and implementing regulations eliminate the Chinese round-tripping phenomenon is an open question at this juncture. On the one hand, the new tax regime *in theory* should partially reduce round-tripping, because the new framework repeals the *de jure* discriminatory tax treatment that previously had favored FIEs doing business in China *vis-à-vis* their domestic counterparts. Moreover, the new legislation appears to provide Mainland tax authorities with the requisite enforcement teeth to regulate effectively non-arm's length transfer-pricing practices between Chinese enterprises and their Hong Kong affiliates. On the other hand, the new EIT Law recycles many of China's formerly prohibited *de jure* export subsidies into equally prohibited *de facto* export subsidies, as well as into actionable specific domestic subsidies, that may foster continued round-tripping in the future. Furthermore, the profit margins that are retained in Mainland China are intentionally set at very thin levels by the related parties. The rise of corporate tax rates may not effectively restrain the behavioral pattern of these parties due to the insignificant increase of their corporate taxes.

2. Factors That May Encourage Chinese Round-Tripping Practices in the Short Term

Although the new Chinese EIT Law eliminates on a *de jure* basis the discriminatory tax treatment that heretofore favored FIEs and other foreign enterprises over their PRC domestic rivals, several factors caution against leaping to the general conclusion that Sino round-tripping activities will become an issue of the past. With the exception of the statutory repeal of the discriminatory tax treatment described above, neither Beijing nor the new tax legislation has effectively confronted and remedied the other economic and legal factors that have heretofore provided entrepreneurs with the necessary incentives to carry out round-tripping practices in China's offshore conduits.

First, Hong Kong is still a *de facto* foreign tax haven without any transfer-pricing rules, CFC provisions, or "thin-capitalization" controls that can combat and effectively regulate transfer prices charged by Chinese and Hong Kong affiliates. Moreover, Hong Kong's corporate income-tax rate of only 17.5% is 7.5 percentage points below China's new unified rate of 25% and provides the necessary cross-border fiscal differential that encourages the first step of round-tripping, namely, disguised capital flight. The 7.5 percentage-point differential gives Chinese enterprises with SAR affiliates the incentive to undervalue export or overvalue import transactions on an artificial basis in order to show lower profits on the Mainland and higher profits in Hong Kong. By doing do, such affiliates can evade not only the full Chinese tax liability of 25 percent but also the PRC's capital controls as well. Article 9 of the bilateral tax treaty then further encourages such strategies by providing SAR enterprises with the added incentive to over-charge their Mainland affiliates for Hong Kong-sourced components imported into China.

Second, the Mainland has had statutory transfer-pricing provisions on the books since 1991,[215] but has been extremely lax in enforcing such legal requirements. No guarantee exists that China's SAT will enforce the new transfer-pricing obligations aggressively. In this context, one study quoted above has underscored that SOEs in the PRC are primarily responsible for the round-tripping of recycled Chinese domestic capital. This finding provides SAT authorities with a disincentive to enforce the new transfer-pricing provisions vigorously, because the Government of China may be reluctant to enforce its new tax law against PRC government individuals. As an aside, the new statute does not eliminate transfer-pricing practices *per se*, but rather provides PRC taxpayers with the opportunity to utilize more sophisticated transfer-pricing schemes, such as Advance Pricing Arrangements ("APAs")[216] and Cost Sharing Arrangements ("CSAs").[217]

Third, China has neither repealed its capital controls nor improved its domestic financial markets or its private-property regulatory regime to such an extent as to eliminate or reduce the incentives for Sino round-tripping activities. Stated otherwise, the same economic and legal impediments that hindered PRC domestic investment before the passage of the new Enterprise Income Tax Law continue to exist today. Consequently, the economic and legal conditions that are necessary to trigger Mainland capital flight that eventually evolves into full-blown round-tripping activities continue to exist despite the enactment of the new law.

Fourth, both the Hong Kong-China FTA and the Hong Kong-China bilateral tax treaty actively support the continuation of round-tripping practices. The former pact provides importers with incentives to artificially inflate the customs value of China's imports sourced from the SAR, while the latter treaty entices PRC taxpayers to establish affiliated enterprises in tax-haven Hong Kong, an outcome that is an essential pre-requisite for round-tripping. Similarly, Article 9 of the tax convention not only tolerates, but insulates from any legal attack the practice whereby Hong Kong enterprises systematically overcharge their Chinese affiliates for Hong Kong-sourced component parts imported into China.

Fifth, the new law codifies a variety of interrelated statutory provisions that create potential loopholes. Most notably, apparently "to avoid double taxation,"[218]Chinese lawmakers surprisingly excluded partnerships, partnership enterprises, and Sino-foreign contractual joint-venture arrangements from the legal ambit of the new EIT Law.[219] Furthermore, in sharp contrast to other affiliated Chinese resident enterprises operating on the Mainland,[220] those that establish branches, partnerships, or any other non-legal entities in China have the legal right to prepare a consolidated income-tax return.[221] As a result, such Chinese entities can lower their overall PRC tax liability by having a branch or partnership (that acts as a *de facto* subsidiary) show losses.

Loopholes such as these will most likely facilitate round-tripping practices to the extent that foreign investors learn how to exploit the legal deficiencies to their advantage.

Sixth, the new statute sets out vague tax incentives that are susceptible to administrative abuse. In particular, the new law confers extremely broad authority on the PRC State Council to establish at any time new tax exemptions by means of administrative fiat: "[n]on-taxable income shall include:…[o]ther non-taxable income as [defined] by the State Council."[222] Likewise, the new law ambiguously provides that "[e]nterprise income tax incentives shall be awarded to industries and projects on which the State has placed heavy emphasis to promote their development and growth."[223] Consistent with the above principles that are subject to potential manipulation, Article 35, in tandem with Article 36, of the EIT statute specifies that the "actual implementation of tax incentives as [established] by this Law shall be tailored by the State Council…in accordance with [China's] economic and societal development needs…."[224] These provisions as a whole can encourage non-transparency that can lead to a reduced Chinese tax burden for certain FIEs.

Seventh, in the event of a conflict between the new tax law and the China-Hong Kong tax convention, the latter prevails, because, as previously demonstrated, Hong Kong is a "foreign government" for PRC taxation purposes.[225] Significantly, in contrast to China's new statute, the treaty expressly covers "partnership[s]."[226] In addition, the convention fails to define any of the key terms, phrases, or concepts related to non-arm's length transfer prices charged by "associated enterprises" of an affiliated group. Accordingly, the treaty default rule curiously mandates that Hong Kong's non-existent definition with regard to transfer pricing applies to such transfer prices charged by Hong Kong entities to their Mainland affiliates.[227] Inasmuch as Article 9 of the bilateral arrangement regulates only the *under-reporting* of related-party profits, [228] instead of proscribing the typical round-tripping practice whereby Hong Kong enterprises overcharge their Chinese affiliates for specialized SAR components, it is questionable as to whether either the Hong Kong's tax law or the convention will dissuade round-tripping practices.

VIII. RESEARCH FINDINGS AND CONCLUSION

By virtue of the integrated and comprehensive statistical analysis carried out in this study that attempts to make estimated adjustments to the trade discrepancy, including that for Chinese round-tripping activities, the following summarizes the major findings concerning the China-Hong Kong *entrepôt* effect and its overall impact on the PRC's global trade surplus:

The individual causes underlying the statistical inconsistency that distorts official Chinese trade data includes the following: **(i)** China-Hong Kong *entrepôt* effect – that is, Hong Kong's re-export trade and middleman markups; **(ii)** divergent customs standards used internationally to value exports and imports; **(iii)** "phantom" Chinese trade; **(iv)** Sino round-tripping practices, which refer to Chinese domestic capital recycled abroad in offshore tax havens subsequently returns to the Mainland disguised as foreign investment (estimated for being responsible for approximately 50% of China's total trade discrepancy, or US$159.7 billion in 2007); **(v)** smuggling practices; **(vi)** all additional unidentifiable factors such as transshipment activities undertaken through third countries, timing of exports and imports, inconsistent geographic coverage issues, misclassification of goods, exchange-rate fluctuations, and statistical errors and omissions.

China's new Enterprise Income Tax Law may not have much of an impact on the overall reported trade discrepancy as it does not address all variables and incentives that contribute to round-tripping practices. Specifically, Hong Kong continues to have a favorable corporate income tax rate of 17.5% versus China's new unified rate of 25%. In addition, since a majority of companies participating in round-tripping practices are SOEs, China may be reluctant to enforce the EITL on governmental officials.

China's round-tripping practices and capital-flight activities occurring in Hong Kong is a major factor that not only contributes to divergent private savings and investment levels in the Mainland and the rest of the world, but also is the largest factor responsible for China's current-account surplus.

Additionally, we found that the reunification of Hong Kong with China one decade ago, the PRC's subsequent WTO accession in 2001, the ensuing implementation of the Hong Kong-China FTA in 2004, and the effective ratification of the Hong Kong-China tax treaty in 2007 have all spawned such an unprecedented growth in undetected trade and capital flows between the Mainland and Hong Kong that policymakers are unable to measure correctly China's economic impact globally. In this regard, we also found that the resulting trade-data and capital-flow discrepancies have implications that run far deeper than simple statistical errors and omissions. Specifically, China's *entrepôt* trade, round-tripping practices, and capital-flight activities – all of which are carried out through Hong Kong – largely provides the explanation for the substantial and growing divergence between China's official trade statistics and its trading partners mirror trade data. Rather than provide an effective legal framework for the elimination of any of these tendencies, China's new EIT Law, we concluded, may only partially address such non-commercial activities in the future. Discrepancies in reported trade data between China and its trading partners will likely continue to increase, as China's share of global trade continues to grow.

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List of Interviews
(Conducted April 2008)

Location	Interviewees
Hong Kong Census & Statistics Department	Freda Tung and other officials from the Hong Kong Census & Statistics Department
Hong Kong Monetary Authority, Hong Kong	Director of Research Department at Hong Kong Monetary Authority
Bulova Watch International Ltd., Hong Kong	Manager of Bulova Watch International Ltd.
Phone Interview in Beijing, China	Official from Customs General Administration, Beijing, China
Peking University, Beijing, China	Senior Research Fellow from China Economic Studies Center, Peking University, Beijing
Beijing, China	Director of Fair Trade Bureau, Ministry of Commerce, Beijing, China
Beijing, China	Chief Executive Officer of a Beijing based international trade company; trade official of a customs declaration broker house
Qinhuangdao City, Hebei Province, China	Customs officials from Qinhuangdao Customs Adiministration and Hebei Customs Administration
Qinhuangdao City, Hebei Province, China	Representative of a local international trading company
Qinhuangdao City, Hebei Province, China	Officials of city-level Bureau of Statistics

Note: Names of some interviewees are omitted due to requests for anonymity.

ENDNOTES

[1] *See* Kate Bronfenbrenner *et al, Impact of the U.S.-China Trade Relations on Workers, Wages and Employment*, 1, 42*,* Submitted to the the U.S.-China Security Review Commission/the U.S. Trade Deficit Review Commission (June 30, 2001)("Bronfenbrenner Study").

[2] Robert C. Feenstra, Wen Hai, Wing T. Woo, Shunli Yao, *The the U.S.-China Bilateral Trade Balance: Its Size and Determinants*, 1, 4, Department of Economics, University of California, Davis, (May 1998).

[3] *Id*.

[4] *See* Raymond Fisman, Peter Moustakerski, and Shang-Jin Wei, *Outsourcing Tariff Evasion: A New Explanation for Entrepôt Trade*, 2 (October 12, 2005).

[5] UNCTAD Trade and Development Report, 3 (2005).

[6] *See* Jiang Jingjng, *Wal-Marts China's Inventory to hit US $18 b this year*, China Business Weekly (November 29, 2004), http://www.chinadaily.com.cn (downloaded on June 6, 2007).

[7] *See Tax Havens of Asia, Africa, and the Pacific*, http://www.lectlaw.com/filesh/bbg34.htm (downloaded on June 5, 2007).

[8] *See* Raymond Fisman, Peter Moustakerski, and Shang-Jin Wei, *Outsourcing Tariff Evasion: A New Explanation for Entrepôt Trade*, 2 (October 12, 2005).

[9] *Id*.

[10] *See* Raymond Fisman, Peter Moustakerski, and Shang-Jin Wei, *Outsourcing Tariff Evasion: A New Explanation for Entrepôt Trade,* NBER Working Paper, No. 12818 (October 12, 2005)(contending that *entrepôt* economies are used to facilitate tariff evasion).

[11] *See* UNCTAD Trade and Development Report, 3 (2005). The customs and fiscal territories of Macau, another Chinese SAR, are legally separate and distinct from those of China. *See Hong Kong*, http://en.wikipedia.org (downloaded on June 5, 2007). The same rule applies to Taiwan.

[12] The importing nations that have witnessed the largest statistical discrepancies with China whereby such countries' official import data report volume-and-value figures that are significantly higher than those recorded by China's official export statistics include the following countries: **(i)** all nations in North America; **(ii)** a majority of European jurisdictions; **(iii)** Australia; **(iv)** New Zealand; **(v)** Argentina; **(vi)** Malaysia; **(vii)** Thailand; and **(viii)** India. *See* Michael J. Ferrantino, Zhi Wang, *Accounting for Discrepancies in Bilateral Trade: The Case of China, Hong Kong, and the United States*, Office of Economics Working Paper, the U.S. International Trade Commission, 1, 16-17 (April 2007). Findings of Canadian researchers analyzing bilateral China-Canada trade parallel those of the U.S. researchers evaluating China-US trade. *See* Sandra Bohatyretz and Bruna Santarossa, *Merchandise Trade Reconciliation Study: Canada-China, 2002 and 2003*, Analytical Paper, Statistics Canada, ISBN:0-662-39968-4 (August 2005).

[13] WANG Wai-yi, Osbert and TUNG Sze-wan, Freda. Interview with representatives of the Census and Statistics Department. 15 April 2008.

[14] Chinese customs broker. Interview took place 22 April 2008.

[15] Geng Xiao, *People's Republic of China's Round-Tripping FDI: Scale, Causes and Implications*, The University of Hong Kong, 1, 2, Reference No. 1137 (July 2004)(emphasis added).

[16] Michael J. Ferrantino, Zhi Wang, *Accounting for Discrepancies in Bilateral Trade: The Case of China, Hong Kong, and the United States*, at 28, Office of Economics Working Paper, the U.S. International Trade Commission (April 2007).

[17] The *merchandise trade balance* forms part of the *current account* (*i.e.,* trade in goods and services, net income flows, financial aid from governments abroad) which, in turn, comprises part of a country's *balance of payments*. *The balance of payments* is generally determined by a country's exports and imports of goods, services, and financial capital, as well as financial transfers. The *balance of payments* reflects all payments and liabilities to foreigners (*i.e.*, debits) and all payments and obligations received from foreigners (*i.e.*, credits). Accordingly, the *balance of payments* is the sum of the ***current account***, the ***capital account***, and the ***financial account***. The *balance-of-payments* mathematical identity provides as follows: current account + capital account + financial account + net errors and omissions = change in official reserve account. The basic principle underlying this mathematical identity is that a country such as the United States can consume more than it produces (*i.e.,* current-account deficit) only if nations from abroad with a capital-account surplus like China supply the United States with capital. *See* Herbert Stein, "The Balance of Payments" in The Concise Encyclopedia of Economics, http://www.econlib.org/library/Enc/BalanceofPayments.html (downloaded on December 26, 2007). *See also* Charles P. Kindleberger, Peter H. Lindert, *International Economics*, 1, 119, 149, 159-60, 315, 319 (Richard D. Irwin, Inc., 1978).

[18] A country's *capital account* records the international flows of transfer payments relating to capital items, including the country's inflows and outflows of payments and transfer of ownership of fixed assets (*i.e.*, capital goods). The *financial account*, in turn, represents the net change in foreign ownership of domestic financial assets. *See generally* Charles P. Kindleberger, Peter H. Lindert, *International Economics*, 257 (Richard D. Irwin, Inc., 1978).

[19] According to Black's Law Dictionary, "federalism" is a neutral term referring to the "interrelationships among [decentralized] states and [the] relationship between [such] states and the federal [central] government." Black's Law Dictionary, 612 (6th Ed. 1990). Federalism is a form of political-economic organization in which government powers are shared simultaneously by a national central government and quasi-sovereign states, provinces, regions, districts, or municipalities of the same country.

[20] *See* WTO Agreement, art. 12, para. 1 ("Any State or separate customs territory possessing full autonomy in the conduct of its external commercial relations and of the other matters provided for in this Agreement and the Multilateral Trade Agreements may accede to this Agreement, on terms to be agreed between it and the WTO. Such accession shall apply to this Agreement and the Multilateral Trade Agreements annexed thereto.

[21] *See Hong Kong*, http://en.wikipedia.org (downloaded on June 5, 2007). A distinguishing characteristic of a typical federation is that government powers are shared simultaneously by a national central government and quasi-sovereign states, provinces, regions, districts, or municipalities of the same country. *See* Black's Law Dictionary, 612 (6th Ed. 1990). In sharp contrast to mainstream federalist constitutions, the unorthodox China-Hong Kong legal structure does not set forth any concurrent government powers. Rather, pursuant to the Sino-British Joint Declaration signed on December 19, 1984, China's zone of competency in Hong Kong is strictly and exclusively limited to the formulation of foreign policy and the execution of national security policy, including national defense and the armed forces. By contrast, Hong Kong's sphere of competency in the former British territory broadly covers all remaining government powers and functions inherent to political sovereignty, including, but not limited to, the following powers and functions: **(i)** diplomatic representation before international trade bodies (*e.g.,* WTO); **(ii)** negotiation, conclusion, and ratification of international trade, tax, and investment treaties; **(iii)** negotiation, conclusion, and ratification of debt policies; **(iv)** formulation of foreign sovereign economic and trade policy; **(v)** formulation and regulation of immigration matters, including the issuance of visas and residency authorizations to foreign nationals, such as foreign investors; **(vi)** formulation and administration of fiscal (tax) and customs policy; **(vii)** issuance of currency; **(viii)** regulation of intra-region commerce; **(ix)** establishment of a regional budget; **(x)** formulation and execution of monetary policy; **(xi)** administration of a central bank; **(xiii)** formulation of the general budget bill; **(xiv)** formulation and regulation of planning policies relating to water sources from both inside and outside Hong Kong in accordance with international law and international conventions; **(xv)** maintenance of general population statistics and census, as well as trade and investment statistics; **(xvi)** regulation of electric energy and distribution; **(xvii)** formulation and execution of environmental and labor policies; **(xvii)** formulation and

administration of economic development and general planning policies; **(xviii)** formulation and administration of public health policy; **(xix)** formulation and execution of public educational and instructional policy; and **(xx)** creation, regulation, and disposition of private property rights. *See generally Hong Kong*, http://en.wikipedia.org (downloaded on June 5, 2007).

[22] *See Hong Kong*, http://en.wikipedia.org (downloaded on June 5, 2007).

[23] Press Release, *Hong Kong remains world freest economy*, http://www.info.gov.hk/gia/general/brandhk/0109165.htm (downloaded June 5, 2007). During the consecutive 10-year period comprising 1995-2004, the Heritage Foundation ranked Hong Kong as "the freest economy in the world". The Heritage Foundation Index of Economic Freedom ratings reflect an analysis of 50 different economic variables that are grouped into 10 categories encompassing the following: **(i)** banking and finance; **(ii)** capital flows and foreign investment; **(iii)** monetary policy; **(iv)** fiscal burden of government; **(v)** trade policy; **(vi)** wages and prices; **(vii)** government intervention in the economy; **(viii)** property rights; **(ix)** regulation; and **(x)** informal or black market activity. In 2004, Hong Kong recorded an overall score of 1.34, an improvement over its 2003 score of 1.44. *Id*.

[24] World Bank, published in *El Mercurio*, B-1, (Santiago, Chile) (October 28, 2005).

[25] Press Release, *Hong Kong remains world freest economy*, http://www.info.gov.hk/gia/general/brandhk/0109165.htm (downloaded June 5, 2007).

[26] *See Hong Kong*, http://en.wikipedia.org (downloaded on June 5, 2007).

[27] *See Tax Havens of Asia, Africa, and the Pacific*, http://www.lectlaw.com/filesh/bbg34.htm (downloaded on June 5, 2007).

[28] Hong Kong Economic and Trade Office, London, *The Government of the Hong Kong Special Administrative Region*, http://www.hketolondon.gov.hk (downloaded on June 5, 2007).

[29] *See Tax havens of Asia, Africa, and the Pacific*, http://www.lectlaw.com/filesh/bbg34.htm (downloaded on June 5, 2007).

[30] Although the 17.5 % rate constitutes the general company profits tax rate in Hong Kong, other rates apply as well: **(i)** companies and corporate entities are subject to a standard tax rate of 17.5% on "assessable profits"; **(ii)** business entities other than company-corporate entities are subject to a tax rate of 16% on "assessable profits"; **(iii)** interest made on qualifying maturity debt instruments is taxed at 8%; **(iv)** re-insurance of offshore risks is taxed at 8% of "assessable profit"; and **(v)** life-insurance policies are assessed at 5% of the value of the premiums arising in Hong Kong. A Hong Kong licensing company that grant rights to use a trademark, copyright, patent, or know-how pays a flat profits tax of 1.75% (*i.e.*, 17.5% on 10%) of the ensuing royalty payments. Related expenses are non tax-deductible, however. Income from the international operations of shipping companies is exempt from the Hong Kong profits tax, unless the ships are operating in Hong Kong waters or proximate to the same, in which case only that portion of the income earned in Hong Kong is subject to the profits tax of 17.5%. The sale of goods on consignment in Hong Kong on behalf of a non-resident is subject to a tax of 1% of the turnover, without any deductions, unless accounts show that the consignment transaction would have been subject to a lower amount in profits tax than under the consignment tax. In the latter case, the 17.5% profit tax rate applies. The value-added by services provided by Hong Kong "middlemen" for the territory's *entrepôt* trade, such as arranging for transportation and insurance, as well as identifying customers, is subject to Hong Kong income-tax liability. Despite the above, the following sources of trading income are exempt from the Hong Kong profits tax: **(i)** interest received or capital gains made on the purchase, retention, or sale of a government bond issued under the Loans (Government Bonds) Ordinance; **(ii)** exchange-fund debt instruments; **(iii)** Hong Kong dollar-denominated multi-agency debt instruments; and **(iv)** specified investment schemes (*e.g.*, unit trust, mutual funds) which comply with the requirements of a government supervisory authority tax. *See Hong Kong Corporate Taxation,* http://www.lowtax.net/lowtax/html/hongkong/jhkdctx.html (downloaded on June 6, 2007).

[31] *Hong Kong Corporate Taxation,* http://www.lowtax.net/lowtax/html/hongkong/jhktax.html (downloaded on June 6, 2007); Cobus Group, *Hong Kong Offshore*, http://www.shelteroffshore.com (downloaded from the Internet on June 5, 2007).

[32] Hong Kong corporate and trust laws are virtually identical to those of the United Kingdom. Consequently, most business activities are generally carried out by limited liability companies, limited partnerships, sole proprietorships, and even trusts. As a result of the common-law heritage of Hong Kong, trusts are widely understood and used in the former British territory. *See Hong Kong Corporate Taxation,* http://www.lowtax.net/lowtax/html/hongkong/jhktax.html (downloaded on June 6, 2007); Cobus Group, *Hong Kong Offshore*, http://www.shelteroffshore.com (downloaded from the Internet on June 5, 2007).

[33] Application of the "territorial principle" entails that only income which meets the following 3 criteria is subject to the assessment of the Hong Kong profits tax: **(i)** the business entity must "trade" inside Hong Kong; **(ii)** the income must arise from such a trade; and **(iii)** the income must arise in, or be derived from, Hong Kong. Hence, the residence or non-residence status of a business entity is an irrelevant consideration for purposes of ascertaining whether that entity is subject to, or exempt from, the Hong Kong profits tax. Advanced tax rulings are available in the SAR and are particularly recommended with regard to the question of whether "trading income" constitutes "onshore" and taxable income or "offshore" and tax-exempt income. *See Hong Kong Corporate Taxation,* http://www.lowtax.net/lowtax/html/hongkong/jhktax.html (downloaded on June 6, 2007); Cobus Group, *Hong Kong Offshore*, http://www.shelteroffshore.com (downloaded from the Internet on June 5, 2007). ***Based on the above criteria, the profits and losses of a foreign (Chinese) branch or subsidiary of a Hong Kong parent company are neither taxable nor deductible in Hong Kong. Id.***

[34] The following allowances are deductible for Hong Kong profits-tax purposes: **(i)** a deduction for a contribution (or provision for a contribution) by an employer amounting to not more than 15% of the employee's annual salary into a recognized retirement plan registered pursuant to the Occupational Retirement Schemes Ordinance. (Since the Mandatory Provident Fund Scheme became effective on December 1, 2000, allowable deductions are either 5% of an employee's gross salary or a maximum amount of approximately the U.S.US$2,560 per month); **(ii)** a full deduction for charitable donations not exceeding 10% of annual assessable profits after deducting depreciation allowances; **(iii)** any Hong Kong tax paid on foreign source income – which, by law, is chargeable to profits tax in Hong Kong. (**N.B**. Foreign source income is not customarily subject to taxation in the territory.); **(iv)** any property tax already paid; and **(v)** depreciation allowances for capital equipment: **(a)** a 100% first-year allowance for manufacturing plant and machinery; **(b)** a 100% first-year allowance for computer equipment; **(c)** a 60% allowance for the cost of all other plant and machinery during the first year, with 10%-30% of the capital asset written-off thereafter; **(d)** a 20% allowance for the cost of construction of an industrial building during the first year, with a 4% per annum depreciation rate thereafter; and **(e)** refurbishing/renovating expenditures in 5 equal installments at 20% per annum. *See Hong Kong Corporate Taxation,* http://www.lowtax.net/lowtax/html/hongkong/jhkotr.html (downloaded on June 6, 2007).

[35] Dividend income received by a Hong Kong parent company from either a resident or a foreign subsidiary (*e.g.*, Chinese subsidiary) is not considered income in the hands of the Hong Kong holding company and, therefore, is not subject to an assessment of the Hong Kong profits tax. *See Hong Kong Corporate Taxation,* http://www.lowtax.net/lowtax/html/hongkong/jhkotr.html (downloaded on June 6, 2007).

[36] No withholding taxes as such exist in Hong Kong; however, there are certain circumstances in which a Hong Kong company making an income payment to a foreign subsidiary or holding company (which is deemed to be Hong Kong source income) needs to withhold the tax. For instance, when a Hong Kong entity pays royalties for the use of intellectual property to its own offshore licensing affiliate, then the tax due must be withheld by the Hong Kong company effecting the royalty payment. *Hong Kong: Offshore Taxation Regimes*, http://www.lowtax.net/lowtax/html/hongkong/jhkotr.html (downloaded on June 6, 2007).

[37] *See Hong Kong Corporate Taxation,* http://www.lowtax.net/lowtax/html/hongkong/jhkotr.html (downloaded on June 6, 2007); PriceWaterhouseCoopers, *2007 Corporate Tax Information for Asia Pacific Region–Hong Kong,* http://wwws.pwccn.com (downloaded on June 9, 2007).

[38] *See* PriceWaterhouseCoopers, *Transfer Pricing in Hong Kong*, http://wwws.pwccn.com (downloaded on June 9, 2007). In Hong Kong, transfer pricing is a term of art that generally describes all aspects of intra-company pricing arrangements between related business entities and typically applies to intra-company transfers of tangible and intangible property. Although intra-company transactions across borders are growing rapidly and are becoming much more complex in the globalized economy, the Hong Kong Inland Revenue Department has not yet focused its enforcements efforts on attempting to regulate transfer-pricing activities of related-party enterprises.

[39] PriceWaterhouseCoopers, *2007 Corporate Tax Information for Asia Pacific Region – Hong Kong*, http://wwws.pwccn.com (downloaded on June 9, 2007).

[40] Bronfenbrenner Study at 42. One noteworthy example involved the Hong Kong-Shanghai Banking Company ("HSBC"), Hong Kong's oldest corporation, which transferred its data-collection office from the former British territory to Guangdong Province in 2001. Another noteworthy example involved Wal-Mart, which moved its Hong Kong operations to Shenzhen, China, in February of 2002. *See Wal-Mart's China inventory to hit US$18 billion this year*, http://www.chinadaily.com.cn/english/doc/2004-11/29/content_395728.htm (November 29, 2004)(downloaded on June 6, 2007)("If Wal-Mart were an individual economy, it would rank as China's eight-biggest trading partner, ahead of Russia, Australia and Canada").

[41] Mainland and Hong Kong Closer Economic Partnership Arrangement, art. 3, para. 1 (2004).

[42] Hung-Gay Fung, Jot Yau, Gaiyan Zhang, *Market Impediments, Trade, and Foreign Direct Investment: Evidence from China's Round-Tripping*, University of Missouri at Saint Louis and Seattle University, 1, 25, n. 11 (November 27, 2006); Mainland and Hong Kong Closer Economic Partnership Arrangement, art 17, para. 2 (2004)

[43] *Id*., art. 5, para. 1.

[44] *Id*., art. 5, para. 2.

[45] *Id*., art. 5, para. 3 ("No later than 1 January 2006, the Mainland will apply zero tariff[s] to the import of goods of Hong Kong origin that are outside Table 1 of Annex 1. Detailed implementation procedures are set out in Annex 1").

[46] *See* Mainland and Hong Kong Closer Economic Partnership Arrangement, Annex 2 (2004) (setting out rules of origin for trade in goods). Export products that satisfy the CEPA rules-of-origin requirements are entitled to preferential tariff treatment upon their importation into the customs territories of either China or Hong Kong. Goods directly imported from "one side" into the "other side" that are entitled to zero tariff rates under CEPA comprise "originating goods". The expression "originating goods," in turn, refers to **(a)** "goods wholly obtained in one side," or **(b)** "goods not wholly obtained in one side…[but having] undergone [a] substantial transformation in that side." *Id*., Annex 2, para. 2 (2004).

[47] The CEPA value-added calculation formula provides as follows: "value of raw materials" + "value of component parts" + "labor costs" + "product development costs"/ FOB value of the exported goods x 100% ≥ 30%. *See* Hong Kong Closer Economic Partnership Arrangement, Annex 2, para. 5(4) (2004). The phrase "product development costs" refers to both "product development" and related "development expenses". *Id.,* para. 5(4)(i).

[48] *See generally* Canada China Business Council, *Guangdong Region*, http://www.ccbc.com (downloaded on June 6, 2007.

[49] *See id.*

[50] *See id.*

[51] *See* Mainland and Hong Kong Closer Economic Partnership Arrangement, art. 14, para. 1 (2004)("In order to further promote the development of the tourism industry of Hong Kong, the Mainland will allow residents in Guangdong Province to visit Hong Kong individually. This measure will be implemented on a trial basis first in Dongguan, Zhongshan and Jiangmen and it will be extended to the entire Guangdong Province no later than 1 July 2004").

[52] *See* PriceWaterhouseCoopers, *Comprehensive Double Tax Arrangement ("DTA") between the Mainland of China and Hong Kong*, August 2006, http://www.pwccn.com (downloaded on June 9, 2007).

[53] *Hong Kong: Double Tax Treaties*, http://www.lowtax.net/lowtax/html/hongkong/jhkotr.html (downloaded on June 6, 2007).

[54] PriceWaterhouseCoopers, *Comprehensive Double Tax Arrangement ("DTA") between the Mainland of China and Hong Kong*, August 2006, http://www.pwccn.com (downloaded on June 9, 2007).

[55] *See* Richard L. Doernberg, *International Taxation*, West Nutshell Series, at 125 (West Group, 4th ed. 1999)(explaining the concept of "treaty shopping").

[56] *See* Enterprise Income Tax Law of the People's Republic of China, art. 3 (2008) (unofficial English translated version prepared by Deloitte Touche Tohmatsu CPA Ltd).

[57] *See* Arrangement for the Avoidance of Double Taxation on Income and Prevention of Fiscal Evasion Between the Mainland of China and the Hong Kong Special Administrative Region, art. 21 (2007). *See also* Enterprise Income Tax Law of the People's Republic of China, art. 23 (2008) (codifying foreign tax-credit mechanism into Chinese tax law); *Avoidance of Double Taxation between Hong Kong and the Chinese Mainland*, http://tpwwbapp.tdctrade.com (downloaded on June 6, 2007).

[58] *See* Arrangement for the Avoidance of Double Taxation on Income and Prevention of Fiscal Evasion Between the Mainland of China and the Hong Kong Special Administrative Region, art. 11, para. 2 (2007); PriceWaterhouseCoopers, *Comprehensive Double Tax Arrangement ("DTA") between the Mainland of China and Hong Kong*, http://www.pwccn.com (August 2006) (downloaded on June 9, 2007)(clarifying that the 7% withholding tax rate applies to interest payable from the Mainland).

[59] *Id.; Avoidance of Double Taxation between Hong Kong and the Chinese Mainland*, http://tpwwbapp.tdctrade.com (downloaded on June 6, 2007) (emphasizing that the "5% withholding tax rate applies to dividends paid by [a] Mainland company to a Hong Kong resident, provided that the recipient is a [Hong Kong] company that holds at least 25% of the capital of the Mainland company, 10% in all the cases").

[60] *See* Arrangement for the Avoidance of Double Taxation on Income and Prevention of Fiscal Evasion Between the Mainland of China and the Hong Kong Special Administrative Region, art. 10, para. 2 (2007); *but see* PriceWaterhouseCoopers, *Comprehensive Double Tax Arrangement ("DTA") between the Mainland of China and Hong Kong*, http://www.pwccn.com (August 2006)(downloaded on June 9, 2007) ("Although dividends received by foreign investors from a foreign invested enterprise domiciled in the Mainland are currently exempt from Mainland taxation, the provision in the new [Hong Kong-China bilateral tax] arrangement will provide some protection for Hong Kong investors from any possible withdrawal of this tax exemption at some later stage. It gives a greater level of certainty to those investing into China through Hong Kong. The reduced withholding rates on dividends, royalties, and interest are amongst the lowest rates available in double tax treaty signed by the Mainland").

[61] *Hong Kong: Double Tax Treaties*, http://www.lowtax.net/lowtax/html/hongkong/jhkotr.html (downloaded on June 6, 2007).

[62] *See* Arrangement for the Avoidance of Double Taxation on Income and Prevention of Fiscal Evasion Between the Mainland of China and the Hong Kong Special Administrative Region, art. 11, para. 2 (2007); PriceWaterhouseCoopers, *Comprehensive Double Tax Arrangement ("DTA") between the Mainland of China and Hong Kong*, http://www.pwccn.com (August 2006) (downloaded on June 9, 2007)(clarifying that the 7% withholding tax rate applies to interest payable from the Mainland).

[63] *See* Arrangement for the Avoidance of Double Taxation on Income and Prevention of Fiscal Evasion Between the Mainland of China and the Hong Kong Special Administrative Region, art. 11, para. 2 (2007); PriceWaterhouseCoopers, *Comprehensive Double Tax Arrangement ("DTA") between the Mainland of China and Hong Kong*, http://www.pwccn.com (August 2006) (downloaded on June 9, 2007).

[64] *See* Arrangement for the Avoidance of Double Taxation on Income and Prevention of Fiscal Evasion Between the Mainland of China and the Hong Kong Special Administrative Region, art. 12, para. 2 (2007); PriceWaterhouseCoopers, *Comprehensive Double Tax Arrangement ("DTA") between the Mainland of China and Hong Kong*, http://www.pwccn.com (August 2006) (downloaded on June 9, 2007).

[65] *Hong Kong: Double Tax Treaties*, http://www.lowtax.net/lowtax/html/hongkong/jhkotr.html (downloaded on June 6, 2007).

[66] *See Hong Kong: Double Tax Treaties*, http://www.lowtax.net/lowtax/html/hongkong/jhkotr.html (downloaded on June 6, 2007)(interpreting Article 13(5) of the Arrangement for the Avoidance of Double Taxation on Income and Prevention of Fiscal Evasion Between the Mainland of China and the Hong Kong Special Administrative Region (2007)). In cases in which the transferred shares of stock are equal to or exceed 25% of the ownership interest of the Mainland enterprise, or in cases in which the assets of the Chinese resident enterprise are comprised principally of immovable property (*i.e.*, real estate) situated on the Mainland, the resulting capital gain is taxable in China. See *Hong Kong: Double Tax Treaties*, http://www.lowtax.net/lowtax/html/hongkong/jhkotr.html (downloaded on June 6, 2007).

[67] PriceWaterhouseCoopers, *Comprehensive Double Tax Arrangement ("DTA") between the Mainland of China and Hong Kong*, http://www.pwccn.com (August 2006)(downloaded on June 9, 2007).

[68] *See Hong Kong: Double Tax Treaties*, http://www.lowtax.net/lowtax/html/hongkong/jhkotr.html (downloaded on June 6, 2007).

[69] Arrangement for the Avoidance of Double Taxation on Income and Prevention of Fiscal Evasion Between the Mainland of China and the Hong Kong Special Administrative Region, art. 12, para. 2 (2007); PriceWaterhouseCoopers, *Comprehensive Double Tax Arrangement ("DTA") between the Mainland of China and Hong Kong*, http://www.pwccn.com (August 2006)(downloaded on June 9, 2007).

[70] *See* PriceWaterhouseCoopers, *Comprehensive Double Tax Arrangement ("DTA") between the Mainland of China and Hong Kong*, http://www.pwccn.com (August 2006)(downloaded on June 9, 2007).

[71] Arrangement for the Avoidance of Double Taxation on Income and Prevention of Fiscal Evasion Between the Mainland of China and the Hong Kong Special Administrative Region, art. 24, para. 1 (2007).

[72] *Id.*

[73] *Id.*, art. 24, para. 2.

[74] See *Tax Havens of Asia, Africa, and the Pacific*, http://www.lectlaw.com/filesh/bbg34.htm (downloaded on June 5, 2007).

[75] *See* http://forum.tdctrade.com (downloaded on June 5, 2007).

[76] *See* the U.S. Treasury Analysis—Semi-annual Report on International Economic and Exchange Rate Policies (June 2007 Report), Appendix 2, p. 2. Information can be retrieved via: http://www.ustreas.gov/offices/international-affairs/economic-exchange-rates

[77] *See* the U.S. Treasury Analysis—Semi-annual Report on International Economic and Exchange Rate Policies (June 2007 Report), Appendix 2, p. 2. Information can be retrieved via: http://www.ustreas.gov/offices/international-affairs/economic-exchange-rates (emphasizing that the value of the U.S. goods re-exported to China through Hong Kong in 2005 comprised 14% of total reported the U.S.

exports shipped to China) *with* Bronfenbrenner Study at 67 (stating that “[t]here is a significant share of the U.S. exports to China that are funneled through Hong Kong as re-exports to China [about 42 percent in 1995]…some of these Hong Kong re-exports originating in the the U.S. and bound for China are not identified correctly as the U.S. exports to China in the U.S. trade data”). *See also* Michael J. Ferrantino, Zhi Wang, *Accounting for Discrepancies in Bilateral Trade: The Case of China, Hong Kong, and the United States*, Office of Economics Working Paper, at 1-4 (stressing that as “[e]xpressed as a share of the U.S. reported imports from China, the share of Hong Kong re-exports of goods of Chinese origin has declined from about 61 percent in 1985 to about 14 percent in 2006”).

[78] *See* John W. Schindler, Dustin H. Beckett, *Adjusting Chinese Bilateral Trade Data: How Big is China’s Trade Surplus?*, 27-55, Board of Governors of the Federal Reserve System, International Journal of Applied Economics, 2(2) (September 2005).

[79] *See* Hong Kong Closer Economic Partnership Arrangement, Annex 2, para. 5(4) (2004)*; see also* K.C. Fung, Lawrence J. Lau, *New Estimates of the United States-China Bilateral Trade Balances*, at 1, 10, Asia-Pacific Research Center, Institute for International Studies, Stanford University (1999)(“Re-exports, as defined by the Hong Kong government, occur when imports to Hong Kong are consigned to a buyer in Hong Kong who takes legal possession of the imported goods and then sells and ships the imported goods to another party in a third country. The buyer in Hong Kong may undertake minor processing of the imports before re-exporting them elsewhere; however, the character and nature of the goods is not fundamentally altered so that no Hong Kong origin is supposed to be conferred.

[80] *See also id*. at 17 (“Another very important factor that renders both the U.S. and Chinese trade data inaccurate is the existence of Hong Kong re-export markups. The standard interpretation of these mark-ups is that [they are] profit margins of the *unrelated-party* Hong Kong middleman. The *unrelated-party* Hong Kong middlemen purchase goods from China or the United States, then add a profit margin to the value of these goods before they re-export them elsewhere. Information about these re-export markups is difficult to obtain. But in February of 1996, the Census and Statistics Department of Hong Kong released results about its annual surveys of re-export trade. From the results of these surveys, we obtain new estimates of these re-export markups for the period 1989-1994. Sources from China and personal interviews with Hong Kong government officials and businessmen supply the remaining estimates”)(emphasis supplied).

[81] Robert C. Feenstra, Wen Hai, Wing T. Woo, Shunli Yao, *The the U.S.-China Bilateral Trade Balance: Its Size and Determinants*, at 4, Department of Economics, University of California, Davis (May 1998).

[82] *See, e.g.,* K.C. Fung, Lawrence J. Lau, *New Estimates of the United States-China Bilateral Trade Balances*, Asia-Pacific Research Center, Institute for International Studies, Stanford University, at 1, 17, n. 9 (1999) (“In Fung and Lau [1996], we used re-export markups based on surveys conducted by the Hong Kong Trade Development Council. The markups we use here are newer and more comprehensive.” “It is interesting to note that the re-export markups are quite high for Chinese exports to the United States, on the order of 25 percent of the cost of the re-exported goods, whereas the re-export markups on the U.S. exports to China are quite low – approximately 6 percent. Thus, not adjusting for the re-export markups can also distort the measurement of US-China bilateral trade balance”); Sarah Y. Tong, *The US-China Trade Imbalance: How Big is it Really?,* China: An International Journal 3,1: 131-154, 136, 137-139 (March 2005)(“Another adjustment to make when considering Hong Kong’s re-export trade is the re-export markup.” “These mark-ups may be interpreted as the value-added contribution of the Hong Kong middlemen.” “The Hong Kong government collects information about these re-export markups. *See* Hong Kong Monthly Digest of Statistics [(publishing estimates of Hong Kong re-export markups)]”. “Hong Kong’s re-export mark-ups are quite high for Chinese goods, around 25 percent of the cost of the goods re-exported.” “The re-export mark-ups for goods imported from sources other than China are much lower, about 6 percent, including those re-exported to China”); Bronfenbrenner Study at 67 (“A survey of re-export trade carried out by the Hong-Kong Census and Statistics Department showed the average re-export markup on Chinese exports to the United States is about 25 percent…The 25 percent markup [that] gets paid to Hong Kong middlemen, not to China, inflates the value of Chinese imports in the U.S. data”).

[83] *See* G. Hufbauer and D. Rosen, "American Access to China's Market: The Congressional Vote on PNTR," Institute for International Economics," No. 00-3, April, at 5. 2000.

[84] *See, e.g.,* K.C. Fung, Lawrence J. Lau, *New Estimates of the United States-China Bilateral Trade Balances*, at 14, Asia-Pacific Research Center, Institute for International Studies, Stanford University (1999)("To take into account re-exports through Hong Kong, we assume that the official Chinese export data capture only *direct exports* and that re-exports through Hong Kong to United States constitute *indirect exports"*).

[85] *See* the U.S. Treasury Analysis—Semi-annual Report on International Economic and Exchange Rate Policies (June 2007 Report), Appendix 2, p. 2. Information can be retrieved via: http://www.ustreas.gov/offices/international-affairs/economic-exchange-rates

[86] *Id.*

[87] *Id*. Such indirect Chinese import trade *sometimes* can present issues of double-counting as well. The double-counting phenomenon occurs in cases in which China's trading partners are indeed able to identify and correctly report their export trade to Hong Kong (that is then re-exported to the Mainland) as legitimate exports to China. *However, the Hong Kong customs authorities also report such re-export trade to China as Hong Kong exports to China as well*. As a result, China's aggregate import volumes and values may *sometimes* be overstated by the volume and value of such Hong Kong re-export trade and must be reduced accordingly. To eliminate such double-counting, one must subtract from the Chinese import database *only* the volume and value of such Hong Kong re-exports shipped to China that originate from China's trading partners that the Mainland customs authorities erroneously double-count. When subtracting such Hong Kong re-export trade from the Chinese import database, one must strip out the 6%) Hong Kong "middlemen" mark-up attributable to such indirect trade.

[88] *See* the U.S. Treasury Analysis—Semi-annual Report on International Economic and Exchange Rate Policies (June 2007 Report), Appendix 2, p. 2. Information can be retrieved via: http://www.ustreas.gov/offices/international-affairs/economic-exchange-rates

[89] *Id.*

[90] *Id*. With respect to the U.S.-China bilateral trade, the United States trades goods not only directly with China, but also indirectly through Hong Kong. Under-counting with regard to such indirect Chinese trade can *sometimes* occur in certain circumstances, especially when the United States reports the U.S. goods shipped to Hong Kong that are re-exported to China as the U.S. exports to Hong Kong, instead of the U.S. exports to China. Although such a scenario occurs less frequently today, it still does take place at some indeterminate frequency. Even though Chinese customs authorities usually can attribute the actual origin of these Hong Kong re-exports to the United States (rather than to Hong Kong) and records them as such, the U.S. customs authorities *sometimes* do not report such trade as the U.S. exports destined to China. Therefore, the U.S. exports to China are *sometimes* understated by the volume and value of the indirect the U.S. export trade re-exported through Hong Kong for ultimate importation into China *that the U.S. customs authorities sometimes erroneously fail to report as legitimate the U.S. trade with China*. Simply put, if no adjustment is made for such Hong Kong re-export trade, then the U.S. exports shipped to China, as reported by the U.S. customs authorities, can be under-reported or under-counted. To eliminate the resulting trade distortion, one must add to the the U.S. export database the volume and value of *only* that indirect U.S. export trade shipped to China through Hong Kong that the U.S. authorities fail to record in correct fashion.

[91] *See* the U.S. Treasury Analysis—Semi-annual Report on International Economic and Exchange Rate Policies (June 2007 Report), Appendix 2, p. 2. Information can be retrieved via: http://www.ustreas.gov/offices/international-affairs/economic-exchange-rates

[92] *Id.*

[93] *Id.*

[94] *Id.* China trades goods not only directly with the United States, but also indirectly through Hong Kong. To adjust for the under-reporting or under-counting of indirect Chinese exports shipped to the United States through Hong Kong, one must add to China's reported exports *only* those Mainland shipments that are re-

exported through Hong Kong before their final importation into the United States that Chinese authorities do not correctly record. The under-counting phenomenon *sometimes* occurs when China erroneously reports merchandise shipped to Hong Kong (that is then subsequently re-exported by Hong Kong "middlemen" to the United States) as Chinese exports to Hong Kong, rather than as legitimate Chinese exports to the United States. Although the U.S. customs authorities usually are able to attribute the origin of these re-exported goods to China (rather than to Hong Kong), Chinese customs authorities *sometimes* do not report such trade as Chinese exports to the United States. Therefore, China's exports, as reported by Chinese customs authorities, are *sometimes* understated by the volume and value of Chinese export shipments re-exported from Hong Kong to the United States that Chinese Customs erroneously fails to record in proper fashion.

[95] *See* the U.S. Treasury Analysis—Semi-annual Report on International Economic and Exchange Rate Policies (June 2007 Report), Appendix 2, p. 2. Information can be retrieved via: http://www.ustreas.gov/offices/international-affairs/economic-exchange-rates

[96] *Id.*

[97] *Id.*

[98] *Id.* Such indirect Chinese import trade can *sometimes* present issues of double-counting as well. The double-counting phenomenon occurs in cases in which China is indeed able to identify and correctly report *some* of its export trade shipped to the rest of the world (that is re-exported to China's trading partners through Hong Kong) as legitimate Chinese exports to the rest of the world. *However, the Hong Kong customs authorities also report such re-export trade to the rest of the world as Hong Kong exports to China's trading partners as well.* As a result, the aggregate import volumes and values of China's trading partners are *sometimes* overstated by the volume and value of such Hong Kong re-export trade, because the customs authorities of China's trading partners *sometimes* engage in double-counting. To eliminate this trade distortion, one must subtract from the import database of the rest of the world *only* the volume and value of such Hong Kong re-exports shipped to China's trading partners that originate from China that the customs authorities of China's partners erroneously double-count. When subtracting such Hong Kong re-export trade from the import database of the rest of the world, one must strip out the 25% Hong Kong "middlemen" mark-up attributable to such indirect trade.

[99] *See* Michael J. Ferrantino, Zhi Wang, *Accounting for Discrepancies in Bilateral Trade: The Case of China, Hong Kong, and the United States*, at Abstract, 1-4, Office of Economics Working Paper, the U.S. International Trade Commission (April 2007)(emphasis added).

[100] Michael F. Martin, *What's the Difference? – Comparing the U.S. and Chinese Trade Data*, CRS Report for Congress (April 10, 2007).

[101] *Id.*; Bronfenbrenner Study at 42.

[102] *See* Michael J. Ferrantino, Zhi Wang, *Accounting for Discrepancies in Bilateral Trade: The Case of China, Hong Kong, and the United States*, at 1, 5-6, Office of Economics Working Paper, the U.S. International Trade Commission (April 2007).

[103] *See* K.C. Fung, Lawrence J. Lau, *New Estimates of the United States-China Bilateral Trade Balances*, at 1, 8, Asia-Pacific Research Center, Institute for International Studies, Stanford University (1999).

[104] *Id*. at 6, n.1.

[105] *See* the U.S. Treasury Analysis—Semi-annual Report on International Economic and Exchange Rate Policies (June 2007 Report), Appendix 2, p. 2. Information can be retrieved via: http://www.ustreas.gov/offices/international-affairs/economic-exchange-rates

[106] *Id.*

[107] *See* Bronfenbrenner Study at 69; John W. Schindler, Dustin H. Beckett, *Adjusting Chinese Bilateral Trade Data: How Big is China's Trade Surplus?*, at 27, Board of Governors of the Federal Reserve System, International Journal of Applied Economics, 2(2) (September 2005).

[108] Michael J. Ferrantino, Zhi Wang, *Accounting for Discrepancies in Bilateral Trade: The Case of China, Hong Kong, and the United States*, at 10, Office of Economics Working Paper, the U.S. International Trade Commission (April 2007).

[109] *See* John W. Schindler, Dustin H. Beckett, *Adjusting Chinese Bilateral Trade Data: How Big is China's Trade Surplus?*, at 27, Board of Governors of the Federal Reserve System, International Journal of Applied Economics, 2(2) (September 2005); Bronfenbrenner Study at 69.

[110] Michael J. Ferrantino, Zhi Wang, *Accounting for Discrepancies in Bilateral Trade: The Case of China, Hong Kong, and the United States*, at 16-17.

[111] *Id.*

[112] Bronfenbrenner Study at 70.

[113] *See* Robert C. Feenstra, Wen Hai, Wing T. Woo, Shunli Yao, *The the U.S.-China Bilateral Trade Balance: Its Size and Determinants*, at 9, Department of Economics, University of California, Davis (May 1998). Conceptually, smuggling may be viewed as the most extreme case of under-invoicing, because the transaction is not recorded at all, and its value is zero. *See* Michael J. Ferrantino, Zhi Wang, *Accounting for Discrepancies in Bilateral Trade: The Case of China, Hong Kong, and the United States*, at 10, Office of Economics Working Paper, the U.S. International Trade Commission (April 2007). Situations that provide incentives for under-invoicing also give rise to smuggling activities, especially if the incentives translate into an extremely high pay-off. *Id*. Incentives for smuggling are particularly enticing when either exports or imports of a commodity are illegal, such as certain drugs, explosives, weapons, pornography, and endangered species, as well as products that infringe vested intellectual property rights. *Id*.

[114] *See* Robert C. Feenstra, Wen Hai, Wing T. Woo, Shunli Yao, *The the U.S.-China Bilateral Trade Balance: Its Size and Determinants*, at 9, Department of Economics, University of California, Davis (May 1998).

[115] *Id.* Automobiles and cigarettes, as well as fruit, used to be the major goods smuggled into China. Refined petroleum products have now displaced these products. By reconciling reported exports and imports of certain East Asian countries, the quantity of refined petroleum products smuggled into China has been estimated to be ten million (10,000,000) tons per year. Approximately one hundred thousand (100,000) automobiles, both new and used, are reported to be smuggled into China every year. As is well known, a significant amount of cigarette trade between the United States and China takes the form of the U.S. exports smuggled through Hong Kong en route to the Mainland. *See* K.C. Fung, Lawrence J. Lau, *New Estimates of the United States-China Bilateral Trade Balances*, at 22-23, Asia-Pacific Research Center, Institute for International Studies, Stanford University (1999).

[116] *See* Bronfenbrenner Study at 70.

[117] *Id.*

[118] *See* K.C. Fung, Lawrence J. Lau, *New Estimates of the United States-China Bilateral Trade Balances*, at 22, Asia-Pacific Research Center, Institute for International Studies, Stanford University (1999).

[119] *Id.* at 23.

[120] *Id.*

[121] Michael J. Ferrantino, Zhi Wang, *Accounting for Discrepancies in Bilateral Trade: The Case of China, Hong Kong, and the United States*, at 5, Office of Economics Working Paper, the U.S. International Trade Commission (April 2007).

[122] *Id*.

[123] *See* Michael J. Ferrantino, Zhi Wang, *Accounting for Discrepancies in Bilateral Trade: The Case of China, Hong Kong, and the United States*, at 14-15, Office of Economics Working Paper, the U.S. International Trade Commission (April 2007); Michael F. Martin, *What's the Difference? – Comparing the U.S. and Chinese Trade Data*, at 20, CRS Report for Congress (April 10, 2007).

[124] *Id*.

[125] Michael J. Ferrantino, Zhi Wang, *Accounting for Discrepancies in Bilateral Trade: The Case of China, Hong Kong, and the United States*, at 7, 15, Office of Economics Working Paper, the U.S. International Trade Commission (April 2007). Issues also arise with regard to the difference between "general" versus "special" trade and "goods in transit". Examples of imports that are included in "general" but not "special" trade are imports which are entered into special warehouses or free-trade zones, but which do not clear customs given that such goods do not enter into the customs territory of the importing country. Exports that are included in "general" but not "special" trade consist of re-exports of merchandise that are produced outside the country of re-exportation that are not "substantially transformed" in the country of re-exportation. The United States maintains both general trend trade data, known as "general imports" and "total exports," and special trade data, known as "imports for consumption" and "domestic exports". The difference between total exports and domestic exports in the the U.S. data is called "foreign exports." Michael J. Ferrantino, Zhi Wang, *Accounting for Discrepancies in Bilateral Trade: The Case of China, Hong Kong, and the United States*, at 6, n.4, Office of Economics Working Paper, the U.S. International Trade Commission (April 2007). Even general trend data may omit merchandise that physically enters or leaves a port. There is an additional category, known as "goods in transit," which includes merchandise that passes through ports, but which is not unloaded from the ship or aircraft. Most countries have little or no data for "goods in transit".

[126] Michael F. Martin, *What's the Difference? – Comparing the U.S. and Chinese Trade Data*, at 5, CRS Report for Congress (April 10, 2007).

[127] *Id*.

[128] *See* Hung-Gay Fung, Jot Yau, Gaiyan Zhang, *Market Impediments, Trade, and Foreign Direct Investment: Evidence from China's Round-Tripping*, at 1, 2, 27 University of Missouri at Saint Louis and Seattle University (November 27, 2006).

[129] *Id*.

[130] According to China's official legal definition, the phrase "foreign direct investment" refers to investment carried out through one of 3 legal types of Chinese foreign business entities: **(i)** WFOEs; **(ii)** Sino-foreign equity joint ventures; and **(iii)** Sino-foreign cooperative or contractual joint ventures (*e.g.,* partnerships). *See generally* "China's FDI merry-go-round," FDI ForeignDirectInvestment, FT Business Financial Times, http://www.fdimagazine.com (April 2, 2003)(downloaded on June 6, 2007); Hung-Gay Fung, Jot Yau, Gaiyan Zhang, *Market Impediments, Trade, and Foreign Direct Investment: Evidence from China's Round-Tripping*, at 1, 2, University of Missouri at Saint Louis and Seattle University (November 27, 2006). Chinese FIEs trace their modern legal origins to the promulgation in 1991 of China's FIE income-tax law.

[131] *See* "China's FDI merry-go-round," FDI ForeignDirectInvestment, FT Business Financial Times, http://www.fdimagazine.com (April 2, 2003)(downloaded on June 6, 2007); Hung-Gay Fung, Jot Yau, Gaiyan Zhang, *Market Impediments, Trade, and Foreign Direct Investment: Evidence from China's Round-Tripping*, at 2, University of Missouri at Saint Louis and Seattle University, 2 (November 27, 2006); UNCTAD Investment Brief, Number 2 (2007).

[132] Michael J. Ferrantino, Zhi Wang, *Accounting for Discrepancies in Bilateral Trade: The Case of China, Hong Kong, and the United States*, at 28, Office of Economics Working Paper, the U.S. International Trade Commission (April 2007).

[133] *See generally* Hung-Gay Fung, Jot Yau, Gaiyan Zhang, *Market Impediments, Trade, and Foreign Direct Investment: Evidence from China's Round-Tripping*, at 3, University of Missouri at Saint Louis and Seattle University (November 27, 2006). See also Michael J. Ferrantino, Zhi Wang, *Accounting for Discrepancies in Bilateral Trade: The Case of China, Hong Kong, and the United States*, at 9-10, Office of Economics Working Paper, the U.S. International Trade Commission (April 2007).

[134] Michael J. Ferrantino, Zhi Wang, *Accounting for Discrepancies in Bilateral Trade: The Case of China, Hong Kong, and the United States*, at 4, Office of Economics Working Paper, the U.S. International Trade Commission (April 2007). First, by means of underreporting exports, a Chinese exporting firm can avoid certain Chinese currency-conversion restrictions and can freely convert its earnings to any foreign currency. Second, earnings kept offshore can be returned home through an affiliated foreign entity (but acting on behalf of the Chinese exporting firm) as so-called "foreign investment" that heretofore enjoyed preferential tax treatment on the Mainland. Some of the undervalued export earnings return to China, while another portion of these earnings typically remains offshore. This practice occurs with the assistance of a related-party trading partner of the Chinese exporting firm that is situated in the offshore conduit. To make the amount of money remaining in China look legitimate, the Chinese exporting firm must understate its export earnings to the Chinese authorities, so that any remitted earnings will match the reported earnings at home. *See* Hung-Gay Fung, Jot Yau, Gaiyan Zhang, *Market Impediments, Trade, and Foreign Direct Investment: Evidence from China's Round-Tripping*, at 6, University of Missouri at Saint Louis and Seattle University, November 27, 2006); UNCTAD Investment Brief, Number 2 (2007).

[135] Hung-Gay Fung, Jot Yau, Gaiyan Zhang, *Market Impediments, Trade, and Foreign Direct Investment: Evidence from China's Round-Tripping*, at 4-5, University of Missouri at Saint Louis and Seattle University, (November 27, 2006).

[136] Michael J. Ferrantino, Zhi Wang, *Accounting for Discrepancies in Bilateral Trade: The Case of China, Hong Kong, and the United States*, at 10, Office of Economics Working Paper, U.S. International Trade Commission (April 2007).

[137] See the U.S. Treasury Analysis—Semi-annual Report on International Economic and Exchange Rate Policies (June 2007 Report), Appendix 2, p. 2. Information can be retrieved via: http://www.ustreas.gov/offices/international-affairs/economic-exchange-rates

[138] Geng Xiao, *People's Republic of China's Round-Tripping FDI: Scale, Causes and Implications*, at 1, 6, 10 The University of Hong Kong, Reference No. 1137 (July 2004).

[139] Memorandum, *Countervailing Duty Investigation of Coated Free Sheet ("CFS") Paper from the People's Republic of China* – Whether the Analytical Elements of the Georgetown Steel Opinion are Applicable to China's Present-Day Economy, 1, 3 (May 29, 2007) ("Georgetown Steel Memorandum").

[140] *See* Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises, Art. 2 (1991)(superseded("`*Enterprises with foreign investment'* referred to in this Law mean Chinese-foreign equity joint ventures, Chinese-foreign contractual [partnership] joint ventures and foreign-capital enterprises that are established in China. `*Foreign enterprises'* referred to in this Law mean foreign companies, enterprises and other economic organizations which have [permanent] establishments or places in China and engage in production or business operations, and which, though without establishments or places in China, have income from sources within China"). As set forth in the text of our study, foreign business entities established in China include **(a)** Sino-foreign equity joint ventures, **(b)** Sino-foreign contractual joint-ventures or partnerships, and **(c)** wholly-owned FIEs. Other foreign enterprises, in turn, generally refer to foreign companies, enterprises, and other economic organizations with "permanent establishments" situated on the Mainland that are engaged in production or business operations, as well as other entities and individuals that, although they do not have any kind of presence in China, derive income that is effectively connected with the Mainland. During the past decades through December 31, 2007, FIEs

and other foreign enterprises that had "permanent establishments" in China were generally subject -- in the absence of any tax incentives or concessions -- to the Chinese national corporate income-tax rate of 30%, as supplemented by a local income tax rate of 3%, for income attributable to the following activities: **(i)** production and business operations; **(ii)** interest; **(iii)** rentals; **(iv)** royalties; and **(v)** income derived from sources both inside and outside China that is "effectively connected" with a Chinese "permanent establishment". *See* PriceWaterhouseCoopers, *Setting up in China*, http://wwws.pwccn.com (downloaded on June 9, 2007). Foreign enterprises without any "permanent establishment" or other presence in China, but which derived profits, interest, rentals, royalties, and other income from Chinese sources, were taxed at the rate of 10% though December 31, 2007. *Id.*

[141] *See* Thomas Hall, *Controlling for Risk: An Analysis of China's System of Foreign Exchange and Exchange Rate Management*, 17 COLUM. J. ASIAN L. 433, 468, 2004 (explaining that "[f]oreign currency borrowing transactions…remain heavily restricted. However,…[t]he foreign debt regulations are less restrictive of borrowing by FIEs, which are generally free to borrow and repay foreign loans at will").

[142] *See* Geng Xiao, *People's Republic of China's Round-Tripping FDI: Scale, Causes and Implications*, at 15, The University of Hong Kong, Reference No. 1137 (July 2004).

[143] *Id.* at Table 5 (showing that Hong Kong by itself accounted for 45.73% of China's foreign direct investment in 2002).

[144] *See* Bronfenbrenner Study at 29.

[145] *Id.*

[146] *Id.*

[147] *See* Charles E. McLure Jr., Hoover Institution, Stanford University, *Transfer Pricing and Tax Havens: Mending the LDC Revenue Net,* 1, 8 (downloaded from the Internet on June 6, 2007).

[148] *Id.* at 16.

[149] *See* Bronfenbrenner Study at 70.

[150] *See* Charles E. McLure Jr., Hoover Institution, Stanford University, *Transfer Pricing and Tax Havens: Mending the LDC Revenue Net,* at 9 (downloaded from the Internet on June 6, 2007).

[151] *Id.*

[152] *See* Bronfenbrenner Study at 70.

[153] *See* Charles E. McLure Jr., Hoover Institution, Stanford University, *Transfer Pricing and Tax Havens: Mending the LDC Revenue Net,* at 9 (downloaded from the Internet on June 6, 2007).

[154] *Tolley's International Tax Planning* (2002), para. 16.1, ISBN 0754513394 (2002).

[155] Doggart, Caroline, 2002, *Tax Havens and their uses* (originally published in 1970), Economist Intelligence Unit, ISBN 0862181631.

[156] TUNG, Freda. Statistician, Census and Statistics Department, Hong Kong Special Administrative Region. Interview took place 15 April 2008.

[157] Charles E. McLure Jr., Hoover Institution, Stanford University, *Transfer Pricing and Tax Havens: Mending the LDC Revenue Net*, at 3, (downloaded from the Internet on June 6, 2007). In this regard, Switzerland and the United States, both developed countries, are tax havens for passive-investment assets, because interest income generated by foreign nationals residing outside the United States and Switzerland are not subject to the income tax laws of those countries. *Id.* at 3, n. 6. In other words, Chinese foreign nationals residing on the Mainland do not pay any the U.S. income tax for any of their the U.S.-source

interest income attributable to bonds, certificates of deposit, money markets, and other interest-bearing instruments. *Id*.

[158] *See* http://forum.tdctrade.com (June 5, 2007). *See also* See "China's FDI merry-go-round," FDI ForeignDirectInvestment, FT Business Financial Times, http://www.fdimagazine.com (April 2, 2003)(downloaded on June 6, 2007); Hung-Gay Fung, Jot Yau, Gaiyan Zhang, *Market Impediments, Trade, and Foreign Direct Investment: Evidence from China's Round-Tripping*, at 2, University of Missouri at Saint Louis and Seattle University (November 27, 2006); UNCTAD Investment Brief, Number 2 (2007).

[159] *See generally* Geng Xiao, *People's Republic of China's Round-Tripping FDI: Scale, Causes and Implications*, at 3, 10. The University of Hong Kong, Reference No. 1137 (July 2004); Paper can also be retrieved via: http://adbi.adb.org/conf-seminar-papers/2004/06/01/820.prc.fdi.cpp/

[160] *See generally* "China's FDI merry-go-round," FDI ForeignDirectInvestment, FT Business Financial Times, http://www.fdimagazine.com (April 2, 2003)(downloaded on June 6, 2007); Hung-Gay Fung, Jot Yau, Gaiyan Zhang, *Market Impediments, Trade, and Foreign Direct Investment: Evidence from China's Round-Tripping*, at 2, University of Missouri at Saint Louis and Seattle University (November 27, 2006); UNCTAD Investment Brief, Number 2 (2007).

[161] *See* "China's FDI merry-go-round," FDI ForeignDirectInvestment, FT Business Financial Times, http://www.fdimagazine.com (April 2, 2003)(downloaded on June 6, 2007).

[162] Hung-Gay Fung, Jot Yau, Gaiyan Zhang, *Market Impediments, Trade, and Foreign Direct Investment: Evidence from China's Round-Tripping*, at 2, University of Missouri at Saint Louis and Seattle University (November 27, 2006).

[163] HE, Dong. Head of Economic Research, Hong Kong Monetary Authority. Interview conducted on 16 April 2008.

[164] *Id.* at 13 ("What it means is that [the] PRC lends a lot of capital to the US in the form of current account surplus with [the] US but at the same time [the] PRC borrows a lot from its Asian neighbors in the form of PRC's current account deficits with Asian neighbors").

[165] Two types of round-tripping activities take place between China and Hong Kong: **(i)** rent-seeking round-tripping; and **(ii)** value-seeking round-tripping. Rent-seeking "round tripping" -- the initial purpose of which is to escape cumbersome Chinese impediments and regulations (*e.g.*, capital controls) imposed on the Mainland -- creates no value-added. By contrast, "round tripping" for value-added services, by definition, does create value through superior offshore financing. Most cross-border mergers and acquisitions constitute value-seeking round-tripping activities, which refers to so-called "Red Chip" initial public offerings ("IPOs") carried out on the Hong Kong stock exchange. Examples of such IPOs include China Unicom, China Mobile, Sinopec, PetroChina, China Telecom, CNOOC, MTR, China South Air, and j-Cable Comm. When a Mainland company prepares for a listing as a "Red Chip" company in Hong Kong, China, it registers on the Hong Kong stock exchange as a new local company in the SAR, with the accompanying injection of capital into Hong Kong from its Mainland parent company. Hence, the listing of Chinese companies in Hong Kong leads to an inflow of foreign capital from the Mainland into the SAR. This foreign capital inflow is considered foreign direct investment into Hong Kong, provided that the portfolio investment exceeds the 10% Hong Kong threshold. After the "Red Chip" company in Hong Kong has acquired additional financial capital through the IPO consummated in the former British colony, the "Red Chip" company can then use the IPO-generated funds to purchase other substantive profit-generating projects on the Mainland, such as additional FIEs. This latter transaction constitutes foreign direct investment from Hong Kong into China, provided that the investment in question satisfies the 10% ownership threshold imposed by Chinese law. Hence, the net result of the IPO listing of Mainland companies in Hong Kong triggers a relatively large foreign direct investment "merry-go-round" from China, to Hong Kong, and then back to the Mainland. *See generally* Geng Xiao, *People's Republic of China's Round-Tripping FDI: Scale, Causes and Implications*, at 19-20, The University of Hong Kong, Reference No. 1137 (July 2004).

[166] Robert C. Feenstra, Wen Hai, Wing T. Woo, Shunli Yao, *The the U.S.-China Bilateral Trade Balance: Its Size and Determinants*, at 1, 7, Department of Economics, University of California, Davis, (May 1998).

[167] *Id.* at 1, 9-10. To attract massive amounts of foreign investment and foreign technology into China during the past decades, the Chinese government enacted the following comprehensive labyrinth of tax concessions, exemptions, reductions, and other fiscal incentives targeted at FIEs and foreign enterprises that were in full force and effect through December 31, 2007. These multiple concessions embrace the following fiscal incentives: **(1) Concessions on Business Tax, VAT, and Customs Duty: (a)** incomes derived by R&D centers established by FIEs and foreign wholly-owned enterprises and incomes derived by foreign enterprises and foreign individuals from technology transfer, technology development and related consultancy, and technical services were exempt from business tax; **(b)** raw materials, auxiliary materials, parts, components, accessories and packaging materials imported by FIEs for outward processing or assembly of products and for the production of goods for export were exempt from import tariffs based on the quantity of finished products actually processed and exported; **(c)** FIEs under the "encouraged category" were entitled to full VAT rebate on the purchase of domestically-produced equipment within their investment amount if such equipment appears in the catalogue of duty-free imports; **(d)** imports of equipment and supporting technologies, accessories and parts for own use by existing FIEs under the "encouraged category," foreign-invested research and design centers, and FIEs with advanced technologies and export-oriented FIEs were exempt from import tariffs and import-related taxes in accordance with the *Circular of the State Council on the Adjustment of Tax Policy on Equipment Imports;* **(e)** imports of equipment for own use by FIEs for producing products in the *Catalogue of State New and High Technology Products* and imports of supporting technology, accessories, and parts as set out in the controlling private-party contract were exempt from import tariffs and import-related VAT, with the exception of commodities listed in the *Catalogue of Non-Duty-Free Commodities to be Imported for Domestic-Funded Projects;* **(f)** imports by FIEs of advanced technology in the *Catalogue of State New and High Technology Products* and software fees paid overseas as stipulated in the governing contract were exempt from import tariffs and import-related VAT; and **(g)** for R&D centers established by FIEs, imports of equipment or related technologies, accessories and parts for own use that are not produced domestically, or the performance of those produced domestically fails to meet the needs of the enterprises were exempt from import tariffs and import-related VAT in accordance with the *Circular of the State Council on the Adjustment of Tax Policy on Equipment Imports (Circular No. 1997/37)*, provided that the imports were within the enterprises' total investment amount; **(2) Concessions on Corporate Income Tax: (a) <u>Preferential Tax Rate</u>**: FIEs in the following regions (sectors) were entitled to corporate income tax at the reduced rate of 15%: **(i)** FIEs in the Shenzhen, Zhuhai, Shantou, Xiamen and Hainan SEZs; **(ii)** foreign enterprises with establishments or venues in SEZs and engaged in production and business operations; **(iii)** production FIEs established in economic and technological development zones or areas approved by the State Council and in the Pudong New Area in Shanghai; **(iv)** technology- and knowledge-intensive projects launched by FIEs in old urban districts of SEZs, economic and technological development zones, and coastal economic open areas approved by the State Council with long investment recovery periods and foreign investment exceeding US$30 million; **(v)** production FIEs engaged in energy, transportation, and port construction projects; **(vi)** production FIEs engaged in export processing in bonded areas; **(vii)** recognized high-technology FIEs in new- and high-technology industrial development zones at state-level approved by the State Council; **(viii)** for foreign-invested banks, Sino-foreign joint venture banks, and other financial institutions in SEZs and other areas designated by the State Council with foreign capital investment or operating capital transferred from the head office to the branch office exceeding the U.S.US$10 million -- and with an operating period of 10 years -- corporate income tax was levied at a reduced rate of 15%. In addition, such enterprises were eligible for corporate income-tax exemption in the first profit-making year and for reduction by half in the second and third years with the approval of the local tax authorities. Production FIEs in the following regions were entitled to corporate income tax at the rate of 24%: **(i)** other types of production FIEs in old urban districts of coastal economic open areas, SEZs, and economic and technological development zones in which the 15% preferential tax rate was not applicable; **(ii)** open coastal cities, open cities along the Yangtze River, and in inland and border regions, as well as in other areas designated by the State Council; **(iii)** state-tourist resorts; **(b) Specific Exemption and Reduction of Corporate Income Tax: (i)** ***foreign-invested production enterprises in the following industries and sectors with an operating period of over 10 years were eligible for corporate income-tax exemption in the first and second profit-making years and for reduction by half (50%) in the third (3rd) to fifth (5th) years***: machine building; electronics; energy (excluding exploration of oil and natural gas); metallurgy (excluding excavation of rare metals and precious metals); chemicals; building materials; light industries; textiles and apparel; packaging; medical equipment; pharmaceuticals; ***agriculture; forestry; animal husbandry; fishery; water conservancy; construction; transport (excluding passenger transport); technology development for producer services; geological surveying***; industrial information consultancy; maintenance services for production equipment

and precision instruments; and other sectors endorsed by the state (such as enterprises engaged in engineering design for construction, installation, and assembly projects, as well as the provision of labor services for engineering projects, cultivation, farming, and plantation projects; ***R&D of production technology***; provision of transportation and warehousing services to clients using their own transport and warehousing facilities). ***In addition, newly-established software companies could enjoy the above tax exemption and reduction, without being subject to the 10-year operating period requirement***; **(ii)** ***FIEs under the encouraged category established in the central and western regions were entitled to the reduced 15% corporate income tax for 3 years upon expiration of the above mentioned tax holiday***. During this period, if an enterprise is recognized as an "export enterprise" and its "export value" amounted to over 70% of its total output value in the current year, it would be entitled to pay corporate income tax at the reduced flat rate of 10%. ***Upon application and with the approval of the State Administration of Taxation ("SAT"), FIEs engaged in agriculture, forestry, and animal husbandry, as well as FIEs established in the economically-backward remote and border areas, could pay corporate income tax at the reduced rate ranging from 15% to 30% for another 10 years upon expiration of the above mentioned tax exemption and reduction period***; **(iii)** ***Sino-foreign joint ventures engaged in port and wharf construction and with an operating period of over 15 years were eligible for corporate income-tax exemption in the first 5 profit-making years and for reduction by half (50%) in the following 5 years***; **(iv)** ***infrastructure projects related to airports, ports, wharfs, railways, highways, power stations, coal mines, and water conservancy facilities, in addition to agricultural development in the Hainan SEZ with an operating period of over 15 years were eligible for corporate income-tax exemption in the first 5 years and reduction by half (50%) in the following 5 years***; **(v)** ***infrastructure projects related to airports, ports, railways, highways, and power stations in the Pudong New Area in Shanghai with an operation period of over 15 years were eligible for corporate income tax exemption in the first 5 years and for reduction by half (50%) in the following 5 years***; **(vi)** the following types of enterprises were eligible for corporate income-tax exemption during the first profit-making year and for reduction by half (50%) in the second (2^{nd}) and third (3^{rd}) years with the approval of the local tax authorities: **(a)** FIEs engaged in services in SEZs with foreign investment exceeding the U.S.US$ 5 million and with an operating period of over 10 years; and **(b)** foreign-invested banks, Sino-foreign joint-venture banks, and other financial institutions in SEZs and other areas designated by the State Council with foreign capital investment exceeding the U.S.US$10 million and with an operating period of over 10 years; **(vi)** ***recognized high-tech Sino-foreign joint venture enterprises in state-level high-technology development zones with an operating period of over 10 years were exempt from corporate income tax in their first 2 profit-making years with the approval of the tax authorities***; **(vii)** foreign-invested export-oriented enterprises were entitled to pay corporate income tax at the reduced rate of 15% or 10% following the expiration of the corporate income-tax exemption-and-reduction periods, provided that their export sales value was over 70% of their total output value in the current year. ***FIEs under the "encouraged category" established in the central and western regions are entitled to pay corporate income tax at the reduced rate of 15% or 10% for an additional 3 years following the expiration of the above-mentioned tax exemption and reduction periods***; **(viii)** ***foreign-invested high-technology enterprises were entitled to pay corporate income tax at the reduced rate of 15% or 10% for 3 years following the expiration of the corporate income-tax exemption and reduction periods, provided that their status as "high-technology enterprises" remains unchanged;*** **(c)** **<u>Tax Rebate on Re-investment by FIEs</u>:** any foreign investor of an FIE that re-invested its profits obtained from the enterprise directly into that enterprise or using the profit as capital investment to establish another FIE with an operating period of at least 5 years was, upon approval granted by the competent tax authorities, eligible for a 40% tax refund of the corporate income tax already paid on the re-invested amount. If the foreign investor re-invested its profit directly in establishing or expanding an export-oriented ***or high-tech enterprise in China***, then the corporate income tax already paid on the re-invested amount would be 100% refunded; **(d)** **<u>Other Exemptions and Reductions of Income Tax</u>:** **(i)** profits of foreign investors derived from FIEs were exempt from income tax; **(ii)** interest revenue of international financial institutions derived from loans to the Chinese government or state banks were exempt from tax; **(iii)** interest revenue of foreign banks derived from loans to Chinese state banks at preferential rates were exempt from income tax; **(iv)** ***royalties paid to foreign enterprises for their provision of special technologies to China for scientific research, exploitation of energy resources, development of transportation, production of agriculture, forestry and animal husbandry, and development of important technologies, were eligible for income-tax assessment at the reduced rate of 10%, provided that the prior approval of SAT were obtained***. ***For those enterprises that employ advanced technologies, income tax will be exempted***; **(iv)** incomes from dividends, interest, rentals, royalties, and other sources of foreign enterprises effectively connected with SEZs, economic and technological development zones, coastal economic development zones, and other open areas designated by the state were eligible for exemption from income tax or a reduced rate of 10%. ***In addition, for enterprises offering favorable terms for capital and equipment investment or involved in the transfer of advanced technology, the provincial or municipal governments enjoyed the discretion to decide whether to grant further exemptions and reductions to income taxes***; **(v)** ***for foreign enterprises which have no permanent establishments or venues within Chinese national territory, but which derive income from interest, rentals, royalties, and other sources originating in China, and for those foreign enterprises which do have permanent establishments or venues in China, but which derive incomes that are not effectively connected with such establishments or venues, apart from the exemption in income tax granted by law, such enterprises were eligible to pay income tax at the reduced rate of 10%***; **(vi***)* ***in the case of FIEs under the "encouraged category," as well as foreign enterprises with permanent establishments or venues engaged in production or business operations within Chinese national territory, 40% of their investment in the purchase of domestically-produced equipment in the current year could be offset against the incremental corporate income tax of the preceding year. If the incremental corporate income tax in the current year were less than the equipment purchase value, then the balance could be carried forward to the following tax year for offset purposes against incremental corporate income tax (the payable income tax prior to the year of the equipment purchase is used as the base).*** The maximum period for such offset was 5 years. For FIEs enjoying income-tax exemption and reduction in accordance with statutory and administrative regulations, application could be made during the tax-exemption period to extend the offset period to not more than 7 years; **(vii)** ***for FIEs that purchase domestically-produced equipment for the following purposes outside their total investment amount, 40% of the purchase amount could be offset against the incremental corporate income tax of the preceding tax year***: **(a)** ***raising economic efficiency and product quality***; **(b)** ***increasing product range***; **(c)** ***promoting product upgrade***; **(d)** expanding exports; **(e)** ***reducing costs***; **(f)** ***conserving energy***; **(g)** ***strengthening the comprehensive utilization of resources***; **(h)** ***treating waste materials, waste water, and air pollutants effectively***; and **(i)** ***protecting workers through improving existing facilities and production conditions by way of adopting advanced and new technologies, new processes, new equipment and new materials***; **(viii)** with the approval of the tax authorities, FIEs that increased their technological-development expenses by more than 10% over the previous year were allowed to offset their taxable income in the current year by 50% of the amount of technological-development expenses; **(ix)** ***governments of various provinces, autonomous regions, and municipalities also had introduced local income-tax exemptions or reductions for those sectors or projects in which foreign investment is encouraged***; **(3) Individual Income Tax Concession for Foreigners:** The following personal income of foreign nationals was eligible for individual income-tax concessions: **(a)** housing allowance; meal allowance; removal expenses and laundry fees received in non-cash forms or in the form of cash reimbursement could be deducted from the taxable income; **(b)** travel allowance at reasonable levels were exempt from individual income tax; **(c)** a reasonable portion of home-visit allowance, language-training fees, and children's education expenses could be deducted from taxable income; **(d)** dividends and bonuses received from FIEs were exempt from individual income tax; **(e)** any foreign national residing in China consecutively or accumulatively for not more than 90 days (or 183 days for those individuals from countries that have signed bilateral tax treaties with China) in a tax year were exempt from individual income tax if his or her wage or salary were not paid or borne by his employer in China and were not borne by a permanent establishment of his employer in China; **(f)** with the approval of the competent Chinese tax authorities, any foreign national residing in China for more than 1 year, but fewer than 5 years, his or her wage or salary during the duration of work outside China and paid by the non-China employer could be exempt from individual income tax; **(4) Tax Concessions for Central and Western Regions:** ***FIEs under the "encouraged" category in the western region that enjoy the "two-year exemption and three-year reduction by half" tax concession were eligible for corporate income tax at the reduced rate of 15% for 3 more years following the expiration of the initial tax concession. FIEs recognized as high-technology or export-oriented enterprises with an export value amounting to over 70% of their annual output value in the current year were eligible for a 50% reduction of corporate income tax during this 3-year period; however, the reduced tax rate could not below 10%***. For textual support of the previous Chinese tax concessions, exemptions, reductions, and other fiscal incentives, *see 4.2 Tax Exemption and Reduction*, tdctrade.com, http://www.tdctrade.com/chinaguide/4-2.htm (September 2006)(downloaded on January 3, 2008). ***As demonstrated in a subsequent section of the text of our study, the PRC central government effectively recycled the above fiscal incentives highlighted in bold italics when enacting China's new Enterprise Income Tax Law, effective January 1, 2008, together with the implementing regulations.***

[168] Robert C. Feenstra, Wen Hai, Wing T. Woo, Shunli Yao, *The the U.S.-China Bilateral Trade Balance: Its Size and Determinants*, at 1, 8, Department of Economics, University of California, Davis, (May 1998).

[169] *Id.* at 1, 8.

[170] Http://tpwwbapp.tdctrade.com (September 2006) (downloaded on June 6, 2007).

[171] *See* Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises, art. 5 (1991)(repealed)("The income tax on enterprises with foreign investment and the income tax which shall be paid by foreign enterprises on the income of their establishments or places set up in China to engage in production or business operations shall be computed on the taxable income at the rate of thirty percent, and local income tax shall be computed on the taxable income at the rate of three percent").

[172] Consistent with endnote 246, the repealed Chinese FIE income-tax law considered FIEs operating in the following Mainland industries or sectors during the period 1991 through December 31, 2007, to constitute "productive" FIEs that warranted preferential tax treatment: **(i)** machine manufacturing and electronics industries; **(ii)** energy-source sectors (not including exploitation of oil and natural gas); **(iii)** metallurgical, chemical, and building material industries; **(iv)** light industries, textiles, and packaging industries; **(v)** medical equipment and pharmaceutical sectors; **(vi)** agriculture, forestry, animal husbandry, fisheries, and water conservation sectors; **(vii)** construction industries; **(viii)** communication and transportation sectors (not including passenger transport); **(ix)** development of science and technology, geological survey, and industrial information consultancy; and **(x)** other industries as specified by the PRC State Council. *See* Ernst and Young, *Special Economic Zones and Tax Exemption in China, China Competence Center*, *Tax*, 1 (downloaded from the Internet on June 6, 2007). In *Coated Free Sheet Paper from the People's Republic of China*, a the U.S. countervailing duty action aimed at several PRC government programs, the U.S. Department of Commerce determined that China's FIE tax-incentive scheme constituted a countervailable government subsidy under the WTO Agreement on Subsidies and Countervailing Measures ("WTO Subsidies Agreement") and the the U.S. Tariff Act of 1930, as amended. In analyzing the Chinese fiscal program, Commerce emphasized that the underlying purpose of the repealed FIE income-tax law was to attract foreign businesses to the Mainland. *See Coated Free Sheet Paper From the People's Republic of China: Amended Preliminary Affirmative Countervailing Duty Determination*, 72 Fed. Reg. 17,484, (April 9, 2007); Final Commerce Decision Memorandum, 1, (October 17, 2007).

[173] *See* Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises, art. 8 (1991)(superseded)("Any enterprise with foreign investment of a production nature scheduled to operate for a period of not less than ten years shall, from the year beginning to make profit, be exempted from income tax in the first and second years and allowed a fifty percent reduction in the third to fifth years. However, the exemption from or reduction of income tax on enterprises with foreign investment engaged in the exploitation of resources such as petroleum, natural gas, rare metals, and precious metals shall be regulated separately by the State Council. Enterprises with foreign investment which have actually operated for a period of less than ten years shall repay the amount of income tax exempted or reduced already").

[174] *See* Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises, art. 8 (1991); (Ernst and Young, *Special Economic Zones and Tax Exemption in China, China Competence Center*, *Tax*, 1 (downloaded from the Internet on June 6, 2007).

[175] *Round-Tripping Foreign Direct Investment in the People's Republic of China: Scale, Causes and Implications*, at 11, ADB Institute, http://adbi.adb.org/discussion-paper (downloaded on June 6, 2007).

[176] *4.2 Tax Exemption and Reduction,* http://tpwwbapp.tdctrade.com, (September 2006) (downloaded on June 6, 2007).

[177] *See* Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises, art. 7 (1991)(repealed)("The income tax on enterprises with foreign investment established in Special Economic Zones, foreign enterprises which have establishments or places in Special Economic Zones engaged in production or business operations, and on enterprises with foreign investment of a production nature in Economic and Technological Development Zones, shall be levied at the reduced

rate of fifteen percent. The income tax on enterprises with foreign investment of a production nature established in coastal economic open zones or in the old urban districts of cities where the Special Economic Zones or the Economic and Technological Development Zones are located, shall be levied at the reduced rate of twenty-four percent. The income tax on enterprises with foreign investment in coastal economic open zones, in the old urban districts of cities where the Special Economic Zones or the Economic and Technological Development Zones are located or in other regions defined by the State Council, within the scope of energy, communications, harbour, wharf or other projects encouraged by the State, may be levied at the reduced rate of fifteen percent. The specific measures shall be drawn up by the State Council").

[178] Enacted in 1997, the *Circular of the State Council on Adjusting Tax Policies on Imported Equipment*, (GUOFA No. 37)(Circular No. 37) exempts both FIEs and certain Chinese domestic enterprises from the payment of Chinese VAT and customs duties that is due on imported capital equipment used for production purposes. The objective of this PRC government program is to encourage foreign investment and to introduce into China foreign advanced technology. All enterprises eligible for the VAT and customs-duty exemptions must have PRC government-approved projects that are consistent with the *Catalog of Key Industries, Products, and Technologies the Development of which is Encouraged by the State*. In *Coated Free Sheet Paper From the People's Republic of China*, Commerce determined that the VAT and customs-duty exemptions governing imported capital equipment constitute a countervailable government subsidy. With regard to "specificity," Commerce stressed that only certain Chinese domestic enterprises and FIEs are eligible to receive the VAT and customs-duty exemptions under the program. *See Coated Free Sheet Paper From the People's Republic of China: Amended Preliminary Affirmative Countervailing Duty Determination*, 72 Fed. Reg. 17,484, (April 9, 2007); Final Commerce Decision Memorandum, 1, (October 17, 2007).

[179] *Round-Tripping Foreign Direct Investment in the People's Republic of China: Scale, Causes and Implications*, at 11. ADB Institute, http://adbi.adb.org/discussion-paper (downloaded on June 6, 2007).

[180] *See* Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises, art. 10 (1991)(repealed)("Any foreign investor of an enterprise with foreign investment which reinvests its share of profit obtained from the enterprise directly into that enterprise by increasing its registered capital, or uses the profit as capital investment to establish other enterprises with foreign investment to operate for a period of not less than five years shall, upon approval by the tax authorities of an application filed by the investor, be refunded forty percent of the income tax already paid on the reinvested amount").

[181] Robert C. Feenstra, Wen Hai, Wing T. Woo, Shunli Yao, *The the U.S.-China Bilateral Trade Balance: Its Size and Determinants*, 1, 4, Department of Economics, University of California, Davis, (May 1998).

[182] *See* Geng Xiao, *People's Republic of China's Round-Tripping FDI: Scale, Causes and Implications*, at 1, 9, The University of Hong Kong, Reference No. 1137 (July 2004).

[183] See Arrangement for the Avoidance of Double Taxation on Income and Prevention of Fiscal Evasion Between the Mainland of China and the Hong Kong Special Administrative Region, art. 3(3) (2007).

[184] *Id.*, art. 9.

[185] By sharp contrast, when China's *bilateral trade* with the United States is examined, the main source of the statistical discrepancy occurs in China's *export* trade, as opposed to its *import* trade. *See, e.g.,* Michael F. Martin, *What's the Difference? – Comparing the U.S. and Chinese Trade Data*, at 2, CRS Report for Congress (April 10, 2007)("most of the discrepancy between the trade data from the two nations stems from significantly different figures for China's exports to the United States"). Data comparisons show large and increasing differences between China's exports to the United States, as recorded by official Chinese statistics, and the U.S. imports from China, as published in official the U.S. data. *Cf.* Sarah Y. Tong, *The the U.S.-China Trade Imbalance: How Big is it Really?*, China: An International Journal 3,1, at 137 (March 2005) ("[T]here is much more re-exporting of Chinese goods to the the U.S. through Hong Kong than there is re-exporting of the U.S. goods to China. The former is generally more than five times larger than the latter. Thus the implication is that there is more serious distortion in the reporting of Chinese exports to the the U.S. than there is for Chinese imports from the the U.S."). These discrepancies have increased dramatically from

$20.7 billon in 1995 to $59.1 billion in 2003. The top five harmonized system chapters in which the Chinese-the U.S. bilateral statistical discrepancies occur – namely, **(i)** footwear, **(ii)** machinery, **(iii)** electrical machinery, **(iv)** furniture, and **(v)** toys and sporting goods – account for approximately two thirds (66%) of the difference between the the U.S. and Chinese figures on both a volume and value basis. *See* Michael F. Martin, *What's the Difference? – Comparing the U.S. and Chinese Trade Data*, at 3, CRS Report for Congress (April 10, 2007). With regard to the the U.S. export-China import side of the equation, there is also a consistent and growing discrepancy in the opposite direction, with the volume and value of the U.S. exports to China (as reported by the United States) being significantly less than the volume and value of Chinese imports originating from the United States (as reported by China). This discrepancy was the U.S.US$3.7 billion in 1995 and the U.S.US$5.5 billion in 2003. Chinese imports from the United States of machinery, electrical machinery, and optical medical equipment comprise the product categories with the greatest statistical discrepancies on the Chinese import side of the equation. With these two sets of trade statistics increasingly diverging in opposite directions, the overall discrepancy between official the U.S. and Chinese data has widened from the U.S.US$24.4 billion in 1995 to the U.S.US$64.6 billion in 2003. Recent studies have estimated the bilateral trade data trade discrepancy at the U.S.US$88.2 billion for trade-year 2006; that is, according to the United States, the 2006 bilateral trade deficit with China was the U.S.US$232.5 billion, while, according to China, its trade surplus with United States was only the U.S.US$144.3 billion for that year. *See* Michael F. Martin, *What's the Difference? – Comparing the U.S. and Chinese Trade Data*, at 1, CRS Report for Congress (April 10, 2007). *See also* John W. Schindler, Dustin H. Beckett, *Adjusting Chinese Bilateral Trade Data: How Big is China's Trade Surplus?*, at 27, Board of Governors of the Federal Reserve System, International Journal of Applied Economics, 2(2) (September 2005) (reporting that a the U.S.US$65 billion statistical trade discrepancy between official Chinese and the U.S. trade data exists for calendar-year 2003). "The United States has the largest discrepancy with China, while Japan, Taiwan, and Germany have the next three largest, respectively. *Id*. at 33; *but see id*. at 27 ("And most remarkably, in 2003, China and Japan reported trade deficits with one another"). As demonstrated in the text of our study, Sino round-tripping activities contaminate China's bilateral-trade statistics with the United States, Japan, Taiwan, and Germany.

[186] *See* Hung-Gay Fung, Jot Yau, Gaiyan Zhang, *Market Impediments, Trade, and Foreign Direct Investment: Evidence from China's Round-Tripping*, at 1, 2, 27, University of Missouri at Saint Louis and Seattle University (November 27, 2006). Paper can be downloaded via: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=972174.

See also "China's FDI merry-go-round," FDI ForeignDirectInvestment, FT Business Financial Times, http://www.fdimagazine.com (April 2, 2003)(downloaded on June 6, 2007); UNCTAD Investment Brief, Number 2 (2007). For an explanation of the concept of "tax arbitrage," *see* Richard L. Doernberg, *International Taxation*, at 375-379, West Nutshell Series (West Group, 4th ed. 1999).

[187] *See* Hung-Gay Fung, Jot Yau, Gaiyan Zhang, *Market Impediments, Trade, and Foreign Direct Investment: Evidence from China's Round-Tripping*, at 2, University of Missouri at Saint Louis and Seattle University (November 27, 2006). *See also* "China's FDI merry-go-round," FDI ForeignDirectInvestment, FT Business Financial Times, http://www.fdimagazine.com (April 2, 2003)(downloaded on June 6, 2007); UNCTAD Investment Brief, Number 2 (2007).

[188] *See* Hung-Gay Fung, Jot Yau, Gaiyan Zhang, *Market Impediments, Trade, and Foreign Direct Investment: Evidence from China's Round-Tripping*, at 16, University of Missouri at Saint Louis and Seattle University (November 27, 2006). Paper can be downloaded via: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=972174.

See also "China's FDI merry-go-round," FDI ForeignDirectInvestment, FT Business Financial Times, http://www.fdimagazine.com (April 2, 2003)(downloaded on June 6, 2007); UNCTAD Investment Brief, Number 2 (2007).

[189] Geng Xiao, *People's Republic of China's Round-Tripping FDI: Scale, Causes and Implications*, The University of Hong Kong, 1, 2, Reference No. 1137 (July 2004)(emphasis added).

[190] *Id*.

[191] Enterprise Income Tax Law of the People's Republic of China, art. 60 (2008) (establishing the effective date of the new legislation as January 1, 2008).

[192] *See* Explanation on the Draft Enterprise Income Tax Law of the People's Republic of China, delivered by Finance Minister, Jin Renqing, at the Fifth Session of the Tenth National People's Congress, 11 (March 3, 2007)("With the entry into force of the new Tax Law, the statutory nominal income tax rate for…domestic enterprises…will see an eight percentage point decrease from 33 percent to 25 percent. However, for those foreign-funded enterprises that have been enjoying the preferential tax rate of 24 percent or 15 percent, their statutory nominal tax rate will rise by one or ten percentage points respectively").

[193] Article 1 of the new PRC tax law provides that "[a]ll enterprises and other income receiving organizations…within the territory of…China shall be the taxpayer of the enterprise income tax…." Enterprise Income Tax Law of the People's Republic of China, art. 1 (2008). *See also* Implementation Rules of the Enterprise Income Tax Law of the People's Republic of China, art. 3 (2008)(defining the phrase "[e]nterprises established within the territory of China pursuant to Chinese laws" to include "enterprises, business units, social organizations, and other organizations that earn revenue, which are established within the territory of China in accordance with Chinese laws and regulations"). Article 4 of the new law further establishes that the "[e]nterprise income tax shall be levied at the rate of 25%." Enterprise Income Tax Law of the People's Republic of China, art. 4 (2008); PriceWaterhouseCoopers, *Transfer Pricing Implications of China's New Corporate Income Tax Law*, Issue 7, http://wwws.pwccn.com (March 2007) (downloaded on June 9, 2007).

[194] Article 2 of the new fiscal statute provides that "[e]nterprises are classified as resident enterprises and non-resident enterprises. A resident enterprise…refers to [any] enterprise which is established within the territory of China pursuant to Chinese laws or an enterprise established within the territory of another country or other tax region pursuant to that country or that region's laws *whose actual management or control is located in China*. A non-resident enterprise…refers to an enterprise established within the territory of another country or other tax region pursuant to foreign laws, whose actual management or control is located outside of China but which has [a permanent] establishment in China or even if it does not have [such] an establishment in China, has income derived from China." Enterprise Income Tax Law of the People's Republic of China, art. 2 (2008)(emphasis added). Article 3 of the EIT law further provides that PRC "resident enterprises" shall pay the 25% Chinese income tax on all income generated on a worldwide basis: "[r]esident enterprises shall pay the enterprise income tax for income sourced within and outside of China." *Id*., art. 3. By contrast, non-resident enterprises shall pay PRC income tax only on Chinese-source income or on income effectively connected with a Chinese "permanent establishment".

[195] *See* Implementation Rules of the Enterprise Income Tax Law of the People's Republic of China, art. 9 (2008) (articulating rule that "[t]axable income of an enterprise is calculated on an accrual basis").

[196] *See* PriceWaterhouseCoopers, *Transfer Pricing Implications of China's New Corporate Income Tax Law*, Issue 7, http://wwws.pwccn.com (March 2007) (downloaded on June 9, 2007). In principle, all newly-created FIEs situated in Chinese SEZs are subject to the new unified tax rate of 25 percent, because Article 1 of the EIT statue provides that "[a]ll enterprises…within the territory of…China shall be the taxpayer of the enterprise income tax [of 25%]….." Enterprise Income Tax Law of the People's Republic of China, art. 1 (2008). Notwithstanding this language, the second paragraph of Article 57 of the new law authorizes the PRC State Council to provide foreign high-technology enterprises situated in Chinese SEZs with open-ended tax concessions. *See id*., art. 57, para. 2.

[197] *See* Enterprise Income Tax Law of the People's Republic of China, art. 60 (2008) (repealing China's 1991 FIE income-tax law); PriceWaterhouseCoopers, *Transfer Pricing Implications of China's New Corporate Income Tax Law*, Issue 7, http://wwws.pwccn.com (March 2007) (downloaded on June 9, 2007).

[198] Explanation on the Draft Enterprise Income Tax Law of the People's Republic of China, delivered by Finance Minister, Jin Renqing, at the Fifth Session of the Tenth National People's Congress, 5 (March 3, 2007).

[199] *See* Enterprise Income Tax Law of the People's Republic of China, art. 60 (2008).

[200] *See id., a*rts. 57, 60; PriceWaterhouseCoopers, *Transfer Pricing Implications of China's New Corporate Income Tax Law*, Issue 7, http://wwws.pwccn.com (March 2007) (downloaded on June 9, 2007).

[201] Enterprise Income Tax Law of the People's Republic of China, art. 57 (2008); Implementation Rules of the Enterprise Income Tax Law of the People's Republic of China, art. 131 (2008)("Enterprises which have been approved to be established prior to the promulgation of the EIT Law as cited in Article 57, paragraph 1 of the Tax Law refer to enterprises which have completed business registration procedures prior to the promulgation of the EIT Law").

[202] Enterprise Income Tax Law of the People's Republic of China, Arts. 57, 60 (2008); PriceWaterhouseCoopers, *Transfer Pricing Implications of China's New Corporate Income Tax Law*, Issue 7, http://wwws.pwccn.com (March 2007) (downloaded on June 9, 2007).

[203] New transfer-pricing provisions appear in Chapter 6 (Special Tax Adjustments) of the new fiscal legislation. This chapter generally addresses both tax-avoidance schemes and transfer-pricing issues. Chapter 6 improves existing legislation and regulations, introduces new and modern concepts, and grants additional powers to China's SAT. *See* PriceWaterhouseCoopers, *Transfer Pricing Implications of China's New Corporate Income Tax Law*, Issue 7, http://wwws.pwccn.com (March 2007) (downloaded on June 9, 2007).

[204] *See* Enterprise Income Tax Law of the People's Republic of China, art. 46 (2008). The new Enterprise Income Tax Law introduces for the first time in China's tax history so-called "thin-capitalization" rules to prevent Chinese enterprises that receive an excessive number and value of related-party loans, as opposed to capital-contributions, from evading Chinese tax liability. Article 46 of the new legislation provides that the ratio of debt to equity for related parties must follow a "specified ratio"; otherwise, the interest from the excess debt granted by a controlling entity to its affiliate "shall not be deductible when computing [Chinese] taxable income." *Id.*; PriceWaterhouseCoopers, *Impact of China's new Corporate Income Tax Law on Foreign Investors*, Issue 6, http://wwws.pwccn.com (March 2007)(downloaded on June 9, 2007). *See* also Implementation Rules of the Enterprise Income Tax Law of the People's Republic of China, art. 119 (2008).

[205] *See* Enterprise Income Tax Law of the People's Republic of China, art. 45 (2008).

[206] *See* Enterprise Income Tax Law of the People's Republic of China, art. 45 (2008). In cases in which the profits of any CFC -- situated in an offshore jurisdiction with an income-tax rate that is generally below 12.5% -- are not distributed or are distributed in a reduced amount under a company policy lacking any "reasonable operational need[]," Article 45 of the new legislation provides that such undistributed profits shall be considered a deemed dividend "attributed to the resident [controlling] enterprise[]" that is subject to Chinese tax liability. *Id.*

[207] *See* Implementation Rules of the Enterprise Income Tax Law of the People's Republic of China, art. 118 (2008)("The effective tax rate as cited in Article 45 of the EIT Law, being significantly lower than the tax rate set forth in Paragraph 1 of Article 4 of the EIT Law, refers to the effective tax rate being lower than 50% of the tax rates set forth in Paragraph 1 of Article 4 of the EIT Law").

[208] Enterprise Income Tax Law of the People's Republic of China, art. 41 (2008). *See also* PriceWaterhouseCoopers, at 9. *Transfer Pricing in China* (October 2006)(citing to OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations). The arm's-length principle mandates that "associated enterprises" transact business with one another as if they were unaffiliated third parties. In other words, a Chinese FIE cannot sell products or services to its affiliate at a price that significantly deviates from the price at which the same products or services are sold to an unrelated third party under similar circumstances. *Id. See also* Implementation Rules of the Enterprise Income Tax Law of the People's Republic of China, art. 110 (2008) ("The arm's length principle as cited in Article 41 of the EIT Law refers to the principle that unrelated parties abide to when carrying out business transactions in accordance with fair market prices and common business practices").

[209] Implementation Rules of the Enterprise Income Tax Law of the People's Republic of China, art. 109 (2008).

[210] *Id.*, art. 115 ("Where the tax authorities deem an enterprise's taxable income in accordance with Article 44 of the EIT Law, the following methods may be used: 1) deem the taxable income by reference to the profit margin of same-type or similar enterprises; 2) deem the taxable income based on the enterprise's cost plus reasonable expenditures and profit; 3) deem the taxable income by reasonable proportion of the consolidated profit of the related party group; and 4) deem the taxable income with other reasonable methods. Where an enterprise disagrees with the taxable income deemed by the tax authorities in accordance with aforementioned provisions, it shall provide relevant proof to the tax authorities. The deemed taxable income may be adjusted subject to the tax authorities' verification").

[211] *See* PriceWaterhouseCoopers, *Impact of China's new Corporate Income Tax Law on Foreign Investors*, Issue 6, http://wwws.pwccn.com (March 2007)(downloaded on June 9, 2007); PriceWaterhouseCoopers, *Transfer Pricing in China*, at 22, 23. http://wwws.pwccn.com (downloaded on June 9, 2007). Chapter 6 of the new EIT statue codifies a general anti-avoidance rule that expressly authorizes China's SAT to make a price-tax adjustment (*i.e.*, special tax levy), together with the assessment of an interest penalty (*i.e.*, special interest levy), in cases in which the taxpayer enters into a non-arm's length related-party arrangement "without [a] bona fide commercial purpose[]". Enterprise Income Tax Law of the People's Republic of China, art 41 (2008)

[212] *See* Implementation Rules of the Enterprise Income Tax Law of the People's Republic of China, art. 123 (2008) ("Where transactions between an enterprise and its related parties do not comply with the arm's length principle, or an enterprise makes other arrangements without bona fide commercial purposes, the tax authorities have the right to make tax adjustments within 10 years from the tax year when the transactions occurred").

[213] *See* PriceWaterhouseCoopers, *Transfer Pricing Implications of China's New Corporate Income Tax Law*, Issue 7, http://wwws.pwccn.com (March 2007) (downloaded on June 9, 2007).

[214] *Id.*

[215] *See* PriceWaterhouseCoopers, *Transfer Pricing in China*, at 4 (October 2006); Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises, Art. 13 (1991)(repealed)("The payment or receipt of charges or fees in business transactions between an enterprise with foreign investment or an establishment or a place set up in China by a foreign enterprise to engage in production or business operations, ***and its associated enterprises***, ***shall be made in the same manner as the payment or receipt of charges or fees in business transactions between independent enterprises. Where the payment or receipt of charges or fees is not made in the same manner as in business transactions between independent enterprises and results in a reduction of the taxable income, the tax authorities shall have the right to make reasonable adjustment***")(emphasis supplied).

[216] Enterprise Income Tax Law of the People's Republic of China, art. 42 (2008) (legislating advance pricing agreements). Advance Pricing Arrangements ("APAs") constitute agreements executed by the competent tax authorities and taxpayers concerning the future application of transfer-pricing policies. *See* PriceWaterhouseCoopers, *Transfer Pricing in China*, at 7 (October 2006). APAs are an effective means to mitigate against future transfer-pricing risks by ensuring that Chinese authorities deem future profits generated by an affiliated corporate group to be "reasonable". *Id.* Article 42 of the new legislation expressly authorizes taxpayers to negotiate and conclude APAs with China's SAT with regard to "pricing principles and computation methods used in business transactions between the enterprise and its related party…." Enterprise Income Tax Law of the People's Republic of China, art. 42 (2008). *See also* Implementation Rules of the Enterprise Income Tax Law of the People's Republic of China, art. 113 (2008) ("An advanced pricing agreement as cited in Article 42 of the EIT Law refers to an agreement that is concluded after negotiation and confirmation with the tax authorities, upon an enterprise's application to them, in respect of the enterprise's pricing principles and computation methods for related party transactions in future years in compliance with the arm's length principle"). Although China's SAT had previously provided detailed guidance concerning the use of APAs by virtue of Guo Shui Fa [2004] 118, the new APA mechanism legislated into the new EIT Law demonstrates strong support thereof by the central government in Beijing. *See* PriceWaterhouseCoopers, *Transfer Pricing in China*, at 7 (October 2006).

[217] Enterprise Income Tax Law of the People's Republic of China, art. 41 (2008) (legislating cost-sharing arrangements). Cost Sharing Arrangements ("CSAs") are mechanisms pursuant to which affiliated enterprises of a related corporate group share the costs and risks of the development of intangible assets. *See* PriceWaterhouseCoopers, *Transfer Pricing in China*, at 7 (October 2006). Each related-party participant in the CSA bears its share of the costs and the risks of the venture and, in return, will own whatever intellectual property is created by the arrangement. *Id.* By virtue of R&D evaluations, economic analysis, and negotiations with the Chinese tax authorities, CSAs can help mitigate against existing risks, such as international double taxation involving royalties generated by intellectual property rights. *Id.* The second paragraph of Article 41 of the new PRC tax law authorizes taxpayers to conclude CSAs with the Chinese tax authorities. See Enterprise Income Tax Law of the People's Republic of China, art. 41 (2008) In the past, multinational companies were reluctant to share intellectual property or services with their Chinese affiliates for various reasons, with the key factor being that shared costs were nondeductible in the hands of the Chinese subsidiaries. Additionally, local tax authorities were unfamiliar with CSAs. *See* PriceWaterhouseCoopers, *Transfer Pricing in China*, at 7 (October 2006). Thus, the new provision in the EIT Law provides a transparent framework that paves the way for China to attract more advanced intellectual property and sophisticated services from overseas investors, especially from Hong Kong, in accordance with carefully-crafted CPAs. *See id.*

[218] Explanation on the Draft Enterprise Income Tax Law of the People's Republic of China, delivered by Finance Minister, Jin Renqing, at the Fifth Session of the Tenth National People's Congress, 8 (March 3, 2007).

[219] The second paragraph of Article 1 of the new EIT Law expressly provides that "[s]ole proprietorships and <u>partnerships</u> are not under the purview of this law." Enterprise Income Tax Law of the People's Republic of China, art. 1 (2008) (emphasis added). *See also* Implementation Rules of the Enterprise Income Tax Law of the People's Republic of China, art. 2 (2008) ("Sole proprietorship enterprises and partnership enterprises as cited in Article 1 of the EIT Law refer to sole proprietorship enterprises and partnership enterprises established pursuant to Chinese laws and regulations").

[220] *See* Enterprise Income Tax Law of the People's Republic of China, art. 52 (2008) ("Unless otherwise [approved] by the State Council, enterprises shall not be allowed to pay enterprise income tax on a consolidated basis").

[221] *Id.*, art. 50 ("When a resident enterprise within China sets up one or more operating units that are not separate legal entities, it shall combine the income of the home office and units and pay the computed enterprise income tax thereon").

[222] *Id.*, art. 7(3).

[223] *Id.*, art. 25.

[224] *Id.*, arts. 35, 36. *See also id.*, art. 33 ("When computing taxable income, income derived from the production of goods by an enterprise which ensures the production of goods in line with state production policies as well as a comprehensive utilization of resources is eligible for deductions against total revenue").

[225] *Id.*, art. 58 ("Where the provisions of a tax treaty/agreement concluded between the government of the People's Republic of China and a foreign government are different from the provisions of this Law, the provisions of the treaty/agreement shall prevail").

[226] Arrangement for the Avoidance of Double Taxation on Income and Prevention of Fiscal Evasion Between the Mainland of China and the Hong Kong Special Administrative Region, art. 3(1)(3) (2007)(defining the term "person" to include "an individual, a company, a trust, ***a partnership*** and any other body of persons")(emphasis supplied).

[227] *See* Arrangement for the Avoidance of Double Taxation on Income and Prevention of Fiscal Evasion Between the Mainland of China and the Hong Kong Special Administrative Region, art. 3(3) (2007) (establishing the principle that "[a]s regards the application of this Arrangement by One Side, any term not

defined therein shall, unless the context otherwise requires, have the meaning which it has at the time under the laws of that Side concerning the taxes to which this Arrangement applies, and any meaning under the applicable tax laws of that Side prevails over a meaning given to the term under other laws of that Side").

[228] *See id.*, art. 9.