

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.

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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.¹ Chairwoman Hodge expressed her frustrations with Amazon.co.uk.'s advantageous relationship with Luxemburg, where all their profits seemed to end up.² She

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1. See *Starbucks, Google, and Amazon Grilled over Tax Avoidance*, BBC (Nov. 12, 2012), <http://www.bbc.com/news/business-20288077> (discussing the hearing and questions posed by the Public Accounts Committee, the parliamentary body responsible for overseeing government expenditures).

2. Public Accounts Committee, Minutes of Evidence, 2012-13, HC 716, at Q336, <https://publications.parliament.uk/pa/cm201213/cmselect/compubacc/716/121112.htm>.

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.”³ She then demanded, “[w]hy aren’t you paying corporation tax in the U.K?”⁴ 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.⁵ Member of Parliament Mr. Austin Mitchell asserted, “[y]ou are either running the business very badly, or there is some fiddle going on.”⁶

At the time of the Public Accounts Committee hearing in 2012, Starbucks had operated in the United Kingdom for fifteen years.⁷ 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.⁸ However, the United Kingdom’s hands are tied because none of the financing strategies of Starbucks, Google, or Amazon are illegal.⁹ The United Kingdom is not alone in feeling frustrated and embittered about the clever tax loopholes available to multinational enterprises (MNEs).¹⁰ 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.¹¹

The issue of tax avoidance is universal—every country and industry feels its effects.¹² Yet, one industry and jurisdiction in particular has been largely overlooked—the e-commerce industry in the People’s Republic of China (China).¹³ 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.”

11. ORG. ECON. CO-OPERATION & DEV. [OECD], *Myths and Facts about BEPS*, <https://www.oecd.org/ctp/myths-and-facts-about-beps.pdf> (last visited Oct. 31, 2018).

12. See *id.* (describing gaps in international tax laws as an issue that affects all countries).

13. See Xinmo Zhang, *Why Most Online Vendors in China Escape Taxes*, EJINSIGHT (May 11, 2015, 10:49 AM), <http://www.ejinsight.com/20150511-why-most-online-vendors-china-taxes/> (detailing the Chinese government’s efforts to circumvent an attempted local tax crackdown on e-commerce business to encourage economic growth).

the world's second largest capital-exporter.¹⁴ China's digital economy significantly contributed to this dramatic shift.¹⁵ China's e-commerce market is growing at an exponential rate, far surpassing that of the United States.¹⁶ Chinese consumers turn to e-commerce because online retailers have lower costs, higher quality, and a wider selection of goods.¹⁷ E-commerce platforms, such as Alibaba and JD.com,¹⁸ provide an easy and convenient way for interested foreign businesses to expand into the Chinese market.¹⁹ Chinese MNEs have utilized offshore jurisdictions,²⁰ 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."²¹ These e-commerce titans in China use a unique corporate structure called a "variable interest entity" (VIE),²² 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.²³ Companies using a VIE structure are able to assert that they are not residents in their primary operating jurisdiction.²⁴ 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.*

16. Frank Tong, *Online Retail Sales in China Soar Past \$1 trillion in 2017*, DIG. COM. 360 (Feb. 8, 2018), <https://www.digitalcommerce360.com/2018/02/08/online-retail-sales-china-soar-past-1-trillion-2017/> [hereinafter *Online Retail Sales*].

17. JEFF WALTERS ET AL., BOSTON CONSULTING GRP., *THE WORLD'S NEXT E-COMMERCE SUPERPOWER 10* (2011).

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/>.

19. See, e.g., *Expanding our Routes to Market in China Through E-Commerce*, MONDELEZ INT'L, <https://www.mondelezinternational.com/newsroom/our-stories/ecommerce-china> (last visited Oct. 31, 2018) (detailing Mondelez International's decision to partner with Alibaba and JD.com in order to capture the growth of online snack sales in China).

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 ZOROMÉ, INTERNATIONAL MONETARY FUND, *CONCEPT OF OFFSHORE FINANCIAL CENTERS: IN SEARCH OF AN OPERATIONAL DEFINITION* (2007).

21. Jan Fichtner, *The Anatomy of the Cayman Islands Offshore Financial Center: Anglo-America, Japan, and the Role of Hedge Funds*, 23 REV. INT'L POL. ECON. 1034, 1046 (2016).

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.

24. See Robyn Mak, *Home Away from Home*, REUTERS (Mar. 3, 2015), <https://www.breakingviews.com/considered-view/alibabas-split-nationalities-invite-trouble/> (explaining how Alibaba is considered a resident of the Cayman Islands by investors and a resident of Hong Kong by Chinese authorities).

Alibaba listed on the New York Stock Exchange (NYSE)—claims that it is not subject to tax in China.²⁵ The expansion of Alibaba and JD.com into other markets through new brands and business units, such as Tmall Global and Joybuy.com,²⁶ 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).²⁷ Two years later the OECD released fifteen BEPS Actions, which seek to combat, among other objectives, double taxation, non-taxation, and tax havens.²⁸ The OECD continues to release updated reports for each BEPS Action.²⁹

China, along with sixty-seven other jurisdictions, signed a multilateral instrument to implement the BEPS Actions in June 2017.³⁰ 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.³¹ Furthermore, given that China is the world's second-largest economy,³² with the world's largest population,³³ the inability to prevent the suspicious VIE

25. See Alibaba Holding Grp., Ltd., Annual Report (Form 20-F) at 51 (July 27, 2018), <https://otp.investis.com/clients/us/alibaba/SEC/sec-show.aspx?FilingId=12879202&Cik=0001577552&Type=PDF&hasPdf=1> [hereinafter Alibaba 2018 Annual Report] (arguing why Alibaba Holding Group should not be considered a resident under China's tax laws).

26. Tmall Global, operated by Alibaba Group, is the international division of Tmall.com. It aims to provide international goods to domestic consumers in mainland China. TMALL GLOBAL, <http://ecommercechinaagency.com/tmall-international-agency/> (last visited Nov. 13, 2018). Joybuy.com, operated by Chinese ecommerce giant JD.com, offers and delivers Chinese products to consumers overseas. JOYBUY, <https://help.joybuy.com/help/question-list.html> (last visited Nov. 13, 2018).

27. *Closing Tax Gaps—OECD Launches Action Plan on Base Erosion and Profit Shifting*, OECD (July 19, 2013), <http://www.oecd.org/ctp/beps/closing-tax-gaps-oecd-launches-action-plan-on-base-erosion-and-profit-shifting.htm>; BRIAN J. ARNOLD, INT'L TAX PRIMER 188 (3d Ed. 2016) (explaining that "base erosion" and "profit shifting" are essentially interchangeable terms).

28. See generally OECD, *OECD/G20 Base Erosion and Profit Shifting Project: 2015 Final Reports Information Brief* (2015) [hereinafter *2015 Final Reports Information Brief*].

29. See OECD, *BEPS Actions*, <http://www.oecd.org/tax/beps/beps-actions.htm> (last visited Oct. 31, 2018) (listing all the action plans and showing recently updated reports).

30. *China Signs Multilateral Instrument to Implement BEPS Reforms*, KPMG (June 9, 2017), <https://home.kpmg.com/cn/en/home/insights/2017/06/china-tax-alert-19.html>.

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.")

32. Rob Smith, *The World's Biggest Economies in 2018*, WORLD ECON. FORUM (Apr. 18, 2018), <https://www.weforum.org/agenda/2018/04/the-worlds-biggest-economies-in-2018/>.

33. U.S. Census Bureau Current Population, U.S. CENSUS BUREAU, <https://www.census.gov/popclock/print.php?component=counter> (last updated July 1, 2018).

corporate structure from flourishing could cause many headaches down the road.³⁴ Additionally, governments and the international community benefit from the success and legitimacy of BEPS.³⁵ 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 delegitimizing 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)."³⁶ The future legality of VIEs remains dubious.³⁷ Alibaba continues to make 91% of its revenue in mainland China,³⁸ despite its foreign incorporation in the Cayman Islands.³⁹ Yet, the Chinese internet sector is growing rapidly and backed by middle-class demand⁴⁰ so

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.").

36. *A Legal Vulnerability at the Heart of China's Big Internet Firms*, ECONOMIST: SCHUMPETER (Sept. 16, 2017), <https://www.economist.com/news/business/21728984-variable-interest-entities-are-their-weakest-link-legal-vulnerability-heart-chinas> [hereinafter *A Legal Vulnerability*].

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

ECONOMIC TRANSFORMATION (Cheng Li, ed., Brookings Inst. Press 2010).

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.

43. Kaitlyn Johnson, *Variable Interest Entities: Alibaba's Regulatory Work-around to China's Foreign Investment Restrictions*, 12 LOY. U. CHI. INT'L L. REV. 249, 250 (2015).

44. See Yu-Hsin Lin & Thomas Mehaffy, *Open Sesame: The Myth of Alibaba's Extreme Corporate Governance and Control*, 10 BROOK. J. CORP. FIN. & COM. L. 437, 444–45 (2016) (explaining that China subjects all foreign investment to a strict government approval process which deters foreign investment in sensitive sectors).

45. *A Legal Vulnerability*, *supra* note 36.

46. Dan Harris, *Doing Business in China Under China's Tax System*, HARRIS BRICKEN: CHINA L. BLOG (Jan. 10, 2016), <https://www.chinalawblog.com/2016/01/doing-business-in-china-under-chinas-tax-system.html>.

47. *A Legal Vulnerability*, *supra* note 36.

48. Ian Emerson Brown, *China's Leaked CSRC Report Five Years Later: Baseline For VIE Trajectory?*, 39 HOUS. J. INT'L L. 197, 201 (2017); Erik P.M. Vermeulen, *OECD Russia Corporate Governance Roundtable Technical Seminar, Beneficial Ownership and Control: A Comparative Study* 13 (March 2012).

49. See Serena Y. Shi, *Dragon's House of Cards: Perils of Investing in Variable Interest Entities Domiciled in the People's Republic of China and Listed in the United States*, 37 FORDHAM INT'L L.J. 1265, 1266–67 (2014) (describing what U.S. investors actually own when investing in VIEs).

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."⁵² VIEs essentially give foreign investors "control[] through *contracts*, rather than ownership."⁵³ 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.⁵⁴ Chinese founders of the operating company also hold an equity stake in this offshore holding company.⁵⁵ In turn, this offshore company "channels equity capital into a wholly foreign-owned enterprise (WFOE)."⁵⁶ The WFOE is typically located in Hong Kong "to act as a legal buffer as well as an entry point into China."⁵⁷

Due to its foreign status, the WFOE operating in China is unable to operate and obtain essential licenses in China.⁵⁸ To overcome this issue, the WFOE creates a domestic operating company (Chinese Op. Co.) in China owned only by Chinese shareholders.⁵⁹ The WFOE then enters into various contractual agreements—the "last link of the chain with actual equity ownership"⁶⁰—to enable it to vest operating power in the domestic operating company.⁶¹ The Chinese Op. Co., through these contractual agreements, usually transfers profits and voting rights back to the WFOE.⁶² In turn, the WFOE will transfer profits to the offshore holding company.⁶³ Given the Chinese nationality of the shareholders, the Chinese Op. Co. is in compliance with Chinese laws regulating investment ownership.⁶⁴

Scholars have dubbed the structure of a VIE as "creative compliance."⁶⁵ Unlike

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).

54. Quintus Dienst, *Tax Issues and Legal Obstacles Chinese Companies Face When Seeking to Capitalize Overseas Using a Variable Interest Entity Structure* 15, 18 (May 2, 2012) (unpublished B.A. thesis, Zeppelin University) (on file with author).

55. Guo, *supra* note 53, at 578.

56. Shen Wei, *Will the Door Open Wider in the Aftermath of Alibaba?—Placing (or Misplacing) Foreign Investment in a Chinese Public Law Frame*, 42 H.K. L.J. 275, 279 (2012).

57. Brown, *supra* note 48, at 204.

58. David Schindelheim, *Variable Interest Entity Structures in the People's Republic of China: Is Uncertainty for Foreign Investors Part of China's Economic Development Plan?*, 21 CARDOZO J. INT'L & COMP. L. 195, 205 (2012).

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.

62. Brown, *supra* note 48, 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 interpretation of Accounting Research Bulletin No. 51, “Consolidating Financial 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

66. Lin & Mehaffy, *supra* note 44, at 439–40.

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.

71. *Summary of Interpretation No. 46*, FASB, <http://www.fasb.org/summary/finsum46.shtml> (last visited Nov. 1, 2018).

72. *See FASB Issues FIN 46 to Curb Enron-Style Abuses*, ACCT. WEB (Jan. 20, 2003), <https://www.accountingweb.com/aa/standards/fasb-issues-fin-46-to-curb-enron-style-abuses> (announcing the purpose for the issuance of FIN 46); *see also The Fall of Enron*, NPR, <https://www.npr.org/news/specials/enron/> (last visited Nov. 1, 2018) (explaining that Enron went 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 Behavior of Different Market Participants*, 19 ASIA-PACIFIC J. ACC’T & ECON. 30 (2012) (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.⁷⁶ Through a series of contracts, an offshore holding company has de facto “control over the VIE and its operating profits.”⁷⁷ Per FIN 46(R), the offshore company would be the primary beneficiary that consolidates financial reporting of the VIE and WFOE.⁷⁸

C. Contract Terms and Rights

Because shareholders lack direct controlling financial interests in VIEs, traditional voting rights are not available.⁷⁹ A VIE structure relies on a network of fundamental contracts to function.⁸⁰ The first set of contracts involves financing.⁸¹ The offshore-listed company, through a loan agreement, provides capital to the Chinese Op. Co. by way of the WFOE.⁸² The Chinese owners also execute an “equity pledge agreement,” which guarantees equity to the WFOE.⁸³ 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.”⁸⁴ Finally, a “consulting or technical service agreement” allocates the operating company’s profits to the WFOE.⁸⁵

The second set of contracts regulates shareholders’ rights.⁸⁶ Through a proxy agreement, the WFOE obtains the shareholder rights of the Chinese Op. Co.⁸⁷ 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.”⁸⁸ 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.⁸⁹ 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).

80. Shi, *supra* note 49, at 1277; see also W. Tyler Perry, *Development and Distrust: A Critique of the Orthodox Path to Economic Prosperity*, 110 NW. U. L. REV. 477, 485–87 (2016) (discussing generally the contracts and rights within a VIE structure).

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).

82. Shi, *supra* note 49, at 1277–78.

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.⁹⁰

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.”⁹¹ In fact, VIE structures employed by the Singapore-incorporated GigaMedia Limited (GigaMedia) collapsed as a result of a leadership dispute in 2010.⁹² The board of GigaMedia became unsatisfied with then-CEO Wang Ji and attempted to oust him by restructuring the company’s leadership.⁹³ 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.⁹⁴ 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.”⁹⁵ This major setback became a cautionary tale for the industry: the contracts upholding a VIE structure work only if everyone plays by the rules.⁹⁶ 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.”⁹⁷

The VIE structure is a house of cards balancing on the presumed enforceability of all of the contracts upholding it.⁹⁸ 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.⁹⁹ Investors also face risks if the VIE structure itself is deemed invalid by Chinese authorities.¹⁰⁰ While China has an incentive to keep its e-commerce industry alive,

90. See Vermeulen, *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); see also Lin & Mehaffy, *supra* note 44, at 465 (noting that Alibaba is incorporated in the Cayman Islands and does not have to follow Delaware’s fiduciary laws).

91. Brown, *supra* note 48, at 206.

92. See Lin & Mehaffy, *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).

93. See Damjan DeNoble, *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).

94. *Id.*

95. Lin & Mehaffy, *supra* note 44, at 447.

96. See DeNoble, *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.”).

97. Perry, *supra* note 80, at 486.

98. See Johnson, *supra* note 43, at 253 (noting that the legal contracts establishing the VIEs can only be enforced by China).

99. See *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).

100. See *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,¹⁰¹ 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.¹⁰² 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.¹⁰³ The services provided by a WFOE in the e-commerce industry typically include “website maintenance, programming, sales support, fulfillment services, curriculum development, etc.”¹⁰⁴ In some cases, the WFOE may also receive a royalty for licensing key intellectual property (IP) assets to the operating company.¹⁰⁵ In sum, a Chinese Op. Co. can legally funnel all of its profits through a WFOE to reach the offshore holding company,¹⁰⁶ 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.¹⁰⁷

III. BEPS ACTIONS

After the global economic recession in 2007, the international community sought to promote financial transparency for large MNEs.¹⁰⁸ 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.¹⁰⁹ 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.*

106. Dienst, *supra* note 54, at 21.

107. *See* U.S.-CHINA ECON. AND SEC. REV. COMM’N, THE RISKS OF CHINA’S INTERNET COMPANIES ON U.S. STOCK EXCHANGES 5 (2014) (discussing how Chinese firms continue to use VIEs to list on U.S. exchanges because the high return outweighs the risk).

108. *See* OECD, *Background Brief: Inclusive Framework on BEPS*, at 9 (Jan. 2017), <https://www.oecd.org/ctp/background-brief-inclusive-framework-for-beps-implementation.pdf> (describing how the financial crisis and aggressive tax planning strategies by MNEs gave rise to the BEPS project); *see generally* Kimberly Amadeo, *2007 Financial Crisis Explanation, Causes, and Timeline*, THE BALANCE (Nov. 2018) <https://www.thebalance.com/2007-financial-crisis-overview-3306138>.

109. *See* OECD, *Explanatory Statement: OECD/G20 Base Erosion and Profit Shifting Project*, ¶¶ 2, 19 (2015), <http://www.oecd.org/ctp/beps-explanatory-statement-2015.pdf> [hereinafter *Explanatory Statement*] (discussing the aims of the BEPS).

preventing tax avoidance abuses and promoting transparency through various measures and “soft law instruments.”¹¹⁰ 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.”¹¹¹ BEPS seeks to “[ensure] that profits are taxed where economic activities generating the profits are performed and where value is created.”¹¹² 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.¹¹³

A. Action 1—Digital Economy

BEPS Action 1 addresses tax issues that have arisen as the global economy has become increasingly more digital.¹¹⁴ 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.”¹¹⁵ Action 1 also aims to address the “accelerated” expansion of “global value chains” jurisdictions,¹¹⁶ which enables MNEs to disperse activities and easily transfer intangibles worldwide to take advantage of favorable tax jurisdictions.¹¹⁷ 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).¹¹⁸

110. See *Myths and Facts About BEPS*, *supra* note 11, ¶¶ 1, 6 (discussing how the G20 Finance Ministers and Heads of State endorsed the Action Plans and will implement the soft law instruments once an agreement has been reached with OECD members); see also *Explanatory Statement*, *supra* note 109, at 4–5 (detailing the history and purpose of BEPS).

111. OECD, *Taxing Multinational Enterprises: Base Erosion and Profit Shifting (BEPS)*, BEPS Update No. 3 (Oct. 2015), <https://www.oecd.org/ctp/policy-brief-beps-2015.pdf>.

112. *BEPS Actions*, *supra* note 29.

113. *Id.*; see also *Myths and Facts About BEPS*, *supra* note 11, ¶ 1 (noting that the BEPS seeks to revise international tax rules that allow MNEs to shift profits by altering the Transfer Pricing Guidelines and recommending ways to improve domestic laws).

114. OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report: OECD/G20 Base Erosion and Profit Shifting Project*, at 11 (2015), <https://www.oecd-ilibrary.org/docserver/9789264218789-en.pdf?expires=1540854668&id=id&accname=ocid177427a&checksum=0A7D803A19423A99E0DB2173DEF872F3> [hereinafter *Action 1*].

115. *Id.*

116. *Id.*

117. See *id.* ¶ 2, at 16 (noting how the digital economy depends on intangibles, which can hamper the administrability of tax regimes); see also *infra* Parts III.B, III.D for a discussion on transfer pricing and harmful tax practices.

118. Creating a PE in a certain jurisdiction subjects that entity to tax liability. MNEs avoid creating a PE in a jurisdiction in order to avoid such a tax liability. See ARNOLD, *supra* note 27, at 157 (explaining that PE refers to a fixed place of business or a dependent agent acting therein); see also *Background Brief: Inclusive Framework on BEPS*, *supra* note 108, at 19 (noting that a goal of the BEPS is to prevent the avoidance of a PE); see *infra* Part III.C for a discussion on issues with 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.¹¹⁹ 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.”¹²⁰ In addition, Action 1 discusses the difficulties in attributing value to data for tax purposes, especially for unique forms of digital products and services.¹²¹ Finally, Action 1 acknowledges that while technology has enabled the vast expansion of global business,¹²² 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.¹²³ 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.¹²⁴ Although the practice of transfer pricing is not illegal, the manipulation of transfer pricing results in a diversion of tax liability.¹²⁵ Furthermore, the inability to appropriately tax value in the correct jurisdiction promotes economic inequality and threatens the integrity of governments.¹²⁶ In particular, transfer pricing harms developing countries, which disproportionately rely on corporate tax for revenue and growth.¹²⁷

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,¹²⁸ 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).

127. JOEL COOPER ET AL., *TRANSFER PRICING AND DEVELOPING ECONOMIES* xix. (2016).

128. *BEPS: Why You’re Taxed More than a Multinational*, OECD INSIGHTS (Feb. 13, 2013), <http://oecdinsights.org/2013/02/13/beps-why-youre-taxed-more-than-a-multinational/>.

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“operating in several countries but managed from one (home) country.”¹²⁹ MNEs operate as a global conglomerate of companies and use “locally incorporated subsidiaries” or PEs to conduct business.¹³⁰ In a traditional model, a corporation enters into contracts with other independent corporations to exchange goods or services.¹³¹ In contrast, MNEs engage in internal transactions with their subsidiaries (“intra-group integration”) to avoid transactions through the market.¹³² Such an integration model allows MNEs to pool their resources, optimize the cost of production, and lower transactional costs.¹³³

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.¹³⁴ Operating in multiple jurisdictions requires MNEs to develop detailed compliance policies.¹³⁵ MNEs exist as a sort of omnipresent entity that must comply with demanding and sometimes conflicting laws.¹³⁶ However, MNEs often defy such rules by engaging in manipulative transfer pricing practices in less-transparent jurisdictions.¹³⁷

Transfer pricing occurs when an affiliate or subsidiary transfers goods or services to a related affiliate within the same MNE or firm.¹³⁸ However, affiliates often inaccurately price the true value of these transfers when going from high-tax jurisdictions to low-tax jurisdictions.¹³⁹ The affiliate in the low-tax jurisdiction may

129. *Multinational Corporation (MNC)*, BUSINESSDICTIONARY, <http://www.businessdictionary.com/definition/multinational-corporation-MNC.html> (last visited Dec. 9, 2018).

130. U.N., *Practical Manual on Transfer Pricing for Developing Countries* (2017), ¶ A.1.2. (2017) [hereinafter U.N., *Transfer Pricing Manual*].

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.

136. *See* Tom Lickess, *Why You Can't Ignore New Transfer Pricing Requirements*, RADIUS BLOG (Feb. 7, 2018), <https://www.radiusworldwide.com/blog/2018/2/why-you-cant-ignore-new-transfer-pricing-requirements> (explaining that each country has its own transfer pricing documentation, reporting requirements, and deadlines).

137. *See World Investment Report: Chapter 5—International Tax and Investment Policy Coherence*, UNCTAD, <http://worldinvestmentreport.unctad.org/wir2015/wir2015-ch5-international-tax-and-investment-policy-coherence/> (last visited Nov. 1, 2018) (noting that tax avoidance is enabled by tax rate differentials and legislative disparities among jurisdictions).

138. *See, e.g.*, JANE G. GRAVELLE, CONG. RES. SERV., R40623, TAX HAVENS: INTERNATIONAL TAX AVOIDANCE AND EVASION 12 (2015) (defining transfer pricing).

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.

143. Bibiana A. Cruz Martínez, *The Arm's Length Standard vs. The Commensurate with Income Standard: Transfer Pricing Issues in the Valuation of Intangible Assets*, 2 U. P.R. BUS. L. J. 302, 306 (2011).

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.”).

145. U.N., *Transfer Pricing Manual*, *supra* note 130, ¶ 1.4.4.

146. See Wagdy M. Abdallah & Ahmed S. Maghrabi, *Do Multinational Companies Have Effective Transfer Pricing Systems of Intangible Assets and E-commerce?*, 19 INT'L J. COMM. MGMT. 115, 119 (2009) (listing the six methods for valuating transfer prices: comparable uncontrolled price, resale price, cost plus, comparable profit, transactional net margin, and profit split).

147. See Allison Christians, *The Flawed, Insensible, Unworkable Arm's Length Standard*, TAX, SOC'Y & CULTURE (May 24, 2012, 9:57 PM), <http://taxpol.blogspot.jp/2012/05/flawed-insensible-unworkable-arms.html> (criticizing the OECD's arm's length principle for being difficult to apply in practice).

148. See generally OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, ¶¶ 1.14–15, 1.32 (July 2017) [hereinafter *OECD Transfer Pricing Guidelines*].

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.¹⁵¹ BEPS Actions 8–10 seek to address the valuation of transfer prices and emphasize the need for uniform reporting requirements and compliance standards.¹⁵² 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.¹⁵³

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”¹⁵⁴ 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.¹⁵⁵ Risk may easily be overlooked, yet it also constitutes much of a company's value.¹⁵⁶ Assessment of risk assumption involves recognizing where risk lies in order to appraise the most accurate value.¹⁵⁷ For example, tax authorities should consider whether an MNE has fragmented activities across many subsidiaries, thereby dispersing the risk.¹⁵⁸

The internet has enabled MNEs both to transact with its affiliates from anywhere in the world and move its business operations online.¹⁵⁹ Due to their unique qualities, appraisal value of intangible assets is hard to ascertain and verify, and thus transfer pricing issues often arise.¹⁶⁰ Action 1 also emphasizes concerns

151. 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).

152. 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).

153. 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).

154. *OECD Transfer Pricing Guidelines*, *supra* note 148, ¶ 1.123, at 79 (emphasis added).

155. *Actions 8–10*, *supra* note 152, at 14.

156. 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).

157. *OECD Transfer Pricing Guidelines*, *supra* note 148, ¶ 1.56, at 53.

158. 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).

159. See Abdallah & Maghrabi, *supra* note 146, at 116 (noting that technological advancements have also encouraged e-commerce companies to integrate for convenience).

160. See Martínez, *supra* note 143, at 303 (noting that not only are intangible assets hard to value, but they are often a corporation's most prized assets, such as patents and other forms of intellectual property).

that “intangibles” raise for tax authorities.¹⁶¹ Intangible assets encompass all of the “nonphysical, nonmonetary assets of a firm.”¹⁶² Intangibles are not limited to intellectual property, but also include employees, licensees, software, procedures, distribution, mailing lists, and the like.¹⁶³ An e-commerce business in particular holds many intangible assets, such as software, licenses, an online payment system, and customer data,¹⁶⁴ which are easily transferable to another jurisdiction and potentially difficult to value.¹⁶⁵

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.¹⁶⁶ 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.¹⁶⁷ Evaluating such intangibles requires analyzing their “partial excludability, inherent risk, and nontradability.”¹⁶⁸ 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.¹⁶⁹ If an MNE possesses an intangible that is non-tradable, the MNE lacks vital valuation information that markets usually provide.¹⁷⁰ MNEs also employ the strategy of overvaluing key, unique royalties to be paid to related parties in a favorable tax jurisdiction.¹⁷¹ 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.”¹⁷²

161. *Action 1*, *supra* note 114, ¶ 152, at 65.

162. Yariv Brauner, *Value in the Eye of the Beholder: The Valuation of Intangibles for Transfer Pricing Purposes*, 28 VA. TAX REV. 79, 87 (2008).

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.”).

164. *See* Ron Dod, *How to Value your E-commerce Business*, VISITURE (Oct. 18, 2016), <https://www.visiture.com/blogs/value-e-commerce-business/> (listing various intangible assets to consider when valuing an e-commerce business).

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).

167. *Action 1*, *supra* note 114, ¶¶ 153, 187, at 65, 80.

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 (explaining 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.”¹⁷³ A country may have the jurisdiction to tax an entity that holds a PE through its business in that country.¹⁷⁴ If tax authorities determine that an MNE has a PE in its jurisdiction, the MNE may be subject to corporate tax.¹⁷⁵ Consequently, MNEs may assign revenue-generating functions to their subsidiaries and affiliates to avoid creating a PE.¹⁷⁶ The international community has expressed a desire to reform PE rules but has avoided tackling the MNEs’ clever avoidance of PE creation.¹⁷⁷ The international community fears that unraveling the PE rule would create confusion and greatly disrupt economic activities.¹⁷⁸ Action 7 seeks to address this avoidance of PE once and for all by abolishing commissionaire structures¹⁷⁹ and narrowing particular activity exceptions.¹⁸⁰

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.¹⁸¹ 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.¹⁸² 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.¹⁸³ 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.*

175. *The Ultimate Guide to Permanent Establishment*, SHIELDGEO, <https://shieldgeo.com/ultimate-guide-permanent-establishment/> (last visited Nov. 3, 2018).

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).

177. Lee A. Sheppard, *Twilight of the International Consensus: How Multinationals Squandered Their Tax Privileges*, 44 WASH. U. J. L. & POL’Y 68, 78 (2014) (describing PE as a problem that multiple countries have flagged, but that no one wants to solve).

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).

183. *Comments on Draft Additional Guidance on Attribution of Profits to a Permanent Establishment*, BEPS MONITORING GROUP (Sept. 14, 2017), <https://bepsmonitoringgroup.wordpress.com/category/action-7/>.

presence” in the jurisdiction.¹⁸⁴ 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.

D. Action 5—Tax Havens: Harmful Tax Practices in Advantageous Jurisdictions

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.¹⁸⁵ 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.¹⁸⁶ Critics of the BEPS project note the OECD’s relatively lax stance and inconsistency regarding notorious tax havens.¹⁸⁷ 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.¹⁸⁸

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.¹⁸⁹ 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.”¹⁹⁰ Action 5 attempts to implement transparency by requiring the “compulsory spontaneous exchange of information in respect of rulings.”¹⁹¹ 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,¹⁹² especially if a double tax treaty applies.

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

184. *Action 1*, *supra* note 114, ¶ 184, at 79.

185. See generally OECD, *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance: Action 5: 2015 Final Report*, 10 (2015), <https://doi.org/10.1787/9789264241190-en> [hereinafter *Action 5*].

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).

187. See, e.g., George Turner, *Will the G20 Ever End the Global Problem of Tax Avoidance and Tax Evasion?*, TAX JUST. NETWORK (July 3, 2017), <https://www.taxjustice.net/2017/07/03/will-g20-ever-end-global-problem-tax-avoidance-tax-evasion/>.

188. See generally OECD, *Harmful Tax Practices—2017 Progress Report on Preferential Regimes: Inclusive Framework on BEPS: Action 5* (2017), <https://doi.org/10.1787/9789264283954-en>.

189. *Action 5*, *supra* note 185, ¶ 28, at 24.

190. Explanatory Paper, OECD, *Agreement on Modified Nexus Approach for IP Regimes*, <https://www.oecd.org/ctp/explanatory-paper-beeps-action-5-agreement-on-modified-nexus-approach-for-ip-regimes.pdf> (last visited Nov. 2, 2018).

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/a2233928z424b2.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.”²⁰² Such secrecy not only attracts direct investment, but also serves as an epicenter for hedge funds, offshore banking, and portfolio investment.²⁰³

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.²⁰⁴ These issues arise when states engage in tax competition games to attract value-added activities to their jurisdictions so as to increase revenue.²⁰⁵ Moreover, international enforcement against tax avoidance issues proves challenging, given inconsistent disclosure requirements in varying jurisdictions and fears of overreaching regulatory approaches.²⁰⁶ 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.²⁰⁷ 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.²⁰⁸

In addition, OECD has a reputation for bias, and is considered by some to be a “global club of rich nations.”²⁰⁹ Critics view OECD’s aims as ineffective and unfair toward developing countries.²¹⁰ In fact, OECD’s 2017 Transfer Pricing Guidelines even acknowledge that it can be burdensome for both taxpayers and tax authorities

202. 2018 *Financial Secrecy Index*, TAX JUSTICE NETWORK (Jan. 30, 2018), <http://www.financialsecrecyindex.com/>.

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).

207. See Sissie Fung, *The Questionable Legitimacy of the OECD/G20 BEPS Project*, 10 ERASMUS L. REV. 76, 81 (2017) (discussing States’ hesitations and concerns related to national sovereignty for global tax proposals and initiatives).

208. Robert Goulder, *The Inadequacy of BEPS to Fix What’s Wrong with the Corporate Income Tax*, FORBES (May 13, 2016, 12:01 PM), <https://www.forbes.com/sites/taxanalysts/2016/05/13/the-inadequacy-of-beps-to-fix-whats-wrong-with-the-corporate-income-tax/>.

209. Krishnadev Calamur, *Every Country Is a Tax Haven*, ATLANTIC (Nov. 7, 2017), <https://www.theatlantic.com/international/archive/2017/11/paradise-papers-tax-havens/545147/>.

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.²¹¹ 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.²¹² 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.²¹³

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.²¹⁴ These criticisms present valid points that OECD policymakers may take into consideration as they continue to release updated reports.²¹⁵

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.²¹⁶ China created strict investment rules in order to protect these “politically sensitive” domestic sectors.²¹⁷ 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.²¹⁸ A Chinese Op. Co. can now operate in “restricted” industries, while still attracting foreign investors.²¹⁹ 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,²²⁰ yet they can still access

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).

212. Reuven S. Avi-Yonah & Haiyan Xu, *Evaluating BEPS: A Reconsideration of the Benefits Principle and Proposal for UN Oversight*, 6 HARV. BUS. L. REV. 185, 219 (2016).

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.

216. Zacks Equity Research, *Alibaba's Business Structure: Does it Involve Risks?*, NASDAQ (Oct. 1, 2014, 9:00 AM), <https://www.nasdaq.com/article/alibabas-business-structure-does-it-involve-risks-analyst-blog-cm397135>.

217. *A Legal Vulnerability*, *supra* note 36.

218. *Id.*

219. Vermeulen, *supra* note 48, at 13.

220. See Paul Mozur, *The World's Biggest Tech Companies Are No Longer Just American*, N.Y. TIMES (Aug. 17, 2017), <https://www.nytimes.com/2017/08/17/business/dealbook/alibaba-sales-revenue-first-quarter-profit.html> (examining the difficulties U.S. e-commerce companies like Facebook and Amazon face when entering the Chinese market and how these difficulties simply

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.²²¹ China allowed foreign direct investment (FDI) to flow into the country, but it prohibited FDI in certain “sensitive” sectors.²²² The Chinese government considers such sectors to be “strategic and emerging industries” or sectors that are vital for “political or national security reasons.”²²³ These include the media, internet, banking, natural resources, and agriculture.²²⁴

The Catalogue for the Guidance of Foreign Investment Industries separates sectors into “restricted” and “prohibited” categories.²²⁵ Foreign investors are proscribed from engaging and investing in any sector on the prohibited list.²²⁶ The prohibited list ranges from industries such as “production of *Xuan* paper and Chinese ink ingot” to “movie production companies, distribution companies, and theaters.”²²⁷ 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).”²²⁸ Item number 26 on the “prohibited” list forbids foreign investment in “business premises for internet-access services.”²²⁹

The greatest risk for VIEs is that the Chinese government decides they are illegal.²³⁰ China first recognized the existence of VIEs in 2011 when a leaked copy of the proposed VIE regulations surfaced.²³¹ 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.²³² Sections (3) and (5) invalidate any contract if “(3) there is an attempt to conceal illegal goals under the guise of legitimate forms;” or “(5) mandatory provisions of laws and

bar these companies from altogether entering it).

221. Shi, *supra* note 48, at 1271.

222. *See id.* at 1270–74 (explaining the introduction of FDIs into China and their restrictions).

223. Johnson, *supra* note 49, at 252.

224. Waishang Touzi Chanye Zhidao Mulu (2017 nian Xiuding) (外商投资产业指导目录 (2017年修订)) [Catalogue of Industries for Guiding Foreign Investment (2017 Revision)] (promulgated by the Nat’l Dev. & Reform Comm’n and Ministry Com. People’s Rep. China, June 28, 2017, effective July 28, 2017), CLI.4.297212(EN) (Lawinfochina).

225. *Id.* at pt. 1, 2.

226. *Id.* at Explanations, ¶ 3.

227. *Id.* at pt. 2, ¶¶ 10, 25.

228. *Id.* at pt. 1, ¶ 21.

229. *Id.* at pt. 2, ¶ 26.

230. Lin & Mehaffy, *supra* note 44, at 447–48.

231. *See* Brown, *supra* note 48, at 200 (noting that a report from the Chinese Securities and Regulatory Commission (CSRC) leaked in 2011, which contained a legal plan to invalidate the VIE structure in China).

232. Lin & Mehaffy, *supra* note 44, at 447.

administrative regulations are violated.”²³³ 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.²³⁴ China likely does not want to disrupt this very successful industry,²³⁵ 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.²³⁶ 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.²³⁷ The Draft sought to target VIEs by employing a “substance-over-form” analysis for differentiating between foreign enterprises and Chinese enterprises.²³⁸ In doing so, tax authorities would be able to look to contractual agreements in assessing who controls an enterprise.²³⁹ Yet, two years later, in 2017, China still had not enacted any of the language from the Draft.²⁴⁰ Perhaps the forces of Alibaba, Tencent, Baidu,²⁴¹ and other e-commerce titans have grown too big to fail—so China may never invalidate VIE structures outright.²⁴² 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.²⁴³

233. Zhonghua Renmin Gongheguo Hetongfa (中华人民共和国合同法) [Contract Law of the People’s Republic of China] (promulgated by the Standing Comm. Nat’l People’s Cong., Mar. 15, 1999, effective Oct. 1, 1999), art. 52(3), (5), CLI.1.21651(EN) (Lawinfochina).

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.

238. Brown, *supra* note 48, at 210.

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).

241. Tencent is a corporate tech giant similar to Alibaba, with business in instant messaging (through apps QQ and WeChat), mobile games, video streaming, and more. As of January 2018, Tencent was the world’s fifth most valuable listed company. Mark Sweney, *Tencent, the \$500bn Chinese Tech Firm You May Never Have Heard of*, GUARDIAN (Jan. 13, 2018, 5:02 AM), <https://www.theguardian.com/business/2018/jan/13/tencent-the-500bn-chinese-tech-firm-you-may-never-have-heard-of>. Baidu is a Chinese search engine company, comparable to Google, and is the primary search engine in China. *Baidu*, INVESTOPEDIA, <https://www.investopedia.com/terms/b/baidu.asp> (last visited Oct. 28, 2018).

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

244. *Number of Digital Buyers in China from 2016 to 2022 (in Millions)*, STATISTA, <https://www.statista.com/statistics/246032/number-of-online-buyers-in-china/> (last visited Oct. 28, 2018).

245. *China Country Commercial Guide: China-eCommerce*, INT'L TRADE ADMIN. (July 14, 2017), <https://www.export.gov/article?id=China-ecommerce>.

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).

247. See Mirko Warschun et al., *The Age of Focus: 2017 Global Retail Development Index*, ATKEARNEY, <https://www.atkearney.com/global-retail-development-index/article/?a/the-age-of-focus-2017-full-study> (last visited Oct. 28, 2018) (noting India overtook China last year as the top developing country for retail investment).

248. CLARK, *supra* note 246, at 10.

249. See generally DAVE M. HOLLOWAN, CHINA CATALYST: POWERING GLOBAL GROWTH BY REACHING THE FASTEST GROWING CONSUMER MARKET IN THE WORLD 85–90 (2013).

250. See Jiayang Fan, *China's Selfie Obsession*, NEW YORKER (Dec. 18 & 25, 2017), <https://www.newyorker.com/magazine/2017/12/18/chinas-selfie-obsession> (noting China's powerful obsession with social media presence and personalities).

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 HOLLOWAN, *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.²⁵⁵ Chinese e-commerce companies hoping to raise equity by listing on the Chinese stock market faced many obstacles.²⁵⁶ Companies often could not meet the strict net profit requirements to list on Chinese stock exchanges.²⁵⁷ 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.²⁵⁸ 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.²⁵⁹ As a solution, e-commerce companies turned to the VIE structure.²⁶⁰ The VIE structure gives Chinese companies access to much-needed foreign capital without explicitly violating Chinese law.²⁶¹ Alibaba is a prime example of such an e-commerce success story that utilized the VIE structure.²⁶²

C. Alibaba: China's E-commerce Titan

Alibaba, China's mega online retailer, has led the boom in e-commerce popularity in China.²⁶³ Alibaba operates similarly to Amazon by providing an online marketplace for buyers and sellers, yet Alibaba “does not hold inventory or participate in logistics.”²⁶⁴ 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.²⁶⁵ On Singles Day in 2018, Alibaba sold more than \$30.8 billion in merchandise within twenty-four hours.²⁶⁶ Consumers spent \$1 billion within the first two minutes of Singles Day kickoff.²⁶⁷ 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. See *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).

264. Kristina Zucchi, *How Does Alibaba Make Money? A Cheat Sheet*, INVESTOPEDIA (Nov. 1, 2018, 1:42 PM) <https://www.investopedia.com/articles/investing/121714/how-does-alibaba-make-money-simple-guide.asp>.

265. Benjamin Haas, *Chinese Shoppers Spend a Record \$25bn in Singles Day Splurge*, GUARDIAN (Nov. 27, 2017, 8:55 AM) <https://www.theguardian.com/world/2017/nov/12/chinese-shoppers-spend-a-record-25bn-in-singles-day-splurge> (noting that 2017 Singles Day saw sales four times larger than Black Friday and Cyber Monday).

266. Arjun Kharpal, *Alibaba Sets New Singles Day Record with More than \$30.8 Billion in Sales in 24 Hours*, CNBC (Nov. 21, 2018, 8:14 PM), <https://www.cnbc.com/2018/11/11/alibaba-singles-day-2018-record-sales-on-largest-shopping-event-day.html>.

267. *Id.*

conglomerate of e-commerce sites, such as Taobao, Tmall, and Juhuasuan.com.²⁶⁸ It sells nearly everything from private islands to Buicks to apples.²⁶⁹

Alibaba operates a very diverse business, owning companies that specialize in various types of e-commerce.²⁷⁰ Some experts have dubbed Alibaba as Amazon, eBay, PayPal, and to some extent, Google rolled into one.²⁷¹ Taobao, Alibaba's most successful subsidiary, sells new and used goods and controls roughly 90% of the consumer-to-consumer market in China.²⁷² For the business-to-consumer market, Taobao controls nearly 50%.²⁷³ Alibaba also owns Alipay, which functions as its primary mobile payment system on its various platforms.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).²⁷⁵

While Alibaba has certainly made e-commerce popular, most of its transactions still involve distributing domestic goods in China.²⁷⁶ In order to expand their services beyond China's borders, Alibaba and other Chinese tech companies are looking abroad for their next move.²⁷⁷ The industry has turned to cross-border e-commerce (CBEC) to provide coveted foreign merchandise to its customer base in China.²⁷⁸ CBEC specifically entails delivering foreign merchandise through an online platform.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.²⁸⁰ The cross-border channel was expected to hit 8.8 trillion yuan (\$1.3 trillion) in 2018.²⁸¹

268. *Id.* at 8.

269. *Id.* at 10–11.

270. Zucchi, *supra* note 264.

271. *Id.*

272. HOLLOWAN, *supra* note 249, at 86 (noting eBay as an example of a consumer-to-consumer business); Tom Marling, *In Positive Year for Alibaba, Taobao Lags Behind*, AIM GROUP (May 18, 2017), <https://aimgroup.com/2017/05/18/in-positive-year-for-alibaba-taobao-lags-behind/>.

273. *Id.*

274. *See id.* (describing the success of Alipay for online shopping); Ayoub Aouad, *Alipay is Setting up for Global Dominance*, BUS. INSIDER (May 10, 2017, 4:50 PM), <http://www.businessinsider.com/alipay-is-setting-up-for-global-dominance-2017-5>.

275. Zucchi, *supra* note 264.

276. *See Annual E-commerce Revenue of Alibaba from 2010 to 2018, by Region (in Million Yuan)*, STATISTA, <https://www.statista.com/statistics/226793/e-commerce-revenue-of-alibacom/> (last visited Nov. 14, 2018) (showing that a majority of Alibaba's revenue comes from domestic sales in China, as opposed to international sales).

277. Chenan Xia, *Cross-Border E-commerce is Luring Chinese Shoppers*, MCKINSEY & CO. (Feb. 2016), <https://www.mckinsey.com/industries/high-tech/our-insights/crossborder-e-commerce-is-luring-chinese-shoppers>.

278. *Id.*

279. *Id.*

280. *Id.*

281. Song Jingli, *China's Cross-Border E-commerce Expected to Hit \$1.3t in 2018*, CHINA DAILY (Oct. 30, 2017, 1:22 PM), http://www.chinadaily.com.cn/business/2017-10/30/content_33890583.htm.

Alibaba launched its CBEC subsidiary Tmall Global in February 2014.²⁸² Tmall Global engages with foreign importers to deliver authentic luxury merchandise to Chinese consumers.²⁸³ In 2016, Tmall Global's marketplace advertised an estimated 14,500 overseas brands, with 80% of them being first-time Chinese market sellers.²⁸⁴ Chinese consumers have taken a liking to foreign brands, which carry a perceived higher quality and safety.²⁸⁵ This is likely due to Chinese consumers' broad distrust in the quality and safety of domestic products.²⁸⁶ Anything international has become synonymous with quality, authenticity, and status.²⁸⁷ CBEC also enables foreign importers to access previously hard-to-reach consumers.²⁸⁸ Many consumers, especially in mid-to-smaller sized cities, do not have the means to travel abroad to access foreign luxury brands.²⁸⁹ 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.²⁹⁰ AHG is located in the Cayman Islands and functions as its offshore holding company, or "special purpose vehicle."²⁹¹ The founding Chinese partners, called the

282. Ann Christin Mahrt, *What is the Actual Difference Between Tmall and Tmall Global in China?*, EHUB NORDIC (Mar. 1, 2017), <http://www.ehubnordic.com/2017/03/01/what-is-the-actual-difference-between-tmall-and-tmall-global-in-china/>.

283. See HAU LEE ET AL., U.S.-TO-CHINA B2C E-COMMERCE: IMPROVING LOGISTICS TO GROW TRADE 6 (2016) (listing popular products amongst CBEC shoppers, including cosmetics, perfume, and jewelry).

284. Frank Tong, *Thousands of Foreign Brands Enter China Through E-commerce*, DIG. COM. 360 (Jan. 19, 2017), <https://www.digitalcommerce360.com/2017/01/19/foreign-brands-enter-china-through-e-commerce/>.

285. Philip Wen, *China's Policy Honeymoon on Foreign Goods Could Be Over*, SYDNEY MORNING HERALD (Apr. 11, 2016, 9:16 AM), <https://www.smh.com.au/business/chinas-policy-honeymoon-on-foreign-goods-could-be-over-20160410-go2t39.html>.

286. *Id.*

287. *The Chinese Obsession with Australian Brands*, MARKETING TO CHINA (June 2, 2017), <https://www.marketingtochina.com/chinese-obsession-australian-brands/>; see also Vishal Bali, *5 Things We Can Learn from China's E-commerce Explosion*, NIELSEN (Feb. 1, 2018), <https://www.nielsen.com/cn/en/insights/news/2018/5-things-we-can-learn-from-chinas-e-commerce-explosion.html> (describing Chinese consumers' fascination with foreign brands).

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

289. See *5 Ways China's Daigou Market Does More Harm Than Good for Luxury Brands*, JING DAILY (Mar. 6, 2016), <https://jingdaily.com/5-ways-chinas-daigou-market-good-luxury-brands/> (describing incentives for Chinese consumers to buy foreign luxury items from abroad rather than domestically).

290. *Alibaba IPO: The Biggest IPO in History*, N.Y. STOCK EXCH., <https://www.nyse.com/network/article/Alibaba-Lists-on-the-NYSE> (last visited Nov. 14, 2018).

291. Alibaba Prospectus Supplement, *supra* note 198, at S-4, S-45.

“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).

294. *See* BRANDON WHITEHILL, COUNCIL OF INSTITUTIONAL INV’RS, BUYER BEWARE: CHINESE COMPANIES AND THE VIE STRUCTURE 6 (2017) (explaining in general the structure of a VIE, and interaction with the associated WFOE and the offshore shell company that lists on a foreign stock exchange).

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).

297. *Partnership Committee, ALIBABA GROUP*, https://www.alibabagroup.com/cn/ir/governance_9 (last visited Nov. 7, 2018) (noting that the Partnership Committee consists of Jack Ma, Joe Tsai, Daniel Zhang, Lucy Peng and Eric Jing); *see* Alibaba 2018 Alibaba Annual Report, *supra* note 25, at 172 (stating that the Partnership consisted of thirty-six members as of July 27, 2018). *But see* Shan Li, *Alibaba’s Jack Ma Cedes Control of Key China Business Licenses*, WALL ST. J. (Oct. 1, 2018, 6:05 AM), <https://www.wsj.com/articles/jack-ma-removes-himself-as-owner-of-alibaba-business-licenses-1538365628> (indicating that Jack Ma is ceding some of his legal control of the Partnership).

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.

302. *See, e.g.,* Vince Martin, *Why Investors Should Stay Cautious on Alibaba Group Holding Ltd Stock*, INV. PLACE (Oct. 30, 2017, 10:40 AM), <https://investorplace.com/2017/10/alibabagroup-holding-ltd-baba-stock-cautious/#.WmU3jKiWbic>.

303. *See* Liyan Chen et al., *Alibaba Claims Title for Largest Global IPO Ever with Extra Share Sales*, FORBES (Sept. 22, 2014, 11:51 AM), <https://www.forbes.com/sites/ryanmac/2014/09/22/alibaba-claims-title-for-largest-global-ipo->

it hit the largest initial public offering of all time by raising \$25 billion.³⁰⁴ Yet, in 2014, Morgan Stanley Capital International (MSCI)³⁰⁵ listed AHG as the worst in its class for corporate governance.³⁰⁶ The MSCI governance metrics report cited several warnings for shareholders, such as “the lack of shareholder rights and independent board representation.”³⁰⁷ MSCI warned of the powerful rights vested to the Partnership, which combined minority interests in AHG to create a super “controlling block” voting agreement.³⁰⁸ This voting agreement restricts the abilities of U.S. shareholders to exercise their rights and to modify the leadership of the board.³⁰⁹ Yet, the VIE structure relies on the existence of the Partnership to function and to circumnavigate Chinese laws against foreign ownership.³¹⁰

In addition to corporate governance, MSCI drew attention to Alibaba's poor accounting methods.³¹¹ At the time of its Initial Public Offering (IPO),³¹² Alibaba's external auditor, the Hong Kong affiliate of PricewaterhouseCoopers (PwC), had not been investigated by the Public Company Accounting Oversight Board (PCAOB)³¹³ given Alibaba's substantial operations in China.³¹⁴ China requires that the PCAOB obtain governmental approval before conducting audits.³¹⁵ The U.S. Securities and Exchange Commission (SEC) also investigated AHG for poor accounting transparency of its various subsidiaries and affiliates.³¹⁶ As major corporations using VIE structures, like Alibaba, continue to grow, additional loopholes and exploitations warrant scrutiny by the international tax community.

ever-with-extra-share-sales/#7c339d708dcc (stating that Alibaba began trading on the New York Stock Exchange on the Friday before the article was written).

304. *See id.* (identifying \$25 billion IPO as largest in the world).

305. John Christy, *The History of Morgan Stanley Capital International*, BALANCE (June 18, 2018), <https://www.thebalance.com/history-of-morgan-stanley-capital-international-msci-1979067>.

306. MSCI INC., ALIBABA GROUP HOLDING LTD.: GOVERNANCE METRICS REPORT - ANALYSIS I (Sept. 11, 2014).

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).

311. MSCI INC., *supra* note 306, at 2.

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).

314. MSCI INC., *supra* note 306, at 2.

315. *Id.*

316. James Covert, *'High-Up' Alibaba Staffer Helping SEC Probe into Tech Giant*, N.Y. POST (Nov. 1, 2016, 12:12 AM), <https://nypost.com/2016/11/01/high-up-alibaba-staffer-helping-sec-probe-into-tech-giant/>.

V. TAX IMPLICATIONS AND LOOPHOLES 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

317. Justin Hopkins et al., *When Enron Met Alibaba: The Rise of VIEs in China* 14 (May 2017) (unpublished manuscript) (available at https://www.hbs.edu/faculty/conferences/2017-imo/Documents/Mark_Lang_HLZ.pdf) (explaining the troublesome uncertainty with how the SAT should tax the VIE structure and its related transactions).

318. *See China's SAT Issues New Measures for Special Tax Investigation Adjustments and Mutual Agreement Procedures*, PWC (Apr. 14, 2017), <https://www.pwc.com/gx/en/tax/newsletters/pricing-knowledge-network/assets/pwc-tp-china-sat-spec-tax-adj-map.pdf> [hereinafter *New Measures*] (describing SAT's effort to implement BEPS goals into its tax reform).

319. *See* Alibaba 2018 Annual Report, *supra* note 25, at 51 (applying China's Enterprise Income Tax Law).

320. KPMG, *New China Withholding Tax Administrative Guidance*, CHINA TAX ALERT, Nov. 2017, <https://assets.kpmg.com/content/dam/kpmg/cn/pdf/en/2017/11/china-tax-alert-28.pdf>.

321. *See* Michelle Markham & Yixin Liao, *The Development of Transfer Pricing in China*, 29 AUSTL. TAX F. 715, 719 (2014) (stating that China's SAT retroactively adopted regulations applicable to China's Enterprise Income Tax Law in 2009).

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 Tongqi Ziliao Guanli Youguan Shixiang de Gonggao (国家税务总局关于完善关联申报和同期资料管理有关事项的公告) (promulgated by State Admin. of Taxation People's Rep. China, June 29, 2016, effective June 29, 2016), CLI4.275536(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.*

offshore disguised as a service fee.³²⁶

In addition, the VIE structure for the e-commerce industry, a sector dependent on intangibles, raises the likelihood of transfer pricing issues.³²⁷ 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.³²⁸

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."³²⁹ Thus, the transfer of the VIE's entire profits triggers a transfer pricing issue and should raise a flag to tax administrators.³³⁰ 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.³³¹ 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.³³²

B. Tax Havens: Enterprise Income Tax Law

Similar to other jurisdictions, China has expressed its intention to crack down on anti-avoidance tactics.³³³ 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

326. See *supra* Part II.D for a discussion on profits allocation outside of China.

327. See Hopkins et al., *supra* note 317, at 14 (noting that sending licensing payments to the parent company would be considered an internal transfer subject to transfer pricing scrutiny).

328. See Alibaba Prospectus Supplement, *supra* note 197, at S-34.

329. Paul Gillis, *Accounting for VIE Taxes*, CHINA ACCT. BLOG (Dec. 8, 2013, 5:22 PM), <http://www.chinaaccountingblog.com/weblog/accounting-for-vie-taxes.html>.

330. See *id.* ("Who signs an agreement with a service provider letting them charge you a price equal to all your earnings?").

331. Hopkins et al., *supra* note 316, at 35.

332. See Paul Deméré et al., *The Economic Effects of Special Purpose Entities on Corporate Tax Avoidance 2* (Sept. 2017) (unpublished paper) (available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2557752) (describing the procedure of special purpose entities, which includes VIEs).

333. ERNST & YOUNG, UNOFFICIAL TRANSLATION BY ERNST & YOUNG (CHINA) ADVISORY LIMITED GUOSHUIFA [2009] NO.2: THE ADMINISTRATIVE MEASURES OF SPECIAL TAX ADJUSTMENTS (TRIAL) (THE "FINAL MEASURES") 34.

entire chapter on the “Administration of the General Anti-Avoidance Rule.”³³⁴ 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.”³³⁵

Because VIEs involve offshore holding companies, the SAT needs to determine whether such offshore companies can be considered Chinese enterprises for taxpaying purposes.³³⁶ To determine residency, SAT looks at the location of the “de facto management body” of the offshore enterprise.³³⁷ On January 1, 2008, China’s Enterprise Income Tax Law became effective.³³⁸ 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 Chinese law within the territory of China, or set up under the law of a foreign country (region) but whose actual³³⁹ 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.³⁴⁰

Only a “resident enterprise” is subject to paying enterprise income tax, levied at 25%.³⁴¹ A “non-resident” must pay taxes on any income derived from China.³⁴² 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.³⁴³ 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

334. *Id.*

335. *Id.*

336. *See generally* FULI CAO, CORPORATE INCOME TAX LAW AND PRACTICE IN THE PEOPLE’S REPUBLIC OF CHINA 22 (2010).

337. Alibaba 2018 Annual Report, *supra* note 25, at 51.

338. Zhonghua Renmin Gongheguo Qiye Suodeshui Fa (2017 nian Xiuzheng) (中华人民共和国企业所得税法 (2017修正)) [Enterprise Income Tax Law People’s Republic of China (2017 Revision)] (promulgated by the Standing Comm. Nat’l People’s Cong., Feb. 24, 2017, effective Feb. 24, 2017), CLI.1.291045(EN) (Lawinfochina).

339. Other translations use “de facto management” instead of “actual.” *See* Alibaba Prospectus Supplement, *supra* note 197, at S-83.

340. Enterprise Income Tax Law of the People’s Republic of China (2017 Revision), *supra* note 337, art. 2.

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.

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an enterprise.”³⁴⁴

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.³⁴⁵

The regulations of Circular 82 leave gaping holes open for VIEs.³⁴⁶ 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.”³⁴⁷ 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.³⁴⁸ It argues that its central assets, board meeting minutes, and records are located outside of China.³⁴⁹ 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].”³⁵⁰ 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.³⁵¹ Alibaba is largely considered to be a “Chinese” company,³⁵² 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.

352. *See* Robyn Mak, *Home Away from Home*, REUTERS (Mar. 3, 2015), <https://www.breakingviews.com/considered-view/alibabas-split-nationalities-invite-trouble/> (discussing how Alibaba's residency depends on which perspective you view it from: the investors, regulators, or founders).

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.³⁵³ 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)."³⁵⁴ 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."³⁵⁵ Furthermore, China may also be able to tax foreign shareholders on dividends and capital gains tax.³⁵⁶ If applied, those taxes would severely deter foreign investors from continued investments in Chinese e-commerce.³⁵⁷

C. Enforcement

China has a history of poor domestic tax enforcement.³⁵⁸ Its cash-based society makes it easier to commit tax fraud.³⁵⁹ China's recent commitment to the BEPS Actions shows its political willingness to collaborate on issues of tax avoidance,³⁶⁰ 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.³⁶¹ 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.³⁶² 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 (Jan. 3, 2017, 10:48 AM), <https://investorplace.com/2017/01/4-reasons-alibaba-group-holding-ltd-baba-stock-no-go/#.WoWP44Nua70> (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.

355. Alibaba 2018 Annual Report, *supra* note 25, at 51.

356. *Id.* at 51–52.

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

358. Helen Roxburgh, *The Crackdown on Tax Evasion in China*, CKGSB KNOWLEDGE (Mar. 17, 2015), <http://knowledge.ckgsb.edu.cn/2015/03/17/policy-and-law/the-crackdown-on-tax-evasion-in-china/>; see also William Gamble, *The Middle Kingdom Runs Dry: Tax Evasion in China*, FOREIGN AFF., Nov.-Dec. 2000, at 16, <https://www.jstor.org/stable/pdf/20049964.pdf?refreqid=excelsior%3A3d557dc1e6a27a7c8cd1e63c9121199a> (addressing the Chinese central government's tax collection problems).

359. Roxburgh, *supra* note 358.

360. See generally *id.*

361. See John Brondolo & Zhiyong Zhang, *Tax Administration Reform in China: Achievements, Challenges, and Reforms* 34 (IMF, Working Paper No. 16/68, 2016) (addressing the need for reforms in the SAT).

362. *Id.* at 34.

address new business models,³⁶³ 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 2020.³⁶⁴

In addition to new legislation and regulations, China will also need to address its culture of bribery.³⁶⁵ 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.³⁶⁶ MNEs like Alibaba have already shown non-compliance with certain accounting and reporting requirements,³⁶⁷ 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.³⁶⁸ 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.”³⁶⁹ 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*).

365. See *China Corruption Report*, BUS. ANTI-CORRUPTION PORTAL, <https://www.business-anti-corruption.com/country-profiles/china/> (last visited Oct. 22, 2018) (citing tax collectors as the second most frequent recipients of bribes in China).

366. See generally Paul Heiler & Scott Smith, *Transfer Pricing Issues in Emerging and Developed Economies—Multinationals Need to Broaden Their Approach*, 21 J. INT'L TAX'N 32, 32–37 (2010) (overviewing transfer pricing rules and practices for major emerging economies).

367. See Lily Kuo, *Why an Accounting Scandal at Alibaba's New Firm Spells Trouble*, QUARTZ (Aug. 15, 2014), <https://qz.com/249990/why-an-accounting-scandal-at-alibabas-new-firm-company-spells-trouble/> (raising questions about how Alibaba is audited).

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.”³⁷⁰

VIEs risk counteracting the aims of the OECD’s BEPS Actions. Action 1 demands more tailored rules for the digital industry.³⁷¹ The e-commerce industry breeds dozens of issues, given that the network of online transactions generates less transparency and hinders enforcement of taxes.³⁷² The VIE is a byproduct of the e-commerce industry, given strict regulations against foreign ownership in the internet sector.³⁷³ 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.³⁷⁴ 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.³⁷⁵ 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 7.³⁷⁶ 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),³⁷⁷ 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.

370. Alibaba 2018 Annual Report, *supra* note 25, at 42, 46.

371. See *supra* Part IV.A for a discussion on BEPS Action 1.

372. See E-Commerce and Taxation: A Virtual Reality, OECD OBSERVER (Jan. 2001), http://oecdobserver.org/news/archivestory.php/aid/416/E-commerce_and_taxation:_a_virtual_reality.html (explaining the fundamental tax challenges e-commerce technology posed when it was just gaining traction in the early 2000s).

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 III.B 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.³⁷⁸ The 2007 financial crisis was a byproduct of the “wait-and-see” approach and in retrospect,³⁷⁹ 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.³⁸⁰

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.

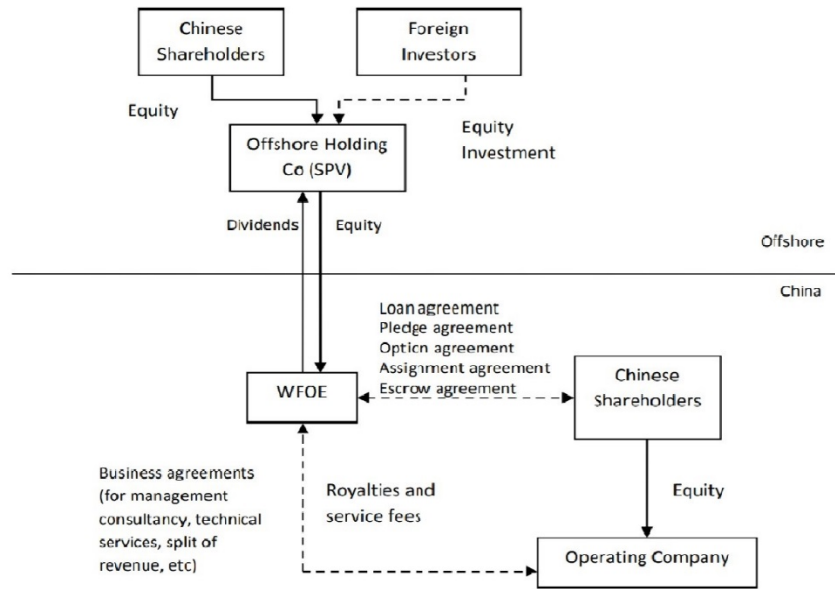
378. *See generally* Thomson Reuters BEPS Readiness Survey: U.S. Companies Taking “Wait and See” Approach, 61 FED. TAXES WEEKLY ALERT art. 4 (Oct. 15, 2015).

379. Ylan Q. Mui, *Fed Slow to Abandon Optimism Even as a Few Sounded the Alarm*, 2007 *Transcripts Show*, WASHINGTON POST (Jan. 18, 2013), https://www.washingtonpost.com/business/economy/fed-slow-to-abandon-optimism-even-as-a-few-sounded-alarms-2007-transcripts-show/2013/01/18/410481b8-619a-11e2-9940-6fc488f3fec9_story.html?noredirect=on&utm_term=.e5051819357a.

380. *See generally* ADRIAN BLUNDELL-WIGNALL ET AL., *THE ELEPHANT IN THE ROOM: THE NEED TO DEAL WITH WHAT BANKS DO* (2009), <http://www.oecd.org/finance/financial-markets/44357464.pdf> (discussing potential bank reform ideas).

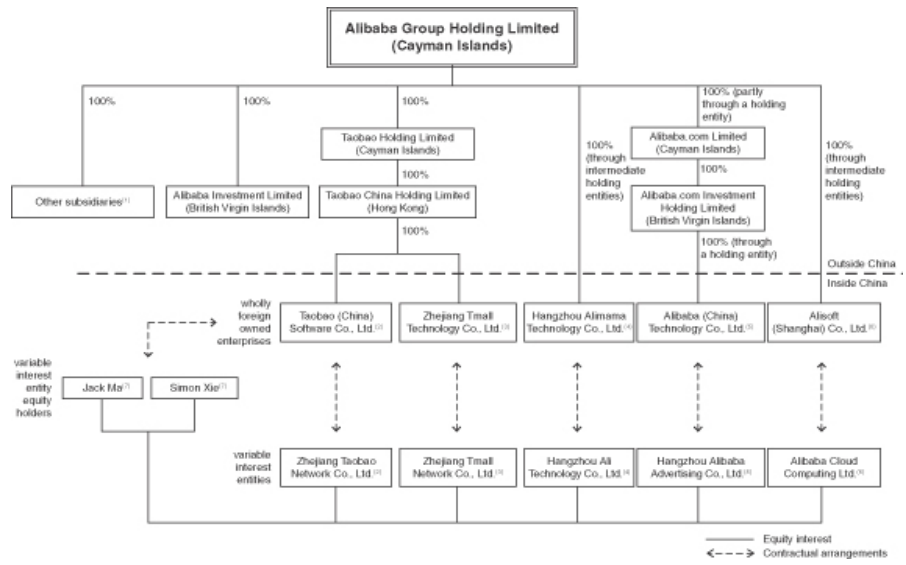
APPENDIX

Figure 1³⁸¹



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

Figure 2³⁸²



382. Alibaba 2018 Annual Report, *supra* note 25, at 115.