

# *University of New South Wales*

University of New South Wales Faculty of Law Research Series  
2009

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*Year 2009*

*Paper 26*

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## The Economic Benefits of the Use of Guanxi and Business Networks in a Jurisdiction with Strong Formal Institutions: Minimisation of Taxation

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# The Economic Benefits of the Use of Guanxi and Business Networks in a Jurisdiction with Strong Formal Institutions: Minimisation of Taxation

Nolan Cormac Sharkey

## **Abstract**

Why rely on informal institutions when conducting business? Because it leads to a greater economic return. The current academic status quo on the use of guanxi and business networks by Chinese entrepreneurs in both China, South East Asia and beyond is that it is a response to the weak formal institutional environment . It is argued that weak institutional environments create an economic rationale for the use of guanxi and business networks. From this base, it is further asserted that the use of guanxi and business networks will reduce and disappear with the strengthening of formal institutions in China and other jurisdictions. This paper will challenge this latter assertion by arguing that there are strong economic benefits to those that are able to operate through guanxi and business networks in a jurisdiction with strong formal institutions. The primary benefit that will be examined is the reduction or elimination of business taxation which is a very significant issue in most jurisdictions with strong institutional environments. This paper will demonstrate how guanxi and business networks can be used to avoid taxation in the strong formal institutional environment such as that represented by Australia.

# The Economic Benefits of the Use of Guanxi and Business Networks in a Jurisdiction with Strong Formal Institutions: Minimisation of Taxation

Nolan Cormac Sharkey \*

## THE USE OF GUANXI IN BUSINESS

The discussion of the use of networks and guanxi in Chinese business is not free from controversy. Most scholars do not question its existence (at least in part). That is, there is clear evidence to show the instrumental and extensive use of strong reciprocal informally constituted inter-personal bonds (guanxi) by Chinese entrepreneurs in the conduct of business in China and beyond. It has also been shown that people can be bound by these bonds into networks that are used to facilitate economic activity (guanxi networks). Thus the extensive use of guanxi and networks can be viewed as a Chinese business modality.

There is, however, critical debate as to the causes, rationale and therefore future of this business modality. Early work attributed the phenomenon to the fact that Chinese business people's economic activities were socially embedded<sup>1</sup> and Chinese social values dictated that business be pursued through guanxi and networks. The behaviour was therefore not pursued with a rational objective but was simply the result of social embeddedness.

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<sup>1</sup> Fei, X. (1992). *From the Soil: The Foundations of Chinese Society*. Berkley, University of California Press.

Fei never uses the term "social embeddedness" but see the following for why I argue that Fei is referring to social embeddedness: Granovetter, M. (1985). "Economic Action and Social Structure: The Problem of Embeddedness." *American Journal of Sociology* 91: 481 - 510.



A conclusion that may be drawn from this is that network business activity leads to economic inefficiency. The argument here is quite clear. That is, that the most efficient economy is one where market forces and prices determine economic decisions and therefore allocation. Given that in the case of Chinese entrepreneurs, it is being asserted that economic decisions are being highly influenced by inter-personal relationships, economic inefficiency must accordingly result. Therefore, as long as Chinese business people hold “Chinese” social values, the behaviour will continue to the detriment of economic performance. For this reason Chinese capitalism is seen as a significant contributing factor to problems such as the economic meltdown in Asia beginning in 1997<sup>2</sup>.

Other scholars have however asserted that the social embeddedness of Chinese business and the resulting use of guanxi and networks is a major contributing factor to the success of Chinese entrepreneurs in China and South-East Asia<sup>3</sup>. They point to the phenomenal economic growth of China and other economies dominated by Chinese business as evidence of this. In addition, they highlight the success of Chinese business persons relative to other groups in countries such as Malaysia, Singapore and Thailand. The theoretical argument here is that the most efficient economy is not one where the market dictates all prices and economic allocation. Rather there is a completely different structure and logic to Asian markets and the use of guanxi and business networks is a more efficient allocation mechanism as evidenced by the success of the tiger economies<sup>4</sup>.

More recent academic works have challenged the fundamental idea that the use of guanxi and networks results from social embeddedness. That is, it is contested that Chinese business persons let personal relationships dictate their economic decision making simply because they are Chinese. Rather, it is asserted that the core business values that Chinese entrepreneurs hold are not materially different from any other group. Instead, the phenomena of guanxi and network use where they occur are seen as a rational response to the circumstances in which Chinese entrepreneurs have had to do business<sup>5</sup>.

The above assertions are supported by demonstrating that Chinese entrepreneurs operating in both transformation China and many parts of South-East Asia have had to contend with formal institutional environments that are very poorly developed and weak, aggressively negative towards them or both<sup>6</sup>.

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<sup>2</sup> Backman, M. (1999). Asian eclipse : exposing the dark side of business in Asia. Singapore, J. Wiley.

<sup>3</sup> Lever-Tracy, C., D. F.-K. Ip, et al. (1996). The Chinese diaspora and mainland China : an emerging economic synergy. Houndmills, Basingstoke, Hampshire  
New York, Macmillan Press ;  
St. Martins Press.

Biggart, N. W. and G. G. Hamilton (1997). On the Limits of Firm-Based Theory to Explain Business Networks: The Western Bias of Neoclassical Economics. The economic organization of East Asian capitalism. Thousand Oaks, Calif., Sage Publications.: 33 - 54.

<sup>4</sup> See generally: Redding, S. G. (1990). The spirit of Chinese capitalism. Berlin, W. de Gruyter.

<sup>5</sup> Krug, B. (2004). China's rational entrepreneurs : the development of the new private business sector. London ; New York, RoutledgeCurzon.

Hendrischke, H. (2002). The Role of Social Capital, Networks and Property Rights in China's Privatization Process. Chinese Enterprise Models, University of New South Wales, Sydney, UNSW Centre for Chinese Studies.

<sup>6</sup> Chan, K. B. (2000). Chinese business networks : state, economy and culture. Singapore



Developed formal institutions for doing business were largely non-existent in pre-colonial South-East Asia when Chinese business first took root in the region<sup>7</sup>. The colonial period bore witness to formal institutions largely geared towards European colonial interests while the post-colonial period has seen the slow and incomplete development of formal institutions in many of the newly independent states. In China, formal institutions for private economic activity were obliterated by communism and have only begun to reemerge since 1979. They still remain weak<sup>8</sup>.

Formal institutional environments that are or have been negative towards Chinese entrepreneurs have also been common in the region. The source of this negativity being that many states in the region have been anti-entrepreneur, anti-Chinese or both. At many points in history, the imperial Chinese state has been at the very least unsupportive of entrepreneurial activity. The origins of this attitude being a belief in a state order from peasants to emperor that does not value entrepreneurs or merchants<sup>9</sup>. The period of staunch communism in China was clearly against entrepreneurs and lingering socialist values have ensured that entrepreneurs during much of the transition period have tended to be discrete about their affairs.

In certain other parts of the region similar state values based upon anti-merchant traditions and communist experience have had a similar effect in many eras. However, the situation has been made significantly more severe by anti-Chinese sentiment in both colonial and post-colonial states in the region. Fear and resentment of Chinese influence and potential economic domination in most post-colonial states in South-East Asia have led to both direct and indirect measures to suppress Chinese economic activities or prevent them<sup>10</sup>.

Colonial states on the other hand simply attempted to ensure that the European colonists were the primary beneficiaries of all economic activities. These situations have therefore been anything but strong formal institutional environments in which Chinese entrepreneurs could operate. A particularly difficult situation when many of the Chinese pursuing business activities have been doing so due to their exclusion from other sectors of the economy such as primary production. Even in the case of imperial China itself, it has been argued that those that have turned to commerce have done so due to their in-substance exclusion from other sectors due to the impossibility of economic success<sup>11</sup>. In this case, however, the lack of opportunity has been caused by the inability of these people to sustain themselves through primary production rather than formal exclusion.

Trade and business activity involve shifts of wealth between individuals and groups. It is therefore a general prerequisite for the existence of such activities at any meaningful

Copenhagen S, Demark, Prentice Hall Pearson Education Asia Pte. Ltd. ;  
Nordic Institute of Asian Studies. Pp 1- 13

<sup>7</sup> For a review of early Chinese business in South East Asia see: Wang, T. P. (1994). The Origins of the Chinese Kongsj. Selangor, Pelanduk Publications.

<sup>8</sup> Wu, W.-p. (2000). Transaction Cost, Cultural Values and Chinese Business Networks. Chinese Business Networks. C. K. Bun. Singapore, Prentice Hall.

<sup>9</sup> For a detailed study of Chinese commercial practices and their origins see: Gates, H. (1996). China's Motor: A Thousand Years of Petty Capitalism. Ithaca, NY, Cornell University Press.

<sup>10</sup> Chan, K. B. (2000). Chinese business networks : state, economy and culture. Singapore

Copenhagen S, Demark, Prentice Hall Pearson Education Asia Pte. Ltd. ;  
Nordic Institute of Asian Studies.

<sup>11</sup> See generally: Gates, H. (1996). China's Motor: A Thousand Years of Petty Capitalism. Ithaca, NY, Cornell University Press.



scale that institutions are available to protect rights to wealth and reinforce adjustments to them. At the very least formalized property rights should exist. Thus in a developed capitalist state property rights are upheld by the state and courts while trade is reinforced by contracts and the legal institutions that support these. Commerce is therefore supported by formal state institutions.

As has been shown above, formal institutional support has often not been available to Chinese entrepreneurs in China and the region. The answer as to how Chinese entrepreneurs have been able to engage in extensive commercial activities without strong formal institutional support is that institutional support has been obtained through informal or popular institutions<sup>12</sup>. Chinese entrepreneurs have relied upon the use of trust obtained through appropriate interpersonal relationships (guanxi) and networks to provide the institutional support for their business activities. The substitutability of these informal institutions for formal institutions is borne out by the general success of these entrepreneurs in not only getting business done but in often prospering.

The rationality of the use of guanxi and business networks in undeveloped or exclusionary formal institutional environments is therefore clear. Chinese business methods are highly suited to prospering in these environments due to their lack of reliance upon formal institutions to engage in economic activity. Chinese entrepreneurs have therefore been able to succeed without legal support and with extremely constrictive bureaucratic impediments.

The argument that Chinese business modalities are not the result of social embeddedness but a rational response to a particular environment is therefore a strong one attested to by historical circumstance. Further credence is added to the argument by studies that show that in China, South East Asia and other areas, when the formal institutional environment has provided entrepreneurs with the appropriate support, they have often made use of the formal institutions instead of informal institutions<sup>13</sup>. There are studies that show that large firms in China seek employees through the market and not through connections. In the case of Singapore<sup>14</sup>, Hong Kong, Taiwan and western countries, it may be argued that Chinese entrepreneurs base their decisions on market factors due to the strong institutional support<sup>15</sup>. Finally, reinforcing the argument in the other direction, there are studies that show that certain

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<sup>12</sup> Wu, W.-p. (2000). Transaction Cost, Cultural Values and Chinese Business Networks. Chinese Business Networks. C. K. Bun. Singapore, Prentice Hall.

Hendrischke, H. (2002). The Role of Social Capital, Networks and Property Rights in China's Privatization Process. Chinese Enterprise Models, University of New South Wales, Sydney, UNSW Centre for Chinese Studies.

Wank, D. L. (1999). Commodifying communism : business, trust, and politics in a Chinese city. Cambridge England ; New York, Cambridge University Press.

<sup>13</sup> Guthrie, D. (2002). Information Asymmetries and the Problem of Perception: The Significance of Position in Assessing the Importance of Guanxi in China. Social Connections in China. T. Gold, Guthrie, Doug and Wank, David. Cambridge, Cambridge University Press: 37 -56.

<sup>14</sup> Chan, K. B. a. N. B. K. (2000). Myths and Misperceptions of Ethnic Chinese Capitalism. Chinese Business Networks. K. B. Chan. Singapore, Prentice Hall. pg 292

<sup>15</sup> Li, P. S. (2000). Overseas Chinese Networks: A Reassessment. Chinese Business Networks: State Economy and Culture. C. K. Bun. Singapore.



non-Chinese groups also make use of similar informal institutions when faced with a lack of formal institutional support<sup>16</sup>.

Based on the above, it is becoming increasingly common to assert that Chinese business modalities that make use of networks and guanxi are not the product of Chinese culture and society at all. Rather they are simply a rational response to the formal institutional environment. The conclusion that is drawn from this is that as the formal institutional environment in China and the region improves, the use of informal institutions will disappear as reliance upon formal institutions replaces them<sup>17</sup>. Thus the demand for guanxi and network institutions disappears as formal institutions appear. This, after all, is why informal institutions are not a feature of modern developed economies.

There is little doubt that the use of guanxi and networks is a rational response to poor formal institutions. However, studies that see it as nothing more than such a response do not question whether there is a demand for these informal institutions even when there are fully developed formal institutions to support business. If such a demand can be shown to exist then it is unlikely that the use of guanxi and business networks will simply disappear with the strengthening of formal institutions. Rather it is likely to be perpetuated.

In addition to the above, if a significant demand for such informal institutions can be shown to exist in economies with strong formal institutions but these informal institutions do not generally exist, it reopens the question as to whether Chinese culture, society and values are a critical part of the phenomena of guanxi and network use after all.

Mayfair Yang<sup>18</sup> has already argued that the use of guanxi and networks is a tool in the toolbox of cultural assets available to Chinese entrepreneurs when needed. Her argument being an attempt to bring culture back into a debate that increasingly attempts to argue that essentially the use of guanxi and networks is the rational course that will be taken by any person in a poor formal institutional environment. Yang does view the use of guanxi as a rational response. However, she argues that it is a tool available to those with a Chinese culture and not necessarily to those without.

The fact that the use of guanxi and networks is not an available tool to many cultures is already attested to by the failure of many non-Chinese groups to succeed in weak formal institutional environments due to the lack of institutional support. This fact being something which is too often ignored by those that seek to show that Chinese culture is irrelevant by demonstrating that some other group uses similar informal institutions to overcome problematic formal institutions.

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<sup>16</sup> Rutten, M. Individualism and Collective Forms of Business Organisation: Rural capitalists in India, Malaysia and Indonesia. *Chinese Entrepreneurship and Asian Business Networks*. T. Menkhoff, Solvay. London, Routledge.

<sup>17</sup> Gomez, E. T. and X. Xiao (2001). *Chinese business in Southeast Asia : contesting cultural explanations, researching entrepreneurship*. Richmond, Surrey, Curzon, Guthrie, D. (2002). Information Asymmetries and the Problem of Perception: The Significance of Position in Assessing the Importance of Guanxi in China. *Social Connections in China*. T. Gold, Guthrie, Doug and Wank, David. Cambridge, Cambridge University Press: 37 -56.

<sup>18</sup> Yang, M. M.-h. (2002). "The Resilience of Guanxi and Its New Deployments." *China Quarterly* 170: 459 - 476.



The fact that Chinese culture and society does not have a monopoly on guanxi/network type institutions does not mean that these very institutions are not a particular characteristic of Chinese society. It simply means that some other societies or cultures have similar characteristics but not all of them and seemingly not modern western secular cultures with Christian roots.

This paper seeks to add strength to the type of argument put forward by Yang that the use of guanxi and networks are tools available to those with a Chinese culture to be used when it is rational to do so. It is generally accepted that there is a demand for guanxi and network use in poor formal institutional environments. The fact that many non-Chinese groups do not respond with the use of guanxi in these environments is ignored in favour of showing certain groups that do. In this paper, it is intended to show a demand for guanxi and networks in strong formal institutional environments. The fact that this additional demonstrated demand goes unmet in many societies without Chinese culture will further strengthen the argument that Chinese culture is a critical part of the use of guanxi and networks.

Demand for guanxi and networks in strong institutional environments will be demonstrated in the context of income tax evasion and arbitrage in such environments. As with other studies of guanxi, entrepreneurs will be the key focus. First the very high value of reduced tax burdens in most strong institutional environments will be demonstrated. Secondly, the key methods of reducing tax burdens through arbitrage and evasion as commonly encountered will be examined to see how tax reduction may be achieved and consider how the government may react to constrain these methods. Finally, the utility of informal bonds such as guanxi and social networks (where they exist) in facilitating tax arbitrage and evasion and circumventing government constraints will be demonstrated. Through these steps it will ultimately be asserted that guanxi and social networks significantly increase entrepreneurs' ability to engage in tax evasion and arbitrage. Given the high value associated with reducing tax burdens in most strong institutional environments, there is a continued demand for guanxi and social networks in such environments.

#### **THE VALUE OF REDUCED BUSINESS TAX BURDENS TO ENTREPRENEURS**

Income tax is a highly significant cost associated with business activities in most developed countries. It can in fact be the largest cost that any entrepreneur will face in relation to their business activities. This is because it is not unusual for the ultimate income tax burden to approach 50% of business profits. In addition to this other taxes such as value added tax may add further significant costs to a business activity.

The significance of the cost of taxation to entrepreneurs in developed countries is amply demonstrated in the Australian case. Here, the top marginal income tax rate including associated levies has just been reduced to 46.5% of net income. While the company tax rate is only 30% (already a highly significant amount), company business profits will ultimately be taxed at marginal individual rates as company profits are distributed as dividends to shareholders. This means that net income earned through companies is still potentially taxed at 46.5%.

In addition to income tax, Australia's goods and services tax (GST) will be imposed at a rate of 10% on all sales of goods and services, an amount that can be highly significant in relation to net profit. It would constitute 30% of net profit if net profit was 30% of sales. While GST is arguably a cost on consumers and not business, this is



not entirely the case for all businesses and there is certainly a significant commercial advantage to those that can reduce their GST burden. If the GST is evaded the business can either reduce the cost of their product thereby increasing sales or keep the evaded GST and increase the return on their activities.

The rates of taxation imposed in countries such as Australia mean that there is indisputably significant value attached to the reduction of taxation. This will be the case whether this reduction is achieved through planning, avoidance or evasion. For example, a restaurant owner that sells a meal for \$22 may only make \$5.35 after costs (say \$10), income tax (\$4.65) and GST (\$2). This amounts to 24.3% of sales value. If this person were to successfully evade taxation by not declaring the sale for tax purposes the return becomes \$12 or 54.5%. This amounts to a more than doubling of the return on the activity.

The value associated with reducing tax burdens through more legitimate means in Australia is further attested to by the significance of the tax profession and the value of the tax planning industry. The potential cost of taxation is of such significance that a tax reduction technique, legitimate or otherwise, can determine the actual viability of a business venture or even an industry. It is indisputable that the ability to successfully reduce your tax burden is highly desirable and valuable.

#### **REDUCING BUSINESS TAX BURDENS THROUGH ARBITRAGE**

High general-rate income and other taxes inevitably allow for a lower tax burden in the case of certain taxpayers and situations. They may also impose a higher burden or in some manner differential tax treatment on certain other taxpayers or situations. There are numerous reasons for this including equity, social policy, simplicity, economic policy, enforceability and jurisdictional limitation. Thus taxpayers on lower incomes may attract a lower rate of taxation due to their inability to reasonably pay the general rates or to encourage their businesses to grow. On the other hand undesirable activities may attract heavier tax burdens while those that are desirable may attract a lighter burden. Finally, it may be impossible to collect a high rate of tax in relation to certain situations and the Government may then impose an enforceable lower amount of tax.

All the above issues inevitably result in a tax where highly differential tax burdens will arise depending on characterisation of taxpayer, business, both of these or some other factor. This in turn results in significant arbitrage possibilities as financial benefit accrues to those that can alter the relevant factors. These financial benefits are very valuable due to the high general rate of taxation imposed and the fact that one of the aforementioned policies may apply a nil tax rate or even a negative tax rate<sup>19</sup>. The exploitation of these arbitrage opportunities is at the heart of tax planning and tax avoidance.

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<sup>19</sup> This may be the case when a welfare payment is made to those on low incomes.



### **NON-MARKET BASED TRANSACTIONS AND ARBITRAGE**

Non-market based transactions are integral to tax arbitrage through planning and avoidance. They can be used to shift income from one taxpayer to another who is granted differential treatment. They can also be used to transfer value from one situation to another. Finally, non-market based transactions can be used to alter the actual nature of a taxpayer or situation.

Many well known tax arbitrage strategies ranging from income splitting by professionals and small business to international transfer pricing by multinationals rest upon essentially simple non-market based transactions that shift income from one taxpayer to another. It may be a self-employed doctor paying a 'wage' to their spouse in the case of the former or the payment of royalties and management fees to offshore associates in the latter. In terms of altering the actual nature of a situation through non-market based transactions, an example may be inflating investment in research and development through an associate to qualify for preferential treatment.

### **EVASION OF TAXATION AND THE HIDING OF EVIDENCE**

Evasion of taxation differs somewhat from arbitrage through planning and avoidance. In the case of evasion the taxpayer may seek to simply hide a transaction or activity entirely in order that they do not pay tax in relation to it. This may be readily done by simply not declaring an amount of cash income. However, to be done successfully at a significant scale, the taxpayer will need to be able to hide outward signs of business activity and income accumulation. This is because tax authorities can turn to these outward signs to assess income in cases of evasion. Successful large scale evasion therefore requires the hiding of asset ownership, the disguising of assets' origins, the hiding or disguising of business input transactions (For example employees and purchases) as well as the hiding of sales transactions. Tax authorities will otherwise be able to determine that revenue has been earned on the basis of business inputs or wealth accumulation alone.

From the above discussion it should be clear that the prevention of tax arbitrage by tax law and tax authorities depends upon the ability to identify and adjust non-market transactions. The prevention of evasion on the other hand depends upon the identification of any signs of business activity or wealth accumulation. Conversely, successful tax arbitrage rests upon disguising non-market transactions as market transactions while successful tax evasion rests upon hiding or disguising transactions and assets.

### **COUNTERING ARBITRAGE AND EVASION**

Developed tax laws contain a range of measures that are aimed at dealing with both unacceptable arbitrage and evasion. These are complemented by policies and measures adopted by taxation administrators to prevent the same. In relation to arbitrage, the tax law will adjust or nullify or allow for the adjustment or nullification of non-market transactions. It may also deem certain transactions to be non-market transactions. Tax administration activity will in its turn be focused upon the identification of non-market transactions so that they can be adjusted or nullified as appropriate.

In relation to evasion, the tax law will contain measures that allow for the determination of a taxpayer's tax liability from available information when the usual complete information is unavailable. More critically, tax administration activity will

focus on identifying tax evasion and collecting any available information that will allow the law to operate correctly.

### **IDENTIFYING NON-MARKET TRANSACTIONS – THE ‘ASSOCIATE’ CONNECTION**

A key difficulty that arises in relation to nullifying or adjusting non-market transactions is identifying them. Without such identification, adjustment is impossible. Once they are positively identified, adjustment or nullification of non-market transactions may be readily achieved. In carrying out the task of identifying non-market transactions both the tax law and administration make use of the separate concept of an associate taxpayer or related party (hereafter associate).

The concept of the associate is essential to the identification of non-market transactions and arrangements. To this point the concept of a non-market or non-arm's length transaction is often used synonymously with the concept of an associate or related party transaction. The concepts are, however, quite distinct. A non-market or non-arm's length transaction is a transaction that is not priced through market interactions such as bargaining. An associate or related party transaction, on the other hand, is a transaction between taxpayers that are related to one another. The link between the two concepts is that it is presumed that non-market transactions will only occur between associates.

If the presumption that association is a prerequisite to non-market transactions holds true, then identification of the latter can commence with the identification of the former. This makes the task much simpler as associates will generally be far more readily identifiable than non-market transactions due to the fact that characterizing entities and persons is easier than characterizing transactions. In some cases the law or administration may simply deem transactions between associates to be the relevant non-market value transactions. Doing this simplifies the process even further but may lead to inequities as it cannot be asserted that all transactions between associates are non-market based.

The presumption that association of some sort is a prerequisite for non-market transactions would appear to be self-evidently true. A taxpayer would be expected to maximize their individual utility through a market based bargaining process in all transactions unless the transaction is with another taxpayer associated with them. When the taxpayers are associated, however, they may be willing to depart from market bargaining as they may not ultimately suffer genuine economic loss by doing so.

This may be because they ultimately share wealth in some way or because they have a myriad of interactions through which they can correct for the prima-facie economic loss. Thus, a tax administrator may question the wage paid to a close family member in a small business but assume that the wage paid to an unrelated taxpayer is based upon the market. Likewise a purchase of goods from a subsidiary company overseas may be scrutinized but not one from an independent supplier.

There is therefore a strong link between the extent of arbitrage opportunity and non-market transactions. There is also a strong link between non-market transactions and associates. These two links together mean that the greater and more diverse a taxpayer's group of associates is, the greater that taxpayer's scope for tax arbitrage is. In addition the greater the group of associates, the larger the job of identifying them and scrutinizing their interactions is for the tax administration.



## WHO ARE ASSOCIATES?

In considering the link between associates and non-market transactions, it is instructive to consider which taxpayers are usually considered to be associates. Section 318 of the Australian *Income Tax Assessment Act* (1936) (ITAA 1936) contains the most extensive definition of associate used in Australian income tax law. It is used in a number of key areas along with other less extensive definitions for certain purposes<sup>20</sup>. It has been reproduced in Appendix A along with an extract from s995-1 (*Income Tax Assessment Act* 1997) that defines what a relative is. The definition of a relative is essential to the definition of an associate as a relative will be an associate. Relatives are also “related entities” being a term that is used in the stead of associate for some purposes<sup>21</sup>.

A review of taxpayers that are included as associates in the definition indicates that they fall into several broad categories:

- Individuals that are relatives (including spouses) are associated
- Entities that have a control connection based upon shareholdings and other legal factors are associated
- Those in a legal partnership relationship are associated
- Trusts and their beneficiaries are associated
- Companies that customarily act in accordance with the wishes of others are associates of the others

A review of the above categories, in turn, indicates why in most cases associates will be readily identifiable. It should not be too difficult to identify if two natural persons are relatives as defined in s995-1. This can be done through family records. Identifying and proving control relationships between entities may in some cases be time consuming but share register records and legal documentation make the task accomplishable. Likewise with partnerships and trusts, contracts and establishment documentation will in most cases allow for ready identification of associates. It is acknowledged that this may not be so in all cases due to the concealment of contracts and other documentation. However, the need to reveal deeds and agreements in many formal processes ensures that concealment is not as common as it could be.

The final category may prove more difficult to determine and the extent of its application is far less clear than with the other categories. However, its inclusion is necessitated by the fact that companies can be controlled or influenced in a number of situations when the formal control tests are not otherwise satisfied. This results from the multiple powers that are available to both officers and shareholders in relation to a company that can be used to direct company actions. Thus while it is impossible to specifically list in the law all the possible situations when sufficient influence will exist, it will be possible to determine its existence in many circumstances.

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<sup>20</sup> The definition was originally intended for use in the Controlled Foreign Company regime but its use has been expanded to that of a general definition of “associate” in many respects. A key example of this is its use in Division 7A of the ITAA1936 dealing with deemed dividends. There was a separate definition of associate contained in s26AAB for s108 and other issues but this was largely similar to the s318 definition and has in fact been replaced by it.

<sup>21</sup> Primarily s26-35 which limits deductions when they are paid to related entities.



The success of legal and administrative measures that attempt to contain tax arbitrage through non-market transactions is brought about through the scrutiny and adjustment of interactions between associated taxpayers. Such scrutiny and adjustment is feasible as associated taxpayers are readily defined and identifiable as being relatives and entities with defined formal legal relationships that are recorded. The underpinning logic of this mechanism is that taxpayers will only engage in non-market transactions and arrangements with relatives or entities with the type of recorded formal relationship specified above.

#### **ASSOCIATES AND THE HIDING OF TRANSACTIONS, ASSETS AND ACTIVITIES**

As with arbitrage through planning and avoidance, the process of identifying wealth and signs of business activity in countering tax evasion needs to pay particular attention to the associates of the taxpayer being scrutinised. In addition associates need to be considered in the process of reconstructing income figures during the deemed assessment process that is the remedy for tax evasion.

Wealth can be hidden by placing it formally in the names of associates. However, most taxpayers would be loath to put their assets formally into the hands of non-associates for fear of losing the assets that are no longer legally theirs. The origins of wealth can also be attributed to associates rather than the earning of income. When questioned on how a taxpayer afforded their house, for example, they may state that they received a large cash gift or loan from a relative in the past knowing that the relative will back them up. This strategy is unlikely to be feasible with non-associates who will be unlikely to support the taxpayer due to the perceived consequences for themselves.

Signs of business activity or factors that may be used in the process of generating a deemed assessment may also be hidden through the use of associates. Business inputs are a key basis for estimating gross income as they often have a strong statistical relationship to outputs. However if major business inputs such as purchases and labour are provided by associates they will be far more readily disguised than if non-associates are the relevant providers. This is for the same reason as stated above in the context of non-arm's length transactions. That is, non-associated employees will insist on formal records being kept in relation to their employment and wages for their own protection. These records are then available to the tax administration. However, associate employees may be willing to not record their activities or record their activities in a misleading fashion. This is because either the protection does not matter to them as they are essentially supported by the taxpayer or because they can ensure that they are treated correctly through non-formal mechanisms.

The availability of non-formal institutions for protection and trust in business activities and transactions comes hand in hand with dealing with associates. This alternative institutional support means that formal institutional support is not required if it is undesirable for a particular reason. A simple example would be that a parent that lends money to their child may be able to rely on family pressure to ensure that the money is repaid. There is then no need to draw up a loan contract, register a mortgage or ask for detailed business accounts in relation to the loan. These tasks will then be avoided if they are undesirable or even if they are simply not felt to add to the situation.

The need for formal institutional support is the driving factor behind the creation and availability of most documents, registers, records, accounts and contracts that record business activity, transactions and assets. These records are however then available to tax administrators and constitute their primary source of information to work with. This is clearly an undesirable outcome for a would-be tax evader. Returning to the parent above, the recording of the loan may lead to income tax on interest and stamp duty on contracts. It would also highlight the activity of the child for which the money is being used.

There is therefore a clear benefit and rationale for dealing with associates and relying on informal institutions for protection. If you sell to associates you may not need to issue receipts, if you buy from associates you may not need contracts and invoices, if you use associates as sources of credit and equity, you may not need to produce detailed and accurate financial statements or record ownership through a corporate register or partnership contract. Without these various records, the ability of the tax administration to determine the extent of a taxpayer's business activities is seriously hindered.

#### **ASSOCIATE SCOPE**

The previous sections of this paper have made several key assertions. The first is that the ability to successfully reduce or eliminate tax burdens through either arbitrage or evasion is highly valuable due to the significance of the legal tax burden in relation to private business in a developed economy.

The second key assertion is that the existence, extent and diversity of a taxpayer's associates have a direct bearing on the taxpayer's ability to successfully reduce or eliminate their income tax burden. This is the case regardless of whether this reduction or elimination is done through tax planning, tax avoidance or tax evasion. A person with a small group of associates may be able to divert a minor amount of income to take advantage of lower tax rates but is unlikely to be able to run their business through associate connections. The pool of associates would simply be inadequate to seek major debt or equity or locate supplies or custom.

The third key assertion is that the limiting of associates to specific close relatives such as those defined in s995-1 of Australia's Income Tax Act (1997) and entities with a formal specified relationship as covered in s318 (ITAA 1936) allows income tax law and administration to counter arbitrage and evasion by providing mechanisms to scrutinise, adjust or nullify interactions between what is a relatively discrete group of taxpayers. At the very least, these definitions mean that when deciding whether the interactions between two taxpayers should be investigated, the administration will be able to determine whether they are associated and therefore whether arbitrage and evasion may be an issue. They will also be within their rights in making any adjustments.

#### **ASSOCIATES IN A WESTERN SOCIETY**

Thus much arbitrage and evasion depends on associates while counter arbitrage and evasion measures target associates. The efficacy and appropriateness of these counter measures does however rest on the accuracy of the underlining assumption that non-market transactions and arrangements or those arrangements that are supported by informal institutions are generally limited to associates. That is, close relatives as



defined or taxpayers with a specified formal relationship. Put another way it depends upon associates only being those close relatives and specified taxpayers.

The accuracy of this assumption in societies such as modern Australian society and other western societies where such rules of association have been developed seems reasonable. If any criticism were to be leveled at the definition of associate in the ITAA, it would be that it is overly harsh. This is because the assumption that dealings between relatives such as adult siblings or individuals and their uncles and aunts would be off-market or informal is just as often false as it is true. Even many parents and their adult children in modern Australia can be said to deal with one another at arm's length. However, the inclusion of relatives as defined is necessary as it is clear that in western societies such relatives may deal with one another informally and off market.

The ideal of individual independence is deeply rooted and strong in western society<sup>22</sup>. It is also growing stronger as witnessed by the growing propensity of even the closest familial relationships such as spouses to rely upon formal institutional specification of individual property rights rather than operate in a unitary fashion or trust informal institutions. This independence is reinforced by formal institutions and dependent on formal institutions. It in turn in itself reinforces these formal institutions. It leads to the belief that reality is that which is represented by formal institutions.

That is, an individual's property can only be that which is recorded as his or hers in titles, registers or contracts. To alter these records is to alter reality and to not have these records of ownership, say, is to not own. There are no strong informal institutions to create an alternative reality other than in the case, sometimes, of close relatives. Otherwise there must be a formally constituted relationship to offer appropriate formal institutional protection.

The result of the above situation is that associates (as defined in the ITAA) does largely capture the extent of possible non-market transactions and probably goes far beyond this extent. The fact that the associate definition used in the ITAA is not generally thought to be too narrow by tax administrators, policy makers or academics in Australia is testament to the adequacy of the definition in capturing those who may interact through informal institutions.

#### **INCREASED SCOPE FOR ARBITRAGE IN A CHINESE SOCIETY**

Focusing on Chinese society, a very different outcome emerges. The assumption that the group of taxpayers captured by the definition of relative and associate in the ITAA defines the extent of possible off-market or informal institutional interactions in relation to Chinese society is highly inaccurate. The extent of the group of persons who should be considered associates in Chinese society goes far beyond this group. It follows that in accordance with the second key assertion above, members of Chinese society have far more scope to engage in successful taxation arbitrage or evasion. In turn, in accordance with the first key assertion above, members of Chinese society possess a highly valuable tool if they operate as entrepreneurs in a state, such as Australia, that imposes income tax on business income at a high rate. If the entrepreneurs operating in that state come from various different social backgrounds,

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<sup>22</sup> Fei, X. (1992). *From the Soil: The Foundations of Chinese Society*. Berkley, University of California Press. See Chapter 4 in particular



then the Chinese entrepreneurs have a significant competitive advantage through their extensive group of associates. As explained earlier, this competitive advantage may be so valuable in a competitive industry that it leads to domination of that industry by Chinese entrepreneurs.

#### **THE PERPETUATION OF CHINESE BUSINESS MODALITIES IN STRONG FORMAL ENVIRONMENTS**

Thus, it is a fallacy to assert that the strengthening of formal institutions will lead to the demise of the use of informal institutions in the manner that Chinese entrepreneurs have used them in the past. This is because there remains a significant benefit associated with these business modalities in the form of reduced tax burdens. Of course, there are also competitive disadvantages associated with the use of the modalities as an entrepreneur may be limited in the scope of their business operations due to the need to deal with associates. However, the cost associated with this often highlighted disadvantage needs to be compared to the value associated with reduced tax burdens. The advantage may indeed outweigh the disadvantage.

It is also worth noting that tax benefits may not be the only benefits associated with the use of informal institutions. In a highly regulated formal economy informal institutions can be used to reduce or eliminate other obligations in the same manner as taxation. For example liability and risk arising from customers and creditors can be reduced. In Australia, entrepreneurs go to great lengths to protect their assets from bankruptcy. This is attempted through formal methods such as trusts. However, the use of formal methods again opens the doors to authorities to counter such avoidance of liability. The widened scope of associates in the Chinese context is again an advantage here. As developed jurisdictions with strong formal institutions generally go hand in hand with high tax burdens and more regulation, the value of informal institutions is actually increased. It is interesting to note that the developed Chinese jurisdictions of Hong Kong and Singapore impose very low tax burdens.

#### **COUNTERING ARBITRAGE IN CHINESE SOCIETY**

Finally, to round off this discussion, the third assertion above needs to be returned to. It was asserted that authorities and laws can counter tax arbitrage and evasion also by focusing on associates. Here it must therefore be considered whether the increased scope of associates in Chinese society can be effectively countered by a wider definition of associate to be used in tax law and administration. If this is the case, the advantage of the informal institutions will be diminished or eliminated and there will be no value in them and no demand for them.

#### **ASSOCIATES IN CHINESE SOCIETY**

The literature on Chinese social connections, guanxi and networks is extensive. The key focus of this literature is the strong informal bonds (guanxi) that individuals in Chinese society have with certain other individuals that are mutually beneficial. The concept of the network refers to groups of individuals linked by these bonds for common benefit. The extent both in terms of numbers of individuals and in geographical terms is also a noted feature of networks. The strength of these informal bonds is what has allowed Chinese entrepreneurs to succeed in the face of a poor or antagonistic formal institutional environment. It would follow from the very nature of guanxi and networks that anybody that is linked to another person through a guanxi network should be considered to be an associate for taxation purposes if such a definition is to be effective in a Chinese society.



The question that arises from the above is whether persons that are likely to have the appropriate relationship with one another can be characterized in a way that allows the law to identify them. This is what is done in the current Australian law where close relatives (as defined) are included as associates. Referring to seminal work on Chinese society such as that done by Fei Xiaotong<sup>23</sup> as well as to some studies of 'patricorps' in South East Asia and beyond<sup>24</sup>, the impression is that membership of the patrilineage-extended family would be the appropriate characteristic.

#### FAMILIES AND PATRILINEAGES

Fei's work argues that economic activity is organized through the patrilineage in Chinese society and that relatives with the appropriate relationship will almost inevitably collude for mutual benefit. Very specific detail is often given on the nature and strength of the relationship within the family as well. For example married daughters would not be expected to have a strong collaborative relationship with their parents and brothers but sons would. If these assertions hold true for Chinese society, it means that it is possible to define associates in a manner more suited to Chinese society. The members of the patrilineage as defined by Fei would all be defined as associates creating a far wider net than that provided by the definition of relative in s995-1 of the ITAA.

The definition would also differ as arguably (for reasons just mentioned) married daughters, say, would not be appropriately branded associates. The strength of the informal bonds between patrilineage members as portrayed in Fei's work would merit a case for the patrilineage to constitute a tax unit let alone a group of associates.

#### FLEXIBILITY AND STRENGTH IN RELATIONSHIPS

Having seen a possible solution to defining associates in a Chinese society, a problem arises when further evidence on Chinese social connections is reviewed. That is that Fei's descriptions are not an accurate portrayal of Chinese social relationships at least in contemporary Chinese society. Arguably, they were not accurate in the past either. Rather, they represent an ideal for Chinese social relationships, a core of ideas which does underpin Chinese society but does not portray it accurately. Indeed, a deeper reading of Fei's work indicates his awareness of this<sup>25</sup>.

There is clear evidence that guanxi relationships or network membership in contemporary Chinese society is not limited to blood relations. There is also evidence that two closely related (by blood) persons may not be involved in collusive economic activity even when the opportunity exists. This is particularly so in China itself. Rather strong informal relationships are developed between individuals through a commonality that cannot be typified in any concrete manner. It may be that the individuals are old school friends or army friends. It may be that they are blood relatives. It may be that they originate from the same village or that their ancestors are from the same village. The commonality may in itself be quite superficial, however, a strong bond may nevertheless be formed.

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<sup>23</sup> Ibid. pp 83 -85

<sup>24</sup> See amongstst many: Gates, H. (1996). *China's Motor: A Thousand Years of Petty Capitalism*. Ithaca, NY, Cornell University Press.

EAAU (1995). *Overseas Chinese business networks in Asia*. Parkes Australia, East Asia Analytical Unit Dept. of Foreign Affairs and Trade.

<sup>25</sup> (Fei, 1992) Pp 63 -64



The strength and success of these bonds rests at least partly on the invocation of the institutions of trust, loyalty and connectivity as described by Fei. However, the very flexibility of whom these bonds can be formed between is in itself a key feature of Chinese social connections. The most important factor is not the commonality seized upon but the talent of the individuals involved at building relationships. This flexibility is recognized even in the earliest works such as Fei's where after indicating that the familial bonds are so strong carries his analysis further to show that despite the strength of these bonds they can actually be discarded when they are not useful and be generated with others who are not members of the family. He indicates that a successful person is one that is good at "extending" himself<sup>26</sup>. That is, at extending his strong informal bonds.

#### **ALL THAT MATTERS IS WHETHER THERE IS A RELATIONSHIP**

Ultimately, in Chinese society what counts is whether two persons have the "guanxi" relationship and not whether they are family or school friends<sup>27</sup>. This means that it is not possible to describe a category of persons such as "relatives" in the law and hope to capture the majority of those that have strong informal bonds. The only way to describe them would be that associates are those that have a (say) "guanxi" bond but this does absolutely nothing to help identify those that do.

If a wide definition was drawn up to include the extensive blood relative network, old school and army associates, those from a common village or dialect then many may be included. However such a definition would be far too extensive to be workable and would include too many people that do not have any such relationship. Thus it is impossible to combat arbitrage and avoidance through the use of associates by focusing on associates when dealing with Chinese society. Associates while many and diverse cannot be identified.

#### **THE VALUE OF GUANXI IN A STRONG FORMAL INSTITUTIONAL ENVIRONMENT**

There is ultimately a great deal of value associated with doing business through informal institutions such as guanxi networks in a strong formal institutional environment. This value does not arise from the protection that informal institutions offer when there are no strong formal institutions as has been the case historically in China and South East Asia. Rather, it arises from the ability to avoid or reduce costs and obligations associated with strong institutional environments. The case here has been made in relation to taxation but it is clear that issues of liability to creditors and others are also relevant.

The fact that this demand for guanxi and networks in doing business in strong formal institutional environments such as Australia goes unmet on the part of the local "western" society is evidence in favour of the hypothesis that the use of guanxi is a cultural tool available to those with Chinese culture<sup>28</sup>. Otherwise why are strongly bounded networks of individuals not a feature of Australian business large or small? There are clear advantages to their use and, at least in the privately owned sector, not necessarily significant disadvantages at the level of the entrepreneurs themselves<sup>29</sup>. However, the inability to trust others without first having a formal relationship and

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<sup>26</sup> (Fei, 1992) Pg. pp 60 -70

<sup>27</sup> (Hendrischke, 2006; M.-h. M. Yang, 1994)

<sup>28</sup> (M. M.-h. Yang, 2002)

<sup>29</sup> This is not to say there are not disadvantages to the economy as a whole. There are.



record of specific rights is more a feature of these Australian entrepreneurs and their relationships with others.

The advantages of the use of informal institutions are actually maximized when other groups operating in a particular jurisdiction do not rely upon informal institutions as the reduced costs of taxation and potential liability give those operating through informal institutions a competitive advantage that is extremely significant. Of course, they have competitive disadvantages as well but these need to be valued against the massive advantages.

Thus the use of informal institutions such as guanxi networks should be expected to continue regardless of attempts made to strengthen formal institutions. This is because there is significant value associated with this modality of operation. This is regardless of whether the future development of China or Malaysia is being considered or whether the exposure of, say, Australia to Chinese business modalities is being considered. In the global economy this exposure of states such as Australia is not a case of immigrant society. Without any local Chinese community, the Australian tax system is fully exposed to Chinese business modalities through international trade and investment.

Finally, it is worth considering whether strong formal institutions can be developed or maintained in the face of the significant use of informal institutions. When a significant group of persons makes use of informal institutions, the formal institutions are ultimately weakened for those that depend on them. This weakening increases the value of the use of informal institutions for the same reason they were used in China in the first place. That is to counteract a weak formal institutional environment. Thus the use of informal institutions weakens the formal institutional environment while the weakening of the formal institutional environment increases the use of informal institutions. This is a sobering thought in a globalizing world that calls for a single institutional environment as this global institutional environment may not be dominated by strong formal institutions.

## APPENDIX A – DEFINITION OF AN ASSOCIATE

### Section 318 Associates

#### *318(1) [Entity]*

For the purposes of this Part, the following are associates of an entity (in this subsection called the "primary entity") that is a natural person (otherwise than in the capacity of trustee):

- (a) a relative of the primary entity;
- (b) a partner of the primary entity or a partnership in which the primary entity is a partner;
- (c) if a partner of the primary entity is a natural person otherwise than in the capacity of trustee - the spouse or a child of that partner;
- (d) a trustee of a trust where the primary entity, or another entity that is an associate of the primary entity because of another paragraph of this subsection, benefits under the trust;



- (e) a company where:
  - (i) the company is sufficiently influenced by:
    - (A) the primary entity; or
    - (B) another entity that is an associate of the primary entity because of another paragraph of this subsection; or
    - (C) another company that is an associate of the primary entity because of another application of this paragraph; or
    - (D) 2 or more entities covered by the preceding sub-subparagraphs; or
  - (ii) a majority voting interest in the company is held by:
    - (A) the primary entity; or
    - (B) the entities that are associates of the primary entity because of subparagraph (i) of this paragraph and the preceding paragraphs of this subsection; or
    - (C) the primary entity and the entities that are associates of the primary entity because of subparagraph (i) of this paragraph and because of the preceding paragraphs of this subsection.

*318(2) [Company]*

For the purposes of this Part, the following are associates of a company (in this subsection called the "primary entity"):

- (a) a partner of the primary entity or a partnership in which the primary entity is a partner;
- (b) if a partner of the primary entity is a natural person otherwise than in the capacity of trustee - the spouse or a child of that partner;
- (c) a trustee of a trust where the primary entity, or another entity that is an associate of the primary entity because of another paragraph of this subsection, benefits under the trust;
- (d) another entity (in this paragraph called the "controlling entity") where:
  - (i) the primary entity is sufficiently influenced by:
    - (A) the controlling entity; or
    - (B) the controlling entity and another entity or entities; or
  - (ii) a majority voting interest in the primary entity is held by:
    - (A) the controlling entity; or
    - (B) the controlling entity and the entities that, if the controlling entity were the primary entity, would be associates of the controlling entity because of subsection (1), because of subparagraph (i) of this



paragraph, because of another paragraph of this subsection or because of subsection (3);

(e) another company (in this paragraph called the "controlled company") where:

(i) the controlled company is sufficiently influenced by:

(A) the primary entity; or

(B) another entity that is an associate of the primary entity because of another paragraph of this subsection; or

(C) a company that is an associate of the primary entity because of another application of this paragraph; or

(D) 2 or more entities covered by the preceding sub-subparagraphs; or

(ii) a majority voting interest in the controlled company is held by:

(A) the primary entity; or

(B) the entities that are associates of the primary entity because of subparagraph (i) of this paragraph and the other paragraphs of this subsection; or

(C) the primary entity and the entities that are associates of the primary entity because of subparagraph (i) of this paragraph and the other paragraphs of this subsection;

(f) any other entity that, if a third entity that is an associate of the primary entity because of paragraph (d) of this subsection were the primary entity, would be an associate of that third entity because of subsection (1), because of another paragraph of this subsection or because of subsection (3).

[Subsection (2) amended by Act No 41 of 1998 s 3 and Sch 6, Item 18, with effect from 4 June 1998, by deleting 'application of this' from sub-subparagraph (e)(i)(B).]

*318(3) [Trustee]*

For the purposes of this Part, the following are associates of a trustee (in this subsection called the "primary entity"):

(a) any entity that benefits under the trust;

(b) if a natural person benefits under the trust - any entity that, if the natural person were the primary entity, would be an associate of that natural person because of subsection (1) or because of this subsection;

(c) if a company is an associate of the primary entity because of paragraph (a) or (b) of this subsection - any entity that, if the company were the primary entity, would be an associate of the company because of subsection (2) or because of this subsection.

*318(4) [Partnership]*



For the purposes of this Part, the following are associates of a partnership (in this subsection called the "primary entity"):

- (a) a partner in the partnership;
- (b) if a partner in the partnership is a natural person - any entity that, if that natural person were the primary entity, would be an associate of that natural person because of subsection (1) or (3);
- (c) if a partner in the partnership is a company - any entity that, if the company were the primary entity, would be an associate of the company because of subsection (2) or (3).

*318(5) [Time of association]*

In determining, for the purposes of this section, whether an entity is an associate of another entity at a particular time (in this subsection called the "test time"):

- (a) an entity (in this subsection called the "public unit trust entity") that, apart from this subsection, is the trustee of a public unit trust at the test time is to be treated as if it were a company instead of a trustee; and
- (b) the public unit trust entity is taken to be sufficiently influenced by another entity or other entities if the public unit trust entity is accustomed or under an obligation (whether formal or informal), or might reasonably be expected, to act in accordance with the directions, instructions or wishes of the other entity or other entities (whether those directions, instructions or wishes are, or might reasonably be expected to be, communicated directly or through interposed companies, partnerships or trusts); and
- (c) another entity or other entities are taken to hold a majority voting interest in the public unit trust entity if either of the following percentages is not less than 50%:
  - (i) the percentage of the income of the trust represented by the share of the income to which the other entity or other entities are entitled, or that the other entity or other entities are entitled to acquire;
  - (ii) the percentage of the corpus of the trust represented by the share of the corpus to which the other entity or other entities are entitled, or that the other entity or other entities are entitled to acquire.

*318(6) [Terms explained]*

For the purposes of this section:

- (a) a reference to an entity benefiting under a trust is a reference to the entity benefiting, or being capable (whether by the exercise of a power of appointment or otherwise) of benefiting, under the trust, either directly or through any interposed companies, partnerships or trusts; and
- (b) a company is sufficiently influenced by an entity or entities if the company, or its directors, are accustomed or under an obligation (whether formal or informal), or might reasonably be expected, to act in accordance with the directions, instructions or wishes of the entity or entities (whether those directions, instructions or wishes are, or



might reasonably be expected to be, communicated directly or through interposed companies, partnerships or trusts); and

(c) an entity or entities hold a majority voting interest in a company if the entity or entities are in a position to cast, or control the casting of, more than 50% of the maximum number of votes that might be cast at a general meeting of the company.

318(7) ["Spouse"]

In this section, and in any other provision of this Act insofar as that provision has effect for the purposes of this section, a reference to the spouse of a person (in this subsection called the "first person") does not include a reference to a person who is legally married to the first person but is living separately and apart from the first person on a permanent basis.

#### **Section 995-1 (ITAA 1997)**

relative of a person means:

- (a) the person's \*spouse; or
- (b) the parent, grandparent, brother, sister, uncle, aunt, nephew, niece, lineal descendent or \*adopted child of that person, or of that person's spouse; or
- (c) the spouse of a person referred to in paragraph (b).

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