

Note

An Update on Taxation in China

I. INTRODUCTION

On April 12, 1986, the central government of the People's Republic of China issued a new five year plan reaffirming the country's commitment to economic decentralization. The PRC announced a plan to broaden the role of free market forces and to curtail the interdependence of commercial enterprise and the state.¹ This plan demonstrates China's current quest to make more varied and efficient use of capital investment.

U.S. investors may wish to consider the effects of the new plan on doing business in China. This note examines specific features of China's tax system to aid the U.S. investor in planning under the present tax system and in predicting future developments. To the extent that a tax system reflects national economic policy, it is necessary to evaluate the Chinese tax system not only on its own terms but also in light of China's experimentation with profit-motivated business and investment.

This discussion takes up three aspects of tax planning in China: first, an overview of the present tax scheme; second, the influence of that tax scheme on whether and how to do business in China; and third, the interaction between Chinese tax incentives and U.S. tax law. A summary of PRC income taxes is provided in the chart following the text.

II. AN OVERVIEW OF TAXES ON FOREIGN INVESTMENT

This section describes and contrasts the principal tax provisions applicable to foreign investors in an effort to provide an understanding of current Chinese tax policy and assist the taxpayer in making business choices. This section first covers the taxation of Chinese domestic enterprises. It then explains the Individual Income Tax

1. Sterba, *Central Control Subdued Under Peking's Plan*, Wall St. J., April 15, 1986, at 39.

Law (the individual income tax),² which applies to Chinese and foreigners. Finally, it addresses the Income Tax Law Concerning Joint Ventures with Chinese and Foreign Investment (the joint venture income tax),³ and the Foreign Enterprise Income Tax Law (the foreign enterprise income tax).⁴ Tax aspects of a foreign investor's business choices are described in section III.

Rather than include foreign ventures in the regime designed for taxation of domestic enterprises, China has for the most part promulgated a separate system for such ventures. One explanation for this may be that operations with foreign participation do not directly share revenues with the state, as do state-owned enterprises. As China's economy becomes more decentralized, however, the rationale for maintaining two separate systems of taxation fades. It has recently been proposed, for example, that even such industries as "internal airlines, post and telecommunications departments" should be allowed to retain 90% of their profits.⁵ As pricing restrictions ease, those profits will presumably reflect real earnings, and will be subject to tax. If such proposals become law, China's economic system would allow for a uniform scheme of taxation. At the same time,

2. Individual Income Tax Law of the People's Republic of China [hereinafter IIT Law] (Zhonghua Renmin Gongheguo Geren Suode Shui Fa) (Sept. 10, 1980) (trans. in TAXES AND INVESTMENT IN ASIA AND THE PACIFIC, Vol. 1, app. 4(e) [hereinafter TIAP] (published by International Bureau of Fiscal Documentation 1984 and Supp. 1985)).

3. Income Tax Law Concerning Joint Ventures with Chinese and Foreign Investment [hereinafter JVT Law] (Zhonghua Renmin Gongheguo Zhong Wai Jingying Hezi Qiye Shui Fa) (Sept. 10, 1980) (trans. TIAP, *supra* note 2, app. 4(c)).

4. Foreign Enterprise Income Tax Law [hereinafter FEIT Law] (Zhonghua Renmin Gongheguo Waiguo Qiye Fa) (Dec. 18, 1981) (trans. TIAP, *supra* note 2, app. 4(a)). Among other important taxes is the industrial and commercial consolidated tax, a turnover tax on goods and services along the chain of production. Reference to the turnover tax will only be made as need arises in the context of the other laws. See Gelatt, *Tax Aspects of Business with the PRC*, 22 COLUM. J. TRANSNAT'L L. 421, 441-42 (1984); TIAP, *supra* note 2, at 162.

Other recent writings on tax law in China include: Bell, *People's Republic of China — Personal Income Tax*, 11 GA. J. INT'L & COMP. L. 373 (1981); Castleman, *Taxation in the People's Republic of China: The System and its Function*, 46 ALB. L. REV. 776 (1982); China Laws for Foreign Business — Taxation (CCH Australia) (1985); Fields, *Taxation: The People's Republic of China Income Tax Laws*, 22 HARV. INT'L L. J. 234 (1981); Hammer, Jack and Ho, *The Important New U.S.-China Treaty: Its Impact on U.S. Firms*, 37 TAX EXEC. 53 (1984); Han, *People's Republic of China's Foreign Enterprise Income Tax Law and Regulations*, 6 HASTINGS INT'L & COMP. L. REV. 689 (1983); Huang, *The Income Tax Laws of the People's Republic of China*, 25 B. B. J. 13 (1981); Jack, Hammer, and Conn, *Taxation of Foreign Enterprises in China*, 30 CAN. TAX J. 416 (1982); Note, *Taxation of Joint Ventures in the People's Republic of China: A Legal Analysis in the Context of Current Chinese Economic and Political Conditions*, 15 VAND. J. TRANSNAT'L L. 513 (1982); Pomp, Gelatt and Surrey, *The Evolving Tax System of the People's Republic of China*, 16 TEX. INT'L L. J. 11 (1981); and Reynolds, *Doing Business with the People's Republic of China: Tax Considerations*, 14 INT'L LAW. 49 (1980).

5. Sterba, *supra* note 1.

there may be other policy reasons which would prolong the existence of separate tax systems.⁶

A. Taxation of Domestic Enterprises

Since 1950, China has applied an "industrial and commercial income tax" to all non-state-owned entities such as collective and private enterprises.⁷ The tax is assessed yearly, but enterprises must estimate and pay quarterly installments. The base figure for taxable income is the change in net worth for the accounting period, with allowances for exemptions, deductions, and depreciation.⁸ This method is in principle the same as that used in the U.S.

Income is taxed at rates ranging from 5.75% on less than 300 yuan per year, to 34.5% on income of 10,000 yuan or more.⁹ Also, for specific enterprises a local surcharge ranging from 10% to 100% of annual taxable income may be levied, based on the amount of industrial and commercial income tax.¹⁰ There is no preferential rate of taxation for capital gains, which simply appear as part of the change in net worth.¹¹

Since October of 1984, state-owned enterprises have been subject to an income tax.¹² Large and medium-sized state-owned enterprises are taxed at a uniform rate of 55%; small enterprises are taxed on the basis of an eight-grade progressive income tax rate.¹³

Reportedly, collective enterprises are now taxed at the progressive rates applied to small state-owned enterprises.¹⁴ This step toward unification of the tax system may reflect the Chinese commitment to putting both state-owned and private enterprises on a profit-making, pay-their-own-way basis. Certainly, the very existence of a domestic enterprise tax system for both kinds of enterprises suggests that state-owned enterprises will not always enjoy financial support from the government; increasingly they will need to consider tax aspects of business as do private enterprises. Furthermore, as both state-owned

6. These reasons, relating to incentives and controls, will be examined in section IV of this article.

7. TIAP, *supra* note 2, at 105. Since collective enterprises will now be taxed in the same manner as small state-owned enterprises, it is unclear what function an industrial and commercial tax serves in China. See *infra* note 14 and accompanying text.

8. *Id.* at 105-06.

9. *Id.* at 161.

10. *Id.* at 161.

11. *Id.* at 106.

12. *Id.* at 107. An experimental profit tax on a number of selected state-owned enterprises has existed since 1979. This experiment extended to all profit-making state-owned enterprises in 1983.

13. *Id.* There are also applicable excise and windfall taxes.

14. *Id.* at 105.

and private enterprises come to operate on a profit-loss basis, presumably the need for separate foreign and domestic tax structures will diminish.¹⁵

The domestic enterprise income tax is apparently both short and simple. Together with the taxes on foreign business, it forms a "generally conventional tax system."¹⁶ However, this apparent simplicity should not deter the business planner from further investigation, especially with regard to the tax provisions applicable to foreign business. Major features of the tax system are of recent origin, and the income taxes are only beginning to be a vital source of revenue in China. Nevertheless, the future may lie the way of the consolidated turnover tax:¹⁷ this turnover tax targets 107 items, each subject to a different rate and to surcharges and exemptions.¹⁸ The potential exists for comparable (or greater) complexity in the income tax statutes, especially as Chinese capital structures become more sophisticated.

The Chinese have a tendency to make up for nominal simplicity through informal understandings and agreements. Thus, the business planning inquiry cannot end with these relatively straightforward statutes and regulations. Section III will describe some of the relevant complexities of the tax system in practice.

B. The Individual Income Tax

To foreign investors familiar with the so-called "iron rice bowl" system in China, an individual income tax seems quite anomalous. However, under new regulations, Chinese citizens are subject to a 20% to 60% tax on income in excess of an amount determined by salary status.¹⁹ The new regulations do not apply to foreign taxpayers.²⁰

15. See *supra*, text following note 4. Also, the China-U.S. Tax Treaty requires that citizens and enterprises of both nations not be subject to taxation any more "burdensome" than that imposed on domestic individuals or enterprises. Agreement Between the Government of the United States of America and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Tax Evasion with Respect to Taxes on Income, Apr. 30, 1984, United States-People's Republic of China, art. 23, 1 CCH Tax Treaties ¶ 1403 [hereinafter Treaty] (ratification approved by U.S. Senate July 24, 1986). This requirement has already been satisfied at least by the individual tax, applied to both foreigners and Chinese citizens. See *infra*, text accompanying notes 19-40. However, since the Treaty recognizes the validity of the current enterprise taxes, see article 2, apparently separate tax structures may be maintained without necessarily being in violation of article 23.

16. Gelatt, *supra* note 4, at 503.

17. *Id.* at 442.

18. TIAP, *supra* note 2, at 162-64.

19. Renmin Ribao (People's Daily), Zhonghua Renmin Gongheguo Geren Shouru Tiaojie Shui Zhanxing Tiaoli (Provisional Regulations of the PRC on Individual Income Adjustment Tax), Dec. 12, 1986, at 4, col. 5.

20. *Id.* art. 2.

The tax has two main rate systems applicable to foreigners. The first applies to "wages and salaries," and has a progressive structure: the first 800 yuan per month is exempt, and marginal rates from 5% to 45% apply thereafter (the top rate applying to monthly income over 12,000 yuan).²¹ The second applies to "compensation for personal services [such as income from a legal practice²²], royalties, interest, dividends, bonuses and lease of property," and other kinds of income.²³ Income of this kind is taxed at a flat 20% rate.²⁴ For income from compensation for services, royalties, or property leasing, a deduction of 800 yuan is allowed for expenses if the amount in a single payment is less than 4000 yuan; for single payments greater than 4000 yuan, a deduction of 20% is permitted.²⁵ Foreign-source income, when taxed at all, is computed and taxed separately on a yearly basis.²⁶

One simple aspect of the statute is that, apart from the basic deduction in the progressive and flat taxes, no other deduction as such is allowed. However, properly verified "advances or reimbursements by foreign companies to their employees for specific company expenses" are apparently exempted from employees' incomes.²⁷ An open question is whether the statute's simplicity will give way to increasing complexity as foreigners conduct more long-term business in China, and earn greater (and more varied) income there.

Exemptions are also granted on the basis of the taxpayer's residence status. For example, as mentioned above, only persons residing in China more than five years are taxable on worldwide income.²⁸ Those who reside in China from one to five years are taxable only on income from China and foreign income remitted to China.²⁹ Persons residing in China less than one year are taxed only on "income gained within China."³⁰ These distinctions depend on the source generating the income, not the place of payment.³¹ However, foreigners who reside in China less than ninety days have an exemption for wages and

21. See *supra* note 19, at 4.

22. Detailed Rules and Regulations for the Implementation of the Individual Income Tax Law [hereinafter IIT Reg.] (Zhonghua Renmin Gongheguo Geren Suode Shui Fa Shishi Xize) (Dec. 14, 1980), art. 4.2 (trans. TIAP, *supra* note 2, app. 4(f)).

23. IIT Law, *supra* note 2, art. 2(2)-2(4), 2(6).

24. *Id.* art. 3(2).

25. *Id.* art. 5(2); IIT Reg., *supra* note 22, art. 11.

26. IIT Law, *supra* note 2, art. 7; IIT Reg., *supra* note 22, art. 16.

27. Gelatt, *supra* note 4, at 433.

28. IIT Reg., *supra* note 22, art. 3.

29. *Id.*

30. IIT Law, *supra* note 2, art. 1.

31. IIT Reg., *supra* note 22, art. 5.

compensation paid to them outside of China.³² Non-residents are taxed in full on personal service compensation, royalties and property leasing income earned in China.³³ Other exemptions, not based on source, include the receipt of dividends from equity joint ventures and urban and rural cooperatives.³⁴

The Ministry of Finance has changed the value of the exemptions based on residence status. This is an example of why caution must be used in relying on statutory language. Apparently the Ministry will allow a foreign resident in China to exempt foreign-source income whether or not remitted to China, "provided the foreigner's presence is attributable to his employment by a joint venture, cooperative venture, or foreign enterprise in China, and does not result from an intent to take up long-term residency in China."³⁵ This exemption may mean only that tax authorities are thus far not adequately prepared to monitor foreign income. It may also be an effort to encourage foreign workers to bring in much-needed foreign currency.

It should be apparent that China's individual income tax laws primarily address earned income. There is no specific capital gains tax or tax applicable to the sale or exchange of property,³⁶ but the Ministry of Finance has reserved the right to tax "other kinds of income."³⁷ While China has begun to encourage the sale of securities and other exchanges incidental to stock redemption and corporate liquidation and reorganization, no provision covers taxation of these transactions. The importance to U.S. investors of tax laws in these areas depends not only on the development of Chinese capital markets, however, but also on the legal capacity of foreigners to own property in China.³⁸

As it stands, the individual income tax is relatively straightfor-

32. *Id.* art. 5(1). By Treaty, however, "professional services" income is not taxed in China if the taxpayer resides in China less than 183 days and has no permanent establishment. Treaty, *supra* note 15, art. 13. A similar provision applies to salaries. *Id.* art. 14.

33. Treaty, *supra* note 15, art. 11.

34. *Id.* art. 5(2).

35. Gelatt, *supra* note 4, at 430. See also TIAP, *supra* note 2, at 111.

36. See Gelatt, *supra* note 4, at 433. By comparison, under the U.S. Tax Reform Act of 1986, preferential capital gains rates will be eliminated in the U.S., at least until the next round of reform. The Chinese, however, may find preferential rates a useful addition to their broad scheme of channeling investment through such devices as Special Economic Zones.

The immediacy of the problem of the tax treatment of securities income is demonstrated by the recent announcement of the creation in China of "bond-trading centers" to establish a market for domestic enterprise bond issues. Fung, *China Prepares to Start Center to Trade Bonds*, Asian Wall St. J., Aug. 4, 1986, at 1, col. 6.

37. IIT Law, *supra* note 2, art. 2(6).

38. The Constitution of the PRC prohibits private ownership of land: "No organization or individual may appropriate, buy, sell or lease land, or unlawfully transfer land in other ways." THE CONSTITUTION OF THE PEOPLE'S REPUBLIC OF CHINA, art. 10. The Constitution

ward. Once the foreign worker determines his status as a resident and the allocation of his income under the progressive or flat rate structure, the rest seems mechanical: it is just a matter of complying with various withholding and filing requirements. There are (so far) no opportunities for sheltering income in losing or capital gain ventures, or for deferring gain recognition. The nearest Chinese equivalent seems to be the exemption provided for interest income on accounts with Chinese state banks and credit cooperatives of the PRC.³⁹ Future individual and other tax treatment of capital gains and securities-related transactions should prove a complex addition to the Chinese tax system.⁴⁰

C. The Joint Venture Income Tax

The joint venture income tax is a combination of tax accounting provisions and tax incentives. Since equity joint ventures are incorporated in China,⁴¹ the venture joint tax law is even simpler than that for individuals, at least to the extent the individual tax varies with residence status. Whether this tax is also effective at raising revenue for the state is a question which remains to be answered through empirical research.

A joint venture is taxable on all income, whether domestic or foreign.⁴² There is a flat tax on income of 30%, plus a "local surtax" of 10% on the 30% tax.⁴³ Thus, the effective rate is 33%. If the foreign member of the joint venture wishes to remit its profits abroad, a further 10% withholding tax is levied on that amount.⁴⁴ Alternatively, either member of the venture may re-invest profits within China for at least five years, and thereby obtain a 40% refund of taxes paid on the profits re-invested.⁴⁵ The income tax is assessed annually, but must be paid quarterly.⁴⁶

Other provisions of the joint venture tax law may relieve some of

provides also that citizens may own "lawful property," *id.* art. 13, but does not address the question of foreign ownership of property.

39. IIT Law, *supra* note 2, art. 4(2).

40. "As tax officials gain more experience and confidence, they are likely to develop techniques and approaches that deviate from the mainstream and fulfill the expectations of many third world leaders that China will emerge as an intellectual leader in tax issues." Gelatt, *supra* note 4, at 504.

41. Joint Venture Law of the PRC [hereinafter Joint Venture Law] (Zhonghua Renmin Gongheguo Zhong Wai Hezi Jingying Qiye Fa) (July 8, 1979) (trans. TIAP, *supra* note 2, app. 1(a)), art. 1.

42. JVT Law, *supra* note 3, art. 1.

43. *Id.* art. 3.

44. *Id.* art. 4.

45. *Id.* art. 6.

46. *Id.* art. 8.

the fears of foreign investors that joint ventures will be slow to show a profit. For instance, one basic provision allows losses to be carried forward for up to five years.⁴⁷ A related provision adds another incentive to that of the carry-forwards. A joint venture chartered to operate for ten years or more may "be exempted from income tax in the first profit-making year and allowed a 50% reduction in the second and third years."⁴⁸ Certain joint ventures may be eligible for more extended reductions.⁴⁹ In other words, a joint venture pays no income tax on continuous net losses. When it turns a profit, it has one to five years to offset losses against positive income, and, when the offset is depleted, it has a tax exemption on the next year's profit, followed by the reduced rates for two years. The Chinese apparently have devised this system on the assumption that a joint venture will become progressively more profitable following "losses in the initial stage of operation."⁵⁰ It is not clear what happens if a joint venture is only erratically profitable; presumably the enterprise may repeatedly take advantage of loss carry-forwards, but the tax exemption and reductions seem to apply only once.⁵¹

Taxable income is defined as "net income in a tax year after deduction of costs, expenses and losses."⁵² Deductions are allowed for such expenses as wages, inventory turnover, and apparently, the consolidated industrial and commercial tax.⁵³ In contrast to U.S. tax law, "interest on capital" is not deductible.⁵⁴ The reason for this is to prevent the venture from paying out disguised dividends;⁵⁵ the restriction does not apply to interest on loans made in the ordinary course of business.⁵⁶ Since interest paid by a joint venture to an individual is

47. *Id.* art. 7.

48. The exemption occurs "upon approval by the tax authorities of an application filed by the enterprise." *Id.* art. 5.

49. *Id.* This article cites as examples ventures in "such low-profit operations as farming or forestry or located in remote, economically underdeveloped outlying areas . . ."

50. Detailed Rules and Regulations for the Implementation of the Income Tax Law Concerning Joint Ventures with Chinese and Foreign Investment [hereinafter JVT Reg.] (Zhonghua Renmin Gongheguo Zhong Wai Hezi Jingying Qiye Suode Shui Fa Shishi Xize) (Dec. 14, 1980), art. 5 (trans. TIAP, *supra* note 2, app. 4(d)).

51. See JVT Law, *supra* note 3, art. 5. The exemption and subsequent reductions begin to take effect in the "first profit-making year," which is defined as the first year of profit net of any loss carry-forwards. JVT Reg., *supra* note 50, art. 15. This tax holiday thus appears to be a once-only benefit.

52. JVT Law, *supra* note 3, art. 2.

53. JVT Reg., *supra* note 50, art. 8.

54. *Id.* art. 9(3). Presumably a joint venture capitalized with debt and not equity would not be able to deduct the interest on the debt.

55. See Gelatt, *supra* note 4, at 452.

56. *Id.* at 452.

taxable to the individual while a dividend is not,⁵⁷ the limit on interest deductibility also acts as a penalty. The interest payment is made out of after-tax income at the "corporate level," and it is taxed again in the hands of the lender. Dividends are not deductible either, but they are not taxed again in the hands of the recipient.

A final problem area relating to deductibility concerns payments into "reserve funds, the bonus and welfare funds for the workers and staff members and the expansion funds of the venture."⁵⁸ These funds apparently act as a kind of self-insurance for a joint venture, providing a pool of capital to protect both the enterprise and the employees against future cash shortages.⁵⁹ Profit available for distribution to the shareholders is only the amount net of taxes and payments into these funds. The payments are not "currently deductible," and it is also unclear whether payments made *out* of the fund are deductible, despite the deductibility of similar payments made out of "general joint venture funds."⁶⁰

As in the U.S., the cost of fixed assets must be depreciated, not deducted.⁶¹ The method is limited "generally" to straight-line depreciation,⁶² probably for administrative convenience. Also, consistent with the rest of the Chinese tax system, capital gains are included in ordinary income.⁶³ So far, the Chinese have not adopted depreciation and capital gains as investment incentives, as was until recently done in the U.S.⁶⁴ Since the Chinese do appear eager to offer other types of tax incentives such as tax holidays, perhaps they will consider adoption of depreciation and capital gains preferences as well. The use of other tax incentives, in conjunction with both joint ventures and foreign enterprises, will be examined more closely in section III.

D. The Foreign Enterprise Income Tax

The foreign enterprise income tax law applies generally to all foreign ventures, other than joint equity ventures, doing business in China.⁶⁵ Echoing the structure of the individual tax, the foreign enterprise tax makes a fundamental distinction based on whether a

57. IIT Reg., *supra* note 22, art. 5(2).

58. Joint Venture Law, *supra* note 41, art. 7.

59. This is not to suggest that the funds are adequate for major casualty losses. They seem more analogous to bad debt reserves held by banks.

60. Gelatt, *supra* note 4, at 454.

61. JVT Reg., *supra* note 50, art. 9(1).

62. *Id.* art. 12, ¶ 2.

63. *Id.* art. 15.

64. In the U.S. the availability of such incentives has been reduced by the Tax Reform Act of 1986.

65. FEIT Law, *supra* note 4, art. 1.

foreign enterprise has an "establishment" in China. While the foreign enterprise tax parallels the joint venture tax in basic features such as calculation of net income, depreciation and deductions, it does raise other issues, such as the meaning of "establishment," which may concern U.S. investors.

1. Companies with Establishments

Foreign enterprises "which have establishments in the People's Republic of China engaged in independent business operation or co-operative production or joint business operation with Chinese enterprises"⁶⁶ are, like foreign residents, subject to a progressive income tax. The rates range from 20% on annual income under 250,000 yuan to 40% on annual income exceeding 1,000,000 yuan.⁶⁷ Unlike joint ventures, foreign enterprises with establishments are also subject to a local 10% tax on income, although the local tax may be reduced or eliminated in some cases.⁶⁸ (The local tax is calculated as 10% of income before application of the national tax.⁶⁹) Certain foreign enterprises engaging in "low profit occupations," such as farming, forestry and animal husbandry, may also apply for limited national tax reductions and exemptions.⁷⁰

One unusual feature of the foreign enterprise tax law is the treatment of those enterprises which cannot document their taxable income. In such cases, the tax authorities will impute profit based on that of "other enterprises of the same or similar trade,"⁷¹ and tax it according to the regular schedule. Presumably this provision helps prevent tax evasion, and encourages accurate financial accounting.

The law does not state whether foreign companies with establishments will be taxable on their worldwide income or just on Chinese-source income.⁷² This may represent a desire to preserve flexibility in the tax law so it can accommodate a wide variety of foreign corporate structures. The immediate advantage of the flexibility to the Chinese

66. *Id.* art. 1.

67. *Id.* art. 3. This compares with a new U.S. top corporate tax rate of 34%, to take effect after 1987. I.R.C. § 601 (1986); N.Y. Times, Sept. 28, 1986, at A34, col. 3.

68. *Id.* art. 4. Article 4 provides, in part: "Where a foreign enterprise needs reduction in or exemption from local income tax on account of the small scale of its production or business, or its rate of profit, this shall be decided by the people's government of the province, municipality or autonomous region in which the enterprise is located."

69. Detailed Rules and Regulations for the Implementation of the Foreign Enterprise Income Tax Law [hereinafter FEIT Reg.] (Zhonghua Renmin Gongheguo Waiguo Qiye Suode Shui Fa Shishi Xize) (Feb. 7, 1982), art. 5 (trans. TIAP, *supra* note 2, app. 4(b)).

70. FEIT Law, *supra* note 4, art. 5.

71. FEIT Reg., *supra* note 69, art. 24; Gelatt, *supra* note 4, at 465.

72. Gelatt, *supra* note 4, at 465.

is that they can, for example, tax Chinese subsidiaries of foreign corporations on worldwide income (since they, like joint ventures, would be incorporated in China), while only taxing a division or branch of a foreign corporation on its Chinese-source income.⁷³

Evidence of increasing Chinese tax law sophistication can be found in the deductibility of interest payments, and of certain payments made by foreign operations in China to their home offices, under the foreign enterprise tax law. The Chinese show an awareness of and willingness to provide for bona fide interest payments, but the law denies a deduction for anything resembling disguised dividends. In contrast to the joint venture tax law,⁷⁴ the foreign enterprise tax explicitly provides for deduction of interest paid on debt, if rates are "reasonable," and the terms documented and "normal."⁷⁵ Similarly, the law provides that "reasonable overhead expenses . . . that are relevant to production and operation" and other legitimate payments to head offices abroad are deductible if properly documented.⁷⁶ Hence, these provisions should allow a deduction for real business costs, while preventing disguised dividends from being expatriated tax-free.

2. Companies Without an Establishment

Foreign enterprises without an "establishment" in China are subject to a 20% withholding tax on gross income from "dividends, interest, rentals, royalties and other sources in China."⁷⁷ Under the new China-U.S. Tax Treaty (the "Treaty"), U.S. companies without a "permanent establishment" are not subject to income tax in China;⁷⁸ however, remitted dividends, interest, and royalties may be taxed at a 10% withholding rate.⁷⁹ No deductions for these items have been spelled out.⁸⁰ However, there are tax exemptions for interest on certain loans and deposits ("given at a preferential interest rate") by foreign banks and "international financial organizations."⁸¹ Foreign investors may be more concerned that the 20% tax does apply to "income obtained from the provision of various patents, technical

73. *Id.* at 465, n.209.

74. *See generally supra* text accompanying note 54.

75. FEIT Reg., *supra* note 69, art. 12.

76. *Id.* art. 11.

77. FEIT Law, *supra* note 4, art. 11; FEIT Reg., *supra* note 69, art. 28.

78. Treaty, *supra* note 15, art. 7.

79. *Id.* arts. 9-11.

80. FEIT Reg., *supra* note 69, art. 28.

81. FEIT Law, *supra* note 4, art. 11; *see also* Gelatt, *supra* note 4, at 473-74. "International financial organizations" are such entities as the International Monetary Fund, the World Bank, and "other finance organizations of the U.N." FEIT Reg., *supra* note 69, art. 29-31.

know-how, copyright and trademark interests for use in China.”⁸² While this would include know-how such as “technology for creating computer programs,”⁸³ tax reductions or exemptions for high technology transfers may be available.⁸⁴

3. The Meaning of “Establishment”

A question central to tax planning in China is what constitutes an “establishment.” The law states that an establishment may include “management offices, branches, representative offices, factories and places where natural resources are exploited and where contracted projects of building installations, assembly and exploration are operated.”⁸⁵ However, the characterization of enterprises with substantial operations in China, or of enterprises essentially doing business from abroad, is not at issue. The “gray area” seems to involve activities carried out by representative offices or other agents doing preliminary or exploratory work.⁸⁶ Definitional language in the recently approved tax treaty with the U.S. may afford some clarification. The China-U.S. Tax Treaty contains language suggesting that an office engaged in consulting for over six months,⁸⁷ or an office with broad authority to conclude contracts,⁸⁸ would be considered a “permanent establishment.” However, a facility used solely for storage, purchasing goods, collecting information, or “activity of a preparatory or auxiliary character”⁸⁹ would not.

Such interpretative exercises may also become easier as the Chinese continue to legislate. For example, there are now Interim Provisions for the Collection of Industrial and Commercial Consolidated Tax and the Foreign Enterprise Income Tax,⁹⁰ which apply specifically to “permanent representative offices” of the kind discussed above. Consistent with the “permanent establishment” language of the Treaty, the Provisions subject qualifying representative offices to the progressive foreign enterprise tax, and to the consolidated turnover tax.⁹¹

Thus, the foreign enterprise tax sacrifices some simplicity for

82. FEIT Reg., *supra* note 69, art. 27.

83. Gelatt, *supra* note 4, at 476, n.269.

84. *Id.* at 477.

85. FEIT Reg., *supra* note 69, art. 2. This language is reflected in the new China-U.S. Tax Treaty. Treaty, *supra* note 15, art. 15.

86. *See* Gelatt, *supra* note 4, at 464.

87. Treaty, *supra* note 15, art. 5.3(c).

88. *Id.* art. 5.5.

89. *Id.* art. 5.4.

90. Issued by the Ministry of Finance on May 14, 1985. TIAP, *supra* note 2, at 131.

91. *Id.* at 58.

flexibility in creating a broad plan of "corporate" taxation. Nonetheless, it is essentially fair and no more complex than is necessary in coping with new market-oriented institutions.⁹²

III. THE INFLUENCE OF TAX ON BUSINESS CHOICES

Learning the general nature and substance of the Chinese tax laws does not complete the inquiry for the foreign investor. The statutes alone do not reveal the total effect of taxes on business planning. The other two major concerns are the effects of Chinese tax laws in conjunction with other tax incentives and the effect of U.S. tax law, including the new Treaty with China.

A foreign investor weighing these concerns, however, may not want to take the idea of minimizing taxes as the guiding principle as might be the case for tax planning in the U.S. Rather, "a foreign company should consider such potential benefits as the goodwill and increased business opportunities that might accrue from contributing to the Chinese fisc."⁹³ Two practical considerations bolster this idealistic principle. First, as will be shown, many Chinese taxes are creditable against U.S. tax liability. Second, Chinese taxes are payable in renminbi, even if levied on foreign exchange income.⁹⁴ Since it is difficult to exchange and expatriate renminbi anyway, a foreign business may as well pay the tax in China, accrue the "goodwill" and seek a credit back home.⁹⁵ As always, the opportunity for short term gain should be viewed in light of long term growth or decline, and in light of other business goals.

92. The foreign enterprise income tax subjects enterprises with an establishment to a graduated tax on net income. Enterprises without an establishment are subject to a withholding tax.

This may be compared to the U.S. tax treatment of foreign enterprises. A "foreign corporation engaged in trade or business within the United States . . . shall be taxable" according to the graduated tax and provisions governing U.S. corporations. I.R.C. § 882 (1986). However, under § 881, foreign corporations earning income such as "interest . . . , dividends, rents, salaries, . . . and other fixed or determinable annual or periodic gains, profits, or income" which is "not effectively connected with the conduct of a trade or business within the United States" are subject to a withholding tax. *Id.* at § 881. Hence, it appears that the Chinese have contrived a solution substantially similar to that used (and found workable) in the U.S.

93. Gelatt, *supra* note 4, at 425.

94. See FEIT Law, *supra* note 4, art. 13.

95. However, an enterprise may wish to make a more aggressive effort to minimize its Chinese tax liability to the extent that it exceeds the enterprise's U.S. taxes. This may be more of a problem under the Tax Reform Act of 1986. The U.S. top corporate rate will be only 34%, compared to 40% under China's FEIT Law. See *id.* art. 3. In general, the excess foreign tax cannot be credited, but must be carried forward to future taxable years. See I.R.C. § 904 (1986).

A. Chinese Tax Incentives

Tax considerations alone may not determine a foreign investor's business choice, but tax incentives are certainly a factor in deciding not only what form of business to conduct, but where in China to conduct it. At the same time, one must be resigned to the high degree of uncertainty which may upset the most careful plans.⁹⁶ Hopefully, the implementation of the tax treaty and increased familiarity on the part of the Chinese with their new tax system will help reduce this uncertainty.

1. Choice of Business Form

The choices of form fall into three main categories: doing business from outside China so as to avoid progressive individual taxes and "establishment" taxes entirely, doing business as a joint equity venture, or doing business as a foreign enterprise, which includes several forms.

As far as conducting business from abroad is concerned, the major tax problem is the danger of receiving establishment status due to supporting or expediting operations in China. The Treaty should enable a careful planner to avoid the danger, since the accord gives an explicit definition of "establishment."⁹⁷ However, even a company engaged solely in sales may wish to have a representative office, and a representative office with too much authority or too substantial business activity may render the company subject to the progressive tax.⁹⁸ The more a foreign corporation views China as a resource rather than simply as a market, the more it will have to proceed beyond these "establishment" issues to decide between a joint equity venture or some other form.

One alternative, unique in a tax sense, is to do business in China

96. The uncertainty, or flexibility, may work to the detriment or benefit of the taxpayer. For example, on one occasion Chinese tax authorities treated a U.S. law partner's income as "wages or salaries" subject to the progressive tax, contrary to the interpretation previously given the law. On the other hand, the Ministry of Finance may allow exemptions beyond the standard 800 yuan, under the personal tax law. Hannes, *PRC: Recent Income Tax Developments*, E. ASIAN EXEC. REP., Feb. 1984, at 9, 11.

97. Article 5 of the Treaty provides in general that an establishment is "a fixed place of business through which the business of an enterprise is wholly or partly carried on." Treaty, *supra* note 15, art. 5.1. However, maintenance of facilities or goods in China "solely for the purpose of storage, display or delivery" does not constitute an establishment. *Id.* art. 5.4(a),(b). An enterprise should be aware, nevertheless, that even without a "fixed place of business" in China, it may be deemed to have an establishment if contracts are "habitually" concluded there. *Id.* art. 5.5.

98. However, it should be recalled that the first 250,000 yuan of income is only subject to a 20% tax, so low income operations have less of a problem. *Supra* text accompanying note 67.

by compensation trading. The foreign business brings goods, machinery or equipment to China and accepts payment in kind. Perhaps because of their acute foreign exchange problems, the Chinese are willing to tax this trade at only the 20% non-establishment rate.⁹⁹ Moreover, as long as the transaction is completely "in kind," it may be exempt even from that tax under "the 1983 regulations providing tax exemptions for" advanced technology offered on "preferential terms."¹⁰⁰ Compensation trading, if appropriate for the taxpayer's business plans, therefore may provide a way to avoid establishment problems altogether.

The joint equity venture, as already shown, provides such advantages as a flat tax rate, a tax refund on re-invested profits, and tax exemptions and reductions on profits in the early years.¹⁰¹ Other incentives have been introduced to complement these statutory benefits, showing again that reliance on the statutes alone is inadequate. For example, the exemption from tax in the first profit-making year has been extended to two years, and the 50% reduction now applies to the third through fifth years.¹⁰² A joint equity venture may also enjoy certain exemptions from the consolidated turnover tax—such exemptions apply principally to goods imported for the venture's own use.¹⁰³ On an even more ad hoc basis, the Ministry of Finance is apparently willing to grant exemptions from the consolidated turnover tax on export sales.¹⁰⁴ Finally, as a general matter, joint equity ventures are subject to a lower rate of consolidated turnover tax than are foreign enterprises.¹⁰⁵

Statutory tax considerations alone do not seem to favor choosing the foreign enterprise form, which includes contract joint ventures,¹⁰⁶ contract projects¹⁰⁷ and other wholly-owned foreign ventures. As establishments, all are subject to the progressive tax rates, and they do not enjoy the broad exemptions or reductions of tax on early profits that joint equity ventures do. However, the gap may be closing. For example, a wholly-owned foreign enterprise may now apply for a

99. Gelatt & Theroux, *Tax Treatment in China*, CHINA BUS. REV., Jan.-Feb. 1984, at 22, 25. No guidelines have been issued as to how to measure taxable gain realized in compensation trade.

100. *Id.* at 25.

101. *Supra* notes 43-45 and accompanying text.

102. Hannes, *supra* note 94, at 11.

103. Gelatt, *supra* note 4, at 500.

104. *Id.* at 501.

105. *Id.* at 500.

106. FEIT Law, *supra* note 4, art. 1.

107. FEIT Reg., *supra* note 69, art. 2.

refund of taxes paid on re-invested profits.¹⁰⁸

Other ad hoc incentives also go beyond the statutes to make the foreign enterprise more attractive from a tax standpoint. For example, a contract joint venture may obtain an exemption from the consolidated turnover tax on some items, as well as from some customs duties.¹⁰⁹ A contract project, if it involves activities such as installation or training related to an equipment sale, may be exempted from income tax through 1990.¹¹⁰ The same may be true for services provided with a technology transfer.¹¹¹

2. Choice of Location

The Chinese have also decided to promote certain locations by means of tax incentives. Three "types" of locations provide, among other things, significant tax exemptions and reductions. The three types are: Special Economic Zones (SEZs); Economy and Technology Development Zones (fourteen Coastal Cities); and Original Urban Districts (OUDs).¹¹²

Any foreign or joint Sino-foreign venture in an SEZ is subject to a reduced flat income tax of 15%.¹¹³ For specified enterprises with at least a ten-year contract life, other benefits include a tax exemption on the first two profit-making years, followed by three years of a 50% tax reduction.¹¹⁴ Enterprises engaged in "service trades"—if they have a \$5 million investment paid in and are chartered to operate for ten years or more—may obtain a tax exemption on the first profit-making year, followed by a two-year 50% reduction.¹¹⁵ An SEZ may, at its discretion, exempt enterprises from the local income tax.¹¹⁶ The withholding tax on dividends remitted abroad by the foreign partner of a joint venture is waived.¹¹⁷ "[O]verseas business people who have not set up offices in China" may enjoy a halved rate of 10% on income or

108. The Law of the People's Republic of China on Enterprises Operated Exclusively with Foreign Capital, art. 17 (Apr. 12, 1986) (trans. Xinhua News Agency News Bulletin no. 13603, Apr. 13, 1986).

109. Gelatt, *supra* note 4, at 494.

110. *Id.* at 496.

111. *Id.* at 497.

112. Provisional Regulations for Special Economic Zones and 14 Open Cities on Reduction and Exemption of Enterprise Income Tax and Consolidated Industrial and Commercial Tax by the State Council of the People's Republic of China (Nov. 15, 1984) [hereinafter Provisions] (trans. GUIDE TO CHINA'S FOREIGN ECONOMIC RELATIONS AND TRADE: CITIES NEWLY OPENED TO FOREIGN INVESTORS (1985)).

113. *Id.* § 1 1.

114. *Id.* § 1 1(1).

115. *Id.* § 1 1(2).

116. *Id.* § 1 2.

117. *Id.* § 1 3.

in some cases less,¹¹⁸ and the consolidated turnover tax may be waived or reduced for many items, such as those imported for "the means of production."¹¹⁹ Finally, individuals working in SEZs may enjoy a reduced rate of 3% to 30% on wages,¹²⁰ and a reduced rate of 15% on income derived from sources such as personal services and royalties.¹²¹

Incentives in the fourteen Coastal Cities follow a similar course. Foreign enterprises or joint ventures are entitled to the reduced 15% rate,¹²² and if scheduled to operate for ten years or more may apply for the two-year tax holiday and a subsequent three-year 50% reduction.¹²³ The local income tax may be waived.¹²⁴ The 10% tax on dividends remitted by joint ventures is waived.¹²⁵ Enterprises without an "establishment" are again only taxed at a rate of 10% or less.¹²⁶ As in SEZs, there are also broad exemptions from the consolidated turnover tax.¹²⁷ However, there is apparently no provision for reduction of the individual income tax in the fourteen Coastal Cities.

ODUs provide additional incentives within "the original city limits of the fourteen coastal port cities and Shantou, Zhuhai and Xiamen."¹²⁸ In such areas, ventures offering high technology, a large investment (\$30 million), or engaged in "energy, communication or harbour construction" may apply for a reduced tax rate of 15%.¹²⁹ Certain other specifically listed enterprises may qualify for a 20% reduction in their respective original rate.¹³⁰ Otherwise, exemptions and reductions similar to those provided in the SEZs and fourteen Coastal Cities are available.

Tax incentives offer the foreign investor some options on how and where to operate. While the choice depends in the final instance on a number of business factors, tax considerations are important in the following way: since the minimum tax liabilities follow from either compensation trading, or participation in a joint equity venture

118. *Id.* § I 4.

119. *Id.* § I 5.

120. Gelatt & Theroux, *supra* note 99, at 27.

121. This provision applies if, after the deduction allowance of 800 yuan, the aggregate amount of income per month is less than 4,000 yuan. If the adjusted aggregate is above 4,000 yuan, the rate becomes 20%. TIAP, *supra* note 2, at 124.

122. *Id.* at 125.

123. Provisions, *supra* note 112, § II 2; TIAP, *supra* note 2, at 125.

124. Provisions, *supra* note 112, § II 2.

125. *Id.* § II 3.

126. *Id.* § II 4.

127. *Id.* §§ II 5-7.

128. *Id.* § III 1; TIAP, *supra* note 2, at 127.

129. Provisions, *supra* note 112, § III 1.

130. *Id.* § III 1.

in one of the special economic regions, the U.S. investor will want to determine whether the business he wishes to do in China can be cast in such a form. It is true that reduced PRC income taxes, while creditable against U.S. taxes, will probably be equalled or exceeded by the taxpayer's U.S. tax liability. However, low Chinese tax rates may help improve the enterprise's cash flow within China, lessening the need for infusions of foreign exchange by the U.S. investor. The U.S. business may also gain marginal benefit from the time value of money by paying low taxes in China, if the higher U.S. taxes can be paid later.

B. U.S. Tax Law and the China-U.S. Tax Treaty

As a general rule, U.S. taxpayers are taxable under the Internal Revenue Code (I.R.C.) on their worldwide income. However, to relieve taxpayers from the burden of double taxation, the I.R.C. permits taxpayers to at least partially credit foreign taxes against domestic taxes, or deduct those foreign taxes from taxable income.¹³¹

The taxpayer may elect to take either the credit or the deduction in a taxable year.¹³² Since a credit reduces tax liability dollar-for-dollar, it is usually preferable. However, the taxpayer may opt for the deduction if, for example, the foreign tax burden is high relative to the U.S. tax rate, because the allowable credit per year is limited by the applicable U.S. taxes.¹³³ This situation may arise when income is derived from long-term capital gains (recognized in the U.S. but not in China).¹³⁴

U.S. corporate investors will be concerned with the applicability of the tax credit to China's enterprise income taxes. The key issue in this regard is what kind of taxes are creditable. The limitations on the credit available per year are also important.

131. I.R.C. §§ 901-05 (1986).

132. I.R.C. § 275(a)(4)(A) (1986).

133. P. POSTLEWATE, *INTERNATIONAL CORPORATE TAXATION* 83 (1980); I.R.C. § 904 (1986).

134. POSTLEWATE, *supra* note 133, at 83. However, when the 1986 Tax Reform Act takes effect, capital gains preference will be eliminated. On the other hand, overall corporate rates will drop dramatically. In some cases, then, the deduction will be more attractive, depending on the taxpayer's worldwide tax profile.

Qualified U.S. individuals may further elect to exclude up to U.S.\$80,000 of foreign-earned income plus limited housing expenses per year instead of taking a credit or deduction. I.R.C. § 911. The \$80,000 figure applies for 1986. The Tax Reform Act of 1986 lowers the ceiling to \$70,000. I.R.C. § 1233(a) as reported by the Conference Committee on Sept. 18, 1986. CCH Standard Federal Tax Reports no. 41, Sept. 21, 1986, p. I-506. However, this election is open only to those working abroad for at least a year. I.R.C. § 911(d)(1) (1986). Those not qualified may seek a deduction or credit for the foreign taxes; the overall effect seems to simplify the filing of returns for U.S. citizens working abroad on a long-term basis.

A foreign tax must be levied on "income" in order to be creditable.¹³⁵ The characterization of a foreign tax as an "income tax" is often controversial, but a taxpayer must prove certain criteria have been met. The tax must attach to realized gain, net gain, and the "receipt of income" as these concepts are understood in U.S. tax law.¹³⁶ Also, a tax "paid in lieu of a tax on income,"¹³⁷ may qualify if, for example, it effectively reaches only net gain in cases where there are "administrative difficulties in computing and applying the income tax."¹³⁸

The Tax Treaty settles the issue with respect to the various income taxes. It provides in general that the individual income tax, the joint venture income tax, the foreign enterprise income tax, the local income tax, and any "identical or substantially similar taxes" shall be considered income taxes for purposes of the U.S. foreign tax credit.¹³⁹

It is not clear whether a direct or indirect credit will be available. For example, since the joint equity venture, under Chinese law, is a "limited liability company"¹⁴⁰ incorporated in China,¹⁴¹ it would seem to qualify for treatment as a foreign subsidiary for U.S. tax purposes. However, whether the enterprise will be considered a branch or partnership, thus providing the U.S. taxpayer with a direct credit under I.R.C. section 901, or a foreign corporation, providing the U.S. taxpayer with an indirect credit under section 902, will ultimately depend on definitions in the I.R.C.

The main tax distinction is that, in the direct credit situation, the U.S. taxpayer realizes the income and tax liability of the foreign operation concurrently, while in the indirect credit case, the U.S. taxpayer may incur the liability and obtain a credit when dividends are remitted.¹⁴² The two considerations which stand out, then, are that U.S. tax law determines both whether the Chinese taxes qualify for creditability, and how and when the U.S. taxpayer may use the credits.

The Tax Treaty imposes no radical changes; it clarifies definitional issues, such as: what constitutes an "establishment,"¹⁴³ when an individual is subject to tax,¹⁴⁴ and what types of business deductions

135. I.R.C. § 901(b)(1) (1986).

136. POSTLEWAITE, *supra* note 133, at 86.

137. I.R.C. § 903 (1986).

138. POSTLEWAITE, *supra* note 133, at 86 n.30.

139. Treaty, *supra* note 15, art. 2(1),(2); art. 22(2).

140. Joint Venture Law, *supra* note 41, art. 4.

141. *Id.* art. 1.

142. I.R.C. § 902(a) (1986).

143. Treaty, *supra* note 15, art. 5; FEIT Reg., *supra* note 69, art. 2.

144. Treaty, *supra* note 15, art. 4.

are allowed.¹⁴⁵ The Treaty also limits the withholding tax on remitted dividends, interest and royalties to 10%.¹⁴⁶ Furthermore, in regulating double taxation, the Treaty clarifies which kind of operation will fall in the section 902 indirect credit class: "the case of a United States company owning at least 10% of the voting rights in a company which is a resident of China and from which the United States company receives dividends."¹⁴⁷ This certainly describes joint equity ventures, and may also apply to other enterprises organized as subsidiaries in China.¹⁴⁸

The final aspect of the Treaty which is of present interest is that despite Chinese efforts it excludes any tax-sparing provisions. However, China reserves the right to have them included should the U.S. grant that right to any other country.¹⁴⁹ A tax-sparing credit would allow the Chinese to reduce taxes on foreign (or joint venture) enterprises as an incentive, without a corresponding reduction of the credit available against U.S. taxes. So far, the U.S. has adamantly opposed tax-sparing credits.¹⁵⁰ Presumably the United States Treasury has no interest in helping taxpayers shelter income abroad.

The U.S. policy against tax-sparing credits calls into question the effectiveness of Chinese tax incentives, and therefore the value of the incentive policy for the foreign investor. These and other policy questions are the subject of section IV.

IV. CONCLUSION: OBSERVATIONS ON TAX POLICY IN CHINA

Developing countries seek to use taxation to achieve three objectives: limiting and controlling foreign ownership; raising revenue; and importing foreign capital.¹⁵¹ As the foregoing discussion indicates, China's tax system fully reflects these policies.

In conjunction with China's economic laws, the tax system acts as a control on the foreign presence in China. By providing different incentives for different kinds of ventures, the tax system channels foreign capital. Foreign investment is also controlled by the strong pressures and incentives to do business in specified areas such as the SEZs.

145. *Id.* art. 7.

146. *Id.* arts. 9(2), 10(2), 11(2).

147. *Id.* art. 22(2)(b).

148. The Law of the People's Republic of China on Enterprises Operated Exclusively with Foreign Capital, *supra* note 108, art. 2.

149. Letters of Agreement to Treaty, *supra* note 15, 1 CCH Tax Treaties ¶ 1445 (exchanged in Beijing on Apr. 30, 1984 by President Reagan and Premier Zhao Ziyang.)

150. Schreyer, *A Guide to the China-U.S. Tax Treaty*, E. ASIAN EXEC. REP., Aug. 1984, at 13.

151. Kingson, *The Coherence of International Taxation*, 81 COLUM. L. REV. 1151, 1163 (1981).

To raise revenue, the Chinese have imposed the broad-based taxes outlined above. Individuals, state-owned enterprises, collectives and the other types of Chinese and foreign business entities are all subject to taxation. It is true that as recently as 1980 it was still possible to ask, "Why should the state tax the profits of an enterprise when the profits accrue to the state anyway?"¹⁵² However, the Chinese studied established models when developing their own plans to raise revenue from foreign investment. For example, to formulate their joint venture tax laws, the Chinese looked to Yugoslavia and Romania as models.¹⁵³

Finally, the Chinese have demonstrated at least the intent to use tax to encourage the influx of foreign capital. This intent manifests itself in the form of tax holidays for certain enterprises and in the attempt to include a tax-sparing provision in the Tax Treaty with the U.S.¹⁵⁴ However, the use of tax incentives to attract foreign capital may be questionable policy. As we have seen, the absence of tax-sparing credits means that profits realized through Chinese incentives are nullified by U.S. taxes.¹⁵⁵ Indeed, it has been argued that "[t]here is no rational basis for using tax incentives as instruments for inducing the flow of [direct foreign investments]."¹⁵⁶ Professor Robert Hellawell has suggested that tax incentives are inherently ineffective, and that tax incentives may have little influence on business planners' decisions on where to invest.¹⁵⁷ However, even though tax incentives may not attract foreign capital, they can nonetheless fulfill the function of controlling the form and location of ventures within China.

Judging from the evidence of the recent past, it seems reasonable to conclude that the tax system will not change radically in design, although details may change to serve commercial growth and the development of capital markets in China. Barring radical shifts in Chinese politics, it is likely that the U.S. investor can depend on the

152. Reynolds, *Doing Business with the PRC: Tax Considerations*, 14 INT'L LAW. 49 (1980).

153. *Id.* at 62.

154. See Letters of Agreement, *supra* note 149.

155. However, given the reduced rates in the U.S. under the 1986 Tax Reform Act, the statutory Chinese tax may now be more likely to exceed the U.S. tax in some cases, making Chinese tax reductions more valuable.

156. Yelapaala, *The Efficacy of Tax Incentives Within the Framework of the Neoclassical Theory of Foreign Direct Investment: A Legislative Policy Analysis*, 19 TEX. INT'L L. J. 365, 414 (1984). For Yelapaala's discussion of the neutralizing effect of the tax credit, see *id.* at 395-96.

157. Hellawell, *U.S. Income Taxation and Less Developed Countries: A Critical Appraisal*, 66 COLUM. L. REV. 1393, 1412 (1966).

tax system to continue to take a familiar form in responding to the needs of Chinese and foreign business.

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SUMMARY OF PRC INCOME TAXES*

Status	Tax ^a	Rates	Selected Available Incentives	Special Economic Zone Incentives
Individual	Individual Income Tax	-wages & salaries 5% to 45% marginal rates ¹ -service, periodic income 20% rate ²	-Income subject to tax varies with residence status ³	-wages & salaries 3% to 30% marginal rate -service, periodic income 15% rate
Joint Equity Venture ^b	Joint Venture Income Tax	-combined local & national tax of 33% -10% withholding on remittances	40% refund of taxes paid on profits reinvested for 5 years income tax exemptions in first two profit making years; 50% reduction in third fifth years	-15% flat tax rate -withholding tax may be waived -local tax may be waived consolidated turnover tax may be reduced or waived
Foreign Enterprise: -compensation trading -contract joint ventures ^c -contract projects ^d -wholly owned foreign enterprises ^e	Foreign Enterprise Income Tax	enterprises with an "establishment" -national tax of 20% to 40% ⁴ local tax of 10% enterprises without an "establishment" -no tax on business profits ⁵	-high-technology transfers may be granted a tax exemption -wholly-owned foreign enterprises may apply for a refund of taxes paid on reinvested profits	-15% flat tax rate -local tax may be waived consolidated turnover tax may be reduced or waived

* This chart does not summarize the effects of the various non-income taxes such as the consolidated turnover tax

a U S foreign tax credit is available for all three income taxes See Tax Treaty, *supra* note 15, arts 2(1), 22(2)

b A joint equity venture is a Chinese legal entity Both parties contribute capital and share proportionally in profits and liabilities

c A contract joint venture is formed pursuant to contract; no legal entity is formed

d A contract project is typically an agreement for construction or other projects of a particular nature and limited term

e Rules governing wholly foreign enterprises may be found in the Law of the People's Republic of China on Enterprises Operated Exclusively with Foreign Capital *supra* note 108

1 The first 800 yuan per month is exempt The top rate applies to 12,000 yuan or more per month Other rates apply to PRC citizens *Supra* note 19

2 Residents are allowed the greater of 800 yuan or 20% as a deduction

3 The general rule is that a non-resident shall not be subject to tax in China if not present in China more than 183 days, or if his income is not attributable to a fixed base in China Tax Treaty, *supra* note 15, arts. 13 and 14

4 The bottom rate applies to annual income up to 250,000 yuan The top rate applies to annual income over 1,000,000 yuan

5 Dividends, interest and royalties may be subject to a maximum gross withholding tax of 10% Tax Treaty, *supra* note 15, arts 9, 10 and 11

