

# The Jurisprudential Logic and Institutional Improvement of Anti-avoidance Rules: A Localized Interpretation Based on the Principle of Substantive Taxation

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## Abstract

This paper discusses the jurisprudential basis and institutional limits of China's anti-avoidance regime by analyzing the Guangzhou Defa case and the Tianchang Tianqin cases. It argues that anti-avoidance works on "limited transcendence" of tax legality through substantive taxation. This power, while necessary for the protection of the tax base, must be limited by procedural regularity, constituent elements, and the principle of proportionality. The Defa case supports veil piercing, whereas the Tianqin case stresses statutory limits. The paper argues for a balanced model of governance which balances effective enforcement with protection of taxpayer rights. It suggests specific pathways for codifying general anti-avoidance rules (GAAR) by drawing on comparative insights from the Organization for Economic Co-operation and Development (OECD) base erosion and profit shifting (BEPS) framework and domestic judicial trends. It also puts forward measures to establish a pre-ruling system to enhance legal certainty.

## Keywords

Anti-avoidance, Substantive taxation, Tax legality, General anti-avoidance rules, Taxpayer rights

## Introduction

In today's fiscal climate, tax avoidance has evolved from simple evasion to sophisticated, multi-layered schemes designed to exploit systemic loopholes [1]. For China, this challenge is exacerbated by its transition to a digital economy and its integration into global value chains. Complex financial derivatives, the platform economy and the growth of cross-border e-commerce have created a maze of transactional possibilities that often live in the grey areas of statutory interpretation. Hence anti-avoidance measures have become necessary tools to protect national tax sovereignty and to maintain fiscal fairness. However, the implementation of these measures is burdened with a fundamental tension between two pillars of tax law - the principle of substantive taxation and the principle of tax legality [2].

Article 56 of the Constitution and its development in the Tax Administration Law have established the principle of tax legality, that is, the tax obligations must be based on explicit legal norms. On the contrary the principle of substantive taxation takes into account economic reality and not legal form. Taxpayers can organize transactions to lessen tax liability, a liberty recognized globally as the

"right to tax planning", but this liberty is not unfettered [3]. The "substance-over-form" doctrine is used by tax authorities where legal forms are misused to mask economic reality. But this "piercing the veil" power is a double-edged sword. Without strict limits it undermines legal certainty and the autonomy of private law and can stifle legitimate business activities.

In this paper I map this tension by deconstructing the jurisprudential logic embedded in landmark judicial decisions. The paper contends that a well-developed anti-avoidance regime must strike a delicate balance between the revenue needs of the state and the constitutional protection of property rights. Drawing on the jurisprudence of the Supreme People's Court (SPC), we observe a slow transition from aggressive revenue collection to a more subtle approach that recognizes procedural justice. The 2018 Individual Income Tax (IIT) reform that formally enshrined the GAAR into Chinese domestic law is a critical turning point that warrants re-examination by scholars. In this paper I will argue that the existing "fragmented" nature of anti-avoidance rules needs to be systematically overhauled so as to prevent the

arbitrary exercise of administrative discretion.

### **Jurisprudential cornerstone: Substantive taxation as the core instrument**

Anti-avoidance is not a matter of penalizing illegality but of fixing arrangements that are “formally legal but substantially deviate from legislative intent” [4]. This distinction is crucial. Tax evasion involves illegal acts like falsifying accounts, whereas avoidance exploits the gaps within the law. The bridge to fill this gap is substantive taxation. The use of this concept requires a sound theoretical framework so as not to turn it into a tool of arbitrariness.

### ***The Guangzhou Defa case: Judicial confirmation and delimitation***

The Guangzhou Defa Real Estate Construction Co., Ltd. v. Guangzhou Local Taxation Bureau case is technically decided under Article 35 of the Tax Administration Law on the determination of taxable amounts, but it is very insightful on anti-avoidance methodology. In this case, Defa auctioned assets with only one bidder, which resulted in a transaction price well below market value. The tax authority recalculated the taxable income on the basis of the valuation report. The SPC confirmed this adjustment but issued a groundbreaking ruling on late payment surcharges.

Jurisprudentially, the Court has indicated that legal form is not inviolable, when it is used as a mere façade to disguise an unfair economic reality. This is consistent with the international “piercing the veil” doctrine used in anti-abuse rules. But the SPC sets important limits. First, the adjustment had to be based on objective evidence of market distortion, not just on subjective suspicion. The court pointed out the need for third party appraisal reports to determine the “fair market value”. Second, and most importantly, the Court did away with the surcharges on late payments. This is an important application of the principle of proportionality: It differentiates between correction of proper tax liability and punishment. We would not wish to attach the stigma or financial penalty of punishment to anti-avoidance adjustments, unless fraudulent intent is proven, in the same way as penalties for tax evasion.

Moreover, the Defa case illustrates the idea of “reasonable commercial expectation”. The court’s ruling overturning the surcharges recognized the dependence

taxpayers have on the perceived transparency of transactional forms. If the tax authority wants to look beyond the form, it must have clear statutory authority to do so and it cannot impose penalties retroactively for no fault. This decision set a precedent for the “no penalty without fault” rule in subsequent tax interpretations and was a limit on overreach by the administration.

### ***From “assessment” to “anti-avoidance”: A jurisprudential extension***

The Defa case demonstrates that substantive taxation is a neutral analytical tool. It is a bridge between routine tax assessment (dealing with “obviously low pricing”) and complex anti-avoidance (dealing with “abuse of legal forms”). Both follow the same basic methodology of giving primacy to economic substance over legal form. But the jump from simple assessment to complex avoidance requires a higher standard of proof. Deviations from market prices (e.g. transfer pricing) are frequently statistical in routine assessment. The focus in anti-avoidance is on “business purpose” and “subjective intent”.

This reasoning provides a domestic basis for the “economic substance doctrine”, suggesting that Chinese courts will look beyond labels to the substance of the commercial reality when enforcing tax claims. For example, a company may set up a special purpose vehicle (SPV) in a tax haven with no employees, no office and no real business activities other than holding assets. There is no economic substance. In the Defa case it is clear that, in the absence of a specific GAAR provision at the time, the courts were prepared to apply substantive principles to prevent erosion of the tax base. Today, with Article 8 of the Enterprise Income Tax Law (EITL) and Article 36 of the IIT Law, this judicial philosophy has been codified, but the standards for application remain nebulous, necessitating further clarification regarding what constitutes a “reasonable commercial purpose”.

This extension from mere assessment to qualitative evaluation reflects a delicate balancing act between tax enforcement and private law autonomy. While parties are free to structure transactions under the principle of autonomy of will, the state retains the power to intervene when legal forms are manipulated solely for tax avoidance. However, this “piercing” power carries significant risks of overreach. The transition toward recognizing the economic substance doctrine thus

necessitates a corresponding emphasis on judicial restraint. Unlike routine assessments based on statistical deviations, anti-avoidance inquiries require a holistic analysis of the transaction's architecture. Without clear parameters distinguishing legitimate tax mitigation from abusive avoidance, the "spear" of substantive taxation risks becoming a tool of arbitrary governance, undermining the very legal certainty it seeks to uphold. Consequently, the evolution of this doctrine demands a robust framework of procedural safeguards to ensure that the pursuit of revenue does not eclipse the taxpayer's right to certainty.

### **Institutional boundaries: Constraints of tax legality and procedural justice**

If substantive taxation provides the "spear" for anti-avoidance, tax legality and procedural justice constitute the indispensable "shield". The power to disregard legal forms is exceptional and must be exercised within strictly defined boundaries to prevent the slide into administrative absolutism.

#### ***The Tianchang Tianqin case: Tax legality as an insurmountable baseline***

The Tianchang Tianqin Pharmaceutical Packaging Co., Ltd. v. Chuzhou Local Taxation Bureau case serves as a crucial check on administrative power. Following the civil rescission of an equity transfer contract due to a breach of contract by the buyer, the taxpayer sought a refund of the paid enterprise income tax (EIT). Both the tax authority and the court rejected the claim, holding that tax obligations are determined by statutory criteria, independent of subsequent changes in civil law relations. The jurisprudential warning is clear: Anti-avoidance measures, no matter how economically justified, must have explicit statutory authorization. Tax authorities cannot rely solely on the "spirit of the law" or substantive reasoning to negate a vested tax right or create a new liability [6]. The Tianqin case reinforces that in a system governed by the rule of law, "substantive taxation" without "legal form" is tantamount to arbitrary power. This is particularly relevant for general anti-avoidance rules (GAAR), which must be grounded in clear statutory texts rather than vague administrative guidelines to avoid violating the prohibition against analogous taxation. The court in Tianqin effectively separated the "tax moment" from the "civil moment". For tax purposes, the

completion of the registration of the equity change is often the triggering event. Allowing refunds based on subsequent civil nullification could lead to immense uncertainty and administrative chaos. However, critics argue that this strict formalism can lead to unjust enrichment by the state if a transaction truly fails. This tension reveals the need for statutory exceptions or "clawback" provisions that allow for adjustments when a transaction is invalid from its formation. Nevertheless, the Tianqin case stands as a bulwark against the unchecked expansion of substantive taxation, insisting that any deviation from legal form must be explicitly permitted by law.

#### ***The deficiency of subjective elements and business purpose testing***

A critical flaw in current practice is the neglect of subjective intent. Internationally, a finding of tax avoidance typically requires demonstrating that the arrangement was undertaken for the primary purpose of obtaining a tax benefit and lacked a bona fide commercial purpose. This is known as the "main purpose test (MPT)". However, Chinese tax authorities often rely on "objective imputation", presuming avoidance intent simply because a transaction results in a tax saving (e.g., a shareholder loan not repaid by year-end) [7].

This implies guilt and makes the taxpayers undertake an impossible task to prove a negative. For instance, if a company prefers debt financing rather than equity financing to take advantage of the deduction of interest, is this considered avoidance? According to a strict objective test, it may be detected. However, under a subjective test, the existence of a real business necessity for cash flow would clear the taxpayer. This method differs greatly from the anti-tax avoidance rules proposed by the OECD BEPS Project and enforced in the EU anti-tax avoidance directive (ATAD). Unless a thorough investigation is made into the actual intentions of the taxpayer and the existence of non-tax commercial reasons, the anti-avoidance rules may turn into ineffective means which punish legitimate tax planning, thus raising the tax payment burden and restraining economic activities.

Furthermore, the concept of "commercial purpose" results in various understandings in different Chinese tax regions. In some provinces, a certain action may be

regarded as a reasonable business reason (such as reorganizing assets to improve efficiency), while it might be considered tax avoidance in others. Such inconsistency conflicts with the rule of equality before the law and leads to unfair competition for the enterprises.

### **Constructing a new paradigm of certainty, objectivity, and fairness**

To settle these conflicts, China should develop a system which combines enforcement with right protection by means of structural reforms. This involves changing from an enforcement method depending on experience and temporary changes to a governing approach based on clear rules and cooperative obedience.

#### ***Advancing rules from “fragmentation” to “systematization”***

The present dispersion of anti-avoidance rules in different laws causes inconsistent implementation and legal ambiguity. A comprehensive GAAR implementing regulation is required. Firstly, a combined definition of avoidance should be adopted: “an action carried out mainly with the intention of obtaining an unfair tax advantage, which nullifies the aim and intention of the related tax law” [8]. This definition should include both the subjective aspect and the objective aspect clearly.

Second, it is important to set up the “Economic Substance” test. In comparison with the unclear “reasonable commercial purpose”, the economic substance test emphasizes objective criteria: Has the transaction caused an essential change in the economic condition of the taxpayer instead of affecting only the tax payment? The following points should be considered: the presence of employees, physical offices, business risks of the enterprise and the fulfillment of normal business rules. If “safe havens” can be utilized for transactions which have important non-tax economic effects, it will greatly enhance the legal certainty. For instance, transactions below a specific amount or those carried out between unrelated parties shall not be regulated by the general anti-avoidance rule (GAAR) except when abuse is proved.

Third, the regulation must define the order of norm priority. Specific anti-avoidance rules, for example, the controlled foreign corporation (CFC) rules or thin capitalization rules, should mainly prevail over the general anti-avoidance rule (GAAR). GAAR should be

used only when SAARs are ineffective or insufficient to deal with avoidance. This “last alternative” position is usual in countries such as Germany and Australia and avoids the unnecessary application of general provisions.

#### ***Transitioning from “subjective presumption” to “objective demonstration”***

The proof burden should be changed. According to the principle of “he who asserts must prove”, the tax authorities should be responsible for showing the non-existence of a genuine commercial purpose. At present, the burden is usually transferred to the taxpayer when a “suspicious” arrangement is found. In order to achieve this, the law ought to establish a systematic investigation procedure. Before applying the GAAR, the tax authorities are required to send a Notice of Proposed Adjustment which specifies the particular facts indicating the avoidance and gives the taxpayer a chance to submit counter-evidence during a compulsory “discussion period”.

Moreover, the procedural safeguards need to be improved. China should set up national advance tax ruling (ATR) system immediately. By permitting taxpayers to obtain an approved decision for complicated transactions in advance, the ATR system changes the prevention of tax avoidance from an inspection after the event to a cooperative ex-ante compliance procedure. This decreases the litigation risk and benefits a more stable business climate. An efficient ATR system requires publicity of the ruling procedure. It needs to disclose the anonymized rulings to give guidance to the public. At the same time, it follows the principle of consistency. This guarantees that the tax department does not object to a transaction which has got a favourable ruling, except when fraud or misrepresentation is detected [10].

Furthermore, the significance of judicial review needs to be enhanced. The courts not only need to adhere to the administrative decisions but should also carefully review the basis of the GAAR applications. This includes verifying if the tax authority has considered properly the business justification of the taxpayer and if the adjustment is at an appropriate ratio to the claimed avoidance.

#### ***Upholding restraint in tax interpretation***

Judicial review must be careful in the understanding of anti-avoidance clauses. As stated in the SPC’s judgment in the Defa case, courts should distinguish between tax

avoidance (requiring change) and tax evasion (requiring punishment). The purposive approach (interpreting according to the purpose of the law) should be used to remove ambiguities, instead of increasing the range of taxation. Any disadvantageous interpretation which increases the scope of the anti-avoidance regulation should be strictly checked to prevent interfering with the basic principle of tax legality.

The judiciary's function as the chief defender of the rule of law should prevent the "spear" of anti-avoidance from striking the "shield" of the taxpayers' rights except for the most definite legal basis. This needs judges possessing special knowledge in taxation. Setting up special tax tribunals or chambers within the people's courts, like those in France or Canada, may enhance the tax jurisprudence quality. These special organizations can formulate a stable body of precedents which define the scope of the substantive taxation, offering valuable advice to both the tax authority and the taxpayers.

Furthermore, it is necessary to establish the relationship between tax law and civil law. Though Tianqi pointed out the independence of tax decisions, certain legal modifications are required. For example, if a contract loses its validity because of its unlawfulness, the corresponding tax effects should be modified. On the contrary, if a contract is merely revoked for violation, the tax effects may be different. A definite legislative system which stipulates these connections will decrease the dependence on judicial rulings in every individual case.

### Conclusion

The change in anti-avoidance regulations indicates a continuous adjustment of the government's income requirements, the progress of market innovation and the protection of taxpayers' rights. The study of the Defa and Tianqin cases shows an attempt by the judiciary to limit the administrative discretion using the principles of proportionality and legality. To build a comprehensive anti-avoidance system, it is not sufficient to focus only on revenue collection; it also needs to be established clear, stable and certain rules which can regulate people's actions and decrease the cost of compliance.

This requires a change in two aspects: from an "ad-hoc investigator" to a "rule-maker" and from an adversarial approach to a cooperative manner. The future reforms should mainly include three modifications: implementing a unified rule-based management by

means of a complete GAAR regulation, promoting ex-ante decisions by using an effective ATR system, and improving cooperative compliance through better tax administration and education.

China stands at a critical juncture. As it seeks to attract foreign investment and foster domestic entrepreneurship, the predictability of its tax system is paramount. Overly aggressive anti-avoidance measures can deter investment, while lax enforcement can erode the tax base and exacerbate inequality. By grounding GAAR in the rigid framework of tax legality. The system ensures due process and respects the separation of powers between the legislature, administration, and judiciary. Through these approaches, China can achieve the triple goals of maintaining tax equity, promoting economic efficiency, and protecting fundamental taxpayer rights. The journey towards a mature tax state is ongoing, and the refinement of anti-avoidance rules is a central pillar of that journey.

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### Conflicts of Interest

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