ALIBABA’S VIE STRUCTURE AND EROSION OF BEPS GOALS IN CHINA’S E-COMMERCE INDUSTRY

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ABSTRACT

Alibaba stands as China’s underdog success story in the e-commerce industry, yet much remains unexplored about the consequences of its unique Variable Interest Entity (VIE) structure. Chinese e-commerce companies turned to the VIE structure as a means to circumnavigate China’s restrictions against foreign ownership. The VIE structure operates through a network of contracts between China and an offshore entity based in a low-tax jurisdiction. The VIE structure poses many legal uncertainties, and this Note addresses its ambiguous tax consequences through an analysis of the base-erosion and profit shifting (BEPS) Action Plans and their application to Alibaba’s VIE structure.

In 2013, the Organisation for Economic Co-Operation and Development (OECD) announced its fifteen Action Plans to eliminate BEPS harmful tax practices among multinational enterprises. This Note addresses how the VIE structure exacerbates the use of tax havens (Action 5), illegal transfer pricing (Actions 8–10), and permanent establishment distortion (Action 7), thereby undermining the specific actions pronounced in BEPS. This Note argues that the tax implications from China’s VIE structure are incompatible with the aims of BEPS and offers suggestions for China and the international community to close this tax loophole. This Note asserts that a “wait and see” approach for the validity of VIEs is destined to fail and risks delegitimizing the BEPS Action Plans.
I. INTRODUCTION

In November 2012, Margaret Hodge, the United Kingdom’s then-Chair of the Public Accounts Committee, grilled executives from Starbucks, Google, and Amazon about their companies’ tax avoidance in the United Kingdom. Chairwoman Hodge expressed her frustrations with Amazon.co.uk’s advantageous relationship with Luxemburg, where all their profits seemed to end up. She

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exclaimed, “I thought I was buying from a U.K. company, which was delivered from a U.K. warehouse, [items] that have never appeared in any other jurisdiction.” She then demanded, “[w]hy aren’t you paying corporation tax in the U.K?” Similarly, Hodge and her committee members wanted to know how Starbucks kept claiming millions of pounds in losses in the United Kingdom over a fourteen-year period while boasting to investors about how great business is going in the United Kingdom. Member of Parliament Mr. Austin Mitchell asserted, “[y]ou are either running the business very badly, or there is some fiddle going on.”

At the time of the Public Accounts Committee hearing in 2012, Starbucks had operated in the United Kingdom for fifteen years. During the entirety of that decade and a half, Starbucks only paid £1.6 million in corporate taxes, whereas its competitor, Costa, paid £15.5 million in taxes for the 2010–2011 Fiscal Year alone. However, the United Kingdom’s hands are tied because none of the financing strategies of Starbucks, Google, or Amazon are illegal. The United Kingdom is not alone in feeling frustrated and embittered about the clever tax loopholes available to multinational enterprises (MNEs). Reports show that countries are “losing up to ¼ of a trillion dollars of tax revenues annually” from the failure to address tax avoidance maneuvers.

The issue of tax avoidance is universal—every country and industry feels its effects. Yet, one industry and jurisdiction in particular has been largely overlooked—the e-commerce industry in the People’s Republic of China (China). In a notable shift from its previous role as a capital importer, China transformed into

3. Id. at Q347.
4. Id. at Q348.
5. When questioning Starbucks representative Mr. Troy Alstead, Chairwoman Hodge argued, “I can take you to 2011 [where you had] losses of £33 million, and John Culver, president of the international division, told investors, ‘we are very pleased with the performance in the UK.’ Yet you filed £33 million losses.” Id. at Q197.
6. Id. at Q235.
7. Id. at Q204.
8. Public Accounts Committee, Minutes of Evidence, supra note 2, at Q235.
9. See Stephanie Gruner Buckley, What Amazon, Google, and Starbucks Said to MPs About Why They Pay Little or No UK Tax, QUARTZ (Nov. 12, 2012), https://qz.com/26498/what-amazon-google-and-starbucks-said-to-mps-about-why-they-pay-little-or-no-uk-tax/ (quoting committee chairwoman Hodge who asserted that the committee was not accusing Amazon, Google, and Starbucks of acting illegally, but of being immoral).
10. A MNE is also referred to as a “MNC”—a multinational corporation. This Comment will use “MNE.”
12. See id. (describing gaps in international tax laws as an issue that affects all countries).
the world’s second largest capital-exporter. China’s digital economy significantly contributed to this dramatic shift. China’s e-commerce market is growing at an exponential rate, far surpassing that of the United States. Chinese consumers turn to e-commerce because online retailers have lower costs, higher quality, and a wider selection of goods. E-commerce platforms, such as Alibaba and JD.com, provide an easy and convenient way for interested foreign businesses to expand into the Chinese market. Chinese MNEs have utilized offshore jurisdictions, such as the Cayman Islands, to funnel direct investment and to avoid taxes as well as to “conceal the ownership of assets and to gain access to foreign capital markets.” These e-commerce titans in China use a unique corporate structure called a “variable interest entity” (VIE), which presents significant tax avoidance issues.

As discussed below, a VIE structure operates through a network of contracts across various jurisdictions—primarily the United States, Cayman Islands, British Virgin Islands, and China—to skirt government regulations and to permit more capital flow for China’s e-commerce businesses. Companies using a VIE structure are able to assert that they are not residents in their primary operating jurisdiction. For example, Alibaba Holding Group, Ltd. (AHG)—the holding company for

14. See Chris Xing et al., China After BEPS, for Now . . ., INT’L TAX REVIEW (Nov. 28, 2017), http://www.internationaltaxreview.com/Article/3772187/China-after-BEPS-for-now.html (noting that China’s transformation began in 2005 and discussing how China’s outward direct investment overtook its foreign direct investment in 2015, not only making China a capital exporter for the first time but also the world’s second-biggest exporter).
15. Id.
18. Alibaba is China’s—and one of the world’s—biggest e-commerce company, with three websites that host millions of sellers and businesses. JD.com is also a large Chinese e-commerce company and competitor of Alibaba. See David Meyer, China Now Has Two of the Top Ten Most Valuable Brands in the World for the First Time, FORTUNE (May 29, 2018), http://fortune.com/2018/05/29/chinese-brands-alibaba-tencent-brandz/.
20. In finance, the term “offshore” is used to refer to foreign banks, corporations, and investments, which are often used for tax evasion. See generally AHMED ZOROME, INTERNATIONAL MONETARY FUND, CONCEPT OF OFFSHORE FINANCIAL CENTERS: IN SEARCH OF AN OPERATIONAL DEFINITION (2007).
22. See infra Part II.A for the definition of VIEs and how they are used to avoid taxes.
23. See infra Part II.A for a discussion on the special entity structuring of VIEs.
Alibaba listed on the New York Stock Exchange (NYSE)—claims that it is not subject to tax in China. The expansion of Alibaba and JD.com into other markets through new brands and business units, such as Tmall Global and Joybuy.com, raises concerns over whether they are creating a global tax avoidance scheme through the VIE structure.

Tax avoidance by China’s e-commerce industry also has implications for the international community. In 2013, the Organisation for Economic Co-operation and Development (OECD) announced the launch of action plans designed to eliminate tax avoidance practices, calling the project “Base Erosion and Profit Shifting” (BEPS). Two years later the OECD released fifteen BEPS Actions, which seek to combat, among other objectives, double taxation, non-taxation, and tax havens. The OECD continues to release updated reports for each BEPS Action.

China, along with sixty-seven other jurisdictions, signed a multilateral instrument to implement the BEPS Actions in June 2017. The implementation and enforcement of tax avoidance laws to the VIE structure concern the international community, especially considering China’s dominance in the e-commerce industry. Furthermore, given that China is the world’s second-largest economy, with the world’s largest population, the inability to prevent the suspicious VIE avoidance scheme raises serious concerns for the international community.


31. See Closing Tax Gaps—OECD Launches Action Plan on Base Erosion and Profit Shifting, supra note 27 (“The Action Plan recognizes the importance of addressing the digital economy, which offers a borderless world of products and services that too often do not fall within the tax regime of any specific country, leaving loopholes that allow profits to go untaxed.”).


corporate structure from flourishing could cause many headaches down the road. Additionally, governments and the international community benefit from the success and legitimacy of BEPS. If states fail to regulate or implement BEPS’ goals for growing industries, such as China’s e-commerce industry, BEPS faces the risk of delegitimization.

This Comment will explore the aforementioned issues with VIEs and BEPS in relation to China’s e-commerce industry. Part II will define the VIE structure as well as the contracts and partnerships it relies on to function. An outline of the BEPS Actions follows in Part III with an emphasis on Action 1 (digital economy), Action 5 (harmful tax practices), Action 7 (permanent establishment), and Actions 8–10 (transfer pricing). Part IV of this Comment will address reasons why VIEs flourish in China specifically and how Chinese regulations regarding the e-commerce industry encourage their use. Part IV will also discuss Alibaba’s VIE structure and how its unique “Alibaba Partnership” creates a precarious corporate governance framework. Part V will outline how the current tax laws and regulations in China may apply to the VIE structure. Part V will further identify the difficulties in adapting the rules to Alibaba’s fragmented VIE structure while noting the company’s public responses concerning its corporate structure and tax liabilities. Finally, this Comment will conclude with proposed solutions for both China and the international community, specifically the OECD, to clarify the tax implications of the VIE structure. This Comment will argue that the growth and extension of China’s e-commerce industry and its use of the VIE structure will further erode BEPS’ aim and purpose, and failure to take any step toward regulation of VIEs greatly risks delegitimating BEPS.

II. VARIABLE INTEREST ENTITIES

_The Economist_ summed up the unique VIE structure in an illustrative way: “[i]t is as if Facebook were domiciled in Samoa, listed in Shanghai and its website and brand sat in separate legal entities that were the property of Mark Zuckerberg (but which he had agreed to allow Facebook to run and profit from).” The future legality of VIEs remains dubious. Alibaba continues to make 91% of its revenue in mainland China, despite its foreign incorporation in the Cayman Islands. Yet, the Chinese internet sector is growing rapidly and backed by middle-class demand so

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34. See infra Part II.C for a discussion of VIEs’ legal vulnerabilities.
35. See 2015 Final Reports Information Brief, supra note 28, at 3 (“The confidence that citizens have as to the fairness of the tax system is also at stake when there is a perception that some can legally avoid tax liabilities.”).
37. See id. (discussing the many uncertainties over the legality of VIEs and how they are China’s version of too-big-to-fail institutions).
38. Id.
39. Id.
40. See generally Cheng Li, _Introduction to CHINA’S EMERGING MIDDLE CLASS: BEYOND_
Chinese authorities have an incentive to keep the VIE structure afloat.41 The failure of Chinese authorities to take action against VIEs will likely expand their use and popularity, making any future retraction of them unreasonable or more difficult.42

Recently, over 100 Chinese companies have structured their businesses using a VIE, including many e-commerce companies.43 These companies utilized the VIE structure to circumvent China’s strict rules against foreign investment in certain sectors, such as the internet and telecommunications,44 and to open up such sectors to foreign investors, including those in the United States.45 Virtually every giant e-commerce company operating in China—Alibaba, Amazon China, Baidu, Tencent, and Weibo—are not actually Chinese companies; rather, they are foreign companies using a VIE structure.46 For such businesses, VIEs have proved astoundingly successful, garnering about $1 trillion from foreign investors.47

A. Defining a VIE

In China, a VIE is a business structure built upon a series of contracts between an offshore company and an onshore operating company for the purpose of circumnavigating China’s strict laws against foreign ownership.48 The offshore company may become a publicly listed company, in the United States for example, and shareholders own equity in the offshore holding company.49 Shareholders thus have “de facto control” over the operating company.50 The conglomeration of contracts entitles the offshore company to obtain “future benefits,” such as “variable interest,” from the onshore operating company.51 Certain reporting requirements


41. See Zhang, supra note 13 (suggesting that Chinese tax authorities are reluctant to crack down on taxing e-commerce sellers to protect economic growth).

42. See infra Part IV for a discussion on how the VIE structure flourished in China.


45. A Legal Vulnerability, supra note 36.


47. A Legal Vulnerability, supra note 36.


50. Id. at 1307.

51. Brown, supra note 48, at 201.
demand that the variable interests all be consolidated into a listed company’s (the offshore company’s) financial disclosures “to discourage accounting fraud and duly promote transparency.”

VIEs essentially give foreign investors “control[] through contracts, rather than ownership.” Appendix Figure 1 shows a diagram of the complicated relationships between VIEs and other entities.

The offshore holding company, or a “special purpose vehicle” (SPV), is typically located in a low-tax jurisdiction, such as the Cayman Islands. Chinese founders of the operating company also hold an equity stake in this offshore holding company. In turn, this offshore company “channels equity capital into a wholly foreign-owned enterprise (WFOE).” The WFOE is typically located in Hong Kong “to act as a legal buffer as well as an entry point into China.”

Due to its foreign status, the WFOE operating in China is unable to operate and obtain essential licenses in China. To overcome this issue, the WFOE creates a domestic operating company (Chinese Op. Co.) in China owned only by Chinese shareholders. The WFOE then enters into various contractual agreements—the “last link of the chain with actual equity ownership”—to enable it to vest operating power in the domestic operating company. The Chinese Op. Co., through these contractual agreements, usually transfers profits and voting rights back to the WFOE. In turn, the WFOE will transfer profits to the offshore holding company.

Given the Chinese nationality of the shareholders, the Chinese Op. Co. is in compliance with Chinese laws regulating investment ownership.

Scholars have dubbed the structure of a VIE as “creative compliance.”

52. Id.
53. Lin & Mehaffy, supra note 44, at 444 (emphasis added); see also Li Guo, Chinese Style VIEs: Continuing to Sneak Under Smog?, 47 CORNELL INT’L L.J. 569, 580 (2014) (discussing how the contractual ownership structure of VIEs looks similar to equity ownership).
55. Guo, supra note 53, at 578.
57. Brown, supra note 48, at 204.
59. See Guo, supra note 53, at 577–78 (using the phrase “OpCo” to refer to the domestic operating company and describing how OpCos allow WFOEs to conduct business in restricted sectors).
60. Brown, supra note 48, at 204.
61. Schindelheim, supra note 58, at 204–05.
63. Id. at 205.
64. Guo, supra note 53, at 578.
65. See Wei, supra note 56, at 279; see also Lin & Mehaffy, supra note 44, at 445 (calling VIE “creative compliance” structures because they avoid the strict approval processes of the Chinese government).
traditional U.S. corporate governance rules, shareholders own a direct equity stake “to the revenues of the operating company” and do not have normal voting rights.66
The VIE structure essentially presents such shareholders with a different vehicle to
drive their equity and to exercise their rights.67 However, this vehicle makes
shareholders vulnerable to financial risk because they have “disproportionate control
rights in relation to their economic rights in the corporations.”68 The patchwork of
contracts between the offshore entity, WFOE, Chinese founders, and the Chinese
Op. Co. provides shareholders with weaker enforcement mechanisms for their rights
in contrast to the more ironclad fiduciary duties recognized in the United States.69

B. Primary Beneficiary

Typically, the primary beneficiary of a VIE is a shareholder called a “variable
interest holder.”70 The Financial Accounting Standards Board (FASB) first
identified the existence of a VIE structure in 2003 when it released FIN 46(R) as an
Statements.”71 Following the Enron scandal, the FASB released Bulletin No. 51 to
establish better accounting reporting requirements.72 FIN 46(R) mandates that
public companies consolidate VIEs that “do not effectively disperse risks among the
parties involved.”73 Under FIN 46(R), the primary beneficiary, or shareholder with
the controlling financial interest, is responsible for consolidation if the risk is not
adequately dispersed.74 FIN 46(R) defines a primary beneficiary as “the party that
absorbs a majority of the entity’s expected losses, receives a majority of its expected
residual returns, or both, as a result of holding variable interests.”75 The new
consolidation rules aimed to prevent fraud by improving transparency surrounding

67. See id. (explaining how the VIE structure attempts to replicate the traditional shareholder-corporation relationship).
68. Id. at 450.
69. Given that VIEs are located offshore from the United States, it is unclear whether U.S.
shareholders would be entitled to the same fiduciary duties from a VIE structure as those owning a
stake in a company with a traditional corporate structure. See id. at 464–65.
70. Dienst, supra note 54, at 18.
(last visited Nov. 1, 2018).
72. See FASB Issues FIN 46 to Curb Enron-Style Abuses, ACCT. WEB (Jan. 20, 2003),
(announcing the purpose for the issuance of FIN 46); see also The Fall of Enron, NPR,
bankrupt after employing “special purpose entities” to hide substantial amounts of debts and losses
from its financial statements and the company was able to bury such losses into several different
partnerships); Umit G. Gurun et al., Anticipatory and Implementation Effects of FIN 46 on the
(discussing the effect of the Enron disaster on the release of FIN 46).
73. Summary of Interpretation of No. 46, supra note 71, at 3.
74. Id.
75. Id.
the allocation and ownership of risks. Through a series of contracts, an offshore holding company has de facto “control over the VIE and its operating profits.” Per FIN 46(R), the offshore company would be the primary beneficiary that consolidates financial reporting of the VIE and WFOE.

**C. Contract Terms and Rights**

Because shareholders lack direct controlling financial interests in VIEs, traditional voting rights are not available. A VIE structure relies on a network of fundamental contracts to function. The first set of contracts involves financing. The offshore-listed company, through a loan agreement, provides capital to the Chinese Op. Co. by way of the WFOE. The Chinese owners also execute an “equity pledge agreement,” which guarantees equity to the WFOE. The WFOE also typically has an “options agreement” with the Chinese owners to “purchase . . . equity in the [Chinese Op. Co.] at the lowest permissible price under the PRC law.” Finally, a “consulting or technical service agreement” allocates the operating company’s profits to the WFOE.

The second set of contracts regulates shareholders’ rights. Through a proxy agreement, the WFOE obtains the shareholder rights of the Chinese Op. Co. Some VIE-structured companies may also use a “preferential stock structure,” which deprives shareholders of traditional voting rights and vests the companies’ founders—who usually form a partnership—with “all decision-making authority.” However, the partnership has the right to remove any partner for cause by a simple majority vote and thus may check any abuse of power. Although an agreement can guarantee a controlling interest in the Chinese Op. Co. for shareholders of the

76. See Gurun et al., supra note 72, at 56 (explaining the aims of FIN 46(R)); see also Guo, supra 53, at 572 (“Although [Special Purpose Entities] were mostly used for legitimate business purposes, inadequate accounting guidance in this area allowed some companies [Enron] to manipulate their financial statements to hide losses and fabricate earnings.”).

77. Dienst, supra note 54, at 21.

78. Id. at 19.

79. See ERNST & YOUNG, FINANCIAL REPORTING DEVELOPMENTS: A COMPREHENSIVE GUIDE 178 (2017) (noting that shareholders have disproportionately few voting rights and do not have a controlling financial interest in VIEs).


81. See Perry, supra note 80, at 485 (explaining that the WFOE and the shareholders of a VIE must enter into at least four contracts, including a loan agreement).


83. Id. at 1278.

84. Id.

85. Id.

86. See id. (explaining how proxy agreements reallocate shareholder rights).

87. Id.

88. See Johnson, supra note 43, at 255 (noting that Alibaba uses a “preferential stock structure” that gives its founders all the power to make decisions for the company).

89. Lin & Mehaffy, supra note 44, at 453.
offshore-listed company, it does not guarantee enforceable fiduciary duties.\footnote{90}{See Vermeulen, \textit{supra} note 48, at 13 (explaining that although Yahoo has a controlling stake in Alibaba, Yahoo could not prevent Alibaba from spinning off its online payment division); \textit{see also} Lin & Mehaffy, \textit{supra} note 44, at 465 (noting that Alibaba is incorporated in the Cayman Islands and does not have to follow Delaware’s fiduciary laws).}

Despite these protections for both shareholders and managing partners, “an unhappy shareholder or member of [a Chinese Op. Co.] can bring the VIE structure to its knees.”\footnote{91}{Brown, \textit{supra} note 48, at 206.} In fact, VIE structures employed by the Singapore-incorporated GigaMedia Limited (GigaMedia) collapsed as a result of a leadership dispute in 2010.\footnote{92}{See Lin & Mehaffy, \textit{supra} note 44, at 446–47 (explaining that GigaMedia was an online gaming company that was incorporated in Singapore but operated through three Chinese VIEs).} The board of GigaMedia became unsatisfied with then-CEO Wang Ji and attempted to oust him by restructuring the company’s leadership.\footnote{93}{See Damjan DeNoble, \textit{Gigamedia and the Perils of VIEs: Dude, Where’s My Chop?}, HARRIS BRICKEN: CHINA L. BLOG (June 30, 2011), https://www.chinalawblog.com/2011/06/vie.html (outlining the events that led to GigaMedia’s demise).} In retaliation, Wang Ji departed the company and took the VIEs—the essential operating licenses and registration certificates—which enabled their key subsidiaries to operate in China.\footnote{94}{Id.} As a result, GigaMedia could not “consolidate the profits from the VIEs in that year and ultimately was required to deconsolidate its WFOE’s financial results.”\footnote{95}{Lin & Mehaffy, \textit{supra} note 44, at 447.} This major setback became a cautionary tale for the industry: the contracts upholding a VIE structure work only if everyone plays by the rules.\footnote{96}{See DeNoble, \textit{supra} note 93 (“Gigamedia’s . . . problems should be filed away in the multi-volume treatise of China caution stories, as an example of what can go wrong between a foreign company and its Chinese partner.”).} The GigaMedia example thus supports the assertion that a VIE “is an investment structure that requires a tremendous amount of faith, understanding, goodwill, and, most importantly, luck.”\footnote{97}{Perry, \textit{supra} note 80, at 486.}

The VIE structure is a house of cards balancing on the presumed enforceability of all of the contracts upholding it.\footnote{98}{See Johnson, \textit{supra} note 43, at 253 (noting that the legal contracts establishing the VIEs can only be enforced by China).} China’s rule of law “remains undeveloped,” meaning investors take on a high level of risk because a Chinese court could invalidate any one of the contracts, making the whole VIE structure unravel.\footnote{99}{See \textit{id.} at 253–54 (explaining that contracts upholding VIEs are only binding if Chinese courts are willing to validate them, exposing foreign investors to substantial risk).} Investors also face risks if the VIE structure itself is deemed invalid by Chinese authorities.\footnote{100}{See \textit{id.} at 261 (discussing how China has not confirmed the legality of the VIE structure but recent regulations suggest that the structure could be nullified).}
if it were to deem any portion of the VIE structure invalid, investors would be left holding worthless stock.

D. Profits Allocation

The ability to transfer all profits from a Chinese Op. Co. to a WFOE, and eventually to an offshore listing company, serves as the crucial moving part to the VIE machine. The “Exclusive Technical Services Agreement” requires the operating company to pay the WFOE nearly all of its “pre-tax profits” but disguises this payment as a “service fee” to the WFOE. The services provided by a WFOE in the e-commerce industry typically include “website maintenance, programming, sales support, fulfillment services, curriculum development, etc.” In some cases, the WFOE may also receive a royalty for licensing key intellectual property (IP) assets to the operating company. In sum, a Chinese Op. Co. can legally funnel all of its profits through a WFOE to reach the offshore holding company, which, as this Comment argues, should trigger key BEPS concerns. The VIE structure allows companies to operate on thin ice and challenges traditional notions of accounting and corporate governance. Despite the glaring risks, the colossal demise of predecessors such as GigaMedia has not frightened Chinese e-commerce companies from expanding the use of VIEs.

III. BEPS ACTIONS

After the global economic recession in 2007, the international community sought to promote financial transparency for large MNEs. As the world has become more digitally focused, transparency has become more difficult, leading global leaders and experts to worry about the crafty maneuvers MNEs use to avoid taxes, hurting the global economy as a result. In 2015, the OECD, in partnership with the G20, released its final comprehensive BEPS Action Plans in hopes of

101. See id. at 260–61 (exploring cases where the Supreme People’s Court of China indicated the potential illegality of VIE structures).
102. See Perry, supra note 80, at 489 (noting that all profits can be transferred from the “heavily regulated” VIE to the WFOE without violating Chinese law).
103. Id.
104. Guo, supra note 53, at 579.
105. Id.
preventing tax avoidance abuses and promoting transparency through various measures and “soft law instruments.” The essential objective of each action is to “close gaps in international tax rules that allow [MNEs] to legally but artificially shift profits to low or no-tax jurisdictions.” BEPS seeks to “[ensure] that profits are taxed where economic activities generating the profits are performed and where value is created.” BEPS contains fifteen actions—functioning as recommendations for participating countries—which all seek to improve transparency and to limit tax avoidance through domestic tax legislation.

A. Action 1—Digital Economy

BEPS Action 1 addresses tax issues that have arisen as the global economy has become increasingly more digital. Action 1 also serves as a lens through which the other actions may be viewed. The 2015 Action 1 Final Report addresses concerns stemming from the digitalization of the economy such as “mobility, reliance on data, network effects, the spread of multi-sided business models, [and the] tendency toward monopoly or oligopoly and volatility.” Action 1 also aims to address the “accelerated” expansion of “global value chains” jurisdictions, which enables MNEs to disperse activities and easily transfer intangibles worldwide to take advantage of favorable tax jurisdictions. Action 1 specifically notes the difficulty in taxing global e-commerce activities given the flexible nature of logistics and ease of MNEs to dodge the creation of a “permanent establishment” (PE).
Action 1 notes that while the digital economy does not present any new tax issues per se, it “exacerbate[s]” and accelerates previous tax concerns. New business practices, along with the ease of information technology (IT) communication, have eroded the traditional purposes behind tax policies, such as differentiating tax liability based on presence: “[t]he fact that less physical presence is required in market economies in typical business structures today . . . raises challenges for international taxation.” In addition, Action 1 discusses the difficulties in attributing value to data for tax purposes, especially for unique forms of digital products and services. Finally, Action 1 acknowledges that while technology has enabled the vast expansion of global business, current tax policies are not able to keep up with companies’ ability to reach every corner of the Earth with the click of a mouse.

B. Actions 8–10 and 13—Transfer Pricing

BEPS sets out several actions that address the issue of transfer pricing, which has increasingly become a high priority in the international community. Transfer pricing refers to “the price established in a transaction between related persons” and it can often be manipulated by MNEs to avoid tax liability. Although the practice of transfer pricing is not illegal, the manipulation of transfer pricing results in a diversion of tax liability. Furthermore, the inability to appropriately tax value in the correct jurisdiction promotes economic inequality and threatens the integrity of governments. In particular, transfer pricing harms developing countries, which disproportionately rely on corporate tax for revenue and growth.

The integrated complexity of MNEs must be addressed to understand the concept of transfer pricing. MNEs make up roughly 60% of the world’s global trade, which is why their tax practices warrant scrutiny. An MNE is a company

119. Action 1, supra note 114, at 11.
120. Id. ¶ 246, at 98.
121. Id. ¶ 248, at 99.
122. Id. ¶ 247, at 98–99.
123. See BEPS Actions, supra note 29 (noting that the BEPS Actions advocate for international tax rules to address tax avoidance, three of which address transfer pricing).
124. ARNOLD, supra note 27, at 89.
125. See Transfer Pricing, TAX JUSTICE NETWORK, https://www.taxjustice.net/topics/corporate-tax/transfer-pricing/ (last visited Oct. 31, 2018) (explaining that transfer pricing is not illegal, but several hundred billion dollars of tax revenue are lost each year because of it).
126. See Gabriel Zucman, Inequality is the Great Concern of Our Age. So Why Do We Tolerate Rapacious, Unjust Tax Havens?, GUARDIAN (Oct. 10, 2015, 07:05 PM), https://www.theguardian.com/commentisfree/2015/oct/11/inequality-will-continue-until-corporations-stop-avoiding-tax (arguing that corporate tax avoidance positively correlates to inequality and that the recent release of the BEPS Action Plans provides an opportunity to reform this unjust system); see generally JOEL COOPER ET AL., TRANSFER PRICING AND DEVELOPING ECONOMIES (2016).
“operating in several countries but managed from one (home) country.” MNEs operate as a global conglomerate of companies and use “locally incorporated subsidiaries” or PEs to conduct business. In a traditional model, a corporation enters into contracts with other independent corporations to exchange goods or services. In contrast, MNEs engage in internal transactions with their subsidiaries (“intra-group integration”) to avoid transactions through the market. Such an integration model allows MNEs to pool their resources, optimize the cost of production, and lower transactional costs.

Intra-group transactions within an MNE are not so straightforward in practice. Keeping track of internal transactions, which is vital for transfer pricing, becomes increasingly complicated when considering the various subsidiaries, organizational models, legal titles, and domestic laws. Operating in multiple jurisdictions requires MNEs to develop detailed compliance policies. MNEs exist as a sort of omnipresent entity that must comply with demanding and sometimes conflicting laws. However, MNEs often defy such rules by engaging in manipulative transfer pricing practices in less-transparent jurisdictions.

Transfer pricing occurs when an affiliate or subsidiary transfers goods or services to a related affiliate within the same MNE or firm. However, affiliates often inaccurately price the true value of these transfers when going from high-tax jurisdictions to low-tax jurisdictions. The affiliate in the low-tax jurisdiction may

131. See id. ¶¶ A.2.1.–.2. (noting that such contracting with independent parties results in expensive transactional costs for corporations).
132. Id. ¶¶ A.2.3., A.2.6.–.7.
133. See id. ¶¶ A.2.7.–.8. (explaining how globalization has enabled MNEs to better integrate and expand their range of services).
134. See U.N., Transfer Pricing Manual, supra note 130, ¶ A.4.2. (noting that transfer pricing becomes complicated when MNEs are large and have global businesses with different business models; it is unclear whether their internal transactions will be accepted in the countries where they operate).
135. Id. ¶ A.4.8.
139. Id.
then sell the good or service at a high price. 140 In the end, the transfer of the good or service is taxed less in the high-tax jurisdiction because it was undervalued, and the MNE makes a profit from the sale of the good or service in the low-tax jurisdiction. 141

Tax authorities often use the arm’s length standard to assess the validity of a transfer price. 142 Under the arm’s length standard, authorities analyze a transfer price between related parties, within the same MNE, and compare its value to transactions completed between unrelated parties. 143 Applying the arm’s length standard in practice has proven very challenging. 144 A tax authority would first need to determine the unbiased price: the transfer price used between unrelated parties. 145 Several methods are available to evaluate this transfer price, 146 and the availability of so many different valuation methods can create arbitrary and asymmetrical results. 147 In order to establish a universal valuation method, the OECD adopted the arm’s length principle as the standard for determining transfer prices in Action 8. 148

The application of the arm’s length principle is comparatively simple when dealing with tangible goods. However, it becomes more complicated for transactions involving services, trade secrets, licenses, or other intangible goods. 149 Although tax accounting firms and tax authorities devised methodological ways to determine an arm’s length price for intangibles, 150 without market forces present, the risk of

140. See id. (stating that prices may be distorted when affiliated companies trade with each other).

141. See Transfer-Pricing, supra note 125 (“The end result is, instead, that [the affiliate] has shifted its profits artificially out of [high-tax jurisdictions] and into a tax haven. As a result, tax dollars have been shifted artificially away from [high-tax jurisdictions] tax authorities and have been converted into higher profits for the multinational.”).

142. ARNOLD, supra note 27, at 92.


144. See ARNOLD, supra note 27, at 92 (“The above definition of the arm’s-length standard provides little guidance as to how transfer prices should be established in concrete situations.”).


149. See COOPER ET AL., supra note 126, at 213 (explaining the specific difficulties associated with intangibles).

150. See Abdallah & Maghrabi, supra note 146, at 119 (discussing various valuation methods).
setting an arbitrary price becomes higher. Additionally, the lack of uniformity among different tax authorities in setting an arm’s length standard of measurement to determine the transfer price further exacerbates BEPS issues.\footnote{See OECD Transfer Pricing Guidelines, supra note 148, ¶¶ 4–5, at 15–16 (noting the lack of uniformity in tax administrations’ different approaches to transfer pricing and encouraging OECD members to adopt the arm’s length principle to bridge this gap).} BEPS Actions 8–10 seek to address the valuation of transfer prices and emphasize the need for uniform reporting requirements and compliance standards.\footnote{See OECD, Aligning Transfer Pricing Outcomes with Value Creation: Actions 8–10: 2015 Final Reports, 9 (2015), https://read.oecd-ilibrary.org/taxation/aligning-transfer-pricing-outcomes-with-value-creation-actions-8-10-2015-final-reports_9789264241244-en#page1 [hereinafter Actions 8–10] (noting how evaluation of the arm’s length principle can be improved to limit tax avoidance maneuvers).} Determining the most accurate transfer price to reflect actual value requires a very fact-heavy analysis, which is why BEPS Actions 8–10 outline valuation strategies for tax authorities to implement in their audits.\footnote{See id. at 12 (discussing how transfer pricing relies on specific “facts and circumstances” surrounding a transaction and how BEPS offers guidelines for tax authorities).}

BEPS Actions 8–10 aim to sharpen the arm’s length principle by analyzing whether a given transaction “possesses the commercial rationality of arrangements that would be agreed between unrelated parties under comparable economic circumstances . . . ."\footnote{OECD Transfer Pricing Guidelines, supra note 148, ¶ 1.123, at 79 (emphasis added).} To determine the commercial rationality of a price, BEPS Actions 8–10 recommend that in addition to comparability, tax authorities should give special consideration to other forms of value, such as “assumption of risk” and capital contributions.\footnote{See Actions 8–10, supra note 152, at 14.} Risk may easily be overlooked, yet it also constitutes much of a company’s value.\footnote{See id. ¶ 1.65, at 23–24 (noting that control of risk carries value for the party that has the capacity to engage in risk-assuming behavior and the capacity to function after assuming the risk in light of the dangers and opportunities inherent to the risk).} Assessment of risk assumption involves recognizing where risk lies in order to appraise the most accurate value.\footnote{OECD Transfer Pricing Guidelines, supra note 148, ¶ 1.56, at 53.} For example, tax authorities should consider whether an MNE has fragmented activities across many subsidiaries, thereby dispersing the risk.\footnote{See Actions 8–10, supra note 152, ¶ 1.55, at 21 (noting the independency of fragmented entities would need to be considered when assessing value).}

The internet has enabled MNEs both to transact with its affiliates from anywhere in the world and move its business operations online.\footnote{See Abdallah & Maghrabi, supra note 146, at 116 (noting that technological advancements have also encouraged e-commerce companies to integrate for convenience).} Due to their unique qualities, appraisal value of intangible assets is hard to ascertain and verify, and thus transfer pricing issues often arise.\footnote{See Martínez, supra note 143, at 303 (noting that not only are intangible assets hard to valuate, but they are often a corporation’s most prized assets, such as patents and other forms of intellectual property).} Action 1 also emphasizes concerns
that “intangibles” raise for tax authorities. Intangible assets encompass all of the “nonphysical, nonmonetary assets of a firm.” Intangibles are not limited to intellectual property, but also include employees, licensees, software, procedures, distribution, mailing lists, and the like. An e-commerce business in particular holds many intangible assets, such as software, licenses, an online payment system, and customer data, which are easily transferable to another jurisdiction and potentially difficult to value.

Given the ease with which MNEs can transfer intangibles, BEPS devotes the most attention to transfer pricing in all of its actions, as measured by frequency of action. The digital economy makes it easier for MNEs to undervalue intangible assets in high-tax jurisdictions and then cache valuable assets in low-tax jurisdictions. Evaluating such intangibles requires analyzing their “partial excludability, inherent risk, and nontradability.” Intangibles’ non-tradability is particularly pertinent, as it signifies the absence of a market, or rather something that is not capable of being traded in the open market, which makes pricing difficult. If an MNE possesses an intangible that is non-tradable, the MNE lacks vital valuation information that markets usually provide. MNEs also employ the strategy of overvaluing key, unique royalties to be paid to related parties in a favorable tax jurisdiction. The existence of non-tradable intangibles should serve as a warning for tax authorities to more thoroughly investigate and scrutinize related transactions.

C. Action 7—Permanent Establishment

The concept of PE serves as a common threshold in the international community for determining whether there is jurisdiction to tax “non-residents.”

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161. Action 1, supra note 114, ¶ 152, at 65.
163. See, e.g., Martínez, supra note 143, at 303 (listing the U.S. Department of Treasury’s definitions of intangible assets); see also Brauner, supra note 162, at 88 (“An important feature of many intangibles is that they have public goods characteristics, since they are easily diffused.”).
165. Action 1, supra note 114, ¶ 153, at 65.
166. See BEPS Actions, supra note 29 (showing four actions dedicated to the issue of transfer pricing).
168. Brauner, supra note 162, at 89.
169. See Explanatory Statement, supra note 109, at ¶ 16, 7 (noting how OECD seeks to update transfer pricing guidelines in light of increased use of intangibles and the accompanying difficulty in pricing).
170. See Brauner, supra note 162, at 91 (exhibiting the dangers of holding intangibles in a market-less vacuum, where risk sharing, leverage, and valuation reliability do not exist).
171. Action 1, supra note 114, ¶ 189, 80–81.
172. Non-residents are defined as legal entities that do not meet the residency test. Residency tests vary by jurisdiction, but commonly involve either a “place-of-management” or “place-of-
A PE is generally defined as “a fixed place of business, such as an office, branch, factory, or mine.” A country may have the jurisdiction to tax an entity that holds a PE through its business in that country. If tax authorities determine that an MNE has a PE in its jurisdiction, the MNE may be subject to corporate tax. Consequently, MNEs may assign revenue-generating functions to their subsidiaries and affiliates to avoid creating a PE. The international community has expressed a desire to reform PE rules but has avoided tackling the MNEs’ clever avoidance of PE creation. The international community fears that unraveling the PE rule would create confusion and greatly disrupt economic activities. Action 7 seeks to address this avoidance of PE once and for all by abolishing commissionaire structures and narrowing particular activity exceptions.

According to traditional PE rules under a standard double tax treaty, a PE is not created if an independent agent or subsidiary engages in activities that are “preparatory or auxiliary” in nature. MNE principals may assert that their subsidiaries in a high-tax jurisdiction serve as “independent agents” or engage in certain non-PE-creating activities in order to avoid tax liability by dodging the creation of a PE. BEPS Action 7 narrows the scope of non-PE activities to loop in more MNEs under PE liability, thereby preventing the “fragmentation” of activities between related groups as a means of avoiding greater tax liability. Action 1 also addresses the avoidance of a PE by outlining concerns for online businesses that create value in high-tax jurisdictions but do not have a “physical incorporation” test, or some combination of both. See ARNOLD, supra note 27, at 19.

173. Id. at 22.
174. Id.
176. See id. (remarking that it is difficult to predict PE and that some global regions have begun establishing PE on the basis of any generated revenue within a host country).
178. See id. (noting that some countries wish the subject of PE to remain untouched to maintain the status quo).
179. A commissionaire structure is also used by MNEs, whereby a person “enters into contracts in the name of or on behalf of another person, but those contracts are not legally binding on that other person.” MNEs use commissionaire structures in high-tax jurisdictions to avoid liability. ARNOLD, supra note 27, at 157.
180. See id. at 158 (discussing BEPS-proposed changes to PE treatment).
181. See id. at 159 (explaining how a PE can be established according to articles under the U.N. Model Double Taxation Convention between Developed and Developing Countries and furthermore providing that preparatory or auxiliary activities involve the purchase, maintenance, display or storage of goods, and other such similar activities).
182. See id. at 158–59 (discussing how the preparatory or auxiliary activities of an independent agent may not create PE).
presence” in the jurisdiction. The nature of e-commerce activities makes it easy for MNEs to avoid the creation of a PE. An agent or subsidiary may perform services in a jurisdiction but have enough independence so that the MNE principal is never liable for corporate tax.


Action 5 seeks to improve transparency and reporting of harmful tax practices in advantageous jurisdictions tax havens (low-tax jurisdictions), preferential regimes, and non-OECD economies. Action 5 aims to target harmful tax practices by requiring that a regime: (1) only tax “substantial activity” occurring within its borders, and (2) provide documentation on tax standards and information to promote global transparency. Critics of the BEPS project note the OECD’s relatively lax stance and inconsistency regarding notorious tax havens. Indeed, prominent tax havens such as the British Virgin Islands and the Cayman Islands were never mentioned in the OECD’s 2017 Progress Report on Preferential Regimes.

The “substantial activity” requirement proposed by Action 5 applies a “nexus” test to qualifying taxpayers in prominent intellectual property regimes to determine where the value of their activities takes place. The nexus test “only allows a taxpayer to benefit from an IP regime to the extent that it can show that it itself incurred expenditures, such as R&D, which gave rise to the IP income.” Action 5 attempts to implement transparency by requiring the “compulsory spontaneous exchange of information in respect of rulings.” It is critical that tax authorities possess information regarding a taxpayer’s treatment in another jurisdiction when deciding how they will treat such a taxpayer, especially if a double tax treaty applies.

MNEs establish subsidiaries or affiliates in tax havens, which enable them to

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184. Action 1, supra note 114, ¶ 184, at 79.
186. Id. ¶¶ 23–41 (explaining that the “substantial activity” rule was developed to combat tax recognition in tax havens where no legitimate value creation took place).
191. Action 5, supra note 185, ¶ 91, at 46.
192. See id. (demonstrating how the OECD framework provides for the transparent inter-jurisdictional exchange of information with regard to rulings).
transfer profits earned in the high-tax jurisdiction to a tax haven, thereby minimizing their overall tax liability.193 Action 5 outlines other ways attractive jurisdictions tend to entice MNEs, such as cloaking the tax base and transfer pricing valuation methods in secrecy, not sharing information with other jurisdictions, and participating as signatories to several tax treaties.194 Recently, the subject of tax havens has provoked controversy within the international community and tax authority regimes when the revelation of the “Panama Papers” in 2016 exposed the secret offshore accounts of corporations, politicians, and even some prominent public officials.195

Chinese VIEs turn to the popular Cayman Islands to avoid tax liability.196 The not-so innocuous “archipelago of islands” south of Cuba attracts foreign assets totaling 1,500 times more than its GDP.197 Resident corporations and individuals in the Cayman Islands do not pay corporate, income, gains or appreciation, inheritance, or estate tax.198 Furthermore, the Cayman Islands are not member to any double tax treaties, which makes it more difficult to obtain information and ensure transparency.199 The Cayman Islands operate as a “secrecy jurisdiction” for corporations and their subsidiaries to hide from taxes and regulations.200 The secrecy from regulations may be attributable to the state’s common-law system, which permits flexible interpretation of regulations.201 The Tax Justice Network lists the Cayman Islands as third in the world on its 2018 Financial Secrecy Index, which ranks jurisdictions on “their secrecy and the scale of their offshore financial

193. See Jessica L. Ho, How to Train a Toothless Dragon: Finding Room for Improvement in China’s Transfer Pricing Regulations, 54 VA. J. INT’L L. 437, 439 (2014) (explaining the purpose of tax havens and how various actors such as transnational companies transfer profits out of high-tax jurisdictions).

194. See Action 5, supra note 185, ¶¶ 15–16, at 20 (listing potentially harmful ways that jurisdictions attract MNEs).

195. See Lawrence J. Trautman, Following the Money: Lessons from the Panama Papers: Part 1: Tip of the Iceberg, 121 PENN. ST. L. REV. 807, 812 (2017) (noting that the accounts of prominent individuals such as British Prime Minister David Cameron, Argentinian President Mauricio Marci, Russian President Vladimir Putin, and certain high-ranking Chinese officials, were exposed).

196. See Wei Shen & Casey Watters, Is China Creating a New Business Order? Rationalizing China’s Extraterritorial Attempt to Expand the Veil-Piercing Doctrine, 35 NW. J. INT’L. L. & BUS. 469, 520 (2015) (“An offshore holding company is incorporated in a ‘satellite’ common law jurisdiction, typically in Hong Kong, the Cayman Islands, British Virgin Islands or Bermuda.”).

197. Fichtner, supra note 21, at 1035.

198. See Dienst, supra note 54, at 18 (stating that the Cayman Islands is a tax-free jurisdiction); see also Alibaba Holding Grp., Ltd., Prospectus Supplement (Rule 424(b)(2)) at S-82 (Nov. 29, 2017), https://www.sec.gov/Archives/edgar/data/1577552/000104746917007364/a2233928x424b2.htm [hereinafter Alibaba Prospectus Supplement] (explaining the tax system in the Cayman Islands).

199. The Cayman Islands have signed limited Tax Information Exchange Treaties with other nations, but it has not signed on to a comprehensive double tax treaty. See Cayman Islands: Double Tax Treaties, LOWTAX, https://www.lowtax.net/information/cayman-islands/cayman-islands-tax-treaty-introduction.html (last visited Nov. 1, 2018).

200. Fichtner, supra note 21, at 1037, 1051–52.

201. See Dienst, supra note 54, at 19 (explaining that civil code systems clearly state what can and cannot be done, whereas common law systems allow more room for interpretation).
activities.” Such secrecy not only attracts direct investment, but also serves as an epicenter for hedge funds, offshore banking, and portfolio investment.

E. Reactions and Criticism

Issues of transfer pricing, double taxation, and tax havens are particularly challenging to address, given the lack of sovereignty in the international system. These issues arise when states engage in tax competition games to attract value-added activities to their jurisdictions so as to increase revenue. Moreover, international enforcement against tax avoidance issues proves challenging, given inconsistent disclosure requirements in varying jurisdictions and fears of over-reaching regulatory approaches. Critics of BEPS, including both States and international organizations, find it difficult to reach a global consensus on transfer pricing and tax avoidance issues in part because every country wants to boost its tax revenue. These critics also claim that BEPS falls short and that the focus should be on reforming traditional international jurisdictional tax norms in light of globalization.

In addition, OECD has a reputation for bias, and is considered by some to be a “global club of rich nations.” Critics view OECD’s aims as ineffective and unfair toward developing countries. In fact, OECD’s 2017 Transfer Pricing Guidelines even acknowledge that it can be burdensome for both taxpayers and tax authorities.


203. See Claire Boyte-White, Why Are the Cayman Islands Considered a Tax Haven?, INVESTOPEDIA (Nov. 9, 2017, 11:17 AM), https://www.investopedia.com/ask/answers/100215/why-cayman-islands-considered-tax-haven.asp (discussing the factors such as absence of corporate or income tax on foreign earnings that make the Cayman Islands an attractive low-tax jurisdiction).

204. See Adam H. Rosenzweig, Why Are There Tax Havens?, 52 WM. & MARY L. REV. 923, 940 (2010) (finding that a lack of sovereignty as well as States’ desires to maintain control over their own jurisdictions render it impossible for one tax jurisdiction to control the taxing practices of another).

205. See id. (noting that tax competition that may be detrimental to the global economy is nevertheless used to attract investment to specific jurisdictions).

206. See Shen & Watters, supra note 196, at 553–54 (explaining that due to the lack of uniformity in disclosure among jurisdictions and of an agreed-upon regulatory scheme, enforcement of these issues is weak).


210. See, e.g., Irene Burgers & Irma Mosquera, Corporate Taxation and BEPS: A Fair Slice for Developing Countries?, 10 ERASMUS L. REV. 29 (2017); see also Laurens van Apeldoorn, BEPS, Tax Sovereignty and Global Justice, 21 CRITICAL REV. OF INT’L SOC. & POL. PHIL. 478, 479–80 (2016) (explaining that the OECD’s logic in formulating BEPS was flawed).
to comply with the high volume of information needed to capture an accurate transfer price. However, the Guidelines also assume that tax authorities are sophisticated and developed enough to comply with such rigorous procedures. OECD also relies on “voluntary self-regulation and self-monitoring” for enforcement of its BEPS Actions. Critics find that such a compliance system is bound for failure, because tax havens are incentivized to perpetuate tax benefits to attract activities, thereby boosting revenue.

Although BEPS may not solve the entirety of the world’s international tax problems, it does represent a significant initial effort to reform the tax system and shines a spotlight on issues of tax avoidance. BEPS serves as a catalyst for an important conversation that needs to take place in the international community regarding the erosion of tax bases and the rampant abuse of profit shifting, as seen in the activities of colossal MNEs like Starbucks, Amazon, and Google. These criticisms present valid points that OECD policymakers may take into consideration as they continue to release updated reports.

IV. VIEs IN CHINA: ALIBABA AND THE CHINESE E-COMMERCE INDUSTRY

China does not allow foreign ownership in certain protected industries, such as the internet, finance, and telecommunications. China created strict investment rules in order to protect these “politically sensitive” domestic sectors. As a result, Chinese businesses created VIEs to circumvent China’s laws and to open up the internet sector to U.S. markets and foreign investment. A Chinese Op. Co. can now operate in “restricted” industries, while still attracting foreign investors. In a way, this gives companies like Alibaba the best of both worlds: they do not have to fear competition from foreign tech firms, such as Amazon, yet they can still access

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211. See OECD Transfer Pricing Guidelines, supra note 148, ¶¶ 1.12–1.13, at 37–38 (explaining the difficulties taxpayers and tax authorities face in navigating the arm’s length principle).


213. See id. (covering the fecklessness of Action 5, including the self-regulating compliance regime, and addressing that countries prone to tax competition will not change their activities based on such a regime).

214. See supra Part I for a discussion on tax avoidance measures by Starbucks, Google, and Amazon.

215. See generally BEPS Actions, supra note 29.


217. A Legal Vulnerability, supra note 36.

218. Id.


prized foreign capital and expand their business.

A. China’s Policy Against Foreign Ownership

When China opened its doors to the outside world following the Cultural Revolution in the 1970s, it did not swing the doors wide-open. China allowed foreign direct investment (FDI) to flow into the country, but it prohibited FDI in certain “sensitive” sectors. The Chinese government considers such sectors to be “strategic and emerging industries” or sectors that are vital for “political or national security reasons.” These include the media, internet, banking, natural resources, and agriculture.

The Catalogue for the Guidance of Foreign Investment Industries separates sectors into “restricted” and “prohibited” categories. Foreign investors are proscribed from engaging and investing in any sector on the prohibited list. The prohibited list ranges from industries such as “production of Xuan paper and Chinese ink ingot” to “movie production companies, distribution companies, and theaters.” Item 21 on the “restricted” list restrains foreign investment in “telecommunication companies . . . value-added telecommunication services (with the proportion of foreign investment not exceeding 50%, except for e-commerce).” Item number 26 on the “prohibited” list forbids foreign investment in “business premises for internet-access services.”

The greatest risk for VIEs is that the Chinese government decides they are illegal. China first recognized the existence of VIEs in 2011 when a leaked copy of the proposed VIE regulations surfaced. This marked the first notable step by China to potentially regulate VIEs. Because of its loophole nature, the status of VIEs straddles a gray area of legality—a Chinese court could rule them in violation of section (3) or (5) of Article 52 under China’s Contract Law. Sections (3) and (5) invalidate any contract if “(3) there is an attempt to conceal illegal goals under the disguise of legitimate forms;” or “(5) mandatory provisions of laws and
administrative regulations are violated." Invalidating VIEs would not only have consequences for U.S. shareholders of Chinese internet shell companies such as Alibaba Holding Ltd., but it would also have negative implications for China’s entire internet sector. China likely does not want to disrupt this very successful industry, yet China may also not want to passively allow an entire sector to circumnavigate its authority and laws.

Others believe that China’s failure to address VIEs head-on means the Chinese government acquiesces to their existence. In 2015, the State Council of China issued draft legislation, named the Foreign Investment Law of the People’s Republic of China (Draft), which aimed to reform China’s foreign investment laws and policies. The Draft sought to target VIEs by employing a “substance-over-form” analysis for differentiating between foreign enterprises and Chinese enterprises. In doing so, tax authorities would be able to look to contractual agreements in assessing who controls an enterprise. Yet, two years later, in 2017, China still had not enacted any of the language from the Draft. Perhaps the forces of Alibaba, Tencent, Baidu, and other e-commerce titans have grown too big to fail—so China may never invalidate VIE structures outright. If China does enact some legislation, perhaps the current e-commerce players will be granted a “get out of jail free card” and be exempted from any changes.


234. See generally Wei, supra note 56.

235. See Brown, supra note 48, at 199 (noting China’s hesitation to immediately invalidate VIEs, given that such a move could result in unwanted economic consequences); see also Guo, supra note 53, at 601 (remarking that economic concerns prevent China from intervening).

236. Steve Dickinson, Chinese VIEs are Dead. Done. Over. Stick a Fork in Them., HARRIS BRICKEN: CHINA L. BLOG (Jan. 22, 2015), https://www.chinalawblog.com/2015/01/china-vies-are-dead-done-over-stick-a-fork-in-them.html (“Yet . . . these highly capitalized, powerful companies are all operating illegally . . . openly and with the tacit acquiescence of the PRC regulatory authorities.”).

237. Lin & Mehaffy, supra note 44, at 448.


239. Id.

240. See id. at 211–12 (exploring various directions in 2017 that China might take in the future if it decides to start regulating VIEs).


242. See Brown, supra note 48, at 212 (noting that China’s economy has become very dependent on the continued success of its e-commerce industry).

243. Dickinson, supra note 236.
B. E-commerce Boom and Need for Capital

China is an internet-consuming powerhouse. The number of digital buyers in China hit over 580 million in 2017, and the number is expected to reach over 800 million by 2021.244 China’s e-commerce spending constitutes over 40% of the global total.245 China has many unique advantages over other e-commerce markets,246 making it difficult for other countries to keep up with China’s e-commerce pace.247 The Chinese middle class has grown considerably in the last decade, and Chinese internet use has evolved into a lifestyle.248 China is home to successful online companies that have changed the way the Chinese live, spend, consume, and even pay.249 China, once known as a society based on collectivism, is now a society with a strong “appetite for individualism” and consumerism.250 As founder of Alibaba Jack Ma once famously said, “[i]n other countries, e-commerce is a way to shop; in China, it is a lifestyle.”251

Despite being the most populous country in the world, the spending potential of China’s middle class has traditionally been undervalued.252 In the late 1990s, aspiring e-commerce businesses used the internet as a means to stimulate consumer spending for the growing middle class.253 Sellers also benefited as online retail platforms provided access to millions of Chinese consumers who previously lacked access to, and information about, the retail market.254 As a result, Chinese consumers depend on e-commerce now more than ever.

Prior to using the VIE structure, e-commerce companies in China struggled to


246. See DUNCAN CLARK, ALIBABA: THE HOUSE THAT JACK MA BUILT 4 (2016) (noting how Alibaba has changed Chinese consumer behavior and its impact on retail is more prominent than Amazon’s impact in the United States).


248. CLARK, supra note 246, at 10.


251. CLARK, supra note 246, at 10.

252. See id. at 3 (noting that Chinese culture values savings more than U.S. culture, which explains why Chinese household consumption lags significantly behind the United States’).

253. See Cheng Li, supra note 40, at 8 (explaining that businesses boasted about the rise of the middle class as a marketing tool); see also CLARK, supra note 246, at 9–10 (noting how Taobao [Alibaba subsidiary] recognized the transformative power of online shopping to spark middle class consumption).

254. See HOLLOMAN, supra note 249, at 89 (noting that online shopping became popular due to the ability to access information, such as price comparison information).
raise the necessary capital to expand. Chinese e-commerce companies hoping to raise equity by listing on the Chinese stock market faced many obstacles. Companies often could not meet the strict net profit requirements to list on Chinese stock exchanges. Listing abroad was another option, although China’s Security Commission of the State Council (SCSC) requires a rigorous application and approval process for any Chinese company wishing to list on a foreign stock exchange. Such regulations serve as a deterrent force for private Chinese companies—as of 2012, no private Chinese company had ever applied for approval to list on a foreign market. As a solution, e-commerce companies turned to the VIE structure. The VIE structure gives Chinese companies access to much-needed foreign capital without explicitly violating Chinese law.

C. Alibaba: China’s E-commerce Titan

Alibaba, China’s mega online retailer, has led the boom in e-commerce popularity in China. Alibaba operates similarly to Amazon by providing an online marketplace for buyers and sellers, yet Alibaba “does not hold inventory or participate in logistics.” China celebrates an annual e-commerce shopping holiday every November 11th called “Singles Day,” similar to Black Friday in the United States or Boxing Day in Canada. On Singles Day in 2018, Alibaba sold more than $30.8 billion in merchandise within twenty-four hours. Consumers spent $1 billion within the first two minutes of Singles Day kickoff. Alibaba operates a

255. See Dienst, supra note 54, at 10 (describing the difficulties Chinese enterprises face in finding private equity sources).
256. See id. at 10–12 (examining the problems facing Chinese companies in listing on domestic and foreign exchanges).
257. Id. at 11–12.
258. Id. at 12–13 (detailing the regulations put out by SCSC in the early 1990s).
259. Id. at 13.
260. Id. at 16
261. See Dienst, supra note 54, at 16 (explaining how VIEs get around PRC regulatory restrictions on FDI).
262. See Alibaba Prospectus Supplement, supra note 198, at S-4 (stating that Alibaba’s corporate structure relies on VIEs).
263. See China Country Commercial Guide: China-eCommerce, supra note 245 (noting that Alibaba is one of the domestic platforms that has dominated the e-commerce industry).
267. Id.
conglomerate of e-commerce sites, such as Taobao, Tmall, and Juhuasuan.com.\textsuperscript{268} It sells nearly everything from private islands to Buicks to apples.\textsuperscript{269}

Alibaba operates a very diverse business, owning companies that specialize in various types of e-commerce.\textsuperscript{270} Some experts have dubbed Alibaba as Amazon, eBay, PayPal, and to some extent, Google rolled into one.\textsuperscript{271} Taobao, Alibaba’s most successful subsidiary, sells new and used goods and controls roughly 90\% of the consumer-to-consumer market in China.\textsuperscript{272} For the business-to-consumer market, Taobao controls nearly 50\%.\textsuperscript{273} Alibaba also owns Alipay, which functions as its primary mobile payment system on its various platforms.\textsuperscript{274} In addition, Alibaba earns revenue from its various other businesses such as Juhuasuan (similar to Groupon), Alibaba Cloud Computing, Aliwangwang (instant messaging service), Laiwang (messaging application), Sina Weibo (China’s version of Twitter), and Youku Tudou (China’s version of YouTube).\textsuperscript{275}

While Alibaba has certainly made e-commerce popular, most of its transactions still involve distributing domestic goods in China.\textsuperscript{276} In order to expand their services beyond China’s borders, Alibaba and other Chinese tech companies are looking abroad for their next move.\textsuperscript{277} The industry has turned to cross-border e-commerce (CBEC) to provide coveted foreign merchandise to its customer base in China.\textsuperscript{278} CBEC specifically entails delivering foreign merchandise through an online platform.\textsuperscript{279} In 2015, CBEC value reached an estimated $40 billion, although this only amounted to a bit more than 6\% of China’s total e-commerce value.\textsuperscript{280} The cross-border channel was expected to hit 8.8 trillion yuan ($1.3 trillion) in 2018.\textsuperscript{281}

\begin{flushleft}
268. \textit{Id.} at 8.
269. \textit{Id.} at 10–11.
270. Zucchi, \textit{supra} note 264.
271. \textit{Id.}
273. \textit{Id.}
278. \textit{Id.}
279. \textit{Id.}
280. \textit{Id.}
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Alibaba launched its CBEC subsidiary Tmall Global in February 2014. Tmall Global engages with foreign importers to deliver authentic luxury merchandise to Chinese consumers. In 2016, Tmall Global’s marketplace advertised an estimated 14,500 overseas brands, with 80% of them being first-time Chinese market sellers. Chinese consumers have taken a liking to foreign brands, which carry a perceived higher quality and safety. This is likely due to Chinese consumers broad distrust in the quality and safety of domestic products. Anything international has become synonymous with quality, authenticity, and status. CBEC also enables foreign importers to access previously hard-to-reach consumers. Many consumers, especially in mid-to-smaller sized cities, do not have the means to travel abroad to access foreign luxury brands. Alibaba’s vision is certainly global, leading to the conclusion that its risky corporate structure will follow its international expansion.

1. Alibaba’s VIE Example

Alibaba’s corporate organization provides the best example of a VIE, in part because there is more public information available due to its listing on the NYSE. AHG is located in the Cayman Islands and functions as its offshore holding company, or “special purpose vehicle.” The founding Chinese partners, called the

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286. Id.


288. See Online Retail Sales, supra note 16 (explaining how China’s e-commerce growth has expanded due to consumer demand from rural areas).


“Alibaba Partnership,” as well as foreign stockholders, have a stake in AHG.292 The Alibaba Partnership (Partnership) operates in China and owns essential key technology and business licenses on behalf of AHG.293 The Partnership then pays AHG royalty fees essentially funneling all of Alibaba’s assets to the AHG.294 Appendix Figure 2 shows the organizational structure for Alibaba’s VIE.

The Partnership operates as an exclusive board with immense power.295 The Partnership is formally registered in the Cayman Islands as an exempted limited partnership and consists of thirty members, including the original founders.296 Managed by the “Partnership Committee,” the Partnership consists of five prominent Alibaba leaders297 who dictate both the “nomination of partners and Partnership Committee members.”298 Per AHG’s Articles of Association, the Partnership has the authority to nominate the board of directors.299 Such a structure divests shareholders of traditional voting rights.300 AHG even acknowledges the deviation of this architecture: “[t]his governance structure and contractual arrangement limit the ability of our shareholders to influence corporate matters, including any matters at the board level.”301

Alibaba’s use of the VIE structure received harsh criticism and triggered warnings for interested investors.302 AHG, Alibaba’s offshore holding company, first listed its shares on the NYSE in September 2014.303 Alibaba broke records when

292. Id. at S-35, S-36.

293. See Alibaba 2018 Annual Report, supra note 25, at iii (defining VIEs as 100% owned by Chinese citizens who hold various types of licenses).


295. See Lin & Mehaffy, supra note 44, at 439–40 (explaining how the Partnership has substantial control).

296. See id. at 452 (describing the Partnership structure within Alibaba).


298. See Lin & Mehaffy, supra note 44, at 452.

299. Alibaba Prospectus Supplement, supra note 198, at S-35; see also Lin & Mehaffy, supra note 44, at 453.

300. See Lin & Mehaffy, supra note 44, at 453–55 (detailing differences in voting rights of the Partnership Committee and shareholders).

301. Alibaba Prospectus Supplement, supra note 198, at S-36.


it hit the largest initial public offering of all time by raising $25 billion. Yet, in 2014, Morgan Stanley Capital International (MSCI) listed AHG as the worst in its class for corporate governance. The MSCI governance metrics report cited several warnings for shareholders, such as “the lack of shareholder rights and independent board representation.” MSCI warned of the powerful rights vested to the Partnership, which combined minority interests in AHG to create a super “controlling block” voting agreement. This voting agreement restricts the abilities of U.S. shareholders to exercise their rights and to modify the leadership of the board. Yet, the VIE structure relies on the existence of the Partnership to function and to circumnavigate Chinese laws against foreign ownership.

In addition to corporate governance, MSCI drew attention to Alibaba’s poor accounting methods. At the time of its Initial Public Offering (IPO), Alibaba’s external auditor, the Hong Kong affiliate of PricewaterhouseCoopers (PwC), had not been investigated by the Public Company Accounting Oversight Board (PCAOB) given Alibaba’s substantial operations in China. China requires that the PCAOB obtain governmental approval before conducting audits. The U.S. Securities and Exchange Commission (SEC) also investigated AHG for poor accounting transparency of its various subsidiaries and affiliates. As major corporations using VIE structures, like Alibaba, continue to grow, additional loopholes and exploitations warrant scrutiny by the international tax community.

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304. See id. (identifying $25 billion IPO as largest in the world).
307. Id.
308. Id. at 1, 8.
309. Id. at 1.
310. Id.; see generally Lin & Mehaffy, supra note 44, at 451–52 (describing the evolution and formation of the Partnership).
312. Initial Public Offering (IPO), INVESTOPEDIA, https://www.investopedia.com/terms/i/ipo.asp (last visited Nov. 2, 2018) (“An initial public offering is when a private company or corporation raises investment capital by offering its stock to the public for the first time.”).
313. PCAOB is a U.S. non-profit established by Congress to oversee audits of public companies. About the PCAOB, PCAOB, https://pcaobus.org/About/Pages/default.aspx (last visited Nov. 26, 2018).
315. Id.
V. TAX IMPLICATIONS AND LOOPOLES IN CHINESE LAW AND REGULATIONS

VIE structures operate as a vehicle to siphon considerable amounts of value outside of China, which erodes China’s tax base and exacerbates income equality. Yet, to its own detriment, the State Tax Administration of China (SAT) has not implemented clear rules or regulations which primarily target the taxation of VIE structures.317 In 2017, China did implement new laws regarding transfer pricing in response to the BEPS Actions Plans.318 Despite this effort at reform, VIEs still escape tax liability through China’s Foreign Enterprise Law,319 which addresses the taxation of offshore entities with primarily Chinese ownership.320

A. Transfer Pricing Laws

For transfer pricing, China strictly investigates and pursues interparty transactions. China adopted the arm’s length principle in 2009, when it enacted its first comprehensive legislation on transfer pricing.321 In 2017, SAT released Public Notice 6, which details updated transfer pricing regulations and incorporates many goals from BEPS.322 Public Notice 6 aims to improve monitoring of MNEs profits during investigations.323 In addition, Public Notice 6 considers intangible assets to improve the comparability process for transfer pricing.324 Furthermore, SAT may require that an MNE taxpayer disclose details of its transactions with its related parties.325 While the new regulations represent a positive step forward, they do not address the ability of non-resident enterprises, under which VIEs operate, to engage in inaccurate transfer pricing. VIEs still have the means to transfer all their profits


322. See New Measures, supra note 318, at 2 (comparing SAT’s regulations to the recommendations given by BEPS); see also Guojia Shuiwu Zongju Guanyu Wanshan Guanlian Shenbao he Tongji Ziliao Guanli Youquan Shixiang de Gonggao (国家税务总局关于完善跨境关联交易申报纳税的公告) (promulgated by State Admin. of Taxation People’s Rep. China, June 29, 2016, effective June 29, 2016), CLI.4.275536(EN) (Lawinfochina) [hereinafter Public Notice 6] (stating that the new regulations sought to implement BEPS plans).

323. New Measures, supra note 318, at 3.

324. Public Notice 6, supra note 322, at IV(3).

325. Id.
In addition, the VIE structure for the e-commerce industry, a sector dependent on intangibles, raises the likelihood of transfer pricing issues. VIEs function by creating many related entities that hold strict contractual control over the transfer of assets among the related entities. Whenever many related parties engage in plentiful transactions, transfer pricing becomes a central issue. Alibaba has even addressed these issues head-on:

If the PRC tax authorities determine that any contractual arrangements were not entered into on an arm’s length basis and therefore constitute a favorable transfer pricing, the PRC tax liabilities of the relevant subsidiaries and/or variable interest entities and/or variable interest entity equity holders could be increased, which could increase our overall tax liabilities.

The SAT may encounter two issues when evaluating transfer prices within a VIE: the label of the service purported to be offered, and the price for this service. WFOEs often charge a service fee to the VIE “for services rendered that is equal to the entire profits of the VIE.” Thus, the transfer of the VIE’s entire profits triggers a transfer pricing issue and should raise a flag to tax administrators. The SAT “might disagree with the classification of the transfer between the VIE and WFOE as a maintenance/managerial fee,” and seek to adjust the transfer price. This process assumes that the SAT is evenly regulating transfer prices of VIEs between their WFOEs. Regardless whether the transfer price is adjusted, the VIE and WFOE, as related parties, will not pay taxes on the transfer and can shift profits outside of China.

**B. Tax Havens: Enterprise Income Tax Law**

Similar to other jurisdictions, China has expressed its intention to crack down on anti-avoidance tactics. In 2009, China’s STA issued Guo Shui Fa No. 2 (also entitled Circular 82), its key regulation on transfer pricing issues, which includes an
entire chapter on the “Administration of the General Anti-Avoidance Rule.”

Under Article 92, tax authorities may initiate an investigation if anti-avoidance activities are suspected such as: “(1) abusive use of tax incentives; (2) abusive use of tax treaties; (3) abusive use of the forms of enterprise organization; (4) tax avoidance through tax havens; [and] (5) other business arrangements without bona fide commercial purposes.”

Because VIEs involve offshore holding companies, the SAT needs to determine whether such offshore companies can be considered Chinese enterprises for taxpaying purposes. To determine residency, SAT looks at the location of the “de facto management body” of the offshore enterprise. On January 1, 2008, China’s Enterprise Income Tax Law became effective. Article 2 classifies enterprises into “resident” and “non-resident” enterprises:

The term “resident enterprise” as mentioned in this present Law is an enterprise which is set up under the law of a foreign country (region) but whose actual management organ is within the territory of China.

The term “non-resident enterprise” as mentioned in this present Law means an enterprise which is set up under the law of a foreign country (region) and whose actual management organ is not within the territory of China but who has organs or establishments within the territory of China, or who does not have any organ or establishment within the territory of China but who has incomes sourced in China.

Only a “resident enterprise” is subject to paying enterprise income tax, levied at 25%. A “non-resident” must pay taxes on any income derived from China. However, per the Enterprise Income Tax Law, a foreign enterprise that is incorporated in another country but is controlled or funded by Chinese investors may be considered a resident if the SAT determines that its “de facto management body” is located inside China. The SAT defines “de facto management body” as “a management body that exercises full and substantial control and management over the manufacturing and business operation, personnel, accounting and properties of...

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334. Id.
335. Id.
341. See id. art. 4 (distinguishing resident and non-resident enterprise income tax rates).
342. CAO, supra note 333, at 23.
343. Alibaba Prospectus Supplement, supra note 197, at S-83.
Circular 82 also explains that a foreign enterprise will be considered a resident enterprise if any of the following factors apply:

(i) the primary location of the day-to-day operational management is in the PRC; (ii) decisions relating to the enterprise’s financial and human resource matters are made or are subject to approval by organizations or personnel in the PRC; (iii) the enterprise’s primary assets, accounting books and records, company seals, and board and shareholders meeting minutes are located or maintained in the PRC; and (iv) 50% or more of voting board members or senior executives habitually reside in the PRC.

The regulations of Circular 82 leave gaping holes open for VIEs. VIEs could operate the offshore holding companies in a way that ensures it does not “meet all or most of the effective management factors listed in Guo Shui Fa [Circular] 82.”

The Chinese Op. Co. and partnership can make a strong argument that the offshore holding company retains de facto control and management because they have contractual rights to the profits. Furthermore, partnerships of founders are usually registered offshore as well, so a VIE likely has proof to support its argument that the official location of the management body is not located in China. This distortion of residency enables VIE structures to avoid tax.

In its SEC Prospectus Supplement, AHG asserts that they are not subject to global income tax in China because they are not a resident enterprise of China. It argues that its central assets, board meeting minutes, and records are located outside of China. It notes: “we are not aware of any offshore holding companies with a corporate structure similar to ours that have been deemed a PRC ‘resident enterprise’ by [SAT].” While the Partnership is registered in the Cayman Islands, most of its day-to-day business is conducted in China and its business revenue comes from domestic sales in China. Alibaba is largely considered to be a “Chinese” company, yet its clever corporate structuring enables it to avoid classification as a resident enterprise, thereby creating a huge tax break for Alibaba.

344. Id.
345. Id.
346. See generally CAO, supra note 335, at 22.
347. Id.
348. Alibaba Prospectus Supplement, supra note 197, at S-83 (emphasis added). Note that Alibaba continues to assert that it is not subject to income tax on 25% of its global income because it asserts that it is not a “resident” of China. Alibaba 2018 Annual Report, supra note 25, at 51.
349. Alibaba Prospectus Supplement, supra note 198, at S-83.
350. Id.
351. Annual E-commerce Revenue of Alibaba from 2010 to 2018, by Region (in Million Yuan), supra note 276.
China’s regulations governing taxable entities lack the capacity to properly classify and tax a VIE structure. VIEs have a contractual obligation to get their profits out of China. However, it is not clear how the SAT would tax exits of capital: “the liquidation of earnings from the VIE to the legal owners, or directly to the WFOE could be characterized either as dividends (taxed at 20%), interest on the loan (taxed at 25%), or service payments (taxed at 5%) or some combination (e.g. both a dividend and interest payment).” Alibaba noted in its disclosures that if China does tax it as a resident, its “profitability and cash flow may be materially reduced as a result of our global income being taxed under the Enterprise Income Tax Law.” Furthermore, China may also be able to tax foreign shareholders on dividends and capital gains tax. If applied, those taxes would severely deter foreign investors from continued investments in Chinese e-commerce.

C. Enforcement

China has a history of poor domestic tax enforcement. Its cash-based society makes it easier to commit tax fraud. China’s recent commitment to the BEPS Actions shows its political willingness to collaborate on issues of tax avoidance, but the success of BEPS depends on domestic implementation and enforcement. The SAT has not adapted its enforcement and compliance policies to address increased globalization and diversification of taxable Chinese value. As a previously capital-importing country, China has not yet formed policies to address new risks that come with being a capital-exporting country, such as transfer pricing, deferred recognition of Chinese companies’ incomes in foreign jurisdictions, and unreported assets and income abroad. Furthermore, the SAT has not implemented policies to

353. See Hopkins et al., supra note 317, at 1–2 (noting that due to the use of loans from WFOEs to VIEs in China, foreign investors have contractual rights to cash flow VIEs); see also Lucas Hahn, 4 Big Reasons Alibaba Group Holding Ltd (BABA) Stock is a No-Go, INV. PLACE (Jun. 3, 2017, 10:48 AM), https://investorplace.com/2017/01/4-reasons-alibaba-group-holding-ldd-baba-stock-no-go/#.WoWP44Nu70 (warning foreign investors that foreign shareholders only receive profits from Alibaba due to a contract between the holding firm and the VIE).

354. Hopkins et al., supra note 317, at 35.


356. Id. at 51–52.

357. See id. at 52 (cautioning investors that if dividends or gains from transfer payable to non-PIC investors are subject to PIC taxes, shares may lose substantial value).


359. Roxburgh, supra note 358.

360. See generally id.


362. Id. at 34.
address new business models, such as the VIE. China hopes to address these shortcomings—it announced a five-year plan in 2015 to reform and modernize its tax administration by 2020.

In addition to new legislation and regulations, China will also need to address its culture of bribery. While the SAT can be tough on certain groups of taxpayers, it also has the reputation for currying favor with preferred industries, and companies’ connections with local tax authorities have played a larger role in tax collection than any regulations. MNEs like Alibaba have already shown non-compliance with certain accounting and reporting requirements; thus, concealed or adjusted transactions may have occurred with the acquiescence of SAT authorities and outside auditors.

VI. CONCLUDING REMARKS

The VIE presents a difficult conundrum for the world: E-commerce industries need capital to expand their business, thus incentivizing companies to create VIEs, and exacerbating already problematic tax avoidance and profit shifting. One thing remains clear—the Chinese government and the international community can no longer ignore the existence of the VIE structure and the tax avoidance problem it poses. E-commerce companies created VIEs with the clear intention of circumnavigating Chinese laws, yet the authorities failed to quash their growth when they had a chance. The inherent risk of VIE structures for tax reporting and compliance, as well as for corporate governance, demands that some sort of policies or rules be created to address their existence. Indeed, in its SEC Registration Statement, Alibaba conceded that “there are risks and uncertainties associated with our variable interest entity structure.” The company recently acknowledged in its

363. See id. at 33–34 (noting the confusion by SAT on how to tax the internet and e-commerce industry); see also Alibaba 2018 Annual Report, supra note 25, at 46 (noting the difficulty in applying Chinese tax laws due to their quick developments and varied applications).

364. See Brondolo & Zhang, supra note 361, at 38 (discussing the potential reforms that could result from this new initiative stemming from the project entitled Plan to Deepen Reform of the National and Local Tax Administration System).


368. See Agamoni Ghosh, Is the E-commerce Space All About Capital?, ENTREPRENEUR INDIA (July 12, 2017), https://www.entrepreneur.com/article/297120 (stating that capital plays a pivotal role in the survival of e-commerce companies); see generally A Legal Vulnerability, supra note 36.

369. Alibaba Holding Group Ltd., Amendment No. 7 to Form-1 Registration Statement (Form F-1) at 10 (Sept. 15, 2014).
2018 SEC Annual Report that its tax obligations contain “significant uncertainties,” and as a result, it may have to pay taxes on “future revenue or income.”

VIEs risk counteracting the aims of the OECD’s BEPS Actions. Action 1 demands more tailored rules for the digital industry. The e-commerce industry breeds dozens of issues, given that the network of online transactions generates less transparency and hinders enforcement of taxes. The VIE is a byproduct of the e-commerce industry, given strict regulations against foreign ownership in the internet sector. It is not likely that China will modify this rule or create an exception due to its own interest in protecting the profitable e-commerce industry. China has a profound and historical interest in protecting “sensitive” sectors, so it is unlikely that the VIE structure will die off due to a lack of regulations. Even if China does somehow validate the VIE structure, it does not solve the tax avoidance issues that are already in place—with an exodus of profits flowing to the Cayman Islands.

As a result of the complicated corporate organization of VIEs, which includes various subsidiaries and entities, the structure serves as an efficient tax avoidance tool. The issue of tax avoidance by VIEs could be addressed through the BEPS Actions against harmful tax practices—Action 5—and abuses in permanent establishment—Action 7. These actions outline promising techniques to detect BEPS issues, but they lack clear implementation or enforcement mechanisms. Notably, BEPS’ materials avoid the Cayman Islands. Whereas China has taken baby steps to address the VIE concerns, other jurisdictions may perhaps be substantially less sophisticated in enforcement or oversight, especially in such jurisdictions that benefit greatly from profit shifting, such as the Cayman Islands. It seems puzzling that a group of the most powerful countries can create action plans addressing tax havens and transfer pricing, while largely ignoring the largest enabling jurisdictions of such practices.

Finally, VIEs provides an easy vehicle to engage in unfair transfer pricing. The BEPS Actions sought to crack down particularly on transfer pricing (Actions 8–10), yet they fail to address the vast exchange of inter-group transactions from China’s e-commerce industry. This omission risks unraveling the BEPS’ work and legitimacy as an institution. Actions 8–10 stress the importance of transparency, but transparency is only as effective as the general enforcement of tax procedures already established in the jurisdiction. China needs to continue to overhaul its tax enforcement regime before issues of transfer pricing can be fully addressed.

371. See supra Part IV.A for a discussion on BEPS Action 1.
373. See supra Part IV.A for a discussion on China’s foreign investment restrictions.
374. Id.
375. Deméré et al., supra note 332, at 26 (noting the economic tax advantages to offshore entity vehicles).
376. See supra Part III.C & D respectively for a discussion on BEPS Action 5 and 7.
377. See supra Part IIIB for a discussion on BEPS Action 8–10.
Although solutions to issues created by the VIE structure are not clear, it is obvious that a “wait-and-see” approach is destined to fail. The 2007 financial crisis was a byproduct of the “wait-and-see” approach and in retrospect, and the world has learned that ignoring boiling bubbles will not stop the trouble from brewing, but will only make the burst even more destructive. Furthermore, a solution to the VIE issue lies not only with the e-commerce industry but also with the sectors that enable it to execute this structure, such as the banking and finance industries.

As Alibaba and other companies seek to expand their global presence, the use of the VIE structure may also proliferate. In China, many of its e-commerce and internet businesses have the potential to appeal to the global masses far beyond China’s borders. However, risks abound if a VIE structure upholds the largest e-commerce retailer in the world in a jurisdiction with lax BEPS-related oversight. Although much remains unknown regarding the legality, fiscal soundness, and ethics of VIE structures, their risks reveal a clear path toward havoc if left unaddressed.

381. Wei, *supra* note 56, at 281.
Figure 2