

# PROPOSAL FOR VOLUNTARY DISCLOSURE PROCEDURES IN CHINA

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## Abstract

How should taxpayers who have not complied with their Chinese tax obligations voluntarily correct their tax affairs? Many countries have adopted tax amnesties and voluntary disclosure procedures for that purpose. Unlike those countries, China does not have nationwide voluntary disclosure procedures. However, the Chinese tax authorities frequently reduce or waive penalties for taxpayers who voluntarily disclose their noncompliance and settle their unpaid taxes. This article calls for the adoption of nationwide voluntary disclosure procedures in China and explores the design considerations of such procedures. As China is modernizing its tax laws and strengthening its tax enforcement, this proposal is worth serious consideration.

**Keywords:** China, Tax Amnesty, Tax Enforcement, Voluntary Disclosure.

## I. INTRODUCTION

How should taxpayers who have not complied with their Chinese tax obligations voluntarily correct their tax affairs? Many countries have adopted tax amnesties and voluntary disclosure procedures for that purpose.<sup>4</sup> Unlike those countries, China does not have nationwide voluntary disclosure procedures. Nonetheless, in practice, the Chinese tax authorities have been reducing or waiving penalties for taxpayers who voluntarily disclose their past noncompliance, file tax returns for previous years, and pay the required taxes. In contrast to the lack of nationwide tax voluntary disclosure procedures, China's customs authorities have been implementing a nationwide voluntary disclosure program since 2016.

Correcting tax noncompliance will have increasing importance in China in the next few years. Following global trends, China is rapidly strengthening its tax enforcement, targeting both domestic tax residents and foreigners with Chinese tax obligations. Since late 2018, China has started and will continue to receive, on an annual basis, details of Chinese tax residents who hold offshore financial assets in financial institutions in dozens of countries.<sup>5</sup> This automatic exchange of financial account information (AEOI) is expected to expose noncompliance by taxpayers who have not reported income from offshore financial assets in their tax filings in China, and strengthen the enforcement of the tax rules that apply to offshore income and assets.

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<sup>4</sup> The Organisation for Economic Co-ordination and Development (OECD)'s (2015) survey of 47 countries found that most countries operate a general voluntary disclosure program (p. 9).

<sup>5</sup> For China's AEOI relationships, see "Activated Exchange Relationships for CRS Information" (2020) on the OECD website: <http://www.oecd.org/tax/automatic-exchange/international-framework-for-the-crs/exchange-relationships/>.

The Chinese tax authorities have also taken other important steps to improve the enforcement of the country's income tax laws. China's individual income tax (IIT) reform, which came into effect on 1 January 2019, aims to tackle inequality by reducing the tax burden on low and middle-income earners, and by increasing tax collection from high-income earners (Wong, 2018; Zhou, Jiang, Sarelius, & Zhang, 2018). Zhou et al. (2018) note that "IIT enforcement, particularly vis-à-vis wealthy Chinese nationals, may see a significant uptick in severity in the years ahead", a view that is also held by several other commentators. The high-profile case of Fan Bingbing, who was ordered to pay nearly 884 million yuan in unpaid tax and penalties, may be part of a broader campaign by the Chinese tax authorities against tax evasion (Zou, 2018). The combination of these reforms and enforcement efforts indicates that China is transitioning into a regime in which tax laws are enforced more strictly.

How do tax evaders react to increases in enforcement efforts? Some tax evaders might be caught by the authorities and will be required to pay their taxes, as well as civil and criminal penalties. Others may try to continue to evade tax, possibly taking actions to avoid detection by the authorities (Noked, 2018a, 2018b). However, others may choose to correct their tax affairs voluntarily (Johannesen, Langetieg, Reck, Risch, & Slemrod, 2018). The decision about whether or not to voluntarily report past noncompliance depends on several factors, including the tax evader's risk aversion, and the expected costs and benefits of self-reporting in comparison to those of continuing to evade tax (Noked, 2018c). The features of the voluntary disclosure procedures substantially impact the costs and benefits of becoming compliant voluntarily.

In general, providing a way for noncompliant taxpayers to correct their tax affairs voluntarily can be beneficial for society.<sup>6</sup> As shown in the law and economics literature, an optimal law enforcement scheme that includes self-reporting (i.e., a way for noncompliant people to voluntarily disclose their noncompliance and pay a reduced penalty) is superior to an optimal law enforcement scheme without self-reporting (Kaplow & Shavell, 1994). First, a voluntary disclosure scheme should reduce enforcement costs because fewer resources are needed to identify and prosecute the people that voluntarily disclose their noncompliance. Second, risk-averse people benefit from paying a certain penalty. Third, a voluntary disclosure can save social costs where the sanctions imposed without self-reporting are costly (Kaplow & Shavell, 1994). Fourth, a voluntary disclosure may result in better remediation of social harm because it enables tax evaders to correct their noncompliance and to do it earlier (Innes, 1999a, 1999b; Livernois & McKenna, 1999). Fifth, it can also reduce social costs by reducing incentives for tax evaders to undertake costly activities in order to avoid detection (Innes, 2001).

However, voluntary disclosure schemes may reduce deterrence and create stronger incentives for tax evasion (Malik & Schwab, 1991). There are mixed views in the literature about this effect, and as to whether voluntary disclosure schemes are desirable despite this effect (Marceau & Mongrain, 2000). Even if voluntary disclosure schemes reduce deterrence, the empirical evidence documents only small effects on post-amnesty compliance (Alm, 2012). The risk that a voluntary disclosure scheme will reduce deterrence appears to be lower where there is a transition into a stricter enforcement regime.

Although China does not have a nationwide voluntary disclosure policy, the Chinese tax authorities have been following voluntary disclosure practices, under which taxpayers who

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<sup>6</sup> According to the OECD, a carefully drafted voluntary disclosure scheme can benefit everyone involved: taxpayers participating in the scheme, the general population of compliant taxpayers, and the government (OECD, 2015, p. 9; OECD, 2009, p. 7).

voluntarily disclose their past noncompliance and pay the required taxes are subject to reduced or no penalties. The Chinese tax authorities occasionally announce a grace period for taxpayers within a particular sector to correct their tax affairs voluntarily without sanctions and, if they fail to do so, they will be subject to a greater risk of penalties. Local tax authorities have been following voluntary disclosure practices that vary across localities.<sup>7</sup> While some local tax authorities have adopted formal and detailed voluntary disclosure procedures, most Chinese tax authorities follow practices that are largely informal, in the sense that there are no clear rules as to the applicable procedures and penalties.

The fact that the Chinese tax authorities already implement voluntary disclosure practices means the relevant policy question is not whether China should allow noncompliant taxpayers to voluntarily disclose their noncompliance and receive reduced penalties—the Chinese tax authorities have already answered this question in the affirmative. The main question for China is how to design its voluntary disclosure policy: should it adopt nationwide voluntary disclosure procedures and, if so, what should the terms of such procedures be?

This article calls for the adoption of nationwide voluntary disclosure procedures by the State Taxation Administration (STA). It argues that adopting nationwide voluntary disclosure procedures in China would result in enhanced transparency, consistency, and certainty, thereby improving the efficiency and the fairness of the Chinese tax system.

There are several potential advantages of such procedures. First, improved predictability and certainty regarding penalties would incentivize noncompliant taxpayers, especially risk-averse ones, to participate in the voluntary disclosure scheme. Second, a nationwide voluntary disclosure policy may improve the rule of law in taxation through enhanced clarity and transparency. Such a policy may also increase the perception of fairness if the voluntary disclosure procedures are designed to treat noncompliant taxpayers similarly where their conduct is similar, and if the procedures can be implemented nationwide in a consistent manner. Third, the government's cost of administering, and the taxpayers' cost of participating in, a formal nationwide scheme could be lower than the costs of varying practices that are separately designed and enforced at various levels. Fourth, a formal scheme could facilitate coordination with non-tax regulators, such as the State Administration of Foreign Exchange (SAFE) at the national level. It would be in the government's interest to reduce tax evasion and recover lost tax revenues. The adoption of such procedures is in line with the approach other countries have taken to facilitate and encourage voluntary disclosure.<sup>8</sup>

The article explores several key considerations for policymakers when designing the voluntary disclosure policy: which taxes and offenses should be covered? Who should be eligible to participate in a voluntary disclosure scheme? What penalties, taxes, and interest should be applied? What information should be collected? Should the voluntary disclosure policy also cover currency exchange control violations? The purposes of this article are to open a

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<sup>7</sup> This was particularly the case prior to the 2018 reform of China's tax administration. China introduced a substantial reform of the organization of its tax administration in 2018, which ended the separation of central tax administration and local tax administration. Although the reform has led to an integration of tax administration, the tax revenue sharing system between central and local governments remains; many local tax regulations and rules introduced prior to the integration are still effective. For further discussion about this reform, see Li and Krever (2018).

<sup>8</sup> The OECD's (2015) survey of 47 countries found that most countries operate a general voluntary disclosure program (p. 30).

discussion about what the terms of China's voluntary disclosure policy should be and to identify the key design issues that should be considered.

This article is organized as follows: Part II provides an overview of voluntary disclosure schemes and the relevant literature. Part III discusses the current voluntary disclosure practices in China. Part IV explores the design considerations of voluntary disclosure procedures in China. Part V offers a conclusion.

## II. BACKGROUND: VOLUNTARY DISCLOSURE SCHEMES

According to the OECD, voluntary disclosure schemes or programs are “opportunities offered by tax administrations to allow previously noncompliant taxpayers to correct their tax affairs under specified terms” (OECD, 2015, p. 7). Tax amnesties are generally similar to voluntary disclosure programs and, although there is no clear distinction between them, tax amnesty programs are typically offered on a temporary basis and provide a larger reduction in penalties and tax liability (Baer & Le Borgne, 2008). Voluntary disclosure programs can be offered on a temporary or permanent basis and, although they reduce or waive penalties, they generally do not reduce the tax liability (OECD, 2015, p. 14).<sup>9</sup> This article refers to both types as “voluntary disclosure schemes.”

Voluntary disclosure schemes have been adopted by dozens of countries in recent decades (Michaels, Beck, & Jarrett, 2015; OECD, 2015). While many countries have adopted permanent voluntary disclosure procedures, others have adopted temporary schemes.<sup>10</sup> The schemes had a notable proliferation in the last decade as a way for countries to recover shrinking tax revenues during the financial crisis<sup>11</sup> and as a response to the anticipated implementation of AEOI.<sup>12</sup>

The law and economics literature analyzes the potential benefits and costs of voluntary disclosure schemes. Kaplow and Shavell (1994) show that an optimal law enforcement scheme that includes self-reporting is superior to an optimal law enforcement scheme without self-reporting. Under an optimal voluntary disclosure scheme, a participant should pay a sanction equal to (or slightly less than) the penalty that would apply if he or she were caught, multiplied by the probability of being caught. The deterrence against harmful acts should not be materially affected by such a scheme because the individual's expected gain from the harmful act is the same as without voluntary disclosure. While such a scheme does not change the deterrence of tax evasion, it has several advantages. First, it reduces enforcement costs because fewer resources are needed to identify and prosecute the people that self-report their noncompliance (Kaplow & Shavell, 1994; Malik, 1993). Second, risk-averse people benefit from paying a certain penalty. Third, schemes with self-reporting can save social costs where the sanctions imposed without self-reporting are costly (e.g., imprisonment) (Kaplow & Shavell, 1994).

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<sup>9</sup> Some voluntary disclosure programs are offered on a temporary basis (e.g., the United States' 2009 offshore voluntary disclosure program).

<sup>10</sup> For a discussion on global trends in tax amnesties until 2004, see Baer and Le Borgne (2008, pp. 20-21); for more recent trends, see OECD (2015); Michaels et al. (2015).

<sup>11</sup> For example, the United States enacted its 2009 offshore voluntary disclosure program as a way to increase tax revenue during the financial crisis.

<sup>12</sup> For example, Indonesia implemented its tax amnesty in 2016 in order to encourage its noncompliant taxpayers to correct their tax affairs before AEOI began.

Self-reporting may also result in better remediation of the social harm caused by tax evasion (Innes, 1999a; Livernois & McKenna, 1999). Taxpayers who voluntarily disclose their past noncompliance are typically required to pay the tax they owe with certain reduced penalties. A failure to pay the required tax and penalties may result in the taxpayer being rejected from the scheme, and harsher penalties may apply. If there is no voluntary disclosure option, only the taxpayers that are caught will pay the tax and penalties (Innes, 1999a; Livernois & McKenna, 1999). Voluntary disclosure also enables tax evaders to correct their noncompliance earlier (Innes, 1999b). Thus, governments that offer voluntary disclosure schemes may be able to recover tax revenues that would have been harder to collect otherwise. Voluntary disclosure may also save social costs by reducing incentives for tax evaders to engage in costly activities in order to avoid detection (Innes, 1999a). Where tax evaders are averse to lying, self-reporting can better deter violations at a lower monitoring cost (Innes, 2017).

Although voluntary disclosure schemes may increase the compliance of tax evaders who choose to participate in these schemes, they may reduce deterrence and create stronger incentives for tax evasion (Alm, McKee, & Beck, 1990; Fisher, Goddeeris, & Young, 1989; Langenmayr, 2017; Malik & Schwab, 1991).<sup>13</sup> However, voluntary disclosure schemes may be desirable despite the fact that they provide people with an increased incentive to evade tax (Marceau & Mongrain, 2000). The impact on compliance may depend on the enforcement efforts made after the voluntary disclosure scheme has been introduced (Gerlach, 2013). The risk that a voluntary disclosure scheme would reduce deterrence appears to be lower where there is a transition into a stricter enforcement regime (Alm et al., 1990; Baer & Le Borgne, 2008; Fisher et al., 1989).

The empirical literature on voluntary disclosure schemes has largely focused on the impact of such programs on long-term noncompliance and revenue effects (Alm & Beck, 1990, 1993; Alm et al., 1990; López-Laborda & Rodrigo, 2003; Stella, 1991). Other aspects analyzed in the literature include the impact of tax amnesties on tax evaders (Alstadsæter, Johannesen, & Zucman, 2017; Fisher et al., 1989), and whether tax amnesties should be followed by stricter enforcement of tax evasion (Alm et al., 1990; Alm & Beck, 1991; Alm et al., 1990; Uchitelle, 1989). Much of the empirical work on amnesties has focused on amnesties at the state level in the United States (Alm & Beck, 1990; Alm et al., 1990; Fisher et al., 1989; Luitel & Sobel, 2007; Mikesell & Ross, 2012), although some studies focus on other countries, such as India, Spain, and Norway (Alm, Martinez-Vazquez & Wallace, 2009; Alstadsæter et al., 2017; Castro & Scartascini, 2017; López-Laborda & Rodrigo, 2003; Torgler, Schaltegger & Schaffner, 2003). The empirical evidence shows only small effects on post-amnesty compliance, and the evidence on the revenue impact of amnesties is mixed (Alm, 2012).<sup>14</sup>

Importantly, China has already adopted voluntary disclosure practices as part of its tax enforcement apparatus, as discussed below. These voluntary disclosure practices probably impact the compliance incentives and the enforcement costs, possibly in the manners identified in the literature.

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<sup>13</sup> Boise (2007) notes that tax amnesties are potentially detrimental to compliance for the following reasons: (a) tax amnesties may undermine the perceived fairness of the tax system among taxpayers; (b) tax amnesties may diminish the perception of tax evasion as a serious offense and; (c) taxpayers may expect the government to offer more tax amnesties in the future, which may undermine the incentives for tax compliance. Lederman (2012) applies Boise's analysis to the U.S. Offshore Voluntary Disclosure Program (OVDP).

<sup>14</sup> From a policy perspective, if the impacts on compliance incentives and revenues are small, this could support the view that the design of voluntary disclosure policies should focus on other considerations, such as fairness, enforcement costs, and compliance costs.

### III. CHINA'S VOLUNTARY DISCLOSURE PRACTICES

China does not have formal, nationwide voluntary disclosure procedures for taxes implemented in the country.<sup>15</sup> The draft amendment to the Law of the People's Republic of China on Tax Collection and Administration (LTCA) in 2015 proposed that tax authorities may reduce or waive penalties for taxpayers who voluntarily disclose tax noncompliance and settle their unpaid taxes.<sup>16</sup> However, this draft provision was not included in the final amended LTCA.<sup>17</sup> It is unclear whether such provision would be included in future amendments to the LTCA.

The STA notice on random tax inspection provides that taxpayers who are selected in a random tax inspection can be provided with a self-correction opportunity, and those who can disclose noncompliance and voluntarily pay taxes should be given penalty reductions or waivers.<sup>18</sup> The "self-correction" procedure appears to be similar to a voluntary disclosure scheme. However, this notice cannot provide a general legal basis for voluntary disclosure.<sup>19</sup>

Despite the lack of a nationwide voluntary disclosure policy, the Chinese tax authorities have been following voluntary disclosure practices under which taxpayers who voluntarily disclose their past noncompliance and pay the required taxes are subject to reduced or no penalties.<sup>20</sup> The Chinese tax authorities occasionally announce a grace period for taxpayers within a particular sector to correct their tax affairs voluntarily without sanctions. If they fail to do so, they are subject to a greater risk of penalties. A recent example is the STA enforcement effort targeting the entertainment industry and the use of yin-yang contracts to evade and avoid taxes. To encourage self-reporting, the STA announced that those who corrected their conduct voluntarily and paid the evaded taxes by 31 December 2018 would not be penalized (Luo, 2018). In addition to the STA's informal voluntary disclosure practices, local tax authorities have been following voluntary disclosure practices that vary across localities. In addition, China's customs authorities formally adopted a voluntary disclosure procedure in 2016. Although China has separate tax authorities and customs authorities, the way the Chinese government addresses voluntary disclosure in the context of customs (an indirect tax) can provide insights into wider voluntary disclosure matters. The local and customs voluntary disclosure policies are discussed below.

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<sup>15</sup> The Chinese government had short-lived experiences with a self-correction program at the national level in the 1990s. See State Council Notice on Inspection of Taxation, Finance, and Pricing Administration in 1995 (Guofa, [1995] 26); State Council Notice on Inspection of Taxation, Finance, and Pricing Administration in 1997 (Guofa [1997] 33). This article does not focus on the experiences with the self-correction in the 1990s because the relevant factors, including the Chinese economy and the Chinese tax system and enforcement, have substantially changed since the 1990s.

<sup>16</sup> See draft amendment to the Law on Tax Collection and Administration, article 124.

<sup>17</sup> Law on Tax Collection and Administration (NPCSC, passed 4 Sep. 1992, amended for the third time, 24 Apr. 2015).

<sup>18</sup> STA Notice on Issuing Implementation Measures on Promotion of Random Tax Inspection, art. 2(4) para. 2 (Shuizongfa [2015] 104, effective Aug. 25, 2015).

<sup>19</sup> Under China's legal system, administrative rules such as the above-mentioned STA Notice must be in accord with national laws and administrative regulations. Such central government department rules can only be used as reference in tax litigation by the courts. See Law on Legislation (NPC, passed 15 Mar. 2000, amended 15 Mar. 2015), arts. 80, 87-91; Law on Administrative Litigation (NPCSC, passed 4 Apr. 1989, effective 1 Oct. 1990, amended 1 Nov. 2014 and 27 Jun. 2017), art. 63. For a general discussion of China's legal system, see Chen (2019).

<sup>20</sup> According to tax professionals, tax authorities typically reduce or waive the administrative penalty, but the late payment surcharge is usually not waived.

The structure of the Chinese tax administration in the past may explain why local tax practices proliferated while no nationwide voluntary disclosure procedures were ever adopted. Until 2018, local tax authorities were responsible for the collection of IIT and various other taxes, including income tax on private companies (Li & Krever, 2018). While local practices developed, no voluntary disclosure procedures were adopted at the national level. Both local tax authorities and local offices of the STA applied various voluntary disclosure practices to improve tax collection and administration. Local tax authorities may have felt that they had more leeway when managing the collection of taxes for which they were responsible, which led to the development of different local policies. Since the integration of the national and the local tax bureaus in 2018, the STA has been responsible for all tax collection and administration at the local level (Li & Krever, 2018). This has created an opportunity for the STA to consider whether the current voluntary disclosure practices could be standardized and improved.

### A. Local Voluntary Disclosure Practices

As there are no nationwide voluntary disclosure rules to correct tax noncompliance, local tax offices have been deciding whether or not to adopt voluntary disclosure practices locally.<sup>21</sup> Many local tax authorities have introduced rules concerning self-reporting of past noncompliance.<sup>22</sup> These rules, which are frequently titled as “self-reporting” or “self-correction,” provide ways for noncompliant taxpayers to voluntarily disclose their past noncompliance and receive reduced penalties. The legal basis for implementing a voluntary disclosure program at the local level in the absence of national law or regulation appears to be the Law on Administrative Penalty (LAP).<sup>23</sup> Article 27 of the LAP provides that an administrative body shall reduce the administrative penalty where a party has taken the initiative to eliminate or lessen harmful effects caused by its illegal act; no penalty should be imposed where the illegal act is minor, without harmful consequences, and the party has corrected its illegal act.<sup>24</sup> It is unclear whether this provision is a sufficient legal basis for local practices when reducing or waiving the applicable penalties.<sup>25</sup>

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<sup>21</sup> This was particularly the case prior to the 2018 reform of China’s tax administration. This measure has raised the issue of whether local rules and policies are still valid after the reform, given that the local tax administration established prior to the reform no longer exists. Thus far, there has been no clear answer. In practice, if local rules issued before the 2018 reform are not contradictory to later rules promulgated by the STA or have not expired, they may remain valid.

<sup>22</sup> The discussion here is based on a survey of around 40 local rules on self-correction or voluntary disclosure issued from 1995 to the present time. The rules were issued by about 30 tax authorities at the provincial, city, and county levels. These surveyed rules include: (1) rules issued by state tax bureaus at the local levels, including state tax bureaus in the provinces of Anhui, Gansu, and Jiangxi, in Beijing municipal, and in the cities of Dalian and Xiamen; (2) rules issued by local governments, including Liaoning provincial government, the city governments of Benxi, Dazhou, Fushun, Jinzhou, Liupanshui, Luohe, Loudi, Shenyang, Tieling, Zhengzhou, and Zhoukou, and Xinbin Manchu autonomous county; and (3) rules issued by local tax bureaus at various local levels, including those of Hubei, Hunan, Jiangsu, and Guangdong, as well as the cities of Anshan, Beijing, Chengdu, Dalian, Fushun, Guangzhou, Haikou, Nanning, Qingdao, and Xiamen. The covered regions span from China’s northwest to its coastal areas, and from developing regions to developed regions.

<sup>23</sup> Law of the People’s Republic of China on Administrative Penalty (NPCSC, passed Mar. 17, 1996, amended for the first time Aug. 27, 2009 and the second time Sep. 1, 2017) (hereinafter LAP).

<sup>24</sup> LAP, art. 27 para. 1(1) and para. 2.

<sup>25</sup> Some local practices involve waiving penalties in respect of taxes where the revenue has been assigned to local governments. For example, Notice of Fushun City Government on Implementation Measures of Conducting Census on Tax Bases of Property Tax and Urban Land Use Tax (Fuzhengfa [2010]106), art. 4(1). While the Notice was issued to investigate the enforcement and compliance of the two taxes from Jul. 2010 to Dec. 2011, it appears to be still effective.

Another ambiguity arises in the interpretation and application of the term “fine on late payment” under the Law on Mandatory Administrative Procedures (LMAP). According to this law, a “fine on late payment” is one type of mandatory administrative execution.<sup>26</sup> Such a fine can be waived if the illegal act is minor or does not cause obvious social harm.<sup>27</sup> This is different from the provisions under the LTCA which provide that where a taxpayer fails to pay taxes (or where a withholding agent fails to withhold taxes) within the specified time, the tax authorities shall impose a late payment surcharge on the late tax payment on a daily basis, at the rate of 0.05 percent of the amount of taxes in arrears, from the date the tax payment was due, in addition to the payment of any taxes due.<sup>28</sup> The meaning of the term “fine on late payment” under the LMAP seems to overlap with that of the term “fine on late tax payment” used in various places in the LTCA. The provisions under the LTCA seem to prevail on the grounds that special laws take priority over general laws.

Local voluntary disclosure practices vary as to the taxes and the taxpayers to which they apply. These practices frequently focus on the collection of local taxes, especially from profitable industries that operate in the local area.<sup>29</sup> Voluntary disclosure schemes are occasionally used by some local governments to facilitate specific economic activity in the region.<sup>30</sup> Most local voluntary disclosure practices are largely informal, in the sense that they do not follow specific rules or procedures.<sup>31</sup> However, several local tax authorities have adopted detailed procedures at the local level.<sup>32</sup> In most local tax authorities, which allow voluntary disclosure through informal practices, the tax officers have broad discretion with regard to the appropriate reduction or waiver of penalties.<sup>33</sup> In contrast, several local governments have adopted rules

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<sup>26</sup> Law on Mandatory Administrative Procedures (NPCSC, passed Jun. 30, 2011, effective Jan. 1, 2012), art. 12(1).

<sup>27</sup> *Ibid.*, art. 16 para. 2.

<sup>28</sup> LTCA, art. 32. According to tax professionals, the late payment surcharge is usually not waived.

<sup>29</sup> Such local taxes frequently include stamp duties, property taxes, and urban land use taxes. For example, Liaoning province, Fushun city, Benxi city, and Xinbin Manchu autonomous county have all issued specific documents about tax self-correction, targeting only property tax and urban land-use tax.

<sup>30</sup> For example, in Hubei province, where a small or medium-sized enterprise (SME) prepares to become a listed company, the enterprise will be relieved from the administrative penalty and the overdue fines during the process of self-correction for listing if it pays taxes that are delayed unintentionally. See Hubei Provincial Local Tax Bureau Opinions on Tax Policy for Supporting the Development of Small Companies (Edizhengfa [2013] No. 71), art. 27.

<sup>31</sup> For example, there are no specific rules for the self-correction practices in the cities of Haikou, Tieling, and Loudi. See Notice of Haikou Local Tax Bureau on Conducting Self-Correction on Stamp Tax ([2016] 7); Notice of Tieling City Government on Forwarding Implementation Measures of City Local Tax Bureau on Census of Property Tax and Urban Land Use Tax Bases ([2015] 55); Notice of Loudi City Government on Conducting Special Inspection of Tax Collection and Administration ([2009] 3).

<sup>32</sup> For example, the local rules adopted in Hunan. See Hunan Provincial Local Tax Bureau Public Announcement on Hunan Tax Inspection Office Measures on Management of Self Correction ([2014] 5, issued and effective Feb. 17, 2014).

<sup>33</sup> For example, under the local rules on self-correction procedures in the cities of Fushun, Dalian, and Liupanshui, local tax bureaus have the discretion to decide whether or not to reduce or waive administrative penalties and even fines relating to late tax payments. They also have the discretion to determine administrative penalties within a broad range of 50 percent to five times the amount of tax due. See Notice of Fushun City Government on Forwarding Implementation Measures on Census of Property Tax and Urban Land Use Tax Bases ([2010] 16), Notice of Dalian Office of State Taxation Administration on Implementation Measures on Inspection of Tax Leakage ([2002] 62), and Liupanshui City Government on Forwarding Implementation Measures of Six City Bureaus on Special Tax Inspection on Vehicles Operation Industry in the City ([2005] 104).



that provide criteria for the reduction or waiver of penalties.<sup>34</sup> These local voluntary disclosure practices are not temporary measures, as they are not limited in time. Yet, the local authorities can change these practices or terminate them.

## B. Customs Voluntary Disclosure Program

Chinese customs authorities have adopted a nationwide voluntary disclosure program. In 2014, China's General Administration of Customs (GAC) launched a pilot voluntary disclosure program in ten customs offices, including Beijing, Shanghai, and Shenzhen. The program aimed to incentivize companies to voluntarily report noncompliance with the applicable customs rules and receive reduced penalties.

The pilot program began to be rolled out across the nation in October 2016 through a major overhaul of the Regulations on Customs Inspection (RCI), the most basic legislation relating to investigations by the customs authorities.<sup>35</sup> Article 26, which was added into the revised RCI, provides that enterprises or entities that import or export goods shall be subject to a reduced administrative penalty if they voluntarily disclose to the customs authorities any noncompliance with customs rules and regulations. This amendment offers a legal basis for the customs authorities to provide formal voluntary disclosure procedures.

After enacting this amendment, the GAC introduced a detailed chapter on customs voluntary disclosure procedures in the Implementation Measures of RCI (IMRCI).<sup>36</sup> A business entity's voluntary disclosure may be confirmed if the entity has taken the initiative or has voluntarily disclosed to the customs authorities its noncompliance or violation of the customs' regulatory rules, unless such disclosure falls into one of the following exclusions:<sup>37</sup> first, cases where the customs authorities had already obtained information about the disclosing entities' noncompliance; second, cases where the customs authorities had notified disclosing entities of an inspection; and third, cases where the disclosed information is substantially incorrect or incomplete.<sup>38</sup> An entity filing a timely and complete voluntary disclosure will be subject to reduced or no penalties once the disclosure report has been verified by the customs authorities.<sup>39</sup> Another IMRCI provision is that where the noncompliance is minor, has been corrected by the disclosing entity, and no damage has been caused, it should not be subject to

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<sup>34</sup> For example, local tax authorities in Anshan and Dalian have adopted rules that determine when the tax authority should grant a reduction or waiver of penalty. See Anshan Local Tax Bureau Implementation Measures (Provisional) on Regulating Administrative Discretion on Administrative Penalty (Andishuifa [2011] 37) art. 28, and Dalian State Tax Bureau Standards on Application of Tax Administrative Penalty (Dalian STB Public Notice [2014] 16), art. 43. The Beijing local tax bureau issued a similar document in 2003 to regulate the application of fines for late tax payment in 2003, though the document ceased to be in effect in 2007; see Beijing Local Tax Bureau Measures on Administration of Overdue Fines (Jingdishuizheng, [2003] 536) art. 24.

<sup>35</sup> Regulations of the People's Republic of China on Customs Inspection (State Council, revised Jun. 19, 2016, effective Oct. 1, 2016).

<sup>36</sup> Implementation Measures of RCI (GAC, Order No. 230, issued Sep. 26, 2016, effective Nov. 1, 2016), ch. 4.

<sup>37</sup> Implementation Measures of RCI, art. 25.

<sup>38</sup> *Ibid.* It is unclear whether the customs authorities have the discretion to deny a disclosure from the voluntary disclosure program where the disclosure satisfied all requirements and did not fall into the exclusions. Article 26 of RCI stipulates an entity shall be granted a reduction of penalty if it voluntarily discloses noncompliance and accepts handling decisions made by the customs authorities. By contrast, the relevant provision of IMRCI uses the term "may" in respect of confirming an entity's disclosure as "voluntary disclosure."

<sup>39</sup> Implementation Measures of RCI, arts. 26, 27.

the administrative penalty.<sup>40</sup> Finally, IMRCI provides that the customs authorities can reduce or waive fines for overdue taxes at their discretion.<sup>41</sup>

Prior to the roll-out of the nationwide customs voluntary disclosure program in October 2016, the rules and practices adopted by selected pilot regions varied.<sup>42</sup> For example, in Guangzhou, a voluntary disclosure report required participants to submit detailed information about their noncompliance, the reasons for such noncompliance, and details of the steps they would take to prevent noncompliance in the future.<sup>43</sup> In contrast, Shanghai's voluntary disclosure procedure was much simpler, requiring only the reporting entity's basic information and details of the violation.<sup>44</sup> The discrepancy in the local practices was eliminated upon the nationwide implementation of the revised RCI in 2016.<sup>45</sup>

It is unclear whether or not the customs voluntary disclosure program creates a sufficient incentive for noncompliant entities to self-report their noncompliance. According to the rules of the program, an exemption from penalties should only apply in cases of minor noncompliance, i.e., either a missed tax payment (or export tax refund) accounting for less than 10 percent of customs payable or refundable taxes, and the total amount should not exceed 250,000 yuan, or a procedural violation without leading to revenue losses to the government (Song, Xia, & Zheng, 2018). As a result, the incentive to participate is lower where the noncompliance is more serious and the customs underpayment is higher. In addition to the penalties, noncompliant entities may decide against participating in the program because they may incur indirect costs as a result of a reduction in their credit rating and their inclusion in governmental noncompliance lists. These factors may result in a suboptimal incentive to participate in the voluntary disclosure program. There is empirical evidence showing that large companies tend to have a greater motivation to participate in the program (Song et al., 2018).

#### IV. PROPOSAL FOR VOLUNTARY DISCLOSURE PROCEDURES

We have shown in the previous part that China has already adopted voluntary disclosure practices as part of its tax enforcement apparatus. Although the Chinese authorities could, in theory, outlaw these practices and disallow any reduction in the penalties for taxpayers that voluntarily report past noncompliance, the likelihood of this appears to be remote. As discussed above, the Chinese tax authorities have been increasing enforcement efforts, while reducing or waiving penalties for taxpayers who voluntarily disclose their past noncompliance and pay the required taxes. The fact that the STA and many local tax bureaus have long been implementing voluntary disclosure practices indicates that voluntary disclosure should generally result in lower penalties. The roll-out of the nationwide customs voluntary disclosure program indicates that China is in the process of facilitating more, not fewer, opportunities for voluntary disclosure as part of its efforts to improve law enforcement and tax compliance. The

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<sup>40</sup> Implementation Measures of RCI, art. 27 para. 1.

<sup>41</sup> Implementation Measures of RCI, art. 27 para. 2.

<sup>42</sup> China currently has 43 customs offices, and each office has subordinate offices. GAC of PRC, *Organization Structure*, <http://www.customs.gov.cn/customs/zsgk93/302254/index.html>.

<sup>43</sup> Guangzhou Customs Public Notice on Implementation of Enterprises Voluntary Disclosure [2016] No. 3.

<sup>44</sup> Shanghai Customs Public Notice on Implementation of Enterprises Self Disciplinary Management in Shanghai Pilot Free Trade Zone [2014] 32.

<sup>45</sup> GAC also issued rules for specific issues and zones, such as relief of overdue fees, and rules for selected regions, primarily designated free trade zones (FTZ). It is possible that GAC issued specific documents for FTZs because there are many international and domestic businesses engaged in cross-border trade in these FTZs. The procedures in the FTZs are largely similar to the nationwide procedures.

international experience and trends show that this approach is shared by many countries (OECD, 2015, p. 30).

The policy question that this part explores is whether the current voluntary disclosure policy is optimal. We first consider whether China should adopt nationwide voluntary disclosure procedures or whether it should continue the current practices. After concluding that nationwide procedures are likely to be superior to local and largely informal practices, we discuss the design considerations of such procedures.

## **A. Nationwide Procedures v. Current Practices**

China's current tax-related voluntary disclosure practices are largely informal.<sup>46</sup> At the national level, the STA does not follow a formal voluntary disclosure policy. At the local level, as discussed above, local tax authorities frequently have rules that allow self-reporting of tax noncompliance. However, in many localities, there are no detailed rules on the procedures and penalties.

Formal voluntary disclosure procedures, unlike informal practices, generally follow explicit statutory or regulatory rules on several substantive and procedural issues. A formal scheme will typically provide the parameters for calculating the applicable penalties, taxes, and interest, so that the implications of participating in the scheme will be predictable and certain. A formal scheme will also provide rules on eligibility for the scheme, the procedural requirements, and the prescribed process. Informal practices leave more discretion and flexibility to tax authorities, which could lead to the abuse of power without sufficient legal safeguards and scrutiny of the exercise of the discretion. The OECD (2015) states that a carefully drafted voluntary disclosure program can benefit everyone involved: taxpayers participating in the program, the general population of compliant taxpayers, and the government (p. 7). As discussed below, adopting nationwide formal voluntary disclosure procedures in China could improve the efficiency and the fairness of the Chinese tax system, and promote the rule of law in taxation.

### *1. Predictable Penalties and Participation Incentives*

Under current voluntary disclosure practices, the tax authorities frequently have broad discretion regarding the penalties, which may be assessed on a case-by-case basis. In addition, where there is no formal policy regarding the non-indictment of people who voluntarily disclose their tax noncompliance, participants could be at risk of criminal prosecution. Thus, under the current voluntary disclosure practices, taxpayers cannot predict with certainty the consequences of voluntarily disclosing their noncompliance. In contrast, the applicable penalties under a formal voluntary disclosure scheme are generally more predictable and certain.

As noted above, one of the advantages of a voluntary disclosure scheme is that risk-averse people benefit from paying a certain penalty (Kaplow & Shavell, 1994). Uncertainty regarding the applicable penalties under a voluntary disclosure scheme reduces that benefit. Noncompliant taxpayers, especially risk-averse ones, will have weaker incentives to voluntarily disclose their noncompliance if there is a substantial risk of high penalties.

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<sup>46</sup> This discussion does not refer to the customs voluntary disclosure program but only to the practices relating to taxes administered by tax authorities.

Therefore, it is possible that fewer taxpayers will voluntarily disclose their noncompliance under informal practices if the penalties are uncertain.

## 2. *Fairness*

Formal voluntary disclosure procedures can enhance the perception of fairness in the tax system.<sup>47</sup> Under nationwide voluntary disclosure procedures, taxpayers with similar conduct are more likely to be treated similarly. Where various local and largely informal procedures are implemented, and tax officers have broad discretion regarding the penalties and the process, there is a higher likelihood that taxpayers with similar conduct will be treated differently. This variation should be lower where the penalties and the process follow nationwide procedures.

In addition, voluntary disclosure procedures should not create an unfair advantage for noncompliant taxpayers who participate in the voluntary disclosure scheme over compliant taxpayers. Under varying local and largely informal voluntary disclosure practices, there is a risk that some tax officers might grant excessively favorable treatment to tax evaders who voluntarily disclose their tax evasion. This concern can be addressed by the STA adopting uniform nationwide procedures.

## 3. *Administrative and Compliance Costs*

The government's costs of administering, and the taxpayers' costs of participating in, a nationwide scheme would likely be lower than the costs of the current practices. With nationwide voluntary disclosure procedures, noncompliant taxpayers who wish to voluntarily disclose their noncompliance will likely need to engage tax advisers (such as tax lawyers and accountants), who will prepare the required tax returns, forms, and documents. The reporting requirements can address common problems encountered by voluntary disclosure filers.<sup>48</sup> Where the requirements are clear, and common problems are addressed, the cost of filing a voluntary disclosure (exclusive of the cost of the applicable penalties and taxes) should be relatively low. The cost of filing a voluntary disclosure might be higher where there are no formal and uniform procedures. Where the practices vary across tax authorities, the cost of services provided by tax advisers could be higher because tax advisers need to invest more time in learning the applicable requirements, and communicating and negotiating with the relevant tax officers.<sup>49</sup>

The cost of administering nationwide procedures could be lower than the cost of administering local and largely informal practices. The cost of implementing well-designed rules that require little or no discretion is likely to be lower than the cost of implementing practices under which tax officers have broad discretion to make decisions on a case-by-case basis. In addition, tax officers incur additional costs when they need to communicate their requirements to the taxpayers and their representatives, and to negotiate with them.

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<sup>47</sup> For further discussion about tax fairness and horizontal equity, see Galle (2008) and the literature reviewed in that article.

<sup>48</sup> For example, the U.S. OVDP offered a simplified computation method for passive foreign investment companies because many participants did not have the historical data required for the tax filings under the general rules. This solution reduced the compliance costs without materially changing the taxes due (Noked, 2018c).

<sup>49</sup> This argument is similar to the comparison of rules and standards in the law and economics literature (Kaplow, 1992). If each local bureau or each officer needs to develop their own rules, then the cost would be higher than implementing centrally designed rules.

#### 4. Coordination with Non-Tax Regulators

More costs may be saved by adopting nationwide procedures that facilitate coordination with non-tax regulators. Some taxpayers who have not reported their offshore assets and income may also have violated China's currency exchange control rules. Nationwide voluntary disclosure rules can provide a way for taxpayers to correct their affairs with the tax authorities and other regulators at the same time. As discussed below, countries with currency exchange control regimes typically address the exchange control issues as part of their voluntary disclosure schemes. It would be harder to facilitate such coordination under local and largely informal practices.

#### 5. Compliance Incentives and Stricter Tax Enforcement

Where the expected penalties under formal procedures and informal practices are similar, the *ex-ante* incentive for taxpayers to engage in tax evasion should generally be similar. To the extent that compliance is affected by taxpayers' notions of the tax system's fairness, formal procedures have the potential to increase the general compliance because they are fairer, as discussed above, in Section IV. A. 2 ("Fairness"). In addition, well-designed formal procedures could result in more tax evaders becoming compliant, as discussed above, in Section IV.A.1 ("Predictable Penalties and Participation Incentives"). Therefore, adopting formal voluntary disclosure procedures instead of informal practices may increase long-term compliance.

Importantly, China is transitioning into a stricter tax enforcement regime, especially with respect to offshore financial assets. As from late 2018, China has received, on an annual basis, information about Chinese tax residents who hold offshore financial assets in financial institutions in dozens of countries. As of February 2020, China has been conducting AEOI with 69 jurisdictions, and this number will increase in the future.<sup>50</sup> AEOI will likely expose noncompliance by some Chinese tax residents who have not reported income from these offshore financial assets in their tax filings in China. Introducing formal nationwide voluntary disclosure procedures with enhanced information transparency could incentivize noncompliant taxpayers to become compliant before the government spends resources on investigations.

In addition to implementing AEOI, the Chinese tax authorities are increasing their efforts to curb onshore individual tax evasion. China's IIT reform, which took effect on 1 January 2019, aims to tackle inequality by reducing the tax burden on low and middle-income earners, and taking a tougher stance on high-income earners and foreign workers (Wong, 2018; Zhou et al., 2018). Several commentators note that the enforcement efforts targeting wealthy Chinese tax residents may see a significant increase in the next few years (Zhou et al., 2018). They also note that the merger of state tax bureaus and local tax bureaus in 2018 is also likely to strengthen IIT enforcement, particularly vis-à-vis wealthy Chinese residents (Zhou et al., 2018).<sup>51</sup> One reason for this improvement in enforcement is the STA's increased ability to collect information from various provinces and sources (Li & Krever, 2018).

Moreover, the rapid advancement in information systems for tax administration, and the enhanced collaboration and cooperation with other government agencies that have taken place

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<sup>50</sup> For China's AEOI relationships, see "Activated Exchange Relationships for CRS Information" (2020) on the OECD website: <http://www.oecd.org/tax/automatic-exchange/international-framework-for-the-crs/exchange-relationships/>

<sup>51</sup> Until the reform in 2018, local tax bureaus were responsible for the collection of IIT. After the reform, the unified tax administration is responsible for the implementation of IIT (Li & Krever, 2018).

in recent years have played a role in improving tax law enforcement.<sup>52</sup> These reforms and developments indicate that China is transitioning into a regime of stricter enforcement of tax laws.

Some analysts contend that voluntary disclosure may be desirable where there is a transition into stricter compliance (Alm et al., 1990; Fisher et al., 1989). Amnesties facilitate a fairer transition to a tougher enforcement regime (Leonard & Zeckhauser, 1987), and an amnesty that comes unexpectedly may accelerate the transition to such a regime (Macho-Stadler, Olivella & Pérez-Castrillo, 1999). Increasing enforcement efforts is likely to lead to more formal and informal voluntary disclosures.<sup>53</sup>

In light of China's transition into a stricter tax enforcement regime, adopting nationwide voluntary disclosure procedures would be timely and advantageous. There could be substantial cost savings if China were to adopt nationwide procedures. Tax authorities' resources are frequently scarce. Adopting such procedures at the national level can achieve cost-efficiency in the transition to a better tax enforcement regime. Such procedures could enhance transparency, consistency, and certainty. Finally, when there is a transition into a stricter enforcement regime, offering a scheme that provides penalty relief incentives for participants is less likely to erode long-term tax compliance (Alm et al., 1990; Fisher et al., 1989; Macho-Stadler et al., 1999), and could be perceived as fair (Leonard & Zeckhauser, 1987).

## B. Design Considerations

The question of how to design voluntary disclosure procedures involves several policy decisions. The discussion below elaborates on several key issues that policymakers in China should consider.

### 1. Covered Taxes and Offenses

Voluntary disclosure schemes are generally available for taxpayers who have committed tax evasion or related offenses. In countries with currency exchange control, schemes may provide relief for currency exchange control violations.<sup>54</sup> Voluntary disclosure schemes do not typically provide relief for offenses unrelated to the tax noncompliance. In general, if a taxpayer has earned taxable income through illegal activities, such as drug trafficking, and this income has not been reported, he or she might be able to report the income through a voluntary disclosure scheme, avoiding prosecution and harsh penalties for the tax offenses. However, the taxpayer

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<sup>52</sup> As noted by several tax commentators, China's tax authorities have become more equipped to supervise and detect taxpayers' non-compliance with the assistance of the latest big data technologies to perform data analysis (Zhou et al., 2018). For a recent review of China's tax development and the use of internet and information technology in taxation, see STA, State Taxation Administration Annual Report 2018, available at <http://www.chinatax.gov.cn/download/pdf/swnb2018en.pdf>, at 80-89. China's active participation in the OECD-led information exchange programs has also helped tax authorities to obtain necessary information about taxpayers' financial situations overseas to improve tax law enforcement. See STA Annual Report 2018, at 90-106.

<sup>53</sup> Johannesen et al. (2018), estimated the compliance responses to the U.S. enforcement efforts starting in 2008. They documented a sharp increase in self-reporting of offshore accounts that coincided with the enhanced enforcement efforts (Johannesen et al., 2018). Some of the self-reporting of offshore accounts was through the formal voluntary disclosure program (OVDP), although the majority of people who self-reported filed "quiet disclosures" outside the OVDP. For taxpayers participating in the OVDP and filing quiet disclosures, there was a substantial increase in the reported taxable capital income after the disclosure.

<sup>54</sup> See the discussion *infra* on currency exchange control issues.

may be charged for the non-tax offenses he or she has committed. Some countries' voluntary disclosure schemes do not apply to taxpayers with illegal sources of income.<sup>55</sup>

It is important to determine the taxes and offenses that would be covered under the voluntary disclosure scheme. One approach would be to specify that the scheme will cover specific taxes and laws (e.g., income tax, value-added tax, customs duty, and currency exchange control violations). Alternatively, it is possible to adopt a broader approach in which the participants who satisfy the requirements of the scheme will not be subject to any criminal liability for any offense committed in connection with the reported conduct except certain serious crimes.

Immunity from criminal charges can also be provided to parties related to the participants who may have been involved in related offenses. For example, a voluntary disclosure scheme in Argentina exempted from criminal liability not only the participants, but also other parties that may have been involved in related offenses, including managers and auditors (Michaels et al., 2015). This approach increases the incentive to participate in the voluntary disclosure scheme. If a director or another party who might have been involved in the noncompliance is not released from liability, that party might use its influence over the noncompliant taxpayer so as to not participate in the voluntary disclosure program.

## 2. Eligibility

Who should be eligible to participate in a voluntary disclosure scheme? Some countries' schemes require that the taxpayer is not currently under an audit or investigation. For example, in the United States, a taxpayer is generally not eligible to participate in a voluntary disclosure program if he is under investigation, regardless of whether he knows about the investigation.<sup>56</sup> As taxpayers might be under investigation without their knowledge, they can ask for pre-clearance to confirm that they are eligible for the voluntary disclosure program.<sup>57</sup> Similarly, entities under investigation cannot participate in China's customs voluntary disclosure program. South Africa's voluntary disclosure program disqualifies taxpayers who were given notice of an audit or investigation, although exceptions can be made if the tax authority believes the reported noncompliance would not have been detected through the audit or the investigation.<sup>58</sup> Other countries have adopted more lenient approaches to eligibility. For example, Sri Lanka's past tax amnesties allowed taxpayers under investigation or prosecution to participate.<sup>59</sup> The economic literature suggests that a voluntary disclosure scheme with reduced penalties may be optimal not only before criminals are detected, but also where criminals are detected but not yet convicted (Feess & Walzl, 2005). As China's customs voluntary disclosure program excludes entities that are already under investigation, it is likely that tax voluntary disclosure procedures in China will adopt a similar approach. The current practices of the Chinese tax authorities appear to be consistent with this position.

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<sup>55</sup> For example, see the U.S. Voluntary Disclosure Practice; U.S. IRM section 9.5.11.9(2)

<sup>56</sup> U.S. IRM section 9.5.11.9(4). This was also a requirement under the U.S. OVDP.

<sup>57</sup> For more information about the pre-clearance process, see Noked (2018c). A U.S.-style approach might deter taxpayers from voluntarily disclosing their unreported income and assets. This is because the tax authority might have some information about the taxpayer, such as information obtained through AEOL, but it has not yet launched a meaningful investigation against the taxpayer. Depending on the tax authority's definition of "investigation," there is a risk that such a taxpayer might be disqualified from participating in the voluntary disclosure scheme. If such a taxpayer files a pre-clearance request, this might increase the likelihood of him being investigated and prosecuted. As a result, tax evaders might decide to avoid this risk by not participating in the voluntary disclosure scheme.

<sup>58</sup> South Africa Revenue Service (n.d.) at 4.

<sup>59</sup> Sri Lanka, Inland Revenue (Special Provisions) Act (No. 10 of 2003) sec. 4.

China will also need to consider whether both entities and individuals should be allowed to participate in the schemes. Some countries, such as France and Austria, had special programs that allowed only natural persons to participate (OECD, 2015, pp. 41, 60). In cases where entities are closely held, there may be little practical importance to such limitations. China's current practices have primarily focused on entities. However, it is possible that the improvement of individual income tax enforcement would result in a stronger incentive for individuals to correct their tax affairs.<sup>60</sup>

In order to deter voluntary disclosure filers from future noncompliance, it is possible to allow taxpayers to participate in a voluntary disclosure scheme only once. Alternatively, it is possible to allow repeat tax evaders to voluntarily disclose their noncompliance more than once, but impose harsher penalties on recurring noncompliance.<sup>61</sup>

### *3. Penalties, Taxes, and Interest*

#### *a. Penalties*

Most countries that offer voluntary disclosure schemes generally do not impose criminal charges on eligible participants that comply with the terms of the schemes (OECD, 2015; Michaels et al., 2015). Although China's current practices do not explicitly address this issue, it appears that noncompliant taxpayers who make timely and complete voluntary disclosures on their own initiative are not charged with tax crimes. If the government intends to provide a waiver of criminal penalties for filers of timely and complete voluntary disclosures, this should be made clear in the formal procedures. This would benefit risk-averse people and create a stronger incentive for voluntary disclosure (Noked, 2018c).

Countries often reduce or waive civil penalties for voluntary disclosure filers (OECD, 2015). As noted above, the penalties should be equal (or slightly less than) the penalties that would apply if the taxpayer were caught, multiplied by the probability of the taxpayer being caught (Kaplow & Shavell, 1994). In reality, setting the penalties at their optimal level is challenging because taxpayers' probabilities of getting caught and the expected penalties vary. As it is impractical to calculate the optimal penalty for each taxpayer, it is possible to group together taxpayers with similar characteristics (Noked, 2018c). The United States tries to follow this approach by treating taxpayers who willfully evade tax and non-willful noncompliant taxpayers differently. Although it is justified to impose stricter penalties on taxpayers with a higher level of culpability, it is more costly to administer multiple schemes for multiple groups of voluntary disclosure filers, and there is a risk that tax evaders with high levels of culpability would falsely argue that they meet the criteria that qualify them for a more lenient penalty regime.<sup>62</sup>

As noted above, Chinese tax authorities have already been reducing or waiving penalties for taxpayers who voluntarily reported their past noncompliance and settled their unpaid taxes. Adopting a predictable and certain penalty policy would encourage taxpayers to disclose their noncompliance voluntarily. It would also promote fairness and transparency because participants with similar conduct would be subject to the same penalty regime. However, to mitigate the potential unfairness between taxpayers with higher and lower levels of culpability,

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<sup>60</sup> The broad term "parties", under Article 27 of AML for eligibility of penalty relief, can be interpreted to include individuals.

<sup>61</sup> There should be some reduction in penalties to create an incentive to participate in the scheme.

<sup>62</sup> In the United States' experience, there was a concern that willful tax evaders certified that they were non-willful in order to receive lower penalties (Oei, 2018).



the voluntary disclosure procedures can provide that the applicable penalties may deviate from the standard penalty policy in certain limited circumstances, subject to case-by-case approval by the STA.

### ***b. Taxes***

General voluntary disclosure schemes usually require the payment of the full tax due with respect to a period of noncompliance (OECD, 2015, p. 30). Some countries adopt certain simplified calculation methods for calculating the tax owed in past years.<sup>63</sup> This simplification can be designed so that it does not reduce the amount of tax due. Some countries' temporary tax amnesties relieve, in whole or in part, taxpayers from paying their unpaid taxes (OECD, 2015, p. 30). International Monetary Fund researchers recommended that tax amnesties should not reduce the amount of tax owed (Baer & Le Borgne, 2008). Reducing tax evaders' tax liability may be perceived as being unfair to taxpayers who have been compliant and may erode long-term compliance. However, some analysts argue that reducing the tax liability may accelerate the transition to a regime of stricter enforcement (Macho-Stadler et al., 1999). Therefore, permanent voluntary disclosure procedures should require full payment of the unpaid taxes for previous years. Reduction of the tax liability may be considered on a limited basis where stricter tax enforcement is expected.

Currently, China's voluntary disclosure practices and government rules do not grant any reduction of the tax liability for voluntary disclosure filers. We expect that the payment of the unpaid tax would be required if China were to adopt formal voluntary disclosure procedures. The procedures should explicitly require the payment of the unpaid tax for a specified number of previous years in order to enhance certainty and incentives for taxpayers to participate.<sup>64</sup>

### ***c. Interest***

The approach with respect to interest charges depends on whether the interest is punitive or whether it reflects the time value of money. Reducing or waiving punitive interest charges should be considered a reduction of penalties. Where interest is not charged at all under the terms of a voluntary disclosure scheme, the benefit for the participants goes beyond waiving penalties because they receive the time value of money from deferring the payment of their unpaid taxes. Thus, a permanent voluntary disclosure scheme that only reduces penalties should impose interest charges to account for the time value of money (Baer & Le Borgne, 2008). Following this approach, the STA should consider adjusting the late payment surcharge so that it would account for the time value of money without punitive charges for voluntary disclosure filers.

## ***4. What Information Must be Disclosed***

The details of the disclosure requirements should be based on the features of the voluntary disclosure scheme. Many countries require the filing of amended tax returns for a specified number of previous years. In addition, some countries prescribe certain forms or require additional certifications and information from participants in voluntary disclosure schemes. If

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<sup>63</sup> For example, a scheme in the United Kingdom offered a simplified method of calculating the taxes due (Michaels et al., 2015). The U.S. OVDP offered a simplified computation method for passive foreign investment companies (Noked, 2018c).

<sup>64</sup> For example, the United States requires the filing of tax returns for the past six years. See Updated Voluntary Disclosure Practice (2018).

there are eligibility requirements, the voluntary disclosure filers should provide information and documents to support the claim that they meet these requirements.<sup>65</sup>

The OECD (2015) notes that governments can use the information obtained from voluntary disclosure filers for intelligence gathering in order to gain a better understanding of tax evasion practices and weaknesses in the tax enforcement system (p. 15). Governments can also use this information to identify financial institutions, advisers, and other intermediaries who have helped to facilitate tax evasion.<sup>66</sup>

### *5. The Permanent Nature of the Procedures*

Voluntary disclosure in exchange for a reduced penalty, as suggested in the law and economics literature, should be a permanent part of the law enforcement system (Kaplow & Shavell, 1994). Thus, the voluntary disclosure procedures envisaged in this article should be offered on a permanent basis, so that taxpayers will always be able to voluntarily disclose their noncompliance and receive reduced, predictable penalties. The STA can be authorized by law to change the procedures from time to time. This should be in line with China's LAP on penalty reduction and waiver in general.

### *6. Foreign Exchange Issues*

It is important to consider the coordination between tax and currency exchange control policies. In general, the same conduct of holding unreported offshore assets may violate both tax laws and foreign exchange control laws. Currently, where Chinese taxpayers' conduct involves noncompliance with tax laws and currency exchange laws, they cannot correct their affairs with the relevant tax bureau and the relevant currency exchange control office on a coordinated basis—they need to approach each authority separately.

Several countries that have currency exchange restrictions addressed currency exchange control issues through their voluntary disclosure schemes.<sup>67</sup> The Chinese government may consider providing a similar mechanism for coordination between the tax authorities and SAFE. This could address noncompliance that involves both tax and currency exchange rules through one process, and reduce the overall administration and compliance costs.

Importantly, uncoordinated penalty policies may disincentivize taxpayers from voluntarily disclosing their noncompliance. If a taxpayer voluntarily discloses that he or she holds offshore assets, this information might be shared with SAFE. Even if there are reduced penalties or no penalties for the tax violations, taxpayers may decide not to voluntarily disclose if they believe that SAFE might impose high penalties based on foreign currency control rules. Therefore,

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<sup>65</sup> For example, under the U.S. Streamlined Procedures for taxpayers whose failure to report offshore financial assets and income was non-willful, filers should certify, under penalty of perjury, that their noncompliance “did not result from willful conduct on their part.” See “Streamlined Filing Compliance Procedures” (2020).

<sup>66</sup> For example, the U.S. OVDP required disclosing details of the financial institutions that handled unreported offshore accounts, details of people who advised or assisted the participant in opening the offshore accounts, and information on representatives of foreign financial institutions that advised the participant to hold funds offshore or not to report them in the United States. See IRS Form 14454.

<sup>67</sup> For example, South Africa, Argentina, and Sri Lanka offered schemes that addressed both tax and currency exchange control noncompliance. See Rosso Alba (2016) regarding Argentina; “Voluntary Disclosure Programme (VDP)” (2018), (regarding South Africa's Special Voluntary Disclosure Programme); Sri Lanka, Tax and Foreign Exchange Amnesty Act (No. 4 of 1997); Sri Lanka, Tax and Foreign Exchange Amnesty Act (No. 47 of 1998); Sri Lanka, Inland Revenue (Special Provisions) Act (No. 10 of 2003).

adopting a coordinated, predictable, and certain penalty policy that addresses both the tax and currency exchange issues could incentivize taxpayers to disclose their noncompliance voluntarily.

The design of the voluntary disclosure procedures can address concerns about tax privacy.<sup>68</sup> For example, the voluntary disclosure procedures can provide that a person who files a voluntary disclosure with the tax authorities could choose that his or her information would also be shared with SAFE, and that both tax and currency exchange noncompliance issues would be addressed through one process.<sup>69</sup>

Policymakers can further consider whether the repatriation of offshore funds back to China should be required, and whether taxpayers' choice to repatriate funds should affect their tax liability and penalties.<sup>70</sup>

## V. CONCLUSION

The OECD (2015) stated that “[f]or countries that have not yet done so, it would seem timely to consider introducing a voluntary disclosure programme and how it might be designed” (p. 14). Following the OECD recommendation, this article considers how China should design its voluntary disclosure policy. It identifies the advantages of adopting nationwide voluntary disclosure procedures to replace the current voluntary disclosure practices. It also explores the design considerations of such procedures. Adopting nationwide voluntary disclosure procedures would be timely and appropriate as China is modernizing its tax laws and strengthening its tax enforcement.

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<sup>68</sup> For a discussion on the benefits and costs of tax privacy and the extensive literature on this topic, see Blank (2011). This debate is outside the scope of this article.

<sup>69</sup> The discussion about tax privacy assumes that there is little or no information leakage and informal information sharing in the absence of formal information-sharing mechanisms. This discussion has little importance if tax privacy is not protected, even if there are no formal information-sharing mechanisms.

<sup>70</sup> For example, the Indonesian tax amnesty imposed lower tax rates where the taxpayers repatriated the relevant offshore funds (“Tax Amnesty Program Indonesia”, 2017). Another example is a Mexican tax amnesty which required the repatriation of all the unreported offshore funds (Aguayo-Garza & López-Domínguez, 2017).

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